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Research Paper No. 61: Half-yearly Review of the Global and Local Securities Markets

28 July 2017

Executive summary

1. During the first half of 2017, the Dow and S&P in the US rose 8% and 8.2% respectively. The Nasdaq outperformed and gained 14.1%. Major benchmark indices hit record highs, largely led by tech stocks. In early 2017, the US market advanced on hopes for stimulus policies by the new Administration as well as positive retail sales and employment data. Later, the market became volatile amid uncertainties about the feasibility of implementing expansionary fiscal and pro-business policies. The US Federal Reserve (the Fed) raised interest rates in March and June by a total of 50 basis points and outlined its plan to reduce its bond holdings later in 2017. These actions seemed to have a limited impact on the market, as the moves were well-communicated.

2. In Europe, the FTSE rose 2.4% and the DAX gained 7.4%. Both hit record highs. The CAC advanced 5.3%. In early 2017, the markets advanced on hopes that the European Central Bank (ECB) would continue its quantitative easing programme. In addition, the results of the French presidential election in May were in line with market expectations. However, in June, the markets fell amid heightened concerns over the Brexit[1] negotiations after the Conservative Party lost its parliamentary majority in the United Kingdom (UK) general election.

3. The Nikkei 225 Index advanced 4.8% during the first half of 2017, tracking the gains in overseas markets. The index rose above the 20,000 level for the first time since December 2015. Market participants estimated that corporate earnings growth would be at least 10% during the year. However, gains were partly offset by worries over geopolitical tensions in North Korea.

4. On the Mainland, the Shanghai Composite Index (SHCOMP) rose 2.9% while the Shenzhen Composite Index (SZCOMP) dropped 3.6% during the period. Small-cap stocks underperformed on concerns about high valuations. Large caps rose on the back of improving economic data such as higher gross domestic product (GDP) growth and industrial profits. However, gains were trimmed amid concerns over tightening liquidity and Mainland regulators' tougher stance against speculative activities. While Moody's downgraded the Mainland's credit rating to A1 from Aa3 in May, the announcement of A-share inclusion into the MSCI Emerging Markets Index in June provided support.

5. In Hong Kong, the Hang Seng Index (HSI) and the Hang Seng China Enterprises Index (HSCEI) rose 17.1% and 10.3% respectively. Hong Kong outperformed after a year of relatively mild increase compared to the gains in other major markets in 2016. The HSI rose for six months in a row, touching the highest level in almost two years at one point. The market was lifted by expectations of funds inflows through Southbound trading of Stock Connect. Rate hikes in the US were largely expected and had a limited impact because the Fed had reassured markets of a gradual tightening.

6. Some major risks and uncertainties facing global and Hong Kong stock markets include:
   - uncertainties about the future path of interest rate hikes in the US and details of the Fed's balance sheet reduction plan, as well as concerns over the new US President's ability to push forward the proposed stimulus policies;
   - concerns over a revival of renminbi depreciation pressures, an economic slowdown on the Mainland and possible measures to cool down asset markets;
   - uncertainties in Europe over the Brexit negotiations and regional economic outlook; and
   - risk of a possible market correction in Hong Kong amid higher valuations and a catch-up in interest rates with the US.

7. Trading in both the cash market and exchange-traded derivatives rose. The average daily trading in the cash market rose 15% compared with the second half of 2016; trading in futures products dropped 6%, while options products trading rose 13%.

[1] A referendum in the UK on 23 June 2016 resulted in a vote to leave the European Union.

Performance of stock markets during the first half of 2017

8. During the first half of 2017, major overseas markets rose to multi-year or historical highs. The new US President's supportive measures, accommodative monetary policies of major central banks and abundant liquidity boosted hopes for reflation. The Hong Kong market outperformed major overseas markets after recording a relatively mild increase compared to other major markets in 2016. Optimism about funds inflows through Southbound trading of Stock Connect provided support.

The US

9. Extending the gains posted in 2016, all major US benchmark indices hit record highs during the first half of 2017, largely led by tech stocks. The Dow and S&P rose 8% and 8.2% respectively. The Nasdaq outperformed and gained 14.1%. As at end-June 2017, the S&P500 index was 55% higher than the peak in 2007, while the Nasdaq was 115% higher than the pre-crisis level.

10. In early 2017, the US market advanced on hopes that the new President would increase infrastructure spending and implement financial deregulation which would support economic growth. Positive retail sales and employment data paced gains.

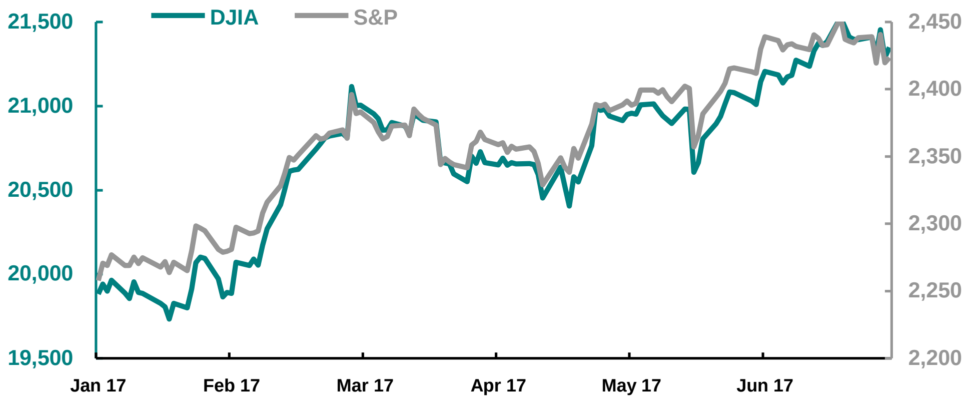
11. Later, the market became volatile amid uncertainties about the feasibility of implementing expansionary fiscal and pro-business policies. In March, the Fed raised interest rates by 25 basis points as expected and gave re-assurance of a gradual pace of future rate hikes. However, markets were cautious about possible monetary tightening as the Fed also indicated plans to reduce its balance sheet. Geopolitical tensions in Syria, North Korea and Russia also weighed on market sentiment.

12. In May, losses were recouped, lifted by tech stocks on upbeat corporate earnings. The VIX, an indicator of expected volatility, hit a 23-year low of 9.8 in June. The market once tumbled on worries over political uncertainties and doubts about the implementation of new government policies. The market rebounded quickly as investors found relief in the new US President's first budget plan.

13. The market extended gains on optimism about the economic outlook given upbeat comments from Fed officials. In June, the Fed raised interest rates by 25 basis points and outlined its plan to reduce its bond holdings later in 2017. The moves were well-communicated and seemed to have a limited impact on the market.

14. As the market accumulated significant gains, investors became doubtful about the sustainability of the rally. The Fed warned in June that the valuation of the stock market was high and risks were building up. After adjusting for inflation and benchmarking against long-term earnings, the cyclically adjusted price-to-earnings ratio of the S&P500 was about 30 times. This was at the 97 percentile of its historical range, ie, the current valuation was higher than 97% of the time in its history.

Performance of Dow and S&P during the first half of 2017



Source: Bloomberg

Performance of major stock markets

		End of June 2017	% change			PE Ratios
		Index Level	Year-to-date	2016	2015	End-June 2017
Hong Kong and the Mainland						
Hong Kong	-HSI	25,764.6	+17.1%	+0.4%	-7.2%	13.88
	-HSCEI	10,365.2	+10.3%	-2.8%	-19.4%	8.55
Mainland	-Shanghai Comp	3,192.4	+2.9%	-12.3%	+9.4%	17.06
	-Shenzhen Comp	1,897.7	-3.6%	-14.7%	+63.2%	35.40
Asia						
Japan	-Nikkei 225	20,033.4	+4.8%	+0.4%	+9.1%	19.15
Australia	-AOI	5,764.0	+0.8%	+7.0%	-0.8%	20.29
Taiwan	-TWSE	10,395.1	+12.3%	+11.0%	-10.4%	16.19
Korea	-KOSPI	2,391.8	+18.0%	+3.3%	+2.4%	17.24
Singapore	-STI	3,226.5	+12.0%	-0.1%	-14.3%	13.13
Thailand	-SET	1,574.7	+2.1%	+19.8%	-14.0%	15.96
Malaysia	-KLCI	1,763.7	+7.4%	-3.0%	-3.9%	16.58
Indonesia	-JCI	5,829.7	+10.1%	+15.3%	-12.1%	24.89
India	-Nifty	9,520.9	+16.3%	+3.0%	-4.1%	22.38
Philippines	-PCOMP	7,843.2	+14.7%	-1.6%	-3.9%	21.55
Vietnam	-VN	776.5	+16.8%	+14.8%	+6.1%	16.55
US						
US	-Dow	21,349.6	+8.0%	+13.4%	-2.2%	18.77
	-Nasdaq	6,140.4	+14.1%	+7.5%	+5.7%	32.72
	-S&P	2,423.4	+8.2%	+9.5%	-0.7%	21.45
Europe						
UK	-FTSE	7,312.7	+2.4%	+14.4%	-4.9%	31.76
Germany	-DAX	12,325.1	+7.4%	+6.9%	+9.6%	19.80
France	-CAC	5,120.7	+5.3%	+4.9%	+8.5%	18.95
PIIGS and Hungary						
Portugal	-PSI20	5,153.0	+10.1%	-11.9%	+10.7%	37.94
Italy	-FTSEMIB	20,584.2	+7.0%	-10.2%	+12.7%	n.a.
Ireland	-ISEQ	6,827.6	+4.8%	-4.0%	+30.0%	22.18
Greece	-ASE	823.7	+28.0%	+1.9%	-23.6%	n.a.
Spain	-IBEX	10,444.5	+11.7%	-2.0%	-7.2%	16.42
Hungary	-BUX	35,205.4	+10.0%	+33.8%	+43.8%	10.17
Middle East and North Africa						
Egypt	-EGX30	13,395.8	+8.5%	+76.2%	-21.5%	16.37
Dubai	-DFMGI	3,392.0	-3.9%	+12.1%	-16.5%	15.65
Other BRIC markets						
Brazil	-IBOV	62,900.0	+4.4%	+38.9%	-13.3%	16.94
Russia	-MICEX	1,879.5	-15.8%	+26.8%	+26.1%	6.51

Source: Bloomberg

Europe

15. After recording gains in 2016, major European markets continued to rise. The FTSE rose 2.4% and the DAX gained 7.4%. Both hit record highs. The CAC advanced 5.3%.

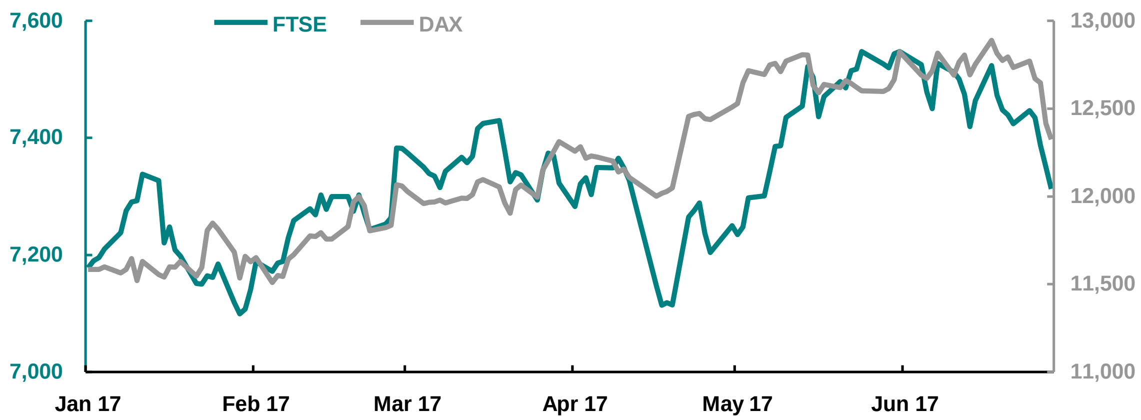
16. In early 2017, the markets rose on hopes that the ECB would continue its quantitative easing programme. Yet gains were limited by concerns over the financial health of Italian banks.

17. In March, the markets rose as the Liberal Party's victory in the Dutch general election lifted sentiment. Improvements in business confidence supported the markets. However, there were growing worries about the Brexit negotiations, which officially started on 29 March 2017.

18. In April, investor sentiment was affected by concerns over tensions in Syria and North Korea. The result of the French presidential election in May was in line with market expectations. However, the lack of progress in reaching an agreement on the Greek debt deal weighed on the market.

19. In June, European markets fell amid heightened concerns over the Brexit negotiations after the Conservative Party lost its parliamentary majority in the UK general election. Expectations that the ECB might reduce the size of stimulus programme also paced losses. The FTSE was further dragged down by a strengthening pound after Bank of England officials expressed support for rate hikes at its monetary policy meeting.

Performance of FTSE and DAX during the first half of 2017



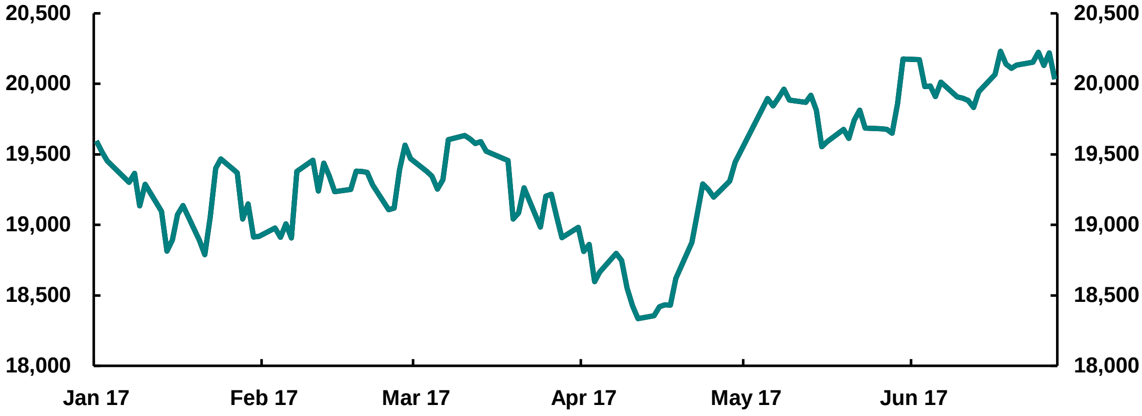
Source: Bloomberg

Asia

20. The Nikkei 225 Index advanced 4.8% during the first half of 2017, tracking the gains in overseas markets. The index rose above the 20,000 level for the first time since December 2015. Market participants estimated that corporate earnings growth would be at least 10% during the year. However, gains were partly offset by worries over geopolitical tensions in North Korea.

21. Other major regional markets also rose during the period, with gains ranging from 0.8% in Australia to 18% in Korea.

Performance of Nikkei 225 during the first half of 2017



Source: Bloomberg

The Mainland

22. After declines in 2016, the SHCOMP rose 2.9% while the SZCOMP dropped 3.6% during the first half of 2017. The average daily turnover in the Mainland market decreased 15.9% to RMB436.6 billion, compared with an average of RMB519.1 billion in 2016.

23. Small-cap stocks underperformed on concerns about high valuations. During the first half of 2017, the Shanghai Small-cap Index and Shenzhen ChiNext Index fell 1.9% and 7.3% respectively. In contrast, indices tracking large-cap stocks such as the CSI 300 Index and A50 Index rose 10.8% and 14.9% respectively during the period. PE ratios of indices tracking small-cap stocks such as the ChiNext Index dropped from 66 times as of end-2015 to 38 times as of end-June 2017. On the other hand, PE ratios of indices tracking large-cap stocks such as the CSI300 Index and A50 Index remained stable at about 14 times and 11 times respectively.

24. The diverging performance of large-cap and small-cap stocks on the Mainland was partly due to optimism about capital inflows into large-cap stocks amid news about the MSCI A-share inclusion. It was also reported that the Government increased its stakes in index heavyweight stocks to support the stock market in March during the National People's Congress and in May during the Belt and Road Forum and after Moody's downgraded the Mainland's credit rating to A1 from Aa3. Investors were concerned about higher valuations of small-cap stocks and preferred to invest in large-cap stocks with lower valuations. In addition, the expectation of faster initial public offering (IPO) approvals in 2017 fueled worries about an increase in the supply of small-cap stocks. Given deleveraging activities, there were worries that the increase in funding costs of small-cap stocks would be more than that of large-cap stocks.

25. In early 2017, large caps paced gains on the back of solid economic data. GDP growth in Q1 2017 was 6.9%, the highest growth since Q3 2015, driven by strong investment and property sales. Optimism about mixed-ownership reforms, infrastructure spending and a rebounding renminbi also lent support. However, the upside was limited on concerns about an increase in share supply due to an acceleration in IPO approvals and share sales by major shareholders. There were also heightening concerns about regulatory measures to curb credit growth. Worries over capital outflows grew as foreign exchange reserves as of end-January 2017 fell below US$3 trillion for the first time in almost six years.

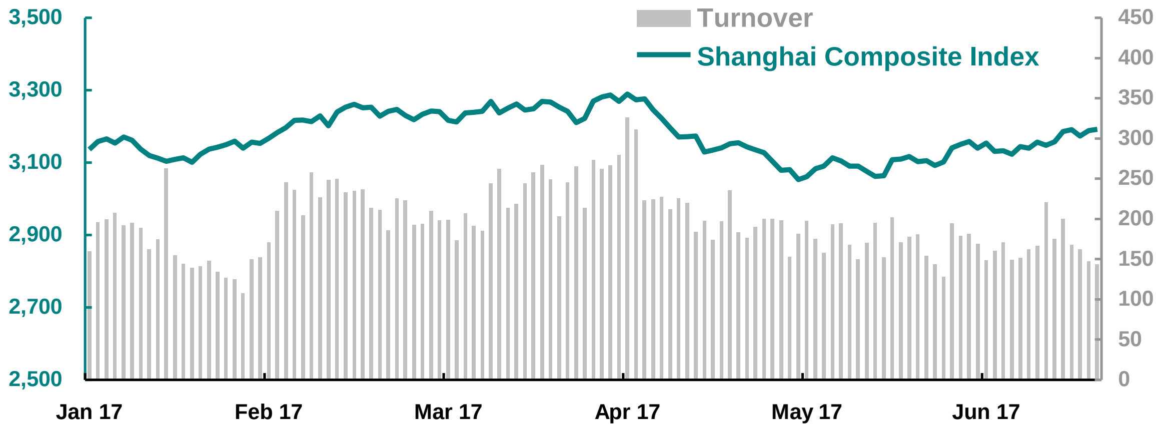
26. In March, the market declined amid concerns over tightening liquidity and Mainland regulators' tougher stance against speculative activities. Property market curbs and uncertainties about the economic outlook weighed on the market. Some losses were trimmed by optimism about

the establishment of the Xiong'an New Area and the implementation of the Belt and Road initiative.

27. In May, the market further dropped as the China Banking Regulatory Commission tightened rules on wealth management products and Mainland banks raised interest rates on housing loans. Sentiment was also dampened by weaker economic data including the China Manufacturing Purchasing Managers' Index and retail sales.

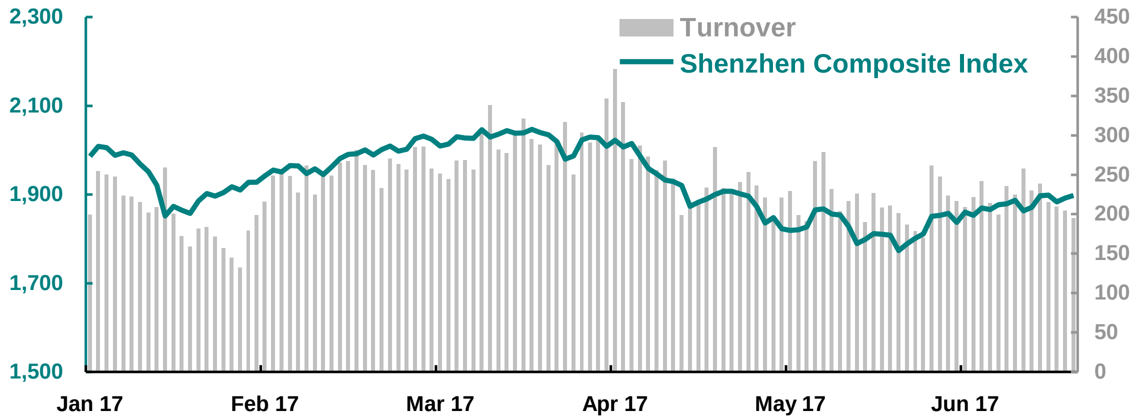
28. In June, the MSCI announced its decision to include A-shares in the MSCI Emerging Markets Index. The market rebounded on optimism about fund inflows and expectations for the deceleration of IPO approvals. Encouraging economic data also paced gains. While consumer price inflation remained moderate, producer prices recorded strong increases, reversing the earlier trend of continuous declines in the past years. Growth in industrial profits also accelerated.

SHCOMP and Shanghai market turnover (RMB billion) during the first half of 2017



Source: Bloomberg

SZCOMP and Shenzhen market turnover (RMB billion) during the first half of 2017



Source: Bloomberg

Hong Kong

29. After recording a mild gain in 2016, the Hong Kong market advanced and outperformed most major markets during the first half of 2017. The HSI and the HSCEI rose 17.1% and 10.3% respectively. The HSI rose steadily for six months in a row and touched the highest level in almost two years at one point. Nevertheless, it should be noted that the gain was not broad-based. Of the 3,764 points increase in the HSI during the period, Tencent, HSBC and AIA together contributed 2,131 points or 57%.

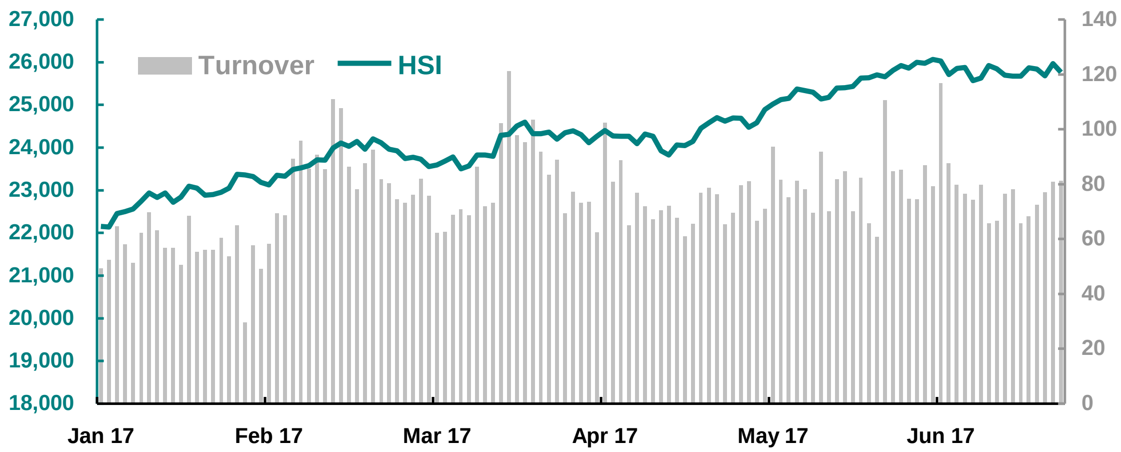
30. In early 2017, the local market advanced. Solid GDP growth on the Mainland as well as the upbeat performance of financial and tech stocks paced gains. Investor sentiment was boosted by hopes of pro-growth initiatives and possible tax cuts by the new US President. Rate hikes in the US did not surprise the markets, which also expected future increases to be gradual. Expectations over funds inflows through Southbound trading under Stock Connect also lifted the market.

31. Despite downgrades of the credit ratings of the Mainland and Hong Kong by Moody's in May, the local market extended gains. Sentiment was boosted by the MSCI's decision to include A-shares in the MSCI Emerging Markets Index in June.

32. Nevertheless, H-shares underperformed as declining commodity prices dragged down related stocks. In addition, worries lingered over the Mainland's deleveraging measures and regulatory tightening.

33. Trading in the local stock market increased. During the first half of 2017, the average daily turnover amounted to $76 billion[2], 15% higher than the $66.3 billion in the second half of 2016.

HSI and Hong Kong market turnover ($ billion) during the first half of 2017



Source: Bloomberg

[2] Unless otherwise stated, the currency ($) in this paper denotes the Hong Kong dollar.

Risks and uncertainties facing global and Hong Kong stock markets

34. The performance of global and Hong Kong stock markets will continue to be affected by a combination of risks and uncertainties.

- In the US, as the market rally has been attributable to abundant liquidity amid monetary easing, investors will be highly sensitive to signals about a possible pullback of stimulus policies. While the market may have priced in the possibility of further monetary tightening, the future path of interest rate hikes and the details of the balance sheet reduction plan remain uncertain. Moreover, as the market has accumulated substantial gains and PE ratios have reached multi-year highs, there is a risk of downward adjustment, and even more so in the event of a sudden reversal of sentiment. Political uncertainties and concerns about the new US President's ability to push forward the proposed stimulus policies such as tax cuts also weigh on the market outlook.
- On the Mainland, investors are sensitive to signs of capital outflows, a revival of renminbi depreciation pressures and changes in foreign exchange reserves which may affect liquidity conditions. Concerns over an economic slowdown continue to linger amid ongoing efforts to restructure and rebalance the economy. Measures to curb credit growth and cool down the asset and property markets will also weigh on sentiment. In addition, there are uncertainties about further measures that can arise from the government's watchful scrutiny over the financial markets. Given the close linkage with the Mainland market, the Hong Kong market may be affected.
- In Europe, the Brexit negotiations and the economic outlook are highly uncertain. These have heightened concerns that the business environment and corporate earnings may be negatively affected, and that the new relationship between the UK and the European Union may affect the market outlook. Investors are also cautious towards upcoming elections and the stability of the banking sector in the region. Sentiment has become fragile as markets are hovering around record highs. It can be further affected by movements in exchange rates and changes in monetary policy.
- In Hong Kong, risk of a possible market correction has grown amid higher valuations and a catch-up in interest rates with the US.
  - Following the recent market rally, the PE ratio of the HSI reached 13.9 times, higher than the two-year average of 11 times.
  - Under the linked exchange rate system, the interest rate in Hong Kong should not deviate from that in the US in the long term. As interest rates in the US continue to rise, the interest rate in Hong Kong will eventually increase or even catch up with the US, and the cumulative impact on the securities market may be significant. In addition, capital inflows may recede or even reverse.

Major statistics of the Hong Kong securities market during the first half of 2017

Stock Connect

35. Shenzhen-Hong Kong Stock Connect commenced on 5 December 2016 following the launch of Shanghai-Hong Kong Stock Connect on 17 November 2014.

36. As at end-June 2017, cumulative net buy since the launch of the respective schemes stood at:
    - RMB157.8 billion to Shanghai and RMB86.5 billion to Shenzhen via northbound trading;
    - RMB422.7 billion from Shanghai and RMB40.9 billion from Shenzhen via southbound trading.

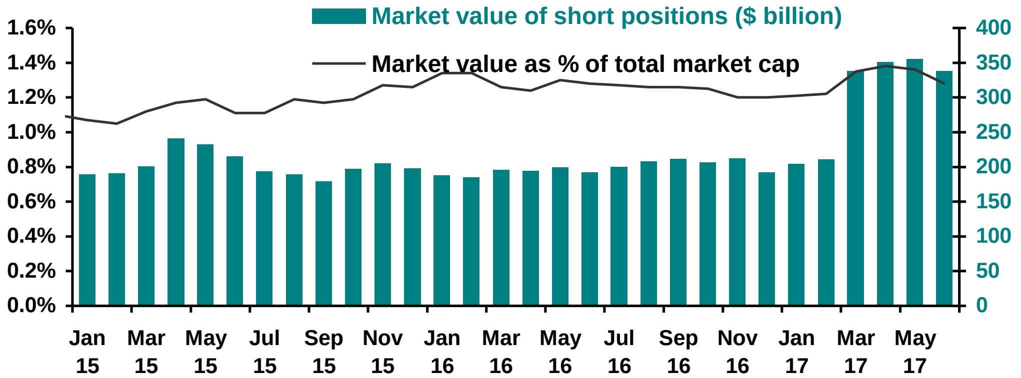
37. During January – June 2017:
    - the average daily northbound trading (Shanghai and Shenzhen, including buy and sell trades) was RMB7.1 billion, or 0.8% of trading in the Mainland market, compared with an average of RMB3.3 billion in 2016. Since 5 December 2016, 39% of northbound trading was towards Shenzhen and 61% was towards Shanghai; and
    - the average daily southbound trading (Shanghai and Shenzhen, including buy and sell trades) was RMB6.8 billion, or 5.1% of trading in the Hong Kong market, compared with the average of RMB3.2 billion in 2016.

Short-selling activity

38. Compared to the second half of 2016, short selling in Hong Kong was higher in absolute terms but lower as a percentage of total market turnover. The average daily short selling was $8.1 billion, or 10.7% of total market turnover in the first half of 2017. In the second half of 2016, the average daily short selling was $7.2 billion, or 11% of total market turnover.

39. Based on data submitted to the SFC, as at 30 June 2017, aggregated short positions amounted to $338.1 billion (or 1.3% of the market cap of the reported stocks). The new short position reporting regime, which came into effect on 17 March 2017, expanded coverage to include all designated securities eligible for short selling. The market value of short positions has therefore increased since then.

Market value of short positions



Source: SFC
Remark: The new short position reporting regime, which became effective on 17 March 2017, expanded coverage to include all designated securities eligible for short selling. The market value of short positions has therefore increased since then.

Initial public offerings

40. There were 68 IPOs raising a total of $53.6 billion in Hong Kong during the first half of 2017; in 2016, there were 117 IPOs ($194.8 billion). IPO funds raised by Mainland companies accounted for 91% of the market total during the first half of 2017.

Exchange-traded funds (ETFs) and leveraged and inverse products

41. The number of ETFs fell to 125 as at end-June 2017 from 127 as at end-2016. Their average daily turnover was $4.6 billion in the first half of 2017, which was 21% higher than the $3.8 billion in the second half of 2016. ETFs accounted for 6% of total market turnover in the first half of 2017 (similar to that in the second half of 2016). The average daily turnover of A-share ETFs was $1.1 billion, contributing 24% of total ETF turnover (compared with $1.2 billion and 32% in the second half of 2016).

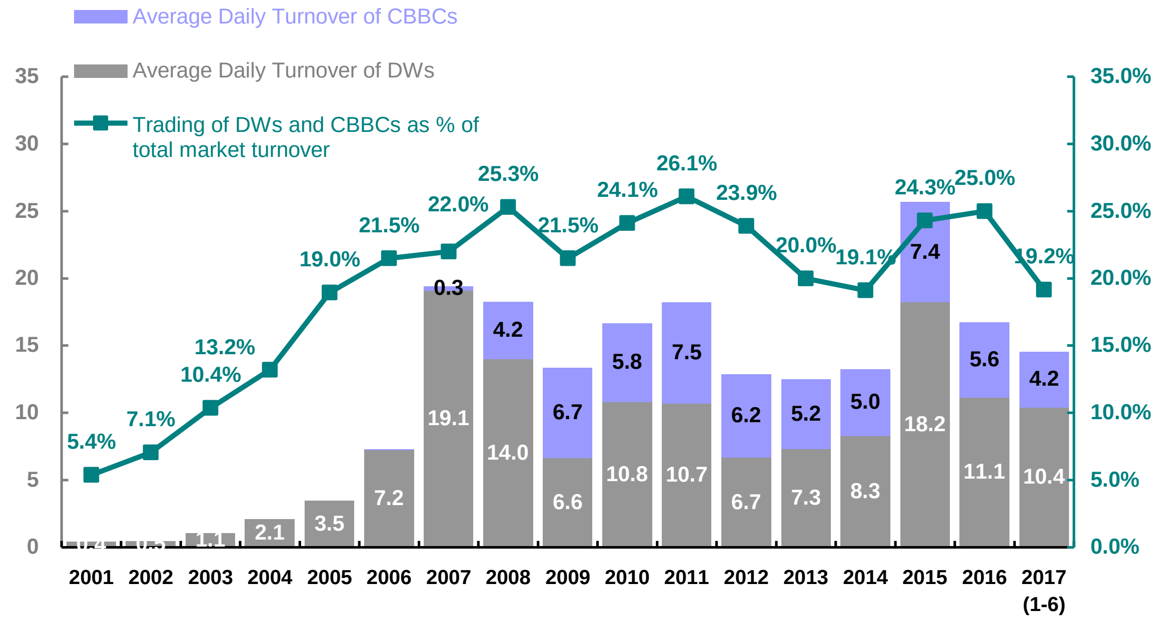
42. Seventeen leveraged and inverse products tracking the HSI and the HSCEI were launched in March 2017. Their average daily turnover was $667 million during March to June 2017.

Derivatives warrants (DWs) and callable bull/bear contracts (CBBCs)

43. In the first half of 2017, trading in DWs increased in absolute terms and declined slightly as a percentage of total market turnover. The average daily turnover of DWs rose to $10.4 billion (13.7% of total market turnover), compared with $9.1 billion (13.8% of total market turnover) in the second half of 2016.

44. In the first half of 2017, trading in CBBCs decreased both in absolute terms and as a percentage of total market turnover. The average daily turnover of CBBCs decreased to $4.2 billion (5.5% of total market turnover), compared with $5.2 billion (7.9% of total market turnover) in the second half of 2016.

Turnover of DWs and CBBCs ($ billion)



Source: SFC

Exchange-traded derivatives

45. In the first half of 2017, driven by the growth in the options market, the average daily trading in exchange-traded derivatives increased by 5%, compared to the second half of 2016.

46. The average daily trading in futures products fell 6%. Among futures products, HSI futures and HSCEI futures were the most actively traded contracts, representing about 39% and 41% of all futures trading respectively. Compared to the second half of 2016, the average daily trading volume of HSI futures and HSCEI futures fell by 7% and 1% respectively.

47. The average daily trading in options in the first half of 2017 rose 13%. Stock options remained the most actively traded options products and their trading volume rose by 17%, compared to the second half of 2016.

Average daily trading volume of derivatives traded on HKEX by product type (contracts)

		1H 2017	2H 2016	1H 2016
Futures	HSI Futures	114,609	123,521	138,433
	Mini-HSI Futures	40,765	48,478	52,639
	HSCEI Futures	120,288	122,048	145,893
	Mini-HSCEI Futures	13,808	17,241	22,297
	Stock Futures	586	658	1,183
	Renminbi Currency Futures	3,004	2,217	2,194
	Other futures products	2,826	1,883	3,297
	Total Futures	**295,886**	**316,046**	**365,936**
Options	HSI Options	36,938	37,239	38,526
	Mini-HSI Options	6,454	6,270	5,243
	HSCEI Options	83,830	78,921	78,775
	Stock Options	354,969	302,746	292,861
	Other options products	1,438	1,619	86
	Total Options	**483,629**	**426,795**	**415,491**
Total Futures and Options		**779,515**	**742,841**	**781,427**

Remark: Figures may not add up to totals due to rounding.
Sources: HKEX and SFC