SECURITIES AND FUTURES COMMISSION
證券及期貨事務監察委員會

SFC
證監會

Research Paper No. 62: A Review of the Global and Local Securities Markets in 2017 (Featuring Stock Connect Trading and the Expansion of the Short Position Reporting (SPR) Regime)

26 January 2018

Executive Summary

1. The US market advanced for the ninth consecutive year in 2017, marking the longest gain in history. All major indexes hit record highs. In 2017, the Dow, S&P 500 (S&P) and Nasdaq rose 25.1%, 19.4% and 28.2% respectively. Strong corporate earnings, solid economic fundamentals, optimism over tax reform and accommodative monetary policy supported the market rally. However, geopolitical tensions in North Korea and the Middle East as well as the potential withdrawal of the US from the North American Free Trade Agreement (NAFTA) dampened bullish sentiment.
2. In Europe, the FTSE, DAX and CAC advanced 7.6%, 12.5% and 9.3% respectively. Optimism over the economic outlook and continued monetary policy stance lifted the markets. However, a stronger Euro as well as political uncertainties in the region increased volatility. The UK market underperformed on slower economic growth as well as worries about the Brexit negotiation process and monetary tightening.
3. In Asia, the Nikkei 225 Index rose 19.1% in 2017, marking the sixth consecutive year of gains. The rally was supported by strong corporate earnings and economic fundamentals, as well as optimism due to continuity in fiscal and monetary policies. Other major regional markets rose, ranging from increases of 7.8% in Australia to 48.0% in Vietnam.
4. On the Mainland, the Shanghai Composite Index (SHCOMP) gained 6.6% while the Shenzhen Composite Index (SZCOMP) dropped 3.5%. Market volatility eased on expectations that the government would maintain market stability ahead of a leadership reshuffling. Large-cap stocks rebounded and outperformed amid a stabilised economy, stronger renminbi and solid corporate earnings. However, gains were capped by worries about government tightening and deleveraging measures as well as rising debt and valuation concerns, particularly for small-cap stocks.
5. In Hong Kong, the Hang Seng Index (HSI) rose 36.0%, whilst the Hang Seng China Enterprises Index (HSCEI) gained 24.6%. The strong gains were mainly attributable to rallies in leading overseas markets. In the US, the rally was supported by expectations of gradual rate hikes by the Federal Reserve (the Fed). On the Mainland, the market was buoyed by signs of stabilization in the economy and the renminbi. Southbound inflows through Stock Connect also provided support.
6. Some of the major risks and uncertainties facing the Hong Kong market include:
   - faster-than-expected action by the Fed to hike interest rates and reduce its balance sheet;
   - outflows from emerging markets (EMs) as the US dollar strengthens;
   - hikes in Hong Kong's benchmark interest rate to catch up with the US; and
   - more pronounced tightening measures and deleveraging in Mainland financial markets.
7. The average daily trading in Hong Kong's stock market rose 32% to $88.2 billion[1]. Trading in futures products fell 8% while trading in options products increased 32%.

[1] Unless otherwise stated, $ denotes the Hong Kong dollar.

Performance of stock markets during 2017

8. Most major markets rose amid strong economic fundamentals and solid corporate earnings. Market liquidity remained abundant amid gradual tightening or tapering by major central banks. The Mainland market rebounded amid a stabilised economy, stronger renminbi and solid corporate earnings. After recording a mild gain in 2016, the Hong Kong market caught up with and outperformed major overseas markets. Southbound inflows through Stock Connect provided support.

The US

9. The US market advanced for the ninth consecutive year in 2017, marking the longest gain in history. All major indexes hit record highs. In 2017, the Dow, S&P and Nasdaq rose 25.1%, 19.4% and 28.2% respectively. The Dow and S&P were more than 70% higher than their 2007 peaks. VIX, an indicator of investor risk aversion, hit a trough of 9.14 in late 2017, reflecting market complacency.

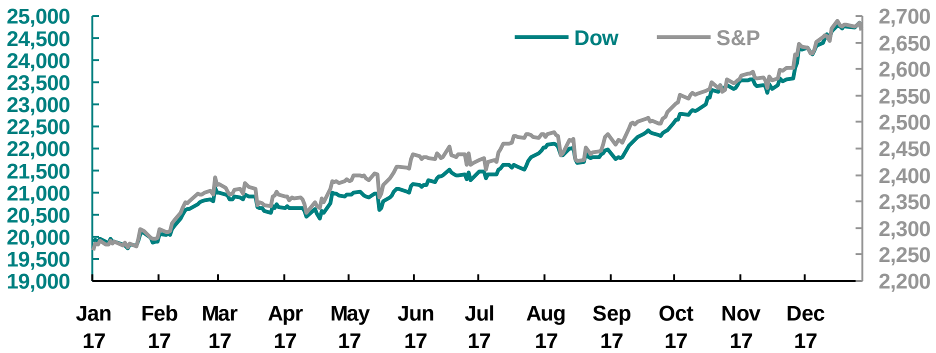
10. The strong gains in the US market were mainly attributable to:

    - **Strong corporate earnings** – Corporate earnings in the US continued to exceed expectations amid strengthening economic growth both domestically and across the globe. Earnings of S&P stocks in Q3 2017 grew 12%. Analysts predicted an earnings growth rate in 2017 of about 12%, with the energy, materials and technology sectors posting the strongest growth.
    - **A weakening USD –** A weaker US dollar provided support, particularly for multinational firms. The US dollar fell 10% in 2017, the biggest annual decline since 2003. It reversed a gain of some 30% between 2011 and 2016. Strategists estimated that every 1% fall in US dollar represents growth of about a half percentage point of forward earnings per share. As such, the fall in the US dollar in 2017 might add roughly 5% to S&P earnings per share in 2018.
    - **Solid economic fundamentals –** Macroeconomic data was largely positive in 2017. Real gross domestic product (GDP) growth was more than 3% in Q2 and Q3 2017, the fastest pace in three years. The labour market strengthened and the unemployment rate fell to a 17-year low. Consumer spending and housing data also remained resilient. The Fed expected that GDP growth would remain at 2.5% in 2018, with solid increases in consumer spending and business investment.
    - **Optimism over tax reform –** The Senate passed a tax overhaul bill which would cut the corporate tax rate to 21% from 35%. Analysts estimated that the tax bill would lift S&P earnings by 5%. Banks and retailers were expected to benefit most from the proposed corporate tax cuts.
    - **Accommodative monetary policy –** The market rally was supported by abundant market liquidity amid loose monetary policy. The Fed raised interest rates three times in 2017 and further tightening is expected to be gradual. Furthermore, the appointment of the new Fed Chairperson signaled a continuation of a dovish monetary policy, possibly tilted towards a more neutral stance. Market perception is for a cautious reduction in the Fed balance sheet depending on the market and economic situation.

11. However, geopolitical concerns trimmed some gains in 2017. North Korea stepped up its missile tests, heightening worries of inadvertent conflict and adding to market uncertainty. Conflicts in the Middle East also weighed on sentiment. The possibility of faster-than-expected rate hikes and the potential withdrawal of the US from NAFTA added further risk to the economic outlook.

12. An extended market rally stretched valuations in the US. The cyclically adjusted price-to-earnings (CAPE) ratio of the S&P was about 30 times, higher than in 97% of its history. This gave rise to growing concerns as to whether the US economy can sustain further stock market gains.

Performance of Dow and S&P during 2017



Source: Bloomberg

Performance of major stock markets

		End-2017	% change			PE Ratios
		Index Level	2017	2016	2015	End-2017
Hong Kong and the Mainland						
HK	-HSI	29,919.2	+36.0%	+0.4%	-7.2%	13.92
	-HSCEI	11,709.3	+24.6%	-2.8%	-19.4%	9.15
Mainland	-Shanghai Comp	3,307.2	+6.6%	-12.3%	+9.4%	16.78
	-Shenzhen Comp	1,899.3	-3.5%	-14.7%	+63.2%	28.58
Asia						
Japan	-Nikkei 225	22,764.9	+19.1%	+0.4%	+9.1%	19.52
Australia	-AOI	6,167.3	+7.8%	+7.0%	-0.8%	19.07
Taiwan	-TWSE	10,642.9	+15.0%	+11.0%	-10.4%	19.07
Korea	-KOSPI	2,467.5	+21.8%	+3.3%	+2.4%	12.85
Singapore	-STI	3,402.9	+18.1%	-0.1%	-14.3%	11.10
Thailand	-SET	1,753.7	+13.7%	+19.8%	-14.0%	16.92
Malaysia	-KLCI	1,796.8	+9.4%	-3.0%	-3.9%	10.29
Indonesia	-JCI	6,355.7	+20.0%	+15.3%	-12.1%	23.24
India	-Nifty	10,530.7	+28.6%	+3.0%	-4.1%	23.73
Philippines	-PCOMP	8,558.4	+25.1%	-1.6%	-3.9%	23.10
Vietnam	-VN	984.2	+48.0%	+14.8%	+6.1%	19.26
US						
US	-Dow	24,719.2	+25.1%	+13.4%	-2.2%	20.77
	-Nasdaq	6,903.4	+28.2%	+7.5%	+5.7%	60.81
	-S&P	2,673.6	+19.4%	+9.5%	-0.7%	22.45
Europe						
UK	-FTSE100	7,687.8	+7.6%	+14.4%	-4.9%	22.95
Germany	-DAX	12,917.6	+12.5%	+6.9%	+9.6%	19.00
France	-CAC	5,312.6	+9.3%	+4.9%	+8.5%	18.26
PIIGS and Hungary						
Portugal	-PSI20	5,388.3	+15.2%	-11.9%	+10.7%	10.56
Italy	-FTSEMIB	21,853.3	+13.6%	-10.2%	+12.7%	n.a.
Ireland	-ISEQ	7,038.3	+8.0%	-4.0%	+30.0%	26.24
Greece	-ASE	802.4	+24.7%	+1.9%	-23.6%	28.26
Spain	-IBEX	10,043.9	+7.4%	-2.0%	-7.2%	15.11
Hungary	-BUX	39,377.3	+23.0%	+33.8%	+43.8%	11.23
Middle East and North Africa						
Egypt	-EGX30	15,019.1	+21.7%	+76.2%	-21.5%	11.44
Dubai	-DFMGI	3,370.1	-4.6%	+12.1%	-16.5%	21.29
Other BRIC markets						
Brazil	-IBOV	76,402.1	+26.9%	+38.9%	-13.3%	18.90
Russia	-MICEX	2,109.7	-5.5%	+26.8%	+26.1%	7.17

Source: Bloomberg

Europe

13. Major European markets remained bullish after posting solid gains in 2016. The FTSE, DAX and CAC rose 7.6%, 12.5% and 9.3% respectively in 2017. Both the FTSE and DAX rose to record highs in late 2017 (14% and 66% higher than their respective peaks in 2007), whilst the CAC hit a 10-year high. The DAX recorded its sixth consecutive year of gains.

14. Optimism over the improving economic outlook and continued policy support in the Eurozone lifted markets.

- In Q3 2017, real GDP growth in the Euro area was 2.6%, marking the 17^{th} consecutive quarter of growth and the strongest year-on-year growth since 2011. The sustained economic recovery was supported by solid export growth in Germany and Italy. In late 2017, the jobless rate fell to its lowest level since 2009.

- Amid tamed inflation, the European Central Bank (ECB) announced its plan to extend its asset purchase programme until September 2018 to stimulate growth, albeit at a slower pace.

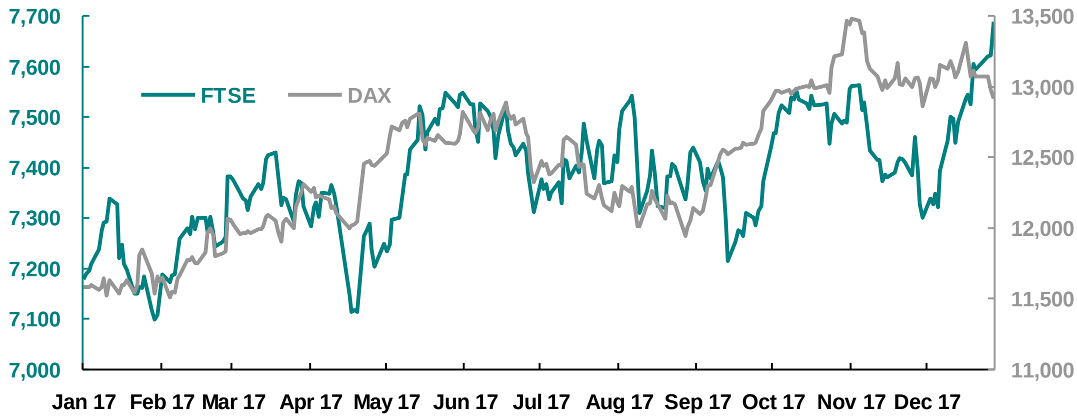
15. However, a stronger Euro as well as political uncertainties in the region added volatility to the markets.

    - The Euro rose 14% in 2017, the strongest gain in 14 years, reversing declines in the past three years. This might have affected earnings growth.
    - While Angela Merkel won the German Chancellor's election, negotiations on the formation of a coalition government faced complications. In Spain, tensions lingered as pro-Catalan independence parties gained a majority in the late 2017 election. Earlier, elections in France and the Netherlands also prompted uncertainties and investor anxiety.

16. The UK market underperformed on slower economic growth as well as worries about the Brexit negotiation process and monetary tightening.

    - Year-on-year real GDP growth in the UK was 1.9% in Q2 2017 and 1.7% in Q3 2017. Analysts raised concerns that the economy might continue to slow relative to past growth.
    - While the UK reached a Brexit deal with the EU in late 2017, uncertainties remain over the outcome of the next stage of negotiations in 2018, affecting business sentiment and investment. Amid related concerns, Moody's downgraded the UK's credit rating from Aa1 to Aa2 in September 2017.
    - The Bank of England (BOE) raised interest rates by 0.25% to 0.5% in late 2017, the first hike in over 10 years. It also signaled the potential for further rate hikes in 2018.

Performance of FTSE and DAX during 2017



Source: Bloomberg

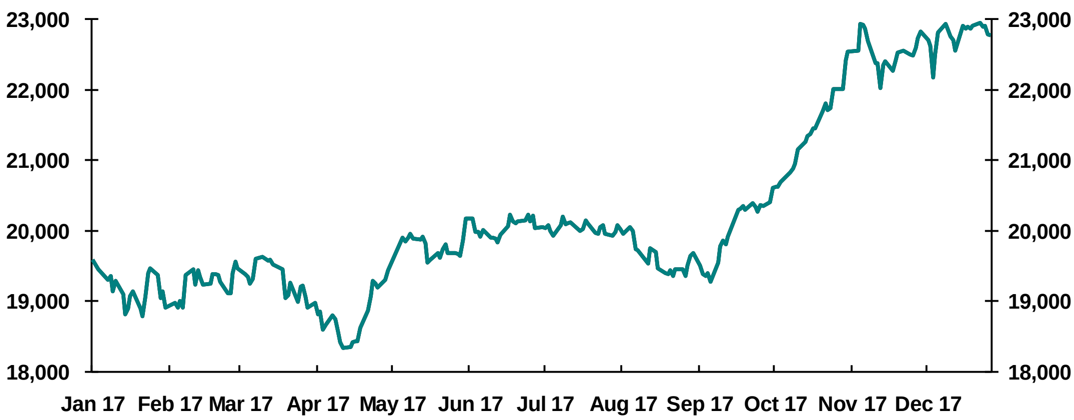
Asia

17. In Japan, the Nikkei 225 rose 19.1% in 2017, marking the sixth consecutive year of gains. The market hit a 26-year high in late 2017 amid strong corporate earnings and economic fundamentals.

    - Pretax profits of non-financial Japanese companies rose 18% from Q1 to Q3 2017, to a record high of 60 trillion yen (US$540 billion). Deflation worries eased.
    - Bucking the occasional economic contractions in previous years, GDP growth was positive for seven consecutive quarters and reached 2.5% in Q3 2017, exceeding market expectations. The unemployment rate hit a 24-year low in late 2017.
    - The market rally was supported by optimism about the continuity of fiscal and monetary policies after Shinzo Abe was re-elected as Prime Minister. In contrast to the tightening or tapering by many overseas central banks, the Bank of Japan maintained its ultra-low interest rate, cut its inflation forecast and reiterated the need to provide stimulus via monetary easing.
    - News of overseas investors' net purchases of Japanese stocks and hopes about the Bank of Japan's buying into exchange-traded funds provided support to the market.

18. The performance of other major Asian markets ranged from increases of 7.8% in Australia to 48.0% in Vietnam. Regional markets were supported by a concerted pick-up in global growth which boosted corporate profits and commodity prices. S&P GSCI, a composite commodity sector index, gained 11%, benefiting regional economies relying on related exports. However, geopolitical tensions in North Korea capped gains.

Performance of Nikkei during 2017



Source: Bloomberg

The Mainland

19. On the Mainland, the SHCOMP rose 6.6%. After recording a sharp loss during H2 2015, the SHCOMP stabilised and traded within a range of around 3,050-3,450 (400 points) in 2017, compared to ranges of around 700 points in 2016 and 2,240 points in 2015. Market volatility eased on expectations that the government would maintain market stability ahead of a leadership reshuffling. The average daily turnover in the Mainland market was RMB458.6 billion, 11.7% lower than the average in 2016.

20. The SZCOMP dropped 3.5%. Investment preferences seemed to shift from small-cap towards large-cap stocks with lower valuations and solid earnings. The ChiNext Price Index, which tracks mostly small-cap stocks, dropped 11% in 2017, with the PE ratio remaining at about 41 times at the end of 2017, similar to the level at the end of 2016. In contrast, large-cap stock indices including the CSI300 Index and A50 Index rose 22% and 32% respectively. Their PE ratios increased from 15 times to 17 times and from 10 times to 13 times respectively.

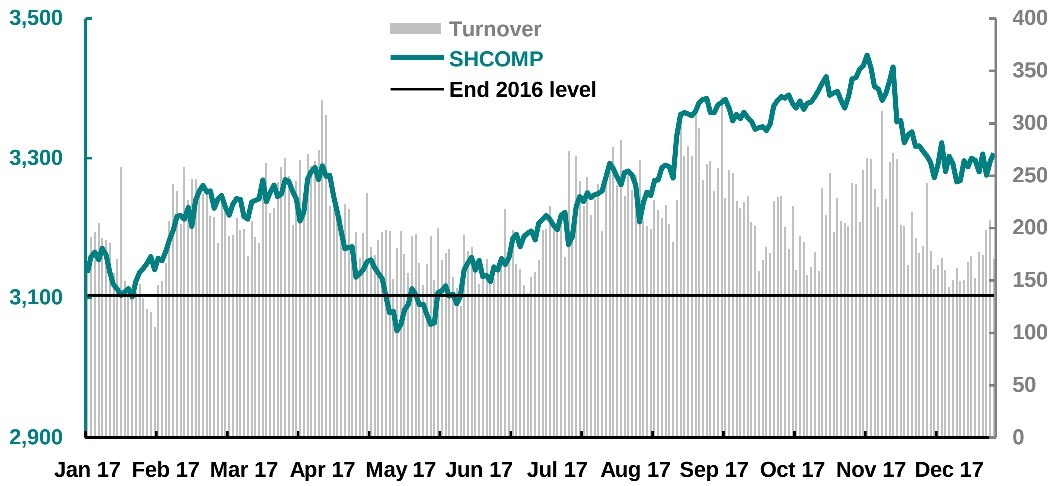
21. Large-cap stocks rebounded and outperformed amid a stabilised economy, stronger renminbi and solid corporate earnings.

    - In 2017, the Mainland economy achieved broad-based growth. Real GDP growth of 6.9% in 2017, the first year-on-year rebound after a six-year decline, surpassed the annual economic growth target of 6.5% and has remained at moderately high levels of 6.7% to 6.9% for 10 consecutive quarters, signifying the transition of the economy to a more gradual and sustainable growth model. A significantly higher nominal GDP growth rate of 11% in 2017 compared to an 8% growth rate in 2016 helped to boost corporate earnings. The market also anticipated that Mainland authorities would pursue economic restructuring and a prudent monetary policy under a stable economic environment. Consequently, strong growth in the consumption, services and new economy sectors boosted related stocks. Reform of state-owned enterprises, development of the Belt and Road Initiative as well as the establishment of Xiongan New Area and the Guangdong-Hong Kong-Macau Greater Bay Area provided additional support.
    - In 2017, the renminbi stabilised and rebounded 6.7% amid a weakening US dollar and the strengthening of the exchange rate fixing mechanism by adding a counter-cyclical adjustment factor. The renminbi recorded its strongest annual gain in nine years. Its appreciation was supported by stricter control over capital outflows and stronger foreign reserves, which rose for 11 consecutive months to US$3.1 trillion.
    - Large-caps paced gains on buying by foreign institutional investors through different channels including Stock Connect and the Qualified Foreign Institutional Investor (QFII) scheme amid optimism about A-share inclusion in the MSCI Emerging Markets Index in 2018.

22. However, the rise in the Mainland market was modest. Gains were capped by worries about tightening and deleveraging measures as well as rising debt and valuation concerns, particularly for small-cap stocks.

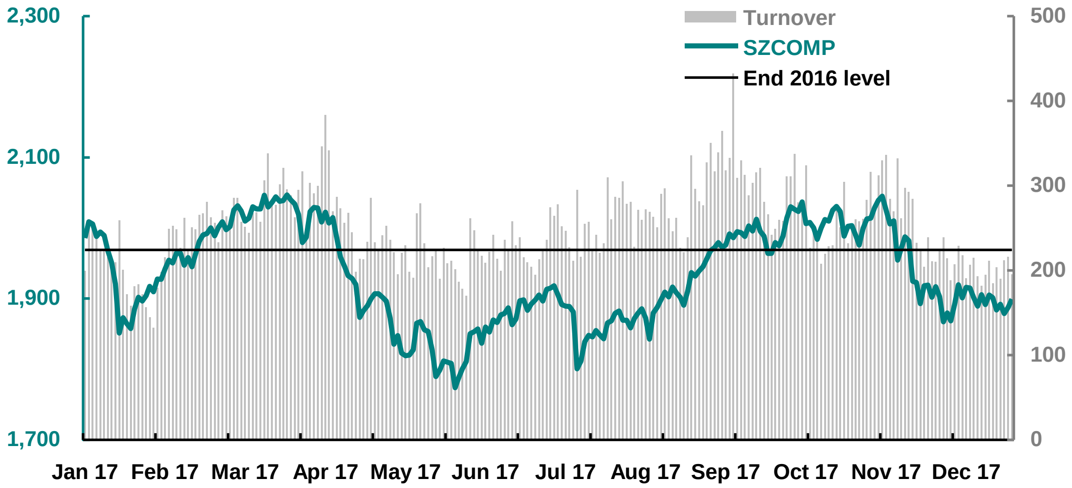
    - Market sentiment was affected by worries about possible tightening measures in the property market and deleveraging in the financial sector. There were concerns that deleveraging measures deployed to address high corporate debt would increase financial risk and destabilise the economy. Small-cap stocks underperformed due to their higher vulnerability to tougher regulations and increased borrowing costs.
    - In May, Moody's downgraded China's credit rating from Aa3 to A1. In September, S&P cut China's sovereign rating from AA- to A+. Both rating agencies raised concerns that strong debt growth would affect financial stability.
    - Sentiment was also dampened by worries that the acceleration of listing approvals would increase the supply of stocks, particularly small-caps. The number of IPOs rose 93% to 437 in 2017, creating worries that market liquidity would be drained.

SHCOMP and market turnover (RMB billion) during 2017



Source: Bloomberg

SZCOMP and market turnover (RMB billion) during 2017



Source: Bloomberg

Hong Kong

23. The Hong Kong market outperformed major overseas markets in 2017. After recording a mild increase in 2016, the HSI caught up with global markets in 2017 and surged 36.0%. The HSI hit the 30,000 level for the first time in a decade. In absolute terms, the HSI rose 7,919 points in 2017, the largest-ever annual advance. The HSCEI rose 24.6% to a 2-year high. Trading was very active, with an average daily turnover of HK$88.2 bn, 32% higher than the average in 2016.

24. The strong gains in the HSI were mainly attributable to:

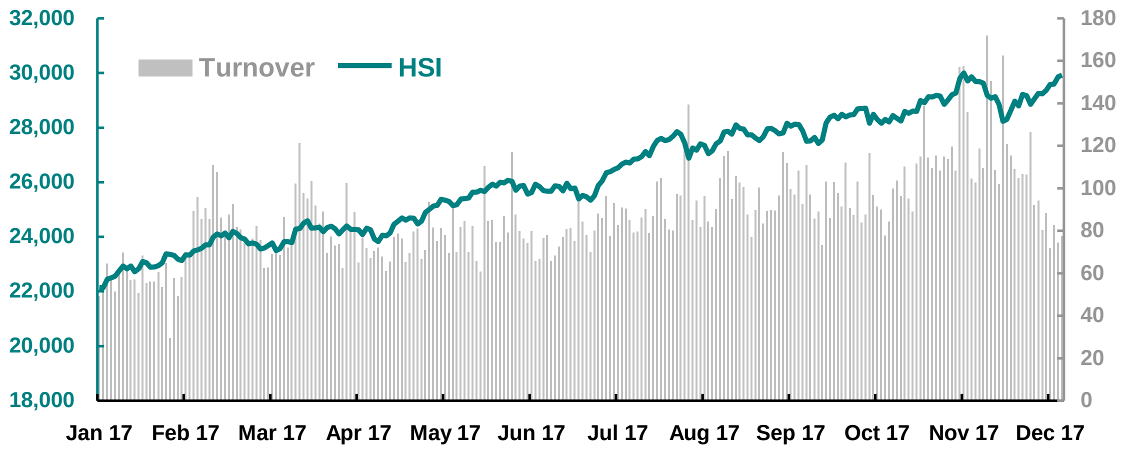
- **Rallies in leading overseas markets –** Global markets advanced amid optimism about corporate earnings and improving economic fundamentals. In particular, the US stock market hit a record high and the economic recovery gathered momentum. Apart from the US, several major markets, including Germany, the UK, South Korea and India, also hit record highs in 2017. The sustained weakness of the US dollar, which depreciated 10% in 2017, was another factor encouraging the continuous inflow of capital to Hong Kong and other EMs.

- **Expectations of gradual interest rate hikes and tax reform in the US –** Investors were also optimistic about the continuation of an accommodative monetary policy stance and the US Fed's expectations that economic conditions would warrant gradual increases in interest rates. The progress of tax reform, which would benefit most corporations, also supported the broader market.
- **Southbound inflows through Stock Connect –** Southbound net buy in 2017 amounted to HK$339.9 billion, 38% higher than that of HK$246.0 billion in 2016. Mainland investors favoured investment in large-cap stocks through southbound trading and provided support to the broader market.
- **Favourable factors in the Mainland –** The Mainland economy showed signs of stabilisation. Optimism about the inclusion of A-shares in the MSCI Emerging Markets Index in 2018 also boosted sentiment. H-shares rose amid solid earnings and expectations of accelerating state-owned enterprise reforms. In addition, the renminbi stabilized, supporting Mainland companies' earnings growth in Hong Kong dollar terms.

25. However, gains were not broad-based and were concentrated in a few large-cap technology and financial stocks. Of the 7,919 point increase in the HSI, Tencent, HSBC, AIA, Ping An and HKEX collectively contributed 4,959 points, or 63% of total gain. Overall, sentiment was bullish. Participation by retail investors continued to grow and some IPOs were heavily over-subscribed.

26. As the Hong Kong stock market advanced substantially within a short period of time, the market outlook was clouded by valuation concerns as well as uncertainties in local and overseas markets.
    - Concerns about tightened liquidity trimmed gains in the local market. The one-month HIBOR hit 1.0% in late 2017, the highest level since 2008.
    - The performance of H-shares was affected by the relative underperformance of the SHCOMP, which gained only 6.6% in 2017 amid deleveraging measures as well as tighter financial regulations and liquidity conditions on the Mainland.
    - There were also concerns about the sustainability of the US market rally, which would depend on the timing, pace and magnitude of tightening, as well as wider economic conditions.
    - In addition, investor sentiment was affected by geopolitical tensions in North Korea and the Middle East as well as worries about the Brexit negotiations.

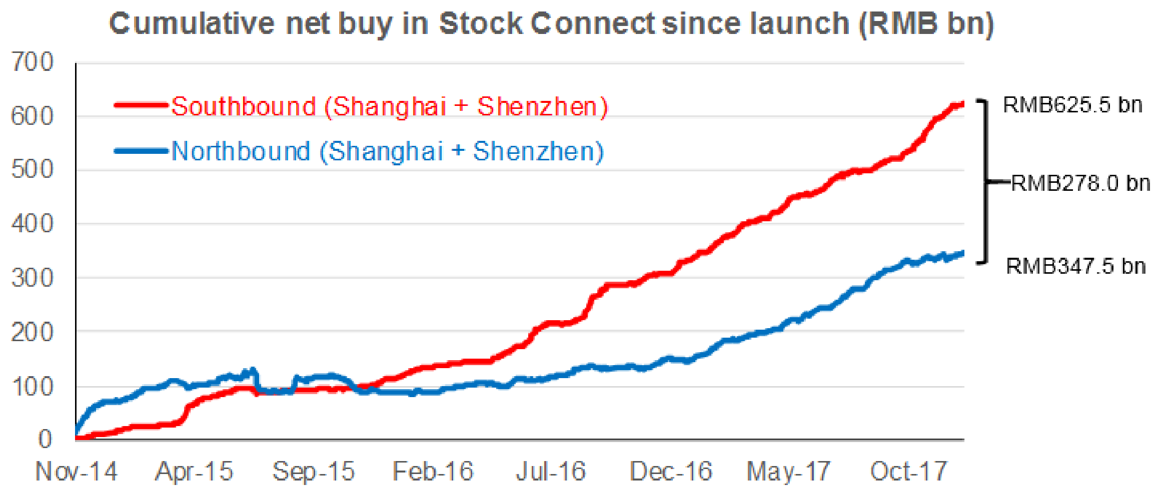
HSI and market turnover ($ billion) during 2017



Source: Bloomberg

Stock Connect Trading

1. Since its launch three years ago, Stock Connect has provided an important channel for Hong Kong and Mainland investors to trade eligible stocks in each other's markets. It has opened up the vast onshore Mainland equity market to the rest of the world and enabled Mainland investors to diversify portfolios outside their home market.
2. Stock Connect now covers some 1,500 Mainland stocks and 440 Hong Kong stocks, representing over 80% of the two markets' combined market cap. Stock Connect has been running smoothly and its clearing and settlement systems have been able to accommodate rapidly increasing flows.
3. Southbound trading from Shanghai and Shenzhen into Hong Kong has resulted in a net inflow of RMB625.5 billion since the launch of the programme. Inflows have been strong to HSI heavyweights in sectors such as financials, IT and property. Via northbound trading, international investors have so far bought RMB347.5 billion worth of A-shares. They showed strong interest in financial and infrastructure stocks in Shanghai as well as technology and consumer stocks in Shenzhen.



4. Stock Connect has accounted for an increasing share of the Hong Kong's market turnover over time. On average, daily southbound trading reached 6% of total trading in Hong Kong in 2017, doubling that of 3% in 2016. Northbound trading also increased to 1% of the Mainland market total, from 0.3% in 2016.
5. Amid improved access to the Mainland market via Stock Connect, MSCI decided to include A-shares in its Emerging Markets Index in 2018. Further liberalisation of the Mainland market could possibly lead to the inclusion of A-shares in other international indices and increases in index weightings over time.
6. Further enhancements to Stock Connect can be expected. Consideration will be given to expanding the quota and the range of stocks and financial products available for trading. This will add to the breadth and depth of the programme and result in greater participation by both Mainland and international investors.
7. Through Stock Connect, Hong Kong will continue to leverage its role as a super-connector between China and the rest of the world. The increased cross-boundary flow of renminbi funds under Stock Connect will help to strengthen Hong Kong's position as an offshore renminbi centre.

Risks and uncertainties facing the Hong Kong market

27. The Hong Kong market has remained resilient, with major segments functioning normally. Nevertheless, the market has accumulated substantial gains within a short period of time and this raises the possibility of a market correction. Investors should remain alert to the possibility of a sudden turnaround in market sentiment, which could be triggered by a confluence of factors.

28. In the US, the Fed has raised interest rates five times since 2015 and three hikes are forecast in 2018. The market has not experienced rate hikes of this pace and magnitude for over a decade. The Fed has also started to unwind its balance sheet, which will have a significant impact on global markets. Unanticipated tightening in financial conditions amid monetary policy surprises in the US would result in financial stress in Hong Kong given its role as an international financial centre.

29. The bullish performance of EMs in 2017 has been underpinned in part by a weak US dollar. Interest rate hikes in the US will result in a stronger US dollar and capital will likely move out of EMs. In addition, appreciation of the US dollar will also affect commodity prices, in turn affecting EM currencies. The withdrawal of central bank stimulus and interest rate hikes may negatively impact EMs, which are vulnerable to sudden outflows. Higher volatility in regional stock markets and currencies will also likely affect the Hong Kong market.

30. So far, the benchmark interest rate in Hong Kong has remained very low and unchanged. However, under the Linked Exchange Rate system, the interest rate in Hong Kong will eventually increase in tandem with the US. The cumulative impact on the securities market may be significant especially if the interest rate catches up with US interest rates. As capital inflows reverse, the Hong Kong dollar and stock market performance will be affected.

31. On the Mainland, there are worries about more pronounced tightening measures in the property market and deleveraging in the financial sector. China's sovereign rating was downgraded on concerns that strong debt growth would affect financial stability. The IMF advised that China might need to accelerate the pace of reforms to contain the risks associated with increasing corporate debt. A steeper-than-expected deleveraging could destabilize the economy and increase financial risk. Rate hikes and a balance sheet reduction in the US may lead to a rebound in the US dollar, putting pressure on the renminbi and hurting the corporate earnings of Mainland companies in US dollar terms. Trade conflicts stemming from protectionism in the US may add volatility to Mainland and Hong Kong markets.

Major statistics for the Hong Kong securities market during 2017

Trading activity in the local stock market

32. Trading in the local stock market increased in 2017. The average daily turnover amounted to $88.2 billion, 32% higher than the $66.9 billion in 2016.

33. Mainland stocks (including H-shares and red chips) remained the most actively traded. Their share of total market turnover was 35% in 2017 (34% in 2016), whilst that of HSI stocks (excluding H-shares and red chips) was about 20% (18% in 2016).

Average daily turnover ($ billion)

	2017		2016		% change over 2016
HSI (ex H-shares & red chips)	17.5	(20%)	12.3	(18%)	+42.3%
Mainland stocks	30.5	(35%)	22.7	(34%)	+34.3%
H-shares	22.7	(26%)	16.3	(24%)	+39.3%
Red chips	7.8	(9%)	6.4	(10%)	+21.8%
Derivative warrants	12.2	(14%)	11.1	(17%)	+9.9%
Callable bull/bear contracts	4.8	(5%)	5.6	(8%)	-14.3%
Exchange-traded funds	4.3	(5%)	4.1	(6%)	+4.9%
Others	19.0	(21%)	11.1	(17%)	+70.7%
Market total	**88.2**	**100%**	**66.9**	**100%**	**+31.9%**

Remark: Percentages in parenthesis denote market share.

Sources: Hong Kong Exchanges and Clearing Limited (HKEX) and SFC

Stock Connect

34. Trading through Shenzhen-Hong Kong Stock Connect commenced on 5 December 2016 following the launch of Shanghai-Hong Kong Stock Connect on 17 November 2014. The schemes allow investors in the Mainland and Hong Kong stock markets to trade eligible shares listed on the other market subject to daily quotas.

35. Under both Shanghai-Hong Kong Stock Connect and Shenzhen-Hong Kong Stock Connect, northbound daily quotas are set at RMB13 billion, whilst southbound daily quotas are set at RMB10.5 billion.

36. As at end-2017, the cumulative net buy was:

- RMB347.5 billion via northbound trading; and
- RMB625.5 billion via southbound trading.

37. During 2017:

- average daily northbound trading (Shanghai and Shenzhen, including buy and sell trades) was RMB9.6 billion, or 1.1% of trading in the Mainland market (compared to the average of RMB3.3 billion or 0.3% of market trading in 2016).
- average daily southbound trading (Shanghai and Shenzhen, including buy and sell trades) was RMB8.6 billion, or 5.6% of trading in the Hong Kong market (compared to the average of RMB3.2 billion or 2.8% of market trading in 2016).

Short-selling activity

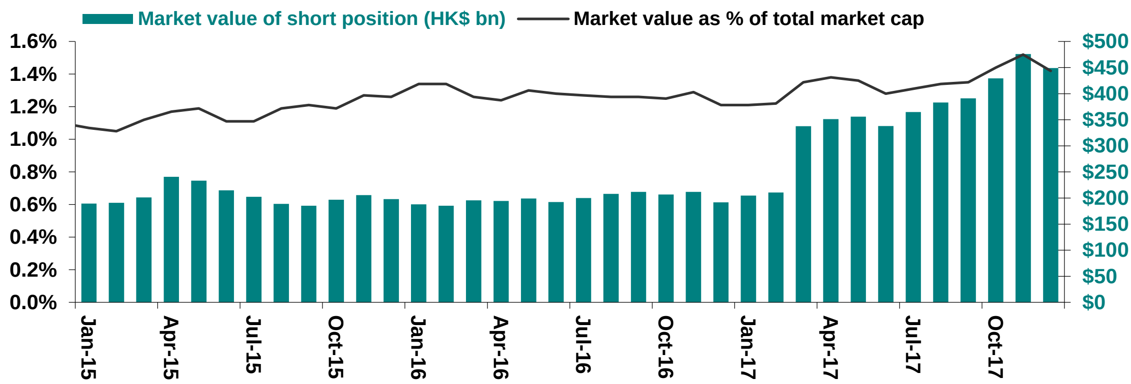
38. Compared to 2016, short selling in Hong Kong was higher in absolute terms but lower as a percentage of total market turnover. Average daily short selling amounted to $9.0 billion, or 10.3% of total market turnover in 2017. In 2016, average daily short selling amounted to $7.8 billion, or 11.8% of total market turnover.

39. Based on data submitted to the SFC, as at 29 December 2017, aggregated short positions amounted to $449.1 billion (or 1.4% of the market cap of the reported stocks).

Expansion of the short position reporting (SPR) regime

1. The short position reporting (SPR) regime was first introduced in June 2012. Under the regime, holders of short positions are required to report to the SFC if their net short positions in HSI and HSCEI constituents as well as financial stocks reach a threshold of 0.02% of the issued share capital of a listed company, or a market value of HK$30 million, at the close of the last trading day of each week.

Market value of short positions



2. The new SPR regime became effective in March 2017. It expands reporting requirements for the 911 designated stocks eligible for short selling, up from the previous coverage of 137 stocks. The enhanced regime improves market transparency and facilitates the SFC's monitoring of short selling activities.

3. Since the launch of the new regime, the market value of reportable short positions has remained at a stable percentage of underlying market cap. Patterns of short position holdings have been largely consistent with those seen before the expansion of the SPR regime. As of 29 December 2017:

- The aggregated market value of short positions was HK$449.1 billion, about 1.4% of the total market cap of reported stocks, similar to the 1.2-1.3% under the previous regime and lower than the 3-4% in the US market. In addition to the increase in the number of stocks covered, the recent increase in the aggregated market value of short positions in Hong Kong has also been driven by a price effect amid strong gains in the market.
- Of the 600 designated securities which had reportable short positions, 80% or 481 stocks were newly covered by the regime and included non-index small-cap stocks and exchange-traded funds (ETFs).
- The top 10 stocks with the largest short positions accounted for 46% of the total amount recorded.
- Total market short positions by stock type:
  - ➢ HSI and HSCEI stocks accounted for 66%;
  - ➢ other non-index small-cap stocks accounted for 33%; and
  - ➢ ETFs accounted for 1%.

4. Major short position holders are investment banks and hedge funds. This pattern has remained stable.

	10 March 2017 (Old regime)	29 December 2017 (New regime)	Change	% change
No. of stocks covered	137	911	+774	+565%
No. of stocks with short positions reported	119	600	+481	+404%
Aggregated short position (HK$ bn), of which:	206.7	449.1	+242.4	+117%
Old SPR stocks	206.7	304.7	+98.0	+47%
New SPR stocks	0	144.4	+144.4	n.a.

Initial public offerings

40. There were 160 IPOs in Hong Kong in 2017. Total IPO funds raised amounted to $128.2 billion, compared to $194.8 billion (117 IPOs) in 2016. In 2017, IPO funds raised by Mainland companies (including H-shares, red chips and Mainland private enterprises) accounted for 77% of the total amount.

Top 10 stock markets by equity funds raised through IPOs (2017)

	Equity funds raised through IPO		
	US$ billion	Worldwide ranking	Asia ranking
US (NYSE)	28.2	1	
Shanghai	20.4	2	1
UK (London)	17.4	3	
Hong Kong	16.4	4	2
Shenzhen	13.7	5	3
India	10.2	6	4
Europe (Euronext)	8.2	7	
US (Nasdaq)	7.4	8	
Korea	7.1	9	5
Australia	5.2	10	6

Sources: World Federation of Exchanges and HKEX

ETFs and Leveraged and Inverse Products (L&I Products)

41. The average daily turnover of ETFs in 2017 was $4.3 billion, 5% higher than the $4.1 billion in 2016. ETFs accounted for 5% of the total market turnover in 2017, compared to 6% in 2016. The average daily turnover of A-shares ETFs was $1.4 billion, accounting for 33% of total ETF turnover, compared to $1.6 billion and 39% respectively in 2016.

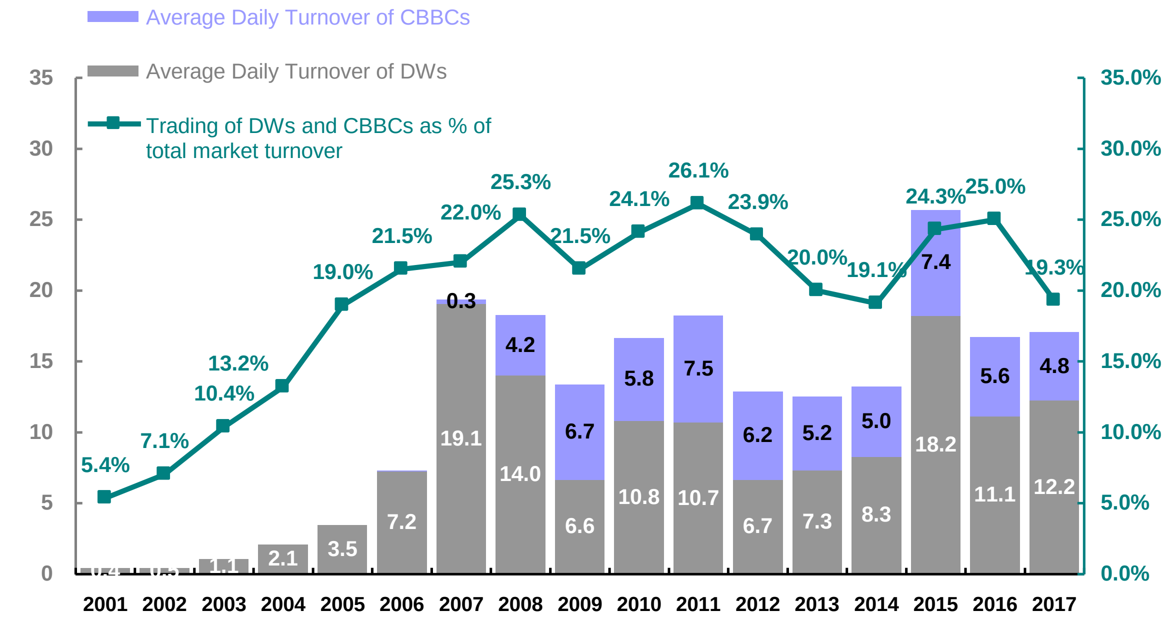
42. 18 L&I Products tracking the HSI and the HSCEI were launched in 2017 and their average daily turnover was $474 million during the year.

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

43. In 2017, trading in DWs increased in absolute terms but decreased as a percentage of total market turnover. The average daily turnover of DWs was $12.2 billion (13.8% of total market turnover), compared to $11.1 billion (16.6% of total market turnover) in 2016.

44. In 2017, trading in CBBCs decreased both in absolute terms and as a percentage of total market turnover. Average daily turnover of CBBCs amounted to $4.8 billion (5.5% of total market turnover), compared to $5.6 billion (8.4% of total market turnover) in 2016.

Turnover of DWs and CBBCs ($ billion)



Sources: HKEX and SFC

Exchange-traded derivatives

45. In 2017, the average daily trading in exchange-traded derivatives rose by 14.2%.

- Average daily trading in futures products fell by 8.4%. Amongst all futures products, HSI futures and HSCEI futures were the most actively traded contracts, each accounting for about 40.9% and 37.4% of all futures trading respectively. The average daily trading volume of HSI and HSCEI futures fell 2.6% and 12.7% respectively from 2016.
- The average daily trading in options products rose by 32.4%. Stock options remained the most actively traded options products and their trading volume rose by 43.8% from 2016.

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

		2017	2016	2015
Futures	HSI Futures	127,478	130,826	85,991
	Mini-HSI Futures	46,507	50,516	40,674
	HSCEI Futures	116,812	133,729	135,139
	Mini-HSCEI Futures	14,823	19,718	30,391
	Stock Futures	492	915	2,951
	RMB Currency Futures (USD/CNH)	3,025	2,181	1,062
	Other futures products	2,848	2,601	1,210
	Total futures	**311,985**	**340,486**	**297,418**
Options	HSI Options	41,009	37,869	30,427
	Mini-HSI Options	6,643	5,767	4,185
	HSCEI Options	80,073	78,849	61,961
	Mini-HSCEI Options*	1,527	800	N/A
	Stock Options	428,499	297,903	374,346
	Other options products	83	69	183
	Total options	**557,834**	**421,257**	**471,102**
Total futures and options		**869,819**	**761,744**	**768,520**

Remarks: The average daily trading volume was based on the number of trading days after the product was launched.
* Trading of Mini-HSCEI Options commenced on 5 Sep 2016.
Sources: HKEX and SFC