



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

Research Paper No. 41 – Half-Yearly Review of the Hong Kong Securities Market

15 July 2008



Executive Summary

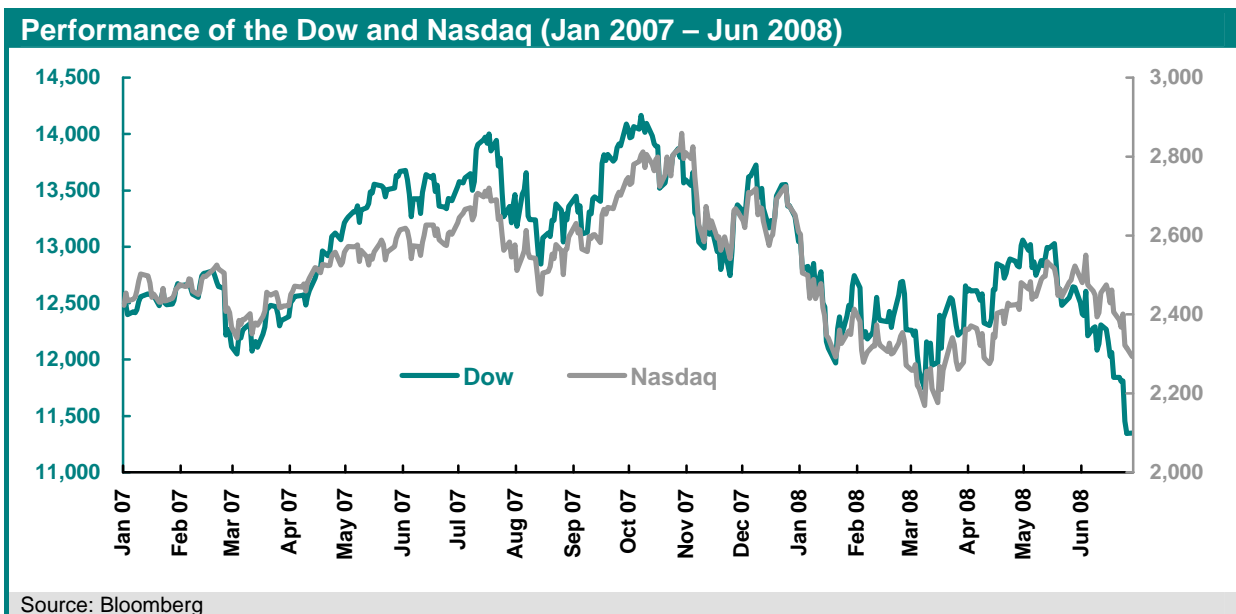
1. During the first half of 2008, the Hang Seng Index (HSI) fell 21% and it was largely affected by the bearish performance of the US and the Mainland markets.
 - (a) In the US, the subprime problem continued to affect the financial institutions and the credit market. Investors worried about the worsening health of financial institutions. Furthermore, the rising oil prices increased concerns over stagflation which clouded economic and interest rate outlook. During the first half of 2008, the Dow dropped 14% from its end-2007 level.
 - (b) On the Mainland, undermined by a possible recession in the US, markets declined on worries over the impact on the Mainland economy. In addition, accelerating inflation heightened worries over monetary tightening. During the first half of 2008, the Shanghai Composite Index slid 48% from its end-2007 level.
 2. Tracking the losses of the US and the Mainland markets, the Hong Kong stock market also declined. Uncertainties over the global economic performance and interest rate outlook, together with high oil prices, weighed on the market. Amid monetary tightening on the Mainland, H-shares underperformed. From mid-March to early May, local markets once rebounded on strong corporate earnings and bargain hunting activities. However, since May, local markets consolidated again. As of the end of June 2008, the HSI dropped 21% from the end 2007 level. The Hang Seng China Enterprises Index (HSCEI) dropped 26% over the same period.
 3. Regarding trading activities, the average daily turnover on the Hong Kong stock market was HK\$87 bn in the first half of 2008, 25% lower than the level for the second half 2007. The share of trading by institutional and retail brokers was largely stable, indicating that the participation by different groups of investors in the local market remained little changed from the second-half level of 2007. The market share of short selling activities rose relative to the reduced market turnover, but no irregularities were observed. The trading in futures and options contracts remained active, with the average daily turnover falling 2% only from the second half of 2007.
 4. Initial Public Offering (IPO) activity slowed in the first half of 2008. Some companies halted their IPOs during subscription period and some delayed their IPO plans due to sluggish market performance. Market response to IPOs was mixed.
 5. Looking ahead, since the subprime crisis and subsequent problems are yet to be resolved, its impact on worldwide markets including Hong Kong is likely to continue. Rising oil prices also accelerate inflation and cloud the global economic outlook and interest rate movements.
 6. Apart from that, the performance of the financial markets, the economy and the currency fluctuation in any Asian economy may affect other regional markets including Hong Kong. Likewise, rising inflationary pressures on the Mainland and the impact of a global economic slowdown on the Mainland economy may affect the performance of both the Mainland and Hong Kong stock markets.
-



Performance of Worldwide Stock Markets

US/Europe

7. During the first half of 2008, the US and European markets continued to be affected by the subprime problem and high oil prices. As of the end of June 2008, the US Dow dropped 14.4% from the end 2007 level, posting the biggest first half-yearly drop since 1970. Major European markets also dropped 12.9-21.0% during the period. The bearish performance of the US and European market spread to other markets around the globe. As of the end of June 2008, the S&P 500 and Nasdaq dropped 12.8% and 13.5% respectively from their end 2007 levels. In Europe, the FTSE, DAX and CAC fell 12.9%, 20.4% and 21.0% respectively in the same period. Most Asian markets were also affected, with losses in benchmark indices ranging from 10.4% in Thailand to 56.9% in Vietnam.
8. In early 2008, the subprime problem continued to weigh on the equities markets. The problem led to disappointing earnings at investment banks and subsequent liquidity drain in the financial markets. Investors worried about the worsening health of financial institutions. High oil prices and a weak US dollar also clouded the economic and inflation outlook.
9. From mid-March to early May, markets rebounded somewhat. The US Federal Reserve cut the Fed Funds Target Rate – the benchmark interest rate – and introduced some market supportive measures such as cash injection into the banking sector, providing impetus for the rebound. Better-than-expected corporate earnings also lent some support.
10. However, since May, oil prices extended the rally to a high of US\$140 per barrel on 30 June. High oil prices lifted concerns about stagflation, i.e. accelerating inflation and slowing economic growth. Also, revived concerns over more possible write-downs of the financial institutions due to the subprime losses weighed on the markets as well.





Performance of Major Indices

| | | Index Level | | % change from | | PE Ratio |
|-------------|----------------|-------------|----------------------|---------------|--------------|------------|
| | | end Jun 08 | Peak in 2007 | end 2007 | Peak in 2007 | end Jun 08 |
| Hong Kong | -HSI | 22,102.01 | 31,638 (Record high) | -20.5% | -30.1% | 13.43 |
| | -HSCEI | 11,909.75 | 20,400 (Record high) | -26.1% | -41.6% | 15.43 |
| | -HSCCI | 4,750.72 | 7,021 (Record high) | -22.3% | -32.3% | 17.74 |
| | -H-FIN | 14,883.85 | 23,738 (Record high) | -17.9% | -37.3% | 18.37 |
| China | -Shanghai Comp | 2,736.10 | 6,092 (Record high) | -48.0% | -55.1% | 20.64 |
| | -Shenzhen Comp | 793.13 | 1,551 (Record high) | -45.2% | -48.9% | 24.01 |
| US | -Dow | 11,350.01 | 14,165 (Record high) | -14.4% | -19.9% | 14.33 |
| | -Nasdaq | 2,292.98 | 2,859 (7-year high) | -13.5% | -19.8% | 34.64 |
| | -S&P 500 | 1,280.00 | 1,565 (Record high) | -12.8% | -18.2% | 21.20 |
| Europe | -FTSE100 | 5,625.90 | 6,732 (8-year high) | -12.9% | -16.4% | 11.18 |
| | -DAX | 6,418.32 | 8,106 (Record high) | -20.4% | -20.8% | 12.06 |
| | -CAC | 4,434.85 | 6,168 (7-year high) | -21.0% | -28.1% | 11.23 |
| Japan | -Nikkei 225 | 13,481.38 | 18,262 (7-year high) | -11.9% | -26.2% | 15.95 |
| Australia | -AOI | 5,332.90 | 6,854 (Record high) | -16.9% | -22.2% | 13.93 |
| Singapore | -STI | 2,947.54 | 3,876 (Record high) | -14.9% | -23.1% | 10.70 |
| Taiwan | -TWSE | 7,523.54 | 9,810 (7-year high) | -11.6% | -23.3% | 12.74 |
| Korea | -KOSPI | 1,674.92 | 2,065 (Record high) | -11.7% | -18.9% | 13.00 |
| India | -Nifty | 4,040.55 | 6,159 (Record high) | -34.2% | -34.4% | 13.94 |
| Thailand | -SET | 768.59 | 915 (12-year high) | -10.4% | -16.0% | 13.00 |
| Malaysia | -KLCI | 1,186.57 | 1,447 (Record high) | -17.9% | -18.0% | 12.75 |
| Indonesia | -JCI | 2,349.11 | 2,811 (Record high) | -14.4% | -16.4% | 14.96 |
| Philippines | -PCOMP | 2,459.98 | 3,874 (Record high) | -32.1% | -36.5% | 10.89 |
| Vietnam | -VNINDEX | 399.40 | 1,171 (Record high) | -56.9% | -65.9% | n.a.# |

Remark:

The PE for the VNINDEX was not available because most corporate earnings of the Vietnamese companies were not audited.

Source: Bloomberg

Mainland

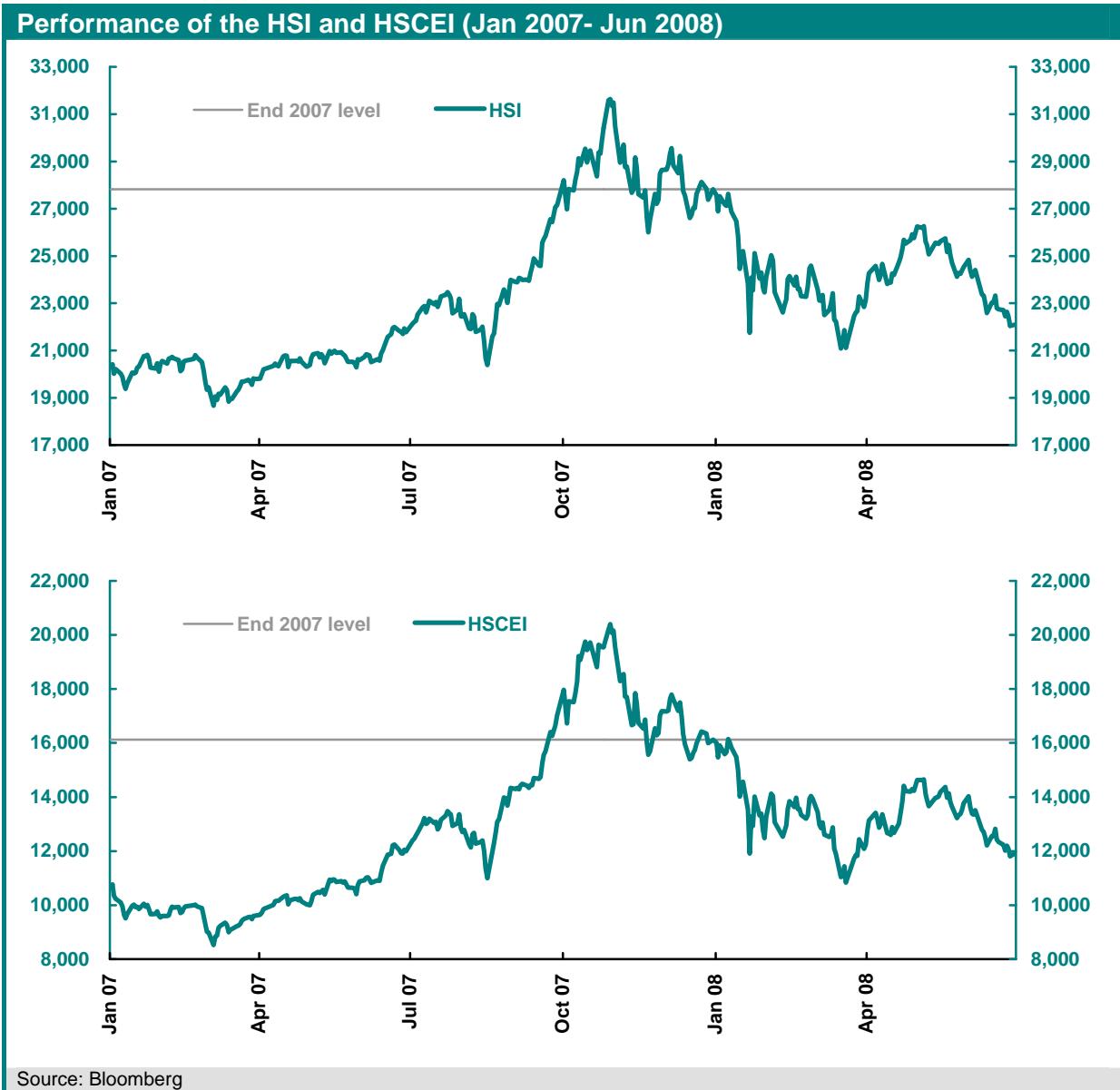
11. During the first half of 2008, the Mainland market slid undermined by the bearish performance in overseas markets and monetary tightening. The cloudy outlook of the US economy – Mainland's major export destination – also added concerns about its impact on the Mainland economy. Accelerating inflation on the Mainland heightened worries over monetary tightening. During the first six months, the People's Bank of China lifted the bank reserve requirement ratio by a total of 350 basis points to 17.5%. Investors expected that monetary tightening would continue amid high inflation. Liquidity concerns due to sizable fund-raising activities and the end of lock-up period of non-tradable shares also weighed on the market.
12. The Mainland authorities restricted the sale of non-tradable shares after the lock-up period and reduced stamp duty on stocks transaction in late April. Markets rebounded briefly, but dropped again later. By the end of the first half of 2008, the Shanghai Composite Index has fallen below the 3,000 level and dropped 48.0% from the end of 2007, and 55.1% from its peak in October 2007. Its price earnings (PE) ratio also dropped to 21 times from the peak of 48 times in October 2007.

Hong Kong

13. During the first half of 2008, the Hong Kong market continued to be affected by the bearish performance of the US and Mainland markets. Uncertainties over the global economic performance and interest rate outlook, together with high oil prices, weighed on the market. Amid monetary tightening on the Mainland, H-shares underperformed.



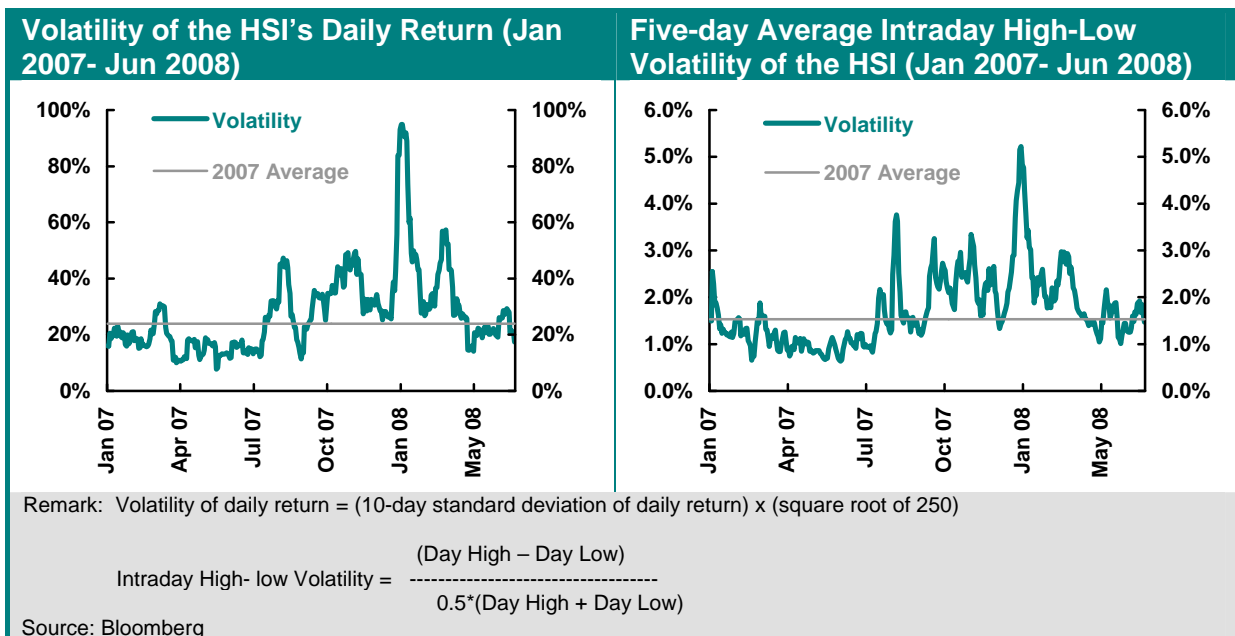
14. From mid-March to early May, the local market rebounded, helped by strong corporate earnings and bargain hunting activities. The HSI rose 25% from the trough on 17 March to a high level of 26,262 on 6 May, while the HSCEI rose 35% from the trough on 20 March to a high level of 14,651 on 6 May. However, since May, local markets consolidated again on the back of the persistent rise in oil prices, global stagflation worries and monetary tightening on the Mainland. As of the end of June 2008, the HSI had dropped 20.5% from the end-2007 level or 30.1% from its peak in October 2007. The HSCEI fell 26.1% from the end-2007 level or 41.6% from its peak in October 2007.





Market volatility

15. Local markets were volatile in early 2008. On the back of global market corrections in January, the volatility of the HSI's daily return hit some 90%. In January, the HSI recorded both its biggest-ever daily point loss and gain of more than 2,000 points. During the first half of 2008, the volatility of the HSI's daily return rose to an average of 35.7% from 30.3% in the second half of 2007. The intra-day high-low volatility of the HSI also rose to an average of 2.1% from 1.9% over the same period. Despite higher volatility, the operations of the cash and derivative markets were largely smooth.
16. Since late March 2008 however, the market has stabilised and volatilities have retreated. In June, the volatility of the HSI's daily return and the intra-day high-low volatility of the HSI averaged about 23.8% and 1.5% respectively, lower than the average level for the whole first half of 2008.



Trading activity in the local stock market

17. During the first half of 2008, trading activity in the local stock market was moderate. The average daily turnover amounted to HK\$87.3 bn, 24.7% lower than the level for the second half of 2007 but was 47.3% higher than the level for the first half of 2007. Mainland stocks remained the most actively traded stocks, although their turnover fell by 28.4%. The trading of HSI stocks (excluding H-shares and red chips) dropped 15.5%, but the decline was the smallest among different classes of shares.

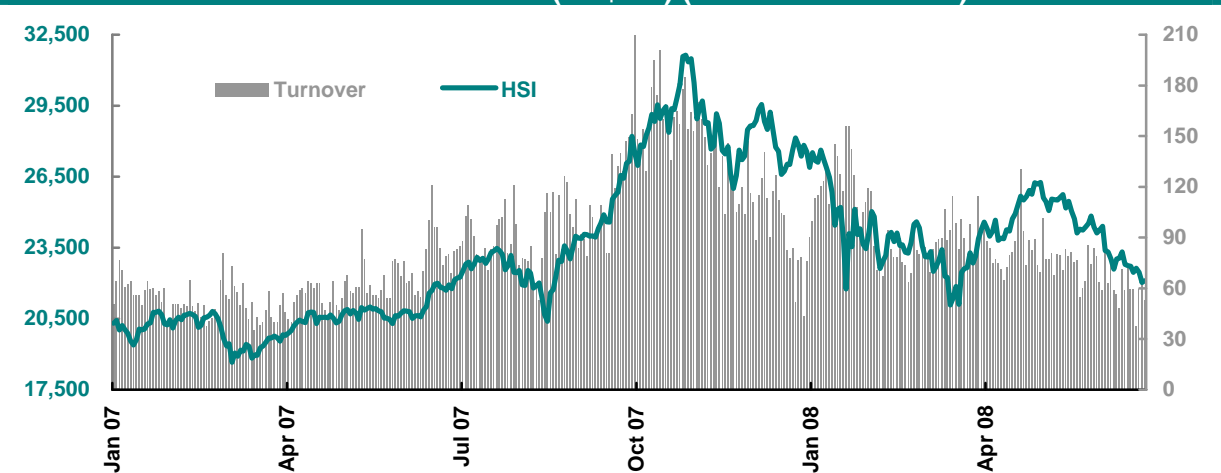


Average Daily Turnover (HK\$ bn) and Market Share (%)

| | H1 2008 | H2 2007 | H1 2007 | % change from | |
|-------------------------------|--------------------|---------------------|--------------------|---------------|---------------|
| | | | | H2 2007 | H1 2007 |
| HSI (ex H shares & red chips) | 13.1 (15.0%) | 15.6 (13.4%) | 8.5 (14.4%) | -15.5% | +53.7% |
| Mainland Stocks | 41.0 (47.0%) | 57.2 (49.3%) | 27.7 (46.8%) | -28.4% | +47.9% |
| <i>H-shares</i> | 29.9 (34.2%) | 43.0 (37.0%) | 19.9 (33.5%) | -30.5% | +50.5% |
| <i>Red chips</i> | 11.1 (12.7%) | 14.3 (12.3%) | 7.9 (13.3%) | -22.1% | +41.4% |
| Derivative Warrants | 21.2 (24.3%) | 26.7 (23.0%) | 11.2 (19.0%) | -20.3% | +89.0% |
| Others | 11.9 (13.7%) | 16.5 (14.2%) | 13.5 (22.7%) | -27.7% | -11.5% |
| Market Total | 87.3 (100%) | 116.0 (100%) | 59.2 (100%) | -24.7% | +47.3% |

Remark: Figures in parentheses are shares of market total.
Source: HKEx

HSI Performance and Market Turnover (HK\$ bn) (Jan 2007- Jun 2008)



Source: Bloomberg

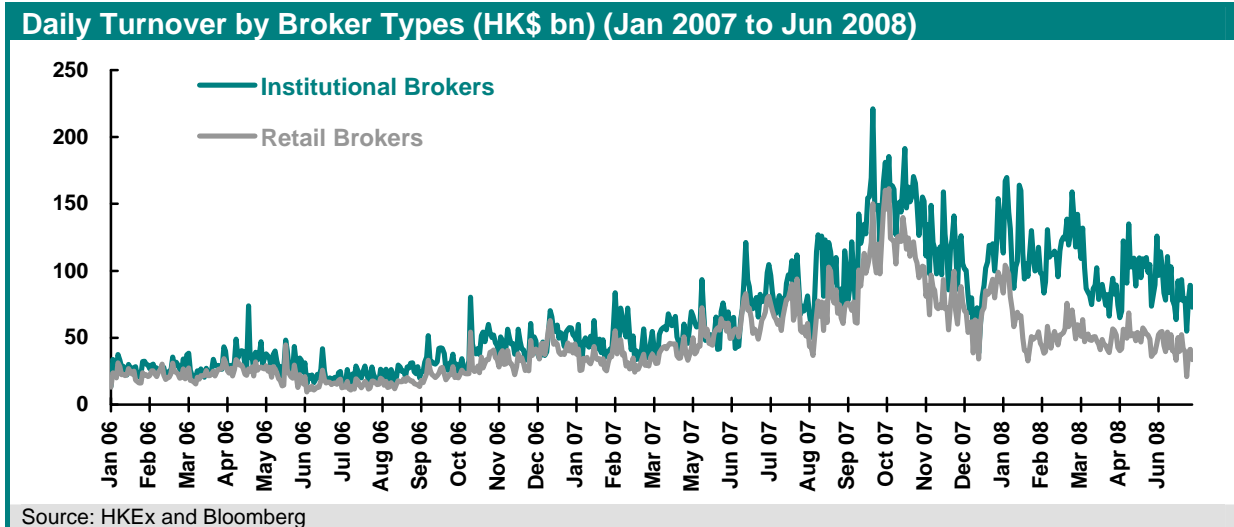
Trading by broker type

18. In the first half of 2008, the share of trading among institutional and retail brokers was stable. This indicated that the participation by different groups of investors in the Hong Kong market remained little changed. Compared to the second half of 2007, the share of trading by institutional brokers increased slightly to 67% from 65% in H2 2007, whilst market share of retail brokers dropped to 33%.

Average Daily Turnover and Average Transaction Size by Broker types (H1 2008 and H2 2007)

| | Average Daily Turnover (HK\$ bn) | Market Share | Average Transaction Size (HK\$) |
|-----------------------|----------------------------------|-----------------|---------------------------------|
| Institutional Brokers | 91.9 (117.4) | 66.5% (64.6%) | 179,698 (234,273) |
| Retail Brokers | 46.4 (64.4) | 33.5% (35.4%) | 102,297 (95,311) |
| Overall | 138.2 (181.7) | 100.0% (100.0%) | 143,326 (154,483) |

Remark: Both buy and sell transactions are included. Figures in brackets are data for H2 2007. Figures exclude trading in derivative warrants.
Source: SFC Research



Short selling activity

19. During the first half of 2008, short selling dropped in absolute terms, but increased relative to total market turnover. No irregularities were observed. During the period, the average daily short selling was HK\$6,484 mn, or 7.4% of the total market turnover. In contrast, the figures for the second half of 2007 were HK\$7,635 mn and 6.6% respectively.

IPO activity and performance

20. Initial Public Offering (IPO) activity slowed in the first half of 2008 due to sluggish market performance. A total of nine companies halted their IPOs during the subscription period, while media also reported that some companies postponed their IPO plans. From January to June 2008, there were 18 IPOs raising a total of HK\$50.4 bn, of which HK\$36.7 bn (or 73%) related to the Mainland companies.
21. The performance of 18 IPOs was mixed. On average, they traded at 8.4% above their IPO prices on the first day of listing, with individual performances ranging from a loss of 19.2% to a gain of 111.8%. Subsequent performance was also mixed. As at the end June 2008, the prices of four IPOs were above their IPO prices, one was flat, while those of the other 13 were below, with the loss / gain ranging from -39.7% to +52.1%.

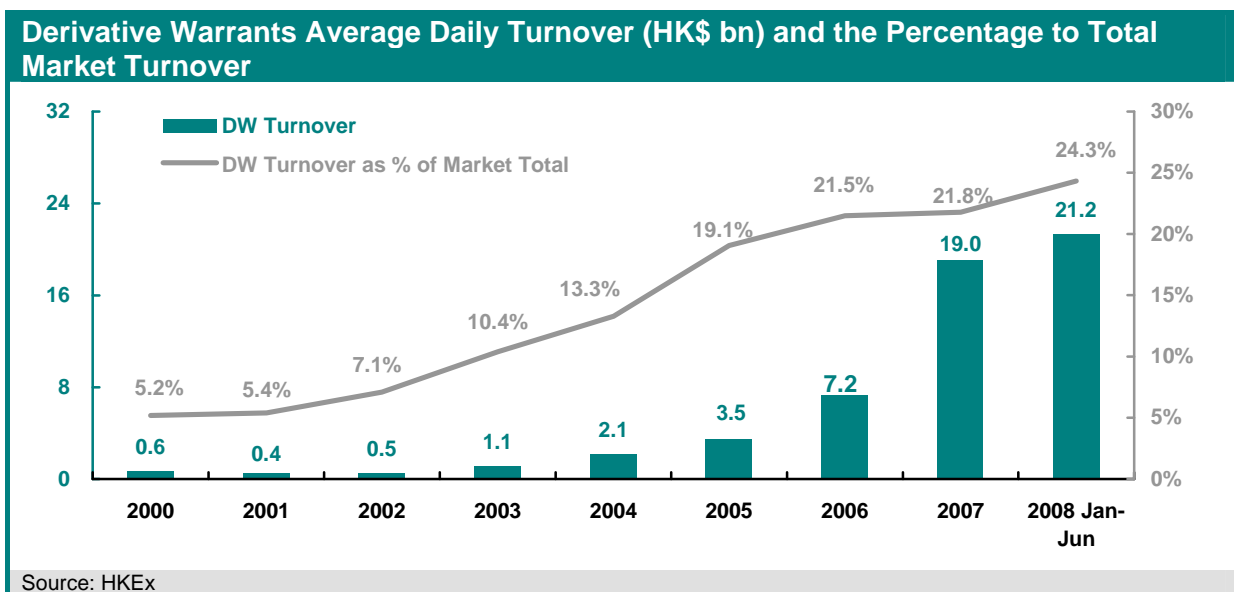
Exchange-traded funds (ETF)

22. The exchange-traded funds (ETF) market in Hong Kong continued to grow robustly. During the first half of 2008, six ETFs tracking equity indices were launched, lifting the total number of ETFs to 25. Over the same period, the average daily turnover in ETFs was HK\$1.6 bn, rising 113% from the average level in the second half of 2007. The FTSE/Xinhua China A50 Index ETF and Tracker Fund were the two most actively traded, respectively accounting for 63% (HK\$1,017 mn) and 15% (HK\$239 mn) of the total ETF trading activities.



Derivative warrants

23. As at the end of June 2008, there were 4,446 derivative warrants listed on HKEx, 0.1% higher than at the end of 2007. However, the total market value of derivative warrants decreased by 84% to HK\$7.0 bn, possibly attributable to corrections in the underlying stock prices. The total market value of these derivative warrants accounted for less than 0.1% of the total market capitalization. Therefore, the systemic risks of derivative warrants on the broad market remained limited at this stage.
24. Trading in derivative warrants was stable. The average daily turnover during the first half of 2008 was HK\$21.2 bn, accounting for 24% of the total market turnover. The corresponding levels for the second half of 2007 were HK\$26.7 bn and 23%.



Exchange-traded derivatives

25. Both open interest and the trading of the derivative markets declined somewhat during the first half of 2008. This was largely in line with the spot market. As at the end of June 2008, the total open interests were 5.1 million contracts, 11.1% less than its end 2007 level. During the first half of 2008, the average daily trading volume of derivative contracts was 430,149 contracts, 2.1% less than that for the second half of 2007.
26. The smaller decline in derivative trading (as compared to the decline in the trading of stocks) can be attributable to the more volatile market which induce more hedging or arbitrage activities. No irregularities were observed.
27. Among futures products, HSI futures remained the most actively traded contract, accounting for nearly half of all futures trading. Its average daily trading volume increased by 7.6% in the first half of 2008, compared to the second half of 2007. The second most actively traded futures were HSCEI futures. Its trading volume increased by 0.8% and accounted for about one-third of all futures trading. Meanwhile, trading in mini-HSI futures grew by 26.4%, the strongest increase among all futures products. The mini-HSCEI future was launched on 31 March 2008, but the turnover of this new product has been thin so far, with a daily average of 1,133 contracts.



28. In the options market, trading declined slightly during the first half of 2008 after recording robust growth in the second half of 2007. Stock options remained the most actively traded options products, but its trading volume dropped 1.6% during the first half of 2008, compared to its volume for the second half of 2007. The trading volume of the HSI and HSCEI options products also dropped.

| Average Daily Trading Volume of Derivatives by Product Type (Contracts) | | | | |
|---|-------------------------------------|----------------|----------------|----------------|
| | | H1 2008 | H2 2007 | H1 2007 |
| Futures | HSI Futures | 84,131 | 78,160 | 61,728 |
| | Mini-HSI Futures | 29,520 | 23,360 | 11,813 |
| | HSCEI Futures | 55,827 | 55,391 | 32,875 |
| | Mini-HSCEI Futures* | 1,133 | - | - |
| | Hang Seng China H-Fin Index Futures | 0.08 | 2 | 24 |
| | FTSE/Xinhua China 25 Index Futures | 0.29 | 5 | 22 |
| | Stock Futures | 714 | 1,219 | 1,656 |
| | 3-Month HIBOR Futures | 117 | 106 | 153 |
| | Other Futures products** | 5 | 5 | 0 |
| | Total Futures | 170,895 | 158,248 | 108,271 |
| Options | HSI Options | 14,476 | 29,958 | 31,118 |
| | Mini-HSI Options | 450 | 224 | 345 |
| | HSCEI Options | 5,355 | 7,974 | 6,108 |
| | FTSE/Xinhua China 25 Index Options | 3 | 4 | 9 |
| | Stock Options | 238,970 | 242,961 | 131,040 |
| | Total Options | 259,254 | 281,120 | 168,620 |
| Total Futures and Options | | 430,149 | 439,369 | 276,891 |

Remark: * Mini-HSCEI Futures were launched on 31 March 2008
 ** One-Month HIBOR Futures and Three-year Exchange Fund Note Futures.
 Source: HKEx

Conclusion

29. During the first half of 2008, the Hong Kong stock market was very much affected by the economic and financial conditions in the US and the Mainland. The US subprime problem, which triggered substantial market decline in late 2007, continued to impact international financial markets. Looking ahead, since the subprime crisis and subsequent problems are yet to be resolved, its impact on the US markets and the spillover on other regional markets including Hong Kong is likely to continue. In addition, the rising oil prices accelerate inflation, adding to uncertainties over the economic outlook and interest rate movements in the US and other parts of the world. These are the key risk factors which will continue to have an impact on the Hong Kong market.
30. Apart from that, the Hong Kong stock market will continue to be affected by the performance of regional financial markets, including the Mainland's. The economic performance and currency fluctuation in any Asian economy may also affect other regional markets. Likewise, inflationary pressures on the Mainland and the impact of a global economic slowdown on the Mainland economy may affect the performance of both the Mainland and Hong Kong stock markets.