SECURITIES AND FUTURES COMMISSION

Research Paper No. 50: A review of the global and local securities markets in 2011

19 January 2012

Executive summary

1. In 2011, major markets around the globe were confronted by a number of uncertainties.

2. The US credit rating was downgraded from AAA to AA+ with a negative outlook, and there were concerns about US banks given their exposures to European debt. Later, given a positive economic outlook and optimism about an accommodative monetary policy, the US markets generally outperformed. Other major markets however retreated as risks brought about by the European sovereign debt problems grew. Uncertainties about the global economic outlook paced losses. In Asia, the Japanese market was hit by the massive

2011, the People's Bank of China (PBoC) lowered the reserve requirement ratio by 50 basis points (bps), the first time in three years. In late December 2011, the Shanghai Composite Index fell to below 2,200 points (a 33-month low) as trade and economic growth slowed down. By the end of 2011, the Shanghai Composite Index had dropped 21.7% from its end-2010 level.

8. In Hong Kong, market sentiment was clouded by the European sovereign debt problem, the downgrading of the US credit rating and the macro tightening measures in the Mainland. By the end of 2011, the Hang Seng Index (HSI) and the Hang Seng China Enterprises Index (HSCEI) had dropped 20.0% and 21.7% respectively from their end-2010 levels.

9. The Hong Kong stock market underperformed most other major markets, partly due to:
   (a) A high participation of European and US investors (around 70% of trading by overseas investors) in the Hong Kong market. Changes in their sentiment affect the performance of the Hong Kong market.
   (b) A heavy weighting of financial stocks in the HSI (45% for the HSI, which is higher than the 16% for FTSE and the 9% for Dow). As financial stocks were hit most by the debt problems in the US and Europe, the Hong Kong market was affected disproportionately.
   (c) A heavy weighting of Hong Kong in global indices. For example, for MSCI, the weighting was reported to be around 3% to 4%, the second highest in Asia after Japan, compared to around 1% to 2% three years ago. The higher weightings resulted in larger movements of capital flows.

10. Trading in exchange-traded derivatives grew in 2011, while trading in the cash market was moderate. In 2011, the average daily trading in the cash market rose 1% while that in futures and options increased 20% and 25% respectively from 2010.

11. Looking forward, major markets will continue to face significant headwind. The US and European debt problems appear to have become increasingly complicated and may last for some time. Further downgrading of credit ratings of sovereigns and financial institutions will dampen markets worldwide. Political elections in various countries may affect the economy and the pace of reforms. Uncertainties about economic outlook will affect market sentiment. In the Mainland, uncertainties about inflation and economic outlook as well as monetary policies will continue to weigh on sentiment. All these factors will have implications for the Hong Kong market.

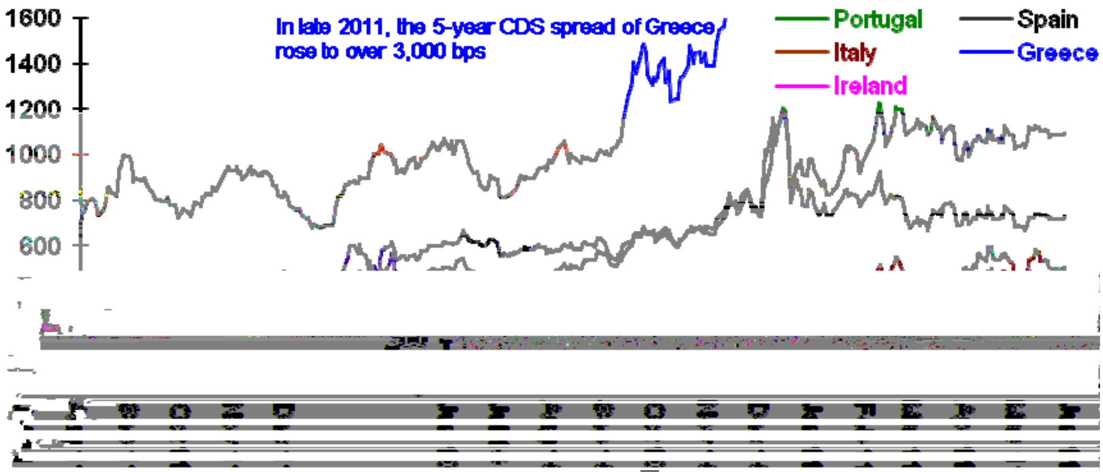
Performance of worldwide stock markets in 2011

12. In 2011, major markets around the globe were confronted by a number of uncertainties. The US credit rating was downgraded, and there were concerns about US banks given their exposures to European debt, affecting market sentiment. Later, the US markets generally outperformed given a positive

European rescue facilities. Concerns also grew of a possible debt restructuring in Greece and a spread of the Eurozone debt problems to bigger nations including Italy, Spain and France. Greece was downgraded by Moody's to Ca and by S&P's to CC in July. Italy's credit rating was also downgraded to A by S&P's in September and to A2 by Moody's in October. In October, Spain's credit rating was also downgraded by S&P's to AA- and by Moody's to A1.

17. In late 2011, investors were worried that France might lose its top sovereign rating. Also, 10-year bond yields in Italy and Spain rose above 7%, the level at which Ireland and Portugal had to seek bailouts previously. The higher borrowing costs added to uncertainties about the sustainability of their public finances. Moreover, there were worries that the austerity measures in Italy and Spain might have a negative impact on economic growth in the Eurozone. Disagreement among European leaders on how to alleviate the debt problems paced losses, and increased worries of the possible breakup of the Eurozone. There was also concern about the financial strength of European banks, given their huge exposures to debt in the Eurozone. In addition, political uncertainties weighed on the market as Greece and Italy changed their prime ministers. In December, S&P's warned of a possible cut in the credit ratings of 15 Eurozone countries and some major European financial institutions. The European Central Bank's highly anticipated 25 bps cut in interest rate in early December gave limited support to the markets. The European Central Bank subsequently launched the Long Term Refinancing Operation to ease banks' liquidity drains.

18. By the end of 2011, the FTSE, DAX and CAC had fallen 5.6%, 14.7% and 17.0% respectively, while the PIIGS markets had plunged 13.1% to 51.9% (except Ireland, which rose 0.6%).



Five-year credit default swap (CDS) spreads (basis points)

Source: Bloomberg

Asia

19. During 2011, the Japanese market retreated amid concerns about its economic performance. In March 2011, Japan was hit by a massive 9.0-magnitude earthquake. The subsequent tsunami and radiation leakage shook not only Japan's economy but also stock markets around the world. In August 2011, Moody's downgraded Japan's sovereign rating

from Aa2 to Aa3 as sluggish economic growth added to concerns about fiscal deficits. The persistent strength of the Yen also added pressure to the market. By the end of 2011, the Nikkei was 17.3% lower than its end-2010 level.

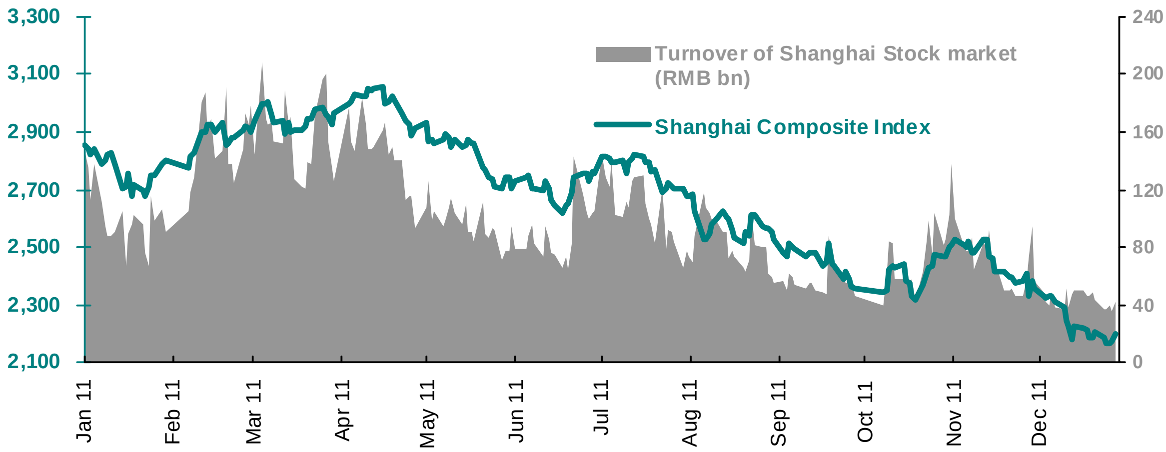
20. Concerns remained that the European sovereign debt problems might affect regional economies, since some Asian countries rely on exports to Europe and trade financing from European banks. Compared to their end-2010 levels, the performance of benchmark indices in Asia ranged from a loss of 27.5% in Vietnam to a gain of 4.1% in the Philippines.

The European Sovereign Debt Problem

21. In 2011, risks brought about by the European debt problem to the global market grew. While market attention previously focused on smaller nations, primarily Greece, there were growing concerns of contagion to bigger nations such as Italy, Spain and France. The problem also

three times to 3.5% during 2011. There were also worries about local government debt problems and the tightening of liquidity conditions. Authorities introduced measures to curb property prices such as property tax in some cities and bans on buying second homes.

27. GDP growth eased somewhat to 9.1% in Q3 2011 from 9.7% in Q1 and 9.5% in Q2, raising worries about the risk of a hard landing. Effective 5 December 2011, the PBoC lowered the reserve requirement ratio by 50 bps, the first time in three years. While consumer price inflation eased, there were uncertainties about a possible slowdown in economic growth given a slowdown in the growth of industrial production and exports. In late December, the Shanghai Composite Index fell to below 2,200 points, a 33-month low, and by the end of 2011, the Shanghai Composite Index had dropped 21.7% from its end-2010 level.



Shanghai Composite Index

Source: Bloomberg

Hong Kong

28. The Hong Kong market rose briefly in early 2011 but retreated in the aftermath of the natural disasters and nuclear crisis in Japan. Volatile oil prices amid the political unrest in the MENA region also hit the market. Later, market sentiment was clouded by the deterioration of the European sovereign debt problems and the downgrading of the US credit rating. Investors were worried about the effectiveness of the measures to solve the European debt problem and the gloomy economic outlook. Investors were also concerned about further macro tightening measures in the Mainland.

29. The HSI and HSCEI bottomed to around 16,000 and 8,100 in early October. By the end of 2011, the HSI and the HSCEI had dropped 20.0% and 21.7% respectively from their end-2010 levels. The Hong Kong stock market underperformed most other major markets. This was partly due to the following:

(a) A high participation of European and US investors in the Hong Kong market – among overseas investors, European and US investors are the largest group, accounting for around 70% of trading by overseas investors in Hong Kong. The performance of the Hong Kong market is therefore susceptible to changes in their sentiment.

(b) Heavy weighting of financial stocks in the HSI – the weighting of financial stocks in the HSI was around 45%, which was much higher than that of other benchmark indices such as the FTSE (16%) and Dow (9%). As financial stocks were hit the most by the debt problems in the US and Europe, the Hong Kong market was affected disproportionately.

(c) Heavy weightings of Hong Kong in global indices – the current weightings of Hong Kong in global indices such as the MSCI and FTSE were high. For MSCI, the current weighting was reported to be around 3% to 4%, the second highest in Asia after Japan. These were higher than the around 1% to 2% of three years ago. Capital flows are triggered as fund managers adjust their portfolios for funds tracking benchmark indices. The higher weightings resulted in larger movements of capital flows.

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

		2011	2010	2009
Futures	HSI Futures	94,036	84,462	89,368
	Mini-HSI Futures	41,933	33,336	32,761
	HSCEI Futures	61,116	49,919	59,428
	Mini-HSCEI Futures	7,516	3,985	1,726
	Stock Futures	1,809	961	1,058
	3-Month HIBOR Futures	2	4	98
	Gold Futures	15	23	62
	Other futures products*	263	27	4
	Total Futures	**206,688**	**172,717**	**184,505**
Options	HSI Options	43,452	34,197	15,723
	Mini-HSI Options	3,888	1,939	646
	HSCEI Options	15,364	11,690	6,642
	Stock Options	302,750	245,485	225,074
	Other options products**	133	55	2
	Total Options	**365,586**	**293,365**	**248,087**
Total Futures and Options		**572,275**	**466,082**	**398,134**

Remarks:
The average daily trading volume was based on the number of trading days after the product was launched.
* One-Month HIBOR Futures, Three-year Exchange Fund Note Futures, Hang Seng China H-Financials Index Futures, FTSE/Xinhua China 25 Index Futures, HSI Dividend Point Index Futures (launched on 1 November 2010) and HSCEI Dividend Point Index Futures (launched on 1 November 2010)
** FTSE/Xinhua China 25 Index Options, Flexible Hang Seng Index Options and Flexible H-shares Index Options

Sources: HKEx and SFC ReseEx a FTSEd616 6es I06a FTSEd616 6es7.6(China H-)-5.1(Fina56)es 77583 Tw(35wC