Research Paper No. 51: Half yearly review of the global and local securities markets

25 July 2012

Executive summary

1. In early 2012, stock markets around the world advanced on solid economic data. However, from April, most markets became more volatile amid worsening Eurozone debt problems and concerns about the global economic outlook.

2. In early 2012, US markets reached multi-year highs amid optimism over an economic recovery. However, from April, the markets became volatile again amid uncertainties about the Eurozone debt problems. Concerns about Greece's possible default and exit from the Euro weighed on the markets. In June, the markets recovered given optimism about market stabilisation measures to deal with the Eurozone debt problems. As at the end of June 2012, the Dow, Nasdaq and S&P500 were respectively 5.4%, 12.7% and 8.3% higher than their end-2011 levels.

3. In the first quarter of 2012, European markets rose given solid economic data worldwide and easing worries over the Eurozone debt problems. However, the downgrading of the credit ratings of some European sovereigns weighed on sentiment. There were also worries about a possible default of Greek debts and its exit from the Euro. Concerns about the solvency of banks in Spain also weighed on the markets. In late June, European policymakers unveiled measures to stabilise markets and recapitalise banks. This provided support to the markets. The DAX and CAC ended the first half of 2012 8.8% and 1.2% higher respectively while the FTSE ended flat. Meanwhile, markets in the PIIGS countries (i.e. Portugal, Ireland, Italy, Greece and Spain) fell between 5.4% and 17.1%, except for the Irish market, which ended 8.5% higher than its end-2011 level.

4. Major Asian markets advanced in the first quarter of 2012, following major overseas markets. However, gains were trimmed from April amid a gloomy economic outlook and the worsening debt problems in the Eurozone. By the end of June 2012, major Asian markets managed to record gains ranging from 0.6% in Australia to 20.1% in Vietnam.

5. The Mainland market rose during early 2012 on optimism over monetary easing. The reserve requirement ratio was cut by a total of 100 basis points (bps) in February and May. Optimism about supportive government policies paced gains. However, some gains were trimmed amid concerns about the Mainland's economic slowdown and the Eurozone debt problems. In early June, the central bank cut interest rates by 25 bps, the first cut since 2008. However, the market remained weak given concerns about the risks of a possible slowdown in the economy. During the first half of 2012, the Shanghai Composite Index was up only 1.2% from its end-2011 level.

6. The Hong Kong stock market rose in early 2012 amid optimism about further policy easing in the Mainland and robust economic data in the US. However, these gains were largely erased in May amid concerns about the debt problems in the Eurozone and risks of an economic slowdown in the Mainland. In June, the market recovered following a rebound in the US markets. As at the end of June 2012, the Hang Seng Index (HSI) was 5.5% higher than its end-2011 level while the HSCEI was 3.6% lower.

(b) European and US investors make up a large part of the investor base in Hong Kong – European and US investors accounted for about 70% of trading by overseas investors in the Hong Kong market. Changes in their sentiment can therefore have a significant impact on the market performance here.
(c) High weightings of Hong Kong in MSCI and FTSE indices (For MSCI, the weighting is around 3-4%, the second highest in Asia after Japan, compared to the level of 1-2% three years ago). Many funds track such benchmark indices. As they adjust their portfolios, this can cause more capital flows into and out of Hong Kong; and
(d) There is a heavy weighting of financial stocks in the HSI – Financial stocks make up about 47% of the HSI, which is significantly higher than for FTSE (16%), Dow (10%) and S&P500 (13%). As financial stocks were hit the most by the debt problems in the Eurozone, the Hong Kong market was affected accordingly.

8. The global market outlook will continue to hinge on the Eurozone debt problems and the worldwide economic situation. In the US, economic recovery remains fragile while the prospect of further monetary easing is uncertain. In Europe, investors remain concerned about the possible contagion of the debt problems. In the Mainland, worries about the risks of a possible slowdown in the economy continue to weigh on sentiment. Major developments in the Mainland and overseas markets will continue to have implications for the Hong Kong market.

9. European financial institutions are important players in the Hong Kong market. The combined share of major German and French financial institutions (in terms of cash market turnover) was about 11.1% during the first half of 2012. In the derivatives market, these institutions accounted for 6.8% of the trading in HSI futures and 9.1% in HSCEI futures.

10. Trading in the cash market and exchange-traded derivatives fell in the first half of 2012. Average daily trading in the cash market fell by 14%, while trading in futures and options decreased by 12% and 21% respectively.

Performance of stock markets in the first half of 2012

11. In early 2012, stock markets around the world advanced on solid economic data. However, from April, most markets became more volatile amid worsening Eurozone debt problems and concerns about the global economic outlook:

- The US markets seemed comparatively resilient and benchmark indices managed to stay in positive territory during the first half of 2012.
- Most major European markets ended the first half higher, but the PIIGS markets mostly fell.
- In the Mainland, the market rose, encouraged by optimism over government policy support. However, gains were limited by worries about risks of a possible slowdown in the economy.
- In Hong Kong too the HSI rose initially, but gains were later trimmed amid a worsening economic outlook for the Mainland and global economies, as well as increasing concerns about the Eurozone debt problems.

Performance of major stock markets

		end June 2012	% change	
		Index	YTD	during 2011
Hong Kong and Mainland				
Hong Kong	-HSI	19,441.46	5.5%	-20.0%
	-HSCEI	9,574.84	-3.6%	-21.7%
China	-Shanghai Comp	2,225.43	1.2%	-21.7%
	-Shenzhen Comp	921.41	6.3%	-32.9%
Asia				
Japan	-Nikkei 225	9,006.78	6.5%	-17.3%
Australia	-AOI	4,135.46	0.6%	-15.2%
Taiwan	-TWSE	7,296.28	3.2%	-21.2%
Korea	-KOSPI	1,854.01	1.5%	-11.0%
Singapore	-STI	2,878.45	8.8%	-17.0%
Thailand	-SET	1,172.11	14.3%	-0.7%
Malaysia	-KLCI	1,599.15	4.5%	0.8%
Indonesia	-JCI	3,955.58	3.5%	3.2%

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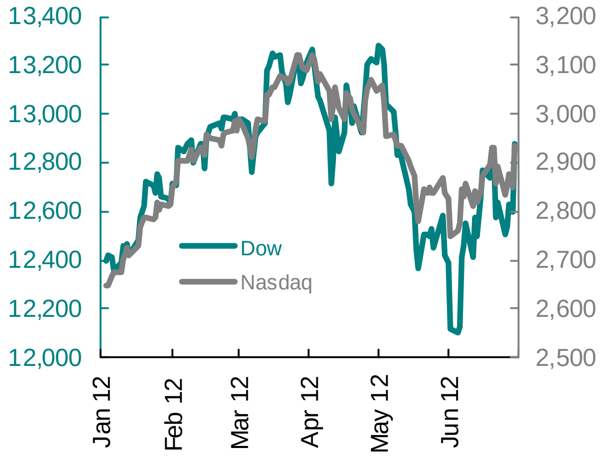
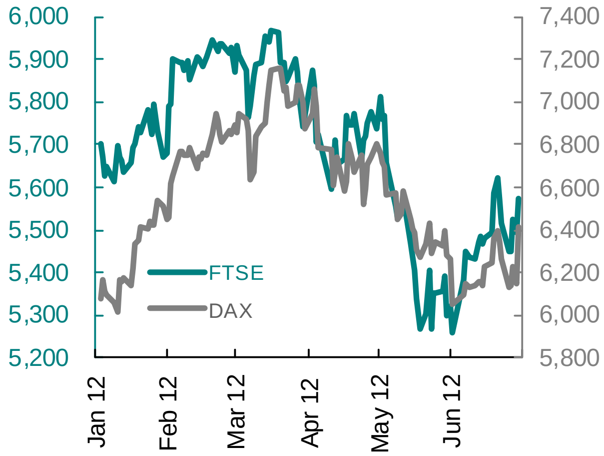


Performance of the Dow and Nasdaq



Performance of the FTSE and DAX

Source: Bloomberg

Europe

15. The performance of European markets during the first half of 2012 was mixed. The DAX and CAC ended the first half at 8.8% and 1.2% respectively above their end 2011 levels, while the FTSE ended flat. The Greek market once tumbled 22.8% to a 22-year low. The Spanish market also slid 28.9% to a nine-year low, while the Italian market once dropped 14.7% to its lowest level since October 2009.

16. During the first quarter of 2012, European markets rose on the back of solid economic data worldwide. Worries over the Eurozone debt problems also eased after Greece's successful debt restructuring and the International Monetary Fund's (IMF) proposal to raise additional bailout funds to tackle the debt problems.

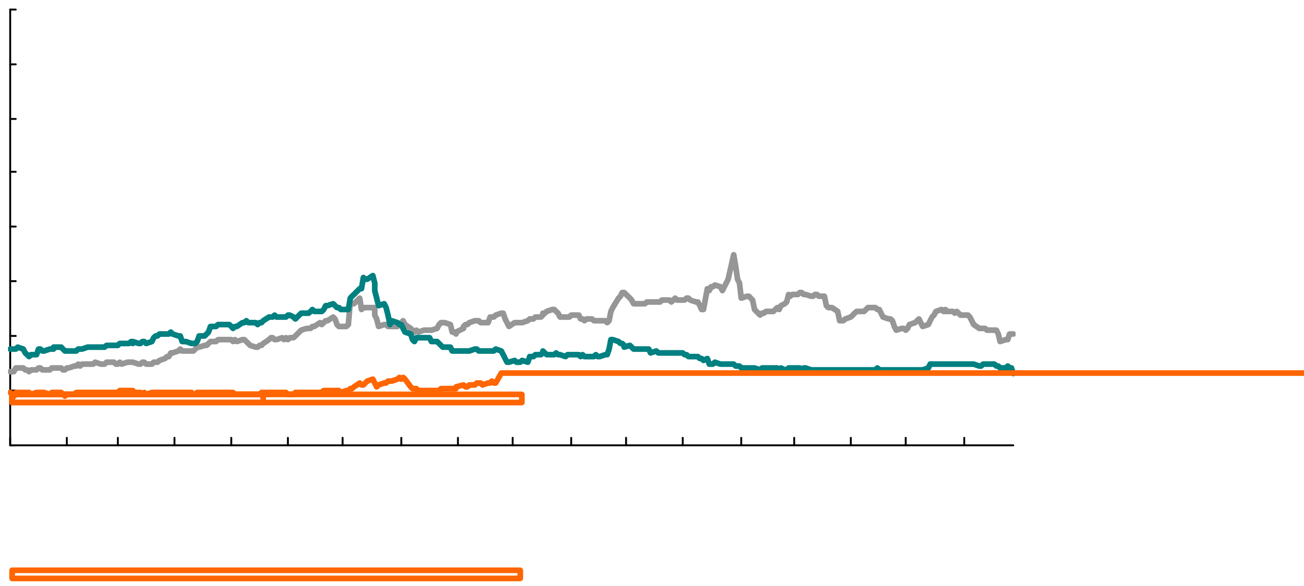
17. However, in April, worries about the Eurozone debt problems re-surfaced when the credit ratings of several European sovereigns including France, Italy and Spain were downgraded, and yields on Spanish and Italian bonds increased sharply. Although the European Central Bank kept interest rates unchanged at 1%, and deployed the Securities Markets Programme to purchase Eurozone debts, these measures provided limited support for markets. Worries over the Eurozone debt problems intensified further after elections in France and Greece in early May. There were concerns that political uncertainties in the region might undermine authorities' efforts to tackle the debt problems.

18. In Greece, after the first congress election in May, the anti- and pro-bailout parties failed to form a coalition government due to a split in views over the bailout terms set by the European Union (EU) and IMF. The political deadlock heightened worries that Greece might reject an international bailout agreement, default on its debts and eventually exit the Euro. However, with the pro-bailout parties winning the second congress election in June, fears over a near-term exit of Greece from the Euro eased somewhat.

19. There were also concerns about the stability of the banking sector in Spain. The Spanish government nationalised Bankia, the fourth largest bank in the country. Rumours about substantial cash withdrawals from banks by depositors also paced losses. In addition, there was news about the deteriorating fiscal condition of the country's municipal governments. In early June, concerns about the solvency of Spanish banks eased as the EU agreed on a 100 billion euro-bailout plan for Spanish banks. In late June, European

policymakers unveiled measures to stabilise markets and recapitalise banks, providing support to the market.

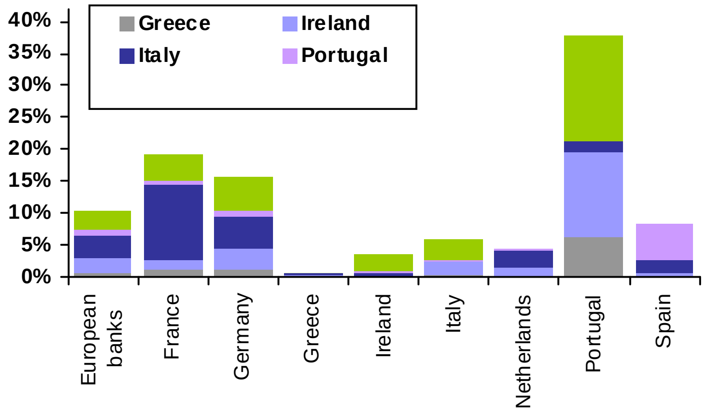
20. The credit default swap spreads of European sovereigns and financial institutions rose in 2012 while the yields of major debt-laden countries also surged. The 10-year Spanish bond yield hit a record high and broke the 7% mark, a level which investors generally perceive as a sign for triggering international bailout.



European Sovereign Debt Problems

22. Since 2010, the Eurozone debt problems have affected investor sentiment and increased market volatility. Investors initially focused on smaller nations, such as Greece, Portugal and Ireland. However, there were growing concerns of contagion to bigger nations such as Spain, Italy and France.

23. Greece has been the main concern over the years, but the impact of a possible writedown of the Greek debt varies. For European banks as a whole, the impact may be relatively limited since the claims of European banks on Greece amount to only about 0.6% of their total foreign claims. However, the impact on the banks of a particular country (and hence, the impact on that country) may be much larger. For instance, the exposure of Portuguese banks to Greek debts account for 6.2% of their total foreign claims.



The Mainland

32. The Hong Kong market is structurally prone to be more volatile for these reasons:

(a) Large-cap companies listed in Hong Kong derive a significant portion of their revenues from outside Hong Kong – A large number of HSI constituents are Mainland companies, generating revenues largely from the Mainland. Out of the 49 HSI constituents, 21 are Mainland companies (including 11 H-shares and 10 red chips[1], together accounting for almost half of the HSI weightings). About 85% of the revenues of the 20 largest constituent stocks in the HSI (which account for some

Risks and uncertainties over financial markets and economic outlook

33. It is likely that the global market outlook will continue to hinge on the Eurozone debt problems and the worldwide economic situation. Major markets are facing the following potential risks:

    (a) Europe: The prospects of the European markets will remain uncertain, clouded by the Eurozone debt problems and changes in governments as well as the downgrading of various European sovereigns and global banks. While Greece's pro-bailout parties won the second election, investors remain cautious about the stance of the new leaders towards austerity measures and bailout plans. Effectiveness of bailout plans on the European banks and the financial system of Eurozone countries will weigh on the markets. Worries about the risks of recession in Europe will also affect market sentiment.

    (b) The US: Economic recovery in the US remains fragile while the prospect of further monetary easing is uncertain. The market is also susceptible to spillovers from the Eurozone debt problems. The presidential election in November will be another important factor affecting market outlook.

    (c) The Mainland: Worries about the risks of a hard landing for the Mainland economy will continue to weigh on sentiment. The Central Government's possible supportive policies as well as fiscal and monetary stimulus will impact economic growth and have implications for the market.

    (d) Hong Kong: The economic outlook in the US and developments in the Eurozone debt problems will affect the stock market performance in Hong Kong. As a proxy for capturing growth in the Mainland, any major developments in the Mainland will also have implications for the Hong Kong market.

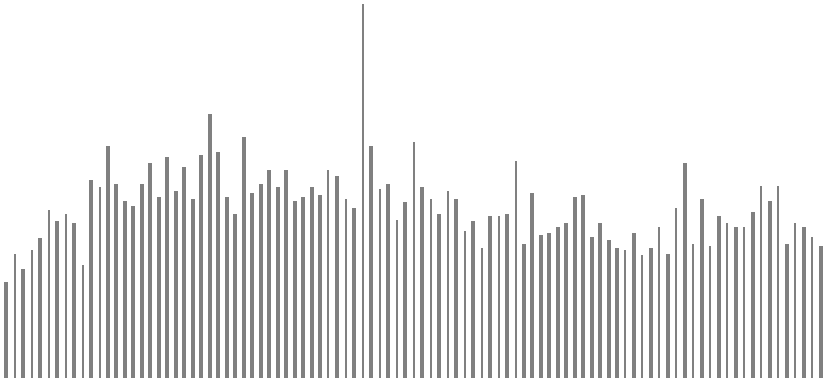
Trading activity in the local stock market

34. Trading in the local stock market remained active in early 2012 amid optimistic market sentiment. However, trading became sluggish from April as the market began to correct. During the first half of 2012, the average daily turnover amounted to $57 billion[2], 14% lower than its $66 billion level in the second half of 2011 and 23% lower than its $74 billion level in the first half of 2011.

35. Mainland stocks remained the most actively traded stocks. Its share of total market turnover was 38% in the first half of 2012, while that of HSI stocks (excluding H-shares and red chips) was about 15%.

Average daily turnover ($ bn)

	1H 2012		2H 2011		1H 2011		% change over	
							2H 2011	1H 2011
HSI (ex H shares & red chips)	8.6	(15%)	8.7	(13%)	10.5	(14%)	-1%	-18%senti02 refs43



40. Trading in CBBCs decreased both in absolute terms and as a percentage of the total market turnover. The average daily turnover of CBBCs decreased to $7.0 billion (12.3% of total market turnover), compared to $9.3 billion (14.0% of total market turnover) in the second half of 2011.