Research Paper No. 60: A

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Executive Summary

1. In the

Performance of stock markets during 2016

8. During 2016, most major markets rose on the back of abundant market liquidity, shored up by optimism about the US President-elect's promise of supportive economic initiatives. While concerns about US interest rate hikes and political uncertainties following the United Kingdom's (UK) vote to leave the European Union (EU) did weigh on investor sentiment, optimism prevailed in the US and Europe. The Mainland market fell on worries and uncertainties about the country's economic outlook and a weakening of the renminbi, trimming gains in the Hong Kong market.

The US

9. The US market advanced, supported by abundant market liquidity in a low interest rate environment. All major indexes hit record highs. By the end of 2016, the Dow, S&P and Nasdaq rose 13.4%, 9.5% and 7.5% respectively.

10. In early 2016, the US market dropped amid uncertainties about the global economic outlook and volatile commodity prices. At one point, oil prices fell below a 12-year low of US$30 on concerns about global oversupply and weak demand. The depreciation of the renminbi also weighed on investor sentiment.

11. The US market witnessed a strong rebound in February due to easing concerns about monetary tightening. Investor optimism was lifted as the Fed hinted at a possible slowdown in the pace of interest rate hikes amid concerns about financial market volatility and a weakening economic outlook. Stimulus policies by major central banks and a recovery in oil prices also paced gains.

12. In June, the market fell on investor disappointment that the UK voted to leave the EU. However, the market recovered quickly on easing concerns about the impact of Brexit. Expectations of further supportive measures by major governments and central banks boosted investor sentiment.

13. In early November, the market declined on heightening worries about the outcome of the US presidential election but later advanced amid promises of the President-elect's tax cut and infrastructure spending initiatives. Upbeat economic data and corporate earnings also provided support.

14. Post-election gains extended into December. The US Dollar Index rose to a 14-year high. Investors perceived that some policy initiatives by the President-elect would be reflationary. In December, the Fed raised interest rates by 25 basis points, as widely expected, and projected about three hikes for 2017. The 10-year government bond yield hit 2.597%, the highest level since September 2014. The US market hovered near its historical high despite mixed economic data and valuation concerns. The price-to-earnings (PE) ratios for the Dow and the S&P reached 19 times and 21 times respectively, both

increased, while the British pound hit its lowest level against the US dollar since 1985. S&P Global Ratings and Fitch Ratings downgraded the UK's credit rating, whilst Moody's Investors Service lowered the UK's rating outlook from stable to negative.

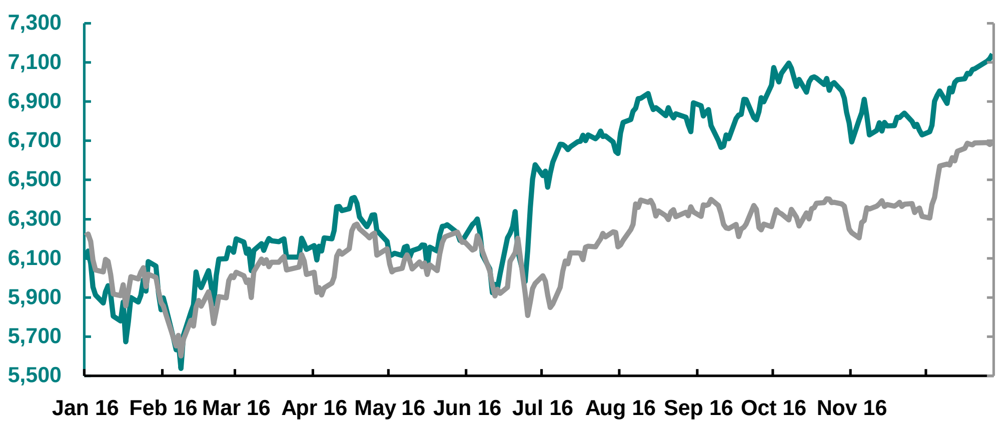
18. The mood changed later in the year, with major European markets rebounding strongly as worries about Brexit eased amid hopes for central bank stimulus to support markets and the economy.

19. The Bank of England beat market expectations and the FTSE outperformed other major European markets. The monetary stimulus package in August was larger than expected, and included a rate cut to a record-low level of 0.25% and a £60 billion quantitative easing programme. Large caps led gains on hopes that a weaker British pound might translate into stronger overseas revenue. Energy stocks also rose on higher oil prices after the Organization of the Petroleum Exporting Countries agreed to cut production.

20. However, concerns loomed and capped gains. The financial soundness of some German and Italian banks created some anxiety and added pressure on European markets. In addition, Brexit concerns revived after the new UK Prime Minister announced plans to begin the formal Brexit negotiation process by March 2017. Finally, political uncertainties about the US presidential election in November and the Italian referendum in December also weighed on sentiment.

21. Optimism returned in early December, as the ECB extended its bond-purchase programme until end-2017, although the size of stimulus was reduced by €20 billion to €60 billion per month from April 2017. Markets also gained amid optimism about the restructuring plan for, and state bailout of, Italian banks. Post-election gains in the US further lifted investor sentiment.

Performance of FTSE and DAX during 2016



Source: Bloomberg

Asia

22. In Japan, the Nikkei 225 Index rose 0.4% in 2016, marking the fifth consecutive year of gains. Initially, despite the negative interest rate policy adopted by the Bank of Japan in early 2016, the market fluctuated in negative territory amid fading hopes for further government stimulus measures. The decline continued in the wake of the Brexit vote in mid-2016. The yen, however, strengthened to a two-year high of 99.89 on increased demand for safe-haven investments. The market rose towards the end of the year as the yen weakened to a 10-month low of 118.18 following the Bank of Japan's decision to purchase bonds in November and amid US dollar strengthening on the back of the US interest rate hike in December.

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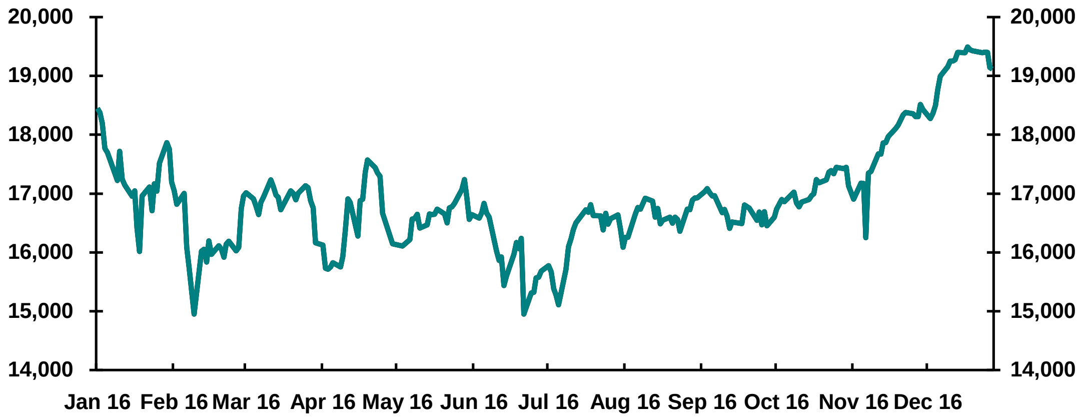
23. The performance of other major Asian markets was mixed in 2016, ranging from a 3% drop in Malaysia to a 19.8% increase in Thailand.

Performance of Nikkei during 2016



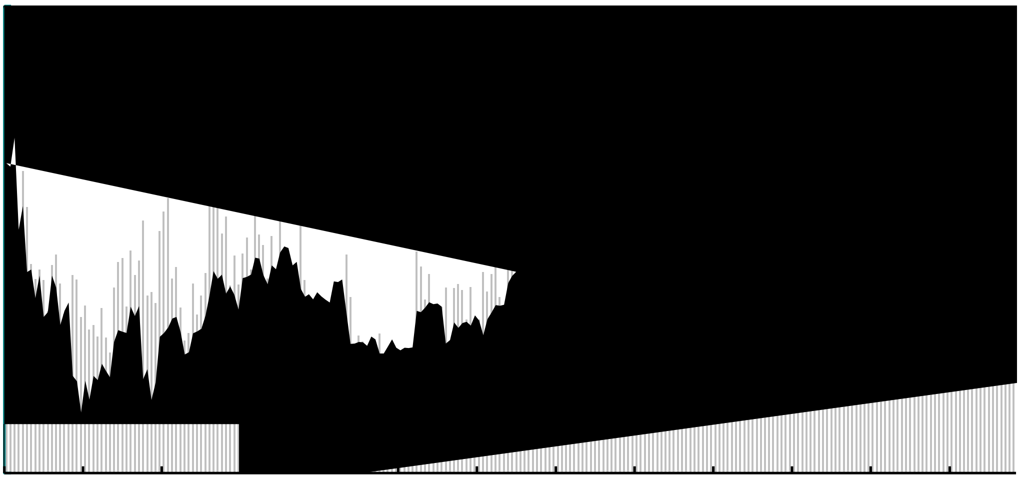
Source: Bloomberg

The Mainland

24. After recording substantial gains in 2014 and 2015, the SHCOMP dropped 12.3% and the SZCOMP fell 14.7% in 2016. The average daily turnover in the Mainland market decreased 50.2% to RMB519.1

29. Market participants commented that, given a lack of investment tools in the domestic market, the buoyant liquidity in the financial system led to a succession of asset bubbles, ranging from a housing frenzy to a commodity boom. Measures to curb excessive speculation proved challenging to policymakers, as efforts to curtail a specific sector seemingly gave rise to price inflation in other sectors; hot money appeared to shift across different asset classes. In particular, this was observed in the property and bond markets which had heated up after the stock-market correction in mid-2015. This happened again with the boom in the commodity market as measures were rolled out to cool the housing rally and tighten leverage in the bond market in late 2016.

SHCOMP and market turnover (RMB billion) during 2016



Source: Bloomberg

SZCOMP and market turnover (RMB billion) during 2016

Source: Bloomberg

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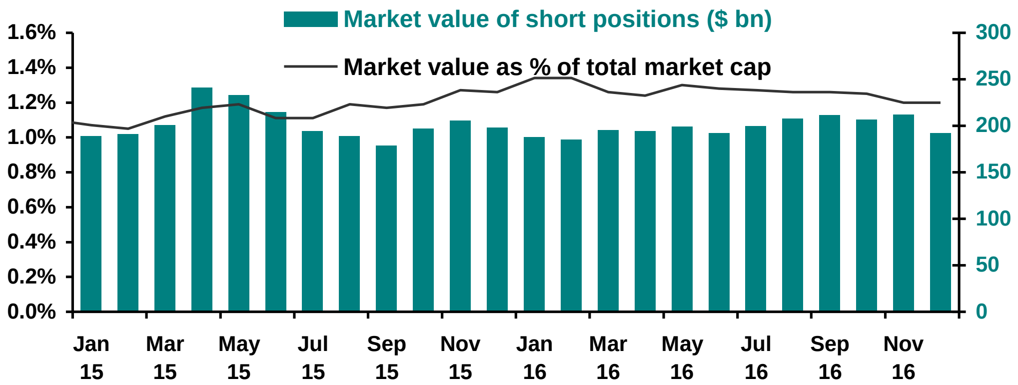
44. Based on data submitted to the SFC, as at 30 December 2016, the aggregated short positions amounted to $192 billion (or 1.2% of the market cap of the reported stocks).

Market value of short positions ($ billion) during 2016



Source: SFC Research

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

		2016	2015	2014
Futures	HSI Futures	130,826	85,991	69,098
	Mini-HSI Futures	50,516	40,674	28,177
	HSCEI Futures	133,729	135,139	89,005
	Mini-HSCEI Futures	19,718	30,391	13,884
	Stock Futures			