HONG KONG
MARKET REPORT FOR ASF2009

HONG KONG SECURITIES ASSOCIATION
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Worldwide Financial Market Conditions

The Financial Tsunami of 2008 originated out of the US where a series of defaults on subprime mortgages caused financial havoc on a whole range of financial assets initially, and subsequently spread to other physical assets. The wide reach of US financial institutions meant that US financial assets found their way into the portfolios of almost every investor class throughout the world. As banks began to question the solvency of other banks, liquidity dried up and even the most prime of borrowers suddenly found themselves frozen out of the credit markets.

In an effort to restore liquidity to the capital and credit markets, Governments around the world announced stimulus plans to boost growth while central banks introduced expansionary monetary measures. As at the end 2008, major markets had tumbled between 31.3% to 66% from their end-2007 levels.

The US subprime problem began to surface in 2007. HSBC shocked the markets by announcing losses on subprime and related instruments. Other financial institutions soon followed by reporting losses in related investments, such as collateralised debt obligations (CDOs) and asset-backed securities (ABS). Credit markets tightened as banks hesitated to lend to each other because of concerns over counterparty default risks. This, in turn, further worsened corporate liquidity conditions.

In March 2008, Bear Stearns faced serious liquidity problem and was eventually rescued by JPMorgan on the back of a guarantee from the US government. The credit and capital markets breathed a collective sigh of relief. This proofed to be to soon as a series of problems began unraveling culminating in the disastrous month of September when:

- Fannie Mae and Freddie Mac, were bailed out by the US government
- Lehman Brothers filed for bankruptcy protection
- AIG, which had also reported significant liquidity problems, was rescued with emergency funding from the US government
- Merrill Lynch was forced into a shotgun marriage with Bank of America
- Morgan Stanley and Goldman Sachs applied to become commercial banks

In the course of 6 months the 5 largest investment banks in the US and arguably in the world disappeared.

Economic Downturn

The problems in the financial industry overflowed into the broader economy. Corporations faced difficulties in obtaining loans for their daily operations and had to curb spending and investments. Unemployment worries and falling home values also crimped consumer spending. The US economy entered a recession to a degree not seen in decades.

Market Supportive Measures

The financial crisis and sharp economic slowdown which occurred in the latter part of 2008 galvanised many governments and central banks worldwide into introducing various measures to stabilise financial markets and to stimulate growth. These include interest rate cuts, quantitative easing, capital injection to financial institutions, tax cuts, etc.

To ease the credit crunch, central banks around the world injected liquidity into the banking system and cut interest rates during 2008. The US Federal Reserve cut the Fed Funds Target Rate to 0% to 0.25% from 4.25% as of the end of 2007. Other central banks also cut their benchmark interest rates to historical or multi-year lows.

Governments and central banks around the world launched rescue packages to help the financial sector, including plans to purchase troubled assets, moves to acquire shares of banks and to guarantee deposits. In early October, the US government approved a bailout plan of about US$700 billion. The combination of interest rate cuts and the rescue plans had the desired effect of restoring market confidence. Credit markets eased somewhat, with the three-month US dollar London Interbank Overnight Rate (LIBOR) falling to below 1.5% in late December from 4.8% in October.

The US government introduced stimulus packages, such as a bundle of growth-stimulating measures costing US$787 billion and a US$700 billion Troubled Asset Relief Program to clear distressed assets at financial institutions. As these supportive measures took time to take hold, the US gross domestic product (GDP) dropped 2.6% year on year in the first quarter of 2009 and the unemployment rate rose to 9.5% in June. Nevertheless, some economic indicators such as the housing and manufacturing data showed early signs of recovery. This buoyed investor expectations of a recovery by late 2009 or early 2010. In addition, the financial stimulus packages and the declaration of voluntary bankruptcy of major automakers eased uncertainties over the banking and auto sectors. Positive news also emerged from the stress test on 19 US-based banks, which showed that the capital shortfall at these banks was manageable.

Market Performance: US/Europe

On 10 March 2008, immediately after the collapse of Bear Stearns, the Dow was 11.5% lower than its end-2007 level. While markets rebounded strongly after the Fed and JPMorgan rescued the bank, concerns over the health of financial institutions in general and economic worries kept weighing on equities. In September, the collapse of the top two mortgage lenders and Lehman Brothers sparked another round of financial turmoil and heightened recession fears. In November, markets reached their bottoms for the year, and later stabilising somewhat on hopes of various stimulus plans. During the year, the Dow and the S&P500 tumbled 33.8% and 38.5% respectively, posting their biggest yearly declines since 1930's. Nasdaq fell 40.5%, its biggest decline ever.

The intra-day volatility of the Dow rose to an average of 2.7% in 2008, compared to 1.1% in 2007 and 2.1% in 1987. The implied volatility of the S&P500 options retreated to 35.6% as at the end of 2008 from the peak of 70% during the year, but it was still at historical high levels.

In 2008, the FTSE, DAX and CAC lost 31.3%, 40.4% and 42.7% respectively.

In early 2009, the US and European markets continued to decline. Major benchmark indices reached their lows in early March on the back of adverse economic outlook and worries about distressed assets and capital shortfall of financial institutions. The liquidity problem *and possible bankruptcy of US automakers also dampened investor sentiment. In early March, major benchmark indices were about 20% – 25% lower than the end-2008 levels.*

During the 2nd quarter, major banks and some corporations reported better-than-expected earnings, and the results of the stress test of banks, and encouraging economic data also lent support to the market. Even the spread of H1N1 flu appeared to have limited impact on stock markets. As of the end of June 2009, the Dow recovered from low point in early March and was down 3.8% fro the year.

European markets also trimmed most of their earlier losses. By the end of June, the FTSE and CAC dropped 4.2% and 2.4% respectively whilst the DAX remained flat, compared to the end-2008 levels.

Asia

During 2008, regional markets fell on worsening economic outlook and investor sentiment. The strengthening of the yen (to 90.6 yen to the US dollar as at end 2008 from 111.8 a year ago) intensified the unwinding of carry trades and major benchmark indices in Asia tumbled, with losses ranging from 39.3% in Malaysia to 66 % in Vietnam. Most markets posted their biggest yearly declines historically or since the Asian financial crisis in 1997.

During the first half of 2009, Asian markets began to recover, with increases ranging from 7.9% in Australia to 49.5% in Indonesia on hopes of global economic recovery.

Mainland China

The performance of the Mainland market will be covered by the China Securities Association. However, the Mainland economy and Mainland enterprises have a disproportionate effect on HK. Mainland enterprises account for over 65% of the market capitalisation and over 70% of the turnover of the HK market, and to many international fund managers HK is seen as a proxy for the Mainland economy and market. All the major Mainland enterprises are dual listed in HK, and for international investors, HK has some advantages such as free movement of capital, no restrictions on foreign ownership, and a friendly tax regime.

At the start of 2008, a large part of the Mainland was hit by the biggest snowstorm in a decade. Consumer inflation rose to a 12-year high of 8.7% in February. In May, the massive earthquake in Sichuan caused further economic losses. In the first half of 2008, the People's Bank of China (PBoC) raised the bank reserve requirement ratio six times by a total of 300 basis points (bps) to 17.5% leading to concerns over an economic slowdown and monetary tightening to curb inflation.

In the second half, undermined by the worldwide financial turmoil, worries over an economic slowdown intensified. In addition, concerns about an oversupply of shares in the stock market (as lock-up periods under the share reform programme expired) also weighed on the stock market.

To avoid a hard landing of the economy, the PBoC shifted its policy stance from monetary tightening to easing. It cut the benchmark interest rate five times by a total of 216 bps and cut the bank reserve requirement ratio three times by a total of 200 bps during the second half. The government also introduced a RMB4 trillion stimulus plan to boost the economy. Markets began to stabilise thereafter.

After rising 97% in 2007, the Shanghai Composite Index fell to a low last October and closed the year with a loss of 65.4%, posting the biggest-ever yearly decline.

During the first half of 2009, the Mainland stock market was not much affected by slowing domestic economic growth amid the recession overseas. Despite the contraction in economic activities, the stock market advanced, buoyed by optimism over further economic stimuli. A total of RMB7.3 trillion in new loans have been made so far this year to boost consumption and infrastructure investment. This lifted hopes of sustainable economic growth in the Mainland. By the end of June of 2009, the Shanghai Composite Index rose 62.5% from the end-2008 level on expectation that the Mainland's economic recovery would outperform in terms of both pace and strength.

On the Mainland, after launching the RMB4 trillion fiscal stimulus plan in November 2008, the government continued to introduce various policies to lay the groundwork for possible growth in the economy and financial markets. Tax reforms, industry restructuring, regulatory reforms and development of financial markets would all help enhance the competitiveness of different industries. During the first half of 2009, economic growth slowed due to the global recession. Exports dropped by 22% year on year in the first half of 2009 whilst GDP growth slowed to 6.1% in the first quarter and consumer prices declined for the first time in six years.

Hong Kong

During 2008, the performance of the local markets largely tracked those overseas and the weak Mainland market weighed heavily on the Hang Seng Index (HIS).

On 17 March, undermined by losses in overseas markets due to the failure of Bear Stearns, the HSI was 24.2% lower than its end-2007 level. Although the market rebounded strongly later as overseas markets rallied, the rebound was short-lived.

In the second half, local markets were hurt again, this time, by the global financial turmoil. On 27 October, the HSI tumbled to the 2008 low of 11,016 points, the lowest level seen since May 2004.

In late 2008, following the stabilising of overseas market amid optimism over worldwide stimulus measures, local markets also recovered somewhat. For the whole of 2008, the HSI tumbled 48.3%, posting the biggest drop since 1974.

Market volatility surged with the intra-day volatility of the HSI averaging 2.7% during 2008, compared to 1.5% in 2007 and 2.8% in 1998 during the Asian Financial Crisis. The implied volatility of the HSI options also reached a record high of 132% but retreated to about 56% as at year-end.

In Hong Kong, GDP fell 7.8% year on year in the first quarter of 2009. The SAR government also announced various supportive measures to lift the local economy, namely, infrastructure projects, tax rebates and loan guarantees. The Mainland government also helped support *the Hong Kong economy and financial market through various initiatives, such as, the currency swap agreement, cross-border infrastructure projects, the broadening of Renminbi bond issuance, strengthening of economic cooperation and tourism.*

Trading Activities in the Local Stock Market

During 2008, the average daily turnover in the cash market fell 18.1% to $72.1 billion from $88.1 billion in 2007. On a monthly basis, the decline was more significant. During December 2008, the average daily turnover was $43.1 billion, 63.9% lower than $119.5 billion in January 2008.

However, it is worth noting that the decline in turnover value was very due mainly to a decline in stock prices. In actual fact, the turnover volume had increased. With HSI constituent stocks, for instance, the average daily trading volume rose 24.5% to 2.5 billion shares.

The proportion of equities trading by institutional brokers increased slightly to 68% in 2008 (compared to 63% in 2007). The proportion of retail brokers was 32% (37% in 2007).

During the first half of 2009, the Hong Kong market was initially affected by uncertainties over global economic performance and concerns about financial shares in the US. The HSI fell to a low of 11,344 on 9 March. Since then, local market have rebounded strongly amid optimism over global economic recovery, additional stimulus plans on the Mainland and concerted international efforts in stabilising financial markets and stimulating economies worldwide. Local property stocks outperformed on hopes of an economic recovery. In addition, strong capital inflow to the Hong Kong banking system and stock market also helped bring about a rebound. As of the end of June 2009, the HSI had risen 27.7% from the end-2008 levels.

The intra-day volatility of the HSI during the first half of 2009 dropped slightly to an average of 2.5% from the 2.7% level of 2008. The implied volatility of the HSI options also retreated steadily to 32% as at end June 2009 from 56% at end-2008.

During the first half of 2009, trading activity in the local stock market was moderate. The average daily turnover amounted to $58.3 billion, 2% higher than the level for the second half of 2008 and 33% lower than the level for the first half of 2008. Locally-listed Mainland stocks remained the most actively traded. The trading of HSI constituent stocks (excluding H-shares and red chips) was about 14% of the total.

The proportion of equity trading by institutional brokers decreased to 58% of the total during the first half of 2009 (compared to 68% in second half of 2008). The proportion of retail brokers rose in tandem to 42% from 32% in the same period.

Short-selling Activities

Short-selling activities increased in 2008, both in absolute terms and as a percentage of total trading. The increase probably was related to the sluggish market performance and more trading opportunities amid a more volatile market. Nevertheless, it is worth noting that there is no consistent relationship between market performance and changes in short selling activities.

During 2008, the average daily short-selling turnover was $5.4 billion in 2008 or 7.5% of the total market turnover (compared to $5.3 billion and 6% in 2007). Short-selling turnover in the fourth quarter was lower than the levels recorded earlier. During that quarter, the average daily short-selling turnover was $3.3 billion or 6.6% of the total market turnover, compared to $5.7 billion or 7.4% for the second quarter and $5.4 billion or 8.5% for the third quarter up to 19 September 2008 (i.e. shortly after Lehman Brothers collapsed).

During the first half of 2009, short selling dropped in both absolute terms and relative to total market turnover. No concentration either at stock level or at broker level was observed. Short selling averaged $3,301 million daily or 5.6% of the total market turnover, compared to $4,305 million or 7.5% for the second half of 2008.

IPO Activities and Performance

IPO activities slowed in 2008. Last year, 29 IPOs (27 on the main board and two on the Growth Enterprise Market) were launched. This was far lower than the total of 80 IPOs in 2007. The total fund raised by IPO was $66.0 billion, 77% lower than the $292.4 billion raised in 2007. Of
the 29 IPOs, four were H-share companies that raised a total of $29.5 billion, 61% lower than in 2007. On debut, 12 stocks fell below their IPO prices. As of year-end, the performance of the 29 IPOs ranged from a loss of 75.5% to a gain of 61.9% from their IPO prices.

IPO activities were sluggish initially during the first few months of 2009, but became more active in May and June. The local market launched 12 IPOs, raising a total of $17.4 billion in the first half of 2009, compared to 11 IPOs and $15.6 billion in the second half of 2008.

The performance of the 12 IPOs was mixed. On average, they rose 8.6% from their IPO prices on the first day of listing, with individual performance ranging from a loss of 11% to a gain of 39.2%. Subsequent performance was relatively more satisfactory. As of the end of June 2009, only one of them was below its IPO price, whilst the other 11 traded above IPO prices. Their loss/gain ranged from -11.9% to +283.8%.

Derivative Warrants

The market value and turnover of the derivative warrants market shrank in 2008. The shrinkage was in part due to increasing market volatility that resulted in a jump in the implied volatility of derivative warrants, which undermined their attractiveness. Investors therefore turned to Callable Bull/Bear Certificates (“CBBCs”), which are similar to derivative warrants but not subject to the impact of implied volatility. The smaller derivative warrants market was therefore offset by the growing CBBC market.

As at the end of 2008, there were 3,011 derivative warrants with a total market value of $4 billion (4,483 and $43.3 billion as at the end 2007). The average daily turnover of derivative warrants during 2008 was $14 billion, accounting for 19.5% of the total market turnover ($19.1 billion and 21.7% in 2007).

Trading in derivative warrants issued on the benchmark indices shifted to CBBCs. However, trading in derivative warrants issued on individual stocks did not follow this pattern. Therefore, total trading in derivative warrants and CBBCs remained relatively stable during 2008. Their aggregate trading accounted for 25.3% of total market turnover, compared to 22.0% in 2007.

Callable Bull/Bear Contracts

The CBBC market posted robust growth in 2008, underpinned by the entry of new issuers in the first half. As at the year-end, the number of issuers increased to 10, compared to only three as at the end of 2007. The number of CBBCs also rose nine times to 1,314 from 131 as at the end of 2007. Most were issued on the HSI and HSCEI. The CBBC market value rose 261% to $1.1 billion from $300 million as at the end of 2007. Trading activities surged, with turnover averaging $4.2 billion a day in 2008 or 5.9% of the market total (compared to $300 million or 0.3% in 2007).

During the first half of 2009, the average daily turnover of DWs dropped to $6 billion, or 10.3% of total market turnover, from $7 billion (12.2%) in the second half of 2008.

The trading of CBBCs increased in both absolute terms and as a percentage of total market turnover. In the first half of 2009, the average daily turnover of CBBCs rose to $6.8 billion, or 11.6% of total market turnover, from $6.3 billion (11%) in the second half of 2008.

Exchange Traded Funds

The ETF market continued to grow, with the addition of seven ETFs in 2008 that tracked regional indices and spot gold. This lifted the total number of ETFs to 24 as at year-end from 17 as at end-2007. The total ETF market value rose 152% to $266.5 billion at year-end from $105.6 billion at end- 2007. The average ETF daily turnover rose 177% to $1.8 billion or 2.5% of total market turnover during 2008 (compared to $0.7 billion and 0.7% in 2007).

The ETF market in Hong Kong continued to grow during 2009. The number of ETFs rose to 32 as of the end of June 2009 from 24 at the end of 2008. However, their average daily turnover dropped 15% to $1.7 billion during the first half of 2009 from $2 billion in the second half of 2008.

Exchange Traded Derivatives

Trading in the derivative contracts rose, while open interest dropped in 2008. During 2008, the average daily turnover in the futures market rose 38% to 184,040 contracts, compared to 133,566 contracts in 2007. While open interest in futures contracts fell 14% to 184,551 contracts as at the end of 2008, HSI futures and HSCEI futures remained the most actively traded among futures contracts. During the year, the average daily turnover in HSI futures was 89,368 contracts, accounting for 48.6% of all futures trading. The corresponding figures for HSCEI futures were 59,428 contracts or 32.3%.

For the options market, the average daily turnover was 248,086 contracts during 2008, up 10.0% from a year ago. Stock options were the most actively traded options, accounting for

90.7% of all options trading. As at the end of 2008, open interest in stock options counted 3,984,346 contracts, 25% lower than the end-2007 level.

Trading of futures products decreased during the first half of 2009. Among futures products, HSI futures remained the most actively traded, accounting for nearly half of all futures trading. The average daily trading volume for HSI futures decreased by 7.1% from the second half of 2008. The second most actively traded futures were HSCEI futures, whose trading volume decreased by 12.5% and accounted for nearly one-third of all futures trading. Open interest of HSI and HSCEI futures also dropped to 79,772 contracts and 71,607 contracts respectively.

In the options market, trading declined slightly during the first half of 2009. Stock options remained the most actively traded among options products, but its trading volume dropped 2.6% compared to its volume for the second half of 2008. The trading volume of the HSI options rose, whilst that of the HSCEI option products dropped.

Financial Review of the Securities Industry For the year ended 31 December 2008

The market turnover on The Stock Exchange of Hong Kong Limited (SEHK) contracted by 18% in 2008 as compared to that in 2007. The average daily turnover in 2008 was $72.1 billion versus that of $88.1 billion in 2007.

At the end of 2008, the Hang Seng Index closed at 14,387 points, 48% lower than the preceding year's closing.

The overall net profit of all SEHK participants in 2008 fell to $13.4 billion, a 59% drop from $32.4 billion in 2007. The net profits of Category A, B and C brokers were $8.25 billion, $4.95 billion and $0.16 billion respectively. The decrease in net profit of SEHK participants was mainly attributable to lower commission income and fee income.

As at the end of December 2008, the amount of margin loans stood at $17.2 billion, representing a decrease of 59% from the end of 2007. Average collateral coverage decreased as well, from 5.3 times as at the end of 2007 to 4.4 times as at the end of December 2008.

Uncertainties Over the Market and Economic Outlook

Despite a recent strong rebound of the global stock markets, fundamental support in the economy is not yet broad-based. Economic data show that the global economy is still shrinking and economic recovery looks tentative. The recent rally in the HK stock market seems to be underpinned by a strong capital inflow. Capital movements are known to be volatile and subject to sudden reversals. Meanwhile, rebounding commodity prices will add inflationary pressures and may force an end to the easy monetary conditions necessary to support recovery.

Comparison Between the Current Financial Crisis and the Great Depression in 1929

The US and European stock markets rebounded some 30% – 60%. from their lows in March 2009 until end-June on hopes of an economic recovery, and the ample liquidity generated by the trillion dollars stimulus plans of worldwide governments.

However, during the 1929 Great Depression, the US stock markets also experienced similar rebounds after falling to an intermediate bottom, but subsequently experienced further corrections again before reaching the genuine low.

The current financial crisis shares a number of similarities with the Great Depression. Before the Great Depression, investors were highly speculative, leveraged investment was common, and credit expanded rapidly prior to the stock market crash. In the current financial crisis, cheap credit after the burst of the tech bubble and the 9/11 incident inflated housing prices; financial institutions invested heavily in subprime mortgages whose collapse triggered the crisis. The losses were magnified by the complex and opaque derivative products and the high leverage of financial institutions. Eventually, many financial institutions were not able to withstand the losses and had to be rescued by governments.

Following the stock market crash in both crises, the credit market froze, leading to severe contractions in economic activities. There were waves of bank runs during the Great Depression. In the current financial crisis, commercial banks in the US and Europe were nationalised or bailed out by the governments. Deleveraging and the sale of assets at deep discounts were common in both crises.

In the Great Depression, the bear run of the stock market lasted for three years. The S&P500 dropped 86% from the peak in September 1929 to a low in June 1932. During those three years, the stock markets experienced 12 major rebounds and consolidations until it reached the genuine low. The S&P500 rose 12% - 46% in each rebound and dropped 25% - 61% in each consolidation. Therefore, compared to the rebounds during the Great Depression, the current 36% rebound of the S&P500 over a period of about three months was not particularly strong.

Nevertheless, it is also worth mentioning that the current economic and financial conditions are very different from the times of the Great Depression so the two crises are not strictly comparable.

- Shorter business cycles nowadays – Business cycles are much shorter now so the duration of the economic recession and the bear run of the stock market may be shorter compared to the Great Depression. According to the International Monetary Fund, economic recessions after a financial crises lasted for an average duration of about seven quarters; the current US recession has lasted for six quarters (The US National Bureau of Economic Research affirmed that the recession started from the fourth quarter of 2007). Some analysts expect the US economy to recover by late 2009 or early 2010. Thus the bear run in the stock market might not be as long as in the Great Depression.

- Timing and magnitude of government support – The duration and severity of a recession that resulted from a financial crisis depended on how governments responded and restored confidence. In the current financial crisis, governments have responded much faster than during the Great Depression. In this regard, the current recession could be shorter.

- In the Great Depression, the US government's support to the financial markets and economies was limited at the early stage; the stock market found its low in June 1932. International cooperation was also limited due to political tensions, and protectionism among major countries certainly did not help.

During the current financial crisis, worldwide governments acted promptly to cut rates, increase money supply, bail out financial institutions and guarantee both deposits and loans to avoid widespread disruptions and dislocations in the functioning of financial markets and economies. Concerted international efforts to restore confidence and stabilise the financial system, the launching of stimulus packages to reduce the impact of recession, the introduction of financial reforms to strengthen the global financial, and rejection of trade protectionism are hallmarks of the current response. This has helped to stabilise economies and support recovery.

Implications from Previous Crises and Outlook

The impact of a major financial crisis on the economy depends on the timeliness and quality of policy responses. Failure to implement timely, decisive and appropriate policies to break the feedback loop could result in self-reinforcing negative spill-overs from the financial system to the economy and back to the financial system.

Compared to the 1929 Great Depression, the responses of most governments in the current financial crisis have been much more decisive and prompt. However, whilst economies have begun to show early signs of stabilisation or recovery, concerns remain that the huge stimulus and supportive measures may lead to inflation and pressure on currencies. The policy challenge is to have appropriate exit strategies for such measures so as not to undermine recovery and growth prospects. Investors should be reminded that the stock markets could remain volatile on the back of uncertainties over the sustainability of economic recovery and the stability of the financial markets.

The recent rally in stock markets should be taken with cautious optimism. Experience shows that during a bear run or a recession, stock markets could be volatile before reaching a genuine low after the initial fall. In this environment, a stock market rebound is not sustainable if it lacks fundamental support.