

Half-Yearly Review of the Securities Market

Research Department of the Supervision of Markets Division¹

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Summary

Market sentiment continued to be bullish during the first half of 2005. Yet, concerns over interest rate hikes and worries about rising oil prices capped the upside potential of the US markets. In Asia, underpinned by improving economic fundamentals, the performance of major markets was buoyant during the first half of 2005. In Hong Kong, markets dropped initially amid signs of capital outflow, but the losses were recouped later supported by the speculation over a possible RMB revaluation and continued recovery of the property market. The People's Bank of China revalued the RMB by 2% and pegged it to a basket of currencies with effect from 21 July 2005. The local stock markets responded positively to the announcement.

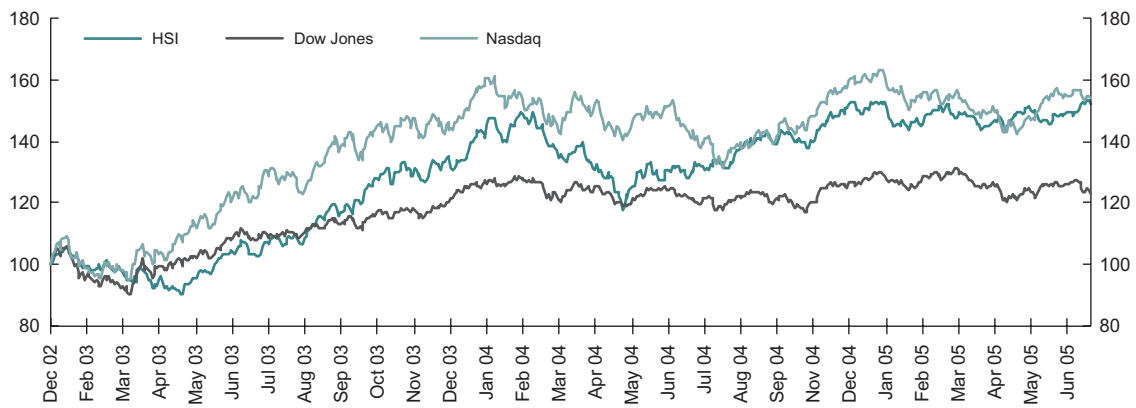
Performance of Major Stock Markets during 2005 H1

1. Concerns over interest rate hikes and worries about rising oil prices capped the upside potential of the US markets, whilst the European markets advanced amid optimism over corporate earnings and economic growth of the region. In Asia, underpinned by improving economic fundamentals, the performance of major markets was buoyant during the first half of 2005. In Hong Kong, markets dropped initially amid signs of capital outflow, but the losses were recouped later supported by the speculation over a possible RMB revaluation and continued recovery of the property market. On balance, the HSI slid 0.2% during the first half of 2005. The People's Bank of China revalued the RMB by 2% and pegged it to a basket of currencies with effect from 21 July 2005. The local stock markets responded positively to the announcement.
2. Market sentiment in the US was initially dampened by high oil prices and concerns over a slowdown in economic growth. Rumours about huge losses in the hedge fund industry also weighed on markets. However, the losses were trimmed down later by robust economic performance and declining oil prices. During the first half of 2005, the Fed raised the Fed Funds Target Rate (FFTR) four times for a total of 100 basis points (bps). The moves were within market expectations and the Fed indicated that rate hikes would continue in a measured pace. During the first six months of 2005, the Dow, S&P 500 and Nasdaq dropped 4.7%, 1.7% and 5.4% respectively. The price-earnings ratios (PERs) for the Dow, S&P 500 and Nasdaq were 18 times, 19 times and 44 times respectively as of the end of June 2005.

US/Europe

¹ This paper is for pure fact-finding and research purpose, and is not an attempt to comment on the developments of any markets/ companies or interpret the policies concerned. The views expressed in this paper do not represent those of the SFC.

Chart 1 – Performance of the US and Hong Kong Markets (end 2002 = 100)

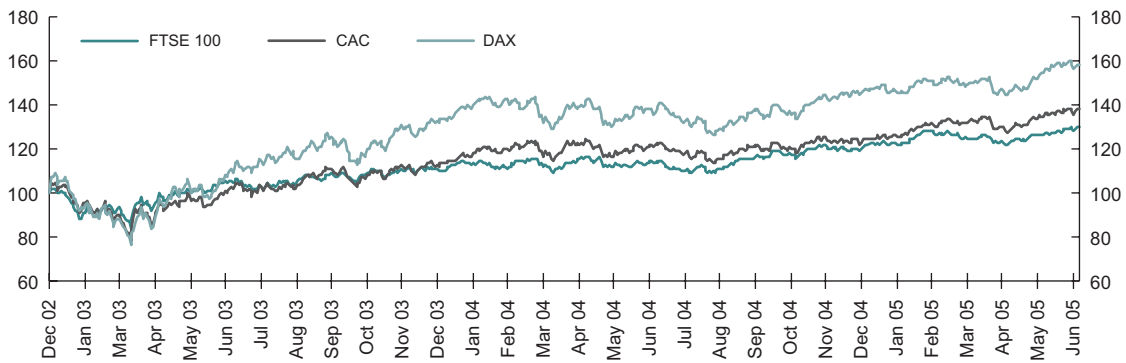


Source: Bloomberg

3. The European markets advanced further during the first half of 2005, led by improvement in corporate earnings. The FTSE100, DAX and CAC rose 6.2%, 7.8% and 10.7% respectively. As of

the end of June 2005, the PERs for the FTSE100, DAX and CAC were 14 times, 15 times and 16 times respectively.

Chart 2 – Performance of the European Markets (end 2002 = 100)



Source: Bloomberg

Asia

4. The Japanese markets edged higher on positive outlook over the domestic economy and a weakening Yen. However, concerns about the negative impacts of higher energy and material costs overshadowed. The Nikkei inched up 0.8% during the first half of 2005, whilst its PER was 36 times as of the end of June 2005. Most

other Asian markets also advanced during the period, with major benchmark indices rising from 1.1% in Thailand to 12.5% in Korea, except for Malaysia which lost 2.1%.

5. In the Mainland, markets slid to 8-year lows clouded by concerns over further macro-economic

tightening and the government's pilot scheme to float the non-tradable shares of listed companies. A total of 46 companies in two batches were selected to participate in the trial reform of non-tradable shares. Concerns over the huge supply of stocks added pressures on the markets. Meanwhile, the authorities have taken various measures to curb speculation in the fast-expanding

property sector. During the first half of 2005, the Shanghai Composite Index and the Shenzhen Composite Index receded 14.7% and 17.4% respectively. As of the end of June 2005, the PERs for the Shanghai Composite Index and the Shenzhen Composite Index were 18 times and 22 times respectively.

Table 1 – Performance of Major Stock Markets (end 2005 H1)

		2005 H1	% Change from (in local currency)		% Change from (in US\$)	
		Index	End 2004	2004 H1	End 2004	2004 H1
Australia	-AOI	4,229.90	4.4%	19.8%	2.0%	30.6%
Mainland, China	-Shanghai Composite	1,080.94	-14.7%	-22.7%	-14.7%	-22.7%
	-Shanghai A	1,135.12	-14.7%	-22.7%	-14.7%	-22.7%
	-Shanghai B	65.30	-13.7%	-24.8%	-13.7%	-24.8%
	-Shenzhen Composite	260.73	-17.4%	-26.5%	-17.4%	-26.5%
	-Shenzhen A	269.17	-18.1%	-27.0%	-18.1%	-27.0%
	-Shenzhen B	216.42	-1.5%	-13.0%	-1.5%	-13.0%
Hong Kong	-HSI	14,201.06	-0.2%	15.6%	-0.2%	16.0%
	-S&P/HKEx GEM	898.58	-9.1%	-16.7%	-9.1%	-16.4%
	-HSCEI	4,861.87	2.5%	13.3%	2.6%	13.7%
	-HSCEI	1,648.40	5.9%	21.4%	5.9%	21.8%
India	-S&P CNX Nifty	2,220.60	6.7%	47.5%	6.7%	56.2%
Indonesia	-JCI	1,122.38	12.2%	53.2%	6.6%	47.6%
Japan	-Nikkei 225	11,584.01	0.8%	-2.3%	-6.7%	-4.2%
Korea	-KOSPI	1,008.16	12.5%	28.3%	12.6%	43.3%
Malaysia	-KLCI	888.32	-2.1%	8.4%	-2.1%	8.4%
Philippines	-PCOMP	1,924.23	5.6%	21.8%	6.0%	22.1%
Singapore	-STI	2,212.66	7.1%	20.4%	3.7%	22.7%
Taiwan	-TWSE	6,241.94	1.7%	6.9%	2.1%	14.2%
Thailand	-SET	675.50	1.1%	4.5%	-4.8%	3.5%
France	-CAC	4,229.35	10.7%	13.3%	-1.1%	12.5%
Germany	-DAX	4,586.28	7.8%	13.2%	-3.7%	12.3%
UK	-FTSE100	5,113.20	6.2%	14.5%	-0.8%	12.7%
US	-DJIA	10,274.97	-4.7%	-1.5%	-4.7%	-1.5%
	-Nasdaq	2,056.96	-5.4%	0.4%	-5.4%	0.4%
	-S&P 500	1,191.33	-1.7%	4.4%	-1.7%	4.4%

Source: Bloomberg

Hong Kong

- In early 2005, the local markets were dragged down, as the rebound in USD prompted investors to unwind their USD carry trade positions. The HKMA's refinements to the Linked Exchange Rate system also triggered interest rate hikes and there were indications of capital outflow. As of the end of June 2005, the Aggregate Balance dropped to HK\$1.3 bn from HK\$15.8 bn as of end December 2004. The 3-month HIBOR also rose to 3.39% from 0.35% over the same period. The local banks raised the best lending rate by 125-150 bps following the interest rate hikes in the US.
- Nevertheless, the markets recouped some losses later as positive performance of overseas markets lent support to local stocks. The market sentiment

was also lifted by the speculation over a possible RMB revaluation and continued recovery of the property market amid strong sales of residential projects. On balance, the HSI slid 0.2% during the first half of 2005. The PER of the HSI was 16 times as of the end of June 2005.

8. Share prices of H-shares and red chips outperformed, despite of credit-tightening

measures in the Mainland. This was partially attributable to the gains of Mainland-related oil stocks on record high oil prices. Rumours of a possible RMB revaluation also propelled buying of Mainland-related companies. During the first half of 2005, the H-share index (HSCEI) and red chip index (HSCCI) advanced 2.5% and 5.9% respectively. The PER was 11 times for the HSCEI and 13 times for the HSCCI.

Chart 3 – Performance of Hong Kong Markets (end 2002 = 100)



Source: Bloomberg

Chart 4 – PER for Benchmark Indices of Hong Kong Markets



Source: CEIC

Trading Activities on Hong Kong Stock Market during 2005 H1

9. Trading activities in Hong Kong remained active in the first half of 2005. The average daily turnover increased 11.5% to HK\$16.9 bn during the first half of 2005 from the HK\$15.1 bn during the second half of 2004.

The average daily turnover of

- HSI constituent stocks added 16.6% to HK\$7.1 bn;
- H-shares rose 1.2% to HK\$3.2 bn;
- red chips rose 8.3% to HK\$2.3 bn; and
- derivative warrants rose 24.1% to HK\$2.7 bn during the first half of 2005.

Table 2 – Average Daily Turnover during 2005 H1

	Average Daily Turnover (HK\$ mn)			% Change in 2005 H1 over	
	2005 H1	2004 H2	2004 H1	2004 H2	2004 H1
Market total	16,852	15,118	16,837	+11.47%	+0.09%
HSI constituents	7,056	6,051	6,662	+16.61%	+5.90%
H-shares	3,185	3,146	4,438	+1.23%	-28.24%
Red chips	2,344	2,164	2,786	+8.29%	-15.88%
Derivative warrants	2,723	2,194	2,015	+24.08%	+35.14%

Remark: As some red chips are also HSI constituent stocks, figures reported in this table are not exclusive.
Source: HKEx

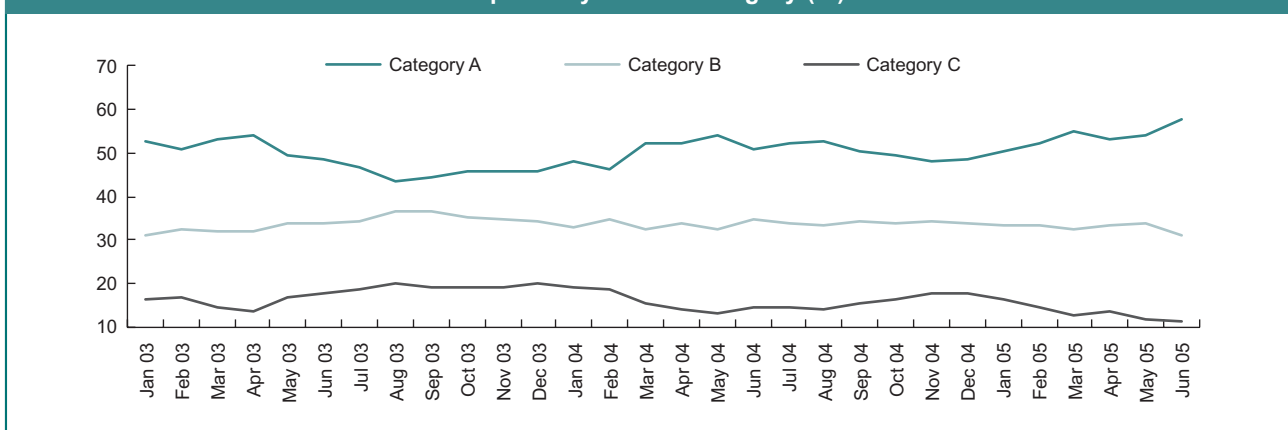
10. The average daily turnover of HSI constituent stocks accounted for 42% of the total. The turnover of H-shares and red chips accounted for 19% and 14% respectively. The turnover of derivative warrants contributed 16% to the total.

Trading activities of the Hong Kong stock market by broker category²

11. Category A SEHK participants handled the largest share of market transactions. The share of

Category A SEHK participants increased to 53.6% in the first half of 2005, from 50.1% in the second half of 2004. The share of Category B SEHK participants was 33.0% in the first half of 2005, slightly lower than the level of 33.9% in the second half of 2004. The share of Category C SEHK participants was 13.4% in the first half of 2005, lower than the 16.0% in the second half of 2004.

Chart 5 – Market Share of SEHK Participants by Broker Category (%)



Source: HKEx

² SEHK participants are categorized into Categories A, B and C, based on the value of transactions handled. Category A SEHK participants refer to the top 14 brokers, whilst Category B SEHK participants refer to those ranked 15-65 and the rest are Category C SEHK participants.

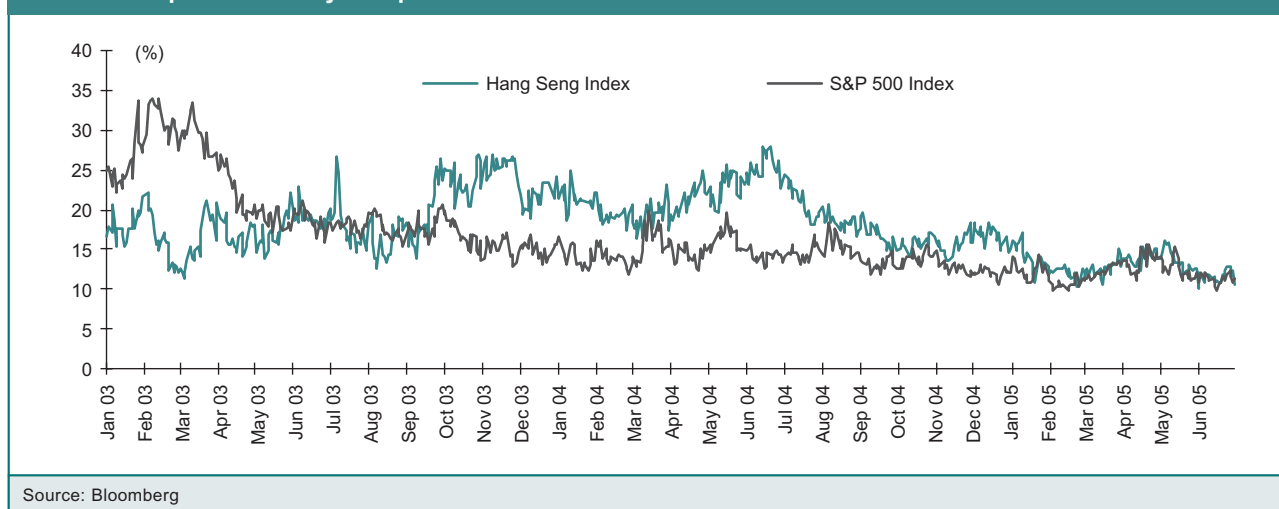
Short selling activities

12. Short selling activities grew slightly faster than the overall market turnover, but still remained at reasonable levels. Short selling averaged HK\$558 mn a day during the first half of 2005, 3.3% of the total market turnover. The corresponding figures were HK\$443 mn and HK\$615 mn, representing 2.9% and 3.7% of the total market turnover in the second half of 2004 and in the first half of 2004 respectively.

Implied volatility

13. Uncertainty about future stock prices, as approximated by the implied volatility of options on the HSI, has been declining since June 2004. It used to be higher than the implied volatility of options on the S&P 500 index, but the gap has narrowed. At present, the implied volatility of options on the HSI stayed almost at the same level as its US counterpart.

Chart 6 – Implied Volatility of Options on HSI and S&P 500 Index



Initial Public Offering (IPO) Activities

14. IPO activities became more active during the first half of 2005, with 21 IPOs raising a total of HK\$65.2 bn. The amount was 58% higher than in the second half of 2004 and 17% higher than in the first half of 2004. This was also the highest since the first half of 2000 when HK\$84.0 bn was raised. The rise was mainly attributable to the

fund-raising activities of Mainland enterprises (i.e. H-shares and red chips). During the first half of 2005, the amount raised for Mainland enterprises doubled from HK\$28.5 bn in the second half of 2004 to HK\$57.9 bn during the first half of 2005. Mainland enterprises accounted for 89% of the total during the first half of 2005.

Table 3 – Highlights of the IPOs by Stock Type

	2005 H1	2004 H2	2004 H1	2003 H2
Number of IPOs				
Total (Main Board + GEM)	21	32	40	45
<i>Mainland enterprises</i>	6	11	13	14
- H-shares	4	6	11	12
- Red chips	2	5	2	2
Funds raised by IPOs (HK\$ mn)				
Total (Main Board + GEM)	65,207.4	41,287.0	55,872.2	51,936.4
<i>Mainland enterprises</i>	57,887.7	28,489.4	26,861.6	44,453.7
- H-shares	56,915.2	15,106.6	25,603.8	41,491.3
- Red chips	972.5	13,382.8	1,257.8	2,962.4

Source: HKEx

15. In particular, there were three major IPOs in June 2005. All were H-share companies:

- China Shenhua Energy, raising HK\$25.5 bn;
- Bank of Communications, raising HK\$16.8 bn; and
- China COSCO, raising HK\$9.5 bn.

The total amount of funds raised by the three IPOs was HK\$51.9 bn. This accounted for 80% of the total amount of funds raised through IPOs during the first half of 2005.

Trading Activities of Local Derivatives Market during 2005 H1

16. Trading activities on the derivatives market increased slightly. The average daily turnover of futures and options contracts was 87,887 contracts in the first half of 2005, representing a growth of 12.7% from the second half of 2004.

Table 4 – Trading Activities of Local Derivatives Market by Product Type (Contracts)

		Total Turnover			Average Daily Turnover			Growth %	
		2005 H1	2004 H2	2004 H1	2005 H1	2004 H2	2004 H1	2005 H1/ 2004 H2	2004 H2/ 2004 H1
Futures	HSI Futures	4,530,539	4,344,339	4,257,220	37,598	34,616	35,039	8.6%	-1.2%
	Mini-HSI Futures	669,253	730,232	727,449	5,554	5,819	5,987	-4.6%	-2.8%
	H-shares Index Futures	903,877	890,561	853,139	7,501	7,096	7,022	5.7%	1.1%
	3-Month HIBOR Futures	16,215	22,552	35,755	135	180	294	-25.0%	-38.8%
	Stock Futures	4,781	8,395	8,879	40	67	73	-40.3%	-8.2%
	FTSE/Xinhua China 25 Index Futures ¹	1,265	n.a.	n.a.	44	n.a.	n.a.	n.a.	n.a.
	Other Futures products ²	1,841	2,111	3,520	15	17	29	-9.2%	-41.4%
	Total Futures	6,127,771	5,998,190	5,885,962	50,853	47,794	48,444	6.4%	-1.3%
Options	HSI Options	1,297,680	932,032	1,097,036	10,769	7,427	9,029	45.0%	-17.7%
	Mini-HSI Options	14,564	10,917	15,965	121	87	131	39.1%	-33.6%
	H-shares Index Options ³	111,848	72,119	5,639	928	575	470	61.4%	22.3%
	Stock Options	3,037,341	2,769,771	2,842,061	25,206	22,070	23,391	14.2%	-5.6%
	FTSE/Xinhua China 25 Index Options ¹	1,206	n.a.	n.a.	42	n.a.	n.a.	n.a.	n.a.
		Total Options	4,462,639	3,784,839	3,960,701	37,034	30,158	33,021	22.8%
Total Futures and Options		10,590,410	9,783,029	9,846,663	87,887	77,952	81,465	12.7%	-4.3%

¹ Trading in FTSE/Xinhua China 25 Index Futures and Options commenced on 23 May 2005.
² Include MSCI China Free Index Futures, Dow Jones Industrial Average Futures, One-Month HIBOR Futures and Three-year Exchange Fund Note Futures.
³ Trading in H-shares Index Options commenced on 14 June 2004.
Remarks: Trading in MSCI China Free Index Futures suspended with effect from 29 March 2004.
Trading in Dow Jones Industrial Average Futures suspended with effect from 21 March 2005.
Source: HKEx

17. The growth was attributable to the rises in the trading volume of:

- HSI Futures (8.6% in the first half of 2005 after a drop of 1.2% in the second half of 2004);
- HSI Options (45% in the first half of 2005 following a drop of 18% in the second half of 2004); and

- Stock Options (14% in the first half of 2005 after a decline of 5.6% in the second half of 2004).

The trading volume of H-shares Index Options and Mini-HSI Options also recorded remarkable growth of 61% and 39% during the first half of 2005, but that of 3-Month HIBOR Futures further decreased 25% in the first half of 2005.

18. Open interest of HSI Futures averaged 113,137 contracts in the first half of 2005.³ This was 2% lower than the corresponding figure of 115,201 contracts in the second half of 2004, and 14% higher than the level of 99,280 contracts in the first half of 2004. The relatively active trading on derivative products appeared to be in line with the active trading activities of the underlying and possible hedging activities against related products.

Risks to the Securities Market

19. Major risks to the securities market in Hong Kong include:

- the magnitude of further interest rate hikes in the US in the future;
- the possibility of further tightening in the Mainland;
- capital movements;
- possible volatilities in other stock markets; and
- possible volatilities in other currencies.

Nevertheless, as economic fundamentals continue to improve, such risks seem to be limited. ■■

³ The average open interest of HSI Futures over a 6-month period is provided here to even out the spikes in open interest prior to settlement. In practice, the SFC monitors the market from a short-term (daily) perspective to a long-term (yearly) perspective.