CESC Annual Index Report 2016

China Exchanges Services Co., Ltd. (CESC)

Highlights

- Hong Kong stocks outperformed Mainland A shares in 2016. CES A80 and CES SCHK100 were down 6.1 per cent and 1 per cent respectively while cross-border CES 120 was resilient, up 0.2 per cent.
- Shenzhen Connect officially kicked off, resulting in a huge market of RMB70 trillion comprising Hong Kong, Shanghai and Shenzhen stocks. CES 300, which fully reflects the performance of eligible stocks under the Connect programme, shed 1.9 per cent.
- CES G10 gained 27.7 per cent during the year and had a risk-adjusted yield of 0.9, which was higher than those of broad base indices.
- Taiwan stocks were Asia's best performers with a cumulative gain of 11 per cent in the whole of 2016. Mainland A shares were the worst performing, with CSI 300 retreating 11.3 per cent.
- The RMB was added to the IMF's Special Drawing Rights (SDR) basket, which already included USD, EUR, JPY and GBP.
- Open interest of HKEX's USD/CNH futures hit an all-time high of 45,635 contracts.
- Offshore ETFs on physical A shares are mainly issued in Hong Kong and now have total assets amounting to more than RMB28 billion.
- Singapore's A-share index futures saw no growth, with full-year trading volume down 18 per cent from 2015.

I. Performance of CESC Indices

Hong Kong stocks and Mainland A shares moved in different directions in 2016. **Hong Kong stocks outperformed A shares, which were under pressure from the RMB's depreciation and capital outflow. While CES A80 and CES SCHK100 were down 6.1 per cent and 1 per cent respectively, CES HKMI, which tracks Hong Kong listed Mainland stocks, ended the year up 1.8 per cent. Cross-border indices were resilient with CES120 up 0.2 per cent, while CES 300, which fully reflects the performance of eligible stocks under the Connect programme, was down slightly** (see table 1).

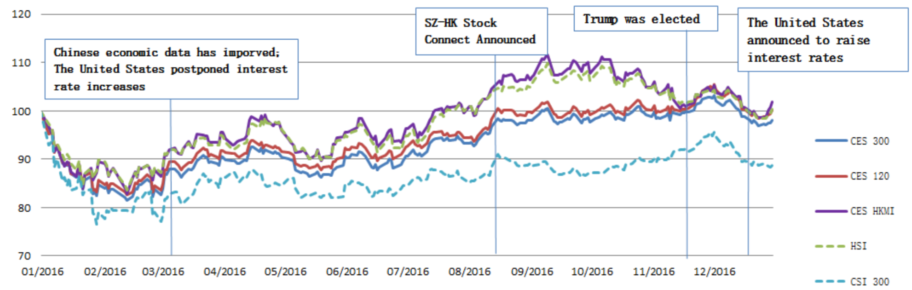
In January 2016, due to global slowdown and a sharp fall in oil prices, Mainland and Hong Kong stock markets retreated significantly. Major indices plunged 10-26 per cent during the month. Hong Kong stocks bottomed out in February with valuations falling to about the same level as the financial tsunami in 2008. The P/E ratios of CES SCHK100 and CES HKMI were 9.8 and 7.5 times respectively, which were extremely low by global standards. The two indices rebounded 19 per cent and 21 per cent respectively in the following 10 months.

Table 1	Index Point	Monthly Return	Volatility	Risk-adjusted Return
CES G10	3,938.31	27.73%	32.68%	0.85
CES HKMI	5,515.90	1.80%	20.59%	0.09
HSI	22,000.56	0.39%	18.45%	0.02
CES 120	5,052.40	0.17%	17.07%	0.01
CES SCHK 100	4,254.33	-1.01%	17.50%	-0.06
CES 300	3,624.74	-1.87%	16.89%	-0.11
HSCEI	9,394.87	-2.75%	22.64%	-0.12
CES A80	5,911.41	-6.12%	18.92%	-0.32
FTSE A50	9,970.30	-6.92%	18.08%	-0.38
CSI 300	3,310.08	-11.28%	21.67%	-0.52
SSE Composite	3,103.64	-12.31%	22.49%	-0.55
CES 280	5,803.98	-13.05%	23.14%	-0.56
SZSE Component	10,177.14	-19.64%	27.95%	-0.70

Source: CESC and Wind; data as of 30 December 2016

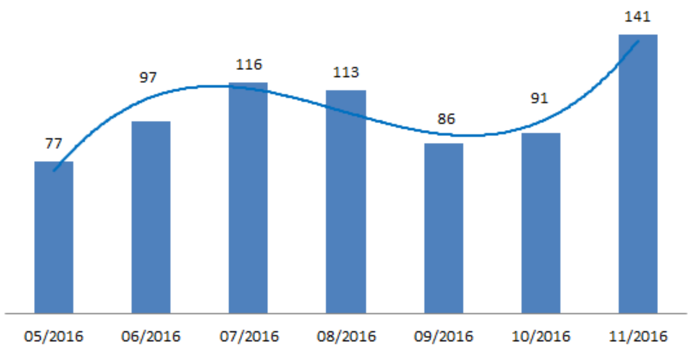
In March, the US Fed's suspension of its interest rate hikes and a dovish outlook on rate hikes eased capital outflow from the Mainland. The Mainland's official PMI returned to above the confidence threshold for the first time since August 2015 signalling economic recovery. In the ensuing seven months, A shares began to rise with CES A80 climbing 12 per cent (see chart 1).

Chart 1 Stock Performance of HK & Mainland China Markets in 2016



The Mainland and Hong Kong capital markets eagerly waited for the launch of Shenzhen Connect in 2016. After the announcement of approval for the link in August, CES 300 changed the universe of securities for its "Shenzhen A Shares" segment to include all eligible stocks for Northbound trading under Shenzhen Connect in a bid to reflect accurately changes in stocks under the Connect programme. As seen from chart 1 and 2, CES 300 climbed steadily in active trading after the announcement, with combined average daily turnover of its constituents surging from RMB76.8

Chart 2 Average Daily Trading Volume of CES 300 (Billion)



billion in May to RMB140.6 billion in November for a gain of 83 per cent. The rally demonstrated investors' positive response to the Stock Connect programme.

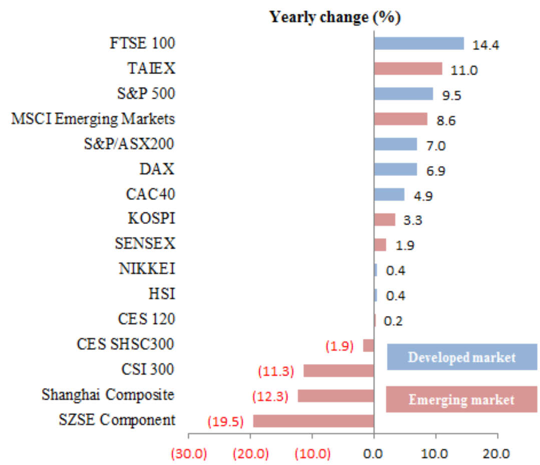
In November and December, the US dollar strengthened following Donald Trump's win in the presidential election in early November and the US Fed's rate hike in mid-December. Capital outflow from emerging markets was faster than expected, resulting in sharp volatility in the Mainland and Hong Kong stock markets.

CES G10 performed robustly throughout 2016, gaining 27.7 per cent and posting a risk-adjusted yield of 0.9, which was higher than those of broad base indices. Macau's gaming sector was evidently recovering in 2016. According to Macau's Gaming Inspection and Coordination Bureau, December was the fifth straight month the enclave posted a year-on-year increase in gaming revenue, with full-year cumulative gross revenue amounting to MOP223.2 billion. It shows Macau's strategies to adjust its gaming business have been effective so far. Analysts said a diversified range of businesses including hotels, leisure and entertainment will be Macau's new drivers of growth.

II. Other stock indices

2016 saw wild swings in global stock markets. Thanks to a rebound in commodity prices, emerging markets which export natural resources, such as Russia and Brazil, put up a good show. Russian stocks and Brazilian stocks jumped 26.8 per cent and 38.9 per cent respectively leading the MSCI Emerging Market Index up 8.6 per cent. In Europe and the US, FTSE 100 rallied 14.4 per cent in the UK, S&P 500 rose 9.5 per cent in the US, Germany's DAX soared 6.9 per cent and France's CAC40 advanced 4.9 per cent. In Asia, Hang Seng Index and Nikkei rose slightly. Taiwan stocks were the best performers, surging 11 per cent in the whole year. Mainland A shares were the worst performing, resulting in a CSI 300 retreat of 11.3 per cent (see chart 3).

Chart 3 Movement in Global Stock Indices in 2016



Source: CESC and Bloomberg, as of 31 December 2016

Impacted by various black swan incidents, global stock markets saw sharp fluctuation in 2016. Early in the year, stocks in emerging markets were dumped along with commodities. MSCI Emerging Market Index plunged 9 per cent in January. Oil prices fell through US$30 a barrel to a level not seen since 1999. In the Mainland, a circuit breaker mechanism introduced for the stock market on 1 January was triggered twice within four days of its implementation, resulting in trade suspensions, panic selling and the CSRC's suspension of the mechanism on 8 January. CSI 300 tumbled more than 20 per cent during the month. Except for the Mainland, prices of emerging market stocks and commodities rebounded significantly in the second quarter and regained ground lost since the end of 2015.

In June, the UK's vote in favour of Brexit shocked the markets. The British pound plunged 16.3 per cent against the US dollar to a 31-year low. Brexit is expected to undermine London as an international finance centre. As the European Union is currently the largest market for Britain's exports and the leading source of its imports, Brexit means various trade agreements will have to be re-negotiated and uncertainties will hang over the UK's economy. To stimulate the economy, the Bank of England lowered interest rates and expanded its monetary easing. Thanks to these measures as well as a series of fiscal policies, British stocks reversed their falls and ended the year with a 14.4 per cent gain. The British stock market was the best performer among developed countries in 2016.

In September, the US Department of Justice's demand of a US$14 billion fine from Deutsche Bank was widely reported. Fearing a cash flow crisis at the bank, large hedge funds dumped its shares, driving their price down 45.8 per cent for the first three quarters of the year.

Global stock indices initially reacted to Donald Trump's unexpected win in the US presidential election in November with sharp fluctuations, but the news was swiftly digested and proposals in Trump's policy platform favourable to the US economy were noted. They include, among other things, the simplification of tax bands, profit tax reduction, encouragement of the return of companies that moved overseas, investment in infrastructure and job creation. S&P 500 ended the year 3.5 per cent higher than its level immediately after Trump's election, reflecting investors' positive outlook on the US economy.

In December, the US announced its second interest rate hike since the financial tsunami. According to the Fed, the US labour market has continued to strengthen and economic activity has been expanding at a moderate pace. The market believed more US rate hikes were on their way and liquidity would continue to return to US dollar assets and push up demand for the US dollar. The US dollar index ended the year at 102.29, up 3.6 per cent.

Black swan incidents caused short-term market turbulence during the year, but conditions soon stabilised. Overall, the turmoil ended in gains.

III. Review of offshore A-share-related activities

The RMB joined the IMF's SDR basket, which already included USD, Euro, JPY and GBP.

On 1 October, the RMB was officially added to the IMF's SDR basket and became the basket's third top currency with a weighting larger than that of JPY and GBP. The decision reflected the RMB's prevalent use in payment for international trades and extensive trading in major FX markets. The new SDR basket includes USD, Euro, RMB, JPY and GBP, whose weightings are 41.73 per cent, 30.93 per cent, 10.92 per cent, 8.33 per cent and 8.09 per cent respectively.

Shenzhen Connect officially kicked off, resulting in a huge equity market of RMB70 trillion comprising Hong Kong, Shanghai and Shenzhen

The long-awaited Shenzhen Connect eventually kicked off on 5 December, resulting in a huge equity market of RMB70 trillon comprised of HKEX, SZSE and SSE.

The launch of Shenzhen Connect gave Mainland investors access to 417 Hong Kong stocks including the 100 constitutents of the Hang Seng Composite LargeCap Index, the 193 constitutents of the Hang Seng Composite MidCap Index, the 95 constitutents of the Hang Seng Composite SmallCap Index and 29 from A+H share sector not already constituents of these indices. They represent about 87 per cent of the market cap of Hong Kong-listed stocks and 91 per cent of their average daily turnover. Under the link, Hong Kong investors have access to 881 Shenzhen A shares including 267 listed on the main board, 411 on the SME board and 203 on ChiNext. These represent about 71 per cent of the market cap of Shenzhen A shares and 66 per cent of their average daily turnover.

Open interest of HKEX's USD/CNH futures hit an all-time high of 45,635 contracts

HKEX launched the world's first USD/RMB futures in September 2012 with the unit of quotation, margining and settlement denominated in RMB. According to Hong Kong market data, the futures' total trading volume in 2016 was 538,594 contracts (nominal value: about RMB376 billion), more than double that of 2015. Year-end open interest reached an all-time high of 45,635 contracts (nominal value: about RMB31.8 billion), representing two-thirds of open interest of the world's USD/RMB futures.

To support the RMB's internationalization, HKEX launched four additional RMB futures products on 30 May 2016. They are comprised of EURO-RMB, JPY-RMB, AUD-RMB and RMB-USD futures. With the exception of RMB-USD futures, which are denominated in US dollar, all of the additional futures products are denominated in RMB.

Offshore ETFs on physical A shares are mainly issued in Hong Kong, with total assets amounting to more than RMB28 billion

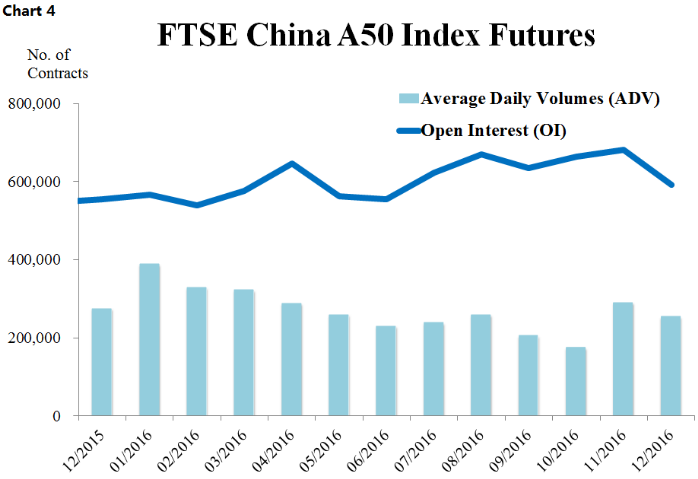
A number of fund houses with RQFII investment quotas have introduced offshore ETFs on physical A shares in Hong Kong, the US and Europe, but only CSOP FTSE China A50 ETF (RMB17.2 billion) and ChinaAMC CSI 300 Index ETF (RMB9.5 billion), both of which were issued in Hong Kong, have an asset size of about RMB10 billion. Hong Kong is clearly the primary market where offshore ETFs on physical A shares are issued. The total asset size of such ETFs is above RMB28 billion.

Offshore A-share ETFs are still mainly issued by Mainland issuers, though their experience in the issuance of offshore products is limited. With the easing of RQFII quotas, it is hoped that in the not too distant future, more foreign entities will participate in the offshore A-share ETF market.

Singapore's A-share index futures saw their full-year trading volume fall 18 per cent from 2015

The trading volume of Singapore's FTSE A50 Index futures in 2016 was about 3.24 million contracts, down 18 per cent from 2015. Open interest at the end of the year was 590,000 contracts (notional value: RMB41 billion), which was up slighlty from the end of 2015 (see chart 4).

Chart 4



Source: SGX statistics as of 30 December 2016

As FTSE A50 Index futures are mainly used by overseas investors to hedge their holdings in Mainland A shares, the overall stability of open interest in the futures in 2016 suggests their users attach a lot of importance to risk management and long-term operations.

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