



Current Operation and Future Prospects of Shanghai— Shenzhen—Hong Kong Stock Connect

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This year marks the 20th anniversary of Hong Kong's return to the Motherland. When we review the developments of Hong Kong's stock market during the past 20 years, Shanghai—Hong Kong stock connect and Shenzhen—Hong Kong stock connect (hereinafter referred to as stock connect), as the groundbreaking mechanism of coordinated development between Mainland and Hong Kong stock market, also attract plenty of attention. This article analyzes the performance of stock connect since its launch, its main features, and its prospects.

Developments and features of stock connect

As a pilot mechanism of connectivity between Mainland and Hong Kong markets operating under the principle of “closed loop cross-boundary fund flow, RMB settlement, maintaining investor trading habits and stringent risk management”, Shanghai—Hong Kong stock connect has been running for more than two and a half years since its launch on 17th November 2014. Two years after the smooth operation of Shanghai-Hong Kong stock connect, Shenzhen—Hong Kong stock connect was launched on 5th December 2016 and has been in operation for more than half a year. Throughout the keen expectations before the launch of stock connects, the relative calmness since their operation and then the deep adjustment of the stock markets in mid-2015, stock connects have been operating smoothly. Thanks to the improvements and upgrades of the mechanism, linkage between these two markets has increased, while their own characteristics have remained intact. Stock connects have effectively promoted the coordinated development of Mainland and Hong Kong stock markets

1. Improvements and upgrades of the mechanism

Developments of stock connect have gone from effective control to orderly opening, from concentration to diversification. In terms of quota control, the mechanism established two thresholds including aggregate quota and daily quota, to mitigate the impact on Hong Kong's stock market from Mainland retail investors in the short term. This helps to fully guarantee the

security and relative independence of the two stock markets during increased market fluctuations. After the adjustment in stock markets, the stock connects mechanism canceled the aggregate quota at the end of 2016 when the aggregate quota was about to exceed the limit. But the mechanism still maintains the daily quota, reflecting its aim of balancing risk control and market opening. In terms of eligible stocks, the Shanghai—Hong Kong stock connect initially covered only large and medium-sized stocks in these two stock markets, raising the barriers to investors. Then Shenzhen—Hong Kong stock connect, launched at the end of 2016, covered some small-sized stocks and GEM stocks but added requirements of investor qualifications and market capitalization, to provide diversified investment choices while at the same time protecting the interests of investors.

2. Moderate use of quota

According to the proportion of daily quota balance to total daily quota in past years, use of daily quota of stock connect is at rather moderate levels except for the first day of the launch of Shanghai—Hong Kong stock connect and before the stock market boom in April 2015, when the quota of southbound connect was exhausted. As a result, the performance of stock connect was once considered falling short of market expectation. However, two factors should be taken into account. First, the basis for calculating quota in stock connect is the offset balance between buy orders and sell orders, so when buy and sell orders were relatively balanced, that the reported use of quota could be lower than actual trading activity. Second, as the bridge of connectivity between Mainland and Hong Kong, it is not accurate to measure the success of stock connect only according to turnover. Rather, the overall smooth operation should be considered a success.

Since the launch of Shenzhen—Hong Kong stock connect on 5th December 2016, use of quota in Shenzhen northbound trading is relatively stable. Except the first day when less than 80 per cent of the northbound daily quota was used, roughly 90 per cent of the daily quota was used in most of the trading days. In comparison, Shanghai northbound trading witnessed larger fluctuation, sometimes less than 90 per cent of the daily quota being used while on quite a few trading days more than 100 per cent of the daily quota were used (net sell). Southbound trading showed similar pattern. About 90 per cent of the daily quota was used in Shenzhen southbound trading, while such proportion in Shanghai southbound trading ranged widely from 40 per cent to 120 per cent. Comparing the southbound trading to northbound trading, use of quota in southbound connect is obviously better, especially in Shanghai southbound trading, which provides support to Hong Kong stock market in the first half of this year.

3. Northbound and Southbound trading tend to balance

In terms of trading activity, stock connect has gone through the initial stage of “cold in the south and warm in the north” to “cold in the north and hot in the south”, and finally to the balance stage currently. In the first half of this year, northbound turnover recorded 808.562 billion yuan, while southbound turnover printed 841.508 billion yuan. Both one-way turnover and total turnover are higher than those of last year, reflecting the incremental effect after the introduction of Shenzhen—Hong Kong stock connect. Looking at change of average daily turnover in each month, Shanghai northbound trading continued to outperform Shenzhen northbound trading, the same pattern applies to southbound trading. On the other hand, southbound trading in Shanghai—Hong Kong stock connect outperformed its northbound trading, while the situation in Shenzhen—Hong Kong stock was the opposite. This suggests that large enterprises in Hong Kong (such as banking, real estate, insurance, automobiles etc.) are more favored by Mainland investors, while Hong Kong investors are more optimistic about the new economy enterprises in Shenzhen.

4. Connectivity between these two markets increased but differences remain

Stock connect mechanism increased the connectivity between Mainland and Hong Kong markets. Statistics showed that the impact of Hang Seng Index on the Shanghai composite index was less than 1% before the launch of Shanghai—Hong Kong stock connect but reached a height of 17% afterwards, and the correlation between the two indices once increased from 0.4 to 0.92. The sharp adjustment in both markets in 2015 was a good example. According to a 2014/15 survey from Hong Kong Exchanges and Clearing Limited, the proportion of institutional investors in Hong Kong spot market fell significantly in recent years, while the proportion of individual investors rose steadily. On the other hand, in the past two years, Hang Seng China AH Premium Index fell from 150 but rebounded when it hit 120, reflecting the differences of investor structure, market maturity and trading habits between Mainland and Hong Kong market will remain for a long time. It is premature to judge these two markets will assimilate at this moment.

Future prospects and opportunities

As an innovation of the interconnection between Mainland and Hong Kong markets, stock connect, after experiencing volatility and becoming more inclusive, has a lot of room for growth. In the short term, the A shares’ inclusion into MSCI, the introduction of insurance funds into stock connect businesses, bond connect, and RQFII quota increases for Hong Kong will provide stock

connect with new opportunities. In the long term, stock connect will become more robust thanks to closer cooperation between the two markets in regulation and financial integration, as well as RMB internationalization.

One of the short term factors is prospective reforms as a result of A shares' inclusion in MSCI. According to the MSCI, the A shares' weight of 1.73% of the emerging market index will be equivalent with about 17-18 billion dollars. As fund flows increase, daily quotas of stock connect will probably be raised or even abolished. Meanwhile, increasing number of institutional investors will boost turnover. The participation of insurance funds in stock connect will also boost investor sentiment. As of early July, investments by insurance companies via stock connect amounted to 174.3 billion Yuan. Moreover, bond connect, as well as Hong Kong's RQFII quota being raised from 270 billion to 500 billion Yuan, will support the growth of Hong Kong's financial markets.

In the long term, the interconnection between Mainland and Hong Kong financial markets will provide Shanghai, Shenzhen, and Hong Kong with plenty of opportunities. Currently, the market capitalization of Shanghai, Hong Kong, and Shenzhen was ranked 4th, 7th, and 8th worldwide, respectively. As the three markets become increasingly connected, turnover will increase, while investment vehicles will also become more abundant. In the meantime, building a robust system and regulatory cooperation will safeguard stock connect, as both mainland and Hong Kong markets are proposing reforms that will improve their operation. Moreover, the cross-border regulatory mechanism established in March will ensure effective data sharing and regulatory coordination, helping maintain market order and protect investor interests. Furthermore, policy initiatives will continue to yield benefits. RMB internationalization will further consolidate Hong Kong's position as a leading offshore RMB center and support stock connect, while the Guangdong free trade area and the Guangdong—Hong Kong—Macao greater bay area will provide Hong Kong with strategic opportunities.

In summary, as an innovation in connecting stock exchanges, stock connect may make progress in two dimensions. First, the selection of investments could broaden from stocks to bonds, commodities, futures, and derivatives. Second, stock connect will provide a testing ground for prospective interconnection of other exchanges worldwide. Meanwhile, stock connect is faced with the challenges of market volatility, exchange rate risks, and information asymmetry. To attract more investors, stock connect will need to continue to improve regulations, optimize taxation management, and relax investor restrictions.