Remarks by Mr Norman T.L. Chan,
Chief Executive of the Hong Kong Monetary Authority
on 22 January 2016
at the announcement of
Exchange Fund's investment results for 2015

(Translation)

Review of 2015

Global financial markets took a roller-coaster ride in 2015. First half of the year saw Mainland China and Hong Kong equities reaching new highs. However, market sentiments took a drastic turn for the worse in the third quarter and global financial markets were turbulent. The Exchange Fund suffered a loss of HK$63.8 billion in that quarter alone. With a rebound in the global equity markets in October, the loss recorded by the Exchange Fund in the first three quarters was basically recouped at end October. Nevertheless, the financial markets worsened again going into November and December. Although the Exchange Fund recorded a gain of HK$18.5 billion in the fourth quarter, it still could not offset the accumulated loss in the first three quarters.

2. In summary, for 2015 as a whole, the Exchange Fund posted an investment loss of HK$18.3 billion. Of this, bond holdings brought an income of HK$15.9 billion. Equity holdings registered a gain of HK$2.4 billion, with a profit of HK$7.4 billion from overseas equities and a loss of HK$5 billion

from Hong Kong equities. Other investments, comprising mainly private equities and real estate investments under the Long-Term Growth Portfolio (LTGP), contributed a gain of HK$8.3 billion. As at end-2015, the total market value of the LTGP's investments stood at HK$139.3 billion, with outstanding investment commitments of HK$122.4 billion. Private equities and real estate investments under the LTGP recorded an annualised, since-inception internal rate of return of about 12%. In addition, a negative currency translation effect of HK$44.9 billion was booked after translating the Exchange Fund's non-US dollar investments into Hong Kong dollar as a result of a strengthening of the US dollar. The overall rate of return of the Exchange Fund in 2015 was -0.6%. Mr Eddie Yue, our Deputy Chief Executive, will provide more details on the performance of the various portfolios of the Exchange Fund in a briefing afterwards.

3. In 2015, the fee payable to the Fiscal Reserves was HK$46.7 billion while the fees paid for placements by Government funds and other statutory bodies totalled HK$14.7 billion. The Accumulated Surplus of the Exchange Fund decreased by HK$90.3 billion to HK$545.2 billion.

4. Despite a negative return of 0.6%, the Exchange Fund's loss is relatively mild comparing with major market indices. With such adverse financial environment last year, many investment funds' performance was

disappointing and some even incurred losses of varying degrees. Even the more conservative bond funds were no exception.

5. In fact, in anticipation of a worsening investment environment, we have already deployed a series of defensive moves over the past two years. These include shortening the duration of our bond portfolios, increasing cash holdings, and reducing non-US dollar assets. We have also quickened the pace of investment diversification, especially through investments under the LTGP. These moves have enhanced the resilience of the Exchange Fund and helped mitigate some potential losses.

6. One may wonder, in the absence of major financial crisis like the one in 2008, why the Exchange Fund still incurred an investment loss in 2015. As I have said many times before, after the 2008 global financial crisis, central banks in the US, Europe and Japan in turn introduced ultra-low interest rates and large-scale quantitative easing (QE) programmes in an attempt to stimulate the economy and boost employment. These monetary policies had significant bearing on the global financial environment and fund flows, and their repercussions have started to emerge. First, with short-term US Treasury yields close to zero and some European sovereign bond yields even in the negative territory, bonds' balancing effect in a bond/equity mix portfolio was much subdued. Secondly, the protracted abundance of global liquidity drove

investors to equity and other asset markets in pursuit of higher return. Asset prices were inflated as a result and many asset markets are now enduring downward pressure of varying degrees. Thirdly, massive fund inflows into the emerging market economies (EMEs) had buoyed EMEs currencies while weakening the US dollar.

7. However, amid market expectations of US interest rate hikes, we started to see reversal of fund flows and consolidation in the global asset markets. In particular, short-term US Treasury yields began to rise. Global equities were giving up past years' gains. The US dollar also strengthened sharply, signifying the start of a strong US dollar cycle. 2015 marked a tumultuous year for the energy and commodity markets as well as equities and EME currencies, with a magnitude and speed of correction rarely seen in recent years. For example, the US dollar index surged by almost 10% last year, resulting in an unavoidable negative currency translation effect for the Exchange Fund when translating its non-US dollar assets into Hong Kong dollar.

Investment Outlook for 2016

8. Barely a few weeks into 2016, we have already observed further turbulence in the global financial markets, which once again underscored the

imbalance and instability of the current global financial conditions. We must therefore be prepared that the financial markets may continue to see wide fluctuations for some time. The US interest rate normalisation has begun in December 2015. But the pace and magnitude of further US interest rate hikes and their impact on the US and global economies, fund flows and asset markets are still uncertain.

9. The US exit from QE is an uncharted territory, very much like when this unprecedented policy was first introduced. Facing a complex and difficult investment environment, the HKMA will continue to manage the Exchange Fund prudently and make suitable defensive moves in response to market changes. Last but not least, I would like to reiterate that the statutory purposes and long-term investment strategy of the Exchange Fund call for a focus on the medium- and long-term performance of the Fund, instead of short-term fluctuations in the markets.