Remarks by Mr Norman T.L. Chan,
Chief Executive of the Hong Kong Monetary Authority
on 29 January 2019
at the announcement of
Exchange Fund's investment results for 2018

(Translation)

When I announced the Exchange Fund's investment results for 2017 a year ago, the markets were filled with optimism. I said that the markets might have under-priced some risk factors, including the pace of US interest rate normalisation, the negative impact of the US government's foreign trade policy and protectionism on global trade, and geopolitical risks. If things did not turn out to be as rosy as were expected, this could easily trigger significant corrections and volatilities in the asset markets.

Equity Holdings

2. Looking back, all these under-priced risks had indeed materialised one after another in 2018, and there were considerable volatilities and adjustments in global financial markets. First of all, amid investor jitters about the escalating trade dispute between Mainland China and the US, stock markets in emerging market economies and Hong Kong had been on a downswing since the end of January, with the Hang Seng Index losing as much as 27% from its January peak. Major stock markets in Europe and the US had also declined sharply since the fourth quarter, posting a double-digit fall. For 2018 as a whole, global equities declined across the board in general, with the MSCI World Index (which covers stock markets in major developed economies) falling more than 10% and the MSCI Emerging Markets Index 16.6%.

The Hang Seng Index of Hong Kong dropped 13.6%. In this extremely difficult environment, the Exchange Fund's equity holdings recorded an investment loss of HK$59 billion, with foreign equities losing HK$38.3 billion and Hong Kong equities HK$20.7 billion.

Bond Holdings

3. As the US Federal Reserve raised interest rates four times and continued to shrink its balance sheet in 2018, US interest rates went up. In particular, the 10-year US Treasury yield rose to a high of 3.24% in early November before retreating to 2.7%, at the year-end, which was 20 basis points above the 2.5% level at the start of the year. As we know it, bond prices generally go down when yields go up. Having said that, thanks to the conservative and defensive investment strategy of the HKMA, the Exchange Fund's bond holdings recorded a gain of HK$57.4 billion in 2018, which almost offset the loss of its equity holdings.

Currency Translation Effect

4. Due to capital inflows into the US, the US dollar Index rose by 4.4% in 2018, bringing a negative currency translation effect of about HK$9 billion on non-US dollar assets of the Exchange Fund.

Long-term Growth Portfolio

5. As at end-September last year, the Long-term Growth Portfolio (LTGP) recorded an investment income of HK$24.5 billion. The HKMA established the

LTGP ten years ago to invest in private equity and real estate to diversify investment risks and strive to enhance medium- to long-term return of the Exchange Fund. Currently, the invested amount and undrawn commitment of the LTGP totalled HK$478.3 billion. The investment return of the LTGP has been rather satisfactory, with since-inception annualised internal rate of return at 13.8% up to the end of September 2018. The LTGP has helped reduce the volatility of investment returns of the Exchange Fund and enhance the Fund's overall return. This was particularly notable in 2018.

Overall Investment Performance of the Exchange Fund in 2018

6. There are three situations that are unfavourable to the Exchange Fund's investment return: falling equity prices, rising bond yields and a strong US dollar. Notwithstanding a combination of these three adverse conditions in 2018, the Exchange Fund managed to record a positive investment income of HK$13.9 billion instead of a loss.

Placements by Fiscal Reserves and Statutory Bodies

7. According to the sharing arrangement between the Government and the Exchange Fund, the fee payable by the Exchange Fund to Fiscal Reserves was HK$43.8 billion, while the fees for placements by Government funds and statutory bodies totalled HK$13.8 billion in 2018. These figures do not include the fee payable to the Future Fund in 2018. The amount will be announced in the HKMA Annual Report 2018 to be published later this year when the composite rate for 2018 is available.

Outlook for 2019

8. Looking ahead, it is very likely that the investment environment in 2019 will remain as unpredictable and difficult as in 2018. First, the global economy and financial markets will continue to be affected by the US-China trade tension. Although both sides have resumed high-level trade talks recently, it is still uncertain whether they will be able to reach an agreement before the deadline on 1 March. There are no winners in a trade war. The deteriorating market sentiment and slowing investment activities last year reflected to a large extent the market concerns on such a situation. Furthermore, as the Brexit agreement reached between the British Government and the European Union was vetoed by the British Parliament, it is uncertain whether there will be a no-deal "hard" Brexit or a second Brexit referendum. In case of a "hard" Brexit, the macroeconomic environment and financial markets in Europe will be badly hit. Last but not least, the future direction of the US economic and monetary policies is unclear. Recently, there have been increasing market concerns about the US economy beginning to slow down. Emerging market economies including Mainland China are also facing increasing downside risks. All these risk factors will bring about greater uncertainties and potential risks to the global macroeconomic environment and asset markets.

9. As the market outlook for 2019 remains highly uncertain, the HKMA will continue to manage the Exchange Fund prudently. We will monitor market developments closely and enhance our defensive measures as and when appropriate. We will also continue to diversify our investments so as to further enhance the Exchange Fund's resilience against market volatilities.