

Monthly Highlights

- The People's Bank of China (PBoC) extended the trading hours for Renminbi to 23:30 starting on 4 January 2016. The extended hours of onshore market was matched by the HKEx's after-hours futures trading, which can serve as an efficient risk management tool for investors.
- HKEx's USD/CNH futures contract recorded a monthly ADV of 2,071 contracts (US\$207 Mn notional) in December 2015, 98 per cent increased from November 2015. Open Interest reached 24,018 contracts (US\$ 2,402 Mn notational) on 31 December 2015, close to the all-time high record of 23,887 in February 2014.
- HKEx's Chief China Economist, Dr Ba sees that China's domestic bond market is expected to remain active and keep growing in 2016, and bond defaults are expected to return to more normal levels.
- Interview with Michele Leung of S&P: the recent rally in China's local bond market is liquidity driven more than fundamental play, thanks to the volatilities in equity market.

From the Chief Economist's Vantage Point

Outlook: China's Bond Market in 2016

Contributed by Dr. Ba Shusong, Chief China Economist, HKEx

With the IMF's decision to include Renminbi into its SDR basket, more and more overseas institutional investors started to increase their RMB holdings. Demand for Renminbi assets inevitably rose, especially for bonds. Given a number of factors, China's domestic bond market is expected to remain active and keep growing in 2016. Bond defaults are expected to return to more normal levels.

I. Mainland bond markets reform has been speeding up with market volume growing fast

The CSRC has published new administrative measures for corporate bond issuance and trading, which extended the scope of corporate bond issuers to all corporate entities, simplified issuance approval procedures, and emphasised the importance of regulation during and after a transaction. The NDRC has published proposals on the further liberalisation of the corporate bond market, including adjustments to improve the approval efficiency for corporate bond issues. Meanwhile, the NAFMII (National Association of Financial Market Institutional Investors) is working to regulate issuers by tiers and categories, lower the issuance threshold(s) for super and short-term commercial papers (SCPs), and raise the efficiency of private placement notes (PPNs) issuance. It also aims to reform the registration of issues, liquidity, rankings and quotas of non-financial corporate debt financing vehicles. Together, these measures provide a healthy environment and a sound regime for the bond market to develop rapidly.

As of the end of November 2015, the value of outstanding Chinese bonds stood at RMB46.8 trillion, up 30% from the RMB36 trillion at the end of 2014. It was the fastest growth in six years.

As of the end of October 2015, direct financing accounted for 21.22% of public financing, and bond financing under direct financing accounted for 16.78% of public financing.

Fig. 1 Outstanding Balances in Chinese Bond Markets and YOY Growth

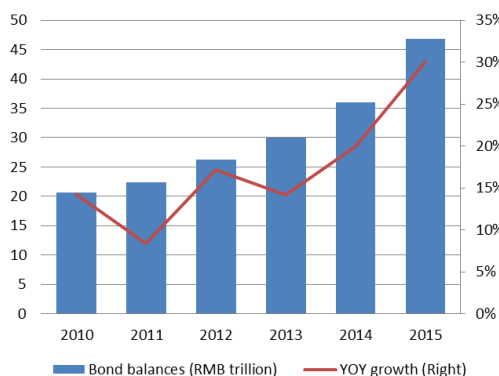
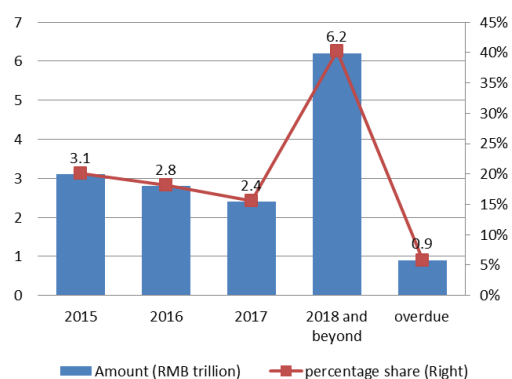


Fig. 2 Maturities of Local Government Debt Outstanding



II. Debt replacements have been proceeding steadily with local debt market likely to expand fast

1) By the end of 2015, about RMB16 trillion of local government debts will remain outstanding

According to arrangements by relevant authorities, screenings of outstanding local government debts have been completed. According to statistics, as at the end of 2015, local government debt will stand at RMB16 trillion, of which RMB15.4 trillion will be local government debt outstanding at the end of 2014 and RMB600 billion will be additional debt approved by the NPC for local governments in 2015.

Of the RMB15.4 trillion of local government debt outstanding at the end of 2014, RMB9.1 trillion was general debt and RMB6.3 trillion was designated debt. Their maturity structures were shown in figure 2.

2) Local debt market likely to grow fast as debt replacements continue in an economic downturn

In terms of new debt for local governments, the quota of RMB0.6 trillion for 2015 has been completely allotted. Considering the downward pressure on China's overall economy and local governments' huge demand for capital, China is expected to further raise the ceiling for local government debt in the coming years.

At the end of 2014, there was RMB15.4 trillion of local government debt outstanding, of which RMB 14.2 trillion was debt to be replaced, after taking out the RMB1.2 trillion of local government bonds. It is likely China will allow the replacement to be completed over a period of time to alleviate possible market impact. If the transition is to last three years, for instance, about RMB4 trillion to RMB5 trillion of bonds for debt replacement would be issued a year.

In terms of actual implementation, the MOF has granted a total debt-replacement quota of RMB3.2 trillion in three phases. Local debt outstanding at the end of November 2015 amounted to RMB4.6 trillion. Excluding new issues in the future, upon the replacement of all debt, the value of local government bonds outstanding should be around RMB16 trillion.

III. Chinese bond markets expected to remain active in 2016

A bull run was seen in Chinese bond markets in 2015. In 2015, monetary easing continued in China has been overall in line with the loose monetary environment across the globe. PBoC continued to inject liquidity into the market through cutting the reserve requirement ratio and interest rates, prompting slides in the benchmark interest rates. Meanwhile, the Chinese stock market saw risk appetite diminishing with considerable volatility in 2015. Large amounts of capital flowed into bonds and pushed down credit-type bond yields.

In the second half of 2015, increased leverage was seen in the bond market, with exchange-traded and interbank collateral repo rates hovering at low levels.

The market has been cautiously optimistic about bond markets in 2016. For example, the market believes low interest rates may be required in the government's debt replacement and leverage adjustment process and demands for debt assets may increase as the structure of public wealth changes. Many researchers are also concerned about the impact of US rate hikes on the bond market and possible capital divergence when the Chinese stock market recovers.

Fig. 3 Interest rates of credit-type bond issuance

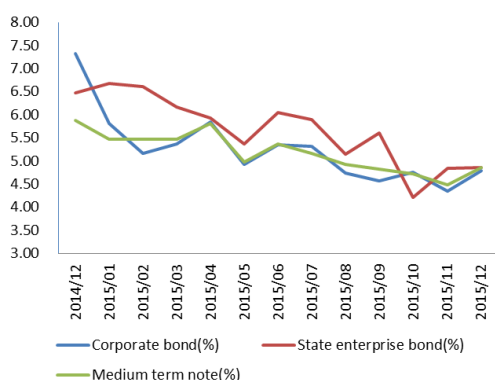
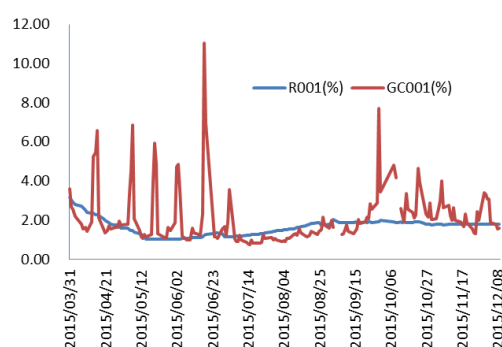


Fig. 4 Interbank 1-day collateral repo rate vs exchange-traded 1-day collateral repo rate



IV. Frequency of Chinese bonds defaults will return to normal levels with the pricing function for credit spreads becoming visible

1) Frequency of Chinese bonds defaults will return to normal levels during economic structural transition

Defaults were frequent in the bond market in 2015. The situation is expected to return to normal in 2016 as capital reduction and deleveraging gathers speed. Bond defaults have spread from public to private products, from state enterprises to private enterprises and from defaults on interest to defaults on the principal. In the absence of regional systemic financial risks, the market has begun to accept defaults of single bonds. Defaults of Chinese bonds are returning to normal levels.

2) Risk pricing function of credit spreads is becoming visible

Changes in credit spreads of state enterprise bonds, Medium Term Notes and AAA and AA grade corporate bonds show that the credit spreads for low grade debentures have been quite wide in December 2015 and has been widening. It shows credit spreads have taken into account credit risk premium, and bonds with lower rating are compensating the investors by providing wider credit spreads.

Between September and November 2015, there was a narrowing of credit spreads between state enterprise bonds, medium term notes and corporate bonds. A crucial short-term factor leading to the situation has been the scarcity of debentures amid over-abundant liquidity.

Fig. 5 Credit spreads of state enterprise bonds with different credit ratings

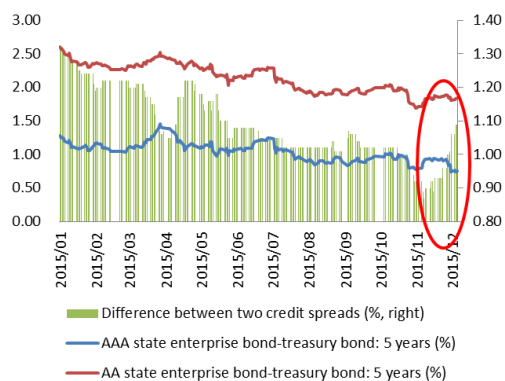


Fig. 6 Spreads of Medium Term Notes (MTN) with different credit ratings

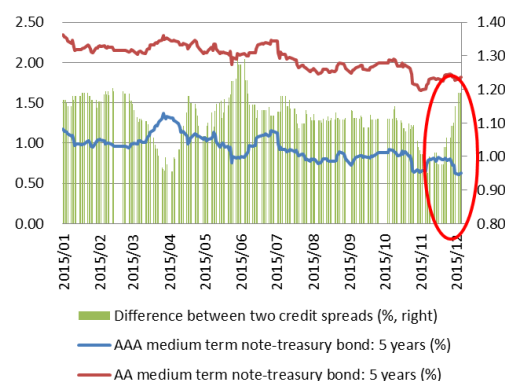


Fig. 7 Spreads of corporate bonds with different credit ratings

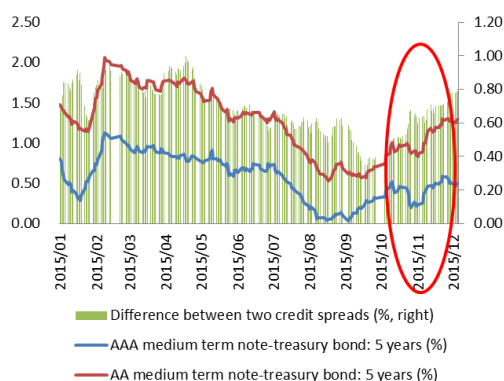
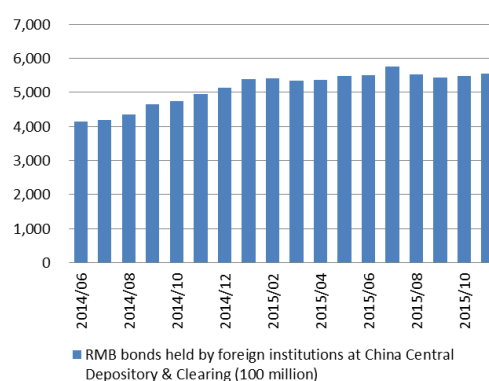


Fig. 8 RMB bonds held by foreign institutions



V. Chinese bond market opening accelerated

RMB bonds held by overseas institutions are expected to increase. In July 2015, the PBoC issued the Notice on Issues Concerning Investment of Foreign Central Banks, International Financial Institutions and Sovereign Wealth Funds with RMB Funds in the Inter-bank Market, easing rules further for the entry of foreign institutions into the interbank bond market. An approval system gave way to a filing system, and foreign institutional investors were allowed to decide their investment amount themselves. Besides cash bond and repo trading, bond lending, bond forwards, interest rate swaps, forward rate agreements and other transactions are also possible now. As of the end of November 2015, interbank market RMB bonds held by foreign institutions at China Central Depository & Clearing Co amounted to RMB555.5 billion. After the RMB's inclusion in the SDR currency basket, demand for capital allocation to RMB bonds is expected to increase.

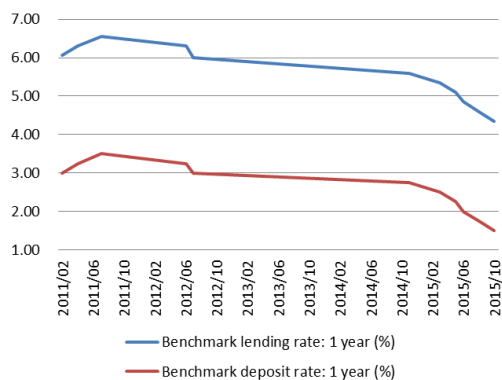
Panda bonds are at an early stage of development but there has been a notable increase in issuance. Panda bonds are at an early stage of development. Before 2015, IFC, Asian Development Bank and Daimler AG issued RMB4.5 billion in RMB-denominated bonds. At present, only the 2009 ADB bonds remain outstanding. There was a notable increase in Panda bond issuance in 2015. According to available information, RMB20.5 billion in panda bonds is being planned for the interbank bond market. A number of foreign institutions are also applying for private issuance of panda bonds in the exchange-traded bond market.

Table 1 Panda bond issuance in 2015

Issue time	Issuer	Issue size
Sep 2015	Hong Kong and Shanghai Banking Corporation Limited	RMB1 billion
Sep 2015	Bank of China (Hong Kong) Limited	RMB10 billion
Oct 2015	China Merchants Holdings (Hong Kong) Co Ltd	RMB500 million
Nov 2015	British Columbia of Canada	RMB6 billion
Dec 2015	Government of South Korea	RMB3 billion

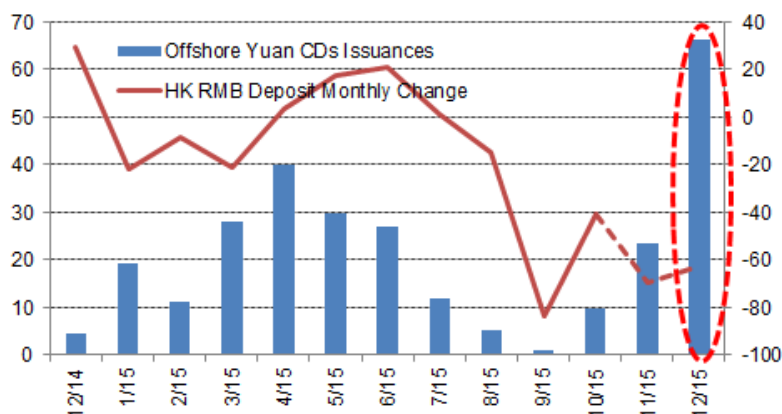
An important contributing factor is the narrowing of spreads between Mainland and overseas markets. To international investors/issuers, a currency commonly used to denominate asset prices will increasingly become a currency with an investment characteristic; and a currency commonly used to denominate debt prices will increasingly become a currency with a financing characteristic. A currency's characteristic decides how it is used in the international market. Spread levels are a key factor that decides whether a currency has an investment or financing characteristic. Take the Japanese Yen as an example. The currency has an obvious financing characteristic, mainly because interest rates are very low in Japan. The RMB has an obvious investment characteristic. An important reason for this is that interest rates in China are higher than in other developed economies, which also explains the sluggish performance of panda bonds in recent years. Nevertheless, since 2015, China has lowered its reserve requirement ratio five times and interest rates five times. Its monetary policy is relatively relaxed now with one-year benchmark lending rate down from 5.35% at the beginning of the year to 4.35%, and one-year benchmark deposit rate down from 2.5% at the beginning of the year to 1.5%. This has created the conditions for panda bond issuance.

Fig. 9 China's one-year benchmark lending and deposit rates

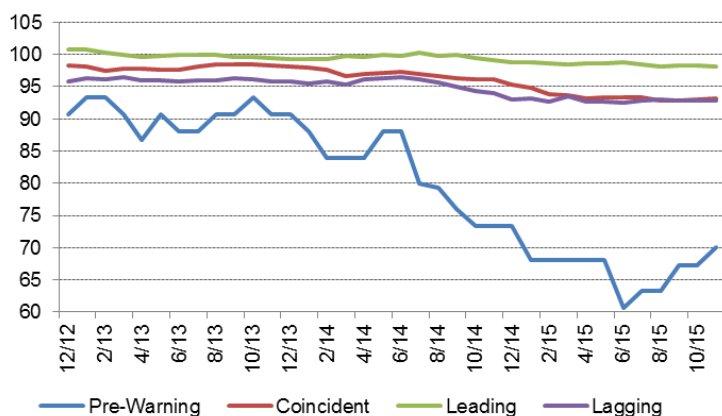


China Macro Update

Offshore Yuan CDs Jump to Record



Macro-Economic Climate Index



Regulatory/Policy Developments

- Offshore Chinese banks are selling a record amount of RMB-denominated certificates of deposit as China takes steps to curb outflows of the currency. Sales jumped to an unprecedented RMB66.1 billion (US\$10.2 billion) this month, data compiled by Bloomberg show. That comes after Hong Kong's RMB deposits, the world's largest, shrank to the smallest in two years. The Chinese government has in the past month imposed restrictions on RMB outflows, including ordering a halt to offshore banks borrowing from domestic markets through bond repurchases, and suspending new applications in a program that allows domestic investors to buy overseas assets denominated in the currency. The measures are aimed at making it harder for speculators to short the RMB in the offshore market.
- China will allow limited convertibility of the RMB in three free trade zones (FTZ) in Guangdong, Fujian and Tianjin, a move further liberalising its capital account after its currency was admitted to the IMF's reserve basket. Onshore institutions that are registered in the FTZs and that do not fall into negative lists each will be able to freely convert up to US\$10 million worth of RMB annually. Multinational companies based in these FTZs also will be allowed to do cross-border two-way cash pooling within a corporate group.

Macro Economy Update

- "Flexible" and "forceful" are the key words emerging from a meeting of China's leaders that focused on the danger of allowing economic growth to slow too much. Statements released Monday at the culmination of a Central Economic Work Conference emphasised the need to create monetary conditions for structural reforms that include restraining the country's reliance on credit.

Market/Product Developments

- Trading in Shanghai will end at 11:30 p.m. local time starting on 4 January, instead of the current 4:30 p.m., the People's Bank of China (PBoC) said in a statement on 23 December, adding that permitting foreign institutions with significant volumes to trade in the onshore foreign-exchange market will help narrow the gap between the currency's rates at home and abroad.
- The China Foreign Exchange Trading System (CFETS) introduced an RMB trade-weighted index (TWI) on 11 December. The PBoC highlighted this index on its website as an important and more appropriate reference for the market that has overly fixated on the bilateral USD-RMB exchange rate.

Key Research Reports/Conferences

- The RMB is now the second most active currency between Japan and Mainland China/Hong Kong with the RMB accounting for 7 per cent of payments, by value, compared to 3 per cent two years ago, according to SWIFT's latest RMB tracker.

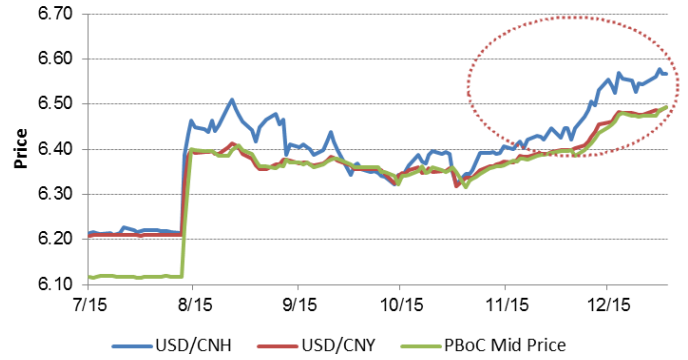
China Key Economic Indicators	Current	Prior	Chg	Next Release Date
Real GDP (yoy %)	6.9	7	↓	01/19/2016 10:00
CPI (yoy %)	1.5	1.3	↑	01/09/2016 09:30
PPI (yoy %)	-5.9	-5.9	↔	01/09/2016 09:30
Industrial Production (yoy %)	6.2	5.6	↑	01/19/2016 10:00
FAI (yoy %)	10.2	10.2	↔	01/19/2016 10:00
Foreign Investment (yoy %)	1.9	4.2	↓	01/08/2016 01/12
CFLP Manufacturing PMI	49.7	49.6	↑	02/01/2016 09:00
PBOC Bankers Confidence Index	37.9	40.6	↓	TBC
PBOC Bankers Loan Demand Index	56.8	56.7	↑	TBC
CEMAC Leading Economic Index	98.11	98.34	↓	01/28/2016 01/31
Exports (yoy %)	-6.8	-6.9	↑	01/13/2016
Imports (yoy %)	-8.7	-18.8	↑	01/13/2016
M2 Money Supply (yoy %)	13.7	13.5	↑	01/10/2016 01/15
Retail Sales (yoy %)	11.2	11	↑	01/19/2016 10:00
Consumer Confidence Index	113.1	109.7	↑	01/06/2016 09:45
Regulated Reserve Ratio (%)	17.5	18	↓	Infrequent
Official Foreign Exchange Reserves (USD bn)	3438.28	3525.5	↓	01/07/2016
Three-Month SHIBOR (%)	3.09	3.04	↑	Continuous
10-Year Gov't Bond Yield (%)	2.86	3	↓	Continuous
CNY/USD Exchange Rate	6.5032	6.378	↑	Continuous

RMB FX Market Dynamics

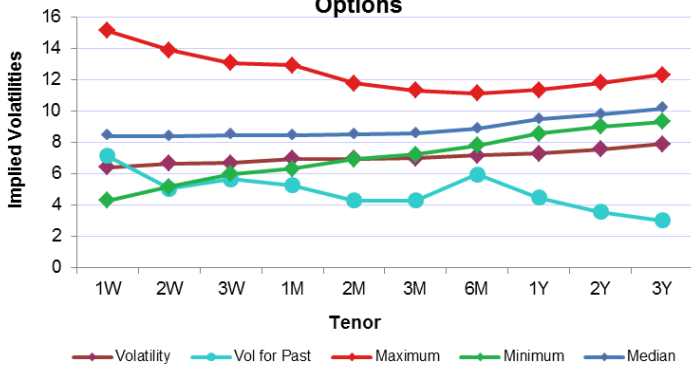
Offshore RMB FX Market Comments

- The Hong Kong-traded offshore yuan hit an intraday low of 6.5965 on 30 December morning, its weakest since late September 2011.
- According to market forecast data from Bloomberg, the USD/CNH rate will most likely stay within the range of 6.5 to 6.6 before the first quarter of 2016.
- The spread between the onshore and offshore markets for the yuan has been growing since the devaluation, approaching 1,000 pips towards the end of December. On the heels of this recent divergence between onshore and offshore Yuan, China has suspended some foreign banks from trading FX.

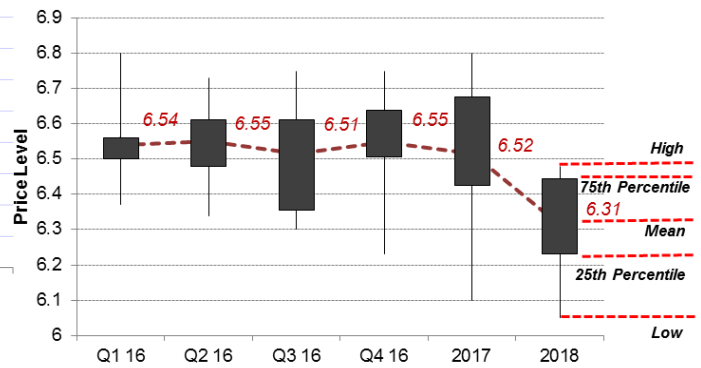
Onshore/Offshore RMB Price Range



Implied Volatilities of OTC USD/CNH ATM Options



Market Forecasts for the Price Level of USD/CNH

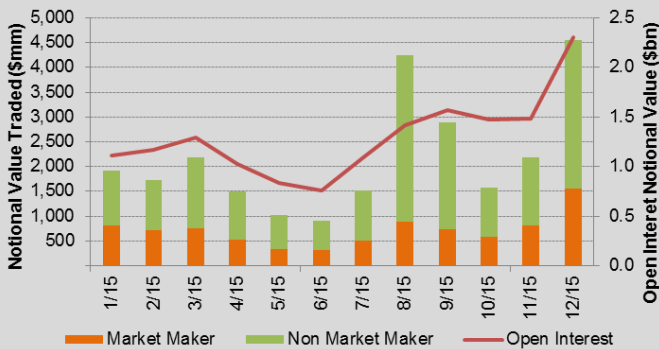


HKEx's USD/CNH Futures

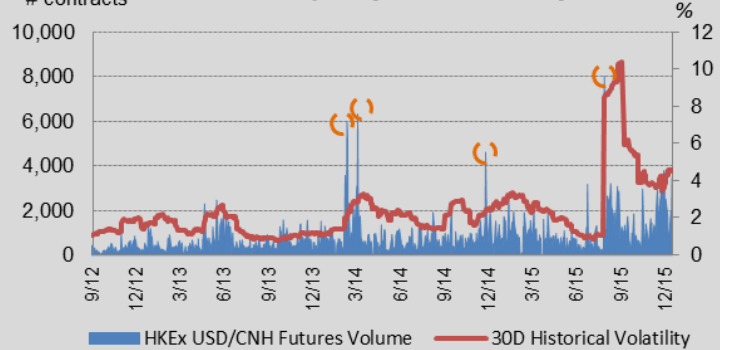
Product Highlights

- HKEx's USD/CNH futures contract recorded a monthly ADV of 2,071 contracts (US\$207 Mn notional) in December 2015, 98 per cent increased from November 2015. Open Interest reached 24,018 contracts (US\$ 2,402 Mn notational) on 31 December 2015, close to the all-time high record of 23,887 in February 2014.
- Trading volume was high in the March 2016, June 2016 and December 2016 contracts, which accounted for 57 per cent of total monthly volume in December. Open interest was high in the June 2016, December 2016 and March 2017 contracts, which accounted for 65 per cent of total open interest at the end of December.

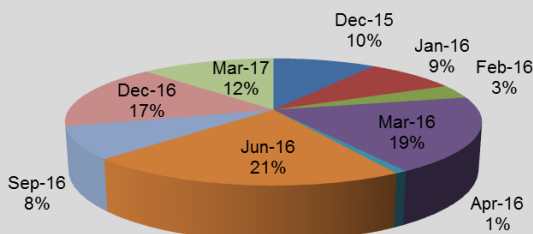
USD/CNH Futures Turnover and OI



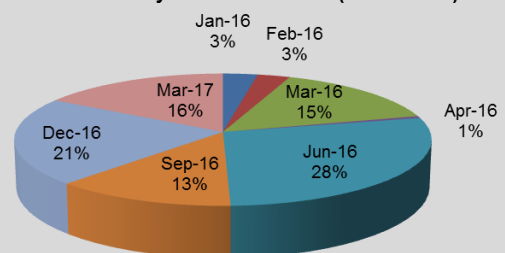
HKEx USD/CNH Futures Contract Provides Best Liquidity Amid Volatility



Breakdown of Volume by Contract Month (12/2015)



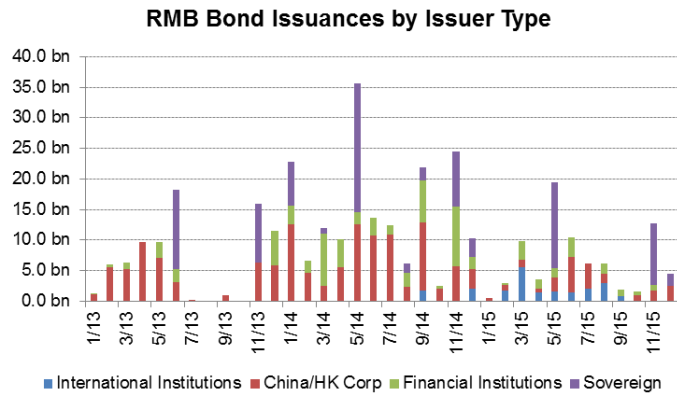
Breakdown of OI by Contract Month (31/12/2015)



Offshore Bond Market Dynamics

Offshore RMB Bond Market Comments

- There was only two primary issuance in the CNH space this month with RMB 4.5bn of new issues. Deposits in Hong Kong increased by 1.2per cent MoM to RMB 864.2bn at the end of November. The total remittance of RMB for cross-border trade settlement amounted to RMB 508.9bn in November, compared to RMB 410.8bn in October.
- Total issuances plunged 55 per cent year-on-year in 2015 to RMB 79.7bn, the lowest level since 2012, according to Wind data. As long as the onshore bond market continues to provide favorable funding levels to issuers, offshore RMB corporate bond supply is expected to remain low.



Onshore Bond Market Dynamics

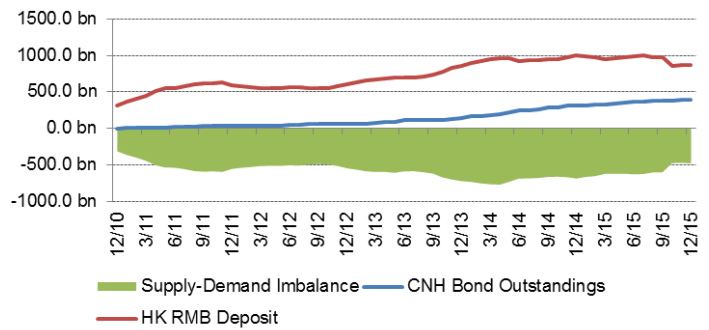
Onshore RMB Bond Market Comments

- Onshore bond issuance decreased 11.4 per cent to RMB2.3 trillion in December from RMB2.6 trillion in November.
- Total issuances on the exchanges has increased substantially in 2015, almost double the issuance number and triple the issuance value seen in 2014. The top three contributions come from the categories of LGB, corporate bond, and ABS, accounting for more than 80% of the increase.
- China's Panda bond market is gaining plenty of traction as four Panda bonds have been issued since China reopened the market in the end of September. And with a pair of sovereign issuers eager to launch their deals, the asset class is set to soon eclipse dim sum bonds.

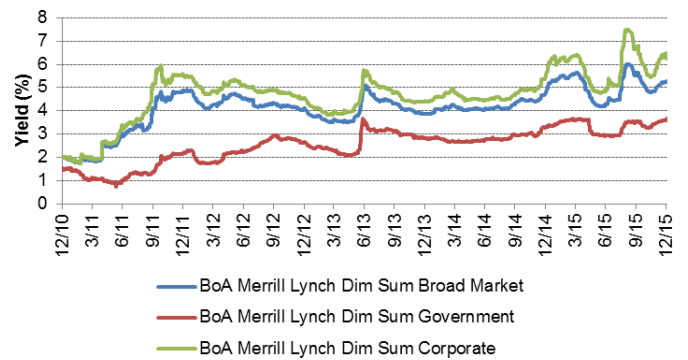
Key Figures on Interbank Market Cash Bond Transactions (classified as per bond types)			
Bond Type	Number of Deals	Trading Value(100M)	Yield to Maturity(%)
Policy Financial Bond	37,322	47,089.95	3.1344
Treasury Bond	9,285	12,555.89	2.7883
Medium-term Note	15,055	11,842.06	4.6979
Corporate Bond	11,943	7,760.92	4.9228
CDs	3,944	10,001.00	3.1699
Commercial Paper	20,122	15,187.75	3.6032
Central Bank Paper	56	188.60	2.8120
Others	4,239	5,008.42	4.9606
Total	101,966	109,634.59	3.5379

NAFMII Guidance for Non FI Debt Issuing (as of 2015/12/30)																
	1Yr	MoM	3Yr	MoM	5Yr	MoM	7Yr	MoM	10Yr	MoM	15Yr	MoM	20Yr	MoM	30Yr	MoM
AAA+	3.22	↓	3.72	↓	3.95	↓	4.25	↓	4.47	↓	5.05	↓	5.22	↓	5.48	↓
AAA	3.40	↓	3.87	↓	4.14	↓	4.53	↓	4.78	↓	5.36	↓	5.65	↓	5.92	↓
AA+	3.64	↓	4.26	↓	4.62	↓	5.03	↓	5.42	↓	6.01	↓	6.37	↓	6.65	↓
AA	4.15	↓	4.75	↓	5.18	↓	5.66	↓	5.97	↓	6.69	↓	7.02	↓	7.48	↓
AA-	5.47	↓	6.04	↓	6.53	↓	7.38	↓	7.86	↓	8.35	↓	8.73	↓	9.00	↓

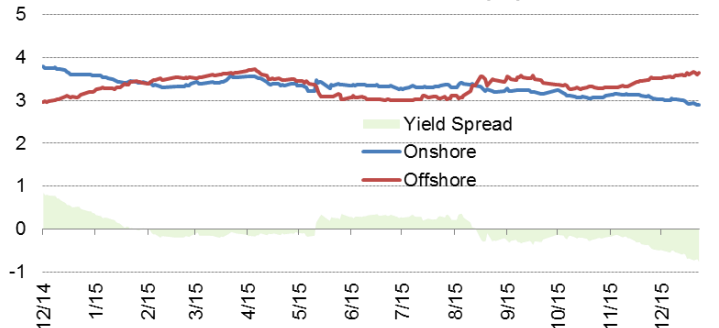
Offshore RMB Deposits vs. Outstanding Dim Sum Bonds



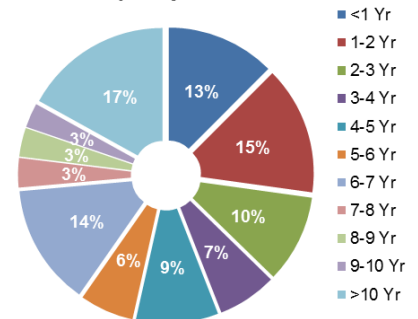
Dim Sum Bond Performance



MoF T-Bond Yield 5Y: Onshore vs. Offshore (%)



MoF T-Bond Outstanding Split by Tenor

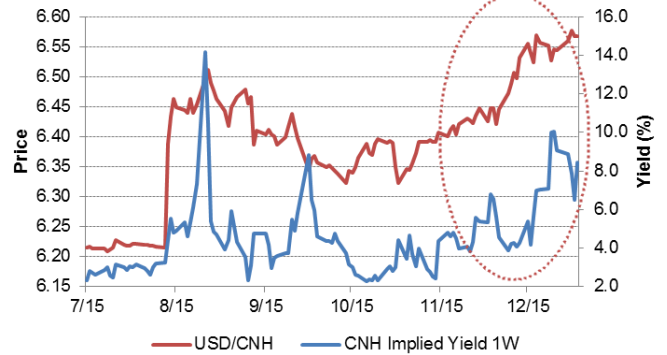


Onshore/Offshore Short-Term Interest Rate Dynamics

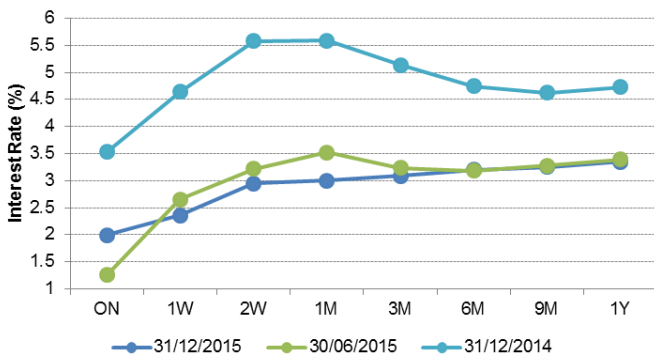
Onshore/Offshore RMB STIR Market Comments

- The offshore CNH liquidity has been drained up by the on-offshore arbitrage flow and seasonal holiday effect recently.
- Following the PBoC actions of suspending some foreign banks from FX trading, the cost of borrowing yuan in Hong Kong decreased substantially from 7.9 per cent to 5.5 per cent on 30 December.
- The CNH HIBOR yield curve is generally uptrend in December as the yields on the short-end increased substantially from the lower level seen in November.

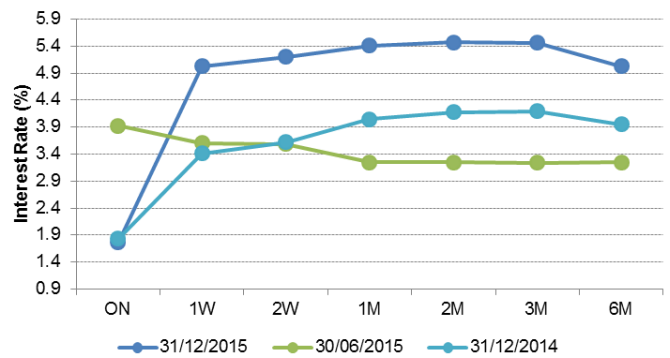
CNH Implied Yield Spike Driven by FX Movement



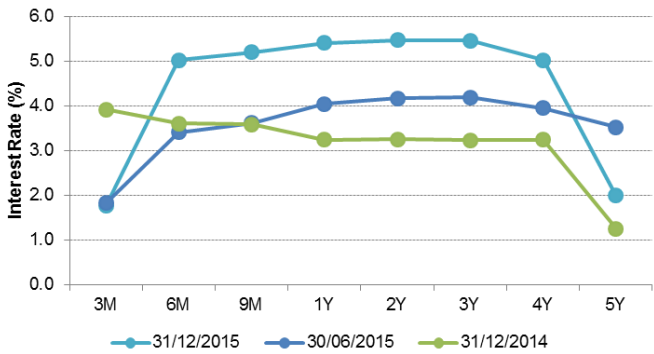
CNY SHIBOR Yield Curves



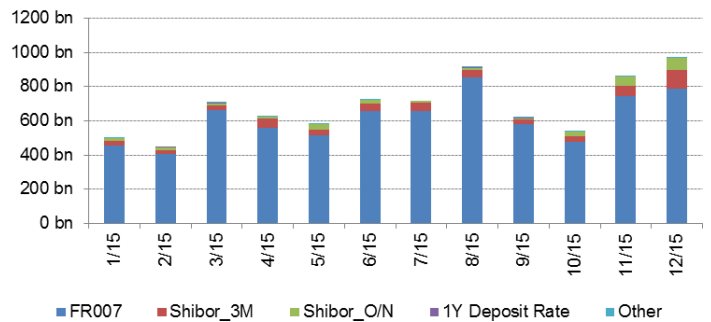
CNH HIBOR Yield Curves



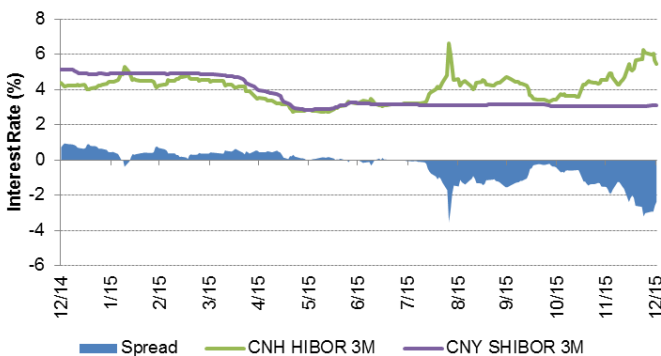
Onshore IRS (7D Repo) Yield Curves



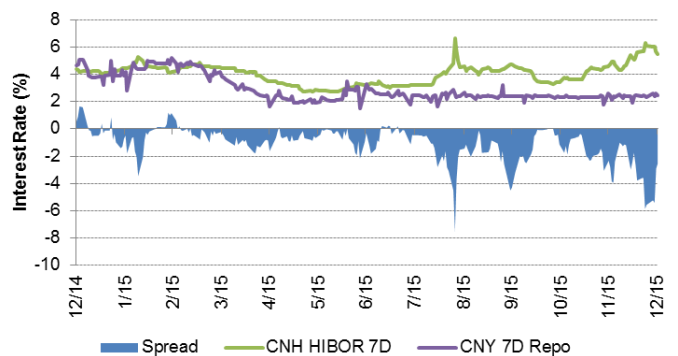
Onshore IRS Trading Notional Principal



CNY SHIBOR vs. CNH HIBOR



CNY 7D Repo vs. CNH HIBOR

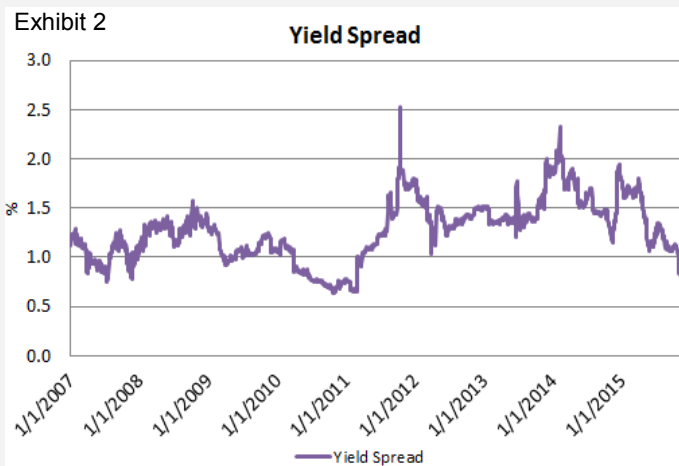


Expert Corner

Contributed by Michele Leung, Director of Fixed Income Indices, S&P Dow Jones Indices

Chinese Corporate Bonds: The Rally and Beyond

Despite the slowdown in Chinese economy and currency weakness, the local bond market, as represented by the S&P China Bond Index, rallied 6.63% YTD, data as of Dec 3, 2015. The Chinese corporate market has been expanding rapidly, the market value grew 21 times to CNY 11 trillion since December 2006, it currently represents 33% of overall market exposure, see exhibit 1. The credit spreads are also trading tighter and now reached a 5-year low (see exhibit 2). Yet the market argued the recent rally is liquidity driven more than fundamental play, thanks to the volatilities in equity market.



If we take a closer look, the volatility of Chinese equities is 8 times of the Chinese bonds in the past year. The total return of Chinese bonds is relatively robust, compared with the negative returns in the equity market. Please see exhibit 3 for the statistics, note these returns are in USD and already accounted for the currency fluctuation.

While the spreads tightened significantly with the bond rally, the recent default headlines shed light on the emerging credit risks. For example, Sinosteel, a centrally-owned SOE, postponed its option exercise date and deferred its interest payment. It received broad attention as it is the first onshore enterprise bond to default. It has also shown that SOEs are not immune to the economic slowdown and implicit government support should no longer be presumed. In fact, the majority of the outstanding corporate bonds are issued by local or central SOE.

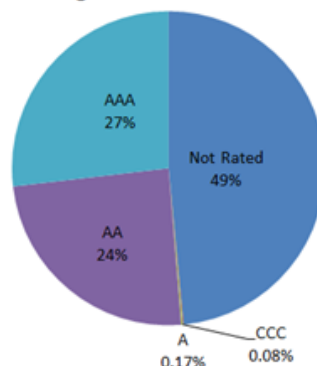
Exhibit 3: Index Comparison

Index	1Yr Return	1Yr Risk	1Yr Risk Adj Return
S&P China BMI (US Dollar)	-3.32%	29.07%	-0.1143
S&P China Composite Select Bond Index (USD)	3.30%	3.38%	0.9770

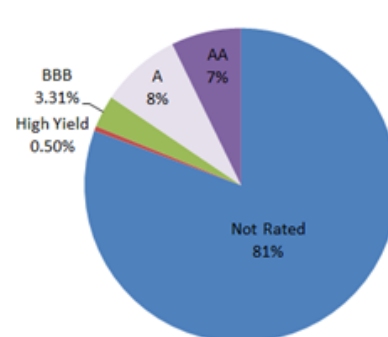
Traditionally, investors have used credit ratings as an assessment of the credit worthiness of a borrower. According to the S&P China Bond Index, over 51% of overall exposure are rated A or above by at least one of the local rating agencies; of which, 27% are being rated as AAA. Nevertheless, there may be discrepancies between ratings by Chinese local rating agencies versus corresponding global ratings, if any. Note while some of the local rating agencies are established via joint ventures with international players, the onshore corporates are not typically rated by international rating agencies at the bond level, only issuer level ratings are available. This lack of consistency and transparency make it more difficult for investors to gauge the credit quality of the corporate bonds.

Exhibit 4

The Rating Breakdown by Local Rating Agencies on Bond Level



The Rating Breakdown by International Rating Agencies on Issuer Level

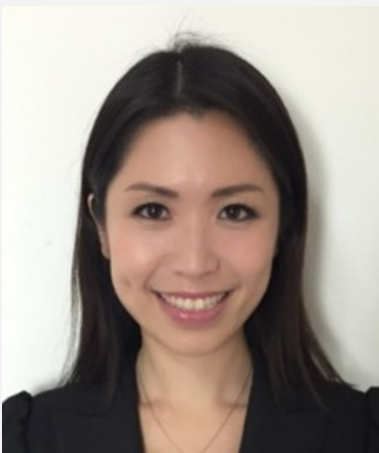
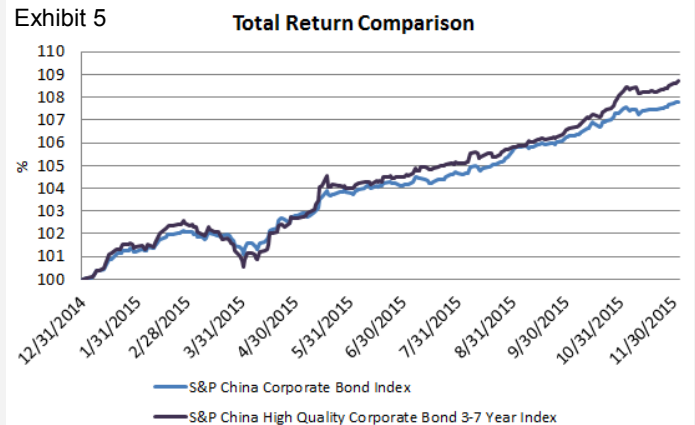


Hence, it is increasingly important for investors to have tools to screen for high quality bonds in midst of market volatilities. S&P Dow Jones Indices launched the S&P China High Quality Corporate Bond 3-7 Year Index earlier this year in response to measure such market. The index adopted a two-tier approach in order to identify the high quality corporate bonds in China. Securities must satisfy the following two ratings criteria in order to be eligible for inclusion:

- Issuers must be rated investment grade by at least one of the international rating agencies (S&P, Moody's and Fitch). The minimum credit rating for investment grade is BBB-/Baa3/BBB-.

- Securities must be rated 'AAA' by at least one of the following local Chinese rating agencies
 - China Chengxin International Credit Rating Co., Ltd
 - China Lianhe Credit Rating Co. Ltd.
 - Dagong Global Credit Rating Co., Ltd.;
 - Shanghai Brilliance Credit Rating & Investors Service Co., Ltd.
 - Pengyuan Credit Rating Co. Ltd

The S&P China High Quality Corporate Bond 3-7 Year Index currently tracks 40 corporate bonds with yield-to-maturity at 3.71%. Its total return has been 8.70% YTD, outperforming its benchmark, the S&P China Corporate Bond Index, which rose 7.81% in the same period.



Michele Leung is Director, Fixed Income Indices, at S&P Dow Jones Indices. With over 10 years of investment experience, Michele has solid product knowledge across different assets class and particularly in fixed income. Michele oversees the creation and management of Asian fixed income indices. Michele currently provides marketing collaterals and blogs, which are available on www.spdji.com

Prior to joining S&P Dow Jones Indices, Michele was senior associate at China International Capital Corporation. And previously, Michele was the fixed income product specialist in J.P. Morgan Private Bank. Michele is also a chartered Financial Risk Manager (FRM).

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