Economics

DBS Focus

Hong Kong: A second year of recession

Economics

Group Research

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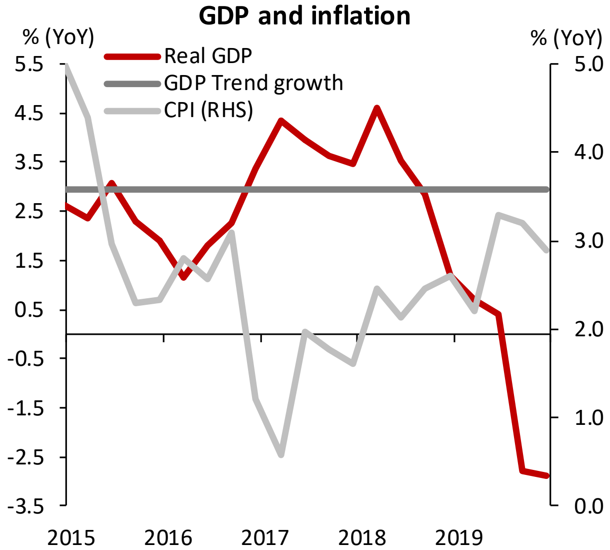
- *The 2019-nCoV pandemic will extend Hong Kong's technical recession into 1Q20, its longest since 2001.*
- ***Implication for forecast**: We have downgraded the GDP forecast for 2020 to -0.9% from +1.5% previously.*
- ***Implication for investors**: The hangover from the protests and the fallout from the pandemic will hurt retail sales and the property market, but the downside risk could well be limited if the worst of the crisis passes by the end of 2Q.*

GDP and inflation



Source: CEIC, DBS

Real GDP YoY forecasts

Indicators (%)	1Q20	2Q20	3Q20	4Q20	2020
Consumption	-3.0	-2.7	1.1	2.0	-0.7
Investment	-15.0	-10.0	0.5	4.0	-5.1
Government spending	13.0	8.0	5.0	2.0	7.0
Net export	-7.0	-5.0	-3.0	-1.5	-4.1
GDP	**-3.8**	**-3.0**	**1.2**	**2.2**	**-0.9**

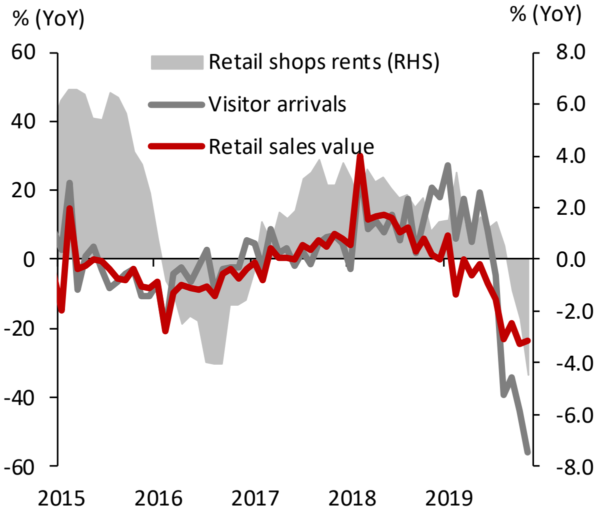
Longest technical recession since 2001

The outbreak of the Wuhan Coronavirus (2019-nCoV) will likely extend Hong Kong's technical recession into 1Q20, making it the longest since 2001. On a sequential basis, real GDP has already contracted by a third straight quarter by 0.4% QoQ in 4Q19 from lingering social movement and the China-US trade war. We have downgraded Hong Kong's GDP forecast for 2020 to -0.9% from +1.5% previously.

Sequentially, impact of the virus on the economy would be severe in the first quarter. Private consumption, which accounts for over 60% of the city's GDP, will take the hardest hit. The re-export sector (99% of exports) will remain subdued as factories in China may cease operations temporarily. Also, Chinese importers may re-route imports from the US given the trade obligation. Investment sentiment will also stay sluggish in view of enormous uncertainties.

Yet, the plunge will not be as significant as that in the Global Financial crisis and Asian Financial Crisis (-7.8% and -8.3%) given the relatively low base comparison in 2019 (+0.7% in 1Q19). We should see some stabilization in 2Q on a warmer weather and a technical rebound of 1.9% in 2H20, thanks to the expected recovery of the Chinese economy. A large-scale stimulus is also expected to cushion the recession.

Tourist arrivals, retail sales and rent



Source: CEIC, DBS

Downside to tourism and retail sales

The tourism and consumption related sectors have been dampened by a weakening Chinese economy and domestic social instability. Private consumption and services exports continued to shrink by 3.0% and 25.0% respectively in 4Q19, from 3.3% and 14.4% in the previous quarter. Retail sales registered the 10^{th} consecutive decline of 23.6% in November; tourist spending accounted for 40% of the sector's performance. This was the fifth double-digit plunge in a row. In fact, visitor arrivals slumped by 50.0% in 4Q19. Tourist hot picks such as goods from department store, clothing, jewelry, and cosmetics/medicines fell by 30-40%. Restaurant receipts also dropped by 11.8% in 3Q19.

The near-term outlook for the retail sector remains weak due to ongoing pandemic risks. During the SARS outbreak in 2003, visitor arrivals to Hong Kong dropped by almost 70%. As Hong Kong is deeply more connected with the rest of the world and especially China today, the fallout on consumption and tourism sector will be more than 17 years ago. Lifted by the tourist inflow from China ever since the implementation of Individual Travelling Scheme, number of total visitors jumped by 319% during 2003-2018. Although the sector performance was dampened by the social unrest in 2H19, shares of visitors from the Mainland China stayed at 79% in 2019. Visitors from the rest of the world could hardly arrest the drop given its less significant contribution. We expect the hotel occupancy rate, which fell from average of 91.4% in 2018 to 65.0% in 4Q19, to drop further in 2020. Likewise, business receipts of tourism, convention & exhibition are expected to contract further from its -27.8% drop in 3Q19.

Domestic consumption will continue to plunge from negative wealth effect via a weaker stock market and rising unemployment. The Hang Seng Index has already corrected from the post-Phase 1 trade deal of 29,000 in mid-January to 26,500 as of yesterday. More joblessness is likely after the Chinese New Year. In fact, the unemployment rate of the sectors related to consumption and tourism (or 16.5% of the labour force) has already jumped from 3.9% in 2Q to 5.2% 4Q. In turn, the overall jobless rate has, on a 3-month moving average, bounced of its 20-year low of 2.8% to 3.3%.

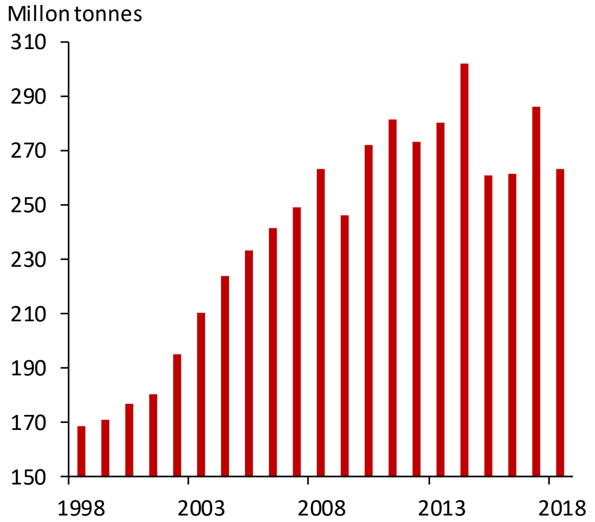
Retail rents will need to sharply correct to prevent large scale business closures and lay-off. This would be particularly challenging for shopping malls tenants because of the reluctance of mall operators to restructure rental terms.

No respite from the trade deal

Exports of goods rebounded to 3.3% in December after 13 consecutive declines, thanks to the suspension of additional US tariffs on imports from China. This was, however, not enough to prevent the sector from a 2.6% contraction, in real terms, for FY19.

Imports volume also fell by 7.2% amid weakened domestic demand. Looking ahead, exports performance will depend crucially on Phase 2 China-US trade negotiations during the US Presidential Election Year. Core disputes including intellectual property protection, financial market openness and other non-trade barriers remained unsolved.

Air and port cargo throughput



Source: CEIC, DBS

The Phase 1 trade deal requires China to import USD200bn of US agricultural goods, some of which may have redirected from being cleared in Hong Kong to the mainland. In the months ahead, the Coronavirus will constrain industrial output and shrink domestic demand in the Mainland. This will in turn weaken re-exports between China and rest of the world through Hong Kong. As re-exports accounts for 99% of total outward shipments, the lackluster transshipment figures will continue to weigh on the headline GDP growth.

An uncertain time for investment

Likewise, **the investment sentiment weakened further due to social unrest and China-US trade war.** Gross domestic fixed capital formation contracted by 16.2% YoY in 4Q19, worse than its GFC-low of -15.7% in 4Q08. Machinery, equipment and intellectual property plunged amidst a pessimistic business outlook.

In fact, the PMI has contacted for almost two years. The Quarterly Business Tendency Survey (QBTS) also pointed to a weak economic and investment outlook across the board. Both private and public building and construction also headed south.

QBTS: Expected changes in business situation

	Net Balance (% point)				
Sectors / Period	1Q19	2Q19	3Q19	4Q19	1Q20
Manufacturing	-3	-1	-8	-24	-27
Construction	-23	-22	-7	-45	-28
Import/export trade and wholesale	-23	-8	-8	-23	-23
Retail	-6	-8	-24	-61	-39
Accommodation and food services	-5	-9	-17	-44	-42
Transportation, storage and courier services	-13	-1	-9	-26	-33
Information and communications	-3	13	10	6	-2
Financing and insurance	-8	9	-6	-21	-16
Real estate	-5	6	-10	-12	-18
Professional and business services	-7	-4	-3	-25	-13
All	-12	-1	-8	-25	-22

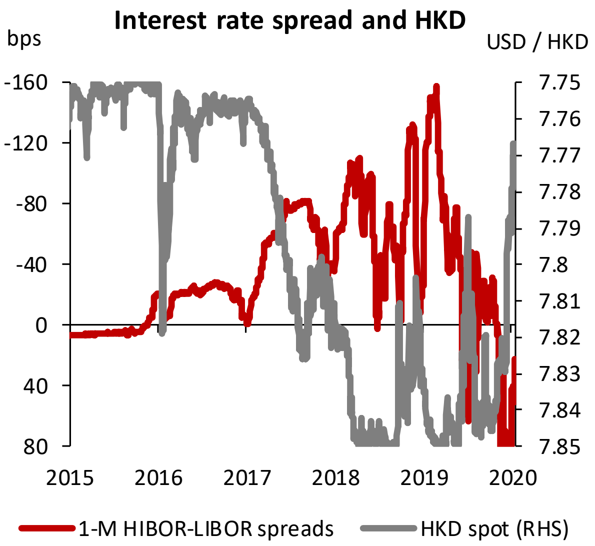
Source: Census and Statistic Department, Hong Kong Government

Decelerating inflation

Headline CPI has edged down to 2.9% YoY in December after it held above 3% for 6 months on the swine fever. Pig stocks in China rebounded by 2% MoM after 12 straight months of declines. In 2020, consumer inflation is expected slow further on the Coronavirus outbreak but avoid the deflation experienced during SARS. Given subdued consumption and a weak job market, we have lowered our CPI from 2.5% to 1.5%.

Resilient financial markets

Hong Kong's financial markets have been resilient. HKD strengthened from 7.85 per USD in August to 7.77 as of today. 1M HIBOR-LIBOR spreads have reversed from -47bps to +59bps. HKD deposits growth also recovered from 1.8% in August to 2.5% in December. Demand for the HKD was strong during the quarter due to deescalating social unrest and strong demand for HKD assets. For example, the number of IPOs in January totaled 24, more than the 14 launched the same month a year ago. Hang Seng Index rallied from 25,000 to 29,000 between August and mid-January.



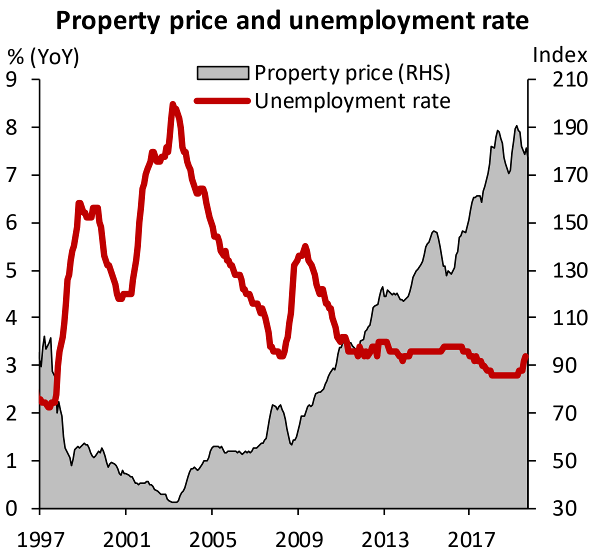
Source: Bloomberg, DBS

Looking ahead, pandemic risk is expected to keep the HIBOR-LIBOR spreads positive. Risk premium increased as reflected by the sharp fall of Hang Seng Index. Corporates may seek additional cash to tide weaker sales and temporary shutdowns. In fact, timed HKD deposits rates offered by Chinese banks have continued to rise after the Chinese New Year. The HKD peg should remain rock-solid on a substantial Exchange Fund (November: USD529bn) that was more-than-double the monetary base.

The budget announcement later this month is likely to include large-scale stimulus to address the lingering recession. The fiscal package since the social unrest only amounted to HKD21bn or 0.7% of the GDP, well below the HKD57bn (3.4% of GDP) during the financial crisis in 2009.

Asset markets

Prices on the secondary market fell by only 6.5% in 2H19 despite the political uncertainties. In fact, it went up by 2.1% in 2019 and 1.0% in YTD 2020. The current pandemic will likely reverse the uptrend. Given the economic downturn in China, business owners may liquidate assets in Hong Kong to increase cash holdings.



Source: CEIC, DBS

Still, we believe the downside risk will be limited for the following reasons.

1. There could be a consolidation of transaction volume. Property owners (secondary market), as well as developers (primary market), are likely to adopt wait-and-see approach, i.e. limit the supply the available properties in the market.

2. Yet, panic sell-off is not likely if the outspread of 2019-nCoV could be contained by 2Q20. Given the previous experience from SARS, the property price index rebounded by 132.9% from the post-SARS low of 31.8 to pre-Global Financial Crisis high of 74.0. This will arrest the short-term price correction expectation and hence actual price movement.

3. The unemployment rate is still far from 5.0%, a level usually triggers large scale of defaults. The labour demand-supply imbalance from aging population should

partly offset the upward momentum of jobless rate.

4. Other indicators also point to a relatively low default risk. Affordability ratio, at 61.6% in December 19, is much lower than the peak of 116.6% in mid-1997. Likewise, loan-to-value ratio was still lower than the historical-high of 68.9% in 3Q02 as at end-19 (53.4%). No. of outstanding negative equity (128 cases) was also much less than the peak at SARS (100,600 cases).

5. Policy support could cushion the downtrend. The Policy Address in October allows potential homeowners to access the property market with higher leverage and weaker stress test requirements.

6. More importantly, the easing of global monetary conditions will continue to support asset prices. In view of the trade tension as well as the disease outbreak, central banks, especially the People's Bank of China, will inject more liquidity into the system (See: 2019-nCoV outbreak: Policy implication and revised outlook for China, February 04, 2020).

7. The long-lasting demand-supply imbalance shall remain (See: Challenge Galore, November 20, 2019). The risk of a sharp correction has been kept at bay.

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Sources: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations).