Economics

DBS Focus

Hong Kong Outlook 2020: Challenges Galore

Economics/Strategy/Rates/FX

Group Research

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- *Near-term outlook is negative due to the ongoing social movement and trade war uncertainty.*
- *But we expect a mild rebound in property prices thanks to policy supports.*
- *Long term trend growth will likely be lowered to 1.5% versus 10-year average of 2.8% amid weakening capital investment.*
- *The likelihood of fully enacting the Hong Kong Human Rights and Democracy Act is low.*
- *Rising US' alertness over technological transfer through Hong Kong to China is a long-term concern.*

Forecasts

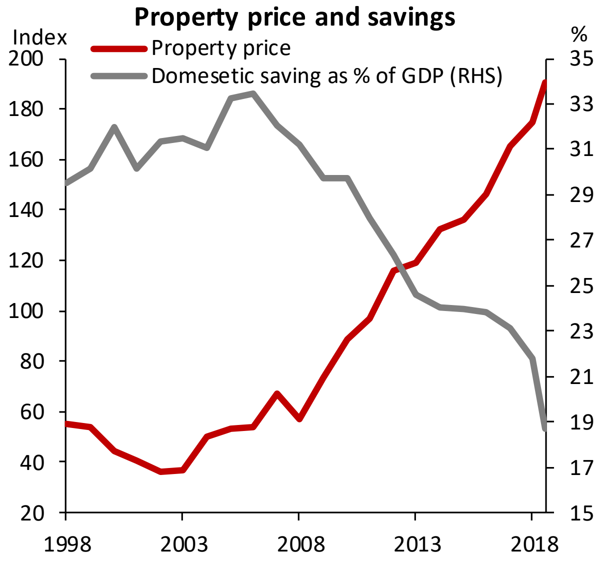
	2018	2019F	2020F	2021F
Real GDP, yoy%, ave	3.0	-1.7	1.5	1.5
CPI, yoy%, ave	2.4	2.7	2.5	2.5
M2, yoy%, ave	4.3	2.5	3.0	2.8
Private sector investment, yoy%, ave	4.7	-20.0	2.0	2.0
Current account, % of GDP	4.3	4.5	4.0	3.7
Trade account, % of GDP	-8.9	-9.5	-9.0	-8.7
Financial and capital account, % of GDP	-6.5	-4.4	-3.9	-3.6
Overall BOP, %GDP	-2.2	0.1	0.1	0.1
Reserves, USD bn	424.7	439.0	420.0	400.0
Fiscal balance, % of GDP	3.4	0.3	0.8	0.7
Exports, yoy%	6.8	-6.0	3.0	5.0
Exports to the US, yoy%	8.7	-14.1	5.0	8.0
Policy rate, eop	2.75	2.00	2.00	2.00
10-yr rate, eop	1.95	1.55	2.00	2.30
USDHKD, eop	7.83	7.85	7.83	7.80

Stormy seas

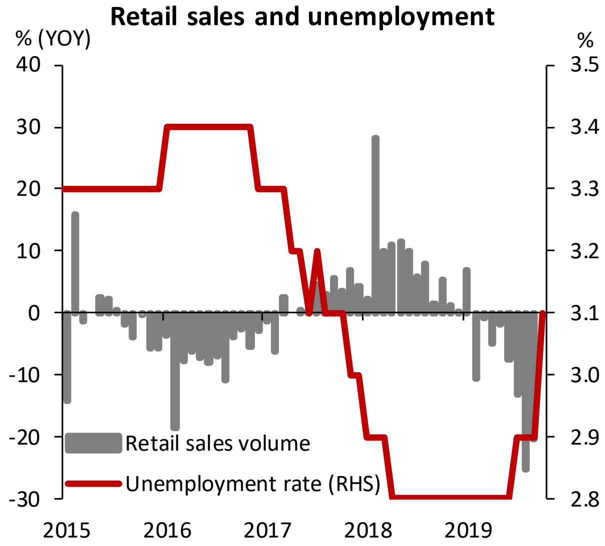
The ongoing social movement and China-US trade war pushed Hong Kong to a technical recession in 3Q. Revised reading on the 3Q19 real GDP growth was -2.9%, the first YoY decline since the Global Financial Crisis in 2008-2009. On a sequential basis, it contracted by 3.2% after recording a 0.5% drop in 2Q. The depth of the economy could serve as a buffer against the economic downturn.

What is surprising is however the resilience of property prices, especially after new polices announced after the Policy Address. The property price has already rebounded 1.7% from its year-low in late October. Number of Sales & Purchase Agreement rebounded by 16.4% m-o-m in October, with transaction volume of Centaline 10 major properties up 29.4% m-o-m.

There will likely be a mild rebound of property prices despite recession. Easing of global monetary conditions, the latest Prime Rate cut, and HKMA's Countercyclical Capital Buffer cut



Source: CEIC, DBS



Source: CEIC, DBS

will continue to support asset prices. The Policy Address also raised cap on the value of properties under the Mortgage Insurance Programme. Potential homeowners could access the property market with higher leverage and weaker stress test requirements. Also, augmentation of increasing land supply policies such as Use of Lands Resumption Ordinance and Lantau Tomorrow (artificial island for 1.1mn population) will not create additional supply in the near term to suppress prices. They remain as medium-long term solutions. Residential price is thus hard to go down in spite of prevailing negativism all over Hong Kong in the near term.

Tourism and retail sales

Exports of travel services (down 32.2%) was also dampened by a weaker Chinese yuan and domestic instability. Retail sales, with tourist spending accounting for 40% of the sector's performance, registered the 8th consecutive decline of 18.3% in September. This was also the third double-digit plunge in a row. In fact, visitor arrivals slumped by 39.1% and 34.2% in August and September respectively. Tourists' hot picks such as clothing, jewelry, and cosmetics/medicines fell by 20%-40%. Looking ahead, the retail sector will stay weak due to subdued local demand.

The unemployment rate of consumption and tourism related sectors (16.5% of labour force) already leapfrogged from 3.9% in June to 5.0% in October, lifting the headline 3 month moving average jobless rate from its 20-year low of 2.8% to 3.1%. Hopefully, the temporary rental adjustments for tenants could contain the risks of large-scale closure of businesses and laid-off.

Investment

The near-term investment outlook is sluggish due to political uncertainties and China-US trade war. Gross domestic fixed capital formation component of GDP contracted by four quarters in a row at 16.3%, represented a further widening from its 10.8% in 2Q. This was largely dragged by the 26.6% plunge of machinery, equipment and intellectual property products, a leading indicator of business sentiment. In fact, the PMI also slumped to post-Global Financial Crisis low of 39.3. The Quarterly Business Tendency Survey (QBTS) also pointed to a weak economic and

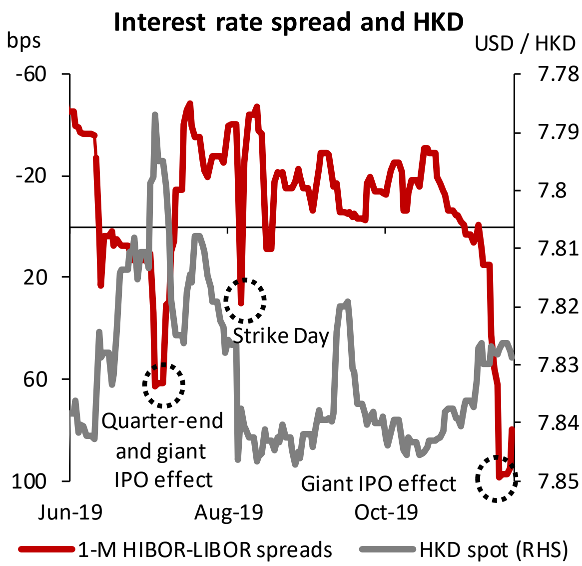
QBTS: Expected changes in business situation				
	Net Balance (% point)			
Sectors / Period	1Q19	2Q19	3Q19	4Q19
Manufacturing	-3	-1	-8	-24
Construction	-23	-22	-7	-45
Import/export trade and wholesale	-23	-8	-8	-23
Retail	-6	-8	-24	-61
Accommodation and food services	-5	-9	-17	-44
Transportation, storage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

Source: Census and Statistic Department, Hong Kong Government

investment outlook across both external and domestic sectors.

Capital expenditure has been weak in Hong Kong. R&D expenditure only accounts for 0.8% of GDP in 2017 (latest figure), compared to that 4.2% of Shenzhen in 2018. In fact, the CAPEX environment is long constrained by the world's least affordable housing market (affordability reached post-Asian Financial Crisis high of 62.4% in 1H19). The saving rate (flip side of investment), has already fallen from 33.4% in 2006 to 21.8% in 2018. It fell further to 18.7% in 1H19. Capital flows to the red-hot housing and financial markets under an ultra-low interest rate environment. The unaffordable housing market hampers long-term investments.

As a result, the average annual labour productivity growth rate also went down from that 2.6% of 1997-2007 to 1.9% of post-GFC 2008-2018. This coincided with an aging population, where labour force of persons aged 65+ (CAGR 2008-18: 12.5%) rose much faster than the overall workforce (CAGR 2008-18: 2.8%) in the past decade. The labour force is expected to reach the plateau in 2019-2022 according to the Hong Kong Government. There is a growing concern of human capital outflow, i.e. well-educated prime workforce migrates with their offspring due to ongoing political instability. This will weigh on the longer term



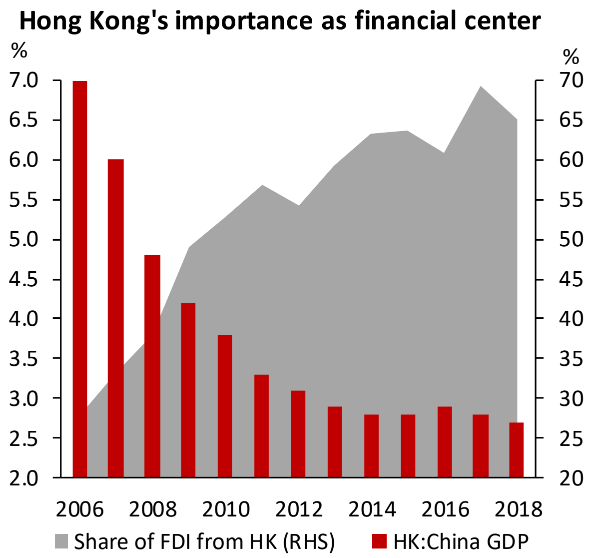
Source: Bloomberg, DBS

labour productivity growth. **HK long term trend growth will likely be lowered to an estimated of 1.5% versus 10-year average of 2.8%.**

Financial stability

Yet, capital outflow remains manageable. Although M2 growth slowed from 3.5% in 2Q to 1.9% in 3Q, HIBORs was largely calm over the past 5 months. Except some upticks due to seasonal effect and large-scale IPOs, 1M HIBOR was range-bound at 1.5%-2.3% levels for most of the time. Both USD/HKD spot and its 12M forward outright were still well within the 7.75-7.85 convertibility band.

Hong Kong dollar peg remains rock-solid. The Exchange Fund is substantial at USD540bn or more-than-double the monetary base. Growth in customer deposits for the USD (3Q19: 6.5%) has outpaced those for the HKD (1.8%) and the CNY (3.9%). This was partly resulted from an inconclusive trade negotiation and the USD's resilience from a relatively stronger US economy vs the rest of the world.



Source: CEIC, DBS

Indeed, **Hong Kong remains as a significant financing gateway of Chinese corporates.** This is exemplified by the recent Alibaba IPO aiming to raise USD13.4bn. Hong Kong was also ranked 1st in terms of fundraising through IPOs in 2018 after the introduction of Weighted Voting Right system. More importantly, China's foreign direct investment from / through Hong Kong increased from 27.8% in 2006 to 65.0% in 2018 despite the ratio of Hong Kong to China GDP fell from 27% in early 1990s to 2.7% in 2018.

Hong Kong's special status

Hong Kong's status of free port and financial center anchors at her international recognition of 'One Country Two System'. **Thanks partially to the US-Hong Kong Policy Act passed in 1992, the city enjoys the privileges such as separate custom territory, imports of sensitive military and civilian dual-use technology, and immigration policies.** The US also respects Hong Kong's status as a member of WTO irrespective to China's participation. The Hong Kong Policy Act Report, an annual review on the Hong Kong economic and political situation, was ceased on the 10th year after Hong Kong was returned to China. Yet, the yearly report was re-introduced after the Umbrella Movement in 2014.

On November 19, the US Senate voted to pass the Hong Kong Human Rights and Democracy Act of 2019 from the House. **The immediate impact on Hong Kong economy is likely to be minimal. First, sanctions would only come after enlistment and enactment of[1]:**

1. Section 7 (a) - List of individuals responsible for committing acts that violate internationally recognized human rights in Hong Kong - The bill bars such individuals

[1] This bill directs various departments to assess whether political developments in Hong Kong justify changing Hong Kong's unique treatment under U.S. law. (Hong Kong is part of China but has a largely separate legal and economic system.)

1. The Department of State shall report annually to Congress as to whether Hong Kong is sufficiently autonomous from China to justify its unique treatment. The report shall address issues including (1) civil liberties in Hong Kong, and (2) how any erosion to Hong Kong's autonomy impacts areas of U.S.-Hong Kong cooperation.
2. The Department of Commerce shall report annually to Congress on China's efforts to use Hong Kong to evade U.S. export controls and sanctions.
3. If the President determines that Hong Kong has proposed or enacted legislation that puts U.S. citizens at risk of extradition to mainland China or to another country that lacks defendants' rights protections, the President shall report to Congress on (1) a strategy for protecting U.S. citizens and businesses in Hong Kong, and (2) whether Hong Kong is legally competent to administer various law enforcement agreements between Hong Kong and the United States.
4. The State Department may not deny work- or student-visa applications from an otherwise qualified Hong Kong resident due to a politically motivated adverse action by the Hong Kong government against the applicant.
5. The President shall report to Congress a list of individuals responsible for committing acts that violate internationally recognized human rights in Hong Kong, including the extrajudicial rendition or torture of any person in Hong Kong. The bill bars such individuals from entering the United States and imposes sanctions on them.

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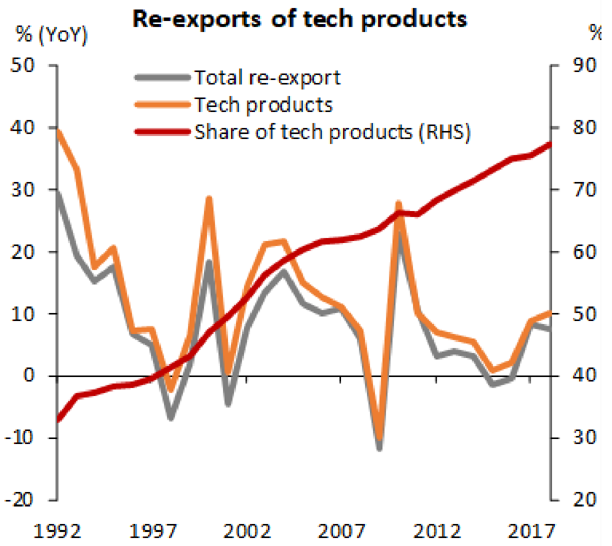
2. **List of dual military and civilian used exports to Hong Kong**

This Act enhances flexibility to augment the Hong Kong Policy Act to the interest of US government. Instead of removing the special status of Hong Kong (all-or-nothing custom territory) by cancelling the Hong Kong Policy Act, the Trump Administration would instead impose additional conditions through the new Act to increase leverage over trade negotiations with China. As far as the Section 7(a) is concerned, it may trigger unforeseen radiation of political consequences as well.

Second, enactment of custom control means there will be **potential import restrictions**. To a certain extent, Hong Kong is now less reliant on technology imports from the US. US products only accounts for 6.4% of total tech import amongst all imported tech products (exclude China, major import origin original of Hong Kong which accounts for 50% of tech imports).

However, rising US' alertness over technological transfer through Hong Kong to China[2] is a long-term concern. There were also disputes over Hong Kong's businesses with other US sanction targets that possesses strong diplomatic tie with the Mainland China such as North Korea and Iran. **As a result, there could be a risk that the restriction list may extend to re-exports (in addition to imports) if the act is passed.** The stakes are high should the UK and EU adopt similar measures. In fact, share of technology products in Hong Kong's re-exports increased from 32.8% in 1991 to 77.3% in 2018. Among tech re-exports, those to China accounts for over 60% of the total value. In fact, contraction of tech re-exports began since the beginning of trade war in 2018.

Although the likelihood of fully enacting this Act is low in the near term given the strong urge from China and US to conclude phase 1 trade deal, this event risk facing Hong Kong shall remain in place over the medium term.



Source: CEIC, DBS

2 In 2018, the US-China Economic and Security Review states:
- "Hong Kong is an important partner in ensuring robust protections against unauthorized shipments of controlled U.S. items to the Mainland…However, the State Department's annual Hong Kong Policy Act report, published in May 2018, noted that U.S. officials "continue to raise concerns about the diversion of controlled items, including during its annual bilateral discussion about strategic trade controls.""

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