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ASIA MACRO STRATEGY

Investment Implications of Hong Kong Protests

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Political Development

The escalation of protest violence between anti-government groups and the police over the past few weeks has significantly overshadowed Hong Kong's market and economic outlook. A near-term resolution looks unlikely as the protesters' key demands remain tough for the Hong Kong administration to accept, unless Beijing softens its current firm support.

The main demands from the protesters are: for Chief Executive Carrie Lam to step down, withdrawal (rather than mere suspension) of the Extradition Law, withdrawal of the official declaration that the mass protests are 'riots', as well an independent committee to investigate the police's use of force against protesters.

Even if part of the above demands is eventually met with some compromise by the authorities, the much bigger risk to Hong Kong is the continuation of protests with escalation of violence, which may provoke direct intervention by Beijing into Hong Kong affairs far earlier than is currently stipulated in the Basic Law.

So far, Beijing seems to remain reasonably controlled regarding its stance on this local saga. It was evident in China State Council's special press conference on Hong Kong affairs held yesterday, by the emphasis on the 'one country, two systems' principle remaining firmly in place.

Economic Impact

Hong Kong's economic prospects is so intertwined with China's economy that any prolonged protests will not only affect local confidence but will especially affect mainland tourists' spending in the city.

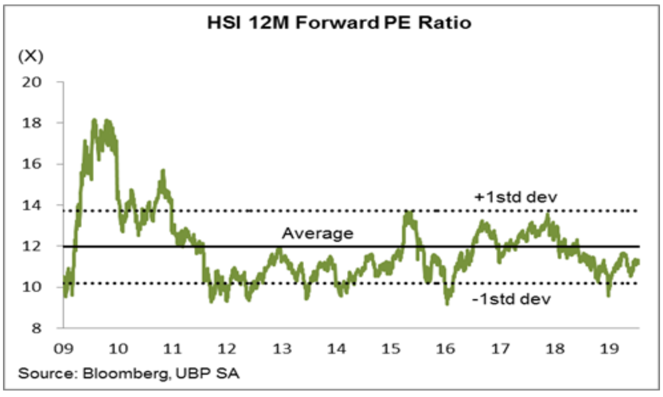
The frequent mass protests have already severely hit local retail sales and tourist earnings. It will also impact local banking and insurance businesses as well as property sales since end-users have increasingly been coming from the mainland.

Housing prices have yet shown any major correction but transactions have started to dry up across the market as protest violence heightens. For example, home sales of a new residential development over the past weekend recorded a mere take-up rate of just 4% of unit offer. A drastic decline from the still buoyant market even up to early July which was largely underpinned by high expectation of lower US and local interest rates.

The key thing to watch for the local property market's longer-term development is whether Hong Kong's status as a global financial and business centre will be eroded. The sky-high valuations of both the domestic residential and commercial markets have been backed by the city's special status as the most open and independent city in China.

Overall, we have further downgraded our Hong Kong GDP growth forecast to 1.1% in 2019 (from 1.4% previously) and to 1.8% in 2020 (from 1.9%), basically expecting growth to weaken noticeably in second-half 2019.

Equity Market



Fundamentally, the local Hang Seng Index (HSI) should be underpinned by expectations of policy easing in China as well the Fed's next rate cuts, while the trade truce between China and the US has also helped market sentiment at least over the summer.

On valuation, HSI is currently trading at 11.1x forward 2019 price/earnings (PE) ratio and 1.1x price/book (PB) ratio after the rebound from the low in May, which is still not demanding and is below past average (12x PE and 1.4x PB ratio).

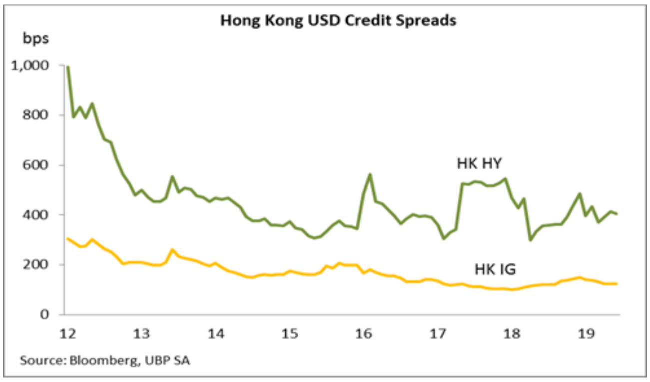
However, the crises induced by local or external events over the past five years has seen the HSI forward PE falling to a low of 9.2x to 9.5x – this should be the market floor should local political problems remains unresolved.

Upside potential looks to be capped as the political saga continues unless some of the protesters' demands are swiftly met, the market can then rebound on China's and US's policy easing and would be further supported by this year's pending sizeable initial public offerings if they go as planned (including Alibaba's $10bn billion local listing).

USD Credits

Hong Kong's sovereign credit rating has stayed solid at AA+ for a long while, and risk of a downgrade will grow should the assessment on political stability and government efficiency receives a downgrade.

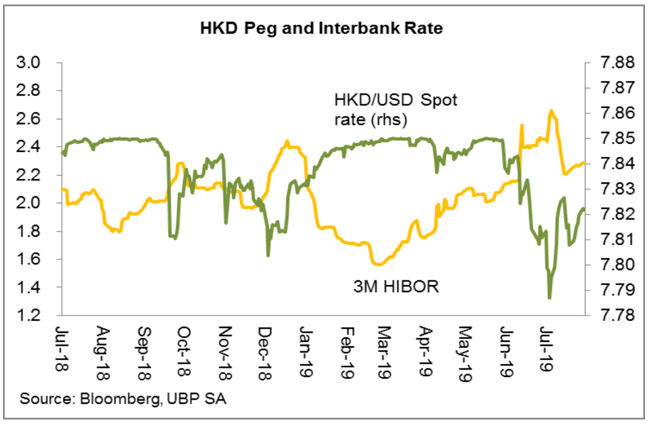
However, the protests so far have yet to show much meaningful impact on credit spreads. Hong Kong investment grade (IG) credit is at 123 basis points (bps) and high-yield (HY) at 406 bps. They are still trading through their respective China counterparts (which are rated two notches lower, on average) by about 30bps and 170bps, respectively.



We expect credit spreads to stay firm on global policy easing but stay watchful on local issuers among real estate developers and retail businesses. However, they are largely investment grade credits and mostly with limited outstanding issues in the market compared with most China credits.

HKD/USD Peg

Pressure is still modest with the spot rate currently trading at around the mid-point of the exchange rate's convertibility undertaking (from the strong side before protests escalated). 3M HIBOR has actually declined somewhat to current 2.28% thanks to the still abundant domestic liquidity (partly prepared for the IPO market) and is now on par with 3M HIBOR.



As argued before, changing Hong Kong's long-established currency broad-system is largely a political decision endorsed by Beijing. In our view, Beijing has no reason to do so at this stage. Economic pressure for change is not strong either and the newly appointed new chief of the Hong Kong Monetary Authority, Eddie Yue, is a long-term veteran of the monetary establishment who is experienced in maintaining the currency peg's stability during uncertainty.

In addition, Hong Kong's foreign exchange reserves have risen to some $445bn which is 1.4x the size of money supply M1. This means that the size of reserves is well covered for any short-term liquidity conversion into USD should capital outflow rise on lingering political uncertainty.

Anthony Chan
Chief Asia Investment Strategist

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Union Bancaire Privée, UBP SA

Hong Kong Branch
Level 26 | AIA Central | 1 Connaught Road Central
Hong Kong
T +852 3701 9688 | F +852 3701 9668
Union Bancaire Privée is incorporated in Geneva, Switzerland, as a limited liability company

Singapore Branch
Level 38 | One Raffles Quay | North Tower
Singapore 048583
T +65 6730 8088 | F +65 6730 8068
Co Reg No T13FC0154G

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