ASIA MACRO STRATEGY

Investment Update on Hong Kong Protests

Report | 6 August 2019

For Professional Investors only in Hong Kong and Accredited Investors only in Singapore

TOP-DOWN VIEWS

Hong Kong's Political and Market Developments

The escalation of protest violence in Hong Kong has worsened and spread into a partial strike among the local workforce. A near-term resolution remains unlikely given the Hong Kong administration's continued tough stance (as evidenced in Chief Executive Carrie Lam's latest press conference on August 5) with Beijing's full-backing.

The main demands from the protesters are: for the chief executive 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.

Hong Kong's economy is set to enter a sharp downturn in the second half of 2019 as the ongoing protest expands in scale and breath. Long-term uncertainty remains on the city's future status as a global business and financial centre as well as its role in the Chinese economy.

The possibility of Beijing's direct intervention into Hong Kong affairs remains even though the central government seems to remain reasonably controlled regarding its stance on this local saga.

Hong Kong's economic and financial market outlook is significantly overshadowed by the perfect storm of escalating local political tension and renewed Sino-U.S. trade war. U.S. President Donald Trump's latest proposition of a 10% tariff on $300bn Chinese exports has caught investors and Beijing off guard.

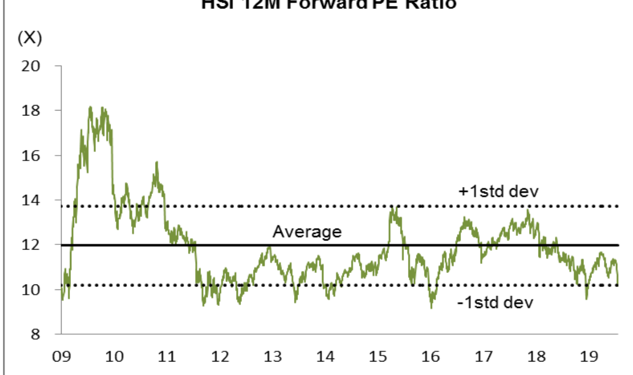
The USD/CNY currency pair has broken the sensitive 7.0 level in response to the new tariff on Chinese goods imposed by the U.S. The USD/HKD has weakened further approaching the weak side of the exchange rate's convertibility undertaking (at 7.85) as short-term capital outflows understandably increase.

Market Valuation Update

To follow up on our earlier market assessment on Hong Kong equities, USD credits and HKD-USD peg, we provide an update on market valuations as well as specific equity and bond 'avoid and switch' ideas recommended by our product specialists during this crisis period.

Hang Seng Index (HSI) Valuation

The local stock index is further dragged down by the renewed trade war risk, even though expectations of policy easing in China and the U.S. has risen given heightening downside growth pressure.



Source: Bloomberg, UBP SA

Given the extended sharp fall this week, the HSI is currently trading at 10.2x forward 2019 price/earnings (PE) ratio and 1.1x price/book (PB) ratio. Forward P/E has declined by a full P/E point over the past month and both P/E and PB ratios are now trading at one standard deviation below mean.

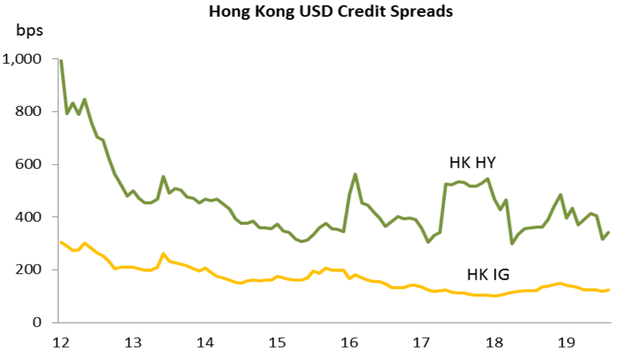
Further downside is anticipated on current negative momentum. The next downside reference level is at around 9.6x P/E during the height of trade war uncertainty in early January. Past crises' lows of HSI over the last five years were at around 9.2-9.5x forward P/E - a potential another 10%-15% correction will begin to make the risk/reward more attractive in our view.

Upside potential looks to be capped as the political saga continues unless some of the protesters' demands are swiftly met, the market then rebounds on China's and U.S.'s policy easing or sizeable IPO resumes (including Alibaba's $10bn local listing).

USD Credit Valuation

Hong Kong USD credit spreads have sold off but has yet to be deemed significant, partly thanks to a high concentration of investment-grade issuers, relatively limited outstanding market issues and global monetary policy easing.

Hong Kong USD Credit Spreads



Source: Bloomberg, UBP SA

Hong Kong investment grade (IG) credit is currently trading at 123 bps (average), up about 5bps from the low of last week but have remained largely unchanged over the past month. . Hong Kong high-yields (HY) have widened by about 35bps over past week and 65bps over past month to 340bps (average).

They are still trading through their respective China counterparts (which are rated two notches lower on average) by about 33bps and 334bps, respectively.

While we favour the more resilient Hong Kong USD credit market at this stage, compared to local equities due to the latter's further downside potential, it is important to watch out for the potential risk of Hong Kong's sovereign rating downgrade. It has been solid at AA+ for a long while but ratings agency Fitch has already warned about the deterioration of political stability, the rule of laws and effectiveness of the local administration.

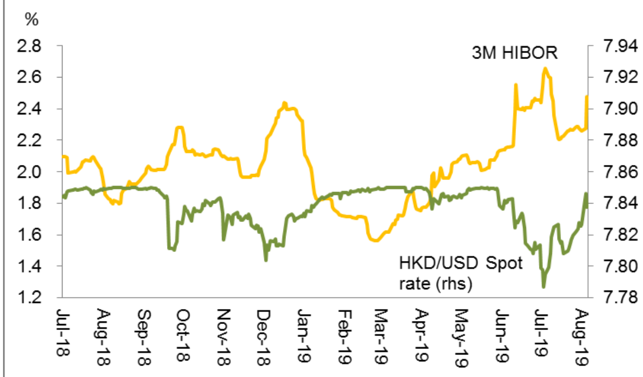
HKD-USD Peg Assessment

The HKD/USD currency pair has leaned closer to the weak side of the long-established peg, but the 3-month HIBOR has nudged up by a mere 20bps this week to a still benign level of below 2.5%. Liquidity drainage has yet to reach a significant stage.

As argued previously, changing Hong Kong's currency broad-system is largely a political decision endorsed by Beijing. In our view, Beijing has no reason to do so at this stage, and economic pressure for change is not strong either.

In addition, Hong Kong's foreign exchange reserves have risen to some $445bn – 1.4 times 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.

HKD Peg and Interbank Rate



Source: Bloomberg, UBP SA

SECTOR / BOTTOM-UP VIEWS

Hong Kong Equity Ideas

First-hit sectors from prolonged protests are tourism and retail, followed by the banking, insurance and property sectors.

While lingering political tension will hurt the overall Hong Kong economy, there are some relatively safer sectors. Based on the share price performances during the past global financial crisis (GFC), online entertainment, communication services, education, telecommunications and healthcare are relative safe havens.

Retail and Tourism

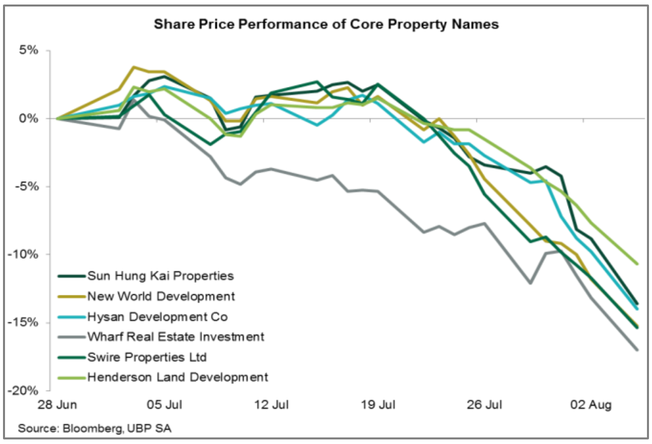
The frequent mass protests have already hit local retail sales and tourists' spending in the city. Hong Kong airport arrivals numbers have not indicated a large change as airport arrivals in June were up 2.7% year-on-year (YoY), versus the average of +3% year-to-date (YTD).

Airport bookings tend to be made well in advance so the June numbers have not fully reflected the expected weakness, but the July numbers released within the next few weeks may tell a different story.

Property

Housing prices in Hong Kong have yet to show any major correction but transaction volume has dried up across the board as political risk heightens.

Home sales of a new residential development over the past two weekends recorded a mere take-up rate of just 4% and 13% of respective units offered. This is an abrupt decline from the still buoyant market even up to early July which was underpinned by expectation of lower U.S. and local interest rates.



Security	Name	Price Change
16 HK Equity	Sun Hung Kai Properties	-13.74%
17 HK Equity	New World Development	-15.38%
14 HK Equity	Hysan Development Co	-13.75%
1997 HK Equity	Wharf Real Estate Investment	-16.80%
1972 HK Equity	Swire Properties Ltd	-16.01%
12 HK Equity	Henderson Land Development	-10.80%

Source: Bloomberg, UBP SA

The key long-term impact to watch is whether Hong Kong's status as global financial and business hub 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.

Mortgage loan growth was holding up well in June (+1.4% MoM /+4.5% YTD) and remains a key loan growth driver. However, new mortgage approval in June has fallen 15% month-on-month (MoM) by value, suggesting some downside risks for future growth. Given the protests, July reading could be even worse.

Banking and Insurance

End-users in these sectors have increasingly been coming from the north of the border. Revenue contribution by mainland tourists for private wealth management and insurance could be as high as 20%-30% for key players. Hong Kong's trip delays or cancellations and the concerns on political uncertainties are key drags for the banking and insurance sectors.

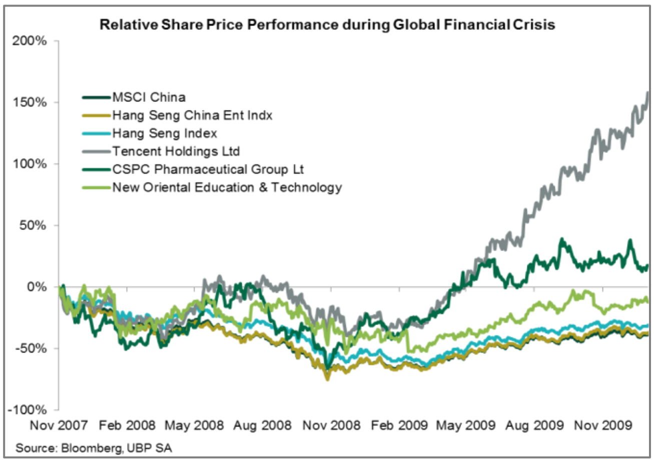
In addition to lower earnings contribution from mainlanders, we believe the overall loan demand will remain subdued this year, as a result of the expected slowing mortgage loan approval and growth. Industry forecasts 5%-7% loan growth YoY in 2019 for large domestic banks.

Based on the latest industry research, insurance products sales in July have been slowing, as many mainland tourists have postponed or cancelled their trips to Hong Kong.

Are There Safe Havens?

Online entertainment and internet sectors are much less correlated to macro and political turmoil. During the global financial crisis (GFC) in 2007-08, Tencent (700 HK) shares jumped 156% while its revenue growth was 36% and 87% in 2007 and 2008, respectively.

We also believe that the communication services, education, telecommunications and healthcare sectors are safe harbours. Sector leaders outperformed their relative index HSI and MSCI China during the GFC.



Security	Name	Price Change
MXCN Index	MSCI China	-37.54%
HSCEI Index	Hang Seng China Ent Indx	-36.55%
HSI Index	Hang Seng Index	-30.55%
700 HK Equity	Tencent Holdings Ltd	156.08%
1093 HK Equity	CSPC Pharmaceutical Group Lt	10.80%
EDU US Equity	New Oriental Education & Technology	-11.85%

Source: Bloomberg, UBP SA

Hong Kong USD Credit Ideas

In the medium term, there will be direct impact on rental income of commercial properties, property price. Retail industry issuers could also be affected with a reduction in the number of visitors.

HK corporate bonds are mainly in IG and closely held by banks, asset managers and insurance companies. Hence, market technical should be supportive on any pull-back on credit spreads unless we see significant fund outflows from fund managers.

Financing of blue-chip corporates are mainly through syndicated loans and private placements. Credit spreads will widen out in line with market sentiment, but the impact will be more on the longer end of the curve and also on the perpetual bonds. Unrated credits will receive less support than rated issuers.

Local banks, subordinated bonds and AT1 will be affected by any downgrade on Hong Kong's rating or an economic slowdown. However, we do not envisage a sharp sell-off as most issuers are investment-grade and have maintained a solid balance sheet.

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