# ASIA MACRO STRATEGY

## Hong Kong: Market Valuation Amid Local Recession

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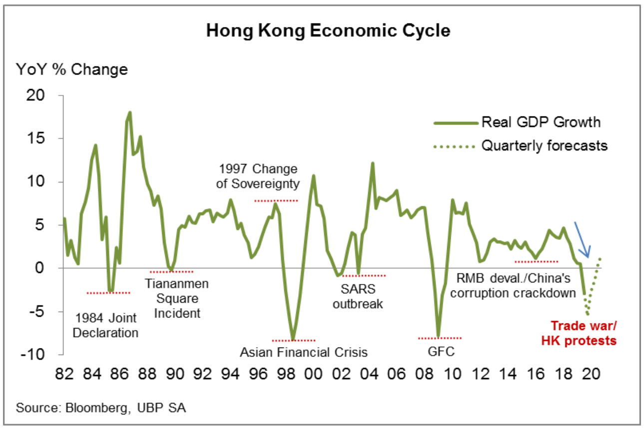
### GDP Release Confirms Shock To System

Last week's release of the third quarter 2019 (3Q19) GDP confirmed the combined shock to Hong Kong's economy induced by the protracted domestic protests and lingering Sino-US trade war uncertainty.

The impact is set to surpass the SARS outbreak in 2003 or China's Tiananmen Square incident in 1989. In our view, it is in danger of resembling the severity of the 2008-2009 global financial crisis or the Asian financial crisis in 1997-1998 if there is no near-term resolution.

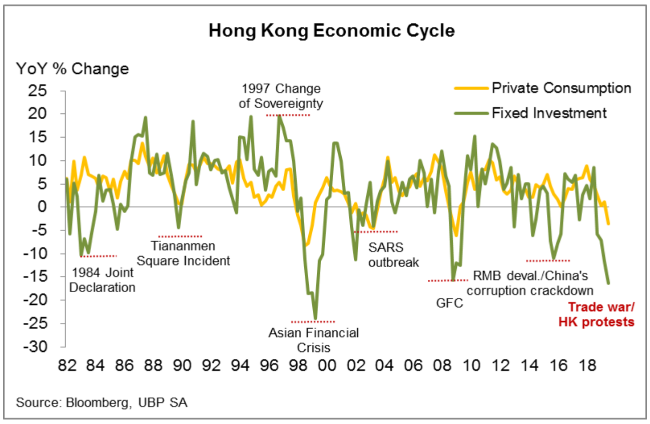
3Q GDP contracted by 2.9% on the year (down 3.2% over previous quarter), as private consumption, fixed investment, merchandise exports and services exports all collapsed at a staggering pace (down 3.5%, 16.3%, 7.0% and 13.7%, respectively). This may be only the beginning of Hong Kong's recession scene.

### How Bad Is The Recession?




Our base-case scenario expects the recession will extend well into first-half 2020 as political confrontation remains largely unresolved even though China-US trade negotiation may progress with improved cooperative spirit.

In short, we forecast that Hong Kong's GDP will contract even more severely by 5.5% (year-on-year) in the final quarter, and 2019 will end with an annual GDP decline of around 1.9% (vs. previous forecast of -0.2%). For 2020, we now project a milder contraction of 0.5% (even assuming some stability may resume by the second-half).




The most visible impact from current political saga is clearly shown on the retail sales and tourism fronts. Arguably, the abrupt decline in retailing business across the board (down over 20% year-on-year in August-September) has already surpassed that seen during all previous major economic and political crises that the city had faced before.

All signs are showing that the retail downturn is heading down beyond that experienced during the SARS outbreak in 2003 when Hong Kong was under prolonged epidemic fear. The absence of tourist arrivals has played a crucial role here especially as visitors from mainland China – the big spenders in local consumer, healthcare and insurance – have abruptly disappeared.

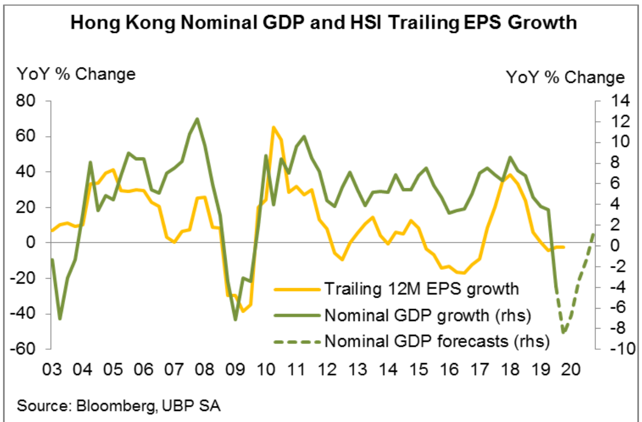
**Market Outlook and Valuation**

Despite the grim economic outlook, we remain fairly constructive on the near-term upside potential of Hong Kong equities, thanks to: 1) still undemanding valuation and; 2) the lifted market sentiment on progress towards possibly signing of the 'phase one' trade deal between Beijing and Washington (see Asia Macro Strategy, China-US Trade Deal: Positive in the Near Term, October 10, 2019).

Economic recession goes hand-in-hand with an earnings downgrade. The chart below shows the close relationship between Hong Kong's nominal GDP growth cycle and our estimation of 12-month trailing earnings per share (EPS) growth of the Hang Seng Index (HSI).

We estimated that nominal GDP contracted by about 4% (year-on-year) in 3Q and is expected to dip further down to a decline of 6.5-8.5% in first-half 2020 before rebounding in the second-half (aided by base effect).

The 12-month trailing EPS growth has also been declining over the past two quarters and by about 2.5-4.0% (year-on-year). Yet, it has been far less drastic than previous earnings down-cycles. As argued before, this is thanks to the growing dominance of China's conglomerates and financials in the HIS, as they are far less directly related to Hong Kong's domestic recession and political chaos.




Based on Bloomberg estimates, HSI consensus EPS forecasts for 2020 has revised down to about 5%, halved from 10-11% at the end of last year. A deeper earnings forecast downgrade is expected given our projected trajectory of nominal GDP in the coming year. We base our scenario assumptions of ESP forecast on a range of, say, +2% to -5%.

**Multiples Expansion on Improved Risk Sentiment**

HSI forward P/E multiples have slowly revived from a low of 10x in August to current 11x since Carrie Lam's administration officially withdrew the Extradition Bill and China-US trade talks began to see some light at the end of the long tunnel.

The April/early May levels (about 11.7x forward multiples) – where investors were most optimistic about an interim trade deal – remain our upside reference for HSI. For any overshooting on the upside multiples and, in the absence of any breakthrough in negotiations in the phase two, caution is needed from the risk and reward perspectives.

**Suggested Trading Range**

Specifically, at current HSI level of 27,600, earnings downgrade to 2%, 0% and -5% will result in forward multiples in the range of 10.8x to 11.6x which implies limited upside potential.

However, our base-case expectation still sees some room for upside valuation to around 11.7x forward P/E and, even with the earnings downgrade range to +2% to -5%, will suggest HSI level between 29,820 to 27,780 accordingly (about 8% to 0.6% upside from here).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