REPORT
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ASIA MACRO STRATEGY

Hong Kong Market Assessment as Geopolitical Risk Intensifies

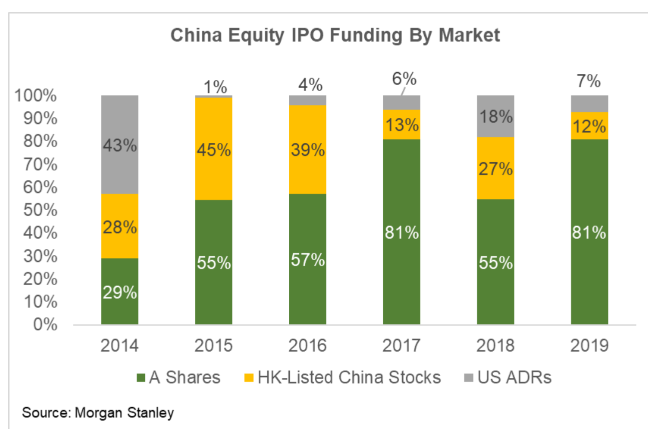
For Professional Investors only in Hong Kong and Accredited Investors (in respect of accounts opted-in to be treated as Accredited Investors) and Institutional Investors in Singapore only

Hong Kong's Hang Seng Index (HSI) underperformed and bucked the global risk-on trend spurred by expectation of economies re-opening.

HSI regained some stability this week after the largest one-day fall in over a decade on 22 May (down close to 6%). Over the past week, HSI increased a mere 0.1% against a gain of 3.7% for the world equity index.

The key developments which have unnerved investors are:

- China's national security law imposed in Hong Kong which bypassed the local constitutional process.
- The US administration's swift response by threatening to remove Hong Kong's US special privileges via the Human Right and Democracy Act.
- The imminent resumption of street protests and signs of resurfacing protest violence may risk choking Hong Kong's economic recovery from the pandemic's drag.
- These developments have affected the otherwise positive news to Hong Kong as a potential 'home' for the return of China American Depositary Receipts (ADRs). The latter was triggered by the US' threat to delist unqualified US-listed Chinese firms and would have boosted Hong Kong's role as China's core offshore funding centre. Also, these tech-heavy ADRs may potentially lift HSI's price/earnings (PE) multiple. During 2015-19, Hong Kong funded 27% (average) of China's total equity financing vs. onshore A-shares' 67% and ADRs' 7%.
- By implication, the HKD should preserve its important value to China and, thus, HKD/USD peg may stay as long as China's USD funding wind-down continues.



The geopolitical risk and local political situation remain fluid and is still evolving, but our initial assessments are as follows:

The US' initial move would be a partial sanction on Hong Kong. The measures may target three levels – individuals, entities, and the whole system. We expect the first strike may focus on the first two areas (ranging from visa restriction to seizing of assets of identified individuals, and may extend to restriction of activities, business transactions and investment

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in the US of individual entity). Extreme measures against Hong Kong's economic and financial system look unlikely, given the vast US business presence (1,300 US operations) and working population (85,000 American residents) in Hong Kong.

Removal of special tariff benefits or tax treatment should have limited impact on the Hong Kong economy given limited direct trade links between Hong Kong and the US (mostly re-exports from China or third parties to the US). The city's domestic exports to US merely account for 1.2% of total exports.

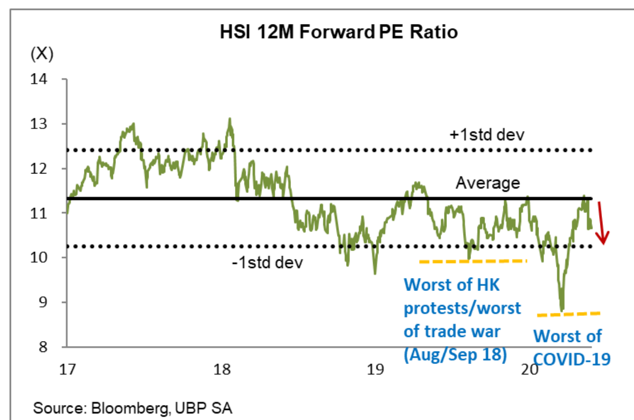
Tech trade and technology transfer to Hong Kong is difficult to quantify but the potential impact may be significant. Hong Kong is the major tech equipment import centre for China because of preferential taxes, and US' restrictions will trigger a shift of similar trade to other countries.

However, Hong Kong has signed many bilateral free-trade agreements with major countries outside of US (e.g. Australia, Japan, EU and Asian peers) and is a member of major multilateral organizations (such as IMF, WTO and WHO). These agreements are unlikely to change abruptly even though the US is trying to influence a broader consensus to support its China's isolation policy.

Market Valuations

On market valuation, it is tough to assess the net effect of the benefits of increased secondary listing of Chinese firms in Hong Kong markets. Concerns over Hong Kong's waning financial centre role may grow, which may have wider implication on real estate values to retail and tourism prospects. However, from the local political risk and China-US tension standpoint, last August/September's low valuation level could be a reference point with the worst protest violence and trade war uncertainty as a backdrop then.

Despite the rebound from late-March's low, the HSI forward PE multiple (currently at 10.7x) remains below the 10-year average of 11.4x.

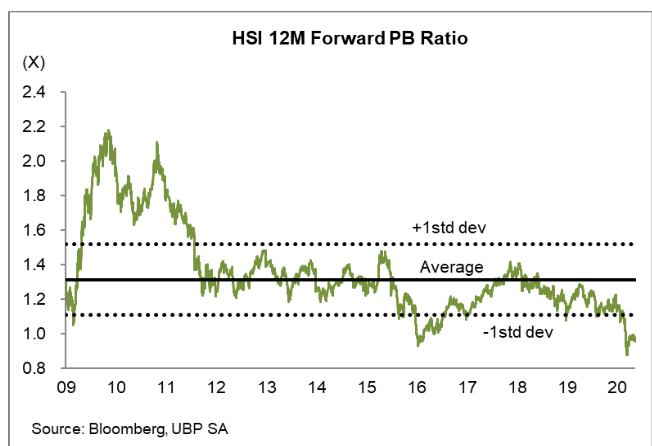


Source: Bloomberg, UBP SA

In comparison, MSCI China's forward multiple has recovered to over 1 standard deviation above the 10-year mean, thanks to effective virus containment and progress of economic normalisation.

Hong Kong should have ride on China's valuation recovery path even with some lags and discounts. We think that HSI's relative constrained valuation has factored in some structural political premium since the political unrest last summer.

HSI forward multiple dropped to a low of 10x in August/September 2019 and dipped to a historical low of 8.8x at the height of pandemic crisis in late March. Assuming no second-wave outbreak and largely based on the revival of domestic political unrest and China-US tensions, the downside risk of market correction should not be too significant from current level. Moreover, HSI's forward price-to-book ratio at 0.9x is way below the 10-year average of 1.3x. Historically, HSI rarely traded below 1.0x price-to-book and stayed there for long.



Source: Bloomberg, UBP SA

Factoring another 3-5% earnings downgrade from current -14% and assuming a 10x forward PE multiple, our downside HSI's target level is around 21,000, a 8-10% decline from current levels.

For switch ideas, we recommend China's oriented H-shares and onshore A shares over HSI as the former markets outperformed Hong Kong during the second half of (2H19) as the local political situation deteriorated. In addition, China's current reflation policy and domestic demand recovery will be better captured in the China indices.

We recommend avoiding domestic consumer and retail sectors as well as real estate (particular developers with high concentration on rental incomes) in view of their underperformance during last year's prolonged protest violence. The tech sector (online, e-commerce, 5G and cloud computing) should maintain their relative outperformance on post-COVID-19 changes in consumer behaviour.

Rating Outlook

In fixed income, the risk of Hong Kong's sovereign rating downgrade remains. However, Fitch's Asia sovereign rating head has said in an interview that the agency's current AA-rating on Hong Kong sovereign and the two notches rating

downgrade shortly over the past nine months should have captured the uncertainty induced by the national security law.

Note that Hong Kong is currently rated one notch higher than China's single A by Fitch and Moody's. A downgrade to single A and lowering it on par with China's might raise the sensitive end of 'one country, two systems' policy. S&P's rating on Hong Kong is higher by two notches at AA+ (stable outlook) – a level unchanged since 2017.

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