ASIA MACRO STRATEGY

Hong Kong Outlook as Trade War and Protests Escalate

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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 only in Singapore

Trade war escalates

The China–US trade war has escalated. Beijing will impose new tariffs of 5–10% on USD 75 bn worth of US products (including soybeans, crude oil, meat products, and automobiles). The duties will start in two phases – on 1 September and 15 December.

US President Donald Trump retaliated immediately by raising the US tariff on $250bn worth of Chinese imports to 30% (from 25%) from 1 October. Other Chinese imports (worth about $130bn) that were set to have 10% tariffs from 1 September will be charged with 15%.

So far, scheduled trade talks in Washington next month remain in the pipeline despite these new tariff hikes over the past week. However, progress is expected to be limited since fundamental differences on major trade and market access issues between the two sides remain stark.

The market is probably preparing for even higher tariffs and retaliation measures spreading further into non-tariff, direct economic sanctions.

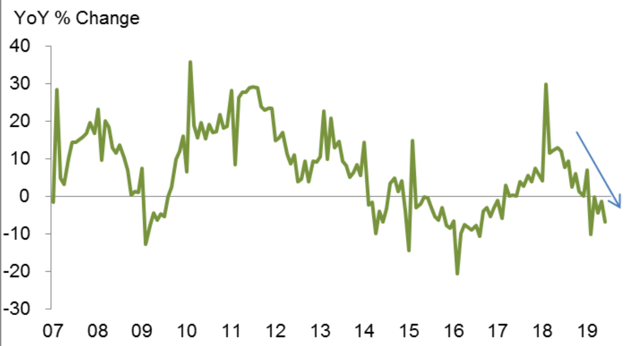
Impact from the Hong Kong protests

Meanwhile, Hong Kong's anti-government protests have extended into their 13th week, with no meaningful concessions from the local administration, given its continued firm backing from Beijing.

The Hong Kong economy is in the midst of the perfect storm of growing Sino–US conflicts and worsening domestic political tension. The downturn in many of its sectors is visible and the local economy is set to enter a severe deceleration in the coming quarter or two as political disputes continue to damage economic activity.

For instance, Hong Kong's retail sales have been contracting for five consecutive months (since February) and were down by 6.7% year-on-year (yoy) in June as protests began.

Hong Kong Retail Sale Growth (Nominal)



Source: Bloomberg, UBP SA

Consumption has worsened further on waning sentiment as well as retail and transport disruption from prolonged protest violence. Retail sales are set to contract at a double-digit rate as seen during past major downturns (e.g. SARS epidemic in 2003, global financial crisis (GFC) in 2009 and RMB devaluation/China's corruption crackdown in 2015–16).

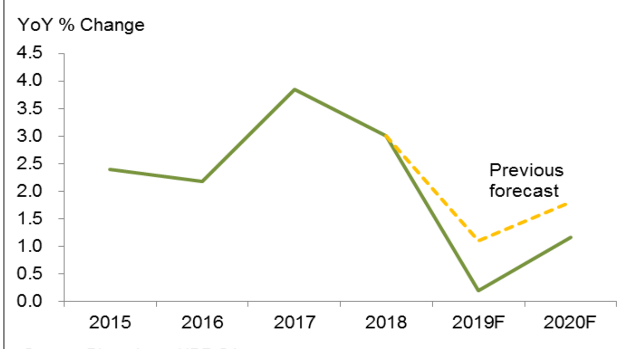
Tourism is another major revenue channel that has faced an abrupt downturn. It is reported that tourist arrivals declined by some 33% yoy during the second week of August and the contraction worsened to 50% in the following week as protests hit Hong Kong's International Airport.

Growth prospects downgrade

We have further downgraded our forecast for Hong Kong's gross domestic product (GDP) growth in light of prolonged political tension. The worse-than-anticipated 2Q/19 GDP growth is also worth noting, at a mere 0.5% yoy (vs. 0.6% in 1Q/19).

3Q/19 GDP is now expected to contract by 0.5% yoy and 4Q/19 GDP will be flat at 0.2% yoy. Thus our full-year 2019 GDP forecast has been downgraded significantly to 0.2% (from 1.1%) and our 2020 projection is down to 1.2% (from 1.8%, see chart below).

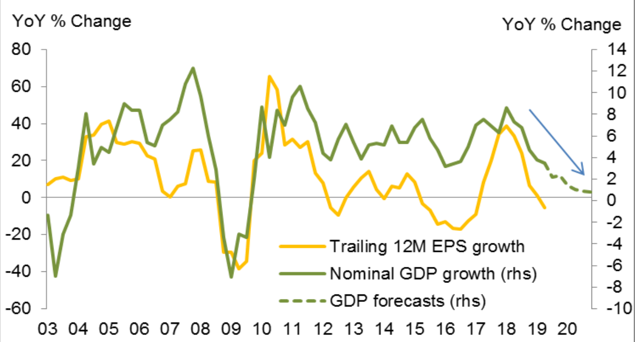
Hong Kong GDP Forecast Downgrade



Source: Bloomberg, UBP SA

Similarly, Hong Kong's nominal GDP growth has already declined from a recent peak of 8.6% in 1Q/18 to 3.5% in 2Q/19, and we forecast a further deceleration to just below 1% by 2H/2020. This will mean further negative earning implications for the Hang Seng Index (HSI) even though the 12-month trailing EPS growth has already slowed down markedly since last year (see chart below).

Hong Kong Nominal GDP and HSI Trailing EPS Growth



Source: Bloomberg, UBP SA

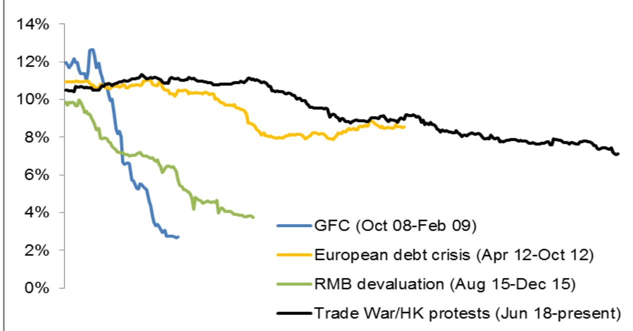
HSI Earnings & Valuation Outlook

Currently, the (Bloomberg) consensus Hang Seng Index (HIS) earnings forecast for FY2020 has lowered to about 7% from the peak of 12% in mid-2018. The earnings downgrade has been steady and more similar to the trend during the European debt crisis in August–October 2012 than the drastic decline during the GFC in 2008–09 and the RMB devaluation in 2H/2015 (see next chart).

While profit trends in major domestically-driven sectors have reported severe contraction already during 1H/19, we are mindful of the changing composition of the HSI where the heavily weighted stocks are Chinese conglomerates and financials. They are not directly related to Hong Kong's local demand (e.g. Tencent, China Mobile, China Construction Bank, Pin An Insurance, etc.). Also, Hong Kong conglomerates' earnings streams have become increasingly global.

Moreover, despite the trade war and economic slowdown, the reported earnings of the Chinese equity market (MSCI China) have so far been surprisingly resilient during 1H/19 (especially in e-commerce- and domestic consumption-related sectors). It also seems to be on track to meet the market consensus forecast of double-digital growth (10–12%) over the full year.

HSI Consensus EPS Forecasts (FY+2)



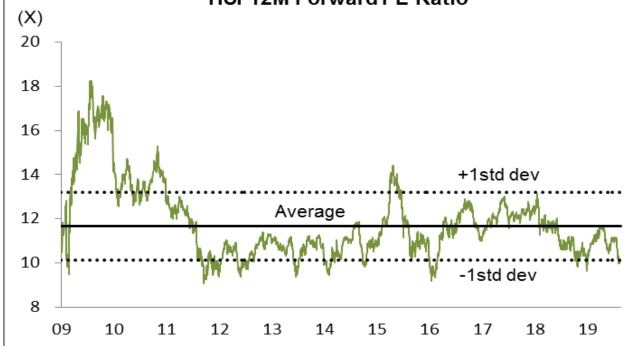
Source: Bloomberg, UBP SA

Meanwhile, the HSI has declined by 16% since April's peak with multiple contractions to the current valuation of 10.1x 12-month forward P/E, which is one standard deviation below its historical average. We have also noticed that the current undemanding valuation has already priced in substantial downside risk ahead.

For example, if earnings forecasts continue to be downgraded, say to the low single digit level around 2–3% (from the current 7%) similar to the lows of past down-cycles, the HSI's forward multiples will remain low at around 10.1x at the current index level of 25,410.

If multiples contraction continues along with earnings downgrades, and the forward P/E falls back to the crisis bottom of around 9.2–9.5x, we estimate that the HSI will correct another 5–10% from the present level (to 22,900–24,100). This will make it a very attractive dip-buying opportunity, especially from a long-term investment perspective.

HSI 12M Forward PE Ratio



Source: Bloomberg, UBP SA

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