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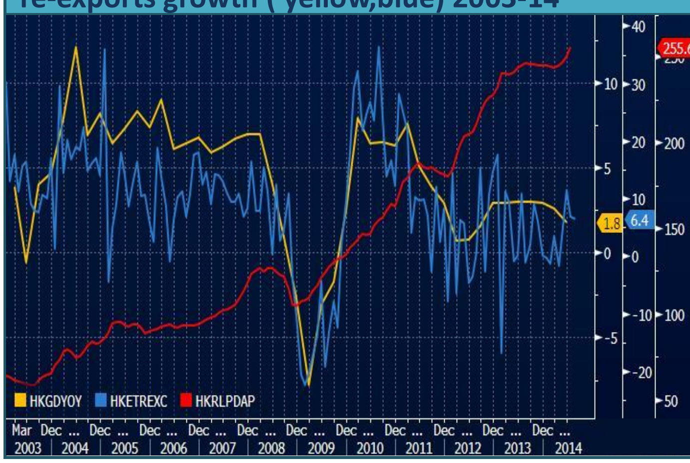
HONG KONG: Beyond the occupation

Summary	Investment Conclusions
There are two issues here: the political outcome of the protest which, sadly, is a foregone conclusion (see Factbox), and the impact of that "foregone conclusion" on the economy and financial markets of Hong Kong. This impact will have two forms, a short term one on retail sales and tourism which could be quite significant but, by definition, temporary, and a longer term one on confidence. The economy and the financial markets of Hong Kong are closely linked with those of China. The impact of the protests in Hong Kong on the economy of China will be miniscule; hence, the longer term impact on Hong Kong will likely be very small as well.	The impact on HSI will be temporary as will be that on retailers. The longer term prospects of Hong Kong as a global financial market and gateway to China will not be altered (either for better or worse) because of the riots unless these become endemic and jeopardize the functioning of these markets. This is most unlikely to happen. Talk of China pushing Hong Kong to relative insignificance in favor of Shanghai forgets that policies alone cannot create global financial centers; they can destroy them but not create them. Hence ruining Hong Kong is absolutely no guarantee of Shanghai's success.

The politics of economics and vice versa

The economy of Hong Kong is driven by trade in services be they financial, export logistics or tourism. Hong Kong does not physically produce anything of any substance. In Chart 1 we show GDP growth (yellow) and re-exports, mostly to China (blue). Both cycles are closely linked with re-exports representing an important growth driver. As the majority of the re-exports are connected with China (re-exports to and from China) then the drop in the global trade in 2008-9 was reflected in the re-export trade and in Hong Kong's GDP. Be noted, however, that China's economy is not exports-driven, despite widespread misconceptions to the contrary. Hence the impact of the global slump in 2008-9 affected Hong Kong via China exporting less to the world rather than because the Chinese economy slumped severely, which it did not! In sum, if China is doing well, and if global trade is not decelerating, then Hong Kong also does well. Clearly, however, the property sector is cyclically immune, with property prices on a one-way trip since 2009. Actually this is a far more worrying development than the potential impact on Hong Kong of the civic unrest. As we will show, the negative real interest rates registered in Hong Kong since the 2009 have contributed to the property boom. The poor publicity in the world media may refocus attention as to whether Hong Kong's institutions can withstand sustained interruption without leading to an outlfow not just of capital, but also of actual businesses.Since we expect that the protests will only have a short term impact, then we also expect that Hong Kong's position in the global and regional markets will not be either seriously affected on a longer term basis.

Chart 1:HK: House price index level(red),GDP and re-exports growth (yellow,blue) 2003-14



Source: Bloomberg

Mcroeconomics and micropolitics

The peg of the HKD to the USD has long been considered as the sine qua non of the economy and policy of Hong Kong. We focus on two issues here. The peg is the main culprit why Hong Kong had from 2009 onwards negative real interest rates which were totally unnecessary for the cyclicals of the economy at the time, but were the direct result of the peg. (Chart 2 yellow line)The result was a boost to the property sector whose reacceleration matches well the onset of sustained negative real rates (red line). Just to emphasize the reversibility of this phenomenon we show in Chart 2 the composite indices of interest rates of the Fed and of HKD. The end of zero rates in the US will mean the start of positive real rates in Hong Kong and the hastening of the end of the property bubble which is a decade long, if not longer, now.

Chart 2: HK,Realrates (yellow),House prices (red),HKD, Fed composite rates(gren, magenta)

Source: Bloomberg

FACTBOX :Students, yes, Power, no.

Fundamental changes in political and/or economic systems were never the result of student protests. Students might wring concessions on education, or embarrass De Gaulle in 1968, or pressurize the US government on Viet Nam where the Viet Kong, and not Jane Fonda, won the war. Fundamental changes always happen with the backing of arms, that of the army or of revolutionary forces. The truth is that fundamental changes demanded by students in Hong Kong, that is of a pluralistic democracy in a city in a communist- run country, could only happen with the backing of the PLA!

The present disturbances in Hong Kong have in no way affected the stability of the peg and, hence, its pernicious effect on property will remain. The peg will have to be reconsidered when the CNY becomes convertible, but this will be unlikely for another 5 years. Hence the impending deflation of the property boom is in no way connected to the current events in Hong Kong, although, clearly, these events will not help. As for the likelihood that prolongation of the instability could permanently damage the markets in Hong Kong, the following needs to be considered.

The way backwards

China would not want to “punish” Hong Kong by diminishing its importance while there are multiple forms of capital controls in China. Hong Kong is the key trading centre for the main Chinese companies quoted in the H market as well as for the timid innovations of links in the off and onshore CNY markets. As for foreign firms leaving Hong Kong, the current instability would need to transform into a permanent change in the independence of the legal system and in the liberal and transparent framework of financial regulation. Commentators have raised the possibility that should China repress forcibly the protests in Hong Kong, then the G20 countries could impose sanctions similar to those imposed on Russia over the Ukraine. This most unlikely because if the sanctions were to be applied to Hong Kong then “the victim would be victimized”. If the sanctions were to be applied to China, then the impact would be felt immediately in Hong Kong being the main offshore market for Chinese equities and bonds. In other words financial sanctions on China would not work unless they were also imposed on Hong Kong. In sum, the impact of the current unrest in the economy of Hong Kong is likely to be short- lived with few, if any, longer term consequences. The longer term political impact is a different matter though.

Andrew Freris (writing completed on 5/10/2014)