Economics

DBS Focus

Hong Kong: Growth downgraded

Economics/Strategy/Rates/FX

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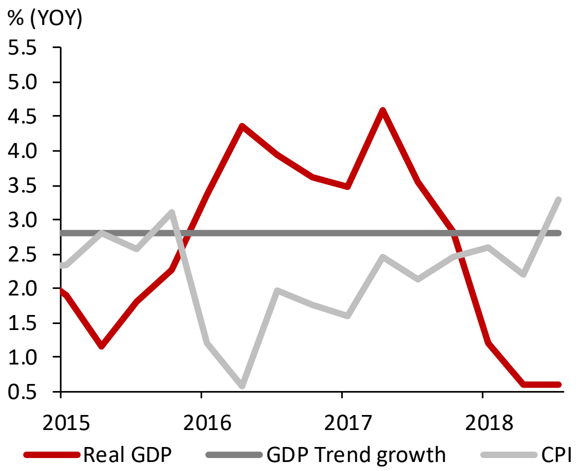
- *We have downgraded Hong Kong's real GDP growth forecasts to 0% from 2.5% for 2019, and to 0.5% from 2% for 2020.*
- *Early estimate of real GDP was 0.6% YOY in 2Q19, undermined by sluggish external trade.*
- *Gross domestic fixed capital formation decelerated to -12.1% in 2Q19 from 7.0% in 1Q19, its slowest pace in the past decade.*

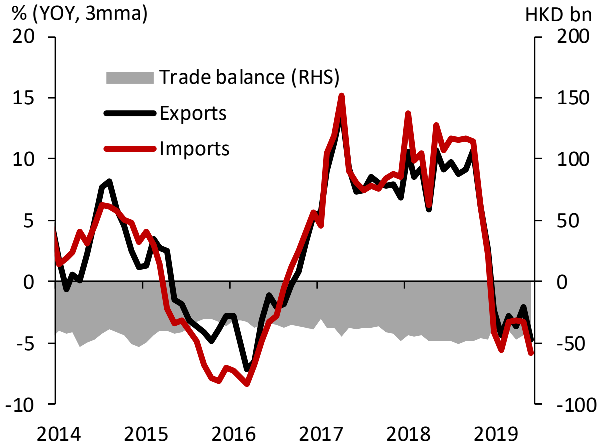
Chart 1: GDP and inflation



Source: CEIC, DBS Group Research

The Hong Kong economy has been hit by external headwinds

Chart 2: Merchandise trade statistics

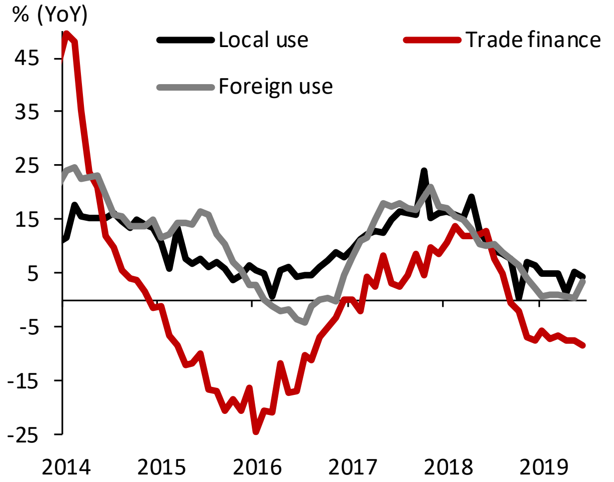


Source: CEIC, DBS Group Research

We have downgraded Hong Kong's GDP growth forecasts to 0% from 2.5% for 2019, and to 0.5% from 2% in 2020. While growth was benign at 0.6% YoY in 2Q19 (Chart 1), it contracted 0.3% QoQ. Another quarter of negative sequential growth in 3Q19 would tip Hong Kong into a technical recession.

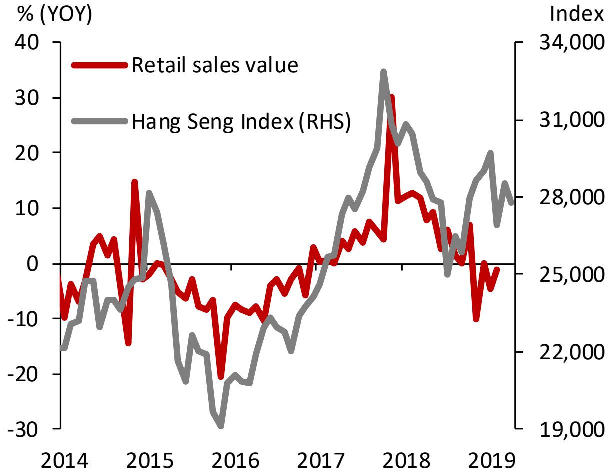
Second quarter growth was hurt by lingering trade tensions between China and the US, Hong Kong's top two export destinations. Merchandise exports growth have contracted eight straight months since November 2018; the -9% YoY print (Chart 2) in June was the biggest drop since February 2016. By country, outward shipment to the US and China fell 6.6% and 5.3% respectively. Exports to advanced economies were also sluggish; EU and Japan fell by 7.4% and 6.5% correspondingly. Likewise, outward cargoes to emerging market such as ASEAN were also flat from a year ago.

Chart 3: Loans by end-use



Source: CEIC, DBS Group Research

Chart 5: Retail Sales and Hang Seng Index

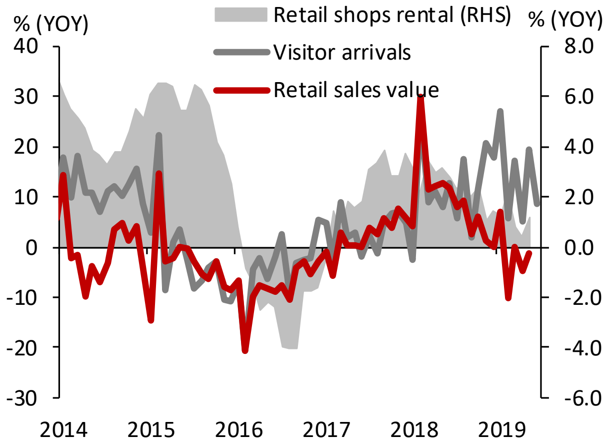


Source: CEIC, DBS Group Research

By product, re-exports were notably weak. The hard-hit sectors here were machinery and transport equipment (which contracted 11.3% in June from -3.1% in May) and manufactured goods (to -10.5% from +1.8%). The 10th contraction (-8.4%) in trade finance in June (Chart 3) has kept the outlook cloudy. More pain will be in store for re-exports if the US imposes 25% tariffs on the rest of the goods it imports from China (USD325bn).

The Hong Kong stock market was volatile in the quarter. Cross-border financial activities decelerated, and export of services moderated

Chart 4: Tourist arrivals, retail sales value and rent



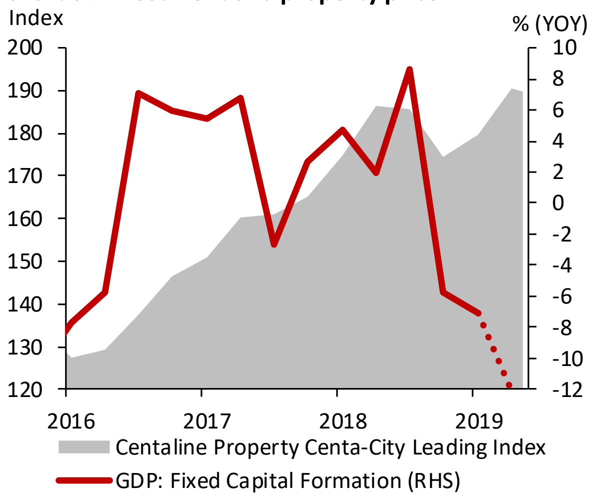
Source: CEIC, DBS Group Research

(to 0.2% in 2Q19 from 0.8% in 1Q19 and 3.3% in 4Q18), especially the transport, financial and other business services sectors. Exports of travel services and visitor spending were also hurt by a weaker Chinese yuan (Chart 4).

There were negative spill-overs from the challenging external environment into the domestic economy. The negative wealth effect from the volatility in the stock market has dampened the growth in private consumption (60% of GDP) to a modest 1.2%. Retail sales value reported the 5th consecutive YoY declines in June (Chart 5). Non-necessities such as jewellery (-17.1%), optical (-11.8%), and electrical & other consumer durable goods (-16.2%) continued to fall.

If prolonged, political uncertainties will further dampen domestic consumption. Retail sales is expected to fall by 5% for 2019. Shops have not been able to operate over the weekend. Visitor arrivals may moderate ahead. If these trends persist, they will eventually feed through the tight labour market and lift the unemployment rate from its 20-year low of 2.8%. Both labour demand and supply have started to moderate since January 2019. Employment and labour force growth have fluctuated between ±0.3% and flattened the labour participation rate of 60.7% in February-June.

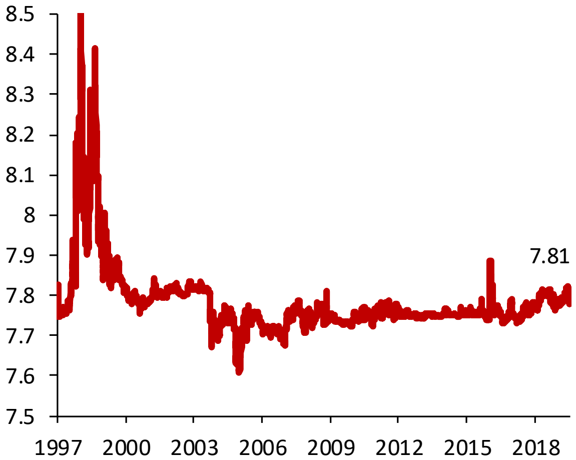
Chart 6: Investment and property price



Source: Bloomberg, DBS Group Research

Gross domestic fixed capital formation decelerated to a decade low of -12.1% in 2Q19 from 7.0% in 1Q19. Although the Centaline Property Centa-City Leading Index hit a new record high in June, investment sentiment stayed weak (Chart 6). On the economic outlook, pessimistic business expectation mirrored the weakness in PMIs (which posted 15 consecutive contractions), not helped by the ongoing domestic instability since late June.

Chart 7: USDHKD 12 Month Forward Points

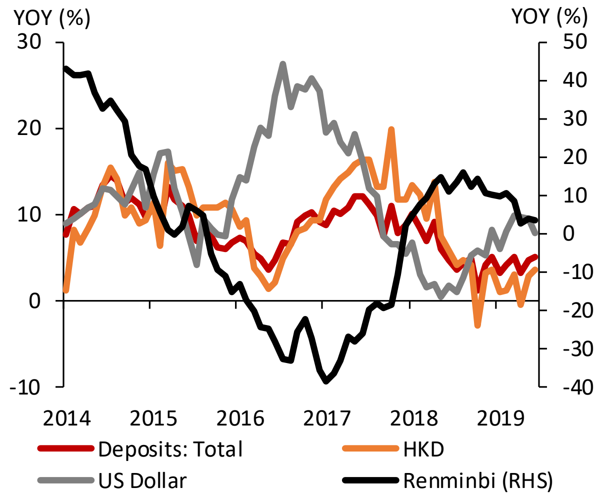


Source: Bloomberg, DBS Group Research

On the monetary front, money supply growth has remained resilient. M2 (HKD) continued to rise by 3.5% in June from 2.8% in May. HKD deposit growth also rose by 3.6%. **Interestingly, political uncertainties did not lead to massive capital outflows.** 1M HIBOR returned to 1.8%-2.0% levels from 2.99% after the large-scale IPO exercise and quarter-end effect in mid-June – early July. Both USD/HKD spot and its 12M forward outright were still well within the 7.75-7.85 convertibility band (Chart 7).

Hong Kong is well-positioned to safeguard its HKD peg. The Exchange Fund is substantial at USD530bn or more-than-double the monetary base**.** While growth in customer deposits for the USD (1H19: 8.5%) has outpaced those for the HKD (1.9%) and the CNY (6.3%) (Chart 8), this was attributed to renewed trade tensions and the USD's resilience from a relatively stronger US economy vs the rest of the world.

Chart 8: Deposits growth



Source: Bloomberg, DBS Group Research

Property prices appeared to have bottomed in February but its recovery has been tepid. According to the Rating and Valuation Department, residential property prices witnessed the first month-on-month decline of -0.8% in June 2019. The Centa-City Leading Index also edged down in July from its record high on June 28. The fall in property prices has not triggered property market sell-off thus far. The healthy job market has kept the delinquency ratio of mortgage loans outstanding for more than 6 months (0.01%)

low. The risky loans - private co-financing scheme, only accounted for 1.9% of total mortgage value. The outstanding number of mortgages in negative equity also fell from 262 cases in end-2018 to 1 case in June. The loan-to-value ratio stayed low at 47.4%. The US rate cut in July and the dovish global rate environment should support housing prices.

The deterioration in the demand-supply balance remains as a key issue over the medium-long term. The vacancy tax is still in legislative procedure. Potential private property supply for the next 3 years stayed at 93,000 flats for the 5th quarter. With policy shifting the public-private housing ratio from 6:4 to 7:3, flat supply has been reduced from 25,500 in FY17/18 to 13,850 in FY18/19. The target for FY19/20 fell by 25% from 18,000 to 13,500. The 20-year Lantau Tomorrow plan can satisfy housing demand for 1.1mn people. Even so, the newly-built artificial islands can only meet the demand of the immigrants with more land required to fulfil local demand.

Inflation has returned

CPI rose by 3.3% YoY in June from 2.8% in May, largely due to food prices (5.6%) from increased pork and fruit prices in China. Apart from elevated import prices, an upward adjustment in public housing rentals will also fuel the inflation. Against a weaker growth outlook, stagflation risks may emerge in 2H19.

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Sources: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations).