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Hong Kong Economy

Virus poses new threat to the already fragile economy

The spread of coronavirus (2019-nCov) has significantly accelerated in recent weeks and fears have been rising quickly in Hong Kong, a city hit severely by SARS in 2003. In this report, we assess the impact of virus outbreak on the outlook of Hong Kong economy:

- **First annual recession in a decade.** Weighed down by US-China trade war and social events, 2019 HK economy slipped into its first recession in a decade. The coronavirus outbreak, the slowdown of mainland China's growth and the weakness of global economic recovery are all among the major drags on economic rebound of HK. We believe that the business confidence and economic activity will remain rather weak this year.

- **Coronavirus outbreak adds insult to injury.** HK now has more experience to manage public health crisis than 2003. However, SARS did not bring a supply shock to HK while 2019-nCov is likely to affect the supply side. In addition, due to weaker growth momentum before the virus and weaker global supply chain, HK economy may need more time to recover this time than it did in 2003. We expect 2020 GDP to shrink by 2%, 0.8% and 7% in the base case, best case and the worst scenario respectively.

- **Vulnerable sectors: private consumption, tourism-related and re-exports.** Due to social environment and virus spread, we now expect retail sales to further drop 5% and visitor arrivals to HK this year to drop 6% in 2020 in the base case. Tourism-related industries may have another challenging year and some companies may suffer more than they did in 2003 during SARS. The shock by 2019-nCov will be greater than SARS to the city's foreign trade, leading to a contraction of 2.5% in 2020.

- **Impact on foreign exchange and money markets.** Tight liquidity and risk-on sentiments together have contributed to the appreciation of HK dollar exchange rate since Nov 2019. Looking ahead, we believe the currency's strength will be short lived, and the carry trade's attractiveness and seasonal demand will fade. We expect HK dollar to weaken to around 7.80 as the city's dimmed economic outlook will weigh on its currency.

- **Impact on job market and inflation.** Combined effects of drop in domestic consumption and decrease in tourist spending will worsen the labor market during the virus outbreak. Overall unemployment rate is expected to rise to around 5% and some severely affected sectors will lay off workers due to the lower demand. Headline CPI is likely to hold largely steadily around 3%.

- **Policy response: more fiscal stimulus.** HK's fiscal reserves still account for some 40% of its GDP at present, reflecting the city's solid economic buffers. However, fiscal stimulus packages wouldn't go far enough to improve the growth momentum amid multiple headwinds.

Hong Kong economic indicators

	2016	2017	2018	2019E	2020E
Population (mn)	7.3	7.4	7.4	7.5	7.5
Unemployment Rate	3.3	3.4	3.2	3.1	5.0
Real GDP (YoY %)	2.2	3.8	2.9	-1.2	-2.0
CPI (YoY %)	3.0	2.4	1.5	2.9	3.0

Source: Hong Kong government, CEIC, CMBIS estimates

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Hong Kong GDP growth (YoY)

Source: CEIC, CMBIS

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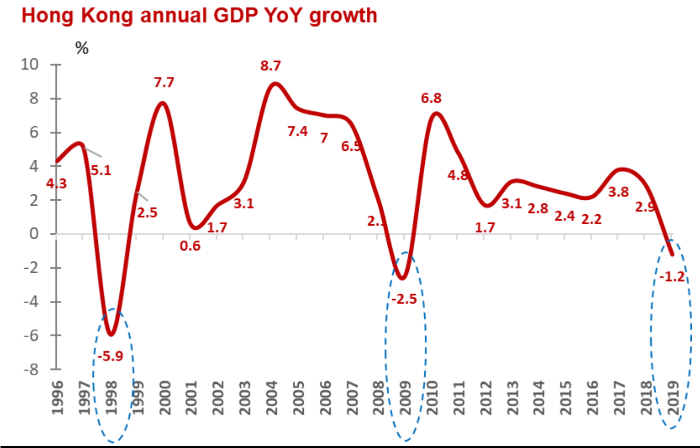
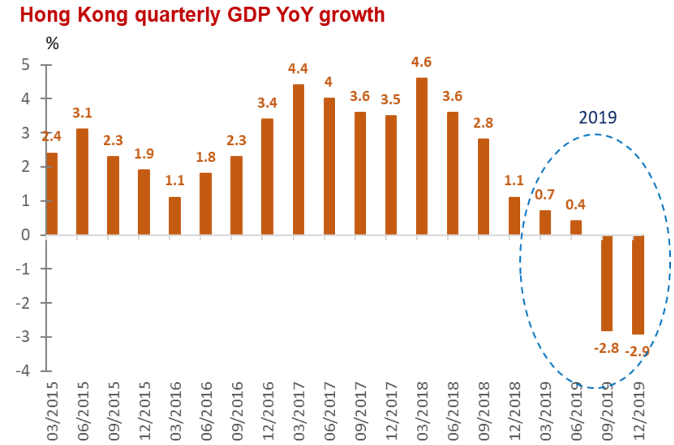
Hong Kong Economy: Focus Charts

Figure 1: Hong Kong economy was in a financial crisis-like situation



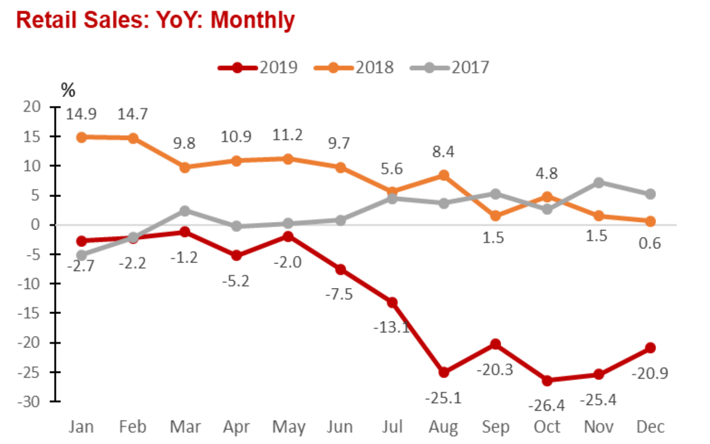
Source: CEIC, CMBIS

Figure 2: The city has been in recession for two straight quarters



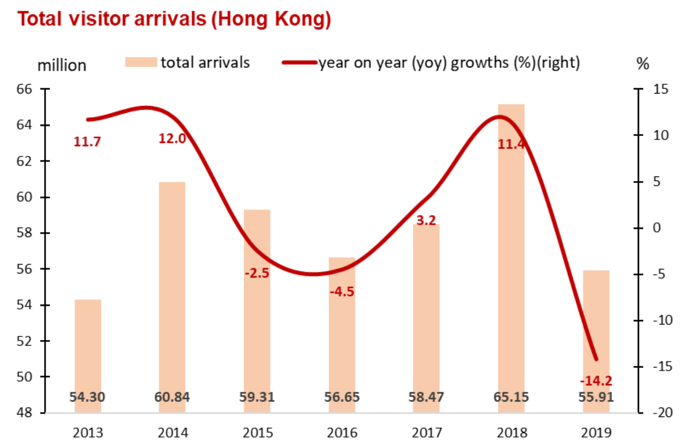
Source: CEIC, CMBIS

Figure 3: Volume of total retail sales dropped rapidly in 2019



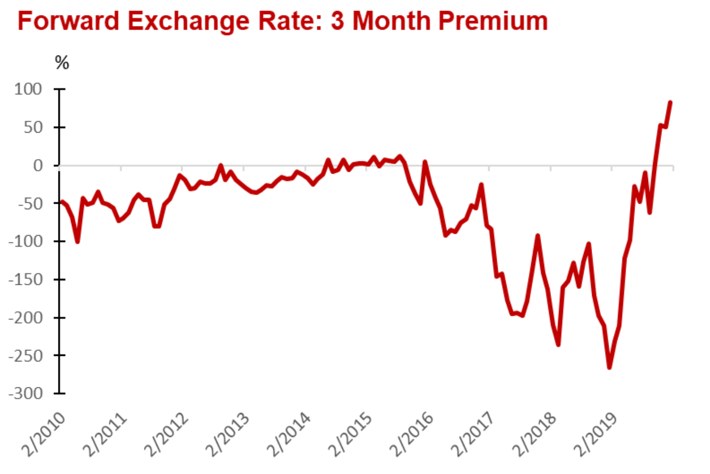
Source: CEIC, CMBIS

Figure 4: Total visitor arrivals to Hong Kong fell dramatically in 2019



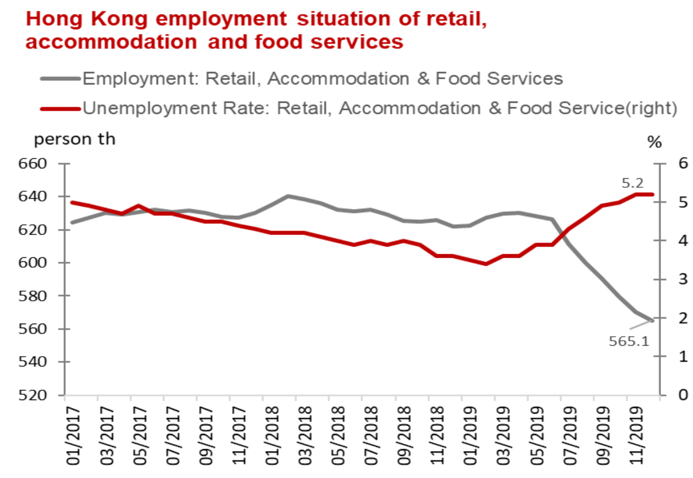
Source: CEIC, CMBIS

Figure 5: Hong Kong dollar forward exchange rate sours to record high



Source: CEIC, CMBIS

Figure 6: Retail, accommodation and food services saw a surge of unemployment rate since mid-2019



Source: CEIC, CMBIS

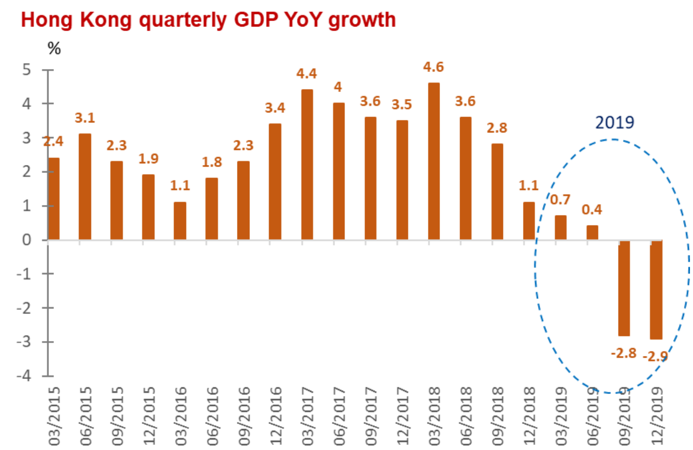
First annual recession in a decade

Recession deepened in 4Q19. Weighed down by US-China trade war and social events, 2019 Hong Kong economy slipped into its first technical recession in a decade. Real GDP contracted by 2.8% in 3Q19 and 2.9% in 4Q19 as a result of weak domestic and external demand.

The slowdown was quite broad-based and significant. In 2019, private consumption expenditure (PCE) and domestic fixed capital investment (GDFCF) decreased by 1.1% and 12.2% respectively. Foreign trade was also seriously hit by raising trade barriers and weakening global demand.

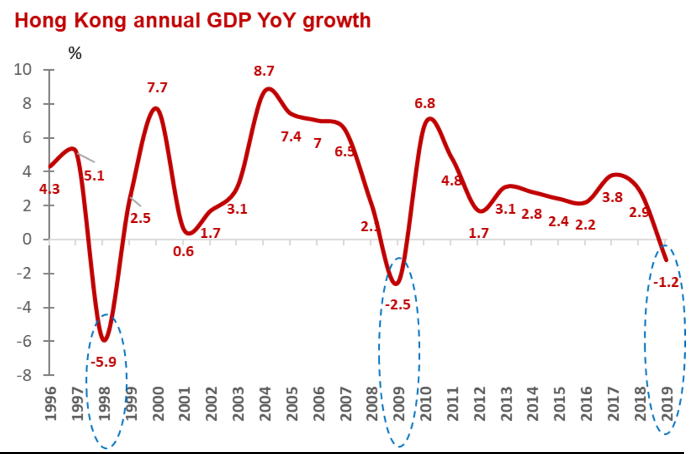
The city suffered the worst economic situation since the financial crises: for the whole year, Hong Kong real GDP decreased by 1.2% in 2019 after increased 2.9% in 2018. Since 1997, only the year of 1998 and 2009 recorded negative annual GDP growth rates (-5.9% and -2.5% respectively), making the current situation a financial crisis-like one. The difference may be that the city now needs more time to get back on track compared to Asian and global financial crises times, because the coronavirus outbreak, the slowdown of mainland China's growth and the weakness of global economic recovery are all among the major drags on economic rebound of Hong Kong this year.

Figure 7: The city has been in recession for two straight quarters



Source: CEIC, CMBIS

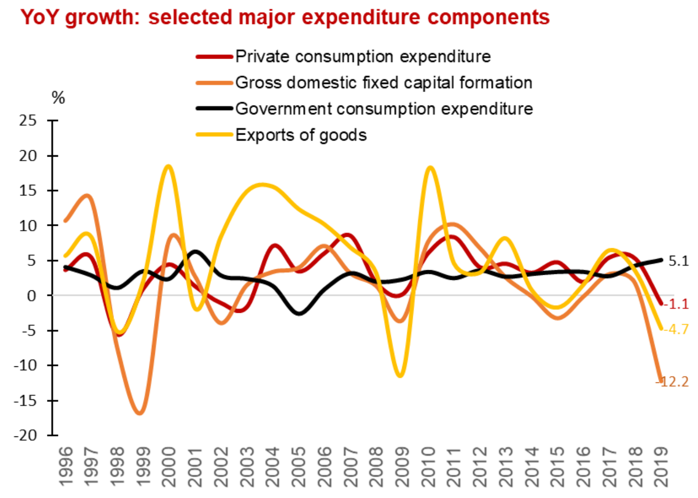
Figure 8: Hong Kong economy was in a financial crisis-like situation



Source: CEIC, CMBIS

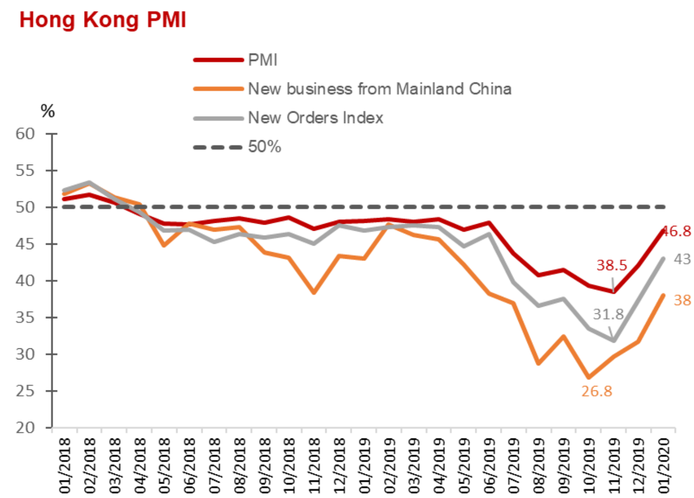
Private sector economy stuck in severe downturn and businesses continued to struggle. Headline Markit PMI of Hong Kong has remained in the contraction zone since early 2018 and slipped sharply since mid-2019. New orders index and new business from mainland China both dropped dramatically since the social events kicked off. Purchasing activity and inventories fall at marked rates. Despite a transient rebound of the data in Dec 2019 and Jan 2020, the rate of deterioration remained sharp and companies remained downbeat regarding the year-ahead outlook for business activity. Moreover, Jan 2020 PMI data did not include the virus effects. **We believe the business confidence and economic activity will remain rather weak for the most time of this year.**

Figure 9: Hong Kong was experiencing a clear and broad-based slowdown



Source: CEIC, CMBIS

Figure 10: Hong Kong PMI has remained in the contraction zone for about 20 months



Source: CEIC, CMBIS

Black Swan: coronavirus outbreak adds insult to injury

Coronavirus in Hong Kong

The spread of coronavirus (2019-nCov) has significantly accelerated in recent weeks. As of 5 Feb, the virus has spread to all 31 provinces and regions in mainland China and 23 countries outside China. Since Hong Kong SAR confirmed its first two cases on 22 Jan, fears have been rising quickly, especially after the city reported its first fatality from the outbreak on 4 Feb and after the risk for potential community outbreak increased dramatically recently. Hong Kong government decided to set stricter rules of cross-border mobility including that all individuals from the mainland, consisting of Hong Kong locals, will be needed to undertake 14 days of quarantine.

Comparing to SARS, is this time different?

Hong Kong's economy was among the worst hit by SARS in 2003. Hong Kong had a cumulative total of 1,755 SARS cases, accounting for 20.8% of the world total of 8,422. During SARS in 2003, there was a sharp fall in GDP growth in 2Q03. It is estimated that the hit by SARS to Hong Kong's 2003 annual GDP growth was 2.6ppt, the largest globally in terms of growth rate drop. Comparing 2019-nCov to SARS, we have highlighted some similarities and differences which matter to economic analysis:

In common:

1) Both viruses are highly contagious and can be fatal;

2) SARS was spreading in the community in Hong Kong, while 2019-nCov has already showed early signs of community spread recently;

3) Both are unexpected negative shocks to Hong Kong's economy;

4)The most significant negative effects are on the demand side, with local consumption and the export of services related to tourism and air travel severely affected in the short run.

Differences:

1) For SARS, the infected individuals and quarantine who had been in close contact with them could be insolated more quickly and effectively, which limited further spread of the disease. 2019-nCov seems to be spreading faster than SARS.

2) Based on the current data, the 2019 coronavirus seems to be less deadly than SARS.

3) Hong Kong was unprepared when SARS hit the city and its seriousness of the outbreak was largely unknown by then. This time the city has more experience to manage public health crisis.

4) SARS did not bring a supply shock to Hong Kong while 2019-nCov is likely to affect the supply side.

Economic implications

1Q20 economic data is likely to be ugly and 2Q20 will depend on the spread of the disease. Domestic demand will continue to collapse as the majority of citizens stay home. Moreover, further border restrictions and the reluctance to travel to Hong Kong are devastating travel and tourism. We identify three areas of Hong Kong economy that are particularly vulnerable to virus outbreak: consumption spending, tourism-related and re-exports.

The impact of 2019-nCov on 2020 whole year Hong Kong GDP will depend on the severity of the virus outbreak and the government's ability to contain it. Since it is still an early stage to quantify the exact cost of the virus, we asses the impacts using scenario analysis:

- Scenario 1 (Base case): In this scenario, we assume the spread of virus could peak around Mar to Apr 2020 and its adverse impact could fade out within 1H20. Based on the SARS experience and on the information we have right now, we think that a temporary impact of around 2-3% on GDP is a reasonable estimate. In this scenario we forecast **a 2% contraction** in GDP during 2020 as a whole.
- Scenario 2 (Best case): In this case there was a breakthrough of medical treatment or other effective measures to contain the disease, and spread of disease could be contained around late-Feb. We expect 2020 GDP **to contract by a modest 0.8%.**
- Scenario 3 (Worst case): There was a large-scale outbreak through community transmission and the disease could not be quickly contained. More and more new cases of the virus without known travel to mainland were reported. If the virus could not be controlled quickly and effectively, a long-term drop in consumption spending and foreign investment would hit the economy seriously. The city's economy would **shrink by as much as 7%** in 2020.

No quick recovery in sight

Why Hong Kong economy needs more time to recover this time than it did in 2003?

In 2003, initial alarmist reports and estimates about the negative economic impacts were not borne out. Fear and panic subsided quickly once the outbreak was under control, and the economy rebounded rapidly. But this time, we see Hong Kong economy to take longer to get back on track mainly for three reasons:

1. **The growth momentum before the virus becomes different.** Before SARS hit Hong Kong, economic recovery had started and real GDP increased by 3.4% in 3Q02 and 5.1% in 4Q02. In 1Q03, exports from China picked up strongly and cargo movement showed rapid growth.

2. **SARS did not bring a supply shock while 2019-nCov is likely to affect supplies.** Even though SARS raged through the province of Guangdong, the cross-border manufacturing base was not disrupted. The production and cross-border movement of goods continued to function smoothly.

3. **Global supply chain is much weaker now.** During SARS, global supply chain remained largely intact, cushioning the adverse impact on Hong Kong economy. At present, global supply chain has been hit by trade protectionism and is undergoing fundamental changes. In other words, global supply chain is too weak to support Hong Kong economy during the special time.

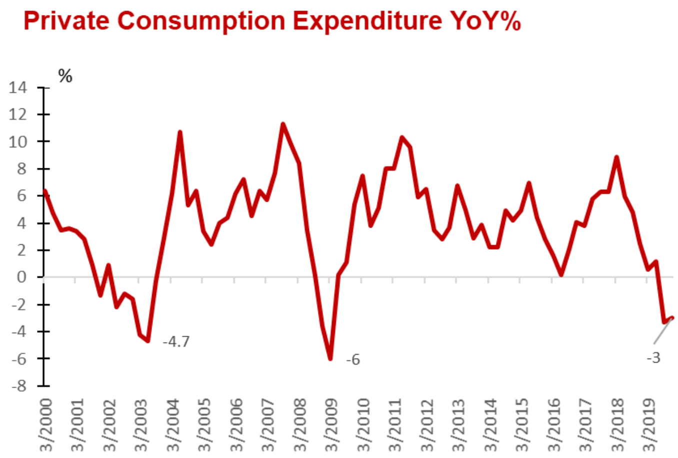
Vulnerable sector 1: private consumption

Because Hong Kong's total private consumption expenditure in 2019 accounts for some 65% of the GDP, a long-term drop in consumption would have very significant adverse impact on economic growth.

Before the virus outbreak, private consumption expenditure (PCE) of Hong Kong decreased by 3.0% in real terms in 4Q19 YoY, compared with the 3.3% decline in 3Q19. For 2019 as a whole, PCE decreased by 1.1% in real terms from 2018.

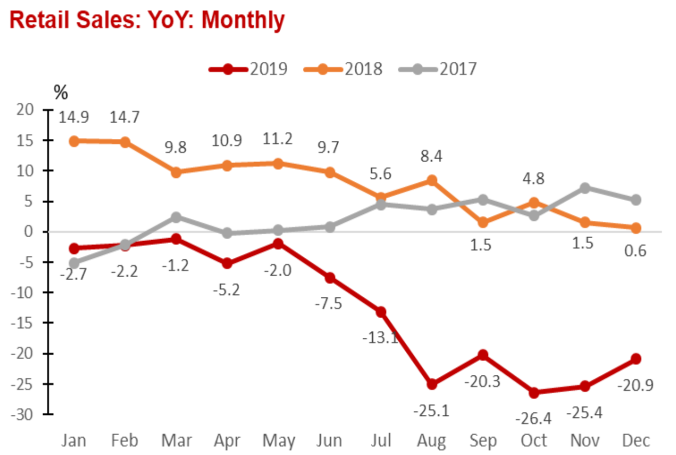
Hong Kong retail sales fell 24.4%, 23.7% and 19.4% YoY from Oct to Dec 2019, recording the steepest declines. After netting out the effect of price changes, volume of total retail sales decreased by 26%, 25% and 21% from Oct to Dec 2019. For the whole year of 2019, retail sales shrank 11.1% YoY to HK$431.2bn.

Figure 11: Private consumption expenditure fell into negative territory in 2019



Source: CEIC, CMBIS

Figure 12: Volume of total retail sales dropped rapidly in 2019



Source: CEIC, CMBIS

Due to the virus outbreak, consumptions by both local people and tourists will shrink dramatically, at least throughout 1Q20. After the disease, local consumption is expected to rebound more quickly than tourists spending. Higher unemployment rate in the city will also weigh on the retail growth. We have adjusted our previous estimation down by 3% and now expect retail sales to **further drop 5% in 2020** in the base case.

The products that are suffering most include **1) jewellery, watches and clocks, and valuable gifts; 2) wearing apparel, footwear, allied products and other clothing accessories; 3) electrical goods and other consumer durable goods; 4) medicines and cosmetics motor vehicles and parts; and 5) optical products.**

Vulnerable sector 2: tourism-related

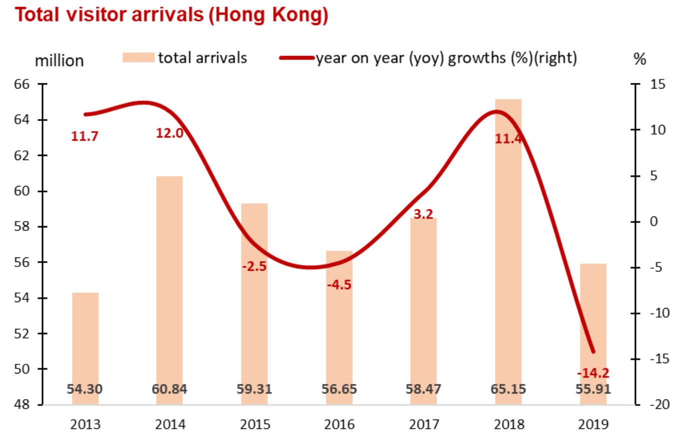
Tourism-related activities constitute an important part of the city's economy, accounting for about 260,000 jobs and generating 4% to 5% of GDP. Since mid-2019, visitor numbers have been falling and the whole year total visitor arrivals dropped by 14.2% from 65 million in 2018 to 56 million in 2019.

Now, the tourism gets its double blow: the virus. Tourist hotspots such as Ocean Park, Disneyland Resort and the Ngong Ping 360 cable car were closed and all public leisure facilities were shut down. After the government announced stricter rules to restrict cross-border personal mobility, we see the arrivals and tourists' numbers have been decreased effectively.

Hotel, airline and retail sectors will suffer more than other services. Taking hotel industry as a typical example, before 2019 Hong Kong hotel usually had their occupancy rates above 80%. This number dropped to about 60% since Aug 2019. The virus gives the hotel industry a double shock as the occupancy rate once fell to 17% during SARS in 2003.

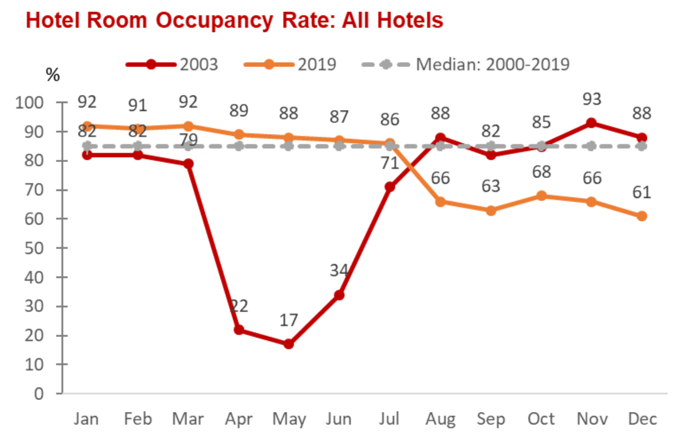
Overall, due to social environment and virus spread, we expect **visitor arrivals to Hong Kong this year to drop 6%** and tourism-related industries to have another challenging year. Some companies may suffer more than they did in 2003 during SARS.

Figure 13: Total visitor arrivals to Hong Kong fell dramatically in 2019



Source: CEIC, CMBIS

Figure 14: Hotel room occupancy rates have dropped to record low in 2019

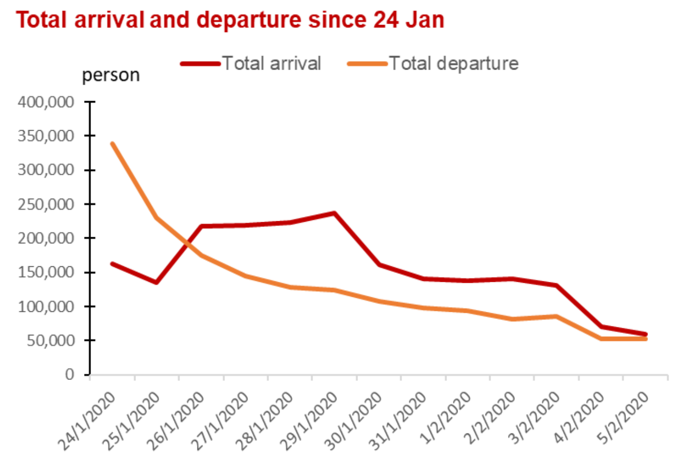


Source: CEIC, CMBIS

Figure 15: Total arrivals and visitors from mainland and other places are decreasing quickly since Feb 2020

Source: Hong Kong government, CMBIS

Figure 16: Arrival and departure changes since 24 Jan



Source: Hong Kong government, CMBIS

Figure 17: Reported losses from SARS in 2003 according to selected businesses

Sector	Source	Date	Reported loss
Food and catering	Hong Kong Federation of Restaurants and Related Trades	Mid-April	50 restaurants closed temporarily
	Café de Coral	Early April	Sales dropped by 20%
Retail	Hong Kong Retail Management Association	Early April	Retail sales fell by 50%
	Sa Sa International	Early April	Sales dropped by 10%
	Giordano International	Mid-April	Sales dropped by 30%
	Mirabell International	Mid-April	Sales fell by 50% YoY
Tourism	Hong Kong Tourism Board	Early April	10.4% drop in visitor arrivals in the last 16 days of Mar03 over a year prior
Airline	Cathay Pacific Airways	Mid-April	Estimated loss per day was US$3mn; cancellation of fights rose from 10% in late Mar03 to over 40% in mid-April
	Dragon Airlines	Mid-April	Flight schedule was cut by 48%
Transport	Citybus	Early April	Passenger level fell by 10%
	New World First Bus	Mid-April	Passenger level fell by 20%
	MTR Corporation	Mid-April	Airport Express Line frequency was cut as passenger levels fell by 50%
Others	The Hong Kong Convention and Exhibition Centre	Early April	12% of bookings were cancelled or postponed
	Cinema Association	Mid-April	Revenue in Mar03 dropped by 47%

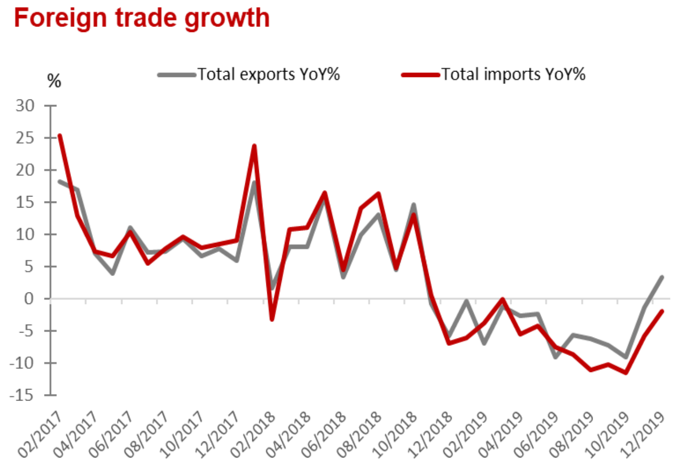
Sources: Siu, A., & Wong, Y. R. (2004). Press reports from Ming Pao and South China Morning Post.

Vulnerable sector 3: foreign trade

Total exports of goods continued to decline for 13 months until Dec 2019 amid the difficult external environment. For 2019 as a whole, the value of total exports and imports of goods dropped by 4.1% and 6.5% YoY respectively. This year, although phase-one deal between US and China reduced trade tensions to some extent, trade uncertainties remain high.

What's worse, we expect the shock by 2019-nCov to be greater than SARS to the city's foreign trade. During SARS, the external trade sector performed quite well and exports of goods continued to grow robustly between Jan and Jun 2003. It was mainly supported by the fact that no major production disruptions were reported in factories in the Pearl River Delta, which were mostly owned by Hong Kong-based manufacturing and trading companies. This time, production in mainland China is heavily affected by the virus and export of mainland China is estimated to fell 0.9ppt to 1.0% in 1Q20, which will hit re-export of Hong Kong. All this may give Hong Kong external trade more burdens to recover. In the base case, we expect foreign merchandise trade of Hong Kong to **contract 2.5% in 2020.**

Figure 18: Hong Kong trade had a temporary rebound after 13-month contraction before the virus hits



Source: CEIC, CMBIS

Figure 19: Trade with mainland accounts for over half of its total trade (as of Dec 2019)

Source: CEIC, CMBIS

Impact on foreign exchange and money markets

Due to seasonal needs from banks, the demand for massive public offering (such as Alibaba) and social events, liquidity conditions are the tightest since the late 1990s and interbank rates are climbing. The Hong Kong dollar's three-month forward points soared to the highest level in 20 years recently, indicating tight liquidity conditions in the foreign-exchange market.

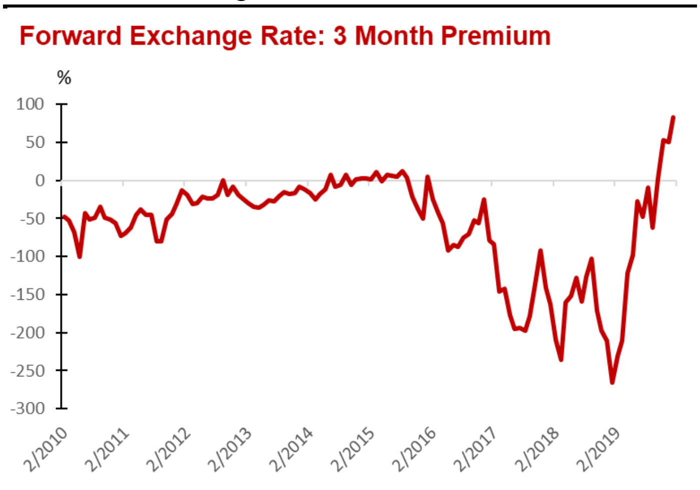
The liquidity condition and risk-on sentiments together have contributed to the appreciation of Hong Kong dollar exchange rate on US dollar since Nov 2019. From a low of HK$7.84 for each US dollar in Aug 2019, it strengthened to 7.79 at the end of 2019 and currently trades at 7.76 (as of 6 Feb). Looking ahead, we believe the currency's strength will be short lived, and the carry trade's attractiveness and seasonal demand will fade. We expect **Hong Kong dollar to weaken to around 7.80** as the city's dimmed economic outlook will weigh on its currency.

Overall, we believe Hong Kong's foreign exchange and money markets have been operating smoothly. Hong Kong Monetary Authority said that it will continue to closely monitor market developments, including any possible impact of the spread of the novel coronavirus. Hong Kong dollar exchange rate and interbank interest rates have remained largely stable. Aggregate balance has remained stable at about HK$54bn. And we view that **the linked exchange rate system is still resilient** amid multiple economic challenges.

Figure 20: Hong Kong dollar has gained its strength since late Nov 2019

Source: Bloomberg, CMBIS

Figure 21: Hong Kong dollar forward exchange rate sours to record high



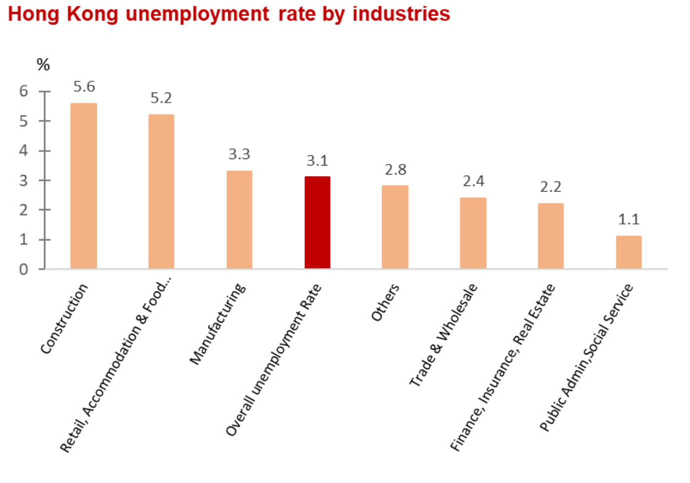
Source: CEIC, CMBIS

Impact on job market

The positive side is that the overall unemployment rate of Hong Kong stayed low at 3.1% by Dec 2019. What is worrisome is that even before the virus outbreak, employment situation in some sectors such as retail, accommodation, food services, has deteriorated. Since mid-2019, unemployment rate in these sectors has surged from 3.9% to 5.2%.

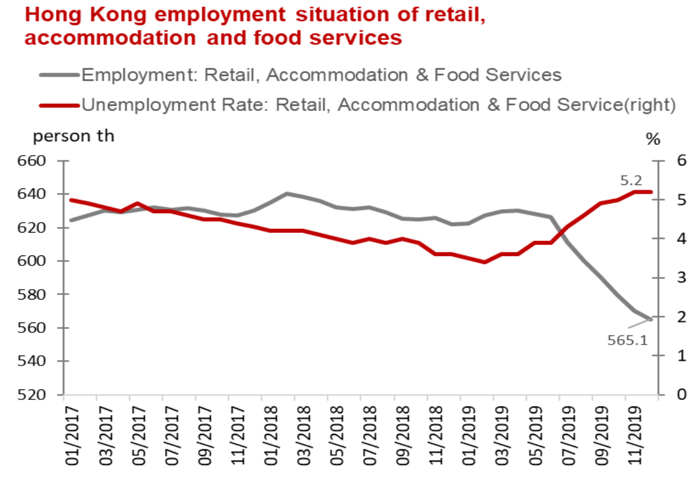
We expect the combined effects of the drop in domestic consumption and the decrease in tourist spending will worsen the labor market in Hong Kong during the virus outbreak. **The overall unemployment rate is expected to rise to around 5%** and some severely affected sectors will lay off workers due to the lower demand, driving unemployment rates in these sectors to above 6%.

Figure 22: Unemployment rates of some sectors were higher than the average level



Source: CEIC, CMBIS

Figure 23: Retail, accommodation and food services saw a surge of unemployment rate since mid-2019



Source: CEIC, CMBIS

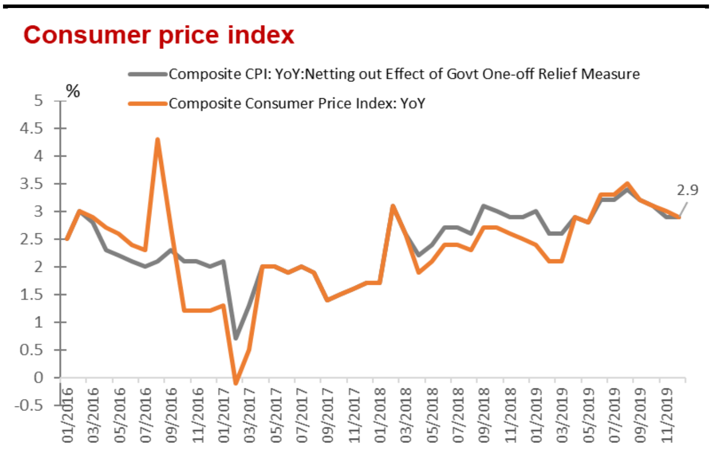
Impact on inflation

Throughout the SARS outbreak, consumer price index continued to show a negative growth rate. After SARS started to abate, CPI declined more rapidly as retailers, restaurants and other business cut prices to entice consumers to spend.

CPI of Hong Kong stayed in a comfortable zone in 2019 and food inflation remained notable amid elevated fresh pork prices. Overall consumer prices rose by 2.9% in Dec 2019, driving by food (excluding meals bought away from home) (13.8%), miscellaneous goods (3.4%) and housing (3.0%).

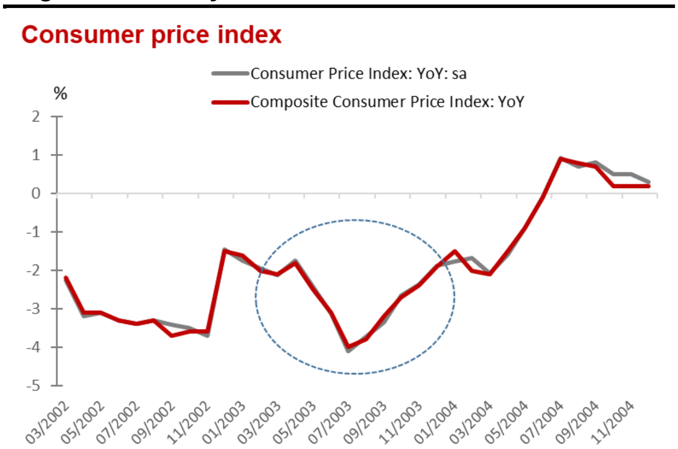
We expect prices of some products to rise due to lower supply including meat and vegetables and some goods produced mainly in mainland China during the virus outbreak. Retailers and restaurants tend to cut prices to get customers back when the virus concerns start to ease. **The whole year headline CPI is likely to hold largely steadily around 3%.**

Figure 24: CPI held largely steadily in 2019



Source: CEIC, CMBIS

Figure 25: CPI during SARS outbreak remained in negative territory



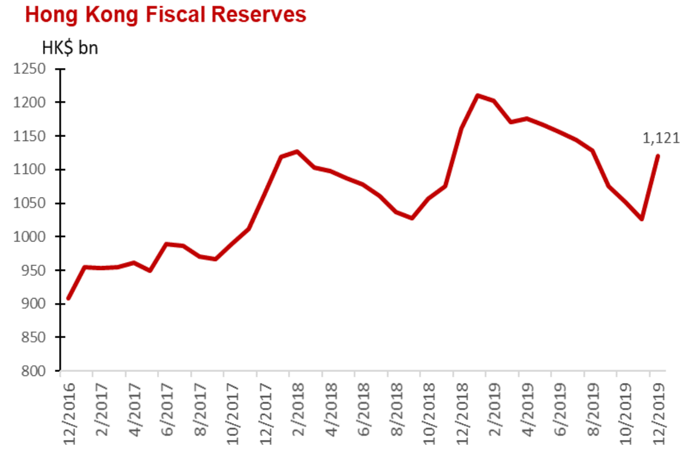
Source: CEIC, CMBIS

Policy response: more fiscal stimulus

Since the social events began, the government has announced a series of stimulus measures worth more than HK$25bn. Government consumption expenditure (GCE) grew by 6.0% in real in 4Q19, after the increase of 5.9% in 3Q19. For 2019 as a whole, GCE increased by 5.1% in real terms over 2018. The stimulus has been targeted at businesses and various social groups, and includes some tax breaks, one-time fuel and utilities subsidies, as well as support for children and the elderly.

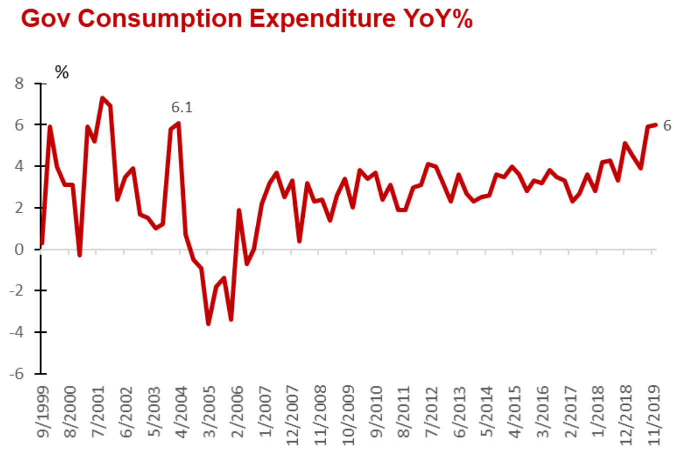
Despite decrease of fiscal reserves during most of the time in 2019, Hong Kong's fiscal reserves still account for some 40% of its GDP at present, reflecting the city's solid economic buffers. Further measures are expected in a budget announcement later in Feb 2020. However, fiscal stimulus packages wouldn't go far enough to improve the growth momentum amid multiple headwinds.

Figure 26: Hong Kong has relatively abundant fiscal reserves



Source: CEIC, CMBIS

Figure 27: Government expenditure is expected to increase more quickly this year



Source: CEIC, CMBIS

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HOLD	: Stock with potential return of +15% to -10% over next 12 months
SELL	: Stock with potential loss of over 10% over next 12 months
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OUTPERFORM	: Industry expected to outperform the relevant broad market benchmark over next 12 months
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