2017 is likely to be as soft as this year

All eyes on currency risks as Hong Kong enters 2017

Monetary conditions in HK have tightened from effective HK$ appreciation and rising US rates expectations since 2015.

The last quarter of 2016 was a soft one for Hong Kong's economy and unless there are dramatic changes to either China's economy or the US$ exchange rate, 2017 may continue to be soft, economists argue. UBS economist Duncan Wooldridge notes that Hong Kong's macro outlook is driven by two key moving parts: monetary conditions – the function of domestic interest rates and HK$ exchange rate (which is pegged to the US$ at a fixed rate) – and the global macro backdrop, particularly relating to China. "Monetary conditions in HK have tightened from effective HK$ appreciation and rising US rates expectations since 2015. This, plus heightened concerns on China in 2H15, had until late 2Q16 caused domestic growth to visibly slow and property prices to drop. But the stabilisation in monetary conditions since 2H16 has allowed the city to temporarily muddle through. Strong US$ (and thus HK) has been the biggest headwind since 2015 by undermining HK's cost competitiveness," he says.

Growth is likely to remain subdued and chug along an L-shaped path in 2017/18.

HK$ REER has moved sideways since 2Q16

Source: CEIC, BIC and UBS calculations. The REER index is compiled by the BIS

Impact of currency strength

Rising US interest rates would also likely see the US$ strengthen which would also strengthen the HK$. Hong Kong has high private debt and is sensitive to interest rates so growth is likely to remain subdued and chug along an L-shaped path in 2017/18, argues Wooldridge. "The retail and hospitality sectors, being the most cost-sensitive, have been the hardest hit since 2015, so some might expect these sectors to recover and contribute the biggest delta to any growth improvement going forward. We doubt that will be the case. Whilst these sectors are indeed finding a floor, as the supply sides become more favourable (lower domestic costs and a less distorted structure) and the relative HK$ appreciation pauses, any recovery thereafter still critically hinges on better end-demand," he says.

A strong HK$ also hurts Hong Kong's competitiveness as a shopping destination of luxury goods. A weaker pound following the Brexit vote has had the unintended consequence of driving sales of Swiss watches in the UK in the post-Brexit months. Outlets of luxury watch brands in London have reported double-digit yoy increase in sales in July and according to the Federation of the Swiss Watch Industry, exports of Swiss watches to the UK rose by 13.4% yoy in July, the highest figure since November 2015. This compares with the 33% yoy decline in exports of Swiss watches to Hong Kong.

Property-durables connection

A soft property market continues to reduce residents' purchases of consumer durable goods, notes Wooldridge. "Taking into account the weaker-than-expected growth in the last three months and the impact of Brexit on luxury good sales, we have adjusted our outlook for retail sales growth from three months ago. We have revised the 2016 retail sales growth estimate down to -8% from -5% and the 2017 forecast to -1.8% from -0.5%."

CLSA economist Ines Lam also says all eyes should be on property prices to forecast how the Hong Kong economy may fare in 2017, noting that apart from the wealth effect, there is one more channel through which the property market affects private consumption. "There is a 70% correlation between the yoy growth of real spending on consumer durables and that of secondary residential prices, indicated by the Centa City Leading Index (CCLI)," notes Lam.