RISING POLITICAL UNCERTAINTY IN HONG KONG

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IN A WORD:

China yesterday approved a proposal to impose new national security legislation in Hong Kong, after the US administration expressed that it could no longer certify Hong Kong's autonomy from China, which could trigger a range of actions from sanctions on Chinese officials to revoking the city's special trading status with the US. Here are our preliminary thoughts on the potential economic and investment implications:

(1) **Revoking the special status of Hong Kong as a separate customs territory** – Direct impacts on Hong Kong economy are limited, as the city mainly engages in re-export activities (domestic exports are very small). With tariffs applying to the originating country, Hong Kong's re-export activities from China to the US have already fallen significantly since last year due to the trade war.

(2) **Worries of capital outflows –** There has been no clear evidence of capital outflow over the past year despite the social unrest since mid-2019. Also, despite the political news flow over the past few days, we continue to see southbound net buying in Hong Kong stock market. Furthermore, the increasing de-listing risk of ADRs in the US is re-listing opportunities for Hong Kong stock market. Nevertheless, we need to keep a close eye on the US-China tensions and

whether it will trickle through the financial sector, which could indirectly impact the Hong Kong financial market.

(3) **HKD peg** –The Hong Kong authorities are in a strong position to keep the HKD peg intact, as we argued in a strategy note published in September 2019 (for details, please refer to https://wealthmanagement.bnpparibas/asia/en/expert-voices/hkd-peg.html). The HKMA must hold anchor-currency reserves at least 100% or exceeding the monetary base. In fact, Hong Kong's massive forex reserves (currently USD 441 billion) is two times the size of the HKD monetary base, comfortably backing the HKD peg. Furthermore, as long as China is committed to maintaining the "1 country 2 systems" policy, the HKD peg as a key symbol is likely to stay. It's in China's interest for Hong Kong to continue its function as an offshore international financial center, playing a catalytic role in the country's financial reform journey (capital account are yet to be fully liberalized). It's also in the interest of the global financial community to sustain the peg and maintain global financial stability.

As the details of the new security law will probably take some time to draft, while the extent of US actions is also unclear, the actual impacts are difficult to gauge at this point of time. However, heightened uncertainty could lead to market volatility in the near term, especially on Hong Kong assets. We recommend a more defensive strategy for Hong Kong stocks, while remaining positive on China equities amid its domestic demand recovery story. Furthermore, political risk is very difficult to predict, investors should always stay diversified with a multi-asset portfolio.

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