

HONG KONG ECONOMIC MONITOR

Treasury Division



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January 2012

Hong Kong Economy in 2012 - Bracing for Global Headwinds

The slowdown of the Hong Kong economy appears to be continuing, but the downturn has been milder than many had expected. Consumption momentum remains largely intact, thanks to tight labor market conditions and strong inbound tourism. Recent trade data also seem to be supportive for Q4 growth.

Going forward, global risks are rising, including the European debt predicament, deficit reduction in the US, and potential financial market volatility, which could dampen the growth outlook of the territory.

Hong Kong's purchasing managers' index (PMI) has stayed in contraction territory for four straight months, suggesting that gusty external headwinds might also squeeze local investment spending. Overall growth numbers will likely turn worse in 1Q12 before turning better. However, given that the global economic problems are structural and therefore could not be resolved easily, Hong Kong's expected recovery in 2H12 is unlikely to be swift. For 2012 as a whole, we expect Hong Kong's economic growth and inflation to ease to an average of 4% and 4.5% respectively.

Exhibit 1: Hong Kong's Economic Forecast

(%, YoY)	3Q10	4Q10	1Q11	2Q11	3Q11	2011F	2012F
Real GDP	6.9	6.4	7.5	5.3	4.3	5.2	4.0
Retail sales value	17.9	19.4	21.0	28.1	27.5	24.0	14.0
Total exports	27.8	14.4	24.7	7.9	4.3	9.8	10.0
Total imports	24.1	15.1	20.6	10.3	8.8	10.9	11.5
Consumer prices	2.3	2.7	3.8	5.1	6.5	5.3	4.5
Unemployment rate*	4.2	4.0	3.4	3.5	3.2	3.5	3.7

Note: (F) Forecast; * Average for the period

Sources: Census and Statistics Department, Hang Seng Bank



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Consumption Momentum Remains Largely Intact

While the growth of consumer spending is on a moderating trend, the pace of slowdown seems to be milder than many had expected. Retail sales value rose 23.1%¹ in October, a modest slowdown compared with the 24.1% increase in September. In real terms, retail sales growth stayed steady at 15.0% in October.

Among the sub-segments, sales of jewellery and watches continued to be the areas of strength, in terms of both value (+47.5%) and volume (+31.0%). The clothing, footwear and allied products (+26.3%) and consumer durable goods (+20.2%) segments also did well in October. Strong visitor arrivals, which grew at a stellar pace of 16.4% in October, offered major support to sales of jewellery and other high-end consumer goods. Indeed, tourists now play a more important role in the retail sector than a decade before. Tourist spending on shopping accounted for about one-third of retail sales last year, compared with less than 12% in 2000 (Exhibit 2). We believe inbound tourism could provide some buffer to Hong Kong's domestic spending next year, underpinned by further extension of the individual travel scheme and stronger purchasing power of Asian visitors amidst a weaker Hong Kong dollar.

Exhibit 2: Tourism Contribution to Hong Kong's Retail Sales (% of Retail Sales Value)

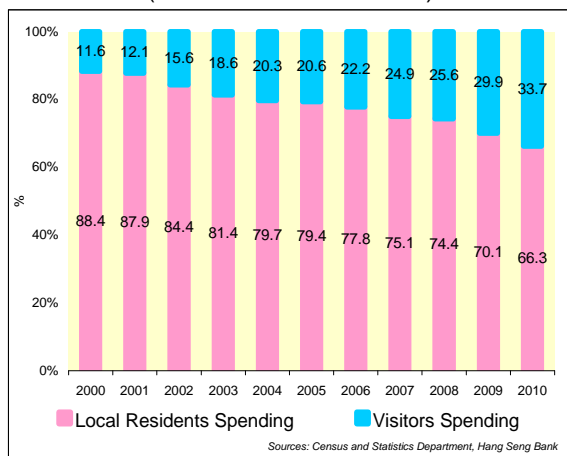
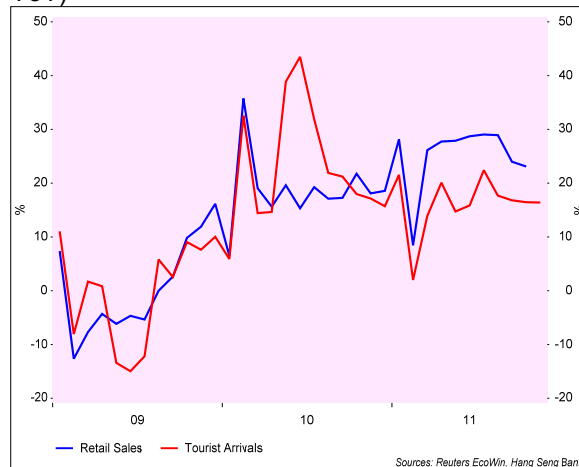


Exhibit 3: Retail Sales and Visitor Arrivals (% YoY)



On the other hand, other items saw more headwinds in recent months. Sales of supermarket and department store advanced 13.1% and 17.4% in October respectively, slower than the 15.5% and 21.6% in the previous month. The moderation of local consumer sales is consistent with the prevailing vigilance among Hong Kong residents, who are more exposed to the volatile financial market conditions and lackluster property sector activities lately.

¹ Changes throughout the report are on year-on-year basis unless otherwise stated



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The slight deterioration in labour market conditions is more of a concern. The seasonally adjusted unemployment rate edged up for a second month in a row to 3.4% in September-November. Yet, at this point, there is little evidence that companies are seeking to lay off staff on a large scale. The number of employed workers remained at a record high in November, even as local employers have become more hesitant in hiring amid the global uncertainty.

Net Export off to a Good Start in the Fourth Quarter

Unless the situation deteriorates, the global economy seems capable of withstanding a mild euro area recession. J.P. Morgan's global purchasing managers' index fell only slightly from 52.0 in September to 51.3 in October. Against such a backdrop, Hong Kong's exports managed to grow by 11.5% in October. As a result, the trade deficit narrowed to HKD23.14 billion in October, the lowest level in nine months, down from a revised deficit of HKD39.96 billion in September.

Exhibit 4: Total Exports (% YoY)

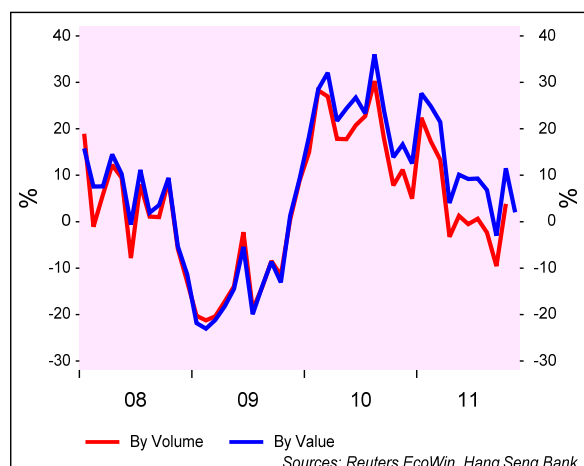
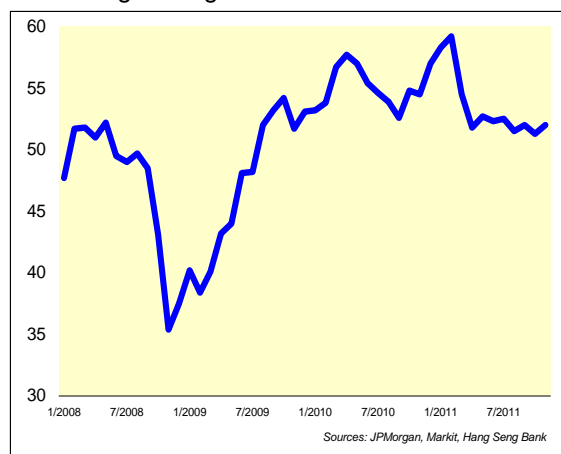


Exhibit 5: JPMorgan Global Composite Purchasing Managers' Index



Whilst the rebound in exports is encouraging, we do not believe a genuine recovery in export activity has begun. The stronger-than-expected trade figure in October could have been caused by deferral of September's shipment. Combining the September's and October's data, exports advanced modestly by 4.2%. In November, export growth moderated further to 2.0%.

We notice that output of the all-important electronics sector in Asian economies has been slowing since the third quarter. Supply chain disruptions from Japan's March earthquake and Thailand's floods are still filtering through, compounding the impact of easing demand from mainland China and the major markets. As such, the relatively favorable trade number in October is likely to be a temporary respite. We have turned more cautious towards the trade outlook, particularly in the first half of 2012.

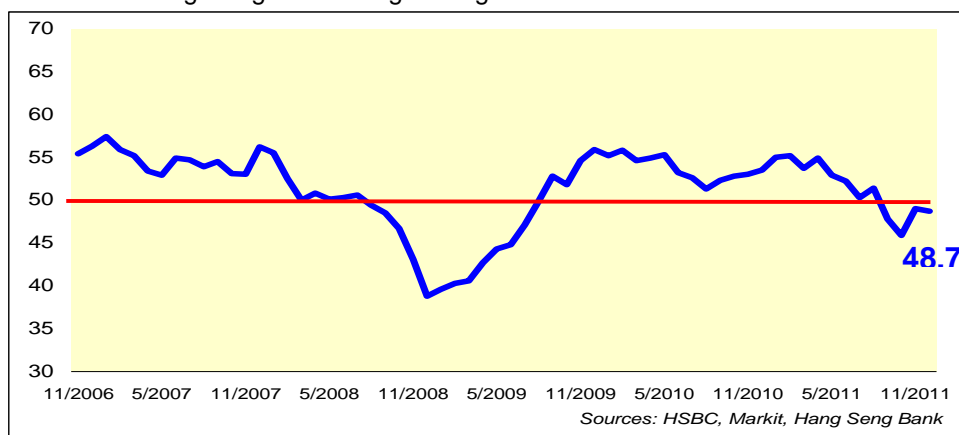




Business Sentiment on a Softer Note

A leading indicator points to slower economic activities ahead. Hong Kong's purchasing managers' index slipped further from 49.0 in October to 48.7 in November, the fourth straight month for the index to be below 50. Readings below 50 signal contraction in economic activities.

Exhibit 6: Hong Kong Purchasing Managers' Index



The slide in Asia's industrial production, owing to softer export demand and domestic inventory dynamics, has been a prime cause for the decline of Hong Kong's PMI. Gusty external headwinds will continue to put a squeeze on investment spending. We expect some retracement in capital spending over the next few quarters. Construction investment, another important component of fixed capital formation, could also slow following corporate retrenchment and sluggish residential activity.

Capital Inflows Show Sign of Easing

Hong Kong has been one of the major recipients of capital inflows after many rounds of quantitative easing undertaken by major global central banks. However, fund inflows have been easing since August. Latest monetary statistics showed a marked deceleration in deposit growth. Total deposits expanded 9.9% in November, notably slower than the growth of 13.9% in the first half. Even RMB deposit, which used to be the fastest growing category of deposits, rose by a mere 1.4% month on month to RMB627.3 billion in November, after registering its first month-on-month decline since 2009 in October.



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Exhibit 7: Deposits – HKD and Foreign Currency (% YoY)

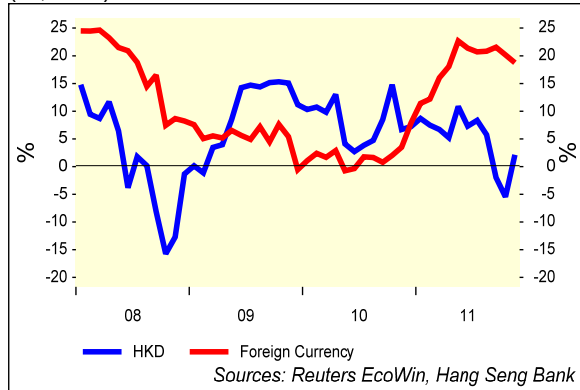
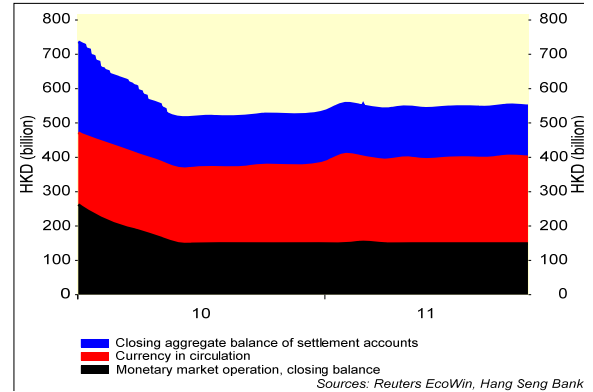
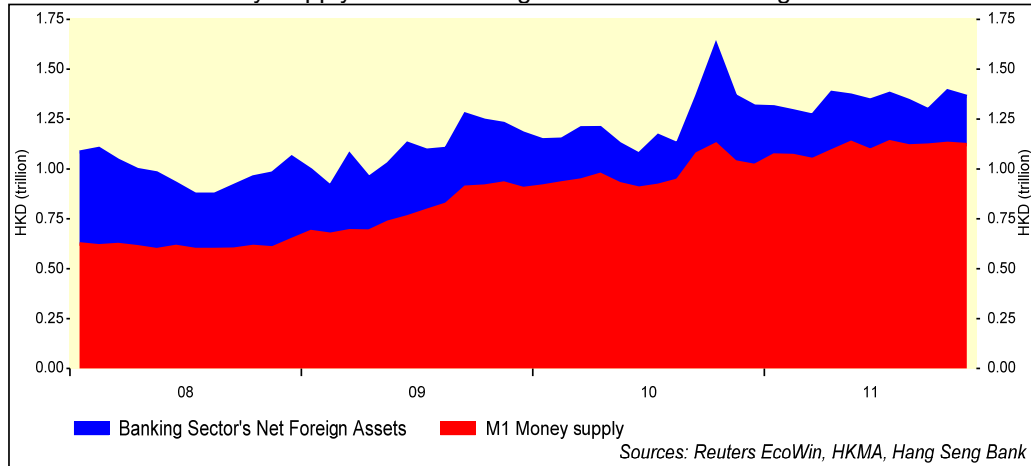


Exhibit 8: Monetary Base Composition



Many of the key advanced economies have a higher probability of slipping into recession in coming quarters. This bodes ill for capital flows into Asia. Nonetheless, we believe that funding risks shall not pose a serious threat to the Hong Kong economy. From a macro perspective, with persistent current account surpluses and ample FX reserves, Hong Kong should be able to withstand an external shock. In addition, monetary conditions remain highly accommodative with total M1 money supply and net foreign asset of the banking sector, a proxy of total liquidity, rising 18.8% in October compared with the end of 2010.

Exhibit 9: M1 Money Supply and Net Foreign Asset of the Banking Sector



Consumer Inflation Eased Slightly

Hong Kong's inflation remains elevated despite easing price pressures over the course of the year. Headline consumer inflation slipped to 5.7% in November, 0.1 percentage point



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lower than the reading in October. The decline was mainly led by slower increases in clothing and footwear prices. However, underlying inflation stood at 6.4%, the highest level since record began in 2007, fuelled by higher food prices and rentals, as well as the impact of a depreciating Hong Kong dollar (Exhibit 11).

Going forward, inflationary pressures will abate as output growth slows and favorable base effects kick in. We expect CPI inflation to settle towards 4% over the next few quarters. Such a benign inflationary environment is a gift to high-beta economy like Hong Kong, leaving more room for policymakers to loosen fiscal policy should external demand deteriorates further.

Exhibit 10: Contribution to CPI (By Component)

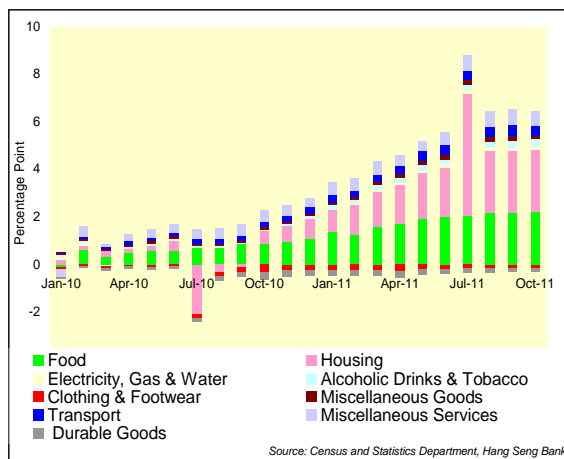


Exhibit 11: Nominal Effective Exchange Rate for the HKD (Import Weighted)



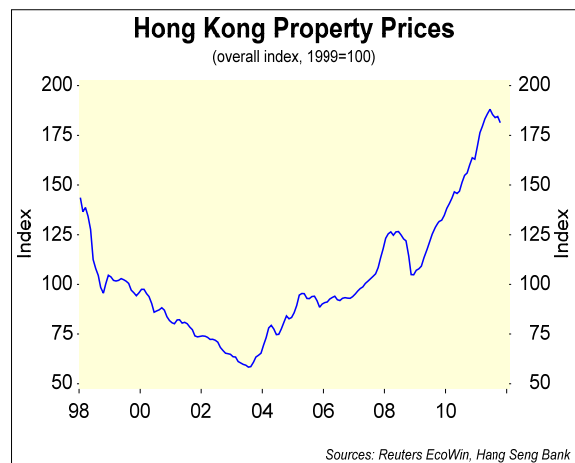
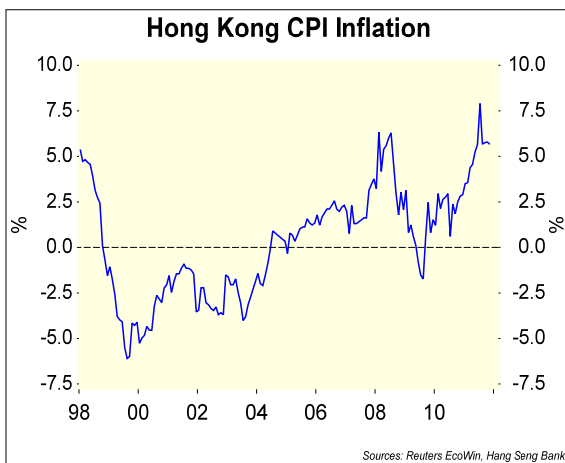
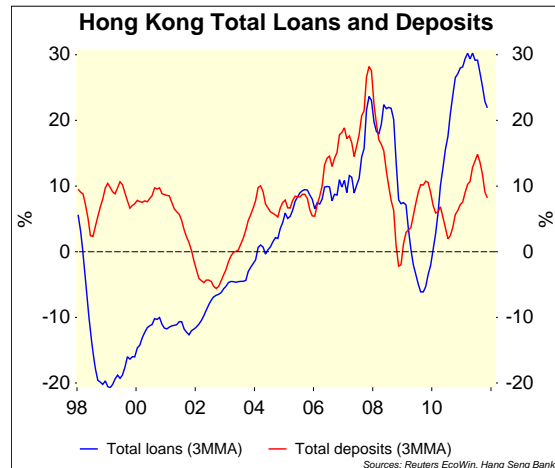
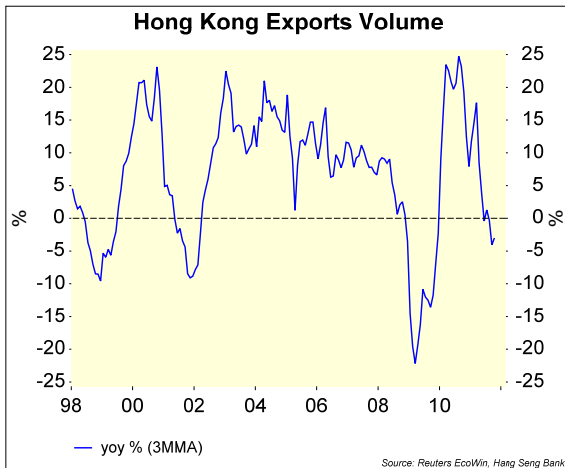
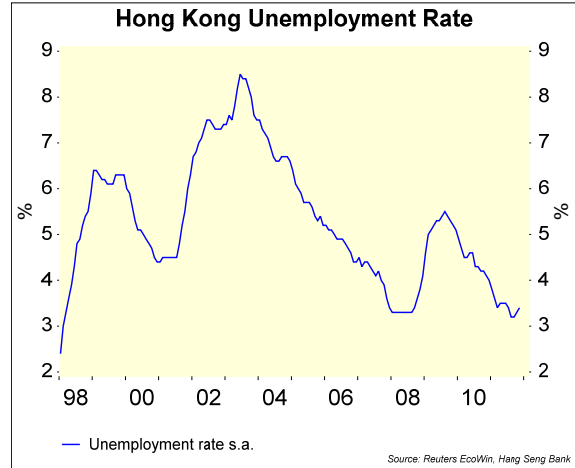
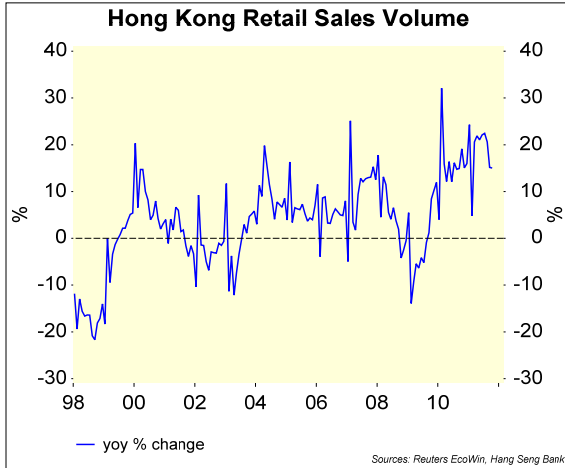
Summary

Hong Kong's growth outlook is increasingly clouded by the global financial market turmoil and the continued deterioration in external demand. Headline risks such as the European debt predicament, deficit reduction in the US and the resulting financial market volatility could further dampen growth outlook of the territory. High frequency indicators available so far (including retail sales and the PMI index) suggest near-flat sequential growth in 4Q11. Growth numbers will likely turn worse in 1Q12 before turning better. Given that the sovereign debt issue is global and secular in nature, we believe the recovery in 2H12 is unlikely to be swift.



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Hong Kong Economic Monitor Statistics

January 2012

	GDP (real)	Retail sales (value)	Retail sales (volume)	Total Deposits		Total Loans		Money supply (Total M3)	Consumer prices	Unemployment rate (s.a.)
	yoy(%)	yoy(%)	yoy(%)	HKD bn	yoy(%)	HKD bn	yoy(%)	yoy(%)	yoy(%)	%
2005	7.1	6.8	6.1	4,068	5.2	2,312	7.3	5.2	1.0	5.6
2006	7.0	7.2	5.7	4,757	17.0	2,468	6.7	15.5	2.0	4.8
2007	6.4	12.8	10.1	5,869	23.4	2,962	20.0	20.6	2.0	4.0
2008	2.3	10.6	5.0	6,060	3.2	3,284	10.9	2.6	4.3	3.6
2009	-2.7	0.6	-0.8	6,381	5.3	3,289	0.1	5.2	0.5	5.4
2010	7.0	18.3	15.5	6,862	7.5	4,227	28.6	8.0	2.4	4.4
2011F	5.2	24.0	17.7	7,342	7.0	5,072	20.0	12.0	5.3	3.5
2012F	4.0	14.0	9.0	7,820	6.5	5,580	10.0	10.0	4.5	3.7
Q1 2010	8.0	18.8	15.9	6,371	5.8	3,469	9.5	5.7	1.9	4.5
Q2	6.7	16.9	13.6	6,352	1.2	3,773	17.8	1.3	2.6	4.6
Q3	6.9	17.9	15.3	6,736	4.9	4,126	25.9	5.2	2.3	4.2
Q4	6.4	19.4	16.7	6,862	7.5	4,228	28.6	8.0	2.7	4.0
Q1 2011	7.5	21.0	16.7	7,077	11.1	4,541	30.9	11.7	3.8	3.4
Q2	5.3	28.1	21.7	7,235	13.9	4,818	27.7	15.9	5.1	3.5
Q3	4.3	27.5	19.4	7,324	8.7	5,030	21.9	11.1	6.5	3.2
Jan 2011	n.a.	28.2	24.3	6,963	10.0	4,354	29.9	10.7	3.4	3.8
Feb	n.a.	8.5	4.8	6,932	9.7	4,416	29.8	10.1	3.6	3.6
Mar	n.a.	26.1	20.6	7,077	11.1	4,541	30.9	11.7	4.4	3.4
Apr	n.a.	27.7	21.9	7,257	11.2	4,623	27.5	12.1	4.6	3.5
May	n.a.	27.9	21.0	7,303	16.4	4,755	32.4	17.7	5.2	3.5
Jun	n.a.	28.7	22.1	7,235	13.9	4,818	27.7	15.9	5.6	3.5
Jul	n.a.	29.0	22.4	7,382	14.2	4,905	27.6	16.3	7.9	3.4
Aug	n.a.	29.0	20.7	7,337	12.9	4,985	26.6	15.4	5.7	3.2
Sep	n.a.	24.1	15.1	7,324	8.7	5,030	21.9	11.1	5.8	3.2
Oct	n.a.	23.1	15.0	7,466	5.9	5,058	20.4	8.4	5.8	3.3
Nov	n.a.	n.a.	n.a.	7,528	9.9	5,117	23.5	12.4	5.7	3.4
YTD	5.6	25.2	19.9	7,528	9.9	5,117	23.5	12.4	5.2	3.4

	Foreign Trade					Residential Property Price Index	Office Rental Index	Tourist Arrivals		HKD per USD (end of period)
	Exports		Imports		Trade balance			'000	yoy(%)	
	HK\$bn	yoy(%)	HK\$bn	yoy(%)	HK\$bn	ytd(%)	ytd(%)			
2005	2,250	11.4	2,330	10.3	-79.3	8.2	28.1	23,359	7.1	7.7525
2006	2,461	9.4	2,600	11.6	-138.8	4.1	15.0	25,251	8.1	7.7745
2007	2,688	9.2	2,868	10.3	-180.5	25.7	14.6	28,169	11.6	7.8015
2008	2,824	5.1	3,025	5.5	-201.1	-11.1	9.2	29,500	4.7	7.7505
2009	2,469	-12.6	2,692	-11.0	-223.3	28.5	-9.8	29,590	0.3	7.7555
2010	3,031	22.8	3,365	25.0	-333.8	21.0	12.5	36,030	21.8	7.7745
2011F	3,328	9.8	3,732	10.9	-404.2	10.0	11.0	41,435	15.0	7.8000
2012F	3,661	10.0	4,161	11.5	-500.6	0.7	-0.7	45,578	10.0	7.8000
Q1 2010	636	26.0	724	34.3	-88.2	6.5	2.3	8,625	16.5	7.7645
Q2	763	24.3	854	29.9	-90.9	9.1	6.4	8,231	30.8	7.7855
Q3	832	27.8	898	24.1	-66.9	15.9	10.2	9,320	24.9	7.7615
Q4	890	14.4	800	15.1	-89.3	21.0	12.5	9,854	16.9	7.7745
Q1 2011	793	24.6	874	20.7	-81.2	10.1	2.9	9,708	12.6	7.7788
Q2	824	7.9	943	10.3	-118.4	15.4	8.5	9,623	16.9	7.7818
Q3	868	4.3	979	8.8	-110.7	12.5	15.0	11,092	19.0	7.7856
Jan 2011	284	27.6	300	19.0	-16.0	4.0	0.5	3,598	21.5	7.7971
Feb	228	24.9	253	25.2	-25.1	8.2	2.0	2,923	2.0	7.7880
Mar	281	21.5	322	18.8	-40.0	10.1	2.6	3,187	13.9	7.7788
Apr	252	4.1	294	6.1	-42.4	12.5	5.1	3,358	20.1	7.7662
May	280	10.1	316	13.0	-35.7	14.0	7.1	3,230	14.7	7.7766
Jun	292	9.2	332	11.5	-40.3	15.4	8.5	3,035	15.9	7.7818
Jul	286	9.3	322	10.2	-35.9	13.8	10.1	3,839	22.4	7.7941
Aug	310	6.8	345	14.1	-34.8	12.8	13.2	4,066	17.7	7.7860
Sep	272	-3.0	312	2.3	-39.9	13.2	13.6	3,187	16.8	7.7856
Oct	306	11.5	329	10.9	-23.1	11.3	14.6	3,794	16.4	7.7680
Nov	279	2.0	323	8.8	-44.1	n.a.	n.a.	3,553	16.4	7.7676
YTD	3,070	10.4	3,448	12.2	-377.3	11.3	14.6	37,770	15.7	7.7676

Note: (F) Forecast

Source: Census and Statistics Department, Hong Kong Monetary Authority, Rating and Valuation Department, Hong Kong Tourism Board, CEIC, Hang Seng Bank





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