On the Road Again: Hong Kong – One Country Two Systems Three Conclusions

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Finally, we got to Hong Kong in late October. I had been looking forward to this but then not so much as the rioting continued far longer than expected. We had taken the view that the USA China trade war would be 'solved' and the more aggressive rhetoric was increasingly accepted as part of the (welcome) retracement by the USA administration of the "friends with all things Chinese" policy of the Obama (and Cameron and Rudd administrations). Expecting a rapprochement meant I had booked some time in Hong Kong.

My friends and business associates assured me that the riots were very geographically contained and that once the students went back to university, they would most definitely abate.

They haven't abated at all and have actually escalated, helped in part by the USA using the opportunity to stick the knife into China with the US Senate unanimously passing the Hong Kong Human Rights and Democracy Act (HRDA). This act calls for protecting democracy (sic) in the city and requires the US government to review whether the "one country two systems" agreement in the handover, is functioning and it provides the power to sanction those who abuse human rights. Effectively Hong Kong is now a territory being used for a vicarious disagreement between the USA and China on economic and geopolitical vested interests. We have seen this before of course as Russia China and the USA carry out their disagreements in Asia, Africa and the Middle East. At least we don't have troops in the street? (Yet? - Ed).

A lot of intelligent comments have passed in the media on these riots and so we see no need to repeat those in detail. We would repeat however that this is more than a protest about extradition to China and includes grievances about becoming second class citizens in your own city state; ridiculously inept policies toward house building and affordability (30x average salary for a first home); and finding that the one country to which you will belong (2047) now has a dictator for life.

We met with Asian economic and political analysts and Robert Medd from Bucephalus. They do a lot of detailed work on accounting and governance which we use extensively. Materials available on request. www.buceph.com.

For our portfolios we have never really had exposure to lower end labour intensive manufacturing companies in Hong Kong. We fully expect these to continue to migrate to Vietnam if not mainland China. Our Hong Kong exposure is biased towards companies operating in the services sector and we expect Hong Kong to continue to operate much as New York does for the USA. Consequently, the protests would not be expected to compromise the existence of the higher value-added companies in which we invest.

China needs foreign capital unless it imposes capital controls on the outward-bound capital, and no doubt will have a banking bad debt crisis to navigate (at least they acknowledge the problem unlike the Europeans). Hong Kong remains the obvious conduit for inward and outward-bound capital with many years of expertise and knowledge accumulated in finance and procurement. It will be critical to the continued development of China. Why intelligent albeit Communist, bureaucrats would wish to blow up such critical and successful infrastructure is unfathomable. They might but it would be an accident we think and not deliberate. As such, we think Hong Kong and the stock exchange remain very viable.

On the other hand, financial sanctions such as preventing USA pension funds from buying Chinese companies, would hurt and conversely it is important for Chinese companies to be successfully listed on Chinese exchanges. (which is why Alibaba, which we own in the global equity strategy, will list on Hong Kong and will be over-subscribed).

China remains an enormous provider of Foreign Direct Investment into the region and so it will be hard for economic sanctions (if imposed) to be effectively targeted solely at Chinese capital while not penalising other Asian countries. So, the geopolitical rhetoric may stay inflammatory, but the likelihood is that it will be 'business as usual' on the ground. Consequently, we remain and have decided to remain at benchmark weight in Hong Kong and China with companies such as Kerry Logistics Network (KLN) and China Lesso Group (CLG) as favourites. KLN is an integrated logistics, supply chain management and seaport management business with more than 47,000 employees in 53 countries. KLN is a beneficiary of the growth of intra-Asian trade and China's Belt and Road Initiative. CLG manufactures and sells building materials primarily plastic pipes and pipe fittings with 23 production facilities in 16 provinces in China. CLG is a key player in the urbanisation of Central China building on their strong base of operations in Southern China.

As for the three conclusions from what in retrospect was a far too brief visit, ("I shall return"?) they are below. The first has implications both positive and negative for Asia and Australia. At some point we will get Stewart Paterson from The Hinrich Foundation to Australia to talk about the implications for trade and investment in Asia from the pull back of the "let China in at all costs" policies of the previous USA administration. Stewart argues that the WTO accession in 2001 hasn't produced what was expected with China failing to play by the rules and getting a free ride to the detriment of the West. (China Trade and Power – Stewart Paterson London Publishing Partnership 2018)

1. The plan of incorporating China in the world economy and assuming it will therefore come to behave as a global citizen, needs to be and will be reconsidered – hence the HRDA.

2. Ethnic similarities CAN be trumped by other human aspirations and values such as equal opportunities, respect for the law, and personal freedom. This is very encouraging and represents an existential threat to the idea that somehow all ethnic Chinese people regardless of where they may live, require and answer to, an authoritarian government.
3. Hong Kong's basic economic structure while currently far too biased to the landowning ultra-rich, is still highly globally competitive with very flexible 'inputs of production' such that asset prices and wages can move up and down, and a large fiscal surplus. We do expect some permanent change in capital investment and trade flows in the region, but we do not write Hong Kong off.

As ever if any questions please contact us at Delft Partners

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