

Hong Kong macro update

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Manager of
FORTUNE
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"Let there be light: and there was light"

Book of Genesis

HONG KONG ECONOMY

New-found optimism

Hong Kong is enjoying new-found optimism after an eventful first half marred by the effects of the war in Iraq, the proposal to enact anti-subversion laws, and SARS. These are all but gone now, with the government deciding against enacting the anti-subversion law last week.

Growth being revised upwards . . .

Despite unemployment reaching a high of 8.7% in July, economic growth forecasts for 2003 and 2004 are being revised upwards from the levels that were contemplated only three months ago. Leading economic forecaster, the Economist Intelligence Unit (EIU), now sees growth of 1.1% and 5.4% for 2003 and 2004 respectively, with deflation easing.

Some broking houses are even more bullish though not everyone shares the optimism.

. . . due to CEPA

The Closer Economic Partnership Agreement ("CEPA") is expected to benefit Hong Kong companies selling into China by giving a cost advantage over suppliers from other countries.

Hong Kong's service industries are also set to benefit. For instance, financial institutions are reportedly eyeing acquisition opportunities in China to capitalise on this.

CEPA in brief

The gist of CEPA is China's removal of trade impediments with Hong Kong.

Signed on 29 Jun 2003 between Hong Kong and the Mainland, CEPA is China's first free trade agreement. The CEPA covers three broad areas: trade in goods, trade in services, and trade and investment facilitation.

Effective from 1 Jan 2004, the Mainland will remove tariffs on 273 manufactured items produced in Hong Kong, covering some 90% of its imports from Hong Kong. A number of service sectors will also benefit from greater market access in the Mainland.

The benefits, however, could peter out over the longer term as China lowers these restrictions with the rest of the world under its WTO obligations.

Source: HK Trade and Industry Dept, ARA

. . . Chinese tourist arrivals

If you feel the streets of Hong Kong are getting a lot more crowded, you are correct. Tourist arrivals have grown 7.5% p.a. since 1992.

The tourist make up has also changed significantly. Most tourists now come from China and Taiwan.

Fig 1. Tourist arrivals in Hong Kong

	1992 (m)	2002 (m)	CAGR (%)
Mainland China	1.1	6.8	19.5
Taiwan	1.6	2.4	4.0
North Asia	1.5	1.9	2.0
South, S. East Asia	1.4	1.9	3.3
The Americas	0.9	1.3	3.8
Europe, M.E., Africa	1.0	1.3	2.0
Others	0.0	0.5	28.4
Australia, Pacific	0.3	0.4	2.9
Total	8.0	16.6	7.5

Source: HK Tourism Board, ARA

Visitor arrivals could be further boosted now that Chinese nationals are able to visit Hong Kong individually, starting with residents of Guangzhou, Beijing and Shanghai. (Previously, they could only visit Hong Kong as part of tour groups.)

The relaxation is expected to gradually apply to residents of other Chinese cities.

As a result, tourist arrivals from China could reach 10 million soon, according to government and private sector estimates.

It has also been reported that, presently, less than 4% of Chinese nationals have passports and only 10 million travelled abroad in 2000, half the number of Japanese doing so.

The amount of hard currency that Chinese nationals are allowed to take out on their trips has also been increased by the government, from US\$2,000 to US\$5,000 (partly to head off criticism of its growing foreign reserves).

Based on the spending pattern of Chinese tourists, Hong Kong's retail sector should benefit as they spend most on shopping.

Fig 2. Tourist spending in Hong Kong

	China (HK\$)	N. America (HK\$)	All sources (HK\$)
Shopping	3,295	1,411	2,277
Hotels	798	2,277	1,182
Meals ¹	663	731	629
Others	413	552	444
Total	5,169	4,971	4,532

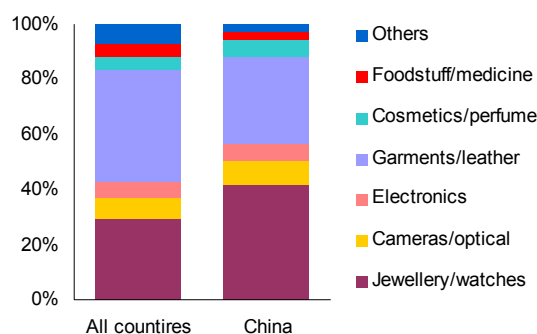
Source: HK Tourism Board 2001, ARA

Notes:

1. Excluding meals in the hotel

Retailers of items subject to high import duties in China should benefit most: jewellery/watches, camera equipment, electronics, and general luxury items. These items make up the largest share of expenditure of Chinese tourists in Hong Kong.

Fig 3. Tourist shopping in Hong Kong



Source: HK Tourism Board 2001, ARA

Spending is also being facilitated by more and more shops in Hong Kong accepting renminbi notes.

Renminbi convertibility in Hong Kong

Officially, the renminbi is convertible only in China. However, banks and shops in Hong Kong increasingly accept renminbi, and there are numerous exchange stalls in the city offering rates that are identical to those of official exchanges in China. Hong Kong is lobbying China to become the first official renminbi-convertible centre outside of the Mainland.

Source: ARA

The opening of Hong Kong's Disneyland in 2005 could continue the momentum, due to cost considerations and tough visa requirements to visit the one in the US.

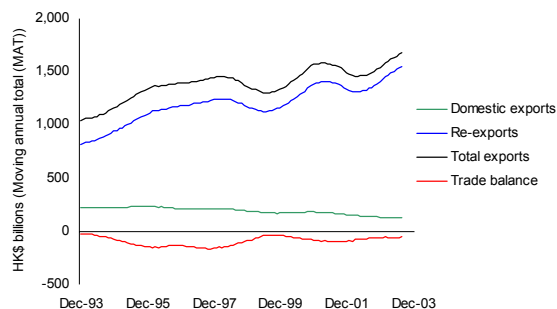
... and continued strength in export sector

Hong Kong's weak domestic economy has overshadowed the strength of its export sector.

Its manufacturers have long been adapting to rising local costs by moving production to South China whilst keeping higher-skilled marketing jobs in Hong Kong.

Goods produced there are then shipped overseas via Hong Kong, and are reflected as re-exports.

Fig 4. Hong Kong merchandise trade

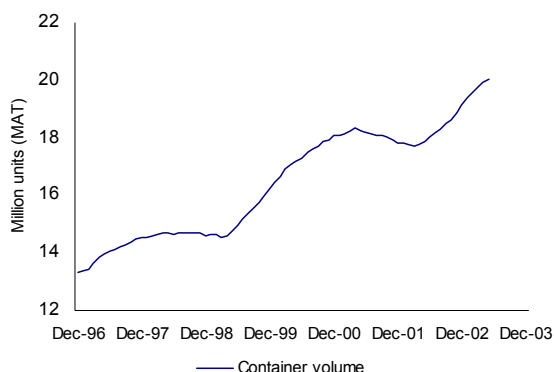


Source: Census and Statistics Dept, Bloomberg, ARA

Hong Kong’s shipping edge reflects its world-class port—a competitive edge borne out of a history of reliability and capability of handling large shipment volumes. (It remains to be seen whether, and how quickly, ports in South China will put a dent in this.)

As well, China’s factories have an insatiable appetite for raw and intermediate materials, and Hong Kong is playing middleman. All in all, container volume has grown 6.5% p.a. since 1996.

Fig 5. Hong Kong container volume



Source: Bloomberg, ARA

HONG KONG RETAIL SECTOR

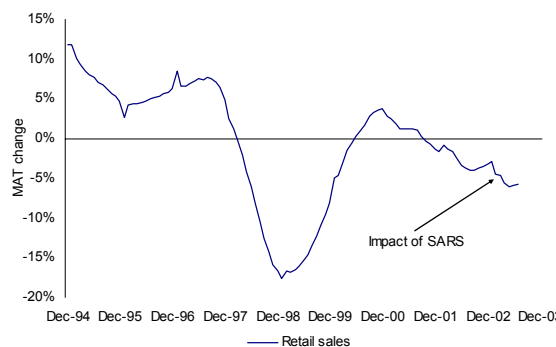
Staging a post-SARS recovery . . .

The turnaround in sentiment is seeing retail sales recover from the lows of the SARS epidemic.

Hong Kong is, however, still experiencing a structural decline in retail sales value, due mainly to deflation.

In volume terms, retail sales are relatively unchanged since 1999, whereas in value terms, it has fallen about 10%.

Fig 6. Hong Kong retail sales value growth



Source: Census and Statistics Dept, Bloomberg, ARA

Note that in percentage terms, the impact of SARS was in fact less severe than that of the 1998 financial crisis due to the high base of the bubble years.

. . . driven by spending of Chinese tourists

Anecdotal evidence currently suggests locals are returning to their normal pre-SARS spending levels, whilst any significant boost to retail sales will likely come from Chinese tourists.

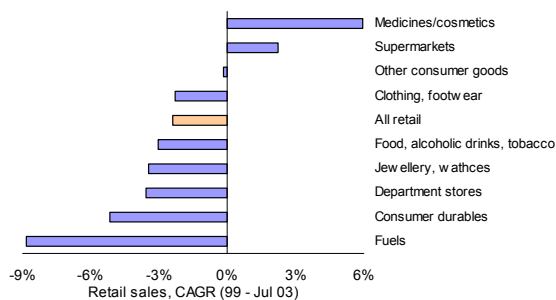
Without the spending of Chinese tourists, retail sales would have fallen more over the last few years.

Necessities, however, remain unaffected

The decline in retail sales since 1997 is also due to Hong Kong consumers cutting down spending on luxury and big-ticket items.

Spending on necessities, on the other hand, continues to grow with the population. Expenditure on medicines and cosmetics, and in supermarkets grew even as deflation hit the economy.

Fig 7. Hong Kong retail sales



Source: Census and Statistics Dept, ARA

Investment transactions coming back

Two major deals were recorded in the last 3 months, Causeway Bay Plaza 1 being the largest recorded so far this year.

Fig 8. Recent investment transactions

	Vicwood Plaza	Causeway Bay Plaza 1
Location	Sheung Wan	C'way Bay
GFA (sf)	400,000	256,000
Use	Office/retail	Office/retail
Occupancy (%)	70	85
Price (HK\$m)	843	1,200
Yield (%) ¹	6.8	6.2
Buyer	MSREF/Pamfleet	Wing On (Holdings)

Source: SCMP, ARA

Notes:

1. Based on current occupancy

Wing On (Holdings) beat 10 other bidders to the asset in a private tender offered by debt-laden Lai Sun Development.

The asset was initially expected to fetch HK\$800 - 1,000 million. That bids came in from both local investors and overseas institutional funds signals improving investor confidence.

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