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Worried About Hong Kong – Part II: Ramifications

Read Part I, "Intervention Risk," from yesterday here.

Any overt Chinese intrusion into Hong Kong:

- marks the end of "one country, two systems"
- cements and accelerates the trend towards "decoupling."
- threatens asset market collapse in Hong Kong
- greatly exacerbates China's extant credit, real estate and capital flow problems
- raises the risk of more extreme China-related tail events

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Please take what follows as "thoughts and observations" rather than predictions. We are in an environment faced with multiple tail risks of inestimable likelihood. Predictions seem foolhardy.

The End of "One Country, Two Systems"

The minute uniformed Chinese become active in Hong Kong, **"one country, two systems" is over.** The logic of any intervention for the purposes of "social stability" dictates a gradual but consistent restriction of freedoms. The fiercer the resistance, the less gradual and more aggressive the restriction of freedoms.

Accelerated Decoupling

The visual of uniformed Chinese on the streets in Hong Kong enforcing curfews and increased surveillance (let alone the possibility of bloodshed) will crystalize to the world what continued accommodation of Communist Authoritarianism looks like.

The U.K.'s game of footsie with China over Huawei's participation in 5G immediately ends. Australian sentiment towards China, already souring, deteriorates further. The threat of Canadian tariffs on China increases significantly should the Conservative take power.

I get it that Europe is financially conflicted and diplomatically wishy-washy. But it's unavoidable that a Chinese intrusion into Hong Kong would bring to an end the European game of playing both sides against the middle.

Obviously, hopes for a U.S-China trade deal will be completely dashed, Huawei will be death-penaltied, and the U.S. entity list will be expanded to encompass any Chinese companies involved in the subjugation of Hong Kong.

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The Hong Kong Policy Act

The United States - Hong Kong Policy Act shields Hong Kong from any tariffs and export controls enacted on China. The latest State Dept. report already served a warning by characterizing Hong Kong's degree of autonomy as "sufficient – although diminished." Both Nancy Pelosi and Mitch McConnell indicated in June a desire to revisit the certification should Hong Kong pass the now-ditched extradition bill. Surely, an overt intervention would trigger a removal of Hong Kong's special privileges under the act.

From today's Washington Post:

> *It would mean the U.S., the world's largest economy, treating Hong Kong as any other part of China -- at a time when each side is slapping tariffs on hundreds of billions of dollars worth of goods. A commentary posted by the American Chamber of Commerce in Hong Kong said it would have a "chilling effect" on U.S. investment and trade in Hong Kong and send "negative signals" globally. "It's pretty much the nuclear option against Hong Kong," said Steve Tsang, director of the University of London's SOAS China Institute. "It would be the beginning of the death of Hong Kong as we know it."*

Hong Kong Asset Markets

To state the obvious, all of the above is terrible for Hong Kong real estate markets. According to one study, Hong Kong's real estate market is the most expensive in the world **by a margin of nearly 50%**:

The Hong Kong Real Estate market will get hit with a triple-whammy under any Chinese intrusion:

- Capital flight in the presence of a currency board could produce severe interest rate spikes
- Exodus of multinational corporates, global banks and the professional services surrounding them
- Exodus of educated youth who would rather live in freedom than die defending it

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Ranking	City	Average property price ($)
1	Hong Kong	1,235,220
2	Singapore	874,372
3	Shanghai	872,555
4	Vancouver	815,322
5	Shenzhen	680,283
6	Los Angeles	679,220
7	New York	674,500
8	London	646,973
9	Beijing	629,276
10	Paris	624,299

China's Financial Problems Metastasize

The Chinese property market is unlikely to remain immune from the deterioration in sentiment if large sums of money begin to be lost across the border in Hong Kong.

Furthermore, **currency pressures and China's acute shortage of Dollar liquidity would interact with any weakness in property markets in a reflexive and amplificative manner**.

- The dream of Bond Index inclusions generating hundreds of billions of Dollars of inflows in coming years dies in light of political scrutiny (Marco Rubio is already sniffing around the MSCI decision).
- China's $800-900bn in offshore USD debt struggles to roll
- FX swap lines from global banks to Chinese banks – currently a key source of Dollar liquidity – will be capped / curtailed / reviewed.

These are all market responses to perceptions of increased risk. It's also possible that political momentum could gather to enact sanction on China, which would codify their reduced access to Dollar liquidity.

Back to Decoupling

China's financial problems and its prospective decoupling from the system of global trade and finance are reflexively reinforcing.

If China responds to curtailed access to Dollar liquidity by raising the walls around its FX market it simply serves to decouple itself.

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If it responds by depreciating the RMB in the hopes of maintaining two-way trading against the Dollar, it puts the onus on non-U.S. trading partners like Europe, Japan and Korea to defend themselves from China's "theft of demand" from economies their already demand-deficient economies.

In sum, all of the "medium term" difficulties that China faces in domestic finance, global trade and capital flows will intensify into problems of immediate urgency. **China's intrusion into Hong Kong would serve as the ultimate "wall" to bring China's can-kicking to an end**.

And that's before we're even getting into the real 'tail" scenarios…

2008-Style Interbank Crisis

Sharp declines in collateral values in Hong Kong, in conjunction with the impairment of China's ability to service its Dollar debt due to reduced access to Dollars and/or RMB depreciation, could trigger concerns over balance sheet health at some large financial institutions.

Global central banks better be ready to respond with alacrity and force. Do we have any basis for confidence that they are?

Taiwan Tail Risk

There has already been some swing towards pro-independence forces in Taiwan:

> *"Beijing holds out Hong Kong's One Country, Two Systems arrangement as the model for eventual unification with Taiwan, which it claims as its own," Ben Bland, a researcher at Australian think tank Lowy Institute." But (Taiwanese) President Tsai Ing-wen was using the extradition bill, and the massive protests in Hong Kong, to highlight once again why her country must keep its distance from China if it is to remain a vibrant democracy."*

If China crosses a line in Hong Kong that makes them an international pariah, cements decoupling aso that they want to really cause a problem for Trump, and January 2020 election in Taiwan go the wrong way from Beijing's perspective, all manner of geopolitical upset becomes possible.

Conclusion

I don't think any of us really know what a Chinese intrusion into Hong Kong would look like until we see it. As noted at the top, these scenarios are not meant as predictions, but simply to highlight some of the risks that could come into focus in the wake of a such a dramatic geopolitical event.

China moving into Hong Kong would be event that may well be too big for markets to reasonably process.

The result in global equity markets, I expect, would be something we could reasonably call "a crash."