Hong Kong Dollar

HKD hits strong end repeatedly as capital inflows surge

Hong Kong Monetary Authority (HKMA) has sold HKD for three times totaling HK$9.3bn on 8 and 9 Jun to defend the local dollar's peg. Since Apr this year, HKMA has been forced to intervene for 12 times after HKD has soared to three-year high and repeatedly touched strong end. We believe that continuous inflow of capital is mainly a result of widening Hibor-Libor spread, fund-raising activities related to IPO boom and global quantitative easing. We expect these factors to be in favor of HKD throughout 2H20 and linked exchange rate system to work well amid speculations about capital flight.

- **Widening interest rate spread and carry trade make HKD more attractive.** After US Fed aggressively slashed policy rate by 100bp in Mar 2020, HKMA only reduced its base rate by 64bp to 0.86%, widening the gap between local borrowing costs and those in US. 1 month Hibor and Libor spread has entered positive territory since Nov 2019 and increased to about 60bp in recent weeks. The interest rate spread makes HKD more appealing versus USD, attracting more carry trades which amplifies the trend.

- **IPO boom begets strong demand of HKD.** Secondary listings of Chinese tech giants JD.com and NetEase in Hong Kong could raise billions of dollars, which also contributes to the recent strength of HKD. This trend may last for a while as more Chinese companies listed in the US may choose Hong Kong for a secondary listing.

- **US Fed's balance sheet expansion is favorable for HKD strength.** Since the financial crisis, HKD started to climb to its strong end of its permitted trading band soon after the expansion of the Federal Reserve's expansion under four rounds of quantitative easing. Conversely, when Fed's balance sheet began to shrink since 2018, HKD started to hit its weakest levels. It shows the correlation between HKD exchange rates and Fed's monetary policies. To respond to COVID-19 impact this year, Fed has expanded its balance sheet at an unprecedented pace by US$2.9tn to about US$7.2tn and is very likely to maintain the dovish tone and keep QE program open-ended for a couple of quarters. All these factors are likely to support HKD to stay nearer to its strong-side limit than the other end. We expect in 2H20 weakness in HKD will be limited.

- **HKD and LERS remain resistant for now.** Under the linked exchange rate system (LERS), HKD is allowed to fluctuate within a range of 7.75 to 7.85. Recently intervention by HKMA helps replenish the city's interbank liquidity pool which has shrunk by 70% over the past two years. Aggregate balance has increased significantly from HK$54.1bn (1 Apr 2020) to HK$95.8bn (8 Jun 2020). The flare-up in US-China tensions recently has triggered concerns over HKD's peg to USD and spurred speculation about capital outflows. We see the likelihood of US suspending free trading of USD with HKD is minimal, and LERS is underpinned by massive forex reserves held by Hong Kong and mainland China. The main long-term risks relate to the detailed policies by US government to revoke Hong Kong's special status.

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USD/HKD

Source: Bloomberg, CMBIS

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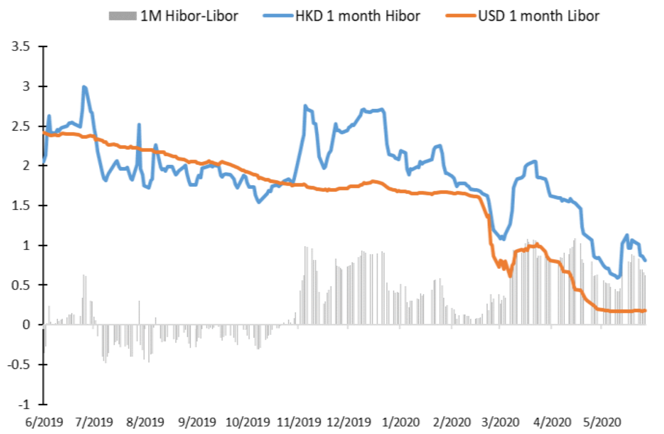
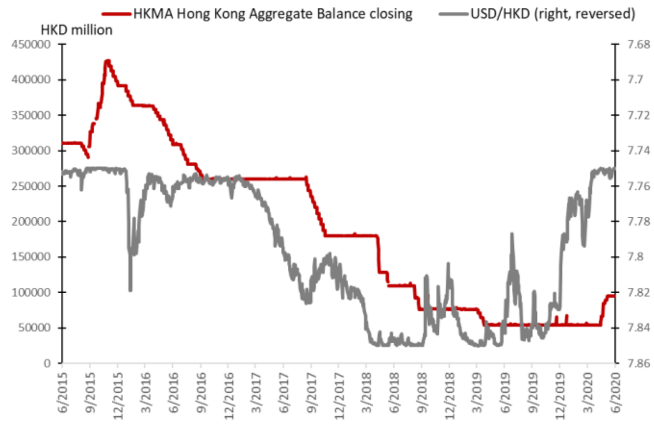
Figure 1: Widening Hibor-Libor spread attracts carry trade



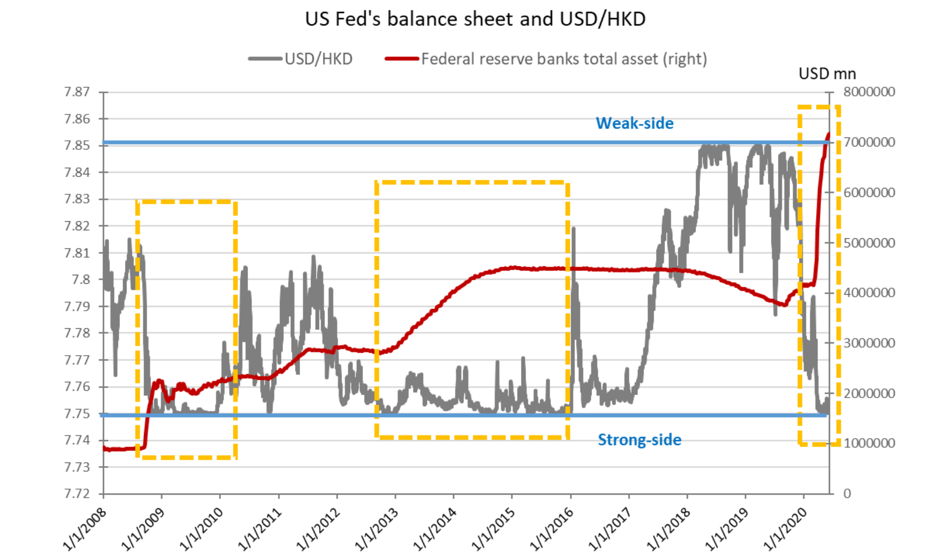
Source: Bloomberg, CMBIS

Figure 2: Aggregate balance of HK has rebounded to HK$94.8bn from decade low



Source: Bloomberg, CMBIS

Figure 3: USD/HKD and the size of the balance sheet of US Federal Reserve



Source: Bloomberg, CMBIS

Figure 4: HKMA has sold a total of HK$39.79bn into market since Apr 2020 to defend the currency peg

Times of intervention	Date of intervention	Sold HKD(million)
1	21 Apr 2020	1,550
2	22 Apr 2020	2,790
3		1,550
4	23 Apr 2020	1,821
5	27 Apr 2020	2,325
6		10,672
7	4 Jun 2020	977
8	5 Jun 2020	3,875
9		4,883
10	8 Jun 2020	4,263
11		1,426
12	9 Jun 2020	3,658
Total		**39,790**

Source: Bloomberg, CMBIS

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