Macro Strategy

DBS Focus

Low aggregate balances to gently lift Hibor

Group Research

April 10, 2019

Eugene Leow
Rates Strategist

Samuel Tse
Economist

Please direct distribution queries to Violet Lee +65 68785281
violetleeyh@dbs.com

- *It is a matter of time before falling aggregate balances at the HKMA lift Hibor but we do not expect an acute jump.*
- *The authorities have room and are likely to keep liquidity ample.*
- *The sizable net northbound flows into China's equity markets have tapered off.*
- *The rates space has already factored in a significant spread compression between Hibor and Libor.*
- *We expect the Prime Rate to hold steady through 2019.*

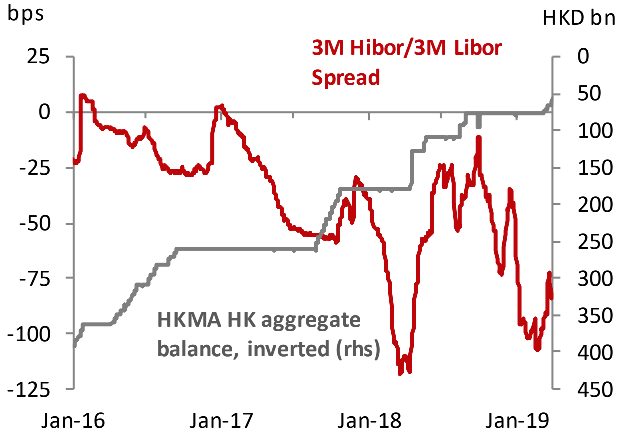
HKD Rates: When will low aggregate balances bite?

The fall in the Hong Kong Monetary Authority's (HKMA) aggregate balance to a post-GFC low has heightened expectations for Hibors to close the gap with their higher Libor counterparts. Having peaked at HKD426bn in 2015, the aggregate balance has since fallen below HKD60bn.

Empirically, there has been no correlation between the 3M Hibor/Libor spread with banking system liquidity since 2015. In fact, the 3M Hibor/Libor spread has widened out and turned more negative since 2015**. However, at some point, low aggregate balances will start to bite and put upward pressures on Hibor.** Several factors suggest that the **fears of an acute jump in Hibor have been overblown.**

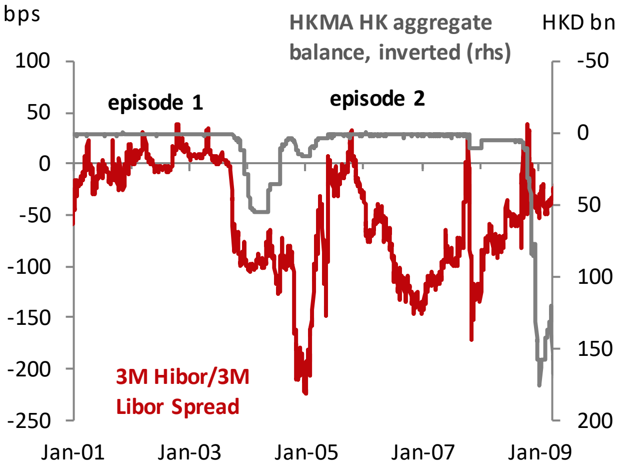
A sizable aggregate balance is a post-crisis phenomenon. Much like the G3 central banks' balance sheets bloated by their quantitative easing measures. **The near-zero aggregate balance in the decade leading up to the 2008/09 crisis should serve as a point of reference for what lies ahead**. For a more incisive look, the pre-crisis period should be split into two episodes: 1) mid-2001 to 3Q 2003, and 2) mid-2005 to mid-2008.

The aggregate balance is falling, but it is not impacting Hibor just yet



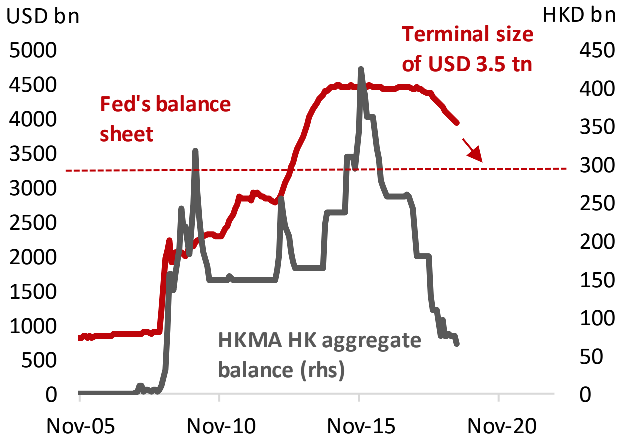
Source: Bloomberg

Pre-2008/09 crisis is a period of low aggregate balances



Source: Bloomberg

The Fed is about to stop balance sheet unwind and this could diffuse downward pressure on the agregate balance



Source: Bloomberg

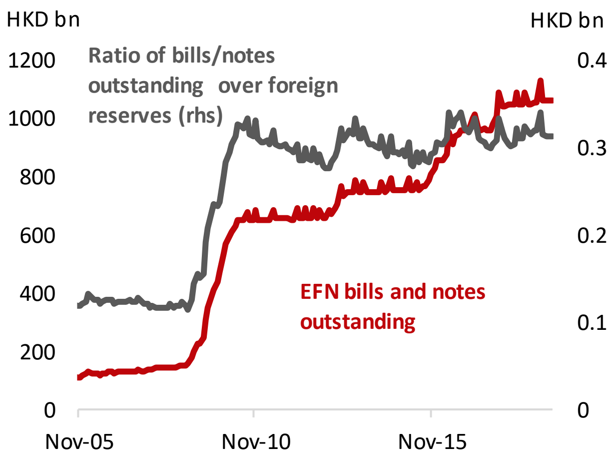
The average aggregate balance stood at HKD0.6bn and HKD2.5bn in the first and second episode respectively. The 3M Hibor/Libor spread of the two periods (at 3bps and -77bps respectively) would be relevant.

Accordingly, it appears that aggregate balances will start to impact Hibor if they are low enough, and the hurdle may be < HKD1.0bn. Comparatively, even if the balance falls to HKD2.5bn, the Hibor/Libor spread can still be large. Clearly, there are other considerations that impact short-term HKD rates. For example, the (87.3) loan-to-deposit ratio of Hong Kong banks today has climbed past 2006-2007 levels towards those in 2001-2003.

The appropriate 3M Hibor/Libor spread has become a function of HKMA's liquidity policy and policies of the major central banks. The Fed is poised to stop unwinding its balance sheet in September at a size of around USD3.5tn. The European Central Bank (ECB) and the Bank of Japan (BOJ) have shown no intention to shrink their balance sheets. Accordingly, the decline in HKMA's aggregate balance should start to slow from a structural perspective. Moreover, **the HKMA may,** as witnessed from mid-2005 to mid-2008, **become more tolerant of ample liquidity conditions** and have **more than enough leeway to release liquidity** if needed. Notably, the amount of Exchange Fund Bills & Notes outstanding exceeds HKD1tn.

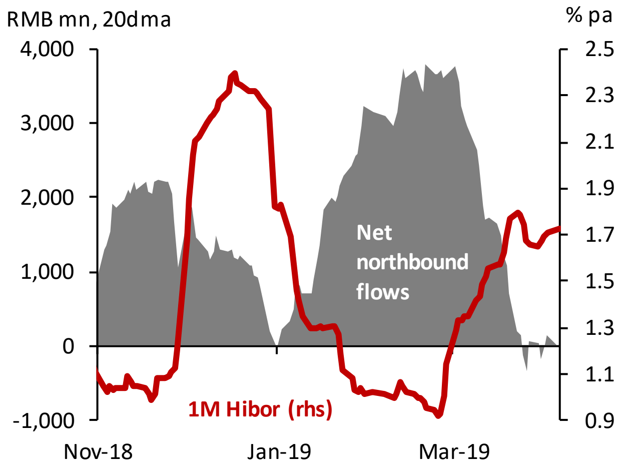
Two short-term forces are worth mentioning. **Firstly, the sizable net northbound flows (N-bound buy - sell transaction volume) into China's equity markets have tapered off.** N-bound inflows reached a historical high in January-February on optimism for a US-China trade deal. However, these flows have dropped to close to zero on profit-taking (CSI is now at a one-year high). This could in

HKMA can release liquidity if needed



Source: Bloomberg

Northbound trading and Hibor



Source: CEIC, DBS

turn weaken demand for CNY and hence diffuse upward pressures on Hibor.

Secondly, there will be impetus for the USD/HKD to drift higher (necessitating HKMA intervention) whenever the Hibor/Libor gap gets too wide. Judging from the recent episodes, a 3M spread of 100bps tends to spur these trades. The current spread is still wide (-82bps) but the implied forward curves (USD swap and HKD swap) have already factored in significant spread compression two years out (the implied spread stands at -20bps). There is some scope for the 3M Hibor to rise relative to the 3M Libor, but we think that the HKD swaps space may have already more than factored this in.

Against this backdrop**, we are not convinced that it makes sense to pay HKD swaps vs USD swaps to bet on even more Hibor underperformance than what has been priced in. Hence, we also expect the Prime Rate to remain at the current level through 2019.**

Related pieces:
US Rates: Late Cycle
US: A marginally dovish hike
Fed's dovish tilt and market implications
USD rates: Pause, not stop

Group Research

Economics & Strategy

Taimur Baig, Ph.D.
Chief Economist - G3 & Asia
+65 6878-9548 taimurbaig@dbs.com

Nathan Chow
Strategist - China & Hong Kong
+852 3668-5693 nathanchow@dbs.com

Masyita Crystallin, Ph.D.
Economist – Indonesia & Philippines
+62 21 2988-4003 masyita@dbs.com

Joanne Goh
Regional equity strategist
+65 6878-5233 joannegohsc@dbs.com

Neel Gopalakrishnan
Credit strategist
+65 6878-2072 neelg@dbs.com

Eugene Leow
Rates Strategist - G3 & Asia
+65 6878-2842 eugeneleow@dbs.com

Chris Leung
Economist - China & Hong Kong
+852 3668-5694 chrisleung@dbs.com

Ma Tieying
Economist - Japan, South Korea, & Taiwan
+65 6878-2408 matieying@dbs.com

Radhika Rao
Economist - Eurozone & India
+65 6878-5282 radhikarao@dbs.com

Irvin Seah
Economist - Singapore, Malaysia, & Vietnam
+65 6878-6727 irvinseah@dbs.com

Duncan Tan
FX and Rates Strategist - ASEAN
+65 6878-2140 duncantan@dbs.com

Samuel Tse
Economist - China & Hong Kong
+852 3668 5695 samueltse@dbs.com

Philip Wee
FX Strategist - G3 & Asia
+65 6878-4033 philipwee@dbs.com

Sources: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations).