Weekly: Hong Kong under spotlight

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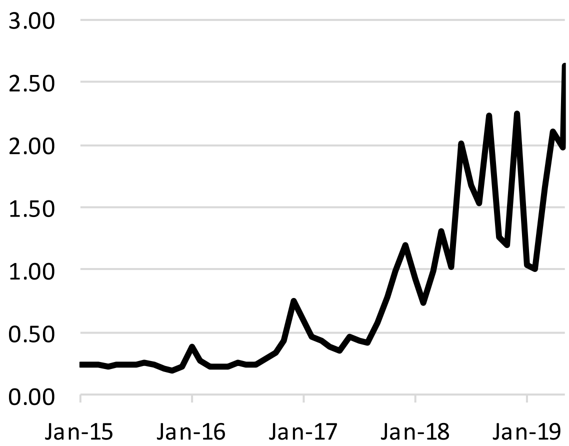
- *Regardless of the outcome of the ongoing political strife, Hong Kong dollar's peg to the USD is under scrutiny*
- *Currency crises come with a major macro misalignment, loss in confidence in the sovereign, and insufficient buffers to deal with capital outflow.*
- *There is some evidence of macro misalignment, but confidence in HKD is not dented, and HKMA has strong buffers*
- *The key is the confidence of Hong Kong's residents. As long as citizens and local businesses maintain their trust in the currency, the HKD peg will stay.*
- *Coordination between HKMA and PBOC to ensure ample liquidity is key at the present juncture.*

The peg can hold, but the cost would be substantial

This week's protests have renewed investors' attention to Hong Kong. Market volatility has risen along with demonstrations against a proposed extradition legislation. On-shore liquidity has tightened, with the HIBOR spiking to a level not seen since 2008.

Overnight rates can rise for a variety of reasons, including seasonal liquidity demand for transactional purposes. Moreover, since Hong Kong's rates follow US short-term rates given the peg to the US dollar, much for the rise in HIBOR in 2018 was directly attributable to Fed rate hikes. But the latest spike goes well beyond innocuous seasonality or cues from US monetary policy.

HIBOR



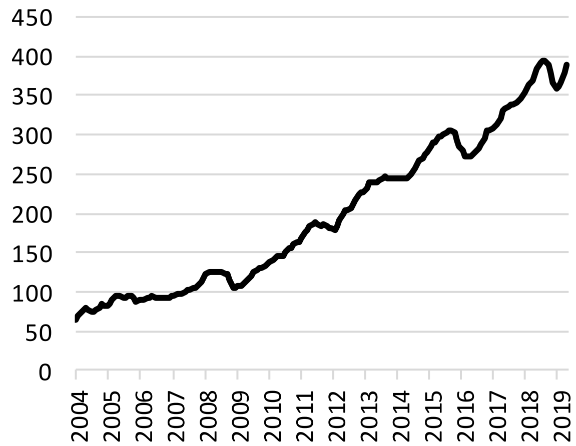
Source: Bloomberg, DBS

The latest spike clearly reflects capital outflows and worsening of sentiments. Although the immediate reason behind that is the ongoing political unrest, there are deeper reasons why investors are questioning the state of HKD's long-standing peg to the USD.

Hong Kong's economy, despite being a world class financial centre that thrives on openness and Western-style rule of law, is far more tied to the Chinese economy today than any other place. Hong Kong's banks' claims to China make up 28% of total external claims, up from 7% during 2000-09. Bulk of Hong Kong's FDIs go to and come from China; same holds with respect to its trade.

Most critically, the economy has experienced a sharp rise in leverage build-up in the past decade, largely due to a property market bubble of enormous proportions. Hong Kong today boasts the highest per square meter price for residential properties in the world, helped by enormous buying interest from mainland China. The rising prices have caused a leverage-fuelled frenzy.

Residential property prices have soared

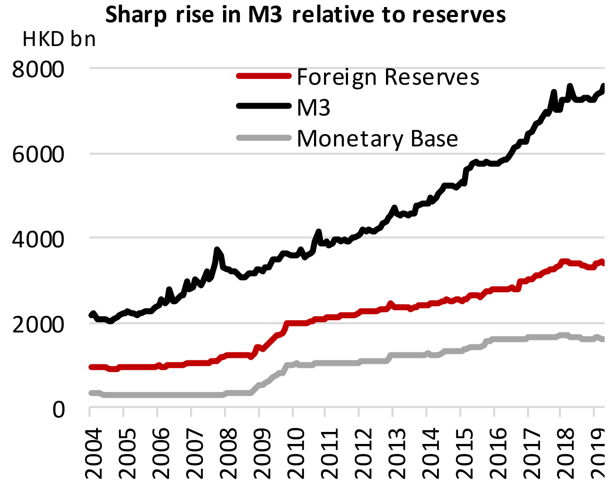


Source: CEIC, DBS

The sharp rise in leverage has affected Hong Kong's monetary aggregates. M3 has quadrupled over the past decade and half, extraordinary for an economy of which the nominal GDP expanded by just two times during the same period. While the currency peg against the USD looks fine when the reserves-to-base money ratio is considered, the fact is if there is a sharp correction in the property market or a panic selling of the HKD, the peg would be challenged. Recent movements in HIBOR already show that the cost of defending the currency will have to be borne by higher interest rates, as selling of USD by HKMA is unlikely to be a sufficient tool.

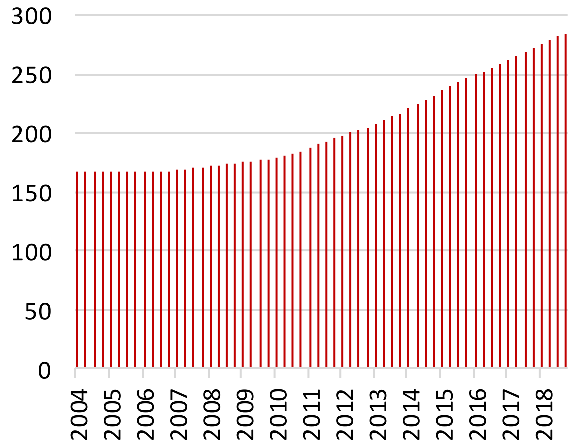
The complicating factor is that higher rates could affect the property market and further erode confidence and erode confidence. If the political situation does not improve soon, speculative pressure against the peg would rise. HKMA has difficult days ahead.

Sharp rise in M3 relative to reserves



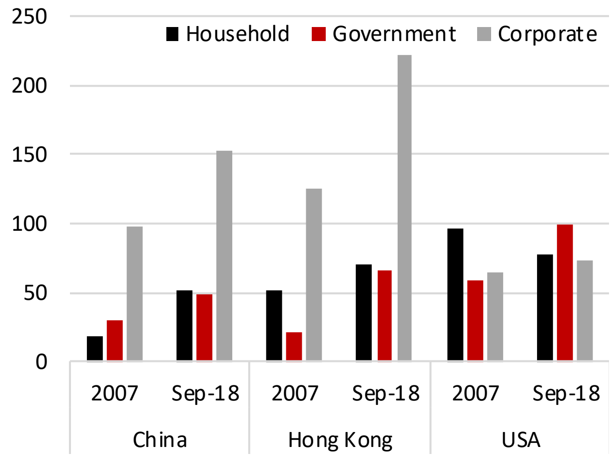
Source: HKMA, DBS

Credit/GDP ratio



Source: CEIC, DBS

Debt/GDP ratio



Source: World Bank, BIS, DBS

Taimur Baig

FX: USD bears vs downside risks in EUR and CNY

The relative strength of the US dollar has been shaken but not shattered by Fed cut expectations. No one expects the Fed Funds Rate to fall at its next week's FOMC meeting on June 19. More importantly, the US 10Y bond yield has held above the Fed's 2% inflation target. Hence, there is little incentive to pile into the euro where negative EU 10Y bond yields have been falling to new lifetime lows below their Japanese counterparts. The support for the USD Index (DXY) remains intact around 96.5 on the euro's failed attempts to break above 1.13.

The fragile Eurozone economy is also at risk to a disorderly Brexit. Tory candidates looking to succeed Theresa May as prime minister appeared determined to deliver Brexit on October 31 with or without a deal. Leading Brexiteer Boris Johnson secured the most votes (114 vs a distant second of 43) at the first ballot to select the Conservative Party leader. UK lawmakers earlier voted 309-298 against legislature to block a no-deal Brexit. Having fallen back to last December's low around 1.26, when Prime Minister May faced a party leadership challenge, the British pound is at risk extending its fall its post referendum low just above 1.20.

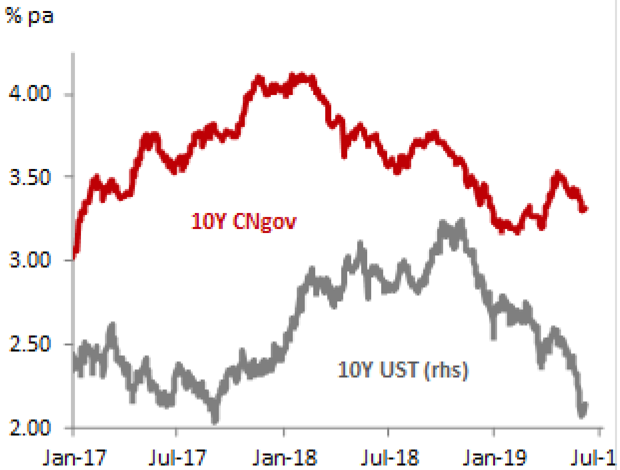
There is less complacency regarding a weaker Chinese yuan past 7 vs USD. US President Trump has upped the ante for Chinese President Xi to meet him at the G20 Summit on June 28. If the meeting does not take place, Trump has threatened to impose a 25% tariff on the remainder USD325bn of Chinese goods while keeping the door open for more tariffs in the future. During his election campaign in 2016, Trump had pledged to impose a 45% tariff rate on Chinese goods. The Tariff Act of 1930 allows a US president to impose tariffs of up to 50%. Having acceded to months of trade talks after the last G20 Summit in December, China has become skeptical that more trade talks would avert more US tariffs. In the event the Xi-Trump meeting does not take place, China is expected to respond with more fiscal and monetary easing to cushion growth, policies that are likely to pressure the yuan lower too. If so, the first signals would come from the 12M NDF outright pushing above 7 and the official mid-rate for USDCNY moving higher from its recent stable range just below 6.90.

Philip Wee

Rates: China govvie outperformance ahead

China and US govvie yields have been diverging since early February. Over the period, 10Y China yields have risen modestly even after taking into account the ratchet up in trade tensions in May. Comparatively, 10Y US yields are down by about 50bps. As a result, the 10Y yield gap has widened out to 112bps, levels last seen in 1Q18. We are not convinced that this phenomenon can be sustained. Optically, these two rates tend to track each other closely over the past five years, with weekly correlation of close to 0.6. There have been episodes of large divergences. However, these tend to fade. In late 2016, the market re-priced US inflation expectations after Trump got elected, but US yields drifted lower through the most part of the following year.

Divergence in CN-US yields unlikely to be sustained



Source: Bloomberg

With the China-US 10Y yield spread looking wide, there could be scope for outperformance in China govvies. We think that US rates may be too aggressive in factoring Fed easing and there appears to be some resistance to lower rates in recent trading sessions. While the Fed has raised the possibility of rate cuts, it might not make sense to bet on even lower rates when the market is already close to 4 cuts over the coming two years. Meanwhile, guidance from the People's Bank of China (PBoC) is modestly dovish. While the weighted average open market operation rate has been steady around 3.25%, we think that further targeted monetary policy support is likely. Accordingly, we think that the 10Y yield spread can narrow towards 80bps.

Eugene Leow

Equities: An insurance Fed cut should support markets

In the past six instances of US Fed rate cuts since 1990, three were deemed as pre-emptive insurance cuts (twice in 1995, 6 months apart, 1998) while the rest are typical cuts in easing cycles (1990, 2001, 2007). The distinctions between the two are that rate cuts are shallower with more moderate growth slowdown under precautionary cuts, but in a typical easing cycle, cuts are deeper and economic slowdowns are sharper. While the notion that Fed rate cuts tend to support the equity market is true, we believe the types of rate cuts need to be differentiated as equity markets respond differently under these two scenarios. **Historically, Asia markets tend to perform better following an insurance rate cut and do worse in an easing cycle**.

We think the next Fed cut would look like an insurance cut similar to the one in 1995. Back then, the first rate cut came in July 1995 following a 6-month rate pause and after a 3-6% aggressive one-year rate hike cycle. **Concerns that the Fed's rate hikes may be overdone, moderating growth and inflation, and a president seeking re-election, are some of the parallels between then and now.** The Fed eventually cut rates thrice back then between 1995 and 1996.

The US market did very well throughout the cycle, from one month before the rate cut to six months thereafter. In Asia, the Hong Kong, Singapore and Indonesia markets did fairly well. We think that the direct transmission of US rate cuts to Hong Kong and Singapore rates had kept the markets buoyant. MSCI China, Taiwan and Korea were the worst performers. For the record, these markets had yet to be included (China) or had been fully included (Taiwan and Korea) in the international benchmark then.

While the circumstances under each rate cut are all different, as long as rate cuts do not come too late, we think equities should be well supported. **Our preferred markets of Hong Kong, Singapore, Philippines and Indonesia are direct beneficiaries of Fed rate cuts**.

Joanne Goh

Highlights of the week:

China: Economic dataflow to weaken further
Rates: The flight-to-safety trade

Key Forecasts

	GDP growth, % YoY				CPI inflation, % YoY, ave			
	2017	2018	2019f	2020f	2017	2018	2019f	2020f
China	6.9	6.6	6.2	6.0	1.6	2.1	2.3	2.3
Hong Kong	3.8	3.3	2.5	2.0	1.5	2.5	2.7	2.5
India*	8.2	7.2	7.0	7.0	4.5	3.6	3.4	3.8
Indonesia	5.1	5.2	5.2	5.1	3.8	3.2	3.6	3.6
Malaysia	5.9	4.7	4.5	4.2	3.8	1.0	1.7	1.6
Philippines**	6.7	6.2	6.1	6.1	2.9	5.2	3.1	3.1
Singapore	3.9	3.2	2.1	2.5	0.6	0.4	1.1	1.5
South Korea	3.1	2.7	2.1	2.4	1.9	1.5	1.1	1.5
Taiwan	3.1	2.6	1.9	1.8	0.6	1.3	0.7	1.0
Thailand	3.3	4.1	3.8	4.0	0.7	1.1	1.0	1.3
Vietnam	6.8	7.1	6.6	6.3	3.5	3.5	3.8	3.4
Eurozone	2.5	1.9	1.2	1.5	1.5	1.8	1.2	1.3
Japan	1.9	0.7	0.7	0.5	0.5	1.0	1.1	1.6
United States***	2.3	2.9	2.5	1.5	2.1	2.4	1.7	1.6

* refers to year ending March ** new CPI series *** eop for CPI inflation

	Policy interest rates, eop							
	1Q19	2Q19	3Q19	4Q19	1Q20	2Q20	3Q20	4Q20
China*	4.35	4.35	4.35	4.35	4.35	4.35	4.35	4.35
India	6.25	5.75	5.75	5.75	5.75	5.75	5.75	5.75
Indonesia	6.00	6.00	6.00	6.00	6.00	6.00	6.00	6.00
Malaysia	3.25	3.00	3.00	3.00	3.00	3.00	3.00	3.00
Philippines	4.75	4.50	4.25	4.25	4.25	4.25	4.25	4.25
Singapore**	1.95	1.95	1.95	1.95	1.95	1.95	1.95	1.95
South Korea	1.75	1.75	1.50	1.50	1.50	1.50	1.50	1.50
Taiwan	1.38	1.38	1.38	1.38	1.38	1.38	1.38	1.38
Thailand	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75
Vietnam***	6.25	6.25	6.25	6.25	6.00	5.75	5.75	5.75
Eurozone	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Japan	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10
United States	2.50	2.50	2.25	2.00	2.00	2.00	2.00	2.00

* 1-yr lending rate; ** 3M SOR ; *** prime rate

	Exchange rates, eop							
	Mar 29	Q2 19	Q3 19	Q4 19	Q1 20	Q2 20	Q3 20	Q4 20
USD/CNY	6.71	6.85	7.00	6.95	6.90	6.85	6.80	6.75
USD/HKD	7.85	7.85	7.85	7.84	7.83	7.82	7.81	7.80
USD/INR	69.2	70.0	71.0	71.5	71.0	70.5	70.0	69.5
USD/IDR	14243	14300	14500	14400	14300	14200	14100	14000
USD/MYR	4.08	4.20	4.25	4.23	4.21	4.19	4.17	4.15
USD/PHP	52.6	53.0	55.0	54.5	54.0	53.5	53.0	52.5
USD/SGD	1.36	1.37	1.40	1.39	1.38	1.37	1.36	1.35
USD/KRW	1135	1170	1180	1170	1165	1160	1155	1150
USD/THB	31.7	32.0	33.0	32.8	32.6	32.4	32.2	32.0
USD/VND	23189	23400	23500	23450	23400	23350	23300	23250
AUD/USD	0.71	0.68	0.64	0.66	0.68	0.70	0.72	0.74
EUR/USD	1.12	1.10	1.08	1.09	1.10	1.11	1.12	1.13
USD/JPY	111	110	112	111	110	109	108	107
GBP/USD	1.30	1.26	1.22	1.24	1.26	1.28	1.30	1.32

Australia, Eurozone and United Kingdom are direct quotes

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