



The Hong Kong Dollar Peg: A Tough Nut to Crack

- Conditions in Hong Kong continue to deteriorate, yet the HKD remains the dog that won't bark.
- Summoned by Xi Jinping to an [ad hoc meeting in Shanghai](#) last week, Carrie Lam was likely apprised of a Fourth Plenum decision to undertake a **more muscular approach** to law and order.
- Rhetoric from both Lam and the mainland press has [taken a dark turn](#):

*"The violence has far exceeded the call for democracy and the demonstrators are now **the people's enemy**," Hong Kong chief executive Lam said in a defiant televised address.*

The editor in chief of China's Global Times tabloid, said Hong Kong police had nothing to be scared of. "You have the backing of not only Hong Kong and Chinese people, but also Chinese soldiers and People's Liberation Army in Hong Kong," Hu Xijin wrote on his blog. "They can go into Hong Kong to provide support at any time."

- [Controversy looms over the status of the November 24 local elections](#), which a People's Daily op-ed suggested should only proceed if order is restored:

*"Only by supporting the police force in **decisively putting down the riots** can [Hong Kong] return to peace and hold fair elections, to help Hong Kong start again,"*

- [Wednesday's reporting on U.S.-China trade](#) is consistent with my contention that [China overplayed its hand](#) in demanding tariff rollback. I'm still well "off-market" at **below 30% odds of a Phase One deal**.
- I continue to run HSI puts as a portfolio hedge
- But **the HKD peg will be a tough nut to crack...**

Facts & Figures

	<u>USD</u>
Hong Kong GDP (end '18):	\$363.0bn
FX Reserves (end-Oct):	\$440.6bn
Monetary Base:	\$211.0bn
Hong Kong Dollar M3:	\$956.0bn
FX Reserves / Monetary Base	209%
FX Reserves / M3	46%

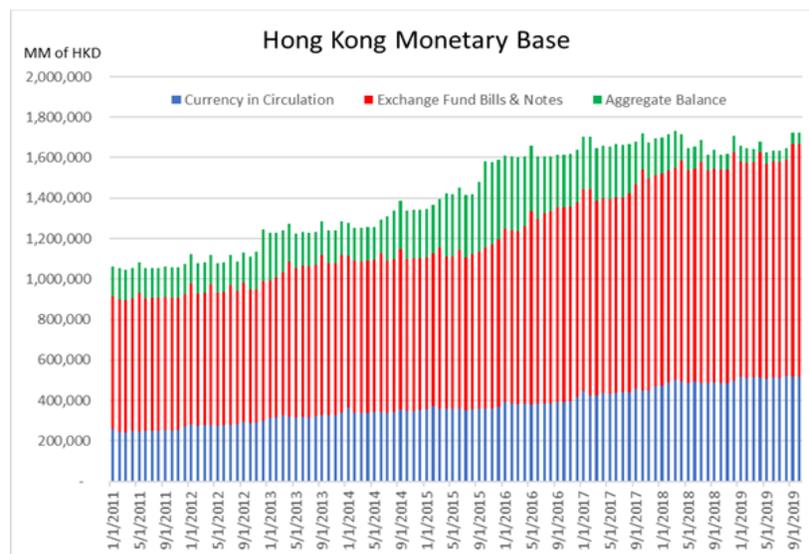


The Hong Kong “Linked Exchange Rate System” (LERS)

- The HKMA pledges to intervene only in an **unsterilized** manner – allowing FX market actions to automatically tighten liquidity.
- However, investors should **anticipate some policy “flexibility”** amidst an **existential threat** to the island’s economy.
- Accumulated buffers provide HKMA with significant ability to **maintain control over interest rates while intervening in FX markets** (i.e. to engage in “sterilized intervention”).

Market Focus on the “Aggregate Balance” is Misplaced

- The “Aggregate Balance” – non-interest bearing balances in clearing accounts – constitutes only a tiny fraction of Hong Kong’s monetary base.
- **65% of the monetary base is in the form of Exchange Fund Bills & Notes** – interest-bearing paper sold into the market as a sterilizing mechanism.
- As FX intervention to defend the peg shrinks the aggregate balance, **HKMA can easily “rebuild” it** by discounting or repurchasing some of the HK\$1.1T in Exchange Fund paper outstanding.
- There’s lots of room before FX intervention will mechanically push funding costs higher.





The Hong Kong Currency Board is Significantly Over-Collateralized

- The Exchange Fund (akin to the central bank balance sheet) warehouses Hong Kong’s Foreign Exchange Reserves:

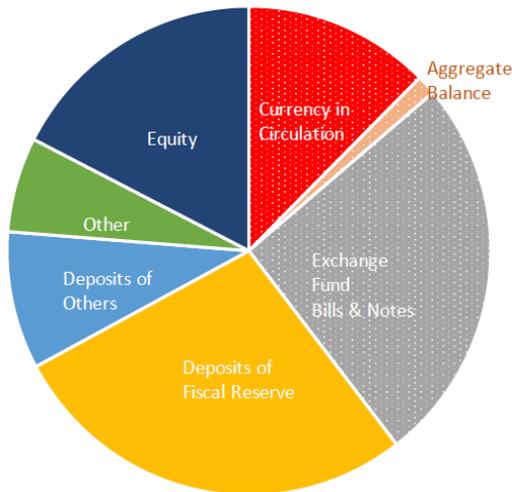
Balance Sheet of the HK Exchange Fund - Assets



<u>Total Assets (bn of HKD):</u>	4,162,921
of which:	
Foreign Currency:	3,971,043
HKD Assets:	191,878

- However, the **monetary base** comprises less than 40% of the liabilities of the Exchange Fund.

Balance Sheet of the HK Exchange Fund - Liabilities



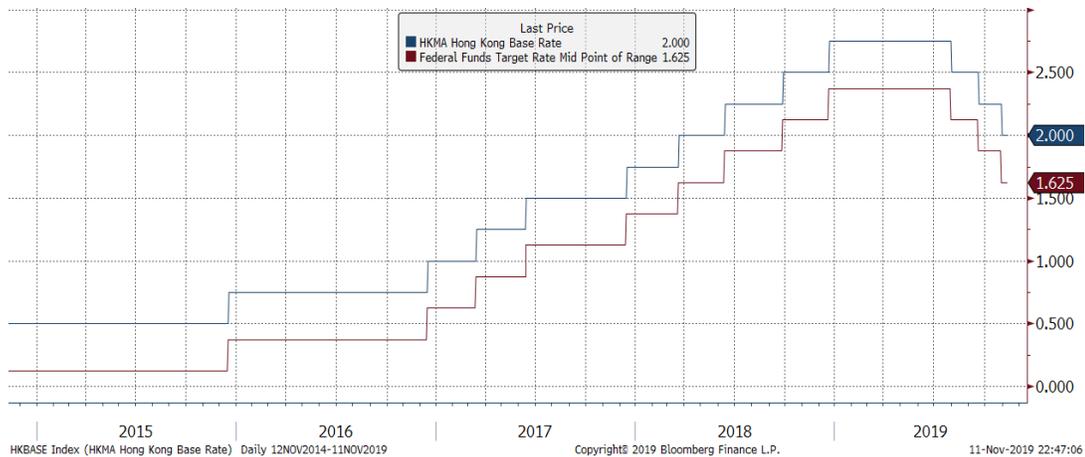
<u>Total Liabilities (bn of HKD):</u>	4,162,921
of which:	
Currency:	520,170
Exchange Fund Bills & Notes:	1,071,399
<u>Aggregate Balance:</u>	<u>54,359</u>
Monetary Base:	1,645,928
Deposits of Fiscal Reserve:	1,149,659
Other Deposits:	378,668
Other Liabilities:	261,394
<u>Equity:</u>	<u>727,272</u>
Non-Base Liabilities:	2,516,993

- The Fund has a **whopping HK\$727bn in equity**, enabling HKMA to engage in substantial intervention funded out of equity write-down.
- Intervention could also be funded via drawdown of **HK\$1.1T in fiscal reserves** stored on the Exchange Fund’s balance sheet – **perhaps in conjunction with a massive fiscal program.**



Non-Automaticity in the HKD LERS: HKMA Manipulates Local Rates

- The HKD regime is **not a pure currency board**, which would involve no local interest-rate manipulation
- **HKMA regularly tweaks local liquidity** (and funding costs) via the issuance or redemption of Exchange Fund Notes & Bills – a sterilizing instrument
- The discounting facility on the large pool of Exchange Fund Notes & Bills should **cap overnight collateralized funding costs** at the HKMA-administered Base Rate:



- That said, the days of sub-US local rates are probably over:



- (Note that the current spike in HIBOR rates is probably being influenced by the posting of brokerage deposits ahead of the large [Alibaba IPO](#) scheduled for Nov. 20).



Speculating Against the Peg is Not “Free”:

- HKMA is committed to a “Convertability Undertaking” (i.e. FX intervention) at 7.75 USDHKD on the strong side and 7.85 on the weak side:



- By manipulating local rates to trade above USD rates, HKMA can push the FX forward points into premium. Here are the 12m USDHKD “forward pips.”



- If the forward pips are positive and the USDHKD spot rate is trading near the top of the band, outright forward rates will trade **through the top of the band**. Here is the 12m USDHKD forward outright rate:



- A one-year bet against the HKD set at a forward outright rate of 7.8546 would entail a loss of 6 to 135 bps if the peg remains intact (depending on where in the 7.57-7.85 range it closes).
- With global rates at rock-bottom, that's a non-negligible deterrent to speculation.

The Large Buffer Deters Attack

- FX reserves at 46% of M3 provide a large buffer against local capital flight.
- Theoretically, HKMA could accommodate – via sterilized intervention - a loss of 20% of M3 to capital flight before subjecting funding markets to the automaticity of the currency board.

The Pegged-Currency Stress Test as a Deterrent to Speculation

- Prime Brokers and other providers of credit to FX speculators learned, with the EURCHF peg break in 2015, that VaR is not a good measure of exposure risk for pegged currencies!
- The result was the “pegged currency stress test,” by which margin on positions in pegged currencies is calculated based on a simple assumption that a peg could break **in either direction** by a fixed percentage, generally 10-25%.
- While its highly implausible that the Hong Kong Dollar could strengthen by 10% overnight, try explaining that to the pencil neck credit officer at your friendly neighborhood prime broker!
- As a result, mustering the requisite leverage to mount a speculative attack on the Hong Kong Dollar is not that easy.



The Tail Scenario is Double-Edged Sword for Short-HKD Specs

- The tail scenario that would motivate aggressive speculation against the HKD is one in which the entire dynamic of local policymaking has shifted.
- If China intrudes and takes over the management of Hong Kong, they will have trashed both Hong Kong's financial markets and China's own international standing.
- At that point, what is preventing the Chinese from **enacting capital controls**?

Conclusions

- Given an existential threat to the real-estate reliant Hong Kong economy, **a defense of the HKD involving sharp increase in local rates would be non-credible.**
- But HKMA has **large buffers** with which it can defend the HKD before allowing the currency board to function in a mechanical manner.
- The "pegged currency stress test" is a significant deterrent to offshore speculation.
- The Hong Kong Dollar benefits from both strong historical credibility and weak future credibility, given the potential for a change in control. **I don't want to be short HKD if things get better and I'm not entirely sure I want to be short HKD if things get worse, either.**

Bottom Line

- Investors who are structurally long HKD-denominated assets should consider an FX hedge as low-cost insurance. Should asset markets swoon, long USDHKD in the 1-year forward outright is likely to perform well.
- Speculating on a peg break is not nearly as compelling as it might look at first blush, as there is a viable counter-argument to such speculation in every scenario: improvement, muddle through, and negative tail.
- **I'll stick with the HSI puts**, which I continue to like even after this week's swoon in the index.