Interest Rates Focus

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Additional HKD liquidity upon FX intervention

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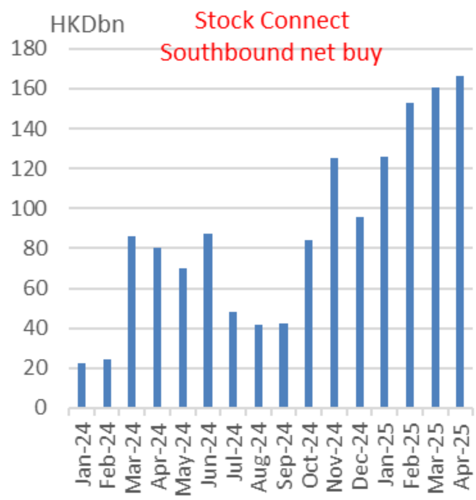
- **HKD liquidity**. Recent HKMA FX intervention has added HKD liquidity to the Aggregate Balance (interbank liquidity), which will help buffer the liquidity tightness amid IPOs, dividend payout activities, and other potential inflows. Over the years, there were several periods of inflows into HKD triggering FX intervention, notably in the year 2020 and in the late 2008 to 2009 period. There were reasons behind each period of major inflows into HKD, including diversions of flows from the USD and equity-related inflows; these factors may also be present currently. The latest PBoC announcement of a slew of support measures may also help sustain inflows into the HKD market.

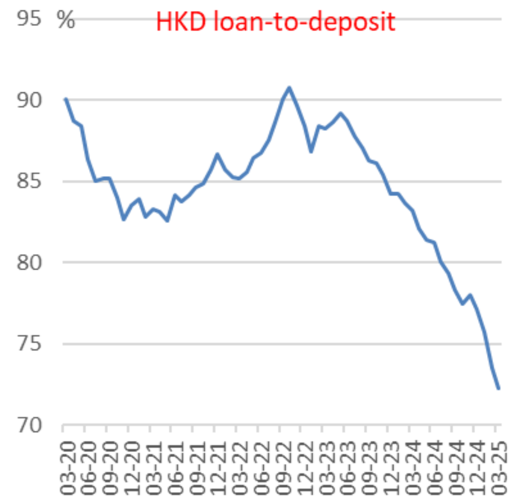
- **HKD rates**. HKD IRS-USD OIS spreads have fallen a lot over the past few days; we are neutral at these spreads near-term, as potential inflows may meet with liquidity injections when spot is still trading near the strong side of convertibility undertaking. Should there be further FX intervention adding to interbank liquidity, there is room for the HKD IRS curve to steepen further, across 1s5s and 1s10s segments. Back-end forward points slid, deviating from interest rate differentials by a relatively wide margin at one point; the deviation has since narrowed (as HKD IRS played catch-up). Over a multi-month horizon, we have an upward bias to short-end HKD-USD rates spreads (for the spreads to turn less negative).

- **Southbound Stock Connect flows** have been strong. Monthly net-buy was HKD150bn for three months in a row, with April seeing net-buy of HKD167bn. Net-buy on 6 May alone, after the long holidays, amounted to HKD13.5bn. As investors will need to exchange CNY into HKD in the offshore market, these equity inflows 1/ add to HKD liquidity tightness if done via FX swaps or put downward pressure on USD/HKD via spot; and 2/add to the CNH pool at the same time; CNH deposits at banks in Hong Kong already went back to above the CNY1trn mark at end February. The latest PBoC announcement of RRR and interest rate cuts, together with other support measures, may sustain inflows into the HKD market. CSRC said REITS would be included in Stock Connect. Earlier in the year, PBoC Governor Pan said mainland would significantly increase the proportion of foreign exchange reserves allocated to assets in Hong Kong.



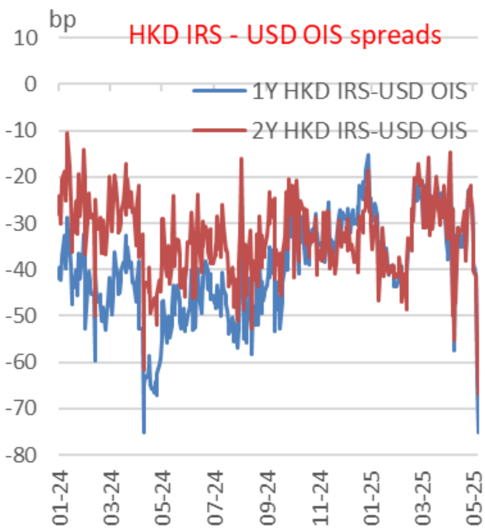
Source: CEIC, OCBC Research

- **IPOs and dividend payout season**. Capitalising on the improved risk sentiment and enhanced market liquidity, IPO activities also picked up substantially so far this year. Total fund raised in the first quarter amounted to HKD107bn, up by 251.5% YoY. The IPO pipeline remains strong, with pending May offerings including one aims to raise USD5bn (approximately 22% of the Aggregate Balance), and another seeking USD2bn (about 9% of the Aggregate Balance). Concurrently, the dividend payout season is set to begin in late May. The combination of IPOs and dividend payment has tended to drive up front-end HIBORs, as investors have usually taken out margin loans for IPO subscription (lock-up period is reduced under the new FINI – Fast Interface for New Issuance though), while corporates would stock up HKD for dividend payment. Our past study suggests that HIBORs with tenors less than one month have tended to rise significantly ahead of listing dates of large-scale IPOs, especially when these offerings attracted considerable investor interest, as evidenced by high oversubscription rates. The eventual funding pressure can be gauged by the size of IPO and subscription ratio relative to the prevailing size of Aggregate Balance. However, this impact is typically short-lived, lasting only for a few days, although it may be intensified if coinciding with other liquidity-draining events. HIBORs have also demonstrated a seasonal pattern around mid-year during dividend payout period.



Source: CEIC, OCBC Research

- **HKD loan demand**. HKD loan-to-deposit ratio has been on an extended declining path, which has prevented HKD liquidity from getting even tighter (referring to the tightness before recent FX intervention). Looking ahead, we expect to see some recovery for loan demand by financial concerns and stockbrokers, amid more fervent trading and fundraising activities in the equity market, as well as mild rebound in loan demand for purchase of residential properties on signs of stabilisation in the housing market. Yet, they may not fully offset the drag from weak loan demand for development and investment of properties and other economic uses. Developers' loan demand is generally more sensitive to housing price downtrend, and less sensitive to uptrend. As demonstrated in previous housing market cycles, it usually took longer for loans for development and investment of properties to rebound as compared to that of buyers' loan demand after each market downturn. That said, HKD loan demand should stabilise somewhat in the longer run, as the cost of funding has remained on a downward trajectory.

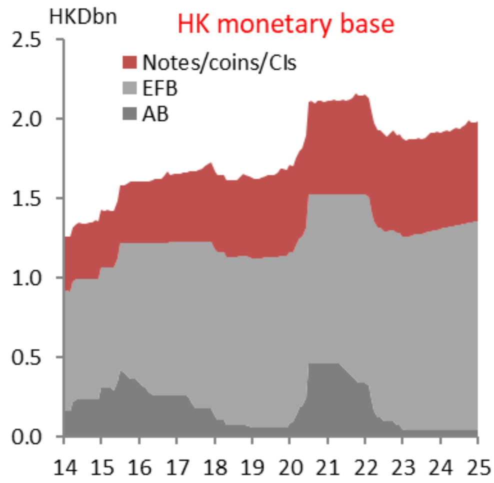


Source: Bloomberg, OCBC Research

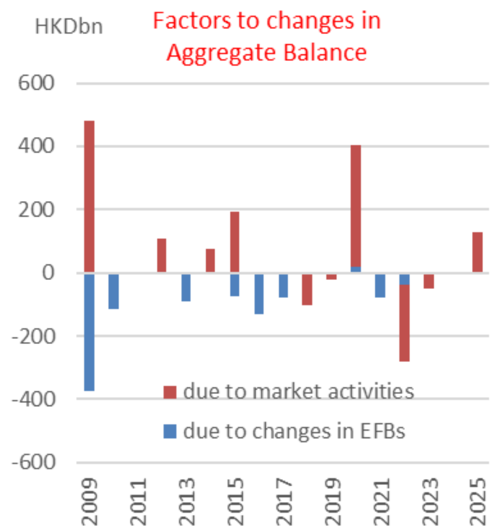
- **HKD-USD rates spreads**. HIBORs were fixed materially lower on Tuesday as Hong Kong returned from holidays, upon the additional liquidity brought about by FX intervention (albeit with settlement on the following day only), compounded by the passing of month-end/long weekend. Wednesday saw another day of sharply lower HIBOR fixings. Upon the falls in HKD IRS, short-end (1Y and 2Y) HKD-USD rates spreads were last 41-49bps lower than end April levels. Near-term, we are neutral at HKD-USD rates spreads at current levels, as potential inflows may meet with liquidity injections when spot is still trading near the strong side of convertibility undertaking. On FX swap, back-end forward points slid, deviating from interest rate differentials by a relatively big margin at one point; the deviation has since narrowed (as IRS played catch-up). 1Y HKD basis (from implied rate) was last at -21bps, which was low but not overly stretched; and there are LHS pressure in some other Asian basis as well.

- Over a multi-month horizon, we have an upward bias to short-end HKD-USD rates spreads (for the spreads to turn less negative). First, we maintain a lower USD rates view, while the passthrough onto HKD rates is likely to be partial only, especially with the prospect of inflows. Second, the latest market reaction saw HKD-USD rates spreads lower already. 1Y HKD-USD rates spread last at -75bps was 5.5 standard deviation below 6-month average; 2Y HKD-USD rates spread last at -67bps was 4.4 standard deviation below 6-month average. Third, if HKD liquidity becomes overly flush, and there is demand for bills, liquidity can be shifted from interbank to Exchange Fund Bills (EFBs).

- ***Background***. Under the currency board system, factors leading to **changes in the Aggregate Balance** (HKD interbank liquidity) are market activities by HKMA, Discount Window activities, and interest payment/net issuances of EFBs. HKMA started this bout of intervention on 2 May during NY session by buying HKD46.5bn worth of dollars from the market, as USD/HKD touched the strong side convertibility undertaking of the HKD. That marked the first intervention since May 2023 (when they sold dollars) and the first dollar purchase since October 2020. The single-day amount was the biggest on record – Tuesday saw a fresh record. As of writing, FX intervention totalled HKD129.4bn. Accordingly, Aggregate Balance will rise to HKD174bn from HKD44.6bn before HKMA FX intervention. Over the years, there were several periods of inflows into HKD, with more significant ones being year 2020 and late 2008-2009, at the magnitude of HKD384bn and HKD646bn respectively, based on the changes in Aggregate Balance due to market activities (fund flows concept based on currency conversion). There were reasons behind each period of major inflows into HKD, including diversions of flows from the USD and equity-related inflows. HKMA had mopped up a lot of this liquidity by increasing issuances of EFBs upon demand for the paper, leaving Aggregate Balance at around HKD45bn level for an extended period – which was a relatively low level at which we had held the view that front-end HKD rates would be volatile and subject to spikes.



Source: CEIC, OCBC Research



Source: CEIC, OCBC Research
*2025: including HKMA forecast change to Aggregate Balance

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