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HKD: Peg stays, but pressures rise

We present eight questions and answers on the USD/HKD peg.

Discussions on the USD/HKD peg are usually centered around the weak side of the convertibility undertaking (i.e., 7.850). This time, the questions are all focused on the strong side of the convertibility undertaking of 7.750 and whether it will hold. In our baseline, we still see no break or change in the peg regime, at least over the medium term. Although the downside pressures on spot USD/HKD have eased for now amid HKD liquidity injections (i.e., HKMA buying of USD/HKD), the recent testing of the 7.750 lower bound has led to some investors gauging the risk of spot USD/HKD breaking through this level. We present eight questions and answers on this:

1. What is causing the downside pressure on spot USD/HKD?

The HKMA (*Bloomberg*, 6 May 2025) highlighted that the strong HKD demand was driven mainly by equity-related demand (e.g., Hang Seng Index +17% in the past month to 8 May). We see other drivers, such as the sharp appreciation of currencies in Asia (especially TWD) on *market expectation* that there may be FX appreciation as part of any trade agreement ahead. BOK Governor Rhee (*Korea Times*, 6 May 2025) also suggested that there was pressure from the US on Asia to appreciate currencies. Another reason may be strong demand for HKD ahead of the expected USD5bn CATL IPO, which could take place later this month (*Bloomberg,* 7 May).

2. How much more can short-end rates fall, and the implications on FX points?

If there is consistent downside pressure on spot USD/HKD, the HKMA would protect the strong side of the policy band by buying USD/HKD, thereby injecting HKD liquidity and leading to a decline in short-term rates (i.e., reducing the attractiveness of holding HKD). During recent periods of HKD liquidity injections, 1M HIBOR fell to 2.09% (8 May 2025) from close to 4% on 2 May 2025, with liquidity injections totaling HKD129.5bn (aggregate balance surplus at HKD174bn). If the recent injections are unable to slow demand for HKD, further injections from the HKMA would emerge, which would only push short-end HKD rates even lower. This was the case during the liquidity injections through September 2003 and 2004, during which 1M HIBOR fell from a high of 1.09% in September 2003 to close to 0% (i.e., +4bp) by 8 November 2004. 12M USD/HKD points fell to as low as -1370pips by end-December 2004 (currently -900pips) from the previous high of around -440pips in September 2004.

3. What caused the sharp fall in HKD rates/FX forward points in 2003-2004?

The main drivers of capital inflows in 2003-2004 were the consistent weakness of USD (DXY -21% in the period), growing market expectations of a RMB revaluation (eventual FX regime shift/revaluation on 21 July 2005), and the recovery of Hong Kong's economy. The similarity this time is investor views of medium-term USD weakness from *fading US exceptionalism* (DXY down 9% from the peak this year) and market views that trade deals in the region may include agreements facilitating local FX appreciation.

4. Can HKMA sustain its USD buying intervention and downside pressure on local rates?

In our view, the HKMA can sustain the buying of spot USD/HKD for a prolonged period

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and push local interest rates substantially lower. It is generally easier to defend appreciation pressure on a fixed exchange rate than depreciation pressure, as the monetary authority is building up FX reserves rather than depleting them. The main domestic challenge from HKMA's sustained USD buying is fueling excess domestic liquidity. However, fundamentally, domestic price pressures in Hong Kong are limited, with headline CPI at 1.4% y-o-y (average 1.7% in the past 12 months), while property prices are also down close to 30% from the peak in September 2021 (to end-March 2024). In addition, if concerns over excess liquidity from the USD buying intervention eventually materialize, the HKMA could increase its exchange fund bill issuance to absorb local liquidity.

5. What if the HKMA decided not to defend 7.750?

Our strong base case is that this will not happen. If this did emerge, we believe there would be a rapid overshoot of spot USD/HKD to the downside. There would also likely be strong speculative demand for HKD, given the revaluation expectation from market participants, but there would also be a few other channels of potential inflows, including the risk of a rapid shift in FX deposits to HKD deposits. From February 2022 (Fed hikes started from March 2022) to March 2025 (latest data), USD deposits as a percentage of total banking sector deposits rose from 36% to 42% (or a total increase of USD245bn in this period; +34%). Corporate/institutional/retail repatriation is an additional risk, given Hong Kong's large net international investment position surplus (~USD2trn; end-2024).

6. What do FX valuation models suggest for HKD?

The average of our *four FX valuations models* for HKD suggests it is close to fair value. However, there are divergences, mainly between the undervaluation of -1.6% based on our FEER model and -8.7% based on our PPP (CPI-based) model. Both REER and REER (adjusted for productivity; 10-year period) are overvalued by 2.5% and 4.6%, respectively. However, if we look at HKD REER deviation over the past 20 years, it suggests around 10.2% overvaluation.

7. Where would the market expect USD/HKD to go?

Our FX valuation models do not point to any consistent directional bias on HKD, with some showing overvaluation/undervaluation (average being close to 0%). However, there are risks the market could view a break of 7.750 on USD/HKD as leading the exchange rate towards that of USD/CNH (~7.23 as of 8 May 2025), which would represent a ~6.7% appreciation from current levels.

8. Are there risks to the HKMA's USD buying intervention from the US?

As we highlight in point 4, we currently do not see any macro/financial stability risks from the HKMA's USD buying intervention/HKD liquidity injections. There is some risk that the US Treasury/Trump administration could raise concerns over those actions, given our belief that they harbour some preference for a weaker USD, and as stated in point 1, along with some potential discussions over Asia FX appreciation as part of a trade deal. We note previous news (*Reuters*, 8 July 2020) that Trump aides weighed proposals to undermine Hong Kong's dollar peg, with the article stating the possibility of "limiting the ability of Hong Kong banks to buy US dollars…" Trump also announced (*Bloomberg*, 7 May 2025) that he would raise Jimmy Lai's case (founder of Apple Daily News) in the upcoming US-China trade talks in Switzerland (9 May), highlighting the risk that Trump could start shifting the focus towards Hong Kong again.

Strategy views

On FX, we continue to favour **long USD/HKD outright positions** as they remain below the strong side of the convertibility rate from around the 2M tenor and beyond. Although there is some mark-to-market risk because of positioning and possible HKD liquidity injections (points/short-end rates could push lower), we strongly believe the strong side of 7.750 will be held and the position will roll positively to spot (low point would be 7.750). We also believe long USD/HKD positioning at this juncture is likely to have been significantly reduced following the recent injections and sharp fall in HKD rates/FX forward points.

On the **FX forward curve**, the 3x12M USD/HKD spread was last around -520pips (i.e., -4.9 standard deviation from its 6M average) from as high as -254pips on 1 May, following the HKD liquidity injections/fall in local rates. Historically, the 3x12M spread has fallen to as low as -1200pips (late 2004) on HKD appreciation expectations and liquidity injections, but this could be an extreme case. In 2004, there was no strong side convertibility undertaking rate, highlighting market concern that spot USD/HKD could break lower (strong side convertibility undertaking rate was implemented on 18 May 2005). In addition, we believe another reason for this behaviour in 2004 was the Fed's hiking cycle (hiking from 1.00% in June 2004 to 5.25% by June 2006), which contrasts with the current outlook of *further Fed rate cuts* . As such, we **establish a long 3x12M HKD forward spread position**, targeting a multi-month move back towards -200pips (3M leg expires on 11 August 2025; conviction level: 3/5) and a possible move beyond, if the outlook for near-term Fed cuts emerges.

On HKD rates, the fairly large liquidity injection from HKMA intervention over the past week, which brought the aggregate balance from HKD45bn to HKD174bn latest, means the fair value of the HK-US spread should have widened from before last week. The latest 3m HIBOR-SOFR spread (at -154bp) is close to the low in April 2023, after which the spread quickly narrowed. We maintain our view that, if market still largely believes the peg will hold, longer-tenor HK-US spreads still need to price in some normalization, even if front-end Hong Kong rates stay depressed for now. As such, we see some room for the HK-US rates spread (3-5yr) to narrow back from current tactically oversold levels, with catalysts potentially coming from 1) upcoming IPOs such as CATL; and 2) some potential arbitrage trades (with 12m outright still well below 7.75). Over a more medium-term horizon, Hong Kong's equity market outlook, loan growth outlook and to some extent Hong Kong government/quasi-government bond supply are some of the key drivers of Hong Kong rates.

Appendix A-1

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