USDHKD

Background

- HKD has been pegged to the USD since 1983 and trades in the 7.75-7.85/USD band set in 2005.
- Hong Kong's role as a financial centre for capital entering Asia has been diminishing since it has grown closer to the Mainland and serious economic woes have been compounded by Fed hikes, its need to defend the peg, and shifting geopolitics.

Capital Outflows

- Hong Kong has been a conduit of capital into Asia, esp. China recently, but the stability, robust legal system, and free speech underpinning that have begun to disappear since China took a harsher stance on its status as a province. On a high level, it will continue to lose out as investors shift to Singapore.
- HK's economy has declined for two years, worsened by its adoption of COVID policies similar to those in China. This backdrop amid economic weakness has triggered significant outflows from local equities, with the Hang Seng dropping 40% in the past 2 years (and looking set for further declines), and financial activity is weakening (low financial services/IPO revenues, 10% the amount of IPOs in H1 2022 vs past year). To compound these issues, HK rates have to track US ones due to the peg, and the Fed has already hiked aggressively and looks set to 'keep at it' in the near-term. Further, record FX operations to defend the peg drain intrabank liquidity and rise borrowing costs.
- Many international funds and residents have used this opportunity to divest from HK assets in favour of foreign ones. The real estate market is very poor and I believe that property sales as residents leave will also drive further outflows. These weaknesses are both cyclical and secular, meaning that a good amount of withdrawn capital is more unlikely to come back, even as commercial rates rise.

Defending the Peg

- The HKMA has a large pool of reserves to defend the peg - just under $440 bn - and has sold $10bn in June alone. China, which has $3 tn in FX reserves, could provide the HKMA with dollars as well.
- While the authorities are quite capable of defending the current peg if they choose to, Hong Kong's model has been doing poorly for years now and this does not appear to be transient. China may also have other motives for switching this system, like further integration or reducing HK's dependence on the USD and US monetary policy, which would complement the Chinese's bigger-picture ambitions regionally and globally - i.e. de-dollarisation, support for the yuan's internationalisation, and regional issues with Taiwan.
- As such, I think that if the pressure on the HKD peg becomes excessive in the coming months, it provides an opportunity to switch regimes, which would include weakening the currency pair by 25% or more from its current upper bound. We can express a view here either directly through the FX or, more likely, through options.