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Level 20,One IFC,1 Harbour View Street, Central, Hong Kong. Tel: 852 3167 4591, Mob 852 9738 0944 Email: afreris@ecognosisadvisory.com, Website: www.ecognosisadvisory.com, Facebook: @ecognosis

ECONOTE No. 70: USD interest rates and Asian local rates: The great, lovely disconnect continues 30/3/2018

Summary	Investment Conclusions
Asian local interest rates have disconnected from USD rates for	Concerns over the renewed hiking cycle of the Fed seem a
years now after the majority of Asian economies adopted relatively	little delayed as the Fed started to hike in Dec. 2016 and has
flexible, if sometimes "guided", forex rate regimes with minimal	hiked since then five times! Hiking 3 times more in 2018 is
capital controls, especially after the 1997 "Asian crisis" (which,	important but only in the context of a well- established
incidentally, it was neither Asian nor a crisis). However, the concept	trend. Further hikes may impact US equities and, hence, may
that a relatively freely floating forex rate decouples local interest	also drag along Asian equities, as well as G2 stocks. That
rates from those of other major currencies seems difficult to sink in.	could be a concern for Asians, but higher USD rates will have
Hong Kong, however, gives the best example, but in reverse, as its	little impact on local rates (except for Hong Kong). USD
USD pegged forex rate allows no independence as to the level and	domestic and external Asian debt can be of concern if the
dynamics of local rates. The renewal of the Fed hiking cycle under	countries in questions are running widening current account
its new chairman will have little impact on most Asian interest rates.	and fiscal deficits, and neither of these is a present concern.

### Hello, is anybody there ? Fed versus the Asians

The US Fed started its hiking cycle of 25bps each time, in December 2016, and then in May, June and Decemebr 2017, and last time in March 2018, five hikes altogether, an unmistakable trend of hikes.During the same time, starting at 2016 to date, these were the reactions/actions of major Asian central banks in terms of their official rates and in time sequence: China no move ( although there were various lending policy changes), Thailand no move, India 3 cuts, Indonesia 3 cuts, Philippines 1 cut, Taiwan 1 cut, South Korea 1 cut and 1 hike , Malaysia 1 cut and 1 hike.Hong Kong is excluded as it hiked 5 times in synch with the Fed. Singapore has no official interest rate but adjusts instead the band of movements of the SGD forex rate. In total, none of these Asian central banks reacted to the Fed moves with a NET hike in their official rates. So much for the impact of Fed on Asian official rates ! Market rates, and especially longer term bond yields, could and did react in different manner, but this is to be expected because of a flexible forex policy in place. Even if a central bank hiked or cut its rates, commercial rates may have reacted differently as the forex rates moved. The impact on interest rate differentials, and especially those versus the USD rates , do not react with iron predetermined rules as expectations could play a major role as to the next movement of exchange rates.

Both Figures 1 and 2 include the usual large Asian economies such as China, S.Korea and India, but also the smaller economies of Thailand and Indonesia.The letter are included as they are putatively more liable to be affected by rising USD rates because and fiscal deficits, and neither of these is a present concern. of their external balances. The evidence indicates that there is no close link in the dynamics of local rates and yields versus USD equivalents. Chinese and Thai 3M rates did not respond to the hiking of US trend as did Chinese and Indonesian 10Y yields. Furthermore the differentials of these Asian interest rates with USD rates, and the movements of their forex rates

is consistent , in general, with the relative flexibility of their

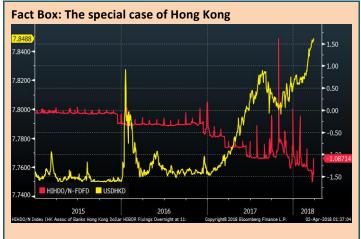
forex policies which allows for the decoupling discussed here.



Source: Bloomberg

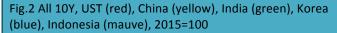
## The odd man out: The HKD and HKD rates

The HKD is pegged to the USD with a maximum of 7.75 and a minimum of 7.85 range vs. the USD. If the exchange rate moves very near or outside these ranges the Hong Kong Monetary Authority (HKMA) will intervene in the markets by buying or selling HKD versus the USD and thus cause the local money markets to move in the appropriate direction by withdrawing or adding liquidity in the system. The intervention rate of the HKMA moves, of course, lockstep with that of the US Fed, namely having been raised 5 times since December 2016. Although the pegging mechanism is, in a sense, mechanical, it does not necessarily work in a mechanical manner as the chart of the Fact Box show. Under the pegged system the differential (red in the Figure) between the HKD overnight rates versus the Fed rate should be about zero, but since 2016 it had started to slip to a negative differential, that is the Fed rate was higher than the HKD O/N.



#### Source Bloomberg

This can be explained by ample liquidity in the money market because of capital inflows relfecting the strong performance, at the time, of the HSI as well as because of the preferences of Mainland investors for the HK property sector. However, under the pegged system, the USD/HKD exchge rate ( yellow in the chart) weakened and started to reach the maximum weakness level under the peg rules of 7.85. The HKMA warned repeatedly that it would intervene and hike market rates higher as necessary to support the USD/HKD rate within the peg limits. The HKMA also warned repeatedly of the consequences of the certainty of higher rates, as the Fed would continue to hike, on the overinflated HK property sector, but to little avail.





Source:

#### From here to eternity?

The US Fed is expected to hike rates at least two if not three times in the course of 2018. The impact of these hikes on domestic Asian short and longer terms rates is likely to be very modest. It would then follow that these hikes on their own would also have little or modest impact on the local equity markets. However as these hikes will likely impact the US equity market, there is bound to be collateral damage on Asian markets through the global capital movement readjustments.

For 2018 our preference in the equities markets has been a hold position in the US precisely because of the likely impact of the Fed hikes, but with a continuing preference for the smaller Asians whose macro performance as well as the relative immunity of their local interest rates from those of the USD rates will be an added an attraction.

Andrew Freris (writing completed 30/3/2018)