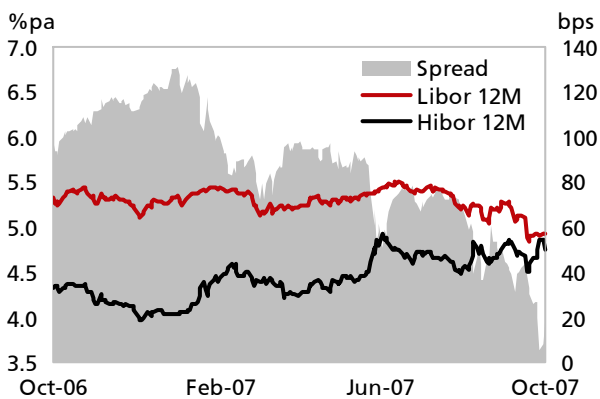


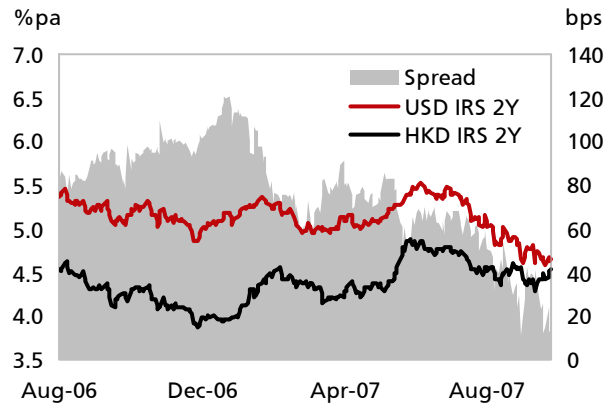
**Trade: Rec 2Y HKD IRS vs Pay 2Y USD IRS**  
**(Rec 1Y/1Y forward HKD IRS vs Pay 1Y/1Y forward USD IRS)**

The HKD remains credibly pegged against the USD, which means the broad trends in HKD rates continue to be set by developments in the USD rates market. But this is only the big picture. Hibors have risen sharply over the past two weeks despite steady Libors, forcing yield differentials narrower across the entire curve. As a result, building positions for wider spreads between HKD and USD swap rates looks attractive again.

**Hibor 12M vs Libor 12M**

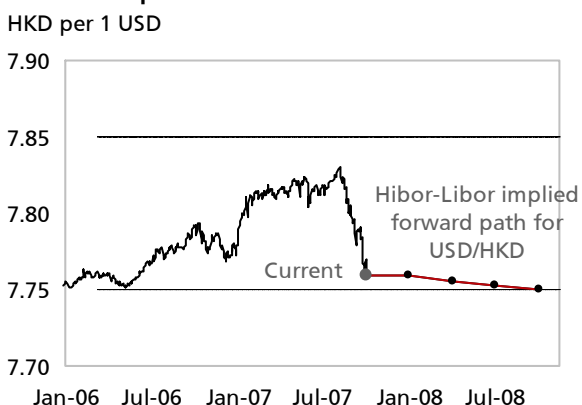


**USD IRS 2Y vs HKD IRS 2Y**

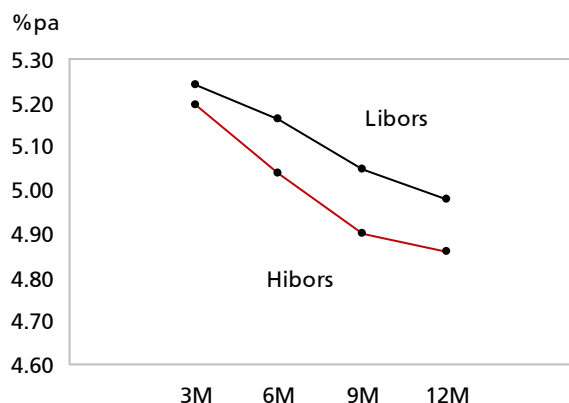


The upward move in Hibors was driven by a sharp appreciation in the currency nearly to the strong side limit of the HKMA's 7.75-7.85 policy band. This led the HKMA to sell HKD into the market and to publicly reaffirm the HKD's peg to the greenback. But it also led Hibors to converge upward toward Libors because, with no further strengthening of the HKD possible (absent a break in the FX regime), Hibors had better be at or above Libor, lest arbitrage opportunities present themselves.

**USD/HKD Spot & Forwards**

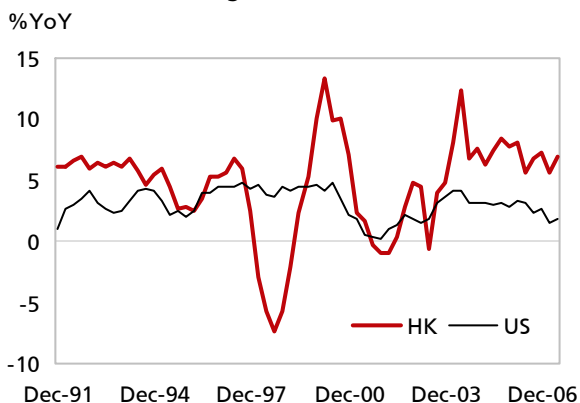


**Hibors vs Libors**



While more than one factor appears to have been behind the fall in USD/HKD, the strengthening of the HKD against the USD is probably best explained by a) the turn in the US growth outlook, which has put the spotlight back onto fundamentals, i.e. weak growth (2%-3% saar) in the US versus strong growth (6%-7%) in Hong Kong and near-12%

HK vs US Real GDP growth



USD/HKD Spot & Hang Seng



growth in China, b) the weak USD environment, and c) the surge in HK equities following China’s announcement on 20 August to relax curbs on overseas securities investment.

Bottom line: spreads have narrowed as USD/HKD has appreciated sharply amid fund inflows but traders are sticking to the view that the peg will hold and no further appreciation is possible. We concur and believe that with USD/HKD near 7.75 the spread narrowing has run its course and the most likely near-term scenario is a widening of differentials.

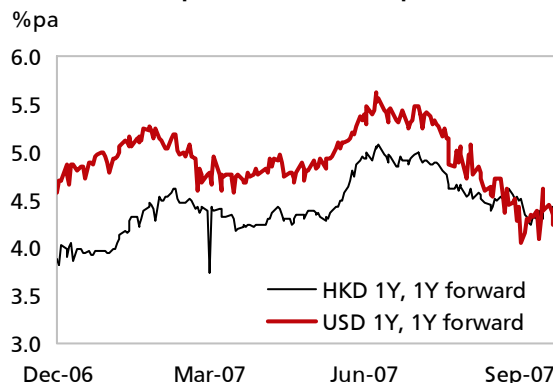
We expect this to be triggered when markets realize that the Fed is only fine-tuning policy and USD/HKD moves higher. We recommend receiving 2Y fixed in HKD vs paying 2Y fixed in USD to exploit this view. We expect spreads in the 2Y sector to widen to 40bps from 13bps currently. Carry currently is negative but acceptable.

|   |        |                  |            |              |              |
|---|--------|------------------|------------|--------------|--------------|
| Receive: 2Y HKD IRS   |        | Pay: 2Y USD IRS  |            |              |              |
|   |        | 2Y HKD IRS       | 2Y USD IRS | Spread       |              |
| Libor 3M  | 5.240  | Yield            | 4.525      | 13           |              |
| Hibor 3M  | 5.192  | Risk             | 1.9        | 1.9          |              |
| USD/HKD   | 7.758  | Notional (\$ mm) | 77.6       | 10.0         |              |
| Rec 2Y HKD IRS fixed pay Hibor 3M floating  |        |                  |            |              |              |
| Notional  | Days   | Rec 2Y HKD IRS   | Days       | Pay Hibor 3M | Carry        |
| 77.6 mm   | 90 365 | 4.525 %          | 90 365     | 5.19 %       | HK\$ -127626 |
| The carry over 90 days on the rec fixed leg of the swap is HK\$-127626 on 78 million notional |        |                  |            |              | US\$ -16450  |
| Pay 2Y USD IRS fixed rec Libor 3M floating  |        |                  |            |              |              |
| Notional  | Days   | Pay 2Y USD IRS   | Days       | Rec Libor 3M | Carry        |
| 10.0 mm   | 90 360 | 4.651 %          | 90 360     | 5.24 %       | US\$ 14725   |
| The carry over 90 days on the pay fixed leg of the swap is US\$14725 on 10 million notional   |        |                  |            |              | US\$ -1725   |

Alternatively, the trade can be expressed in the forward space by receiving 1Y, 1Y forward in HKD vs paying 1Y, 1Y forward in USD. Here the spread has actually fallen to zero. As long as the peg stays, there is no reason for the 1Y, 1Y forward HKD swap rate to rise substantially above the 1Y, 1Y forward USD swap rate.

Risks lie with the forward path of USD/HKD. The trade would suffer if Hibors rise above Libors, implying a rise in USD/HKD. But we believe this is unlikely, even in a strong USD environment. We expect USD/HKD spot to move higher but USD/HKD forward to remain near 7.75.

HKD 1Y1Y swap vs USD 1Y1Y swap



**Recent Trades**

|  |                             |                             |                              |                               |                                  |
|--|-----------------------------|-----------------------------|------------------------------|-------------------------------|----------------------------------|
| <b>Hong Kong</b><br>Rec 2Y HKD IRS vs Pay 2Y USD IRS | <b>Entry date</b><br>3-Oct  | <b>Entry level</b><br>13bps | <b>Target level</b><br>40bps | <b>Current Level</b><br>13bps | <b>Comment</b><br>Initiate       |
| <b>US</b><br>USD 2/10 steepener in bonds             | <b>Entry date</b><br>6-Sep  | <b>Entry level</b><br>46    | <b>Target level</b><br>50bps | <b>Current Level</b><br>-     | <b>Comment</b><br>Closed @ 50bps |
| <b>Singapore</b><br>SGD 2/10 flattener in swaps      | <b>Entry date</b><br>29-Aug | <b>Entry level</b><br>36bps | <b>Target level</b><br>25bps | <b>Current Level</b><br>-     | <b>Comment</b><br>Closed @ 42bps |

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