Hong Kong Turns Carry Trades Around

While Hong Kong may occupy a special role in the heart of free market economists for all of the right reasons, I shall always associate it with weekly news announcements the U.S. was subsidizing the export of 360,000 dozen or so eggs to the city-state under something called the Export Enhancement Program. Americans may be slackers as people, but our chickens take a back-seat to none in the productivity department.

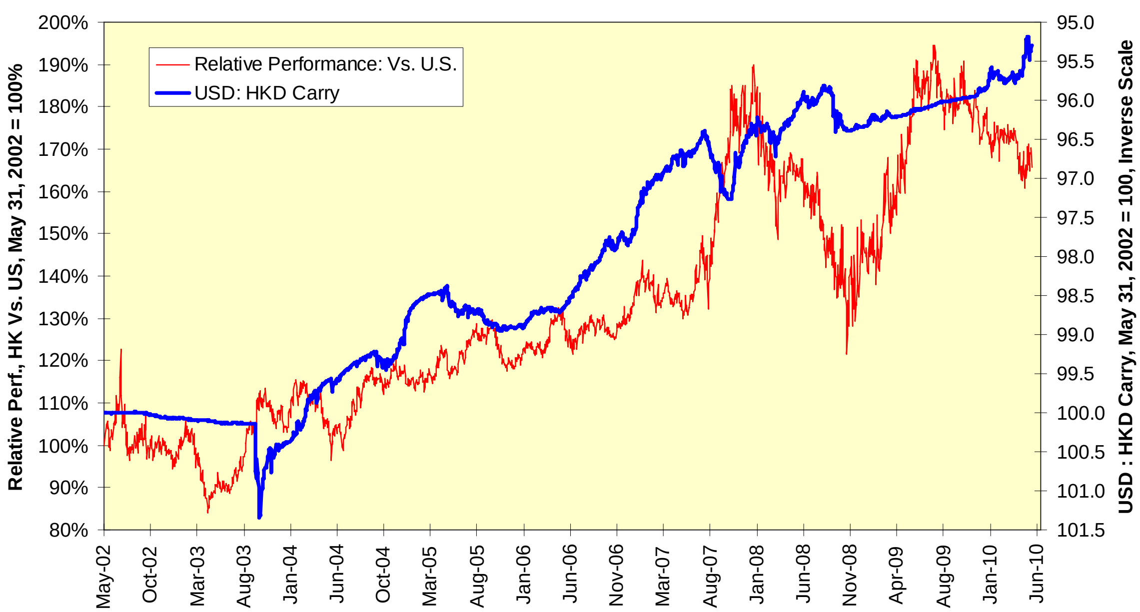
Hong Kong is unique in other respects as well; even though the British returned the colony to China in 1997, the mainland did not want to risk any of those eggs being golden and so, unlike their Communist predecessors in the Soviet Union did not break any to make omelets. The Hong Kong dollar was retained, and the currency has remained in a tight managed-float band versus the U.S. dollar ever since. As speculation regarding an eventual revaluation of the Chinese yuan is never-ending and as the mainland is awash with cash looking for a home, Hong Kong property markets long have been viewed as a good way to bet on China.

Carry Trades And Equities

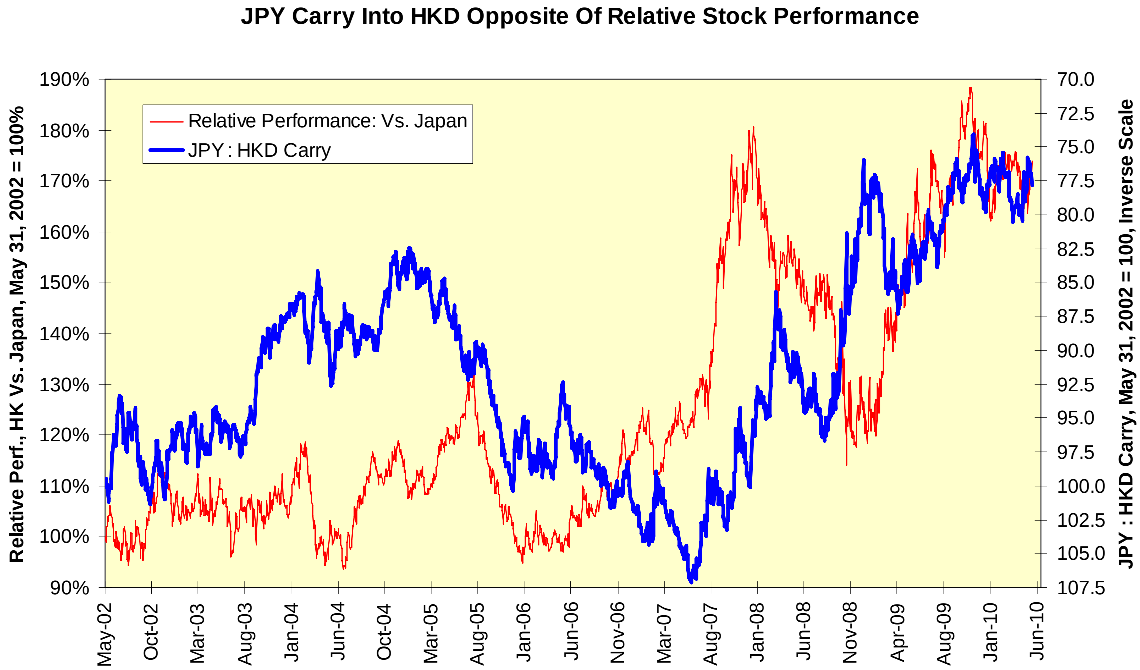
If we shift the asset class in question from real estate to equities, we see a startlingly different picture than what we might expect. The common pattern in nearly all markets fueled by carry trades is a parallel rise and fall between the currency carry and the relative equity performance of the recipient currency's market versus the funding currency's market. A simpler way of putting this might be, "money comes in, stocks go up; money goes out, stocks go down."

This is not the case with either the USD or JPY carries into Hong Kong, however. If we map the relative performance of Hong Kong to the U.S. as a function of the carry return from borrowing USD and lending HKD, we see a generally negative relationship. It might be a stronger negative relationship without the currency band, but we will never know.

USD Carry Into HKD Opposite Of Relative Stock Performance



If we repeat the exercise with the yen carry and the relative performance of Hong Kong to Japan, the inverse relationship becomes both stronger and clearer.



The inference is clear: The more American or Japanese short-term rates rise relative to Hong Kong rates or the stronger either the USD or JPY become, the more we should expect Hong Kong stocks to outperform those of the U.S. and Japan. The mechanism involved is each episode of carry trade unwinding involves a flow of funds back into Hong Kong and a concomitant rise in the Hong Kong stock market. Once the world moves back to “risk-on” trades, the flow reverses.

The tight band of the HKD and CNY against the USD and the availability of a large pool of offshore yen available to the Hong Kong financial system combine to make this city-state a de facto funding source for global carry trades. Moral of the story: A little “follow the money” detective work not only goes a long way but lets you avoid getting egg all over your face.