1. Summary and overview

Two dominant themes defined global macro-financial developments during the period under review: the energy shock stemming from the Middle East conflict and the artificial intelligence (A.I.) investment boom. Both factors are inflationary, driving a pivot from anticipated rate cuts to rate hikes and pushing yields higher in advanced economies. On the growth front, the lift from the A.I. boom has largely offset the drag from the energy shock; however, these benefits have been unevenly distributed, depending on each country's position within the A.I. supply chain. Looking ahead, the global economy is projected to bend rather than break. Future prospects will be shaped by a combination of protracted Middle East tensions, tariff risks, tightening financial conditions, and questions regarding the sustainability of the A.I. boom.

The Hong Kong economy has demonstrated notable resilience against the energy shock, underpinned by its low energy intensity, low exposure to the Strait of Hormuz and prompt policy responses. This stability is further supported by strong trade activity related to the A.I. boom, improved service exports amid rising tourist arrivals, as well as stable consumption and investment in the private sector.

Hong Kong's exchange rate and money markets continued to trade in a smooth and orderly manner. While the local equity market recorded relatively weak performance, initial public offering (IPO) activities remained buoyant. Concurrently, the local debt market expanded steadily. Notably, Hong Kong's Renminbi (RMB) bond market benefited from lower RMB financing cost, the diversification advantage, and a series of key policy initiatives. The residential property market remained buoyant in the first half of 2026, underpinned by improved economic conditions and positive market sentiment. Meanwhile, the commercial real estate market showed signs of stabilsation. In the banking sector, loan growth turned positive, reversing the decline observed in the second half of 2025. The overall asset quality of the banking sector remained manageable; strong capital and liquidity position, combined with sufficient provisions, suggest that the banking sector is well positioned to withstand potential external and local shocks.

The external environment

The global macro-financial environment during the period under review was defined by two dominant themes: the energy supply shock stemming from the conflict in the Middle East and the A.I. investment boom. Both factors have intensified near-term inflationary pressures, driving a pivot from anticipated rate cuts to rate hikes and pushing yields higher in advanced economies. However, their impacts on growth have diverged significantly. While the energy

shock acts as a headwind, the A.I. boom has bolstered global demand. Overall, the boost from the A.I. boom has largely offset the drag from the energy shock, though the benefits have been unevenly distributed, depending on each country's position within the A.I. supply chain.

Regional performance has reflected these divergent forces. The US economy has demonstrated resilience, supported by robust A.I. investment, accommodative fiscal policy, rising oil exports, and strong spending by higher-income households. In contrast, economic activity in the euro area, the UK, and Japan has softened due to high energy costs and tighter financial conditions.

More recently, global financial conditions have tightened further. Long-term sovereign bond yields in the US, UK and Japan rose to their highest since 2007, reflecting inflation uncertainty and higher term premia. Meanwhile, major central banks have turned more hawkish. The US Federal Reserve (Fed) increased its policy rate by 25 bps in September, and its projections point to an additional 25 bps hike by 2026 year-end. Together with the rate hikes by the European Central Bank (ECB) and Bank of Japan (BoJ) in the same month, financial conditions are likely to tighten further in the near term.

Looking ahead, the global economy is projected to bend rather than break. Future prospects will be affected by multiple headwinds. A protracted Middle East conflict could sustain commodity price volatility and inflation while tightening global financial conditions. Long-term yields could rise further on continued heavy bond issuance. In addition, newly proposed US tariff measures and uncertainty over China-Europe trade tensions could possibly disrupt supply chains and weaken growth.

Furthermore, while the A.I. boom continues to support the global economic activity, it has generated increasing financial stability concerns. These include the rapid increase of debt finance to support massive A.I. infrastructure investment; the use of circular financing; growing exposures via private credit, derivatives and margin financing; and greater equity market concentration, particularly in East Asia. Fiscal vulnerabilities in major advanced economies also remain elevated, posing risks of higher global borrowing costs and further tightened financial conditions.

Asia Pacific (APAC) economies demonstrated resilience in the first half of 2026, primarily supported by the ongoing global A.I. investment boom that significantly lifted tech exports, manufacturing activities, and investment. The impact of the Middle East energy shock was also more benign than initially feared, thanks to adjustments in oil demand and supply in major economies, the deployment of commercial and strategic reserves, and targeted policy measures by governments in the region.

However, beneath this general resilience, economy-specific performance has diverged. Economies with weaker connections to the technology supply chain or insufficient buffers against the energy shock face greater challenges, characterised by rising inflationary pressures and downside risks to growth. Looking forward, APAC economies must closely monitor the evolution of geopolitical tensions in the Middle East, the emerging El Niño phenomenon and its impact on food security, and the dynamics of US tariffs under new arrangements.

In the first half of 2026, Chinese Mainland's real Gross Domestic Product (GDP) grew by 4.7%, falling within the annual target range. However, economic activity slowed down in the second quarter, driven by soft domestic demand. The economy continued to exhibit "K-shaped" divergence: surging exports and strong performance in new-economy sectors contrast sharply with weak domestic consumption and shrinking traditional industries. Box 1 examines Chinese Mainland's A.I.-related trade in greater detail. The housing market remained soft overall,

although top-tier cities performed relatively better. Inflation dynamics showed improvement, with the GDP deflator ending a consecutive 12-quarter period of negative growth in the second quarter, influenced by global energy shocks and the A.I. super cycle. Nonetheless, reflation remains narrow, and the pass-through to broader prices is limited. Looking ahead, the economy is expected to remain on track to meet its annual growth target of 4.5–5.0%. Despite lingering external challenges and fragile domestic demand, sustained innovations, industrial upgrading, and continued policy support are expected to underpin stable growth.

The domestic economy

In Hong Kong, the economy recorded solid growth in the first half of 2026, with real GDP increasing by 5.9% and 4.3% year on year in the first and second quarters, respectively. The economy has demonstrated notable resilience against the energy shock, underpinned by its low energy intensity, low exposure to the Strait of Hormuz, and prompt policy responses. This stability is further supported by strong trade activity related to the A.I. boom, improved service exports amid rising tourist arrivals, and stable performance of domestic activity. In particular, private consumption strengthened further, bolstered by solid consumer confidence and stable asset markets. In tandem, investment continued to expand in the first half of the year, underpinned by active property transactions and private sector capital spending. In addition, the labour market remained broadly stable, with the unemployment rate at 3.8% in August 2026. Consumer price inflation increased but remained moderate at 1.9% in August 2026.

Monetary conditions and capital flows

The Hong Kong dollar (HKD) exchange and money markets continued to trade in a smooth and orderly manner. In early March 2026, uncertainties arising from the Middle East conflict prompted investors to unwind short HKD positions, temporarily driving the HKD stronger. Nonetheless, this was subsequently offset by carry trade activities, incentivised by HKD interest rates moving below their US dollar (USD) counterparts, which drove the HKD weaker. Market fluctuations were largely driven by capital flows related to Southbound Stock Connect and other capital market activities.

While Hong Kong Interbank Offered Rates (HIBORs) generally track their USD counterparts under the Linked Exchange Rate System, shorter-tenor rates are also influenced by local supply of and demand for HKD funding. Reflecting shifts in seasonal and capital market-related funding demand, short-term HIBORs eased in early March before generally firming thereafter. Box 2 examines how Fast Interface for New Issuance (FINI) has reduced IPO-related interbank transfers, thereby dampening the impact of large IPO subscriptions on overnight HIBOR.

Going forward, heightened geopolitical risks, the ongoing military conflict in the Middle East, and elevated uncertainty regarding the US trade policy and the sustainability of the A.I. investment boom may increase fund flow volatility. Nonetheless, with ample foreign exchange reserves and robust financial system, Hong Kong is well positioned to withstand these volatilities without undermining financial stability.

Asset markets

During the review period, global equity markets recorded gains, but experienced significant volatility as the Middle East conflict persisted. While continued optimism over A.I.-related developments provided support to global equity markets in the first half of 2026, concerns over the sustainability of massive A.I. capital expenditure triggered a sell-off in A.I.-related hardware and infrastructure companies in July, contributing to volatility in global equity

markets. In Hong Kong, the local equity market recorded weaker performance in the second quarter of 2026, but rebounded notably in July. Looking ahead, the outlook for global equity markets remains highly uncertain. The Middle East conflict and vulnerabilities associated with massive A.I. capital expenditure will remain key sources of risks, while uncertainty over the interest rate paths in major advanced economies and persistent geopolitical and trade tensions could also trigger volatility. For Hong Kong, market sentiment will also be shaped by the economic growth and technological developments in the Chinese Mainland.

In the bond market, yields on long-term US Treasury Notes increased amid rising inflation concerns and risks to long-term US fiscal sustainability. While the yields on HKD Hong Kong Special Administrative Region Government Bonds and corporate bonds also rose, they remained lower than yields on USD bonds of comparable maturities.

A puzzling development in the global bond market is that the average spread for high-yield bonds has remained tight, staying below the historical average despite volatile global financial markets. Box 3 explores this phenomenon by linking it to the rapid growth of the private credit market, and discusses its implications for financial stability.

In the first half of 2026, the issuance of HKD debt securities grew by 11.6% year on year, with issuers outside Hong Kong being the primary contributor. Meanwhile, the issuance of offshore renminbi (CNH) debt securities rose by 60.5% year on year during the first half of 2026. Looking ahead, the lower financing cost and investors' diversification demands are expected to continue supporting HKD and CNH debt securities issuance. Over the longer term, continued large-scale HKD debt securities issuances in the public market could help deepen the HKD debt market, while policy measures to promote RMB internationalisation will further support the development of the CNH debt market in Hong Kong. During the review period, several policy initiatives were introduced to foster the development of Hong Kong's debt market, covering green and sustainable finance, technological innovations, and market infrastructure improvement.

The residential property market remained buoyant in the first half of 2026, underpinned by improved economic conditions and positive market sentiment. Looking ahead, the housing market outlook remains subject to risks and uncertainties, including those stemming from the US interest rate path. That said, the robust domestic economy, coupled with the sustained net inflow of talent and overseas students, should continue to support housing demand in the near term. Meanwhile, the commercial real estate (CRE) market showed signs of stabilisation. In particular, vacancy rates for both grade A offices and retail premises in prime districts improved further.

Banking sector performance

The aggregate pre-tax operating profit of retail banks grew by 20.4% year on year in the first half of 2026, driven by higher net interest income, income from fees and commissions, and income from investment held for trading. This growth was partially offset by the decline in income from foreign exchange and derivatives operations. As a result, banks' return on assets rose to 1.40% in the first half of 2026, up from 1.27% in the same period last year.

The Hong Kong banking sector remains liquid and well capitalised. The average Liquidity Coverage Ratio of category 1 institutions reached 150.5% in the second quarter of 2026, well above the statutory minimum requirement of 100%. The total capital ratio of locally incorporated authorized institutions (AIs) stood at 24.2% in the second quarter of 2026, significantly

exceeding the international minimum requirement of 8%. The asset quality of the banking sector remained manageable and showed signs of improvement, with the classified loan ratio for all AIs declining to 1.82% in the second quarter of 2026.

Financial health among Hong Kong-listed non-financial corporates also showed signs of improvement, reflected by a higher weighted average interest coverage ratio and lower corporate leverage. Despite these recent improvements, their longer-term resilience will depend partly on their ability to adopt new technologies to enhance efficiency and support revenue growth. Box 4 examines this issue by drawing on the recent experience of digitalisation adoption among Hong Kong corporates.

Looking ahead, several downside risks, including the spillover risk from debt vulnerabilities in A.I. firms, ongoing geopolitical tensions in the Middle East, and uncertainty over the future path of US interest rates, could pose challenges to the Hong Kong banking sector. Banks are advised to remain vigilant in assessing the impacts of these risk factors on the asset quality of their loan portfolios.

The Half-yearly Report on Monetary and Financial Stability is prepared by the staff of the Research Department of the Hong Kong Monetary Authority