FEATURE ARTICLE

The Hong Kong debt market in 2016

by the Financial Infrastructure Department

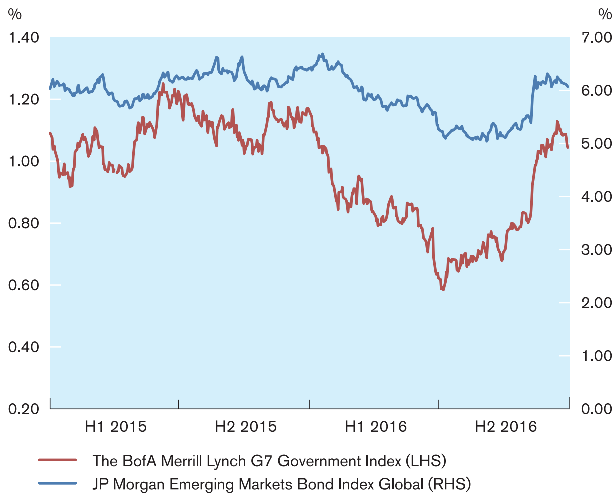
The international bond market continued to be volatile in 2016. Economic and political developments worldwide, coupled with divergent monetary policies, caused repercussions in the debt market. In Europe and Japan, central banks' negative interest rate policies sent government bond yields to very low or even negative levels at some points during the year, before rebounding later in the year. The US Federal Reserve, however, raised the target range for the federal funds rate in December 2016, and signalled further rate hikes during 2017. US Treasuries experienced a surge in yields following the very low levels recorded earlier. In the Hong Kong dollar debt market, the total issuance volume of Hong Kong dollar debt instruments has reached a high level. The Government also issued the inaugural Silver Bond under the Government Bond Programme to support the development of the local bond market.

Overview of the international bond market

The global economy in 2016 was marked by an uneven pace of economic growth. Divergent monetary policies adopted in advanced economies also complicated the international bond market, which saw high volatility during the year. In developed economies, sovereign bond yields trended downwards in the first half of the year before picking up from summer onwards (Chart 1).

CHART 1

Average borrowing costs in developed and emerging markets



Average yields of the following benchmark indices are used as proxies to the yield levels of the corresponding markets:

Developed markets	The BofA Merrill Lynch G7 Government Index
Emerging markets	JP Morgan Emerging Markets Bond Index Global

Source: Thomson Reuters.

The European Central Bank further loosened its monetary policy by lowering interest rates and expanding the asset purchase programme in March 2016. The Bank of England also adopted a more accommodative stance in August 2016 to cushion the shocks brought about by the outcome of the Brexit referendum. These drove down sovereign bond yields. For example, the yield of 10-year German bunds dropped below zero at some points during the year. However, bond yields rebounded later in the year, due to stabilised political developments and diminishing returns on monetary easing.

In the US, following the interest rate hike in December 2015, market expectation of a slow pace of interest rate rises helped keep Treasury yields low for most of 2016. That was before the presidential election in November 2016 and the Federal Reserve's rate hike in December 2016, which triggered surges in Treasury yields and led to concerns of a possible end to the bull bond market.

The outlook for the international bond market in 2017 will remain challenging against the backdrop of heightened inflationary expectations and possible further US interest rate hikes. At the same time, uncertainties over political developments, monetary policies, fund flows and exchange rate movements will continue to have a bearing on the international bond market.

Hong Kong Debt Market Review

Since the global financial crisis, a massive amount of funds has flowed into the Hong Kong dollar. This created a favourable environment for debt issuers to issue Hong Kong dollar debt, the funding cost of which remained low for most of the year. In 2016, demand for Hong Kong dollar debt was supported by slower than expected US interest rate hikes.

As a result, Hong Kong dollar debt issuance increased for the eighth consecutive year to HK$3.05 trillion, an increase of 22% over 2015. Steady growth in issuance size amid the volatile international bond market demonstrated the healthy development of the local debt market. The broad investor base in Hong Kong has attracted more issuers to utilise the local funding platform.

Overseas entities

Overseas issuers other than Multilateral Development Banks (MDBs) increasingly tapped the Hong Kong dollar market in 2016, with issuance volume recording an increase of 71%. The US dollar/HK dollar basis swap rates were positive at some points during the year, and some issuers were able to grasp the opportunities to issue bonds in Hong Kong and swap the proceeds to the US dollar to achieve cheaper all-in funding costs. MDBs also returned to the market in 2016 to take advantage of the low funding costs.

Local corporates and authorized institutions (AIs)

At the same time, local corporates expanded their funding scale in the local debt market with the issuance volume increasing by 77% from 2015. This was partly due to "pre-refinancing" activities to take advantage of the low local interest rates given that much of their US dollar debts are expected to fall due in 2017, as well as funding needs such as payment of dividends. On the other hand, fund-raising activities by AIs also increased by 33% year on year as AIs tried to secure funding and satisfy their regular funding needs through the issuance of Certificates of Deposit under the low interest rate environment.

Local corporates such as Link Real Estate Investment Trust and the MTR Corporation issued green bonds in US dollars and received good response in 2016. In addition, the Financial Secretary advocated the development of green finance in his 2016–17 Budget Speech.

Government Bond (GB) Programme

The HKMA continued to implement the GB Programme in 2016 to promote further and sustainable development of the local bond market. At the end of 2016, total outstanding GBs included twelve issues of institutional bonds, totalling HK$68.3 billion, and three issues of iBonds and one issue of the Silver Bond, totalling HK$33 billion. Apart from the Hong Kong dollar bonds, two US dollar sukuk issues, each with an issuance size of US$1 billion, were also outstanding (i.e. total US$2 billion).

Retail bonds

During the year, the Government issued the sixth inflation-linked retail bond, or iBond, with an issuance amount of HK$10 billion (iBond 6). The number of valid applications reached 507,978, with total subscription of nearly HK$23 billion. As a safe and liquid investment with stable returns, the iBonds have successfully raised the public awareness and interest in retail bonds. Indeed, an estimated 8–15% of the successful subscribers in the past six issuances were first-time investors. The iBonds have also provided a convenient investment vehicle in an environment of low interest rates and demonstrated to other potential issuers that Hong Kong has a buoyant retail bond market worth tapping.

During the year, the Government also launched a two-year Silver Bond pilot scheme. The Silver Bond is an inflation-linked bond with a minimum annual interest rate of 2%, targeting Hong Kong residents aged 65 or above. The size of the inaugural issuance in 2016 was HK$3 billion, with a tenor of three years. The number of valid applications reached 76,009, with total subscription amounting to nearly HK$9 billion. To encourage bondholders to hold the Silver Bond till maturity, the bond has no secondary market and bondholders are not allowed to transfer the bonds to other people. The Government has also put in place an arrangement for early redemption of the Silver Bond, at par plus accrued interest, at the request of the bondholders to cater for their need for liquidity. The Government hopes the financial sector will be encouraged to tap into the potential of the silver market. (Table 1 provides a comparison of the features of iBond 6 and the inaugural Silver Bond).

TABLE 1

Comparison between product features of iBond 6 and Silver Bond

	iBond 6 (2016)	Silver Bond (2016)
Issuance size	HK$10 billion	HK$3 billion
Min. denomination	HK$10,000	HK$10,000
Eligibility criteria	Hong Kong residents	Hong Kong residents aged 65+
Tenor	3 years	3 years
Interest rate	The higher of floating rate (average 6-month Composite Consumer Price Index) and fixed rate (1%)	The higher of floating rate (average 6-month Composite Consumer Price Index) and fixed rate (2%)
Secondary market	▪ Stock Exchange of Hong Kong ▪ Over-the-counter market	▪ No secondary market ▪ Restrictions on transfers
Early redemption arrangement	▪ Nil	▪ Early redemption at par + accrued interest at 2% p.a., upon request by the bondholders

Looking ahead

Given the possible reversal of fund flows and interest rate fluctuations, the Hong Kong dollar debt market may face headwinds in 2017. Nevertheless, the proposal for a potential Mainland-Hong Kong Bond Market Connect (which allows for cross-border bond trading between the markets of Hong Kong and Mainland China) may provide impetus to the local bond market by bringing in new investors. Through the implementation of the GB Programme, the HKMA will continue to support the development of the Hong Kong dollar debt market.