

MNI Market Analysis: Can South Korea Afford Higher Rates?

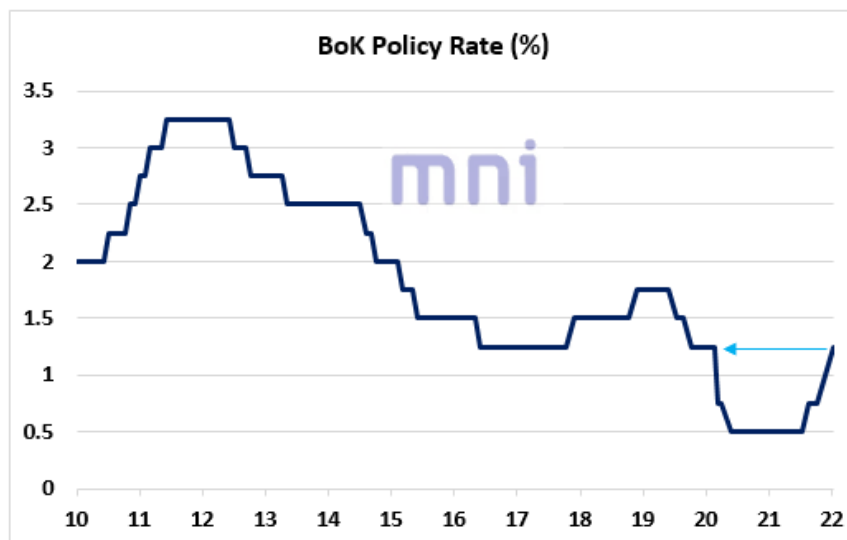
21 January 2022, Yvan Berthoux

Executive summary

- Bank of Korea decided to follow CEEMEA/Latam central banks and has embarked into a tightening cycle in the past six months to ease the rising inflationary pressures.
- However, South Korea's biggest trading partner China is keeping its 'zero-Covid policy', which has been constantly weighing on growth expectations in the past year and therefore could impact Korean economic activity in the medium term.
- A significant slowdown in the economic activity combined with a deceleration in global liquidity could lead to greater volatility in 2022 and therefore weigh on Korean domestic assets and the KRW.

In the past 6 months, we have seen that South Korea has followed CEEMEA/Latam central banks and embarked into a tightening cycle to ease the rising inflationary pressures. Bank of Korea (BoK) raised its policy rate by 25bps this month for the third time since July 2021, bringing the benchmark rate back to its pre-pandemic level.

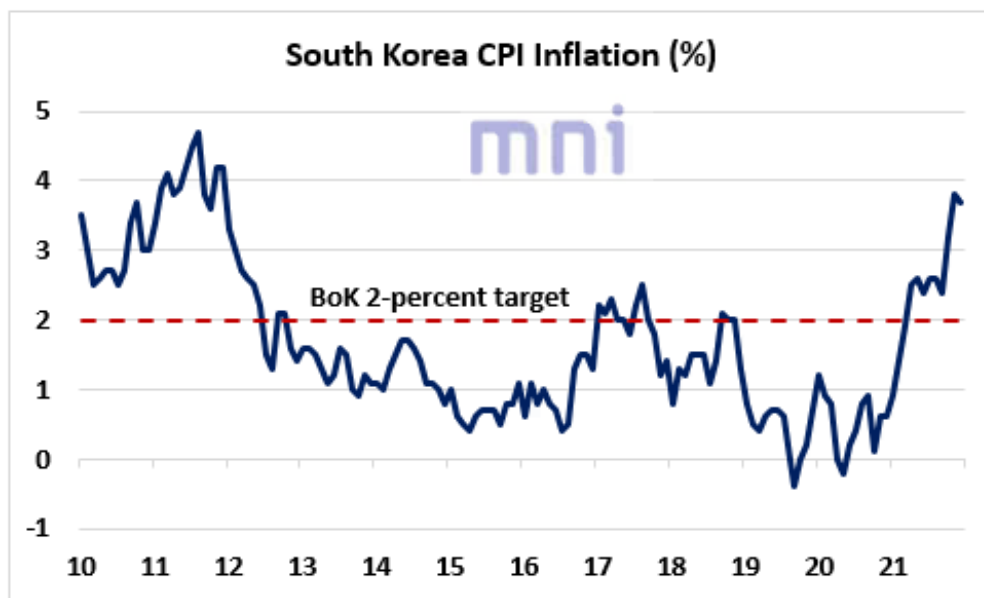
Figure 1



Source: Bloomberg

As for most of the DM and EM economies, inflation has been surprising positively in the past year and is currently standing at its highest level since December 2011, diverging significantly from the BoK 2-percent target (figure 2).

Figure 2



Source: Bloomberg

Even though South Korea's tightening cycle may ease inflationary pressures in the medium term by limiting the downside risk on the KRW, raising rates too aggressively could impact the domestic economic activity. One big issue for South Korea is China, which keeps a 'zero-covid policy' that is significantly weighing on the country's growth expectations. China is by far SK's biggest trading partner, representing over 25% of SK's total exports (figure 3)

South Korea is the only major Asian / SEA country raising interest rates as the rest of the region has decided to keep interest rates unchanged to stimulate growth. In addition, the inflationary pressures have been easing in numerous countries: India, Vietnam, Philippines, and Bangladesh.

Hence, a sluggish growth in the region (mostly due to China's 'restrictive Covid policy') combined with the hawkish BoK could result in a significant slowdown in Korean economic activity, which could also be reflected in domestic asset prices.

Figure 3



Source: worldstopexports.co

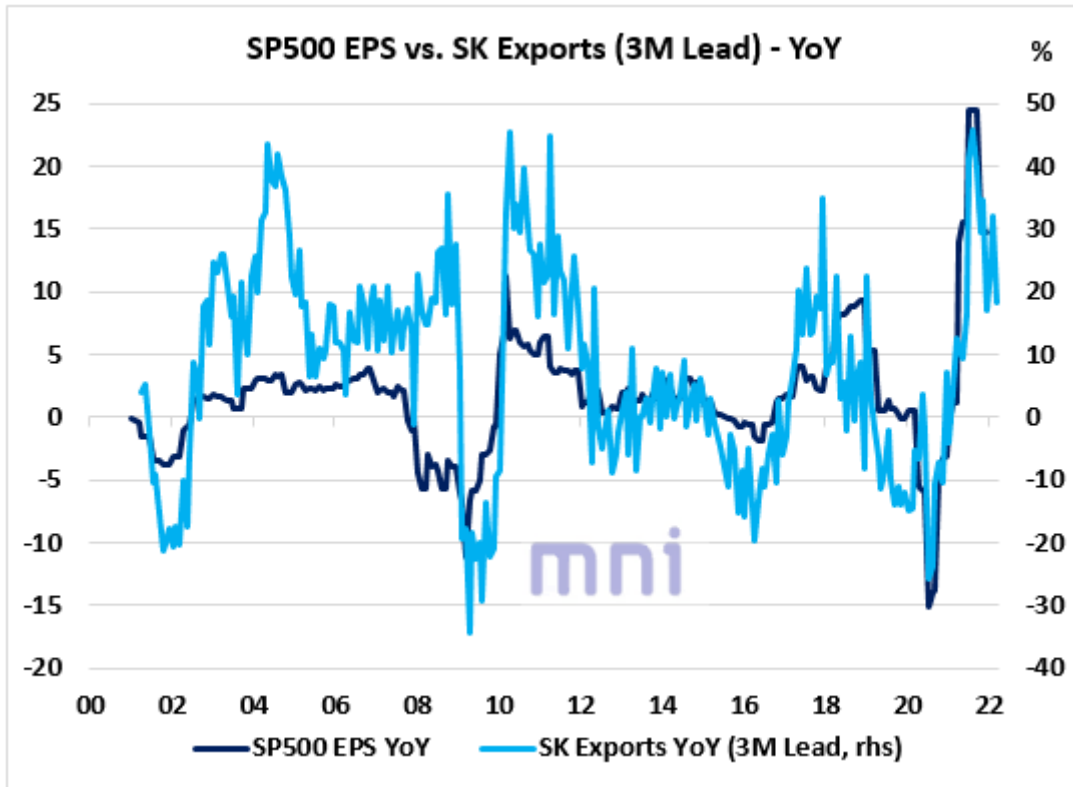
However, the landing in SK economy / asset prices could be softer depending on how far the PBoC is ready to ease. We saw that China has entered an easing cycle in recent months, cutting its LPR by 10bps to 2.85% this week. This move follows the two 50bps cuts in RRR last year as the economic slowdown has been weighing on domestic risky assets. According to a recent interview from our Policy team (see end of article), there is more fiscal and monetary easing to come in China and officials may eventually surprise market participants who have remained sceptical on China easing cycle until now.

Due to its heavily export-driven economy (exports represent over 50% of the country's GDP), South Korea is defined as a 'risk-on' economy. Analysts generally use SK exports as one of the key inputs when computing a global leading economic indicator.

Figure 4 shows that SK exports (YoY) have strongly led US equities earnings in the past 20 years.

Hence, the strong deceleration in SK exports in the past year is also pricing in a slowdown in the momentum in risky assets (i.e. equities).

Figure 4



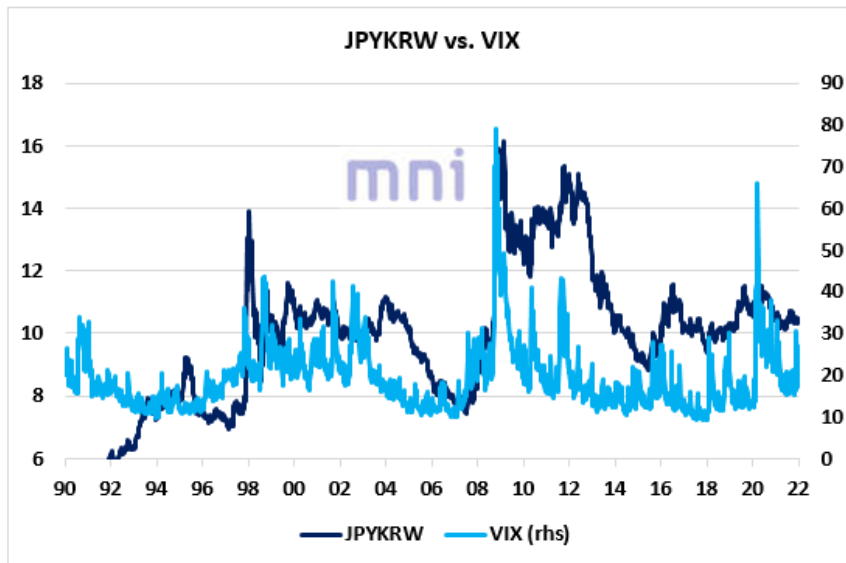
Source: Bloomberg/MNI

The Korean won has also been acting as a ‘risk-on’ currency in the past 30 years, which tends to depreciate significantly in periods of rising volatility (i.e. VIX).

The chart below shows the strong co-movement between JPYKRW (risk off pair) and price volatility (VIX) in the past 30 years. As growth expectations in SK continue to fade in 2022 and global liquidity continues to decelerate, risky assets could experience greater volatility this year, which would be negative for the KRW.

As South Korea has historically offered higher yields than Japan, investors have been chasing Korean assets in expansionary periods but then swap back their Korean assets to Japanese asset (especially JPY) in periods of crisis and market selloffs.

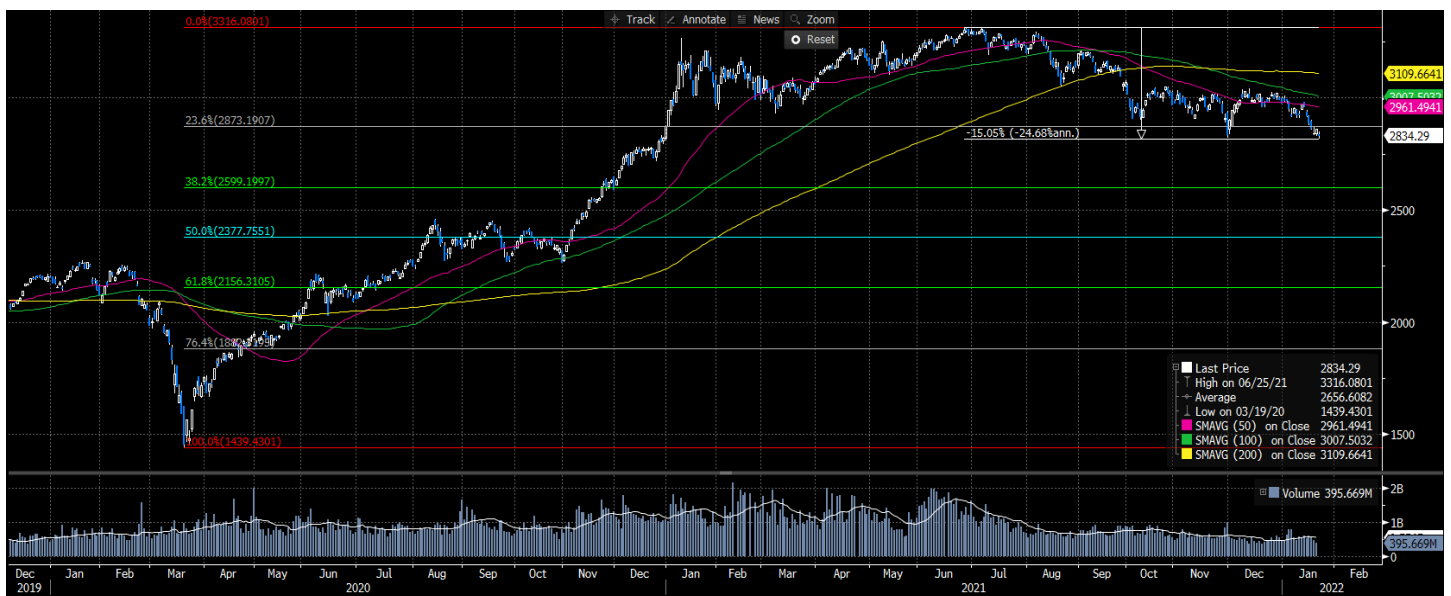
Figure 5



Source: Bloomberg/MNI

Even though Korean equity market is tech-heavy (tech stocks are usually sensitive to the dynamics of liquidity), it has been falling since its historical high reached in June 2021. KOSPI index is down 15% in the past 6 months and is approaching its key support at 2,800; a break below that level would open the door for a move down to 2,600, which represents the 38.2% Fibonaci retracement of the 1,439.40 – 3,316.10 range.

Figure 6

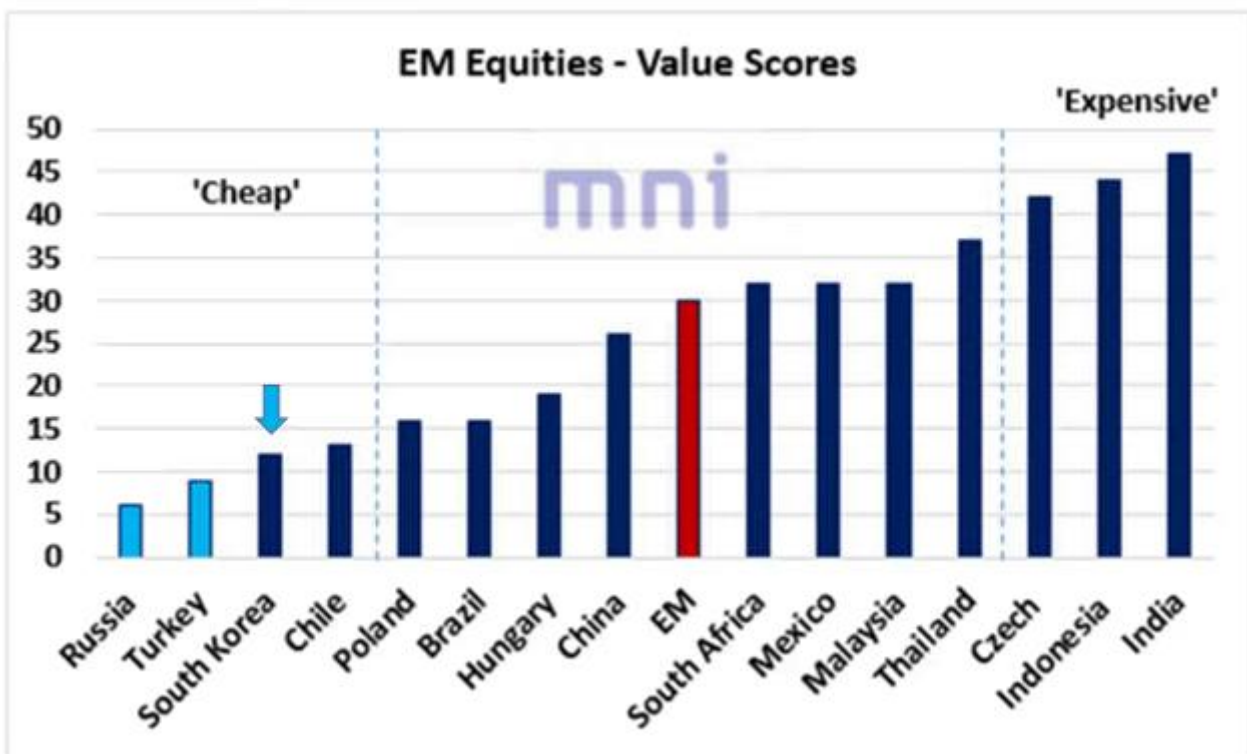


Source: Bloomberg

Interestingly, South Korea is one of the 'cheapest' equity market among the EM world according to our value scoring model. In figure 7, we rank the 16 EM equity markets (15 countries + EM index - MXEF Index) from 'cheapest' to the most 'expensive' ones based on the Price-to-Book, Price-to-Sales and Price-to-Earnings ratios.

Even though South Korean equities may appear attractive using a 'value approach method', this year could be challenging for Korean risky assets as growth expectations continue to fade.

Figure 7



Source: Bloomberg/MNI

MNI INTERVIEW: More Fiscal, Monetary Easing Coming In China (Jan 17 2022)

BEIJING (MNI) - China is set to launch further waves of monetary and fiscal easing, including possible cuts of over CNY1 trillion in taxes and fees, as it de-emphasises a campaign to lower leverage in order to support companies facing continuing pandemic headwinds, weak consumption and imported inflation, former National Development and Reform Commission Secretary General Han Yongwen told MNI in an interview.

Speaking before the People's Bank of China cut two major policy rates on Monday, Han said the government's 2022 fiscal deficit target, usually announced in March during the Two Sessions conference, should maintain an expansionary bias at around 3.2% of GDP.

The fiscal deficit and an increased and front-loaded CNY1.46 trillion quota for local government special bonds will power investment, particularly in the first quarter when the economy's performance may suffer from the base effect comparison with 18.3% growth recorded in the equivalent period of 2021, said Han, now vice chairman of the China Center for International Economic Exchanges, run by the NDRC.

"There is still space for a further tax and fee cut, much more than CNY1 trillion, which will mainly target small and medium-sized companies, manufacturing and green development," said Han.

MORE PBOC EASING

The PBOC could also further cut banks' reserve requirement ratios, as well as potentially money market policy rates and the benchmark lending prime rate, to ease borrowing costs for downstream manufacturers and services firms contending not only with the effects of the Covid pandemic but also imported inflation, he said.

The central bank on Monday cut its one-year medium-term lending facility rate by 10 basis points to 2.85%, the first reduction since April 2020, and lowered the seven-day reverse repurchase agreement rate to 2.1% from 2.2%. Last month's 50 basis-point RRR cut will leverage at least CNY5 trillion for the economy, Han said.

The increasingly hawkish stance of the U.S. Federal Reserve will not deter the PBOC from easing, as Chinese inflation is at moderate levels and capital outflows can be controlled, he said. (See: MNI: PBOC Urged To Seize Dovish Chance Before Fed Hike (Rpt))

SLOWER DEBT GROWTH

Slowing growth in debt helped China's macro leverage ratio drop 5.3 percentage points in the first three months of last year, according to the National Institution for Finance and Development. This gives authorities margin for further monetary easing even as they look to avoid any accumulation of long-term systemic risk, said Han, who expected the ratio to have declined by over 6 percentage points in all of 2021.

Slowing issuance of local government special bonds in the first half of last year came as officials pushed for deleveraging in the belief that the pandemic was easing and the economy would bounce back quickly, but it is now clear that both investment and consumption are still far from normal levels, he said. Stimulus should enable fixed-asset investment to grow by over 6% this year, compared to 5.2% in the first 11 months of 2021, Han said. Some 40% of this investment will feed into higher consumption, he added.

LOCAL GOVERNMENTS

A drive by Beijing for more stimulus could however increase difficulties for some local governments, whose fiscal health has deteriorated during the pandemic and as land sale revenues fall, said Han, also a former vice governor of Hunan Province.

"The key will be to push for industrial restructuring via boosting manufacturing and producer service sectors, to create new sources of growth and speed service sector recovery," he said, adding that central authorities will continue to curb growth in local governments' implicit debts.

While major central banks are increasingly concerned about the danger that an Omicron outbreak could cause further disruption in China's crucial supply chains, feeding global inflation, Han said the country's zero-Covid policies had proved effective and would stay.

"I am confident that the impact of the pandemic will be limited for China's supply chains," he said, noting that authorities have prioritised economic, social and political stability this year, and are increasingly emphasising the domestic economy under the dual circulation strategy.

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