Korea and Won – Under Stress Tests

23 July 2015

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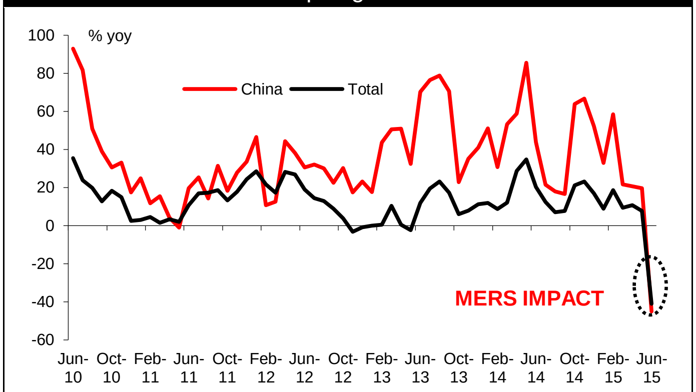
- **Q2 GDP came in lower than expected at 2.2% yoy vs 2.5% in 1Q. NAB Economics maintains a 2.5% GDP outcome in 2015, followed by 2.9% in 2016.**
- **A closer assessment on merchandise exports shows intensifying competition from Japan, as well as China. In the long run, overall structural soundness of the external sector may be protected by services industry.**
- **In the near term, rate cut expectations may rise as the Finance Ministry tightens mortgage loan screening.**
- **FX strategy is long USD/KRW 6M NDF and in light of recent price actions, revises the stop higher to 1130. USD/KRW is forecast to end 2015 at 1180.**

Growth faces headwinds

The economy expanded by 2.2% in 2Q vs 2.5% in 1Q. High frequency indicators point to modest outcomes, particularly in the near term. The MERS (Middle East Respiratory Syndrome) virus has led to 36 deaths, and has damaged business and consumer confidence. There are tentative signs that conditions are being stabilised, although we need to wait and see.

NAB Economics is forecasting a 2.5% outcome in 2015, followed by 2.9% in 2016. The prevalence of MERS, drought-like conditions, and a challenging environment for its exports are key headwinds. We are still more bearish than the Bank of Korea, even as the central bank has cut its GDP forecasts three times this year and the last cut on 9 July brought 2015 official forecast to 2.8% from 3.1%.

International tourist arrivals plunged in June



Source: NAB, Bloomberg

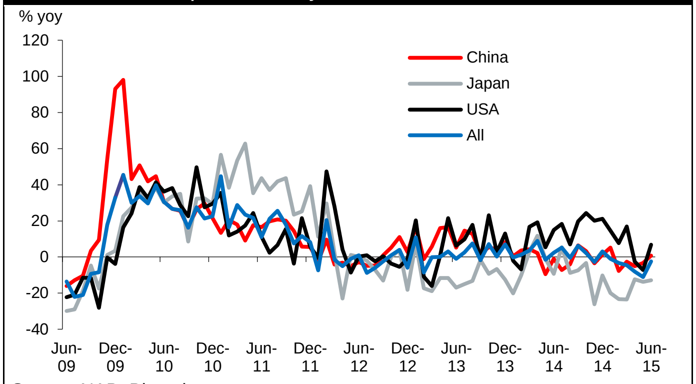
South Korea is facing increasing export competition from Japan (weaker JPY), as well as China (expanding its product mix). A weak export environment, challenging domestic conditions, and exchange rate concerns (particularly with regard to the JPY) might compel the Bank of Korea to cut rates by another 25bp, from its current 1.5%. In addition, the Ministry of Finance just announced it will impose stricter credit standards for mortgage borrowers. Even though the regulations will be implemented in H2 2016, the announcement gave financial markets another reason to expect another rate cut soon. Market seems to be under-pricing the scope of a cut, with about 6bp priced in in three months.

Exports engine spluttering

Exports are critical to South Korea's economy. Exports of goods and services are 57% of the country's GDP. More recently, exports have come under pressure due to weaker global demand and competitive pressures. Over the year to May, 2015 merchandise exports have fallen by 11%.

Looking at exports by destination paints a somewhat sorry picture. Exports to China (Korea's largest export destination) have declined in yoy terms during the first five months of 2015, with the exception of January. Exports to the US, whilst very strong in the January-March period, turned negative, and fell by -7.2% in the month of May. Exports to Japan – another key export destination – have been very weak and falling, declining by -13.5% over the year to May, 2015.

South Korean exports to major economies

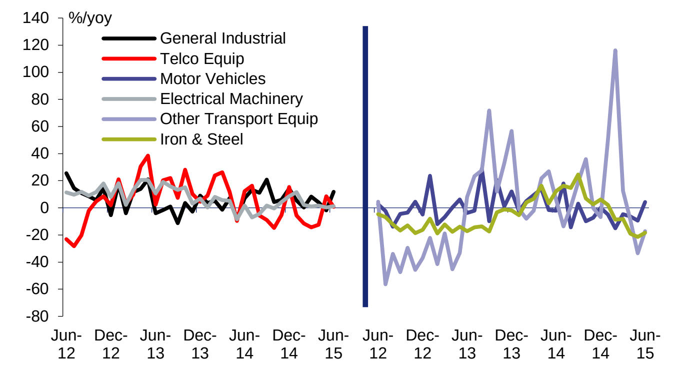


Source: NAB, Bloomberg

In terms of key categories, other transport equipment and iron and steel have experienced sharp declines. Electrical machinery has been broadly flat. Telecommunications and motor vehicle exports have improved after struggling earlier in the year. General industrial has been the standout performer.

Over the years, Korea has closed the quality differential with Japan across a number of product categories. It has also made great strides in expanding its share of global exports, particularly in electrical machinery. Korea has displaced Japan in export share across a number of key product categories, including industrial and electrical machinery. However, the scope for further displacement is limited, according to the Korean Development Institute, as Japan has maintained export dominance in sectors which require highly advanced technology such as specialized machinery, optics and photographic apparatus. China is shaping up to be a major competitive threat, as it encroaches on areas where Korea is traditionally strong, such as shipbuilding, transport and telecommunications equipment.

Key categories of Korean exports



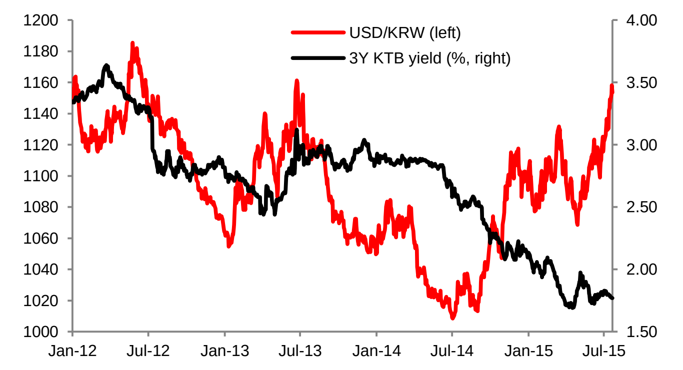
Source: NAB, Bloomberg

Won pressure unlikely to abate in the near term

More cracks on Korea's economic growth and stresses on the Korean Won are showing up through its corporate sector as well as potential seasonal outflows. The KRW is the region's worst performer in the past one month, losing 4.7% vs the USD. Foreigners are exiting the Korean equity markets, with month-to-date net sales totalling US$1.2bn. Foreigners have also turned net sellers in the bond market, offloading US$262mn worth of Korean debt.

Dips in USD/KRW in the near term may entice more interest to build long USD positions. **FX Strategy is long USD/KRW targeting 1180 and in light of recent price actions, would like to push the stop to 1130 from 1030.** The added drag stems from disappointing corporate earnings (Samsung Heavy, Daewoo) and concerns over "zombie companies".

Bond yields and USD/KRW biased higher



Source: NAB, Bloomberg

Carmakers are hurting too. While the weaker Japanese yen has helped inflate earnings of significant exporters like Toyota Motor Corp., it's hit their Korean counterparts hard, including Hyundai Motor Co. The Korean automaker's sales have fallen for three straight months due to a slump in overseas deliveries.

And then there's POSCO, the nation's biggest steel producer, that has pledged to halve its domestic operations and cut overseas units by 30%. Also, there is a growing number of so called zombie companies, ones that are saddled with debt, in need of restructuring but are kept alive by a drip of cheap debt.

Korea's current account profile typically suggests better KRW prospects in the second half of the year, than in the first. A caveat though, is the peak in outbound tourism season in July and August that tends to lead to services deficit within the current account. That has traditionally led to seasonal weakness in the KRW, especially in August, where it depreciated against the USD in 7 out of 9 years. Furthermore, the KRW could be a victim of its own "success", as its strength thus far this year vs EUR (+5.7%), MYR (+3.2%), AUD (+4.9%) may encourage more outbound travel in the next two months than previously.

Structurally, external position remains robust

Despite export challenges, Korea continues to maintain a strong trade surplus. Weak import demand and prices of key imports such as fuel have helped contribute to the outcome.

Over the 6 months to June 2015, South Korea's trade balance was a surplus of USD36.50bn USD 46.34bn. Further, besides industrial goods, South Korea also has significant service exports. It has been very successful in wielding soft power, and promoting itself, particularly across the Asian region.

K-Pop is popular across all the major Asian cities. Further, K-Drama superstars such as Lee Min Ho, Moon Chae Won and Song Hye Kyo are household names across Asia. According to the Korean Creative Content Agency, South Korea's creative exports are worth around USD5.5bn in 2014.

South Korea continues to maintain a positive Current account balance. It is estimated that Korea's Current account surplus will be around 3.5% of GDP in 2015 and 3.1% in 2016. Near term risks include weaker inbound tourism arrivals as a result of the MERS virus.

Further, South Korea's FX reserves are currently USD375bn. This is sufficient to cover almost 8 months' worth of current account payments, according to ratings agency, Fitch.

Further, the ratio of Short-term external debt to Foreign exchange reserves is a very acceptable 30% of GDP, indicating a comfortable external liquidity position.

In summary, South Korea's external position is very strong and helps insulate it from potential external risks. This includes, but is not limited to, anticipated tightening from the US Federal Reserve.

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