

The Korea Economic Slice on KBC

An Exclusive Report from [Korea Business Central](#) and [DS Market Research](#)

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In the fourteen days since a verdict charged the Democratic People's Republic of Korea (DPRK/The North) with sinking the Republic of Korea's (ROK/The South) Cheonan warship, global investors have realigned risks on the Korean Peninsula at the center of their radars. In this edition of the Korea Economic Slice on KBC, we'll venture into history to gauge the significance of the recent alleged attack on the Cheonan and analyze the potential outcomes and economic repercussions. Then, we'll move to identify the coming week's crucial economic reports, technical indicators from the KOSPI, and the effects of global risks in the Korea economy.

The Fifty-Seven Year Long Armistice

In 1953, the armies from both North and South Korea agreed on a truce that was never meant to be permanent. The Korean Armistice was a rudimentary agreement aimed at creating a 4 km demilitarized buffer zone on the proposed border (the DMZ), the “suspension of open hostilities”, and a system for transferring prisoners between sides (BBC News). Here's a snapshot of notable interactions between the two sides since the end of combat in 1953:

1969 – U.S. reconnaissance plane shot down.

1994 – Kim Il-sung dies, freezes nuclear program in exchange for 2 nuclear reactors and \$5 billion of nuclear fuel.

1998 – North Korea fires missile over Japan.

2000 – Kim Jong-il and Kim Dae-jung shake hands at summit in Pyongyang.

2002 – **(June)** North and South vessels battle in Yellow Sea; 30 N. Korean & 4 S. Korean soldiers die. **(December)** The North reactivates Yongbyon reactor. International inspectors are thrown out.

2003 – The North makes claims it has enough

plutonium to make a nuclear bomb.

2005 – The North claims it has built nuclear weapons for self defense.

2006 – North Korea tests nuclear weapon.

2007 – Pyongyang commits to disabling three nuclear reactors. Talks to formally end the war.

2008 – President Lee Myung-bak inaugurated in the ROK. North-South relations deteriorate sharply: North test fires short range missiles, accuses President Lee of sending navy across border.

2009 – **(January)** North accuses Seoul of “hostile intent”. **(April)** North launches long range rocket, walks away from “six-party talks”. **(May)** North says it is no longer bound by 1953 truce. Carries out underground nuclear test. **(June)** U.S. journalists sentenced to 12 years hard labor. North responds to sanctions threats, claiming them as an “act of war”. **(August)** Bill Clinton negotiates the release of the U.S. Journalists; tensions ease.

2010 – South Korean warship, Cheonan, sinks after explosion, killing 46 soldiers. The South officially accuses the North of firing a torpedo from a mini sub, sinking the ship. Kim Jong-il accuses the south of declaring war. President Lee orders trade of any kind to be suspended, closes South's waters to Northern cargo vessels,

threatens to fire on any vessel that enters the South's territories.

(Source: [BBC News Timeline](#))

Most who understand the issues, including Korean citizens, will explain that provocations of violence followed by denial from DPRK leadership in the North, are nothing new on the Korean peninsula. However, it's quite obvious that the combination of nuclear weaponization and more frequent aggression from the North, have led the global community to react to the Cheonan incident more urgently than in previous altercations.

The **Korea Economic Slice on KBC** is produced by [Korea Business Central \(KBC\)](#) and independent analyst [Robert Eberenz \(DS Market Research\)](#), President).

Offering a comprehensive weekly financial outlook, from macro-economic, geopolitical, and technical analysis perspectives, this report provides readers with real time, objective market analysis "from the ground" in the Republic of Korea.



the Bank of Korea's target inflation rate of 3.0%.

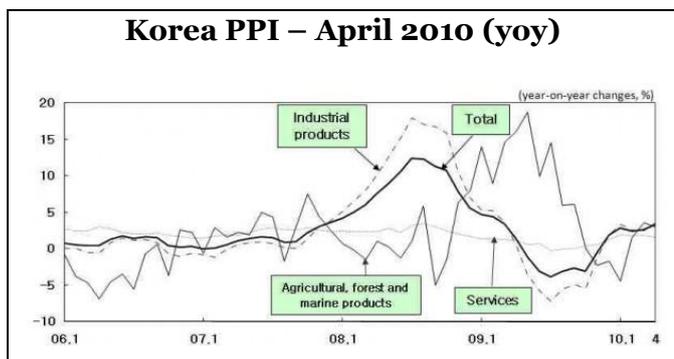
Also on **Tuesday**, we'll get data on the state of the labor market in Korea from the *May Employment Report*. Unemployment has come down from its peak of 5.0% in January 2010 to a still historically high 3.8% in April. In addition, Korea's participation rate in the labor force is at 61%, or 23.7 million workers and climbing, which has concerned economists as domestic household spending and credit have been slow to recover.

Reviewing the data from PPI and the Employment report leads us

into the third important economic story of the week ahead, the *Bank of Korea's (BOK) core rate announcement* on **Wednesday**. The BOK has maintained its interbank lending rate target at 2.0% for 15 consecutive months, and will surprise investors if they make any decision to raise the rate. With inflation below target and unemployment still at recessionary levels, the BOK will almost certainly make no moves here.

Economic Data

Crucial economic data concerning the Republic of Korea in the coming week will begin on **Tuesday**, with the *May Producer's Price Index (PPI)* report. In April the report showed prices paid by producers for basic materials rose by 0.8% from the previous March, translating to a 3.2% year over year (yoy) inflation rate for producers. Industrial products had been dragging prices towards negative growth, but the deflationary environment has ended with the recent rise in both industrial products and agricultural products prices. (Click Image for Full Size...)



It is interesting to note that the *Consumer Price Index (CPI)* report for May already reported that finished goods prices slowed to a **2.3% yearly rate**, from 2.5% in April, perhaps foreshadowing a cooling in PPI on Tuesday. The CPI is below

Investing Implications

Economically, the recent announcements made by President Lee to cut off trade to North Korea change virtually nothing for the South. However, recent feather fluffing, in the form of threats from President Lee and Kim Jong-Il, do increase financial risk premiums tied to all ROK investments in foreign investors' eyes.

While the risk of all-out-war is remote, the ramifications of war on Korea's sovereign debt and corporate equity would be astronomical. Therefore, increased uncertainty over the balance of peace between the two Koreas is directly reflected in the prices of assets in the ROK.

The chart below depicts recent fluctuations in Korea corporate equity investments represented by the KOSPI. (Click Image for Full Size...)



Full size image @

<http://www.diamondslice.com/wp-content/uploads/2010/06/KOSPI-06-02-10.jpg>

By inspecting recent trading action in the KOSPI we can draw several conclusions about the fate of Korean equity investments.

First, we can see that the KOSPI broke below its 200 day moving average (MA) for the first time since April 2009, as did many other global equity indexes, on fears of war with the DPRK and sovereign default contagion stemming from Greece and the EU.

After breaking below the 200 day MA, the KOSPI then found support at the crucial 1550 level, which has now been a reversal point for the index five times in the past twelve months.

Since the KOSPI bottomed at 1550 it has charged right back towards its 200 day MA at 1646, where it last closed at 1630. At 1630, the relative strength index (RSI), which measures the price momentum of financial vehicles, now reads a neutral 48.42 and suggests that investors tread cautiously should the KOSPI fail to break the 200 day MA at 1646.

*All in all, the global debt markets are facing off with Kim Jong-Il to mix one stiff cocktail of uncertainty for Korea investors. Internationally, bond auctions for China Real Estate groups are **drying up** while U.S. investors are now demanding 1.1% higher yields for Goldman Sachs **10 year bonds**, just two months after identical debt was issued in March. This worldwide trend towards higher priced debt is now combining with increased geopolitical risk on The Peninsula, given the altercations surrounding the sinking of the Cheonan ROK vessel, and in our view will lead to increased volatility for the Korean Won, Korea Bonds, and the KOSPI in weeks ahead.*

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