The Korea Economic Slice on KBC (Vol. 1.6)

An Exclusive Report from Korea Business Central and DS - Financial Market Analysis

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In the past nine months we've heard talking heads question the growth and now "overheating" of China's economy, which until Tuesday had compelled only a bleak market response. Now, it seems that the fate of China is far less certain, given a major revision lower of leading economic indicators, combined with price pressure from labor costs and currency exchange risk. In the U.S., equally dire foreshadows were seen in the June Consumer Confidence Report. Opposing the negative developments in Asia and the U.S., Korea released optimistic Consumer Sentiment and Industrial Production reports last week. The optimism in domestic fundamentals mixed with global roadblocks marks a hard line for the Bank of Korea to balance ahead of the central bank meeting on Thursday, July 8. This week we'll examine how weakness in China and the U.S. would affect Korea, and dissect Seoul's interest rate policy moving forward.

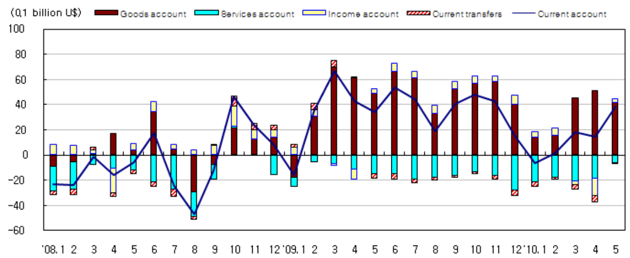
Korea's Export Market

Despite the best efforts of KOSPI investors to hold strong on the heels of the recent rally, Korean stocks sold off on Tuesday, June 29, due to economic fundamental reports from the U.S. and China. According to Bloomberg,

"The benchmark ***Kospi index*** *post[ed] one of only two gains among the 20 biggest equity markets last quarter."*

While it's important to respect markets' voices and realize that asset prices across separate exchanges trade in tandem during times of duress, it is equally crucial that investors grasp the magnitude of trade actually occurring between the U.S., China, and Korea.

Let's first look at the expandable chart below…



From the visual, we can tell that Korea has resumed the strong current account (trade) surplus, represented by the blue trend line, which we also witnessed throughout 2009.

Breaking down the May numbers, it becomes clear that China represents Korea's largest export destination, at 9.63 billion USD, followed closely by Southeast Asia, the E.U., and the U.S., who imported 8.26, 4.26, and 4.17 billion USD of Korean goods respectively.

Digging a bit deeper into the data you find that Korea has trade surpluses with all four of the previously mentioned trade partners, and that the export growth in China and the U.S. grew at 45.2% and 46.1% year over year rates in May. Given the fact that last year, China and the U.S. represented $86.7 and $37.6 billion USD worth of exports, or a total 13.4% of Korea's 2009 GDP, it's clear that the issues abroad have direct implications on the Korean economy.

We can now see that positive growth in Korea's strongest export economies has lead the charge to 40.6% yoy export growth in May. Will this growth continue and at what pace?

Can the KOSPI charge onward and upward through difficult economic data from the U.S. this week? Perhaps, but likely not…

Bank of Korea: Rate Policy

On June 24, the Wall Street Journal reported,

"South Korea's government revised its GDP growth outlook to 5.8% this year, from 5% earlier, prompting economists to push forward forecasts for rate increases by the Bank of Korea…"

So far, India, Malaysia and Taiwan have all raised their benchmark rates, causing many analysts to put Korea next in line.

The Bank of Korea meets next Thursday, July 8, to discuss its interest rate policy and will be increasingly pressured to announce some form of policy moving forward; whether it be a rate change or simply stronger rhetoric.

The core rate in Korea has maintained the 2.0% threshold for 16 consecutive months and is facing a difficult decision. The economy is recovering much faster than Japan, and in more sustainable fashion than China's 11%+ GDP estimates, drawing inflation hawks to the table that demand for a bit of quantitative easing to be removed.

The most recent and notable sign of hot growth in Korea came via the Industrial Output report last week. In May, industrial output again increased, by a yearly 21.5% compared to a 20.1% yoy rate in April. On a monthly basis, the May level was 2.6 higher than April and well above economists' estimates.

Following the announcement, Bloomberg wrote,

"***Lim Ji Won***, *an economist at JP Morgan Chase & Co. in Seoul, said ahead of the report 'We need to normalize rates from super low to low.'"*

What had been holding the Bank of Korea from making a concerted decision to raise rates, and what muffled the inflation hawks temporarily, were signals that domestic demand in Korea was slipping. However, last week we saw that this trend may be shifting.

The June Consumer Sentiment Index reported a headline 112, up from 111 in May, and well above the breakeven 100 mark. Breaking down this leading indicator report, we can see that the main strength of the report was due to two point increases in the "current standard of living" and "expected changes in household income" sections.

The "spending plans" and "domestic economic situation" portions of the report also gained one point each in June, bringing those components to 112 and 104 readings respectively.

The average interest rate on consumer loans decreased 0.10% to 5.74% from the prior month as the yield on household deposits decreased by a lessor 0.8%. This narrowing of bank spreads and decrease in borrowing costs to consumers will be seen as a positive catalyst for future domestic spending and will make it more difficult for the Bank of Korea to keep its benchmark at 2.0%.

The KOSPI has correctly reflected strong positive growth in exports and domestic consumption over the past several months, fueling the dramatic yearly and monthly acceleration in industrial production. If Korea can continue to foster domestic spending and simultaneously benefit from demand in China, Southeast Asia, Europe and the U.S., there will be nothing to fear for Korean equity investors for some time to come. However, the threat of inflation resulting from overly loose monetary policy at the Bank of Korea and forward indications of *difficult times ahead in its major export markets may take an equally negative toll on stocks. In a perfect world Korea could maintain a low rate policy until domestic demand became self sustaining, independent of the situation abroad, but alas we do not live in such a world. Should global markets continue their descent, the KOSPI and publicly traded shares will likely fall with them, offering speculators an opportunity to buy if they believe the Korean miracle can "keep on giving."*

Chart and economic data compliments of Bank of Korea ECOS Statistics system…