February 8, 2023

Korea: Slowing Growth & Sticky Inflation

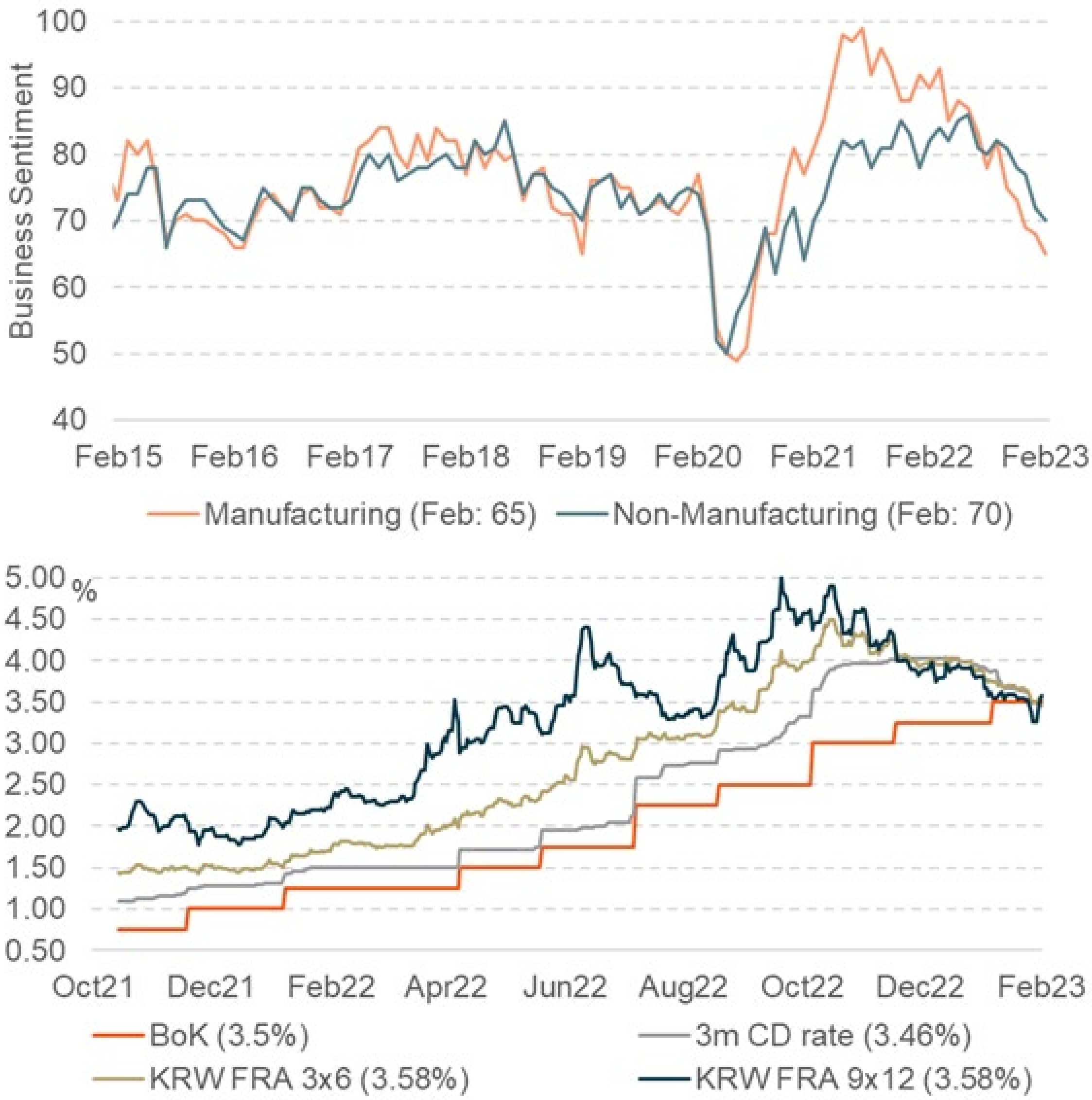
Growth data for South Korea continued to disappoint over the past month. Exports decelerated further, -16.6% y/y in January, weighed on by ongoing woes in tech: semiconductor exports collapsed to -44.5% y/y, the lowest level since January 2009. Imports showed no signs of recovery either, posting a second consecutive negative y/y reading, at -2.6% y/y. Combined, this resulted in staggering trade deficit of $12.7bn in January, which is more than the $10.7bn cumulative trade deficit for the first half of the 2022. The near-term outlook for the trade account is bleak given the global growth slowdown, plus high base effects skewing data for both exports and imports.

The pessimistic outlook is echoed by the latest business survey data. South Korea’s manufacturing PMI posted its seventh monthly contraction in January, coming in at 48.5. Similarly, the February Business Sentiment Index for manufacturing dropped to 65, the bottom of the range, excluding the COVID-related period in early 2020. The non-manufacturing sector, which played a strong supportive role over the past two years, has also started to crumble: February non-manufacturing index at 70 after averaging 81 in 2022. Adding to macro woes is the decline of house prices: -1.8% y/y in December, the lowest since early 2005. This, along with elevated household debt, continues to be the top risks to financial stability, in our view.

Slowing growth and peaked-but-elevated inflation have prompted a dovish shift in the Bank of Korea's (BoK) stance. Note that the BoK in November forecast 2023 GDP at 1.7% and headline CPI at 3.6%, followed by GDP at 2.3% and headline CPI and 2.5% in 2024.

> ## *Tough H1 ahead with deceleration of trade growth. Jan exports -16.6% y/y (Jan22: 15.5%) imports -2.6% y/y (Jan22: 36.2%)*

Rising Rate-Cut Expectations In South Korea



Source: BNY Mellon Markets, Bloomberg L.P.

> ## *Sticky and elevated inflation a challenge*

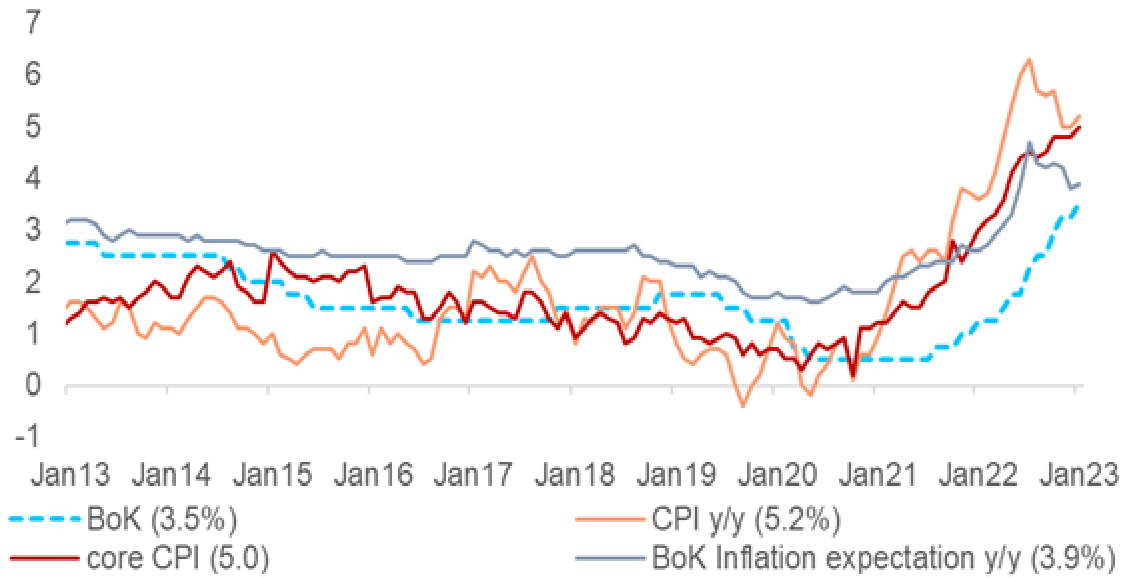
BoK's 3.50%-3.75% terminal rates views

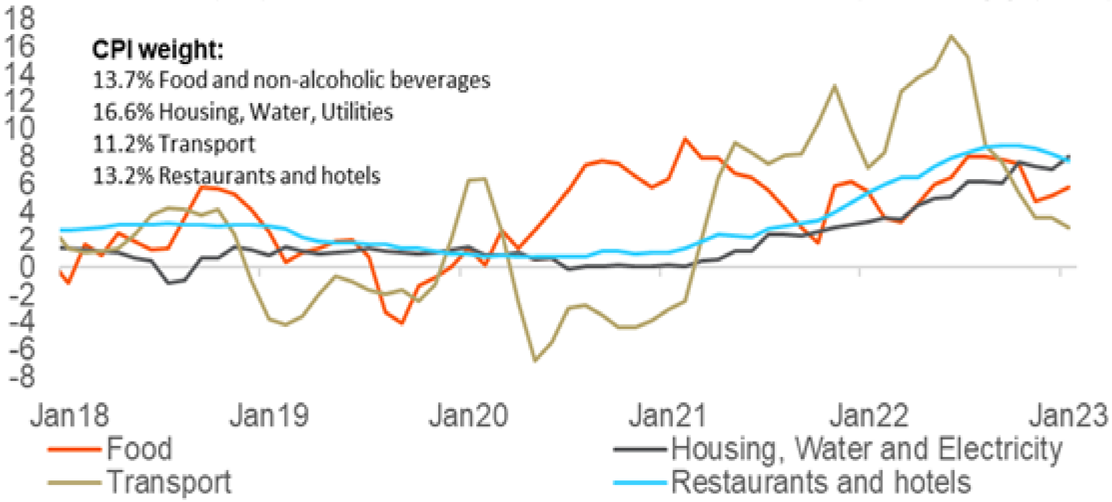
The open discussion that terminal rates would be around 3.50%-3.75% essentially signals to the market that the BoK is at the end of its tightening cycle. The market has adjusted accordingly. For example, 3-month certificate of deposit (CD) rates are around flat against the BoK's base rate (3.50%). KRW 9x12 forward rate agreements (FRAs), or 3-month interest rates in 9 months, are also hovering around the base rate.

We would urge caution, however, were the market to aggressively price in a potential rate cut. After all, January headline inflation unexpectedly rose from 5.0% to 5.2%, and core inflation made new recent highs at 5.0% y/y. Looking at the breakdown, there remains strong upside momentum for the key contributing components, such as Housing, Water, Utilities (8.0% y/y, CPI weight: 16.6%), Restaurants and Hotels (7.7% y/y, CPI weight: 13.2%), and Food (5.8%, CPI weight: 13.7%). All those overshadowed the fast-declining Transports components, at 2.9% y/y (from 16.8% y/y last June). We believe that sticky and elevated inflationary pressure is likely to prevent the BoK from becoming more dovish. Indeed, it might present communication and forecast challenges and put credibility at risk.

Korea and APAC risk assets have started the year positively, taking advantage of China's reopening and growth optimism, as well as the weaker US dollar environment. iFlow data shows good inflow momentum in the equities space this year, after a long period of outflows in 2022. Given the weak macro outlook, however, we would be cautious and measured in our enthusiasm, as we think risks remains tilted to the downside for Korea.

Sticky Inflation A Challenge To BoK's Terminal Rates





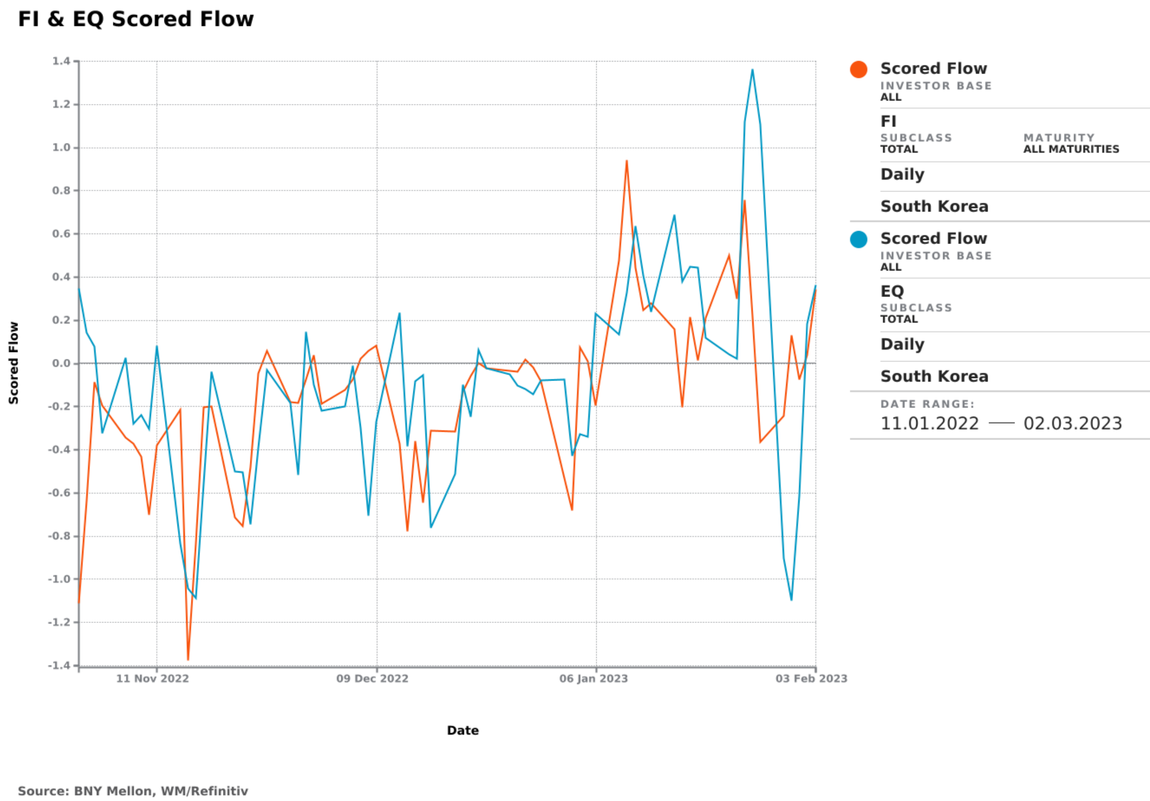
Source: BNY Mellon Markets, Bloomberg L.P.

iFlow shows buying of Korean equities and bonds since the beginning of the year

iFlow shows persistent inflows into Korean equities since the beginning of the year. This is in sharp contrast to the outflows trend in 2022. Similar increasing demand is seen in the fixed income space (both government and corporate bonds). Note that corporate bonds suffered a period of outflows in Q4 2022 on the back of domestic corporate credit-related stress.

That said, flows in the currency remain one-sided: selling. iFlow has recorded only three positive average weekly scored flows since last August. KRW scored holdings are below 2 standard deviations and the 1-year average, the most underheld levels since Q3 2018 and within APAC. That KRW scored holdings remain firmly underheld despite renewed demand for both equities and fixed income could be motivated by investors' hedging demand.

iFlow Shows Korea Equity And Bond Inflows



Source: BNY Mellon Markets, Bloomberg L.P.

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