BNY MELLON

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MACRO MORNING BRIEFING

May 23, 2024

Korea Assets Yet To Reflect Growth Rebound

Growth in South Korea's economy rebounded strongly in Q1, with GDP at 1.3% q/q and 3.4% y/y. The solid recovery was supported by the manufacturing sector (6.6% y/y gains for the past two quarters), as well as by a turnaround in the services sector, where growth edged up to 2.1% y/y after five-consecutive quarters of slowing from 4.4% y/y in Q3 2022. Manufacturing and services account for roughly 26% and 59%, respectively, of Korea GDP.

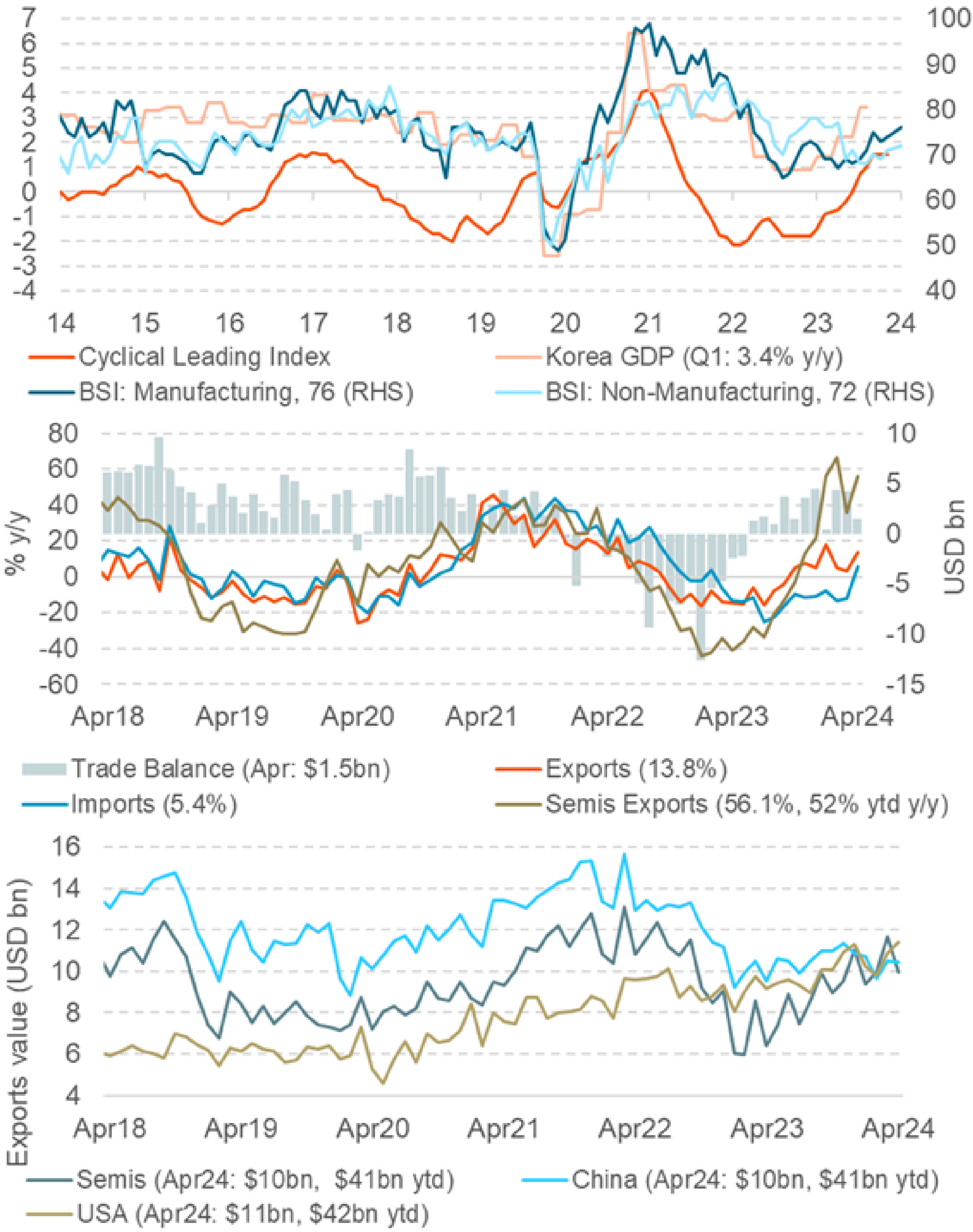
The recovery in exports, especially in semiconductors and automobiles, has been impressive and suggests a high likelihood of sustaining. April data (latest) shows exports up a strong 56% y/y, or +52% ytd y/y. The US has overtaken China as the top export destination since February this year. The recovery in sentiment has been broad-based. The Bank of Korea's May Business Survey Index shows month-ahead manufacturing business conditions up to 76, the highest since September 2022. Non-manufacturing conditions rose to 72 (May and June) after hovering between 68 and 71 since September 2023.

Signs of uncertainty in local equities in the wake of April's legislative election – landslide victory for opposition Democratic Party – proved short-lived. A net drawdown of $1.2bn worth on the part of foreign investors over the two weeks following the election was followed by over $2bn worth of inflows over the subsequent four weeks. Foreigners' net investment in South Korea equities tallies to $15.3bn year-to-date, significantly more than the $4.1bn of net foreign investment into Taiwan equities and in sharp contrast to foreign net selling of $3.1bn of India equities. Cumulative holdings of listed stocks in Korea amount to KRW 802trn, representing 28.9% of market capitalization as of April 2024. That's rebounded steadily from 26.4% in 2022 and 27.4% in 2023, but still below the 33% high at end-2019.

We will continue to monitor progress of the “corporate value-up program”, which aims to support a virtuous cycle of capital market growth. The efforts of the government and other authorities to maintain financial stability (discussed below) are also important factors for market sentiment and asset valuations.

Bank of Korea (BoK) in its May Economic Outlook released last Thursday revised 2024 GDP growth higher, to 2.5% from 2.1% previously, while keeping its headline and core inflation forecasts unchanged at 2.6% y/y and 2.2% y/y, respectively. GDP growth for 2025 was revised lower, to 2.1% from 2.3%, with inflation that year projected to drift down towards 2%. BoK's confidence on growth is driven by stronger momentum in exports and better-than-expected consumption, which BoK does not see affected by upward price pressures.

Exhibit #1: Korea Export Growth & Business Sentiment



Source: BNY Mellon Markets, Bloomberg L.P.

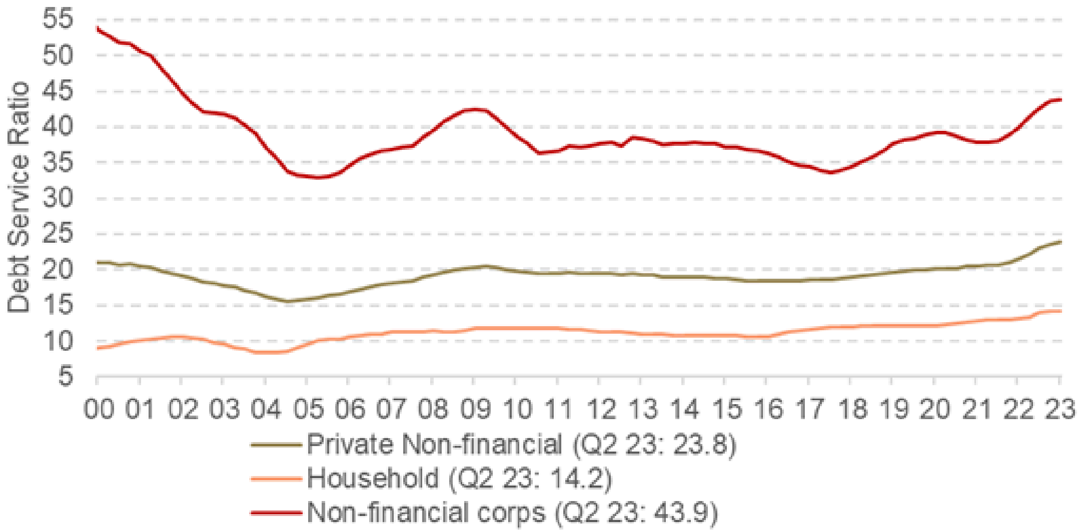
Despite strong economic growth and a recovery in the technology sector, Korea asset valuations have been lagging APAC peers. The KOSPI is +2.6% year-to-date, near the bottom quartile in APAC and far behind the 20% year-to-date gain in the TWSE. Among APAC currencies, KRW is the second-worst performer, -5.5% year-to-date, ahead of only THB, -5.9%. What could explain the lacklustre relative performance of the currency?

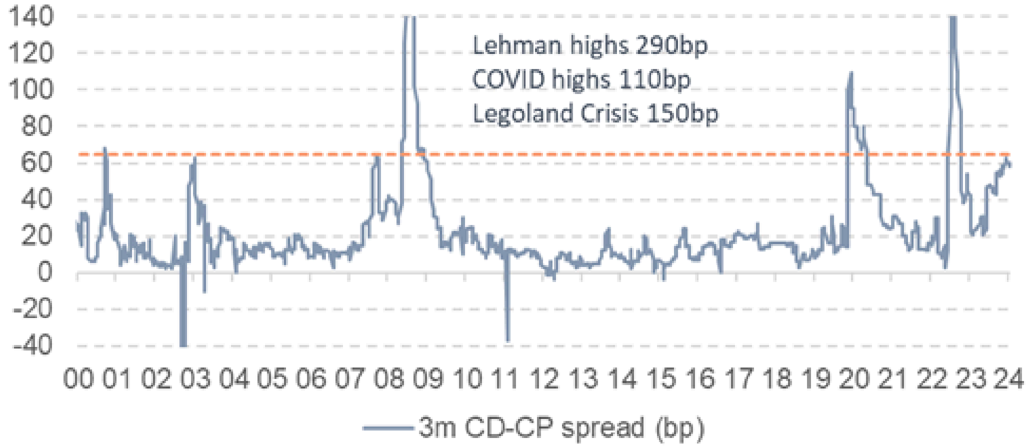
Frequently cited drivers include depreciation of the yen, interest rate differentials, and higher oil prices, which impact Korea's terms of trade via higher import costs. We, however, don't think those alone or together fully justify depressed KRW valuation considering growth momentum and substantial portfolio inflows. We suspect market concerns around financial stability might be contributing, as well. This likely includes the expansive 2024 budget with a consolidated fiscal deficit (including social security) at -1.9% of GDP vs. -0.6% of GDP in 2023. Korea's debt-to-GDP ratio could also be playing a part: it's risen above 50% for the first since 2023, to 50.4%, and is projected to rise to 51% this year and onto 53.0% by 2027.

High indebtedness is often cited as a structural issue in South Korea that needs to be addressed. Project finance-related debt issue is a hot topic, triggered by struggling real estate projects. According to Bloomberg, the total outstanding of project-finance related debt amounted to $170bn as of the end of 2023, or around 2.8% of total financial sector assets. To be sure, we do not foresee this leading to a systemic crisis. We do, however, suggest paying close attention to any signs of corporate funding stress, using the 3-month Commercial Paper (CP) fixing as an indicator. Three-month CP rates have eased from 4.25% in Q4 2023 to 4.18% this quarter (averages) but have been widening versus 3-month Certificate of Deposit (CD) rates. The 3m CP-CD spread had widened from lows of 20bp in Q4 2023 to 58bp at present. That's not as extreme as the 100bp+ spread during COVID-20 or the Legoland crisis in Q4 2022 but is nonetheless historically high.

Another good indicator to follow is the BIS's debt-service ratio (DSR), which is defined as the ratio of interest payments plus amortisations to income. As of Q2 2023, the latest available data, Korea’s DSR for non-financial corporates accelerated to 43.9 (Q2 23: 39.9), the DSR for private non-financial sectors was 23.8 (Q2 23: 21.5), and the DSR for households was 14.2 (Q2 23: 13.2). All three were on upward trajectories a year ago.

Exhibit #2: Corporate Funding Stress & Debt Service Indicators



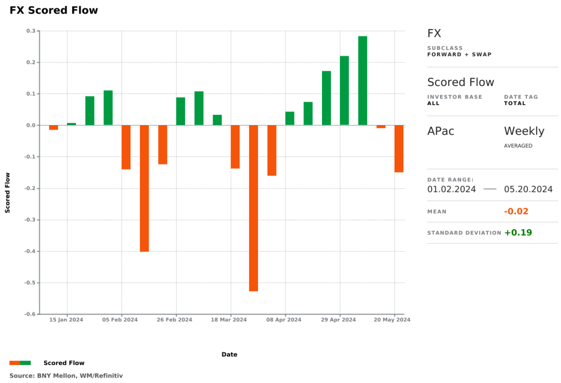


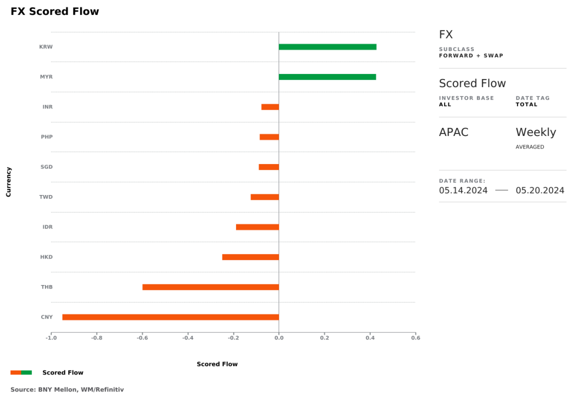
Source: BNY Mellon Markets, Bloomberg L.P.

iFlow shows accelerated outflows from APAC FX over the past week, after a series of strong of inflows since the beginning of April. Individual currency flows were mixed: the most outflows from CNY and THB, weekly average scored flows of -0.96 and -0.60, respectively; and a fifth consecutive week of inflows into KRW. THB scored holdings rewidened to -1.62 and profitability dropped sharply, to 0.74% from nearly 2% at the end of April.

Among APAC assets, investor flows towards China equities remain weak: fifth week of selling despite the strong rally in domestic markets. India equities were sold the most while Malaysia and Taiwan equities were in demand. The highlight in bonds was renewed selling of Indonesia sovereigns. Interest in China sovereign and corporate bonds was muted.

Exhibit #3: APAC FX Outflows, Most From CNY & THB





Source: BNY Mellon Markets, Bloomberg L.P.

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