

Macro Brief – The Korea Puzzle

“Some are more equal than others.” - George Orwell, Animal Farm

Higher Risk Premium Expected

Since the attempted martial law by the embattled President Yoon, whilst promptly dismantled by the democratic mechanisms in place, risk premium for Korean assets have drifted higher. This is no surprise.

But Highly Differentiated Discount

But the seeming puzzle is that the so-called Korea discount* varies significantly across asset classes. This profound differentiation shows up as starkly more pronounced “Korea discount” (correspondingly more acute risk premium) in Korean equities, yet almost indiscernible for Korean bonds (where spreads remain tight).

Index Inclusion

It is tempting to attribute this wedge in risk premium to the inclusion of Korean bonds in the global bond index (WBGI) in contrast to Korean equities being omitted from the parallel equities index (MSCI). We are sympathetic but not sold (on this argument).

Not the Arbiter of Risk

Point being, at best, index inclusion provides reinforcing feedback loops and some “stickiness” of funds. Whereas, it is not the overriding determinant of risk premium. Instead, the prevailing geo-economics uncertainties and political fissures are. And on those accounts, risk re-pricing across is not an unreasonable expectation. At least on account of uncertainty.

Puzzle vs. (Risk) Profile

Whereas, the more entrenched equities-bond risk premium wedge (that predates the martial law attempt) may merely reflect inherent differences in risk profiles/exposures of the asset classes.

Beyond “Going Concern”

Admittedly, the baseline for both (equities and bonds) is the going concern risk. In other words, the survivability of the underlying entities associated with the assets (equities and bonds). But beyond that, it boils down to the difference between the ability/willingness to service debt (bonds) versus the ability to extract value created (equities).

Bonds - Neither Stirred Nor Shaken

And with regard to the promptly defused martial law attempt, confidence in Korea’s (corporates and sovereign) ability and willingness to pay is not shaken. Especially as cash flows (and the equivalent current account of the sovereign) appear largely unfettered. Moreover, the relative attractiveness of liquid Korean paper alongside onshore liquidity chasing these Korean bonds mean that rich valuations have hardly stirred.

Equities - “Value Up” Wavers

In sharp contrast, equities are subject to the risk of greater risk premium. Notably, the “Corporate Value Up Program” is likely to have taken a hit, as nascent progress on diminishing the “Korea discount” is squandered, and the path to catch-up in valuations likely retarded.

Policy Dilution

For one, the distractions of ousting Yoon amid fragile government and fragmented politics is likely to dilute and delay policy efforts to boost equity valuations.

Politics-Business Power Balance

Crucially, the lamentable state of politics could shift the power balance in favour of large and influential conglomerates, at the expense of legislators ultimately trying to rebalance the (share) ownership-executive control of Korean corporates. And insofar that this is arguably one of the leading causes of the “Korea discount”, it gets harder to shake it off.

Geoeconomics Realities & Trade-Off

Finally, the reality of the current state of fraught global geoeconomics is that it gets harder to break up huge conglomerates with disproportionate market power (and risk concentration). Point being, there is a shallow but compelling, fear-driven argument that good governance (including checking the sway and size of conglomerates) may be a geopolitical impediment. So, the short-term trade-off between governance and geoeconomics can further impede the path to realizing “locked” value in Korean equities.

China Risk Proxy

This over and above the more direct China risk exposure of many Korean corporates. Diversification attempts are of course underway. But vulnerabilities remain conspicuous. And the nature of this risk is that it may impact potential for value realisation (and hence, forward-looking equity values) far sooner than it will immediate cash-flows (that support bonds).

Bond-Equities Divergence a Feature, Not Bug

Hence, the divergence in discount/risk premium of Korean equities and bonds is a feature that can persist rather than a bug set for imminent convergence. Crucially, this may co-exist with the prevailing climate of more elevated political uncertainty.

KRW - Accentuated Downside Risks, But Not Entrenched Discount

How about the risk re-pricing of the currency then? This is somewhere between the equities and bonds. There is far greater (downside) sensitivity to political risk premium in the KRW. But equally, the risk premium is not as entrenched as the “Korea discount” in equities. And so we expect enlarged vulnerability to downside volatility in coming months but not without scope for a more pronounced recovery as well when the political uncertainty in Korea subsides. And potential for KRW buoyancy later in 2025 may be boosted if we are right about US tariff threats (on China) is a case of the bark being worse than the bite.

* Refers to discernibly, in some cases very significantly, lower relative valuations via-a-vis comparable peer assets.

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