Economics

DBS Flash

KRW Rates: Overshooting

Strategy/Rates

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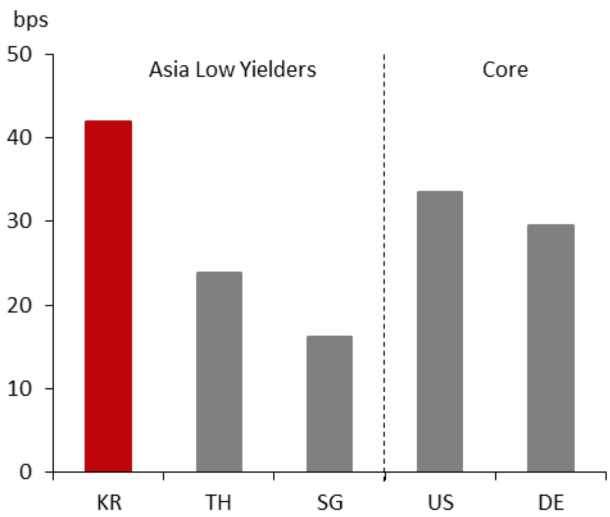
- *Markets appear to be bringing forward expectations of a bottoming in Korean economic activity.*
- *High beta to US-China trade outcomes and rich valuations have driven a large sell-off in Korean rates.*
- *Investors likely took off their long KTB hedges, reinforcing the sell-off.*
- *No clear turnaround in economic data yet. KTB yields may be overshooting.*
- ***Implications for investors** - Stay light on duration, given the volatility in US-China talks.*

Since talks of a phase one US-China deal surfaced in early October, the reaction in Korean rates has been sharp and outsized. To put into perspective, Korean Treasury Bonds (KTBs) have sold off more than core bonds (USTs/Bunds) and far more than Asian peers. In our view, **KTBs underperformed because of a combination of 1) highest beta to US-China trade outcomes and 2) quite rich valuations in the months prior.**

Change in 10Y yields since phase 1 talks

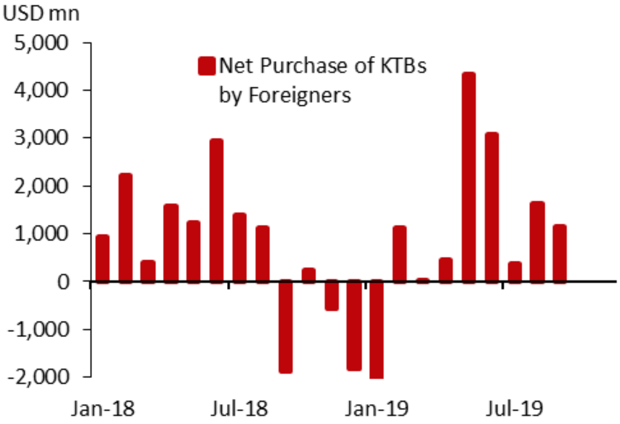


Source: Bloomberg

The extent of weakness in Korea's economic data have been considerably worse than Asian peers due to its high exposure to global growth and semiconductor cycles (trade dispute with Japan was a drag too). When **sentiments recently improving around US-China** and **markets bringing forward their expectations of a bottom in Korean economic activity**, heavily pinned-down KTB yields were always likely to see a bigger rebound vs yields elsewhere.

Technical factors were likely at play too. We hear of investors going long KTBs (and short KRW) as a hedge against global trade wars, downside risks to China growth, and lower CNY. When headlines started hinting at a China-US phase one trade deal, some of those hedges were likely taken off, reinforcing the surge higher in KTB yields and KRW.

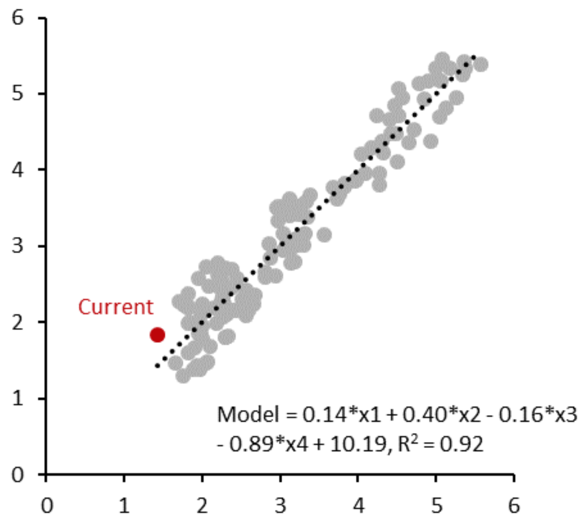
Foreign demand for KTBs was especially strong in the escalation months of May-Aug'18, May'19 and Aug'19



Source: Financial Supervisory Service, South Korea

In the short term, we think KTB yields may be overshooting on the way back up. To be sure, we have **yet to see a clear turnaround in Korean economic data.** For example, exports have been declining for 11 straight months with the latest October print (-14.7% YoY) the lowest in almost four years. Based on a regression model against a number of economic, financial and positioning variables/drivers (x1 - China manufacturing PMI, x2 - Korea CPI, x3 - 3M Korea CD, x4 - Non-comm 10Y UST futures position), we find that current 10Y KTB yields may be as much as 30bps too high. There could be tactical long opportunities if 10Y KTB yields close in on the 2% level.

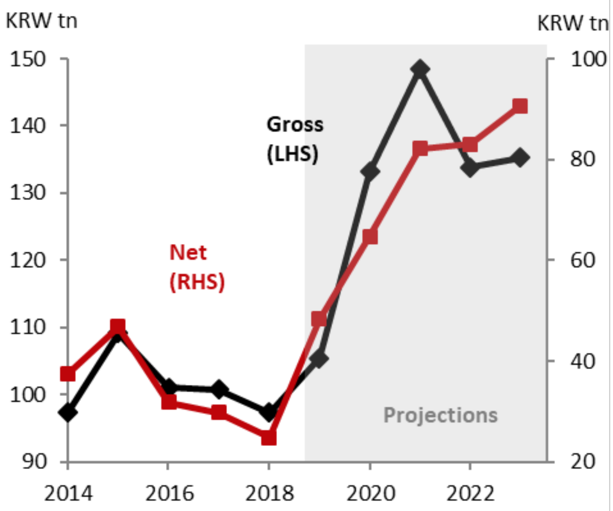
10Y yield - Actual (y-axis) vs Model (x-axis)



For now, **KTBs will likely continue to be primarily driven by the trajectory of US-China trade talks** and yields can overshoot further if we get more positive headlines. Considering the likely volatility and the start-stop nature of negotiations thus far, **we prefer to stay neutral on KTBs and advise light positioning on duration.**

We are monitoring the prospects of more expansionary budgets in the coming years (supply risks). Based on the 2020 Budget proposal (link), fiscal deficit is expected to increase from 1.9% to GDP in 2019 to 3.6% in 2020. From 2021 to 2023, government spending is estimated to rise at an average rate of 5.6% per year. As a result, government debt could climb from 37.1% to GDP in 2019 to 46.4% in 2023. Working off those parameters, our projections show that both gross and net issuances could increase considerably in the coming years. Yearly net issuances could jump from a KRW25-50tn range (2016-2019) to a much higher KRW65-90tn range (2020-2023 projected).

Yearly issuances could rise quite materially.



Source: Ministry of Economy and Finance

Based on several indicators, we think the recent upward move in KTB yields was largely due to positive US-China headlines, rather than the prospects of larger issuances ahead**. If markets start to price for greater supply risks, steepening pressures should intensify on the curve** and we would expect KTBs to underperform other Asian low yielders such as Singapore and Thailand government bonds.

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Sources: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations).