

FX Insight

KRW - Room for Gains but Pace to Moderate

Risk Sentiment Remains a Key Driver of KRW

Recent development in Korea peninsular and KORUS FTA adds to the list of macro-fundamental factors underpinning broad KRW strength: (1) synchronised global economic recovery continues to bode well for Korean exports, benefitting trade-dependent currencies such as KRW; (2) signs of pick up in inflationary pressures leading to room for BoK to tighten monetary policy in 2Q-3Q; (3) broad USD decline underpinned by macro trends helping to amplify gains in KRW. But we caution that general risk sentiment remains fragile amid an escalation of US-China trade war tensions. This could counter against the other positive factors mentioned-above. In addition we are also wary of leaning against the wind activities to temper or slow the pace of gains in the currency. Our study on sensitivity of currencies to changes in risk sentiment (proxied by MSCI World Index) and sensitivity of respective sovereign (local currency) bonds to changes in 10Y UST yields shows that KRW and Korea sovereign bonds are highly vulnerable to equity sell-off and rise in UST yields.

Fair Value for USDKRW at 1090

Our fair value model which takes into account the relative differentials in interest rates, inflation, current account and a deflation proxy variable (defined as the change in the ratio of MSCI World index to JPM Global Aggregate Bond Index) estimates USDKRW at around 1090 levels. This suggests that the current level of spot KRW (vs. USD) is about 3% overvalued relative to our fair value estimate but the current spot remains within the fair value range estimates (+/- 1 standard deviation).

Interim Rebound Risk for 1m USDKRW NDF

1m USDKRW NDF was last seen at 1058 levels. Key area of support remains at 1050 - 1055 levels. Decisive move below this support is required for further downside play towards 1040 levels to materialized. That said we observed that price action on the weekly chart shows a falling wedge pattern potentially forming. This is typically associated with a bullish reversal in the near term. Rebound risks not ruled out in the interim. Resistance seen at 1064, 1075 and 1089 levels. We look for opportunities on any up-move to fade into.

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Recent Development on Trade and Geopolitics - A Positive for KRW

Most recently (30 Mar), the visit by President Xi's special envoy Yang Jiechi to Seoul to meet President Moon was seen as a big step forward in terms of China-S.Korea relations. Yang as special envoy to S.Korea this could was a strong message that China is committed to improve relations. He was sent in a government's capacity as President Xi's special envoy and he also hold important appointments as the head of the Chinese party's Central Foreign Affairs Commission general office and is a member of the 25-seat decision-making Politburo.

In particular Yang promised Moon to expect "visible accomplishments" in the near future on issues relating to resumption in sending group tourists from China to South Korea, resolve Lotte's difficulties in China (i.e. facilitating sales of Lotte marts in China, resuming the construction of Lotte Town in Shenyang), subsidies for electric cars with Korean batteries, help reduce fine-dust pollution from China, etc. Yang even proposed to launch a joint environmental research and cooperation center as early as possible to address the worsening air quality in S. Korea (believed to be partially caused by China).

Recall that early last year, relations between China and S.Korea were strained following the latter's decision to deploy US THAAD. In response, China had banned the sale of package tours to S.Korea while broadcast of Korean entertainment was banned on public Chinese television. Imports of Korean cosmetics were also banned last year.

Improvement in bilateral ties could help to reverse Korea's services account deficit. Chinese tourists accounted for about half the revenue of South Korean hotel chains, cosmetics companies, and duty-free shops. Resumption of Chinese tourist arrival and spending could further extend its current account surplus (currently in its 72nd consecutive month).

Recent visit (25 - 28 Mar) by North Korea leader Kim to Beijing and willingness to hold summit with US is a strong commitment to denuclearization. Plans are underway for South and North Korea to hold a summit on 27 Apr while talks are ongoing for a North Korea-US Summit to be held before end-May 2018. Summit agenda is expected to be centered on denuclearization of Korea peninsula and efforts to improve relations between the two Koreas. We believe this should help to ease geopolitical tensions further and support gains in KRW in the broader term.

Separately last week, it was announced that US have reached an agreement in principle with South Korea on the bilateral KORUS FTA. This came slightly earlier than expected amid rising trade war tensions between US and China. Two concessions were given by South Korea in return for being exempted from the global steel tariff imposed by US - (1) allow US automakers to export 50,000 cars to Korea per year, up from 25,000 currently; (2) while Koreans limit their annual steel exports to US to 70% of its past 3 year average. A revised KORUS FTA that is concluded earlier than expected should be supportive of sentiment and KRW. But we note that the revised deal has not been signed as Trump is considering a postponement of the signing until after the Washington-Pyongyang talks (which is expected to be sometime in May). Delay here may pose temporary downside pressure on KRW.

Escalating US-China Trade Tensions Affect Risk Appetite

While the outlook for KRW is expected to brighten up as geopolitical tensions and trade war fears recede, we stay cautious as general risk sentiment remains fragile amid an escalation of US-China trade tensions, UST yield curve compression (2y10y UST yield spreads narrowed to lowest levels of +47 in more than 10 years, a pre-cursor to elections) and whether stock sell-off seen past days have legs (S&P 500 testing below 200 DMA).

On US-China trade front, there appears to be tit-for-tat responses from both countries. China announced (1 Apr) import tariff on 128 American products worth around US\$3bn, in retaliation to US's import tariffs on steel and aluminum.

Subsequently (4 Apr), US proposed imposing 25% import tariff on a range of Chinese-made high-tech products worth about US\$50bn. The list of items includes lithium batteries, medical devices, communication satellites, etc. amongst the list of about 1,300 items.

In response with the same proportion, scale and intensity, as promised by China, the Ministry of Commerce said that China will levy 25% reciprocal tariffs on a range of US imports worth about \$50bn. The list of items includes planes, soybean, automobile and chemicals, etc. amongst the list of about 106 product types.

However we note that these tit-for-tat responses from US and China on imposing import tariffs are yet to be finalised or implemented. Quiet negotiations are probably underway. US Commerce Secretary Wilbur Ross said that the US is not entering a World War III and left the door open for a negotiated solution. Trump Administration is urging China to lower tariffs on cars and open its market to US financial services as part of talks to resolve a rise in trade tensions. In the event that trade tensions ease further, risk sentiment could turn around and that could support risk-on proxy trades, including KRW.

Escalating Trade Tensions Weigh on Risk Appetite



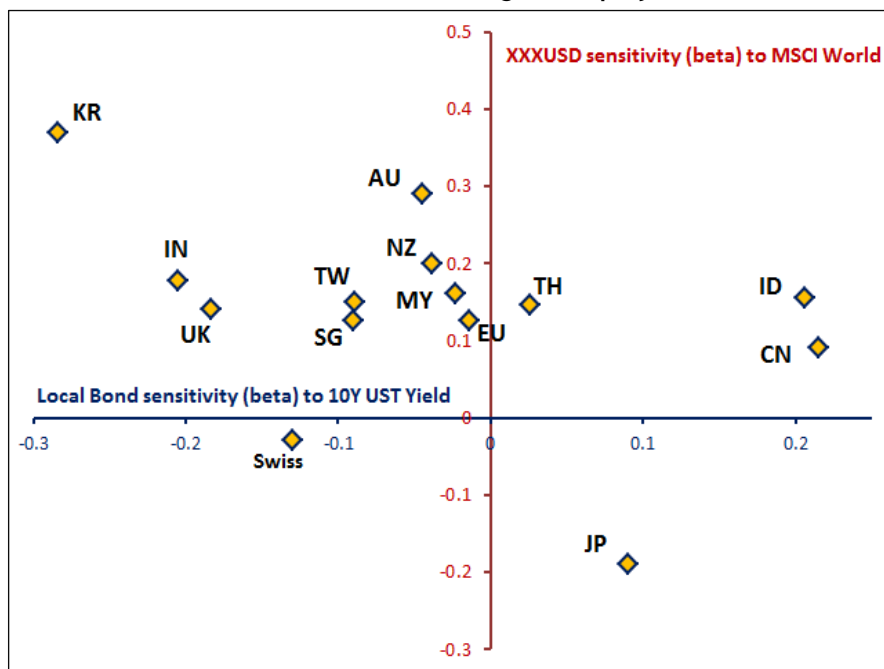
Source: Bloomberg, Maybank FX Research & Strategy

Sentiment is a Major Driver of KRW

Our study on sensitivity of currencies to changes in risk sentiment (proxied by MSCI World Index) and sensitivity of respective sovereign (local currency) bonds to changes in 10Y UST yields shows that **KRW and KR sovereign bonds are highly vulnerable in the event of equity sell-off and rise in UST yields**. In this environment, long JPY and CHF are preferred.

That said if risk sentiment improves (i.e. equity rises), KRW and AUD typically benefit, given its relative high betas.

KRW and KR Bonds Most Sensitive to Changes in Equity and UST Yields



Note: Matrix is constructed based on the coefficients in regression of currencies changes against the USD on MSCI World Index (y-axis) and coefficients in regression of respective local currency sovereign 10Y bonds on 10Y UST yields (x-axis) over the sample period of past 1 year (4 Apr 2017 to 4 Apr 2018) using daily data frequency

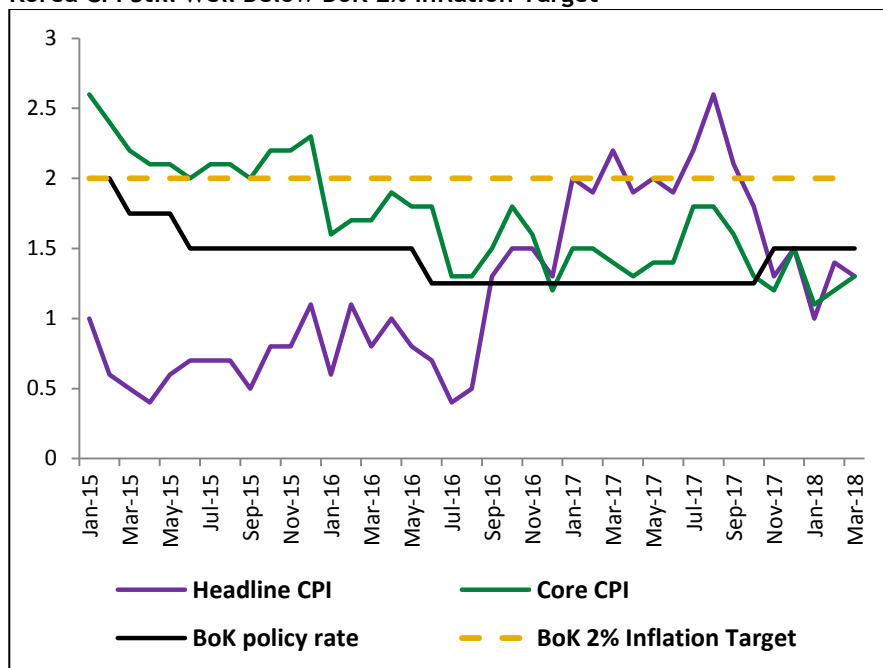
Source: Bloomberg, Maybank FX Research & Strategy

BoK Rate Hike a Possibility in 2Q-3Q 2018

We retain our view for BoK to keep policy rate on hold at 1.5% at the upcoming meeting on 12 Apr. Though inflation rebounded in Feb to 1.4% from 1% in Jan (due to jump in fresh food prices on winter season), inflation remains below BoK's 2% target.

This leaves room for BoK to monitor further data flows. We are still expecting BoK to raise policy rate by another 25bps in 2Q-3Q 2018 from 1.5% if demand-induced price pressures picks up pace amid reacceleration in growth momentum. We believe BoK is monitoring if inflationary pressures from the demand side picks up. Minimum wage will increase by 16% this year, its largest magnitude of increase since 2001. Wage pass-through may have positive impact on consumption spending, growth and lead to inflationary pressures.

Korea CPI Still Well Below BoK 2% Inflation Target



Source: Bloomberg, Maybank FX Research & Strategy

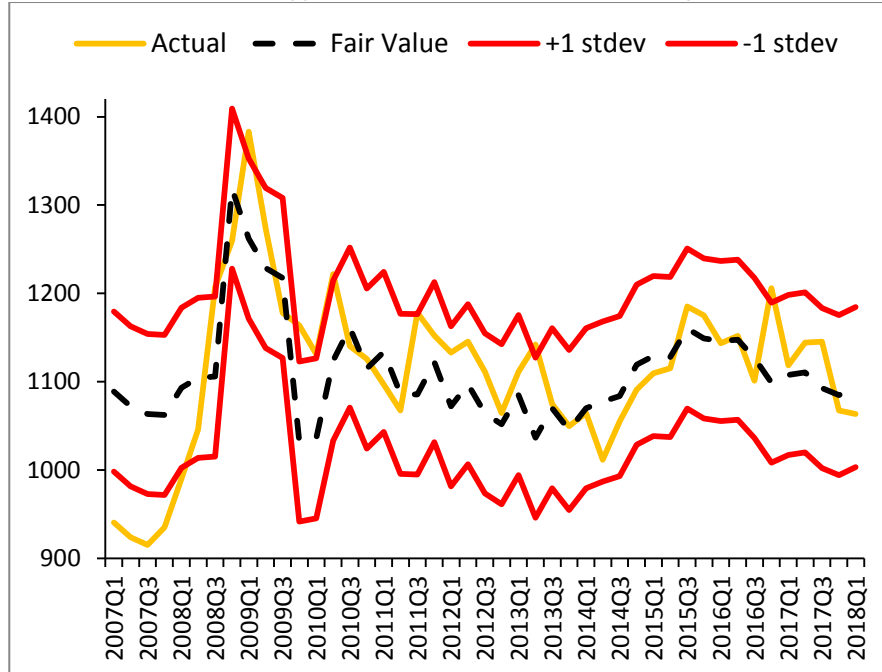
While the surprise contraction in 4Q GDP was the worst result (-0.2% q/q vs. +1.4% in 3Q) since 4Q 2008, the decline was due to fewer work days and base effects. Strength in consumption and government spending was overwhelmed by slowdown in car exports and construction. That said Korea economy expanded 3.1% for 2017, its fastest expansion in 3 years. For 2018, BoK still expects the economy to grow by 3% subject to global demand for memory chips and other manufactured goods.

Room for KRW to Extend Gains but Pace to Moderate

The outlook for KRW is expected to brighten up as geopolitical tensions and trade war fears unwind further. Key area of support for USDKRW at 1050 - 1055 which we believe will be a challenging support to break. We caution that a decisive move below could trigger more downside play for the pair. Recent development in Korea peninsular and KORUS FTA adds to the list of macro-fundamental factors underpinning broad KRW strength: (1) synchronised global economic recovery continues to bode well for Korean exports, benefitting trade-dependent currencies such as KRW; (2) signs of pick up in inflationary pressures leading to room for BoK to tighten monetary policy in 2Q-3Q; (3) broad USD decline underpinned by macro trends helping to amplify gains in KRW.

But we caution that general risk sentiment remains fragile amid an escalation of US-China trade war tensions. This could counter against the other positive factors mentioned-above. In addition we are also wary of *leaning against the wind* activities to temper or slow the pace of gains in the currency. Verbal intervention remains a key risk to watch. Most recently on 3 Apr, Finance Ministry officials warned that authorities will take stern measures in case of excessive movements in currency.

Fair Value Estimates Suggest USUDKRW is Within the Range Estimates

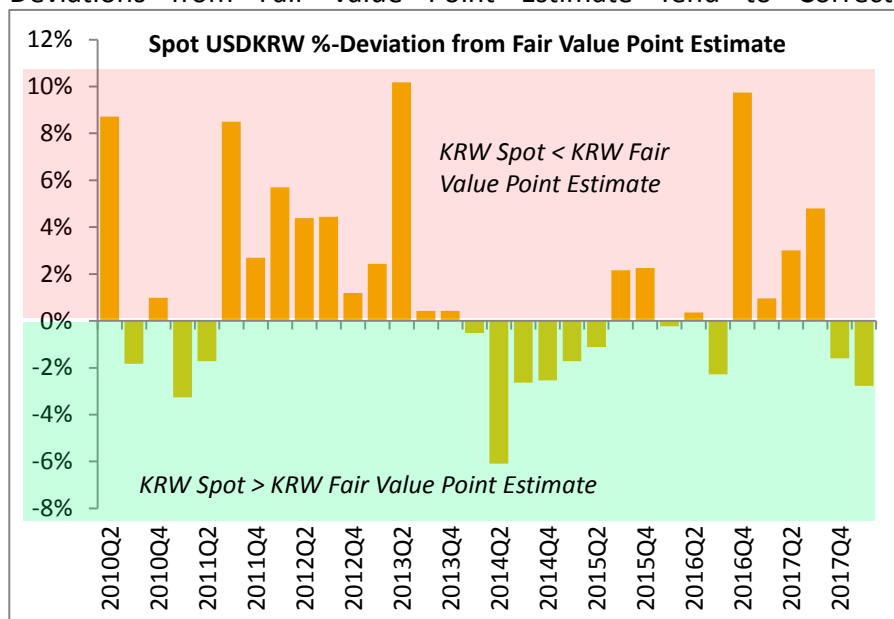


Source: Bloomberg, CEIC, Eviews, Maybank FX Research & Strategy

Our fair value model which takes into account the relative differentials in interest rates, inflation, current account and a reflation proxy variable (defined as the change in the ratio of MSCI World index to JPM Global Aggregate Bond Index) estimates USDKRW at around 1090 levels.

This suggests that the current level of spot KRW (vs. USD) is about 3% overvalued relative to our fair value estimate but the current spot remains within the fair value range estimates (+/- 1 standard deviation). Moreover short term deviation away from fair value point estimate is not uncommon and tends to correct.

Deviations from Fair Value Point Estimate Tend to Correct



Source: Bloomberg, CEIC, Eviews, Maybank FX Research & Strategy

1m USDKRW NDF (Weekly Chart): Near Term Rebound Risks

Pair has traded lower MTD, but move lower appears to have lost some momentum. Last seen at 1058 levels. Key area of support remains at 1050 - 1055 levels. Decisive close below the area could trigger further downside play towards 1040 levels. That said we observed that price action on the weekly chart shows a falling wedge pattern potentially forming. This is typically associated with a bullish reversal in the near term. Rebound could target 1064, 1075 and 1089 levels. Our bias remains to sell on rally.



Source: Bloomberg, Maybank FX Research & Strategy

SGDKRW (Daily Chart): Signs of Upside Risk in the Near Term

Cross was last seen at 806 levels. Shorter term technical suggests the risk of rebound. Resistance seen at 815, 821 levels (200 DMA). Bias remains to fade. Key area of support to watch at 790 - 800 (which have previously served as strong support in 2015, 2017 and 2018).



Source: Bloomberg, Maybank FX Research & Strategy

MYRKRW (Weekly): Signs of Bullish Momentum Waning

Cross was last seen at 274.20 levels. Underlying momentum remains bullish as indicated on monthly charts but shorter term momentum and stochastics indicators suggests risks of moderation. Pullback could revisit 270, 266 levels. Resistance at 280 remains intact. Bullish trend channel formed since early-2017 remains intact.



Source: Bloomberg, Maybank FX Research & Strategy

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