



Theme #10: Yen up and be koreageous – Buy JPY/KRW, USD/KRW

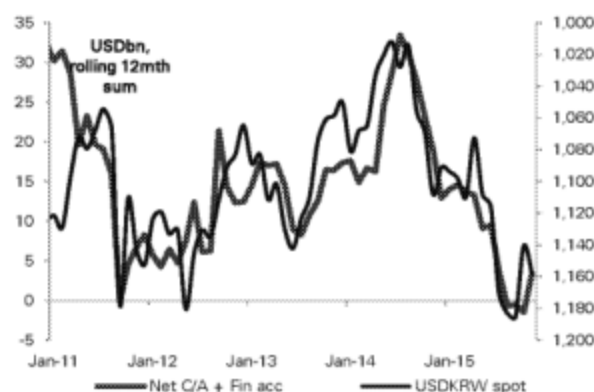
For years, the market has been wary of pushing for KRW weakness, given Korea's sizeable balance of payments surplus. However, the era of sizeable surpluses is over. We expect the recycling of the current account surplus via domestic capital outflows to pick up pace this year, driving USD/KRW higher. The thinning out of the BoP surplus will in general make the won more susceptible to the global risk environment. The change in flow dynamics also has ramifications for the domestic rates market. The increasing supply of duration associated with the prospect of portfolio outflows should translate into a steepening bias given already inverted yield differentials between the long-end KTB and UST curves.

For years, the large current account (CA) surplus Korea possesses helped partly insulate the won from the strong USD environment. Although the currency started to depreciate more notably in 2015, KRW performance has been in line with that of the region. However, the tide is turning, and we believe the won can depreciate more forcefully, for two main reasons.

First, DB Economics expects the CA surplus to shrink to around \$97bn in 2016 from \$121bn in 2015, driven by two factors; 1) slowdown in import compression; and 2) the ongoing slowdown in exports. Note that over the past few years, the widening of the current account surplus has been driven mostly by falls in commodity prices – most notably oil prices (peak to trough, oil prices have declined by 45%).

Second, the recently-announced measures to encourage outflows will also likely play a key role in further recycling the CA surplus, tilting the balance of payments towards a deficit, or neutral at a minimum. These channels can be categorized broadly as; 1) promoting overseas portfolio investment; 2) a change in the overseas investment mandate for National Pension Service (NPS); and 3) encouraging overseas mergers and acquisitions. In our view, the measures could be more effective this time around compared with 2007. Back then, and despite the sizeable portfolio outflows by domestic investors, the high FX hedge ratios had countered the impact on FX of domestic outbound investment. This time around, however, the government has explicitly stated that FX gains on equity investment are to be exempted from tax. On the bond side, over the past few quarters we have seen a strong pick-up in overseas bond investments by lifers in search of higher returns (see chart), which in our view will persist. Similar to equity, FX hedging on these flows is likely to gradually reduce. As of the start of 2016, NPS is now allowed to reduce its FX hedge ratio on overseas bond investment by half in 2017 and to nil in 2018. This profound change will also likely be followed by domestic lifers.

Sizeable surpluses that kept KRW on an appreciation path until late 2014 are no longer the case



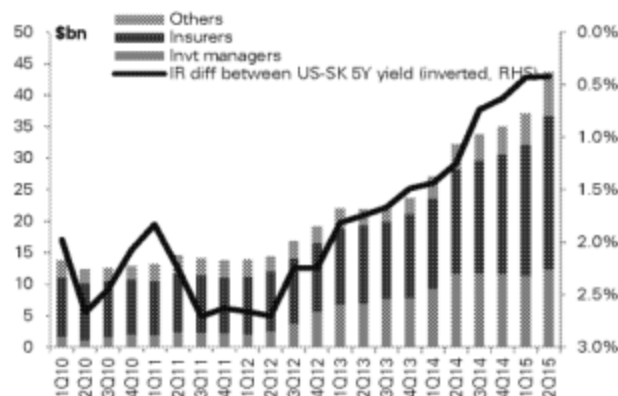
Source: Deutsche Bank, Bloomberg Finance LP, Haver Analytics, CEIC

In 2007, the strong portfolio outflows were neutralized by active hedging activities, which is unlikely this time



Deutsche Bank, Bloomberg Finance LP, Haver Analytics, CEIC

Falling domestic bond yields are pushing more investors to diversify offshore



Source: Deutsche Bank, Bloomberg Finance LP, Haver Analytics, CEIC, Ban of Korea