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Investing for a world of change

Global Macro Insights

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South Korean rates – an opportunity presented by the global rates sell-off

When allocating capital to government bonds with a medium-term horizon we believe it's best to focus on defensive markets that are facing structural headwinds to growth and inflation and should therefore see yields biased lower through time as monetary policy progressively adjusts to support the economy. South Korea is one such economy; it faces structural challenges which threaten to lower the nation's nominal growth rate and deliver deflationary domestic forces.

Structural dynamics

The first structural headwind that Korea faces is demographics. Birth rates in Korea are now the lowest in the world, falling below even Japan whose population has been in outright decline for over a decade. The Korean birth rate has been on a downward trend since the 1960s and, as a result, the working age population began to decline in 2019, with the total population now also on the cusp of moving into outright contraction (Figure 1). Korean demographics are set to play catch-up with those of Japan by 2050, with the total population expected to contract by 9% between now and then. And why does this matter? Simply put, nominal GDP is about how many people an economy has working and how productive they are. Economic growth is then driven by adding more people to the workforce and / or increasing the productivity of workers. With a smaller population, it falls on productivity to pick up the slack and ensure that economic growth is maintained. If productivity increases are unable to offset the population declines, then GDP growth will stagnate or decline, and the economy will struggle with broader deflationary forces.

Such deflationary forces became evident in Japan in the 1990s when working age population growth began to decline. In the case of Japan, we saw core inflation decline from a 5-year average of 2% in 1996, when working age population peaked, to outright deflation of -0.5% 10 years later (Figure 2), which they have struggled to shift higher ever since despite aggressive monetary support.

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Figure 1: Korea working age and total population growth

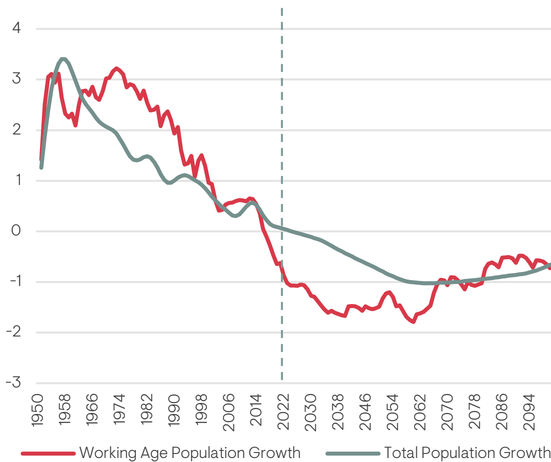
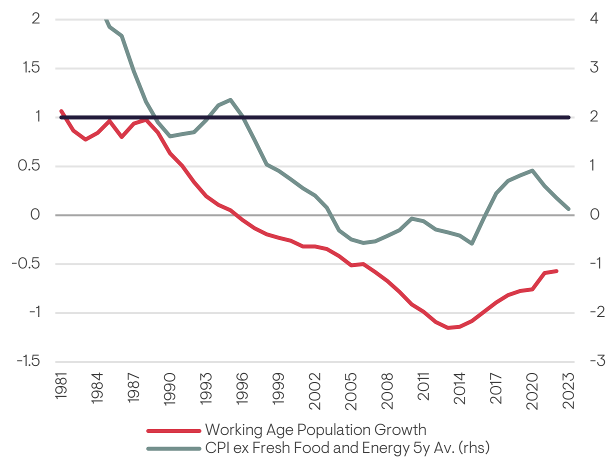


Figure 2: Japan working age population growth vs. CPI



Source: Ninety One, United Nations, Bloomberg 31 March 2022.

In addition, as individuals move toward and into retirement their propensity to consume declines, as they begin to run down debt (deleverage) and conserve savings to ensure they have sufficient spending power throughout retirement. This brings us to the second major structural headwind facing Korea – household debt.

Korean households have been in a leveraging cycle since the 1990s. Aggregate household debt has now risen to over 100% of GDP or 170% of household disposable income (Figure 3), to become one of the highest in the world. The use of debt is effectively bringing forward future demand because, at some point, it has to be paid back. While an economy is leveraging, aggregate demand is higher than that associated with incomes, and when an economy is deleveraging aggregate demand is supressed because people are no longer borrowing money and buying goods. They are paying down debt and consuming at the level below that associated with their incomes. Such a dynamic took place in the US in the decade post the Global Financial Crisis. As Korea's population ages further and moves into decline it is increasingly likely that the economy will shift from a leveraging to a deleveraging cycle, placing downward pressure on both growth and inflation.

An estimated 94% of this debt is linked to housing loans, which themselves are ultimately tied into the housing market whether through mortgages or Jeonse[1] leasehold loans, inexplicitly tying consumer wealth to the health of the housing market and interest rates. As interest rates rise and debt service costs increase (Figure 4), the proportion of incomes that can be spent on broader consumption and growth shrink. Hence, as the Bank of Korea continues through its interest rate hiking cycle, it runs the risk of initiating a deleveraging cycle, given the current demographic inflection point.

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[1] Jeonse is a rental contract within Korea by which the tenant exchanges up to 50-70% of the total property value to be returned in full at the end of the tenancy. Loans for these lump payments are available from financial institutions.

Figure 3: Household debt to disposable income ratios

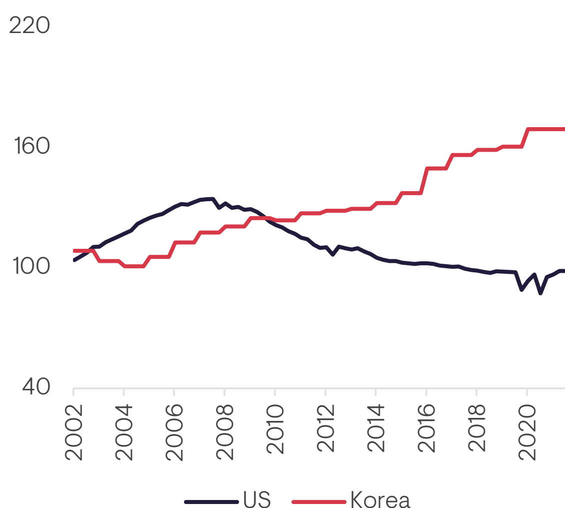
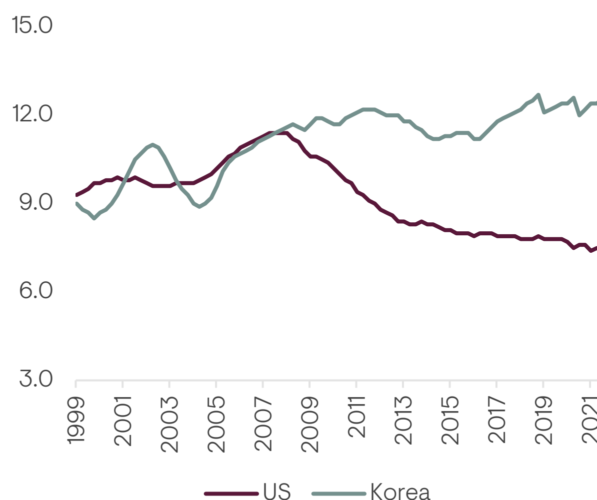


Figure 4: Household debt service ratios (% disposable inc)



Source: Ninety One, Bloomberg, 31 March 2022.

Putting these structural factors together, the United Nations World Population Prospects forecast that the Korean working age population will continue to decline by an average of -1.3% annually over the next 20 years, while trend productivity has historically been in the region of 1.0-1.5% p.a. The sum of these will drive real GDP growth, with additional productivity gains in the future being required to produce a positive outcome. Nominal growth can advance more strongly due to inflation, but any initiation of a deleveraging cycle, coupled with demographics, will leave the economy struggling to meet the Bank of Korea's inflation target of 2%, as has been the case in Japan. As a result, we estimate that trend nominal growth will likely be between 1-2% p.a. over the next decade and, when we consider that longer-dated bond yields in defensive markets tend to anchor around trend growth rates, there appears to be a clear opportunity with Korean government bond yields being above 3% today.

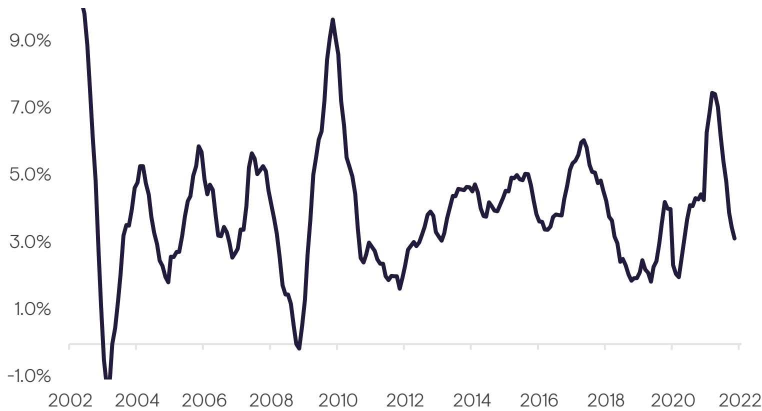
Cyclical dynamics

Having outlined the structural dynamics in Korea, it is our belief that structural opportunities should not be fully engaged until cyclical dynamics begin to align. This is because markets can detach from longer-term fundamentals for sustained periods. So why do we think now is the time to begin engaging this structural view and to buy South Korean rates?

By hiking rates in July 2021, the Bank of Korea was one of the first central banks to implement interest rate hikes in the aftermath of the global pandemic, reacting to the global economic boom which saw a surge in demand for Korean exports, notably electronic components and goods, as well as very strong domestic growth as the economy opened up. This strong demand backdrop alongside global supply constraints and higher energy prices also drove inflation above the central bank's 2% target to the highest level in over a decade. These dynamics have led the Bank to take rates from 0.5% to 1.5% as of April 2022.

However, there is reason to believe that the drivers that have supported tightening are now beginning to turn. One of the key drivers of demand over the past 18 months has been the strong external backdrop, however, the impact of higher prices on real incomes globally, as well as the weakness in China from tightening credit and renewed covid restrictions, are beginning to filter in to demand for Korean exports where recent readings have pointed to a slowing. Indeed, recent domestic data has also begun to slow reflected in the Korean government's leading indicator for growth (Figure 5). Whilst inflation data has provided some comfort that, when external price pressures from high commodity prices fade inflation should fall back towards target.

Figure 5: Statistics Korea leading composite index – 12m change



Source: Ninety One, Bloomberg, 31 March 2022.

Household credit growth has also been exceptionally strong over the past 18 months, with house prices rising 25% since the onset of pandemic. Not only did this influence the central bank's decision to hike interest rates but has also led to the implementation of macro prudential policies, notably the tightening of debt service ratio limits by the FSC (Financial Services Commission). Korea's highly leveraged consumer and housing market means that there's a high sensitivity to changes in the cost and availability of credit. We are now beginning to see the impact of tightening in the domestic lending data, which further risks weakening the domestic growth backdrop in the coming months.

Figure 6: Household lending year-on-year (%)

Source: Ninety One, Bloomberg, 31 March 2022.

This shifting backdrop has led to a more balanced tone from the Bank of Korea, who although highlight the need for a further removal in policy accommodation to ensure inflation remains well anchored, has begun to note that any weakness in growth could lead the Bank to act more cautiously. Indeed, recent comments from the governor noted there is a "trade-off" between inflation and economic growth which reduces the central bank's room to manoeuvre, and as a result it is his belief that policy rates will not have to be taken to restrictive levels as slowing growth is likely to put a ceiling on inflation pressures.

It is our view, that the long-term growth headwinds outlined, notably declining population growth as well as the high level of indebtedness, mean that the level to which policy rates can rise without causing a significant growth slowdown remains low. We currently believe that this level is around 1.5-2.0% compared to a current policy rate of 1.5%, with it likely to decline further in the future as potential growth declines. Despite this and the recent cyclical slowdown being evident, the bond market is pricing policy rates significantly above this level, with market expectations for rates to be hiked by a further 1.5% over the next 12 months to 3.0% and expected to average above this level for the next 10 years (Figures 7&8).

Figure 7: Bank of Korea base rate expectations (%)

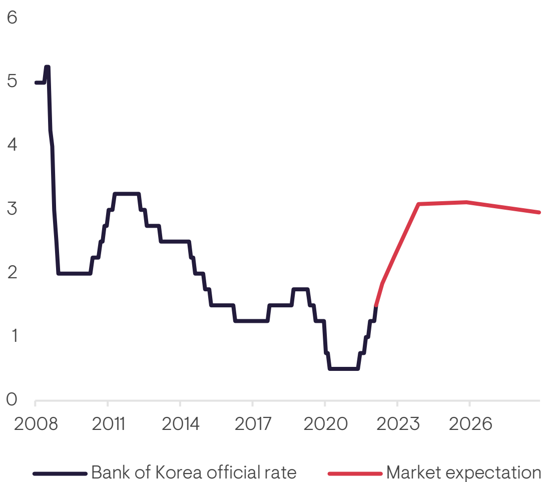


Figure 8: Korea government bond yields (%)

Source: Ninety One, Bloomberg, 31 March 2022.

We believe this backdrop creates an opportunity for capital appreciation as fewer rate hikes are likely to be implemented relative to expectations, whilst also providing investors with a significant income buffer given elevated rate expectations and a high absolute level of yields.

As a result of this aligning of structural and cyclical factors, coupled with attractive valuation, carry and roll, we have been buying both Korean 3-year and 10-year government bonds across portfolios. The risk to our view is a continued repricing higher in global bond yields driven primarily by the US Federal Reserve who may be forced to take interest rates significantly tight to restore price stability. However, we believe that with Korean rate expectations already priced above that of the US and with a very different cyclical and structural fundamental backdrop, the risk premium available compensates investors for this risk.

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