

TIME TO CONSIDER KOREA HEDGED EQUITIES

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The Korean won has been on a tear as one of best-performing emerging-market currencies in 2014.¹ And this has the Korean government and central bank officials worried that the rising Korean won is eroding the competitiveness of Korea's exports. While the currency has grown stronger, Korea's equity markets have lagged other emerging markets this year, partly impacted by the currency's strength. • Korea exhibited a [price-to-earnings \(P/E\) ratio](#) below that of the [MSCI Emerging Markets Index](#).² • **Japanese Yen Factor:** We have discussed Korea as a market focused on the weakening of the Japanese yen and a country most likely to take retaliatory actions to stem the relative currency strength of the won. • **New Appointment Catalyst for Change:** A new finance minister, Choi Kyung-hwan, took office in July, and some believe that his bias is to policies that accelerate economic growth. This could entail more aggressive intervention to stem the currency gains.³ • If the won were to stem or reverse its recent appreciation, [currency-hedged](#) Korean strategies could come into greater focus. **Rare Currency Warning** The Wall Street Journal published "South Korea Issues Rare Warning on Currency Surge" on July 2, 2014. This article described a message released jointly by the Bank of Korea and the finance ministry that reflected concerns "about the possibility of overly one-sided moves among market participants".⁴ These concerns raise the possibility that the central bank will begin to intervene to stem the won's gains. A chart of the Korean won versus the U.S. dollar from July 21, 2009 to July 14, 2014 (approximately the last five years) shows the won at levels close to 1,000 won per dollar, which is among the strongest levels observed in this period.



Source: Bloomberg, with data from 7/21/09 to 7/15/14. Past performance is not indicative of future results.

Another key currency [cross rate](#) is the Korean won versus the Japanese yen because Japan and Korea have many companies that export very similar, in some cases even substitutable, products. On this basis, Japan has become more competitive since the middle of 2012, when the won-to-yen rate was as low as 6.6. The rate has recently passed 10.1.⁵ **Korean Won vs. Japanese Yen, Last Five Years**



Source: Bloomberg, with data from 7/21/09 to 7/15/14. Past performance is not indicative of future results.

A comparison of equity-market returns between Japan⁶ and Korea⁷ over the last two years, measured in their local currencies, the yen and won, might offer evidence that the won's strength is affecting relative performance: Japan's equity markets are up almost 70 percentage points cumulatively, while Korea's equity markets are up only 6 percentage points. **Equity Market Returns, Japan vs.**



Source: Bloomberg, with data from 11/30/2012 to 6/30/2014, the start of the so-called Abenomics period through the end of the most recent quarter; past performance is not indicative of future results.

"NDELSKO Index" refers to the MSCI Korea Index with returns measured in Korean won. "TPX Index" refers to the TOPIX.

Korea

For definitions of terms and indexes visit our [glossary](#). Money has flowed into Japan on expectations that the Bank of Japan (BOJ) and government are taking coordinated actions to end [deflation](#) and reinvigorate Japan's economy. The weakening of the yen has been one factor supporting its markets. Korea's patience for won appreciation and pressure on its major exporters, especially in products that compete with comparable Japanese products, is facing a critical stress test. The joint statement by Korea's Ministry of Finance and the Bank of Korea shows that the run of appreciation for the won may be coming to an end. To that point, on July 15, there was a move in the won that many traders attributed to intervention from the central bank.⁸ I believe that the underperformance of Korean equities in recent years is creating a relatively attractive entry point, especially if the government and central bank were to take more aggressive action to weaken the won. This could be the time to start looking more seriously at Korean currency-hedged equities.

¹Performance measured against the U.S. dollar from 12/31/13 to 6/30/14. South Korean won trailed only the Brazilian real among currencies represented in the MSCI Emerging Markets Index universe over this period. ²Source: Bloomberg, as of 6/30/14. ³Jiyeun Lee and Eunkyung Seo, "Korea Rate Bets Undone as Choi Nomination Flags Growth Push," Bloomberg News, 6/18/14. ⁴Kwanwoo Jun, "South Korea Issues Rare Warning on Currency Surge," Wall Street Journal, 7/2/14. ⁵Source: Bloomberg, with the 6.6 value as of 6/1/12 and the value greater than 10.1 as of 7/3/14. Period chosen to encompass an environment that reflected the picture before Prime Minister Abe began to gain significant influence. ⁶Refers to the TOPIX as a measure of Japanese equity market performance. ⁷Refers to the MSCI Korea Index and the [KOSPI](#), both measures of the

performance of Korean equities. These are widely followed benchmarks of Korean equity performance.⁸Neil Dennis, "Korean Won Falls on Suspected Intervention," Financial Times, 7/15/14.

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Investments focused in Korea are increasing the impact of events and developments associated with the region, which can adversely affect performance. Investments in currency involve additional special risks, such as credit risk and interest rate fluctuations.

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DEFINITIONS

MSCI Emerging Markets Index : a broad market cap-weighted Index showing performance of equities across 23 emerging market countries defined as “emerging markets” by MSCI.

Currency hedging : Strategies designed to mitigate the impact of currency performance on investment returns.

Cross rate : synonymous with exchange rate, which tells the value of one currency in terms of another.

Deflation : The opposite of inflation, characterized by falling price levels.

KOSPI (Korea Composite Stock Price Index) : A market capitalization-weighted index built to measure the performance of all common shares on the Korean stock exchanges.