Emerging Insight

Korea treasury bonds – 'high-beta', yet favorable domestic backdrop

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GEM Fixed Income Strategy & Economics
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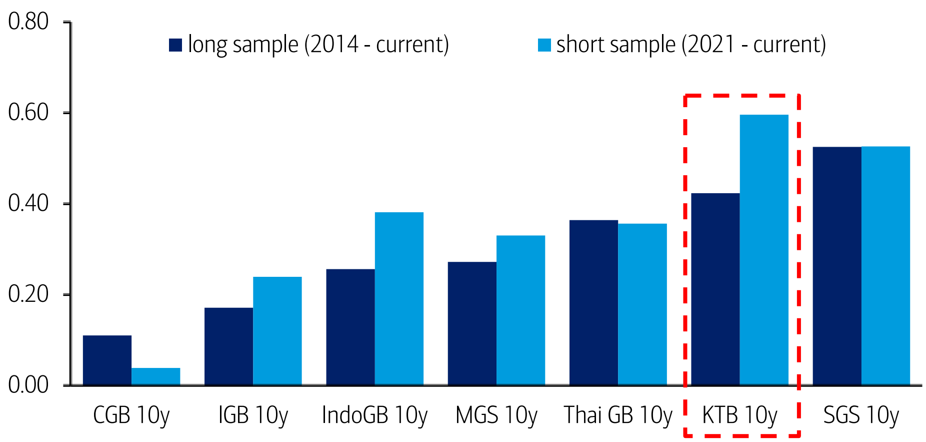
Key takeaways

- KTB's sensitivity to UST has increased, potentially due to higher foreign ownership and more synchronized inflation cycle.
- In the near-term, resilient US data may have spillover effect on KTB yield, but we are constructive over the medium term
- Domestic backdrop for KTB looks favorable - notable decline in net issuance and conservative market expectation on BoK cut.

By Janice Xue

Exhibit 1: EM Asia government bonds' beta coefficient on 10y UST
KTB and SGS have the highest sensitivity to changes in UST yields



Source: Bloomberg, BofA Global Research

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Korea in Focus

It is a well-known fact that Korea treasury bonds (KTBs) have a high sensitivity to movements in the UST markets. Comparing to previous Fed policy cycles, there has been a notable increase in KTB's sensitivity to UST during the March 2022 – July 2023 hiking cycle. We think there are two potential drivers behind that - increased foreign participation, and higher synchronization of inflation and monetary policy cycle. In the near term, resilient US economic data and potential further unwinding of Fed rate cut expectations may have spillover effect on KTBs, but we are constructive on KTBs over the medium term given favorable domestic factors: 1) fiscal prudence and less KTB issuances; and 2) market's conservative rate cut expectations on the BOK.

UST – US treasuries

CGB – China government bond

IGB – India government bond

IndoGB – Indonesia government bond

MGS – Malaysia government securities

Thai GB – Thailand government bond

KTB – Korea treasury securities

SGS – Singapore government securities

BoK – Bank of Korea

CD – certificates of deposits

CPI – consumer price index

MoEF – Ministry of Economy and Finance

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Behind KTB's high sensitivity to UST

Using weekly data covering the past 10 years (long sample) and 3 years (short sample), we calculated the beta coefficients on UST yields for major EM Asia government bonds. Not surprisingly, 10y KTB and 10y SGS have the highest sensitivity to changes in UST yields, while on the other end of spectrum, there is 10y CGB with a beta coefficient close to 0 in recent three years (Exhibit 1).

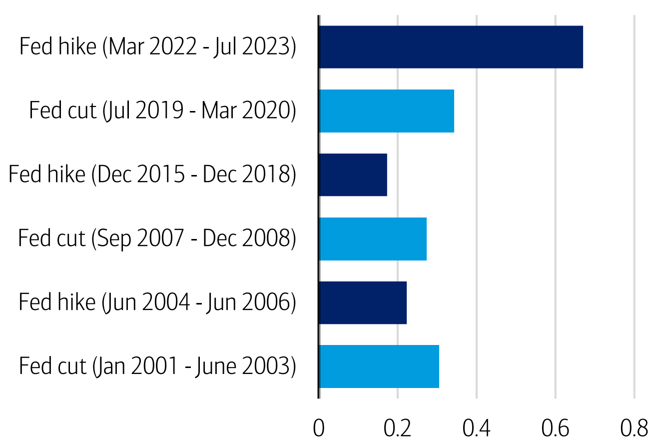
Zooming in to Korea, comparing to previous Fed policy cycles, there has been a notable increase in KTB's sensitivity to UST during the March 2022 – July 2023 hiking cycle (Exhibit 2). We think there are two potential drivers behind that: 1) increased foreign participation; and 2) higher synchronization of inflation and monetary policy.

- Firstly, foreigner investors' holdings of KTBs have been more than doubled from less than KRW100tn in Dec-2019 to KRW220tn, as of Dec-2023, boosting the foreign ownership share to close to 22%. Besides cash bonds space, foreign investors are also very active in the KTB futures market. According to a research paper published by Korea Capital Market Institute, foreign investors contributed 44% and 53% of the trading in 3y and 10y KTB futures during 2022.

- Another potential explanation for the higher sensitivity is the more synchronized inflation and monetary cycle in recent years. As shown in Exhibit 4, there is a strong co-movement trend between US and Korea headline CPI inflation since 2014. One can argue that it is mostly driven by volatilities in energy prices. But even if we turn to look at the core CPI inflation, the path also looked very similar, albeit less severe inflationary pressure for Korea vs US (Exhibit 5). Looking ahead, our economists expect disinflation trend to continue in both countries, suggesting continued synchronization in inflation and monetary cycle.

Looking at KTB moves in recent months, indeed it has been shadowing the moves of UST. 10y KTB yield declined by more than 120bp during the last two months of 2023. Since entering 2024, there has been some rebound but mostly the market has been range-bound. Our US rates team expect 10y UST to trade between 3.75%-4.25% in the near term and like to trade the range tactically with a long duration bias. In the near term, resilient US economic data and potential further unwinding of Fed rate cut expectations may have spillover effect on KTBs, but we are constructive on KTBs over the medium term given favourable domestic factors: 1) fiscal prudence and less net supply of KTBs; and 2) market's conservative rate cut expectations on the BoK.

Exhibit 2: KTBs' beta coefficient on 10y UST in previous Fed cycles
KTB's sensitivity to UST has increased during the latest Fed hiking cycle



Source: Bloomberg, BofA Global Research

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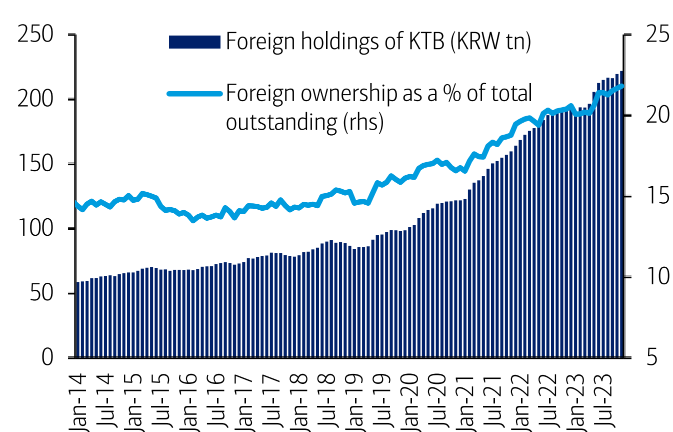
Exhibit 3: Foreign ownership of KTBs
Foreign ownership has risen sharply in recent years



Source: CEIC, Financial Supervisory Service, BoK, BofA Global Research

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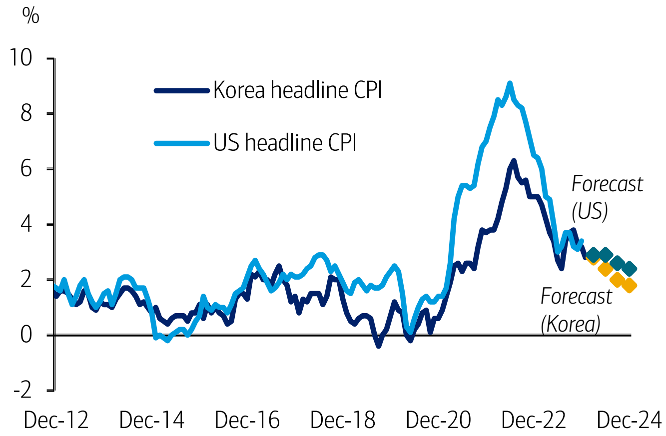
Exhibit 4: Headline CPI inflation in US and Korea
Synchronized headline inflation cycle since 2021



Source: Bloomberg, BofA Global Research

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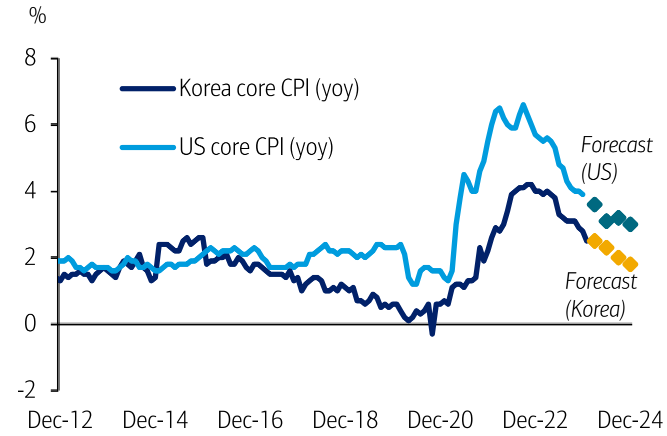
Exhibit 5: Core CPI inflation in US and Korea
Synchronized core inflation cycle since 2021



Source: Bloomberg, BofA Global Research

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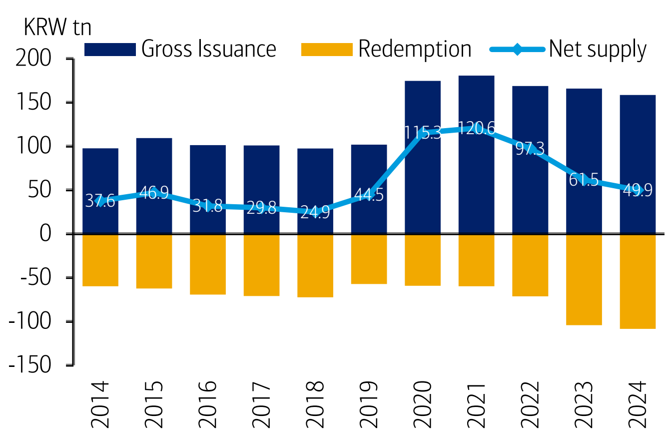
Fiscal prudence and notable decline in yoy KTB supply

Korea government's 2024 budget proposal demonstrated an effort towards fiscal consolidation, with spending increase being set at 2.8% yoy, the smallest rise since 2005. After witnessing a sharp increase in government debt during the Covid-era, the government is also committed to reining in debt growth (see details in Korea Watch: Budget plan: Fiscal prudence to continue despite the near-term revenue shortfall).

According to the issuance plan announced by MoEF, net supply of KTBs is expected to decline by about 19% yoy to KRW50tn in 2024 (Exhibit 6). In terms of issuance distribution across tenors, the official guidance suggests the ratios would be similar to 2023: 30% ± 3% for 2y & 3y, 35% ± 3% for 5y & 10y, and 35% ± 3% for 20y, 30y, & 50y (Exhibit 7). Issuance-pace wise, some moderate front-loading is again expected, with the MoEF planning to issue 55-60% of the bonds during 1H.

Some local media previously reported that the government was considering the issuance of KRW-denominated FX stabilization bonds for the first time in more than two decades. So far, no details have been announced by the government yet, but the media report seems to suggest those bonds would have short maturities (1yr-2yr), so the impact on duration supply should be rather limited.

Exhibit 6: KTB supply – gross and net
Net supply of KTBs is expected to decline by about 19% yoy



Source: MoEF, BofA Global Research

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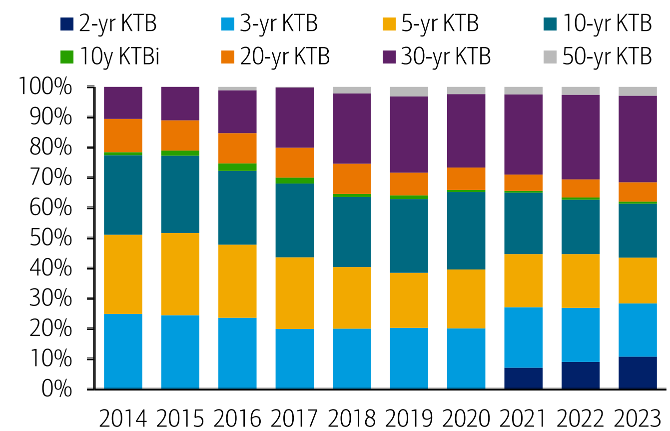
Exhibit 7: KTB issuances across tenors
2024 issuance allocation is expected to be similar to 2023



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Market is underpricing BoK rate cut

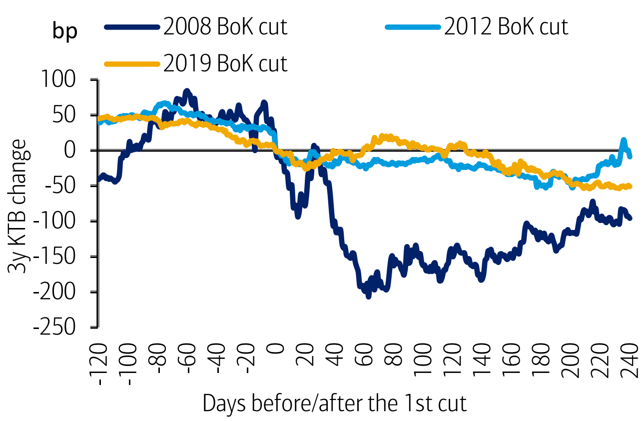
Assuming the spread between 3m CD rate and policy rate stays unchanged (at 17bp), then the interest rate swap market is currently pricing in slightly more than one cut by Oct 2024 (-31bp) and about two cuts by April 2025. Of course, one can challenge the constant spread assumption and argue that if the market is pricing in certain possibility of a higher 3m CD-policy rate spread - which is now trading at 8bp below 5y average level – then the implied rate cut expectation could be slightly underestimated. That said, even after taking into account the uncertainties on the spread, the market's expectation on the BoK rate cut still seems conservative comparing to our house view, which is three 25bp cuts by end-2024, supported by further decline in CPI inflation.

Bottom line: constructive on KTBs

Hawkish comments from the BoK governor, negative carry, and strength in the US data impose some headwinds for Korea rates to rally in the near term. That said, looking at 3y KTB's performance heading into the first policy rate cut in the previous three cycles, it seems that long bonds 3-4 months ahead of the first BoK easing action generally have performed well (Exhibit 8). We will closely watch Korea's domestic inflation trajectory in the coming months and look for opportunities to long KTBs.

Exhibit 8: Changes in 3y KTB yield before and after 1st BoK cut

KTB tended to rally when the 1st cut is within 3-4 month horizon



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News and Views

Brazil: January IPCA surprised to the upside

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Inflation in the month was 0.42% mom, from 0.56% mom in December. The result was above market expectations of 0.34% mom, after mid-month IPCA had surprised to the other side. In 12 months, inflation decelerated to 4.51% yoy (from 4.62% previously). The average of five core measures continued to decelerate in annual terms, now at 4.2% (from 4.3%). However, after seasonal adjustment, inflation momentum ticked up, as 3mma of core inflation is running at 4.0% annualized rate (from 3.4% in December) and core services went up to 5.6% (from 4.5%). On the release, the main upward pressure came again from Food group (1.38% mom, from 1.11% in December), due to climate impacts on perishable items prices (notably, tubers, fruits and vegetables) - intensified by El Niño effect. On the other hand, the Transportation group now represented the main downward pressure (-0.65% mom, from 0.48%), as airfares registered deflation of 15.2% mom (after a cumulative increase of 82.0% in the last four months of 2023).

- **To follow:** Given the explicit concern the BCB registered with the labor market resilience and its impacts on services inflation in the latest minutes, the uptick should reinforce the COPOM view of cautious easing cycle and maintain the pace of 50bp cut in the selic rate per meeting ahead. For inflation, we continue to expect the IPCA to reach 3.7% yoy at 2024YE.

Brazil: Services Volume increased 2.3% in 2023

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Brazil real revenue gains in the services sector rose 0.3% momsa in December (vs 0.9% in November). The print came below market (0.8%) and our (0.6%) expectations. With today´s read, the index went up by 2.3% in 2023 (from 8.3% in 2022) – as 4 out of the 5 groups registered positive variations in the year.

- **To follow:** For 2024, we expect lower inflation and still resilient labor market to continue supporting the services sector through the year.

Mexico: Consumer confidence rebounds in January

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Consumer confidence in January was above expectations, increasing by 0.3 points mom sa to 47.1 (E. 46.8). The main drivers to the upside were future household conditions indicator at +0.9 points mom sa (vs -0.7 in December) and future national conditions at +0.7 points mom sa (vs -0.3 in December). On the other hand, likelihood to buy durable goods indicator fell -0.4 points mom sa (vs -0.2 in December), current household conditions indicator fell -0.3 points mom sa (vs -0.2 in December) and current national conditions fell -0.2 points mom sa (vs -0.2 in December).

- **To follow**: Consumer confidence continue increasing which is in line with our view that the economy will reaccelerate.

Mexico: Mexico added 109k jobs in January

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According to IMSS, formal employment grew by 109.0k in January. In annual terms, formal jobs grew 3.0% yoy. By industry, construction (8.1%), transport and communication (7.0%) and trade (3.8%) were the sectors with the highest annual growth. The average salary in formal jobs increased 10.4% yoy, slightly down from 10.5% yoy in December, to $573.4. Wage growth has been above 10% since March 2022.

- **To follow:** Formal employment and wage growth are decelerating, but remain high, especially wage growth. This will continue to put upward pressure on inflation. While the construction sector has decelerated for the past couple of months, it still shows signs of strength, likely because of nearshoring and public infrastructure projects.

Mexico: Industrial production fell for the second month in a row

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Industrial production in December surprised to the downside at -0.7% mom sa (E. -0.3%, BofA -0.4%) down from -1.0% mom sa in November in real terms. Utilities was the main downward contributor at -1.3% mom sa (vs -0.5% in November), construction fell -0.6% mom sa (vs -2.8% in November), manufacturing decreased -1.2% mom sa (vs -0.5% in November) and Mining was the only contributor to the upside at 1.4% mom sa (vs -1.3% in November). In annual terms IP remained unchanged (0.0% yoy nsa), down from 2.9% in November. Throughout 2023, industrial production increased 3.6%.

- **To follow**: This is another sign of the economic weakness seen in the flash GDP print of 4Q23, which will probably affect the final GDP number coming on February 22. Moreover, this print also helps Banxico's case of considering rate cuts.

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