Local Markets

EM Looking Glass

Korea rates and FX: think the ‘unthinkable’ under the new government

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Key points

- **Lee Jae-myung’s victory with 49.42% of the vote in the snap presidential election on 3 June is positive for Korean equities, but bearish for Korea rates and neutral on the Korean won.** The market has fully priced in the outcome of President Lee’s victory – which consequently was no surprise at all. However, we feel that the market is underestimating the potential impact of Lee’s policies on the market. Given the strong legislative support for the new government, the new president will be of the belief that he can easily implement all of his economic/social policies. Some of them might also be very controversial/unthinkable.

- The details of Lee’s economic policies have not been well articulated well given the short period of preparation for the snap presidential election. A strong fiscal stimulus via a supplementary budget and probable amendments to commercial law are clear at the moment. We also expect another supplementary budget of +KRW35tn soon. However, Lee’s stance on FX policy, especially in relation to trade talks with the US, remains unclear. The tension between Korea and the US is likely to rise as Lee is regarded by some to be close to China. In his inauguration speech, he emphasised strong alliance with the US and Japan but also pledged to take pragmatic diplomacy. In this context, it is worth noting that White House expressed concerns about “China interference and influence in democracies” following the election result.

- The market consensus is that the new government under Lee will result in: 1) a steeper Korean rates curve; 2) a neutral impact on the USD/KRW; and 3) a positive outlook for Korean equities, which aligns with our trade view (Forward start KRW steepener and Trade ideas – Option trade idea to leverage Kospi 200 range breakout). The new government does not seem to have the resources to mitigate the market impact via an additional KTB issuance to fund supplementary budget, and to engineer a stronger Korean won for a trade deal with the US. The global market’s vigilance on fiscal soundness, as seen in the US and Japan, is a challenge for any potential expansionary fiscal policy in Korea too. In this context, **if what was unthinkable in the past is now ‘thinkable’, then one domestic policy option would be to adjust the asset allocation of the NPS in order to contain a rise in Korean rates**.

Public debt to GDP under the progressive governments rose

Progressive governments (Rho Moo Hyun 2003-2008, Moon Jae In 2017-2022)

NPS asset allocation weight

	2021	2022	2023	2024	2025	2026
Local equity	16.8	16.3	15.9	15.4	14.9	14.4
Global equity	25.1	27.8	30.3	33.0	35.9	38.9
Local bond	37.9	34.5	32.0	29.4	26.5	23.7
Global bond	7.0	8.0	8.0	8.0	8.0	8.0
Alternative investment	13.2	13.4	13.4	14.2	14.7	15.0

Source: NPS, Bloomberg, SG Cross Asset Research/EM

NPS asset allocation adjustment – a potential option

An adjustment to the NPS portfolio allocation with a higher weighting in domestic equities and bonds, alongside a lower weighting in global equities and bonds, cannot be ruled out. A decrease in the NPS' USD demand for overseas investment should lead to a stronger Korean won. This may satisfy the US. Furthermore, a larger weighting in domestic bonds should support rising KTB issuance going forward. Lastly, a larger allocation given to domestic equities should engage retail investors in Korea too.

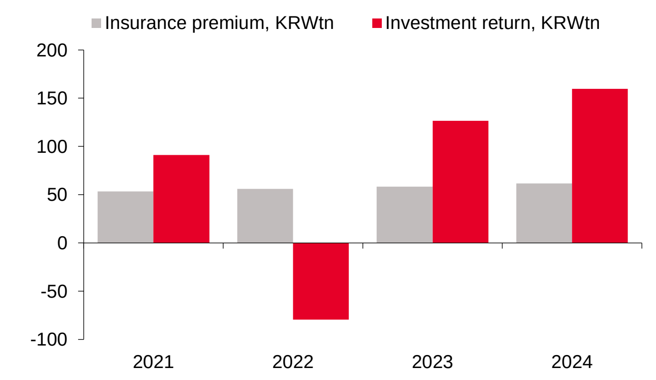
The NPS overseas investment consists of: 1) global equities, 2) global bonds, and 3) alternative investments. Its 2025 annual target weights are set at 35.9%, 8.0%, and 14.7%, respectively. Therefore, around 60% of NPS' annual investment is given to overseas assets, the weighting of which is designed to rise further. By contrast, the weightings of domestic equities and bonds will gradually decline further to 14.4% and 23.7%, respectively, in 2026.

NPS's funding sources are: 1) insurance premiums, and 2) investment income. We think overseas insurance premiums directly affects the USD/KRW.

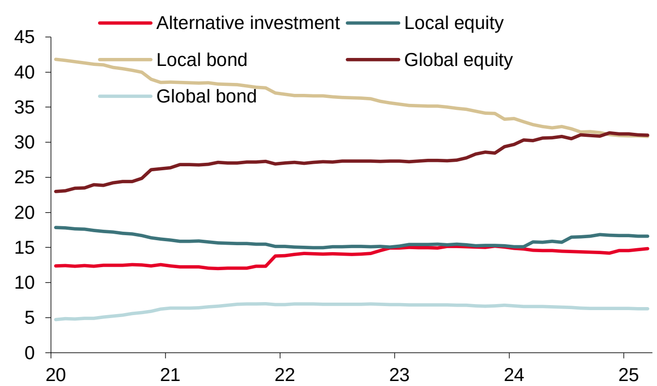
NPS' overseas investment will be no less than KRW39.2tn (c. USD28.6bn) in 2025. Its investment source is funded through: 1) income from insurance premiums, and 2) investment income. We believe investment based on **insurance premiums** directly affects the USD/KRW exchange rate. Income from insurance premiums has risen considerably to KRW61.7tn in 2024 and will rise further in the coming years with annual growth rates of around 5%. Our estimate of income from insurance premiums of KRW65.4tn for 2025 will generate KRW39.2tn (c.USD28.6bn) of overseas investment in 2025.

By contrast, **investment income** has been quite volatile and unpredictable (e.g. -KRW58.2tn in 2022 vs KRW177tn in 2024). In particular, investment income from overseas investment tends to be reinvested in overseas assets. Therefore, reinvestment from investment income will likely only have a limited impact on the USD/KRW.

NPS investment funding, KRWtn



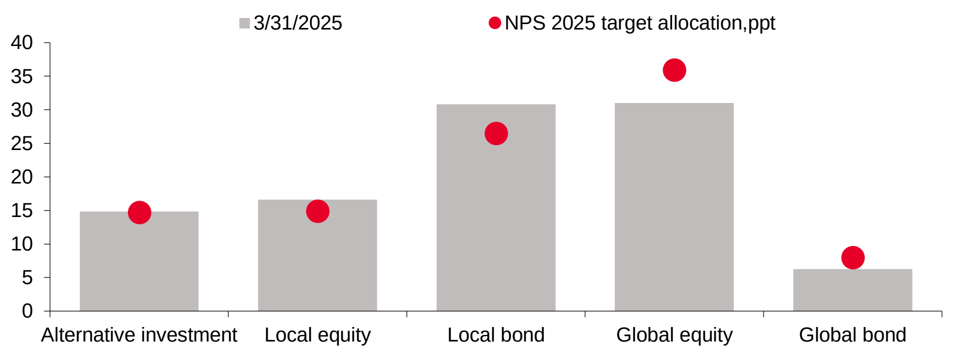
NPS asset allocation evolution, % of financial investment



Source: NPS, Bloomberg, SG Cross Asset Research/EM

The medium-term NPS asset allocation plan indicates that the NPS will continue to expand its global equities portfolio (e.g. global equities weighting of 35.9% for 2025 and 38.9% for 2026). If there is any reduction to this global equities weighting, it could have a substantial impact on the USD/KRW.

The NPS should increase its global equities weighting and reduce that of domestic bonds in order to meet its 2025 asset allocation target

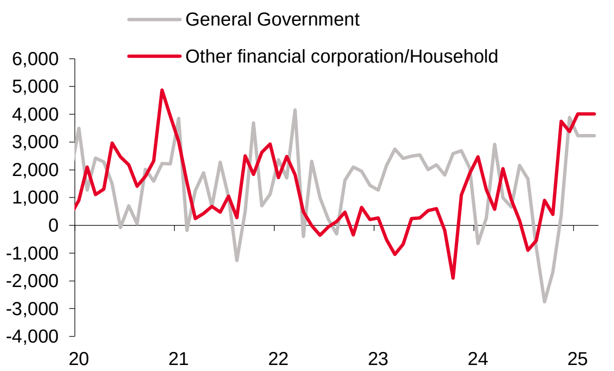


Source: NPS, Bloomberg, SG Cross Asset Research/EM

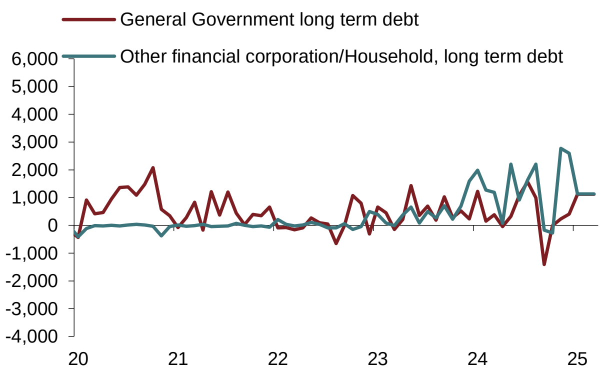
Retail investors' overseas equities investment could be directed towards the local equity market – at least on a temporary basis. The size of retail investors' overseas equity and bonds investment has increased. The new government is expected to boost the local equity market with a regulatory revamp of commercial law and a possible tax break on dividend earnings.

Retail investors' outbound investment has been a factor behind the weakening of the Korean won. However, we are not convinced that regulatory changes under the new government will lead to a structural improvement in corporate governance and competitiveness in the long run. Nevertheless, the short-term impact on the Korean won will likely be positive.

Overseas equity investment in BoP, USDm



Overseas long-term bond investment in BoP, USDm



Source: Bloomberg, SG Cross Asset Research/EM

More than KRW30tn of additional KTB issuance is likely

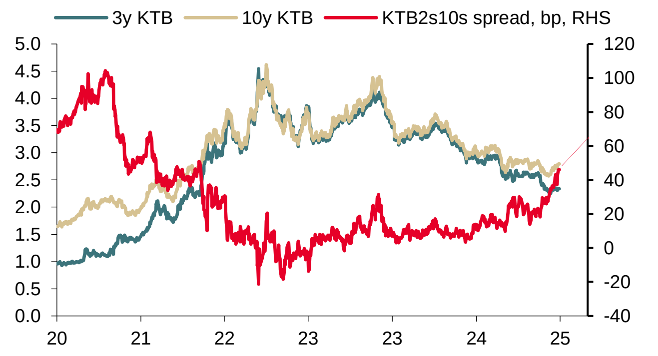
A steepening trend in Korea's rate curves is expected to prevail under the new government. The prospect of larger KTB issuance will exert upward pressure on the yield curve. The KTB 3s10s spread has risen to 46bp and is anticipated to increase further to the 60-70bp range over the next six months.

While offshore bond inflows related to the WGBI inclusion next April will support government funding, we are concerned that the new government's pragmatic diplomatic policy could heighten tensions with Japan and negatively impact Japanese investors. We believe that bond inflows from Japan will be a significant component of the WGBI inclusion. However, these inflows will not come to mitigate the increasing KTB issuance in the second half of this year.

If the 10y KTB yield approaches the 3.0% level from the current 2.79%, the government is likely to consider policy measures to alleviate upward pressure on KTB yields. As discussed earlier, adjustments to the NPS asset allocation can be another option. Additionally, President Lee is expected to urge the Bank of Korea to implement further cuts to the policy rate. BoK Governor Rhee Chang-yong's term will last until April of next year. While it is too early to speculate about who will be the next governor, it is likely that Lee will have a significant influence on the selection. As a result, the front end of Korea's rate curve is expected to remain relatively stable.

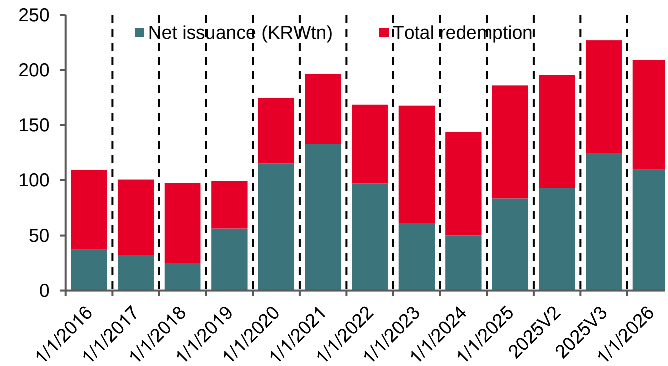
Following the first batch of supplementary budgets totalling KRW13.8tn, with KTB issuance of KRW9.5tn, we anticipate another round of supplementary budgeting of more than KRW35tn to be announced soon. The government may need to issue more than KRW30tn in additional KTBs just to fund this supplementary budget. Many analysts have revised down their growth forecasts for 2025 to below 1.0%, which justifies a stronger fiscal response from the new government. SG pencils in only 0.3% growth in 2025.

KTB3s10s is likely to approach 60bp from the current 49bp



Source: Bloomberg, SG Cross Asset Research/EM

Rising KTB issuance will be a challenge



2025V2 includes KRW9.5tn of additional KTB issuance with the first supplementary budget
2025V3 assumes KRW30.1tn of additional KTB issuance with supplementary budget of KRW35tn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