

Interest Rate Outlook & Strategy

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- This view forces us to the bullish side of the market. With yields up more than 50bps since March, negatives have been priced in and risk/reward favours longs.
- Prospects of a sustained rally, however, remain low in the near-term (even if the BOK keeps rates unchanged) as the bond market will likely continue to languish in fear of future tightening measures.

Economic Outlook

The Bank of Korea holds its regular Monetary Policy Committee meeting tomorrow. A rate hike is expected by many economists and market participants but not by DBS Research. Although we acknowledge that this is a close call, we think it makes more sense for the BOK to keep the overnight call rate target unchanged at 4.5% and use administrative measures to deal with the issues at hand, which include the following:

a) Currency gains

There are concerns among policy makers that the won is strengthening too fast. Deputy Finance Minister Kim Sung Jin commented last Friday that "the current account surplus is narrowing and this reflects that the currency is overvalued" (Chart 1). And Finance Minister Kwon Okyu's warned on Monday that the government will actively respond to gains in the currency when necessary. These are but the latest signs that policy makers remain uncomfortable with the pace of won appreciation.

Interest rate forecasts

oop; yield, %; spread, bps

| | 10-Jul-07 | 3Q07 | 4Q07 | 1Q08 | 2Q08 |
|------------------|-----------|------|------|------|------|
| O/N Call Rate | 4.50 | 4.50 | 4.50 | 4.50 | 4.50 |
| 3M CD Rate | 5.00 | 4.70 | 4.70 | 4.70 | 4.70 |
| 3Y KTB Yield | 5.35 | 5.25 | 5.25 | 5.25 | 5.25 |
| 10Y KTB Yield | 5.55 | 5.50 | 5.50 | 5.50 | 5.50 |
| KTB 3Y/10Y Curve | 20 | 25 | 25 | 25 | 25 |

But while it is true that won gains amid the weak dollar period since 2002 have been steep (42% in the USD/KRW vs 17% in USD/Asia as measured by the Asia Dollar Index), much of the tough language is probably intended as a signal to the market to discourage speculation on further won appreciation.

b) Foreign currency borrowing

Despite the fact that the won has outperformed the Asian dollar index by a wide margin over the last five years, there has been much foreign currency borrowing by resident banks since January 2006 (Chart 2) to take advantage of interest rate differentials. This is of concern to authorities as it means “movements in the currency that aren’t in line with the economy’s performance” as the Finance Ministry and the BOK put it in a joint statement earlier this month.

Although there have not been any formal curbs, MOFE and BOK last week asked banks to reduce their foreign currency exposure and there were rumours that the limit on foreign currency borrowing would be reduced from 6% to 3% of capital. Basis swaps traded lower and KTB yields rose, partly because some banks stopped paying the cross-currency swap against KTBs out of fear they will have to cut their exposure in the swap.

Capital account data shows that short-term overseas borrowing by banks remains high. Net FX borrowing has amounted to US\$16.6bn so far this year (Jan-May), almost half of 2006’s record of US\$31.9bn. We believe the BOK will choose administrative measures to deal with this issue, if window guidance proves unsuccessful. An interest rate hike appears however inappropriate as it leads to an even wider interest rate differential.

c) Credit and money growth

Actions taken by the BOK late last year to tighten liquidity without raising the policy rate per se have shown signs of success¹. Mortgage lending and household debt in general are slowing. Somewhat unexpectedly however, lending to SMEs has continued to accelerate and reached a pace last seen in 2003 (Charts 3 & 4), which has obliged the BOK on June 21 to reduce the funds it makes available to banks for loans to small businesses.

Overall money growth remains rapid, with M3 growth reported to have stayed at 10% YoY in May. This and comments from Finance Minister Kwon that “from the monetary policy side, efforts to control liquidity should be strengthened”, suggests that the BOK will consider an interest rate hike. But the fact that policy makers obviously decided again this route in 4Q last year and in June suggests that further administrative measures might remain the preferred tool, especially given that credit growth now appears to be much less a general problem, but specific to the SME sector.

d) GDP growth and inflation

Lastly, the growth and inflation outlook for Korea does not suggest that the BOK should be in any hurry to hike rates. The economic expansion, in fact, has slowed to 4% YoY in 2Q07 from 6.3% in 1Q06 and it remains to be seen whether growth can improve to

¹ The BOK raised reserve requirement ratios for demand deposits on Nov23, and on Dec21 limits on aggregate central bank loans to commercial banks were cut.

Chart 1: Current Account Balance

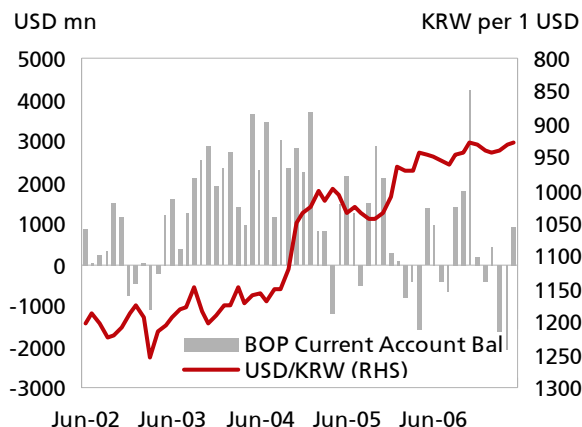


Chart 2: Short-term Foreign Lending & Borrowing

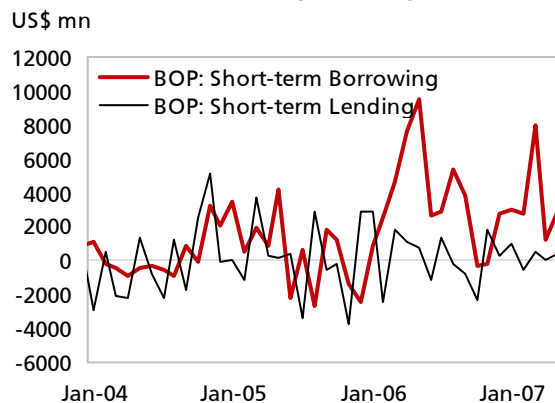


Chart 3: Lending Trends

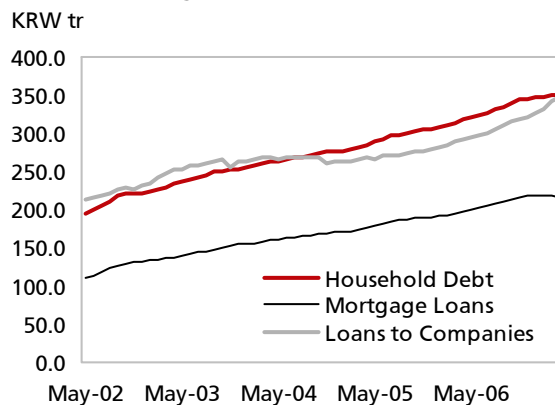
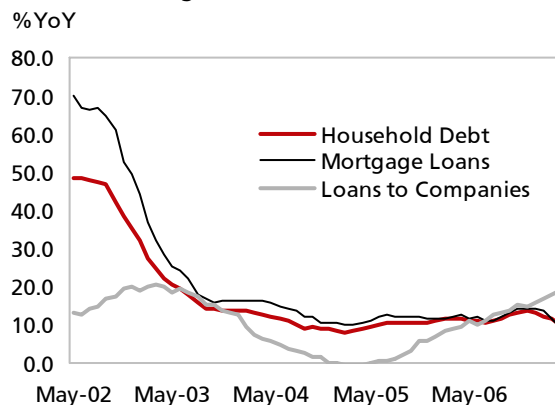


Chart 4: Lending Trends



Source: Bloomberg, DBS

trend (widely estimated to be around 4.5%) in 2H07, given that consumer spending has so far shown only nascent signs of a recovery (Chart 5).

Admittedly, there is a solid trend in industrial production, mainly due to strong exports in the recent months (Charts 6&7). But this does not mean the economy is showing signs of overheating.

In fact, despite the strong showing of exports and some signs of a recovery in consumer spending over the recent weeks, the Bank of Korea yesterday raised its 2007 economic growth estimate only marginally to 4.5% from an earlier forecast of 4.4% (made in December). The central bank now expects the economy to expand 4.7%YoY in the second half, accelerating from 4.4% growth in the first half. Private consumption growth is projected to slow to 4.1% this year from 4.2% in 2006 and business investment is expected slow to 7.5% from 7.6% in 2006. Exports will do better this year than initially thought, probably expanding 13.1% (not 10.8% as forecast earlier). We take the moderate revision as a sign that the BOK remains cautious in its outlook, which in turn suggests that there is unlikely to be a sustained tightening bias in 2H07.

There are no alarm lights on the inflation front. Both headline and core inflation remain relatively tame. Both measures are running near 2.5%, the lower boundary of the BOK's 2.5% to 3.5% target range for the year-on-year measure of headline inflation. But the BOK has warned of upside risks to inflation, saying that "price pressures will strengthen gradually due to rises in prices of global raw materials and as local demand grows". We agree that raw material prices, oil prices in particular, do pose a risk, and a sharp rise from current levels would mean price increases at the producer level. But with a strong won and lack of a strong consumption recovery, we don't expect inflation to rise fast enough to necessitate a policy response. This is in line with BOK expectations, which kept its 2H07 inflation forecast at 2.6% yesterday.

Market View

Given our view on the issues currently facing the central bank, we expect no rate hike tomorrow. Although we acknowledge that this is a close call, we think it makes more sense for the BOK to use administrative measures to address high levels of foreign borrowing and SME lending than to hike rates. This view forces us to the bullish side of the market.

With yields up more than 50bps since March, negatives have been priced in and KTBs could stage a relief rally should the BOK indeed keep its policy rate steady at 4.5%. But prospects of a sustained rally remain low in the near-term (even if the BOK keeps rates unchanged) as the bond market will likely continue to languish in fear of future tightening measures.

Should the BOK surprise us, KTB yields are likely to rise somewhat further but a sharp selloff is unlikely as a string of rate hikes is unlikely to be priced into the front-end of the yield curve.

We expect 3Y and 10Y KTB yields to remain around 5.25% and 5.5% throughout 2H07.

Chart 5: Real GDP Growth

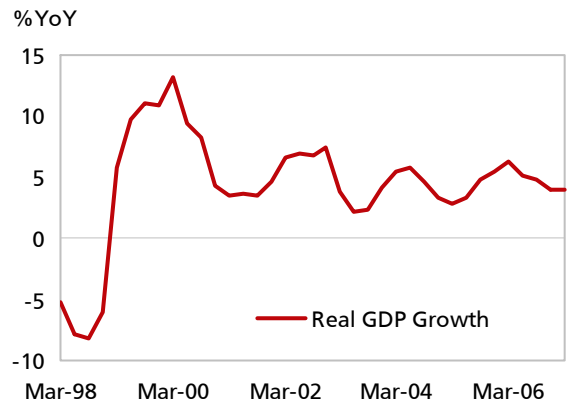


Chart 6: Industrial Production

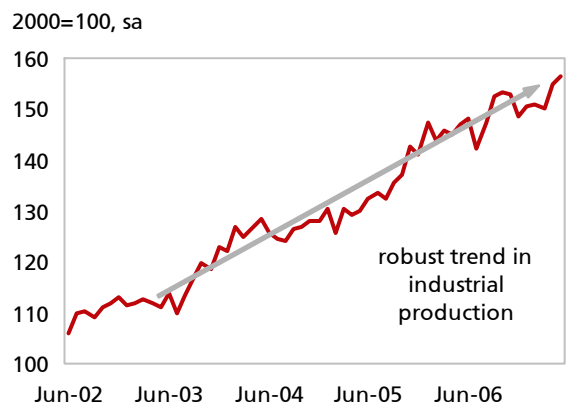


Chart 7: Exports to Top 3 Destinations

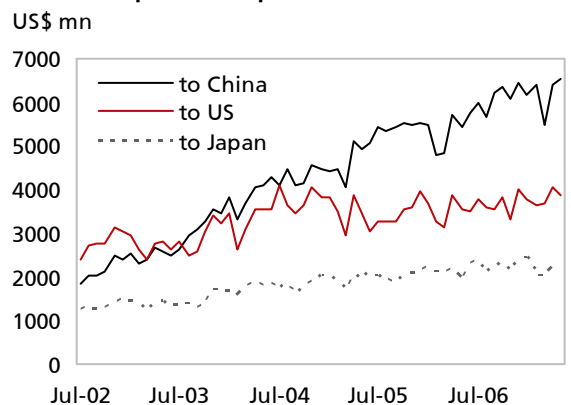
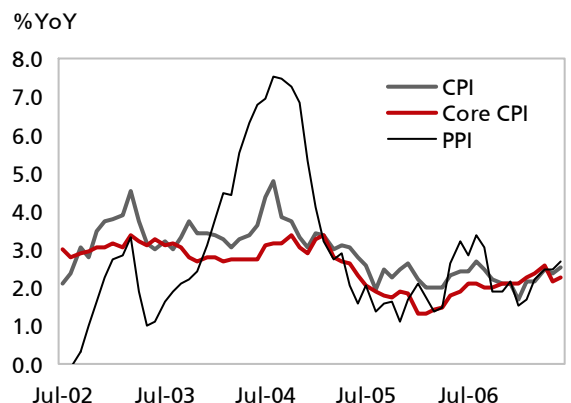


Chart 8: CPI, Core CPI & PPI



Source: Bloomberg, DBS

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