

Interest Rate Outlook & Strategy

- GDP growth was unchanged at 4% YoY in 1Q07 after a steady decline from 5.3% in 1Q06, and we continue to forecast 4.3% growth for the year as a whole. But it now looks unlikely that the BOK will trim its policy rate this summer. In fact, policy will likely remain unchanged throughout the remainder of this year. We no longer expect rate cuts.
- The change to our policy outlook obliges us to revise our market rate projections. With the policy rate expected to remain unchanged in the months ahead, we now forecast a flatter trajectory for the 3M CD rate and KTB yields.
- We expect the KTB yield curve to shift down by 10-30bps. Downward pressure on yields should resurface when current tight liquidity, as evidenced by elevated call rates and the wide spread between the KRW 3M CD rate and the overnight policy target (currently about 18bps above its five-year average), gives way to more normal liquidity conditions.
- Our curve view remains unchanged; i.e. we expect the 3Y/10Y curve to steepen moderately into the expected bond rally. Risks too remain unchanged. They continue to lie predominantly with abating appetite for duration and as such are tilted towards a more pronounced steepening. But structured product issuance and demand for duration appear likely to remain strong in the foreseeable future, which should keep curve-steepening relatively moderate.

In early February we argued that the curve would bull-steepen on the back of disappointing macro data and a growing realization among investors that the BOK would ease monetary conditions by midyear. We also argued that a fall in the 3-month CD rate amid a cooling in the housing market would aid this curve view.

The bullish steepening trade initially worked well in March, but it suffered a setback in April, when the market turned bearish. The curve has re-flattened as rates have returned to February levels.

Interest rate forecasts

eop; yield, %; spread, bps

	3-May-07	2Q07	3Q07	4Q07	1Q08
O/N Call Rate	4.50	4.50	4.50	4.50	4.50
3M CD Rate	5.00	4.95	4.75	4.65	4.65
3Y KTB Yield	5.00	4.85	4.70	4.70	4.70
10Y KTB Yield	5.10	5.05	5.00	5.00	5.00
KTB 3Y/10Y Curve	10	20	30	30	30

The two factors that drove rates higher were stronger-than-expected macro data, especially exports, and the market's recognition that liquidity conditions might not improve as quickly as originally thought. Hence, it is not surprising that while a significant fall in short-rates was priced in late March, their forward path is now almost completely flat again.

A fairly flat trajectory is now also our assessment of the likely path of short-rates, as our economists no longer believe that the BOK will trim rates this year (see our report "Growth on track" on 26 April). As steady policy puts a floor under rates, we have revised our KTB yield forecasts upwards. The new forecasts are shown on the front page.

Official assessments, too, are optimistic. Finance Minister Kwon Okyu said on 13 April that economic growth will accelerate in 2H07, helped by a recovery in domestic demand. But more importantly, measures taken to address the property market, mortgage loans and an increase in short-term debt, appear to be effective. According to Kwon, "the property market is headed for a stable trend while mortgage lending was reduced substantially." The economy is expected to expand about 4.5% this year (after having advanced 5% in 2006).

Our own assessment is that growth appears well on track to meet our full year forecast of 4.3% and we continue to expect CPI inflation to run between 2.0-2.5% in the coming months.

Yield Direction

Given the improved macro outlook and renewed liquidity concerns, we view the April sell-off as a sensible response, but believe yields will fall again in the coming months. Downward pressure on yields will resurface when current tight liquidity, as evidenced by elevated call rates and the wide spread between the KRW 3M CD rate and the overnight policy target (currently about 18bps above its five-year average), gives way to more normal liquidity conditions. (Chart 2).

The return of liquidity should see the yield curve shift down by 10-30bps when the spread between the 3M CD rate and the overnight policy target rate (currently about 50bps) falls towards its long-term average level (32bps). We see the 3Y KTB (current yield = 5.0%) trading in a wide range between 4.7% and 5.1% in the coming months.

Curve

Much of the curve flattening since early April has been in-line with rising front-end yields, which leads us to view the long-end of the Korean bond curve as neither excessively steep nor excessively flat; at least not relative to the 3Y benchmark KTB yield level (Charts 3,4 & 5).

Moreover, the strong correlation between long-end curve steepness and front-end yield level leaves us to expect that a rally would re-steepen the curve in the 5Y-20Y sector.

That said, with the 5Y/10Y/20Y fly spread (50:50 weights) still high at around -2bps, we reckon that the steepening would likely be more pronounced in the 10Y/20Y sector than the 5Y/10Y sector

Chart 1: KRW Onshore IRS Curve

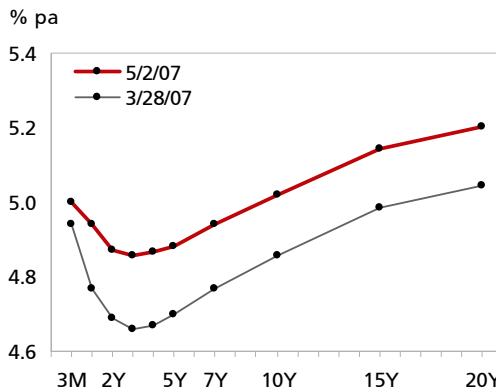


Chart 2: O/N Call Rate Target vs KRW 3M CD

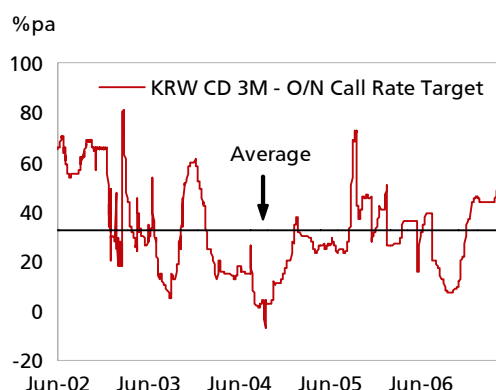


Chart 3: 10s20s KTB curve versus 3Y KTB yield

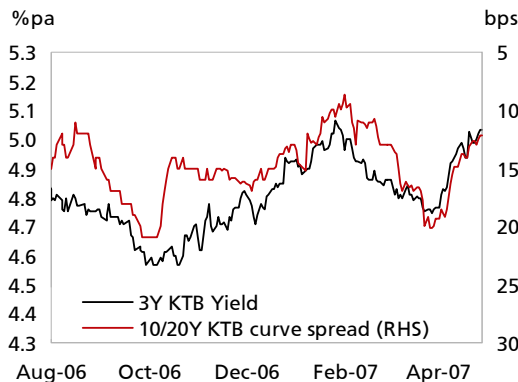
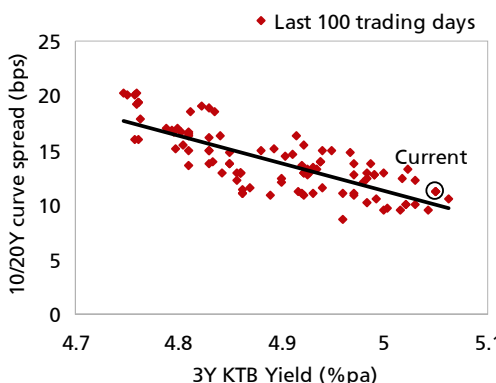


Chart 4: 3Y KTB yield vs 10s/20s curve



(Charts 6 & 7). If so, the relative steepening of the 10Y/20Y curve slope against the 5Y/10Y curve slope will send the fly spread below -5bps.

Given the above, we see the 3Y/10Y KTB curve spread (current spread = 10bps) trading between 5bps and 30bps and the 10Y/20Y spread trading between 10bps and 20bps in the coming months.

Risks to this curve view of course continue to lie predominantly with abating appetite for duration and as such are tilted towards the upside (more pronounced steepening). But structured product issuance and demand for duration appear likely to remain strong in the foreseeable future, which should keep curve-steepening relatively moderate.

Bottom line, after the April sell-off, reward to risk, in our view, clearly favors long positions again. Current liquidity concerns should prove temporary and the possibility of the market pricing rate hikes remains remote.

Yes, the economic outlook has improved, but indicators don't paint a rosy picture. On the supply side, weakness is seen most clearly in manufacturing where industrial production is stalling (in Feb the YoY series fell below zero for the first time since Feb 2005). On the demand side, domestic demand has rebounded to 4%YoY in 1Q07 but it is far from certain that momentum will be maintained.

We see rising rates as an opportunity to accumulate duration, establish flatteners at the front-end and/or steepeners at the back-end and/or sell the wings of the curve against the belly.

Chart 5: Residuals of 3Y KTB yield vs 10s/20s curve spread regression

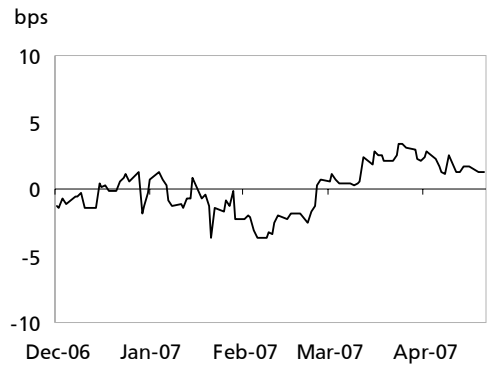


Chart 6: 5Y/10Y/20Y Butterfly in KTBs, 50-50 weights

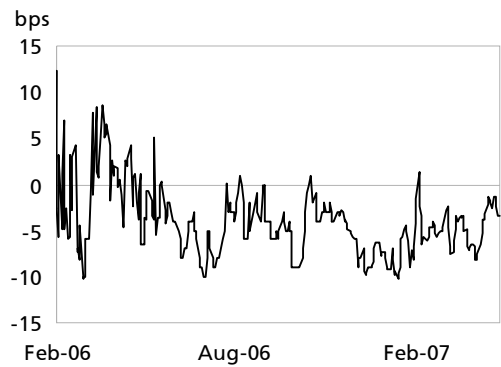
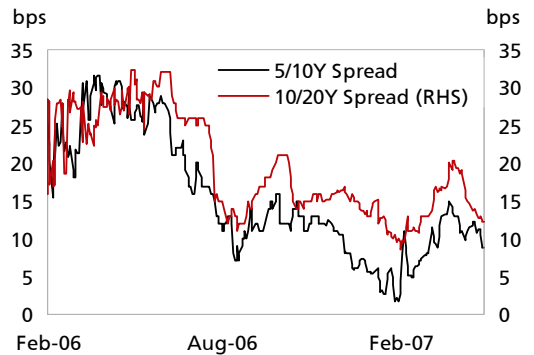


Chart 7: 5Y/10Y KTB curve spread versus 10Y/20s KTB curve spread



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