Coping with Geopolitical Risk: The Case of South Korea

Tensions have reemerged and reached a new peak on the Korean peninsula, following the sinking of a South Korean warship with the loss of 46 sailors, after it was struck by a North Korean torpedo. South Korea moved to cut trade with the North by 50%, denied North Korean ships the use of its sea lanes, and designated the North as its “principal enemy,” a term that has not been used during the past six years of detente. South Korea is calling upon the UN to censure North Korea. The US and South Korea have announced major combined naval exercises. Finally, in what can only be considered a symbolic move, the South has resumed broadcasting propaganda songs across the border.

In response, the North banned South Korean ships and planes from using its airspace and sea lanes, said it was cutting all ties with the South, and will expel all South Korean officials from a joint industrial park in the North. Ominously, there are reports that the North Korean leader, Kim Jong-il has ordered the North Korean military to be ready for war. In the most recent escalation of tensions, North Korea threatened to scrap all “military assurance agreements” with South Korea. These agreements are safeguards against accidental armed clashes. They also protect the safety of South Korean workers in that industrial enclave in the North. U.S. and South Korean forces have elevated their five-step alert level by one step to the second highest level.

The implications of these geopolitical developments are quite different from those in Thailand. If this dispute remains a shouting match, with saber rattling, posturing, and the exchange of commercial and political sanctions, the effects on
the Korean economy and its equity market, while negative, would likely remain modest. However, should armed conflict erupt, the effects would disastrous for both the North and South and would be heavy also for China, Japan, and the South’s main ally, the United States. It would seem that everyone should want to avoid that outcome. China, which has the most leverage over the North, certainly wants to avoid the massive influx of refugees that would develop. The South, backed by the US, would eventually “win” but at a terrible cost, particularly to its main population center, Seoul, which is located within range of the massed artillery just across the border. And one must not forget that North Korea may well be able to deliver nuclear or biological weapons. No rational government would go down this path. “Dear Leader” Kim, however, is not known for rational thinking, and the uncertainties surrounding his eventual succession contribute to the dangerous situation.

Before these developments, the South Korean economy was on route to a healthy recovery. GDP growth looked to be on track for almost 6% for the current year. South Korea has been benefiting from the strong growth in the region, particularly in China, the largest export destination for Korea. Exports account for half of South Korea’s GDP. The MSCI Index for the Korean equity market advanced by 4.03% on a total-return basis in the first quarter, which was better than the 2.45% advance in the MSCI Emerging Markets benchmark.

As of May 27th however, the MSCI Korea index was down 16.57% from the end of April, a rough period for most emerging markets, with the MSCI Emerging Market Index losing -10.97%. The KOSPI index actually rose 1% on the 28th. Apparently, while international investors have scaled down their Korean exposures, domestic investors have shrugged off the heightened tensions and gone bargain hunting.

At Cumberland our Korean positions in our international and global portfolios were already underweight compared to the
heavy weight of Korea in the MSCI Emerging Markets benchmark, about 13%. We have preferred a more diversified exposure to the economic recovery in Asia. While we think the most likely outcome of the current confrontation between North and South Korea will be that war will be avoided and economic recovery in the South will continue, the situation on the peninsula together with the current “risk-off” sentiment in global markets is likely to lead risk-averse global investors to refrain from adding to their exposure to the South Korean equity market. We have further reduced our positions in the Korean ETF, EWY, preferring other Asian equity market ETFs for the time being, as indicated in our Commentary on Thailand.