Korea - the market and its expectations

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The Korean market has been very strong through March and April. MSCI Korea NDR in local currency was up 14% in March and 12.6% in April. The index in USD was up 26.4% in March and 21.4% in April due to a strengthening Won which was up 10.9% in March and 7.9% in April.

The market has advanced with some signs of "green shoots" in the economy, but I believe the market's expectations were simply too pessimistic from late last year and into early this year, which has made it relatively easy for the actual results to beat the market. As you remember, the market rally started globally in early March with Citi Group's unexpected announcement that they were profitable for the first two months of the year.

More specifically on Korea, certainly the market sentiments turned quite sour in November last year and further into December. Most companies suffered a sudden contraction of demand.

- Manufacturing utilisation index (seasonally adjusted) fell 11.5% MoM in Nov and 9% in Dec. Mostly in auto, chemical and IT sectors.
- Industrial production (seasonally adjusted) fell 10.1% MoM in November and another 9.6% in December. Even in the Asian financial crisis, IP did not contract this much MoM. A 5.5% MoM decline in January 1998 was the largest fall at that time.
- Real GDP for Q4 contracted 5.1% QoQ.
- Manufacturing Business Sentiment Index (BSI) came down to 54 in November from 67 in October and further to 46 in December.
- Consumer Sentiment Index (CSI) to 84 in November from 88 in October. 81 in December.
- The IT sector recorded massive losses all together in Q4. IT, including LG Electronics (LGE), accounted for 25.9% of the total market cap of MSCI Korea as of end 2008. Energy and chemical suffered large inventory valuation loss with falling oil prices. Inventory de-stocking amid weak demand were severe across the board. Banks earnings fell significantly QoQ with large provisioning set aside.

With this gloomy macro data and the disappointing Q408 corporate earnings announcement, GDP forecasts and earnings estimates for most corporates were sharply revised down for January and February.

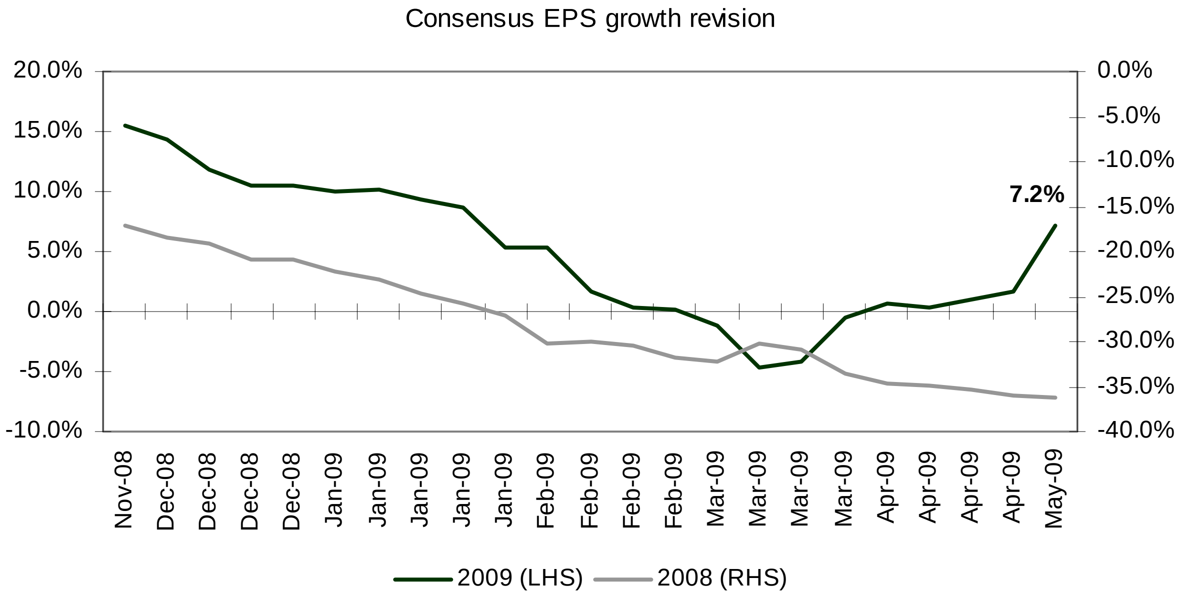
- Some GDP forecasts for 2009 had come down to a decline of 5% and the IMF official estimate is still 4% contraction for 2009.
- Consensus earnings estimates for 2009 were significantly revised down (see below graph). Large cap IT, which made net losses in Q4, including the Samsung Electronics (SEC), saw sharp cuts in particular with low earnings visibility.

However, Q109 macro data and corporate earnings so far have beaten the market overall. The operation was better in Q109 with some inventory restocking compared to Q408, but the market felt that the results came better than expected partly because the expectations were too low.

- The manufacturing utilisation index is also improving MoM after a 1.4% further decline in January. +9.0% in February and +3.6% in March.
- IP improved sequentially in Q1. 1.7% MoM in January, 7.1% in February and 4.8% in March. Though declining YoY, the magnitude of the fall has been decreasing from 25.6% decline YoY in January (Lunar New Year's holiday fell in January this year) to a 10.6% decline YoY in March.
- Real GDP did not contract QoQ but slightly improved 0.1% QoQ. Technically, avoiding "recession" (4.3% contraction YoY). Though government spending and infrastructure construction led the growth, one encouragement is a sequential growth in private consumption which was up 0.4% QoQ.
- BSI, though still below 100, is improving to 57 in March and 69 in April after remaining at 47 and 43 in January and February.
- CSI showed a sharp rise in April to 98 (still below 100 though) after remaining at 84-85 in the first three months of the year.
- On corporate earnings, IT results came in better than expected. SEC recorded net profit of W620bn in Q1 vs. 20bn loss in Q4. Though consensus earnings had been revised up towards the earnings release, the market had expected a loss initially. Handset division (opm of 12%) drove the sharp turnaround. LGE, with surprising improvements in all divisions sequentially, is still loss making at a net level (due to foreign currency translation loss) though was able to reduce the amount of loss. (The market whispers on LGE's possible earnings surprises - starting from the expectation of small profit if any to nearly 500bn operating profit towards the earnings release - drove the share price rally).
- For some other sectors, energy and chemicals have shown earnings surprises in Q1, with better than expected spread/margins, with some help from China demand and relatively low supply in the region. Auto makers' earnings showed resilience with some market share gains overseas, despite low utilisation. Consumer names generated steady earnings.

So what's happening now? There has been a series of upgrades in the street both on macro and corporate earnings.

- Recent 2009 GDP upgrades have been made to a decline of 2-3% from 4-5%. Though IMF keeps its forecast at 4%.
- MSCI consensus EPS growth for 2009 has seen upward revision. If you see below graph, the latest reading of EPS growth for 2009 is 7.2%. Positive growth for 2009 could be partially explained by revising down of the final 2008 numbers (low base), but given the 2008 number is almost final with a c.36% decline from 2007, the sharp upturn of the recent revision is mostly explained by earnings revision. In particular, latest revision came from the IT side. Morgan Stanley indicated that there was 44% upward revision in SEC's EPS.



Source: MSCI, data from Morgan Stanley reports (weekly revision)

Given that the Q1 earnings season has not yet finished, more revision should be made, however, more sharp downward revisions with further Q1 earnings releases seems unlikely as large corporates have already released their results.

Having said that, it still remains to be seen whether Q2 earnings will beat the market's expectations and whether the market rally will continue given its fast pace so far. It seems that the corporates are still on the cautious side. From the comments on their earnings release, they see some inventory restocking but are not yet so confident in the real demand pick up. But market optimism is building with the earnings results coming out better than expected and positive macro indicators. So it will be interesting to see how the market moves in the short term.

For the longer term, if we believe the worst is behind as recent readings of the leading indicators suggest, the market should show some more upside. According to Credit Suisse, historically, Korea is the most leveraged to a bottoming in the leading indicators. Also, Korea consensus EPS growth indicates 22% CAGR from 2009 to 2011, according to Morgan Stanley. It also suggests that MSCI Korea is trading at 14.4x 2009 EPS and 9.9x 2010, with consensus EPS growth of 7.2% and 45.2% for 2009 and 2010 respectively, vs. MSCI Asia ex Japan of 15.1x and 12.3x in 2009 and 2010, with 9.6% contraction and 22.6% growth respectively.

One thing to add from a trading point of view is that Korea is well known as an under-owned market by foreigners. According to Merrill Lynch, Korea is still the most underweight among Global Emerging Markets. Recently, foreign inflow has been increasing.

Net buying trend by investor and foreign ownership

W bn	Foreigners	Retail	Local institution	Corporate	Foreign ownership (%)
2001	8,711	-3,275	-4,091	-1,346	32.22
2002	-2,711	2,678	-386	420	32.79
2003	14,655	-5,486	-9,825	656	37.64
2004	11,770	-7,537	-5,843	1,610	40.11
2005	-3,622	-8,277	8,314	3,586	37.14
2006	-12,004	-999	9,916	3,087	35.13
2007	-27,083	7,261	10,135	9,687	30.96
2008	**-38,065**	**4,153**	**23,882**	**10,030**	**27.22**
YTD2009	**4,657**	**721**	**-6,206**	**828**	**25.78**
Jan-09	650	-1,048	-214	612	
Feb-09	-1,136	2,375	-1,606	367	
Mar-09*	-137	-1,961	1,688	410	
Apr-09	3,920	953	-4,498	-375	
MTD May	1,360	401	-1,576	-185	

** LG Display sale by Philips of W1.2tr is booked in foreign net buying.*
As of May 8, KOSPI and KOSDAQ combined. Foreign ownership at the end of the period.

Source: KOSCOM