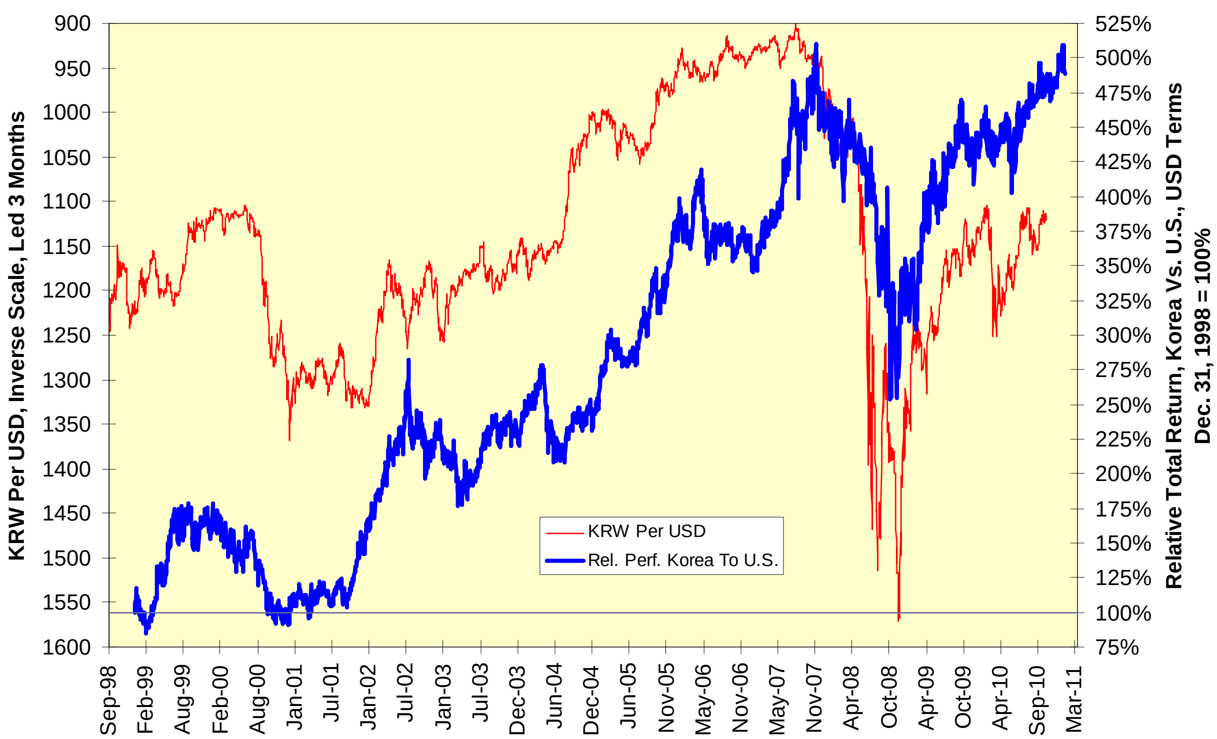
Korea's Lower Carry-Dependence

If India is one of the poster-children for the limits to the carry trade, and I do mean "one" as the conclusions drawn yesterday are applicable to other South and East Asian emerging markets such as Indonesia, Thailand and the Philippines, then Korea stands as an opposite example. The country is striving for inclusion in the "developed" category and is making its case by having both the Korean won (KRW) continue to forge ahead and by having its stock market continue to advance relative to the U.S.

Now if they could only do something about their neighbor to the north.

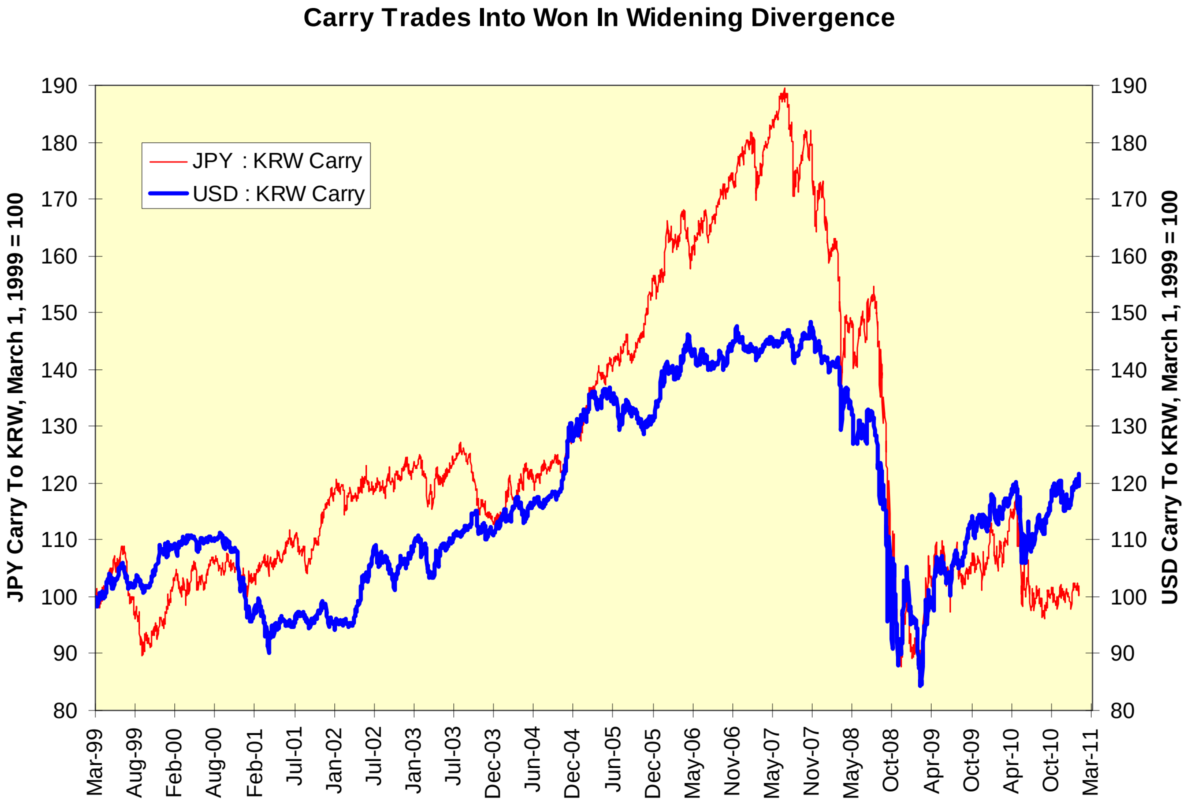
Korea, like its aforementioned Asian neighbors, has been raising short-term interest rates to combat the inflation being imported from money being printed elsewhere. The official bank rate was increased to 2.75% from 2.50% in mid-January. However, unlike those very same Asian neighbors, has yet to see an outflow of capital. Korean stocks – and yes, you can access the whole market via an iShares ETF, traded under the ticker EWY – continue to outperform American ones. This relative performance measure continues to pull the KRW higher with a three-month lag. We can infer the standard carry trade mechanism of money flowing into assets and necessitating the purchase of the currency is intact here. In addition, we can infer Korean economic growth and corporate earnings are anticipated to rise in excess of expected interest rate increases.

Korean Stocks' Relative Performance Leading Won By Three Months



Two Countries, Two Carries

Korea used to be fueled primarily by the yen carry trade back in the day, which according to the chart below was the period of time between March 2005 and July 2007. Once the global credit crunch started to take hold and the yen carry trade unwound, the dollar carry trade assumed a primacy starting in June 2010 even though U.S. short-term rates rose above Japanese short-term rates. The yen carry trade, as my French friends would say, is kaput. You can borrow the dollar without fear of sudden revaluation and as the U.S. has not run a current account surplus in twenty years, there are no net "must-do" purchases of dollars. The yen pops higher every now and then, especially when China starts buying Japanese bonds and feigns shock – shock! – the yen moves higher. Really; what are friends for?



So long as the dollar carry trade remains open and even widens, Korea will be able to dodge the bullet hitting other Asian countries. Until and unless Korean interest rates have to start rising faster than the ability of Korean firms to earn money, the carry trade will thrive south of the DMZ.