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Korean stocks and the won haven't „priced in" a sharp increase in risk

Risks around the Korean peninsula are now very high and have yet to be priced in by markets. These are still assuming the present war of words will be followed by a relaxation in the relationship between North Korea and the outside world as opposed to something worse. But in this case, the motto "buy at the sound of cannon" (attributed to the great nineteenth century financier Nathan Rothschild) should be ignored. South Korean stocks are insufficiently pricing in the current level of risk.

Geo-political risks are now very high

The crisis in North Korea's relations with the outside world has become even more precarious, with the US now matching North Korea in saber-rattling talk. Thus US Defense Secretary James Mattis recently said that the Democratic People's Republic of Korea should abandon all thought of actions which would lead to an end of its regime and the destruction of its people. In principle, the problem of North Korea's nuclear ambitions cannot be solved from outside as it is technically not possible to stop the regime from pursuing its plans for intercontinental ballistic missiles without occupying the country. Absent some intervention, it seems only a matter of time before North Korea has such intercontinental missiles at its disposal.

A limited military action, even if successful, would only postpone the problem for a few years. And military occupation could well spell political suicide for Donald Trump.

Thus it's hard to see any satisfactory solution coming from "outside". And there are no signs of regime change taking place autonomously within North Korea. Even were this to happen, "timing" such a change is almost impossible – just as the "timing" of the fall of the Berlin Wall and the collapse of communism (with the exceptions of Cuba, Venezuela and, significantly, North Korea) could not be forecast for the autumn of 1989.

What happens next?

UN sanctions will probably be largely ineffective and North Korea will likely continue to provoke - making good within weeks on its threat to shoot rockets over Japan, aiming for the sea some 40 kilometers from the US island of Guam. While this would only be an attack "on water", the danger is that land might be hit by accident. But so long as that danger is not realized the chances are that more serious conflict will be avoided as conflict (even of a limited nature) could be ruinous for all parties, in particular for South Korea but, to a lesser extent, also for the US. In this scenario, it is highly probable that the US would also shoot rockets into the seas around North Korea. Our best guess is that hostilities could continue on a "tit for tat" basis until one side tires of it, at which point the conflict might retreat from the headlines without anything having changed fundamentally. As a passionate diver, I condemn the senseless attacks on peaceful fish and sea-mammals as well as marine pollution by rocket scrap, but would welcome this lesser evil. Despite the high probability that the present crisis will not turn out to be severe, a comparatively high probability must be assigned to the risk of military conflict. Obviously this cannot be precisely quantified but we suggest a probability in the range 5%

to 10% is appropriate, rather much less (say below 1%) or much greater (say over 20%). Thus our initial statement that the geopolitical risks are far above average is almost certainly correct.

According to the Washington Post, the Pentagon assumes that North Korea will already be in the possession of some operational intercontinental missiles next year. The world might then have to live with this threat thereafter, with regime change in Pyongyang being the only way out.

How relevant is today's North Korean crisis for the markets

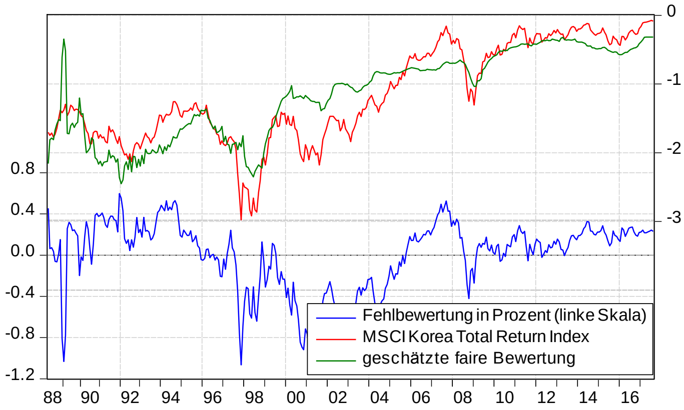
For decades a strategy of buying in Korea at the "ratting of sabers" was the correct one. Investors were regularly rewarded if they bought stocks as tensions surfaced and held them through the following crisis on the assumption that diplomacy would mean the worst could be avoided. But is this time-tested strategy likely to still work today?

Our view would be "yes" if South Korean assets were attractively priced, i.e. priced at a proper discount to reflect the crisis. But are they?

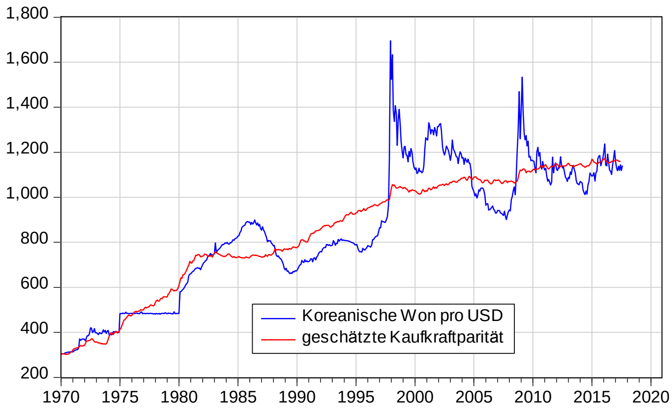
Graph 1 shows our estimate of the deviation of Korea's stock market from "fair value". Graph 2 shows our estimated "fair value" for the Korean won against the US dollar.

The MSCI Korea Index is currently not far from all-time highs, with an estimated overvaluation around 23%. With an inappropriate pricing of risk the market is not attractive. Its recent decline is better explained by factors such as the recent hike in taxation and an increase in the minimum wage than by the present crisis.

Graph 1: Valuing the MSCI Korea



Graph 2: Fair value for the KRW / USD



Financial markets are not pricing adequately the risk on the Korean peninsula, and this holds true for both Seoul's stock market and the Korean won.

And what about the other markets?

Since most other equity markets are also sporting hefty valuations we advise, in general terms, not to be "on the road at full throttle"

For the financial markets, it is not North Korea, rather the threat of a normalization of monetary policy that is the major threat - assuming of course no nuclear conflict.

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