Will the KOSPI hit a new historical high?

Top Korea fund manager *Henry M. Seggerman* explains why it will

First, there was the eerie, impenetrable "double top." On April 18, 2002, the KOSPI closed at 937.61 – a new high not seen since the bubble burst two years earlier – and then retreated. Almost exactly two years later, on April 23, 2004, the KOSPI peaked again at 936.06 – just one point away from the 2002 peak – and retreated once more. The index couldn't possibly break through this cement wall of resistance. But on February 7 of this year, it did.

Then, there was the 1,000 resistance level, invariably preceded by the catch-phrase "psychologically significant." On February 28, this hurdle was also cleared, at least for a few days. What hurdles remain? First, the bubble high of 1,059.04 set on January 4, 2000, and finally, the KOSPI's all-time historical high of 1,138.75 set on November 8, 1994.

In the typical fashion, responding to the recent rally, strategists are competing with each other to upgrade their KOSPI price targets. For Hyundai, it's 1,080. For Morgan Stanley, it's 1,120. For UBS, it's 1,150. For Macquarie, it's 1,190. For Credit Lyonnais, the strategy target is 1,200, but the technical target is 1,360, based on detecting an esoteric "cup and handle" pattern. Westhall Capital and Goldman Sachs are predicting KOSPI 2,000 on a multi-year basis.

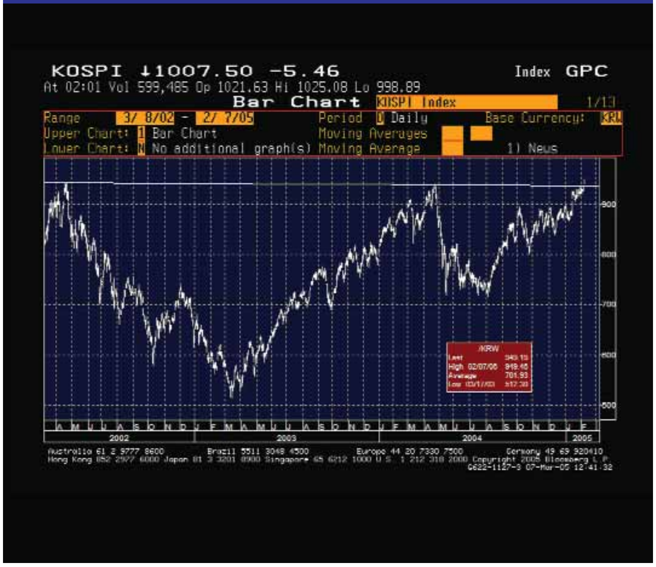
An epidemic of index target upgrades in a rising market is a dangerous indicator of panic buying conditions, and a sell signal to smart money investors. So, it's great news when Citigroup rains on everyone's parade with its 736 KOSPI "downside risk" target, not to mention the "Underweight Korea" drumbeat echoing from Deutsche Bank's perennial contrarian Steve Marvin. There is optimism, but it is by no means unanimous. Ironically, uncertainty can serve to prevent a big correction.

Another important reason for optimism right now is low volatility. What this means is that the stock buying is focused, selective, level-headed, and long-term.

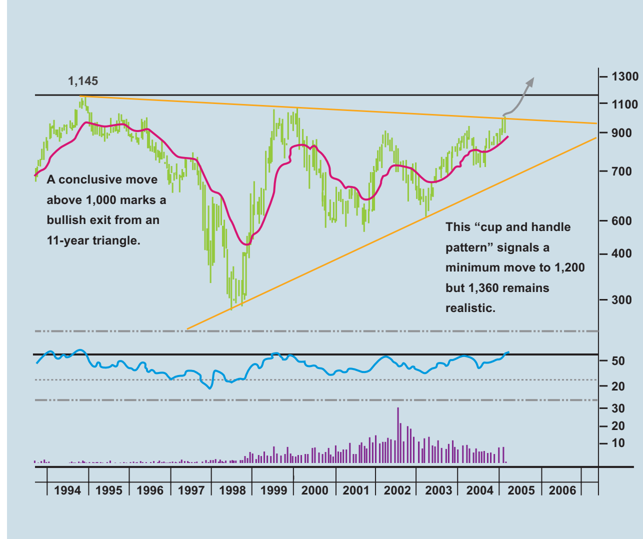
This is in part due to the turnaround in domestic equity investments. Korea's domestic investors had been net sellers of Korean equities for nearly three years until recently. But now, we have been seeing their deliberate return to the market. Very popular have been the installment-type equity funds sold by the banks, which take sums like W1 million per month from the average salaryman or woman's wages and plug it into a basket of blue chips. These investors are nothing like the caffeinated day-traders of 1999 who drove the KOSDAQ turnover rate that year to 1,100%, before bailing out.

In addition, the more traditional Beneficiary Certificate pure stock-type funds rose sharply from W6.5 to over W8 trillion between October, 2004 and February of this year, bringing total equity funds to W10 trillion, an 18-month high. Buybacks

Breaking through the "double top"



Kospi (monthly log with 13-month WMA)



are another factor. After Sovereign Asset Management came 10% away from ousting a founding chaebol shareholder, we will also see more and more blue chip buybacks, as management stakes are made more credible at many thinly-controlled chaebol cash cows.

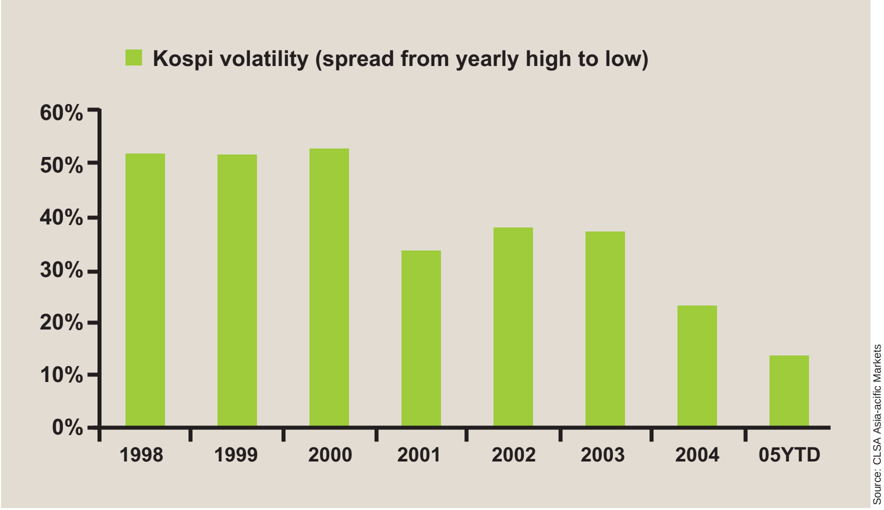
Even more important in this domestic investment turnaround story are Korea's pension funds, which have studiously ignored Korea's stock market for decades until last year. Foreign fund managers criticized the government, as the pension percentage invested in the Korean stock market had been a stingy 4% (Compare that to 46%, for example, in Australia). Now, it's a matter of policy that Korea's pension funds will increase equity exposure, and they have already moved from 4% up to 7%. If you consider that UBS forecasts Korean pension funds will have amassed a staggering W450 trillion within five years, this is the single strongest argument in favour of the KOSPI achieving a new historical high. In fact, the expected continuing pension fund investment can serve to keep the KOSPI from falling. Everybody assumes pension money will flood in if the market falls to 875, so this never happens.

The buzz word heard most often with regard to the KOSPI's rally is "re-rating" – meaning Korea is now ready to trade at a Price-to-Earnings Ratio (PER) closer to developed economies' PERs. The argument is that the market can finally break out of its historical trading range, exceeding earlier ceilings imposed by historical valuations. However, it's extremely important to note that corporate Korea has improved both EPS and ROE over the last five years. When the market hit 1,138 in 1994, its PE ratio was a lofty 17.2x. When the market hit 1,059 in 2000, its PE ratio was an even loftier 18.8x. Today, by contrast, although the market is trading at a five-year high, its PE ratio is a very manageable 8x.

Relative to already-cheap Asia-Pacific markets, Korea is still trading at the deepest discount to (on a Price-to-Book - ROE basis), giving the rally further regional headroom.

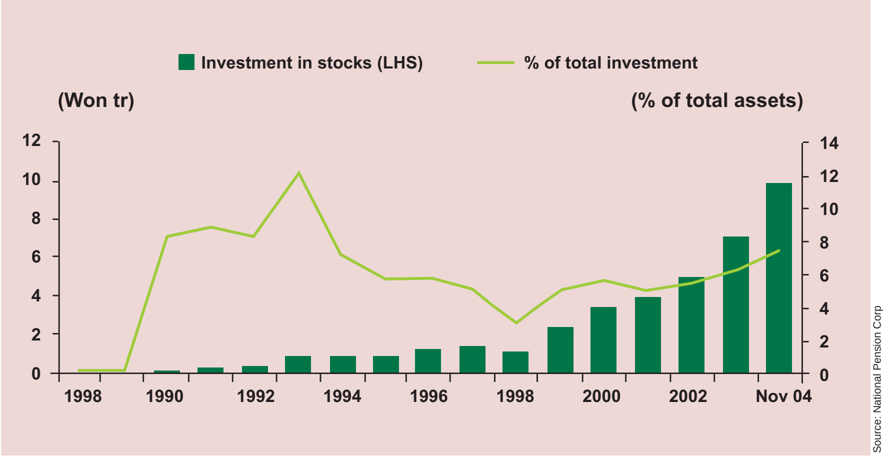
While we are on the subject of re-rating, at this point MSCI ought to move Korea into its lucrative EAFE Index, but it's not going to happen. Essentially, the principal qualification

Volatility decreasing



Korea monthly installment fund account

Equity investment to total assets at the NPF



for this upgrade has been sustainable World Bank Atlas Method High Income status. In August of last year, the World Bank released final 2003 figures indicating that Korea had achieved High Income status for the third year running, demonstrating sustainability. Within days of the World Bank's announcement, MSCI circulated a questionnaire suggesting the time had come to add corporate governance and military risk as brand new qualifications for EAFE admittance.

Turning to Korea's economy, it's understood that when there has been rapid economic growth over a considerable period of time, a stock market will eventually run out of gas, having priced in all of the obvious good news. The most opportune time for a stock market, then, is when its economy is on the verge of a recovery, when the positive signals have not yet become old news. This is certainly the situation for Korea right now.

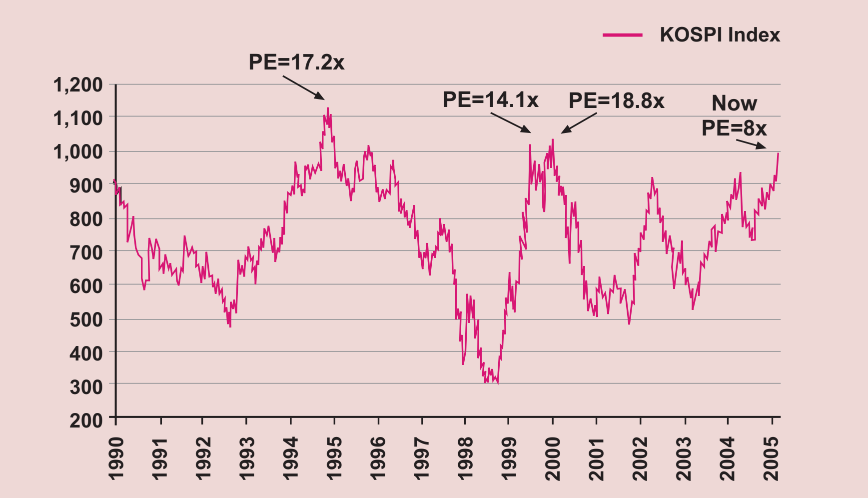
Korea's domestic economy has suffered from a false downturn, from which it is now emerging. After all, consumers merely got in trouble for abusing their credit cards. There was no wave of bankruptcies, massive unemployment, or bread lines. It was a large imbalance, not an implosion. Forcibly depressed credit card usage has revived, sale of durable goods has peeked into growth for the first time in two years, and domestic demand has seen two months of modest year-on-year increases, with department store sales up 6.2% in February. However, consumer sentiment has still lingered below 100 (meaning more doubt than confidence) for almost one year. From a stock market perspective, it's actually better to be at this end of a recovery than at the other end.

More confirmation of domestic recovery is seen in the business sector. Business sentiment in February experienced its biggest one-month jump in 10 years from 85.7 to 119.2.

Construction orders showed modest growth in January for the first time in a year. Also, over 5,000 new businesses were launched in January alone, representing a big jump from December and marking a new two-year high.

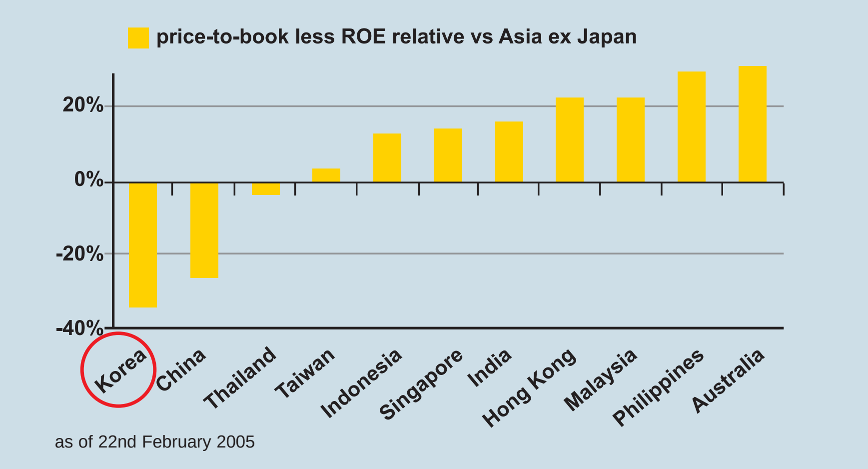
Last year Korea exported over $250 billion, reflecting a blistering growth rate of 31.2%. How can 2005 possibly match this? The answer is that it can't

KOSPI and peak PE



Source: UBS estimates

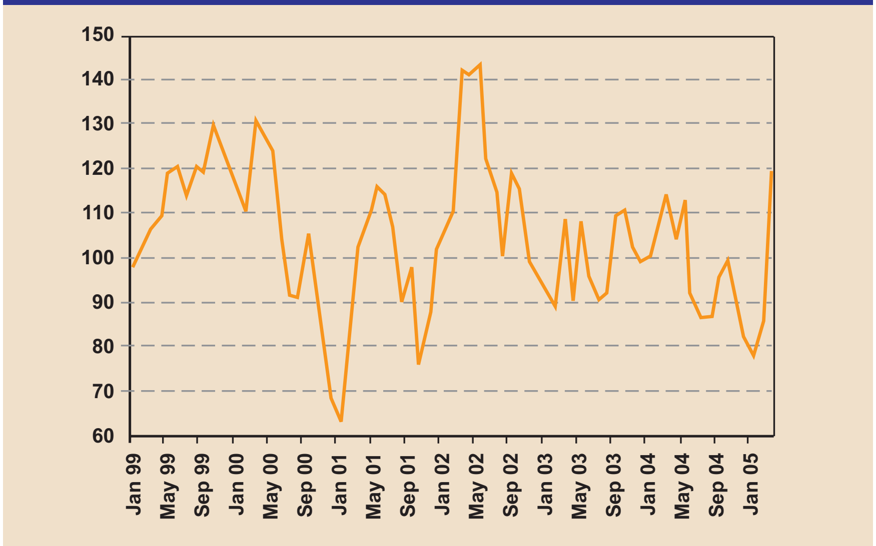
Korea – biggest discount vs. Asia Pacific ex-Japan



as of 22nd February 2005

Source: UBS estimates

Great expectations – FKI Business Expectations Index



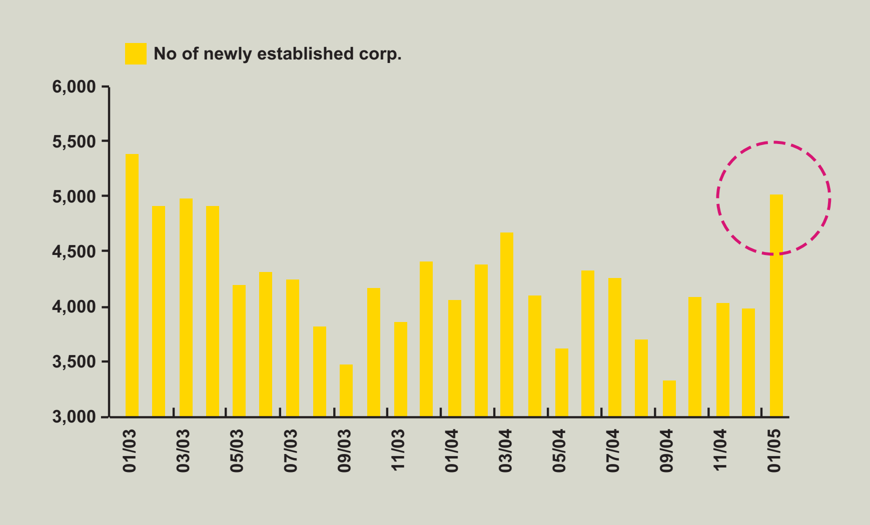
and it won't. So sell-side economists and think-tank Ph.D.s are all floating 2005 export growth forecasts that range anywhere from 10% to 20%, all bespeaking a worrisome growth slowdown. This view is a classic distortion due to the "base effect." The US 2001 recession resulted in some sluggish Korean export numbers in 2002 and 2003, so when US and Chinese export demand from Korea took off last year, all the year-on-year numbers looked phenomenal. What is happening this year will be just that Korean exports shall return to their historically strong rate of growth – although below the stratospheric 2004 level – setting yet another historical record in terms of absolute value. 2004 was just an outlier, a big rebound from two years of sluggishness.

With solid, though not explosive, export expectations, and selective signs of a domestic recovery, Goldman Sachs just raised its 2005 GDP growth forecast from 3.7% to 4.5%. However, the hopes that the KOSPI will hit a new historical high this year spring mostly from liquidity considerations, and less from the economy or "re-rating." Korean retail investors appear to have turned around from three years of net selling, and buybacks proliferate. Plus, there's the expected W450 trillion in pension money, with an unprecedented chunk already promised for the stock market. With so much money burning a hole in NPC's pocket, don't expect to be able to "buy on a dip."

The rally is also dependent on a couple of big factors beyond South Korea's control. China has been Korea's number one export destination for more than a year now. That's why the KOSPI fell 22% in three weeks in April and May of 2004 when the Chinese government announced the implementation of its cool-down measures. China's economy is not expected to burst (especially after seeing the January-February numbers), but in the doubtful scenario it did, the KOSPI would suffer. Regarding North Korea, a [highly unlikely] atomic test might result in a market pull-back, although according to Goldman Sachs, "North Korean newsflow does not appear to have had a sustained impact on South Korea's equity market performance 1990-2005."

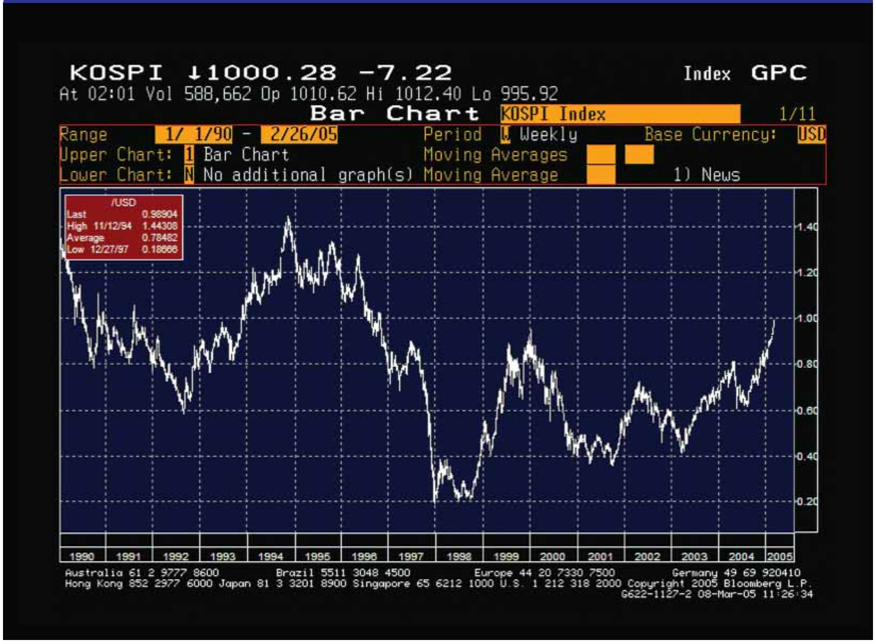
One can also make a strong argument that the KOSPI is not in fact anywhere near its all-time historical high, if you take into consideration foreign ownership. The Korean stock market is 43%-owned by foreigners, which is one of the highest foreign ownership levels in the world. By way of contrast, the Canadian and Brazilian stock markets are only 7%-owned by foreigners. Accordingly, if you look at the KOSPI's 15-year history in US dollars, it needs to rise another 44% to reach its 1994 all-time historical high. If you look at it this way, there are no resistance levels to worry about as far as the eye can see. **FA**

Turnaround in number of newly established enterprises



Source: NSO, Merrill Lynch Research

In fact, 44% below all-time US dollar high



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