ANALYSTS LOVE TO TALK ABOUT CHINA BUT SHOULD FOCUS ON SOUTH KOREA

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On Friday, April 23, I had an interesting conversation with Jeff Weniger, Investment Strategist at BMO Global Asset Management. We spoke at length about the impact of the U.S. dollar on global markets. I found our conversation about the impact of easy monetary policy on economies such as China and South Korea particularly noteworthy. Jeff believes that while we have already seen large currency moves in the yen and the euro, the next frontier for aggressive policy action could potentially be China and South Korea. This may have far-reaching implications for the Chinese Yuan and the Korean Won, given the distinct possibility for these central banks to bring out the big guns. **The Second Largest Weight in Emerging Market Indexes—Ignored** Jeff pointed out that most analysts spend way too much time discussing China. While China is the largest weight (at 21%) in the MSCI Emerging Markets Index, Korea is a close number 2, at approximately 15% weight. Jeff does not believe enough attention is focused there, and I would generally agree with that sentiment. With its industry focused on automobiles, semiconductors and electronics, Korea is currently the 13th largest economy in the world.[1] Jeff believes South Korea needs aggressive easing, as the country has been directly impacted by a currency that has appreciated significantly against the yen. For perspective, four years ago 100 won would buy 6 yen; now it is 11 yen.[2] This has had a deleterious effect on the Hyundai's and Kia's of Korea. Considering that markets don't look in the rearview mirror, it is unsurprising that the Bank of Korea has embarked on cutting interest rates, recently by 25 basis points (bps), from 2% to 1.75%. Jeff thinks its possible Korea will embark on a path toward zero interest rates to combat the won strength. **Valuations in Korean Stocks: 2009 Levels** If we were to consider the price-to-sales (P/S) ratio, South Korea is currently as attractively priced as it was in 2009. While Russian energy is currently not expensive, Jeff's team is hard pressed to find any other asset class or market in equities or bonds that is trading at 2009 valuations. **The Future of Oil** Jeff spoke about the fast global ascendance of energy-saving technologies, with the millennial generation being fully on board with the concept of global warming and taking measures to reduce oil consumption. What is even more promising is the real viability from both a technology and economic standpoint to achieve the goal of energy independence. One example of a company jumping on the energy independence bandwagon is Chevrolet, which is practically giving away a fleet of Chevy Sparks through cheap financing, thus feeding the frenzy for energy-efficient vehicles; instead of paying $2.50 at the pump, the cost for an individual driving energy efficient care could cost closer to $0.85–$0.90. In essence, the demand curve for oil may not just shift down by 1%–2%, such as we've seen during recessions—but it may drop by half. Jeff believes that oil is likely to drop further, and he sees no reason why oil cannot trade back down to $15–$20. Consequently, Jeff likes oil-importing countries such as South Korea, which he sees as being one of three most sensitive to oil prices, along with Germany and Japan. **Global Asset Allocation** From a fixed income perspective, Jeff's team at BMO is hugging the short end of the yield curve and has been trading off interest rate risk in exchange for credit risk through quasi-equity securities such as

REITs, bank loans, high yields, etc. In the emerging market debt space, he feels that countries that have a large portion of their debt denominated in U.S. dollars are at the greatest risk especially if the dollar continues to rally. Jeff's team is constructive on global equities and is over-weight in both international and emerging market equities. It is, however, tougher to make a valuation case for U.S. equities. As rates start to rise in the U.S., he believes that most bond-like sectors, or yielders, will be adversely impacted. In the EM space, more pleasant surprises from the central bank of China PBoC will inevitably propel EM equities higher. *For more research on South Korea, read our Market Insight South Korea at a Crossroads. Read the Conversations with Professor Siegel Series here.* [1]Source: World Economic Outlook Database, 2014 Estimated Current Prices GDP. [2]Source: Bloomberg form October 2011 – April 2015.

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DEFINITIONS

Monetary policy : Actions of a central bank or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.

Frontier market : Typically characterized by a higher degree of potential risk, including issues that may inhibit the flow of assets across national borders and awareness of potential difficulties for foreigners to establish accounts.

Emerging market : Characterized by greater market access and less potential for operational risks when compared to frontier markets, which leads to a larger base of potentially eligible investors.

MSCI Emerging Markets Index : a broad market cap-weighted Index showing performance of equities across 23 emerging market countries defined as “emerging markets” by MSCI.

Easy money policies : Policies that have the goal of stimulating economic activity.

Real interest rate : Interest rate accounting for the impact of inflation. From the nominal interest rate, which does not account for the impact of inflation, the rate of inflation is subtracted to get to the real interest rate.

Basis point : 1/100th of 1 percent.

Valuation : Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

Yield curve : Graphical Depiction of interest rates on government bonds, with the current yield on the vertical axis and the years to maturity on the horizontal axis.

Credit risk : The risk that a borrower will not meet their contractual obligations in conjunction with an investment.

Real estate investment trust (REIT) : Investment structure containing a basket of different exposures to real estate, be it directly in properties or in mortgages. Returns predominantly relate to changes in property values and income from rental payments.

Yield : The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value.