



Daily Note

PERFECT STORM TO HIT KOREAN TRADE

Rory Green

- Korean export growth negative in 2019
- Stimulus coming in Q3/19, but insufficient to offset trade drag
- Tech war silver lining for Korea and Samsung

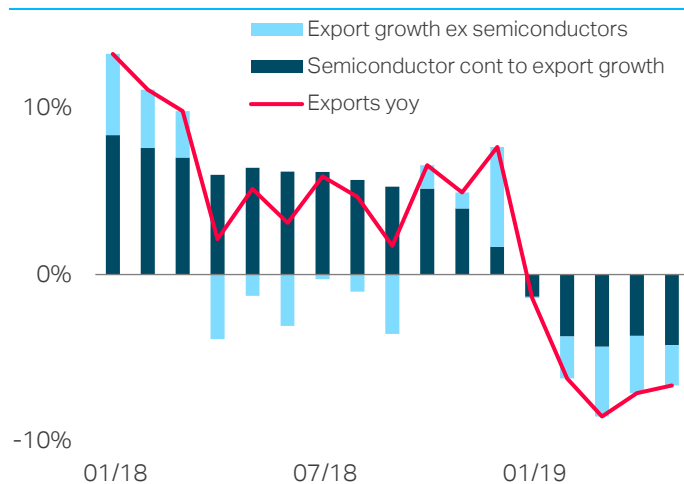
Trade war, tech confrontation and a cyclical bottom in the semiconductor cycle will combine to ensure an actual fall in Korean exports through 2019. Last year, semiconductor sales accounted for a staggering 92% of Korean export growth, a single product dependence more akin to an oil exporter than a tech hub (chart below left). The payback is now coming as trade friction exacerbates a chip price collapse. Export growth ex semiconductors is far from benign, either. A rate cut and fiscal stimulus are coming in Q3, but will be insufficient to offset the trade decline.

Trade war prolongs bottom of semiconductor cycle. The electronic component industry is suffering from falling demand and oversupply. Demand for handsets, computers and data centres - the drivers of chip sales - is contracting simultaneously for the first time. We expect this trend to continue as the trade war hits global activity hard in H2/19, pushing a number of major economies towards recession. On the supply side, chip producers and end-users registered a record inventory build in H2/19. Oversupply and demand contraction is forcing semiconductor prices down and, with them, the US\$ value of Korean and Taiwanese exports.

One of the most powerful forces in economics - base effects - adds conviction to our call.

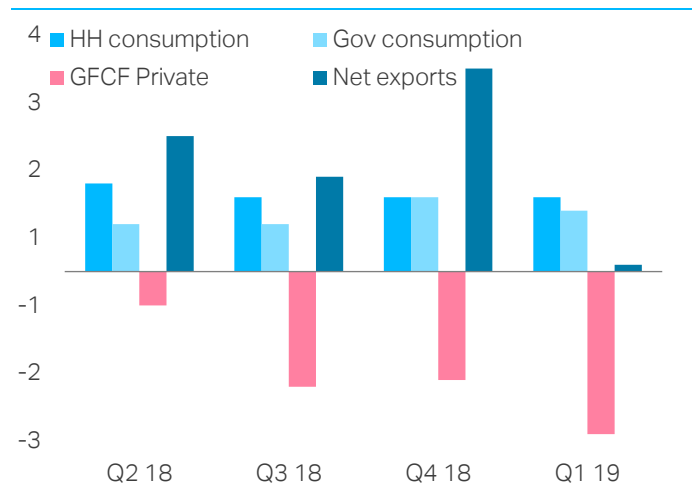
The sheer US\$ value of chip exports last year is a drag on 2019 yoy growth. Combining the base effect with the aforementioned price collapse suggests that semiconductor sales will remain

Semiconductor dependence (3mma yoy %)



Sources: CEIC, TS Lombard.

Investment crash (cont to GDP growth %pts)



Source: CEIC.

negative in 2019, although the bottom in yoy growth has likely passed. We expect negative chip exports to have a monthly drag of 2 ppt on total export growth. If we exclude semis from Korean exports the 2019 ytd growth rate is higher by three fifths albeit still negative at -3.9% YoY.

Tech cycle bottom forming, 5G to lead rebound. Our short-term bearishness notwithstanding, the industry outlook for 2020, and consequently for Korean exports, is positive. Leading indicators -semiconductor business sentiment, shipment volumes, and inventory levels – have all improved. Prices should start to recover as the impact of reduced production and sharp falls in semiconductor facility capex (global industry capex will fall 29% in 2019) come through. A modest relative recovery in semiconductor exports is likely in Q4/19, as demand for 5G infrastructure and handsets picks up.

Ex-semiconductor, the outlook for Korean exports is poor. Inventory levels are still high globally, while the trade war is evidently hurting demand. We breakdown Korean exports into 13 product groups that together account for 75% of total exports. It is difficult to find a positive story at the sectoral level; key export industries - autos, steel, petrochemicals – are in cyclical downturns, too. Only ship building is benefiting after upgrades to emission regulations.

Trade war FX impact. We expect the yuan to breach the USD/CNY 7 level, as the trade war drags on. The won will weaken in tandem, but not enough to help exports. Korean exports are increasingly insensitive to currency moves. This is in large part due to semiconductors. The electronic component is a commodity, with prices in dollars set by global supply and demand trends. We expect trade war-induced Asian FX weakness and the subsequently stronger dollar to provide another headwind to Korean exports.

2019 GDP growth at 2%, a 20 year low. Net exports contributed 55% to GDP growth in 2018. Thus far, negative trade growth has not shown in GDP aggregates. An investment collapse, after President Moon hiked business rates and minimum wages, rather than exports has been the biggest drag on growth. (Chart above right). However, the exports net contribution to GDP will turn negative in Q2/19 GDP. We expect GDP growth to come in at 0.5% QoQ in this quarter.

Seoul stepping up. Officials in Korea are finally aware of the extent of the headwinds facing the economy. We expect the BoK to cut rates in Q3/19. An extra budget (6.7 trillion won) is working its way through parliament. Moreover, economic weakness has forced President Moon to tone down his left leaning inclinations, reducing projected minimum wage increases, and softening language on business taxes. The new pro-business stance and stimulus measures will support domestic demand and GFCF, but will be insufficient to offset the trade drag.

Korean asset risk. The KOSPI is already pricing in a substantial decline in export growth. We believe there is scope for further negative earnings revisions, particularly for firms exposed to the tech cycle. Samsung, (20% of the KOSPI and 3.5% of MSCI EM) and SK Hynix are most exposed. We are therefore underweight the index in our asset allocation.

Tech war silver lining. The ongoing Huawei vs Trump battle puts a number of interesting twists on the Korean export story. The first is the possibility of frontloaded demand. The PRC semiconductor complex, led by Huawei, will look to build an inventory buffer ahead of prospective US sanctions. Inventory building would bring forward demand and could trigger a fleeting uptick in exports. The second potential positive is market share gains for Samsung. The firm will be among the primary beneficiaries of the demise in Huawei's overseas smartphone sales. Third, looking ahead, impediments to China's industrial upgrading are positive for Korea and Taiwan. The "Made in China 2025" plan targets 75% domestic production of chips, a worrying prospect for Seoul. Attacks on China tech that preserve East Asian market share are positive for Korean growth.