BOK Cut Room Seen in Inflation-Linked Debt Slump: Korea Markets

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By Jiyeun Lee

Aug. 28 (Bloomberg) -- South Korea's inflation-protected bonds are set for the worst month in a year, suggesting the central bank has room to surprise economists with one more interest-rate cut.

So-called linkers due June 2023 lost 1.8 percent this month, data compiled by Bloomberg show. Notes maturing in 2021 indicate inflation of 1.56 percent over their lifetime, less than the Bank of Korea's target of 2.5 percent to 3.5 percent through 2015. Governor Lee Ju Yeol lowered the benchmark rate to

2.25 percent from 2.5 percent on Aug. 14 and said price pressures are "not high."

The first reduction in borrowing costs since May 2013 came after the BOK lowered its living cost estimates and Finance Minister Choi Kyung Hwan unveiled an 11.7 trillion won ($11.5

billion) spending plan to boost the slowest growth in more than a year. While most analysts predict Lee will keep interest rates unchanged, Samsung Asset Management Co. and Eastspring Asset Management Co. see room for a further cut.

"Another rate cut within the year is possible as one isn't enough to support the government's growth push," Jack Kim, who helps manage 700 billion won of fixed-income assets for Eastspring in Seoul, including Korean linkers, said in an Aug.

26 phone interview. "Low inflation should make it feasible."

Inflation Outlook

Kim said weak domestic demand and a strong currency means consumer-price gains are likely to trail the central bank's forecast. The BOK revised its 2014 estimate to 1.9 percent from

2.1 percent on July 10 and the finance ministry lowered its to

1.8 percent from 2.3 percent on July 24. The won is Asia's best performing currency in six months, gaining 5.3 percent to

1013.45 per dollar as of 10:43 a.m. in Seoul, curbing import costs.

Samsung Asset, South Korea's biggest fund manager, sees scope for the BOK to lower its benchmark seven-day repurchase rate to 2 percent, most probably in October or November, Lee Do Yoon, its chief investment officer for fixed income, said in an Aug. 21 interview in Seoul. Bank of America Merrill Lynch is the only forecaster among 26 surveyed by Bloomberg predicting another cut in 2014, while the rest said they expect no change.

The yield on linkers maturing June 2023 rose 23 basis points this month to 1.56 percent, the steepest rise since September 2013, Korea Exchange Inc. prices show. The yield on similar notes due two years earlier rose 20 basis points in August to 1.44 percent, the most since November 2013.

Issuance Drops

South Korea's breakeven rate, a measure of price increases bond traders expect over the life of the 2021 linkers, fell from its 2014 high of 1.92 percent on March 4 to a seven-month low of 1.56 percent yesterday. The finance ministry said in an Aug. 19 statement it sold 34 billion won of inflation-protected notes this month, the least since November.

GAM International Management Ltd. sold all of its South Korean bond holdings in May, including inflation-linked notes, according to Caroline Gorman, a London-based money manager for the firm that oversees $6 billion of emerging-market debt.

"We do not feel that inflation risks generally are being underpriced," Gorman said in an Aug. 26 e-mail interview. "So we have limited holdings of inflation-linked bonds across the portfolio right now."

Consumer prices in Asia's fourth-biggest economy rose 1.6 percent in July from a year earlier, the least in three months, official data show. Inflation will accelerate to 1.8 percent in the three months ending Sept. 30 and then 2.3 percent and 2.5 percent in the following two quarters respectively, according to a survey of economists by Bloomberg.

'Cut Unlikely'

"Government efforts to boost domestic spending will bear fruit, pushing inflation to 2.7 percent by next quarter," Park Sang Hun, the Seoul-based chief economist at HI Investment & Securities Co., a survey participant, said by phone yesterday.

"Another rate cut is unlikely unless the global economy deteriorates significantly, which isn't my baseline scenario."

This month's reduction was preceded by a shift in the BOK's policy guidance after domestic consumption fell as the nation went into mourning following a ferry disaster in April killed almost 300 people.

Governor Lee had said after policy reviews in April and May that the next rate move would be “upward” if inflation pressures were to build. He cited downside risks on July 10, when the central bank cut its 2014 gross domestic product growth forecast to 3.8 percent from 4 percent. Lee said after the BOK’s Aug. 14 policy review that while the threat of deflation isn’t big, it needs to be monitored.

“There seems to be a change in how the BOK views inflation,” Kong Dong Rak, a Seoul-based fixed-income analyst for Hanwha Investment & Securities Co., said in an Aug. 26 phone interview. “They used to say inflation will face upward pressure, but now we’re seeing comments suggesting prices will stay low for a prolonged period.”

Kong said he sees the possibility of one more reduction this year, either in October or November.

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