KOREA - Sloan Global Advisors Trade Opportunity August 2021

Trade opportunity:	Exploiting mispricing in Korea vs Australia Interest Rate Policy
Term:	6 months+
Asset Class(es):	3-year Government Bonds (via bond futures).

The following is a portfolio trade idea which Albany is actively pursuing. This ACTO is the first notification of investment ideas that are being created by the portfolio managers at Albany Capital.

Background

While not readily apparent on the surface, the Korean and Australian economies have similar characteristics. Both countries are large trading partners with Asia and more importantly, China. Both have a central bank that acts independently to achieve goals set for them. Both central banks have easedmonetary policy in response to the outbreak of Covid-19. In exiting the easy money period, it appears there will be a difference in timing and that brings about this opportunity.

The two interest rate markets of South Korea and Australia have similar monetary policies guiding them. The divergence came in when Australia moved to lower rates towards zero in 2020. Below we can see the movement of short end cash rates between thetwo countries in the last decade. The mean difference in short term cash interest rates between the two countries has been less than 50 bp over that time.

A correlation of monetary policy should not be a surprise. Both are large open economies that have China as a major trading partner. In 2020, both countries ran high trade surpluses with China: Australia: -$61.4 billion; South Korea: -$60.3 billion. They also have similar sized economies with South Korean GDP at USD$1.74 trill vs Australia atUSD$1.48 trill.

Below we can see the forecast from Bloomberg of the Australian economy major metrics. The RBA noted in their minutes of the last Monetary Policy Meeting that unemployment in Australia declined to 5.0% in June with a trend downwards.

Forecast	2017	2018	2019	2020	2021	2022
Real GDP (yoy%)	2.43	2.88	1.90	-2.38	5.25	4.00
CPI (yoy%)	1.93	1.93	1.60	0.88	1.75	1.50
Unemployment (%)	5.59	5.30	5.16	6.49	- -	- -

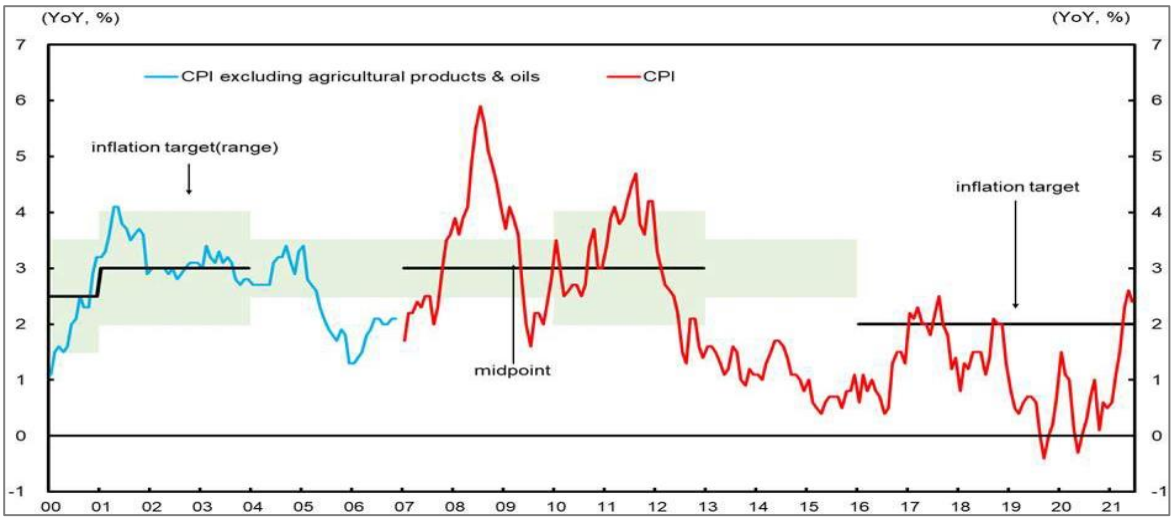
Similarly, we can see the same metrics for South Korea in the table below.

Forecast	2017	2018	2019	2020	2021	2022
Real GDP (yoy%)	3.16	2.91	2.03	-0.90	4.00	3.00
CPI (yoy%)	1.96	1.48	0.40	0.70	1.90	1.50
Unemployment (%)	3.68	3.84	3.76	3.20	3.90	3.80

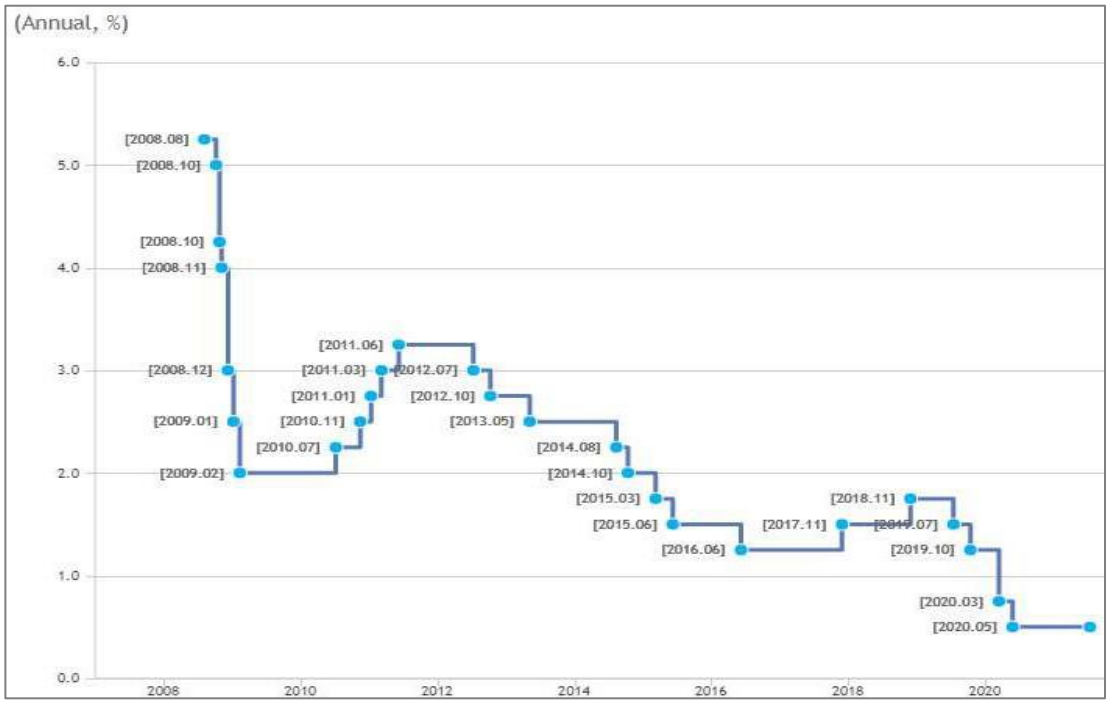
From the Bank of Korea (BOK): *Article 1, Clause 1 of the Bank of Korea Act stipulates that the purpose of this Act is "to contribute to the sound development of the national economy by pursuing price stability through the formulation and implementation of efficient monetary policy". Accordingly, the Bank of Korea takes price stability as the most important objective of its monetary policy. If prices become unstable, uncertainty concerning the future mounts, discouraging economic activities as a whole, and the distribution of income and resources grows distorted. As a result, the stability in economic conditions as a whole is damaged.*

The BOK meets 8 times per year to address policy and assess future conditions. They last met on July 15th 2021. They tend to have an eight-week meeting cycle so their next meetingswill be in late August, Mid-October and the end of November, 2021.

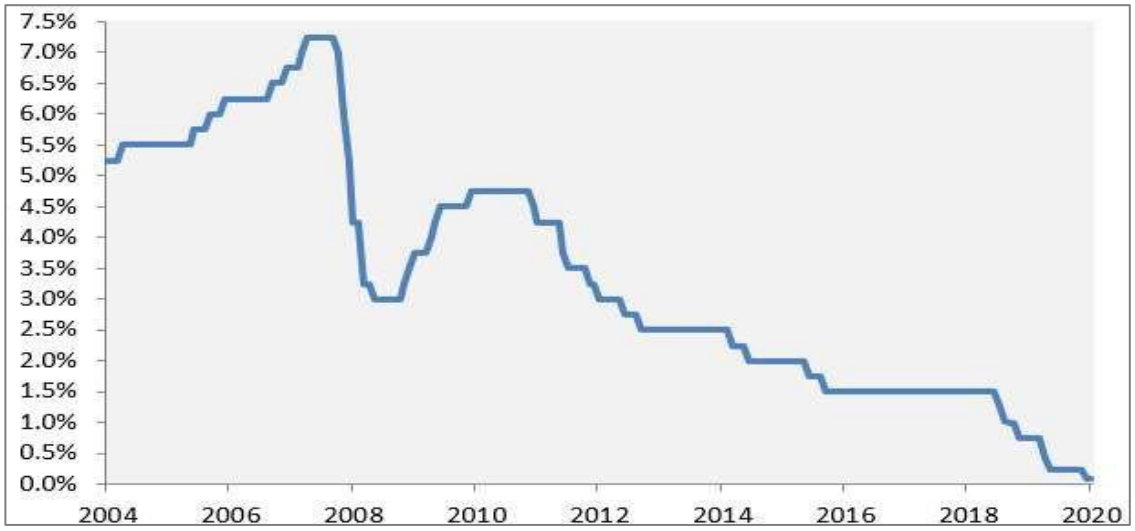
The BOK seeks to achieve their goals through inflation targeting. Currently their target rate is 2%. This has been in place since 2019. From BOK, we can see in the graph below the CPI since 2000 with their horizontal line that dictates their inflation goal.



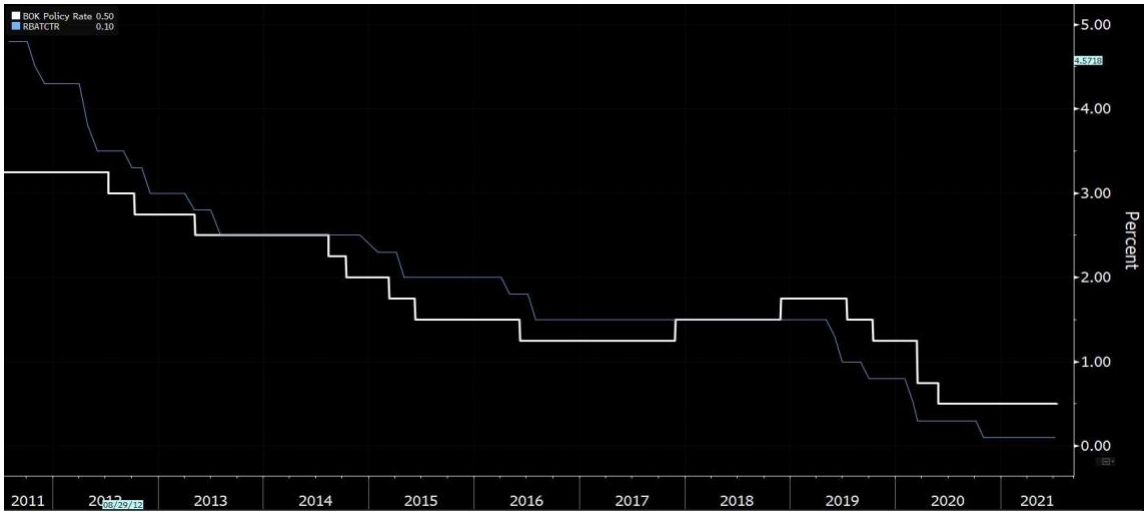
While the BOK is looking for inflation to settle at 2% over the long run, the RBA targets a corridor of 2-3% for their monetary policy goal. Similar to the RBA cash rate, the BOK has a Base Rate for transactions with other parties. We can see this rateover the past 4 years in the graph below from the BOK website. We can see that the BOK last moved rates lower to the current 0.50% in May of 2020 in response to the outbreak of the Covid-19 pandemic.



From the Reserve Bank of Australia (RBA) we can see their cash rate moves over the same period in the graph below. The RBA lowered cash to 0.10% in 2020 in response to the collapse in growth, employment and prices. Given the emergence of variants of the virus, the low level of vaccinated public and slowing global growth, the RBA has been loathe to raise rates. Conversely, the Peoples Bank of China (PBOC) began withdrawing liquidity much sooner than other global central banks. This has affected the economies of their trading partners.



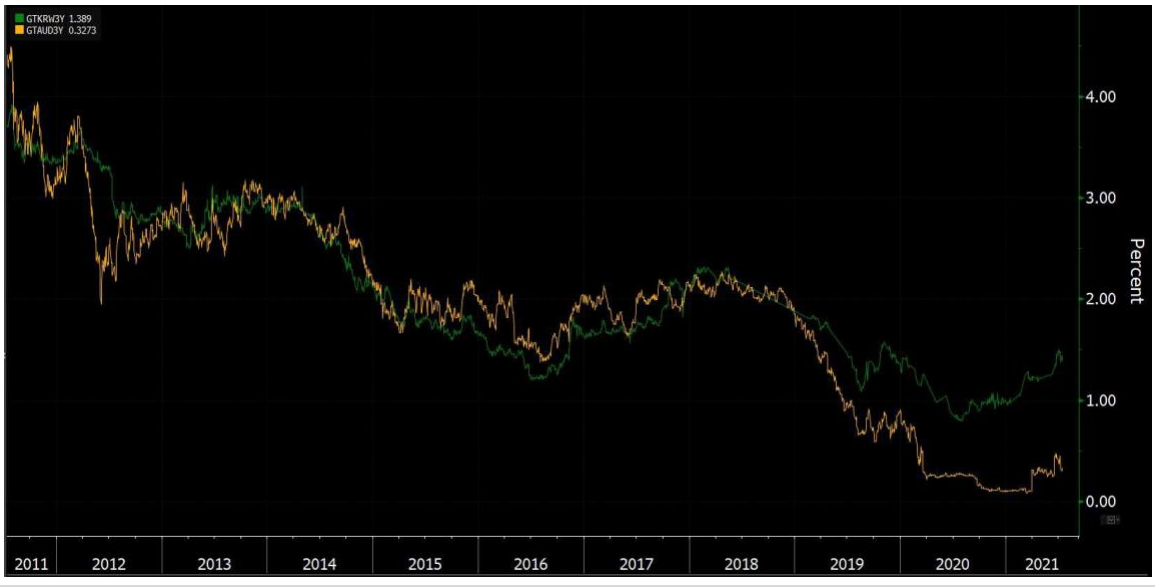
Overlaying the two for the past decade we can see there is a high correlation between the cash target rates of the two countries.



There will always be divergences from other countries when it comes to policies. Some may target growth, inflation or there may be fiscal spending issues affecting monetary policy, social pressures, and even elections. **TheBOK seems to be following China out of the extreme monetary easing imposed last year during the depths of Covid, while Australia appears to be following the BOJ model and implementing both near ZIRP and yield curve controls.**

Transitory Inflation Risks

Below is a telling graph of this diverging policy difference. We will see later the inflationary forces that the central banks are fighting. In the meantime, the graph below shows the divergence of the yield in the 3-year bonds between South Korea and Australia in the recent period. Note that both countries have a 3-year bond futures contract that acts as a reference point for mid-curve transactions. This graph shows despite both countries lowering cash rates to 0.5% (BOK) and 0.10% (RBA), the Korean bonds have slowly edged higher in yield as there is an expectation the BOK will soon remove the punchbowl. In fact, the head ofthe BOK said it will happen this calendar year. Expectations are for an October BOK rate hike.



In the table below we can see the money market rates and participant survey results for Korean monetary policy out to 2023.

	3Q 2021	4Q 2021	1Q 2022	2Q 2022	3Q 2022	4Q 2022	1Q 2023	2Q 2023	3Q 2023	4Q 2023
Central Bank Rate	0.50%	0.75%	0.75%	0.75%	1.00%	1.00%	1.25%	1.25%	1.25%	1.25%
Previous survey	0.50%	0.50%	0.75%	0.75%	0.75%	1.00%	1.00%	1.25%	1.13%	n/a
3-month Koribor	0.72%	0.90%	0.90%	1.05%	1.10%	1.15%	1.38%	1.35%	1.40%	1.40%
Previous survey	0.72%	0.75%	0.90%	0.90%	0.95%	1.01%	1.10%	1.17%	1.25%	n/a
3-Year Note	1.30%	1.40%	1.50%	1.60%	1.65%	1.66%	n/a	n/a	n/a	n/a
Previous survey	1.32%	1.38%	1.36%	1.40%	1.51%	1.53%	1.40%	1.45%	n/a	n/a
10-Year Bond	2.14%	2.23%	2.22%	2.23%	2.34%	2.30%	2.21%	2.22%	2.25%	2.23%
Previous survey	2.17%	2.21%	2.23%	2.20%	2.28%	2.16%	2.08%	2.10%	2.25%	n/a

In contrast, we can see the similar table prepared for the Australian market below. While cash rates in Korea are expected to go to 1.25% in the next couple of years, the RBA asserts they will leave policy rates unchanged at 0.10% over that period.

	2Q 2021	3Q 2021	4Q 2021	1Q 2022	2Q 2022	3Q 2022	4Q 2022	1Q 2023	2Q 2023	3Q 2023
Central Bank Rate	n/a	0.10%	0.10%	0.10%	0.10%	0.10%	0.10%	0.10%	0.10%	0.10%
Previous survey	0.10%	0.10%	0.10%	0.10%	0.10%	0.10%	0.10%	0.10%	0.10%	0.10%
3-month Interbank	0.04%	0.04%	0.05%	0.05%	0.05%	0.05%	0.10%	n/a	n/a	n/a
Previous survey	0.04%	0.04%	0.05%	0.05%	0.05%	0.05%	0.08%	n/a	n/a	n/a
2-Year Note	0.10%	0.10%	0.11%	0.11%	0.12%	0.12%	0.12%	n/a	n/a	n/a
Previous survey	0.10%	0.10%	0.10%	0.10%	0.10%	0.10%	0.12%	n/a	n/a	n/a
3-Year Note	0.23%	0.40%	0.43%	0.48%	0.50%	0.55%	0.60%	n/a	n/a	n/a
Previous survey	0.10%	0.25%	0.33%	0.40%	0.50%	0.50%	0.50%	n/a	n/a	n/a
10-Year Bond	1.82%	1.93%	2.00%	2.03%	2.09%	2.20%	2.25%	2.25%	2.25%	2.25%
Previous survey	1.81%	1.91%	2.00%	2.06%	2.11%	2.20%	2.25%	n/a	n/a	n/a

The risk that this can bring is that if there is another dip or other crises to face, the ability to use interest rates as a tool is limited for Australia. Notably we have already seen several central banks tighten policy whether it be through interest rates or credit policy. China is one of those countries who tightened first and move towards a neutral monetary policy before the next economic crisis presents itself.

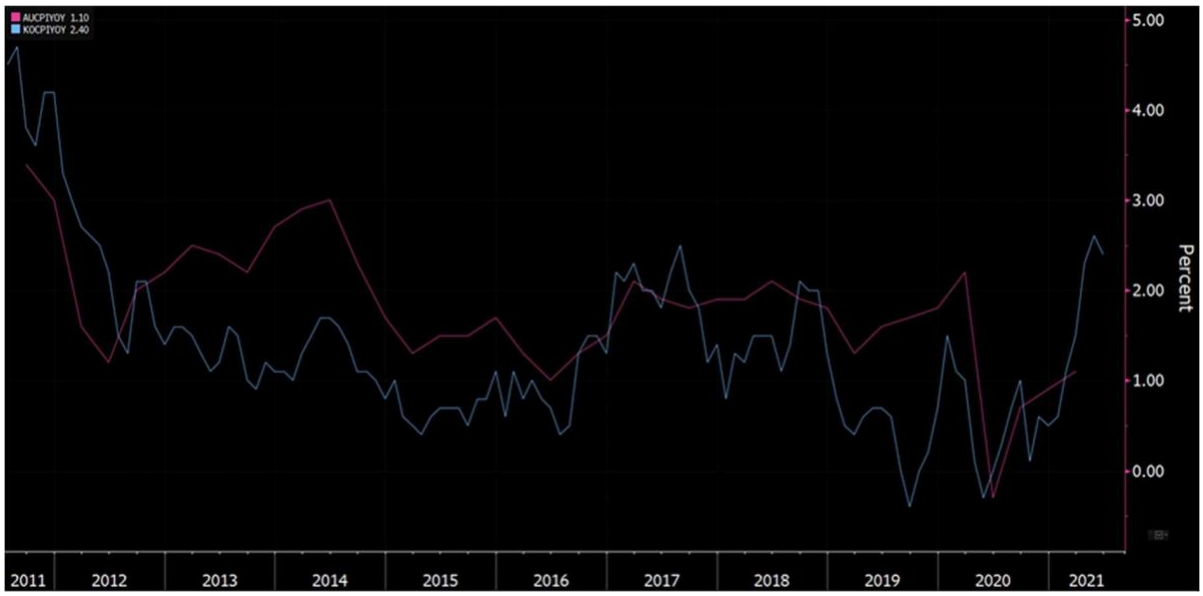
Last year, in Q2:2020, the Australian CPI report showed a rate of -0.3%, a fall from 2.2%the previous quarter. Therefore, we should expect a rise as the deflationary effects of the beginning of Covid fall out. This is the transitory nature that the Fed alluded to in reverse. Since that report was released, we have seen higher inflation due to producer supply constraints, a weaker AUDUSD, higher cost of living and transport costs.

While the Australian release of inflation figures is slow due to the 3-month delay in reporting, we can also get an idea between periods from monthly inflation gauge announcements from the Melbourne Institute of Applied Economic and Social Research.

To be clear there can be variances from the official numbers, but the trend should be representative over time. We can see the latest survey results in the table below as reported by Bloomberg. It shows a pickup in their inflation gauge of 1.2% since their release in March.

	June	May	April	March	Feb.	Jan.	Dec.	Nov.
	2021	2021	2021	2021	2021	2021	2020	2020
	Inflation Gauge							
MoM % change	0.4%	-0.2%	0.4%	0.4%	0.1%	0.2%	0.5%	0.3%
3-mo annualized	0.6%	0.6%	0.9%	0.7%	0.8%	0.9%	0.6%	0.3%
12 months ago	3.0%	3.3%	2.3%	1.8%	1.6%	1.5%	1.5%	1.4%

We can see the graph of the inflation reported by both Korea and Australia in the graph below from Bloomberg. Over the past decade both economies have had similar experiences. Both are also seeing the heightened inflation rate after the collapse in prices last year.



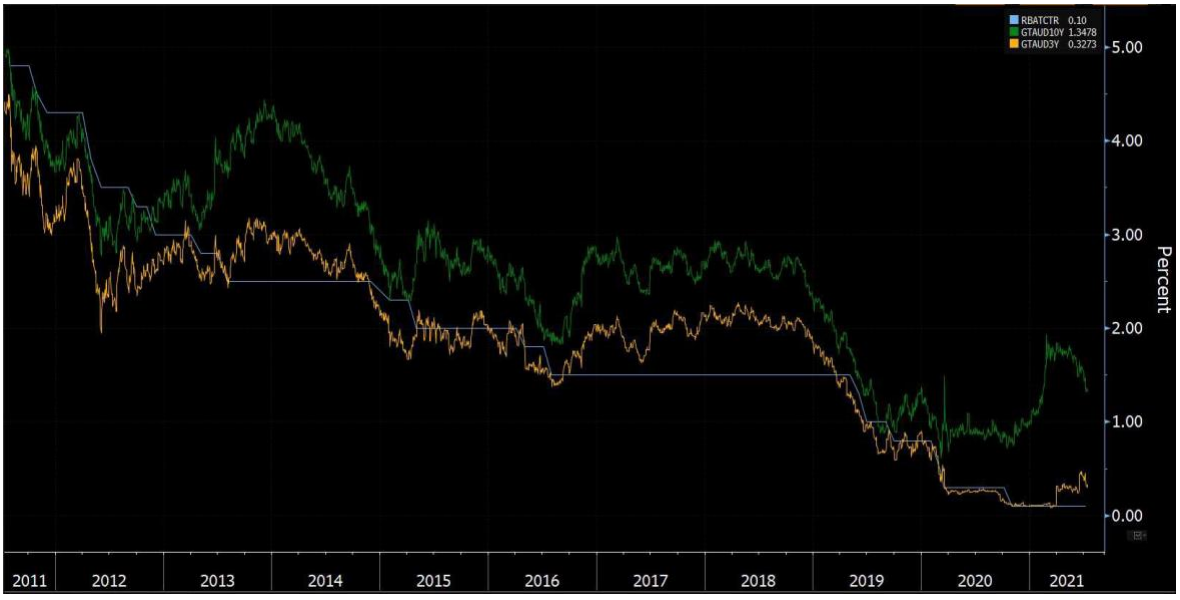
In their July monetary policy statement, the RBA noted that "In the short term, CPI inflation is expected to rise temporarily to about 3½ per cent over the year to the June quarter because of the reversal of some COVID-19-related price reductions a year ago."

With RBA cash target rates at 0.10% and destined to remain there for a long period, the stance of the RBA may well be tested. We are seeing the roots of inflation in many parts of the world. Most central banks are dictating the party line that the Fed has adopted – the effects of inflation will be transitory. There is no doubt that some will be but it is our expectation that the labor force has awoken and that they will be asking for more compensation in the face of higher costs. The move higher in wages and salary is not transitory.

Below, we see the Korean cash rate, 3-year bond and 10-year bond over the past decade. With cash at 0.5% this looks like a typical upward sloping curve with

expectations for furtherrate hikes over coming quarters. We can see how late in the cycle interest rate widen from the cash rates with the BOK able to signal a shift in policy. Currently, the exit from easy monetary policy is on the cards with a move expected in the next couple of meetings. This is a far cry from assertions from ECB, FED, BOJ, RBA and others that rates would remain on hold for an extended period of time.

We can see a similar pattern for the bonds relative to cash in the graph below for Australia. With the explicit statements from the RBA, the bonds have been hugging cash. The outright QE bond buying by the RBA has assured the market that the RBA put is still in place. The question is how will the fare when all around them bond alternatives (like New Zealand and Korea) are normalizing policy rates?



It is our expectation that the pressure on the RBA to normalize rates may come from the pressure of the inflation and economy or the bond market participants- or both. It would fly in the face of logic for the RBA to continue buying the bonds issued by the Australian

Treasury just because they said they would. For now, they have said they will maintain the yield control over the Apr-2024 bond at 0.10%.

Positioning the trade

Australian Superannuation and long-term investment portfolios tend to have a 70/30 ratio of growth/defensive assets. Fixed income tends to make up 10-15%, in absolute terms, of this portfolio. Opportunities are limited in global fixed income with spreads at record lows and yields in many sovereign countries trading at negative interest rates. **In fact, at the time of posting, all of the German yield curve out to 30 years is below zero. German government bonds make up over 6% of the FTSE World Govt Bond Index (WGBI)**

In our opinion, there are few opportunities in mid to long end of the sovereign bond curve with an appropriate reward for the duration risk being assumed. Of note, the Chinese bond market has attracted global investors due to yields above 3%. While attractive, the bond market is less mature than other countries.

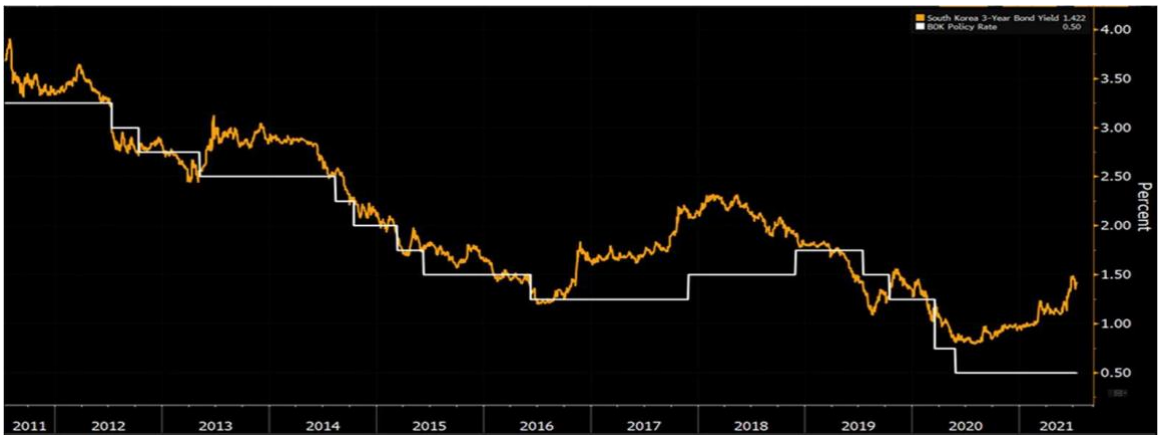
In Australia, the RBA has implemented yield-curve controls for bonds out to a maturity of April 2024. At a yield of only 0.05%, Australian Government Bonds (**AGBs**) with a maturity of 0-3 years, do not represent an appropriate return to compensate for future inflation nor an appropriate return on any (upward) change in interest rates post this curve control period.

While Australian bonds are priced at 100 minus the average yield the Korean bond future is traded on price of a 3-year Korea Treasury Bond with semi -annual 5% coupon rate. We can see the basket of the three Korean bonds in the table below.

	Weight(MM)	Price	StYld	End Px	EYld
1)KTB 1 06/10/23	1000.0	99.6670	1.228	99.7982	1.289
2)KTB1 ¼ 03/10/2	1000.0	98.1865	1.754	97.6906	1.801
3)KTB0 ⅞ 12/10/2	1000.0	99.0145	1.328	99.1449	1.384

This current September futures basket has a bond with maturity October 2023, December 2023 and March 2026. The yield of the futures contract is an average of the three bonds at the forward date. Note the yield of the longer bond is (in the middle) substantially higher than the shorter pair.

As a reminder, the move of the Korean three-year bond vs cash can be seen below



as the market anticipates an interest rate move by the BoK later this year.

The Australian bonds have a similar basket and also trade at an average of that

basket. The basket for the September futures is seen below. Here there are several bonds but not as long a duration in the longer bond. Also note that one of the bonds in the basket isthe reference bond of the RBA and therefore is yielding only 0.065% today. If they were to change policy, we could expect this bond to gap upwards toward the other bonds in this basket causing the basket to move by 25% of this yield change given its weighting inthe basket. At their latest meeting they stated the yield curve control would apply only until the maturity of that April 2024 bond.

	Weight(M)	Price	StYld	End Px	EYld
1)ACGB 0 ¼ 11/24	1000.0	99.8190	0.315	99.8207	0.332
2)ACGB 0 ¼ 11/25	1000.0	98.7880	0.541	98.7897	0.562
3)ACGB 2 ¾ 04/24	1000.0	108.0610	0.065	108.0628	0.069
4)ACGB 3 ¼ 04/25	1000.0	111.3225	0.420	111.3244	0.440

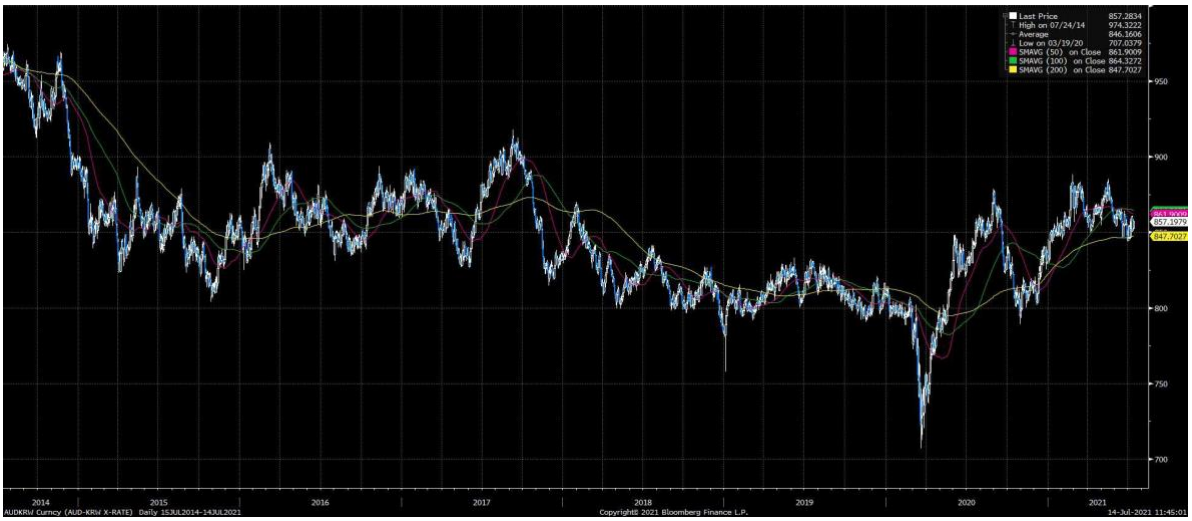
We would expect that over time there will be convergence of these two national bond curves once again. Current spreads are at their widest this decade.

In benchmark driven portfolios we would advocate a futures overlay that would remove all of 3-Year Australian Bond exposure in a FTSE WGBI portfolio, replaced with 3-Year South Korea bonds. As of publication, South Korean Government Bonds are not yet part of the FTSE WGBI whereas AGBs with 0-3 year maturities make up just 0.33% (as at 30/06/2021) of the index's weight. Should South Korean bonds eventually be included in the WGBI, hundreds of billions of dollars will reweight into Korean bonds from Treasuries, JGB, and European country sovereign bonds. (https://www.reuters.com/article/us-southkorea-economy-bonds-idUSKBN2BG0PT)

In Albany Capital's absolute return Global Macro strategy, we are shorting (selling) 3-year AGB futures and going long (buying) the 3-Year South Korea bonds futures. From a risk perspective in the current environment we are targeting a total daily Value at Risk (at a 95% confidence level) for our absolute return portfolio at < 0.75%. We are conscious of the current co-integration between equity and bond markets that has existed for the past 12-18 months. Therefore, even as we carry modest amounts of long equity related risk, any additional long FI positions are being viewed as small risk-additive at the portfolio level. As such, most of our weighting assessment has gone into optimising the spread's sensitivity to interest rate movements and what FI risk we carry elsewhere. In total, this trade contributes about 1.5% of the portfolio's total daily VaR.

Risks

FX – This depends somewhat on what base currency one is running in the investment strategy. Using futures rather than outright purchases and sales of the outright bonds where large nominal amounts of base currency are being converted into AUD and KRW, this trade FX's exposure is limited to AUD/KRW margin for the futures. As a side note, the FX cross KRWAUD is quite stable so the respective CBs are not using their FX policy to do the hard lifting in the fight against inflation. Below is a graph of the FX cross rate over the past decade.



Covid – The worst Covid scenario for this trade would be if the effect of the delta variant in Korea proves to be only a mild suppressant to economic activity but nevertheless causes a delay in the BoK's intended tightening. Without a risk of an imminent tightening, Korean 3-year bond rates could drift higher, causing bond prices to fall. Similarly, if the delta contagion becomes extreme in Australia, prompting widespread lockdowns and a significant economic impingement, 3-year AGBs could be at risk of being pushed below the RBA's floor pricing of 0.15%, causing bond prices to rise.

Conclusion:

We are buying Korean 3-year bond futures KEU1 and sell the Australian 3-year bond futures YMU1. We would look to roll these futures through time to earn the carry of the bonds and wait for convergence in the monetary policies. Please contact the team at Albany Capital (info@albanycap.com.au) if you would like to discuss this trade or our Global Macro strategy in greater detail.

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