

Asset Class/Strategy Market Alert

Political risk rises on death of North Korea's Kim Jong Il

19 December 2011

Key market reactions so far

The death of North Korean leader Kim Jong-il announced today has caused some movement in markets in Asia.

The South Korean stock market is down 3.4% at time of writing, the Korean Won has fallen around 1% against the US dollar, and domestic bond yields in South Korea are up between 0.10% and 0.15%. Other regional stock markets are also down, for example the Hang Seng index in Hong Kong is down 2.1% and the Shanghai Composite index down 1.8%.

Equities, fixed Income and multi-assets portfolios

During previous moments of tension between North and South Korea such as missile tests or border skirmishes markets have reacted even more strongly. Please see table below for an illustration of this:

1. Death of North Korea's founder, Kim Il Sung (July 8, 1994)
<ul style="list-style-type: none">• KOSPI rose +0.34% on the day of press reports on Kim Il Sung's death. KOSPI was down only -0.8% for the next day
2. First Nuclear test (Oct 9, 2006)
<ul style="list-style-type: none">• KOSPI was down 3.58% during the trading session but recovered -2.41%
3. Second Nuclear test (May 25, 2009)
<ul style="list-style-type: none">• KOSPI fell 6.31% during the market but surprisingly rebounded to -0.2% at the closing
4. Sinking of the Cheonan naval vessel (Mar 26, 2010)
<ul style="list-style-type: none">• KOSPI declined 0.91% during the day but was up in later closing -0.34%

Based on the information available so far we will not be making changes to our portfolios or reducing our exposure to Asian or South Korean bond or equity markets.

We will of course continue to monitor the situation closely. Kim Jong-il's death was not unexpected and North Korea was already known to be unstable and in possession of nuclear weapons. So while uncertainty has increased at the margin the overall story is not a new one. We will continue to monitor the situation and will assess factors such as the reaction of China, any further action from the US and any military movements in North Korea as they develop. As a final, hopeful, point it may be that this transition could prove to be a positive factor over the long term. North Korea as it was under Kim Jong-il could

hardly be a more unsettling factor. If the new, Swiss educated, leader were able to move the country forward, perhaps with the support of China, today's news could be seen to be the start of something extremely positive.

Our base case scenario is that the geopolitical risk is already priced into the KOSPI and Korean bond markets and we don't foresee any credit rating downgrades or sharp increase of risk premium in South Korean bond or equity markets.

Some deeper thinking....

The initial market moves look like a simple market reaction to increased uncertainty that the death of the dictator introduces (and regional markets were already down before the announcement), but it is worth looking beyond the headline to see if there are any deeper implications for markets in the region or more broadly.

Kim Jong-il was 69 and had been in poor health for some time. He has led North Korea since the death of his father Kim Il-sung in 1994 and in recent months had made moves to identify his third son, Kim Jong-un, as his successor. Clear facts are not easy to come by in North Korea, but it is believed that Kim Jong-un is in his late 20s, with little experience of government. North Korea's state-run news agency, KCNA, has already made the announcement that "All party members, military men and the public should faithfully follow the leadership of comrade Kim Jong-un and protect and further strengthen the united front of the party, military and the public".

North Korea is potentially of concern due to its possession of nuclear weapons, and its unpredictable military behaviour. As a result South Korea has convened its National Security Council and put its military on alert, Japanese Prime Minister Yoshiko Noda has set up a crisis management team and White House spokesman Jay Carney said the US was "closely monitoring reports" from North Korea and was closely in touch with both South Korea and Japan. North Korea's closest ally, China, has so far not given any official reaction to the news.

There are a number of possible sources of concern. These include the possibility that the transition to the new leader is not a smooth one and a struggle for power develops, increasing the chances of fallout in the region. Kim Jong-un is young and has only been seen as the successor to his father for just over a year. However the military are expected to back him. It is possible that

he may seek to establish his hold on power by conducting a nuclear test or launching some form of military operation. While these ideas are only speculation at present, the uncertainty surrounding an already unstable country has risen

Source of macroeconomic data:
Bloomberg, HSBC Global Asset Management (Hong Kong) Limited, as of 19 December 2011

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