

## Quarterly Country Update: The Korea Fund, Inc.

December 2009

It was another remarkable quarter for Korea as the recovery from the dire global financial crisis continued. Despite seasonal weakness, we are looking at yet another quarter of positive GDP growth for 4Q and positive GDP growth overall for 2009. In the equity market, the KOSPI was up 49.7% in KRW terms and 66.5% in USD terms in 2009. Behind the steep gains lies the prompt and aggressive fiscal and monetary policy support from governments around the world. The Korean government alone spent nearly 5% of GDP to support the economic recovery, not to mention the various spending incentives introduced by China, the US, and the EU. It is likely that policy makers will maintain a certain level of support to sustain the recovery in the coming months. That said, we believe the Korean economy is in better shape than most to maintain the momentum of recovery as government support in 2010 begins to lessen.

In 4Q09, Korea is expected to register yet another quarter of better than expected growth. Most notably, exports continued to recover, posting year-on-year growth of 18% in November and 34% growth in December. We believe strong export growth in 4Q was not only because of the low base effect, but also due to improved product quality and strong branding which attracted global demand. For 2010, we expect export growth to continue. OECD leading indicators signal demand recovery in developed markets. Global inventories are at abnormally low levels, calling for inventory restocking to start in the near term. We could also see further upside surprises in exports as global consumers' pent up demand is unleashed against the back drop of a better economic outlook.

Sang Won Kim  
Lead Portfolio Manager



Sang Won Kim, a Korean National, joined RCM in May 2007 as a Portfolio Manager dedicated to Korean equity portfolios. Sang Won was previously an Investment Analyst in the Asia ex Japan Equity Research team of Schroder Investment Management before relocating to Hong Kong from Seoul. Prior to joining the Group, he spent two years with Samsung Securities as an Equity Research Analyst covering Korean non-life insurers and securities brokers. Overall, Sang Won has over twelve years working experience in researching and analyzing companies in South Korea including his early career as a management consultant. He holds an MBA in Finance and Accounting from the Kellogg School of Management of Northwestern University in U.S. and obtained his Bachelor's degree in Business Administration from Yonsei University in South Korea.

Resilience of private consumption has been one of the more striking features of 2009. The unexpected equity market rally, together with low interest rates, easing inflation, and tax cuts boosted consumption. We believe consumption will remain strong in 2010, even in the face of interest rates, inflation, and policy support that may go in the opposite direction. The previously mentioned positive export growth is expected to lead to increased industrial production and capex spending by the Korean corporate sector. This powerful source of growth will further support domestic demand via the associated recovery in production and employment.

We believe the Korean won will continue to strengthen in 2010 as rising economic optimism will support the strong currency against the USD. However, it is our opinion that the won will remain weaker than the Japanese yen, extending its currency advantage against key Japanese exporters in the IT and Auto sectors. In addition, we believe the Bank of Korea will continue to intervene in the foreign exchange markets until exports prove to be strong enough to withstand any currency effects.

Although impressive macro data suggest that a rate hike is possible in the very near term, we expect the Bank of Korea to remain cautious on any rate hike decision. It recently widened the inflation target by 50bps, suggesting an increased tolerance for inflation. In the event that interest rates do increase in the coming year, any market reaction will likely be moderate as such a move has already been widely expected. On the other hand, if there's any unexpected down side, we believe the Korean government and the Bank of Korea will readily step in again, especially given their ample current account surplus and the FX reserve accumulated in 2009. Korea definitely seems to have sufficient buffer for downside risk.

We believe fundamental improvements will be the driving force for stock markets in 2010. Given that we are looking at better than expected macro results and further demand improvement in developed markets, we may see upside surprises in the equity markets. We expect that the potential for interest rate hikes and better-than-expected domestic consumption will be the key investment themes for 2010. In addition, the strong Korean won will be a further boon for Korean equity markets. We will strategically position ourselves to capture long-term investment opportunities in selected exporters, who are potential beneficiaries of global demand normalization, as well as banking and consumption related names that are highly correlated to the macro economic recovery. However, we will continue to avoid deep cyclical sectors until we see a full turnaround of the cycle.

Thank you.

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Lead Portfolio Manager

The Korea Fund, Inc

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