

Quarterly Country Update: The Korea Fund, Inc.

July 2010

During the second quarter of 2010, the Korean market and economy showed remarkable resilience against both the European credit crisis and the increased geopolitical tension with North Korea. This resilience reconfirmed our confidence that the Korean market will smoothly overcome macro headwinds in 2010 while the global economic recovery slows.

Whilst Europe was experiencing its credit crisis, April remained rather un-eventful in Korea, primarily due to the country's limited exposure to European countries such as Portugal, Italy, Greece, and Spain. These countries, at the core of the debt crisis, only account for 2% of Korea's direct exports. Indeed, in many ways, we actually view the European crisis as an opportunity for Korean exporters, many of whom offer many value-for-money products. For instance, Korean auto makers continue to excel in global markets as consumers seek affordable, but quality, products.

May was the most challenging month for Korean investors as the KOSPI index fell 13.1% in USD terms, falling to the 1,500 level amidst the sovereign debt crisis in Southern Europe and heightened geopolitical tension. The most volatile trading was seen on May 24, when South Korean president MB Lee officially condemned North Korea for its sinking of the South Korean warship, Cheon-an. In response, North Korea announced a total freeze in relations with South Korea and taking a hawkish tone, threatened potential military action. However, we continue to believe that these verbal threats will not change South Korea's stance to resolve the issue via diplomatic means. In fact, the South Korean government has made it clear that it will limit South Korea's military responses to deterrent actions. Also, South Korea will maintain humanitarian aid to North Korea despite the suspension of trading activities. This further demonstrates South Korea's willingness to reengage with North Korea for a peaceful resolution.

History shows that North Korean provocation has only a very temporary impact on the South Korean market. In this instance, the Cheon-an incident only impacted the market

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on one trading day. Currently, the matter has been escalated to the UN Security Council, and is awaiting final resolution by the UN. We expect the matter to be handled in such a way as to moderate tensions on the Korean peninsula. Past experience generally shows that North Korea uses military provocation as a mechanism to increase economic aid, rather than to escalate actual military conflict. Hence, we believe North Korean risk is manageable at the present time.

In June, the market bounced back to the 1,700 level as investors realized that external risks were manageable and the economy was still on track for recovery. Most importantly, export growth in the three months to May showed 4.4% growth, assuring investors that exports are still growing and likely to help drive the Korean economy's sustainable recovery.

For the second quarter, the Korean market ultimately remained largely flat, up 0.3% in KRW terms. On the other hand, the KOSPI fell 7.1% in USD terms, due to a rather sharp KRW depreciation against USD.

We believe this currency weakness is mainly from risk averseness created by the European debt crisis. While we continue to believe that the KRW will appreciate in the longer term, it may remain weak in the near term until Europe shows concrete resolution that can be enforced by EU members. In the mean time, the Bank of Korea's discipline to limit FX derivatives and FX loans should help minimize currency volatility. On top of regulation, a six month record high current account surplus in May will also provide an additional cushion for currency volatility.

In light of the above, and given South Korea is an export-driven economy, the current level of KRW is favorable enough to maintain the price-competitiveness of Korean exporters while not significantly reducing the currency's purchasing power. Furthermore, Europe only accounts for 17% of total exports, of which Southern Europe accounts for 2% of total exports. On the other hand, China remains the largest export destination, and the RMB is expected to appreciate toward the end of year. We expect that RMB appreciation will easily offset decreasing export income from the weak Euro. Hence, as long as oil prices remain stable, current KRW levels could further support Korean exporters' strong performance in the global market.

Heading into the 2nd half of 2010, we see an increased possibility of an interest rate hike. Although the European sovereign debt crisis may further delay the timing of interest rate hikes, it is realistic to expect moderate rises towards the end of the year. Sharp 7.8% GDP growth in 1Q10 and potentially strong GDP growth in 2Q10 mean interest rate hikes may be required to tame inflation risks. We believe the economy is largely ready to absorb moderate rate hikes as the Korean government has proactively implemented measures to address potential credit risks.

The government is also expected to announce further measures to support the weak housing market in 2H10, thereby mitigating the negative impact of a potential rate hike on the property market. With the economy in better shape to absorb any negative impacts from rate hikes, we cautiously believe that the beginning of the rate hike cycle could actually indicate the government's confidence in the economic recovery and thus, overall, will be positive for market sentiment.

For equity market investors, European credit risk and potential interest rate hikes may remain a short term overhang. As such, we expect investors to position themselves more defensively, taking profits from cyclical technology and auto sectors to build positions in more domestic consumption related names. As we argued previously, strong exporters' earnings will increase domestic income levels via wage increases and job creation, thereby boosting domestic consumer purchasing power. As we believe most Asian countries enjoy a similar domestic consumption growth story, we will continue to focus on consumer related names that have a strong foothold in and outside of Korea or with good potential to gain footholds in overseas markets.

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