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North Korea will keep markets guessing

The Communist regime has developed nuclear strength surprisingly fast. Tensions are increasing. No easy solution in sight.

Kim Jong-un has just done his part to stir up tensions again. Last Sunday his regime claimed to have successfully tested a hydrogen bomb that could fit onto a long-range missile. This comes just days after North Korea launched several more missiles of which one flew over Japanese territory. While our main scenario remains that no disorderly/armed conflict will emerge, we see good reasons to stay alert. For one thing, the nuclearization of North Korea has progressed at a much faster pace than predicted by the West. It is currently testing long-range missiles able to carry nuclear heads and to reach the U.S.

Second, while no party seems eager to take this conflict to an armed stage, the leaders of the two main conflict parties share a certain degree of unpredictability and similar motives: both seem to have an interest in keeping an international conflict alive in order to distract from domestic difficulties. Furthermore, Trump seems eager to present himself as an unconventional leader with little inclination to comply with diplomatic protocols. While Kim Yong-un certainly seems to care even less about diplomatic conventions, he seems to have played his cards well so far. The state-run North Korean Central News Agency for example recently showed its intention to provoke the President of the United States by calling him "the source of headache at home and abroad", adding that his policies were either ignored or delayed.[1] With the U.S. having few means to sanction those provocations, these are easy wins for Kim domestically.

At the same time, Trump's standing with the more moderate part of the U.S. electorate has weakened after he seemed to reach out to the far right with his comments on Charlottesville and his pardoning of the controversial Sheriff Joe Arpaio. On foreign matters, however, there are two indications he might be leaning towards a more conventional diplomacy: the sacking of his former advisor Steve Bannon and his speech on the "renewed" Afghanistan policy, which is basically a continuation of the old policy.

Another reason to believe that diplomatic efforts will be upheld and eventually increased, is the fact that China and Russia recently endorsed UN sanctions for the first time. Even on the diplomacy front, however, there are problems of the administration's own making. U.S. Secretary of State Rex Tillerson needs to speed up the nomination process for the many unfilled senior positions in his Department. The U.S. embassy in Seoul in the meantime is still waiting for an ambassador to replace its interim Chargé d'Affairs.

Expectations in a nutshell

- Tensions between North Korea and the U.S. have been increasing lately and are unlikely to abate.
- While sanctions against North Korea are now widely endorsed, military options are limited and a denuclearization seems ever more unlikely.
- Capital markets might be impacted as even unarmed escalations could lead to increased risk aversion or harm trade between China and the U.S.

[1] https://www.bloomberg.com/news/articles/2017-08-29/trump-vows-all-options-open-after-north-korea-missile-launch

So far, some financial assets most exposed to the conflict such as South Korean equities or the South Korean Won have only shown muted reactions. However, this conflict still has the potential to shift the risk appetite of international investors considerably. Our base scenario calls for the continuation of the current unstable situation. While the pace of coordinated international action has increased, so has the danger of an abrupt escalation.

No easy solution

Irrespective of current leadership in both Washington and Pyongyang, the North Korean situation does not lend itself to easy solutions. It has been a problem in the making for decades. The war of 1950-1953 did not end with a peace treaty but only an armistice. Hostilities have been a recurrent element of the divided countries' past. While the respective historic allies of North and South Korea have stuck to their original protégés by and large, North Korea's allies seem increasingly reluctant to further offer unconditional support. Neither China nor Russia seem to be too eager to have another neighbor armed with nuclear weapons (North Korea conducted its first nuclear test in 2006), especially one with the sort of erratic leadership lately on display. At the same time, China probably neither wants a failed state at its doorstep, nor reunification, nor an increased U.S. presence in the region. Russia's interests are likely to be quite similar. But positions are moving. China and Russia recently participated for the first time in the UN securities council vote on the matter. This contributed to the unanimous vote, supporting a prolongation of UN sanctions. While there remain question marks on Russia's willingness to vigorously implement those sanctions, China just decided that its companies are no longer allowed to setup new joint ventures with North Korean companies or increase existing investments. We believe this is likely to have a big impact on North Korea's economy. How has this change come about? Well, the fact that U.S. president Trump has linked China's actions on North Korea with trade relations between the U.S. and China may actually have helped. Whatever the reason, Beijing seems more willing to cooperate.

An open question remains how much influence, whether politically or economically, China can exercise on North Korea. With the latter depending on all sorts of imported goods and materials, most crucially energy, one could argue that China has plenty of cards to play. Nevertheless some observers argue that Kim Jong-un would be prepared to risk supply cuts and the suffering of his people rather than change course.

Economic implications

Capital markets might pay less attention to North Korea's military antics, if it wasn't for South Korea. Less because of the size of its GDP (2% of global GDP, almost 50 times the GDP of North Korea) but because of its pivotal position in global supply chains and its dominant market position in certain industries, in particular for consumer and other electronics. The country produces 40% of the global liquid crystal displays and 17% of global semiconductors. Its strength are memory chips with more than 70% of global DRAM and almost half of the global NAND production based there. South Korea is the world's fifth largest exporter. It is feared therefore that even a conventional attack on South Korea by North Korea would not only damage that nation's economy but also cause major disruptions to international supply chains. Even worse would be the humanitarian catastrophe Pyongyang could cause as South Korea's capital with its population of 10m is less than 50km from the border with the North.

Another possibility of how this crisis could harm the economy is by hurting trade relations. Given Trump's often-stated desire to introduce tariffs and punish China for its "unfair" policies, he could find a welcome excuse to do so in case he feels that China does not exert enough pressure on North Korea. Similarly, South Korea could fall victim to Beijing's retaliation measures in case it wants to punish U.S. allies. Regional frictions could harm international trade even more than a pure Sino-American trade dispute as more than half of Asia's export stay within Asia.

Our three main scenarios:

- **Base scenario:** Military escalation avoided, nuclear threat from North Korea remains, but is contained by sanctions and implicit pressure. We believe that it is as illusionary to believe that North Korea will ever dispose of its nuclear arsenal voluntarily, as it is to believe that any foreign power could manage a surgical pre-emptive strike that would destroy North Korea's nuclear capacities. More aligned and increased sanctions mainly from Russia, China and the U.S. could tame North Korea and stop further provocations. Until the latter becomes evident, financial markets will react to sporadic regional eruptions and changes in tone mainly from North Korea and the U.S.
- **Risk scenario 1:** Military conflict remains limited and can be contained before spreading to a global crisis. This would entail taking the war of words to the next level and eventually involve military action. A trigger could be North Korea crossing a red line by, for example, launching a missile in the direction of the American territory of Guam. Assuming China fails to give North Korea military support, and the UN manages to keep a unanimous stance towards North Korea, the conflict could be contained and further military escalation avoided.
- **Risk scenario 2:** Conflicts escalate to a global one, if, for example the U.S. starts a full-blown pre-emptive attack or if North Korean missiles reach U.S. mainland. Escalation and retaliations could lead to an involvement of China and Japan as well. The main casualty could, however, be South Korea even if only conventional weapons were to be used due to its proximity to North Korea. Enormous human casualties, international trade disruptions and potentially a prolonged trade war between the U.S. and China could be the consequences.

  For both risk scenarios we only see single-digit probabilities.

Capital markets reactions

Tension increased again at the beginning of August. At a press conference held on August 8th, President Trump said that further threats from Kim Jong-un "…will be met with fire and fury, and frankly power the likes of which this world has never seen before." Taken at face value and taking World War II including the nuclear bombing of Hiroshima and Nagasaki as a point of reference, President Trump may have had at least a nuclear strike in mind, when he said those words. Considering this verbal escalation, the reaction in capital markets was rather subdued. The Korea Stock Price Index (Kospi) lost 1.1% that day and another 2.1% the following two days, most of which has been recovered since. The Korean Won actually gained some ground during those three days. The MSCI World Index equally lost 1.1% on August 10, but this has only been the second time this year that it fell by more than 1%. So even if we rule out military action, any further escalation in this matter could cause market participants to reduce their risk exposure in an environment of already mature capital markets.

Glossary

Korea Stock Price Index (KOSPI)

The Korea Stock Price Index (KOSPI) captures the performance of the 759 companies listed on the Korean stock market.

MSCI World Index

The MSCI World Index tracks the performance of mid- and large-cap stocks in 23 developed countries around the world.

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