



UNDERSTANDING THE POLITICS:

South Korea

Portfolio manager of Blackcrane Overseas Alpha, Daniel Kim, discusses what the political turmoil in South Korea could mean for the global markets.

Over the course of the past twelve months, the world has revealed its own version of vomiting after being tricked into drinking kale juice. With a bad taste left in everyone's mouths, this past year has delivered a remarkably synchronized series of repudiations of anything resembling the establishment or incumbent governing party. This was happening across various countries, including events like Brexit and the US presidential elections. The people of South Korea were no different when it came to displaying their disgust over the state of their own political affairs. This peaked when approximately 2% of the entire nation's population gathered around City Hall to demand the abdication of power from the incumbent president, Park Geun-Hye, following a series of scandals that have drawn intense public scrutiny. There has and always will be an ugly political battle between the left and the right, but I do not remember this level of chaos since my business partner's grandfather served as prime minister under President Kim Young Sam back in the '90's.

The puzzling question is, why these scandals matter enough to the extent that they could cause such an unprecedented upheaval. Of course, on paper any one of the scandals look troubling. Funneling tax payer money to line the pockets of personal supporters, using political influence to sway decisions made by large institutions, having a shaman cult leader pick out your wardrobe in hopes of pleasing the gods. Admittedly, the third offense does appear extreme; however, in the big scheme of politics, this does not seem to diverge much beyond the realm of typical political misbehavior. To get a sense of why sentiment in Korea is so horrific right now, and whether or not the dust may eventually settle in a tolerable place for the economy, requires a quick look behind the curtain of this political maelstrom.

What happened?

For the better part of the past decade, a common challenge that all governments, right or left, had to face was how to recover from the Financial Crisis, or the Great Recession. If one were to generalize, South Korean politics is not much different than others found around the world. Namely, there is a right (conservative) group, and their left (progressive) counterparts, although in Korea there are actually four parties (two vs. two). After the Crisis first hit in the US and other Western countries in Europe, the incoming political parties were generally left leaning, which made sense as the Keynesian approach of aggressive monetary stimulus was popular at the time. In South Korea the incoming administration was conservative, but had won the election using an optimistic pro-business campaign. Unfortunately for all of these incoming political parties, the economies they inherited were unmitigated disasters. Regardless of what policy measures were implemented in the years to come, a prolonged period of lackluster economic growth was almost inevitable.

Today, about eight years after the deepest pits of the recession, the broader population across the world is mostly dissatisfied with how their quality of lives have progressed over the years. Generally speaking, larger corporations and institutional investors that had the sophistication to take advantage of an unprecedented quantitative easing cycle, capitalized to their fullest abilities, while the working class was, at least from a relative standpoint, left in the dust. As this superfluous capital sloshed around the world finding their most profitable homes from a capital allocation standpoint, globalization accelerated feverishly. Ultra-cheap capital was used to invest overseas to take advantage of cheap labor which helped catalyze the exodus of manufacturing and other labor intensive jobs.

From a working class Korean citizen's perspective, the headline grabbing Chaebol elites were making a killing while moving their factories (and jobs) out to China, Vietnam, and Thailand. Meanwhile, the income gap between them and the privileged was moving in the wrong direction. So, just as their Western counterparts blamed their dissatisfaction on the incumbent government regimes, the Korean public also needed an easy target at which to direct its anger – tough timing for the president to be entangled in a string of headline catching scandals.

Adding fuel to this fire was that the generally stalwart, right leaning media agencies in Korea bid farewell to this alliance and went on full assault mode against their fellow conservative president. It seems like no coincidence that this onslaught accelerated after the Park administration passed a law that limits gifts to civil servants, doctors, and the media, among other groups, to KRW 50K, or just over USD 40. Believe it or not, this will materially alter the way business is handled in some of these sectors – much to the chagrin of many fat cats in the media industry. After being “betrayed” by the administration like this, the media has eaten up President Park's scandals like hotcakes and have been broadcasting them nonstop to the general public for months now. Unlike we have in the US with a healthy right vs. left saga between Fox and MSNBC, the media in Korea is more or less on the same page when it comes to politics. A perfect recipe for herd mentality to run rampant, which makes the chaotic nature of the whole situation slightly more understandable.

Investment Implications

With Xi Jin Ping, Shinzo Abe, and Kim Jong Un breathing down its neck, South Korea cannot afford to be leaderless at this critical juncture. Properly vetting the recent scandals is an important issue and should be carried out, but at this moment there seem to be bigger fish that need frying. With no disrespect intended, South Korea's temporary leader, Prime Minister Hwang Kyo Ahn, making a phone call to Donald Trump and sending out retaliatory comments to North Korea is just not going to cut it. Rather, Korea's president should be hopping on the next plane to Washington DC to start sweet talking the new administration on trade relations and how to deal with North Korea like Japan is doing. Whether there is a quick step down or expedited impeachment process, the current trajectory of political standstill until the end of the year is the least optimal, but unfortunately most probable outcome.

The ironic takeaway is that in the midst of this turmoil, and in some ways, because of this chaos, select investment opportunities have emerged. At the moment, China is flexing its muscles by exerting additional layers of political pressure on Korea in response to the installation of the fiercely contested Terminal High Altitude Area Defense (THAAD) anti-missile system that the Park administration has supported. Without anyone to defend Korea's side of the argument, the recent retaliatory actions made by China on trade, travel, and the entertainment industry have gone completely unanswered. Naturally, stock market sentiment in anything related to these areas of the economy are fairly dismal at the moment.

Whatever the end result is after this debacle, one of two scenarios is likely to occur. First, even if the right somehow manages to stay in power, the party and its political capital will be dramatically weakened. The second scenario is that Moon Jae In, the leader of the left opposition party, will become the next president of Korea by the end of the year. In either case, the discussion of THAAD will at least directionally swing back towards the left, which would likely hinder if not outright suspend the implementation process. This should ease tensions at least between Korea and China, and would be a material positive for companies that export goods to the mainland – especially the ones that are already executing well operationally even in the midst of these recent actions by China. Technology and certain areas within the cosmetics industry are likely to experience positive reversals in sentiment if this were to occur. If the Trump administration decides to pursue THAAD implementation even without South Korean support, the fight will presumably shift more directly between the US and China. This said, trade relations between the US and Korea may naturally take a hit in the process.

The other, more longer-term outcome of the scandals involving the corporate sector might be a move in the right direction for corporate governance in Korea. Although notable advancements have been made over the past two decades, South Korea is generally still way behind its global peers, at least partially due to the cozy legacy partnership between the corporate sector and the government. Traditionally, government support towards the Chaebol was looked upon favorably by the broader population as they represented the strong pillars of the Korean economy. However, with the post-Recession dissatisfaction and the recent scandals being highlighted so intensely by the media, the public is out for vengeance. At this point, all corporate executives might as well have big bullseyes on their backs which make them sitting ducks for the next round of investigations. Going forward for the gray zone relationship with the Chaebol and government, the cat is out of the bag so corporate governance has no other way to go but improve accordingly.



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Daniel oversees management, portfolio construction, and investment strategy at Blackcrane Capital, LLC. Prior to forming Blackcrane, Daniel was the former Portfolio Manager, Director of Research, and partner of Mastholm Asset Management, LLC. Prior to Mastholm, he worked in the corporate finance division of Samsung Electronics at the headquarters in Seoul, Korea. Daniel received a Bachelor of Science in Operations Research & Industrial Engineering from Cornell University, and a Master of Engineering in Financial Engineering, also from Cornell.

Founded in 2012, Blackcrane Capital is a boutique asset management firm focusing on global and international equities, based in Bellevue, Washington. Blackcrane manages approximately USD 540 million in AUM (February 28, 2017).

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