FIXED INCOME ISSUE REPORT

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Global Fixed Income

MPC minutes and July inflation: Reading the next move

- The July MPC minutes show that: 1) only one member advocated preemptive action; and 2) several of the assumptions behind the BOK's hawkish remarks in July have changed (inflation has eased and the Kospi has fallen).
- With fears of back-to-back rate hikes (in July and August) receding, bond yields have room to fall further, led by short- to medium-term bonds.
- That said, any decline should be limited rather than sustained given the number of events ahead—the BOK's economic outlook and the BOK's dot plot (both will be announced on the day of the August MPC meeting—Aug 27) as well as the government's budget bill (expected around the end of August).

One member advocates preemptive action; assumptions have shifted

The Bank of Korea's (BOK) July Monetary Policy Committee (MPC) minutes confirmed that another rate hike is a foregone conclusion—all six members voted for an increase, and most endorsed a continued tightening bias. This is not new news—the May dot plot showed broad consensus for at least two hikes this year.

What matters now is the urgency of the next rate hike—the July MPC minutes proved to be less hawkish than the market feared (it feared back-to-back rate hikes). Of the six MPC members, only one explicitly advocated a preemptive hike (Member 3). Member 4 also used the word 'preemptive,' but argued for weighing the costs and benefits of preemptive action vs gradual tightening. The other four members confined themselves to data-dependent language such as: "monitoring how the data evolve" and "judging the timing of any further hike after careful assessment." Member 2 did not comment on the future rate path at all.

Many of the assumptions behind the hawkish July remarks have already changed. The won/dollar rate, which Member 1 flagged as a concern at 1,480, has since fallen to 1,424 (the won has strengthened), and exuberance in the equity markets (cited by Members 1 and 6) has cooled (with the Kospi falling).

(Continued on the next page)

Samsung Securities

Core inflation rises, but headline- and living-necessities inflation falls sharply

Korea's headline CPI rose 2.8% y-y in July, returning to the 2% range for the first time in three months. Core inflation, by contrast, rose from 2.5% in June to 2.6%, its fastest growth in 2 years and 7 months.

BOK Governor Hyun Song Shin said at the June MPC meeting that the BOK would watch not only headline and core inflation but also the index of living necessaries (a CPI sub-index of frequently purchased items). That measure plunged to +2.5% y-y in July from +3.4% y-y in June. One member (Member 5) cited the +3.4% y-y figure in the July minutes as direct justification for a rate hike, but the basis for that argument has now gone. With perceived inflation down sharply, we see little justification for pressing ahead with consecutive rate hikes.

Next rate hike to happen in October

We keep our view that the next rate hike will arrive in October. The minutes suggest virtually no member has consecutive rate hikes in mind, and the two assumptions underpinning the hawkish remarks in July (an elevated won/dollar rate; equity markets overheating) have both eased. The index of living necessaries, which the BOK said it watches closely, has also fallen sharply. Urgency for back-to-back rate hikes would build if core inflation kept rising and inflation expectations turned back up, but with the BOK's survey-based inflation expectations standing at 2.7% and the bond market's breakeven inflation rate (BEI) at 2.58%, it is hard to argue that the situation demands immediate action. Our policy rate forecasts remain unchanged: A 25 bps hike in October (for a rate of 3% by end-2026) followed by a 25bps hike in 1Q27 and in 2Q27, for a terminal rate of 3.5%.

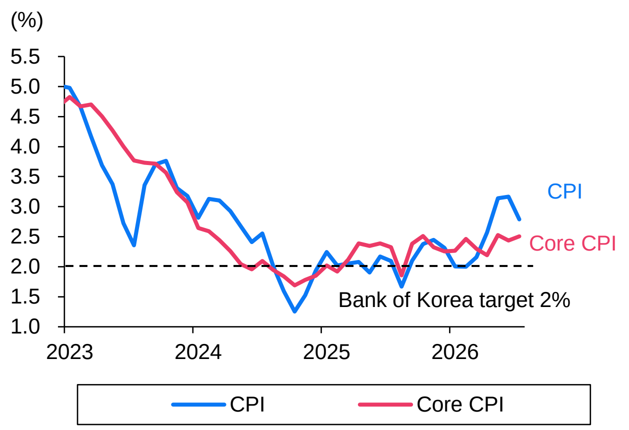
With back-to-back rate-hike fears receding, bond yields have room to fall further, led by short- and medium-term bonds. That said, any decline should be limited rather than sustained given the number of events ahead—the BOK's economic outlook and the BOK's dot plot (both will be announced on the day of the August MPC meeting—Aug 27) as well as the government's budget bill (which is expected to be presented around the end of August).

Key views of individual members at the July MPB meeting

	Key remarks	Calls for a pre-emptive hike
Member 1	Stock market volatility has widened to the peak levels seen during the 2008 global financial crisis, and amid such excessive volatility retail investments funded by margin trading and loans appear to be rising, which is worrying. The won/dollar rate … rose to the KRW1,550/USD level, then fell back to the high-KRW1,400 level as supply-demand imbalances eased. We should decide the timing and size of any further rate hike while closely examining demand-side upwards price pressures, the improving growth trend, and exchange rate and household debt conditions.	None
Member 2	Supply-side price pressures have eased, but with demand-side factors (stemming from stronger growth and wage increases) persisting and the sustained high forex, inflation is likely to remain unsettled for some time. Rising property prices and growing leveraged investments in capital markets are building financial imbalances and emerging as a potential risk to financial stability. I believe now is the best time for structural reform, including in the labor sector, and we should step up efforts to lift the declining potential growth rate by raising productivity through timely and bold reform.	None
Member 3	Growth looks set to exceed its potential by a considerable margin, and the GDP gap should gradually turn positive. A sharp pickup in nominal growth is likely to add further to demand pressure across the economy and push up underlying inflation. As underlying price pressures are expected to build, we need to further strengthen efforts to anchor inflation expectations and entrench price stability through pre-emptive monetary policy action and careful policy communication.	The only member to call for 'pre-emptive action'
Member 4	CPI inflation came in at 3.1% in May and 3.2% in June, staying above 3% for two straight months, while core inflation remained around 2.5%. Services prices in particular are sensitive to demand conditions and are slow to adjust, so unless their pace of increase slows sufficiently, the convergence of inflation towards the target could be delayed. We should decide the pace of hikes by weighing the pros and cons of pre-emptive versus gradual action.	Used the term 'pre-emptive' but argued for weighing it against gradual action
Member 5	CPI inflation edged up from the previous month to 3.2% in June, and living necessities CPI inflation reached 3.4%. Owing to labor market rigidities, this growth momentum is not feeding through into new job creation. It would be desirable to decide the direction of monetary policy while watching the trends in real economy and price indicators	None
Member 6	Inflation expectations have moved sideways after rising immediately after the start of the Middle East war, but a further increase (in inflation expectations) as the domestic economy expands cannot be ruled out. The market has already priced in much of the expected rate hike, and given the improvement in corporate and household income and financial soundness, the overall burden on economic agents from a rate hike should be limited. We should judge the timing of any further base rate hike while closely examining the pace of recovery in energy supply chains and the pass-through of the semiconductor cycle to domestic demand.	None

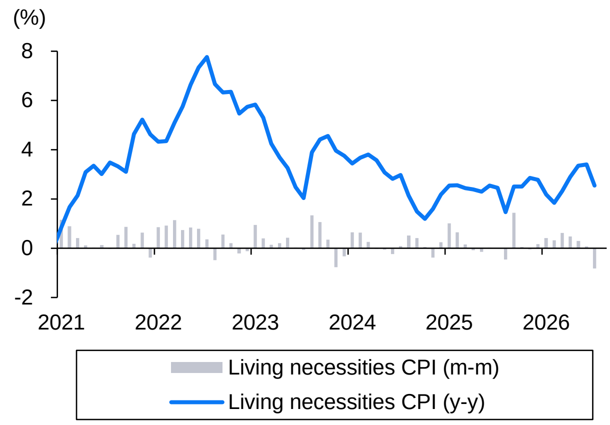
Note: Members 1-6 are labeled in the order their views appeared in the July minutes
Source: Bank of Korea, Samsung Securities

Korea's July CPI at 2.8%, core CPI at 2.6%



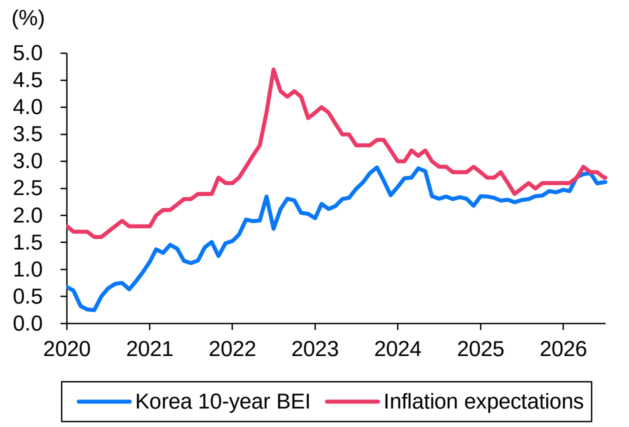
Source: Ministry of Data and Statistics, Samsung Securities

Living necessities CPI: Plunged to 2.5% in July



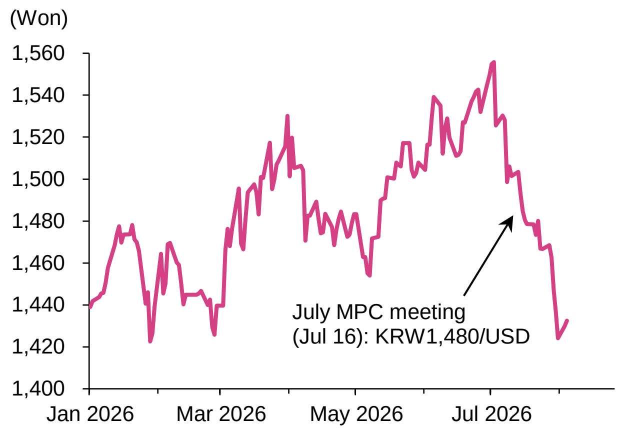
Source: Ministry of Data and Statistics, Samsung Securities

Break-even inflation vs inflation expectations



Source: Infomax, Bank of Korea, Samsung Securities

Won/dollar rate: Lower than at the July meeting



Source: Bloomberg, Samsung Securities

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