FIXED INCOME ISSUE REPORT

2026. 8. 20

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August MPC meeting preview

Still more likely to hike in October

- We expect the Bank of Korea's (BOK) Monetary Policy Committee (MPC) to hold rates steady at its Aug 27 meeting.
- Recent developments, including won appreciation against the US dollar and a correction in equity markets, have reduced the urgency for further rate hikes.
- The BOK is all but certain to raise its growth forecast significantly to at least 3%. However, with the inflation outlook likely to remain largely unchanged, we expect only a minority of MPC members to support a rate hike.

August MPC meeting: October hike more likely than back-to-back hikes

The Bank of Korea's (BOK) Monetary Policy Committee (MPC) meets on Aug 27, just one week from now. We still expect the next rate hike to come in October.

The possibility of back-to-back rate hikes has been a persistent focus for the bond market since July amid sharply higher growth expectations. GDP grew 0.6% q-q in 2Q, well above the market consensus of 0.37%. Real GDI rose 15.6% y-y—the strongest reading since 1Q88. Given the BOK's earlier assessment that 0.1% q-q contractions in both 3Q and 4Q would still allow annual growth to reach 3%, a significant upward revision into the 3% range is now all but certain. Market consensus has risen to 3.25% (Bloomberg), while we forecast 3.5% growth for the year.

Inflation indicators, however, are sending a more mixed signal. The won's recent appreciation—to below KRW1,400/USD from KRW1,480/USD at the July MPC meeting—should ease import-driven price pressures. Retail oil prices also remain constrained by the price cap policy. While core inflation rose to 2.6% in July—its highest in 2 years and 7 months—the increase was driven largely by durable goods, where inflation accelerated from 3.1% in June to 3.9% in July. This primarily reflected higher semiconductor prices, which pushed computer prices up 25.1% and mobile multimedia device prices up 22.5%. By contrast, demand-sensitive personal services inflation edged up just 0.1%pts to 3.5%. Even the living necessities index, which the BOK has said it monitors closely, fell sharply from 3.4% in June to 2.5% in July. It remains too early to conclude that demand-pull inflation has taken hold. Against this backdrop, we expect little change to the BOK's inflation outlook.

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Financial conditions have also shifted. The BOK previously cited loose financial conditions and growing financial imbalances as key reasons for raising rates. However, the recent equity-market correction and rise in volatility have led to some tightening in financial conditions. It is also worth noting that only one of the six MPC member explicitly advocated a preemptive hike in the July meeting minutes. We therefore see little reason to expect a majority of members to support an immediate rate hike solely on the basis of a sharp upward revision to the growth outlook.

Impact on the bond market?

If the BOK holds rates steady, market attention is likely to shift to the dot plot. The key question will be where a majority of MPC members place their dots over the six-month horizon, which extends through 1Q27. We expect the projected path to imply two additional rate hikes, broadly in line with our forecast and market consensus, and therefore see limited scope for meaningful upward pressure on yields.

In this scenario, yields on bonds with maturities of five years or less could face some near-term downward pressure. However, rather than declining across the curve, yield movements are likely to diverge by maturity. As the rate hike cycle progresses, short-term yields (under one year) should gradually rise, while long-term yields—which are subject to factors such as changes in insurer demand, as previously discussed—may see widening spreads at the ultra-long end, sustaining steepening pressure on the curve.

Uncertainty over the terminal rate is likely to persist until the November dot plot is released. The scale of KTB issuance, due to be disclosed in the upcoming budget announcement within the next couple of weeks, will add another variable for the bond market.

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