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Markets

The Last Place You'd Look for Value Stocks

South Korea is caught between two trade wars and its northern neighbor is firing missiles. Bold investors can start hunting through the wreckage.

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Trouble at home? *Photographer: STR/AFP*

If Hong Kong is worried about the economic fallout of political unrest, the city needs only to look at Seoul for a cautionary tale.

Like the former British colony, export-oriented South Korea is caught in the crossfire of the U.S.-China trade war. More than 3% of its GDP comes from goods exported to China, which get assembled, repackaged and re-sold to the U.S. To make matters worse, South Korea is now embroiled in its own spat with Japan, after the Abe administration curbed shipments of key materials to make electronics. Some suspect the measure has a whiff of political retaliation for historical grievances, though Tokyo has denied this.

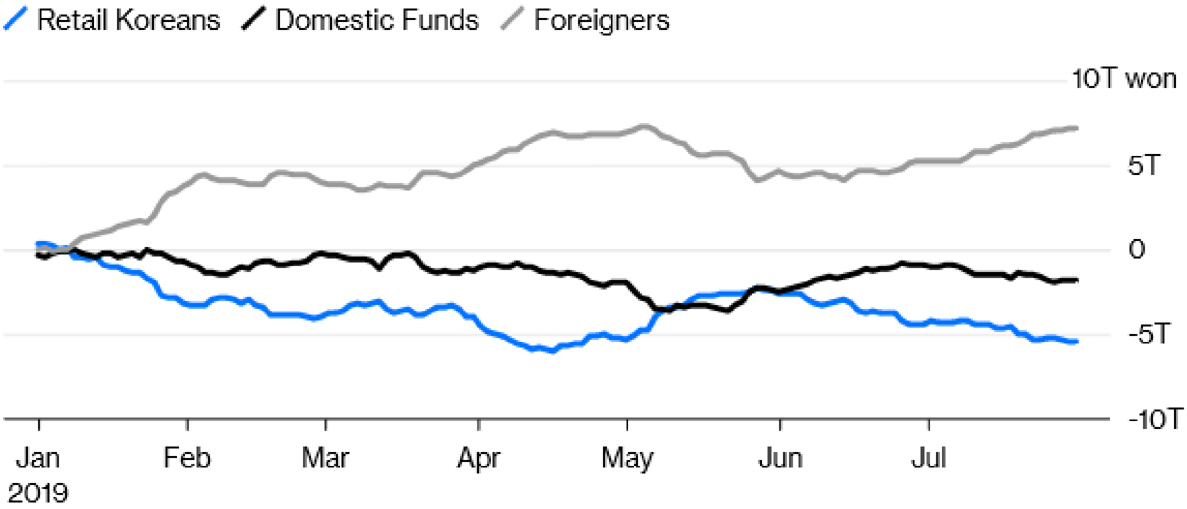
This double whammy is taking a toll. South Korea's stock market, dominated by sprawling family-run businesses, has long suffered from a so-called conglomerate discount – when a company isn't worth as much as its individual parts. But the recent run of dismal performance goes far deeper than that. Among emerging Asia's equity markets, only South Korea is in the red this year. The country's stocks are now valued at only 0.8 times book, a three-and-half year low. Even cheap valuations haven't managed to inspire animal spirits.

Take a closer look and you'll see another surprising twist. It isn't the trade-exposed companies dragging the Kospi Index lower. Shares of semiconductor giants Samsung Electronics Co. and SK Hynix Inc. have advanced 20% and 30% this year, respectively. Even Hyundai Motor Co. has gained 8%, despite a global auto-sales slowdown. These stocks are well supported by hot money from foreign fund managers, who are betting that a weaker won – which has slumped more than 5% against the dollar this year – will boost exporters' shares.

Rather, it's the domestic investors who are bailing. This year, mom-and-pops have already offloaded 5.3 trillion won ($4.5 billion) of their stock holdings, the worst selloff since early 2018, when they sent a rush of money toward the Bitcoin craze. This also helps explain why the small-cap Kosdaq Index, a retail investor's playground, has tumbled 8.8% this year, compared with the Kospi's 1.2% slide. Given foreigners hold roughly a third of South Korean stocks, their enthusiasm can't fully compensate for apathy at home.

An Exodus

While foreigners are still buying Kospi stocks, Korea's retail investors have been avid sellers. Domestic funds are bailing, too

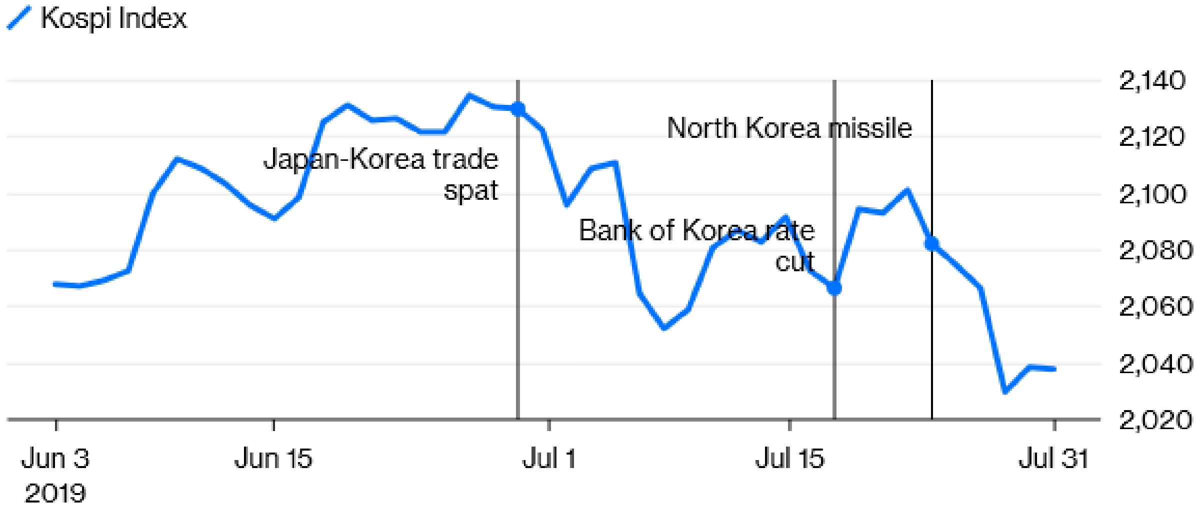


The biggest factor keeping Seoul in a slump may be the government's lack of diplomatic gravitas at a time of heightened geopolitical tension. One month into its trade spat with Japan, Seoul still hasn't reached any resolution with Tokyo. This week, as Japan prepares to remove South Korea from the so-called white list, which grants minimum trade restrictions, President Moon Jae-in's only gesture of commitment to tackling this headache is calling off his Thailand holiday. Meanwhile, Russian planes recently entered South Korea's airspace during a joint military exercise with China – without formally apologizing – and North Korea has fired multiple projectiles for the second time in less than a week.

When it comes to managing their wealth portfolios, South Koreans can be forgiven for wanting to diversify as much as they can – say, by buying into U.S. or Vietnamese stocks. That helps explain why the Kospi missed the bounce emerging markets enjoyed after a temporary truce between China and the U.S. following the G-20 in July.

Korea Discount

A series of geopolitical events has dragged down the Kospi Index. Even Bank of Korea's surprise rate cut hasn't helped



Source: Bloomberg

By now, value-oriented investors may start to find South Korea attractive. Korea Inc.'s corporate governance has improved, thanks to President Moon's tough stance on chaebol. In the last five years, the payout ratio for South Korea's stocks more than doubled to 24%, narrowing its gap with the emerging-market average of 36%. And this earnings season isn't looking so bad either. Roughly 40% of the firms tracked by MSCI have reported, and 58% beat analysts' earnings estimates. It remains to be seen whether South Koreans are willing to bottom fish.

Hong Kong, I am afraid, is starting to look a bit like Seoul. Just like the Kospi, the Hang Seng Index missed its post-G-20 bump, as protests over an extradition bill extended into a second month. Meanwhile, Chief Executive Carrie Lam has been practically absent from public view, even as protests turned violent and started to disrupt residents' daily commutes.

There's nothing investors dislike more than lingering political uncertainty. Prolonged inaction, caused by a lack of leadership, is a big no-no in the world of finance.