

## Words of War The 'Un'-doing Of North Korea

Despite recent geo-political events in Asia these past few weeks, regional markets there have remained relatively sanguine, and although admittedly the South Korean Won has been an under-performer this year compared to some of its regional peers, it's still pretty stable considering the potential risks involved. Spot USD/KRW is currently trading around 1137.80 compared to a high of just above 1200.00 in January this year and 1238.00 in February 2016. On a purely technical basis a break of 1147.00 opens a potential move to 1233.00, and for those who may still be considering hedging their exposure, the straight six-month USD/KRW NDF is currently trading at 1136.50. FX options however are a tad expensive as the cost of buying a six-month USD call KRW with a strike at 1200.00 is now around 1.60%. (*Indicative levels as at May 1st 2017*).

### Crisis - What Crisis?

In 1962 the world came the closest it's yet been to a nuclear war. Fortunately cool heads eventually prevailed both in the White House and Moscow as diplomacy overcame saber-rattling and the rest of humanity breathed a huge sigh of relief. Now in 2017 are we facing another 'missile crisis' which, with very different personalities making decisions in Washington and Pyongyang compared to Kennedy and Khrushchev, has the potential to lead us down a road where diplomacy takes a back seat this time round?

As North Korea's state media threatens a "super mighty pre-emptive strike" that would "reduce America to ashes" and the US navy dispatches a "powerful" carrier group towards the Korean peninsula, the world in general currently appears far calmer over the risk of a nuclear-tipped conflict erupting in East Asia, than it was when Castro allowed the Soviets to park their launchers carrying up to 12 tactical nuclear missiles less than 100 miles from the US mainland. Apart from some of the usual over-the-top and chilling headlines emanating from various media outlets, it appears that most people believe that such a war is unlikely, and this feeling is highlighted by the reaction in global markets which apart from a brief blip when the war-of-words between the DPRK and the US first began, have moved back into a business as usual mood. While we agree with the view that neither side seriously wants an actual physical confrontation to break-out, we think that dismissing such an outcome outright is somewhat fool-hardy, especially when even a small incident or error of judgement could trigger a chain reaction.

Of course the outlandish warnings emanating out of Kim Jong Un's regime is nothing new, we have heard such rhetoric from him and his predecessors ever since the end of the Korean war in 1953. The key differences this time are firstly that we have a businessman in the White House not a seasoned politician, and you can see this by the aggressive response the US has undertaken in dealing with Pyongyang's latest saber-rattling compared to the more measured and less escalatory approach by previous Presidents.

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The second is that North Korea is now much closer to developing an intercontinental ballistic missile capability which could put the entire United States in range, and this is something that would be unacceptable to any administration. One school of thought is that Trump's unpredictability and confrontational method in dealing with North Korea could achieve what years of diplomacy have not, and that is dissolution of the latter's nuclear weapons program in return for major economic assistance. Considering the ever present paranoia within the North Korean regime this to me seems an unlikely outcome, but it may just get them to the negotiating table where a more limited deal could be struck, such as an end to the annual South Korean/US war games, which is one of Pyongyang's biggest bug bears, in return for a commitment by the North to freeze its nuclear program and allow UN inspectors back into the country

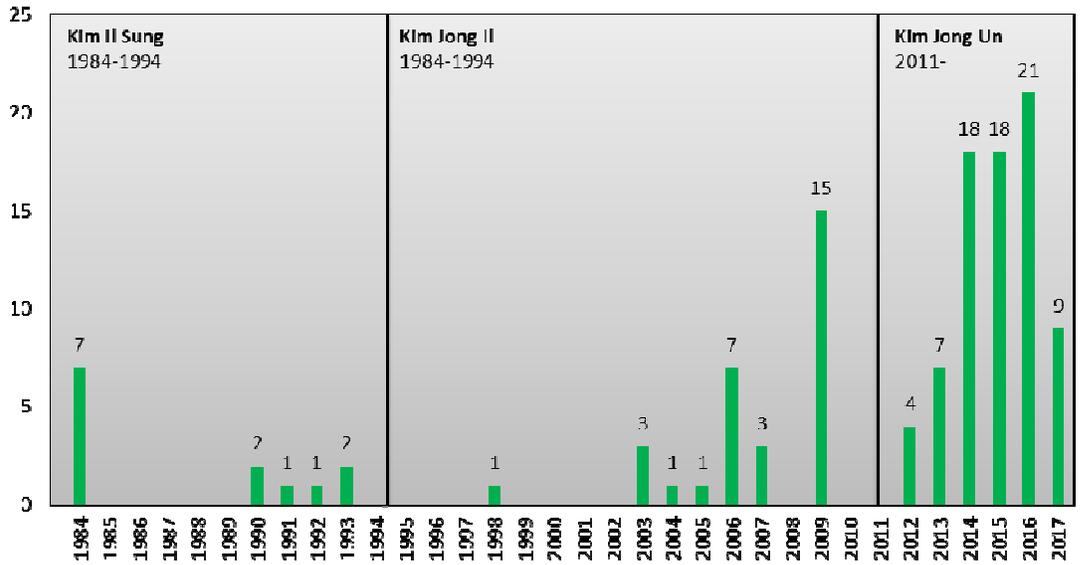
### China's Leverage

It's a positive sign that Washington and Beijing appear to be cooperating on this situation, and its most likely Chinese pressure persuaded the North Koreans not to press ahead with another nuclear test for now. China is the only country that can really squeeze its neighbour economically; this is highlighted by reports of an 80% spike in fuel prices in Pyongyang after Beijing ordered a slowdown of such essential supplies this month. Political ties however, which both sides have referred to as a "bond of blood" since the 1950s, have become strained in recent years and high level contact was markedly scaled down after Kim Jong Un's uncle, Jang Song Thaek (who was also Beijing's primary point man), was executed in 2013 on the orders of his nephew. Relations worsened further after the North Korean leader's half-brother, Kim Jong Nam, who lived in Beijing and Macau and who was technically under the protection of the Chinese authorities, was assassinated by suspected North Korean agents in Malaysia earlier this year. Beijing will also doubtless have been unimpressed by Pyongyang's decision this past Saturday to proceed with another, albeit failed attempt, at a ballistic missile test.

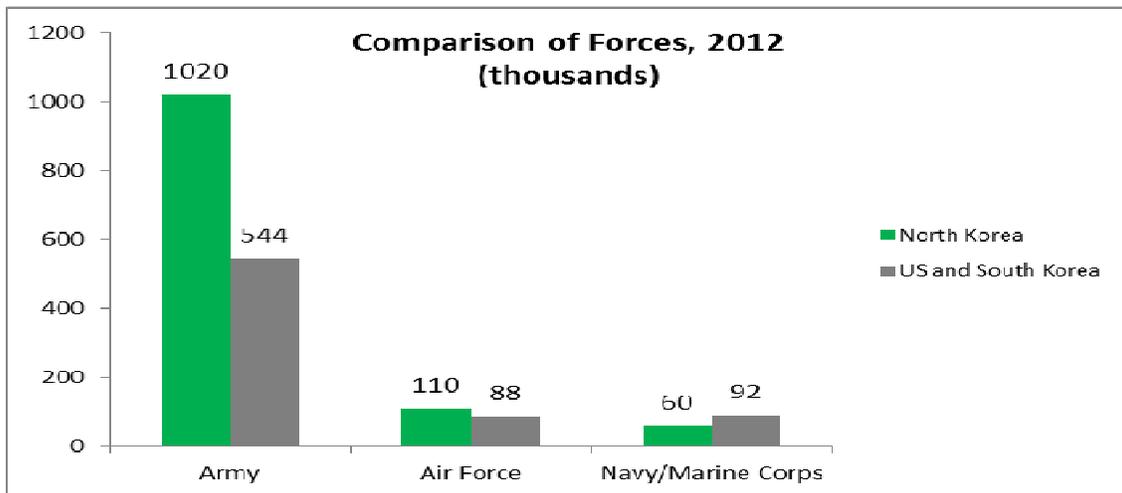
China has two problems, on the one hand it can't afford for North Korea to collapse because this would result in a massive influx of refugees, it is also a good buffer state between China and South Korea and thus the last thing Beijing would want would be a unified Korean peninsula allied to Washington. On the other hand it is also concerned over North Korea's nuclear ambitions which increasingly heighten the risk of a major geo-political miscalculation. Russia too shares a border with North Korea and has publically expressed its concern over the recent escalation of tensions there, even to the point of suggesting last Wednesday that the region was "on the brink of war." Whether via a deliberate act or simply an accident, recent reports suggest that neither the Chinese nor the Russians are taking any chances, with each country's militaries allegedly deploying significant numbers of personnel as well as land and air resources, close to their borders with North Korea at the beginning of last week. Meanwhile South Korea has raised its own alert level and the US has begun deploying its THAAD air defence systems near Seoul. Ironically, and in another display of Trump's business acumen superseding diplomacy, the US President warned last Thursday that he wanted Seoul to pay US\$1 bio for the deployment of THAAD, and planned to either renegotiate or terminate the "horrible" free-trade agreement between the two countries. Such comments whether financially justified or not, cannot come at a more inopportune time and are likely to be especially galling for South Korea which is one of Washington's closest Asian allies. Politically South Korea is also currently in a state of flux after its President Park Geun-Hye was impeached on the back of a corruption scandal, and the leading candidate to replace her is Moon Jae-In who has publically denounced the deployment of THAAD before a new President is in office to evaluate its benefits and risks.

All of the above outlines a serious cocktail of risks which if you look back in history can inadvertently result in an event that nobody wanted or anticipated. A 21st century Korean conflict would likely be short but extremely devastating in both human and economic terms, not just for the Koreans themselves but for the region as a whole. Thus the hope is that the markets are right and cooler heads will eventually prevail, making this just another 'war of words' rather than 'words of war.'

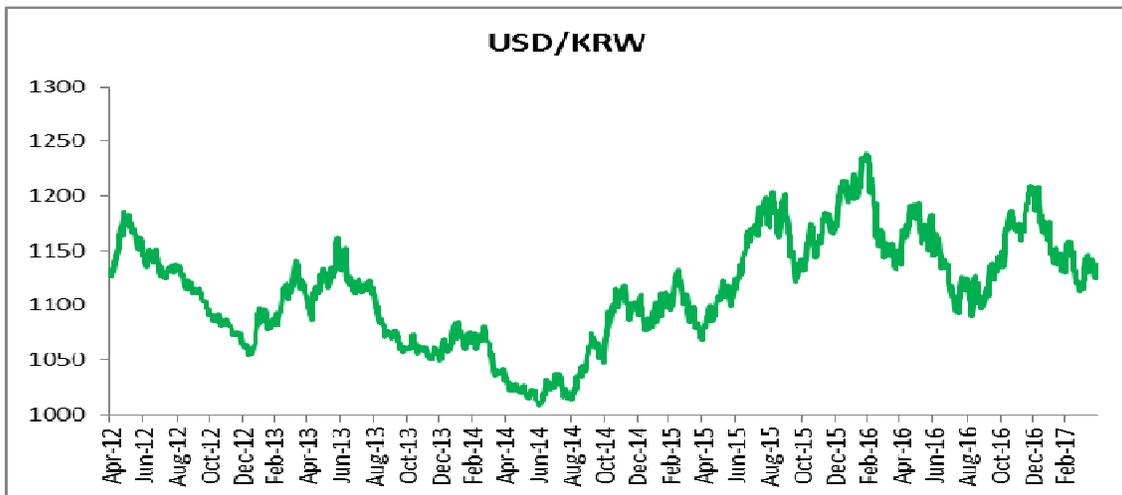
### Ballistic Missile Launches



Source: Bloomberg



Source: Time



Source: Bloomberg.

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