Korea Equity Strategy

Update on the de-leveraging process in Korea (2)

Equity Macro Research

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The Korea market has undergone an **intense period of de-leveraging since mid-June**. The KOSPI index is now down almost -40% from the peak on 22 June in a highly volatile move. What was triggered by routine fundamental concerns and rotational flow was amplified by leveraged ETFs, and in recent days increasingly has the hallmarks of hedge fund positioning unwind. Following our update last week (where we estimated that leveraged ETF unwind was 75% through and equity H/F de-leveraging >50% through), **we now believe that leveraged ETF unwind is complete and hedge funds are done with ~90% of de-leveraging** (both to acceptable levels). While it is likely that the price damage we have seen this week has residual spillovers into further de-leveraging over the coming days, and that many investors continue to exercise caution into the FOMC this week (high risk of a rate hike) and hyperscaler earnings (high expectations), the **positioning setup in Korea now appears attractive on balance – and complements the cheap valuations and earnings momentum.**

- **De-leveraging update: (1) Leveraged ETFs AUM has normalized:** Leveraged ETFs with Korea underlyings grew to $50bn in AUM by late June. Relative to its market size, this was 4x larger than the US and led to very pronounced volatility (and forced de-leveraging on down-days – which then caused positioning unwinds from other investors). With the reversal of the market, this cohort is now down to $17bn. In addition, the previously rapid inflows into these products have stalled in recent days (not much dip buying). As a result, the VKOSPI to VIX ratio has started to decline and will likely fall further. **(2) HF leverage has almost normalized:** Swap capacity constraints kept a lid on HF leverage buildup in Korea. Still, L/S ratios in the JPM Prime book rose up to 5.7x. The process of normalization from there is now well advanced. This ratio dropped to 3.2x by 27 Jul, and given the unwind in the Price Momentum factor over 28 and 29 Jul, HF leverage has likely declined further, and not very far from the top end of 2025's range. **(3) Retail leverage through margins less of a risk:** Margin balances were never particularly high or witnessing rapid growth. Balances have moderated somewhat to ~$20bn now. And, unlike leveraged ETFs that undergo a process of forced de-leveraging on any spot price declines, margin lending comes with buffers and discretion. Korean retail investors still have ample equity gains, cash balances, higher incomes and overseas assets to tap into to absorb any margin calls should they want to keep the position. **(4) Record foreign outflows are slowing:** LO selling pressure has substantially eased as Korea (and particularly the memory names) has underperformed, meaning that the two heavyweights are now only 6.5% and 4.5% weights in MSCI EM (vs 9.5% and 8.3% in late June).
- **Diversification trades remain in play:** We continue to like: (1) "**wealth effect**" exposures (department stores, cosmetics, travel, brokers, construction) have a compelling tailwind; (2) **Bio-pharma** is a substantial laggard that potentially benefits from globally improving sentiment around the healthcare sector; (3) **Pref share** discounts are near record wides – with the resultant elevated yields offering good carry; (4) **Banks** look particularly attractive with a triple tailwind from improving asset quality with income growth, BOK rate hiking cycle a tailwind for NIMs, and heightened market volumes contributing to brokerage revenues.

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Figure 1: KOSPI index has now declined ~40% from the peak of 22 Jun



Source: Bloomberg Finance L.P., J.P. Morgan Equity Macro Research.

Figure 2: This week's move has brought index RSI to oversold levels



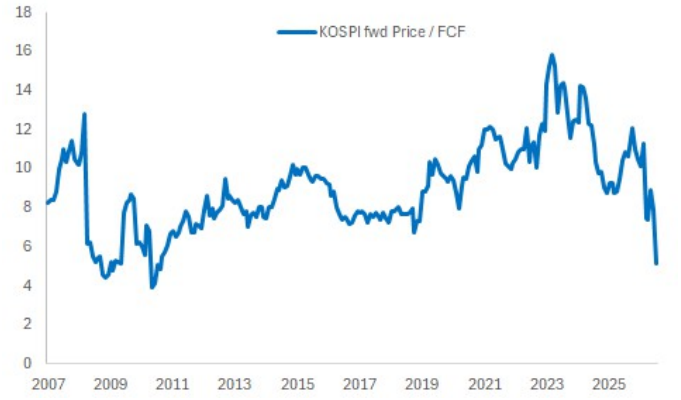
Source: Bloomberg Finance L.P., J.P. Morgan Equity Macro Research.

Figure 3: KOSPI fwd P/E at 5x is cheap – even after adjusting for cyclicality



Source: Bloomberg Finance L.P., J.P. Morgan Equity Macro Research.

Figure 4: 5x estimated FCF is, similarly, "crisis-level" valuation



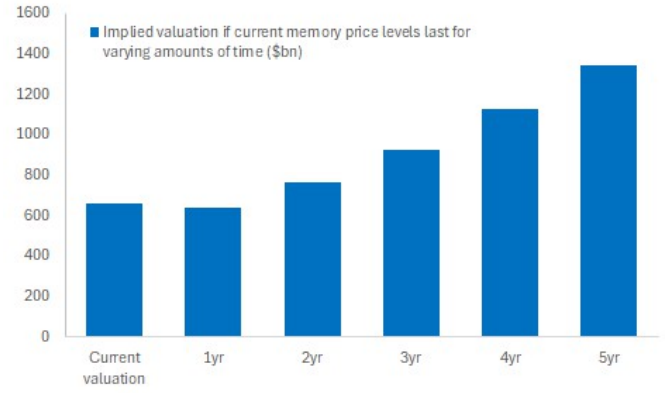
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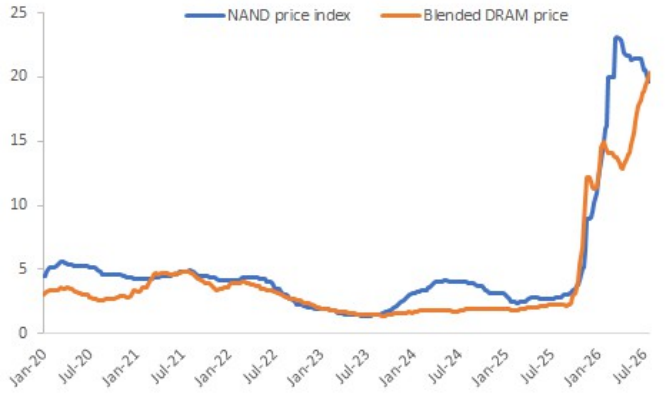
Figure 5: Our simplistic modeling of memory price longevity suggests current market pricing implies memory prices start normalizing to pre-AI levels in early 2027; each extra year adds ~$150bn

Key memory maker's valuation based on how long prices sustain at 2026-average levels. Please ask for details.股票消息群，加qq：1536582800



Source: Bloomberg Finance L.P., J.P. Morgan Equity Macro Research.

Figure 6: Relative to this, spot memory prices on aggregate are still moving higher; contract prices up in 3Q too – albeit at slower pace q-q



Source: Bloomberg Finance L.P., J.P. Morgan Equity Macro Research.

Figure 7: Korea market concentration has been another problem – which led to very narrow breadth until recently

% of stocks outperforming KOSPI on a rolling 6m basis



Source: Bloomberg Finance L.P., J.P. Morgan Equity Macro Research.

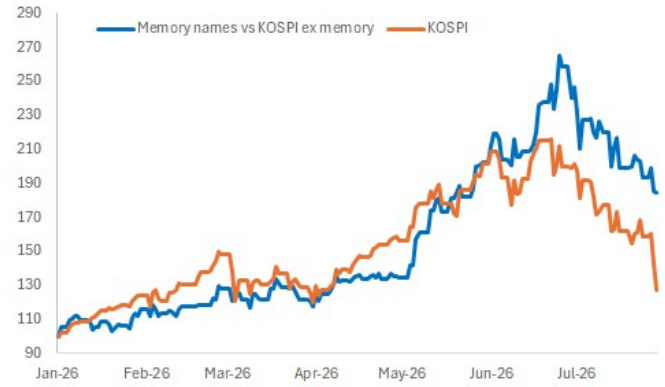
Figure 8: Notably, in the correction in July, market breadth (advance-declines) has actually held up relatively well – indicating losses were also concentrated in few names



Source: Bloomberg Finance L.P., J.P. Morgan Equity Macro Research.

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Figure 9: Indeed, KOSPI decline has matched with underperformance of memory names – but this appears to be stabilizing



Source: Bloomberg Finance L.P., J.P. Morgan Equity Macro Research.

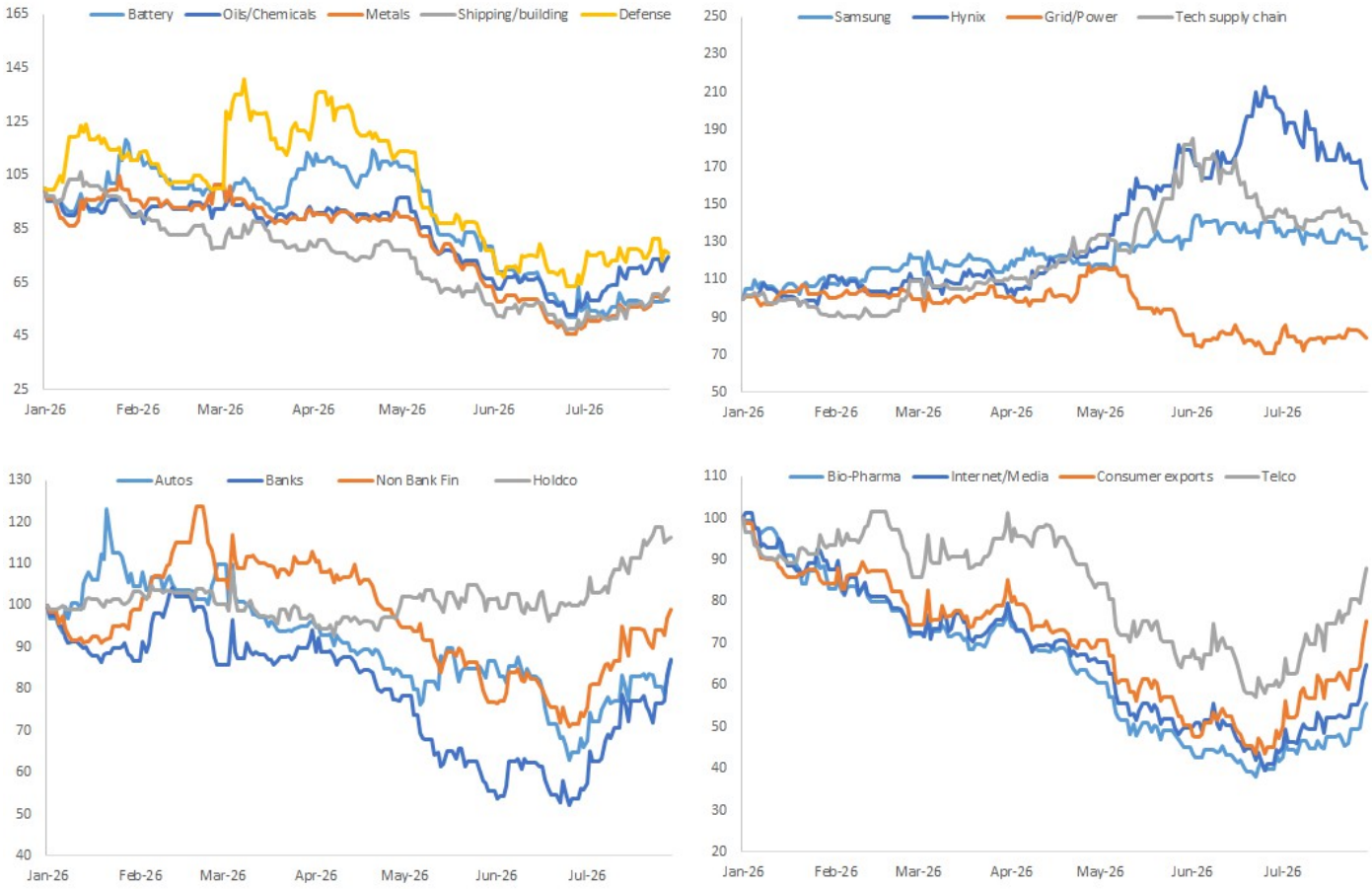
Figure 10: Similarly, in the US, the unwind of concentration has been violent, but likely healthy



Source: Bloomberg Finance L.P., J.P. Morgan Equity Macro Research.

Figure 11: Relative performance of market segments in Korea – big catchup from laggards in Value and Defensive spaces

relative to KOSPI



Source: Bloomberg Finance L.P., J.P. Morgan Equity Macro Research.

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Figure 12: In terms of leveraged ETFs, their AUM has now declined to levels we believe are no longer problematic

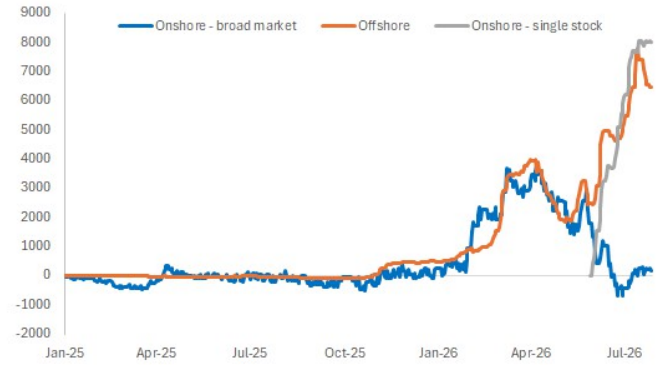
AUM - USD mn



Source: Bloomberg Finance L.P., J.P. Morgan Equity Macro Research.

Figure 13: Inflows into leveraged products has also stalled in recent days – with recent regulatory tightening potentially keeping inflows in check

Cumulative inflows, USD mn



Source: Bloomberg Finance L.P., J.P. Morgan Equity Macro Research.

Figure 14: As a result, KOSPI volatility has started to normalize and will likely continue to

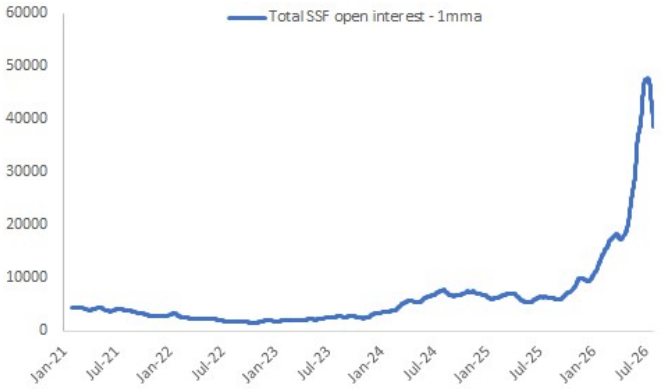
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Source: Bloomberg Finance L.P., J.P. Morgan Equity Macro Research.

Figure 15: The open interest of single stock futures (implementation channel of the leveraged ETFs) continues to moderate as well

USD mn



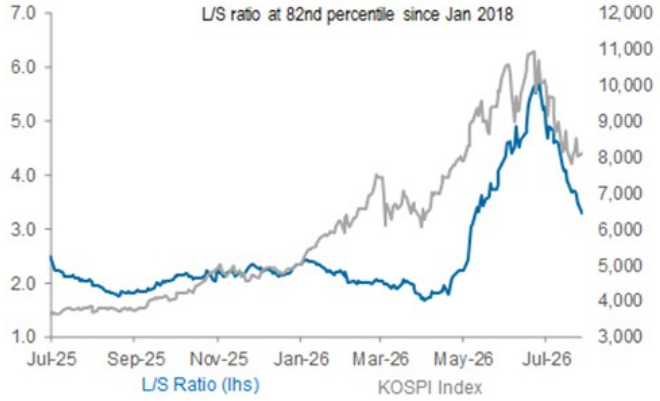
Source: Bloomberg Finance L.P., J.P. Morgan Equity Macro Research.

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Figure 16: L/S ratio for hedge funds in the JPM Prime book has declined from highs…

Latest data as of 27 July



Source: J.P. Morgan Positioning Intelligence.

Figure 17: … and has likely further normalized looking at the sharp underperformance of the Price Momentum factor over 28 and 29 July

Indicative performance of L/S quintiles



Source: Bloomberg Finance L.P., J.P. Morgan Equity Macro Research.

Figure 18: For retail investors, margin leverage is not too high and has not climbed very aggressively this year

USD bn



Source: Bloomberg Finance L.P., KSD, J.P. Morgan Equity Macro Research.

Figure 19: As a share of market cap, margin balances have actually been declining this year

%



Source: Bloomberg Finance L.P., KSD, J.P. Morgan Equity Macro Research.

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Figure 20: For foreign investors overall, they have sold >$110bn of Korean equities YTD, but most of this was due to mandate constraints for LOs on owning large-caps

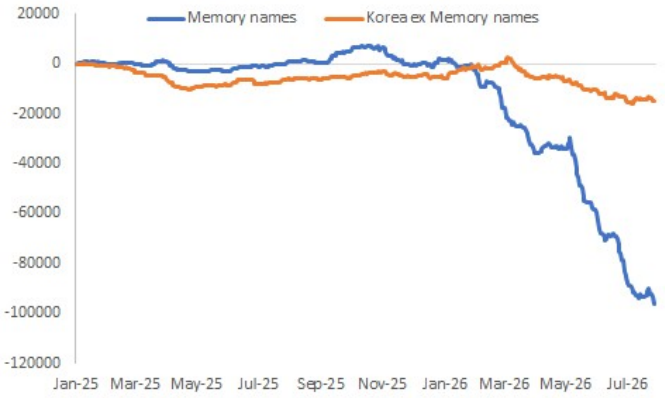
Cumulative flow, $mn, KRX data



Source: Bloomberg Finance L.P., J.P. Morgan Equity Macro Research.

Figure 21: Indeed, 90% of the outflow is from the two memory names; the decline in EM index weights of these stocks has substantially slowed outflows

Cumulative flow, $mn



Source: Bloomberg Finance L.P., J.P. Morgan Equity Macro Research.

Figure 22: Foreign flows by market segments and key market regimes YTD – a lot of sectors seeing buying even during the latest KOSPI correction since 22 Jun

USD mn, KRX data only

	Tech / AI exposure				Value exposure				Industrials and commodities						Others				
USD mn	Samsung	Hynix	Grid/Power	Tech supply chain	Autos	Banks	Non Bank Fin	Holdco	Battery	Oils/Chemicals	Metals	Shipping /building	Defense	E&C	Bio-Pharma	Internet/ Media	Consumer exports	Telco	Services
1 Jan - 27 Feb	-12987	-6419	459	988	-3854	-87	-485	92	1291	780	52	1642	-16	1296	967	324	456	146	45
27 Feb - 31 Mar	-12138	-5412	-170	-482	-2587	-451	-418	-136	-181	-205	-286	62	-616	-13	269	-342	-111	48	-29
31 Mar - 22 Jun	-17913	-17105	-1947	-1611	-4180	-97	50	-2073	1027	963	-79	-1190	833	-220	10	-892	81	-255	-330
22 Jun - now	-10362	-15536	-307	1023	85	-354	116	-2472	-47	-25	56	-244	-69	175	86	15	91	-177	-28

Source: Bloomberg Finance L.P., J.P. Morgan Equity Macro Research.

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