

The Impact of High Oil Prices on the Korean Market

The ongoing conflict in Iran has led to a dramatic spike in oil prices and volatility across global equity markets. Nowhere has this been more acute than across Asian markets, where many countries are net importers of oil and whose economies could suffer significantly. Korea has experienced some of the highest levels of equity volatility, with the broad market KOSPI Index declining by over -16% (in KRW) from its all-time high at the end of February when the price of Brent crude spiked above \$100 a barrel. How the current conflict in Iran unfolds remains unclear, but its impact on market sentiment is significant and Dalton believes that this short-term volatility could be a potential opportunity for select investments in Korea.

Why Are High Oil Prices a Headwind for the Korean market?

As news of military attacks on Iran began coming in, the price of oil spiked immediately as investors weighed the impact of the restriction of oil through the Strait of Hormuz, which controls 20% of the global oil supply. So far, Iran has proven successful in stalling the shipment of oil through the use of mines and drones in the Strait of Hormuz, leading to a dramatic drop in daily shipping volume from 60 tankers a day to just 5 in early March. This has had a significant impact on global oil production and an increase in the cost of oil.

Korea maintains an economic structure that is fundamentally vulnerable to fluctuations in global oil prices. The country is the world's fourth-largest oil importer and the third-largest LNG importer. Approximately 70% of its crude oil and 20% of its LNG imports originate from the Middle East. As a nation, Korea is the world's seventh-largest oil consumer and has the highest oil consumption relative to GDP among OECD members. If oil prices average \$100 per barrel for an extended period of time, it is estimated that Korea's GDP could decline by 0.5%. It is therefore not surprising that investors have taken a cautious approach to Korean equities in March.

Despite these vulnerabilities, Korea maintains strategic petroleum reserves (SPR) sufficient for 2 to 3 months of domestic consumption. If the current blockade of the Strait of Hormuz is resolved swiftly—hopefully within a 1-to-2-month window—allowing oil prices to revert to normalized levels, the economy should be able to absorb the shock without lasting damage. In such a "short-term disruption" scenario, we anticipate a smooth return to long-term economic fundamentals.

What is Driving Korean Market Volatility?

Prior to the US and Israel's joint military action in Iran, the Korean KOSPI Index had been experiencing one of its best yearly starts, recording gains of +35% (in KRW). With the onset of the US/Israel conflict with Iran, the Korean market experienced a sharper correction compared to other developed and emerging markets. We believe this outsized volatility is driven by three primary factors:

1. **High Base Effect and Profit Taking:** At the end of February, the KOSPI Index was one of the top-performing global indices, having risen +160% from a year ago. From this "high base" of momentum performance, the Index suffered significant losses when oil prices began to rise, and investors moved to lock in gains amidst geopolitical uncertainty.
2. **Technical Selling Pressure from Foreign Funds:** The rally in the KOSPI was highly concentrated, with AI-related leaders—specifically SK Hynix and Samsung Electronics—accounting for over 70% of the index's upside. Together, these two stocks now represent more than 40% of the Korean total market capitalization. Because they significantly outperformed the broader market, their weight in many international funds exceeded portfolio and risk guidelines (10% for single stock and 25% country limit etc.), triggering technical sell-offs to meet regulatory or internal diversification mandates.
3. **Retail Leverage and Forced Liquidation:** As the index peaked, late-coming retail investors entered the market using leveraged products. This created a "margin call" domino effect during the initial downturn, where forced liquidations exacerbated the decline and heightened overall market volatility.

The Sell-Off Does Not Reflect Underlying AI Demand Fundamentals

We believe that the current demand cycle for memory is unrelated to oil prices. Rather than dampening the AI cycle, the current conflict is likely to intensify the global "thirst" for AI integration once the dust settles. By utilizing AI in this offensive to enhance precision and operational effectiveness, the U.S. has effectively demonstrated the technology's strategic necessity on the world stage.

If the global economy returns to its prewar growth momentum, we can expect AI investment from both governments and corporations to accelerate for the following reasons: 1) The transition from theoretical potential to proven real-world application increases confidence in ROI; 2) Increased adoption cases - success in high-stakes environments (like defense) serves as a catalyst for adoption in the private sector; 3) Strategic imperative - AI is no longer viewed as an optional efficiency tool, but as a core pillar of national and corporate security.

As vital partners within the global AI value chain, Korea and its key industry players are positioned for a significant re-rating. The combination of proven hardware dominance (HBM, semiconductors) and expanding infrastructure roles suggests that the upward valuation of the Korean technology sector will persist throughout this cycle.

Furthermore, the current conflict has served as a critical validation of Korea's Air Defense Systems, which are utilized by the United Arab Emirates (UAE) and Saudia Arabia. The proven effectiveness of these systems to thwart recent missile and drone attacks from Iran, provides a significant catalyst for the Korean defense sector's next growth phase. Key competitive advantages being recognized globally include cost-efficiency and fast delivering high-performance capabilities at a fraction of the cost of Western competitors. Most of all, the real-world validation of these systems in the Iran war is expected to create sustained upward momentum for Korean defense stocks in the post-war reconstruction and global rearmament cycle.

Future Outlook: Market Polarization and Stock Picking Opportunities

Despite the recent surge, we believe that many companies in the Korean market remain undervalued. While it is true that the AI related segment of the market is trading at over 2x book value, around 70% of listed companies in Korea continue to trade below book value.

This extreme market polarization suggests inefficiencies in the Korean market, providing a significant alpha opportunity for bottom-up stock pickers such as Dalton. Additional structural tailwinds for Korean equities include the government's ongoing efforts to improve corporate governance, protect minority shareholders, and enhance capital efficiency in order to resolve the "Korean Discount".

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