OPINION

Macro-Financial Analysis Division

2026 H2 Financial Market Outlook and Asset Allocation Strategy

In H2 2026, financial markets are expected to be driven mainly by the inflation path and the consequent potential repricing of monetary-policy expectations. In particular, heightened US inflation uncertainty following the Iran war is repricing expectations for the Fed's policy rate and, through the dollar channel, raising upside risks to long-term rates and the exchange rate. With the rate-hike path largely priced in and the term premium stabilizing gradually, the 10-year KTB yield is expected to fluctuate around the low-4% range, though upside risks dominate amid renewed inflation and global tightening concerns. The KRW/USD rate is likely to struggle to form a clear direction, as won-strength factors such as a widening current-account surplus contend with won-weakness factors such as expanding residents' overseas equity investment and foreign net selling of domestic equities. Even if the Bank of Korea raises rates in H2, the impact of a narrowing rate gap is judged limited because the market has largely priced it in. Thus, with the influence of the term premium and FX supply-demand conditions growing, market volatility could widen in H2.

Meanwhile, as concerns over renewed inflation push the stock-bond correlation higher again, bonds' traditional safe-asset function is judged to have weakened relative to the past. In asset allocation, flexible use of alternative assets such as gold, energy, and defensive equities is needed, but a hedge's effectiveness can vary with the cause of inflation and the business-cycle phase. In the current phase, where energy-price shocks are the main inflation driver, the energy sector can be an effective hedge; however, the appropriate hedge can change as the macro environment shifts, so continuous monitoring is needed.

* All opinions expressed in this paper represent the author's personal views and thus should not be interpreted as Korea Capital Market Institute's official position.

Long-Term Interest Rate Outlook

The 10-year Korea Treasury Bond (KTB) yield[1] rose about 136bp over twelve months, from 2.68% in May 2025 to 4.04% in May 2026. Decomposing the change in the long-term rate into expectations about future monetary policy and the term premium using an affine term structure model (Adrian, Crump & Moench, 2013)[2][3] — as shown in Figure 1 — policy-rate expectations contributed 39bp (29%) and the term premium 97bp (71%). In other words, the recent sharp rise in long-term rates was driven mainly by the widening term premium rather than by changes in policy-rate expectations.

Figure 1. Decomposition of the 10Y KTB yield

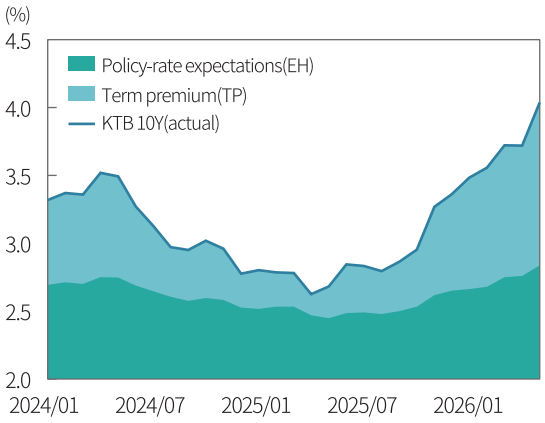
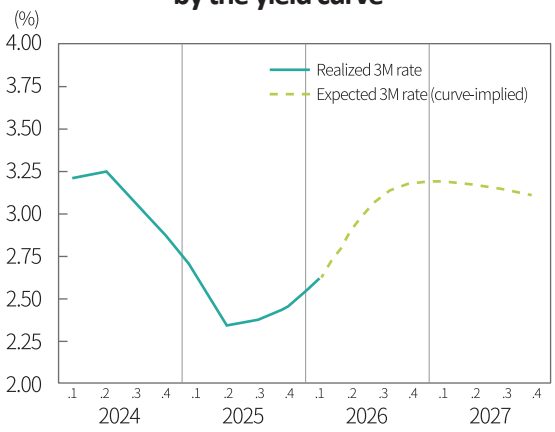


Figure 2. Policy-rate expectations implied by the yield curve



Note: Estimated by applying the Adrian, Crump & Moench (2013) term structure model to Bloomberg zero-curve data. Figure 2 is based on the 3-month treasury rate.

The policy-rate expectation path bottomed at 2.45% in May 2025, then rebounded gradually from June, rising 39bp to 2.84% by May 2026. Expectations of a rate cut formed temporarily

1) The 10-year KTB yield in this report is the 10-year zero-coupon (residual-maturity) rate extracted from the Bloomberg zero curve. Actual market yields were not used because the term structure model requires consistent zero-coupon rates across maturities as inputs.

2) Adrian, T., Crump, R.K., Moench, E., 2013, "Pricing the Term Structure with Linear Regressions," Journal of Financial Economics 110(1), 110–138. The model is simple to estimate and stable across samples, and is published and used by the US Federal Reserve (notably the New York Fed) as a term premium estimate for US Treasuries. For domestic application, however, the sample is relatively short and includes regime changes in the policy framework and market structure, so the estimates carry uncertainty; the decomposition is better read in terms of trend and relative contribution than levels.

3) Policy-rate expectations are the average expected path of short rates over the life of the long-term bond — the policy path priced in by the market. The term premium is the residual of the long-term rate after subtracting the policy-expectation component, i.e., the premium investors require for the interest-rate, inflation, and policy-uncertainty risk of holding long-term bonds. Supply-demand factors, global duration risk, and concerns over fiscal soundness are reflected in it.

amid concerns over a growth slowdown from the US tariff shock, but the path subsequently came to reflect a view that Korea's economy had passed its trough and would recover gradually.[4] Meanwhile, the term premium entered a full-fledged rising phase from October 2025 and had already risen substantially before the outbreak of the Iran war in March 2026. The term premium rose under the influence of global and domestic fiscal factors from H2 2025. Externally, risk premia on major sovereign bonds widened due to the widening US fiscal deficit, instability in the JGB market during the Bank of Japan's policy normalization, and concerns over UK and French fiscal soundness. As required yields on global long-term sovereigns rose broadly, upward pressure was also exerted on the term premium of Korean treasuries. Domestically, two supplementary budgets in 2025 expanded KTB issuance; in particular, the increase in deficit-financing bonds and long-maturity issuance raised the supply burden of long-term bonds, pushing up the term premium.

Regarding the outlook: on the policy-expectations side, the bond market has already largely priced in a path of 2–3 rate hikes by year-end (see Figure 2). The Institute's monetary policy outlook and the median of the Bank of Korea Monetary Policy Board's May dot plot (3.00% at end-2026) are broadly consistent with the market-implied path, so absent further policy surprises the effect of the policy-expectation path on long-term rates should be limited. On the term-premium side, the 10-year term premium stood at 1.20% as of May, well above the May 2025 level (0.2%), and the 30-year term premium is also close to its long-run average. Accordingly, if Middle East geopolitical tensions ease, the term premium could narrow somewhat in the near term. However, given that structural factors such as concerns over major economies' fiscal soundness and bond-supply burdens persist, a full return of the term premium to its 2025 trough appears unlikely.

Combining the two channels, with limited scope for change in the policy-expectation path and the term premium expected to stabilize gradually, we project the 10-year KTB yield to fluctuate around the low-4% range. That said, weighing upside and downside risks, the balance remains tilted to the upside. In particular, some upside risks have already materialized, with the 10-year KTB yield rising to 4.35% on concerns over US monetary tightening. Upside risk factors include rising global energy prices and tightening concerns, a consequent strengthening

4) In May 2025 the policy rate was cut from 2.75% to 2.50% (29 May 2025); at the time the consensus forecast (Refinitiv) for the end-2025 policy rate was 2.0%, implying two further cuts.

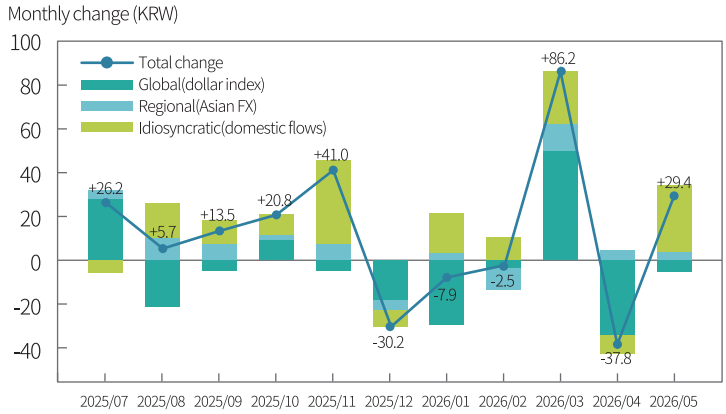
of the Bank of Korea's tightening stance or a steeper-than-expected policy path, and further increases in the term premia of major sovereign bonds including the US. A possible slowdown in domestic insurers' treasury demand is also an upward factor: insurers' long-duration demand varies with the level of rates, and in a rising-rate environment the present value of their liabilities falls, reducing the need to secure additional long-duration assets and potentially weakening their bid for long-term treasuries. Downside factors are relatively limited. If US growth slows and Fed tightening concerns ease, a synchronized decline in global long-term rates could pull domestic rates down. Also, if the recovery of domestic demand such as construction investment lags — unlike the semiconductor-led recovery — the Bank of Korea's rate-hike timing could be delayed; and if energy prices stabilize quickly after the end of the Iran war, strengthening global disinflationary pressure, that too could act as a downward factor.

KRW/USD Exchange Rate Outlook

To assess the direction of the KRW/USD rate in H2 2026, we decomposed recent exchange-rate movements into global (dollar index), regional (Asian currencies), and idiosyncratic (domestic supply-demand) factors (see Figure 3); the recent exchange rate has been driven alternately by the dollar index and by domestic supply-demand factors over time. First, as shown in Figure 4, in H2 2025 the expansion of residents' overseas equity investment led won weakness. During August–November, the idiosyncratic factor exerted about 75 won of depreciation pressure, while the combined contribution of global and regional factors was only 6.5 won. The expansion of the idiosyncratic factor coincided in timing and direction with the surge in residents' overseas equity investment, suggesting that much of the won-weakness pressure stemmed from domestic capital outflows. By contrast, in Q1 2026 the dollar index surged on the Iran war, and the KRW/USD rate (month-end fixing) rose from 1,424 won at end-February to 1,513 won at end-March. The global factor's contribution reached 49.5 won, leading the rise, with dollar strength from the geopolitical shock the key driver. However, even after part of the dollar index's gain was retraced in April–May, the decline in the exchange rate was limited. In particular, in May, although the global factor shrank to essentially neutral, most of the upward pressure came from the idiosyncratic factor. Unlike H2 2025, residents' overseas securities investment slowed markedly, while — as shown in Figure 5 — capital outflows from foreigners' net selling of domestic equities emerged as a new channel of won weakness.

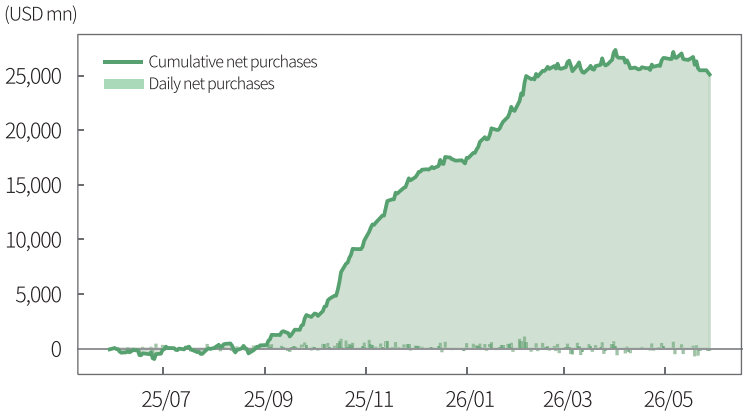
The pace accelerated in June (fixing of 1,546.5 won as of the 9th); this time global and idiosyncratic factors acted simultaneously with almost equal weight, with global dollar strength compounding May's domestic supply-demand shock. These results suggest that the direction of the KRW/USD rate in H2 2026 will likely be determined by the further direction of the dollar index and by changes in domestic FX supply-demand centered on foreign capital flows.

Figure 3. Decomposition of monthly KRW/USD changes



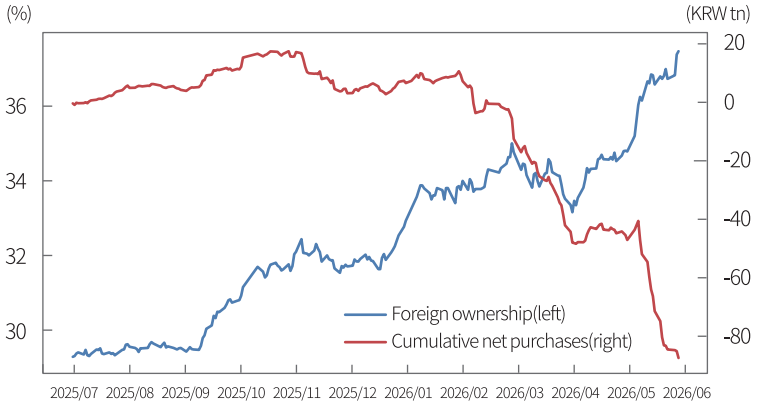
Note: Decomposed by applying hierarchical PCA to monthly log-return data (Jan 2010–May 2026). The first principal component common to 30 global currencies is extracted as the global factor; the regional factor is obtained by applying PCA again to the residuals after regressing out the global factor from 11 Asian currencies; and the idiosyncratic factor is the residual from regressing KRW/USD changes on the two factors. The three components sum to the monthly total change.

Figure 4. Residents' net purchases of overseas equities



Source: Korea Securities Depository

Figure 5. Foreign equity trading and ownership share

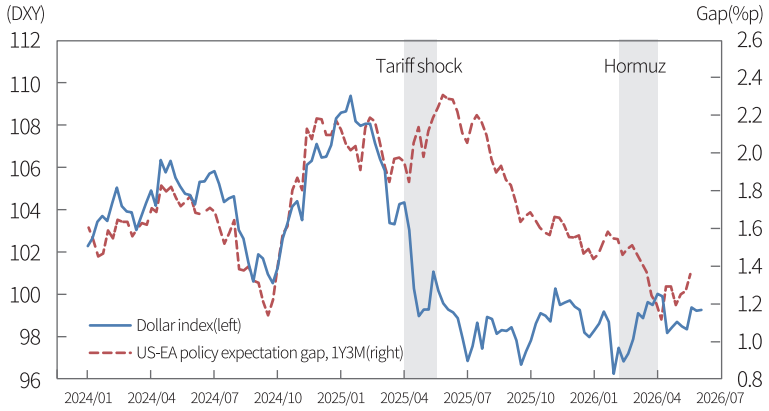


Source: Korea Exchange

The trend in the dollar index[5] is determined by changes in the gap between US and euro-area policy-rate expectation paths (see Figure 6). After the April 2025 tariff shock, the dollar index persistently undershot the level implied by the policy-expectation gap, but after March 2026 expectations of US rate cuts weakened rapidly and most of this gap was closed. Currently, forward rates in the US (SOFR) and the euro area (ESTR) are rising together, but the expected-rate gap between them shows little change. Accordingly, the dollar index is likely to move sideways without a clear direction for the time being. In the near term, if the Iran war ends, the dollar index could temporarily fall as part of the geopolitical risk premium embedded in the dollar unwinds. However, with the expected-rate gap stable and US inflation uncertainty still lingering, a modest rebound thereafter appears more likely. For the dollar index to decline on a trend basis, the end of the war would need to lead to stable global energy prices and slower US inflation, and ultimately a path in which the Fed's tightening stance eases. Conversely, if inflation runs higher than expected or inflation expectations rise again, US tightening expectations would strengthen, potentially adding upward pressure on the dollar index.

5) The euro accounts for the largest share, about 58%, of the dollar index's constituent currencies.

Figure 6. Dollar index and US-euro area policy expectation gap



Note: The policy-expectation gap is the difference between the 1-year-ahead short-rate forecasts (1Y3M) for the US (SOFR) and the euro area (ESTR).

Source: Refinitiv

Meanwhile, despite the projection of a large current-account surplus in 2026,[6] domestic FX supply-demand conditions are judged not to favor won strength. On the resident side, overseas investment demand could expand again on occasions such as the large overseas IPOs[7] scheduled for H2 2026, raising the risk that overseas equity investment — which slowed in H1 — rises again in H2. On the non-resident side, foreign equity flows could constrain won strength: if the KOSPI rally continues, profit-taking-type foreign net selling and the accompanying FX conversion demand could persist. Indeed, although foreigners' net selling of domestic equities reached about 75 trillion won from end-February to end-May 2026, the foreign ownership share actually rose from 34.8% at end-February to 37.5% at end-May.[8] This means that despite large-scale selling, the valuation of foreigners' holdings has remained high, suggesting that substantial additional selling capacity remains.

The recent feature of the Korean market — foreign selling continuing despite share-price strength — stands out more clearly in comparison with Taiwan, which experienced share-price

6) In its May 2026 Economic Outlook, the Bank of Korea projected the current-account surplus to widen from USD 123.1bn in 2025 to USD 250bn in 2026.

7) In 2026, mega-listings of large US private companies are concentrated. Beginning with SpaceX's Nasdaq listing in June, OpenAI and Anthropic are also pursuing listings. Domestic investors' subscription/investment demand for these mega-IPOs could generate substantial FX conversion (won-selling) demand.

8) This reflects that the returns of foreign-held stocks far exceeded the market average. Net selling itself lowered the foreign ownership share by 1.0%p, but the relative-return effect more than offset this (+3.7%p), so the share ultimately rose 2.7%p. By stock, SK Hynix contributed 1.7%p and Samsung Electronics (incl. preferred) 0.9%p — these alone explaining 2.6%p, most of the total rise. Foreigners net-sold Hynix and Samsung, but the price-appreciation effect on existing holdings far exceeded the ownership-reducing effect of selling.

gains driven by improving semiconductor conditions. From H2 2025 through May 2026, foreign net buying and the TAIEX moved broadly together in Taiwan. In Korea, by contrast, although the KOSPI's gain far exceeded the TAIEX's over the same period, the share-price rise was led by domestic investors rather than foreign buying. In particular, with foreign selling persisting after February 2026, share-price strength did not translate into improved FX supply-demand. Ultimately, recent won-weakness pressure is judged to stem substantially not only from simple dollar strength but also from capital-account factors including foreign equity flows.

Of course, factors such as the National Pension Service's expansion of FX hedging and the FX authorities' market-stabilization measures can mitigate won weakness. However, these act less as a force pulling the exchange rate down (won strength) than as a buffer controlling the pace when upward pressure arises. In addition, firms converting overseas-held foreign currency for corporate-tax payments or to fund domestic investment could support the won on the supply-demand side, but such demand is strongly temporary and seasonal depending on payment timing, so it is hard to view as a trend source of strength. As a result, even if the current account maintains a large surplus on strong semiconductor exports, won-selling pressure on the capital-account side — overseas investment expansion and foreign capital outflows — will offset much of it, so a structure in which the current-account surplus does not directly translate into won strength is expected to persist for some time.

Furthermore, the impact on the KRW/USD rate of a narrowing rate gap from Korean rate hikes is judged to be limited. Empirical analysis centered on weekly KOFR–SOFR data from November 2021 to May 2026 shows that the exchange rate does not respond significantly to changes in the realized rate gap, but does respond significantly to changes in policy-rate expectations. Based on the won's idiosyncratic variation after removing global and regional factors, a statistically significant relationship was observed in which a 25bp rise in Korea's expected rate (1Y3M) is associated with about 0.2% won appreciation.[9] This means that what moves the exchange rate is not the realized rate change itself but the change in market expectations. Therefore, even if Korea raises rates by 50bp and the US holds in H2 2026 as expected, as long as this path is already reflected in market expectations, the effect on the

9) Result of regressing the won's idiosyncratic component (weekly log returns) — after removing global (first principal component of 30 currencies) and regional (Asia) factors — on changes in Korea's expected rate (ACM risk-neutral 1Y3M, excluding the term premium) (Nov 2021–May 2026, weekly); significant at the 10% level. That is, Korean monetary tightening has a sign consistent with uncovered interest parity but low statistical and economic significance.

exchange rate is limited — a realized hike is not new information but merely confirmation of a priced-in path. Meaningful exchange-rate movement will emerge only when the policy-expectation paths of major economies including the US are newly adjusted. Specifically, if US tightening expectations strengthen such that SOFR 1Y3M rises 25bp, the dollar index rises about 1 point and the KRW/USD rate then depreciates about 1%, with both steps statistically significant.

Taking all of the above together, the KRW/USD rate in H2 2026 is more likely to fluctuate amid high volatility than to form a clear trend. The expanding current-account surplus and the reduction of the geopolitical risk premium following the end of the Iran war could act as won-strength factors. On the other hand, with the dollar index showing high downward rigidity, won-weakness pressure on the capital-account side — overseas investment expansion and foreign capital outflows — could persist. With high uncertainty around key variables such as the direction of the dollar index, the course of the Iran war, and foreign capital flows, and with these factors having alternately driven the exchange rate over time, volatility is expected to stand out rather than a trend in any one direction. In particular, the high volatility of AI-related equities at home and abroad is expected to contribute to a rise in KRW/USD volatility for the time being.

Changing Stock-Bond Correlation and Asset Allocation Implications

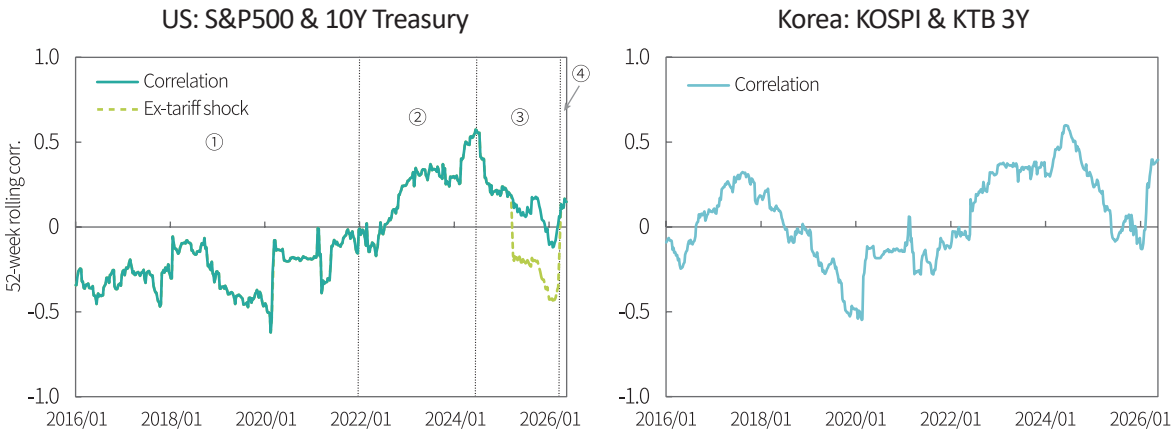
The economic characteristics of inflation directly affect the diversification benefit of stocks and bonds. When inflation is countercyclical, stocks and bonds fall together and the diversification benefit weakens; conversely, when inflation is stable or procyclical, bonds play a safe-asset role, rising in price when equities fall.[10] Over roughly two decades since the 2000s, with inflation stable across major economies, stocks and bonds were generally negatively (−) correlated, which underpinned the traditional diversification strategy.[11] However, after the 2022 inflation shock turned the correlation positive (+), it temporarily recovered to around

10) In this report, a safe asset means an asset that hedges when equity prices fall. See Baek In-seok & Jang Geun-hyeok (2022), "The Relationship between Inflation and Asset Returns," KCMI Issue Report 22-25; and Jang Geun-hyeok (2022), "Implications of Recent Inflation Characteristics for the Diversification Benefit of Stocks and Bonds," KCMI Capital Market Focus 2022-24.

11) In this report, bonds refer to the 10-year for the US and the 3-year for Korea. A negative (−) stock-bond return correlation means diversification is effective; positive (+) means it weakens. Since bond prices move inversely to yields, the bond-yield/equity-return correlation is the opposite sign of the bond-return correlation.

zero during the easing phase, but has recently risen again on concerns of renewed inflation from the Iran war. As seen in the long-term rate outlook above, the recent rate rise is led by a widening term premium; in a phase where rates rise on inflation risk, bond prices fall together with equities when stocks decline, failing to provide a buffer. This is precisely the fundamental cause of the recent positive (+) correlation, and asset allocation strategy therefore needs to be reviewed based on analysis of the changing stock-bond correlation and bonds' safe-asset function.

Figure 7. Stock-bond correlation (52-week rolling)



Note: 52-week rolling correlation of weekly returns of equities (KOSPI, S&P500) and bond indices (US: Bloomberg US Treasury Index; Korea: a synthetic bond using the 3-year rate); the US dashed line excludes the tariff-shock period (first 1–2 weeks of April).

Source: Bloomberg; Bond Information Center.

Figure 7 shows the trend in stock-bond return correlations for the US and Korea.[12] Changes since 2022 can be divided into three broad phases. In 2022–H1 2024 (Phase ②), post-pandemic supply-shock-driven countercyclical inflation persisted and major economies responded with aggressive tightening, so stocks and bonds fell together and a positive (+) correlation became entrenched. From H2 2024 (Phase ③), the Fed's start of rate cuts and easing inflation concerns brought the correlation down to around zero.[13] Finally, from March 2026 (Phase ④), surging oil prices from the Iran war, renewed inflation concerns, and the possibility of a tightening re-

12) For the US, the dashed line excludes the April 2025 tariff-shock (1–2 week) data; like Korea, it shows the correlation recovering to zero and then rising to positive (+) again. For the pre-2016 situation, see Jang (2022).

13) Because the correlation is computed on a 52-week (1-year) moving-average basis, the H2 2024 easing pivot is fully reflected only about a year later, in H2 2025. The correlation reaching around zero in H2 2025 in Figure 7 owes to this moving-average lag.

pivot[14] have renewed the strengthening of the positive (+) correlation. For the US, on a 1-year moving-average basis the level is currently around +0.15, but the March–May correlation rose to +0.72, re-entering a positive-correlation phase. Korea shows the same pattern, with the March–May correlation rising to +0.57.

A point worth noting is whether the return of the correlation to around zero in Phase ③ implies a recovery of bonds' safe-asset function. Table 1 compares, in each phase, the share of weeks in which bond returns were positive (+) when equity prices (S&P500, KOSPI) moved more than 1%, distinguishing equity-down and equity-up weeks. If bonds function as a safe asset, the share of positive bond returns in equity-down weeks should be meaningfully higher.[15]

Table 1. Bonds' safe-asset function by phase (share of positive bond-return weeks)

(Unit: %)

		① Neg. corr. 2015–2021	② Pos. corr. 2022–24H1	③ Falling corr. 2024H2–2026.2	④ Rising corr. 2026.3–
US	Equity-down: positive bond %	79	28	60	0
	(ref.) Equity-up: positive bond %	42	60	68	100
Korea	Equity-down: positive bond %	68	26	46	25
	(ref.) Equity-up: positive bond %	49	66	49	50

Note: Weekly index return beyond ±1%. The (ref.) rows help distinguish whether the bond response is selective buffering against equity declines or due to a common factor such as rate cuts.

Source: Bloomberg; Bond Information Center.

In 2015–2021 (Phase ①), the share of positive bond returns in equity-down weeks was high — 79% (US), 68% (Korea) — confirming bonds' safe-asset function. In Phase ② it plunged to 28% (US) and 26% (Korea), entrenching a situation where bonds failed to buffer losses even when equities fell. In Phase ③, the figures of 60% (US) and 46% (Korea) appear to show a recovery as in Phase ①, but the share in equity-up weeks is almost identical — 68% (US), 49% (Korea) — suggesting the rise in bond prices was driven not by selective buffering but by the common factor of the rate-cut cycle.[16] In Phase ④, the US had no instances of positive bond

14) As inflation accelerated across major economies after the Iran war, the Fed is expected to hold within the year, while the ECB and the Bank of Korea are expected to pivot to hikes (see "H2 2026 Macroeconomic Outlook and Key Issues," KCMI Capital Market Focus 2026-12).

15) Jang (2022, Figure 3) also showed that bond returns cushioned losses during sharp equity-index declines. This report extends that to a weekly basis and analyzes it by phase.

16) The "everything rally" of H2 2025 — when equities, bonds, gold, and bitcoin rose together — is consistent with this. The

returns in equity-down weeks (0%), so bonds did not function as a safe asset. Ultimately, bonds' safe-asset function has not stably recovered since 2022 and is weakening again after the Iran war.

In an environment where bonds' safe-asset function is unstable, alternative hedges need to be considered.[17] Table 2 compares the average returns of major assets when the S&P500 fell more than 1% in a week. None of the assets examined could replace bonds in all phases, suggesting the effective hedge varies with the cause of inflation and the policy phase. In Phase ①, bonds (+0.48%) and gold (+0.33%) were effective safe assets; in Phase ②, bonds turned to −0.54% while gold stayed positive at +0.09%. However, in Phase ④ gold recorded −2.33%, revealing its vulnerability in a rising-rate phase, while the energy sector (+3.63%), a direct beneficiary of rising oil prices, performed relatively well.

Table 2. Average returns of major assets when the S&P500 fell >1% in a week

(Unit: %)

Asset	① 2015–2021	② 2022–24H1	③ 2024H2–2026.2	④ 2026.3–
Bonds (10Y)	+0.48 (79%)	−0.54 (28%)	+0.35 (60%)	−0.80 (0%)
Gold	+0.33 (51%)	+0.09 (52%)	+1.44 (60%)	−2.33 (50%)
Bitcoin	−1.76 (48%)	−2.48 (38%)	+0.23 (55%)	+0.17 (50%)
Energy	−3.47 (14%)	−0.72 (50%)	−1.68 (50%)	+3.63 (100%)
Utilities	−1.62 (34%)	−1.39 (22%)	+0.14 (50%)	−0.54 (50%)

Note: Figures in parentheses are the frequency of positive returns. Bitcoin since 2016. Energy and Utilities are based on the Fama-French 12 Industry Portfolios.

Source: Bloomberg; Kenneth R. French Data Library.

Meanwhile, in an environment like the present where corrections recur on inflation concerns without recession, the role of defensive sectors within equities also deserves attention. In Phase ④, the S&P500's weekly declines have been limited to corrections of around −1 to −2%, and the market has not entered a recession-accompanied bear market.[18]

conclusion is unchanged using a ±0% index-return threshold.

17) Brixton, A., Brooks, J., Hecht, P., Ilmanen, A., Maloney, T. & McQuinn, N., 2023, "A Changing Stock–Bond Correlation: Drivers and Implications," Journal of Portfolio Management. They argue inflation uncertainty is the key factor turning the stock-bond correlation positive (+), in which case alternative diversifiers such as commodities and within-equity sector strategies can play a larger role.

18) A bear market is typically a decline of 20% or more from the peak. Current US and Korean growth, around 2% and 2.9% respectively, are expected to exceed potential growth (see "H2 2026 Macroeconomic Outlook and Key Issues," KCMI Capital

Within this range, the utilities sector limited losses to about one-third of the market decline. In Phase ③ too, utilities recorded an average +0.14% when the S&P500 fell, showing a defensive effect comparable to bonds. However, in the bear-market period accompanied by slowing growth (Phase ②), defensive sectors also fell together, so monitoring of recession risk must accompany this.

In sum, depending on the cause of inflation and the business-cycle phase, gold, the energy sector, and defensive equities could serve to complement bonds' hedging function, and an asset allocation strategy that adjusts flexibly by phase needs to be considered. That said, actual portfolio construction must consider not only hedging effectiveness but also each asset's expected return.

Market Focus 2026-12).