WeeklyBulletin **28 June 2013**

Market Commentary

- The VN-Index declined 5.5% this week on combined volume for both exchanges of $280m, a slight decrease from last week's trading volume. The market has declined 11% over the last 3 weeks.

- Foreign investors sold stocks because of continued concerns about QE3 tapering and because of concerns about the situation in China – ie the Shibor shock and the recent weak economic statistics (interestingly, the Shibor shock mirrors events in Vietnam's interbank market at the end of 2011). Over the last few weeks foreigner investors had been selling their Vietnamese stocks to local investors at a moderate pace as part of the general retrenchment of global investors from emerging markets, but foreign selling has now accelerated at bit. At the same time, local investors have become less enthusiastic buyers of stocks due to concerns about the weak VND and the surprise 1% VND depreciation by the central bank.

- The surprise VND depreciation was coupled with a 50bp interest rate cut, which was also unexpected because inflation in Vietnam seems to have bottomed for the current cycle. The interest rate cut helped boost sentiment. Earlier in the week the VN-Index broke decisively below the 500 level, which triggered margin selling at about the 480 level in the VNI. That margin driven selling further accelerating the downward move in the stock market; at its low point the index had declined 8.5% before rebounding slightly, partially because of the interest rate cut.

- Regarding foreigners' selling due to concerns over QE tapering and China, the pace of foreign selling had been fairly moderate over the last weeks in comparison with the other developing Asean markets, partially because Vietnam was not a big beneficiary of QE inflows. However the pace of foreign selling has now intensified, and is being moderately accelerated by ETF redemptions. We estimate the foreigners have sold nearly $100m worth of stocks over the last few weeks, bringing the total foreign inflow into Vietnam's stock market for the year to about $200m YTD (we made an estimate of recent foreign selling in last week's Weekly Bulletin which was too low in retrospect).

- The Market Vectors ETF saw over $5m of redemptions last week and traded at about a 2% discount to NAV. The Deutsche Bank ETF on the FTSE Vietnam index is also rumored to have seen a similar amount of redemptions. We've noticed in the past that ETF selling linked to redemptions and rebalancing tends not to be executed in a very finessed manor, and is prone to cause strong swings in the individual stocks being sold (or bought in the case of index rebalancing/recomposition).

- <u>VND Depreciation</u>: After a long period of currency stability, Vietnam's central bank, the SBV, lowered the reference rate for the VND by 1% to 21,036; the last major depreciation of the VND was an 8.5% adjustment to the reference rate in February 2010. The official trading band for the VND is +/- 1% around the official reference rate. The unofficial VND rate was around 21,300 at the end of last week, just above the official ceiling rate. The reason that the central bank did not depreciate the currency by more, in order to place the unofficial VND within the new, official trading band is probably because the current bout of VND weakness is likely to be temporary. Pressure on the VND is likely to abate once the situation in Vietnam's gold market stabilizes (see next bullet point), as this is the main factor which is causing VND weakness at the moment.

- We have written about Vietnam's gold market extensively over the last weeks. A brief summary of the story is that Vietnam's banks intensified their purchases of gold over the last months to close out their short gold positions in advance of the SBV's June 30th deadline, which is in turn putting pressure on the VND (ultimately VND needs to be sold to buy USD, which is then used to buy gold).

• Vietnamese banks are short gold because they accepted gold denominated bank deposits on which they paid savers a 2-3% interest rate, but then the banks exchanged some of those gold deposits into higher yielding VND to play the carry trade between gold and the VND (the gold deposits that were not changed into VND were lent out in gold denominated loans, many of which were used to fund property speculation). All gold deposit accounts In Vietnam need to be closed out by June 30th meaning the banks need to return the physical gold to the original savers. Going forward savers who hold gold will need to pay banks a warehousing fee to have that gold held for them.

• Local banks bought 100 tones of gold in 2012 and over 30 tons of gold in 2013. This has pushed the price of gold in Vietnam 15% above world gold prices. Earlier in the year local gold prices were as much as 20% above world gold prices. This large gap between local and world gold prices has put pressure on the VND in two ways: first it has encouraged illegal smuggling of gold into the Vietnam to black market arbitragers (which prompts the sale of VND and purchase of USD), and second the SBV spent about $1b of its reserves importing gold which it then auctioned to the banks. The SBV's gold imports dampened sentiment towards the VND considerably and was the main catalyst for the current bout of Dong weakness, even though reserves are probably around $25b at the moment (the SBV does not clearly disclose its FX reserves).

• Although the SBV's gold imports were the main catalyst for the current negative sentiment towards the VND, Vietnam's currency needs to depreciate about 3% a year because of the inflation differential between the USD and the VND (the inflation differential is greater than 3% but the VND is supported by the fact that about 40-50% / GDP worth of USD and gold are held in the country outside the formal financial system). At the end of last year central bank governor Binh said that he expected the VND to depreciate about 2-3% in 2012.

• The trade deficit is also putting pressure on the VND, although we think this is more of a sentiment issue than a factor which puts significant supply & demand pressure on the currency, as discussed below. The trade deficit in the first half of this year was $1.4b and the trade gap has been widening each month as Vietnam's economy starts to show some signs of recovery, which is boosting the rate of import growth (due primarily to the import of production materials). Also export growth has been slowing as China and world economy begins to slow a bit, as evidenced by weak PMI's around the world. Looking at the numbers, import growth has surged from 6% y-o-y at the beginning of 2013 to about 17% at present, while export growth has fallen a bit from nearly 20% y-o-y in the beginning of the year to about 16% now. The opposite trajectory of these numbers explains why Vietnam's trade balance deteriorated from a $155m surplus in 1H12 to a $1.4b trade deficit in 1H13.

• Declining export growth is clearly not a favorable development, but export growth at FDI companies remains robust at about 25% y-o-y and the outlook for continued FDI inflows is very bright. In 1H12 disbursed FDI was $5.7b, up about 6% y-o-y, and nearly 90% of newly pledged FDI is earmarked for manufacturing (versus 50% during the property bubble years around 2010).

• Another reason for VND weakness is that the currency is not receiving much help from the VND / USD carry trade because interest rates have fallen more than 800bp since the beginning of 2012. Last year a record $11b of overseas remittances flowed into Vietnam, the majority of which are thought to have ended up in bank deposits. That was one reason the currency was stable since the beginning of 2011, but now, based on anecdotal evidence it seems that an increasing proportion of those remittances are flowing into real estate where rental yields are around 8%. Also, falling interest rates have produced big wins for sophisticated bond traders, but our understanding is that many bond investors are looking to take profits on those gains and put their money into USD now that 3 year government yields are below 7.5%.

• Despite all the negative factors for the VND discussed above we do not believe that investors need to worry much about the VND and we think that the current period of currency weakness will pass quickly once the gold market stabilizes over the next few months (the biggest risk investors need to be concerned about in Vietnam is not the currency, but rather that the NPL problem is not sufficiently severe to compel the government to drastically restructure the banks and address the SOE problem).

- Three things make us believe that we are not headed for another period of currency volatility: 1) The central bank bought $18b of reserves last year and about $3b in 1Q13. Even after the SBV's purchases of gold on the world market, Vietnam's FX reserves are probably just above the traditional safety threshold of 3-months' worth of imports (the central bank does not clearly disclose the current level of reserves), 2) bouts of currency weakness in Vietnam are usually caused by high inflation – which prompts local savers to take their money out of VND and into USD and gold. Inflation in Vietnam is currently running at just under 7% y-o-y and likely to stay around these levels, 3) Despite investors' preoccupation with the trade deficit we actually think this is a non-issue as far as the VND is concerned.

- The reason we are not overly concerned about Vietnam's trade deficit is that the country faces a structural trade deficit due to large FDI inflows. Money comes into Vietnam via the capital account but then goes back out via the current account / trade deficit because FDI funded factories need to import the machines and materials required for production. Unfortunately, tertiary industries in Vietnam are generally weak, so basic materials like the textiles used to make garments need to be imported. The trade deficit will improve as the country's exports move up the value chain - we expect Vietnam to run persistent trade surpluses starting in about 3 years due to an explosion in the manufacture of Japanese and Korean high tech products such as electronics and cell phones. Mobile phone exports are on track to reach $20b this year, up from just $2.5b in 2010.

- <u>Economic Statistics and Interest Rate Cut</u>: a series of statistics were released this week which illustrated that economy is weak, but gradually recovering. That economic weakness is the reason for this week's surprise 50bp cut in the deposit rate ceiling (see below). GDP growth of 5% y-o-y in Q2 was a slight pick-up Q1's 4.76% growth rate and resulted in a 4.9% GDP growth rate for 1H13. The Index of Industrial Production (IIP) increased 5.2% y-o-y in 1H13 (which means that actual industrial production grew about 10% y-o-y in the first half of the year). One bright spot is that inventories continue to fall.

- June CPI came in at 6.69% y-o-y, up slightly from 6.36% in May. Inflation seems to have bottomed out for this cycle which is partially because medicine prices have increased 14% since the beginning of the year and medical services prices have risen 17% YTD (due to government sanctioned price hikes). Even without those medical price hikes it was already apparent that the steady fall in inflation that has taken place throughout 2013 has probably come to an end, as evidenced by a modest acceleration in most of the sub-indexes. That said, we don't expect a dramatic pick up in inflation for the rest of this year and it looks like inflation in 2013 will probably be the lowest in 10 years, reinforcing weakness in the economy.

- The weak economic statistics described above led to a surprise 50bp cut in the VND deposit rate ceiling to 7% (and a 75bp cut in the USD deposit rate ceiling to 1.25%). One thing that makes analyzing the Vietnamese economy complicated is that there are several different policy interest rates (discount rate, OMO rate, refinancing rate, deposit interest rate ceiling) and the government focuses on different policy rates at different times. Official policy rates were cut over a month ago but at that time the deposit rate ceiling was not cut which caused us to write some dismissive comments about the rate cut at that time. The deposit rate, which is not technically a policy rate seems to be what the SBV is focusing on the most these days. This time they did cut the deposit rate, but we guess this will be the last interest rate cut of the cycle (some market observers do not agree with that view).

<u>Company News</u>

<u>DIG</u> – Leading SOE real estate developer DIG group was put on the stock exchange's warning list because the company received a qualified audit opinion which recommended that DIG provision against some overdue recievables which were caused by the sluggish real estate market. In our understanding there's no realistic possibility of the stock being delisted and we also note that the stock prices has declined about 20% this year, underperforming the index by nearly 40% so this issue seems to be fully priced in.

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