

Vietnam Monitor (Issue 19)

Yields have peaked, but the VND should gradually depreciate

5 November 2008

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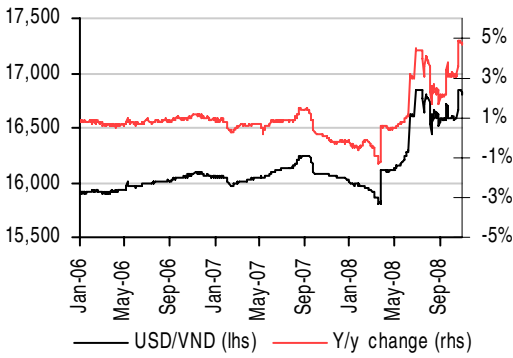
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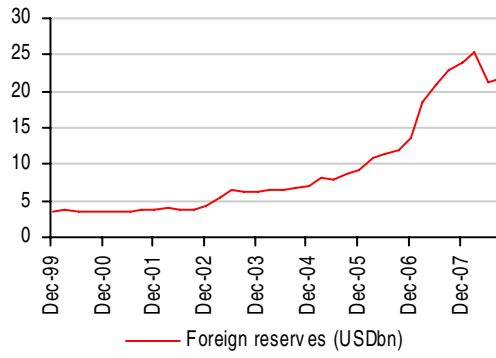
- ▶ **Economics** – The State Bank of Vietnam has cut rates by 2ppt to 12% in pre-emptive moves, joining central banks in the region to support growth. We expect 200bp more easing in the next two to three months.
- ▶ **Equity strategy** – Vietnamese stocks have fallen 64% this year, but PE is still higher than in China or India. Moreover, Q3 results are a reminder of how uncertain earnings are. Foreign investors have sold USD69m, but still own USD3.1bn.
- ▶ **Fixed income strategy** – Domestic factors, e.g. flush bank liquidity, declining inflation, and aggressive monetary easing, have driven VGB yields lower. Local bank demand for VGBs has sufficiently offset foreign investor liquidation in recent months. We expect VGB yields to decline gradually to a floor of 12%.
- ▶ **FX strategy** – VND supports have faded as trade balance improvements peak, FDI slows, and remittances slow. VND's external funding requirement makes it more vulnerable. SBV should now manage USD-VND gradually higher.

USD/VND



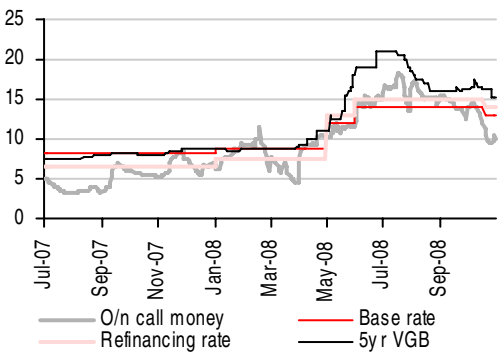
Source: Bloomberg

FX reserves



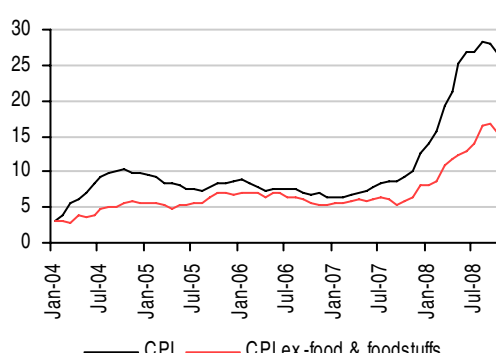
Source: CEIC, *HSBC estimate for 1Q08

O/n call money, benchmark policy rates and 5yr bond yields



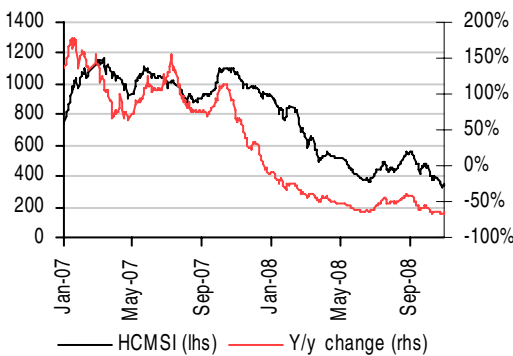
Source: Reuters, HSBC

Headline and ex-food CPI



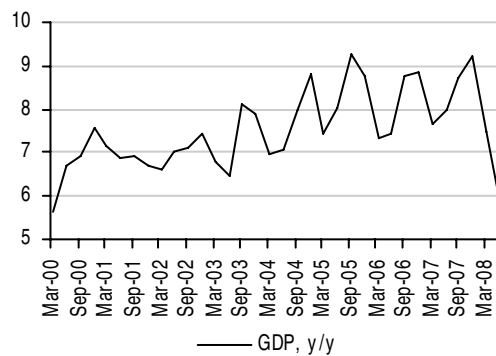
Source: CEIC, HSBC

HCMSI Index



Source: Bloomberg

GDP growth



Source: CEIC

Economics

- ▶ State Bank of Vietnam has cut rates by 2ppt to 12% in pre-emptive moves...
- ▶ ...joining central banks in the region to support growth...
- ▶ We expect 200bp more easing in the next 2-3 months

Overview

Much has happened over the past month. Inflation has fallen for the first time in more than a year, export growth has slowed, the State Bank of Vietnam has cut interest rates by 200bp to 12% (and the dong reserve requirement to 10%), while the dong has hit the top of the band for the first time since mid-July.

So where are we going from here?

- ▶ We think inflation has peaked and will continue to fall given the decline in international oil and food commodity prices. In addition, economic growth has also tempered over the last six months, reducing demand oriented pressures somewhat.
- ▶ Exports will continue to feel the pressure as the developed world faces a synchronised slowdown/recession.
- ▶ The 200bp of cuts so far marks the beginning of an easing cycle. We are looking for another 200bp of easing over the next few months. The exact timing will largely depend on global developments – financial crisis and growth outlook.

- ▶ On currency strategist (see the FX strategy section of this report for details) believes that policy easing is not necessarily currency negative as long as it is measured and gradual.

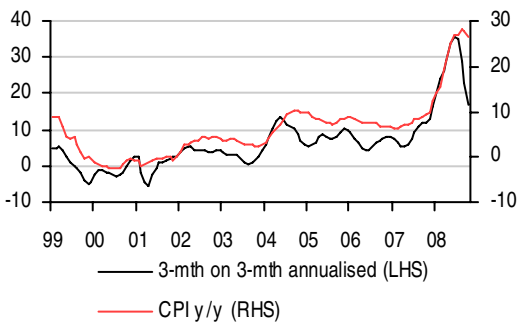
Now onto some details.

Inflation

Inflation in Vietnam fell by 0.2% month-on-month in October on the back of a decline in transportation cost as the government's fuel price¹ cuts feed through, with the decline in housing and construction costs also chipping in. The last time we saw a negative print was back in March 2007. On a seasonally adjusted basis, however, month-on-month inflation still remains in positive territory at 0.4%, though this is one-tenth of the peak of 4% seen in May and compares with a decade average of 0.5%.

¹ Petrolimex cut fuel prices by 11% in August, 3% in September and 12% in October, having increased prices by 31% in July. The retail price of gasoline is now down to VND 15,000 per litre, only VND 500 per litre above the pre-hike level in July. However they still stand 15% above levels at the end of 2007.

1. Headline inflation to temper further



Source: HSBC

In year-on-year terms, inflation decelerated for the second consecutive month to 26.7% compared with a peak of 28.3% in August. Given the decline in global crude prices and food commodity prices against a backdrop of slowing growth at home we think price pressures should come off further. The 3 month-on-3month annualised change of the seasonally adjusted series (see Chart 1), which usually serves as a good short-term indicator, also suggests the same.

Some quick pointers on the details of the report:

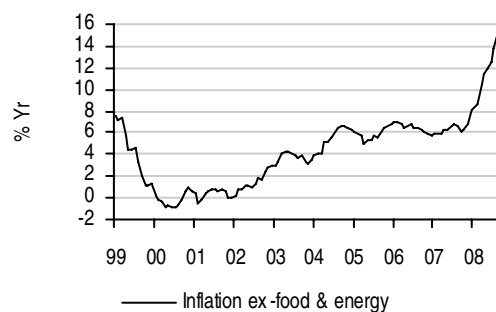
- ▶ Food and foodstuffs inflation softened for the fourth consecutive month to 40.5% y-o-y from a peak of nearly 46% in June. Given the decline in rice and other food commodity prices, and the good agricultural production at home we expect food related prices to come off further.
- ▶ Housing, utilities and construction materials prices slowed to 22.8% y-o-y from a high of 27.4% y-o-y in August. Here the decline in steel prices is key – steel consumption has halved compared to levels at the start of the year, while supply is abundant with some USD 1mn worth of stockpiles² with producers at present. Going

² At the current price, this amount is equivalent to over USD 1bn of working capital, causing great financial difficulty for firms. [28 October, VietnsmNet]

forward, the decline in international gas prices is also expected to feed through to domestic retail gas prices, with gas traders mulling over cutting prices by VND 40-50,000 in November.

- ▶ Transportation and communication prices rose by 24.8% y-o-y, down from 26% in September. Given the cuts in retail fuel prices already announced and with more expected given softer international crude prices, this category should show further falls.
- ▶ Leaving aside the above three sub-indices, other prices such as education, healthcare, housing equipment, clothing etc are still rising. Though the pace of increase has tempered somewhat.
- ▶ It is also worth highlighting that core inflation softened for the first time in over a year, albeit marginally, to 15.3% from 15.7% previously. However it still remains more than double the 5-year average of 7%.

2. Core inflation: turning?

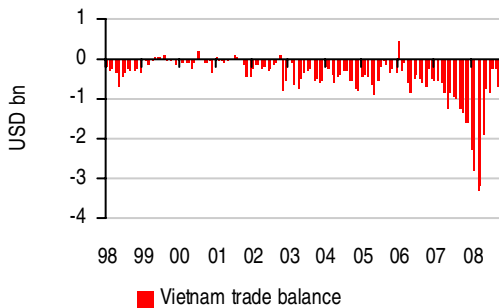


Source: HSBC

Trade deficit

As highlighted in previous editions of the *Vietnam Monitor*, the trade deficit has stabilised over the last five months at under USD 1bn per month. For the October month, the trade deficit was USD 700mn compared with an average of under USD 300mn for the last two months, but much better than the USD 3bn monthly figures seen at the beginning of the year.

3. Trade deficit has stabilised



Source: HSBC

For the first 10-months of the year the trade deficit now stands at USD 16.4bn compared with USD 9.2bn in the same period last year. It is worth pointing out that a large chunk of the deficit has already been funded – foreign direct investment disbursements up until October stand at USD 9.1bn (reaching our full year forecast!) up nearly 40% compared with the same period last year, while remittances in the first half of 2008 were USD 5bn up nearly 30% from the first half of 2007. The government is expecting a trade deficit of USD 19bn for 2008, and FDI disbursements of USD 11bn and remittances of USD 8bn for the year. These numbers seem plausible³, but we would like to highlight that going forward there is a clear risk that FDI inflows could slow – not just for Vietnam but for the region as a whole⁴.

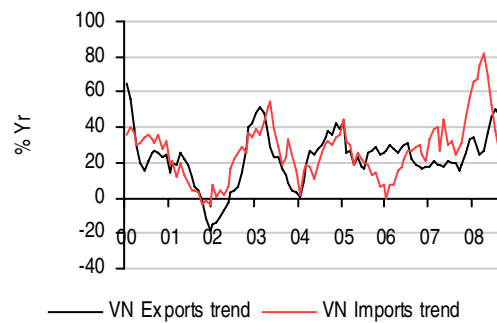
Turning to the components of the trade deficit, import growth continues to slow at a dramatic pace, with the underlying trend, as measured by the 3-month moving average of the year-on-year change, having collapsed to 12% from a peak of nearly 80% in April this year. A large part of this

³ Our forecast for the trade deficit stands at USD 18bn and that for remittances USD 7bn.

⁴ See *Asian FX Special: the Threat of shrinking FDI inflows*, 13 October 2008.

is explained by slowing in automobiles and steel imports.

4. Imports collapsed, exports turning



Source: HSBC

What is not that positive, but to be expected, is that the underlying trend in exports is also turning, having slowed to 35% from a peak of 50% in June. However it still remains well north of decade average of around 20%.

Looking ahead, the easing in base rate, which took the cap on the lending rate to 19.5% from 21% previously, will no doubt provide some respite to manufacturers and also to importers. However the external demand environment is becoming even more challenging as we see a synchronised slowdown/recession in the US, Europe and Japan which together account for 55% of Vietnam's exports. In addition, China sucks in 10% of Vietnam's exports, largely in the form of inputs for its exports. Given that we are looking for exports from China to slow to 5% next year from 20% in 2008, Vietnam will suffer as well.

Policy thoughts

In a surprise move, the State Bank of Vietnam cut the base rate by 100bp to 13% on 20 October, effective from 21 October, and another 100bp on 3 November. According to the Deputy Director of the central bank's monetary policy department, Nguyen Thi Kim Thanh, the moves were taken to prevent a further slowing in the economy given the deepening of the global financial crisis. This is

consistent with central bank behaviour across the region⁵ which has shifted towards policy easing as growth concerns outweigh those of inflation.

We have to admit that the easing in the base rate came sooner than we had anticipated. However given the deteriorating external environment and the fact that the government growth target of 7% for this year is under pressure we suspect the State Bank thought it best to take some insurance by moving pre-emptively. The fact that inflation has turned clearly gave the Bank some policy flexibility.

As our regular readers are aware, with the base rate at 12% the cap on the lending rate (1.5 times the base rate) is now 18% from a high of 21% previously. Even before the cuts most commercial banks were lending at rates closer to 19.5% given the moral suasion from the central bank. After the easing most commercial banks have slashed interest rates. For example, even before the latest 100bp policy rate reduction, the Bank for Investment & Development of Vietnam (BIDV) was offering loans at 17% per annum to regular customers, with the interest rate for exporters being in the range of 16.2-16.5%.

We doubt that this is just a one off cut but more likely the start of an easing cycle which will to some extent undo the 575bp of tightening delivered in the earlier part of the year. We think rates will probably go down by another 200bp over the next 2-3 months, especially as headline inflation declines with base effects being very favourable. The exact timing will depend to a large extent on global developments.

The easing in policy rates and onwards to lending rates will work to ease the pressure on local corporates and support economic growth – with the government no doubt hoping that it would be

able to achieve its 2009 growth target of 7%. We think that the target is a bit too optimistic given the deteriorating outlook for the global economy and also domestic factors such as previous tightening, weak equity and property market etc. – our own growth forecast for next year stands at 5.6%. It should also be remembered that interest rate reductions usually take several months to have an effect.

In addition to cutting the base rate, the central bank has also announced measures to add more liquidity to the entire economy with the objective of protecting the local banking systems from risks of the global financial crisis. Under this the central bank doubled the interest rate paid on compulsory commercial bank reserves to 10% annually and decided to pay off treasury notes worth VND20.3 trillion (USD 1.22bn) issued to banks in March for local banks. The latter would, when completed, work like a 1ppt cut in the reserve ratio.

Given that liquidity remains quite flush in the banking system (see the fixed income strategy section of this report for further details) the central bank did not make the redemption compulsory and didn't even provide a deadline for the same. Taken together with the coupon of 13% on the bills compared with the overnight rate of around 11% or so, our on-shore contacts think that the commercial banks will probably redeem the bills gradually and probably after they are able to lock in better yields from government bonds in the 1-2 year tenor.

Prakriti Sofat

⁵ China, India, Taiwan and Korea have already cut their policy rates.

Equity strategy

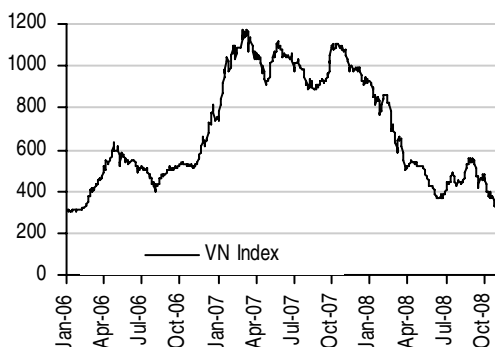
- ▶ Vietnamese stocks have fallen 64% this year, but PE is still higher than in China or India
- ▶ Moreover, Q3 results are a reminder how uncertain earnings are
- ▶ Foreign investors have sold USD69m, but still own USD3.1bn

Further declines

...but still pricier than the rest of Asia

The Vietnamese stock market fell in line with other global markets in October. It was down 24% in local currency and 25% in US dollar terms, similar to the 24% decline in MSCI Asia ex Japan. Year-to-date, however, Vietnam has fallen by 64% in USD terms, considerably more than the 52% decline for Asia as a whole. Only the Chinese A share index has fallen further (67%). Vietnamese stocks have lost 71% of their value since their peak in March 2007.

1. Vietnam stock index



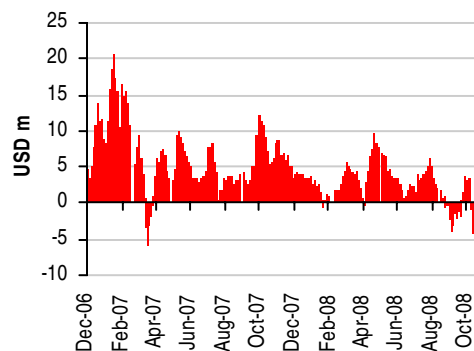
Source: Bloomberg

Foreigners sell

A key trend in the past few weeks is that foreign investors have become consistent sellers of Vietnamese equities. They sold USD21m in

September and another USD48m in October. As Chart 2 shows, this is the first sustained period of selling for at least the past two years. Even while Vietnamese equities were falling late last year and in the first eight months of 2008, foreigners continued to buy.

2. Daily foreign net buying of Vietnamese equities



Source: Bloomberg (To Oct 31)

It seems clear now that closed-end funds have fully invested the money they raised last year, and other funds (GEMS funds, frontier funds and hedge funds) have begun to sell as they raise cash in the face of investor redemptions. Foreigners still own USD3.1bn of listed Vietnamese stocks (and perhaps half as much again of unlisted stocks) and so selling could continue for some time. This is not least since funds which bought into privatisation IPOs last year on the expectation of taking profits at the time of

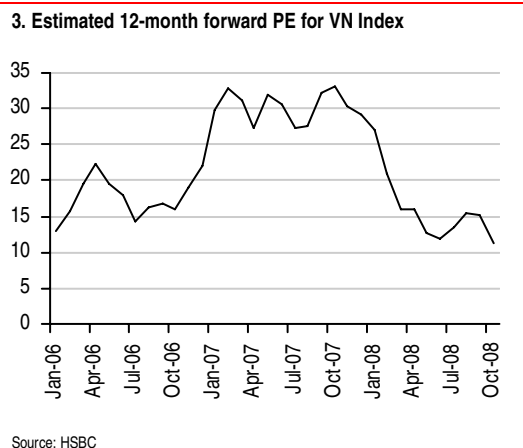
listing have been unable to do so with most listings being postponed.

Premium valuations to the region

One reason for foreign selling is that the Vietnamese market continues to look a little expensive compared to the rest of Asia.

At the end of October, PE based on 2007 earnings was 10.4x compared to an average of 9.2x for Asia ex Japan as a whole. It is hard to calculate a 12-month forward prospective PE for Vietnam, in the absence of consensus earnings forecasts. But on our assumptions that EPS will fall by 10% in 2008 and then grow 15% next year, 12-month forward PE is currently 10.4x (see Chart 3). However, that is not cheap compared to an average of 8.5x for Asia ex Japan (albeit on, admittedly, over-optimistic earnings forecasts). In particular, investors can buy China H shares on 7.5x and Indian shares on 9.3x.

We wonder whether they foreign investors will be prepared to pay such a big premium for Vietnamese shares. While Vietnam undoubtedly has a bright long-term future, the short-term outlook and the transparency of profits for listed stocks are a good deal less reliable than for India or China.



Earnings mixed

The lack of transparency about the outlook for earnings is clear from the Q3 results, which were released in October. In aggregate, companies with market cap of USD100m or greater and published earnings going back to Q1 2007, saw sales grow 34% y-o-y in Q3, but OP growth slow to 18% (from 25% in Q2) and net profit grow by 15% (compared to a 2% decline in Q2). The details are shown in Table 4.

For the first nine months of 2008, for the same universe of companies, sales rose by 45%, OP by 26% and net profit by 7%. There is good reason, though, to think that the full-year profits will come in significantly worse than this. Vietnamese Quarterly earnings are not fully audited and most

4. Quarterly earnings (y-o-y change)

| Code | Name | Mkt cap (USDm) | Sales | | | OP | | | NP | | |
|------|------------------------------|----------------|------------|------------|------------|------------|------------|------------|------------|------------|-----------|
| | | | Q3 | Q2 | Q1 | Q3 | Q2 | Q1 | Q3 | Q2 | Q1 |
| ACB | ASIA COMMERCIAL BANK | 1,097 | 121% | 94% | 74% | -14% | 13% | 24% | -20% | 5% | 22% |
| VNM | VIET NAM DAIRY PRODUCTS JSC | 885 | 15% | 19% | 31% | 101% | 115% | 134% | 82% | 57% | -5% |
| STB | SAIGON THUONG TIN COMMERCIAL | 702 | 107% | 100% | 114% | -46% | 5% | 36% | -51% | 4% | 33% |
| PVD | PETROVIETNAM DRILLING AND WE | 652 | 3% | 35% | 218% | 19% | 50% | 580% | 32% | 52% | 542% |
| PPC | PHA LAI THERMAL POWER JSC | 473 | -4% | 4% | 4% | -15% | 3% | -1% | 22% | 4% | 0% |
| FPT | FPT CORP | 456 | 20% | 45% | 48% | 122% | 77% | 77% | 37% | -21% | 4% |
| HPG | HOA PHAT GROUP JSC | 395 | 13% | 98% | 117% | 38% | 175% | 264% | 47% | 158% | 352% |
| SSI | SAIGON SECURITIES INC | 280 | 144% | -17% | -33% | 169% | -145% | -76% | 215% | -169% | -75% |
| ITA | TAN TAO INVESTMENT INDUSTRY | 262 | 19% | -30% | 43% | -22% | -70% | 47% | -7% | -29% | 35% |
| VSH | VINH SON - SONG HINH HYDROPO | 240 | 5% | 77% | 57% | 5% | 142% | 96% | 201% | 151% | 72% |
| SJS | SONGDA URBAN & INDUSTRIAL ZO | 144 | 18% | -69% | 55% | 85% | -72% | 29% | 30% | -97% | 61% |
| REE | REFRIGERATION ELECTRICAL ENG | 128 | -3% | 7% | 49% | 7% | 47% | -7% | -85% | -165% | -186% |
| VNR | VIETNAM NATIONAL REINSURANCE | 118 | 119% | 96% | 40% | 334% | 135% | 50% | 277% | 105% | 63% |
| KDC | KINHDO CORP | 113 | 31% | 11% | 13% | -11% | -133% | 16% | -22% | -36% | -13% |
| | TOTAL | | 34% | 48% | 54% | 18% | 25% | 34% | 15% | -2% | 9% |

Source: HSBC, Bloomberg

5. Key valuation data for the largest listed Vietnamese stocks (market cap >USD200m)

| Code | Name | Industry Subgroup | Exchange | Mkt cap (USDm) | Ave daily t/over (USDm) | Foreign ownership | Foreign limit | Room for foreign buying (USDm) | PE | Chg 3M |
|------|-------------------------------|--------------------------|----------|----------------|-------------------------|-------------------|---------------|--------------------------------|------|--------|
| ACB | ASIA COMMERCIAL BANK | Commer Banks Non-US | Hanoi | 1,097 | 4.14 | 30% | 30% | 0 | 8.7 | 19% |
| DPM | PETROVIETNAM FERT & CHEMICAL | Chemicals-Diversified | HCM | 1,068 | 3.76 | 19% | 49% | 321.3 | 13.5 | -16% |
| VNM | VIET NAM DAIRY PRODUCTS JSC | Food-Dairy Products | HCM | 885 | 1.16 | 44% | 46% | 14.4 | 15.2 | -17% |
| PVF | PETROVIETNAM FINANCE CO | Finance-Invest Bnkr/Brkr | HCM | 713 | n/a | | n/a | n/a | n/a | n/a |
| STB | SAIGON THUONG TIN COMMERCIAL | Commer Banks Non-US | HCM | 702 | 4.16 | 30% | 30% | 0.0 | 8.3 | 4% |
| PVD | PETROVIETNAM DRILLING AND WE | Oil-Field Services | HCM | 652 | 1.42 | 30% | 49% | 122.6 | 22.7 | -12% |
| VPL | VINPEARL JSC | Resorts/Theme Parks | HCM | 535 | 0.45 | 18% | 49% | 166.1 | 72.5 | -24% |
| VIC | VINCOM JSC | Real Estate Oper/Develop | HCM | 499 | 0.53 | 5% | 49% | 220.6 | 24.4 | -29% |
| PPC | PHA LAI THERMAL POWER JSC | Electric-Generation | HCM | 473 | 0.67 | 18% | 49% | 148.9 | 9.5 | -11% |
| FPT | FPT CORP | Telecommunication Equip | HCM | 456 | 2.02 | 28% | 49% | 94.3 | 10.1 | 22% |
| KBC | KINH BAC CITY DEVELOPMENT SHA | Bldg-Residential/Commer | Hanoi | 403 | 0.51 | 15% | 49% | 135 | 17.3 | -60% |
| HPG | HOA PHAT GROUP JSC | Miscellaneous Manufactur | HCM | 395 | 3.36 | 24% | 49% | 98.2 | 9.0 | -39% |
| SSI | SAIGON SECURITIES INC | Finance-Invest Bnkr/Brkr | HCM | 280 | 2.19 | 48% | 49% | 3.5 | 4.2 | -10% |
| ITA | TAN TAO INVESTMENT INDUSTRY | Real Estate Oper/Develop | HCM | 262 | 0.79 | 33% | 49% | 41.9 | 10.0 | -54% |
| PVS | PETROLEUM TECHNICAL SERVICES | Transport-Services | Hanoi | 261 | 1.60 | 9% | 49% | 105 | 13.8 | -4% |
| VSH | VINH SON - SONG HINH HYDROPO | Electric-Generation | HCM | 240 | 0.40 | 27% | 49% | 52.4 | 14.8 | 2% |

Source: HSBC, Bloomberg, HOSE (Data as of Oct 31)

companies seem not to take extraordinary write-offs (for example from stock and real estate price declines) until the full-year data. A combination of higher interest rates, slowing growth and large extraordinary write-offs leads us to assume a 10% decline in net profit for the full year (the number we used in the PE figure quoted above). However, the resilient growth of operating profit leads us to believe that earnings are likely to improve moderately in 2009.

Further analysis of the data, however, shows significant variation between companies. The listed banks have started to struggle, with both ACB and Sacombank (STB) producing large profit declines y-o-y in Q3. On the other hand, companies that stuck to their knitting and avoided expanding into non-core business, for example PV Drilling, have generally produced strong profit growth.

Investment conclusion

Our view remains that the Vietnamese market is likely to struggle until the end of the year. Foreigners may well continue to sell, valuations are by no means compelling compared to other regional markets, and earnings remain highly non-transparent.

If global risk appetite does return to some extent, we see fund managers looking to other more established emerging markets first, before they turn their attention to Vietnam again.

6. Key stock market data

| | HCM | Hanoi | Total |
|---------------------------------|--------|-------|--------|
| Market cap (USD m) | 10,720 | 3,531 | 14,251 |
| No. of stocks | 163 | 155 | 318 |
| Stocks with mkt cap >USD1bn | 1 | 1 | 2 |
| Stocks with mkt cap >USD500m | 6 | 1 | 7 |
| Stocks with mkt cap >USD200m | 13 | 3 | 16 |
| Stocks that hit foreign limit | 5 | 3 | 8 |
| Daily turnover (USDm, 1mth ave) | 0 | 0 | 0 |
| Foreign ownership | 23.3% | 16.4% | 21.6% |
| PE (2007) x | 10.4 | 10.4 | |
| ROE | 22.9% | 17.2% | 22.8% |

Source: HSBC, Bloomberg, HOSE

Garry Evans

Fixed income strategy

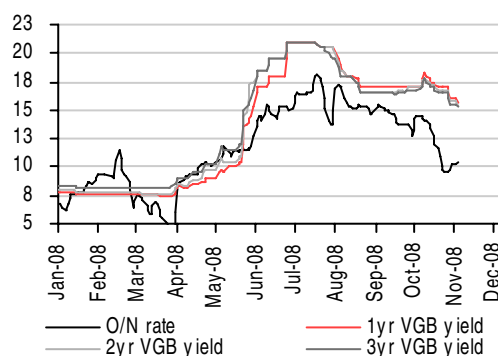
- ▶ Domestic factors – e.g. flush bank liquidity, declining inflation, and aggressive monetary easing – have driven VGB yields lower
- ▶ Local bank demand for VGBs has sufficiently offset foreign investor liquidation in recent months
- ▶ We expect VGB yields to gradually decline to a floor of 12%

In line with our bullish view held since August 2008, Vietnam government bond (VGB) yields extended their decline during October 2008 by an average of 100-125bp across 1-5yr tenors. Valuations in the local bond market have been relatively sheltered from the current rout in global credit markets. Notwithstanding the substantial liquidation of local bonds by offshore investors in recent months, VGBs have seen demand from local investors as they displace foreigners as the primary driver for VGB demand.

holdings to USD1.0bn (or less than one-third of that during the peak in April 2008). That the offshore liquidations occurred just at the onset of positive bond fundamentals suggest to us that many of these foreign redemptions were driven by exogenous factors.

Meanwhile, demand from onshore investors has risen due to improved domestic bank liquidity and lower deposit funding costs. The surplus liquidity environment has been created by a combination of: aggressive easing measures by the SBV and a sharp slowdown in bank lending, which has improved bank liquidity.

1. VGB yields continued to decline – driven by domestic demand – in spite of offshore liquidation in recent months



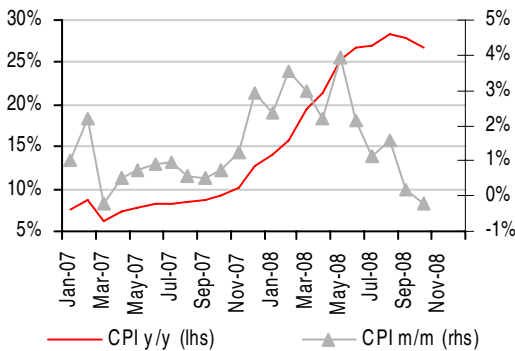
Source: Bloomberg, Reuters, HSBC

Pre-emptive and decisive

During the National Assembly's opening session on 16 October 2008, the assembly reiterated its goal of maintaining a 6.5-7.0% growth target for 2009. Given this ambitious growth target, a slowdown in inflation (in both y-o-y and m/m terms) (see Figure 2) and the risk of an abrupt slowdown in external demand enabled the SBV to begin its monetary easing cycle – even earlier and more decisive than had been previously signalled to the market.

Bond-positive domestic factors – including flush bank liquidity, declining inflation and aggressive monetary easing by the SBV, which we detail below – have offset the reduction in offshore investor

2. Abating inflation pressures provided policy flexibility for the SBV's aggressive easing measures



Source: Bloomberg, HSBC

To summarize, the monetary easing measures taken in recent weeks:

3. Key rate moves demonstrate policy easing is underway

| | 1 Oct-08 | 20 Oct-08 | 3 Nov-08 |
|----------------------------------|----------|-----------|----------|
| Base rate | 14.0% | 13.0% | 12.0% |
| Discount rate | 13.0% | 12.0% | 11.0% |
| Refinancing rate | 15.0% | 14.0% | 13.0% |
| Lending rate ceiling | 21.0% | 19.5% | 18.0% |
| Reserve requirement | | | |
| - VND, non-term | 11.0% | 11.0% | 10.0% |
| - VND, >12mths | 5.0% | 5.0% | 4.0% |
| - FC, non-term | 11.0% | 11.0% | 9.0% |
| - FC, >12mths | 5.0% | 5.0% | 3.0% |
| Interest on VND reserve deposits | 5.0% | 10.0% | 10.0% |
| O/N rate | 14.0% | 11.35% | 10% |

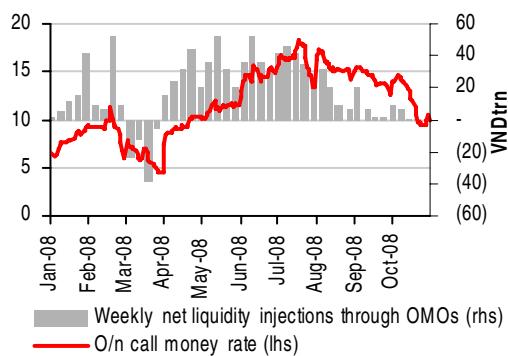
Source: HSBC

On top of these key rate adjustments, the SBV allowed domestic banks “in need” to unlock VND20.3trn in funds held in 12-month T-bills, while it has doubled the interest rate paid on reserve deposits to 10% (from just 1.2% in August 2008). A repurchase of these T-bills in full by the SBV would have the same impact on expanding liquidity as a 1ppt-reserve ratio cut.

Finally, more importantly than the largely symbolic rate cuts announced by SBV is the expansion of money market liquidity as a result of SBV liquidity injections. As of 4 November, surplus money market liquidity amounted to VND50tr, which will be augmented by another VND12tr with the latest cut in the reserve ratio effective 5 November. Taken together, these liquidity injections have caused the

O/N rate to extend its decline sharply during October 2008 (see Figure 4). SBV has, moreover, signalled that it intends to double money market liquidity to approx. VND100tr by year-end. If so, then this may push the O/N rate down further towards the 5-6% handle by year-end.

4. O/N interbank rate declines despite muted OMOs



Source: HSBC, Reuters

With the sharp expansion in money market liquidity, we believe that the SBV has three aims in mind:

- 1 Maintaining GDP growth at or above 7% and alleviating a domestic credit crunch: if maintaining the growth rate at the 7%-target is the end-objective, then raising private investment growth is the means. Still, it is not yet clear to what extent recent liquidity improvements will raise overall credit growth at least in the near-term. After years of abnormally high credit expansion (54% in 2007), domestic banks are still hesitant to extend credit, which softened this year to a y-o-y rate of 19.6% during the ten months ending October 2008 (versus a 2008 target of 30% and 37.7% over the same period in 2007). Instead, as credit growth normalises, banks may focus on rebuilding their deposit base, the growth of which has also slackened (10.6% y-o-y during January-October 2008, vs 33.0% over the same period in 2007).
- 2 Expand money market liquidity to meet liquidity demand towards year-end: thirdly,

SBV liquidity injections may be geared to meet domestic corporates' funding requirements, which tend to spike towards year-end and ahead of the Vietnamese "Tet" New Year, which arrives earlier than usual in late January 2009.

Implications for local bonds

As mentioned in previous months, local government bonds will benefit from the sharp improvement in bank liquidity and a reduction in bank deposit funding costs. At present, bank deposit funding costs are approx. 13%, but further declines are expected on improvements in bank liquidity. In turn, this should unlock further declines in VGB yields and we maintain our target of 12% for 2-3yr VGBs from 14.5-15% currently.

As local banks will mainly channel surplus funds into the local bond market, supply pressures will not derail a further rally in VGBs even when the MOF is behind schedule in terms of its issuance schedule.

Although the Ministry of Finance (MoF) has stated an intention to issue VND15trn and VND8-10trn in VGBs and VDBs, respectively, during 4Q08 quarter-to-date issuance has only reached an est. VND1.4trn. However, concerted efforts to postpone large public investment projects have reduced the MoF's immediate funding needs (see Figure 5 for recent and scheduled auctions).

Finally, flush domestic liquidity and SBV policy easing may add to the upward pressure on USD-VND arising from slowing FDI and foreign worker remittance inflows. In turn, we recommend offshore investors to hedge long VGB positions where possible.

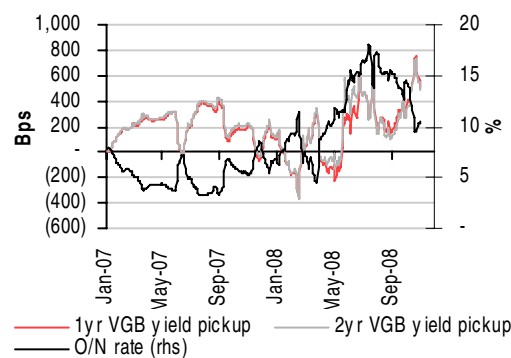
Virgil Esguerra / Pieter van der Schaft

5. Recent and upcoming auctions

| Date | Planned size | Tenor | Type | Target yield | Result (issue size, VNDtrn) |
|-----------|--------------|-------|-------|--------------|-----------------------------|
| 1-Oct-08 | 700 | 2Y | VGB | 15.30% | Size issued 50 |
| | 300 | 3Y | VGB | 15.20% | Size issued 150 |
| 6-Oct-08 | 1,000 | 2Y | VGB | 15.30% | Failed |
| 14-Oct-08 | 300 | 3Y | VDB | 15.20% | Failed |
| | 300 | 5Y | VDB | 15.00% | Failed |
| 15-Oct-08 | 500 | 2Y | VGB | 15.00% | Failed |
| | 500 | 5Y | VGB | 14.50% | Failed |
| 20-Oct-08 | 300 | 2Y | VGB | 15.30% | Failed |
| 21-Oct-08 | 300 | 3Y | VDB | 15.00% | Failed |
| | 300 | 5Y | VDB | 15.00% | Failed |
| 24-Oct-08 | 300 | 3Y | VDB | 15.00% | Size issued 40 |
| | 300 | 5Y | VDB | 15.00% | Size issued 50 |
| 30-Oct-08 | 500 | 2Y | VGB | 14.50% | Size issued 450 |
| 31-Oct-08 | 300 | 5yr | VDB | 15.00% | Size issued 190 |
| 31-Oct-08 | 300 | 3yr | VDB | 15.00% | Size issued 210 |
| 3-Nov-08 | 500 | 12mth | VGBT | 12.99% | Size issued 500 |
| | | | -bill | | |
| 12-Nov-08 | 500-1500bn | tbd | VGB | | |
| 13-Nov-08 | 500-1500bn | tbd | VGB | | |
| 26-Nov-08 | 500-1500bn | tbd | VGB | | |
| 27-Nov-08 | 500-1500bn | tbd | VGB | | |
| 10-Dec-08 | 500-1500bn | tbd | VGB | | |
| 11-Dec-08 | 500-1500bn | tbd | VGB | | |
| 24-Dec-08 | 500-1500bn | tbd | VGB | | |
| 25-Dec-08 | 500-1500bn | tbd | VGB | | |

Source: HSBC

6. Yield pickup is near its highest in at least 2yrs



Source: Reuters, HSBC

FX strategy

- ▶ VND supports have faded as trade balance improvements peak, FDI slows, and remittances slow
- ▶ VND's external funding requirement makes it more vulnerable
- ▶ SBV should now manage USD-VND gradually higher

We first warned that the fundamentals supporting VND were deteriorating when we argued that regional FDI inflows would slow (see our report of 13 October, *Asian FX special: The threat of shrinking FDI inflows*). We flesh out this VND view here. We now believe that USD-VND will need to see a period of gradual depreciation for the next several quarters.

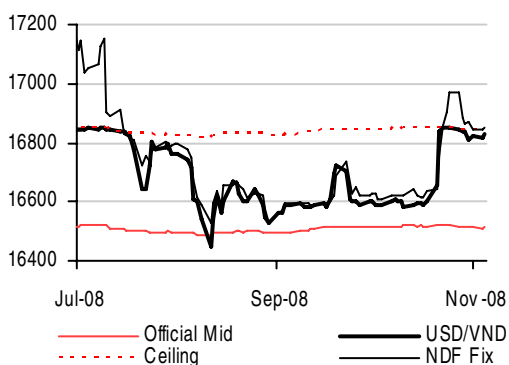
We expect remittances to slow and the improvement in the trade deficit to have peaked. Meanwhile we expect FDI inflows to be sharply curtailed as both the global corporate sector retrenches. Recently, while the USD's surge was expected, the vigour of the move was not. This leaves a stable USD-VND an unwarranted outlier. We now believe that as the short-term VND

fundamentals worsen, and as market conditions erode USD-VND support for stability, the SBV should manage a gradual shift higher in USD-VND.

Eroding support for USD-VND stability

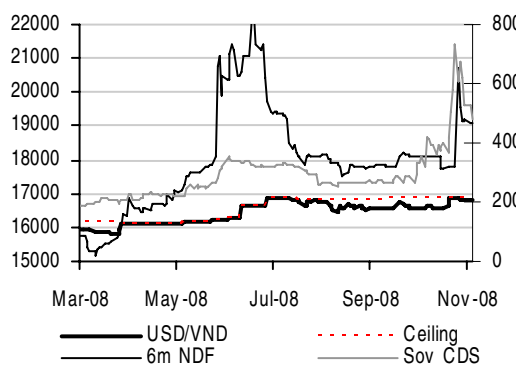
The stability of USD-VND since August has already ended. Spot moved sharply from the near-midpoint range it had been hovering around, quickly hitting the band ceiling. Meanwhile the NDF fixings, a better gauge of where market clearing spot would be breached the band ceiling, appearing to test the 17,000 level again (Chart 1). Similar to 2Q, NDFs liquidity has also disappeared.

1. USD-VND spot, band, and NDF fix



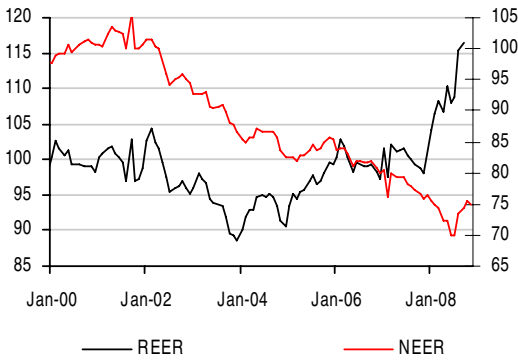
Source: Bloomberg, Reuters, HSBC

2. USD-VND spot, NDF and sovereign CDS



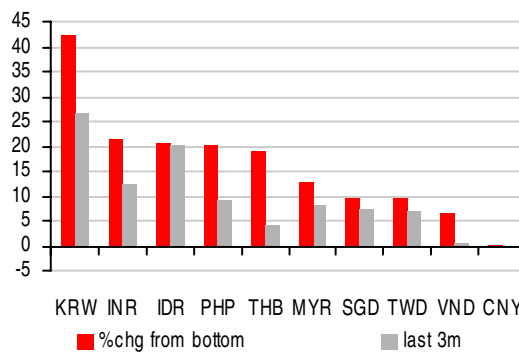
Source: Bloomberg, Reuters, HSBC

3. VND REER and NEER



Source: HSBC, Bloomberg

4. USD-Asia %chg from bottom, and last 3 months



Source: Bloomberg, HSBC

The movement in spot was due in part to foreign fixed income liquidation driven by global deleveraging. However, the surge in premium priced into the NDF curve appear to be less due to concerns about spot, than a more generalized pricing of increased risk in emerging markets. For example, Vietnam's sovereign CDS spread moved prior to the move in NDFs, and by a significantly larger quantum than the 2Q currency scare (chart 2). Still, while spot has stabilized near the band ceiling, the CDS spread remains wider, and NDF liquidity remains absent.

At the very least, a stable USD-VND has become a material outlier among weakening regional currencies (in the past two weeks, even USD-IDR has sharply adjusted higher in the past two weeks, chart 4) leading it significantly strengthen versus its regional peers. This relative overvaluation is exacerbated by a relatively high rate of inflation (chart 3). Such valuation factors become more important, especially as the other fundamental characteristics are turning more currency negative, as we discuss below.

BoP funding requirement VND's key vulnerability

Given the sharply slowing global economy, exports are set to slow quickly. This implies that the recent trade balance improvement has likely already

peaked, as external demand slows much quicker than domestic demand (the Economics section gives more analysis on the recent trade data).

The key vulnerability, however, is that Vietnam has one of the largest current account funding requirements (as a % of GDP) in the region. Our expectation for a sharp slowdown in regional FDI inflows⁶ thus has particularly serious implications for the currency. Earlier we had argued that strong long-term investment flows would help drive currency appreciation while the current account deficit would only switch to surplus in the medium-term as productivity growth kicked in as export oriented productive capacity came on-line.

Remittance flows will likely slow as well going forward, for similar reasons. Anecdotes onshore suggest that much of the recent surge in remittances were primarily for domestic investment purposes. Beyond that, the fact that households particularly in developed markets will become increasingly stressed, suggests that regardless of the ultimate purpose, remittance inflows will need to be diverted the remitters' own funding needs.

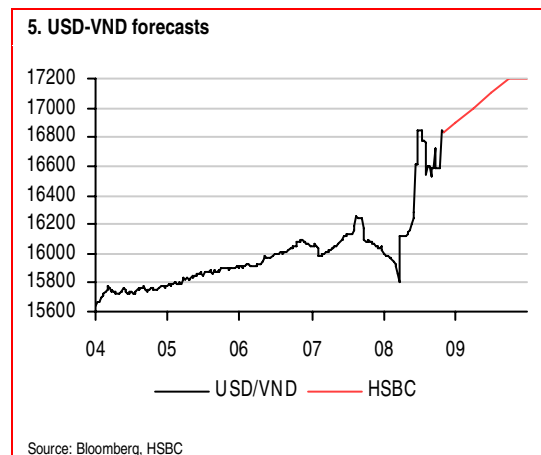
⁶ See "The threat of shrinking FDI flows" 13 October 2008

Slowing FDI and remittance inflows mean that any funding gap will need to be filled by either portfolio inflows or FX reserves. Elsewhere in this document, our equity strategist has already pointed out that foreigners have finally become net sellers of equity, and that we should expect regional equity market underperformance going forward. The outlook for the fixed income flows look more favourable (see the fixed income strategy section of this report), though any onshore FX hedging on these positions will negate any benefit to the currency.

SBV should gradually manage USD-VND higher

Given that we expect a current account funding shortfall that will persist at least through this part of the global macro cycle, we believe it would be prudent for the SBV to gradually manage USD-SBV higher, rather than try to attempt to plug the shortfall from the central bank's FX reserves.

We continue to emphasize the importance of continued development of the exchange rate regime, and particularly the assurance of liquidity in the FX market, particularly when spot is testing the extremities of the trading band, suggesting that FX intervention should primarily be used to ensure the adjustment higher in USD-VND is orderly.



Daniel Hui

Disclosure appendix

Analyst certification

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