Thomas Kägi, economist, thomas-za.kaegi@ubs.com, UBS AG
Hartmut Issel, analyst, hartmut.issel@ubs.com, UBS AG

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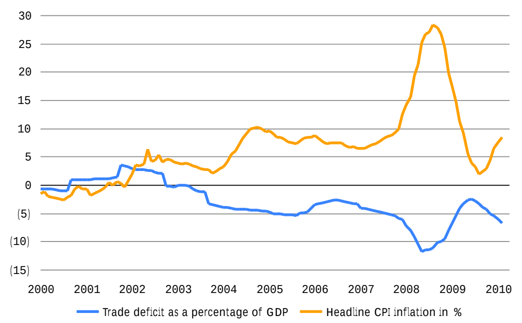
Asia Pacific economics

Vietnam: Here we go again

- While we expect Vietnam's economy to expand strongly in 2010, imbalances are huge and the country is confronted with formidable macroeconomic challenges.
- While authorities are trying to address the yawning trade deficit and accelerating inflation, we believe there is a significant risk of a sharp one-off devaluation of the Vietnamese dong (VND).
- Given the looming currency risks and the related consequences for equities and bonds, we advise caution before investing in Vietnamese assets.

Vietnam's main challenges
Trade deficit and inflation



Sources: CEIC, UBS WMR as of March 2010

Resilient in the global crisis

Vietnam's economy weathered the global financial crisis well, especially considering its large exposure to external trade, with the country's exports and imports combined equaling 160% of 2008 GDP. After very strong growth from 2003-2007, Vietnam's GDP growth slowed to 6.2% and 5.3% in 2008 and 2009, respectively. Most recently, real GDP growth accelerated to 5.3% in the fourth quarter of 2009, from 4.3% in the third. Without major contributions from the export sector, solid domestic demand helped keep growth on fairly acceptable levels in 2009, though below trend growth. We believe the proactive approach taken by the Vietnamese government has successfully supported short-term growth.

However, loose fiscal and monetary policies aggravate already apparent structural issues within the economy, which, if not addressed properly, may lead to a crisis reminiscent of Asia's 1998 collapse. In an attempt to rein in accelerating inflation and a widening trade deficit, Hanoi has introduced plans for price controls and import restrictions. While we strongly support actions to reduce the obvious imbalances, we think recent proposed measures are inadequate.

Huge stimulus packages raise concerns on government finances

To weather the global credit crisis, the Vietnamese government announced a fiscal stimulus package totaling VND 145.6trn (~USD 7bn). As a consequence of the package, Vietnam's fiscal deficit climbed to 10% of GDP, bringing government debt to about 40% of GDP. In response to the mounting deficit, the Vietnamese government raised USD 1bn in its international bond sale in January, which was well received with subscriptions more than double the amount on offer. While this certainly is a sign of foreign investors' confidence in Vietnam's economy, it is also a reflection of the relative scarcity of Vietnam's USD-denominated external government debt as well as the favorable terms. Apart from this recent issue, only a 2006 issue of USD 750mn is available for foreign investors. On the back of a more balanced revenue-expenditure mix and assuming no additional fiscal stimulus, government budget deficits are likely to improve in 2010.

Widening trade deficits further impair the local currency

Trade volumes recovered somewhat in 2009 and export growth moved back to positive territory in November 2009. However, imports, after more than halving during the credit crisis, have recovered more sharply. With that, a previous problem of Vietnam's economy has resurfaced as the trade balance returned to a yawning deficit. We believe Vietnam's exports will rise gradually given the global recovery and the extended loan subsidy for export-oriented companies. However, growth should still be rather limited: the economic growth in Vietnam's major trading partners, the US and Japan, will be rather weak and bumpy according to our forecasts. On the other hand, import growth will outpace export growth on the back of strong domestic demand.

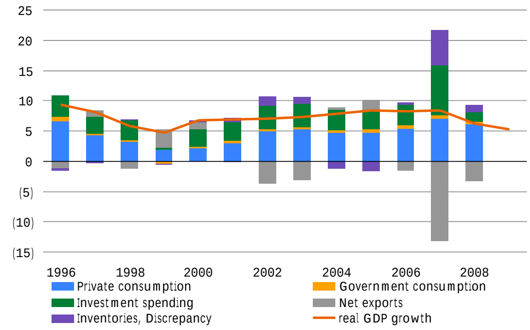
Despite a relatively high savings rate of about 30%, Vietnam is facing a wide current account deficit, which amounted to 10.3% of nominal GDP as of 2008. (This is a good example of Vietnam's lack of adequate statistics: current account data is only available yearly and with a big lag.) The deficit likely narrowed last year as a result of a temporary trade surplus, but we believe it is again approaching double-digit territory as a percentage of GDP. While much of Vietnam's savings deficiency is matched by high foreign workers' remittances and foreign direct investments, we believe capital inflows do not sufficiently cater to financing the current account deficit at the moment. Thus, it is not surprising that the central bank, State Bank of Vietnam (SBV), had to give in to pressures and devalue the dong twice since November. Since February, the USDVND exchange rate has been more volatile than in the past, suggesting that the SBV is struggling to maintain the value of the dong.

Inflation expectations re-emerge

Currently, headline CPI inflation is right above the historical year-on-year trend growth. However, the sequential seasonally adjusted inflation rate jumped rapidly in recent months at above 12% annualized. We believe higher food prices and demand-side pressures will lead to a further increase in inflation in 2010. The government's interest rate subsidy program successfully boosted domestic credit to support economic growth. However, the issue here is that economic growth and credit growth in particular are inflationary. Structurally, Vietnam's economy is not in a position to grow above 8% in real terms without inflationary pressures building up. Similarly, credit growth above 30% will most likely lead to inflation unless Hanoi takes further steps to increase its potential

No recession during the global credit crisis

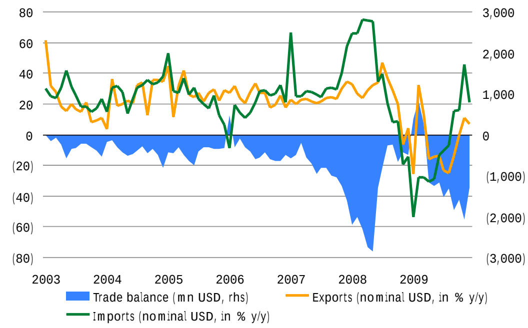
Real GDP with contribution by component in % y/y



Sources: CEIC, UBS WMR as of March 2010

Yawning trade deficit has reappeared

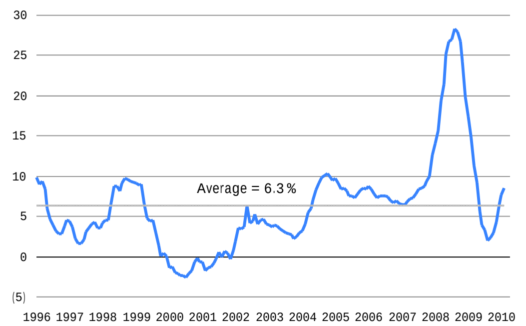
Export and import growth, trade balance



Sources: CEIC, UBS WMR as of March 2010

Inflation troubles are re-emerging

Consumer price index, change year-on-year in %



Sources: CEIC, UBS WMR as of March 2010

growth rate. In addition, a devaluation of the VND, which we expect, should exacerbate imported inflation. The inception of the recent rate hike cycle will help mop up the excess liquidity, but this alone may not be enough to contain inflation.

Downward pressure on the VND should persist

The SBV has devalued the VND by over 6.5% against the US dollar since late November 2009. While we only have data until June 2009, we believe SBV's foreign exchange reserves have been under considerable pressure as a consequence of a large current account deficit and insufficient capital inflows. Furthermore, local confidence in holding VND-denominated assets is relatively low. We believe the VND is trading at a significant discount on the black market and the non-deliverable forwards market (NDF). The forwards market is currently pricing in another 10% depreciation against the USD over 12 months. In general, the stronger the USD is, the bigger the depreciation pressure on the dong will be. Thus, recent turmoil over Greece's debt situation and the ensuing strengthening of the US dollar did not help. Following the recent devaluation, we expect the SBV to be forced to devalue the dong further. The NDF market's expectation for a devaluation in the next 12 months may even be too sanguine, especially if the broader US dollar strength persists.

Not yet in a crisis

Huge current account deficits, surging inflation, strong credit growth, depreciation pressures on a pegged currency – all these symptoms remind us of the Asian financial crisis of 1997/98. However, it is not inevitable that Vietnam will face a similar fate like other Asian countries did 12 years ago. That said, authorities have to address these structural issues quickly. A key issue in our view is that Hanoi has unrealistic growth targets. As mentioned above, economic growth has to be brought to lower levels as the economy is structurally not able to maintain the current pace.

A significant increase in interest rates is the most straightforward way, in our view. This would bring down domestic activity, which is running at too high a pace, given the sluggish external demand. It helps to ease inflation from rising further and would encourage domestic saving, alleviating the shortfall on the current account. Yet, this measure undoubtedly means lower economic growth and it will unlikely be appreciated by asset markets. One key difference to the major victims of the Asian crisis is that Vietnam's ratio of external debt to GDP is at roughly 26%, which is relatively low for an emerging market.

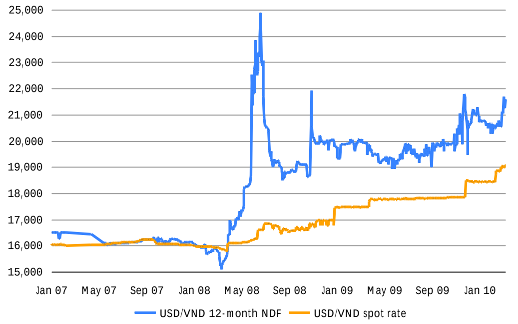
As opposed to significantly increasing interest rates, recent announcements suggest that Hanoi is trying to rein in inflation and its trade deficit by introducing price controls and import restrictions. We are rather skeptical about the adequacy of these measures. First, both price controls and import restrictions will lead to rationing and the development of black market activity. Furthermore, according to newspaper reports, the controls target commodities in particular. Given our expectations that commodity prices will rise significantly in the coming quarters, these price controls will likely prove to be a dead end.

Not yet a focus hot-spot for equity investors

While the Ho Chi Minh Stock Index held up well against the rest of Asia in January and February, this should be viewed more as stabilization.

Forward market expects 12% depreciation

VND exchange rate and non-deliverable forward (NDF)



Sources: Bloomberg, UBS WMR as of March 2010

Unlikely to reach previous highs anytime soon

Vietnam Stock Index

Sources: Bloomberg, UBS WMR as of March 2010

Cheaper, but still expensive

VN index price-to-book value with historical average

Sources: Nomura, UBS WMR as of March 2010

Asia Pacific economics

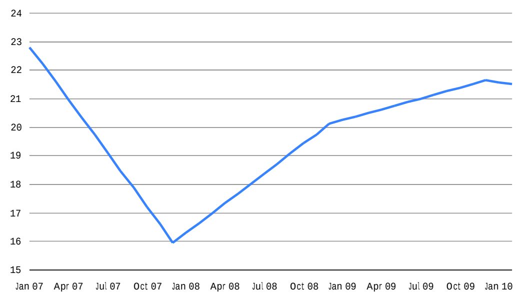
Starting in October 2009, the market dropped by 30% in just two months. Looking at the market from a valuation angle, things do not look too bleak at first glance. Price-to-book ratios, for example, have corrected to levels that do not look high compared with the market's own history. At the same time, profitability levels such as return on equity have recovered recently. It is important to note, however, that the reliability of company data is questionable. The Economist Intelligence Unit, for instance, ranks the country's accounting just one notch above the lowest possible ranking. One also needs to bear in mind that with a 2009 run rate of 38%, the extension of credit in Vietnam happened at an even faster pace than in often-discussed China. Two risks emanate from this. One is the specter of rising loan-loss provisions as credit quality suffers. The other is the set of countermeasures to rein in credit growth, which would also signal negative news for equity markets to the extent that this is not priced in yet. In this context, it should be noted that financials form the single biggest sector of the country.

P/E ratio still above regional average
VN index price-to-earnings ratio

Sources: Nomura, UBS WMR as of March 2010

Recently, the government eased trading rules and it is planning to close about 20 gold exchanges, which to some degree have supported demand for equities and liquidity. Gold and the US dollar traditionally compete with equities in Vietnam. Vietnam's equity market is relatively volatile and less transparent compared with other Asian peers. The stock market is frequently positively correlated with changes in currency reserves. This phenomenon has also been evident recently as arguably dwindling reserves and weaker equity markets went hand in hand. As such, this observation would speak for weakness as long as Vietnam has to defend its currency on the downside and hence is using up reserves. The fact that unofficial currency rates are below the official rate does not bode well in this respect. Equity investors also need to be aware that this market is not very deep and it is often difficult for investors to enter, and that repatriation of money may be difficult. In addition, any further currency devaluation also diminishes the value of equity investments and this threat is very real.

ROE has recovered
VN index return on equity



Sources: Nomura, UBS WMR as of March 2010

In conclusion, we believe there are a few hopeful signs. They are, however, counterbalanced by several unresolved issues. The announcement of reforms is a necessary if perhaps insufficient condition for a sustainable uptrend. In their absence and with the prospects of further devaluation (in contrast to the rest of the region), we believe investment in the Vietnam's equity market is more speculative in nature and investors should only build their position in a well-diversified portfolio.

Appendix

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