

On the Ground | 00:30 GMT 25 May 2011

## Vietnam – Looking for the right entry point

- Despite rising inflation, VND expectations have stabilised as de-dollarisation policy takes effect
- We expect inflation to peak at 22% in Q3-2011, then ease in Q4 and 2012
- We believe VGB yields are approaching a peak; we see opportunities to enter the 1-3Y segment

### Summary

While inflation remains a significant challenge for the economy, the authorities' measures to stabilise the Vietnamese dong (VND) have had some initial success. The spread between the commercial USD-VND exchange rate and the parallel market exchange rate has disappeared, and there are reports that the central bank has been buying USD from the market on occasion.

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Vietnam still faces significant near-term inflation challenges. We expect inflation to surge further to 22% y/y in Q3-2011 before easing towards 20% in Q4. However, with the authorities expected to press ahead with tightening policies and regain investor confidence, we see potential opportunities ahead for foreign bond investors. Yields look set to peak in the coming months, which would coincide with the end of the tightening cycle in Q3-2011. We still expect one modest VND devaluation against the USD in Q3-2011, but the risk of this taking place should recede if the authorities' de-dollarisation efforts continue and local investors are content with the carry between USD and VND. Government measures to curb gold trading have also helped to reduce the role of gold as a third currency in the financial system.

We recommend that investors enter the VGB market at the end of the tightening cycle in Q3-2011. Alternatively, investors could look for early entry opportunities when there are broader signals of a recovery in market confidence, including (1) a pick-up in foreign inflows, (2) a narrowing spread of local gold prices over global prices, and (3) a narrowing spread of the parallel market rate over the official USD-VND rate. The 1-3Y segment is the largest and has historically been the most actively traded; with the current inverted yield curve, we see relative value in the 1-3Y tenor.

**Table 1: Standard Chartered quarterly and annual forecasts for Vietnam**

|                                 | Q4-10A | Q1-11A | Q2-11  | Q3-11  | Q4-11  | 2010A  | 2011   | 2012   |
|---------------------------------|--------|--------|--------|--------|--------|--------|--------|--------|
| Real GDP (% , y/y)              | 7.7    | 5.4    | 6.2    | 6.4    | 6.5    | 6.8    | 6.3    | 7.0    |
| Inflation (% , y/y)             | 10.8   | 12.8   | 19.2   | 22.1   | 20.7   | 9.2    | 18.7   | 8.5    |
| Refinance rate (% , end-period) | 9.0    | 12.0   | 14.0   | 16.0   | 16.0   | 9.0    | 16.0   | 14.0   |
| USD-VND (end-period)            | 19,500 | 20,900 | 20,900 | 21,800 | 21,800 | 19,500 | 21,800 | 22,000 |
| 2Y VGB yield (% , end-period)   | 10.70  | 12.35  | 14.00  | 14.25  | 13.50  | 10.70  | 13.50  | -      |

Source: Standard Chartered Research

## Sentiment is improving, but inflation will rise further

### We raise our peak inflation forecast in Q3 to 22%

The government released an early estimate of May inflation at 2.21% m/m, which implies a y/y rate of 19.78%. This is the highest y/y reading since December 2008. Looking at the breakdown by component, food (+28.3%), transport (+18.9%, driven by a fuel price increase) and housing materials (+21.1%) were responsible for the surge in inflation.

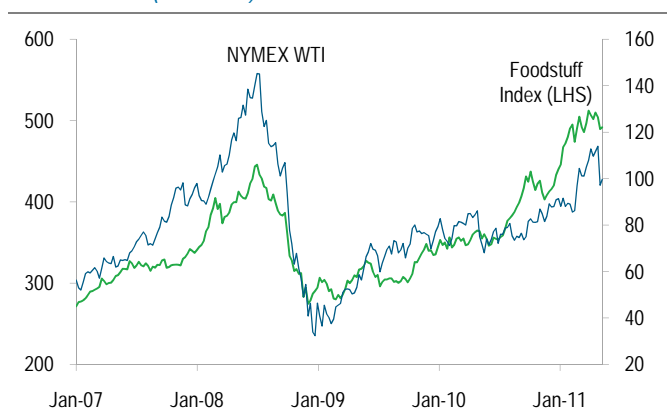
*The rest of Asia is now looking at the peak of inflation; we expect the same in Vietnam, but at a much higher level*

There are indications that y/y inflation may top out in Q3, even though we now forecast the peak at 22%, instead of 18% previously. First, global food prices have been stable since Q1-2011. The CRB/Reuters US foodstuff index has stabilised since Q2, and we expect the rise in grain prices, if any, to be much more moderate than what we have experienced in the past 12 months. Second, energy prices are starting to stabilise. The recent decline in risk appetite in the financial markets has helped to force a correction in oil prices. The NYMEX WTI price has come down from a high of USD 114/barrel (bbl) to below USD 100/bbl, and we expect it to remain in this range for the remainder of this year. Finally, we expect broad currency stability, even as we continue to forecast a modest devaluation in Q3-2011. This should help to prevent significant currency weakness, which would trigger more imported inflation.

### Watch out for the trade deficit

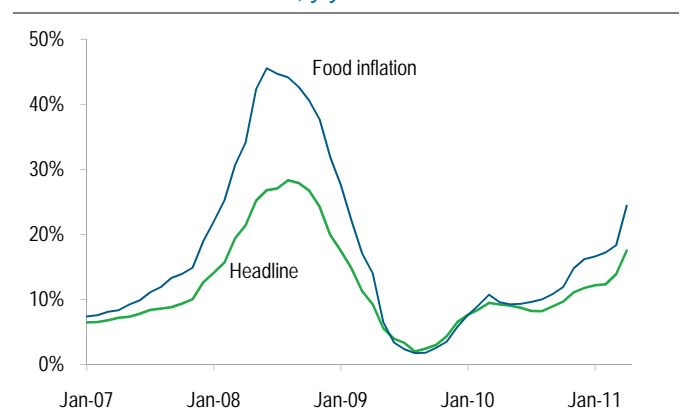
In addition to inflation, the trade deficit is also a concern. We have repeatedly warned of a widening of the trade deficit on the back of rising commodity prices in the past 12 months, mirroring the experience of 2008. Vietnam's monthly trade deficit was USD 1.4bn in both March and April 2011, pushing the average monthly run rate to USD 1.2bn for the first four months of the year. This is in line with our full-year trade deficit forecast of USD 12-15bn (about 13% of GDP) for 2011. This is by no means an alarming figure, since 2008 saw a monthly run rate of USD 2.5-3.0bn, resulting in a trade deficit equivalent to 14.2% of GDP. In 2008, fuel imports and hoarding of steel products were factors behind the sharp widening of the trade deficit. In the first four months of 2011, import growth was led by an explosion in cotton and yarn imports (up 121% and 70% y/y, respectively). Petroleum imports (+63%) also played a part, while automobile imports (+80.2%) grew rapidly after a subdued 2010.

**Chart 1: Global food price showing signs of stabilisation**  
NYMEX WTI (USD/bbl) and CRB/Reuters US foodstuff index



Source: Bloomberg

**Chart 2: Inflation to rise further before peaking in Q3**  
Headline and food inflation, y/y



Source: CEIC



While the current level of the trade deficit is not alarming, as it is at the top end of our forecast range for this year, it deserves close monitoring in case it gains further momentum in the months ahead. While local investors have been primarily concerned about inflation in the past six months, it was the combination of high inflation and a widening trade deficit that led to massive depreciation pressure on the VND back in 2008.

*VND has been surprisingly resilient, despite high inflation, USD strength and wider trade deficit*

### De-dollarisation policy and gold transaction curbs protect the VND

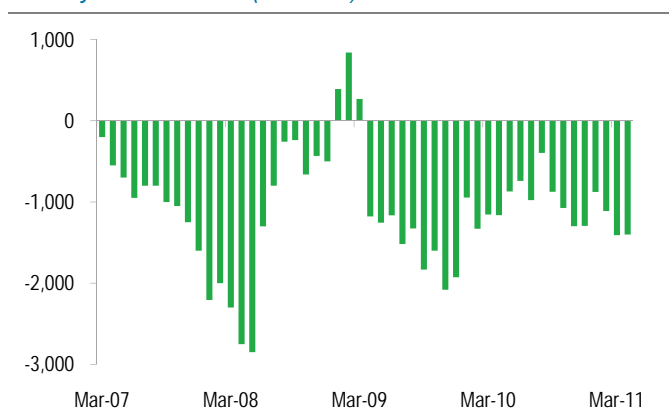
The closing of the spread between the commercial banks' USD-VND FX rate and the parallel market FX market came at an interesting time. The upside surprise in inflation in April and a widening trade deficit would typically lead to a sell-off in the VND, especially in the parallel market if the official USD-VND ceiling (1% above the daily fixing) is reached. Moreover, the recent rebound in the USD (the USD trade-weighted index has rebounded by almost 4% in May) has not prompted retail investors, the parallel market's participants, to add to their long USD-VND positions.

However, the spread between the formal and informal exchange rates has not only closed, but more importantly, the commercial USD-VND FX rate has been trading VND 80-150 (0.4-0.8%) below the official rate.

Various policies implemented by the authorities since February have contributed to this. Caps on USD deposit rates (3% for individuals and 1% for non-credit institutions) have reduced the appeal of holding USD relative to VND. The State Bank of Vietnam's (SBV's) latest banking operation bulletin (for April 2011) put the average VND deposit rate at 13.41%, below the SBV's recommended ceiling of 14%, although there are news reports of banks paying more to attract deposits. The SBV has recently hinted at the possibility of removing the VND deposit rate cap or revising it higher to 15.5-16.5%. The combination of higher VND interest rates and low USD rates, and reduced prospects of a massive currency devaluation, have prompted investors to switch from USD into VND.

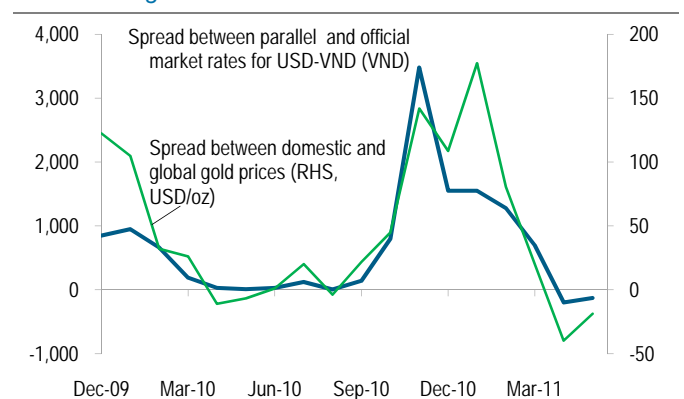
Limitations on gold trading and the use of gold in financial transactions have also encouraged local investors and businesses to use VND. The recent stability in global gold prices has provided additional support for the VND.

**Chart 3: Trade deficit widened again in March and April**  
Monthly trade balance (USD mn)



Source: CEIC

**Chart 4: Confidence in VND has stabilised**  
Demand for gold and USD eases



Sources: Bloomberg, Saigon Jewelry Company

While recently introduced policies have shown early signs of success, a further rise in inflation in the months ahead will require additional refinancing rate hikes to ensure VND stability by boosting demand for VND from banks and households, especially if the deposit rate cap is relaxed or removed. Hence, we expect the refinancing rate to be raised to 16% by Q3-2011, and to stay at that level for the rest of the year.

We also maintain our USD-VND forecast, with the pair expected to trade at 21,800 at the end of 2011. Despite more favourable market action in recent weeks, which signals the effectiveness of VND stabilisation measures, we see risks from a further deterioration in inflation. Hence, we prefer to wait and see how the market reacts.

## Assessing opportunities in the government bond market

### Signs of stability in the economy and the bond market

*We see growing confidence in the VND, an improving inflation outlook and strong domestic demand for bonds*

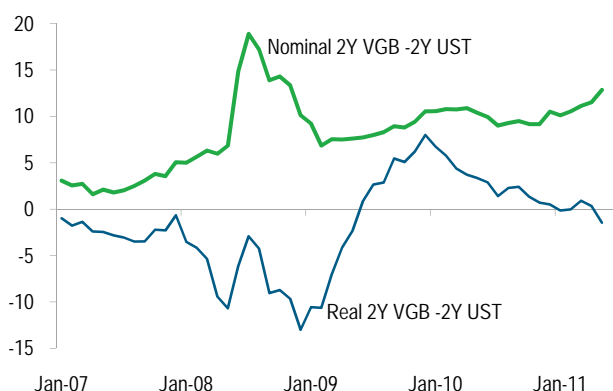
The SBV's aggressive monetary tightening has driven the yield curve higher since Q4-2010, with underperformance at the short end. Going forward, we remain moderately bearish on the government bond market and expect the upward movement in yields to be limited. Growing confidence in the VND, the improving inflation outlook, and robust domestic demand from banks are providing strong support for the bond market.

Devaluation pressure on the VND has dissipated as confidence in the currency grows. As Chart 4 shows, the difference between the official rate and the parallel black-market rate for USD-VND has turned negative since February, while slowing demand for gold is compressing the spread between local and global gold prices. We forecast a modest one-off VND devaluation of about 4% during the remainder of 2011, but we will review our call if signs of stability persist.

Both global and local drivers of inflation should stabilise. We expect the rise in global food and energy prices to moderate in H2-2011. Domestically, the government has hiked interest rates aggressively (see **On the Ground, 30 March 2011, 'Vietnam – Staying with the inflation flight'**) and amended banking regulations in order to curb lending. The high base effect from September 2010 onwards should also help to slow y/y inflation.

**Chart 5: High inflation is a key risk to VGB investment**

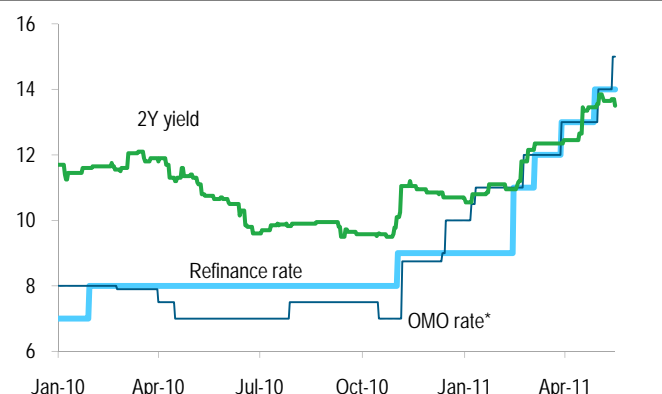
%



Sources: Standard Chartered Research, Bloomberg

**Chart 6: Nearing the end of the rate-hiking cycle**

*We expect interest rates to reach 16% in 2011 (%)*



\* Constructed from 7-day and 14-day OMO rates;

Sources: Standard Chartered Research, Bloomberg, Reuters

Demand from banks should remain strong ahead of maturing inventory in August and September. Banks are using government bonds as collateral to access liquidity facilities extended by the SBV. The SBV has maintained its liquidity support this year, with the average open-market operations (OMO) facility rising to VND 112trn from VND 77trn in 2010. We also estimate the current refinancing facility at VND 70trn, made up of various tenors from 2-6M. Liquidity support from the SBV helps to create natural demand for the VND 237trn worth of government bonds, including VGBs, Vietnam Development Bank (VDB) bonds and T-bills.

Demand from banks has helped to anchor bond yields as interest rates soar. Since October 2010, the refinance rate has risen by 600bps and the overnight interbank rate by 500bps, but bond yields have risen by 300-350bps. As Chart 8 shows, the spread between government bond yields and the constructed policy rate (based on the base policy rate, the refinance rate and the OMO rate) turned negative for the first time in February 2011. We expect this relationship to hold in the current rate-hiking cycle.

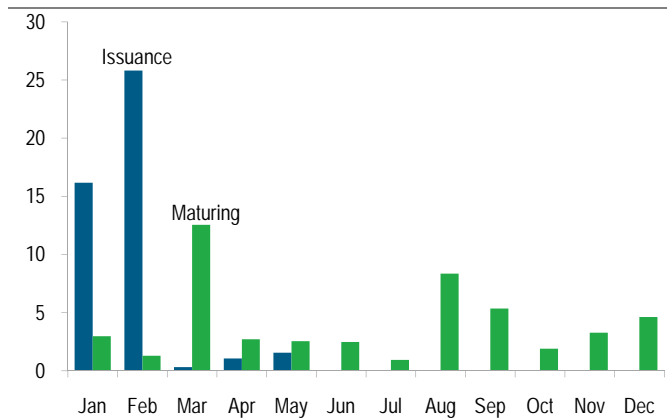
*Consistent monetary policy, stabilising global prices, slowing m/m inflation and VND strength are necessary and sufficient conditions for entering the market*

#### Determining when to enter the market – four factors to watch

We identify four key factors to watch in order to determine the timing of market entry, and the conditions under which inflation and government bond yields should peak. We recommend that investors enter the market when these conditions are met.

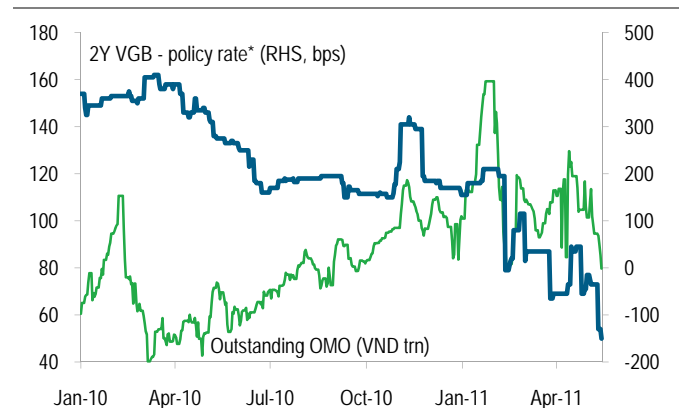
1. The SBV continues to maintain the high-interest-rate environment needed to stabilise inflation, and does not prematurely reverse its rate-hiking cycle. Funding rates for the OMO and refinance facilities are currently 15% and 14%, respectively, and they may increase to 16% this year.
2. Further gains in the ICE Brent price and the CRB/Reuters food index are only marginal. We forecast that the ICE Brent price will average USD 118/bbl in Q2-2011, USD 115/bbl in Q3-2011 and USD 110/bbl in Q4-2011. We monitor the 7-day moving average of the CRB/Reuters food index and will look for a sustained upward trend in the daily change as an indicator of higher inflationary risk.

**Chart 7: 2011 issuance has been front-loaded**  
VGB, T-bills, VDB (VND trn)



Sources: Bloomberg, Standard Chartered Research

**Chart 8: VGB yields are depressed against the policy rate**  
Strong liquidity support from SBV creates demand for bonds



\* Constructed from base policy, OMO and refinance rates;

Sources: Bloomberg, Reuters, Standard Chartered Research

3. Inflation (m/m) falls sharply from June onwards. Following a high m/m inflation print of 2.21% in May, we expect the combined effect of stable prices and slowing demand to curb m/m price growth. We forecast m/m inflation of 1% in June, July and August (assuming a 4% VND devaluation).
4. Confidence in the VND persists. In prior devaluations between November 2009 and February 2011, the spreads between the official rate and the parallel black-market rate were VND 900, VND 122 and VND 1,550. The current spread is highly favourable, at -VND 128. We will remain comfortable with a reading below VND 100, provided that the monthly trade deficit is kept below VND 1.5bn and demand for gold remains muted.

*Investors should watch for early signals to enter the market ahead of the inflation peak*

If these four conditions are met, we expect bond yields and inflation to peak in Q3-2011. However, bond yields could top out ahead of the peak in inflation, and investors should watch for signals of improved market sentiment.

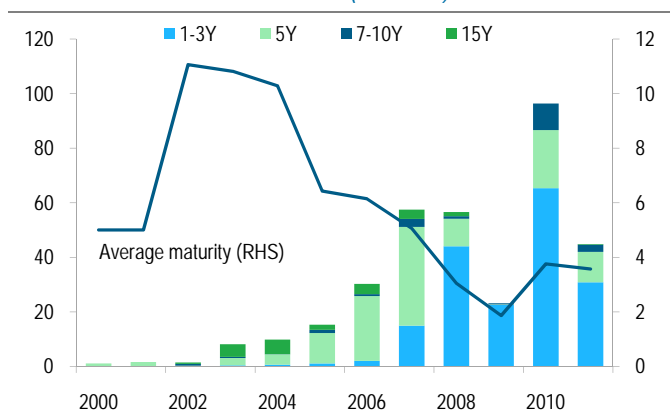
The y/y May inflation estimate, at 19.78%, is the highest since December 2008. If VND strength against the USD and gold persists in the weeks following the final inflation announcement, we will be more confident in a reduced risk of devaluation in Q3-2011. Devaluation is one of the main risks to offshore investment in the VND bond market. To illustrate, the 2Y VGB yield is currently at 13.5%, or roughly 1.1% on a monthly basis. The positive carry for offshore investors would be easily eroded by a one-off 4% devaluation if the government decided to do so in the next three months.

Another signal for early entry is a pick-up in demand from offshore investors, which would further limit the upward pressure on yields caused by rate-hike expectations. As an official record of offshore inflows is unavailable, we will monitor government bond prices in the primary and secondary markets.

We have assumed that the government will not change recently introduced regulations and economic targets that have supported economic stability. In addition, the SBV would need to maintain the current level of liquidity injection, estimated at about VND 100-170trn via the OMO and refinance facilities, in order to ensure consistent demand from banks.

**Chart 9: Issuance profile of LCY government bonds**

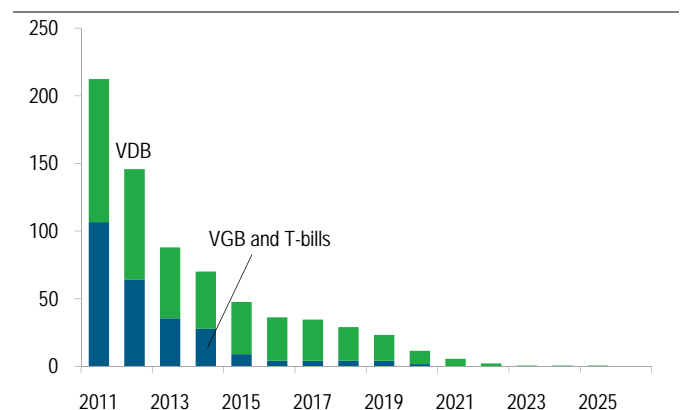
*Issuance shifts from 5Y to 1-3Y (VND trn)*



Source: Bloomberg

**Chart 10: Maturity profile of LCY government bonds**

*VND trn*



Source: Bloomberg



*Yield curve is likely to flatten as we approach the end of the rate-hiking cycle*

### Liquidity and relative value in short-dated government bonds

When the bond-market outlook turns favourable, we recommend that investors enter the 1-3Y segment of the government bond market. Liquidity remains a key risk in this market. The average quarterly trading turnover was 0.12x in 2010, and the current bid/ask spread is 30-50bps. The spread can widen significantly during a sell-off and most market makers quote one-way prices in day-to-day dealings.

Issuance in the last four years has been heaviest in the 1-3Y tenors, and while trading activity has lately been focused on tenors above 3Y due to expectations of slowing inflation (the curve is currently inverted), we see value in short-term instruments.

The 1Y yield has risen above 2-5Y yields since March 2011 as tight liquidity conditions drive short-term rates higher, while expectations of moderating inflation have kept long-dated yields low. We expect this to reverse as we approach the end of the rate-hiking cycle and liquidity returns to the system. While we see relative value in the 1Y bond against longer-dated bonds (see Chart 11 for regression results), the 2Y and 3Y tenors are more actively traded, and are less affected by short-term liquidity conditions.

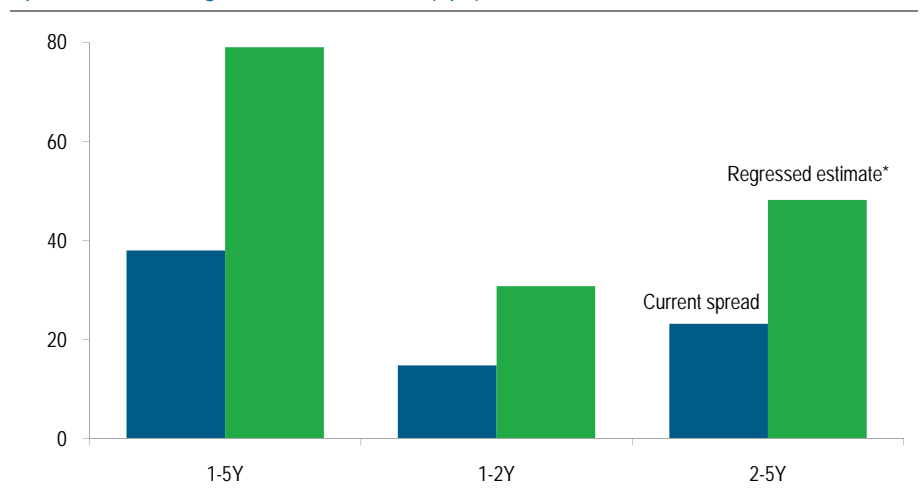
*It takes two to three weeks to open an onshore trading account; alternatively, foreign investors can access the market via offshore accounts using Total Return Swap products*

There are no restrictions on foreign holdings of VND government bonds. Foreign investors are required to apply for a security transaction code and open a securities transaction account with custodian members. The Vietnam Custodian Centre only deals directly with custodian members (registered local securities companies and banks, including Standard Chartered Bank Vietnam Ltd.). A foreign-currency account and a VND account must also be opened with an onshore bank for the exchange and remittance of capital and profits. It takes approximately two to three weeks to open the onshore accounts and receive the trading code.

Alternatively, investors can access the market with their offshore accounts via funded or unfunded Total Return Swap (TRS) structured products.

### Chart 11: Regression exercise shows value in short-dated bonds

*Spreads are low against historical data (bps)*



\* Against interbank overnight rates, 2009-2011;

Sources: Bloomberg, Standard Chartered Research





## Disclosures Appendix

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