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Vietnam – Prepare for the rate-cutting cycle

- **We expect the central bank to cut rates later this year on lower inflation and the need to support growth**
- **Currency depreciation pressure should also ease; we have revised our USD-VND forecasts**
- **On VGBs, limit duration exposure to 0-3Y and look to initiate long positions when liquidity improves**

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Summary

After a year of struggling with inflation, Vietnam is finally seeing a slowdown in consumer price increases. While tight monetary policy and an emphasis on price stability may have come at the expense of growth in the short term, they have been critical to reinforcing market and investor confidence, in our view. Moreover, the deceleration in growth has been modest so far, as the economy still registered 5.9% growth for 2011.

We expect growth to continue at a similar pace in 2012. The challenging external environment is likely to replace domestic austerity as the most important driver of the economy. Vietnam is dependent on Europe as an export destination; the region makes up 14% of its export demand. But diversification to other destinations should partly offset the negative impact of weaker European demand.

Inflation is easing, as expected, and we expect headline y/y inflation to return to single digits by the end of H1-2012. A stable Vietnamese dong (VND) exchange rate will also help to maintain price stability, although possible further increases in electricity tariffs may pose upside risk to inflation. Lower inflation should give the State Bank of Vietnam (SBV) more room to cut rates, even though it has pledged to keep monetary policy tight at least until after Q1-2012.

Given the dovish inflation outlook and favourable supply-demand dynamics, we expect the 2Y Vietnam Government Bond (VGB) yield to fall to 11.3% by Q4-2012. Meanwhile, we recommend confining exposure to the more actively traded 0-3Y segment and initiating long positions when onshore interbank liquidity conditions improve.

Table 1: Standard Chartered forecasts – Vietnam

Previous forecasts in brackets

	Q4-11A	Q1-12	Q2-12	Q3-12	Q4-12	2011A	2012	2013
GDP growth (% y/y)	6.1	5.4 (6.1)	5.0 (6.2)	6.3	6.4	5.9	5.8	6.5
Inflation (% y/y)	18.1	15 (17)	10.9	8.9	7.9	20.9	11.3	8.5
USD-VND*	21,000	21,000 (21,700)	21,000 (21,800)	21,700 (22,500)	21,700 (22,600)	21,000	21,700 (22,600)	21,700 (23,700)
Refi rate (%)*	15.0	14.0	12.0	11.0	11.0	15.0	11.0	11.0
2Y VGB yield (%)*	12.35	12.25	11.75	11.5	11.25	12.35	11.25	11.50

* *End-period;* Source: Standard Chartered Research

Monetary austerity has yielded results in the form of lower inflation, albeit at the expense of weaker growth

Growth momentum supported by domestic factors

GDP expanded 6.1% y/y in Q4-2011

Although conditions on the ground were challenged by high lending rates and a slowdown in external trade in 2011, Vietnam continued to register respectable growth. GDP grew 5.9% for the full year; this translates into 6.1% y/y growth in Q4, according to our calculations. Q4 growth was supported by services, which expanded 8.6% y/y, compared to 7.3% in Q3. Manufacturing growth accelerated to 10% y/y from 7.1% over the same period. This is in line with industrial production figures for December, which showed a 12.2% y/y increase, up from 4.5% in November.

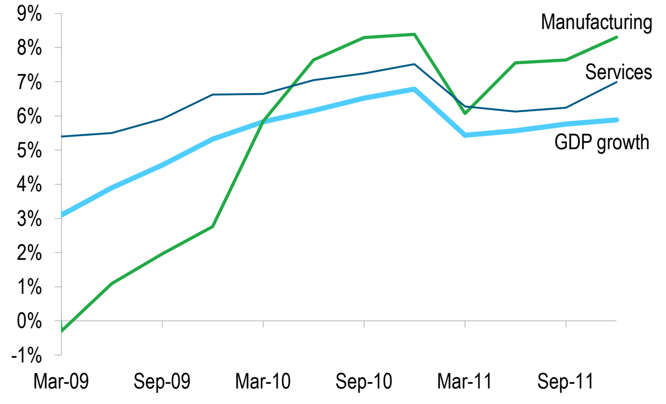
On the other hand, construction contracted by 10.5% y/y in Q4, after expanding 5% the previous quarter. Mining and quarrying activity also underperformed, declining by 1.8% after growing 5.2% in Q3.

Meanwhile, export growth slowed sharply to 18.7% y/y in December from 33.3% in November, falling to its lowest level since May. January exports fell 11% y/y, but this was distorted by the Tet holiday, which fell in February 2011. Amid a weakening external environment, the government may step up state-led investment, especially in infrastructure, to maintain growth momentum. Vietnam has already started to build the Nghi Son oil refinery (the country's second after the Dung Quat oil refinery, completed in 2009) to help narrow the trade deficit – which stood at about 7.5% of GDP in 2011 – and reduce its reliance on refined oil imports. The new refinery is due to be completed in 2014.

With growth momentum robust across most sectors, we expect GDP growth of around 5.8% in 2012. Vietnam's quarterly GDP growth typically accelerates as the year progresses, and we expect a similar pattern in 2012. Domestic demand is likely to remain supported even if the external environment becomes more challenging. Monetary easing this year as a result of slowing inflation should also support growth in H2-2012.

Chart 1: GDP growth is well supported

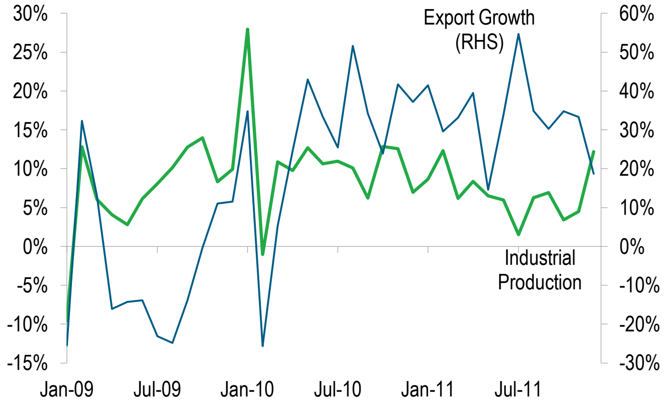
y/y



Sources: CEIC, Standard Chartered Research

Chart 2: Domestic growth, external vulnerabilities

Industrial production and y/y export growth



Sources: CEIC , Standard Chartered Research

We continue to expect inflation to ease to single digits by the end of H1-2012, allowing central bank to ease monetary policy

Inflation momentum has eased, paving the way for rate cuts

After peaking at 23% in August 2011, y/y inflation has slowed for five consecutive months. Headline inflation eased further to 17.3% in January, from 19.8% in November and 18.1% in December. Many components, including foods/foodstuffs and housing/construction, have shown moderating price increases. Inflation for transportation remains high, although it should ease in the coming months given the recent stabilisation in global crude oil prices.

We forecast that inflation will ease further from February, after the Tet celebrations, and return to single digits by late Q2-2012. However, this will depend on stable global commodity prices and gradual and orderly VND depreciation. Possible increases in electricity tariffs could pose further upside risk to inflation in 2012.

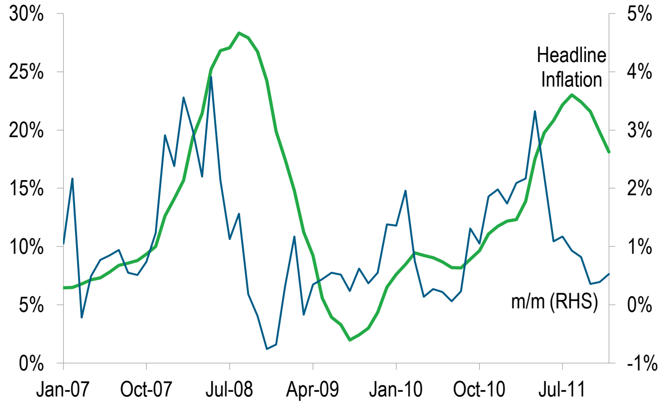
With inflation easing, and with the threat of stagflation receding, we could see policy rate cuts later in 2012. SBV Governor Nguyen Van Binh said recently that "the central bank will adjust policy rates to more suitable levels, aiming to help ease the average level of market interest rates". We expect the central bank to cut the refinancing rate from 15% to 12% by the end of Q2, and then to 11% by Q3.

FX outlook

Vietnam's current account position started 2012 favourably, with a January trade deficit of only USD 100mn (although the impact of Tet may have flattered the trade balance). The trade deficit has been gradually narrowing in recent years, and this supports the VND. Entering 2012, the spread between the official USD-VND exchange rate and the parallel market rate closed again; this reflects more support for the VND, at least in the short term. We have revised our USD-VND forecast to reflect such sentiment, and we expect USD-VND to experience a mild depreciation in 2012. We forecast that the VND will end the year at 21,700 against the USD.

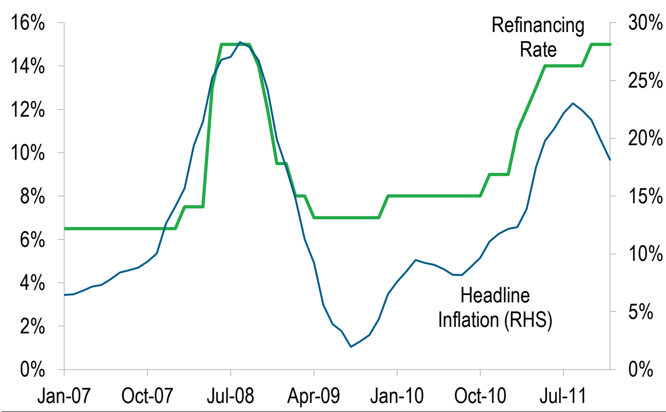
Chart 3: Inflation has been brought under control

Headline y/y and m/m inflation



Sources: CEIC, Standard Chartered Research

Chart 4: Central bank has room to cut rates



Sources: CEIC , Standard Chartered Research

Bond-market outlook

Supply-demand outlook for 2012

- We estimate net supply of VGBs and Vietnam Development Bank (VDB) bonds at VND 51-76trn, versus VND 62trn in 2011.
- Demand-supply dynamics are fairly favourable, as banks and the Vietnam Social Security (VSS) fund can absorb net supply.

Net supply will be largely in line with issuance in 2011, despite a larger deficit

Financing requirements: According to the proposed 2012 budget (released on 16 December 2011), the government expects financing requirements of VND 140trn (4.8% of GDP), versus VND 111.5trn (4.9% of GDP) in 2011. The government's funding sources include VGB issuance, official development assistance (ODA) and bilateral loans, as well as short-term borrowings from the State Treasury cash balance. VGB supply also includes non-marketable securities that are issued via private placement to VSS.

Gross and net supply: The government has not announced its final bond supply targets for 2012. We estimate gross supply of VGBs at VND 80-105trn (net supply of VND 40-65trn). Gross supply will be higher than in 2011 given higher financing requirements, but heavier redemptions will bring net supply to comparable levels to 2011. In the past, the government has been flexible in reducing the issuance amount in favour of cheaper funds when demand dried up.

VDB bonds are government-guaranteed and share the same investor base as VGBs, but they are not used to finance the central government deficit. Assuming the same gross supply of VDB bonds as in 2011, total net supply of VGBs and VDB bonds would be VND 51-76trn in 2012, largely in line with 2011 issuance (at VND 62trn).

Demand from banks can increase significantly if loan growth remains in check

Demand outlook: Banks held more than 95% of outstanding government bonds as of 31 May 2011. Net demand will be VND 40-50trn in 2012 if bond holdings are to remain at 7-8% of total assets. However, we see scope for banks to increase their net purchases to VDN 70trn if limitations on loan growth encourage asset rotation out of loans and into bonds. The government aims to keep loan growth at 15-17% (the same as in 2011), down from an average of 20-25% in past years.

The VSS receives an estimated VND 25-55trn of annual premia

The government issues non-marketable VGBs to VSS. Net demand from VSS will be stable at about VND 10trn, but we see scope for VSS to increase purchases when required. We estimate VSS' full-year premium collection at VND 25-55trn in 2012.

Table 2: Lower financing requirements as a % of GDP

Funding needs (VND trn)

Funding needs	2011	2012
GDP	2,275	2,920
Financing requirements	111.5	140.2
- Budget deficit	48.1	89.9
- Principal payment	63.4	50.3
Financing requirements as % of GDP	4.9%	4.8%
Budget deficit as % of GDP	2.1%	3.1%

Note: Based on official release as of 16 Dec 2011; Sources: MoF, Bloomberg, Standard Chartered Research

Table 3: Banks and VSS can absorb net supply in 2012

Estimates of supply and demand (VND trn)

Breakdown of supply	2011 Net	2011 Gross	2012 Net	2012 Gross
VGBs (including non-marketable)	42.5	71	40-65	80-105
VDB bonds	19.6	35	10.8	35
Total supply	62.1	106	51-76	115-140

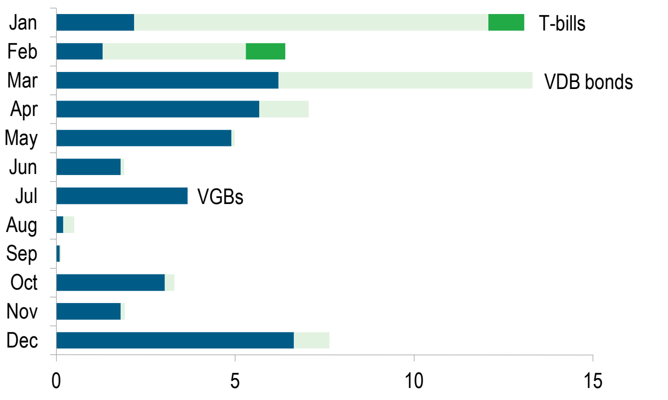
Breakdown of demand	Demand	% of supply	Supply
Banks	40-70	78%-137%	51 Max: 76
VSS	10-55	20%-107%	
Total	50-125	98%-245%	51-76

Sources: MoF, Bloomberg, Standard Chartered Research

Rates strategy

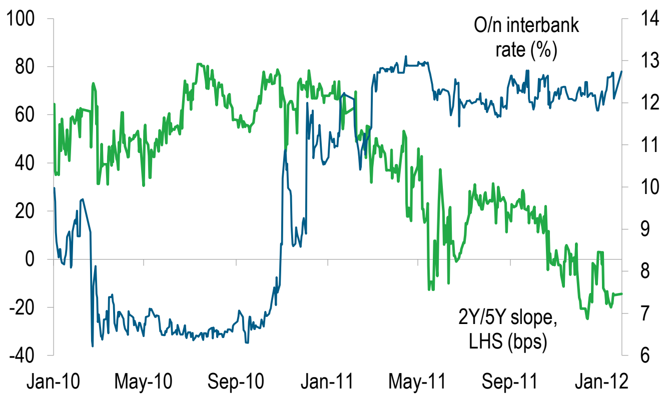
- Given the dovish inflation outlook and favourable supply-demand dynamics, we expect the 2Y yield to fall to 11.3% by Q4-2012 from 12.3% currently.
- The 5Y yield has fallen by 15bps since early December 2012. We recommend confining exposure to the more actively traded 0-3Y segment and initiating long positions when onshore interbank liquidity conditions improve; we expect this to happen if the government cuts the refinancing rate.
- Based on our forecasts, the full-year total return (in local-currency terms) will be 14.3%, versus average interbank funding costs of 12.5% (for onshore banks) and expected FX losses of 3% (for offshore investors).

Table 4: More than 50% of redemptions fall in Q1
Maturity profile in 2012 (VND trn)



Sources: Bloomberg, Standard Chartered Research

Chart 5: The 2Y/5Y curve has inverted as interbank liquidity tightens *(2Y/5Y VGB versus o/n rate)*



Source: Bloomberg

Disclosures Appendix

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