Analyst

Khalil Belhimeur, +65 6427 5125
Standard Chartered Bank, Singapore
Fixed Income Strategist
Khalil.Belhimeur@standardchartered.com

Vietnam – Rise in yields unsustainable

09:00 GMT 30 March 2009

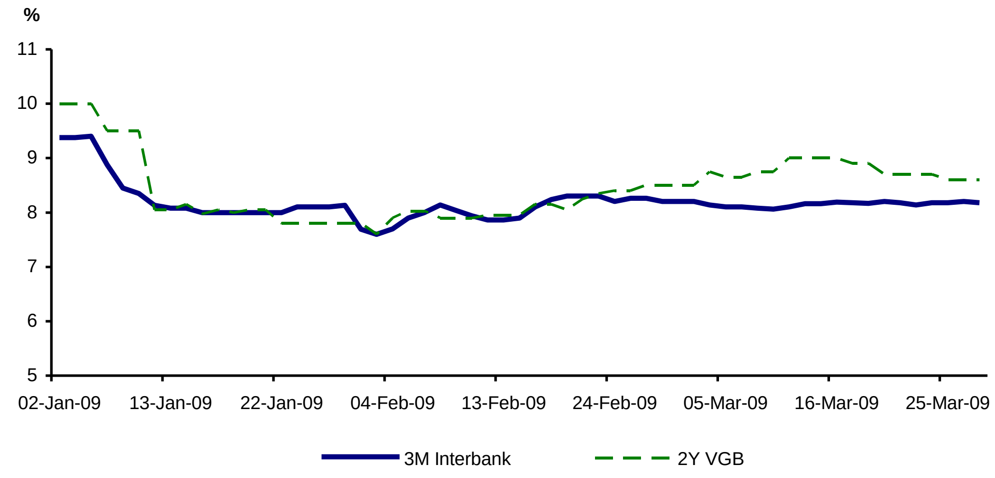
- Liquidity squeeze pushing bond yields higher
- Supply concerns could be overdone
- Demand for bonds to re-emerge on back of slowing economy and return of liquidity

Houdini-like liquidity

After starting the year on a bullish note, fuelled by an aggressively-easing SBV and flush market liquidity, the Vietnam local bond market has witnessed a correction. The 2Y and 5Y T-bonds have come off their respective YTD lows of 7.60% and 7.95%, and are now trading higher by around 100bps.

The main culprit behind this trend reversal has been the tightening liquidity. The Tet holiday, which is characterised by increased consumption-driven credit demand, squeezed funds out of the banking sector. Liquidity was expected to gradually come back into the system. This scenario has, however, proven slow to materialise. With low interest rates and a bearish outlook on the VND, funds may have been converted to USD and other assets. As a response to the increasingly tight liquidity, banks (the most prominent bond investor class) started offloading their bond holdings. With few buyers in the market, bid-ask spreads widened and secondary market trading activity deteriorated.

Chart 1: Liquidity driving bond yields



Source: SCB Global Research

Understanding the situation, the State Bank of Vietnam (SBV) stepped in to provide much-needed liquidity via open market operations (OMOs). More specifically, the central bank had as much as VND 17.2trn lent out to the banking system at the peak of the liquidity squeeze in the second half of February. It has done so at a reduced reverse repo rate (RRP) of 7.5% - the RRP stood at 8% before the Tet holiday. Furthermore, the central bank also opted to cut reserve requirements on deposits of less than 1Y to 3% from 5% towards the end of February. This measure helped release approximately VND 20-30trn back into the banking system. The various steps taken by the central bank are showing signs of success, with interbank rates, whilst remaining volatile, slowly trending downwards.

Fiscal stimulus and how to unlock a credit market

The Vietnamese government has made credit growth a top priority, establishing an initial target for outstanding loan growth of 20% for 2009. In order to meet that target, the government removed the lending rate cap (previously 1.5x the base rate) on consumer loans so as to allow a more market-driven pricing. Additionally, the central bank has also decided to guarantee bank loans to qualifying SMEs, allowing them to gain access to cheaper funding. More importantly, the first tranche (USD 1bn) of the government's USD 6bn fiscal stimulus has been utilised so as to make credit cheap and available to specific sectors of the economy (mostly SMEs). Specifically, the implementation of an interest rate subsidy at the beginning of February, through which the government subsidises interest payments (capped at 4% per annum) has been credited for the VND 179trn surge in gross lending (up to 26 March).

This development was initially deemed to be bond negative given that the loan and bond markets compete for finite funds. This was also advanced as one of the main reasons behind the tight market liquidity. While on the surface this view is seemingly well founded, digging slightly deeper reveals a different perspective. The growth in loans outstanding for the month of February came in at a relatively small 0.23% m/m (0.52% in January). This figure highlights the fact that while gross loans have been surging, the actual net increase has been much smaller. With only loans underwritten after the implementation of the subsidy qualifying for the interest rate support programme, most qualifying companies have opted to refinance their loans in order to take advantage of the scheme. As such, the recent surge in gross loans should not be seen as main driver behind the tightening liquidity, and could very well be a temporary development. Moreover, with economic activity expected to slow further, a sustainable surge in net credit growth is not seen as plausible in the medium term.

In theory, the subsidising of interest rate payments is an effective way of stimulating the credit market. However, the apparent manner in which companies have been utilising the support programme does not serve its underlying purpose, namely promoting economic activity. Moreover, rumours regarding SMEs borrowing at a low cost (on the back of the subsidy) only to place the funds back into the banking system (mostly in the form of deposits) so as to make money via the positive carry, are also a cause for concern.

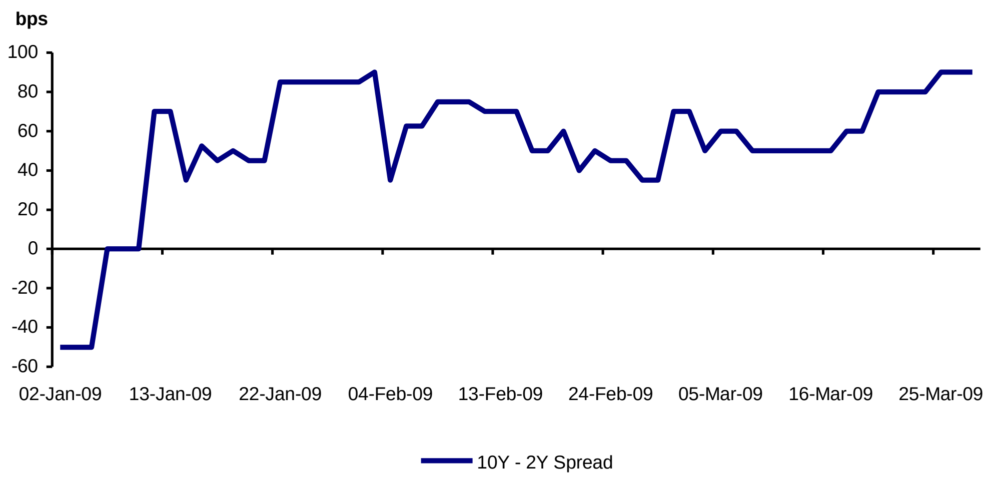
Need for government spending

The Vietnamese economy is still growing, with Q1-09 GDP growth coming in at 3.1% y/y. The government's target of an annual growth of 6.5% seems, however, highly ambitious. International trade figures, while showing signs of bottoming, remain dismal. Vietnam, with an approximate export to GDP ratio of 0.75, remains vulnerable to capricious overseas consumption. While some might take solace in seeing the country report a positive trade balance, this development actually further highlights a slowdown in domestic consumption. Moreover, the country's industrial production has reportedly printed a 2.1% y/y growth for Q1-09, the slowest growth registered since 1990, further illustrating the deterioration in economic activity.

Support from international investors is also drying up. FDI figures have plunged, with the government having reported a year-on-year drop of 70% for Q1. Capital outflows in the financial markets have also been considerable as foreign holdings of both stocks and bonds have evaporated. Understandably, this is a common theme throughout the region, with the surge in global risk aversion and the previously bearish AXJ currencies. Moreover, given the restrictive capital controls and low yields currently expected on Vietnamese investments (due to weakening economy and relatively low interest rates), the inflow of foreign investors back into the local economy does not appear forthcoming in the near term.

The need for increased government spending is thus evident. Accordingly, the government is reportedly expected to spend around USD 17bn in the current year to revive the economy. While a fiscal stimulus of USD 6bn has been approved, only USD 1bn has been implemented (through the interest subsidy) so far. The balance is expected to finance various infrastructure projects and allow for tax cuts. The sheer size of the planned spending has raised concerns regarding the financing of the budget gap, given the expected decline in government revenues. This has been one of the reasons behind the recent steepening of the bond yield curve (see Chart 2). Having already approved a net bond supply of VND 36trn for 2009, the National Assembly is expected to raise that ceiling to VND 55trn (VND 110trn gross) at its next session in May.

Chart 2: Steepening bias on the back of supply concerns



Source: SCB Global Research

The disconnect between official targets and realised scenarios

While the government's target issue amount is large, the actual amount issued will probably end up being smaller. This is seemingly a recurring theme, as the State Treasury had initially planned to issue around VND 90trn but only managed to actually borrow VND 49trn from the capital market in 2008. This was also the case for the Q1-09 issuance schedule. The government had reportedly stated its plan to issue VND 22trn during that time frame, but has so far only managed to issue a meagre VND 2.6trn.

The three main reasons behind this disconnect between government targets and actual figures are the following:

- Aggressive ceilings at primary auctions: since the beginning of the year, the government has frequently capped the stop-out rates at its auctions at below its policy rate of 7%. Market participants, on the other hand, continued to bid in line with secondary market levels. As such, no uptake is viable under those conditions. It is worth noting that the rationale behind the government aggressively capping yields is not only due to its will to keep its borrowing costs low, but also the fear of having bond yields rise above commercial lending rates, thus making bonds more attractive and diverting funds away from the credit market.

- While the government accumulates funds, disbursements have not materialised: the State Treasury has reportedly accumulated over VND 300trn in funds between 2003-2008, but has only disbursed VND 65trn during that time span. With rampant inflation at the time, the government had opted to not implement some of its projects in order to avoid adding to an already over-heating economy. As such, the government's need to raise funds during 2009 remains unclear.

- The USD alternative: while VND liquidity has been tight in the recent past, USD liquidity has been improving with market players preferring to hold the hard currencies. However, given FX controls, investment outlets for USD holdings are limited. As such, the USD-denominated government bonds attracted healthy demand. The government has thus opted to auction a three-tranche USD 300mn (USD 230.1mn issued) bond at a highly appealing price (3% for 1Y, 3.2% for 2Y and 3.6% for 3Y) – at leas in the domestic context. Note that market interest remained strongest in the shorter tenors.

As such, while supply concerns are founded on official government discourse, the amount of VND-denominated bonds to be issued through 2009 will likely be smaller than the target amount currently being advanced.

Where to from here?

The central bank has opted to leave its policy rate steady at 7% for the month of April. With inflation easing for a seventh consecutive month and an economic recovery not expected until at least the second half of this year, the need to hike rates is currently not present. Further monetary easing is, however, still plausible with the interest rate support programme potentially not providing the anticipated boost to economic activity. The added pressure that further rate cuts could place on an already-weakening VND and a banking system mired by high operational costs are reasons behind SBV's current aversion to cutting rates. Moreover, the potential of seeing inflationary pressures re-emerge (mostly in the form of imported inflation, given the weakening VND) in the latter part of the year is also a source for concern.

While interest rate cuts would be the obvious development to steer bond yields lower, the return of liquidity constitutes a more subtle driver of the return of a bullish mood in the local bond market. Liquidity is currently easing, with participation at OMOs dwindling and the O/N rate slowly dropping. More importantly, with commercial lending rates currently capped at 10.5%, the spreads offered over government bonds is seemingly low. Hence, the appeal of the loan market is in question. Furthermore, with economic activity not expected to pick up in the medium term, the demand for loans could also dry up. As such, banks could find themselves with excess funds and limited attractive investment outlets, which was the case at the beginning of the year. We are thus of the view that it is but a matter of time before local bond yields re-embark on their easing trend, favouring the short end of the curve – given that the 'unrealistic' supply concerns discussed previously will hinder the illiquid longer tenors, while we also expect the term premium to remain large on the back of an anticipated economic recovery.

Disclosures Appendix

Regulatory disclosure

Subject companies: **--**

Standard Chartered Bank and/or its affiliate(s) has received compensation from this company for the provision of investment banking or financial advisory services within the past year: **--.**

Global disclaimer

SCB makes no representation or warranty of any kind, express, implied or statutory regarding this document or any information contained or referred to on the document.

If you are receiving this document in any of the countries listed below, please note the following:

United Kingdom: Standard Chartered Bank ("SCB") is authorised and regulated in the United Kingdom by the Financial Services Authority ("FSA"). This communication is not directed at Retail Clients in the European Economic Area as defined by Directive 2004/39/EC. Nothing in this document constitutes a personal recommendation or investment advice as defined by Directive 2004/39/EC.

Australia: The Australian Financial Services Licence for SCB is Licence No: 246833 with the following Australian Registered Business Number (ARBN : 097571778). Australian investors should note that this document was prepared for wholesale investors only (as defined by Australian Corporations legislation).

China: This document is being distributed in China by, and is attributable to, Standard Chartered Bank (China) Limited which is mainly regulated by China Banking Regulatory Commission (CBRC).

Hong Kong: This document is being distributed in Hong Kong by, and is attributable to, Standard Chartered Bank (Hong Kong) Limited which is regulated by the Hong Kong Monetary Authority.

Japan: This document is being distributed to the Specified Investors, as defined by the Financial Instruments and Exchange Law of Japan (FIEL), for information only and not for the purpose of soliciting any Financial Instruments Transactions as defined by the FIEL or any Specified Deposits, etc. as defined by the Banking Law of Japan.

Singapore: This document is being distributed in Singapore by SCB Singapore branch only to accredited investors, expert investors or institutional investors, as defined in the Securities and Futures Act, Chapter 289 of Singapore. Recipients in Singapore should contact SCB Singapore branch in relation to any matters arising from, or in connection with, this document.

South Africa: SCB is licensed as a Financial Services Provider in terms of Section 8 of the Financial Advisory and Intermediary Services Act 37 of 2002. SCB is a Registered Credit provider in terms of the National Credit Act 34 of 2005 under registration number NCRCP4.

UAE (DIFC): SCB is regulated in the Dubai International Financial Centre by the Dubai Financial Services Authority. This document is intended for use only by Professional Clients and should not be relied upon by or be distributed to Retail Clients.

United States: Except for any documents relating to foreign exchange, FX or global FX, Rates or Commodities, distribution of this document in the United States or to US persons is intended to be solely to major institutional investors as defined in Rule 15a-6(a)(2) under the US Securities Act of 1934. All US persons that receive this document by their acceptance thereof represent and agree that they are a major institutional investor and understand the risks involved in executing transactions in securities. Any US recipient of this document wanting additional information or to effect any transaction in any security or financial instrument mentioned herein, must do so by contacting a registered representative of Standard Chartered Securities (North America) Inc., 1 Madison Avenue, New York, N.Y. 10010, US, tel + 1 212 667 1000.

WE DO NOT OFFER OR SELL SECURITIES TO U.S. PERSONS UNLESS EITHER (A) THOSE SECURITIES ARE REGISTERED FOR SALE WITH THE U.S. SECURITIES AND EXCHANGE COMMISSION AND WITH ALL APPROPRIATE U.S. STATE AUTHORITIES; OR (B) THE SECURITIES OR THE SPECIFIC TRANSACTION QUALIFY FOR AN EXEMPTION UNDER THE U.S. FEDERAL AND STATE SECURITIES LAWS NOR DO WE OFFER OR SELL SECURITIES TO U.S. PERSONS UNLESS (i) WE, OUR AFFILIATED COMPANY AND THE APPROPRIATE PERSONNEL ARE PROPERLY REGISTERED OR LICENSED TO CONDUCT BUSINESS; OR (ii) WE, OUR AFFILIATED COMPANY AND THE APPROPRIATE PERSONNEL QUALIFY FOR EXEMPTIONS UNDER APPLICABLE U.S. FEDERAL AND STATE LAWS.

Regulation AC Disclosure:

The research analyst or analysts responsible for the content of this research report certify that: (1) the views expressed and attributed to the research analyst or Analysts in the research report accurately reflect their personal opinion(s) about the subject securities and issuers and/or other subject matter as appropriate; and, (2) No part of his or her compensation was, is or will be directly or indirectly related to the specific recommendations or views contained in this research report. On a general basis, the efficacy of recommendations is a factor in the performance appraisals of analysts.

Data available as of 12:00 GMT 27 March 2009. This document is released on 09:00 GMT 30 March 2009.

Document approved by: Brian Verlaan, Head of Fixed Income Research