Vietnam Macro View

Don’t Ignore VND Bonds - Long the Dong

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- **Unlike other frontier markets, VND bond market is still regarded as a pariah** among foreign investors. We cite four reasons: 1) the trauma of the 2008 bond market crisis; 2) lingering (we argue somewhat misplaced) worries about dong depreciation risk; 3) poor liquidity and small size of the market; and, 4) fiscal solvency concerns on the back of the uncertainly large contingent liabilities from the troubled banking/SOE sector. However, the fourth issue is inconsistent with the fact we see good foreign appetite for dollar denominated Vietnam sovereign bonds.

- **We recommend going long dong via VND government bonds**. We have continued to favor VND bonds in our 2013 Outlook mainly because we are constructive on the dong – we believe it will remain largely stable through our forecast period though appreciation capped by SBV’s intervention. Inflation/fiscal risks linger, but we believe remains manageable – with scant foreign positioning and the steep curve, we recommend 3yr bonds for an after tax yield of 8.1%.

- **We think the outlook for VND has structurally changed**. We think there are four major fundamental developments that have shifted the outlook for the dong, significantly reducing depreciation risk: First, the glacial pace of bank restructuring continues to impair the transmission of easing liquidity and low rates into domestic credit – reluctant to lend, banks instead parking their excess liquidity to bonds, capping domestic/import growth. Second, Vietnam’s exports are *booming* – there has been a very dramatic change in export structure with the rise of high-tech production base – high-tech exports have almost doubled in 2012 to now account for Vietnam’s largest export item. Capped domestic growth and booming exports have *turned VN’s current account into a sizeable surplus in 2012 which we think will persist in 2013-2014F*. Third, long term capital flows such as FDI and official loans have remained resilient, further adding to the structural external surpluses. Fourth, driven by structural external inflows, FX reserves have surged by ~70% last year – and we think will continue to rise, boosting confidence in the dong.

- **Main risks: gross policy errors of over-easing & escalation of a banking crisis**. Our biggest concern is that protracted slow growth may lead to more excessive than expected policy easing (we are still forecasting 100bps rate easing this year) that could unhinge sentiment on the dong, though we take comfort in government already significantly downgrading their growth expectations to 5.5% in 2013F. With 40% of the CPI basket being food, another risk is a significant inflation spike on food supply issues alongside easing bias eroding dong confidence. Lastly, a dramatic erosion of confidence in the banking system and fiscal solvency could be another risk factor, though it’s not clear to us how this necessarily transmits to a sell-off in dong and government bonds amid domestic financial repression and the absence of offshore portfolio flows.

Don't Ignore VND Bonds – Long the Dong

The most ignored local bond market in Asia

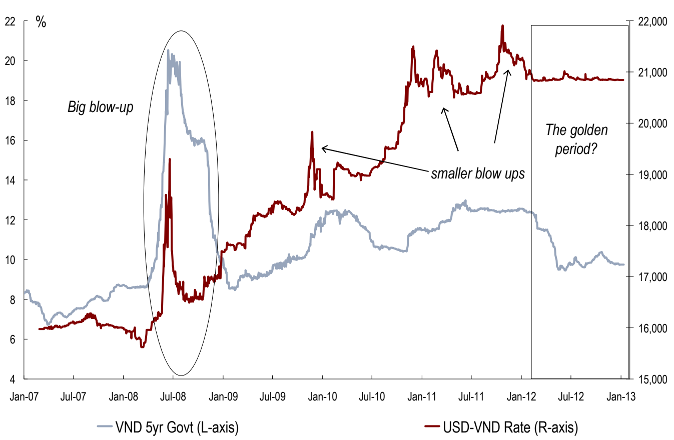
Setting a lower growth target this year and next is seen as a shift away from a heavily pro-growth policy bias…

In a piece we published in November - ***Asia Macro and Strategy Outlook - Prospects for 2013*** - one of our local bond market themes for 2013 was to favor frontier local government bond markets like Sri Lanka and Vietnam, with our particularly more positive view about sustained stability in the Vietnamese dong (VND). Despite a far weaker external position, and weaker sovereign credit risk metrics (as highlighted by the spread premium of Sri Lankan dollar bonds to Vietnam), Sri Lanka local Treasury bonds (and other EM frontier markets globally) has garnered significant foreign interest – while Vietnam dong-denominated government securities has remained an investor pariah for more than four years. We attribute this foreign aversion to four factors:

- **The trauma of the 2008 bond market crisis** – The crisis emanated from too much hot money flowing into Vietnam in 2007 to early 2008, and SBV's unsterilized FX intervention to maintain the dong peg plus macro policies that were too lax precipitated a classic inflation overheating/credit boom, exacerbated further by the sharp rise in global commodity prices. This prompted a sharp reversal in portfolio flows, but because the dong bond/FX market were small and very illiquid, exiting positions resulted in dramatic losses as spot FX and bond yields overshot (see Figure 1).

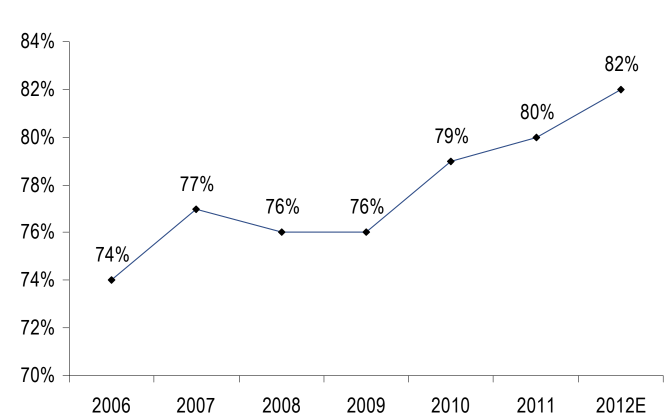
- **Lingering (we believe misplaced) worries about dong depreciation risk** – While the dong has been stable with a bias towards appreciation if not for SBV's intervention over the last year, we think the reputational damage of previous macro policy-mismanagement still lingers. Even after the 2008 Vietnam market crisis, the government made a series of policy errors in 2009-2010 that resulted in another round of credit boom and mini FX flare-ups, this time driven by domestic capital flight – which was only reversed by Resolution No. 11 in 2011. While we think *domestic* confidence in the dong has improved substantially since then – as can be seen by the sharp rise in proportion of bank deposits held in dong – foreign institutional investor perception may be taking longer to turn. They may perceive a 7.3%-8.1% after tax yield on 1-3yr VND bonds as insufficient to compensate for the risk.

Figure 1. VND 5yr bond yields and USD-VND Market Rate



Source: CEIC, Citi Research

Figure 2. Vietnam – Proportion of bank deposits held in VND



Source: State Bank of Vietnam (cited by WB's *Taking Stock Report* in Dec 2012).

- **Poor liquidity and small size of the market, so why bother?**– Compared to other frontier markets like Sri Lanka, Vietnam bond market is even smaller – outstanding VND Treasury bonds is only about $9.68bn or <7% of Vietnam's GDP, which is only now about half the size of the LKR Treasury bond market in nominal terms (34% of Sri Lanka's GDP). Vietnam has a tiny T-bill market (<$800mn) versus $5-6bn in Sri Lanka. Moreover, Vietnamese banks are big buyers of VND government securities given lack of lending appetite – this further reduces secondary market liquidity – bid-ask spread for the more liquid VND bonds of a typical size of $2.5mn is 30bps, while one can trade $50mn LKR bonds with bid-ask of 10bps. On the other hand, one important distinction between Vietnam and Sri Lanka is there is no foreign quota in Vietnam, and as far as we are aware, hardly any foreign positioning.

- **Fiscal concerns on the back of uncertain outlook on contingent liabilities emanating from the banking and SOE sector.** Vietnam's biggest source of fiscal risk is the contingent liabilities from the banking sector. Some analysts believe the NPL ratio is the 15-20% range, which is a contingent liability to the government. However, as the banking sector problem is largely a domestically funded problem with limited external funding reliance and significant capital account restrictions – we believe the lack of "market pressure" may allow the government to take its time to recapitalize the banks as long as the economy can grow and depositor faith in the domestic banking system and the government's blanket deposit guarantee remains largely intact. Nonetheless, *if bank sector problem is truly a sovereign insolvency problem – which we don't think is the case – then why are Vietnam dollar bonds and CDS spreads trading where they are*? Notwithstanding technical factors, there is something internally inconsistent with foreign aversion to dong bonds, but good foreign appetite for dollar-denominated Vietnam sovereign paper.

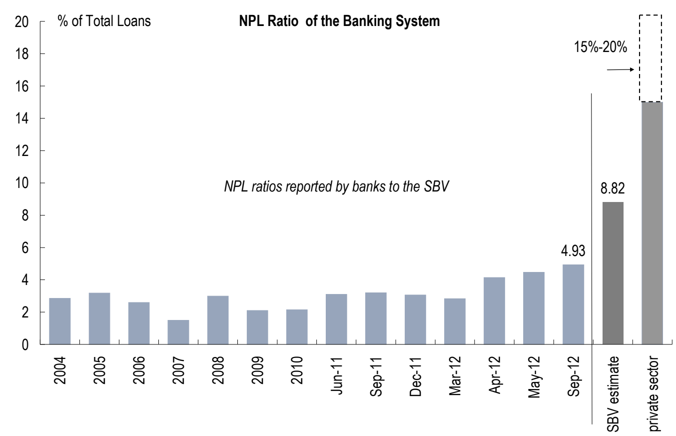
Figure 3. VND Government Bond Market is far more illiquid than peers

		PRC	HK	IN	ID	KR	MY	PH	SG	TH	VN	Regional
Typical Bid–Ask Spread On-the-Run (bps)	Average	2.7	6.4	0.6	6.6	0.6	2.7	2.1	3.1	3.2	30.5	5.8
	Count	19	7	5	21	11	11	16	9	13	5	117
	SD	1.3	2.5	0.5	2.0	0.2	1.2	2.3	0.8	1.5	9.4	8.9
Typical Bid–Ask Spread Off-the-Run (bps)	Average	4.5	8.1	2.7	11.6	1.0	4.6	11.7	3.6	5.9	40.5	9.4
	Count	16	6	5	13	11	10	16	7	13	5	102
	SD	2.7	4.1	1.2	5.4	0.3	2.2	8.6	1.9	2.0	12.0	11.5
Accepted LCY Bond Transaction Size On-the-Run (US$ million)	Average	23.2	7.3	1.7	1.8	6.5	10.0	3.0	7.9	4.7	2.4	6.9
	Count	20	6	5	17	11	12	16	9	13	5	114
	SD	22.0	3.2	1.7	1.2	4.6	6.4	2.8	6.4	8.4	1.2	6.4
Accepted LCY Bond Transaction Size Off-the-Run (US$ million)	Average	18.5	5.4	1.7	5.3	8.4	7.3	1.4	7.6	2.1	2.4	6.0
	Count	16	5	5	13	10	11	16	8	13	5	102
	SD	20.0	2.3	1.7	11.2	3.1	4.6	0.6	6.2	1.7	1.8	5.1

bps = basis points; HK = Hong Kong, China; ID = Indonesia; IN = India; KR = Republic of Korea; LCY = local currency; MY = Malaysia; PH = Philippines; PRC = People's Republic of China; SD = standard deviation; SG = Singapore; TH = Thailand; VN = Viet Nam.
Note: The bid–ask spreads for Indonesian treasury bonds presented above are expressed in terms of yields or basis points to make them comparable with bid–ask spreads in other Asian markets. Bid–ask spreads for government bonds are most often expressed in terms of "cents" in the Indonesian market. In our 2012 survey, the average treasury bond bid-ask spread was 38.8 cents.

Source: AsianBondsOnline 2012 LCY Bond Market Liquidity Survey

Figure 4. NPL Ratio of The Vietnam's Banking System



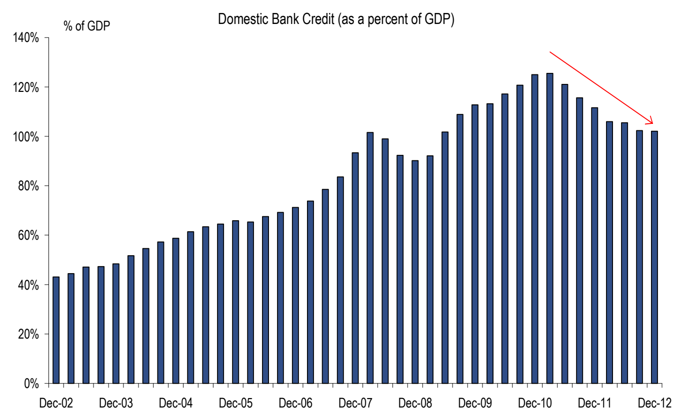
Source: State Bank of Vietnam (cited by World Bank's **Dec 2012 Taking Stock** report)

We think VND outlook has structurally changed

We believe that dong will remain stable vis-à-vis the USD throughout this year. If not for SBV's active intervention to maintain the USD-VND within the band, the dong would have even appreciated. We see the risks to the dong as largely sustaining an asymmetric bias towards appreciation – a change from pre-2012 pattern given four fundamental factors that will likely persist this year:

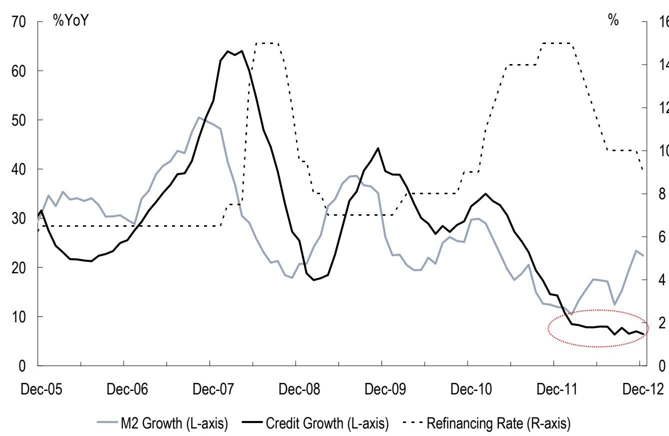
- **With unresolved balance sheet issues in the banking system, the pressure for Vietnamese banks to de-lever remain strong, impairing credit intermediation.** We think the slow progress in bank restructuring will continue to drag down potential growth and the ability and willingness of banks to lend, regardless of the credit growth targets set by the government. We think unresolved banking sector issues impair the transmission of low rates and loose liquidity to inducing credit-fueled demand/overheating risk – a departure from the past. Instead, banks have been parking their rising excess liquidity into government bonds.

Figure 5. Vietnamese banks are undergoing pressure to de-lever their balance sheet from the previous excesses



Source: Citi Research

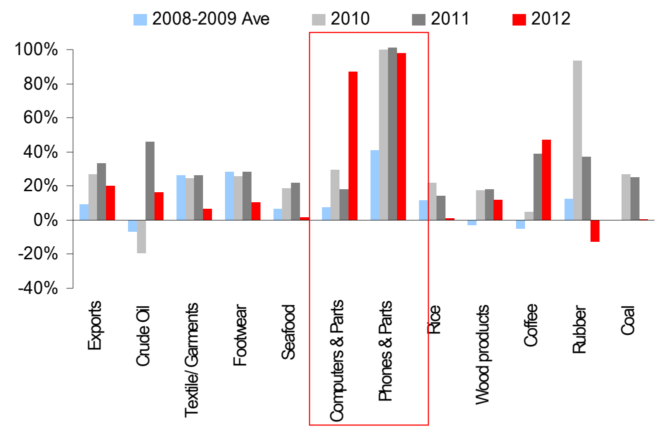
Figure 6. Despite significant rate and liquidity easing, credit intermediation is broken, i.e. banks are reluctant to lend



Source: Citi Research

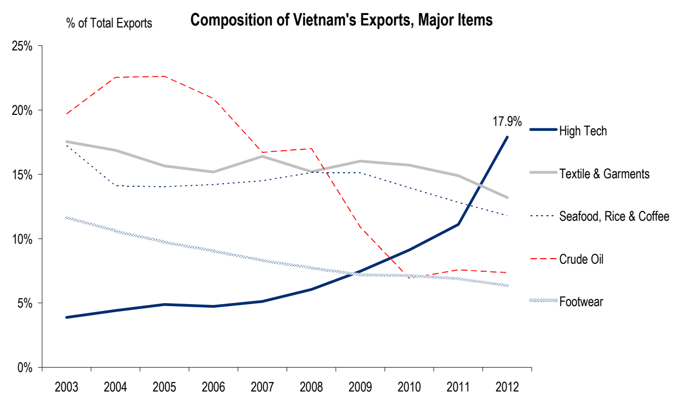
- **A dynamic and dramatically changing export sector, alongside slow domestic growth, has led to a big shift in the trade and current account balance.** Vietnam's exports, up 20% YoY in 2012, have been the best performing in the region. A big driver of this has been dramatic changes in the structure of Vietnam's exports, due to FDI-driven production relocation diversification, creating Vietnam's high tech production base. Computers- and phone-related tech exports — latter especially due to Samsung — saw an impressive 87% YoY and 98% YoY growth, respectively, in 2012. High-tech exports now account for the largest component of Vietnam's exports, eclipsing textile and garments for the first time in history (see Figure 8). It's also worth noting that Vietnam's other non-tech exports have fared reasonably well vis-à-vis peers, indicating lingering competitiveness in the manufacturing sector.

Figure 7. Vietnam – Export Growth by Major Items (%YoY)



Source: Citi Research

Figure 8. Dramatic changes in the composition of Vietnam's Exports



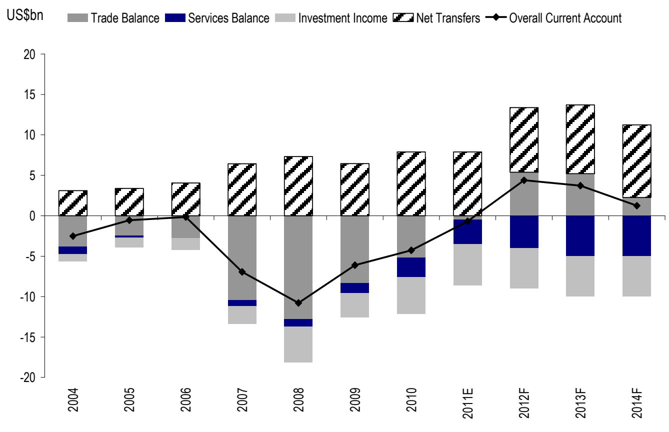
Source: CEIC, General Statistical Office, WB, Citi Research

We've revised up our current account forecasts for 2012-2014F to take into account the better than expected trade and remittance flows that will likely precipitate a sizeable current account surplus of 3.2% of GDP in 2012 (see Figure 9). We think this surplus will narrow over time as domestic economy gradually recovers, but a surplus could be maintained until 2014F, as domestic recovery will likely be capped by the ongoing delay in bank sector restructuring.

- **Access to long term capital flows, be it via net FDI and official loans, has remained resilient throughout the years, adding to structural external surpluses.** Despite sharply slower domestic growth, we believe net FDI flows have not collapsed. While FDI commitments have come down substantially and have declined relative to GDP, net FDI disbursals have remained sticky at about $7bn annually with a dramatic shift in composition over the years – away from construction/real estate-related and domestic-demand, into manufacturing-related FDI as companies seek to diversify production base and offset structural cost-push pressures in countries like China. Thus, when coupled with a CA surplus, Vietnam has seen a persistently large basic balance surplus – around 8% of GDP in 2012 – potentially the largest in Asia next to Singapore. Vietnam also still enjoys access to concessional lending from official donors – which recently pledged $6.5bn in 2013 in the last donor meeting. While ODA pledges have been coming down, we think a lot of this has to do with inability to tap the pledged commitments. We still believe net long term loans from official sources will remain an important, though diminishing support to Vietnam's capital flows.

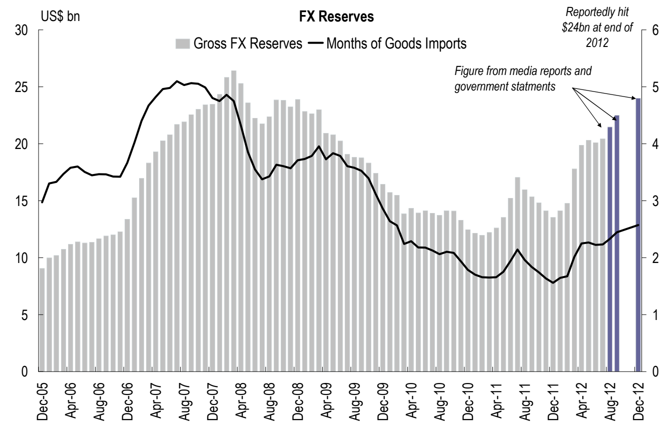
- **Improving foreign currency reserve buffer should bolster confidence in SBV's ability to defend the dong.** We don't think Vietnam's reserve accumulation tack will end anytime soon – while reserve coverage over short-term external liabilities has improved significantly to high levels, FX reserves over M2 is still very low – only about 15% of M2 (up from 11% in end of 2011). Given risk to domestic confidence in the local financial system, we believe targeting a higher FX reserves/M2 is desirable and we suspect SBV will continue with its reserve accumulation drive this year.

Figure 9. Vietnam's current account has likely shifted to a surplus last year which we expect will persist in 2013-2014F



Source: CEIC, Citi Research, IMF

Figure 10. Vietnam's FX reserves have risen dramatically and we see this persisting in 2013-14



Source: IMF IFS, Various news reports, Citi Research

Risks to Consider

While we are more confident about the outlook for the dong stability this year and possibly longer, there are three main risks that could alter this benign view.

First, protracted slow growth may push for a faster and more aggressive and imprudent policy easing bias – both monetary and/or fiscal – than what we expect. Such a move could be risky if the lagged impact of aggressive easing fuels stronger than expected demand, inflation pressures, reignites trade/current account imbalances and a loss of confidence over the government's commitment to macro stability. We could then see a replay of some forms of domestic capital flight (a la 2009-2010) that resulted in large negative "errors and omissions" in the BoP driving dollar shortage vis-à-vis the dong.

This is probably our biggest concern, but we think the risks are manageable: First, we take comfort that the government has already revised down their growth target this year at 5.5% – a reasonably prudent level – which we think is achievable as long as decent agri output and solid export performance persists. Second, while there is always some headline noise of officials wanting to lower lending rates it should be pretty clear that what impairs lending goes beyond cyclical policies but must require structural reforms in the banks which has barely advanced. Third, we don't expect inflation will come down that much (we expect in the 6.5-7.5% range) and, thus, the optics may hopefully help act as a barrier to overly imprudent easing (and another 100-200bps cut may not be so destabilizing as this still brings dong deposit ceiling rate at 400bps above the dollar deposit ceiling rate at a time when Vietnam's external accounts have improved dramatically), and Fourth, while there has been a concerted push to use fiscal policy via various tax relief measures to support growth, this hasn't been accompanied by aggressive public investment spending and the overall financing of the deficit seem manageable. Local bond issuances to fund fiscal easing efforts have been more than absorbed by the banking sector.

Second, inflation volatility from major commodity spike – for example via a major drought – alongside policy easing creates overheating concerns. With 40% of Vietnam's CPI basket tied to food, inflation is sensitive to big commodity price shocks. So far, however, cost push pressures from various administered price

adjustments (e.g. in electricity, fuel, tuition and health service fees we saw last year) did not yield any sustained second-round demand-driven effects given slow growth. However, a big enough shock coinciding with the lagged impact of policy easing could change the picture on inflation and dong expectations.

Third, a loss of confidence in the banking system and fiscal solvency – this could come via some disastrous wave of unanticipated systemic defaults or serious banking and SOE scandals. While we are likely to get negative headlines on rising bank NPLs throughout this year, we think it is unlikely we will see some systemic bank run in Vietnam. We already saw a preview last year of how a major bank scandal involving a personality tied to a systemically important joint stock bank did not create a depositor flight given SBV's liquidity support and credible deposit guarantees from the government. There is no conduit via banks' external funding to also cause a liquidity crunch. SOEs have already been under increasing scrutiny since the Vinashin default in 2010, and while accounting irregularities and undisclosed losses can be revealed further, we think the government has sufficient leeway towards regulatory forbearance. With lingering capital account restrictions and financial repression on domestic residents, we think banking sector noise will not necessarily transmit to some dramatic sell-off in the Vietnamese dong or the government bond markets in the absence of offshore portfolio flows.

Market Outlook

We expect dong to remains stable vis-à-vis the USD throughout out forecast period with limited depreciation risk. Despite improving external accounts, we think SBV still has a strong incentive to intervene and build precautionary reserves, and thus, we don't see the dong appreciating (unless Vietnam sees significant portfolio flows). However, we also don't see significant depreciation risk either – a deliberate devaluation is highly unlikely given authorities' concern about the damaging impact this will do to the confidence in the dong after the 2008-2010 episode, which would also be politically unpalatable and unnecessary given booming exports. Meanwhile, market-driven dong depreciation will likely only materialize if officials pursue a series of gross policy mismanagement – but we believe the lessons from the last crisis will (hopefully) lead them to be more prudent.

Even after the rally we've seen in 2012, we believe VND bonds still provide attractive carry. Given manageable inflation risk (our base case barring a food supply shock) and steep curve, we would recommend extending duration slightly to the three-year point, where on an after-tax basis (note: WHT was cut from 10% to 5% a year ago, there is a 0.1% transaction tax), government bonds would still give you an 8.1% carry, which one can access via CLN or TRS if accessing directly is too cumbersome.

Appendix: Vietnam Macro Indicators

Figure 11. Vietnam Economic Indicators

	2006	2007	2008	2009	2010	2011	2012F	2013F	2014F
Vietnam									
Nominal GDP, US$ bn	60.9	71.2	90.0	91.9	102.4	121.6	139.0	156.6	175.4
Nominal GDP, local currency bn	974,266	1,143,715	1,485,038	1,658,389	1,980,914	2,535,000	2,897,764	3,265,067	3,682,996
GDP per capita, US$	724	836	1,044	1,054	1,163	1,366	1,544	1,722	1,910
Population, mn	84.1	85.2	86.2	87.2	88.1	89.0	90.0	90.9	91.8
Unemployment, % of labour force	4.8	4.6	4.7	4.6	4.3	3.6	4.0	4.0	4.0
Economic Activity									
Real GDP, % yoy	8.2	8.5	6.3	5.3	6.8	5.9	5.0	5.4	5.8
Real investment growth % yoy	11.8	26.8	6.3	4.3	10.4	-9.2	4.4	4.9	--
Real consumption growth % yoy	8.4	10.6	9.2	3.5	10.2	4.7	6.0	5.9	--
private consumption growth % yoy	8.3	10.8	9.3	3.1	10.0	4.4	5.9	6.0	--
Real export growth, % yoy	17.6	16.0	15.1	-6.0	--	--	--	--	--
Real import growth, % yoy	18.8	28.1	15.4	-6.4	--	--	--	--	--
Prices, Money & Credit									
CPI, % yoy	6.6	12.6	19.9	6.5	11.7	18.1	6.8	7.5	6.5
CPI, % avg	7.5	8.5	23.2	7.0	9.2	18.6	9.3	7.2	7.0
Nominal wages, % yoy	18.1	21.4	15.0	12.0	9.6	19.6	14.0	12.0	12.0
Credit extension to private sector, % yoy	25.5	53.9	19.7	37.8	28.0	10.9	6.5	10.0	10.0
Policy interest rate, % eop	6.50	6.50	9.50	8.00	9.00	15.00	9.00	8.00	8.00
1 month inter-bank rate, % eop	8.04	7.55	7.95	10.49	12.23	13.58	9.00	8.00	8.00
Long term yield, % eop	8.29	8.73	10.00	11.68	11.50	12.55	9.75	10.00	10.00
lc/US$, eop	16056	16028	17483	18474	19498	21034	20840	20850	21000
lc/US$, avg	15990	16081	16445	17806	19123	20648	20875	20850	21000
Balance of Payments, US$ bn									
Current account	-0.2	-7.0	-10.7	-7.2	-4.3	-0.7	4.4	3.7	1.2
% of GDP	-0.3	-9.8	-11.9	-7.8	-4.2	-0.6	3.2	2.4	0.7
Trade balance	-2.8	-10.4	-12.8	-8.3	-5.1	-0.5	5.4	5.2	2.2
Exports	39.8	48.6	62.7	57.1	72.2	96.9	114.5	133.9	150.3
Imports	42.6	58.9	75.5	65.4	77.3	97.4	109.1	128.7	148.0
Service balance	0.0	-0.8	-0.9	-1.2	-2.5	-3.0	-4.0	-5.0	-5.0
Income balance	-1.4	-2.2	-4.4	-3.0	-4.6	-5.1	8.0	8.5	9.0
FDI, net	2.3	6.6	9.3	6.9	7.1	7.3	7.2	7.2	7.2
International reserves	13.4	23.5	23.9	16.4	12.5	13.8	23.6	33.7	36.2
Total Amortisations	1.2	1.4	1.5	1.5	2.0	2.3	2.5	2.0	2.0
Public Finances, % of GDP									
Consolidated government balance	-1.1	-5.3	-1.2	-7.2	-3.1	-3.2	-5.2	-3.8	-4.0
Consolidated gov primary balance	-0.3	-4.2	-3.7	-7.5	-1.8	-1.8	-3.6	-2.5	--
Public debt	37.5	39.0	34.9	40.0	45.5	45.9	44.2	43.8	44.3
of which Domestic	11.9	12.6	13.0	16.0	19.2	19.6	20.0	19.8	20.1
Foreign Assets & Liabilities, US$ bn									
External debt	19.1	23.1	32.4	37.3	44.5	49.3	54.7	59.8	70.0
Private	4.5	3.1	6.5	9.3	10.6	10.9	11.5	11.3	40.5
Public	14.6	20.0	25.9	28.0	33.9	38.4	43.2	48.5	29.5
External debt / GDP	31.4	32.5	36.0	40.6	43.4	40.5	39.4	38.2	39.9
External debt / XGS	42.6	42.2	46.2	59.4	56.0	58.8	56.0	52.5	51.2
Short-term debt	2.6	4.6	6.3	5.8	6.8	5.9	6.2	6.8	7.9
Short-term debt/International Reserves (%)	19.1	19.7	26.2	35.0	54.6	42.6	26.1	20.1	21.9

Quarterly Economic Indicators

	2012 Q1	2012 Q2	2012 Q3	2012 Q4	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F
GDP, % yoy	4.1	4.7	5.4	5.5	5.3	5.5	5.4	5.5	6.0
CPI, % yoy	15.4	6.9	6.5	6.8	6.3	7.8	7.6	7.5	8.0
Policy interest rate, % eop	14.00	11.00	10.00	9.00	8.00	8.00	8.00	8.00	8.00
1 month inter-bank rate, % eop	10.63	8.67	6.89	8.02	7.25	7.00	7.00	8.00	8.00
Long term yield, % eop	11.50	9.73	10.13	9.75	9.50	9.50	9.75	10.00	10.00
lc vs USD, eop	20850	20905	20885	20840	20850	20850	20850	20850	20850

Source: CEIC Data Company Limited, Vietnam General Statistical Office, IMF, World Bank, Moody's and Citi Research estimates
*Note: Public debt is general government debt and external debt is based on the residency of the holder of the debt (not by currency denomination).

Appendix A-1

Analyst Certification

The research analyst(s) primarily responsible for the preparation and content of this research report are named in bold text in the author block at the front of the product except for those sections where an analyst's name appears in bold alongside content which is attributable to that analyst. Each of these analyst(s) certify, with respect to the section(s) of the report for which they are responsible, that the views expressed therein accurately reflect their personal views about each issuer and security referenced and were prepared in an independent manner, including with respect to Citigroup Global Markets Inc and its affiliates. No part of the research analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this report.

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