June 1, 2018

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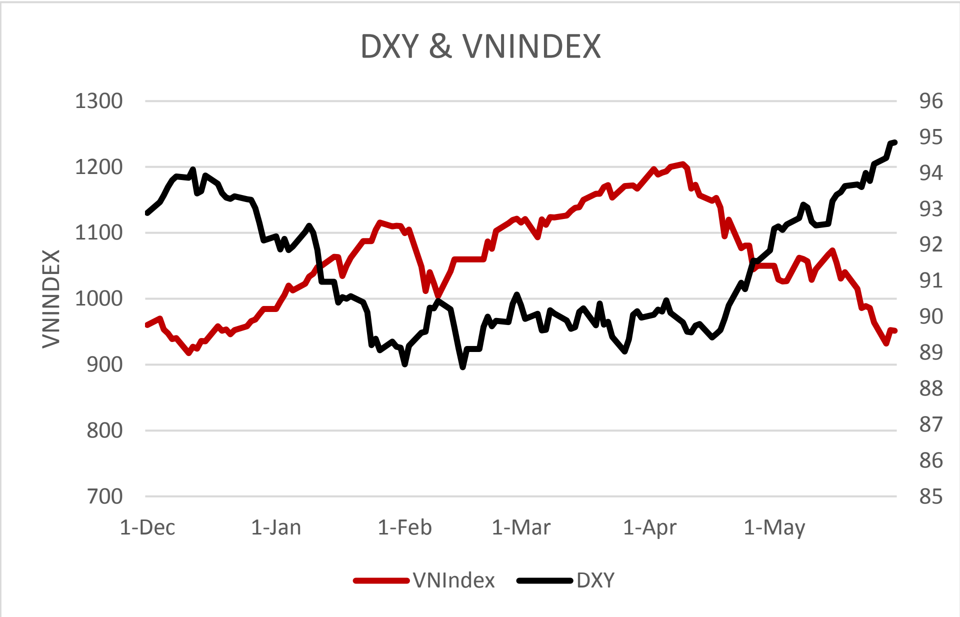
What's Next for the USD & Vietnam

As the chart below illustrates, the recent steep correction in the VN-Index (in red) has been propelled by a surge in the value of the US Dollar since mid-April (the composite "DXY" US Dollar index in black below tracks the value of the dollar against a basket of currencies).



Source: Bloomberg

We believe the DXY index will stabilize around the 92-96 level for the rest of 2018, which should drive a substantial rebound in Vietnamese stock prices this year. We also believe it is likely the value of the VN Dong will only depreciate by about 1-2% against the USD in 2018, because Vietnam does not suffer from the issues that have driven much larger depreciations in Vietnam's EM peers.

Why the Dollar Soared

At the beginning of 2018, there was a strong consensus view that the value of the USD would continue falling, following a circa 10% plunge in 2017[1]. By mid-April, speculators had accumulated the biggest short position against the dollar in seven years according to Goldman Sachs, thus setting the stage for the subsequent surge in the value of the dollar.

Here's a step-by-step recap of what has driven the dollar higher since that time:

1) **Trump's Tax Cuts** prompted US multinationals to repatriate dollars back to the US, which in turn increased the cost of borrowing dollars in London and HK.

   The surge in London Interbank (Libor) interest rates prompted offshore borrowers with USD denominated debts to buy dollars in order to pay back their loans (in lieu of suffering higher USD loan payments).

[1] For example, see: https://www.cnbc.com/2018/01/09/itll-be-another-weak-year-for-the-us-dollar-goldman-sachs-predicts.html

2) **A Short Squeeze** on the US Dollar was sparked by the purchases of US Dollars that were motivated by rising USD Libor interest rates described in #1.

   Speculators had made significant bets anticipating a ***decline*** of the value of the dollar – and were forced to cover those high leveraged bets when the dollar moved against them, further exacerbating the ***increase*** in the value of the dollar.

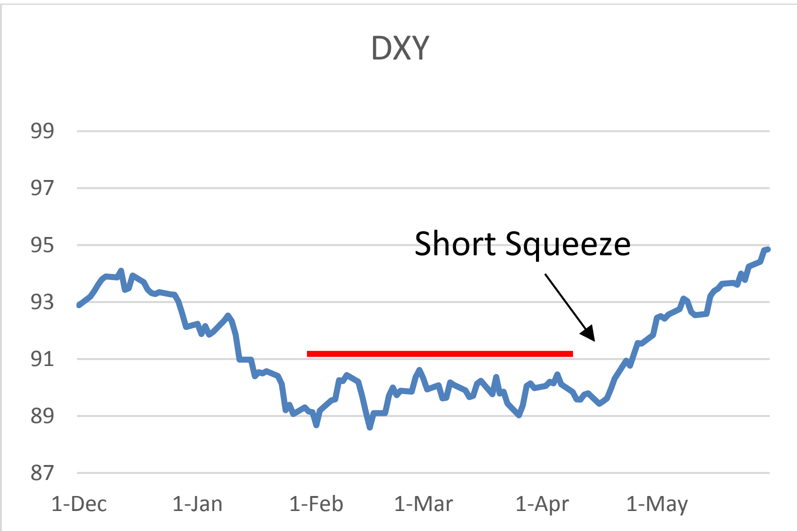
3) **Deteriorating GDP Growth in the EU & Japan** perpetuated the rally in the dollar as the short squeeze described above ran its course.

   Japan's GDP shrunk at a 0.6% annualized rate in Q1, the EU's Purchasing Manager Index (PMI) has plunged all year, and inflation has been falling in both the EU and Japan. Last week, Europe's central bank unexpectedly warned about the "Downside Risks" for Europe's economy, which caused German 10Y government bond yields to plunge.

4) **Italy's Political Crisis** now threatens to push the DXY index over 95, which is a technical level that many FX traders are monitoring closely.

The impacts of #1-3 above are already reflected in the current value of the dollar. Regarding #1, the so-called "TED Spread" between the USD Libor and US T-Bill interest rates peaked at 61 bps recently (readings over 50 bps imply financial distress), but has since fallen back to circa 40 bps, signaling that the repatriation of US Dollars triggered by the Trump tax cuts has already abated somewhat.

Regarding #2, speculators' short positions on the USD have largely been closed, according to the CFTC's[2] "Commitments Of Traders (COT)" report. And regarding #3, German 10Y bond yields plunged from 0.75% in early 2017 to 0.26% now, reflecting the rapidly deteriorating outlook for Europe's economy. Note that German bond yields have fallen by about 20 bps YTD, versus a 60-bps increase in the US!



Source: Bloomberg

Why A Stronger Dollar Hurts Vietnam?

An increase in the value of the USD prompts investors to withdraw money from EMs because:

[2] Commodity Futures Trading Commission, https://cftc.gov/MarketReports/CommitmentsofTraders/index.htm

- USD-denominated debt is more expensive to pay back when the value of the Dollar increases – and USD denominated debt in EMs soared over the last decade to nearly USD4 trillion.
- Current Account Deficit countries (i.e., countries that typically have substantial trade deficits) experience higher inflation when their currencies depreciate, which is because import prices increase following a depreciation of the domestic currency.
- Foreign "Carry Trade" investors withdraw capital from emerging markets when facing exchange rate losses.

Regarding that last point, "hot money" outflows from emerging markets are primarily caused by the unwinding of "carry trades." Foreign investors pour money into emerging markets either to achieve high capital gains over the medium-to-long term in high growth counties (which is why investors put money into Vietnam), or to achieve high investment income over the short term by investing in relatively stable countries like India and Indonesia.

The interest rates in countries like India and Indonesia are higher than those in developed markets, so "carry trade" investors put money into those EMs to earn high investment income. However, the extra income generated by this strategy evaporates when the currency of the investee country depreciates – which triggers "hot money" outflows from the country[3].

Vietnam's Stock Market has "High Beta" exposure to EM

Vietnam's stock market sold off dramatically in response to the strengthening USD, even though the free-market value of Vietnam's currency has only depreciated by 0.6% YTD (versus 4-6% depreciations in Indonesia, India, Philippines). This is because Vietnam's stock market currently gives investors "*high beta*" exposure to the MSCI-EM index, which fell in response to a surging dollar.

Many analysts have noticed that the VN-Index now both tracks -- and actually outpaces -- the MSCI-EM index when it is in an upswing (as it was at the end of 2017 and the beginning of 2018), but the VN-Index also plunged by more than the MSCI-EM during recent sell-offs.

In contrast, Vietnam's FX rate has been more stable than those in other EMs because Vietnam has minimal exposure to the three risks outlined above, stemming from an appreciation in the US Dollar.

The VN Dong is Stable

The three risks outlined above to EM economies and currencies stemming from a strong Dollar are not major concerns for Vietnam, because Vietnam's trade surplus (and its current account surplus) should exceed 2%/GDP this year (comparable to last year), because local companies have not borrowed extensively in USD, and because Vietnam's FX reserves have increased from 2.3 months' worth of imports at end-2016 to over 3 months' imports now[4].

Furthermore, foreign investors generally seek long-term capital gains in Vietnam, rather than attempting to earn high investment income via the "carry trade,"which is typically the main impetus for "hot money" outflows from individual EMs (this week, Indonesia raised

[3] This is currently happening in India and Indonesia. Note that Indonesia's 10Y government bond yield is about 400 bps above US 10Y government bond yields, but a circa 4% depreciation in Indonesia's currency essentially wiped out a year's worth of incremental "carry trade" investment income.

[4] The World Bank, IMF and others recommend EM countries to hold at least three months imports' worth of FX reserves.

interest rates for the second time in a month in order to discourage hot money outflows by carry trade investors).

All of that said, we expect Vietnam's central bank to depreciate the VN Dong by 1-2% in 2018 as part of its efforts to improve Vietnam's export competitiveness vis-à-vis its EM peers, while at the same time maintaining sufficient FX rate stability to encourage foreign investment inflows. In 1997, Chinese policy makers adeptly navigated the Asian Financial Crisis by refusing to depreciate the Renminbi, which subsequently prompted soaring FDI inflows in the 2000s. We believe Vietnamese policy makers are currently pursuing this same strategy in managing the country's FX rate.

What's Next for the Dollar?

As mentioned above, the most recent driver of the DXY index strength has been weakness in Europe's common currency, which is attributable to concerns that an anti-EU populist government may come to power in Italy. However, the DXY has thus far been unable to break above the technically important 95 level, above which another wave of capital withdrawals from EM countries by foreign investors would likely be unleased.

The failure of the DXY to break above 95, despite the inability of Italy to form a government makes it less likely that Dollar will make a sustained break above 95 soon (it's possible that the DXY could break above the 95 level for a few days, and then come back below 95, similar to the recent drop of the 10Y US Treasury yield back below the closely watched 3% level).

Obviously, if the Italian political situation deteriorates further, then the Euro could come under renewed selling pressure, which could push the DXY index over the 95 level. However, in our understanding, the current interim Italian government aims to hold another round of elections in the autumn (or possibly in July, at the earliest), and despite the populist rhetoric of Italian politicians, Italy (unlike the UK) cannot afford to leave the EU because the country received nearly one-quarter of GDP worth of financial transfers from Germany[5], and because the ECB bought about 20% of Italy's government debt.

Finally, assuming the Italian political situation does not deteriorate further, there are powerful forces pushing the value of the USD in both directions – both higher and lower – reinforcing the likelihood that the value of the dollar will not increase much from its current level.

Forces pushing the Dollar ***higher*** include:

- The widening interest rate differential between USD and EUR/JPY/EM currencies
- A reduced supply of USD in global currency markets, attributable to the US Federal Reserve's Quantitative Tightening (QT) balance sheet reduction program
- The recent, surprise move by China's central bank to cut the Reserve Requirement Ratio (RRR) for Chinese banks

Forces pushing the Dollar ***lower*** include:

[5] Germany's motivation for making so-called, "Target 2" transfers stems somewhat from self-interest. Germany runs a huge, ~8% of GDP current account surplus, but if the EU were to disintegrate then the value of Germany's currency would soar, which would decimate German exports.

- A flattening of the UST yield curve (y/c) to a new low (for this economic cycle) of 41bp, coupled with comments by the St Louis Fed President said he expects the y/c to invert in 2018 or early 2019[6]
- The widening of America's "Twin Deficits" (trade deficit and budget deficit)
- The current overvaluation of the USD by circa 15% on a "Purchasing Power Parity (PPP)" basis, according to some estimates

In addition to those points, China is making a concerted effort to displace the role of the USD in Asia, which also puts downward pressure on the dollar (although this is a longer-term driver).

What's Next for EMs and Vietnam?

There are three possible scenarios for what happens to EM and Vietnam stock markets for the rest of 2018, depending the level of the US Dollar.

A sustained climb of the DXY index to above 95 (and especially over the 97 level) would signal that investment opportunities outside the US have significantly dried up, affirming that the US truly is the most attractive investment destination for international investors. Those investors would then likely accelerate capital withdrawals from emerging markets.

DXY Level	Probability	EM & Vietnam Stock Markets
Above 96	Fairly High	Resumed EM sell-off, especially if DXY > 97
92-96	Most Likely	Vietnam stock market recovers, and ends the year up ~15%
Below 92	Unlikely	Ems and Vietnam hit new highs as "the party resumes"

In the more likely case that the DXY index hovers around 92-96, then a gradual resumption of the EM bull market is likely, driven by continued abundant liquidity stemming from the Quantitative Easing (QE) programs of the Japanese and EU central banks.

Quantitative Easing by Japan and the EU were largely responsible for pushing up EM stock markets in 2016-17[7]. The ECB previously guided that it would end its QE program this year, but the current Italian political crisis, coupled with deteriorating growth prospects make that unlikely, and Japan is also very unlikely to significantly scale back its QE program soon, given the country's negative GDP growth.

That said, in the 92-96 DXY scenario, investors would certainly show much more discernment between individual EM markets, which would benefit Vietnam, because Vietnam's stock market and currency stability compares favorably to countries with trade deficits (India, Indonesia, the Philippines) and/or EMs with weak growth prospects (Thailand and Malaysia).

The Risk of a Vicious Circle

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[6] The US corporate yield curve has already completely flattened.

[7] Some economists estimate that about half of the new money supply created by the EU's QE program actually left Europe in search of higher investment returns in the EM and US stock markets. Also, the recent rout in the Turkish Lira was attributed to hot money outflows by Japanese retail investors engaged in a carry trade strategy: https://www.bloomberg.com/news/articles/2018-05-23/turkish-lira-sold-by-japan-margin-traders-in-asia-witching-hour

If the DXY approaches the 100 level, then an EM vicious circle could ignite, in which EM borrowers with outstanding USD denominated debts scramble to buy dollars in order to repay those outstanding loans prematurely, out of fear that the cost of servicing the debt will continue to increase as the Dollar appreciates. That would push up the value of the Dollar even more – which would in turn spark further panic buying of the Dollar by debtors!

This scenario unfolded during the “Latin America Debt Crisis” of the early 1980s, ultimately leading to the famous “Plaza Accord” agreement in 1985 among G5 central banks to reverse the soaring Dollar at that time.