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Vietnam Continues to Power Ahead in 2019

Vietnam continues to enjoy "Goldilocks" economic conditions characterized by rapid 7% GDP growth and low 2% consumer price inflation, making the country an ideal investment destination for both private equity and public stock investors. Furthermore, the government's prioritization of macroeconomic stability in recent years has resulted in a very stable USD-VND exchange rate, and we believe the VN Dong will begin ***appreciating*** within the next two years – which would augment investors' returns.

<u>Strong and Steady GDP Growth in 2019, and for Years to Come</u>

Vietnam's economy grew by 7% in 2018 and again in the first nine months of 2019, driven by the growth of household consumption and manufacturing output.

Consumers are Confident

Household consumption accounts for about two-thirds of Vietnam's economy and has been consistently growing at an 8-9% annual pace in recent years, supported by circa 6-7% wage inflation and by a circa 2-3% urbanization rate. Despite this high urbanization rate (the movement of residents from the countryside to the city), only about one-third of Vietnam's population lives in the country's major cities compared to more than one-half in China, so urbanization should drive household consumption growth for years to come because the incomes of urban consumers are significantly above those of rural consumers.

In 9M19, real retail sales – which are a close proxy for household consumption – grew by 9.2% yoy. That growth rate was comparable to the growth of retail sales in 2018, despite the fact that the growth in the arrival of tourists to Vietnam, which account for over 10% of Vietnam's retail sales, fell from 23% last year to 11% in 9M19, driven by a plunge in Chinese tourist arrival growth (one-third of all tourists) from 30% last year to just 4% yoy in 9M19.

The fact that Vietnam's consumption growth held up in the face of plunging tourist arrival growth implies that domestic consumers are currently feeling very confident, which is corroborated by consumer research firm Nielsen which ranks Vietnam's consumer confidence as the third highest in the world.

The Manufacturing Sector's Double-Digit Growth

The manufacturing sector accounts for nearly 20% of Vietnam's economy, and output has been growing at double-digit rates for years, including 11% yoy growth in the first nine months of 2019. We are optimistic about the prospects for the continued development of Vietnam's industrial base for a variety of reasons, the most convincing of which is the fact that Vietnam is following the same "East Asian Development Model" that Japan, Korea, Taiwan, and to some extent Singapore, used to prosper.

In short, countries pursuing this model initially focus on improving the efficiency of their agriculture sectors, and then channel the resulting economic surpluses into the development of an export-oriented manufacturing sector. China also followed this development model, but it accelerated its progress by using Foreign Direct Investment (FDI) to augment the country's capital stock,

China's success in accelerating its development with FDI encouraged Vietnamese policy makers to court FDI even more aggressively. As a result, Vietnam's FDI inflows have averaged 7% of GDP over the last seven years, versus 4% of GDP for China during the heyday of foreign investment inflows during the 2000s (FDI in Japan/Korea/Taiwan never reached 1% of GDP).

In 9M19, FDI inflows to Vietnam grew 7%, after having grown by 7% in 2018, and there is every reason to believe that the rapid pace of inflows will continue for years to come – especially because manufacturing wages in Vietnam are less than half those in China. Furthermore, numerous surveys of Japanese and other multinationals operating in Vietnam rate the quality of Vietnam's workers as comparable to those in China.

Finally, another compelling reason to believe that Vietnam's manufacturing output will grow at a double-digit pace for at least the next five years is the fact that the manufacturing sectors of every other Asian Tiger economy contributed over 30% of those countries' GDPs during the peak of their industrialization, and as mentioned above, Vietnam's manufacturing sector still accounts for less than 20% of the country's economy.

Macro-economic Stability has Set the Stage for VN Dong Appreciation

Vietnam's government has been prioritizing macroeconomic stability for years in the aftermath of the 2008 global financial crisis, and after the collapse of Vietnam's real estate market in 2011, which spawned a ~17% non-performing loan crisis. The government's focus on macroeconomic stability intensified in 2015 when the sudden, unexpected 3% devaluation of China's currency triggered an immediate 3% drop in the value of the VN Dong, and a 15% plunge in Vietnamese stock prices.

We believe policymakers and the State Bank of Vietnam (SBV) deserve kudos for taming Vietnam's previously volatile macroeconomy and have effectively transformed the country into an investment safe haven within Emerging Markets. We also believe that the government is pursuing a strategy similar to the one China's government charted in the aftermath of the 1997 Asian financial crisis.

The currencies of Indonesia, Thailand, and Malaysia fell by circa 50% during the Asian financial crisis, but China's government made an extraordinary effort at that time to maintain the stability of its FX rate because Chinese policy makers adeptly recognized that maintaining the value of Yuan would eventually be rewarded by foreign investment inflows into the country - which is exactly what happened in the 2000s.

We believe Vietnam is following this exact same strategy of maintaining a predictable and stable USD-VND exchange rate in order to help lure foreign investment into Vietnam, and we think it's clear that the strategy is working, as evidenced by the fact that aggregate foreign capital inflows to Vietnam (i.e., all forms of inward investment) are on track to reach a whopping 15% of GDP this year.

These inflows, together with a 3% of GDP trade surplus in 9M19 have enabled the SBV to buy an estimated USD12 billion of FX reserves YTD, bringing its total amount of reserves to over USD70 billion, which is equivalent to nearly four months' worth of imports, and 27% of GDP.

Robust foreign inflows, coupled with both the government's implementation of a "crawling peg" FX regime in 2016 <u>and</u> its focus on maintaining modest inflation, have resulted in a remarkably stable USD-VND exchange rate in recent years.

Further to that last point, the VN Dong shrugged off last year's turmoil in Emerging Market FX rates, when the currencies of Indonesia and India fell by as much as 13-16%, but the VN Dong ended the year down just 2%. The VND exchange rate also shrugged off depreciation pressures earlier this year when the USD-CNY exchange rate broke the closely watched '7' level. In contrast to 2015, when the depreciation of China's currency prompted a plunge in the value of the VND, the unofficial value of the VN Dong actually appreciated by nearly 0.5% YTD.

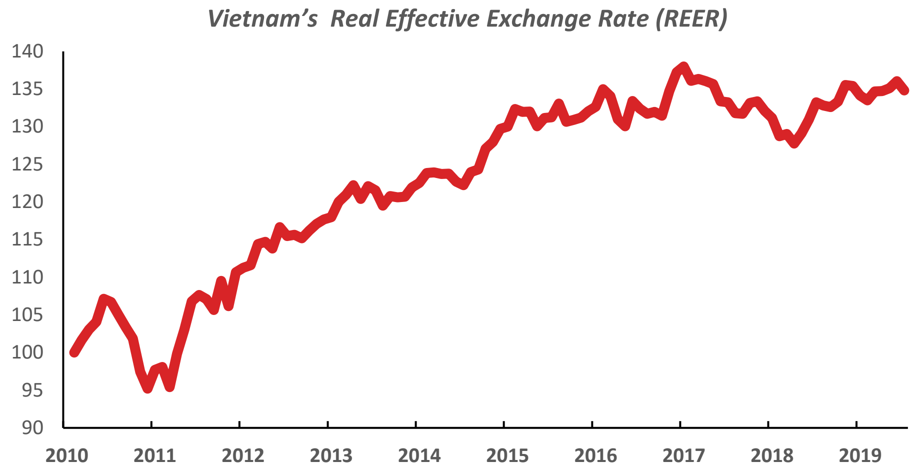
There is a well-known adage among financial market traders that when a market reacts favorably to bad news, it unveils underlying strength in the value of that asset (i.e., "bad news, good action"). The resiliency of the VN Dong over the last two years, despite strong external depreciation pressures, leads us to make the non-consensus call that the VN Dong is about to start <u>appreciating</u>, and we believe this significant appreciation will commence within the next two years.

One reason we expect the VN Dong to begin significantly appreciating within the next two years is because China ran current account (C/A) surpluses for 10 years in a row up to 2005, at which point the accumulated upward pressures on the currency triggered a multi-year appreciation that ultimately lifted the value of the Yuan by about 25% against the US Dollar.

Vietnam has now run C/A surpluses for nine years in a row, and Vietnam's FX reserves have climbed to 28% of GDP, which is almost exactly in-line with the 30% of GDP of FX reserves that China's central bank had accumulated after the country had run C/A surpluses for nine years in-a-row. Furthermore, China's current account surpluses averaged 2% of GDP in the lead-up to the dramatic appreciation of the country's currency – but Vietnam's C/A surpluses have averaged nearly 3%/GDP over the last nine years, which strengthens the argument that the VN Dong is due to start appreciating.

Another reason to expect an appreciation in the value of Vietnam's currency is the significant, and steady appreciation in Vietnam's "Real Effective Exchange Rate" or "REER" over the last eight years, as can be seen in the chart below. This metric evaluates the strength of the VN Dong against all the countries Vietnam exports to and imports from (not just against the USD), and the REER is also calibrated to take into account differences of inflation rates between countries.

The main thing to know is that a steady appreciation of a country's REER is typically a precursor to an appreciation of the so-called "nominal exchange rate", which is the conventional USD-VND exchange rate (23,200 VND at present).



Vietnam Benefits from the Trade War

A plethora of articles in the international business press this year have highlighted the benefits of the US-China trade war for Vietnam. Those articles have boosted investor sentiment, as have the many announcements by and/or speculation surrounding specific companies moving their manufacturing capacity from China to Vietnam. But the trade war has yet to have had a material impact on FDI inflows due to the long lead times entailed in foreign direct investment.

That said, in our view the trade war is simply reinforcing and amplifying the on-going process (which was already happening before the trade war broke out) of both multinational and Chinese companies moving their production facilities out of China due to rising costs in that country. Further to that last point, note that the amount of planned FDI from Chinese companies into Vietnam has more than doubled from last year to this year – albeit from a modest base.

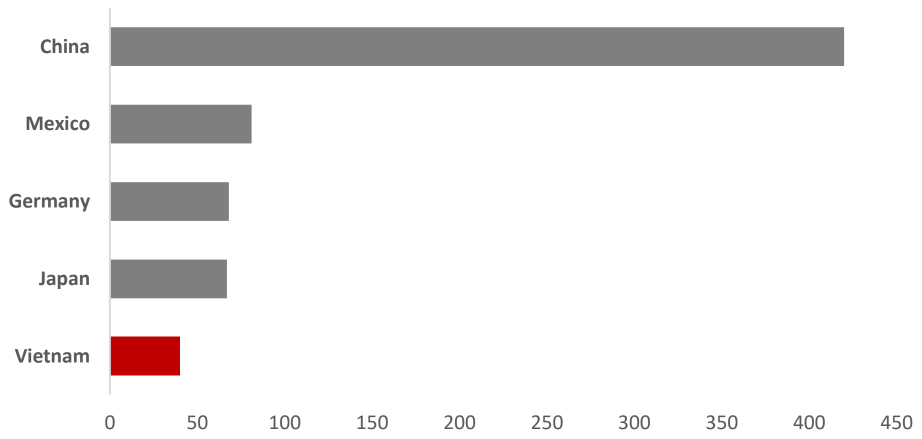
In the short term, the trade war enabled Vietnam to achieve an 8% yoy export growth in 9M19, which was driven by 28% export growth to the US, and which is a stellar performance compared to the circa -10% yoy ***drop*** in the exports of Vietnam's regional peers this year (for example, Korea's exports, which are widely considered the benchmark for the rest of EM Asia, fell 10% yoy in 9M19).

However, this seemingly positive news also comes with a caveat, because along with Vietnam's circa 30% surge of exports to the US in 9M19, its trade surplus with the US also surged by 30% to USD34 billion, putting Vietnam at risk of being targeted by the US in the trade war. To make matters worse, imports from China are up 17%, swelling Vietnam's trade deficit with China to USD28 billion in 9M19.

The similarity of those two numbers (Vietnam's USD34 billion trade surplus with the US, and its USD28 billion trade deficit with China) suggests that firms have been importing semi-finished products from China into Vietnam, and then essentially re-exporting those goods to the US in order to circumvent US tariffs on Chinese imports. Anecdotal evidence also corroborates this, although Vietnam's government is aware of the issue and taking countermeasures to avoid being targeted by the US.

Further to that last point, we think it is unlikely that Vietnam would be targeted by the US for geopolitical reasons, despite the fact the Vietnam is a country with one of the largest trade surpluses with the US.

US Trade Deficits by Country in 2018



Finally, there are growing concerns that FDI inflows to Vietnam prompted by the US-China trade war are pushing up local factory wages, inflating industrial land prices, and straining the Vietnam's logistics capacity.

We published a research report on this topic in which we concluded that the amount of industrial land currently available in Vietnam is sufficient for FDI companies to nearly double their investments in the country, that Vietnam's seaports and airports still have a modest amount of spare capacity (albeit with an immediate need to add capacity), and that less than 10% of Vietnam's workforce is employed by FDI companies.

That said, we also concluded that if an amount of FDI equivalent to just 5% of China's total FDI stock were to flood into Vietnam over a five-year period, then Vietnam's current 6-7% wage inflation rate would almost certainly double immediately.

Conclusions

The trajectory for Vietnam's GDP growth and macroeconomic stability over the next few years is fairly clear: it is likely to remain robust and stable, driven by the on-going buildout of the country's industrial base, which will in turn help fuel the spending growth of the country's consumers. Transitory factors could ebb and flow, but those two sustainable drivers are almost certain to account for the vast majority of economic growth going forward.

An example of such a transitory factor is the impact that the slowdown in China's GDP growth is having on Vietnam this year. However, as we mentioned above, the strength of domestic consumer spending is more-or-less offsetting the transitory impact of weak Chinese tourist arrival growth (an improvement in Vietnam's crude oil production, which accounts for about 4-5% of GDP is also helping offset China-related impacts on Vietnam's economy).

Regarding stability, we believe that the government has been pursuing a policy of maintaining macro-economic stability in order to foster foreign investment inflows into Vietnam, just as the Chinese did in the late-1990s. Here again, transitory factors could come-and-go, such as the current bout of Asian Swine Fever in both China and Vietnam, which could lift Vietnam's current 2% inflation rate up to 3%.

However, gone are the days where loose fiscal and monetary policy in Vietnam spawned banking sector loan crises and fueled bouts of depreciation in the value of the VN Dong. Instead, we believe that the VN Dong is about to embark on a multi-year period of appreciation in value, just as China's currency experienced after having achieved a decade of persistent current account surpluses and accumulating significant FX reserves.