December 18, 2019

Looking Ahead at 2020

Vietnam enjoyed "Goldilocks" economic conditions in 2019, with strong GDP growth and modest, relatively stable inflation. Vietnamese consumers remain among the most confident in the world, and household consumption continues to be high. Meanwhile, the US-China trade war has brought a wave of new foreign direct investment (FDI) to Vietnam, accelerating the pace of expansion in the manufacturing sector that was already under way prior to dispute's start. Additionally, the relatively volatile stock market is looking like it will end the year on the upside. All-in-all, 2019 has been another solid year of growth for Vietnam.

We expect this positive story to continue in 2020. Despite the likelihood that global uncertainty will continue into and through the upcoming year, we believe Vietnam – and its stock market – is well-positioned to continue to weather most external storms that may come its way.

Summary: Another good year ahead, especially for Vietnamese stock prices

- Vietnam's GDP will almost certainly continue growing at a 6.7-6.9% rate next year, while inflation should end 2020 at around 3% (although CPI is likely to peak above 4% yoy in 1Q20 due to the African Swine Fever epidemic). There are clear indicators that Vietnam's two main growth drivers – the manufacturing sector and household consumption – will continue to drive the country's economic growth next year.

- This ideal "Goldilocks" environment of high GDP growth and modest inflation, together with a favorable global backdrop for frontier and emerging market (F&EM) stock prices, combined with the reasonable valuation of Vietnamese stock prices (forward P/E ratio of 14x and 14% expected EPS growth), all mean that the VN-Index is likely to go up by 10-15% next year. Note that our view is in-line with the consensus expectation for an 10-15% increase in the VN-Index next year.

- The outlook for frontier and emerging market stock markets in 2020 is promising for four reasons: 1) both the US and EU central banks have resumed quantitative easing (QE) and money printing essentially explains the rise of global stock prices over the last 5-6 years (for example, US corporate profits were flat over the last five years, but the S&P500 is up over 50% during that time); 2) the value of the USD is set to fall next year, which is a major positive for EM stock prices; 3) F&EM markets have significantly lagged developed market prices in recent years (especially the US stock market); and 4) EM and frontier central banks – including the State Bank of Vietnam – have followed the Fed's lead and aggressively cut policy interest rates in 2019.

Interest Rate Cuts to Propel F&EM Stock Markets
Policy rate cuts in F&EM countries

Countries	Policy rate (%)	YTD Change (bps)
Vietnam	**4**	**-75**
Brazil	5	-150
Chile	1.75	-100
China	4.15	-16
India	5.15	-135
Indonesia	5	-75
Malaysia	3	-25
Mexico	7.50	-75
Philippines	4	-75
Qatar	4.25	-75
Russia	6.25	-150
Saudi Arabia	2.25	-75
South Africa	6.50	-25
South Korea	1.25	-50
Thailand	1.25	-50
Turkey	14	-1000
UAE	2	-75

Another "Goldilocks" year ahead for Vietnam

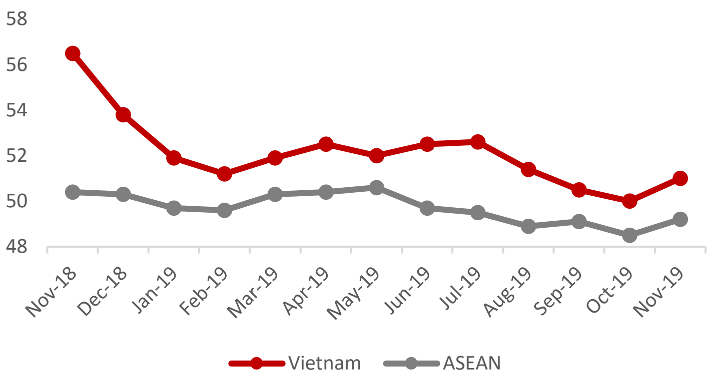
- The "Goldilocks" economic conditions Vietnam enjoyed in 2019 are set to continue next year, and there are three key reasons we expect Vietnam's GDP to continue growing at around a 6.7-6.9% rate in 2020:

    1) **Household Consumption** (~66%/GDP) is set to continue growing at a circa 8-9% pace next year (comparable to this year) because Vietnam's consumer confidence is very high (currently third in the world, according to Nielsen), and because Chinese tourist arrivals rebounded by nearly 70% yoy over the last three months after having slowed dramatically earlier in 2019. Protracted issues in Hong Kong are believed to have prompted mainland tourists to visit Vietnam instead.

One factor that will *not* weigh on household consumption growth in Vietnam are some new macro-prudential regulations from the country's central bank. Although these were highly anticipated, some analysts had feared these would dampen credit growth to consumers.

2) There are two clear signs that **manufacturing output** (~20%/GDP) is set to continue powering ahead at a double-digit growth rate next year. First, Vietnam's Purchasing Managers' Index remained at or above the '50' expansion-contraction level for nearly four years, which is a much longer stretch above the '50' level than for Vietnam's regional peers (for example, the PMIs of Malaysia & Indonesia have been below '50' for most of 2019).

Vietnam vs. ASEAN PMI



Second, disbursements of FDI look set to increase at a near double digit pace in 2019. Since an estimated two-thirds of this money is likely to be channeled into the development of factories and related facilities, this FDI inflow growth is a leading indicator of future growth in output as the country's industrial base gets built out (note that FDI disbursements grew by 9% in 2018, which is also a leading indicator for continued growth of manufacturing output – given the long lead times entailed in some of these projects).

3) The **trade war** is likely to benefit Vietnam in 2020 by supporting export growth, and by reinforcing the on-going trend of companies moving their production facilities from China to Vietnam. Regarding the latter, Vietnam's export growth of circa 8% in 2019 far outpaces that of its regional peers, driven by near 30% growth in exports to the US. Regarding the former, while Vietnam has received a lot of attention in the international business press as the country which will benefit the most from the trade war, the process of actually moving production facilities from China to Vietnam takes time, and there is abundant anecdotal evidence of a growing pipeline of companies preparing to move their production facilities to circumvent tariffs the Trump administration has imposed on China.

Further to that last point, from a "bottom up" point-of-view, note that in the most recent (Q3) US earnings season, *many* listed US companies announced their intentions to significantly curtail their sourcing of manufactured products from China (implying further shifting of production facilities from China to Vietnam), while from a "top down" point-of-view, a recent survey by Standard Chartered bank asserts that well over one-half of manufacturers in China are contemplating moving their factories out of China, and Vietnam is the most frequently cited potential destination.

The "Phase 1" trade deal just agreed between China and the US reinforces all of the points made above, because this ruminated "interim" trade truce does *not* address any of the core issues of concern to the US (especially the protection of intellectual property). In other words, such an interim deal is unlikely to be enough to dissuade companies from continuing to move their factories out of China. We fully expect the continued movement of factories from China to Vietnam, which will help boost Vietnam's GDP growth (and stock market) in 2020.

Vietnam's macro-economy to remain stable

- Vietnam's *total* foreign capital inflows will easily exceed 10% of GDP in 2019 and may even reach 15% of GDP. In order to maintain such an enormous flow of foreign capital to the country, the government needs to maintain a stable macroeconomic environment, and it especially needs to maintain a stable USD-VND exchange rate.

- The government's policies have enabled the country to maintain modest inflation and minimal currency depreciation of the VN Dong against the USD. But an equally important point is that the government has the wherewithal to accomplish these objectives because of its prior prudent management of the economy, and because the State Bank of Vietnam is using Vietnam's enormous capital inflows to augment its FX reserves. Specifically, we expect the government to have bought USD17 billion of FX reserves by the end of 2019, bringing total reserves up to USD77 billion, or four months' worth of imports.

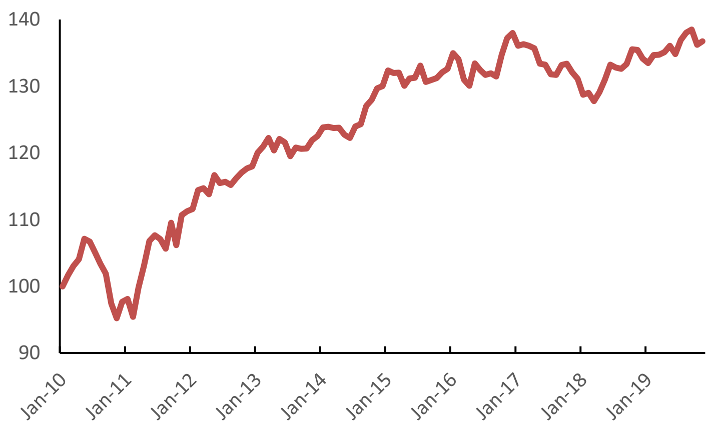
- The government has been able to accumulate these reserves because both the country's current account and balance of payments surpluses are likely to exceed 2% of GDP this year, driven by a circa 4% of GDP trade surplus, which is in turn attributable to the circa 8% export growth mentioned above.

- A stable inflation rate is a prerequisite for a stable FX rate, and previous bouts of inflation in Vietnam were essentially attributable to reckless credit expansion / aggressive lending by the country's banks. Here again, policy makers are pursuing fairly prudent policies in our view, and we expect the SBV to announce a circa 14% system-wide credit growth target for 2020. While that is a bit high, it is not high enough to push up inflation (note that in 2019, credit growth is also circa 14% which is about 1.4x nominal GDP growth, a ratio which is fairly high, but not reckless). That said, there is a risk that the current outbreak of Asian Swine Fever in China and Vietnam could boost inflation, an issue discussed later in this report.

- Finally, we believe that the VN Dong is likely to begin *appreciating* in value versus the USD within the next two years, which is something we expect other analysts to begin discussing next year. To be clear, we are not forecasting an appreciation in the value of the VND next year (we think the value of the USD-VND rate is likely to end the year unchanged at around 23,200), but we do expect other market analysts and economists to begin reaching the same conclusion as we have that the start of a protracted appreciation in the value of the VND is imminent.

- Our reasons for expecting an appreciation in the value of Vietnam's currency include: 1) the so-called Real Effective Exchange Rate (REER) has already been appreciating for years (a country's REER measures movements against a weighted basket of the countries with which that country trades most, adjusted for differences between inflation in all the countries in question), and 2) Vietnam's account surplus and FX reserves are comparable to where China's were in the ten years prior to the point at which the value of China's currency began significantly appreciating.

Vietnam Real Effective Exchange Rate (REER)
(m/m change, Indirect Quote: VND/Foreign Currency, Base 2010)



<u>VN Dong interest rates likely to remain stable</u>

- The SBV cut policy interest rates twice in 2019 to 4%, and we expect a benign interest rate environment in 2020. However, there are some idiosyncratic issues that complicate investors' understanding how interest rates work in the country.

- Interbank interest rates in Vietnam hovered at or below the 2% level for much of the year, which helped drive the country's 10Y government bond yield down to the incredibly low level of 3.5% (note that Indonesian 10Y yields are around 7%, and the country has an investment grade credit rating, versus Vietnam's BB- credit rating).

- Two specific phenomena help to explain these very low level of interbank interest rates and Vietnam Government Bond (VGB) yields. First, the SBV only partially "sterilized" the FX reserves it accumulated this year (i.e., removed a comparable amount of money from the market), which resulted in excess liquidity in the wholesale banking system. China faced a similar situation at the time it was aggressively accumulating FX reserves, but Chinese policy makers aggressively hiked the Reserve Ratio Requirements (RRR) of its country's banking system to circa 20% (vs. 2-3% in Vietnam), which prevented interbank interest rates in China from falling to overly low levels as they did for much of the last two years in Vietnam.

- Next, the government raised significant capital in recent years with the intention of the central bank disbursing this money to physical infrastructure projects and a series of bottlenecks resulted in a situation in which: 1) various government departments with excess, unspent funds deposited that money into Vietnam's commercial banking system, and 2) net Vietnam Government Bond (VGB) issuance fell by about 30% in 2019.

- In 2020, we do not expect the above-mentioned issue with bottlenecks in the disbursement of infrastructure development funds to be resolved, partly due to the political stasis we expect in the run up to Vietnam's next Communist Party Congress in 2021. However, a new regulation enacted in November has compelled government departments that have excess deposits to place a substantial portion of their undisbursed funds directly at the central bank, which caused interbank interest rates to immediately spike up from around 2% to around 4%, and this is the level where we expect rates to remain for the foreseeable future.

- Finally, note there is a significant bifurcation between the (until recently) very low level of wholesale interbank interest rates, and the higher level of interest rates that the banks pay to end-savers and businesses. The SBV recently lowered the maximum interest rate that banks are allowed to pay savers on deposits of up to six-months' maturity from 5.5% to 5%, but the last time the SBV tried to impose a ceiling below the free market interest rate, the banks found ways to circumvent those regulations in order to pay savers even higher interest rates.

<u>The Europe Vietnam Free Trade Agreement (EVFTA) set to take effect in 2020</u>

- The EU-Vietnam Free Trade Agreement (EVFTA), which Vietnam and the EU signed in June 2019, is expected to take effect in 2020. The agreement has attracted some positive attention in the international business press because it is thought that the EVFTA will make Vietnam more competitive than other countries in the region in attracting FDI to Vietnam because the agreement will eliminate nearly all tariffs between the EU and Vietnam. That said, while the EVFTA is clearly a positive for Vietnam, the benefits have probably been overstated in our opinion and we would not expect the EVFTA to boost Vietnam's annual GDP growth by more than 0.2-0.3% for the reasons outlined below, although we are aware of some estimates of larger boosts to Vietnam's growth.

- Under the EU-Vietnam trade agreement, 86% of the tariffs on Vietnam's exports to the EU will be eliminated immediately, with most of the remaining tariffs phased out over the following ten years. We estimate the average tariff on Vietnam's exports to the EU at about 9% (we are not aware of any official estimates), including 9% tariffs on garments and footwear, which account for 20% of Vietnam's exports to the EU.

- Garments and footwear are Vietnam's exports that have the greatest sensitivity to tariff cuts, and economic research suggests that the 9% tariff cut on Vietnam's exports of these products to the EU would boost Vietnam's garment exports to the EU by circa 40%, which would in-turn boost Vietnam's total exports to the EU by 8%. Assuming that the other products Vietnam exports to the EU also have some "price elasticity" (i.e., exports will go up, when tariffs go down), we could assume that Vietnam's total exports to the EU would go up by about 15%, which in turn would increase the country's total exports by about 2%.

<u>Brief comments on the rest of the world and value of the USD in 2020</u>

- Vietnam's total trade with the rest of the world (i.e., exports plus imports) is likely to exceed 200% of GDP in 2019, making the country the most open economy in the history of the modern world (not including "city-states" like Singapore), so Vietnam is highly exposed to developments in the rest of the world economy. Furthermore, local policy makers have done such a good job in stabilizing the local macro economy that Vietnam no longer has outsized idiosyncratic risks, reinforcing the fact that all of the major risks for Vietnam are currently exogenous, rather than endogenous.

- We expect that the USD, "DXY" index is likely to fall by circa 5%, which will be good for Vietnam. The US economy has been decelerating throughout 2019, which prompted the Fed to cut interest rates and to resume its Quantitative Easing (QE) money printing program. But a plethora of evidence is mounting that this deceleration of US GDP growth will continue well into 2020. In contrast, there are clear signs that Europe's economy is now bottoming out, and there are also clear reasons to believe that China's government will begin aggressively stimulating that country economy from mid-2020 to foster buoyant economic conditions for a series of important Chinese political events in 2021 and 2022.

- This "de-coupling" of growth between the US and the rest of the world should benefit Vietnam in two ways. First, it makes a global recession unlikely (which would be particularly bad for EM stock markets), and second, it leaves open the possibility that Vietnam will meaningfully grow its exports to Europe next year (Vietnam's export growth to Europe is essentially flat in 2019, versus 30% increase to the US).

Risks

There are three risks to the optimistic scenario we have outlined above, which are (in order of concern):

1) the on-going African Swine Fever epidemic could cause consumer price inflation in Vietnam to surge above 5%;
2) the Communist Party Congress (i.e., internal elections), which is expected to be held in early 2021, is likely to lead to policy stasis next year, which will particularly impact the real estate industry and infrastructure development; and
3) the on-going US-China trade war is a positive for Vietnam, but the possibility of an escalation presents some risks for Vietnam.

Risk: African Swine Fever

- The African Swine Fever (ASF) epidemic first emerged in China around August 2018 and spread to Vietnam in early 2019. Given the approximate six-month time lag between the development of the disease in China and Vietnam, it is possible to make some educated guesses about what will happen next to pork prices in Vietnam, and therefore to the country's CPI rate. Counterintuitively, the initial impact of the ASF outbreak was to depress pork prices as farmers rushed to sell their pigs before they could become infected. For that reason, the price of pork, which accounts for about 4% of Vietnam's consumer price index basket, initially *fell* substantially in Vietnam, and it has only started surging recently.

- At the time of the publication of this report, wholesale pork prices in Vietnam are up about 80% year-on-year, versus a 135% yoy surge in China. There are clear signs that the worst of the epidemic in China has past (wholesale prices actually dipped slightly in China during the month of November). Also, the governments of both countries have taken aggressive steps to contain the disease and expand both pork production and imports. For those reasons, it is likely that the surge in retail pork prices in China will abate in early 2020, and that Vietnam's pork price inflation will not reach the heights that China's has.

- If the scenario we expect plays out, then it is likely that consumer price inflation in Vietnam, which hovered around 2-3% level for much of 2019, could climb up to a level which is a bit above 4% in early 2020, and then ease back down to the circa 3% level by the end of next year. That said, food price inflation (food prices account for nearly 40% of Vietnam's CPI basket) is currently running at about 6% yoy versus circa 19%, so if Vietnam's food price inflation were to completely catch up to China's, then inflation in Vietnam would surge to over 5% next year.

Risk: Policy Stasis

- Vietnam's next Communist Party Congress (CPC) is expected to be held in early 2021, and speculation is already mounting about which government officials will occupy which posts. In addition to the growing speculation (even apparently among senior members of the party themselves), there is a familiar, growing hesitation by senior government officials to undertake bold policy initiatives or even to sign off on the various proposed projects and initiatives of their underlings until the political environment going forward is clearer.

- Given this mounting (albeit temporary) policy stasis, we do not expect any major privatizations and/or divestments of listed SOEs by the government in 2020, nor do we expect a major ramp up in infrastructure spending next year.

- Next, the HCMC real estate market is currently in the midst of a corruption crackdown which started around the end of 2018. This has resulted in a dearth of new project approvals because the government is revisiting prior zoning decisions, as well as sales of government land to developers. As a result of this crackdown, the number of new apartment sales in HCMC is down about 10% in 2019, while secondary market apartment prices are up about 10%. We do not expect this issue to be fully resolved until there is more clarity about the outcome of the next CPC.

- Despite these concerns, Vietnam is very politically stable and that the economic policies that the government pursues after the next CPC are likely to be more-or-less the same irrespective of which leaders end up occupying which specific government posts. This temporary policy stasis issue is primarily related to the career paths and aspirations of individual government officials, so we expect a resumption of "business as usual" from the middle of 2021.

Risk: The Trade War

- The trade war is a double-edge sword for Vietnam. On the one hand, it is unambiguously positive because it accelerates the development of the country's industrial base by encouraging more-and-more factories to move to Vietnam. However the stellar gains Vietnam has made over the last two years in exporting products to the US risks prompting the US government to target Vietnam with punitive measures (such as declaring Vietnam a "currency manipulator"), and the deluge of trade-war related FDI into Vietnam risks straining the country's physical infrastructure and causing local factory wages to surge.

- Vietnam's exports to the US surged by nearly 30% in 2019, and its trade surplus with the US surged by over 60% to over USD40 billion as of 11M19, but Vietnam's trade deficit with China also surged to over USD30 billion as of 11M19, which raises concerns that some local firms could be importing Chinese products and essentially re-exporting them to the US via Vietnam in order to circumvent US tariffs on that the American government has levied on imports from China.

  There is also abundant anecdotal evidence of this "re-exporting" problem, but we do not expect Vietnam to be targeted by the US in the trade war for two reasons. First, the Vietnamese government is aware of the problem and is taking definitive actions to crack down on the problem. Second, Vietnam's unique geopolitical position has made it incumbent on the US government to maintain good relations with Vietnam in order to pursue its own geopolitical objectives for the region.

- There were articles in the international business press this year lamenting the fact that FDI inflows into Vietnam have pushed up factory wages, inflated the value of Vietnam's industrial land, and strained the country's physical infrastructure. However, these articles claiming that "Vietnam is full" to new FDI largely reflect the views of the manufacturers of low value-added products (such as garments, footwear and furniture), rather than those of the makers of high value-added products such as electronics. Critically, less than 10% of the country's workforce is employed by the FDI sector and nearly 40% of Vietnam's workers are still employed in the highly inefficient agriculture sector.

  All of that said, the scale of China's manufacturing industry is so much larger than Vietnam's that although we do *not* believe the current pace of FDI inflows is swamping Vietnam's ability to absorb those inflows, it is true that if the FDI inflows were to significantly accelerate from their current rate, then wage inflation in Vietnam would significantly increase. Specifically, we estimate that if an amount of FDI comparable to just 5% of China's total stock of FDI were to flow into Vietnam over a five-year period, then manufacturing wage inflation in Vietnam would likely double from its current 7% rate to circa 14% annual wage inflation.

Top Stock Picks

- At the start of this report, we mentioned our expectation that the VN-Index (VNI) benchmark of stock prices in Vietnam will likely increase by 10-15% in 2020 due to several factors. In addition to those, there is the possibility that sentiment could be further boosted if progress were to be made towards the development of a Non-Voting Rights Depository Receipt (NVDR) scheme which would enable foreign investors to more easily access individual Vietnamese stocks that currently do not have foreign ownership room available. The development of such a scheme, comparable to the one that exists in Thailand, would help facilitate the elevation of Vietnam's stock market classification from a "Frontier Market" market to an "Emerging Market" by MSCI, although we do not expect meaningful progress on this topic in 2020 given the "policy stasis" described earlier.

- Banks: The earnings of listed banks are likely to grow by 23% in 2020, which is comparable to expected earnings growth in 2019. This will be driven by expected 13-14% system-wide credit growth next year (also comparable to 2019), which we expect to be driven by circa 30% growth in outstanding mortgages that account for nearly one-quarter of banks' aggregate loan books. Banks' aggregate outstanding mortgages are likely to grow by 40% in 2019 due to the relatively low penetration of mortgages in Vietnam, and because Vietnam's largest real estate developer Vingroup has launched several large scale real estate developments that are comprised of thousands of apartments which are suitable for purchase by local, middle class homebuyers. Specific stocks we like include:

    - Military Bank (MBB), which is trading at a 1.1x P/B valuation and 6x Forward P/E versus 16% expected EPS growth, and which enjoys one of the lowest funding costs in the industry thanks to its circa 33% Current Account Savings Account (CASA) funding ratio.
    - Vietcombank (VCB) which is trading at 2.9x P/B given its status as Vietnam's premier banking sector leader, but its earnings are likely to surge by 28% next year resulting from a new deal to sell insurance products from FWD, Accordingly, Vietcombank's 15x Forward P/E valuation looks reasonable compared to its stellar earnings growth.
    - VP Bank (VPB), which is trading slightly below 1x P/B, and with a 5x Forward P/E ratio, versus 23% expected EPS growth. VP Bank is the local leader in consumer lending and there is a possibility that it will IPO its highly successful consumer finance subsidiary next year, which would be a major catalyst for the stock price.

- Retailers: 2020 earnings growth should continue to be driven by both the continued emergence of a middle class in Vietnam, and by the displacement of "mom and pop" stores by large-scale chains, including our two top stock picks in the sector:

    - Mobile World (MWG) is trading at 10x Forward P/E valuation versus 28% expected EPS growth, despite having already grown EPS by 41% CAGR over the last four years. In 2020, the key drivers for MWG's stock price are likely to include the continued growth of revenues and earnings at its electronics store format, which in turn should be bolstered by the desire for consumers to buy new TVs in order to watch the World Cup and other major football events in 2020 (football is wildly popular in Vietnam). However, MWG's overall earnings will also be bolstered by a reduction in losses at its newish mini-grocery format as that chain comes closer to achieving scale efficiencies.
    - Phu Nhuan Jewelry (PNJ) is trading at a valuation of around 13x Forward P/E versus 20% expected EPS growth with earnings likely to be driven by a push into the countryside, given that 75% of Vietnam's total jewelry sales are still made in "mom and pop" shops.

- Technology: The sector is dominated by leading local technology conglomerate FPT, which is trading at 9x Forward P/E versus 21% expected EPS growth in 2020. Over half of FPT's earnings are derived from its software outsourcing business, which is expected to grow by more than 25% next year. Demand is coming from both foreign (especially Japanese) customers looking to optimize their IT spending and increasingly from local banks that are pursuing "fintech" and other technology initiatives. In addition, more than one-third of FPT's revenues are derived from the provision of telco services such as broadband to households, and those revenues are growing around 15% annually.

- We would also like to highlight the attractiveness of Vietnam's leading steel maker Hoa Phat Group (HPG), which is trading at 7x Forward P/E versus 17% expected EPS growth, with growth driven by a near-doubling of the company's steelmaking production in 2020.

- Finally, we are neutral about the prospects for real estate stocks next year, given the on-going clamp down of new project approvals in HCMC. However, affordable housing developers Nam Long Group (NLG) and Khang Dien Housing (KDH) continue to be beneficiaries of the emergence of middle-class home buyers in Vietnam. Meanwhile, the stock price of Vietnam's leading conglomerate Vingroup (VIC) continues to benefit from ETF inflows given its high weighting in all of Vietnam's major ETFs and stock market indexes, while its real estate development subsidiary Vinhomes (VHM) benefits from the fact that it is one of the only such companies in the country to launch and sell large-scale projects.

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