Vietnam Business Cycle: Where are we?

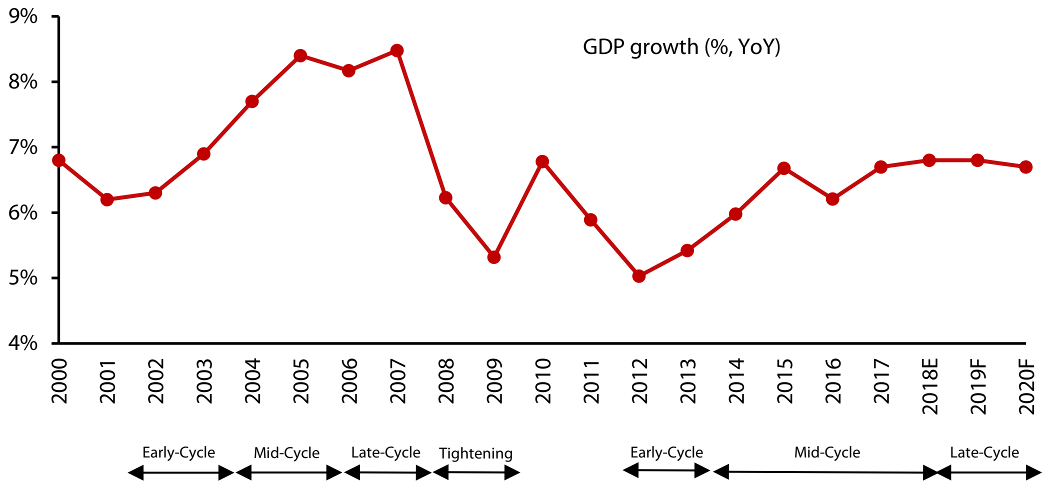
The rise of protectionism is threatening the global economy. International institutions, such as the World Bank and the IMF, forecast slower economic growth in 2019, led by lower growth of investment and trade. Meanwhile, tighter monetary policies are likely to accelerate after a long period of 'free money'. As a result, how to approach deleveraging has become a key issue for policy makers.

For Vietnam's credit-driven economy, the nature of the business cycle will possibly change as potential risks increase. From our point of view, ***Vietnam is entering into the late stage of the business cycle*** in which the economy growth remains moderate while there is significant upward pressure on interest rate as inflation begins to trend higher. Demand growth is still strong, supporting GDP, but inventories are rising.

After a period of recovery following the 2015 slowdown, there is now higher pressure on the government's macroeconomic policies. External risks and possible financial shocks could force the administration to raise interest rates soon.

Notably, speculators are more active, especially in the real estate sector. Risk appetite has risen and lending standards have softened, resulting in an easier access to credit. Therefore, the behavior of borrowers when interest rates rise is difficult to assess. Individuals and corporates have recently lived in an environment of low interest rates and may not be prepared for higher funding costs.

Vietnam's business cycle



Source: ADB, GSO, RongViet Securities

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Vietnam is still a credit-driven economy

Since the "Doi Moi" reform, Vietnam's economy has been going through three business cycles: 1989-2000, 2001-2011 and 2012-current. During the first business cycle, the economy benefited from the "Doi Moi' reforms which included measures to facilitate the move from a centralized economy to a 'socialist-oriented market economy'. The Asian financial crisis in 1997/1998 put a break to that phase.

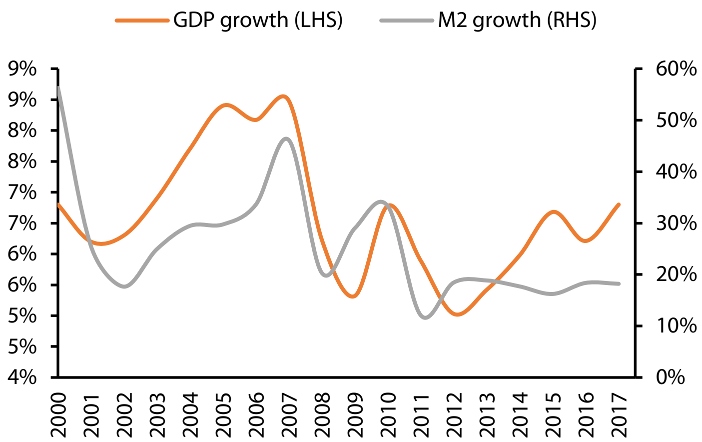
The second business cycle saw the country become more globally integrated as Vietnam joined the World Trade Organization in 2007. However, it came at a cost as the country became more vulnerable to external risks due to financial instability and the global financial crisis in 2008. Double digit credit expansion and various stimulus packages had little impact on boosting the economy up during the post-crisis period. Only after 2012 did the economy got healthier.

The third business cycle proved to bring positive changes for the economy. Consumption now accounts for 70% of GDP. A domestic consumption targeting strategy has been supported by government policies. Meanwhile, investment by non-state sectors increased significantly. While huge FDI projects have taken a leading role since 2014, current domestic private corporations are investing in the manufacturing sector in order to replace imported goods. Such projects will have positive effects on GDP growth for the next two years.

On the aggregate supply front, manufacturing joined the global value chain due to the connection by FDI corporations such as South Korean chaebols. Lately, Formosa, a large-scale steelmaker started operations.

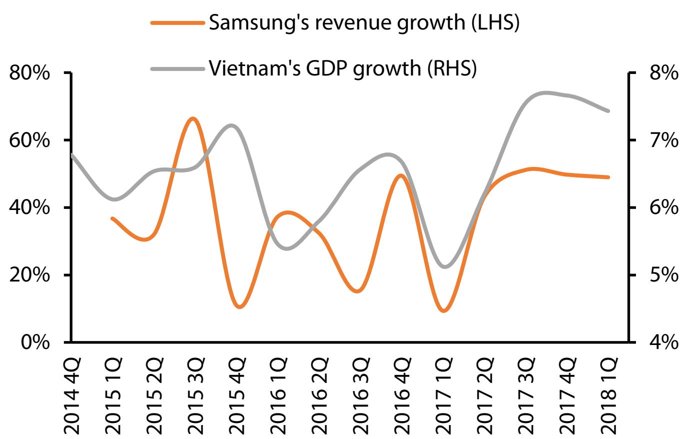
Despite these changes, the economy's structure has not changed significantly as credit growth is still the driving force. That means a lower/higher credit growth will still determine the trajectory of GDP growth. Vietnamese companies still depend on banks' capital as the financial market is undeveloped. There is clearly a positive correlation between M2 growth and average capital growth.

Figure 1: Yearly GDP growth and M2 growth



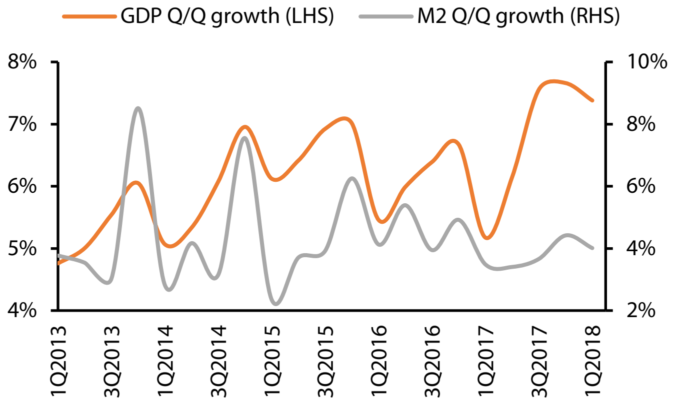
Source: ADB, GSO, RongViet Securities

Figure 2: Vietnam's GDP and Samsung's revenue



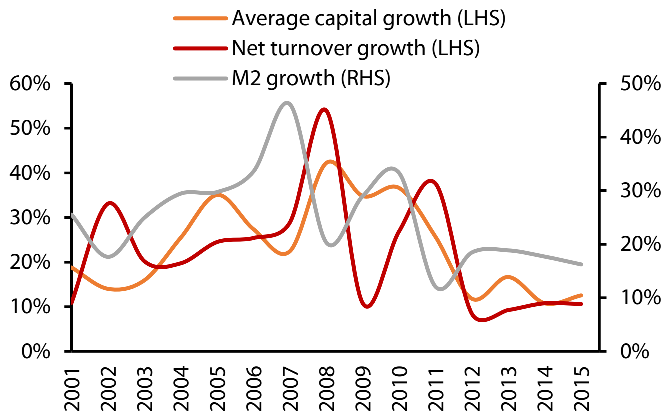
Source: Samsung, GSO, RongViet Securities

Figure 3: Quarterly GDP growth and M2 growth



Source: GSO, RongViet Securities

Figure 4: M2 growth and financial indicators



Source: GSO, RongViet Securities

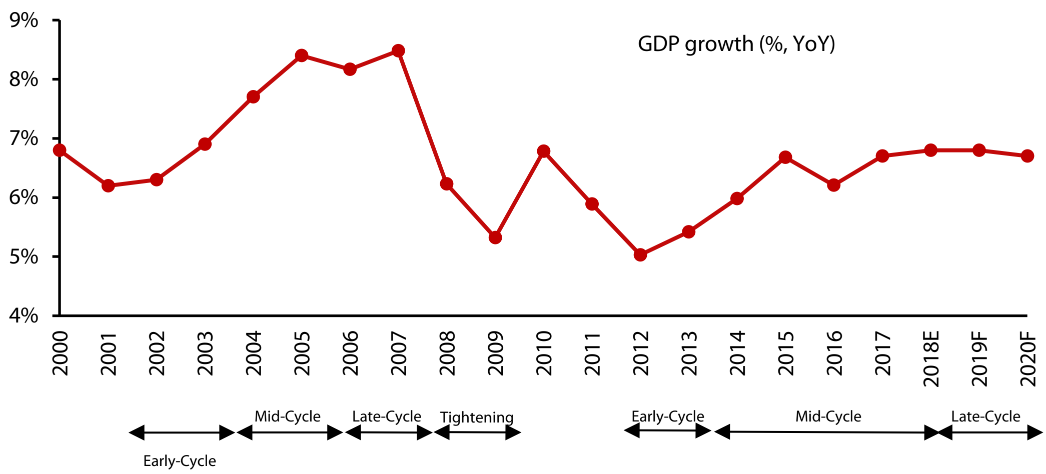
The economy reaches the late stage of the cycle

Based on the economic principles of "*Ray Dalio: How the economic machine works*" and "*Hyman P. Minsky: The financial instability hypothesis*" which focused on debt/credit cycles, we believe that **Vietnam's economy is entering the latest stage of the growth cycle.** Growth remains moderate while there is significant upward pressure on interest rate as inflation begins to trend higher. Demand growth stays strong and supports the economy although inventories rise. Notably, speculators are more active, especially in the real estate sector.

After touching the bottom in 2012, the economy started recovering in 2012-2013 when inventory decreased because of looser monetary policy. In 2014-2015, investments rose and demand got stronger. Excluding the sudden decrease of GDP growth in 2016 due to environmental and weather issues, Vietnam's economy has expanded at a higher pace until 2018.

In our point of view, the economy will grow at a stable and moderate pace in the next few years. The upside is that private investment and consumer demand are key pillars of the economy. The downside risks include external factors, such as trade tensions, geopolitical risks, etc., GDP growth could be reduced by 0.5 – 1.2 percentage points in the case of escalating trade tensions. The gap between the GDP growth between 2017 and 2012 was 1.8%.

Figure 5: Vietnam's business cycle

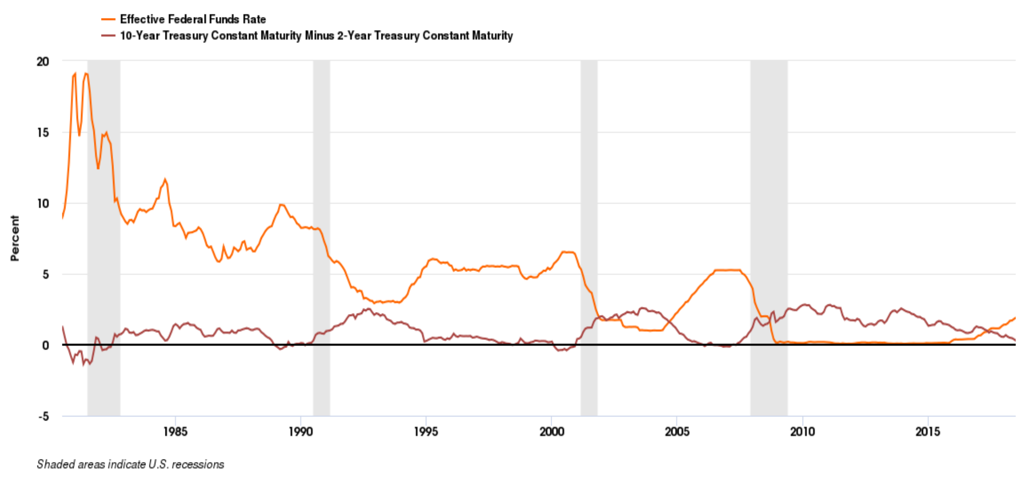


Source: ADB, GSO, RongViet Securities

Upward pressure on interest rates

In our point of view, Vietnam's interest rates will be higher in 2019 as there exists both of external and interanl risks. On the front of external risks, tightening of monetary policies is directly leading to rising global borrowing costs after a long period of favorable global financing conditions. In the US, there are likely two more interest rate hikes in the latter part of 2018 as inflation is close to the FED target. The FED's objective is 3.5% for the benchmark rate by the end of 2019. The European Central Bank (ECB) will close its asset purchase program by 2018 while the Bank of Japan (BOJ) is likely to reset its inflation and monetary policy targets.

Figure 6: Effective Federal Funds Rate



Source: FRED, RongViet Securities

In addition to the US Dollar appreciation, oil price hikes as well as trade tension risks, the pressure on rising borrowing cost is spreading out and threatening the financial stability as well as credit quality in many countries. High foreign currency denominated debt countries are vulnerable to global tightening monetary policies. Various countries have started to raise their benchmark interest rates to fight against inflation and investment outflows.

Currently, high debt pressured countries such as Venezuela, Argentina and Turkey had to devalue or let the market depreciate their currencies in order to try to stem FX outflows and ramping inflation. Investors and lenders are paying attention to possible defaults. In Asia, India lifted its interest rate for the second straight time in 2018. In ASEAN, four big-GDP countries, including Singapore, Indonesia, Malaysia and Philippines, decided to tighten financial conditions while Vietnam and Thailand haven't yet taken actions.

Table 1: Other monetary policies

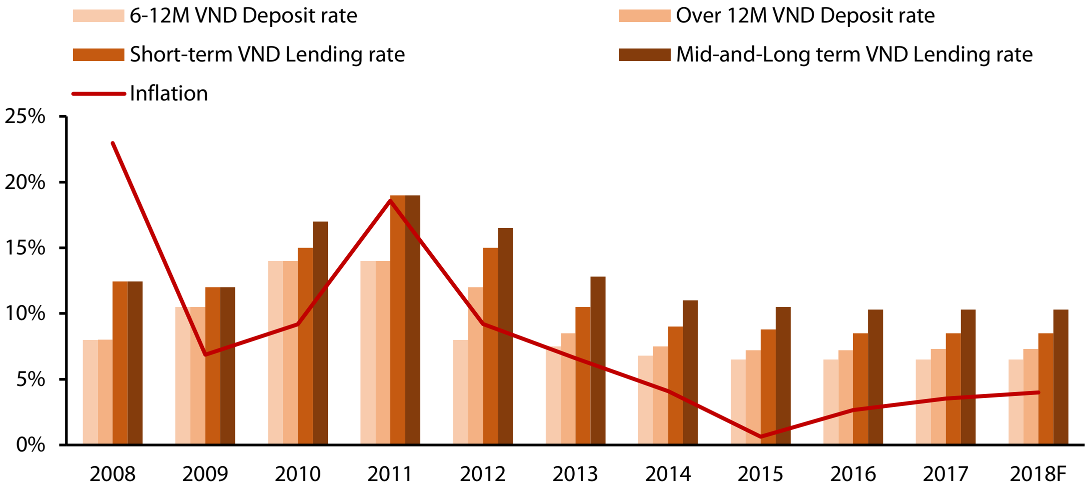
No	Countries	Monetary policy	External debt to export (%)	FX depreciation (%, YTD)
1	Indonesia	Raised interest rates for the fourth time since May 2018	184	7.7%
2	Argentina	Nearly doubled interest rate in 1H2018	259	60.0%
3	Philippines	Raised key interest rates by 50 bps to 4.0%, the biggest rate hike in 10 years	93	7.0%
4	Czech republic	Raised benchmark interest rate for the third time in 2018	N/A	N/A
5	India	Lifted interest rates for the second straight time in 2018	102	10%
6	Singapore	Increased the slope of the Singapore dollar's policy band from 0%	N/A	3.0%
7	Turkey	Hiked benchmark interest rate to 18% from 8% in 2018	210	54.0%
8	Malaysia	First Southeast Asian economy to raise interest rates on January 25th 2018	95	1.4%
9	China	Increasing short-term interest rates	59	5.8%
10	South Korea	Raised interest rates for the first time in more than 6 years in November 2017	N/A	5.1%
11	Canada	Four interest rate hikes in 2017-2018	N/A	6.7%
12	Vietnam	Unchanged interest rate	46	2.7%

Source: Reuters, RongViet Securities

On the front of internal risks, there is no doubt that a higher inflation directly creates upward pressure put on interest rates. Inflation has been on an uptrend after bottoming at close to 0% in 2015. Higher oil and food prices are partly responsible for rising prices in general. Trade tariffs could also potentially boost inflation.

In 2018, inflation is estimated at 4% YoY; the highest level since 2014. Currently, the discount rate dropped to 4.25% per annum from 4.5% per annum in July 2017 while the 6-12M deposit rate stood at 6.5% per annum.

Figure 7: Interest rate vs Inflation

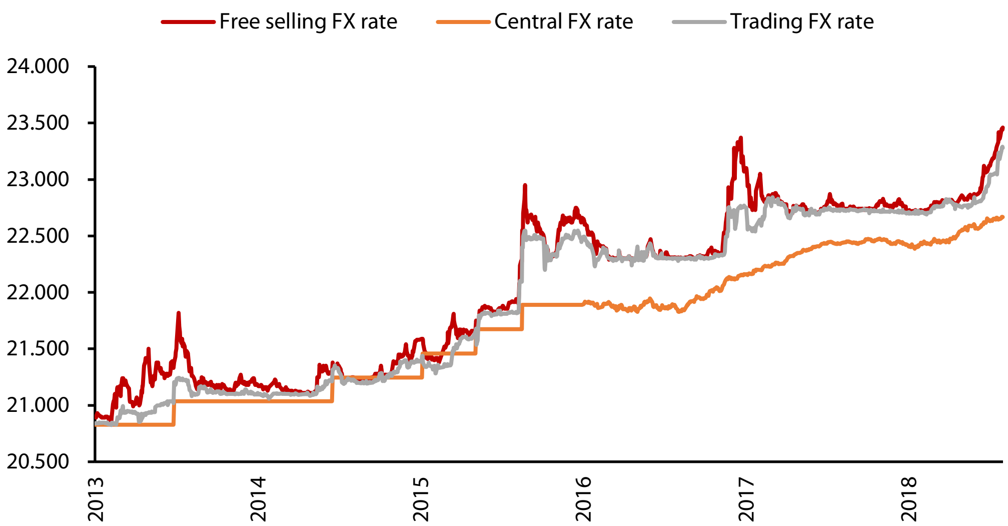


Source: Fiinpro, RongViet Securities

In addition to inflation pressures, the depreciation of the Dong also threatens Vietnam's low-interest-rate environment. Up to the middle of August 2018, banks' trading FX rate has risen by 2.7% ytd while the central FX rate added 1.2% ytd. Notably, the free FX rate increased by approximately 4%.

The policy sets the USD deposit rate at 0% while the USD short-term lending rate is around 2.8 - 4.7 %/year. In order to make the Dong more attractive, the VND deposit interest rate is set above the sum of the Dong's depreciation and the USD deposit interest rate. That means pressure on VND interest rates.

Figure 8: Foreign exchange pressure



Source: Bloomberg, RongViet Securities

Speculative activities are on the way

According to the hypothesis of financial instability, developed by Hyman P.Minksy, excess optimism and over-indebtedness create financial bubbles that the later busts. Irrational exuberance is a factor behind financial crisis. Irrational exuberance refers to a situation where economic agents develop confidence in the economy and financial markets that is misplaced. In periods of irrational exuberance, there is a rapid asset price inflation, an increased willingness to take on risk by lenders and borrowers, a growth in speculative lending, falls in the savings ratio as well as rise in borrowing levels.

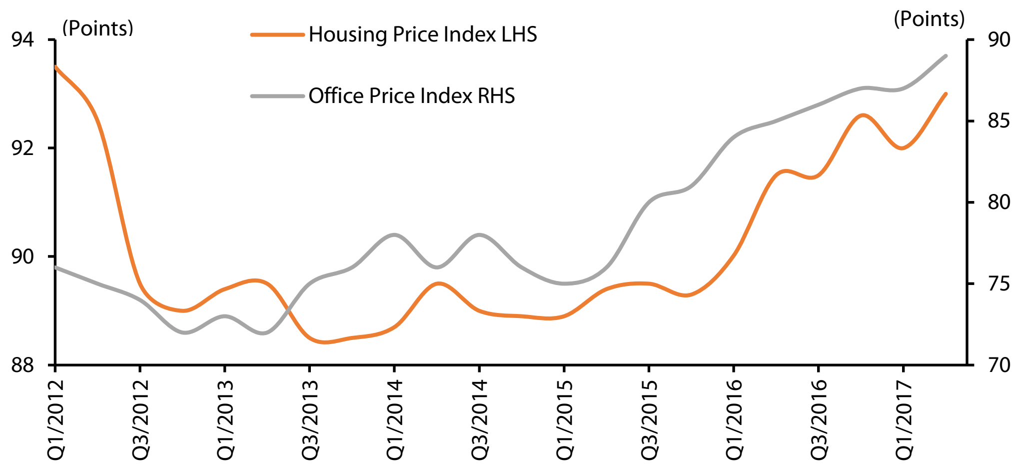
In Vietnam, we see the early signal of irrational exuberance, especially in the real estate market. After a gradual recovery in the real estate market since the bottom in 2012, speculating has arisen. In the market for apartments, we found that nearly half of all transactions are for speculative purpose. That seems to have pushed the housing price up to the historical peak.

Notably, there is wide-spread speculation in the market for land. Rumors of infrastructure projects and the expectations of profit-seeking investors have created magical increases in the value of property assets. According to our surveys, land prices tripled in most of the newly developed districts in Ho Chi Minh and Ha Noi. In addition, the tier-1 and -2 cities as well as the rural lands around the projected special economic zones are booming, leading to fast rising prices.

According to the State Bank of Vietnam (SBV), total credit to real estate accounts for around 10% of total credit. If we include the amount of mortgage held through consumer lending, the measure is up to 18% - 20% of total credit, equivalent to USD 55 Bn. Obviously, it is higher than the safe threshold of 8% - 10% but lower than the 30% seen in 2007-2008.

Let's remind ourselves of what happened 10 years ago. An asset bubble blew out as monetary policy became tighter. The general economy eventually got affected.

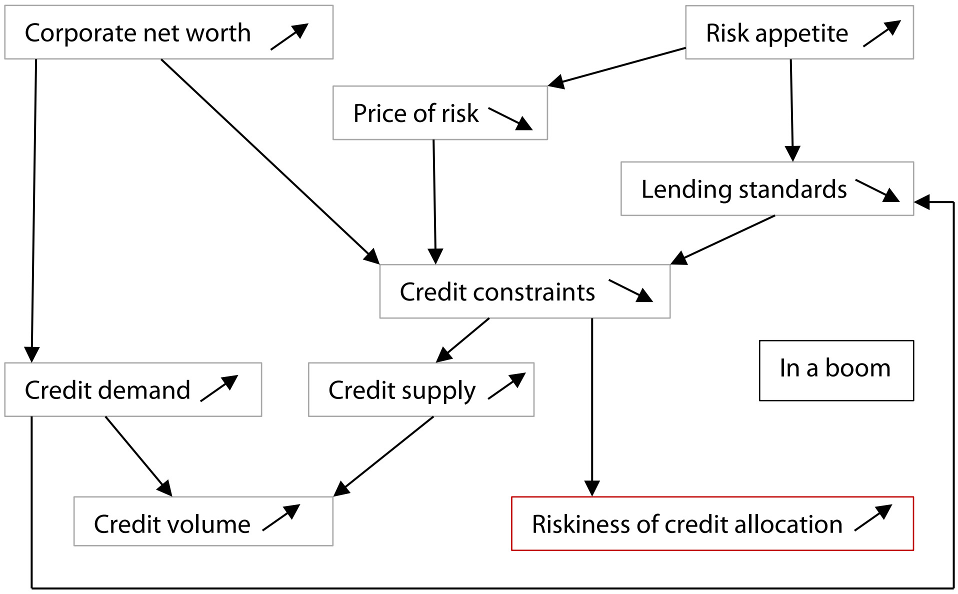
Figure 9: Real Estate's in Ho Chi Minh city



Source: Bloomberg, RongViet Securities

The IMF's conceptual framework implies that a rise in the riskiness of credit allocation during economic expansions. On the demand front, individuals and institutionals can get unduly optimistic beliefs about future economic prospects or asset values. On the supply front, the risk appetite of financial intermediaries with long-term liabilities and short-term assets is likely to make them search for yield when monetary conditions are loose. All of them can result in extending credit to more vulnerable firms and allowing borrowers to increase their leverage excessively.

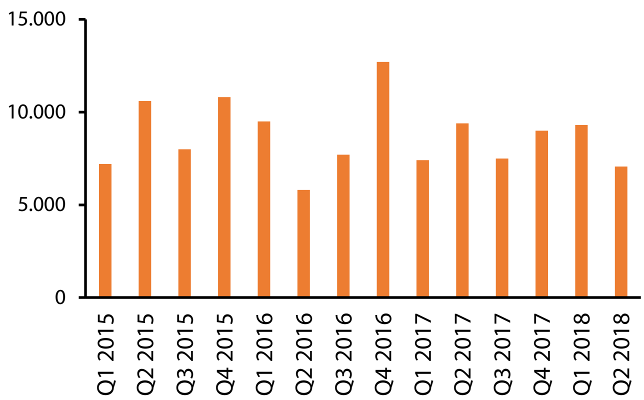
Figure 10: Key drivers of the riskiness of credit allocation



Source: IMF, RongViet Securities

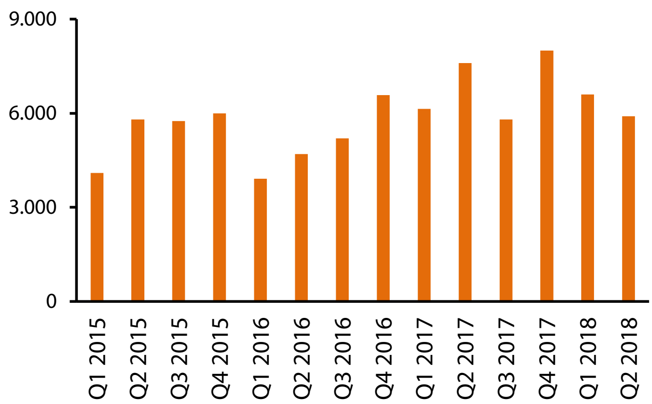
Being aware of such risks, the central bank tightened its monetary policy, especially credit to the real estate market. Some lenders have started asking property buyers for higher borrowing costs. Since the second quarter, total apartment transaction volume dropped by over 20% YoY in Ho Chi Minh and Ha Noi. Besides, land prices have retreated significantly in recent months. In the suburbs of Ho Chi Minh city, land prices decreased by 30% from the peak although those are still higher than in 2017.

Figure 11: Ho Chi Minh sold apartments



Source: CBRE, RongViet Securities

Figure 12: Ha Noi sold apartments



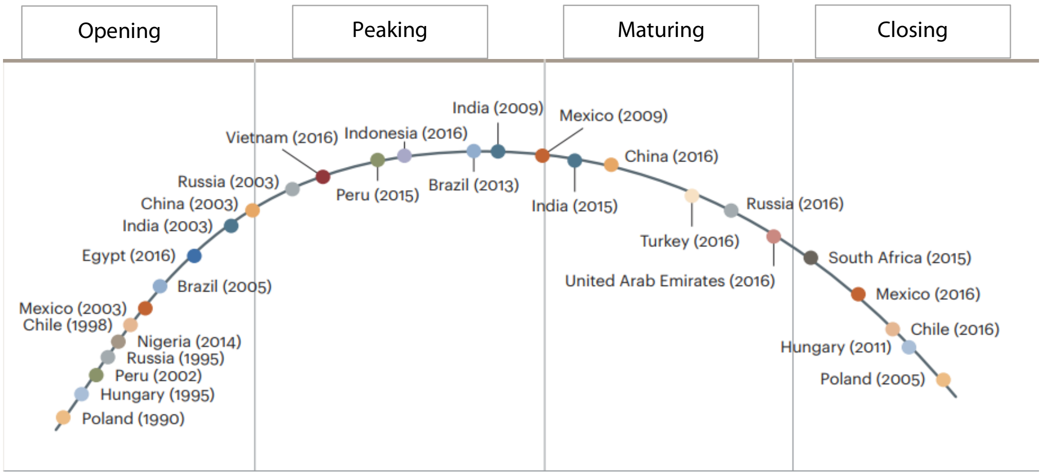
Source: CBRE, RongViet Securities

The economy expands at a moderate pace

We believe that Vietnam's economy will expand at a stable and moderate pace because of strong domestic demand and resilient investments by the private sector.

A recent AT Kearney report signaled that there is more for the development of the retail market. Vietnam ranked 6th out of 30 most attractive retail market in the world. Although total sale of good and services is growing at a stable pace, around 10% YoY, there are structural changes in Vietnam's retail market. Convenience stores and mini-market are the fastest-growing segment while E-commerce's sales are expected to grow at two-digit numbers.

Figure 13: Four stages of retail development

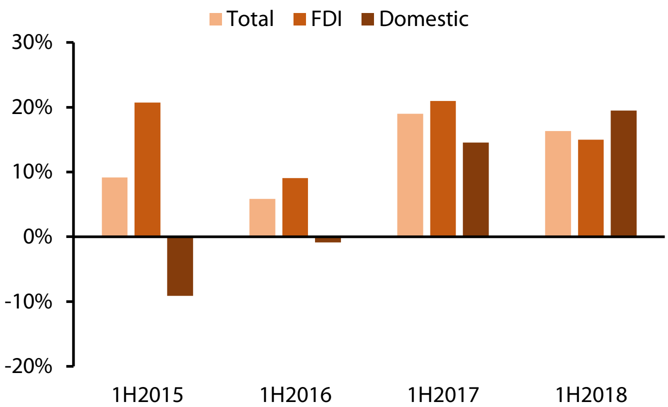


Source: AT Kearney, RongViet Securities

Meanwhile, private investment accounts for over 41% of total investment in 1H2018. A first. Vietnamese conglomerates are willing to invest in the manufacturing sector whose products are to be substitutes for imported goods. Most of these projects are at a "building phase", therefore will have an impact for many years.

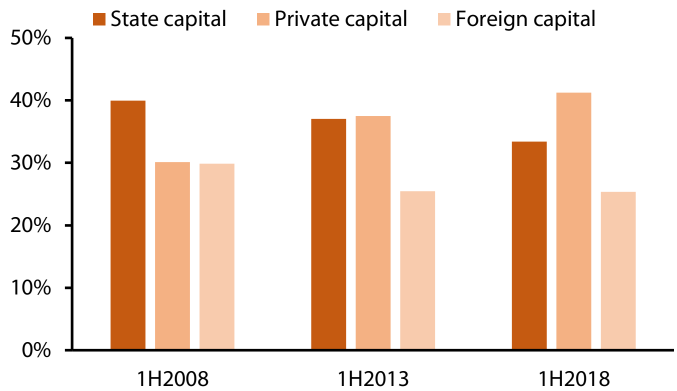
Notably, domestic export growth, around 19.5% YoYin 1H2018, is higher than FDI-related corporations for the first time in recent years. This comes from exports of textile as well as wood and rice. The government is willing to support the agriculture sectors via preferred loans, law reforms, etc. Recently, the Ministry of Agriculture and Rural Development (MARD) has announced plans to exploit the China market.

Figure 14: Export growth (%, YoY)



Source: GSO, RongViet Securities

Figure 15: Investment capital (% of total investment)



Source: RongViet Securities

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