VIETNAM'S MARKET RE-RATING HAS MORE TO DO WITH GLOBAL FACTORS

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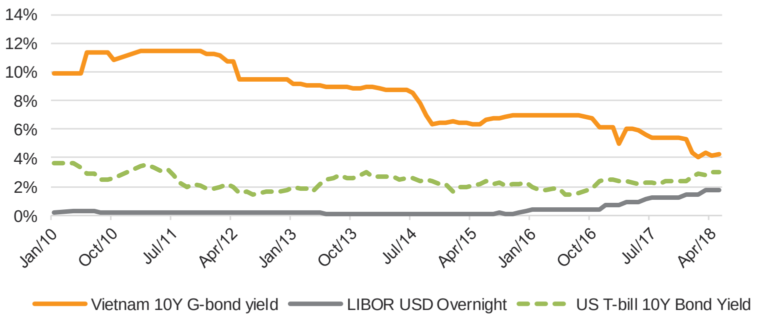
The market correction should not have come as a surprise. At the beginning of January this year when we put out our annual **Vietnam Navigator** year-end strategy report, we were conspicuously circumspect in our expectations of a continued bull-market through 2018 by saying that "We remain cautiously optimistic on the stock market's performance into 2018 as continued strong earnings growth across the listed universe could be countered by a contraction in large cap multiples". We refrained from making a call on the year-end index levels but adhered to our lack of comfort on the VNINDEX crossing the 1,100 point level in our statement "Continued strong economic growth and around 17-20% EPS growth should comfortably hoist the VNINDEX past the 1,100 point psychological level in early 2018 but the picture gets cloudier, thereafter".

Amid calls of the VNIndex breaking 1,500 points by mid-year, we went against the grain to say we were "cautiously optimistic" and advocated selectivity and earnings-driven stories as opposed to counting on continued multiple expansion and "momentum-driven" investing. Our subsequent notes titled **"Is a bubble building in the Vietnam stock market?"** and **"Is the surge in market volatility the canary in the coal mine?"**, continued to caution investors of an impending correction and a surge in volatility by staying focused on value picks with clear investment hypotheses.

Several external factors have coincided to catalyze a market re-rating. Well, now that the much-expected market correction is in full swing it does puzzle us that there was no clear and distinct catalyst for the re-rating. Our interpretation is that the market has been a victim of an unlucky confluence of several external factors while also being a victim of its own stellar success in 2017 and early 2018 which led to unreasonable valuations in the large-cap space. These external factors are described below and should continue to create headwinds for the market through the rest of 2018.

- **A tightening of global liquidity:** As we pointed out in our last market strategy report **"In free fall but for how much longer"**, there is clear evidence of a tightening in global liquidity as reflected in rising US Treasury yields and LIBOR. While this has not really hit Vietnam, low absorption rates on recent Vietnam government bond auctions show that this might be finally starting to bite. This tightening is bound to have triggered portfolio capital flight out of Vietnamese equities.

Figure 1: Vietnam 10Y G-bond Yield versus LIBOR and US T-bill 10Y Bond Yield



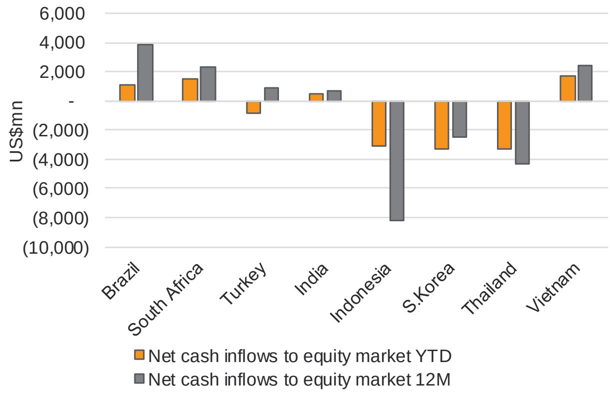
Source: Bloomberg

- **A strengthening US dollar:** Consensus at the start of the year (including our own) called for dollar weakness through 2018. It was believed that Trump's efforts to reduce the US trade deficit would offset any potential lift from repatriation of corporate capital into the US as a result of corporate tax cuts. The dollar has surprised with its strength over the past several weeks. A rising US dollar, combined with rising rates, has made US assets rather compelling on a risk-adjusted basis, triggering huge capital flows out of emerging and frontier market assets.

Figure 2: Dollar index 1 Year performance

Source: Bloomberg

Figure 3: Net FII flows into emerging equity market and Vietnam



Source: Bloomberg

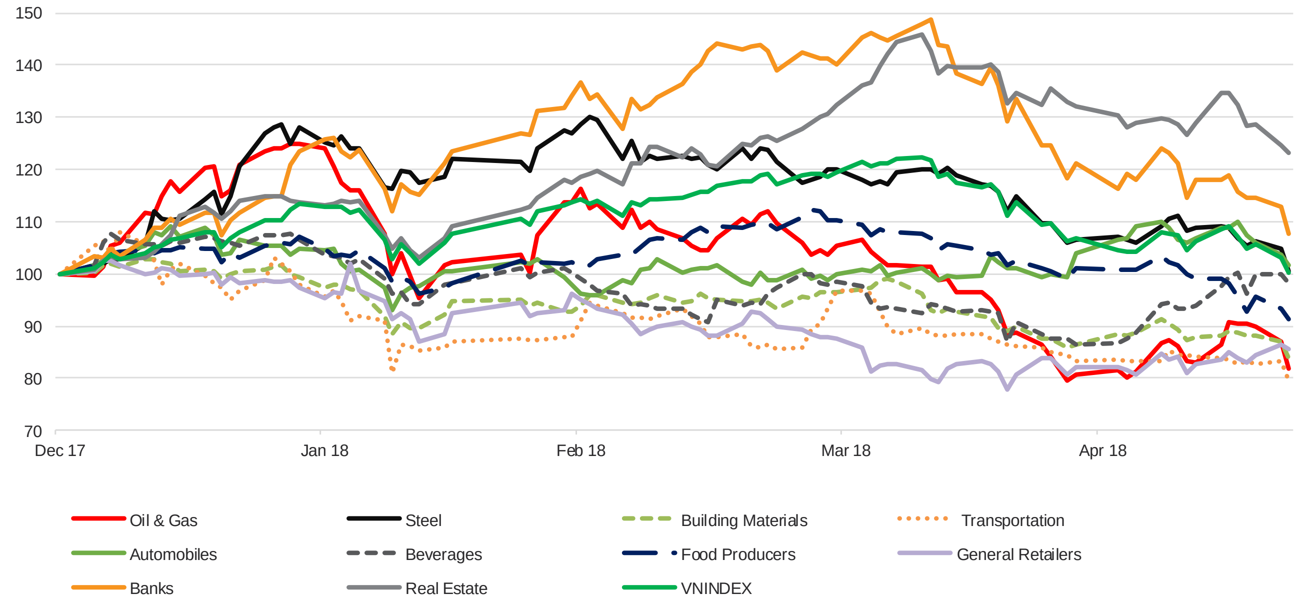
- **Rising oil prices:** While a continued recovery in crude oil prices was widely expected, it was also believed that the re-entry of marginal producers would place a lid on a continued rise in oil beyond USD 60-70 / barrel. The re-entry in force of shale producers and the surprising discipline of OPEC in curtailing output has led oil prices to surprise on the upside. With oil flirting around USD 80/barrel, aspersions are now being cast on continued macro-economic stability in key Asian economies which remain heavily dependent on imported energy. India and Vietnam have, in particular, been singled out for their vulnerability to rising oil prices due to their dependence on imported energy and, also due to the fact that national wealth is not large enough to absorb the shocks of rising crude prices – the governments of both countries run chronic and large fiscal deficits which limits their ability to use fuel subsidies as shock-absorbers for the real economy and the vast majority of the population in both countries remains at relatively low income levels, leaving them with not enough disposable income to absorb the impact of rising fuel bills. The concurrent rise in the US dollar only adds further to the woes of major oil importing nations.

Figure 4: Brent crude oil price 1 year performance (US$/ton)

Source: Bloomberg

Rising energy costs could not only stifle consumption (particularly in lower-income segments of the population) but also fuel inflation which would warrant a tightening of monetary policy in Vietnam. Given the extent to which the market last year and early this year was buoyed by cyclical sectors such as banking and real estate – both of which have benefited greatly from loose monetary conditions) – it is easy to see why the threat of rising inflation could have knocked the wind out of the stock market. In fact, the banking sector has seen the heftiest correction in the recent market re-rating.

Figure 5: Year-to-date indexed performance by sector

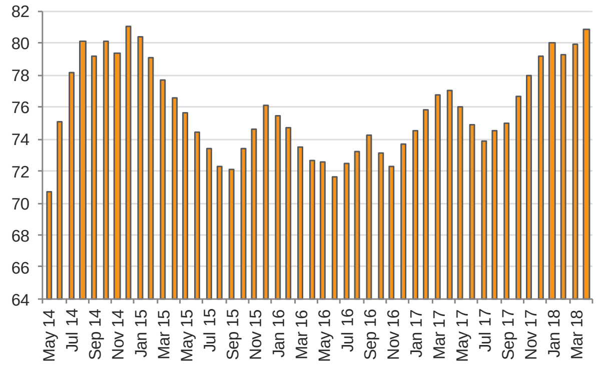


Source: FiinPro

- **Select large source countries of foreign portfolio capital into Vietnam are seeing improving domestic prospects:** In recent years, regional investors have become very active in the Vietnamese stock market as it was a rare bright spot in a region marred by corruption scandals (Malaysia), political instability (Thailand), policy uncertainty (Philippines), geopolitical risks (South Korea) or just weak economic growth (Thailand and Indonesia). This had the dual benefit of catalyzing a shift in geographical allocation of Asia-focused funds away from other countries in the region and into Vietnam. But, perhaps even more importantly, it helped trigger a wave of outbound portfolio investment from countries with large domestic trading capital pools (such as Thailand and South Korea) into Vietnam as domestic investors looked outward for better return prospects. This has changed in recent months as follows:
    - **Thailand is seeing a strong economic recovery:** While predictions abounded of political anarchy in the wake of King Bhumibol's death last year, Thailand has actually stayed surprisingly calm. Combine that with the fact that economic growth seems to be sharply rebounding and you can see why Thai investors have started refocusing their attention on domestic equities. Q1 GDP growth in Thailand was strong at 4.8%, a five-year high. Retail sales growth was close to double digits and consumer confidence has been climbing

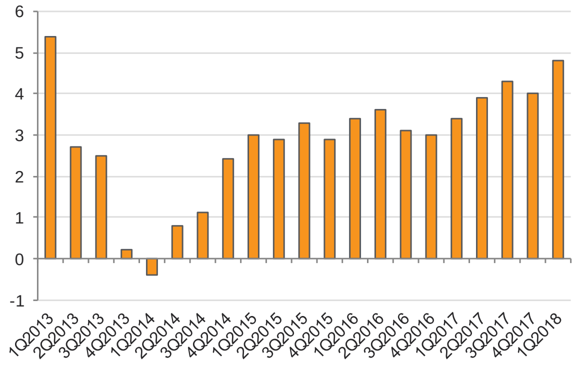
steadily and how within striking distance of the all-time record high.

Figure 6: Thailand's consumer confidence index heading toward a new high



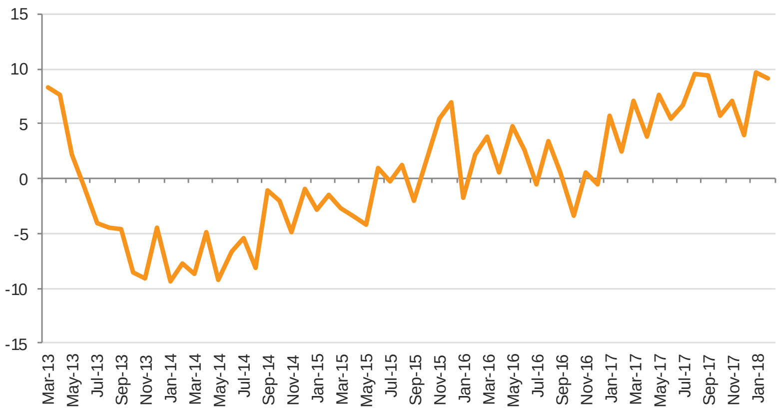
Source: CGS-CIMB RESEARCH

Figure 7: Thailand GDP Quarterly Growth (Measures 2002 Prices, % YoY)



Source: CGS-CIMB RESEARCH

Figure 8: Thailand Monthly Retail Sales (% YoY)



Source: CGS-CIMB RESEARCH

- **South Korea is seeing a geopolitical risk re-rating and recovering growth:** While just a year ago, investors were getting nervous about possible conflict with the North Korea, the mood has changed markedly with the historic meeting of the leaders of North and South Korea and the prospects of the upcoming summit between President Trump and Kim Hong Un. While talks of a nuclear deal with North Korea seem a little premature, the threat of armed conflict has abated significantly. Combine that with talks of possible reunification down the road and it is possible to see why South Korean domestic investors might be eyeing opportunities in their backyard instead of looking at far-flung overseas markets. Perhaps more important is the fact that easing tensions with China have led to the resumption of Chinese tourist arrivals into South Korea which is lifting earnings growth prospects for domestic hospitality, retail and cosmetics companies and also stimulating an improvement in domestic business sentiment.

Figure 9: Korea 5Y CDS Spread 1 year performance

Source: Bloomberg

Home-grown factors have had a role to play in souring investor sentiment

The major local factors that might have contributed to a market re-rating relate to perceived political risk and corporate governance concerns.

There have been rumblings in recent weeks about a possible political witch-hunt against the former ruling camp led by ex-Prime Minister Dung. While these seem to have been driven more by rumours, recent investigations into past government-linked land deals (eg. involving QGC) are being seen as evidence of action on the ground. Anecdotally, we can attest to the nervousness this has created with several of our foreign clients having called in to explicitly inquire about building political risks.

Corporate governance concerns have also re-emerged in the wake of a slew of high-profile recent investigations such as the Ministry of Finance's announced inspection of loan underwriting practices at VPB's consumer finance subsidiary FE Credit, the investigation into HomeDirect's alleged involvement in an online gambling ring and the margin lending practices of brokerage firms.

While we think that talks of rising political risk are overdone, external factors will continue to create headwinds for the stock market.

While there is seldom any "smoke without fire", we think political risks will be contained, going forward. The government has displayed pragmatism and a reform-orientation this far and the new camp in power will want to continue to use the marked improvement in economic fundamentals to define its legacy and legitimize its grip on power. Combine that with the fact that the government is under pressure to ramp up public spending after several sluggish years and has limited fiscal room to fund this, there is a strong dependence on the divestment and SOE privatization program to fund public outlays. Allowing the political agenda to destroy investor confidence and catalyse further falls in the stock market would amount to "shooting oneself in the foot". The recent slowdown in registered FDI (and imports of capital equipment and machinery into Vietnam) only serve to reinforce our view – a large part of Vietnam's appeal even to FDI investors has been its political stability; in an environment where continued pace of FDI inflow growth cannot be taken for granted, we would expect the government to be extra cautious in damaging Vietnam's image as an oasis of political stability in an otherwise tumultuous region.

That being said, key external factors such as tightening global liquidity and faster-than-expected Fed rate hikes are unlikely to abate dramatically. The ensuing “risk-off” sentiment means that foreign portfolio flows cannot be counted upon to kick-start another stock market rally. Even if oil prices don’t rise much further from hereon, the lagged impact of recent rises will eventually come home to roost. Combined with currency pressures triggered by portfolio capital flow reversals, the expected return in inflation is almost certain to warrant domestic interest rate hikes which could crimp earnings of cyclical sectors such as Banking and Real Estate.

Once again, we emphasize the importance of riding longer-term structural growth stories. ACV (rising aviation penetration and inbound tourism), **PC1** (rising power demand and critical infrastructure upgrades) and **HPG** (continued construction steel demand in the wake of a revival in public spending) come to mind. **LPB** continues to be a solid banking pick – even with banks temporarily having fallen out of favour – due to its long-term advantage in tapping into the under-banked population in Vietnam, its huge potential distribution network and its nearly 50% discount to the peer group.

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Score Range:	90 - 100	80 – 89	70 - 79	Below 70 or	No Survey Result
Description:	Excellent	Very Good	Good	N/A	

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RECOMMENDATION FRAMEWORK

Stock Ratings	Definition:
Add	The stock's total return is expected to reach 15% or higher over the next 12 months.
Hold	The stock's total return is expected to be between negative 10% and positive 15% over the next 12 months.
Reduce	The stock's total return is expected to fall below negative 10% over the next 12 months.

The total expected return of a stock is defined as the sum of the:(i) percentage difference between the target price and the current price and (ii) the forward net dividend yields of the stock. Stock price targets have an investment horizon of 12 months.

Sector Ratings	Definition:
Overweight	An Overweight rating means stocks in the sector have, on a market cap-weighted basis, a positive absolute recommendation.
Neutral	A Neutral rating means stocks in the sector have, on a market cap-weighted basis, a neutral absolute recommendation.
Underweight	An Underweight rating means stocks in the sector have, on a market cap-weighted basis, a negative absolute recommendation.

Country Ratings	Definition:
Overweight	An Overweight rating means investors should be positioned with an above-market weight in this country relative to benchmark.
Neutral	A Neutral rating means investors should be positioned with a neutral weight in this country relative to benchmark.
Underweight	An Underweight rating means investors should be positioned with a below-market weight in this country relative to benchmark.

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