Letter From Vietnam

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Standard Life Investments

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View From Above

Bond investors, behold Vietnam!

A generation of fund managers has grown accustomed to investing in the shadow of the red flag of China, but another red flag state in Southeast Asia has been catching the eye of investors. The nation in question has been attracting a steady stream of frontier capitalists for a while, but is increasingly luring mainstream emerging market investors. Meet Asia's new manufacturing workshop – Vietnam.

Vietnam is still a one-party communist state, but it is transitioning from a centrally planned regime to a market economy. In recent years, makers of 4G smartphones, hipster gadgets and fashion gear have flocked into the country. Indeed, some investors have compared Vietnam's current economic development with that of China, about 20 years ago.

An economic revolution is underway and growth has been stellar. This is expected to continue even after US President Donald Trump dealt a death blow to the Trans-Pacific Partnership (TPP) trade agreement, of which Vietnam had agreed to be a signatory. The demise of the TPP is certainly a lost opportunity for Vietnam. It may well delay some of the ongoing economic reforms, but the country is unlikely to suffer too much from the loss. TPP was more of a next-generation trade agreement for Vietnam – one about access and integration as well as fiscal, labour and environmental reforms.

"An economic revolution is underway and growth has been stellar"

Investment Insights

Embracing capitalism

As I stepped out of Ho Chi Minh City's airport during a recent visit, my first to Vietnam for a decade, I was struck by the energy and intensity. There is urgency in every step as the people of Vietnam work towards achieving their aims, whether in business or otherwise.

Vietnam has posted average growth of around 6% annually over the past decade[1] and economic reforms to sustain this growth are taking shape. Manufacturing has been the driver for this progress and both foreign and domestic companies have been encouraged to invest by the combination of low wages and a business-friendly regime. Manufacturers are expected to continue to expand production despite the loss of TPP.

The country's exports have been on an upswing, and should support near-term growth prospects. An ambitious privatisation agenda should also boost its medium-term economic potential.

We own Vietnam's US-dollar sovereign bonds. As a bond investor, I would certainly like to see the Vietnamese government continue to pursue its fiscal reforms. The country needs to address its fiscal deficit which, at over 6% of gross domestic product (GDP), is a concern. However, beyond this risk, we see many more positive dynamics emerging across the economy.

"I was struck by the energy and intensity"

The 'equitisation' process

Under new reform-minded Prime Minister Nguyen Xuân Phúc, there seems to be genuine effort to allow the private sector to take a more central role in the economy as a means of delivering sustainable growth. Real progress has been made in addressing the 25-year-old problem of privatisation, or 'equitisation' in local parlance.

The state owns hundreds of companies, some of which are genuinely profit-making and globally competitive. But there are many others which are essentially social welfare schemes. 'Equitisation' is probably as much about balancing the books as the government has reached its own mandated 65% of GDP limit on public and publicly guaranteed debt.

The country plans to run an average fiscal deficit of 3.7% of GDP over the next five years and expects the public debt/GDP ratio to remain broadly stable. This is feasible, partly because the real interest rate is less than 1%.

Foreign debt is manageable. About 95% of external debt has been engaged on concessional terms. However, with Vietnam's improving income status, this source of funding from international financial institutions is about to get more expensive as official development assistance access rolls off. The government will need to rely more heavily on market-based financing.

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Making tough choices

To be fair, the Vietnamese government seems to be taking some tough action in cutting spending – mainly choking off subsidies to state-owned enterprises, particularly where the private sector can step in – for example, in hospitals and schools.

With the fiscal deficit large and real interest rates low, fiscal and monetary policy cannot drive the next stage of development. The government wants to encourage the private sector to take a more meaningful role in the economy. This means Vietnam's 'equitisation' agenda is likely to accelerate.

Vietnam encourages foreign investment as part of its development strategy and foreign-invested firms play a key role in the economy. High-technology exports, for example, formed 27% of its total manufactured exports in 2014, according to the World Bank. Record foreign direct investment has driven its foreign exchange reserves to multi-year highs. Forex reserves reached a record US$41 billion in early January.[2]

Moreover, Vietnam has a domestic market of nearly 100 million people, with a young workforce, a growing middle class and a hungry consumer market that foreign firms wish to tap into.

Vietnam is a developing economy and there are areas still in need of development. I believe the investment case for owning near and medium-term duration bonds is supported by the country's growth momentum and economic potential.

Mark Baker
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[1]Databank, World Development Indicators, The World Bank Group
[2]'Vietnam forex reserves hit all-time high', VietnamNet Bridge, 9 January 2017.

"Vietnam's 'equitisation' agenda is likely to accelerate"

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INVBGEN_16_1813_Letter_From_Vietnam_TCM 0517