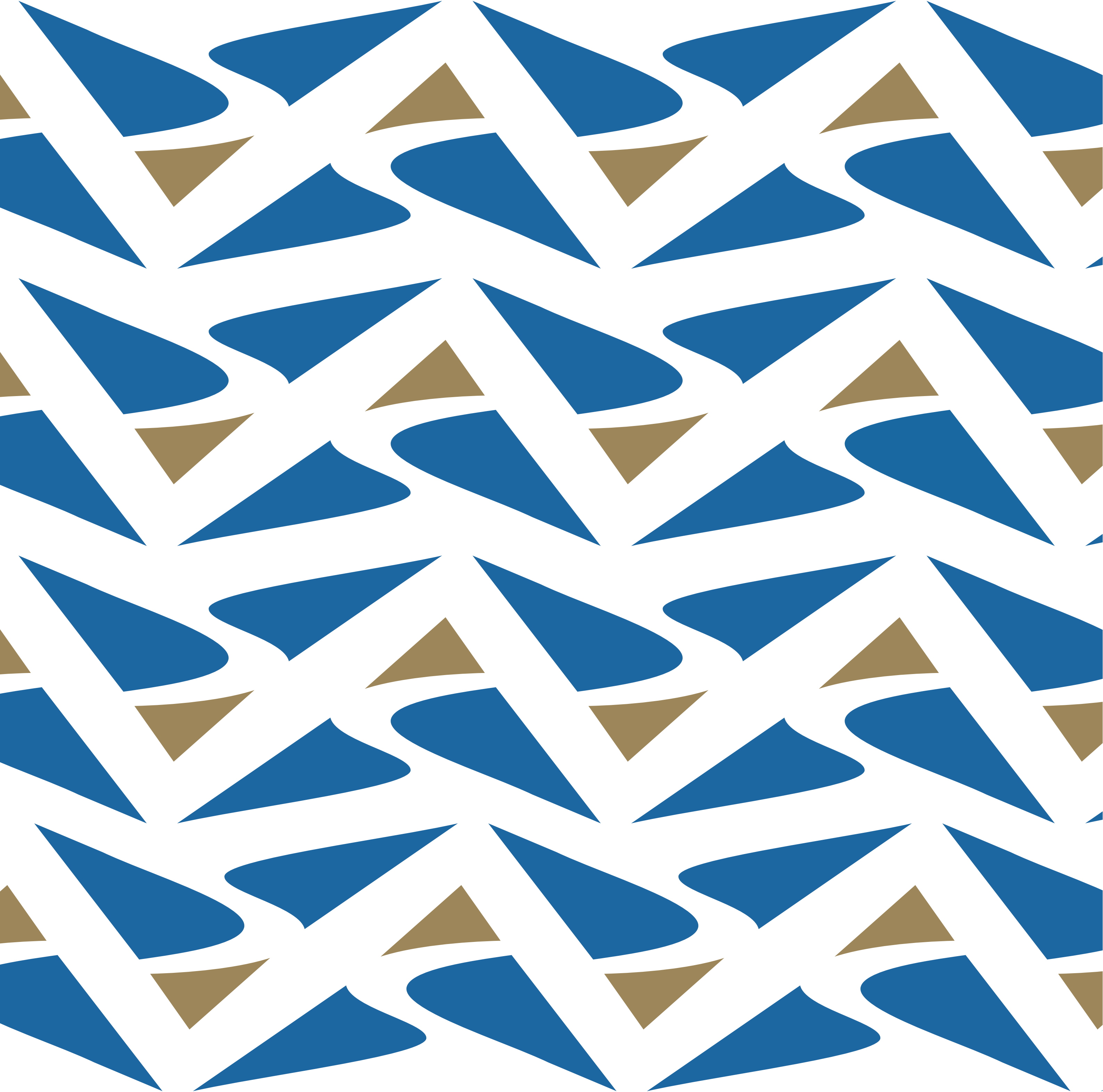

STGFM Insight

Vietnam

22.06.2021

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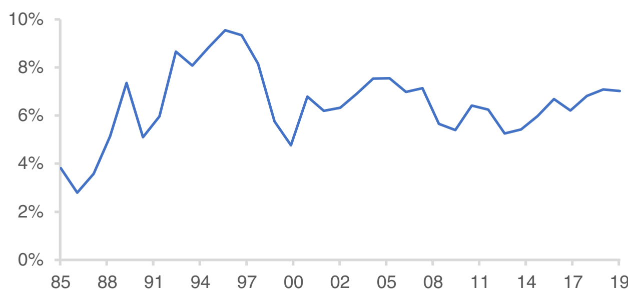
St. Gotthard
Fund Management

An economic success story

The 16th-most populous country with a population of almost 100m, Vietnam, has displayed an impressive level of economic progress in the past decades. Having for long been the synonym for one of the biggest military defeats of the US, culminating with the fall of Saigon (Ho-Chi-Minh-City) in April 1975, the country today is among the fastest growing economies globally. The fact that a communist one-party regime has achieved such impressive growth figures may surprise one or the other reader. These are however the results of a consistent opening of a previously closed economy that started in late 1986, almost 35 years ago. The aim was to achieve a "socialist-oriented market economy" wherein the government encouraged private ownership of farms and factories, economic deregulation, and foreign investment, while maintaining control over strategic industries. Judging from the country's achievements today, the transformation has been highly successful.

Vietnam's Annual GDP



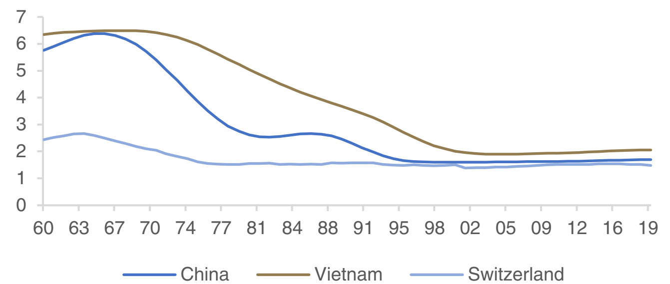
Source: World Bank

In this Insight publication, we want to shed light into the question whether investing in Vietnamese equities – after a strong run-up in the past years – still is attractive or whether the success story will soon have run its course. We take the view that the investment story is far from over: neither has the economic development ended, nor do the tailwinds that have favored the Vietnamese economy disappear anytime soon. An important focus will be put on stock valuation measures, as global investors will weigh the highly promising economic prospects against the priced-in scenario. But demographic developments, social factors such as literacy and quality of schooling, as well as (geo-) political risks will be discussed.

The "next China"?

Having witnessed the rise of China over the past 40 years, after Deng Xiaopeng introduced market-oriented reforms, there are striking similarities between the two countries, the most apparent one being the one-party communist regime. However, and this is a very important point, there are striking differences between China and Vietnam. China's one-child policy, introduced in 1979, has led to a demographic development that has started to weigh on economic trend growth. The average Chinese is 43 years old, the average Vietnamese only 28. The fertility rate, with 2.05 children per Vietnamese woman compared with 1.69 in the case for China, exacerbates this trend.

Selected Fertility Rates



Source: World Bank

On a pure purchasing power-adjusted basis based on IMF estimates for 2021, Vietnam's per-capita-gdp still lies a good third below that of the Middle Kingdom. So there remains a good amount to catch up, in our view, despite impressively rising living standards: according to World Bank figures, today, less than 10% of the Vietnamese population lives below the lower middle income poverty line (USD 3.20 a day, adjusted for inflation) compared to more than two thirds only 20 years ago. Furthermore, the regime in Hanoi has been able to stay out of the growing conflict between the US, for more than two decades the sole superpower, and China, which is overtly starting to challenge American influence in many countries globally.

What if…?

Taking China's economic ascent as blueprint, what could this mean for Vietnam? While there were phases of strong Vietnamese outperformance relative to global equities, the relative high (vs. the MSCI ACWI) was observed in early 2007, some 75% higher than today. We therefore see continued potential for outperformance of Vietnamese stocks vs. global equities and also emerging markets. A note for the sake of exactness: Vietnam still is categorized as a "frontier market", the waiting room so-to-speak for a country to become an "emerging market". We expect that within the next three years maximum, Vietnam will be upgraded to this status by the leading index providers.

Geopolitical tidal change

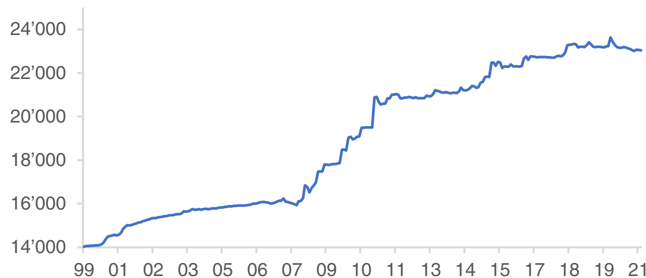
The growing frictions between the two biggest economies, the US and China, will continue in the years to come. An increasingly self-conscious China under longer-time ruler Xi Jinping is challenging the (once America-led) Western coalition of countries. Not last due to the aggressive demonstration of naval power in the South-China Sea under the Nine-Dash Line doctrine, several neighboring countries are increasing their ties with Western countries, often on the economic level. For an export-oriented economy such as Vietnam, with exports amounting to 80% of gdp, free-trade agreements are vital in order to get access to large markets. The signing of the EVFTA (European Union Vietnam Free Trade Agreement) in August 2019 is a good example. With more than 70% of Vietnamese exports exempt from import duties into the EU after August of 2020, trade volume between the two will certainly rise further.

Secular growth advantage

The case of Vietnam makes for very interesting comparisons. After three decades of strong growth, per-capita-gdp has risen respectably, but there is much further potential, thanks to several factors.

In addition to the high share of the working population of the total (75%), education levels as well as worker productivity are high, leading to very healthy levels of foreign direct investment (FDI) over the years. Vietnam ranks 117th of 189 countries in UN's Human Development Index (HDI), clearly ahead of its neighbours Laos (137th) and Cambodia (144th), but behind the People's Republic of China (85th). Many consumer products makers have moved manufacturing activities to Vietnam, often from China, due to wage differences and a general willingness to reduce dependencies from an economic Goliath.

USD/VND



Source: Bloomberg

A number of economic indicators support the expectation of Vietnam rising further through the rankings. Government debt stands at below 50% of gdp, the current account balance at +4% of gdp, and inflation, after two spikes in 2008 and 2011, has averaged 3.5% in the past 9 years. The macro-economic outlook therefore remains positive, not last with an eye on the VND or Vietnamese dong which used to devalue steadily: from 1996 (pre-Asian crisis) to 2020, it lost about 3% annually against the dollar. In the past 5 years, the average devaluation slowed to 0.6% p.a. and it has even gained vs. the greenback since its lows in 2018.

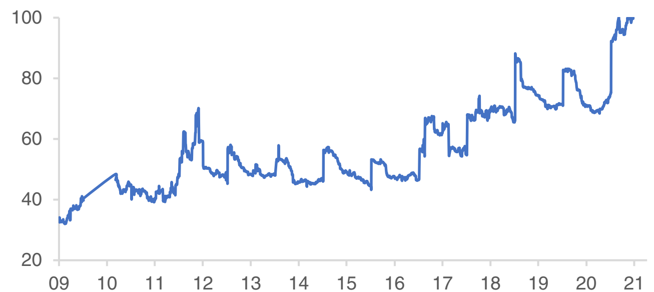
Attractive FDI destination

Political stability is one factor that is frequently mentioned by companies investing in Vietnam. The one-party rule of the Communist Party of Vietnam has allowed for many economic freedoms, but not in the political sphere, signified by a low ranking in the press freedom index, for instance, with Vietnam ranking 175th of 180 countries in total (China ranking 177th). This undisputed rule of one party often leads to severe corruption, which however is being fought vigorously in Vietnam, resulting in its ranking 104th (out of 180) together with Thailand, and ahead of countries such as the Philippines (115th) or Mexico (124th) in Transparency International's Corruption Perceptions Index. Hence, the attractivity to invest into manufacturing capacity is a given, especially in connection with the government's stated goal of attracting further foreign investment by improving infrastructure, both physically and in terms of government services.

Stock market inexpensive considering prospects

The Vietnamese stock market with a market capitalization of some VND 5tn (USD 220bn) is dominated by the Financial (37% of total) and Real Estate (24%) sector, respectively. In its 2020 country report based on Article IV consultations, the IMF mentioned that "the banking system was strengthened, but weaknesses persist". Thanks to government backing of the SOCBs (state-owned commercial banks), systemic risk is contained, in our view. Some of the IMF's suggested policies, such as raising foreign ownership limits beyond current rules (currently at 30%), would clearly add to the banking sector's attractiveness. On an index level, earnings growth in the past 12 years has been at an impressive 10% p.a. (8% in USD) since 2009, compared to 6% for global equities and no growth at all for the MSCI Frontier Market Index earnings.

Vietnam Stock Index: Earnings per Share



Source: Bloomberg

Based on the price-to-earnings (P/E) metrics, Vietnamese equities – despite the strong run-up to date – do not appear expensive, with a forward P/E of 16.5x, a discount of more than 15% to the MSCI All Country World Index (ACWI). The historical average (since 2009) has been about 10%. So even after the impressive outperformance to the MSCI ACWI of the past almost 18 months of some 15%, there is more to come in our view.

Domestic retail investors are joining

One aspect to follow in the short term is the growing stock market participation of local retail investors. With 400'000 new trading accounts opened in 2020 and more than 250'000 in the first quarter alone, daily volumes at the Ho Chi Minh City Stock exchange rose to an all-time high. This domestic demand offset more than the amount (USD 800m) foreign investors pulled from the country's shares so far this year. Short-term, a setback can easily happen, with the proverbial "rubber band" stretched, as it was this mid-January, when the VN Index dropped by 15% within 10 days (the top got taken out some two months later). Corrections in the order of 5-7% are quite frequently occurring and we would use a time of weakness to add to positions.

Relative forward P/E: Vietnam vs. MSCI ACWI

Source: Bloomberg

The case for EM index inclusion

Three years ago, index provider FTSE added Vietnam to the Watch List for a potential upgrade from a Frontier Market to a Secondary Emerging Market. In the 2020 review, the index provider decided that the country still did not meet all the criteria for an upgrade. The next date for a potential upgrade will be the month of September. With Kuwait's move from Frontier to Emerging Market status by index provider MSCI, Vietnam now represents 30% of the MSCI Frontier Market, more than twice the second-biggest index weight, Morocco (12%). That by itself is a strong argument for an upgrade, however there are formal criteria to be met for MSCI EM inclusion, such as the foreign ownership limit. Therefore, further reforms are necessary, but these will come and pave the way for more international capital to be allocated to Vietnamese stocks.

CONCLUSION

- The fundamental case for Vietnamese equities remains robust: strong economic growth, high inflows of foreign direct investment, supporting demographics and political stability speak in favor of the success story to continue.
- “The next China”, as some observers call it, also profits from heightened tensions between its large neighbor to the North and the West, insofar as manufacturing capacity of Western companies continues to be moved from China to Vietnam, leading to further productivity gains.
- With a strong current account and inflation in check, we see the potential for the Vietnamese dong to gain in the coming years, after it had been devaluing for decades, but has stabilized in the past three years.
- Equity valuations have risen of late, but remain below their long-term relative averages vis-à-vis Emerging Markets and also global equities – despite a strong run-up in the past quarters.
- We consider the Vietnamese stock market to continue to thrive, both in absolute and relative terms, and would add to positions at times of weakness.
- Any surprising early inclusion into Emerging Market equity indices by one of the major index providers (FTSE, MSCI, S&P) would trigger many capital inflows, leading to a further surge in prices.

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