Schroders

For professional investors and advisors only

Indonesia
Market Commentary
August 2017

Macroeconomics

Indonesia's consumer price index (CPI) recorded a deflation of 0.07% month-on-month (mom) in August 2017 or an inflation of 3.82% year-on-year (yoy). Core inflation, which excludes food and administered prices, increased 0.28% mom or 2.98% yoy.

Indonesia posted 5.01% yoy GDP growth in 2Q-17. Despite a pick-up in investment, deceleration in government spending and net export dragged down overall GDP growth. The decrease in net exports coupled with income repatriation during dividend payment season, brought 2Q-17 balance of payment (BOP) to USD 0.7bn (down from USD 4.5bn in 1Q-17) as current account deficit (CAD) widened to 1.96% of GDP from 0.98% in previous quarter.

According to the RAPBN 2018, government expect a GDP growth of 5.4% with investment and private consumption as the engine for growth. Inflation is expected to decrease to 3.5% at a time when economy is expected to accelerate and Rupiah weakens to IDR 13,500 per USD, implying a small possibility of administered price hike next year. This is reflected in government's expenditure post that saw energy subsidy increased by 15%, bringing total expenditure to grow 3.3%. Government will be focusing not only on infrastructure, but also on poverty and income inequality which will be tackled through various social programs and more effective targeted subsidies. On the revenue side, government expects total revenue to rise by 8.2% with tax revenue rising by 9.3% on the back of better tax compliance and Automatic Exchange of Information. All of this brings budget deficit assumption to 2.2% to GDP. Worth noting that this draft budget will be finalized and approved by the Parliament in October 2017, hence it is still subject to change.

Bank Indonesia (BI) cut the benchmark interest rate 0.25% to 4.5% on the back of favourable global backdrop and the weak purchasing power reflected by a very low inflation rate. In addition, July 2017's record-high foreign exchange reserve of USD 128bn, which is equivalent to 9 months of import, is more than enough to cover the sudden reversal of risk, if any.

Indonesia posted its first trade deficit this year at USD 0.3bn in July as import outpaced export during the Lebaran festivity. This might be an early sign of domestic demand pick up as capital and consumer goods import printed the largest increase in the past 3 months. Overall, total trade balance as of July reached USD 7.4bn, nearly doubled compared to the same period last year.

Equity

Market Update

The Jakarta Composite Index (JCI) up 0.4% in August 2017, hitting a new all-time high during the month as it peaked at 5,915 before it was closed at 5,864. Despite 2Q-17 earnings disappointments due to weaker than expected spending during Lebaran period, the index continue to rally on the back of monetary easing expectation by Bank Indonesia (BI). Local investors are the main supporters as foreign participants recorded IDR 6.3tn of outflow during the month.

The construction, property and real estate sector performed the strongest at 3.2% in August 2017 in anticipation of interest rate cut, which would lead to expectation that property demand will increase thereafter. The infrastructure, utilities and transportation sector followed closely as it gained 1.9% due to improved outlook in the sector on consolidation amongst the players. Meanwhile, trade, services and investment sector was the worst performer with 2.9% loss as media sector underperformed on concerns over weak advertising spending due to weak economy and long term threat from the internet. Retailers also underperformed due to weak Lebaran spending.

Strategy

The main challenge for Indonesia going forward is the GDP growth recovery. We see Indonesia is still

struggling to boost the GDP growth from 5% level as consumption remains weak. The recovery in consumption spending post-Lebaran also remains very modest.

We expect consumption to improve modestly in 2H-17 with the government accelerating its spending and the absence of subsidy removal. We also expect consumption to improve in 2018 as government will focus on purchasing power, as we are approaching election year in 2019. Private investment may be weaker in 2018 due to several issues like increasing tax scrutiny, political uncertainty due to election and several government policies which are seen non-business friendly.

Going forward, we see government will protect consumer purchasing power by (1) maintaining administered prices planned throughout 2018 and (2) extending staple VAT exemption. Considering the former, 4Q-17 premium and diesel prices are likely to be unchanged in September 2017 review despite economic tags are +8.5% of retail cost. The disbursement of social spending that benefits the poor, is also accelerating in 2017 (24.0% yoy in 7M-17).

Conducive global backdrop and the weak purchasing power reflected by a very low inflation rate have prompted BI to cut benchmark rate by 25 bps. In addition, BI is likely to implement further macro-prudential policies (e.g. Loan-to-value and reserve requirement). The policy will be designed by region-specific based on the non-performing loan (NPL) level of each region.

The stimulus coming from fiscal policy too will be limited in 2018. We still see downside risk on the economic growth assumption in the budget at 5.4% as government assumes investment and private consumption will improve in 2018. We still see a risk for government revenue shortfall as there is no more tax amnesty revenue.

As a result we maintain our defensive strategy due to weak economy and slower earnings growth outlook in 2018 while the market's Price-to-earnings Ratio (PER) remains high at 16.7. We remain overweight in resilient sectors like telecommunications, while we see consumer names should report better numbers in 2H-17. We also overweight in selective banks, which has higher earnings growth relative to peers.

Fixed Income

Market Update

Bond market started positively in the beginning of August helped by the low inflation, which led to BI cutting the benchmark interest rate by 0.25% to 4.5%. Positive sentiments continued during the month and the 10-year benchmark yield declined from 6.94% to 6.63%.

Global factors also affected the market including speculation of tightening by the Fed, especially with the declining unemployment rate in the US. However, dovish tone of the FOMC meeting on August 17 reversed the sentiment and supported IDR bond market. Jackson Hole meeting also gave little information on the direction of US monetary policy. Dovish expectation is further fuelled by series of geopolitical tensions, i.e. North Korea threats to attack Guam and its missile launch which flew over Japan.

The government issued IDR 57.8 tn of bonds in August 2017, making the total year-to-date issuance to IDR 540.2 tn or 78.9% of gross target issuance of 2017 (assuming budget deficit of 2.41% of GDP). Foreign investors continued participating in auctions, and held about 39% of total outstanding amount by the end of the month.

Strategy and Outlook

Concern may come from possible increase in bond supply, as the 2017 budget deficit assumption widened to 2.92% from initial estimate of 2.41% of GDP. This could increase net bond issuance by about IDR80 tn.

Globally, market will continue paying attention to geopolitical risks, and also the development of Fed possible balance sheet reduction. Credit yields are declining, yet spreads are widening due to much lower government bond yields. This may lead to more issuances from more diverse sectors, as investors are looking for values in the credit market.

Low inflation and weak economic growth may continue to support the bond market. We continue to maintain overweight duration in line with our positive outlook in IDR bond market.

Disclaimer

Important Information: The views and opinions contained herein are those of the author(s) on this page, and may not necessarily represent views expressed or reflected in other Schroders communications, strategies or funds. This material is intended to be for information purposes only and is not intended as promotional material in any respect. The material is not intended as an offer or solicitation for the purchase or sale of any financial instrument. It is not intended to provide and should not be relied on for accounting, legal or tax advice, or investment recommendations. Reliance should not be placed on the views and information in this document when taking individual investment and/or strategic decisions. Past performance is not a reliable indicator of future results. The value of an investment can go down as well as up and is not guaranteed. All investments involve risks including the risk of possible loss of principal. Information herein is believed to be reliable but Schroders does not warrant its completeness or accuracy. Some information quoted was obtained from external sources we consider to be reliable. No responsibility can be accepted for errors of fact obtained from third parties, and this data may change with market conditions. This does not exclude any duty or liability that Schroders has to its customers under any regulatory system. Regions/ sectors shown for illustrative purposes only and should not be viewed as a recommendation to buy/sell. The opinions in this material include some forecasted views. We believe we are basing our expectations and beliefs on reasonable assumptions within the bounds of what we currently know. However, there is no guarantee than any forecasts or opinions will be realised. These views and opinions may change. PT Schroder Investment Management Indonesia, 30th Floor IDX Building Tower 1, Jl. Jend. Sudirman Kav 52-53 , Jakarta 12190, Indonesia. PT Schroder Investment Management Indonesia had received an investment manager license from, and is supervised by the Indonesian Financial Services Authority (OJK).