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Indonesia Market Commentary

January 2018

Equity

Market Update

January is a strong month for Indonesian equities as JCI posted another all-time high closing of 6,681 level on 29 January, and closed the month with a +3.9% monthly gain supported by the rally in small cap names. Foreign investors recorded the first monthly net buy since April 2017, as they are the better buyer with Rp1.8tn (US$132mn) net buy during January. Indices-wise, the best performer was the Jakarta Mining index with +25% gains on monthly basis as coal price resiliency to remain above $100/ton throughout the month helped investors' confidence on the sector. In second place is the Jakarta Basic Industry and Chemical index with +11.5% gains on a monthly basis. On the other end of the spectrum, Jakarta Infra Utility and Transport index was the worst performer during the month with -1.8% on a monthly basis due to concern on declining profitability growth on intense data competition. Rupiah strengthened by +1.3% vs. the USD in January, as the USD weakens amongst the bucket of global currencies after US' Government shutdown caused investors to lose more confidence within the Trump regime.

Starting with the 2017 budget achievement, Indonesia posted a tax revenue growth of +4.3% and non-tax revenue of +17.8% on annual basis, bringing total shortfall to only Rp85tn (vs. Rp237tn in 2016). Government expenditure gained considerable momentum in the second half as delayed disbursement of Rice Aid and social spending in 1H17 was compensated in 2H17. All in all, economists in the market still think that 2018 budgeted revenue target remains challenging to achieve as it means tax need to grow by 21% on annual basis from the actual 2017 achievement.

Bank Indonesia (BI) maintained the 7-day reverse repo rate (7DRRR) at 4.25% as they highlighted several risks, including monetary tightening of advanced countries and inflation risk from oil price. During the meeting they admit that monetary policy transmission to banking sector has been limited due to weak loan demand; but it has a stronger effect to the growth of equity and bonds issuance. BI is also considering new macroprudential measure that will be implemented to increase the effectiveness of monetary transmission, liquidity and financial sector deepening. Firstly, average reserve requirement (ARR) is implemented to support more flexible liquidity management for financial institutions, and hence improved monetary transmission. Secondly, Macroprudential Intermediation Ratio (MIR) is aimed to increase the overall credit growth, as bond ownership is now categorized into 'credit/loan' for banks. Lastly, Macroprudential Liquidity Buffer (MLB) replaces secondary reserves requirement for more flexibility in terms of liquidity. These three measures are going to be implemented to commercial banks by July 2018 and to Syariah banks by October 2018. All in all, the Central Bank's target for 2018 includes: GDP growth of 5.1%-5.3%, inflation at 3.5%±1% and CAD at 2-2.5% to GDP.

Moving on to inflation, January's figure of +0.62% on a monthly basis came lower than consensus expectation as it translated into +3.25% on annual basis, slightly down from +3.30% in December. Transportation and communication impact were underestimated by consensus as airfares and train tickets gave a negative contribution to monthly inflation after holiday season. Foodstuff was the main contributor to inflation during January with rice being the main culprit; while non-subsidized fuel price increase has a very minor impact to inflation. Going forward inflationary risk will come from the potential introduction of new electricity formula that will most likely impact the non-subsidized electricity consumers. The cumulative trade balance 2017 figure was US$11.8bn surplus, highest since 2011. Despite breaking records on the annual figure, Balance of Payment is also expected to be healthy on the back of strong trade balance and financial account balance, especially after the success of Government's US$4bn global bonds issuance in December.

Investment strategy

Global market registered mixed performance in December 2017, the US and Eurozone performed better versus Asia region. December US

Equities closed the year pushing to yet another all-time high as market tracks Trump's highly anticipated tax bill and November jobs report was stronger than expected at an unemployment rate of 4.1%. This was also one of the reasons why Federal Reserve decided to raise rates by 0.25% and indicating three more rate hikes next year. US Central Bank also raised 2018 GDP projections from 2.1% to 2.5%. However, progress of Republican's business-friendly tax overhaul, which would include a reduction in corporate tax rate from 35% to 21%, continued to be the main driver for US equities as market closely tracks political progress of the bill. Asian equities struggled as tech stocks, including index heavy weight Tencent, and commodity stocks cooled some of the world's best performing indexes. Meanwhile, Japanese stocks were also hit as Yen strengthened against the US dollar after Democrat's victory in Alabama. The currency was not much affected by Bank of Japan's decision to maintain its 10 year bond yields at around zero while its short-term deposit rate remains at minus 0.1%. The BOJ also plans to continue aggressive monetary easing at an annual rate of 80 trillion yen (USD705 billion) while giving no indication for potential policy change or interest rate hike, keeping index relatively subdued. Meanwhile, government data also revealed household spending rose 1.7% in November (vs 0.5% expectation), which helped support the index. Euro equities also reacted positively on the resolution of Irish border issue which allows negotiations to advance to its second phase. In terms of macro, UK November inflation also hit its highest level since March 2012 at CPI 3.1%, 1% higher than BOE target, which supported the decision to keep interest rates unchanged at 0.5% after November's hike.

Looking forward to 2018, we are seeing a better momentum in Global GDP growth which provides a supportive background to Indonesian equity this year. We are not seeing macro risk this year as inflation remains to be under control. With a high base in first-half 2017 because of rise in electricity price, economists are expecting first-half 2018 to post a sub 3% yearly inflation, which will bring full year inflation expectation to 3.8%, while fiscal budget remains to be manageable. The street view of stable USD should also bode well for our currency and enable BI to continue its accommodative monetary policy.

In terms of growth, the Central Bank is expecting 2017 GDP growth to accelerate to 5.10% YoY (vs. 5.02% YoY in 2016) on the back of improvement in investment, while consumption remains subdued. For 2018, BI forecasts the following: 5.1-5.5% GDP growth, 9-11% third-party fund growth and 10-12% loan growth. We think this year one of the main drawbacks in Indonesian equity in 2018, is the weak economy growth recovery and political uncertainty ahead of election. The hope for consumption recovery comes from the low end spending after being hammered by adjustment in electricity spending in the 1Q17 and higher social subsidy spending this year while Jokowi cash for work program should provide help on low-end consumption. However, the overall growth recovery will remain muted cos the consumption recovery might be slightly offset by low capex spending and weak investment due to political uncertainty ahead of election. We expect overall credit growth investment remains lukewarm at 8% mostly from consumer loan. We forecast investment credit growth remains modest due to low business confidence and moving towards automation.

In 2017 index performed very strongly while earnings growth is lower. Last year's earnings growth mainly attributed from banking and commodity sectors. However, we expect this year earnings growth to be lower due to high base on banking and commodity sectors. While we expect consumers space to register better earnings after a very weak year in 2016 anticipating a better purchasing power coming from higher social subsidies while margin should improve on lower raw material price. In terms of flow last year market already saw US$3bn of net outflow, regardless the index reached its all-time high level supported by local buying. There are three big events which will impact the market performance this year, 1) election, both simultaneous regional election and 2) starting completion of infrastructure project with the connectivity of Trans-Java toll road (from Jakarta to Kertosono) and 3)automation and digital disruption which could be a double edge sword, benefitting manufacturing for cost efficiency and also bad for employment. We think the sectors that will do relatively better is banking, low-end consumer beneficiary and constructions.

Fixed Income

Market Update

Bond market strengthened in January, with 10-year new benchmark yield (FR64) decreasing from 6.47% to 6.22%. Inflation remained under control in December despite a slight increase from the previous month due to food inflation. Bank Indonesia decided to keep the

7-day RR rate at 4.25%, seeing that economic growth can be sustained through ongoing structural reform while acknowledging several risks which include monetary tightening of advanced economies. There have been continued portfolio inflows, which lead to increase in FX reserve to US$132 billion, a 1.4% increase from the previous month.

US Treasury 10-year yield increased from 2.4% to 2.7% during the month, thus spread against IDR government bond has been narrowing. The trend has been affected by positive outlook on US economic growth and expectation of higher inflation. Upward pressure on bond yields is expected to continue this year, as central banks may no longer feel the need to buy assets to stimulate the market due to stable global growth.

By the end of the month, the government has already had a total bond gross issuance of IDR 144.2 trillion, or 16.8% of its full year target assuming budget deficit at 2.2% of GDP. The government mentioned that it would still implement front-loading strategy in bond issuance this year. Demand from foreign investors remained strong, with ownership increasing by IDR 33 trillion and representing 41.3% of total bond outstanding.

Outlook and Strategy

- January inflation was lower than the previous month at 3.25% YoY (0.62% MoM). Foodstuff contributed 0.48 ppt to the monthly inflation with rice contributing half of it. We expect BI benchmark rate to stay, subject to stable inflation and trend in global rate movements.
- GDP growth in 4Q17 was at 5.19% YoY, above consensus estimate of 5.12% as well as 3Q17 figure at 5.06%. Government expenditure has been stable, while private consumption and gross fixed capital formation were better than expected. For the whole FY17, GDP grew by 5.07% YoY, supported by acceleration in investments and net exports.
- Positive capital inflow to the Indonesian market may be supported by extended search for high-yielding currency, and less uncertainty surrounding the Fed balance sheet tapering.
- Fluctuations in oil price will be an important factor, where significant disparity between market price and budget assumption may lead to adjustment in administered fuel prices.
- Low yield environment remained supportive to the corporate bond market, with diversified issuers and tenors up to 7 years.
- We keep our neutral duration strategy and yield enhancement from credit spreads. We still expect global rate direction and changed sentiments in emerging markets to affect the local bond market.

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