Economics & Strategy

DBS Focus

Indonesia in 2018/19: Higher gear?

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Gundy Cahyadi
Economist

Philip Wee
FX strategist

Eugene Leow
Rates strategist

Joanne Goh
Equity strategist

Outlook 2018/19

Economics

- Indonesia has one of strongest fundamentals in Asean, with low debt, moderate inflation, stable governance, and marginal political risk. Yet, afflicted by the hangover from the 2014/15 commodity crash and a still-challenging investment environment, the economy seems to be stuck in a 5% growth trajectory, well below its potential, in our view.
- With policy-making becoming more challenging and the 2019 Presidential election looming, Indonesia would need a major pull from the external environment to move to a higher gear.
- We expect slightly stronger GDP growth of 5.3% and 5.4% in 2018 and 2019. Investments will continue to recover, driven mainly by public infrastructure spending.
- Higher crude oil price is a positive on the budget balance but room for stimulus is limited. We expect slightly higher CPI inflation at 4.0% and 4.5% in 2018 and 2019.
- Bank Indonesia may start hiking rates at the end of 2018, given the anticipated strengthening of the USD.
- The commodity drag lingers on. Loan growth remains weak below 10%, despite generally favourable conditions in 2017.

Currency

- We expect a modest depreciation path for the rupiah towards 14,200 in the next two years.

Rates

- Indonesia government bonds are likely to outperform peers in a moderate USD rate-rise environment.

Equities

- The current valuation is sustainable. Market volatility has fallen over the years and long-term funds should find the market attractive.

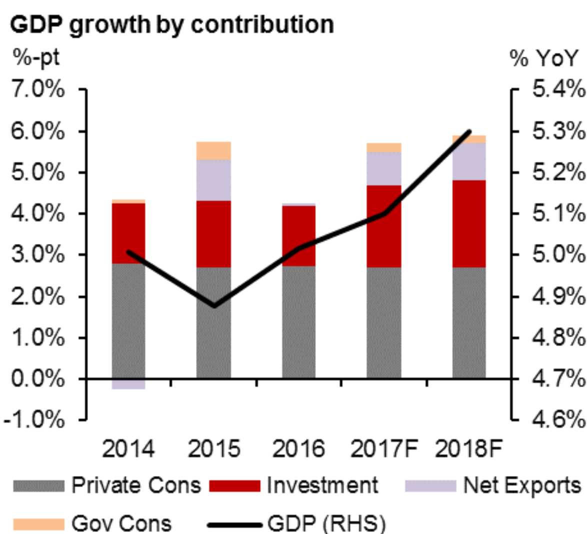
Please direct distribution queries to
Violet Lee +65 68785281 violetleeyh@dbs.com

Refer to important disclosures at the end of this report.

Forecast summary				
	2016	2017F	2018F	2019F
Growth, yoy%, ave	5.0	5.1	5.3	5.4
Inflation, yoy%, ave	3.5	3.9	4.0	4.5
Core inflation, yoy%, ave	3.4	3.2	3.5	3.5
Currency, against USD, eop	13,473	13,600	14,000	14,200
Monetary policy rate, %, eop	4.75	4.25	4.50	5.00
10-year yield, %, eop	7.97	6.80	7.20	7.50

Indonesia has one of strongest fundamentals in the region. Public debt is below 30% of GDP, one of the lowest among emerging market economies. Inflation has been moderate at around 4% in recent years. Governance is stable and political risk is low. Yet, afflicted by the hangover from the 2014/15 commodity crash and a still-challenging investment environment, economic growth has been stuck at 5%, well below Indonesia's potential, in our view.

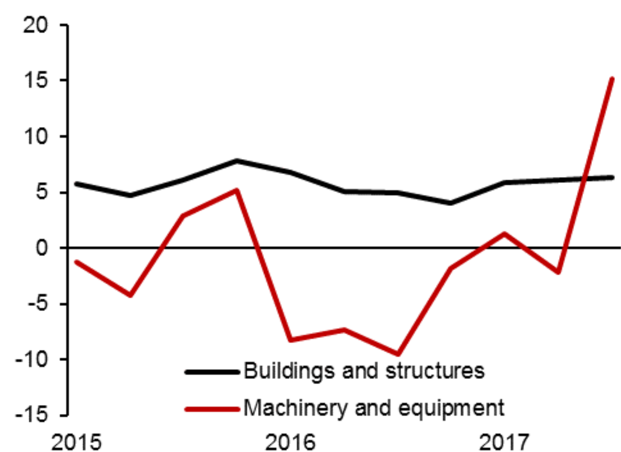
With policy-making becoming more challenging and the 2019 Presidential election looming, Indonesia would need a major pull from the external environment to move to a higher gear. **GDP growth may still pick up slightly to 5.3% and 5.4% in 2018 and 2019, respectively, up from our forecast of 5.1% for 2017**. Stronger commodity prices will translate into higher contribution of net exports to overall GDP growth. Investment growth will continue its gradual recovery. Meanwhile, consumption growth remains relatively stable at 5%.



Recovery in investment growth

Investment growth has a been a drag on the economy since 2013. It makes up a third of the economy but only contributed an average of 28% of growth. Some improvement was visible in 2017, particularly starting from Q3, when investment growth came in a strong 7.1% (YoY), the fastest since Q1 2013. A relatively stable IDR throughout the year has helped support investment demand, as evidenced in the turnaround in imports of capital goods in 2017. Imports of capital goods grew 9.1% in the year-to-date, after averaging -12.4% in 2013-16. Overall, investment growth is likely to contribute about 35% of full-year GDP growth in 2017.

We expect investment growth to average 5.5% in 2018 and 2019, which is decent, considering the average 4.7% in 2013-16. Investments in machinery & equipment grew a robust 15.2% (YoY) in Q3, but this was partly due to pent-up demand in the sector, as investments in the sector have been shrinking in the last two years. As such, we expect the pace to normalise going forward. The bulk of the support for investment growth is still likely to stem from the government's infrastructure push.



Limited room for fiscal stimulus

Even as the government maintains an accommodative fiscal policy stance, there is not much room for stimulus, given the 3% fiscal-deficit rule. We expect the budget deficit to hit 2.6% of GDP in 2018, similar to our forecast of 2.7% for 2017. While our forecast is higher than the government's official deficit target of 2.2% of GDP for 2018, it is driven mostly by a potential shortfall in revenues rather than an increase in spending. Tax revenues target for 2018 is modestly higher by 9% from the 2017 budget. But when compared to actual tax revenues this year (likely to be about 85% of budget),

the 2018 target would represent close to a 30% jump. This is quite unlikely, in our view.

Indonesia's 37 priority infrastructure projects

- The government has named 37 priority projects among its 245 National Strategic Projects (total estimated cost of US$310bn), which are overseen directly by a committee led by the Coordinating Minister for Economic Affairs.
- 17 projects are in the construction phase, 11 in the transaction phase, and nine in the preparation phase.
- Total pledged funding amount to IDR3420tn (approximately US$250bn), 51% of which is from the private sector, 40% by state-owned enterprises, and 9% from the government budget.

17 priority projects under construction

Project	Location
Gas-based powerplant (18 provinces)	Nationwide
Batang, Central Java powerplant	Java
Central-West Java 500kV transmission line	Java
MRT Jakarta South-North Line	Java
LRT Greater Jakarta	Java
LRT Jakarta	Java
Panimbang-Serang toll road	Java
Integrated coastal development	Java
Jambaran-Tiung gas field	Java
Manado-Bitung toll road	Sulawesi
Makassar-Parepare railway	Sulawesi
Balikpapan-Samarinda toll road	Kalimantan
Palapa Ring Broadband	Papua
LNG train development	Papua
Sumatera 500kV transmission line	Sumatera
LRT South Sumatera	Sumatera
Trans-Sumatera toll road	Sumatera

Source: Republic of Indonesia Presentation Book, Bank Indonesia, October 2017.

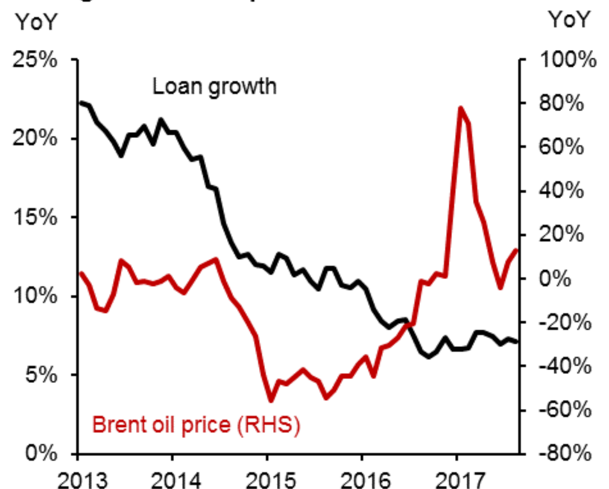
Higher crude oil price is positive for the government's budget. Combined, income tax and non-tax revenues from the oil & gas sector (IDR113tn) stand at about 10% higher than energy subsidies in the 2018 budget (IDR103.4tn). We estimate that every 10% rise in crude oil prices (from the baseline assumption of US$48/barrel in the 2018 budget) will provide an additional IDR6.7tn in net spending, or about 0.05% of GDP. If crude oil prices were to average US$65/barrel next year, we are then likely to see a 0.2%-pt swing in the budget deficit (budget deficit may be potentially lower at 2.0% of GDP).

There is certainly a risk that the government may re-introduce subsidies for gasoline, particularly ahead of the 2019 elections. We don't regard this as a major risk for now and assume that the government will continue to provide subsidies only for diesel as well as the lowest-tiered electricity and liquefied petroleum gas for households.

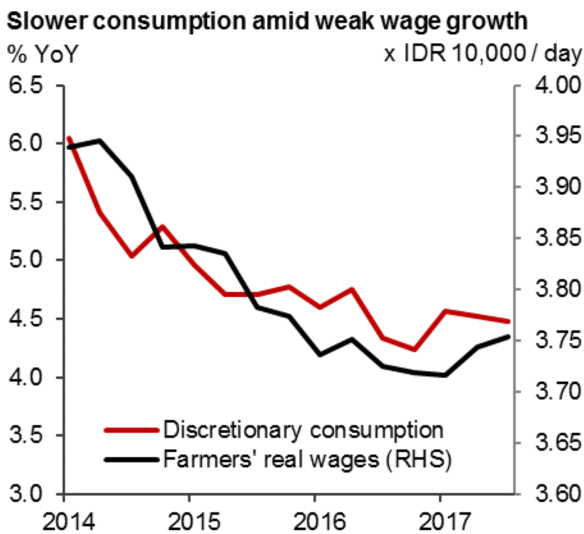
The commodity hangover

The economy is still unable to shake off the commodity drag. Despite a relatively stable IDR, stronger commodity prices, and the 150bps rate cuts delivered by Bank Indonesia (BI) last year, loan growth is likely to end 2017 at around 8%. Before investments picked up in Q3, loan growth has even fallen to 7.7% in June, lower than where it was at the end of 2016. Banks still appear to be reluctant to extend new loans aggressively due to the non-performing-loans overhang. NPL ratio in the mining sector remains relatively elevated at 8% as of August, more than double the overall NPL of 3% in the banking system. Note that the loan-deposit ratio (LDR) has moderated to 89% as of Q3 from 92% at the end of 2016.

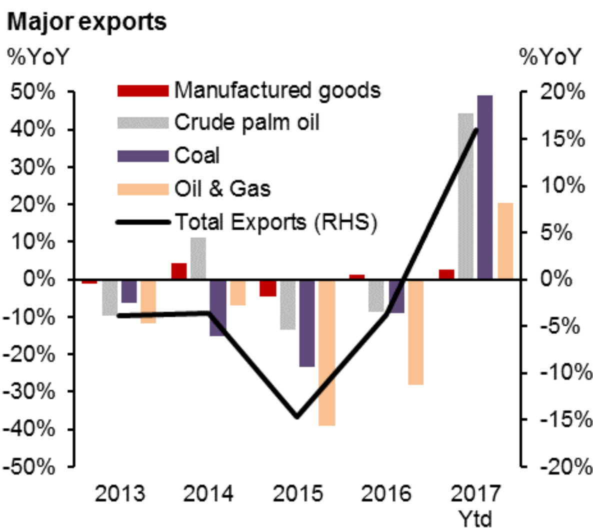
Loan growth and oil price



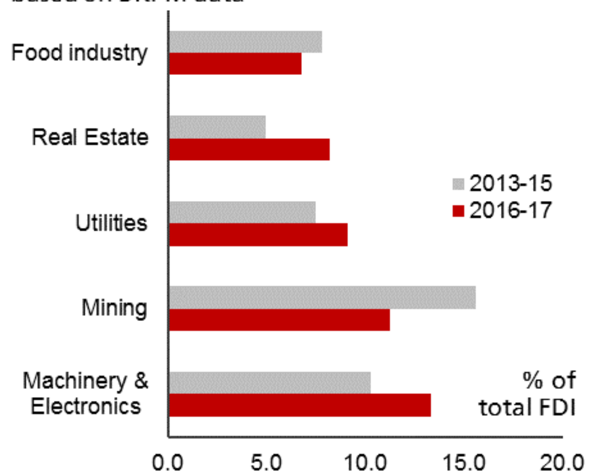
GDP growth would have been faster if we have had stronger discretionary consumption growth among households. While non-discretionary consumption growth remains stable at around 5.2%, discretionary consumption growth continues to underperform at 4.5%. This is well below the 6% level seen just three years ago. Purchasing power remains relatively weak for the lower-income segment of the population. Stronger commodity earnings this year has not translated into higher wages this year. On a real basis, the average wage for farmers was flat this year, after falling 2% and 2.5% in 2016 and 2015, respectively.



Unlike the rest of the region, Indonesia has not benefitted much from the increase in global demand of manufactured goods. Exports has grown a robust 17.9% in the year-to-date, after shrinking an average of 6.5% annually since 2012. **But the bulk of the increase in exports this year has been driven by the commodity sector.** Exports of crude palm oil, coal as well as oil and gas are up 44.2%, 49%, and 20.6%, respectively. Meanwhile, exports of manufactured goods has grown an underwhelming 2.5%.



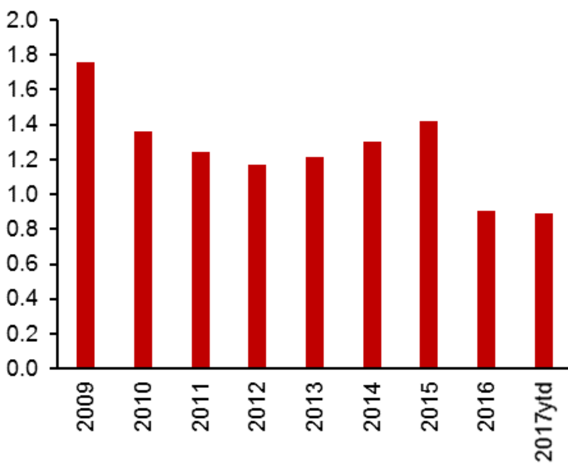
The government is committed to reforms, aimed at reducing the economy's over-reliance on commodities. It has introduced 16 reform packages over the last two years in a bid to raise productivity. The changes range from standardising regulations across provinces to improving public infrastructure. Various incentives are also provided to help the manufacturing sector. While one cannot expect rapid results from these reforms, early signs have been quite encouraging. In the 2018 World Bank's Ease of Doing Business index, Indonesia is ranked no.17, up from 91 and 106 in 2017 and 2016, respectively. Foreign direct investment (FDI) into manufacturing reached a record-high US$16.6bn in 2016. The top destination of FDI in 2016-17 is no longer mining but machinery and electronics, accounting for about 13.5% of total FDI.



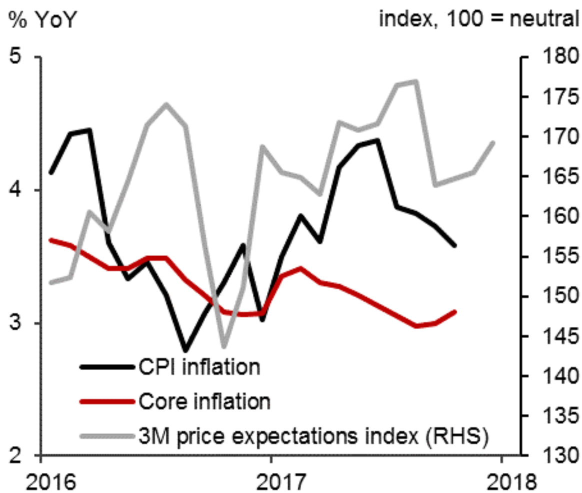
Inflation to stay relatively soft

We forecast CPI inflation to hit 4.0% and 4.5% in 2018 and 2019, respectively, up from our forecast of 3.9% for 2017. CPI inflation has averaged 3.8% so far in H2, lower than the 4.3% average in Q2. Food inflation has continued to weaken during the year. Inflation in the volatile food component of the CPI (18.9% weighting) came in a record-low 0.8% in October. This has pulled down the overall CPI, despite inflation staying circa 5% in both transport/communications and housing/utilities components of the CPI.

Softer underlying demand, as evidenced in the moderation of core inflation, might have played a role in driving food prices lower this year. But we reckon that supply-side factors have been more dominant. The government has made improvements in food distribution channels throughout the country. Inflation dispersion, measured by the standard deviation of inflation across provinces, has eased to 0.89 in the year-to-date, from 0.91 in 2016. It averaged 1.28 between 2011 and 2015.



The price expectations index has also eased markedly since May. The seasonal Ramadan impact was less significant than most had expected at the start of the year. The government raised subsidised electricity prices by about 30% each in Q1 and Q2, but has cancelled the last scheduled hike in Q3. While price expectations are likely to inch higher again towards the year-end, we expect only a gradual increase in the inflation numbers ahead.

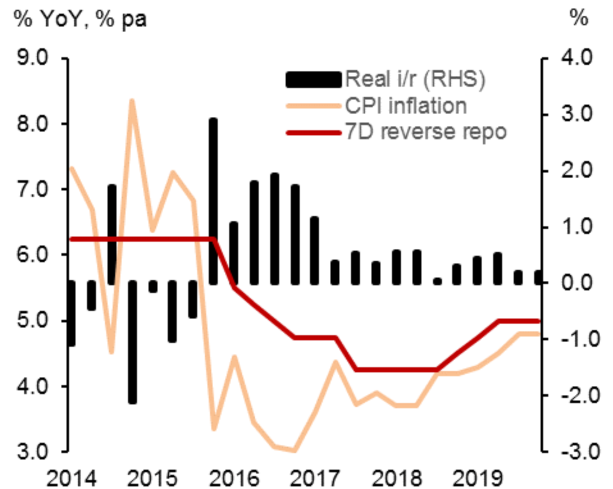


Risks to our inflation forecasts are mainly due to higher crude oil prices. Transport and electricity make up about 25% of the CPI basket. We estimate that for every 10% increase in crude oil prices (from the current US$60/barrel), there will be an additional 0.6%-pt to our inflation forecasts ahead.

BI to hike rates by end-2018

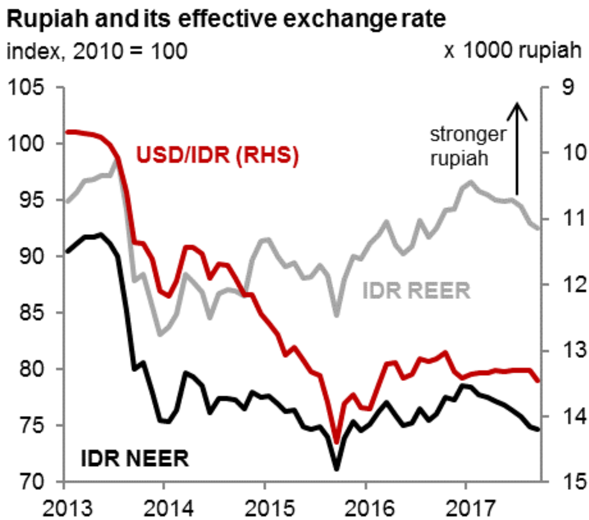
BI lowered its key 7-day reverse repo rate by 25bps each in August and September, on the back of the softer-than-expected inflation and a relatively stable IDR in 2017. At the current level of 4.25%, the policy rate is seen to be accommodative for growth and appropriate for the inflation outlook. Going into 2018, the policy focus has shifted once again to "vigilant of global financial risks, relating to the tighter monetary policy and fiscal reform plans in the US," as reflected in the November monetary policy statement.

We expect BI to start hiking rates again in Q4 2018, bringing the policy rate back to 5% by mid-2019. Not only do we expect inflation to tick up, but anticipation of a stronger broad USD may also mean that higher domestic interest rates are necessary. An excessively weak IDR is likely to be a drag on GDP growth. It may lead to lower demand for imports of capital goods, just as investment growth are starting to show some signs of a gradual recovery. Meanwhile, demand for commodity exports is unlikely to be affected by a weaker IDR, given that Indonesia is a price-taker. Hence, we expect BI to push against considerable IDR weakness.

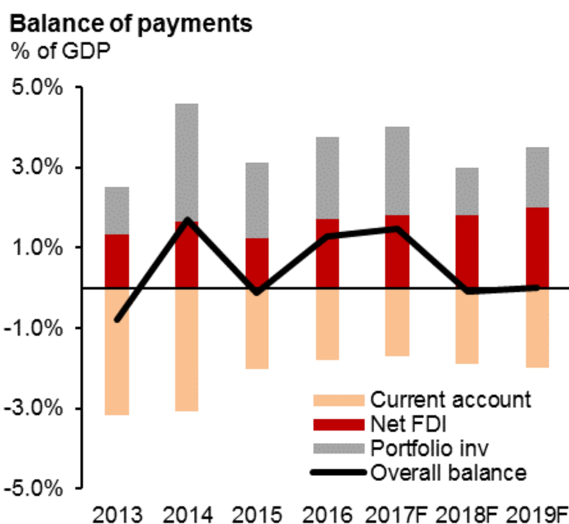


Reserves accumulation has been persistent throughout 2017, as BI continues to normalise foreign portfolio inflows and keep the IDR steady. Foreign currency reserves rose by US$9.6bn in the year-to-date (to US$126bn), driven by the US$8.5bn worth of equity and government bond inflows. As the currency has remained steady against the USD, it has softened against most regional currencies. On a nominal effective exchange rate (NEER) basis, the

IDR has weakened 4.9% in the year-to-date, although it is still 5% higher than the record low seen in September 2015.



The strong reserves accumulation in 2017 suggests that BI is shoring up its defences amid risks of capital outflows. Arguably, however, Indonesia is better positioned to withstand the risks from uncertainties in global markets. The external balance has improved since the Fed taper tantrums in 2013. We forecast current account (C/A) deficit at 1.7% of GDP in 2017, well below the 4.2% seen back in Q2 2013. The C/A deficit may widen slightly to 1.9% and 2.1% in 2018 and 2019, respectively, as investment growth continues to recover. Financing risks are also lower now that net FDI has averaged 1.7% of GDP since 2014, compared to only 1.3% back in 2013.



Eyes on the 2019 elections

The political landscape may heat up in the run-up to the 2019 national elections. Currently, most national polls still point to a two-way fight between incumbent Joko Widodo (Jokowi) and the 2014 nominee Prabowo Subianto in the presidential vote. Public support for president Jokowi remains relatively high. For example, his latest approval rating released by the Centre for Strategic and International Studies stood at 68% in September, even higher than 67% and 51% in 2016 and 2015, respectively. A total of 171 regional / provincial elections will be held in June 2018 and may provide important cues for the 2019 legislative and presidential elections.

A modest depreciation path for the rupiah

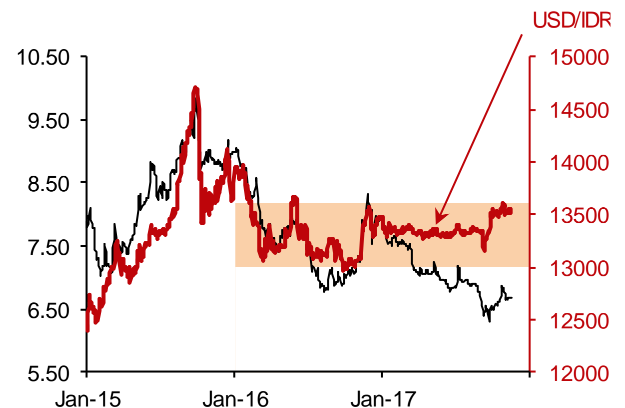
DBS forecasts for USD/IDR

eop	2017	2018	2019
Q1	13322	13700	14050
Q2	13348	13800	14100
Q3	13472	13900	14150
Q4	13600	14000	14200

Forecasts in red, actual data in black

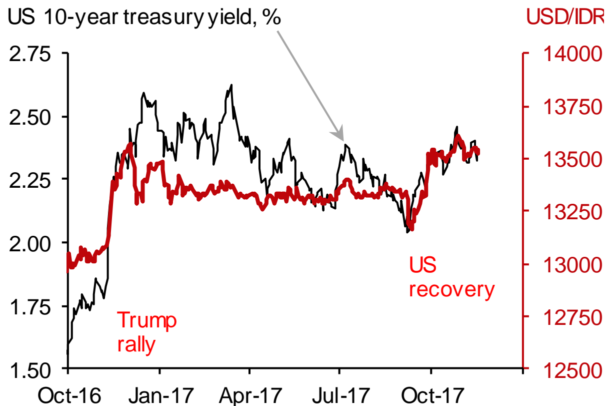
The IDR is expected to shift from its stable 13,000-13,600 range of the past two years to a modest depreciation path to 14,200 in the next two years.

USD/IDR decoupled from ID 10Y bond yield



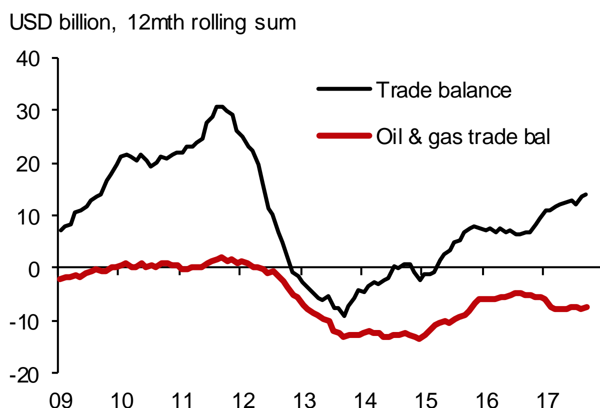
Unlike 2017, the USD will not be dragged down by lower US bond yields. The US 10-year Treasury yield is set to keep rising towards 3% into 2019 on US Fed rate hikes, an incremental unwinding of the Fed's balance sheet, more balanced financial regulation, and the possible implementation of Trump tax cuts next year.

USD/IDR correlated with 10Y US bond yield



This, however, does not imply that the IDR is destined for a repeat of the high volatility seen during the Fed taper tantrums in 2013. Over the past two years, CPI and core inflation were well-behaved within the official 3-5% target. Economic growth has stabilised at around 5% since 2014. The current account deficit this year is set to stay below 2% of GDP for a second straight year. Higher oil prices have yet to prevent the trade surplus from further widening on robust exports.

No pressure from higher oil prices yet



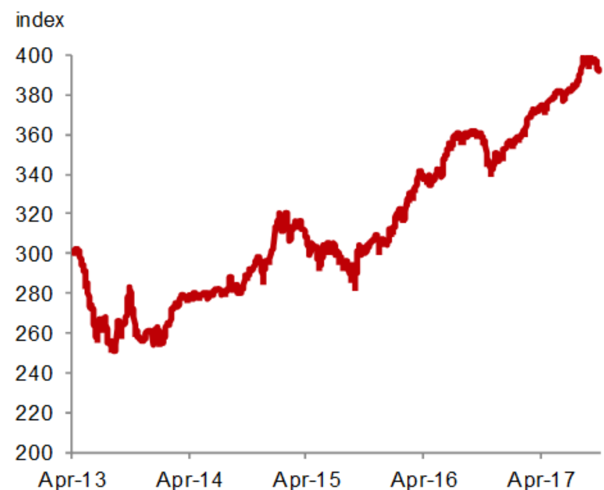
BI's job may become more challenging in 2018 as the next general elections, due in 2019, come into focus. President Jokowi wants to attract more private investment to lift growth to 5.4% in 2018. As room for fiscal stimulus is limited by the 3% deficit ceiling, BI may be encouraged to lower rates again.

Ultimately, upholding financial market stability is also crucial. Other than some upward risks to inflation, the C/A deficit is also likely to widen to about 2% of GDP by 2019. Higher rates will probably be required to help offset the depreciation pressures on the IDR from higher US rates.

IDgov bonds not as expensive as they look

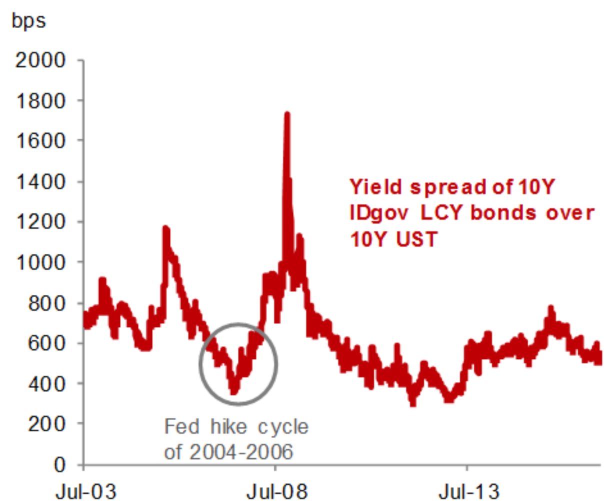
Despite rising US interest rates, Indonesia government (IDgov) bonds are still likely to do well from a total-return perspective. The combination of below-trend growth, still-low inflation, and a dovish central bank (50bps of rate cuts in 2017) has been a boon for government bonds, with the IBoxx ABF Indonesia government total return index up 14.0% since the beginning of the year.

IBoxx ABF IDgov Bond Total Return Index



Sentiment got overly bullish in September, driving 10Y yields temporarily below 6.5%. That has since been unwound as yields climbed towards 6.7%. 2Y bonds behaved similarly, but yields are still generally anchored by the still-low policy rate of 4.25%.

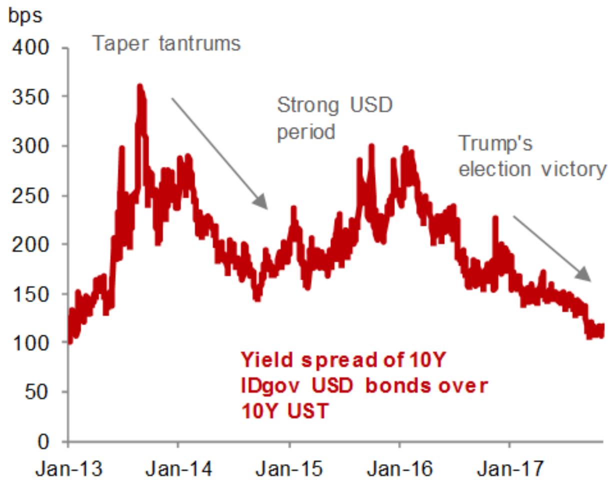
IDgov LCY bonds can outperform in a carry backdrop



Conditions are now less favorable for IDgov bonds as the tailwind from monetary easing is likely over, in

our view. Modest hikes are likely to follow in 2018 and 2019. However, in an environment of rising rates, IDgov bonds should still perform well relative to peers. The carry backdrop should stay intact over the medium term, allowing for further yield spread compression between LCY IDgov bonds and USTs.

Externally driven underperformance in IDgov USD bonds tend to fade



If 10Y yields climb to 7.2% (our forecast for end-2018) over the coming year, the total return over the period would be 3% (assuming no financing, taxes or reinvestment). The principal loss arising from higher yields should be more than offset by the carry (high coupon) offered. Comparatively, if 10Y UST yields touch 2.80% (our forecast for end-2018) over a year, total returns would be negative.

The outperformance can also play out in Indonesia's USD government bonds. By most measures, these bonds look expensive. The yield spread over 10Y UST stands at barely 115bps, (close to the historical low), down from 300bps in early 2016. A more relevant question would be how these bonds would perform if there is a moderate rise in UST yields. We suspect that further spread compression would prove difficult, but material spread widening would require a sharp spike in UST yields (taper tantrums of mid-2013 or Trump's election victory in late-2016) or significant IDR weakness, neither of which forms our core scenario.

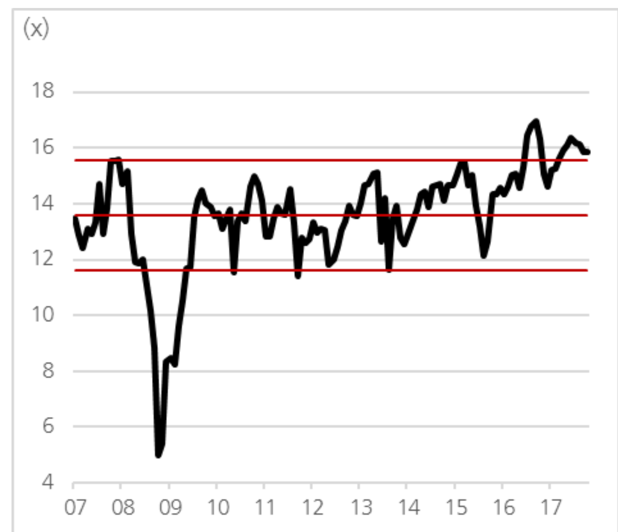
With higher coupons, duration risks for IDgov bonds are less than that for comparable USTs. If UST yields head moderately higher, IDgov bond prices should be less sensitive to the downside. In any case, Indonesia's low inflation and improving external funding dynamics should provide support for IDgov bonds. Externally-driven selloffs, much like what happened in mid-2013 and late-2016, should fade. From this perspective, IDgov bonds appear expensive, but may not be as expensive as they look.

Equity valuations can still be supported

We believe the current rich valuation in Indonesia is sustainable. This is mainly supported by a positive outlook on the global economic landscape, the moderate pace of interest rate hikes, USD strength, and supportive risk appetite for emerging markets. Domestically, the "Jokowi put" applies as the 2019 elections will prompt the government to "make no mistakes" on policies.

We are positive on Indonesian equities. We believe returns could be front-loaded as investors position for pre-election volatility in the second half of the year. Investors can look for sectors and themes such as digital banking, infrastructure, resilient consumer staples, services, as well as export sectors including tourism, agriculture, fishery, and media, which are likely to outperform in an economy undergoing transformation.

MSCI Indonesia's 12-month forward PE valuation



Source: IBES, Datastream, DBS Bank. Bands are period average and plus one / minus one standard deviation bands

Mid-teens' return still possible, JCI target at 6,800

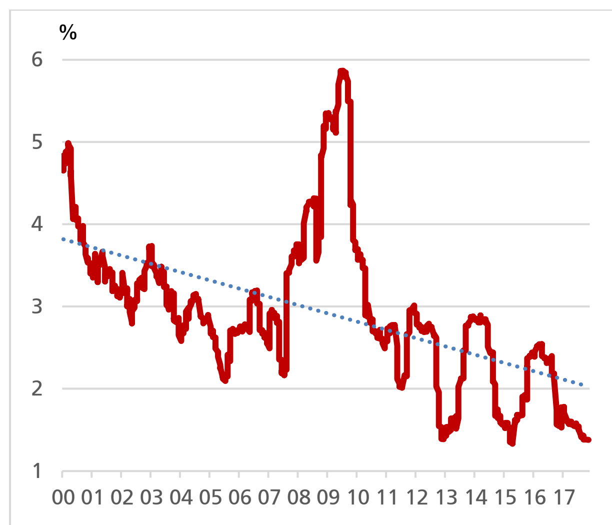
Realistically, the years of strong returns in the early 2000s are unlikely to repeat after many years of P/E expansion. Economic growth has also slowed down

from above-6% to the current 5% pace due to a sustained commodity drag. Still, we expect corporate earnings to grow about 14%, driving the benchmark Jakarta Composite Index (JCI) to 6,800, with P/E valuations staying at the current 16x.

Lower volatility to attract long-term funds

The volatility in the market in the past year has fallen, despite three US Fed hikes in the same period. This has been brought about by a stable IDR and strong reserves accumulation, which has helped strengthen the external balance sheet and reduce the risks of capital outflow. An investment-grade rating, a smaller threat of runaway inflation, as well as sound monetary and fiscal policies are key to the lower volatility, which in turn is a quality favoured by long-term funds.

JCI volatility



Source: Datastream, DBS Bank. Calculated using one-year rolling standard deviation of weekly returns

GDP growth at 5% is still relatively good

We believe the market should come around to a lower GDP growth rate for Indonesia, and look at a more sustainable growth pace, given the constraints of a fiscal-debt limit. Rating agencies have lauded the fiscal discipline and reforms underway to improve revenue and prioritise spending. Overall, the outlook for Indonesia, compared to a few years back, is one marked by resilience and lower volatility.

GDP growth is set to rise at a steady pace moving forward, on the back of lagged impact of lower interest rates and inflation, easing credit, and a recovery in commodity prices. Investment growth could provide upside surprises.

Risks

The larger macro picture of potential US interest-rate normalisation (and hence a stronger dollar and higher bond yields), slowing China demand (hence lower commodity prices), and above-average valuations are against Indonesia in the longer run. Hence, until earnings recover in a big way, Indonesia will still be subject to the tides of emerging market risks.

Domestically, we see two major risks that may spring surprises in one way or another. With politics potentially affecting sentiment ahead of the 2019 elections, we expect returns to be front-loaded in the year. There are also risks from the anticipated BI rate hikes at the end of 2018. However, we don't expect any response in the equity market to be as devastating as previously, given that the hikes are still considered modest. Based on our forecasts for Indonesia's bond and equity returns, we expect total returns of 3% for government bonds and 13% for equities. This should entice local funds to increase their allocation towards equities.

Group Research

Economics & Strategy

Taimur Baig, Ph.D.
Chief Economist - G3 & Asia
+65 6878-9548 taimurbaig@dbs.com

Gundy Cahyadi
Economist - Indonesia, Thailand, & Philippines
+65 6682-8760 gundycahyadi@dbs.com

Nathan Chow
Economist/Strategist - China & Hong Kong
+852 3668-5693 nathanchow@dbs.com

Eugene Leow
Rates Strategist - G3 & Asia
+65 6878-2842 eugeneleow@dbs.com

Chris Leung
Economist - China & Hong Kong
+852 3668-5694 chrisleung@dbs.com

Ma Tieying
Economist - Japan, South Korea, & Taiwan
+65 6878-2408 matieying@dbs.com

Radhika Rao
Economist - Eurozone & India
+65 6878-5282 radhikarao@dbs.com

Irvin Seah
Economist - Singapore, Malaysia, & Vietnam
+65 6878-6727 irvinseah@dbs.com

Samuel Tse
Economist - China & Hong Kong
+852 3668-5694 samueltse@dbs.com

Philip Wee
FX Strategist - G3 & Asia
+65 6878-4033 philipwee@dbs.com

Sources: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations).

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