

Viewpoint: Time to Take Stock

Wednesday, February 01, 2012

It has been quite a good start of 2012 for Indonesia, following Moody's action to upgrade Indonesia's credit rating to investment grade in mid-January, a move that affirmed Fitch's upgrade in the previous month. While market participants might have priced in both credit rating upgrades (and in fact, now market looks for S&P to follow suit), the reaction in the market still proved to be quite material, with the IDR gaining close to 1% and yields on IDR bonds falling by about 20bps on the day of Moody's announcement (the knee-jerk reaction to Fitch's move was more muted given the holiday effect in December). Additionally, news that total FDI for 2011 has reached a record high of close to USD 20bn also proved to be a boost to the local market, understanding clearly that low FDI amount has been one of the shortcomings of the Indonesian market.

Going back to April and October 2011, we had previously expected that an investment credit rating upgrade for Indonesia would trigger stock market gains, some appreciation in the Rupiah but may not have as much of a near-term impact on IDR government bonds. In fact, back then, we had cautioned that some profit taking would be seen in the IDR government bond market following any credit rating upgrade. Since the Fitch's upgrade on Indonesia's credit rating though, we have noted that gains have been witnessed across equities, IDR bonds and the Rupiah.

Changes up until 31 January 2012

	Since Fitch's Upgrade	Since Moody's Upgrade
IDR (% change vs USD)	1.0	1.3
JCI (% change)	5.5	-1.1
Yields on 10y Bonds (bps change)	100	70

Source: Bloomberg, OCBC Bank

As we kicked off February, one would wonder if there is still any sizzle left in IDR-denominated assets now that all the good news seems to have been frontloaded.

Firstly on the Rupiah. The IDR has gained about 1.0% against the USD since Fitch's credit rating upgrade in December, but interestingly, the unit has actually made all these gains only after the upgrade by Moody's. In fact, it has lost about 0.3% of its value against the USD in between the 2 credit rating agencies' move (the interim period). The tight onshore USD liquidity that has persisted since September 2011 was a key reason to why the IDR has been a regional laggard in recent months and the Fitch's upgrade did little to alleviate this, partly also due to the December effect. The upgrade by Moody's has brought some life back to the IDR and we have seen the unit playing some catch-up in recent weeks, but this is partly caused by the increase in risk appetite. **On a NEER basis, the IDR is currently trading at around its 5-year average and should be fundamentally supported going forward provided we don't see a sudden sharp turn in the global risk environment.** Besides the clear reason that it still offers a relatively high yield, one key reason that forms our fundamental positive view on the IDR this is the fact that Indonesia is likely to see its FDI growing higher in the next several years following

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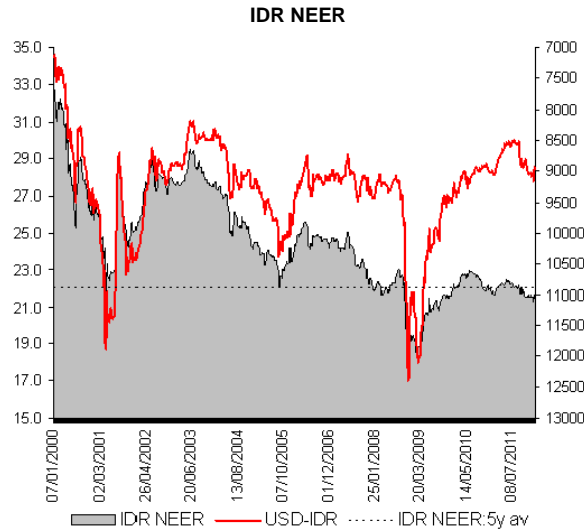
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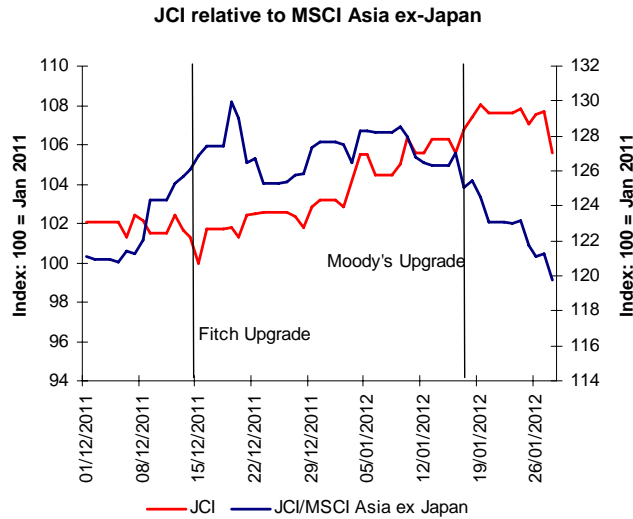
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the credit rating upgrades. The unit has been pretty much propped up by short-term portfolio inflows recent years, and thus, stronger FDI flows ahead would only strengthen the IDR from the flows perspective in spite of volatile nature of portfolio flows.



Source: OCBC

As for equities, the JCI has gained by about 5.5% since Fitch’s action in December, and Moody’s upgrade did little to add to this (in fact, since then, the JCI has fallen back to losing about 1.1% of its values). While 5.5% seems quite decent on the surface, the JCI has actually lagged behind its regional counterparts. In fact, if we take out the regional factor by zooming in on the JCI/MSCI ratio, we can see that this index has fallen by about 4.5% since Fitch’s upgrade.



Source: OCBC

At this juncture, the price-earning ratio still looks relatively attractive, both on historical and regional comparisons. Indonesia is relatively more insulated than its regional counterparts, and even at our low 5.3% GDP growth forecast for 2012, it would still be one of the best performing economies in Asia. With the growth of middle income unlikely to be hampered much by what’s going on at the aggregate level, we expect **domestic participation in the local bourse to continue providing the underlying support for the JCI.**

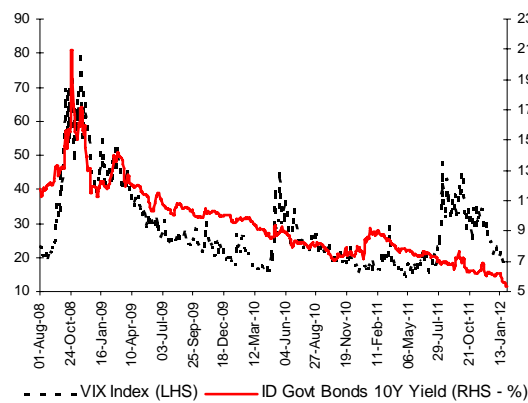
Average PE Ratio in EM-Asia (2006-2011)

	CH	HK	IN	ID	KR	MY	PH	SG	TW	TH
2006	21.4	14.3	20.4	13.9	10.9			16.2	17.4	9.8
2007	51.5	18.2	22.4	17.5	14.6		15.9	18.7	18.4	13.7
2008	27.4	13.0	17.5	15.5	12.7		11.7	10.6	12.6	11.7
2009	23.3	15.1	18.4	12.2	17.1		13.0	13.1	62.0	18.9
2010	22.5	16.7	21.6	15.4	18.3	17.6	12.5	18.7	34.5	15.1
2011	17.6	12.4	19.0	14.9	13.7	14.5	14.6	13.3	15.8	13.2

Source: CEIC, OCBC Bank

Lastly, on IDR bonds, we have persistently said that yields are extremely tight, especially given that our model is still projecting a medium-term inflation trend at about 7%. Yet, yields have continued to fall, and at record low below 5.50%, current yield on the 10y IDR bond is now at about 215bps lower than start 2011. Low inflation, foreigners' seek for high yields, and BI's intervention to buy bonds in the market have all contributed to this record-low bond yield on the benchmark 10y bonds.

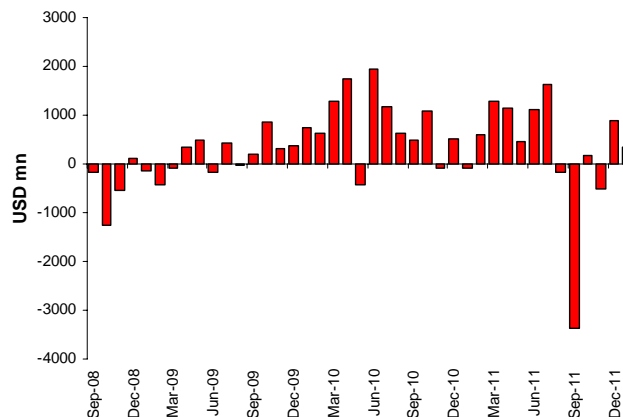
VIX Index and Yield on 10y IDR government bonds



Source: CEIC, OCBC Bank

Going forward, the risk-reward scenario does not justify going deeper into IDR bonds any longer. Fundamentally, this makes sense considering that inflationary risks remain clearly tilted towards the upside – especially if we consider the imminent fuel subsidy changes. The latest comment from the government suggests that a fuel price hike across the board is not to be ruled out and we expect an average 1.0-1.4 ppt addition to headline inflation for every 10% increase in price. While most traders are probably trading with the flow for now, we feel that the threat of inflation should never be ignored and we would be cautious of adding exposure to IDR bonds at current levels.

Monthly Net Flows into IDR Government Bond Market



Source: Indonesia Ministry of Finance, OCBC Bank

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