2018

OUTLOOK

INDONESIA

CRUISING BUT BE ALERT

THEMES

SYNCHRONIZED GROWTH CONTINUES

MONETARY POLICY MOVES TOWARDS TIGHTENING

INFLATION TO PICK UP BUT WILL STILL BE LOW

TECHNOLOGY DISRUPTION CONTINUES

Maybank Asset Management

Happy New Year
to our valued clients and business partners.

At the start of 2018, we take this opportunity to prepare you for the currents and ripples in the investment landscape.

First, let's look over the past year which has been fairly generous but not without surprises. We had projected 2017 to be 'Bumpy But Better' and true enough, there were jolts here and there but no major bruises.

2017 left us in good shape to venture forth confidently.
While 2018 appears calm and definitely welcoming, our theme this year sums it up - 'Cruising But Be Alert'.

As stable, strong or buoyant the investment market may be, we'd advice you to keep a watchful eye on a few global and domestic factors.

For the Equities and Fixed Income markets, we leave you with a 2017 Review, 2018 Outlook and Strategy. May our views help you plan a successful year ahead.

An Overview :

INDONESIA EQUITIES

INDONESIA FIXED INCOME

SYNCHRONISED GROWTH CONTINUES TO SAIL WITH MODEST ROOM TO NAVIGATE.

We expect the global growth that began in 2017 to continue at least through the first half of 2018.

In developed markets, we forecast more modest growth post the surprisingly strong growth acceleration these markets have enjoyed in 2017, while the US and Eurozone are more advanced along the recovery cycle.

> China: slower but steady China could also see slower growth albeit we expect growth to be largely stable. Despite fears that policy measures/reforms *(e.g., a crackdown on polluting industries)* may limit near term growth, we believe the government will manage the reform-growth balance given China remains a command economy.

> ASEAN: machinery and infrastructure take it up a notch. In ASEAN, growth is expected to be stable with the export-driven growth recovery in 2017 broadening to domestic demand and private investment in 2018. Synchronised global growth and continued export recovery will likely spur machinery and equipment investment. In addition, after a prolonged slump, a step up in infrastructure investment will complement the trade-sparked private investment recovery.

> New policies could do the trick. We expect policy makers to be more pro-active in boosting the domestic economy with a focus on job creation and increased infrastructure spending. More populist policies may be introduced in countries with upcoming elections in 2018 and 2019 *(e.g., Thailand, Indonesia, India).*

> Tighter monetary policy in US. Headwinds in ASEAN. While monetary policy in the US looks set to tighten further in 2018, we expect the pace of tightening to be gradual and do not anticipate a severe impact on Asia. Nevertheless, this remains a headwind for Asian markets and in particular ASEAN which tends to be more sensitive to US rates.

> The needle won't move much from low. In general, we see slightly higher rates in Asia ex-Japan in 2018 albeit rates will still remain relatively low. In line with still low money market rates, local currency liquidity will continue to be good. Robust domestic inflows could help offset reduced foreign fund flows into Asia (as a result of tighter monetary conditions). Low rates have enabled the expansion of equity valuation multiples. Going forward, earnings growth/momentum should be a more important driver of share price performance in 2018.

> Inflation making a modest comeback but oh... so shy. Inflation has surprised on the downside in most of Asia in 2017. Thus, we could see a slight pick-up in 2018 off a low base, given rising prices of oil and China-centric hard commodities (e.g., steel). Barring weather shocks, we expect food inflation to be benign. However, inflation likely to remain low with wages growth remains muted. Technology disruption will continue to put downward pressure on wages as automation encourages companies to substitute labour with capital. Low inflation will allow policy makers the leeway to calibrate a smooth normalisation of monetary policy.

> Watch out traditionalists. Tech disruptions are still trending. We expect the trend of disruptive technology to continue, thereby displacing traditional/ 'old economy' roles. Some tech companies have an implied zero cost of capital resulting in an uneven playing field with the traditional incumbent players. These tech companies are able to lower prices sacrificing profitability for market share while putting the incumbents under severe pressure. With technology enabling productivity growth, we are positive on medium-to-long term economic growth. China internet is more profitable with better growth prospects given economies of scale and early adoption by consumers.

KEY IMPACTS

POSITIVE

- → For equities and fixed income
- → For domestic demand, machinery/ equipment and infrastructure
- → For fixed income securities as the reach for yield will continue
- → For oil and selective hard commodities
- → For tech sector; more selective on consumer retail

MIXED

- → For fixed income; higher rates generally negative for FI

NEUTRAL

- → For equities; focus on earnings momentum; greater emphasis on active investment management

Upside RISKS

Favourable policies to boost economic growth.

In Asia, governments have increased infrastructure spending while in the US, there are hopes that President Trump's tax reform plans would boost economic growth. An improving economic outlook could also stimulate increased capital expenditure/business investment.

US tax reform as the booster.

Tax reforms may lift business investment leading to stronger economic growth in the US.

Downside RISKS

Weaker-than-expected economic growth.

The business cycle is mature and we are into the 10th year since the last downturn in 2008. The business cycle will not be repealed and downturns will follow upturns with the only uncertainty being timing.

Asset bubbles popping.

The low interest rate environment has led to asset bubbles as the search for yield has pushed prices of various asset classes including real estate, private equity and European high yield. With global debt levels high, a deflation of asset bubbles may lead to a crisis.

Higher-than-expected inflation.

Current inflation expectations are low but with commodity prices up and labour markets relatively tight, this could lead to an inflation scare. There is a risk that wages may rise sharply if workers take advantage of the tighter job markets and force employees to increase pay.

Geopolitical tensions.

This is on the rise given political instability in Middle East, North Korea and even in Europe.

Bagus Adi Yoga Prawira – Head of Indonesia Research

INDONESIA EQUITIES

2017 REVIEW

Events that coloured the Indonesian equities report card : A few surprises and some as expected

There were several key domestic and international events which supported the Indonesian equity market performance of +19.9% YTD, some of which were within our expectations, while others came as a surprise.

Key domestic events **1)** Indonesia's credit rating upgrade to investment grade by S&P. **2)** Surprise rate cuts in 3Q. **3)** Stubbornly weak consumption data. **4)** Strong earnings growth driven by contractors, banks, telcos and commodities. **5)** Strong trade balance and contained current account deficit *(CAD)*. **6)** Manageable inflation which lowered bonds' risk premium and provided a buffer for equity re-rating. **7)** Heightened political tension which culminated in the blasphemy case of former Jakarta governor Ahok prior to the Jakarta gubernatorial elections.

Key global events **1)** a China-driven reflation. **2)** Global growth synchronisation for the first time in the last decade. **3)** The Fed's dovishness which led to a weaker USD environment favoring Emerging Market *(EM)* assets.

The year started with a scarcity of catalysts as the market was still digesting Trump's policy implications and its timeline. There were concerns that the planned expansionary US fiscal policy would result in sharply higher interest rates. As a result, small and mid-cap stocks performed better driven by domestic retail participation while the large caps lagged as foreign and domestic institutional investors remained on the sidelines. However, it became more apparent that fears of the US reflation trade would not be realized. The Fed turned out to be more dovish than expected and appetite for EM assets re-emerged on the belief that interest rates would stay lower for longer.

In addition, China's supply-driven reflation fuelled a commodity price recovery that benefited commodity-exporting countries like Indonesia.

In contrast to consensus' expectations, we had some doubts about the US reflation trade as we believed Trump's policies would take much longer to be implemented. With Developed Markets *(DM)* in the late stage of the economic cycle, we thought that DM central bankers would raise rates at a gradual pace in order not to inadvertently tip their economies into recession. Thus, given the benign interest rate environment, we were well prepared for inflows into the local bond market and passive inflows through Emerging Market *(EM)* ETFs. Given strong risk appetite, the inflows from EM ETFs into the Jakarta stock exchange more than offset the foreign outflows from the Indonesia equity ETFs *(EIDO)*.

Given a favorable global environment for emerging markets including Indonesia, the large caps, which were supported by inflows from ETFs, started outperforming the small caps going into late 1Q17 to mid 2Q17. Large caps with a turnaround story *(banks, United Tractors (UNTR), industrials)* were the strong outperformers. Towards the middle of 2017, there were significant domestic events. One was the Jakarta gubernatorial elections where early favourite and President Jokowi's favoured candidate, Ahok, lost.

Indonesia 2017

Equity market performance

+19.9% YTD

Who did better?

At the start, driven by domestic retail,small and mid-cap stocks performed well, but...

Wait a minute...

Entering late 1Q17 to mid 2Q17, the large caps were the strong performers.

INDONESIA EQUITIES

2017 REVIEW

Going into the elections and after...

Domestic factors started to come into play in the run up to the Jakarta gubernatorial elections in Apr-17 which was then followed by the S&P upgrade. The outcome of the Jakarta gubernatorial elections did not quite surprise us but what was unexpected was the muted market reaction. In this case, we might have overestimated the impact of local political events against a broader picture of the economy and we did not account for the unexpected S&P upgrade given a volatile political situation.

What came after that was the energy subsidy cut *(i.e., hikes in electricity price)* which was deemed rational given the low inflation environment. However, we did not anticipate that this would have such a negative impact on domestic demand as it did. While Indonesia's current account deficit did improve, this was due largely to a lack of import appetite *(given increased tax scrutiny of importers)* and slow budget disbursement. All in all, the government-driven investment cycle was not enough to counter subdued private sector sentiment. This led to a muted recovery in consumer names *(both staples and retail)*, leading to earnings downgrades for several large cap consumer names that halted the market rally.

Decent 2Q17 results from large cap banks and commodity counters *(especially UNTR)* sustained an overall neutral market which translated into sideways price action in 2Q-3Q17. The market was supported by domestic investors as local pension funds still had room to allocate monies to equities, given a large increase in their liabilities.

In addition, most of the large local mutual funds had ample cash *(c.90%)* and were not inclined to reduce equity allocations further since they had already been relatively neutral to bearish. Risk appetite on small-caps *(e.g. Indah Kiat, Barito Pacific and some commodity stocks)* flourished.

In 3Q17 going into 4Q17, we saw global growth recovering in a synchronized pattern for the first time in the last decade which fuelled rallies in most markets. 3Q17 results were not as disappointing as typically expected during this seasonally weak period. The market's 19.9% YTD return was driven largely by earnings growth which explains the JCI's robust performance despite global and domestic political noise. Interestingly, the realized historical volatility of the JCI as measured on a 12-month rolling basis was at a decade low.

In summary, earnings growth has been quite strong and earnings expectations were not revised down significantly *(with only consumer-related and property names being downgraded)*; hence, JCI performance was fundamentally driven by earnings growth rather than a valuation multiple re-rating. We are currently in the mid-to-late stage of a global cyclical upturn while the domestic credit cycle has bottomed. Meanwhile, a strong trade balance and tame inflation *(despite cuts in energy subsidies)* has buoyed investor confidence in the BI's and government's policy credibility and a stable IDR. We believe the aforementioned factors have lowered the expected risk premium in holding Indonesian bonds and equities. Given that bond yields have fallen more than the earnings yield, we maintain our upside bias for the Indonesian equity market. We are positive as the domestic cyclical growth story remains favourable compared to developed markets which are at a later stage in the recovery cycle.

Surprise!

Yes, it was a volatile political situation but what followed was an unexpected S&P upgrade.

And more...

An energy subsidy cut left an unexpected negative impact on domestic demands.

Going into 4Q17

The previous quarter's results were reasonably good for a seasonally weak period.

19.9% YTD.

Upside bias for equity market

Remaining positive with a favourable domestic cyclical growth.

INDONESIA EQUITIES

2018
OUTLOOK

In constructing our view, we consider three key variables: macroeconomics, liquidity and corporate fundamentals/valuation. We provide the positives and negatives of each variable as follows:

1. Macro

THE POSITIVES	THE NEGATIVES
Increased government spending and disbursement to create an economic multiplier effect, supported by adequate room for higher deficits.	**Delayed asset quality improvement** as loans-at-risk remain elevated, with potentially more downgrades, especially following the end of BI's relaxation policy. This would provide less incentive for banks to lend, halting the recovery in the credit cycle.
More support for the grassroots economy through higher social spending *(i.e., a populist stance)*, which could boost consumption and stimulate investment demand.	**Material shift in domestic political dynamics** that could end the progress of current structural reforms and dampen investment appetite.
Indonesia's improved Balance of Payments *(i.e., strong trade balance alleviating CAD problems, sustained FDI inflows supporting the net financing balance sheet)* leading to ample FX reserves, coupled with manageable low inflation, provides a buffer for capital outflow risk.	**Elevated oil prices whilst other commodities lag** could be detrimental for the CAD, and raise IDR volatility and the risk premium of holding Indonesian assets in general.
A greater likelihood of improving asset quality for banks, a bottoming of the credit cycle and hence a further pick up in GDP growth.	**Hard-nosed tax office efforts to chase more revenues** could create serious hurdles for a consumption recovery if not properly communicated.
Faster infrastructure projects execution prior to the 2019 presidential elections to boost GDP growth through higher raw material needs and improved loan demand.	**China's growth to slow more than expected** which could lead to a correction in commodity prices and dampen global growth. The China reflation trade has been a key reason for market rallies in Asia, especially Indonesia.

INDONESIA EQUITIES

2018
OUTLOOK

2. Liquidity

THE POSITIVES

Less room for foreign active funds to sell compared to the previous market crash. Based on Bloomberg data, there has been net equities outflow of ~IDR33tn *(USD2.4bn)* ytd although many of these trades are crossing transactions between related parties which we suspect are due to reshuffling activities as a result of the tax amnesty. On the other hand, there has been ~IDR9tn net inflow from ETFs *(after ~IDR0.9tn outflow from EIDO ETF)*. Hence, on the whole, we believe the data shows that the foreign active funds have reduced their positions in Indonesia.

Domestic liquidity remains sufficient. M2 growth trends remains promising while current LDR is proof of the ample liquidity in the banking system. Given BI's macroprudential measures on LFR and RIMP *(intermediation ratio)*, domestic liquidity should remain ample for both real and financial sectors. Through RIMP implementation, liquidity in the bond market should improve as banks would take on the 'lender' role; thus creating a buffer for equity re-rating in the event of capital outflows.

Local pension funds' liabilities to grow further. In a low yield environment, these pension funds tend to increase their equity allocation, away from money markets, to chase better returns in order to match their liability needs. Moreover, in the bond market, local pension funds need to comply with an OJK regulation to increase their proportion of fixed-income investments to 50% by next year, which again should provide a buffer in the event of capital outflows.

THE NEGATIVES

Policy normalisation in DM markets, if these differ from market expectations could create volatility in risky assets such as EM countries like Indonesia given heavy foreign ownership and illiquid domestic markets.

Trump's tax reforms and all other policies if successfully implemented during the peak of the US economic cycle could lead to a significant US budget deficit, sending US Treasury yields higher than expected and lowering the real rate differential between Indonesia and the US. Combined with a possible shift in domestic political dynamics, this could create more volatility in the IDR and drive capital outflows.

INDONESIA EQUITIES

2018
OUTLOOK

3. Corporate fundamentals/market valuations

THE POSITIVES

Positive trajectory of corporate earnings. Earnings growth has been reasonable overall and quite strong for certain sectors *(banks, commodities, telcos and contractors)*

Valuations are not lofty compared to 2008, 2013, and 2015. JCI's valuation remains at a 3-year mean. In addition, relative to the MSCI Asia ex-Japan, the JCI is currently trading at 1.43x P/B which is -2STDEV below its 5YR average despite an improving trend of relative ROE since mid-2016.

Corporate guidance on capex started to pick up lately indicating better private investment appetite next year.

Adequate buffer for equity re-rating on normal parity. Current real interest rate differentials between Indonesia and the US stand at c.2% level, justifying the narrow spread between Indonesian bonds and US bonds. As long as the real rates differential is sufficiently positive, we think that market valuations *(fixed income and equities indirectly)* should remain normal.

THE NEGATIVES

Should the credit and asset cycles fail to pick up, earnings (which are supported by the banks) may be downgraded.

Increase in IDR volatility could hurt the economy as Indonesia is still dependent on imports and could warrant a de-rating of equity valuations given that the real rates spread is close to zero.

A standstill in structural reforms caused by a shift in domestic political dynamics and a slowdown in China or globally could also dampen the private capex recovery.

INDONESIA EQUITIES

2018 STRATEGY

Venture forth optimistically but be watchful and prudent.

We remain cautiously optimistic on Indonesian equities but think that some market correction to ~6,150 is plausible given the overbought condition in a 12m rolling basis. However, the trend is still positive and quite strong, hence we think that a 'buy on dips' strategy with sector rotation play could extend for longer – this remain our base case strategy. We would adopt a barbell approach, especially on finance, consumer, retail, basic industrials and commodities-related sectors, although for the latter, we prefer to play alpha names. Macro, corporate fundamentals and valuation factors are tilted to the positive side, but there are liquidity risks such that the market could easily correct to the previous support level if liquidity dries up. However, a potential upside in active foreign flow coming in and higher nominal growth expectation in 2018 should bode well for small-mid caps stocks that have underperformed in the past year.
In terms of cyclicals which are also value plays, we are looking to build positions in construction & property and big-ticket discretionary *(e.g., Astra)*. We are already overweight and remain overweight on basic industrials but selectively so on alpha names rather than large caps.
For trading purposes, mining still offers some short term opportunities, although we prefer to be selective on fresh stories *(e.g. ELSA, PTRO, MEDC, INDY)*. We would prefer to marketweight infrastructure given lofty valuations and underweight agriculture due to a lack of catalysts. However, we would be opportunistic for short term trading whenever possible. Lastly, for momentum plays, we remain positive on the finance and consumer sectors.
We set our base index 12 month target at 6,525 *(2.7% from end-2017)*, with support at 5,925-6,150, back in Nov-17. However, the market was heavily propped up by 6.8% in Dec-17 leading to potential de-rating risk. Nevertheless, if the multiples stays, we believe another c.8-10% upside (higher than our base target) for the market to c.6,800-7,000 *(7,000 is our best case target index set back in Nov-17)* is possible since we think banks could still grow by mid-teens *(c.15%)* in 2018 and a c.8-10% growth is still c.3-5% below consensus' expectation *(i.e., a 30% downgrade in earnings expectations)*. As banks contribute c.29% of JCI weight, even assuming no multiple re-rating, 15% earnings growth would contribute 4.35% return for the market, ceteris paribus. The other c.3-4% return could easily come from other sectors such as the consumer sector *(c.1.1% return contribution) and infrastructure (c.1.2%) return contribution)* on conservative assumptions. Note that this already assumes a -15% earnings growth for the mining sector in line with consensus expectations that might be too conservative. Even if all other sectors were to disappoint, we could still achieve c.7-8% growth for the market. On a more positive note, a sustained commodities up-cycle should lead to consensus upgrades for commodities' stocks EPS growth expectation. This will make a 7,000 target price achievable under no de-rating scenario *(our best case)*. On the other hand, we do think that most of the returns will tend to be front-loaded as more risks may emerge in 2H18. However, should the market break below the support level, it may start pricing in our bear case scenario as mentioned below. We have a bear-case index target of 5,400-5,500, with support seen at 5,000.

Indonesia equities 2018

A trend that is expected to be positive and quite strong. Still, the word is

'cautiously'.

'Buy on dips' strategy

This remains the strategy on sector rotation play.

To overweight or underweight?

Overweight commodity-related, consumer cyclicals and banks. Marketweight infrastructure. Underweight agriculture.

INDONESIA EQUITIES

SCENARIO	ASSUMPTION / RISK	MARKET IMPLICATIONS
BASE CASE	• GDP to grow 5.1%-5.3% in 2018 driven by higher government spending, stable consumption, recovering investment and a sustained positive trade balance. • Nominal GDP growth to be driven by better consumption and ample domestic liquidity, which should eventually result in further credit growth. • Banking credit growth and asset quality should be recovering. • China reflation trade maintained together with a sustained *(relatively)* low risk premium for Indonesia equities and bonds. • Gradual monetary policy normalisation by global central banks.	• FY18-19 EPS growth 9-13% • Year-end Jakarta Stock Exchange Composite Index (JCI index) target of 6,525, forward PE of 15.3x *(3-year avg)*
GOOD CASE	• GDP growth beyond 5.3% on the back of stronger consumption and private investment coupled with upward trending commodity prices. Trump's tax reform does not result in huge dollar repatriation and a significant budget deficit. • Global growth remains in sync with the China reflation trade. Gradual global monetary policy normalisation and well-anchored expectations of CBs monetary policy direction. • Incumbent government proves to be successful in uniting domestic political and social interests. • Further upgrades from credit rating agencies, and much improved FDI in the manufacturing sector.	• FY18-19 EPS growth c.13% • Jakarta Stock Exchange Composite Index (JCI Index) target of 7,000, forward PE of 16.6x *(3-year +0.5 Stdev)*
BAD CASE	• Consumption and investment fail to recover, leading to GDP growth below the 5% level. • Severe domestic political disturbances with a real shift in political dynamics. • USDIDR hitting 14,000 levels or higher driven by severe portfolio outflows caused by both negative external and domestic factors. • Lack of foreign direct investment *(negative funding gap)* which is insufficient to offset CAD. • China 'reflation' trade faltering and commodities turning bearish. • Trump's tax policies fully implemented in a peak cycle US economy, leading to excessive USD strength and budget deficits Risk of narrowing Indonesia's real rate differential with the US to below zero. • Global CBs are deemed to be late in tightening monetary policy, resulting in aninverted yield curve, with markets pricing in the possibility of a recession.	• FY18-19 EPS growth c.5-13% • Jakarta Stock Exchange Composite Index (JCI Index) target of 5,500, forward PE of 13.7x *(3-year -1.5 Stdev)*

INDONESIA EQUITIES

2018 THEMES

First half of 2018

- With index having reached all-time high in 2017 and maintaining its overbought level since late beg-2Q17, a healthy correction to 6,000-6,150's level is plausible. In such conditions we prefer to play sector/style rotation in a barbell approach and start to look for value-proposition play given light corporate data points until end of Jan-18.

- Higher government social spending should start to kick in by 1Q18, boosting consumer confidence and market sentiment, as there will be more fiscal room due to less deficit in 2017. Additionally, year 2018 will be full of political events that may result into higher velocity of money.

- Trump's tax policies may gain momentum and create volatility and capital outflow risk due to higher US bond yields and USD strength. At this stage, Indonesia govvies spread parity with US govvies will be tested given our real rate differential remains sufficiently positive.

- China's 'reflation' trade thesis breadth should be tested at this stage as data points of industrial production and deleveraging effect would be more instructive. In this case, a late-stage equity bull-cycle will tend to coincide with an up-cycle in commodities market *(especially energy and industrial metals)*. This should be in-line with greater confidence of G3 countries Central Banks for monetary policy normalisation on higher nominal growth expectation, signalling an end of bond bull market.

- Positively, we anticipate resilient buffer against capital-outflow risk in 1H18 due to low domestic inflation due to high-base effect, less supply of bonds, ample FX reserves, and plentiful ammunition for local pension funds to buy bonds.

- Additionally, optimism could be reignited after the 4Q17 and 1Q18 results whereby any inline and above achievements could lead to 2018 earnings upgrades. Only potential caveats would be banks asset quality development and consumer companies data points.

- We would look further more on cyclical-value play at this stage *(especially mid-small caps)* as we think BI is unlikely to cut rates further despite a low inflation in order to guard against IDR weakening and in confidence of higher nominal growth ahead. At this stage, we expect more macroprudential measures to be at play.

US and China

Trump's tax policies may create volatility and capital outflow risk. While China's 'reflation' trade may be tested.

Nonetheless...

We expect a resilient buffer against capital outflow risk.

At this stage

We look for cyclical-value plays and expect more macro-prudential

INDONESIA EQUITIES

2018 THEMES

Second half of 2018:

- We believe 2H18 would be a trickier period where consensus' earnings expectations and the credit upcycle will be tested as any ill effect from BI's stance to hold policy rates would become visible.

- At this stage, monetary policy normalisation by most DM central banks *(CBs)* will be more apparent and could induce volatility across markets. The key here is the Fed's balance sheet normalisation plan in the face of Trump trade war stance on China as well as the ECB's and BoJ's tightening plans.

- Risks could materialise as the central banks are hiking rates against late-cycle inflationary pressures. Although our base case does not include a recession due to the central banks' cautious stance (given structurally low inflation expectations), a market correction does not require one. Possible margin compression globally due to higher commodity prices could provide a reason, especially during historically low levels of volatility and low CDS rates for countries like Indonesia. The US and EU yield curves will be the yardsticks as to whether the CBs are ahead or behind the curve.

- Anything that could go wrong domestically might happen at this time as more political noise is expected as the 2019 Presidential elections draw near. However, we expect that the incumbent will try to accelerate the rollout of his policies and avoid any mistakes, which can be another positive factor for the market if done properly.

Domestic political climate

2019 Presidential election is approaching with uncertainties in tow.

Richard Nadapdap – Head of Fixed Income - Indonesia
Zaki Aulia - Fixed Income Portfolio Manager

INDONESIA FIXED INCOME

2017 REVIEW

The Indonesian bond market had a positive 2017 for 3 major reasons.

First, in May17, S&P finally upgraded Indonesia's rating to investment grade. The S&P upgrade was long awaited since Fitch and Moody's had upgraded Indonesia to investment grade in December 2011 and January 2012 respectively. Second, inflation was successfully tamed. By mid-year, the CPI had only rose by 2.35% YTD, and 2.87% by Dec17, so FY17 CPI would likely be at 3.0%, which is far below CPI expectations of 4.0%-4.5% at the beginning of 2017. This leads to the third reason, i.e., Bank Indonesia *(BI)* reduced the benchmark rate twice or by 50bps from 4.75% to 4.25%, which was considered as a brave move and a sign of confidence by many investors. These three factors have brought foreign inflows to the domestic bond market of IDR 130.4tn by October17 which was higher than the FY2016 figure of IDR 107.3tn. Throughout the year, foreign holdings in government bonds ranged from 39.0% - 40.0%. The yield curve shifted lower across tenors by 110 – 160 bps. The yield of the IDR 10yr bonds fell from 7.70% to 6.50%, and touched 6.30% in Sep17. As for new issuances of corporate bonds, after the announcement of the rating upgrade, demand increased significantly. Most of these IPO bonds were 3 to 5 times oversubscribed, especially high rated bonds, SOE bonds, and government-related debt. The favorite 3yr corporate bonds with AA- *(double A Minus)* to AAA *(Triple A)* bonds are offering yields of 100-150 bps lower compared to the previous year. The performance of the Rupiah *(IDR)* was relatively stable. It fluctuated between IDR 13,300 – 13,600 per USD. Indonesia CDS are also hovering at all-time low levels.

Foreign inflows to the domestic bond market.

Demand increased for new issuances of corporate bonds.

INDONESIA FIXED INCOME

2018 OUTLOOK

We expect 2018 to remain a positive year for IDR bonds. We think that the volatility will most likely come from external factors. We expect GDP growth to pick up slightly to 5.3% and 5.4% in 2018 and 2019 respectively. Stronger commodity prices will translate into higher net exports contribution to overall GDP growth. Meanwhile, investment growth will continue its gradual recovery. Investment growth is likely to average 5.5% in 2018 and 2019, which is decent, considering the average 4.7% recorded in 2013-16. Support from the government's infrastructure push remains the dominant driver. Out of the government's 37 priority infrastructure projects, 17 are already in the construction phase, with total pledged funding amounting to about US$250bn. Ahead of the 2019 national elections, we expect fiscal policy to remain accommodative. There is a risk that the government will resist higher energy prices, even if crude oil prices were to continue rising next year. The political landscape may heat up in the run-up to the 2019 national elections. A total of 171 regional / provincial elections will be held in June 2018 and may provide important cues for the 2019 national elections.

We believe CPI inflation may reach 4.0% and 4.5% in 2018 and 2019 respectively. We expect BI to start hiking rates again in Q4 2018, bringing the policy rate back to around 5% by mid-2019. Anticipation of a stronger USD may mean that higher domestic interest rates are necessary. An excessively weak IDR is likely to be a drag on GDP growth. Arguably, Indonesia is now better positioned to withstand the risks from uncertainties in global markets.

INDONESIA FIXED INCOME

2018
OUTLOOK

Potential developments in 2018 and 2019 that could significantly affect the domestic economy.

First, the trend among major central banks, especially the United States, Eurozone, Britain, and possibly Japan, to start tightening monetary policy. As this has long been predicted by the market, the response of global financial markets may not be too negative. We continue to expect more capital inflows to emerging markets, including Indonesia.

Secondly, we see that China, which over the past year and until the beginning of this year was at risk of experiencing a serious economic slowdown (hard landing), seems to have succeeded in reaching a more sustainable growth rate, albeit in the lower range of 6%. This is positive for commodity demand albeit commodity prices will still remain below that seen pre-2008.

Third, we note that increased risk-taking and risk-tolerant behaviour has raised fears of a possible financial crisis of a global scale as that of 2008. However, we do not see a significant increase in crisis risk, at least for 2018. Interest rates in the United States and other major countries will rise much more slowly compared to 2005-2008, thus allowing the market to adjust to tightening monetary policy in stages.

Tightening monetary policy among major central banks

China reaching a sustainable growth rate

No increase in crisis risk.

2018
STRATEGY

We plan to be overweight on duration in 1H18 and may switch to a more defensive stance as we enter 2H18 depending on the inflation numbers.

The volatility of Rupiah will be a big factor influencing the bond market. With the volatility, there will be opportunities to trade in 2018.

INDONESIA FIXED INCOME

KEY THEMES 2018

THEMES	IMPACT	POSITIONS
THE FED RATE CONTINUE TO RISE	Higher volatility on govies and Rupiah.	Neutral on govies. Take positions at attractive yield levels.
POSSIBILITY BENCHMARK RATE HIKE	Yield curve shifts higher.	Be defensive entering 2H18.
HIGHER INFLATION BUT STILL MANAGEABLE DESPITE CENTRAL BANK LOWER ITS TARGET RANGE TO 3.5% +/- 1.0%	Low inflation in 1H18, but will pick up in 2H18.	Neutral on duration and lengthen it on tactical correction.