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EM Macro Strategy

Market Views

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Indonesia: Our top pick in Asia

Strong GDP growth, favourable reform outlook, gradually rising inflation and a stable currency all favour Indonesia

Most of the following analysis is relevant to fixed income and the rupiah, although our final conclusion relates to equities. As of today, we add a positive view on Indonesian equities to our high-conviction absolute views (see Table 1 below).

Key judgments

- The favourable US growth outlook will support a shift from fixed income to equities, while a moderately stronger dollar and relatively limited disruption to global trade will benefit EM assets.
- GDP growth in Indonesia is among the highest in major EM economies and the outlook for structural reform is increasingly positive, although economic nationalism remains a drag on growth.
- Bank Indonesia's cautious monetary policy and focus on currency stability will ensure that inflation remains within the target range and that expectations are well anchored, reducing risks for investors.
- Indonesian equities have underperformed since the US election, offering a relatively attractive entry point.

Table 1: Current Absolute Views

Country	Asset	Market view	Units	Date opened	Opening level	Current level	Performance to date
Russia	Equities	Positive	USD	8-Dec-16	576.0	589.5	+2.3%
Indonesia	Equities	Positive	USD	5-Apr-17	492.7	492.7	+0.0%

Source: TS Lombard.

This publication is part of our EM service. Click here for more details.

Current market prices are as of 8:00 a.m. on 5 April 2017. For more details and for closed views, see our 7 March 2017 monthly Absolute Views. Note that the opening level for the view opened today will be set to today's close of business in subsequent Absolute Views reports.

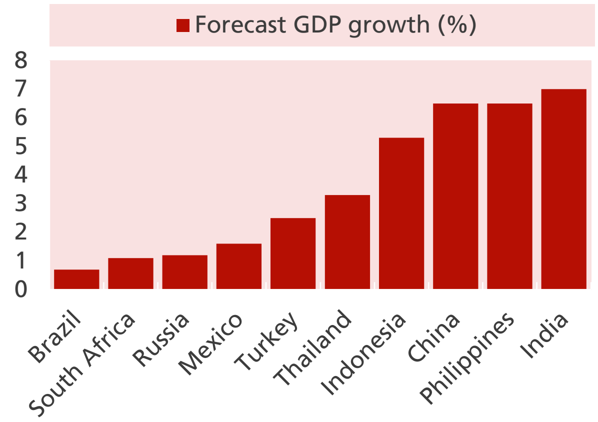
For our relative views on all asset classes for the 10 countries we cover, see the asset allocation view in our 4 April 2017 EM Strategy Monthly.

External factors favour Indonesia

US growth will benefit EM assets, but external risks remain

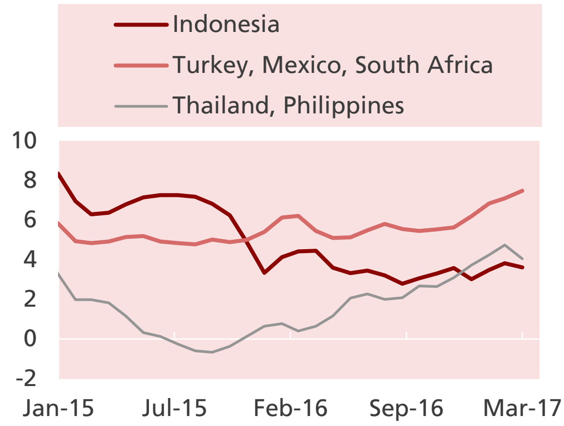
The prospect of US and European economic recovery combined with rising interest rates will continue to favour equities over fixed income, while a moderately stronger dollar and relatively limited disruption to global trade will ensure that many EM economies benefit from the global reflation trend. But the external risks to EM assets – a strong dollar and increasing trade frictions – have not disappeared entirely. In the case of some EM countries, the declining risk perception priced into markets suggests that investors are starting to become complacent (see our 27 March 2017 EM Weekly). The Chinese economic slowdown is another potential risk to EM economies, particularly for those in Asia; but while we expect the Chinese authorities to accept slower growth from next year, the slowdown will continue to be carefully managed (see our 3 March 2017 report Beijing will accept lower growth in 2018). In our latest EM Strategy Monthly, we also note that President Trump's recent stumbles will highlight the over-valuation of US equities and thus could benefit EM.

Chart 1: Consensus 2017 GDP growth forecast for major EMs



Sources: Bloomberg, TS Lombard.

Chart 2: Headline CPI inflation



Sources: Bloomberg, TS Lombard.

Indonesia is relatively resilient to the risk of declining trade . . .

Indonesia is well placed to weather these various external risks. We have previously organized EM economies in terms of financing needs, commodity dependence and openness to trade (see our 26 October 2016 report EM: A simple organizing principle). Within this framework, Indonesia is a relatively closed economy and is likely to be among the more resilient to disruptions in global trade; at the same time, it could be vulnerable to a collapse in commodity prices or to excessive dollar appreciation. Commodity prices should remain well supported in an environment of improving global growth. But a severe tightening of financial conditions owing to a stronger dollar could remain a risk factor for Indonesia, although the declining current account deficit – 1.8 per cent of GDP in 2016, down from more than 3 per cent in 2013 – means that the country is becoming less vulnerable.

. . . and has strong GDP and gradually rising inflation

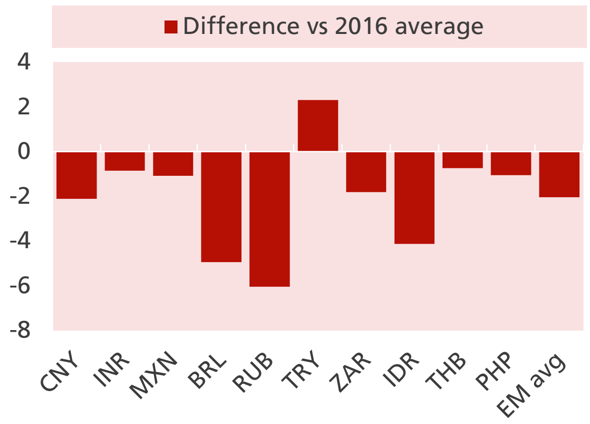
Global reflation is dividing EM economies along the lines of GDP growth outlook and inflation trajectory. Indonesia compares well with other EM economies on both these indicators. GDP growth in Indonesia is among the highest in major EM economies and inflation is rising only gradually (see Charts 1 and 2 above). Bank Indonesia's cautious monetary policy and its focus on currency stability will ensure that inflation remains within the target range and that expectations continue to be well anchored. Monetary policy has contributed to the sharp decline in USD/IDR implied volatility, which has reduced the overall risk for investors (see Chart 3 below). For our view of the differential impact of global reflation on EM currencies, see our 23 March 2017 FX Scorecard.

The outlook for structural reform is improving

Political appointments increasingly favour reform

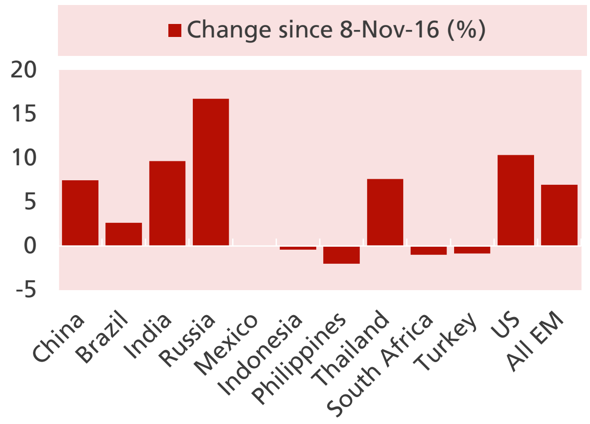
The domestic political environment and the outlook for structural reform are other important considerations for investors. Following our recent research trip to Indonesia, we concluded that although economic nationalism remains a drag on growth, the improving quality of government appointments since the July 2016 cabinet reshuffle is positive for structural reform and sustainable growth and should ultimately benefit asset markets (see our 16 March 2017 report On the road in Asia: Strategy takeaways).

Chart 3: 3-month implied volatility of EM USD-crosses vs their 2016 average



Sources: Bloomberg, TS Lombard.

Chart 4: Change in equity index since the US election (USD terms)



Sources: Bloomberg, MSCI, TS Lombard.

In addition to progress in infrastructure, the government has targeted reforms to boost the country's standing in the ease of doing business measure. Indonesia has shown sustained improvement in recent years; and in the 2017 Doing Business report, Indonesia was highlighted as one of the top 10 most improved countries.

Jakarta elections could be a risk factor

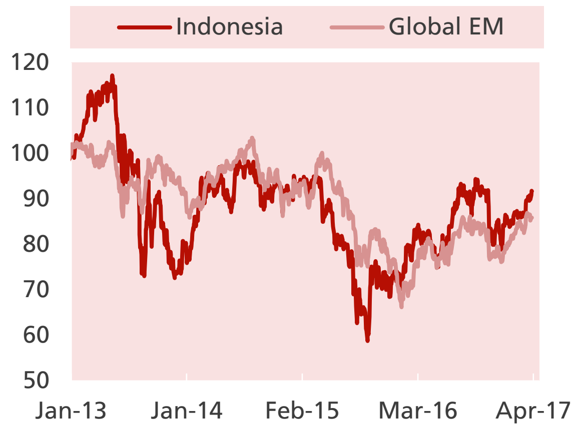
One potential risk factor for markets is the second round of the Jakarta gubernatorial election, due on 19 April. Opinion polls suggest a small lead for the challenger, Anies Baswedan, a former Education Minister; but either candidate could still win. The incumbent, Basuki Tjahaja Purnama, known as Ahok, is facing blasphemy charges, which triggered large-scale public demonstrations against him in November, December and February. However, last month's protests were less well attended, suggesting that the political environment may be starting to stabilize, although there remains a risk that tensions could escalate and, in the worst case, contaminate the national political scene.

Indonesian equities have underperformed

Underperformance offers a relatively attractive entry point

EM equities have performed well this year, and Indonesia is no exception: since January, it has delivered a return in USD of around 9%, which is broadly in line with the EM average (see Chart 5 below, based on the MSCI indices. We note, however, that Indonesia has underperformed since the US election (see Chart 4 above). The sell-off in November, triggered by the US election, was likely exacerbated by the anti-Ahok protests in Jakarta, which were escalating at that time, and by the fact that Indonesia had outperformed global EMs in the preceding few months, making it a natural target for profit-taking. Having recovered in the past few months, Indonesian valuations are above their average levels over the past three years – like those for global EM equities – but are not overstretched compared with levels that prevailed in H2/2016 (see Chart 6 below).

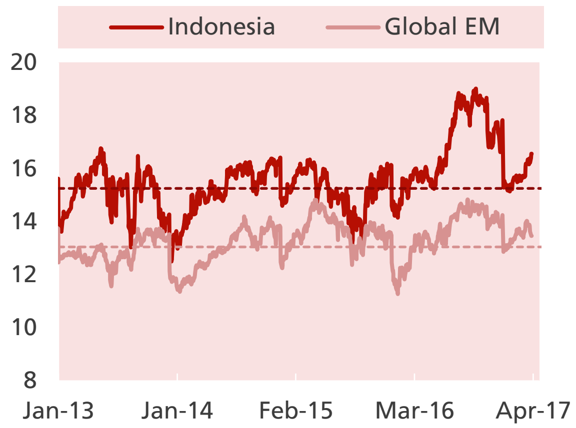
Chart 5: Equity index in dollar terms: Indonesia and global EM*



*Global EM index reproduced with Indonesian sector weights.

Sources: Bloomberg, TS Lombard.

Chart 6: Forward P/E ratio: Indonesia and global EM*



Sources: Bloomberg, TS Lombard.

In conclusion, the underperformance of Indonesian equities since the US election offer an attractive entry point for investors. Indonesia is well placed to benefit from global reflation and an improved external outlook for EM equities, while domestic political risks could decline after the Jakarta election.