

## What's the Catch with Indonesia?

From where we stand today, there are a handful of emerging markets (EMs) where 10-year local-currency bonds yield 8-9%: Brazil, Indonesia, Mexico, Russia, South Africa, and Turkey. Mexico and Turkey are still dealing with inflationary pressures which forced their central banks to tighten policy in 2018. Brazil and South Africa are under new leadership that has yet to address fiscal sustainability issues. Russia continues to face sanctions risk. Meanwhile, Indonesia exhibits below target inflation, a solid investment grade profile, and few geopolitical headlines. So what's the catch with Indonesia? Is there a price anomaly in the bonds or are we missing something?

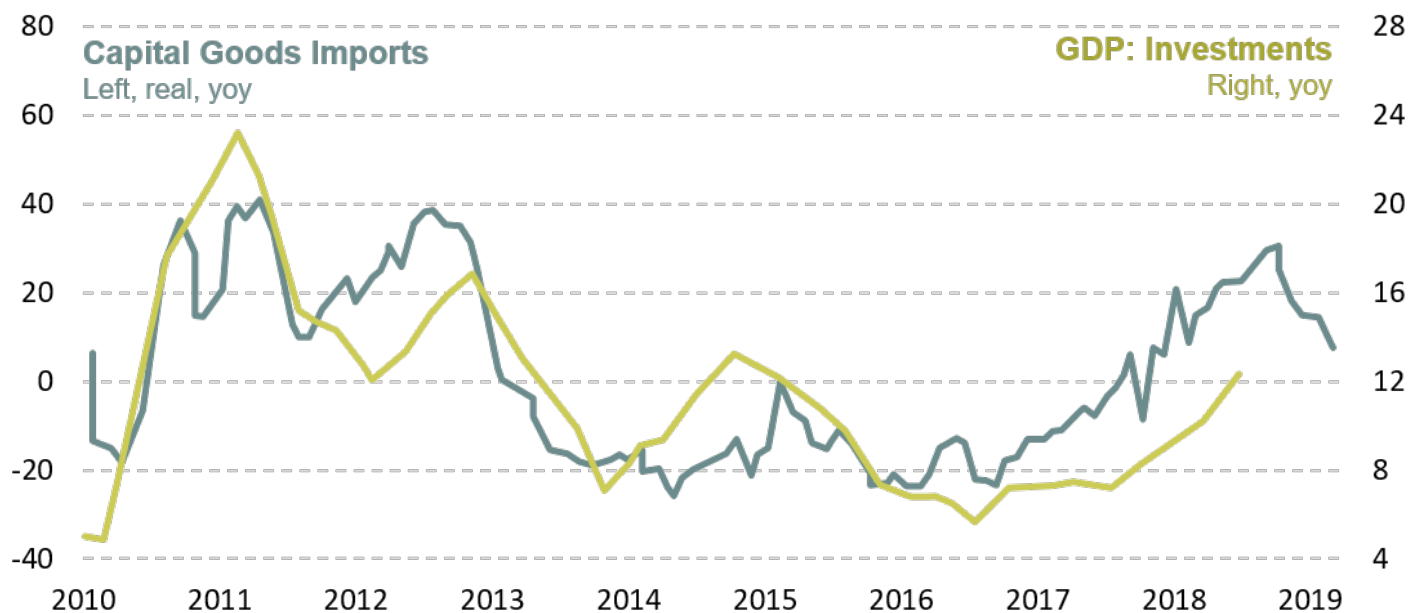
Below, we offer three market concerns that we think are likely overstated.

### The current account (c/a) is unsustainable

Yes, the c/a has widened from -1.7% to -2.7% and is no longer fully covered by foreign direct investment. However, there is scope for the c/a to narrow from here. The government's efforts to slow down infrastructure investments are finally showing through in the data with capital goods imports slowing (Chart 1). The services balance is likely to respond with a lag to the weakening in the exchange rate (Chart 2). Exports suffered from weaker China demand and lower commodity prices, both of which are likely to reverse this year. A narrower c/a could easily be financed by inflows into the local debt market.

### Chart 1: Indonesia: Capital Good Imports are Finally Slowing

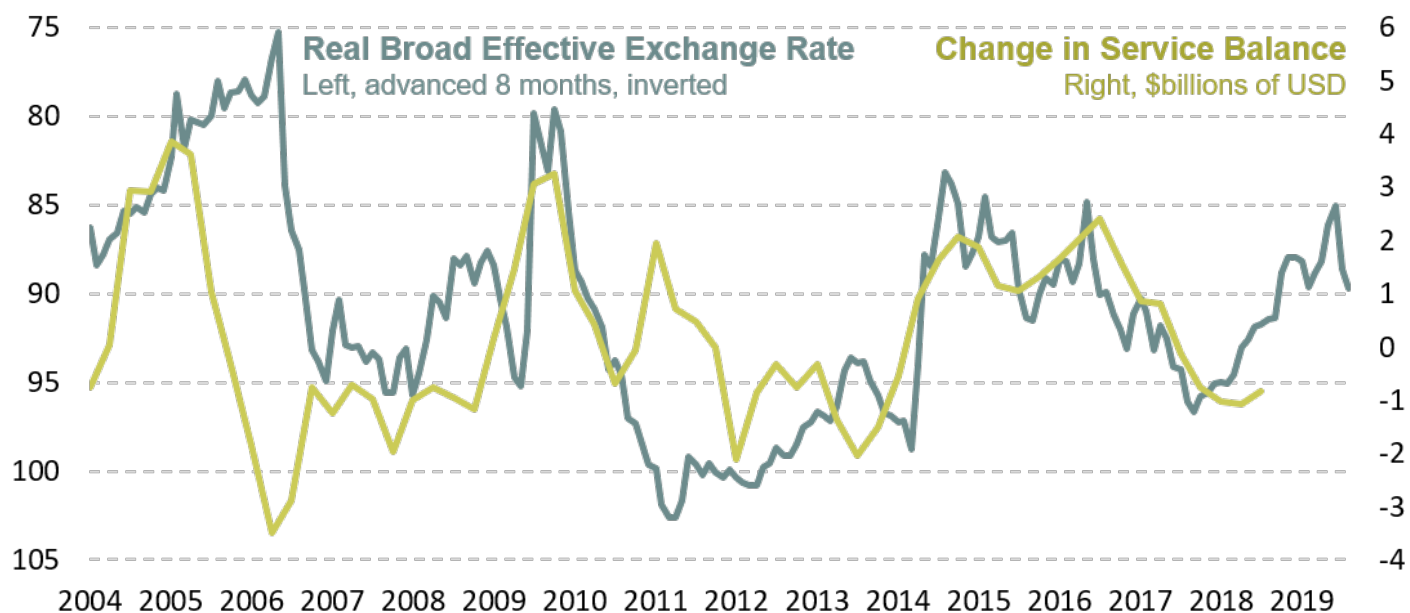
As of 12/31/2018



Source: Haver Analytics

### Chart 2: Indonesia: Services Deficit is Likely to Improve

As of 12/31/2018



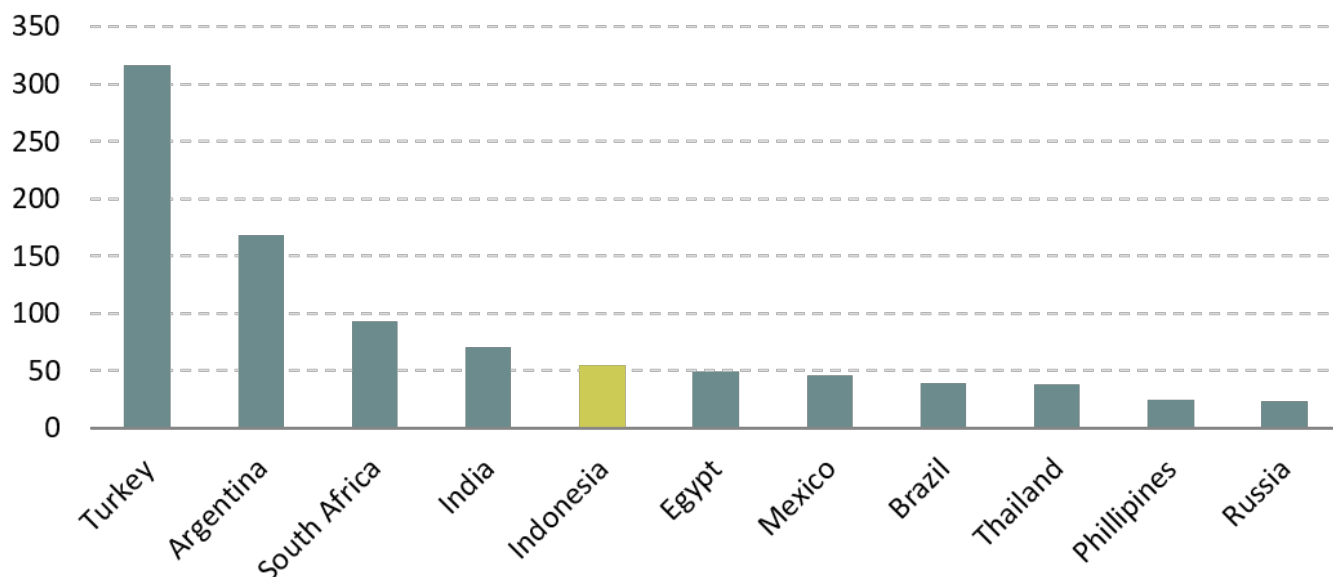
Source : Haver Analytics

## External debt remains a concern

2018 was a year where Federal Reserve quantitative tightening put EM external liabilities under a microscope. While Indonesia does not share the vulnerabilities of a Turkey or Argentina, its underdeveloped capital markets have led local corporates to borrow in international dollar markets despite often being recipients of rupiah revenues. As the rupiah started to weaken, these corporations rushed to hedge their exposure which created a snowball effect in the currency. Proactive policy reaction in the form of rate hikes and the provision of a dollar hedge program should help ease these pressures. It is also worth noting that reserve coverage ratios for Indonesia, although worse than some regional neighbors, look reasonable on an EM basis (Chart 3).<sup>1</sup>

### Chart 3: Vulnerability Ratios for Indonesia are Middle of the Pack

As of 12/31/2018



Source : Haver Analytics

## Politics are going to be pivotal

Indonesia is a relatively young democracy and April will be the first time in recent history when presidential and parliamentary elections will be held at the same time. Ever since the Jakarta elections of 2017, religious issues have played a greater role in domestic politics. While this will surely make for scary headlines in one of the most ethnically and religiously diverse countries in the world, we think the incumbent Jokowi is very likely to be reelected. His ability to deliver economic growth and improve government service has translated to still-high approval ratings. Investors would welcome a second Jokowi term given his commitment to reforms, as evidenced by the country's ability to gain in the World Bank's ease of doing business surveys, rising from a rank of 120th in the world to 73rd.

Like any emerging market, there are certainly risks to investing in Indonesia, but both the currency and rates may have overshot at this point. An improvement in the current account, a better hedged external liability profile for corporates, and uneventful political outcomes could lead to better asset returns in 2019.

<sup>1</sup> External Vulnerability Ratio:  $(\text{Short-term External Debt} + \text{Currently Maturing Long-Term External Debt} + \text{Total Nonresident Deposits Over One Year}) / \text{Official Foreign Exchange Reserves} (\%)$

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