Thursday, 16 August 2018

Strategy

Policy Panacea

The government and central bank have made a synchronized move to combat the rising CAD and currency volatility. While the central bank maintained its tightening policy by hiking the 7-D RR rate by 25 bps to 5.5%, the government will limit imports and provide incentives for exports. The former, in our view, could affect economic growth although populist policies in the form of social spending should help to support consumption.

Policy remedies – on dual fronts

A twin deficit has always been the main spectre overshadowing Indonesia's investment story, especially in relation to its currency. While the windfall income on rising oil prices is enough to increase energy subsidies, thus leading to stable inflation given no hikes in administered prices this year, the growing current account deficit is now taking center stage, creating further IDR volatility. As we highlighted in our recent report ***Widening CAD in 2Q18, BOP in deficit*** (13 Aug 2018), there are 3 primary reasons why the CAD widened in 2Q18: 1. A lower trade surplus in 2Q18; 2. A widening deficit on services accounts of USD1.8b vs USD1.6b in 1Q18 and 3. A USD8.2b Primary Income deficit arising from dividends outflow and coupon payments on debt instruments, inline with seasonality. The first two matters will need to be addressed promptly to prevent the rupiah from coming under more pressure, with responses needed from both the government and central bank.

First measure: Hiking rates

With the Balance of Payments in deficit YTD depleting the country's forex reserves, monetary market operations to support the currency are less desirable, with BI opting to continue its tightening monetary policy by hiking the 7-day Reverse Repo Rate by another 25 bps to 5.5%, culminating in a total of 125 bps rate hikes so far this year. The central bank's focus has shifted toward the short-term priority of stabilising the currency, hiking rates to widen the yield gap in a bid to encourage inflows back into Indonesia. The gap between the 10 year Indo bond over the US Treasury now stands at 513bps vs 390bps at the beginning of the year.

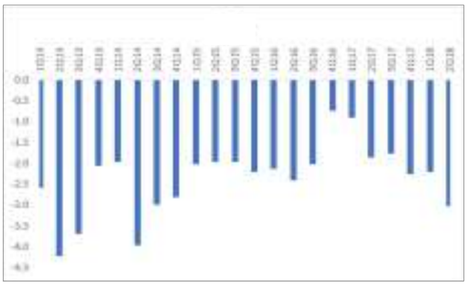
Second measure: Limit imports – a temporary measure

As a temporary measure, the government will seek to limit imports, mainly of 500 consumer goods. The government will also temporarily stop importing government and SOE-controlled capital goods, including by PT Pertamina and PT PLN, as well as provide incentives to exporting companies. The government will issue this regulation in due course and also implement the policy on increasing the usage of domestic biodiesel through the B20 mandate.

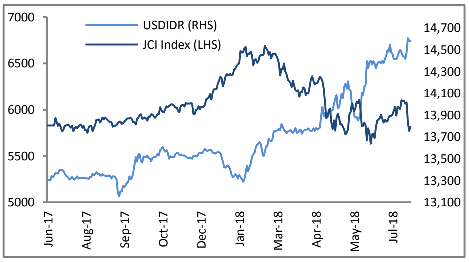
The CAD may reach the upper limit of the safety level

While the CAD in 1H18 was 2.6% of GDP, it will go up to the upper limit of the safety level of 3% by year-end if its current trend continues in 2H18. Based on our calculations, every USD1b of savings in the CAD will reduce the CAD to GDP ratio by 0.1%. As such, at least USD5b of savings in the CAD will be needed to bring the year-end CAD back to the safety level of 2.5% of GDP. The central bank expects the CAD to be under 3% by the year-end.

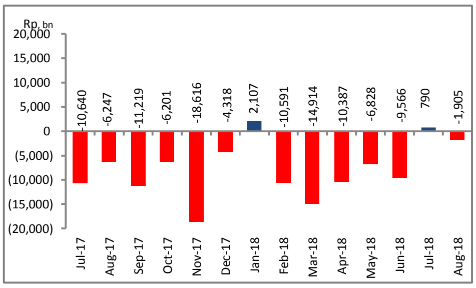
CAD trends (as % to GDP)



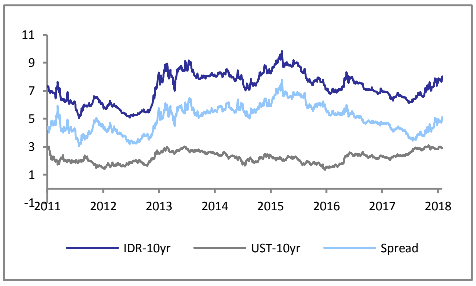
JCI vs USD



Net Foreign Flow



UST10yr-IDN10yr-Spread



Helmy Kristanto
(62-21) 2955 5888
helmy.kristanto@danareksa.co.id

Preference for domestic consumption and exporter plays

The uptrend in the CAD and the measures taken to deal with this issue will ultimately impact the economic growth trajectory in our view. However, the government's populist policies will provide a catalyst for consumption growth. Recently, the government highlighted the need to prioritise human capital development, which would mean more social spending, including a higher village funds budget, especially given the backdrop of the elections taking place in 2019.

Given the weaker currency, interest rate hikes, and the government's move to limit imports, it is highly unlikely that the JCI's high reached on Feb 2018 will be revisited in the short term. We lower our EPS growth assumption this year to 8% from 12% previously, with the year-end JCI range of 6,275 – 6,577, based on 16.6-17.4x PE.

We continue to favour domestic consumption theme stocks and commodity/exporter plays, and remain overweight on the Banking, Consumer, Retailers and Coal/Metal Mining sectors. Our top picks are: BBRI, BBTN, ASII, ERAA, MAPI GGRM, INDF, SCMA, PTBA, ADRO and INCO**.**

Exhibit 1. Stock pick

			Last Price	Market Cap.	Upside	Target Price	P/E (x)		P/BV (x)		ROE (%)
Company	Ticker	Rec	(Rp)	(RpBn)	(%)	(Rp)	2018F	2019F	2018F	2019F	2018F
BRI	BBRI IJ	BUY	3,130	386,072	39.0	4,350	11.7	10.0	2.1	1.8	18.6
Bank Tabungan Negara	BBTN IJ	BUY	2,530	26,793	38.3	3,500	7.7	7.1	1.1	1.0	15.1
Astra International	ASII IJ	BUY	6,825	276,300	26.0	8,600	14.0	12.8	2.1	1.9	15.3
Erajaya Swasembada	ERAA IJ	BUY	2,730	8,709	46.5	4,000	12.5	11.1	2.0	1.8	15.9
Gudang Garam	GGRM IJ	BUY	73,500	141,420	9.9	80,800	17.1	15.5	2.9	2.6	18.3
Indofood	INDF IJ	BUY	6,125	53,780	30.6	8,000	12.0	10.8	1.6	1.5	13.9
Surya Citra Media	SCMA IJ	BUY	1,870	27,342	44.4	2,700	17.4	15.7	5.9	5.0	37.4
Bukit Asam	PTBA IJ	BUY	4,160	47,926	20.2	5,000	9.6	9.0	2.9	2.4	31.2
Adaro Energy	ADRO IJ	BUY	1,800	57,575	55.6	2,800	7.8	8.5	1.2	1.2	16.0
Vale Indonesia	INCO IJ	BUY	3,950	39,249	49.4	5,900	35.2	23.0	1.6	1.6	4.7

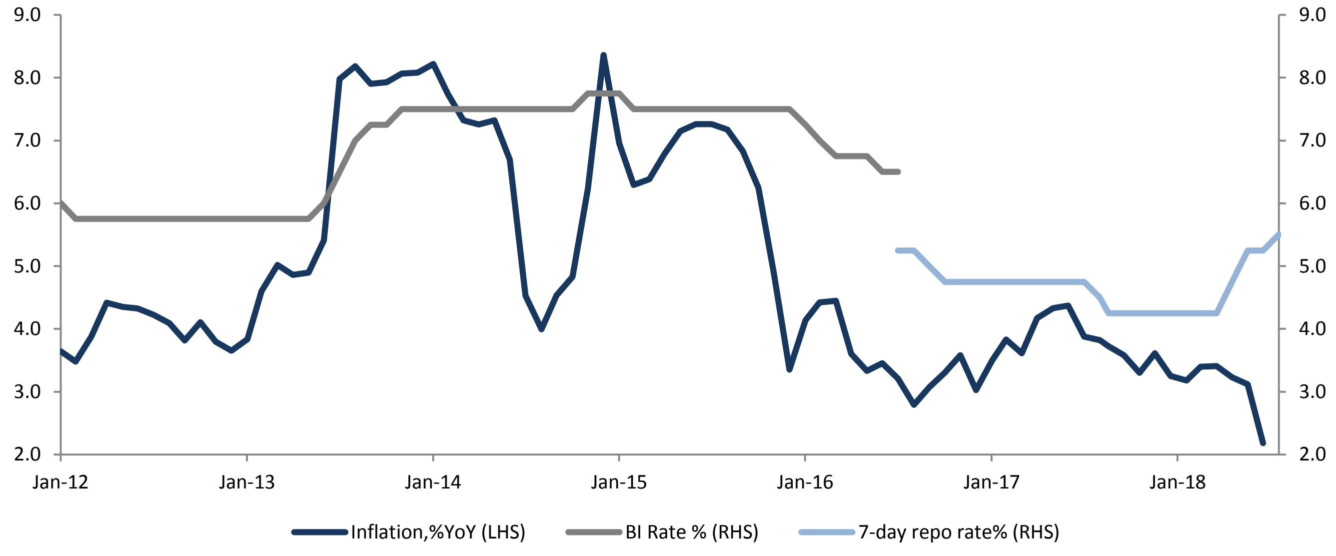
Source: Danareksa Sekuritas

Exhibit 2. Remarks from Bank Indonesia's Board of Governor Meeting

Reason to increase BI7DRRR	To improve interest of domestic financial market
	To control CAD to be in acceptable range
	To tackle negative impacts from rising global economy uncertainty
	To support Government measure to stabilize economy and improve external resilience
Other preemptive action that will be deployed by BI	Deploying double intervention and monetary operation strategy to manage liquidity in money market and foreign exchange market
	Maintaining efficiency of market interest rate through implementation of IndONIA as money market benchmark rate, development of Overnight index Swap, and Interest rate swap
	BI encourages financial market participants to utilize hedging facilities that is provided by Bank Indonesia and other banks. BI has managed to reduce swap premium from 4.85% to 4.62% for 1 month tenor and 5.18% to 4.96% for 1 year tenor
BI's expectation	Considering investment and consumption improvement, despite limited export improvement, Bank Indonesia predicts that the economy growth will be in the range of 5,0-5,4% in 2018 and 5,1-5,5% in 2019
	Inflation target of 2018 is expected to be in the range of 3,5%±1% (yoy)
	BI expects the CAD will be under 3% by the end of year and lower compared to recent CAD
	BI targets credit growth of 10-12% (yoy) and third party deposit of 8,0-10,0% (yoy) in 2018

Source: Bank Indonesia, Danareksa Sekuritas

Exhibit 3. Bank Indonesia benchmark rate and inflation



Source: Danareksa Sekuritas