Their deficits, our problem

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Summary

- The anticipated increase in US debt issuance in Q2 2024 could intensify pressure on the UST market, but the expansion of the Treasury buyback program may alleviate liquidity concerns for longer-dated USTs.
- The current uptrend in UST yields may persist over the long term due to the risk of sustained inflationary pressures, leading to expectations of higher real interest rates in the US. This could be amplified in Asia by the concurrent depreciation pressures from the Yen and Yuan.
- Maintaining stability in SBN yields may become more difficult amid expectations of prolonged higher UST yields, although the expanded KLM incentive seems to be enough to encourage banks to expand their loan portfolios and bolster economic growth.

- Two 'battles' have captured the attention of millions of Indonesians in the past week: the clash between the Indonesian U-23 men's national team against South Korea and the Rupiah's battle against the strengthening US Dollar. While the first battle was only tense for 120 minutes, Bank Indonesia's decision to bring the BI rate to its highest level since 2016 does not mark the crescendo of the exchange rate battle. The Rupiah now stood at 16,210 (-5.28% YTD), only marginally higher than its nadir of 16,255 (-5.57% relative to early in the year) before the BI policy meeting in April 2024.
- This development confirms our scepticism regarding the direct impact of the widened real rate differential in breaking the downward trend now plaguing the Rupiah. Domestic factors such as limited improvements in Indonesia's terms-of-trade (or the more rudimentary coal-to-oil ratio) and the accelerating demand for FX loans portend a widening saving-investment gap, which often translates negatively to the outlook for Indonesia's current account and the Rupiah.
- It is true, however, that the Rupiah's ongoing predicament is explained mostly by external factors. Hot economic data in the US, coupled with the flaring geopolitical tension, have led to a higher risk of a "bear steepening[1]" condition in the US Treasury (UST) market ***(see Chart 1).*** The added risk thus explains foreign investors' declining appetite for assets in the Indonesian financial market, as indicated by last week's USD 300.40 Mn outflows in the SBN market and the USD 277.35 outflows in the domestic stock market.

[1] Long-term rates rising faster than short-term rates

QRA, the UST, and the global bond market: Higher rates, here and there

- The upward trend in the benchmark UST yield is hardly driven by recent events only. Following the textbook economics theory, yields on treasury securities are composed of at least three elements; expectations of future paths of inflation and the interest rate, plus the term premia. **While the breakeven inflation rate has been moving higher in recent times, the increase is insignificant relative to the increase in real rate expectation**, which has been on an upward trend since mid-2022 ***(see Chart 2)***.

- The still-negative UST term premium further highlights the market's expectation for a higher-for-longer yield (and, thus, interest rates) environment. While the UST term premium is already up by around 41.32 bps YTD[2], the negative term premium shows that investors remain disincentivised to take on more duration – signalling widespread expectations that the interest rate would not change significantly in periods ahead (with the market now pointed to a maximum of 25 bps of FFR cuts in 2024). **The higher long-term interest rate expectation also illustrates the Fed's improving inflation-fighting credibility, which may require the central bank to prolong its hawkish bias** given the risk of structurally high global energy prices (due to the industry-wide consolidation in the US shale sector and Saudi Arabia's higher fiscal breakeven oil prices) and the persistently robust demand in the US economy.

"The higher UST yield seems to be a product of higher real rate expectation in the long-term rather than higher supply of T-Notes/Bonds"

- Indeed, the US economy continues to demonstrate resilience in the prevailing high-interest-rate environment, which is still admirable despite the lower-than-expected 1.6% GDP growth in Q1 2024 given the higher tax bill that hit US households in the past quarter. Along with the strong labour market (and the positive wage growth that follows), this resilience may also be attributed in part to the wholesale debt refinancing undertaken by households during the pandemic, which has made the US household less sensitive to changes in short-term interest rates. **The US economy, then, may turn out to be increasingly fiscal-driven, which may continue to drive the US economy forward as policies coming from both sides of the Capitol continue to favour higher fiscal spending (and/or lower fiscal revenue).**

- All of this points to one thing: a widening US deficit. The widening US fiscal deficit, driven by the increasingly fiscal-driven nature of its economy, along with widespread concerns regarding liquidity risk in the UST market, has prompted market participants to devote more attention to anticipating the next quarterly refunding announcement (QRA).

- Compared to the situation some 6-9 months ago, this heightened level of attention to QRA is a new phenomenon. Alas, the outlook seems to be bleak for new QRA watchers. Higher asset prices may translate positively to US tax receipts, which record a 10.62% YoY increase (9.05% QoQ) in Q1 2024. However, one estimate suggests that the US government may announce an upward revision to its Q2 2024 projected borrowings from USD 202 Bn to around USD 275-300 Bn in the upcoming QRA. **The need to raise more debt**

[2] Estimated using 5Y UST, see Adrian, Crump, & Moench (2013)

is more pressing given the significant bill and coupon payment in Q2 2024, which could amount to as much as USD 2.11 Bn next month (compared to the current Treasury general account balance of USD 0.94 Bn).

- The US Treasury Department has been able to mask the increase in net debt issuance by shifting treasury securities issuance towards shorter-dated Bills, which minimises the impact of higher UST supply on the liquidity condition in the market as investors could absorb more T-Bills without assuming more duration risks. However, **periods of T-Bills issuance have led to the speculation that the US Treasury will eventually need to shift the debt issuance towards longer-dated treasury securities *(see Chart 3)***, a move which will rebalance the US debt duration but may amplify the liquidity concerns in the UST market.

- It is safe to say, then, that the widening US fiscal deficit will go in tandem with increasing risks. However, as to who will be left to carry more of the risk remains debatable. **On the one hand, heightened liquidity risks in the UST market could undermine the US' prestige as the premier safe haven market**, a sentiment reinforced by the widely reported shift of Chinese investors from UST to gold.

- On the other hand, Chinese investors' sensationalised UST dumping may obscure the strong underlying current that continues to flow towards the American shore. **Foreign investors still play a significant role in driving up the demand for USTs**, though the increased demand may be linked to robust US corporate revenues as the majority of the UST demand could be traced back to a handful of offshore financial centres. The gap between the US economy's still-robust outlook and the stagnating global economy may also drive up the demand for UST, while **the higher yield due to higher debt issuance may sweeten the deal for investors to come back to the UST market and uproot their investments elsewhere.**

- To add some historical context, the environment of high UST yield and widening US deficits in 1982-1986, which resembles the current situation, led to significant portfolio inflows to the US market – which dismantled the original Eurodollar market that cut off liquidity for many economies in Latin America and the Eastern Bloc. Hence, **this mix of "high yield, deeper deficits" may turn out to be more toxic for peripheral markets rather than the US financial market itself, leading investors to demand more for their investments in these peripheral markets.**

> ***"Higher yields may attract investors to the UST market, which may starve other, more peripheral markets of liquidity"***

- The toxic mix of "high yield, deeper deficits" in the US economy may even hit one of the core financial markets. For instance, **the still-significant policy gap between the Fed and the Bank of Japan moves investors to set their sights on the Japanese market at the moment**, given the BoJ's failure to follow its March 2024 rate hike with a more hawkish policy in the recent policy meeting.

- Prolonged pressure on the JPY, which may start to seep into its headline inflation number through higher imported prices, may force the BoJ to change tact and take a more hawkish action down the line – or, alternatively, **the central bank may continue intervening in the market, selling off their foreign assets (including USTs) in defence of the JPY. Accordingly, then, the UST yield could rise further, or Japanese investors would be lured back by higher yields back home – leaving a void across Asian**

financial markets, where Yen has long been a key funding currency.

- **Financial markets across Asia, then, may face greater urgency to maintain healthy real rate differentials against the UST market.** Fortunately, there is a flickering light that may calm investors in more peripheral markets amid their predicaments. The US Treasury Department has launched three buyback operations throughout April 2024, which could be expanded at later dates should the need arise. The buyback operation shows that the liquidity concern is largely concentrated on the longer end of the UST market, as the New York Fed (who conducted the operation) managed to purchase T-Bonds with as low as 54.56% of its par value (while T-Bills still sold for 92.87%-99.27% of its par value). The expanded buyback operation, then, may lower the risk of spiking long-term rates in the UST market, while the continued increase in the balance of retail money market funds ***(see Chart 4)*** should secure the demand for T-Bills.
- However, given the US government's widening fiscal deficits and the seemingly limited chance for significant FFR cuts in upcoming periods, **the high-yield environment in the UST market could motivate investors to demand more for their investments from their investment in other, more peripheral markets** (including the Indonesian financial market). Ergo, given the more limited 70.5 bps YTD increase in the benchmark SBN yield (compared to 80.2-272.0 bps for other fragile-5 countries), **foreign investors may continue to demand more returns for their investments in the SBN market**.
- The SBN market may continue to face pressure from foreign investors. Fortunately, **the strengthened macroprudential liquidity (KLM) incentive is a good enough motivation for banks to expand their loan portfolio**, as the liquidity incentive will only be given based on certain loan growth thresholds, while the more limited SRBI issuance in recent times may also nudge banks towards accumulating SBN.

"Sell-off pressure may persist in the SBN market, but the expanded KLM incentive should motivate banks to expand their loan portfolio"

Chart 1

A bear in the limelight

Longer-tailed UST yield moves higher than the shorter one as the flaring geopolitical tension increases the attention on the risk of more persistent inflationary pressure.

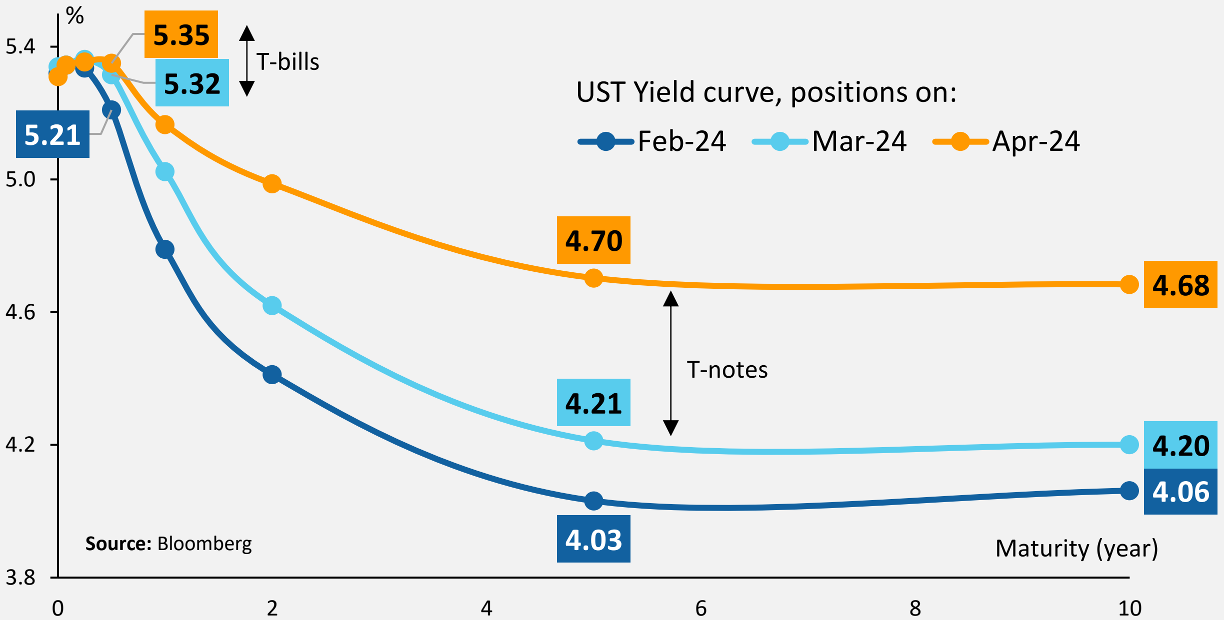

Chart 2

Higher for longer

The higher UST yield seems to be driven almost exclusively by higher real rate expectations while the long-term US inflation expectation remains muted.

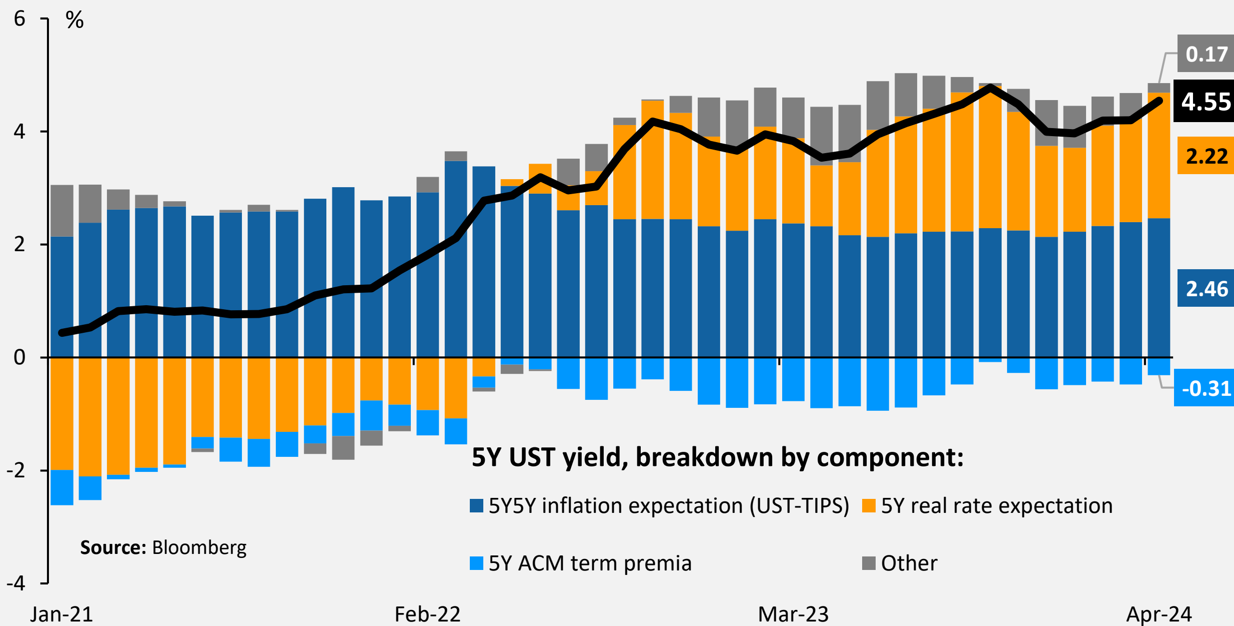

Chart 3

Anticipating the inevitable

Long-term UST issuance has yet to significantly increase (relative to T-bills) in Q1 2024, leading to the expectation that the US Treasury will announce the issuance of more long-term bonds in the upcoming QRA.

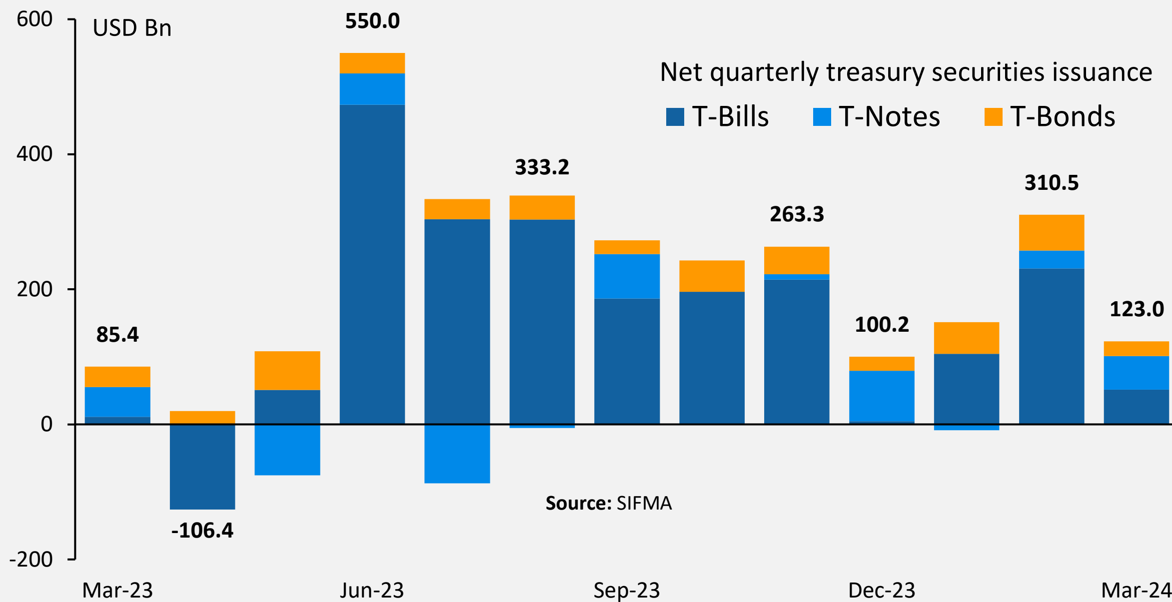

Chart 4

Liquidity risk contained

The liquidity risk in the UST market is largely contained in the longer end of the market as the continued increase in retail money market funds stands as a ready buyer for T-Bills

Economic Calendar

		Actual	Previous	Forecast*
10 April 2024				
US	Inflation rate YoY, %	3.5	3.2	3.4
11 April 2024				
CN	Inflation rate YoY, %	0.1	0.7	1.2
ID	Car Sales YoY, %	-26.2	-18.8	-
12 April 2024				
CN	Balance of Trade (USD Bn)	58.5	125.1	64.0
16 April 2024				
ID	Consumer Confidence	128.8	123.1	123.4
17 April 2024				
ID	Retail Sales YoY, %	6.4	1.1	1.2
22 April 2024				
ID	**Balance of Trade (USD Bn)**	**4.47**	**0.87**	**1.70**
24 April 2024				
ID	**BI Rate Announcement**, %	**6.25**	**6.00**	**6.50**
ID	Loan Growth YoY, %	12.40	11.28	-
29 April 2024				
ID	**Foreign Direct Investment YoY**, %	**15.5**	**5.3**	**-**
1 Mei 2024				
US	ISM Manufacturing PMI		50.3	49.9
US	JOLTs Job Openings (Mn)		8.75	8.70
2 Mei 2024				
US	**Fed Interest Rate Decision**		**5.50**	**5.50**
ID	**CPI Inflation YoY,** %		**3.05**	**2.99**
ID	S&P Global Manufacturing PMI		54.2	54.1
3 Mei 2024				
US	Non-Farm Payroll, (Th)		303	190
US	Unemployment Rate, %		3.8	3.8
6 Mei 2024				
ID	**GDP Growth YoY**, %		**5.04**	**5.08**
8 Mei 2024				
ID	**Foreign Exchange Reserves (USD Bn)**		**140.4**	**138.0**
ID	Motorbike Sales YoY, %		-7.8	-

*Forecasts of some indicators are simply based on market consensus
Bold indicates indicators covered by the BCA Monthly Economic Briefing report

Selected Macroeconomic Indicator

Key Policy Rates	Rate (%)	Last Change	Real Rate (%)
US	5.50	Jul-23	2.00
UK	5.25	Aug-23	2.05
EU	4.50	Jul-23	2.10
Japan	-0.10	Jan-16	-2.80
China (lending)	2.50	Aug-23	4.25
Korea	3.50	Jan-23	0.40
India	6.50	Feb-23	1.65
Indonesia	6.25	Apr-24	3.20

Money Mkt Rates	26-Apr	-1 mth	Chg (bps)
SPN (1M)	5.88	5.80	7.6
SUN (10Y)	7.16	6.67	48.8
INDONIA (O/N, Rp)	5.98	5.81	16.4
JIBOR 1M (Rp)	6.90	6.65	25.5

Bank Rates (Rp)	Jan	Dec	Chg (bps)
Lending (WC)	8.87	8.86	1.70
Deposit 1M	4.68	4.76	-7.90
Savings	0.68	0.69	-1.30

Currency/USD	26-Apr	-1 mth	Chg (%)
UK Pound	0.800	0.792	-1.07
Euro	0.935	0.923	-1.27
Japanese Yen	158.3	151.6	-4.28
Chinese RMB	7.246	7.217	-0.41
Indonesia Rupiah	16,210	15,790	-2.59

Capital Mkt	26-Apr	-1 mth	Chg (%)
JCI	7,036.1	7,365.7	-4.47
DJIA	38,239.7	39,282.3	-2.65
FTSE	8,139.8	7,931.0	2.63
Nikkei 225	37,934.8	40,398.0	-6.10
Hang Seng	17,651.2	16,618.3	6.22

Foreign portfolio ownership (Rp Tn)	Mar	Feb	Chg (Rp Tn)
Stock	3,226.6	3,236.2	-9.67
Govt. Bond	810.7	837.1	-26.42
Corp. Bond	9.4	9.5	-0.10

Trade & Commodities	26-Apr	-1 mth	Chg (%)
Baltic Dry Index	1,721.0	1,989.0	-13.5
S&P GSCI Index	595.9	575.6	3.5
Oil (Brent, $/brl)	89.5	86.3	3.8
Coal ($/MT)	137.5	130.6	5.3
Gas ($/MMBtu)	1.41	1.58	-10.8
Gold ($/oz.)	2,338.0	2,178.8	7.3
Copper ($/MT)	9,852.8	8,748.5	12.6
Nickel ($/MT)	18,937.9	16,417.5	15.4
CPO ($/MT)	829.5	926.2	-10.4
Rubber ($/kg)	1.58	1.62	-2.5

External Sector	Mar	Feb	Chg (%)
Export ($ bn)	22.43	19.27	16.40
Import ($ bn)	17.96	18.44	-2.60
Trade bal. ($ bn)	4.47	0.83	436.66
Central bank reserves ($ bn)*	140.4	144.0	-2.53

Prompt Indicators	Mar	Feb	Jan
Consumer confidence index (CCI)	123.8	123.1	125.0
Car sales (%YoY)	-26.2	-18.8	-26.1
Motorcycle sales (%YoY)	-7.8	-2.9	-3.7

Manufacturing PMI	Mar	Feb	Chg (bps)
USA	51.9	52.2	-30
Eurozone	46.1	46.5	-40
Japan	48.2	47.2	100
China	51.1	50.9	20
Korea	49.8	50.7	-90
Indonesia	54.2	52.7	150

Source: Bloomberg, BI, BPS
Notes:
*Data from an earlier period
For changes in currency: **Black indicates appreciation against USD, **Red** otherwise
***For PMI, **>50** indicates economic expansion, **<50** otherwise

Indonesia – Economic Indicators Projection

	2019	2020	2021	2022	2023	2024E
Gross Domestic Product (% YoY)	5.0	-2.1	3.7	5.3	5.0	5.0
GDP per Capita (US$)	4175	3912	4350	4784	4920	5149
Consumer Price Index Inflation (% YoY)	2.7	1.7	1.9	5.5	2.6	3.2
BI 7-day Repo Rate (%)	5.00	3.75	3.50	5.50	6.00	6.50
USD/IDR Exchange Rate (end of the year)**	13,866	14,050	14,262	15,568	15,397	16.119
Trade Balance (US$ billion)	-3.2	21.7	35.3	54.5	37.0	32.6
Current Account Balance (% GDP)	-2.7	-0.4	0.3	1.0	-0.1	-0.5

*Actual number

** Estimation of the Rupiah's fundamental exchange rate

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