FOMC:
Slower climb on steeper incline

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Executive Summary

- The Fed raised their target rate by 75 bps and sent a message that it may pursue future hikes more carefully, but towards a higher terminal (peak) rate.
- The downsides to the Fed's rate hike campaign have become more apparent, with US leading index pointing to a recession by mid-2023 and liquidity stress rising in multiple countries.
- We expect BI to hike towards 5.50% by year-end, with further hikes by potentially 25-75 bps next year before the Fed finally stop or pivot.

- The Fed raised the target range for their funds rate (FFR) to 3.75-4.00% – a 75 bps increase as fully expected by the market. The question, as ever, was not on the rate hike per se but on the future policy guidance; and here, the market gets a mixed message.

- The Fed is expected to proceed more carefully, by considering "the cumulative tightening of monetary policy" and "the lags with which monetary policy affects economic activity and inflation". This suggests a slower pace of rate hike ahead, as opposed to the 75 bps hikes in the last four meetings.

- But Chair Powell also made two revealing statements. First, he mentioned that the Fed's terminal (peak) rate is now higher than the 4.50-4.75% range that it plotted in September. Then he also affirmed that it considers the risk of over-tightening (and then having to stimulate again) to be more acceptable than that of under-tightening (and letting inflation expectations go untethered).

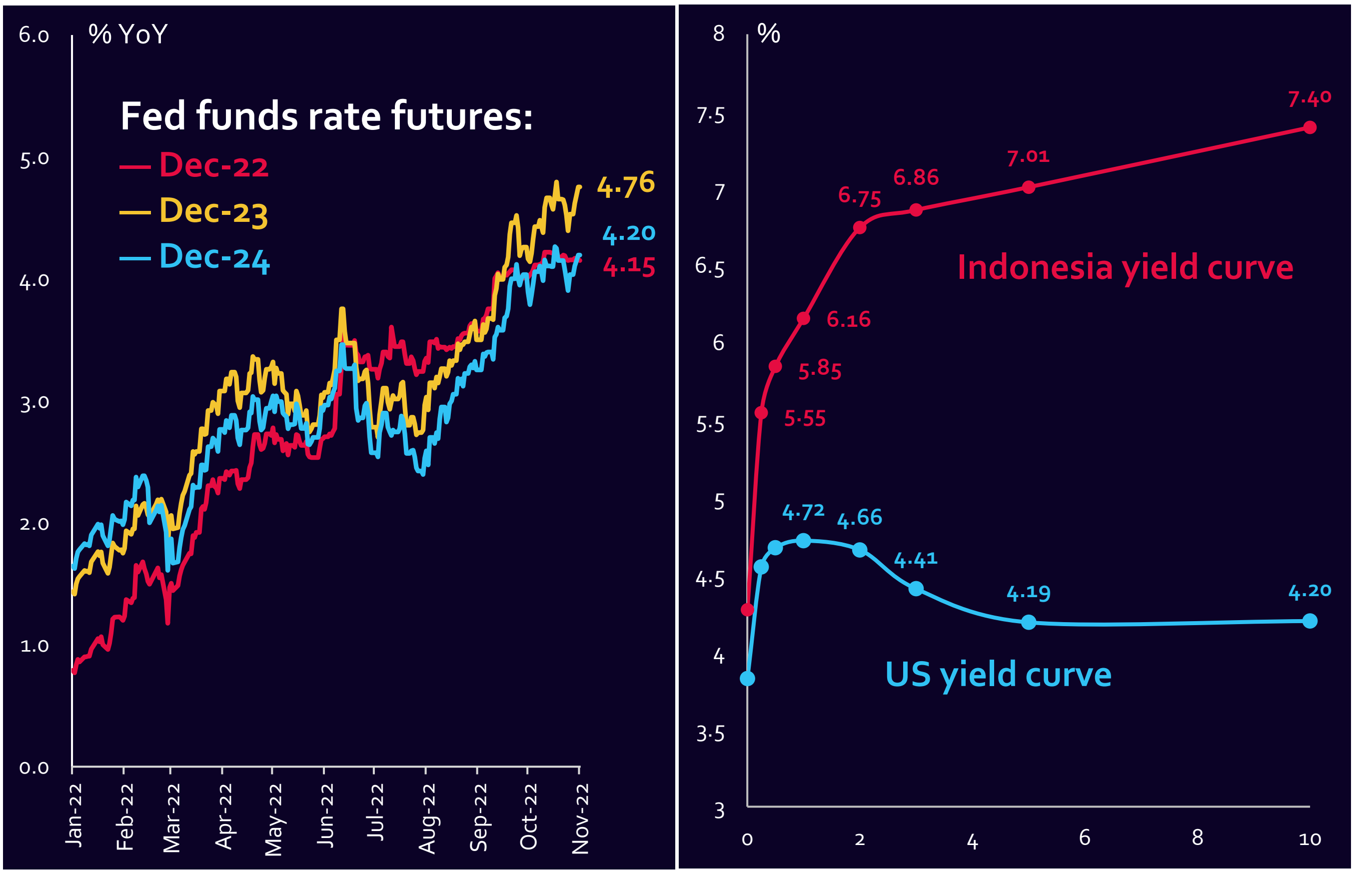
- What Powell suggested, then, is not a pivot but simply a slower climb but on a steeper incline. Small wonder that the market reacted with higher yields, higher volatility, and a shift in terminal rate to 5.00-5.25% in Q2 or Q3-23 before slowly declining again. So is this a realistic trajectory?

- We have little doubt that the Fed is committed to further rate hikes, with inflation now looking more entrenched as it broadened into services (especially shelter). It also may seem like the US economy can absorb more rate hikes, with growth in Q3-22 still looking pretty robust.

- However, this healthy façade may belie a more fragile situation for the US economy. There is a widening gap between the still-healthy coincident indicators and the leading indicators, which are deteriorating fast. Historically, negative change in the leading index predicts a recession within 2-3 quarters, which may or may not be the signal for the Fed to finally stop or pivot for good.

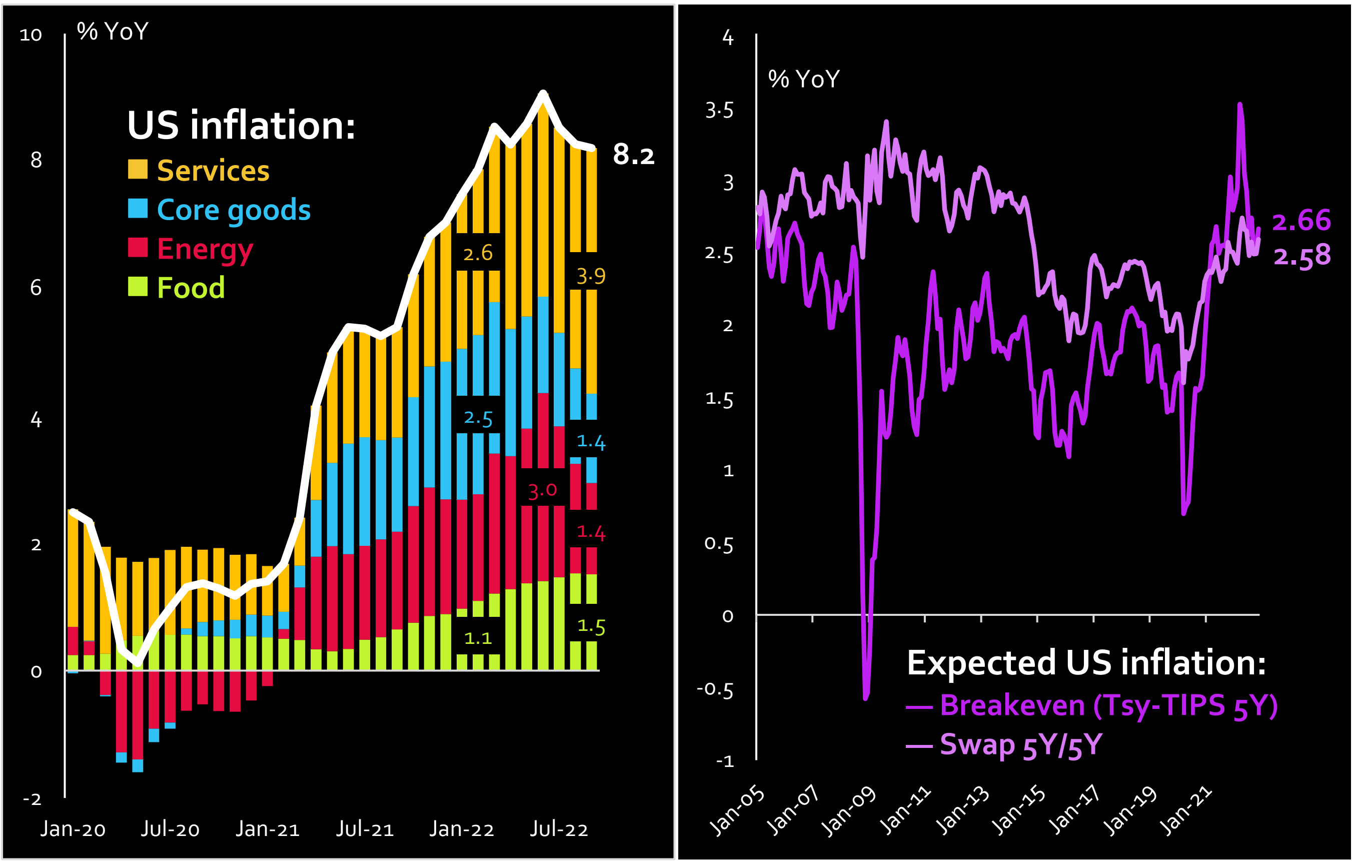
- And this could be a long 2-3 quarters for the world economy indeed. For the past few months, we have seen signs of stress accumulating in the global bond and currency markets. This is especially notable for countries with current account deficits (UK, or Japan and Europe post-energy crisis) that are dependent on USD financing. The choice is to either hike rates to keep up with the Fed (ECB and BoE) or to maintain rates and intervene massively in the market to prevent depreciation, a la the BoJ.
- So what about BI? We expect BI to hike by 50 bps later this month to counteract the Fed's latest move, but after that the pace may slow – just like the Fed's. Thanks to its current account surplus and reduced foreign ownership in sovereign bonds, Indonesia is arguably less sensitive to Fed hikes and does not have to match it toe-to-toe or maintain yield spreads by a certain magic number. As such, we expect the 7-day Repo Rate to end up at 5.50% by the end of the year, with a terminal rate perhaps some 25-75 bps above it.

Panel 1. **Fed hikes expected to continue into 2023, but Indonesia maintains healthy nominal yield spreads versus the US especially in the longer end**



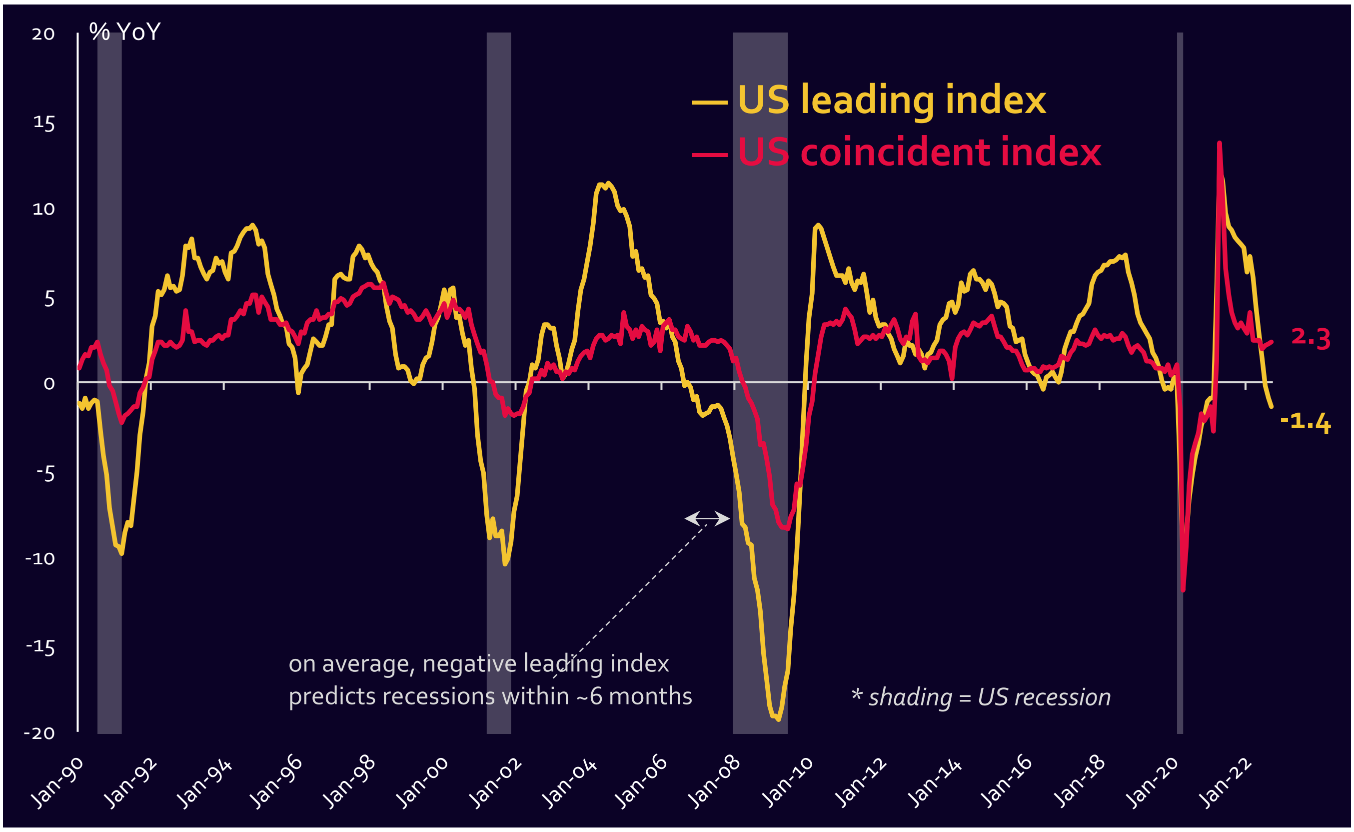
Source: Bloomberg, BI

Panel 2. US inflation has been stubbornly resistant to rate hikes, even though long-run expectations remain quite well-anchored



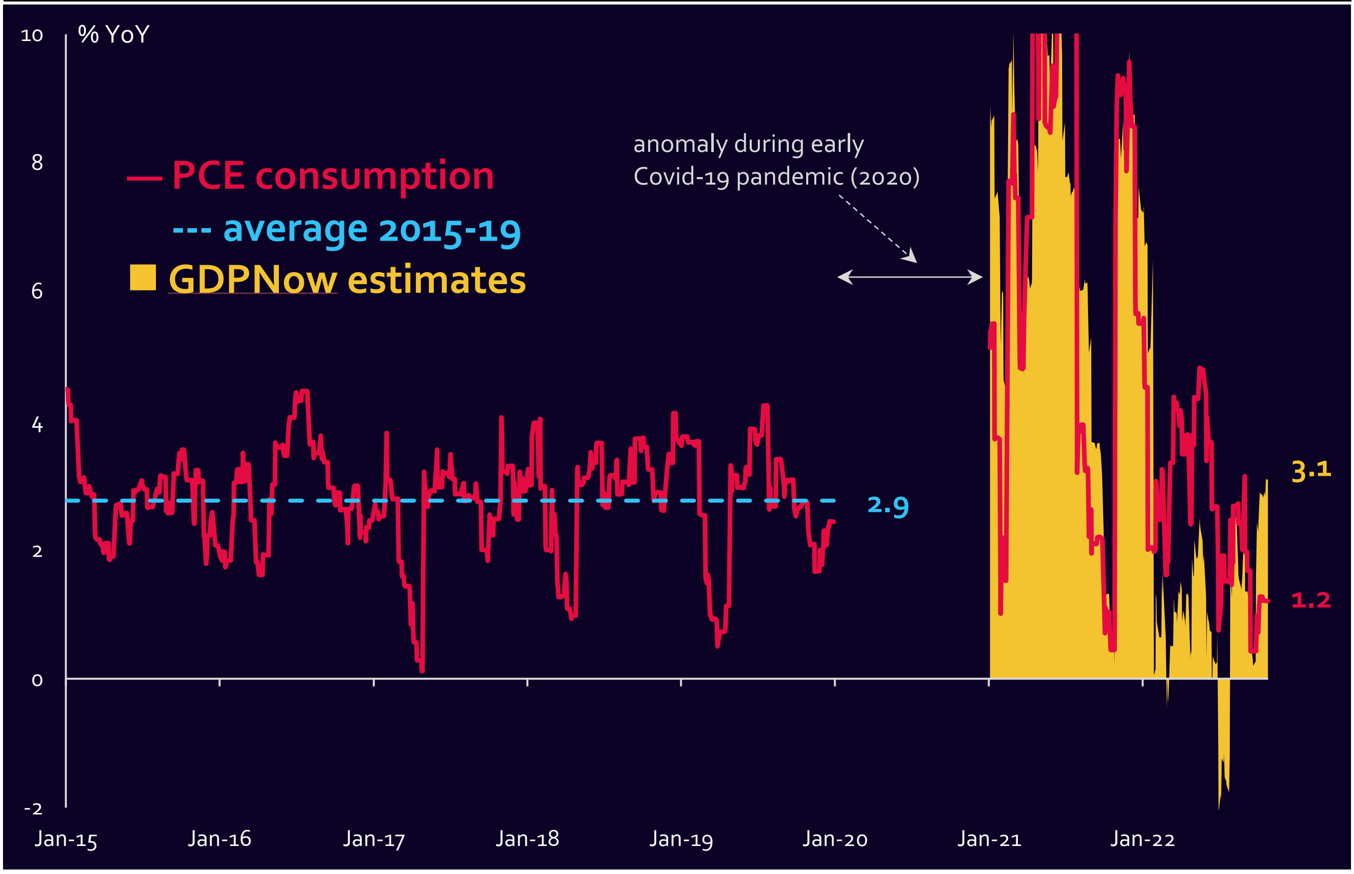
Source: US BLS, Bloomberg

Chart 1. The US economy looks robust for now, but recession risk is rising



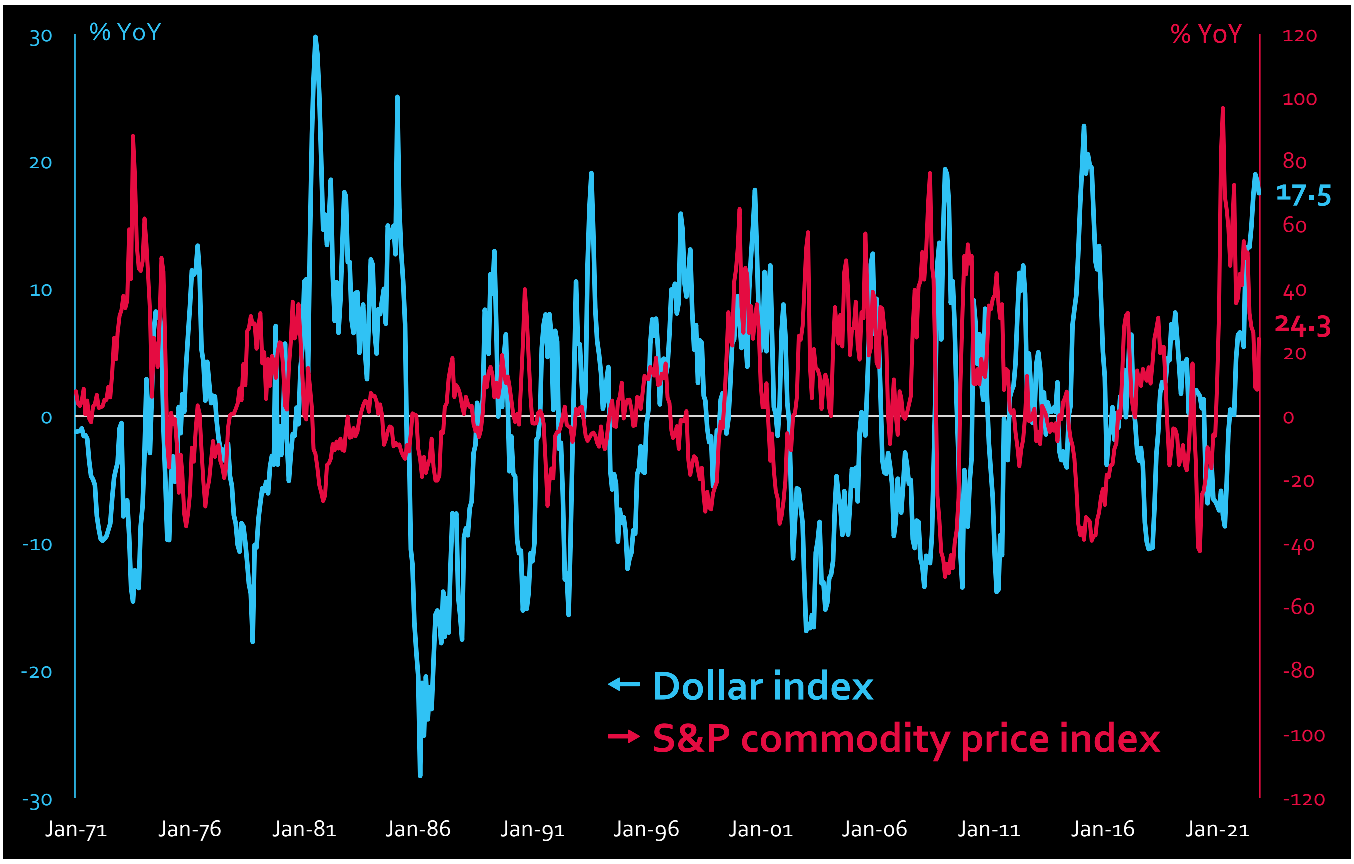
Source: Bloomberg

Chart 2. **GDP nowcast points to slowing demand amidst strong GDP print**



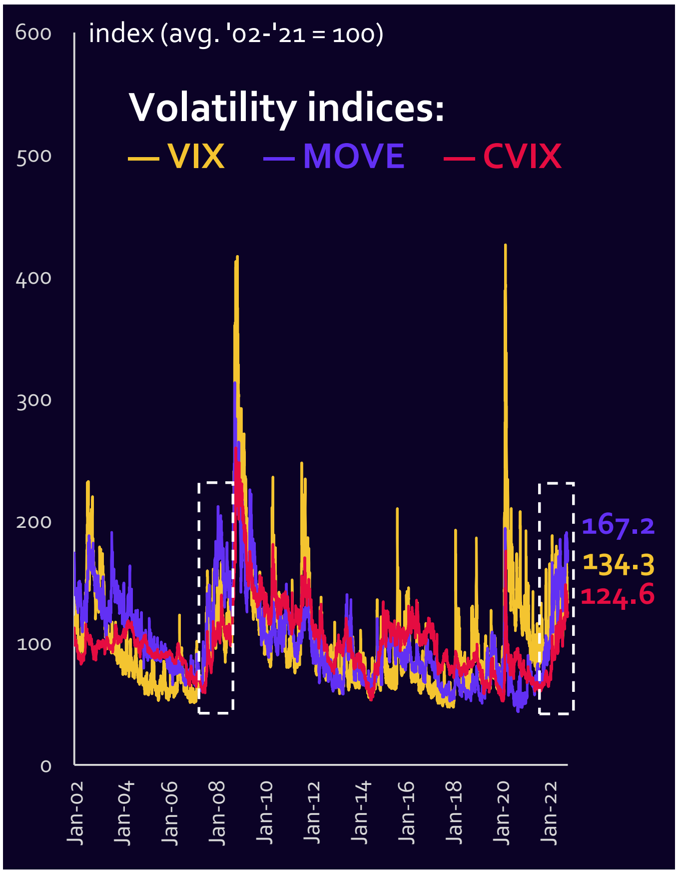
Source: Atlanta Fed

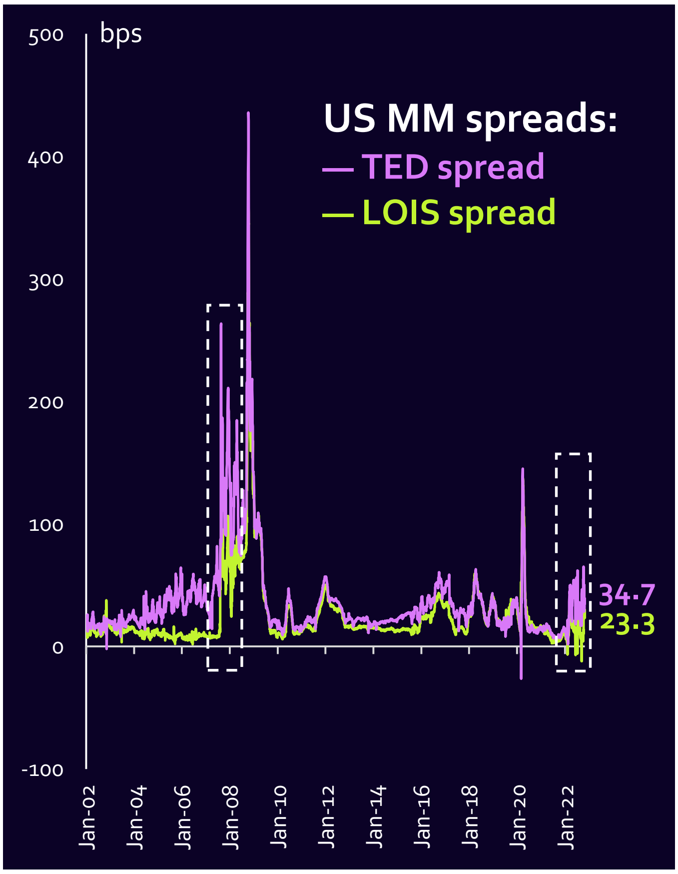
Chart 3. **The Dollar wrecking ball has been quite effective in suppressing commodity prices**



Source: Bloomberg

Panel 3. Stress have risen in Treasury and FX markets while US money market stays quiescent – potentially blinding the Fed to the danger of financial troubles





Source: Bloomberg

Selected Macroeconomic Indicator

Key Policy Rates	Rate (%)	Last Change	Real Rate (%)
US	3.25	Oct-22	-4.95
UK	2.25	Oct-22	-7.85
EU	2.00	Oct-22	-8.70
Japan	-0.10	Jan-16	-3.10
China (lending)	4.35	Oct-22	1.55
Korea	3.00	Oct-22	-2.70
India	5.90	Sep-22	-1.51
Indonesia	4.75	Oct-22	-0.96

Money Mkt Rates	2-Nov	-1 mth	Chg (bps)
SPN (1M)	4.72	4.30	41.4
SUN (10Y)	7.38	7.35	3.3
INDONIA (O/N, Rp)	4.27	3.84	43.2
JIBOR 1M (Rp)	5.44	4.87	56.7

Bank Rates (Rp)	Jul	Jun	Chg (bps)
Lending (WC)	8.42	8.40	1.37
Deposit 1M	2.83	2.84	-1.02
Savings	0.64	0.62	1.50

Currency/USD	2-Nov	-1 mth	Chg (%)
UK Pound	0.878	0.895	1.99
Euro	1.019	1.020	0.16
Japanese Yen	147.9	144.7	-2.14
Chinese RMB	7.290	7.116	-2.39
Indonesia Rupiah	15,648	15,228	-2.68

Capital Mkt	2-Nov	-1 mth	Chg (%)
JCI	7,015.7	7,040.8	-0.36
DJIA	32,147.8	28,725.5	11.91
FTSE	7,144.1	6,893.8	3.63
Nikkei 225	27,663.4	25,937.2	6.66
Hang Seng	15,827.2	17,222.8	-8.10

Foreign portfolio ownership (Rp Tn)	Oct	Sep	Chg (Rp Tn)
Stock	2,630.5	2,526.7	103.76
Govt. Bond	713.2	730.3	-17.02
Corp. Bond	15.4	15.5	-0.12

Trade & Commodities	2-Nov	-1 mth	Chg (%)
Baltic Dry Index	1,321.0	1,760.0	-24.9
S&P GSCI Index	649.3	607.8	6.8
Oil (Brent, $/brl)	96.2	88.0	9.3
Coal ($/MT)	362.5	412.7	-12.2
Gas ($/MMBtu)	4.58	6.40	-28.4
Gold ($/oz.)	1,635.2	1,660.6	-1.5
Copper ($/MT)	7,663.3	7,683.3	-0.3
Nickel ($/MT)	24,063.0	21,012.0	14.5
CPO ($/MT)	883.0	713.7	23.7
Rubber ($/kg)	1.20	1.32	-9.1

External Sector	Sep	Aug	Chg (%)
Export ($ bn)	24.80	27.86	-11.0
Import ($ bn)	19.81	22.15	-10.6
Trade bal. ($ bn)	4.99	5.71	-12.6
Central bank reserves ($ bn)*	130.8	132.2	-1.06

Prompt Indicators	Sep	Aug	Jul
Consumer confidence index (CCI)	117.2	124.7	123.2
Car sales (%YoY)	18.9	16.4	29.4
Motorcycle sales (%YoY)	10.7	11.6	-13.3

Manufacturing PMI	Oct	Sep	Chg (bps)
USA	50.2	50.9	-70
Eurozone	46.4	48.4	-200
Japan	50.7	50.8	-10
China	49.2	48.1	110
Korea	48.2	47.3	90
Indonesia	51.8	53.7	-190

Source: Bloomberg, BI, BPS

Notes:

^Data for January 2022

*Data from earlier period

For changes in currency: **Black indicates appreciation against USD, **Red** otherwise

***For PMI, **>50** indicates economic expansion, **<50** otherwise

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Indonesia – Economic Indicators Projection

	2017	2018	2019	2020	2021	2022E
Gross Domestic Product (% YoY)	5.1	5.2	5.0	-2.1	3.7	5.1
GDP per Capita (US$)	3877	3927	4175	3912	4350	4564
Consumer Price Index Inflation (% YoY)	3.6	3.1	2.7	1.7	1.9	6.4
BI 7 day Repo Rate (%)	4.25	6.00	5.00	3.75	3.50	5.5
USD/IDR Exchange Rate (end of year)**	13,433	14,390	13,866	14,050	14,262	15,584
Trade Balance (US$ billion)	11.8	-8.5	-3.2	21.7	35.3	45.5
Current Account Balance (% GDP)	-1.6	-3.0	-2.7	-0.4	0.3	1.4

** Estimation of Rupiah's fundamental exchange rate

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