

Yield curve inversion: One year on (Part II) On inflation: Keeping an eye on possible inflexion?

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Summary

- The decline in short-term inflation expectations following the announcement of the Jun-23 CPI number and the slowing wage growth appears to revive the “Fed pivot” expectation.
- The threat of reflation stemming from a potential increase in energy prices may limit the room for the Fed to address the weakening economic momentum.
- The combined risks of reflation and economic contractions may push FOMC members to seek a compromise between their inflation target and the long-term outlook for interest rates, potentially exposing the global economy to close-to-2% inflation rates and moderately higher interest rates for an extended period.

- Last week, we examined the alleged ‘misfiring’ of the UST yield curve inversion and concluded that while it may have prematurely signalled a recession, the yield curve inversion should be understood in the context of shifting inflation expectations rather than solely indicating an impending economic contraction. The decline in short-term inflation expectation, which results in a deeper UST inversion, may not result in a recession as long as the disinflation process stems from improvement in the supply-side.
- Since we published that report, we have gotten new CPI data from the US, which put the headline inflation in June at 3.0% YoY (vs. 4.0% in May). This proves to be quite a bombshell data release, with core services ex-housing cooling off sharply from 6.1% just three months ago. Since inflation in this category is largely wage-driven, it is also a sign that Fed policy is starting to ‘break’ (or at least ‘bend’) the job market. Despite still-robust services PMI number, demand for labour in the services sector appears to be weakening lately, leading to slowing wage growth.

A case for a pivot...

- This does not mean that recession will happen soon, of course. American customers may continue to benefit from positive real wage growth for some more months, given the stickiness of previous wage hikes. But this may not continue for too long, leading to

a drop in the aggregate demand level that would suppress both inflation and growth expectations (*see Chart 1*).

- This appears to resurrect the “Fed pivot” expectation, as some in the market have started to price in on the scenario that the FOMC members may be able to ease their policy stance as early as Q4 2023. This expectation, of course, is in contrast with conditions faced by other central banks such as the ECB and BoE, which explains the decline in DXY’s value following the Jun-2023 CPI inflation announcement.

...or a case of renewed shocks?

- However, there are several arguments why the Fed cannot relax their policy as yet, as they have to remain vigilant about a potential return of inflation. Of particular concern are the core goods (commodities excluding food and energy) component, which contributed 1.51% to the headline CPI number at its peak in Jun-2022 before declining to a low of 0.29% in Jun-2023. Aside from USD depreciation, the risk of reflation here could also be exacerbated by the geopolitical contest between China and the US. A ‘divorce’ in supply chains between China and the US is liable to increase costs, as production has to be outsourced to less-efficient (but more US-friendly) countries, or back to the US home base with its much higher cost structures.
- Of bigger concern, however, is the historical pattern between the USD’s value and

- In a way, this sounds like a ‘win-win’ for the US and the rest of the world. As long as the recession is not too severe, lower interest rates are always welcome, while weakening USD improves liquidity conditions outside of the US. Weakening USD is of course inflationary for the US as it increases the price of imported goods, but this would likely be a minor shock relative to what had transpired in the past two years. A weak USD also helps make US-made goods more competitive, in line with the Biden administration’s broad goals to re-industrialize America.

commodity prices (*see Chart 2*). Given the long-term inverse relationship between the

“Disinflation in the wage-driven core services signals that US consumers may not benefit from positive real wage growth for too long”

USD and commodity prices and the USD’s role as the pricing currency in the global commodity market, the downward trend in commodity prices may be halted should the USD continue to weaken,

possibly throwing the Fed to a rematch against commodity inflation.

- The threat of reflation, especially for oil prices, seems to be forgotten at the moment. Slowing economic activities in China and globally have led to underwhelming demand, leaving oil producers to grapple with an oversupply problem even after many production cuts in 2023. However, as we noted in an earlier report on OPEC production cuts, the risk of spiking energy prices has not completely disappeared.

- For one, the oversupply that characterises the global oil market for much of 2023 may soon come to pass. OPEC+ members look set to cut the production quota to 40.463 Mn bl/d in 2024 (41.866 Mn bl/d in 2023), further cutting supply at the moment when the Strategic Petroleum Reserves (SPR) refill may drive up demand (the US government have announced the plan to refill the depleted SPR by a maximum of 12 Mn bbl in Q4-23). We also cannot discount the possibility that leaders like MBS and Putin would try to push oil prices higher in order to unseat Biden, as the countdown to 2024 Elections approaches.
- We should also remember that commodity prices (and energy in particular) often pre-cedes the actual business cycle. Indeed, this is evident in 2022-23, when energy prices fell sharply despite the still-expanding US (and global) economy. Driven by expectations of an impending recession, the number of short positions in the oil market in H1-23 exceeded the levels observed during the previous recession (*see Chart 3*), indicating a heightened pessimism and bearish sentiment among oil traders despite the still-robust macroeconomic data. Although short sellers are still present in the global oil market, the amount of long contracts relative to short contracts appears to be increasing in recent weeks, signalling the return of bullish sentiment among oil

"The growing optimism in the oil market suggests that prices may have bottomed in 2023"

traders. While an increase in net long position does not guarantee an immediate spike in oil prices, the growing optimism in the oil market suggests that prices may have bottomed in 2023.

- As mentioned earlier in the first part of this report (*"On recession: False alarm or Cassandra Warning?"*), the return of inflationary pressures would be the worst-case scenario for the Fed. In the event of potential reflation, the now-slowing wage growth would further diminish US consumers' purchasing power, this time without the cushion of excess savings from the pandemic period. The threat of reflation would trap the Fed in a "hawkish" limbo, unable to lower interest rates to address the threat of US economic slowdown while also facing difficulties in curbing inflation without further harming consumers.

- It is in this scenario where we have to question the Fed's long-term commitment to a 2% inflation target. The more realistic way for the Fed to escape such limbo would probably involve a more flexible inflation target, for instance aiming for average inflation of 2-3% instead of a strict 2% target, while also exposing consumers to a world with higher average interest rates of 4-5% which is quite typical for the US economy during the pre-GFC era.

Finally, the impact on Indonesia and some notes on the new DHE regulation

- At present, FOMC members remain keen on their ideal scenario where the economy slows into a ‘soft landing’ and they have clear opportunities to pivot. This leads them, in the short-term, to double down on their hawkish signals before turning slightly dovish as more signs of slowing activities emerge in 2024.
- The Fed’s posturing seems to have mixed impact on Indonesia. While weakening USD is a plus, the still-hawkish signals, coupled with the more rapid disinflation in 2023, have narrowed the real interest rate spread between Indonesia and the US to a mere 15 bps in Jul-2023 compared to 254 bps in Jan-2023. The narrowing real interest rate spread may have a detrimental impact on foreign capital inflows into the Indonesian bond market, as indicated by sell-offs by foreign investors in the last couple of weeks (*see Chart 4*).
- Foreign investors’ weakening interest in Indonesian bonds may not necessarily lead to an increase in Indonesian government bond yields thanks to still-robust demand from domestic non-banks. Still, the declining foreign inflows may negatively impact the domestic economy, especially the domestic FX liquidity. It is not surprising, then, that the government has taken measures to encourage exporters to keep their revenue within the domestic banking system. We further elaborate on our support for the government’s strengthened export receipts (DHE – devisa hasil ekspor) regulation in our flagship report on the Jun-23 trade number.
- While the strengthened DHE regulation would be productive to improve the domestic FX liquidity condition and hence stabilise the IDR’s value, it may be worthwhile to note that the new DHE rule comes with costs, especially for those in the private sector. The requirement to hold 25% of export revenue for 3 months may make it more difficult for exporters, especially small-scale exporters, to manage their cash flows. These exporters, of course, could rely on bridging loans from banks to address the cash flow gap.
- In theory, locking more DHE at home would improve FX liquidity, but things may not work out as straightforwardly. Exporters face the option of depositing their FX into domestic banks, or into FX instruments provided by the public export-import financing corporation (LPEI) and by BI. The latter includes the TD-DHE, which is currently offered at 5.24-5.64%, and to compete with this, banks would have to raise their offered yields. All in all, this would mean more stable Rupiah and ample FX liquidity at home, but at the probable cost of increasing rate in the domestic Eurodollar market.

“The strengthened DHE rule would help to stabilise the Rupiah at the probable cost of higher rate in the domestic Eurodollar market”

Chart 1

An uneven drop

Short-term inflation expectations points lower following the Jun-23 CPI inflation data, while long-term inflation expectation remains stable

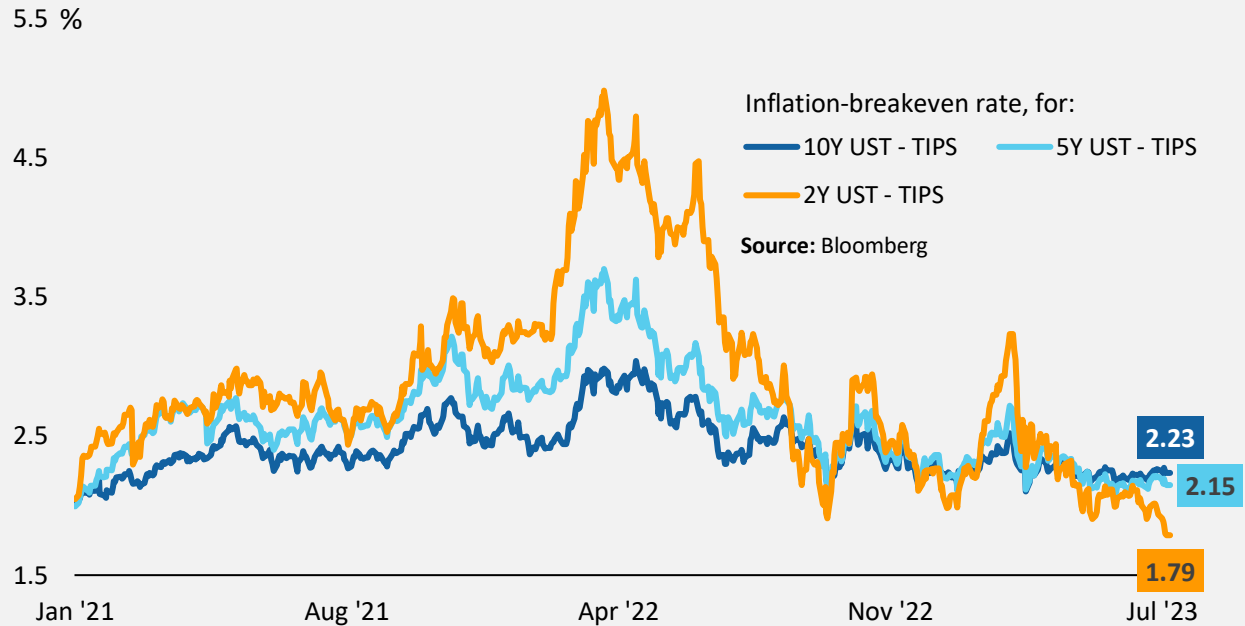


Chart 2

A game of seesaw

A weakening USD often translates to a spike in commodity prices. High commodity prices forced the Fed to abandon their “transitory inflation” outlook in early 2022

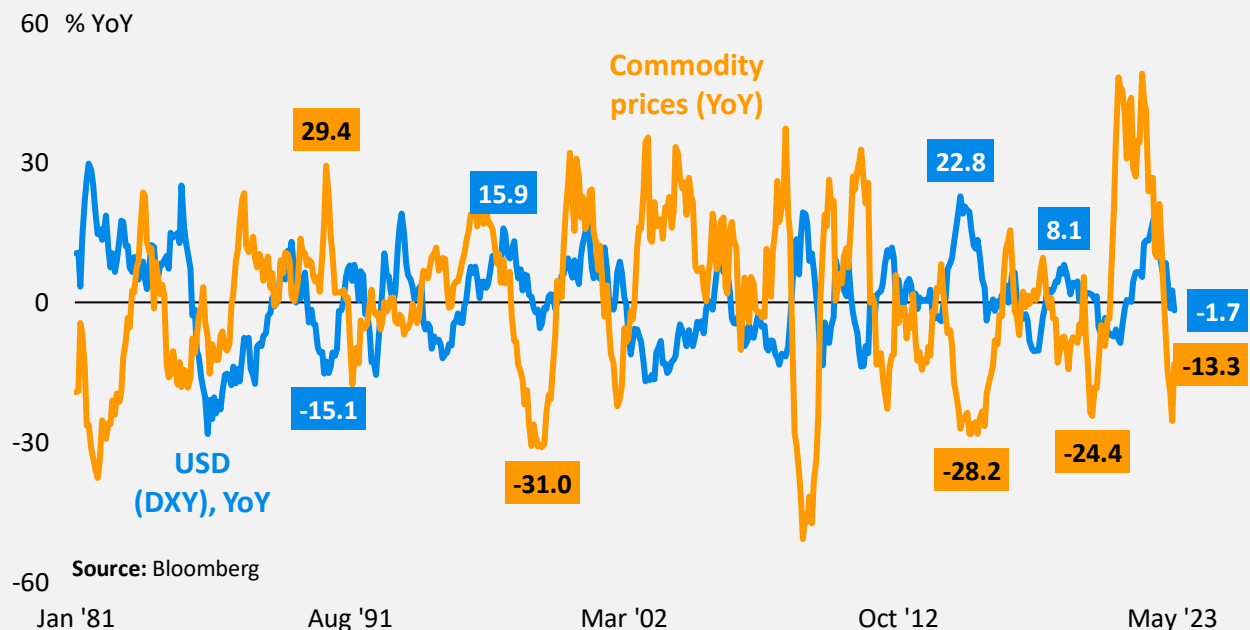


Chart 3

Repositioning manoeuvre

Oil traders had positioned themselves for a recession scenario but have assume more long-position ever since, signaling growing expectations for an increase in oil prices

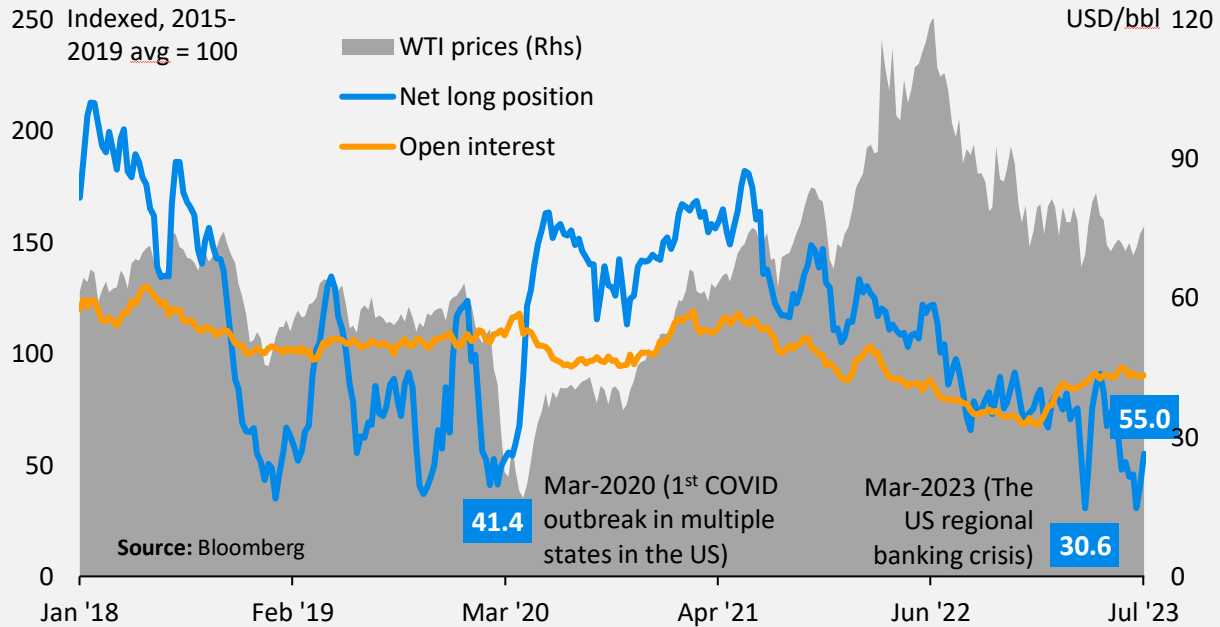
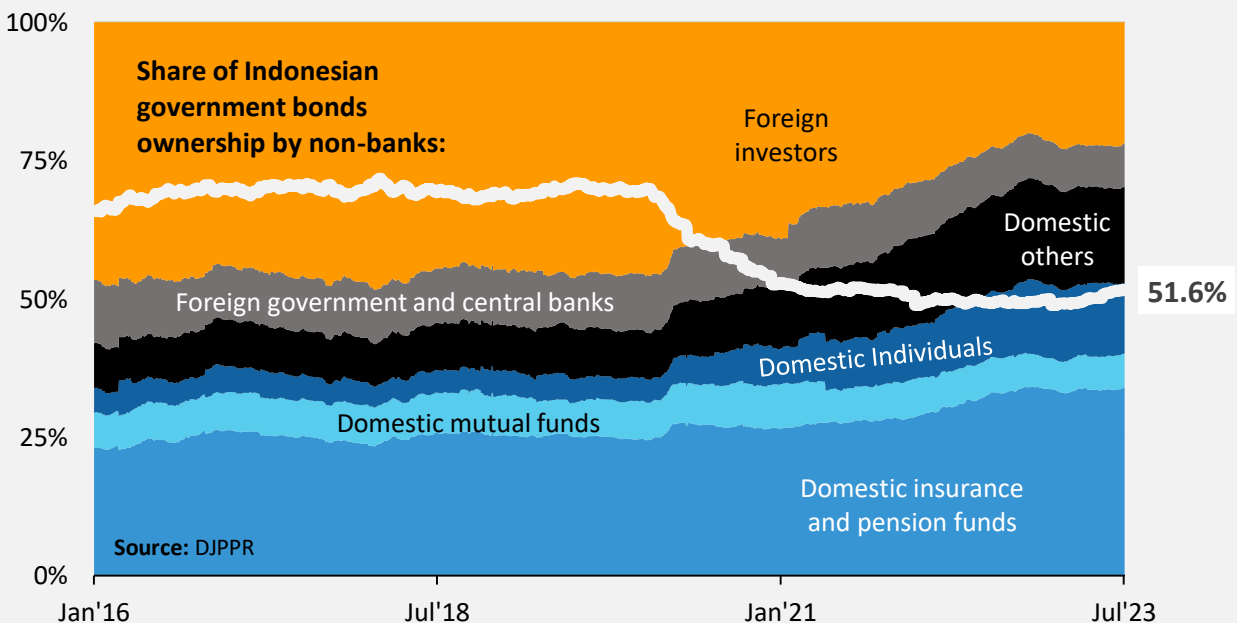


Chart 4

Saved by non-banks

The decline in real yield spread between ID-US bonds may hinder foreign capital inflow but still-strong demand from domestic non-banks should help stabilise Indonesian bonds



Economic Calendar				
		Actual	Previous	Forecast*
3 July 2023				
ID	S&P Global Manufacturing PMI	52.5	50.3	50.6
ID	Inflation Rate YoY	3.52%	4.0%	3.6%
US	ISM Manufacturing PMI	46	46.9	46.3
6 July 2023				
US	Balance of Trade (USD Bn)	-69.0	-74.6	-68.7
7 July 2023				
ID	Foreign Exchange Reserves (USD Bn)	137.5	139.3	139.0
CN	Foreign Exchange Reserves (USD Tn)	3.19	3.18	3.1
10 July 2023				
CN	Inflation rate YoY	0%	0.2%	0.1%
ID	Consumer Confidence	127.1	128.3	128
ID	Motorbike Sales YoY	66.6%	113.4%	-
12 July 2023				
US	Inflation rate YoY	3.0%	4.0%	3.6%
13 July 2023				
CN	Balance of Trade (USD Bn)	70.6	65.8	68.0
ID	Car Sales YoY	4.6%	65.2%	-
14 July 2023				
EA	Balance of Trade (USD Eur)	-0.3	-11.7	-16.4
ID	Retail Sales YoY	-4.5%	1.5%	-
17 July 2023				
CN	GDP Growth Rate YoY	6.3%	4.5%	5.8%
ID	Balance of Trade (USD Bn)	3.46	0.44	1.2
20 July 2023				
ID	Foreign Direct Investment YoY	-	20.2%	-
25 July 2023				
ID	Loan Growth YoY	-	9.39%	-
ID	Bank Indonesia policy announcement	-	5.75%	5.75%
27 July 2023				
US	Fed Interest Rate Decision	-	5.25%	5.5%
ID	M2 Money Supply YoY	-	6.1%	-
EA	Deposit Facility Rate	-	3.5%	3.75%
31 July 2023				
EA	Inflation Rate YoY Flash	-	-	-

*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 (%)	Trade & Commodities	14-Jul	-1 mth	Chg (%)
US	5.25	Jul-23	2.25	Baltic Dry Index	1,090.0	1,074.0	1.5
UK	5.00	Jul-23	-3.70	S&P GSCI Index	562.5	536.6	4.8
EU	4.00	Jul-23	-1.50	Oil (Brent, \$/bbl)	79.9	74.3	7.5
Japan	-0.10	Jan-16	-3.30	Coal (\$/MT)	133.7	142.5	-6.2
China (lending)	4.35	Jul-23	4.35	Gas (\$/MMBtu)	2.50	2.00	25.0
Korea	3.50	Jul-23	0.80	Gold (\$/oz.)	1,955.2	1,943.7	0.6
India	6.50	Jun-23	1.69	Copper (\$/MT)	8,661.8	8,450.0	2.5
Indonesia	5.75	Jun-23	2.23	Nickel (\$/MT)	21,400.5	21,880.0	-2.2
Money Mkt Rates	14-Jul	-1 mth	Chg (bps)	CPO (\$/MT)	828.6	739.1	12.1
SPN (1M)	4.72	4.03	68.8	Rubber (\$/kg)	1.32	1.31	0.8
SUN (10Y)	6.16	6.26	-10.3	External Sector	Jun	May	Chg (%)
INDONIA (O/N, Rp)	5.63	5.58	5.3	Export (\$ bn)	20.61	21.72	-5.12
JIBOR 1M (Rp)	6.40	6.39	0.2	Import (\$ bn)	17.15	21.28	-19.40
Bank Rates (Rp)	Apr	Mar	Chg (bps)	Trade bal. (\$ bn)	3.45	0.44	691.43
Lending (WC)	8.92	8.95	-2.71	Central bank reserves (\$ bn)*	137.5	139.3	-1.28
Deposit 1M	4.18	4.20	-2.70	Prompt Indicators	Jun	May	Apr
Savings	0.67	0.69	-1.70	Consumer confidence index (CCI)	127.1	128.3	126.1
Currency/USD	14-Jul	-1 mth	Chg (%)	Car sales (%YoY)	4.7	65.2	-28.8
UK Pound	0.764	0.793	3.81	Motorcycle sales (%YoY)	66.6	113.4	-19.4
Euro	0.891	0.927	4.03	Manufacturing PMI	Jun	May	Chg (bps)
Japanese Yen	138.8	140.2	1.02	USA	46.0	46.9	-90
Chinese RMB	7.142	7.166	0.34	Eurozone	43.4	44.8	-140
Indonesia Rupiah	14,958	14,860	-0.66	Japan	49.8	50.6	-80
Capital Mkt	14-Jul	-1 mth	Chg (%)	China	50.5	50.9	-40
JCI	6,869.6	6,719.0	2.24	Korea	47.8	48.4	-60
DJIA	34,509.0	34,212.1	0.87	Indonesia	52.5	50.3	220
FTSE	7,434.6	7,594.8	-2.11				
Nikkei 225	32,391.3	33,018.7	-1.90				
Hang Seng	19,413.8	19,521.4	-0.55				
Foreign portfolio ownership (Rp Tn)	Jun	May	Chg (Rp Tn)				
Stock	2,755.0	2,738.1	16.95				
Govt. Bond	846.9	829.4	17.53				
Corp. Bond	11.3	11.8	-0.47				

Source: Bloomberg, BI, BPS

Notes:

Car and motorcycle sales data to be released on the third week of January 2022

^Data for January 2022

*Data from an 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

	2018	2019	2020	2021	2022	2023E
Gross Domestic Product (% YoY)	5.2	5.0	-2.1	3.7	5.3	5.0
GDP per Capita (US\$)	3927	4175	3912	4350	4784	5285
Consumer Price Index Inflation (% YoY)	3.1	2.7	1.7	1.9	5.5	2.3
BI 7-day Repo Rate (%)	6.00	5.00	3.75	3.50	5.50	5.75
USD/IDR Exchange Rate (end of the year)**	14,390	13,866	14,050	14,262	15,568	15,173
Trade Balance (US\$ billion)	-8.5	-3.2	21.7	35.3	54.5	35.3
Current Account Balance (% GDP)	-3.0	-2.7	-0.4	0.3	1.0	-0.7

*Estimated number

** Estimation of the Rupiah's fundamental exchange rate

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