# UST downgrade and the scent of structural bond re-pricing

7 August 2023

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**Summary**

- The surge in UST yields over the past week seems to be concentrated on longer-term bonds, suggesting the expectation of an extended period of elevated interest rates rather than just reacting to the credit downgrade.
- Lingering inflation risks has led central banks to move away from unconventional policies in 2023, eliminating the premium that had previously suppressed bond yields during the QE era.
- The prospect of a global bond repricing could potentially impact the Indonesian bond market. Nevertheless, sound fiscal management and continued strong demand from domestic investors should contribute in stabilising the domestic bond market.

- Policy rate decisions announced last week strengthen the expectation that the post-pandemic hiking cycle is nearing its end. For instance, the Bank of England raised its bank rate by another 25 bps to 5.25% last week, declaring that inflationary pressures in the economy are easing and the current policy posture is substantially restrictive. The same tune was sung by the Fed and the ECB, as both central banks signalled the end of the post-pandemic hiking cycle while still raising policy rates by 25bps during their last meetings.
- Unfortunately, the easing hawkish signal in the past two weeks does not translate to stability in the UST market. The catalyst behind the recent surge in UST yields is quite evident: the ongoing and pronounced increase in the cost of financing US government debt. The federal interest payment bill is on track to exceed the US defence budget, which stood at USD 1.01 Tn, as soon as 2025.
- In various cases, mounting debt burden frequently ushers the regime of fiscal dominance, wherein monetary policy becomes constrained by the pressing obligation of the government to service its debt. Against this possibility, however, the Fed's still-going crusade against inflation reveals that the central bank is likely to assert its independence. The Fed's higher-for-longer outlook, especially against the backdrop of weakening public revenue amidst the anticipated economic tumult, underlines the concern about deteriorating fiscal conditions in the US, which in turn

prompted a credit rating agency to knock the UST from the AAA universe to AA+.

- Expectations of deteriorating fiscal conditions in the US are also shaped by factors that go beyond the gloomy economic outlook. Notably, the intensifying partisanship in US politics has elevated the highly uncertain debt ceiling negotiations into a notable feature, rather than a bug, in the US budgetary system. Another source of concern stems from the current administration's flagship policies, including the Inflation Reduction Act (IRA). Despite its positive effects on investment and job creation, expansive initiatives such as the IRA would necessitate continued investments and subsidies by the government, contributing to fiscal deficits irrespective of the domestic economic environment in the US.

- It is important to note that the recent surge in UST yields is more pronounced in longer-tailed securities ***(see Chart 1)***. This bear-steepening phenomenon appears to be a consequence of the recent issuance of T-notes and T-bonds by the US Treasury Department, which would distribute the burden associated with the TGA refill operation across sources of liquidity beyond the RRP.

- Alas, the rise in long-term UST yields relative to T-bills also points towards a more ominous trend. The bear-steepening dynamic also indicates the market's expectation of an extended period of elevated interest rates ***(see Chart 2),*** highlighting the looming threat of structurally higher inflation – a topic we have discussed in earlier reports. Therefore, **rather than being solely prompted by short-term pressures arising from the credit rating downgrade, the ongoing surge in UST yields might mirror a broader structural trend.**

***"The shift towards more conventional monetary policy would allow bond prices to move closer to optimum, market-driven equilibrium"***

- Rather than laying out an argument for another "new normal" scenario, the argument for a structurally-high UST yield may evoke memories of earlier times ***(see Chart 3)*****.** The evolving global policy stance towards ultra-easy monetary policy over the last couple of decades has resulted in the detachment of the arbitrage relationship between stocks and bonds in favour of bonds. Ultra-easy monetary policy, which was arguably pioneered by the Bank of Japan (at least in the post-Bretton Woods time) as early as 2001 but has since then been adopted by the Fed and the ECB, has allowed the bond market to trade under a QE premium, suppressing its yield relative to stocks.

- At present, however, global monetary policies appear to have reverted to a more conventional stance. The post-pandemic inflationary pressures have prompted central banks such as the Fed and the ECB to halt their bond-buying programmes. The BoJ also seems to be moving towards policy normalisation in recent months, as evidenced by the central bank's surprising decision to increase the flexibility of its yield curve control (YCC) programme during the Jul-23 meeting. This policy "devolution" shift removes artificial demand from central banks in the bond market, resulting in a structural repricing event that now allows USTs (and other sovereign bonds) to move closer to an optimal, market-driven price equilibrium.

- Moving to the Indonesian context, the recent surge in UST yields resulting from the recent downgrade in UST creditworthiness has not significantly impacted the stability that hitherto characterised the Indonesian bond market. However, beneath this relative equanimity, a potential risk becomes increasingly apparent. The domestic bond market may still recorded positive net inflows in the last week, but these inflows are largely attributed to foreign central banks or governments, while the demand from more-private foreign investors appears to weaken ***(see Chart 4).***
- The currently stable condition of the Indonesian bond market, then, is primarily attributed to the robust demand from domestic investors. Indeed, SBN ownership by domestic investors, especially non-bank investors, has exhibited an upward trend in recent periods. Additionally, the Indonesian government's outsized revenue in 2023 has engendered an anticipation of bond issuance below the targeted level, while the tightening control over capital mobility (through the DHE policy for example) may increase the incentives to invest in the domestic bond market. Hence, we anticipate that the yield on Indonesian bonds will remain steady in the foreseeable future. However, it is worth acknowledging that the possibility of structural repricing in the global bond market may eventually pose a risk for the domestic bond market.

***"Sound fiscal outlook and robust demand from domestic investors would shield the domestic bond market from the risk of global bond repricing"***

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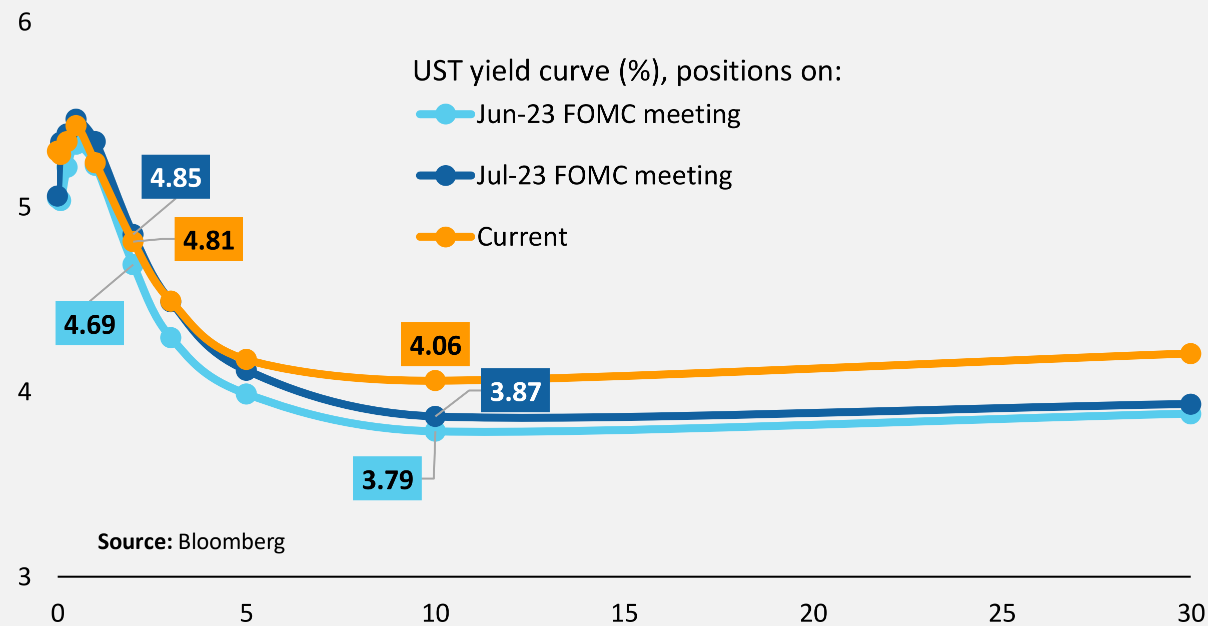
**Chart 1**

**Another bear spotted**

T-notes and T-bonds issuance and the anticipation of a prolonged high-rate environment explain the bear-steepening event following the downgrade in UST credit rating

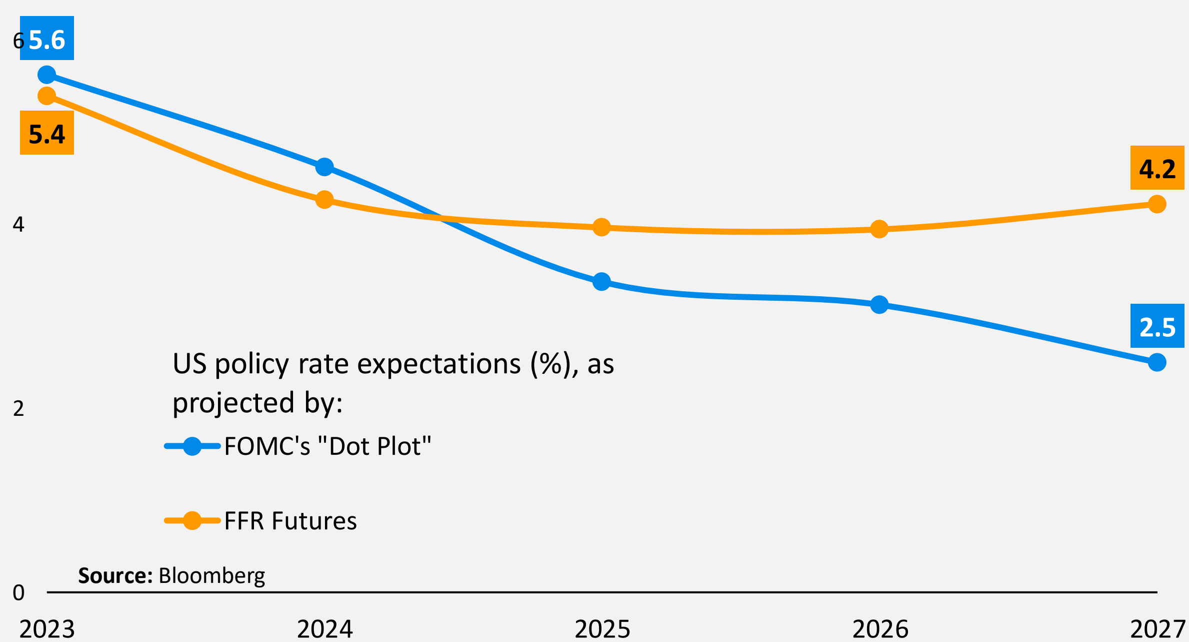



**Source:** Bloomberg

**Chart 2**

**Lofty expectations**

Despite the Fed's rather dovish long-term guidance, market participants expect a prolonged high-interest rate environment as concern over supply shocks remain

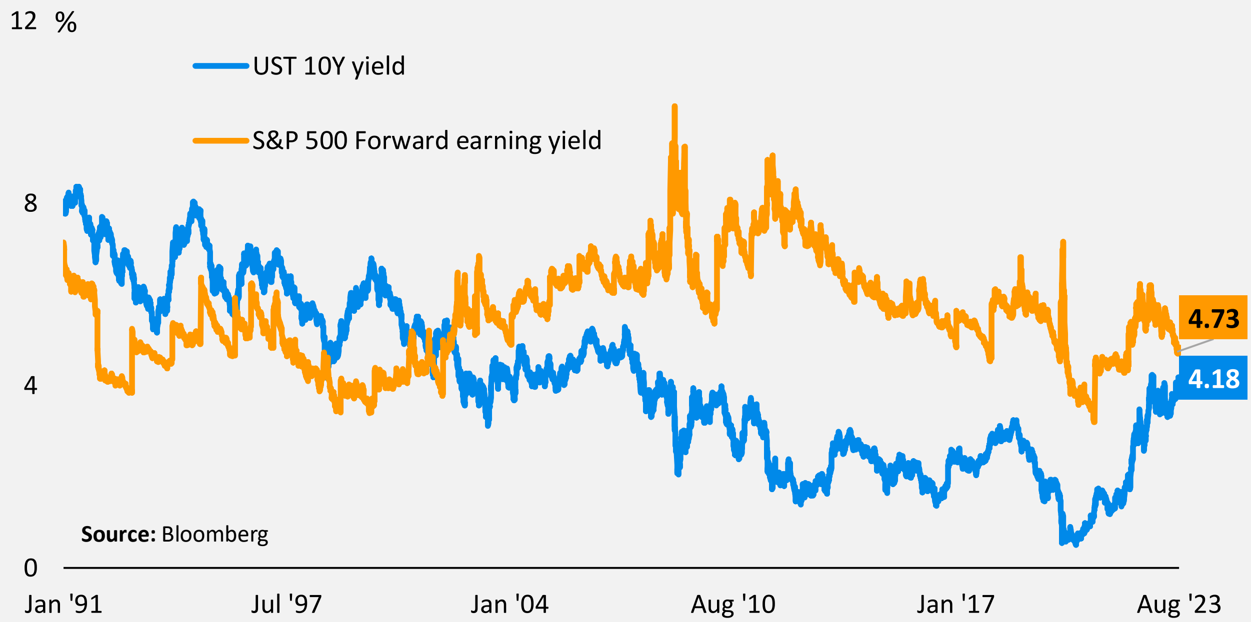



**Source:** Bloomberg

Chart 3

**A blast from the past**

The shift towards a more conventional monetary policy stance has led to a decline in bond values, which have traded on a premium relative to stock prices over the past two decades

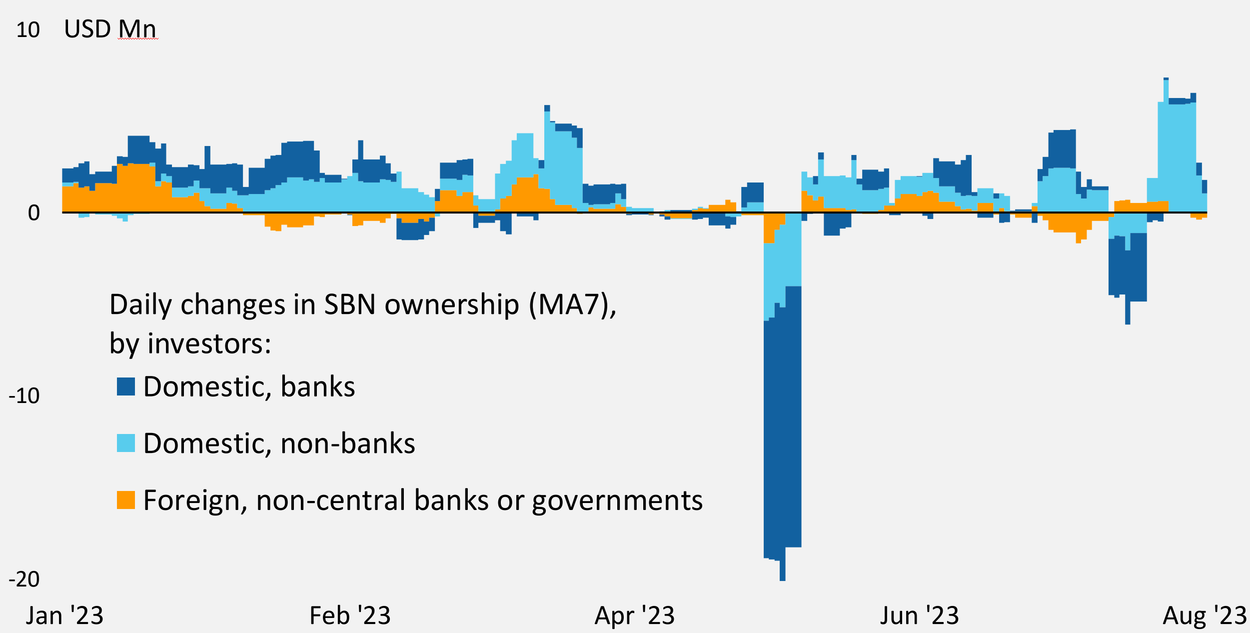



**Source:** Bloomberg

Chart 4

**Standing at its own feet**

Foreign investors' interest in Indonesian bonds appears to be weakening, although demand from domestic investors keeps the yield steady




**Source:** DJPPR

## Economic Calendar

| | | Actual | Previous | Forecast* |
|---|---|---|---|---|
| 1 August 2023 | | | | |
| ID | S&P Manufacturing PMI | 53.3 | 52.5 | 52 |
| **ID** | **Inflation Rate YoY** | **3.08%** | **3.52%** | **3.2%** |
| CN | Caixin Manufacturing PMI | 49.2 | 50.5 | 50.3 |
| US | S&P Manufacturing PMI | 49 | 46.3 | 49 |
| US | JOLTs Job Opening | 9.582 | 9.616 | 9.6 |
| 3 August 2023 | | | | |
| UK | BoE Bank Rate Decision | 5.25% | 5.00% | 5.00% |
| 4 August 2023 | | | | |
| US | Unemployment Rate | 3.5% | 3.6% | 3.6% |
| US | Non-Farm Payroll ('000) | 187 | 185 | 200 |
| 7 August 2023 | | | | |
| **ID** | **Foreign Exchange Reserves (USD (Bn)** | **137.7** | **137.5** | **140.0** |
| **ID** | **GDP Growth Rate YoY** | **5.17%** | **5.03%** | **5.1%** |
| CN | Foreign Exchange Reserves (USD Tn) | 3.20 | 3.19 | 3.19 |
| 8 August 2023 | | | | |
| ID | Consumer Confidence | - | 127.1 | 127.5 |
| CN | Balance of Trade (USD Bn) | - | 70.6 | 69 |
| US | Balance of Trade (USD Bn) | - | -69 | -65.1 |
| 9 August 2023 | | | | |
| CN | Inflation rate YoY | - | 0% | -0.3% |
| 10 August 2023 | | | | |
| US | Inflation rate YoY | - | 3% | 3.1% |
| 11 August 2023 | | | | |
| ID | Motorbike Sales YoY | - | 66.6% | - |
| ID | Car Sales YoY | - | 4.6% | - |
| 15 August 2023 | | | | |
| **ID** | **Balance of Trade (USD Bn)** | **-** | **3.46** | **-** |
| CN | Retail Sales YoY | - | 3.1% | - |
| US | Retail Sales YoY | - | 1.5 | - |
| 16 August 2023 | | | | |
| ID | Retail Sales YoY | - | -4.5% | - |
| 18 August 2023 | | | | |
| ID | Current Account (USD Bn) | - | 3.0 | 1.5 |
| 24 August 2023 | | | | |
| **ID** | **Interest Rate Decision** | **-** | **5.75%** | **5.75%** |

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

## Selected Macroeconomic Indicator

| Key Policy Rates | Rate (%) | Last Change | Real Rate (%) |
|---|---|---|---|
| US | 5.50 | Aug-23 | 2.50 |
| UK | 5.25 | Aug-23 | -2.65 |
| EU | 4.25 | Aug-23 | -1.05 |
| Japan | -0.10 | Jan-16 | -3.40 |
| China (lending) | 4.35 | Aug-23 | 4.35 |
| Korea | 3.50 | Jul-23 | 1.20 |
| India | 6.50 | Jun-23 | 1.69 |
| Indonesia | 5.75 | Jul-23 | 2.67 |

| Money Mkt Rates | 4-Aug | -1 mth | Chg (bps) |
|---|---|---|---|
| SPN (1M) | 4.90 | 4.46 | 44.5 |
| SUN (10Y) | 6.33 | 6.19 | 14.1 |
| INDONIA (O/N, Rp) | 5.59 | 5.62 | -3.4 |
| JIBOR 1M (Rp) | 6.40 | 6.40 | 0.5 |

| Bank Rates (Rp) | May | Apr | Chg (bps) |
|---|---|---|---|
| Lending (WC) | 8.93 | 8.92 | 0.35 |
| Deposit 1M | 4.19 | 4.18 | 1.37 |
| Savings | 0.67 | 0.67 | 0.00 |

| Currency/USD | 4-Aug | -1 mth | Chg (%) |
|---|---|---|---|
| UK Pound | 0.784 | 0.787 | 0.28 |
| Euro | 0.909 | 0.919 | 1.17 |
| Japanese Yen | 141.8 | 144.5 | 1.91 |
| Chinese RMB | 7.173 | 7.216 | 0.60 |
| Indonesia Rupiah | 15,170 | 14,993 | -1.17 |

| Capital Mkt | 4-Aug | -1 mth | Chg (%) |
|---|---|---|---|
| JCI | 6,852.8 | 6,681.8 | 2.56 |
| DJIA | 35,065.6 | 34,418.5 | 1.88 |
| FTSE | 7,564.4 | 7,519.7 | 0.59 |
| Nikkei 225 | 32,192.8 | 33,422.5 | -3.68 |
| Hang Seng | 19,539.5 | 19,415.7 | 0.64 |

| Foreign portfolio ownership (Rp Tn) | Jul | Jun | Chg (Rp Tn) |
|---|---|---|---|
| Stock | 2,892.9 | 2,755.0 | 137.88 |
| Govt. Bond | 846.9 | 846.9 | 0.00 |
| Corp. Bond | 11.3 | 11.3 | -0.03 |

| Trade & Commodities | 4-Aug | -1 mth | Chg (%) |
|---|---|---|---|
| Baltic Dry Index | 1,136.0 | 1,044.0 | 8.8 |
| S&P GSCI Index | 591.7 | 536.7 | 10.3 |
| Oil (Brent, $/brl) | 86.2 | 76.3 | 13.1 |
| Coal ($/MT) | 140.5 | 155.1 | -9.4 |
| Gas ($/MMBtu) | 2.53 | 2.48 | 2.0 |
| Gold ($/oz.) | 1,942.9 | 1,925.5 | 0.9 |
| Copper ($/MT) | 8,523.3 | 8,346.0 | 2.1 |
| Nickel ($/MT) | 21,082.0 | 20,334.0 | 3.7 |
| CPO ($/MT) | 833.6 | 835.3 | -0.2 |
| Rubber ($/kg) | 1.27 | 1.30 | -2.3 |

| External Sector | Jun | May | Chg (%) |
|---|---|---|---|
| Export ($ bn) | 20.61 | 21.71 | -5.08 |
| Import ($ bn) | 17.15 | 21.28 | -19.40 |
| Trade bal. ($ bn) | 3.45 | 0.43 | 708.66 |
| Central bank reserves ($ bn)* | 137.5 | 139.3 | -1.28 |

| Prompt Indicators | Jun | May | Apr |
|---|---|---|---|
| Consumer confidence index (CCI) | 127.1 | 128.3 | 126.1 |
| Car sales (%YoY) | 4.7 | 65.2 | -28.8 |
| Motorcycle sales (%YoY) | 66.6 | 113.4 | -19.4 |

| Manufacturing PMI | Jul | Jun | Chg (bps) |
|---|---|---|---|
| USA | N/A | 46.0 | 40 |
| Eurozone | 42.7 | 43.4 | -70 |
| Japan | 49.6 | 49.8 | -20 |
| China | 49.2 | 50.5 | -130 |
| Korea | 49.4 | 47.8 | 160 |
| Indonesia | 53.3 | 52.5 | 80 |

Source: Bloomberg, BI, BPS
Notes:
^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

## Indonesia – Economic Indicators Projection

| | 2018 | 2019 | 2020 | 2021 | 2022 | 2023E |
|---|---|---|---|---|---|---|
| Gross Domestic Product (% YoY) | 5.2 | 5.0 | -2.1 | 3.7 | 5.3 | 5.2 |
| 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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