Summertime is over for the bond market but calm weather remains

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Summary

- The ongoing increase in the yield on Indonesian government bonds seems to be more influenced by external factors, such as the rising yield on UST securities, rather than reflecting a deterioration in Indonesia's fundamentals.
- Despite the record-low bond yields in Q2-2023, the government's strong fiscal position, driven by better-than-expected revenue, has allowed it to limit bond issuance and rely on the SAL balance.
- The use of the SAL balance in 2023 aligns with the government's goal of reducing interest payments. The depleted SAL balance may expose the government to higher interest payments in the future given the risk of supply shocks that may put an additional burden on the government's budget.

- Several significant events coloured the global economy in the week leading to the next FOMC meeting. Among the most important ones is the release of Aug-23 US CPI data, which saw the headline inflation number jump to 3.7% YoY from 3.2% YoY in Jul-23. Looking past the headline figure, however, the disinflation story continues to grip the market. The FFR futures show that market participants are now growing sceptical that the Fed would need to increase the policy rate by another 25bps, marking an end to the post-pandemic hiking cycle.
- What behind this expectation is the continued decline in the core CPI number (4.3% YoY in Aug-2023, 4.7% YoY in Jul-2023), although the heating PPI number leads some economists to expect that the Fed still has room to go in its fights against inflation.
- Another important events are policy decisions by two major central banks. First, the PBoC reduced its RRR[1] by 25 bps, another piecemeal intervention aimed at boosting liquidity within the Chinese economy. Another one is the ECB's decision to increase its policy rates by another 25bps, lifting the rate on the main refinancing operation to its record-high of 4.50%. Such a policy decision, however, has done little to halt the upward trend in the USD's (DXY) value, signifying the gap in growth expectations between the US economy and other major economies.
- The gap in growth expectations between the US and other global economic powerhouses

[1] Reserve Requirement Ratio

lends credibility to the Fed's "higher-for-longer" signal, which contrasts with the ECB's signals as concerns about over-tightening begin to emerge in Europe. As we discussed in a previous report, the current condition is particularly troubling for Asian markets (including Indonesia – ***see Chart 1***), which are currently facing the risk of a (structural) slowdown in the growth prospect of the Chinese economy.

- Indeed, what happened in the past two weeks is one that investors in Indonesia would rather forget. Foreign ownerships of Rupiah assets have dwindled by USD 672.6 Mn so far in Sep-23, as foreign investors sold USD 223.1 Mn worth of Indonesian stocks. The domestic sovereign bond market also recorded USD 449.5 Mn in net sell-offs in the past two weeks, pushing the yield on 10Y government bonds to just shy of 6.7% for the first time since Q1-2023**.** The summertime of steady foreign capital inflows and record-low yields, then, might have been over for the Indonesian bond market.

"The ongoing upward trend in yields on Indonesian sovereign bonds should not raise too many alarms as the risk premium on Indonesian bonds remain stable."

- However, the ongoing upward trend in yields on Indonesian sovereign bonds should not raise too many alarms. Despite the increasing bond yields, the spread between Indonesian government bonds and US Treasury securities appears to be somewhat stable ***(see Chart 2)***, indicating that the higher yield on the Indonesian government's IOUs is mostly driven by investors' demand for more equitable compensation from the Indonesian bond market vis-à-vis the UST market. The hitherto stable CDS on Indonesian government bonds supports this thesis, as the Indonesian government continue to maintain a stable fiscal outlook amidst the risk of deteriorating fiscal conditions in major economies such as the US and EU.

- With that being said, the now-higher SBN yield presents a lost opportunity for the Indonesian government. Despite some uptick in SBN issuances in May and July 2023, government bond issuance in 2023 appears to have peaked in Jan-2023, during which yield on 10Y SBN averaged 6.76% (compared to 6.31% in May-Jul 2023).

- We should note, however, that there are sound economic reasons behind the government's decision to hold back on issuing bonds when the yield was still low. For instance, higher-than-expected tax and non-tax revenues lead to a substantial build-up of liquidity in the public sector, allowing the government to fund its programmes without relying too much on outside coffers. The lower-than-expected budget deficit in the past two years further highlights the potential of liquidity hitherto trapped in the government's SAL[2] balance, allowing the government to significantly reduce bond issuance despite then-lower interest costs.

[2] *Saldo anggaran lebih* (En: Excess budget balance)

- The decision to limit the supply of SBN in the market also reflects the government's other objectives; addressing the mounting interest payments ***(see Chart 3)***. While Indonesia's interest bills are still at a manageable level, the upward trend in interest payments may increase the budget's sensitivity to the ebb and flow in the global financial market, which may prove to be increasingly volatile in the coming periods. Fortunately, the now-low foreign ownership of Indonesian bonds may help shield the domestic bond market from global volatility. The low foreign ownership would also mean that much of the government's interest payments would be owed to less nimble domestic investors, who are more likely to reinvest their funds in the domestic bond market due to their limited options.

"The now-low foreign ownership of Indonesian bonds may help shield the domestic bond market from global volatility"

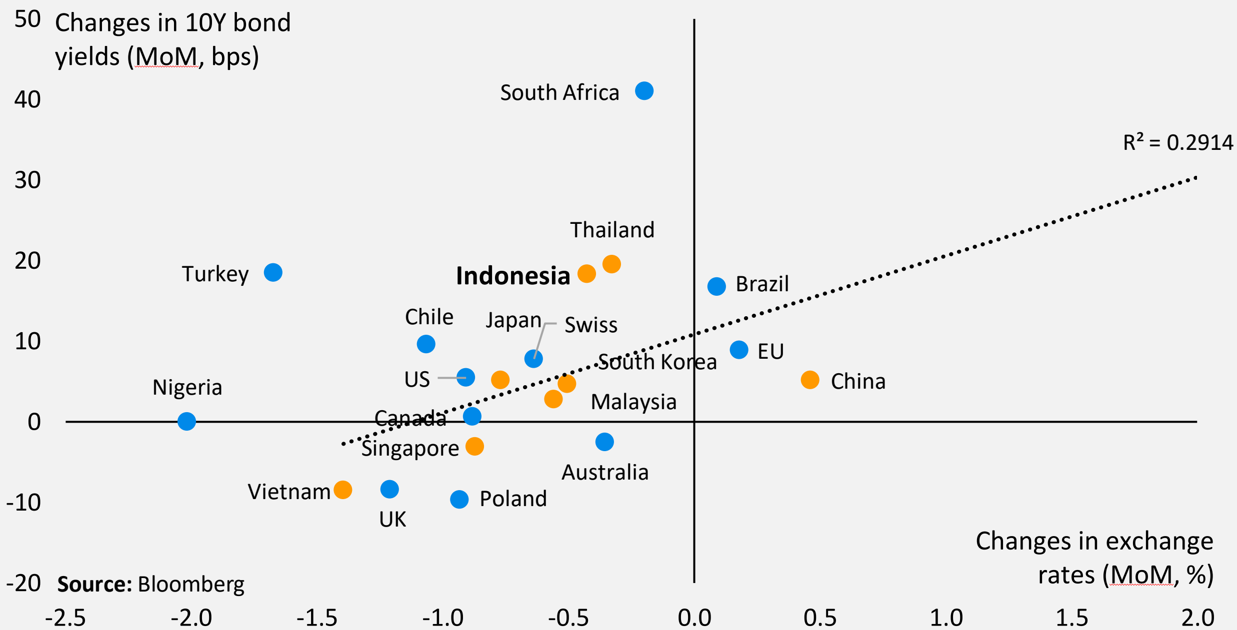
- Keeping a tight lid on the supply of SBN would also help to keep the yield on the Indonesian government bonds stable, which could be crucial given the projected 59.48% YoY increase in debt financing in the 2024 state budget. Alas, the aforementioned opportunity to issue bonds at a record-low yield of 6.1-6.3% could be hard to come by in the subsequent periods. Notwithstanding the China impact on Indonesia and Asian markets, foreign investors may continue to bargain for higher yields from the global bond market – assuming the continued rise in the yield of UST securities. The seemingly limited interest from domestic banks to increase their SBN holdings may not offer much help in halting the upward trend in SBN yields ***(see Chart 4)***, although the still-robust demand from domestic non-bank investors may continue to stabilise the domestic bond market in coming periods.

- Hence, while we continue to keep our cool regarding the ongoing increase in the yield of SBN, the government's current strategy of tapping into the SAL balance while significantly slashing SBN issuance this year may translate to some degree of risk in the forthcoming fiscal year. For instance, the proposed 2024 state budget was built on the assumption of USD 80/bl oil prices. Oil prices, as we know, are currently trading around USD 94/bl, which assuming the trend continues may push budget deficits by 0.38% of GDP in 2024. The present administration, we should note, has a knack for re-routing the budget for less-urgent programmes to fund the shortfall in other, more impactful programmes. However, given the use of the SAL balance in 2023, the potential IDR 87.4 Tn increase in budget deficits in 2024 may also prompt the government to issue more bonds, which could push the yield on SBN above the government's 6.7% target and thus re-exposing the state budget to higher interest payments in the future.

Chart 1

Orchestrated Retreat

The global bond market (including Indonesia) are losing its value in the past month as market consensus are increasingly merging on the Fed's "higher-for-longer" outlook

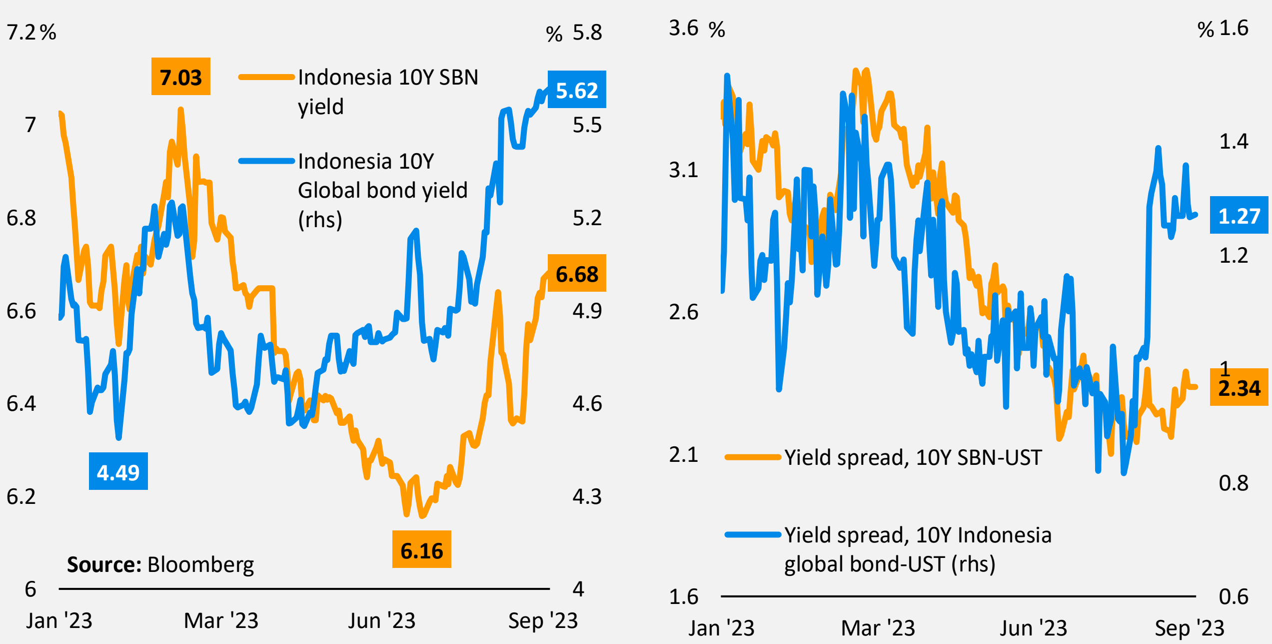


Source: Bloomberg

Chart 2

Fair Compensations

The yield on Indonesian government bonds move upward to compensate the increasingly-higher yield on UST securities rather than a reflection of Indonesia's worsening fundamentals

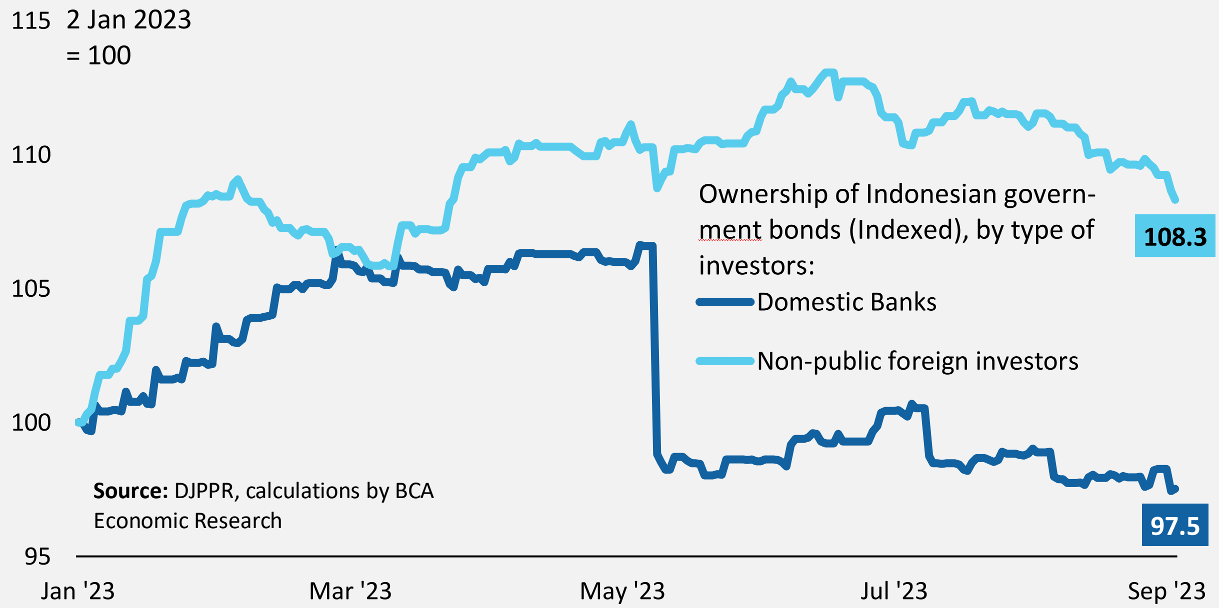


Source: Bloomberg

Chart 3

Towards a less sunny day

The bond market may not be as attractive a financing option for the government in the upcoming periods given foreign investors' demand for higher yields and domestic banks' limited interest to increase its SBN holdings

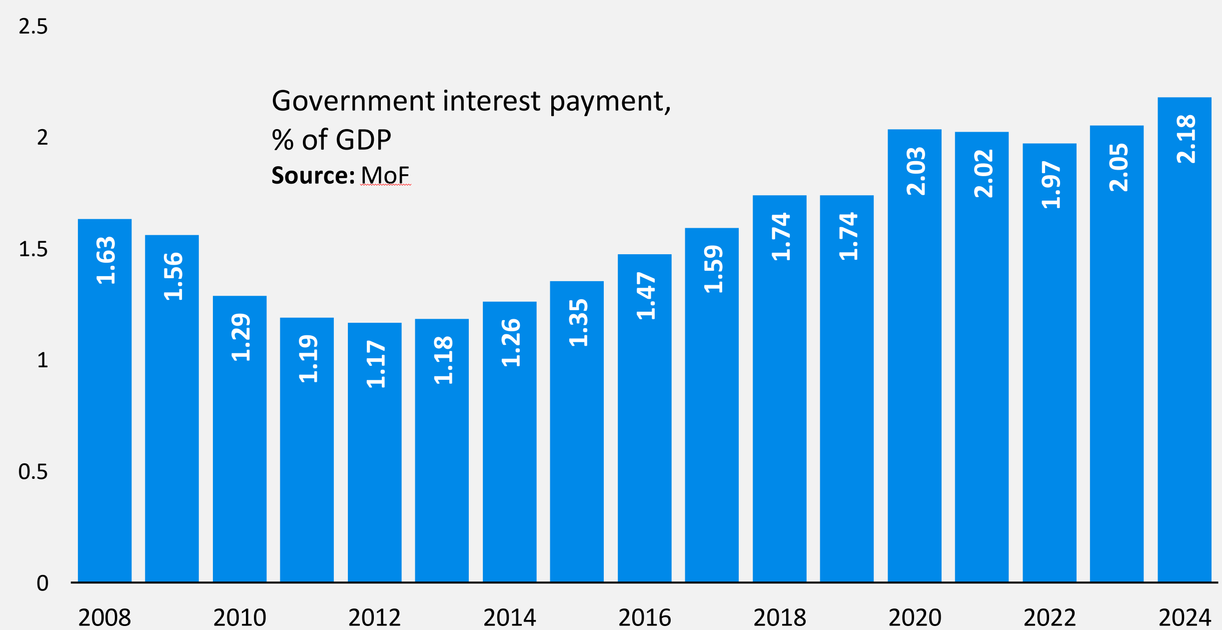


Source: DJPPR, calculations by BCA Economic Research

Chart 4

Cut now, more to come later?

The government is trying to reduce interest expenses by relying more on SAL balances, but the risk of additional budget deficits amidst the risk of rising fuel prices could re-expose the successive administration to high interest payments.



Source: MoF

Economic Calendar

		Actual	Previous	Forecast*
1 September 2023				
ID	S&P Manufacturing PMI	53.9	53.3	53
ID	**Inflation Rate YoY**	**3.27%**	**3.08%**	**3.0%**
CN	Caixin Manufacturing PMI	51	49.2	49.3
US	S&P Manufacturing PMI	47.9	49	47
US	Non-Farm Payroll (‘000)	187	157	180
6 September 2023				
US	Balance of Trade (USD Bn)	-65.0	-65.5	-68.1
7 September 2023				
CN	Balance of Trade (USD Bn)	68.4	80.6	81
ID	**Foreign Exchange Reserves (USD Bn)**	**137.1**	**137.7**	**134.0**
CN	Foreign Exchange Reserves (USD Tn)	3.16	3.20	3.20
8 September 2023				
ID	Consumer Confidence	125.2	123.5	121
9 September 2023				
CN	Inflation rate YoY	0.1%	-0.3%	-0.4%
11 September 2023				
ID	Motorbike Sales YoY	1.8%	45.6%	-
ID	Car Sales YoY	-	-6.8%	-
ID	Retail Sales YoY	1.6%	7.9%	-
13 September 2023				
US	Inflation rate YoY	3.7%	3.2%	3.5%
14 September 2023				
EA	ECB Interest Rate Decision	4.5%	4.25%	4.25%
15 September 2023				
ID	**Balance of Trade (USD Bn)**	**3.12**	**1.29**	**1.6**
CN	Retail Sales YoY	4.6%	2.5%	2.2%
EA	Balance of Trade (Eur Bn)	6.5	18.5	20
21 September 2023				
US	**Fed Interest Rate Decision**	**-**	**5.5%**	**5.5%**
ID	**Interest Rate Decision**	**-**	**5.75%**	**5.75%**
22 September 2023				
ID	M2 Money Supply YoY	-	6.4%	-

*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	Sep-23	1.80
UK	5.25	Sep-23	-1.55
EU	4.50	Sep-23	-0.80
Japan	-0.10	Jan-16	-3.40
China (lending)	2.50	Sep-23	4.25
Korea	3.50	Aug-23	0.10
India	6.50	Aug-23	-0.33
Indonesia	5.75	Aug-23	2.48
Money Mkt Rates	**15-Sep**	**-1 mth**	**Chg (bps)**
SPN (1M)	5.65	4.69	96.0
SUN (10Y)	6.67	6.42	25.1
INDONIA (O/N, Rp)	5.60	5.64	-4.2
JIBOR 1M (Rp)	6.40	6.40	0.0
Bank Rates (Rp)	**Jun**	**May**	**Chg (bps)**
Lending (WC)	8.93	8.93	0.00
Deposit 1M	4.19	4.19	0.10
Savings	0.67	0.67	-0.20
Currency/USD	**15-Sep**	**-1 mth**	**Chg (%)**
UK Pound	0.808	0.784	-2.86
Euro	0.938	0.920	-1.98
Japanese Yen	147.9	145.8	-1.36
Chinese RMB	7.276	7.287	0.15
Indonesia Rupiah	15,353	15,283	-0.46
Capital Mkt	**15-Sep**	**-1 mth**	**Chg (%)**
JCI	6,982.8	6,900.5	1.19
DJIA	34,618.2	34,474.8	0.42
FTSE	7,711.4	7,310.2	5.49
Nikkei 225	33,533.1	31,626.0	6.03
Hang Seng	18,182.9	18,326.6	-0.78
Foreign portfolio ownership (Rp Tn)	**Aug**	**Jul**	**Chg (Rp Tn)**
Stock	2,869.7	2,892.9	-23.21
Govt. Bond	846.3	855.2	-8.89
Corp. Bond	11.1	11.3	-0.20

Trade & Commodities	15-Sep	-1 mth	Chg (%)
Baltic Dry Index	1,381.0	1,247.0	10.7
S&P GSCI Index	618.1	577.2	7.1
Oil (Brent, $/brl)	93.9	84.1	11.7
Coal ($/MT)	166.2	158.0	5.2
Gas ($/MMBtu)	2.74	2.55	7.5
Gold ($/oz.)	1,923.9	1,889.4	1.8
Copper ($/MT)	8,350.4	8,200.9	1.8
Nickel ($/MT)	19,672.5	20,027.0	-1.8
CPO ($/MT)	796.1	830.2	-4.1
Rubber ($/kg)	1.42	1.25	13.6
External Sector	**Aug**	**Jul**	**Chg (%)**
Export ($ bn)	22.00	20.86	5.47
Import ($ bn)	18.88	19.57	-3.53
Trade bal. ($ bn)	3.12	1.29	141.85
Central bank reserves ($ bn)*	137.1	137.7	-0.42
Prompt Indicators	**Aug**	**Jul**	**Jun**
Consumer confidence index (CCI)	125.2	123.5	127.1
Car sales (%YoY)	-8.3	-6.8	4.7
Motorcycle sales (%YoY)	1.8	45.6	66.6
Manufacturing PMI	**Aug**	**Jul**	**Chg (bps)**
USA	47.6	46.4	120
Eurozone	43.5	42.7	80
Japan	49.6	49.6	0
China	51.0	49.2	180
Korea	48.9	49.4	-50
Indonesia	53.9	53.3	60

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

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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	5.2
GDP per Capita (US$)	3927	4175	3912	4350	4784	5285
Consumer Price Index Inflation (% YoY)	3.1	2.7	1.7	1.9	5.5	2.7
BI 7-day Repo Rate (%)	6.00	5.00	3.75	3.50	5.50	5.75
USD/IDR Exchange Rate (end of the year)**	14,390	13,866	14,050	14,262	15,568	15,173
Trade Balance (US$ 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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