Maintaining vigilance amidst the threat of a feigned retreat

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Summary

- The easing pressure on the domestic financial market appears to diminish the immediate necessity for BI to make further adjustments to its policy rate. However, the current calm condition seems to be more influenced by external factors, which may continue to shift given the still-volatile global market.
- The worsening US manufacturing and labour data appear to reduce expectations for the US real policy rate, offering relief for Indonesia and other higher-yielding markets.
- The American households' sensitivity to inflation rather than interest rates may persist in encouraging the Fed to err on the side of policy tightening.

- Our observations of foreign capital inflows into the Indonesian financial market again revealed mixed results last week. On the equity market side, foreign investors continue to head into the exit door, marking a net sell to the tune of USD 130.89 Mn throughout the past week. However, on the debt market side, demand for Indonesian government IOUs among foreign investors appears to have rebounded, with USD 151.84 Mn in foreign capital inflows recorded until midweek ***(see Chart 1)***. Foreign demand for SBN filled the lurch left by investors from the domestic financial sector, which helped to stabilise the benchmark yield around the present 6.8% level.
- Even more encouraging is the fact that foreign demand for SBN is driven by private institutional investors, signalling a calming environment in Indonesia's bond market that fosters a shift towards a risk-on attitude among investors ***(see Chart 2)***. **The now calmer environment, however, appears to be more of a product of the recent development of external conditions** rather than a sizable improvement in the fundamental factors protecting the market for Rupiah-denominated assets.
- In line with the 'bad news is good news' belief, recent updates revealing a deterioration in US economic data have relieved the Indonesian financial market (and others), which have been under constant attack throughout the past month. As shown in Chart 2, the declining bid-ask spread on the domestic bond market is more consistent with the anticipation of the recent FOMC meeting and the subsequent underwhelming US manufacturing and employment data, rather than Bank Indonesia's decision to increase the already high real rate. We move to question, then,

whether the current state of serenity will persist indefinitely or only constitute a temporary respite.

- Considering investors' increasingly "event-driven" behaviour, the forthcoming release of Oct-2023 US CPI data may add to the hope that the current positive trends in Indonesia's bond market will persist, at least for another week until another data arrives. Analysts' estimates for the upcoming US CPI number portend a favourable outcome for the Indonesian bond market. The headline US CPI number is expected to cool to 3.3% YoY in Oct-2023, a rather sizable drop from 3.7% YoY in Sep-2023 thanks in part to the 8.08% YoY decline in petrol prices.
- Nevertheless, amidst the fluctuations in the headline inflation number, and, consequently, the policy rate outlook, it is worth noting that long-term US inflation expectations seem to remain relatively stable ***(see Chart 3)***. While the higher 10Y inflation breakeven rate (2.33 in Nov-23 vs. 2015-2019 average of 1.80) may reflect market expectations of structurally higher inflation, the higher breakeven rate could also be attributed to the Fed's shift towards the flexible average inflation target (FAIT) framework.
- Regardless of what constitutes a 'higher' or 'lower' number**, limited changes in the long-term inflation breakeven rate over the past 18 months indicate the market's view that the inflation dynamic in the US is largely stabilising.** Indeed, despite OPEC+'s best effort to game the market, the supply and demand dynamics continue to yank oil away from the USD 90/bl or above price level, while US consumers are also largely untouched by the ongoing increases in global food prices.

"The rather complacent attitude towards inflation may lead to a double risk of inflationary and interest rate shocks"

- This rather complacent attitude towards inflationary pressure, however, may intensify the risk should inflation come back to haunt the US economy. **The spectre of inflation, including energy inflation, is still lurking in the shadow.** As indicated by the US EIA's projection, even with limited growth in the demand level, the global oil market would tip into an undersupply in 2024. OPEC+'s recently increasing alacrity to announce a surprise production quota further adds to the risk, while the continued withdrawal of the US government's strategic petroleum reserves (SPR) did not help to mitigate the risk of energy reflation in the upcoming period.
- Past events indicate that any potential inflationary shock almost always reverberates into the fed rate expectations. However, recent fluctuations in the FFR expectation do not seem to be influenced much by the twist-and-turn in the long-term inflation expectation. If anything, support for the Fed to maintain a substantially restrictive real policy rate for a prolonged period appears to be dwindling in the past two weeks. The weakening manufacturing activity, followed by the slowing labour market data, may be perceived as one of the principal factors behind the Fed's decision not to increase the policy rate and thus widen the real policy rate, even though the central bank has not been able to anchor the long-term inflation expectation back to their 2% target.

- Such a reading, however, may rely too heavily on the assumption of a perfect trade-off between real rate conditions and US economic growth. A higher real rate is indeed detrimental to the outlook on investments and aggregate consumption, but the extent of its damage to overall economic growth might turn out to be negligible relative to the potential damage posed by unanchored inflation expectations.

- Any of the policy paths that the Fed may choose would, unfortunately, lead to some measure of economic slowdown in the US. However, **the path towards a higher-for-longer real policy rate environment appears to be the lesser of two evils for the Fed's soft landing outlook *(see Chart 4)***. Despite the aggressive rate hikes in 2022-2023, the upswing in mortgage refinancing during the pandemic recession and the increasingly dominant market share of fixed-rate mortgages in the days following the 2008 financial crisis provide existing debtors with protections against the skyrocketing interest rate.

- Hence, while the now-higher real rate has restrained demand for new loans, the still-low share of debt service payments to disposable income (4.01% for mortgage debt in Q2-2023 vs. the 2015-2019 average of 4.28%) suggests that the household sector still has the means to drive the US' consumption-driven economy – depending, of course, on how the still-unanchored US inflation dynamic would play out in the upcoming period.

- **The pro-growth argument, then, justifies the Fed's policy signal to err on the side of higher interest rate conditions** (and thus, substantially restrictive real rates) rather than responding to early signs of the US economic slowdown. While a further breakdown in the US economic data may be more mellifluous for investors, re-anchoring inflation expectations back to its 2% target seems to be the best way for the Fed to maintain the long-term health of the US real economy. Global capital flows, then, will likely continue to ebb and flow as new data emerges, as investors will continue to look for signals of a change in the Fed's real rate outlook between the upcoming FOMC meeting and new data points.

- Luckily, the fundamentals backing the Indonesian financial market remain well-maintained to meet the prospect of another round of global market volatility going forward. For instance, the domestic FX liquidity condition seems to be improving, although the improvement is more of a product of declining FX loans rather than increasing FX revenues. Indonesia's more benign inflationary pressure may also allow BI to maintain healthy real rate differentials against USD-denominated assets. **Given the current tranquil climate, BI may choose to retain its policy rate at the current level. Nevertheless, it might be prudent not to close the door on another 25bps rate hike yet**, given the potential risk of another shift in foreign investors' sentiment that still threatens the Indonesian financial market.

> ***"The Fed may choose to err on the side of higher-for-longer real rates as US consumers seem to be more sensitive to inflation rather than rates"***

Chart 1

The tale of two markets

Foreign investors' demand for Indonesian bonds has been increasing lately, although some wariness remains as the equity market continues to record net foreign capital outflows

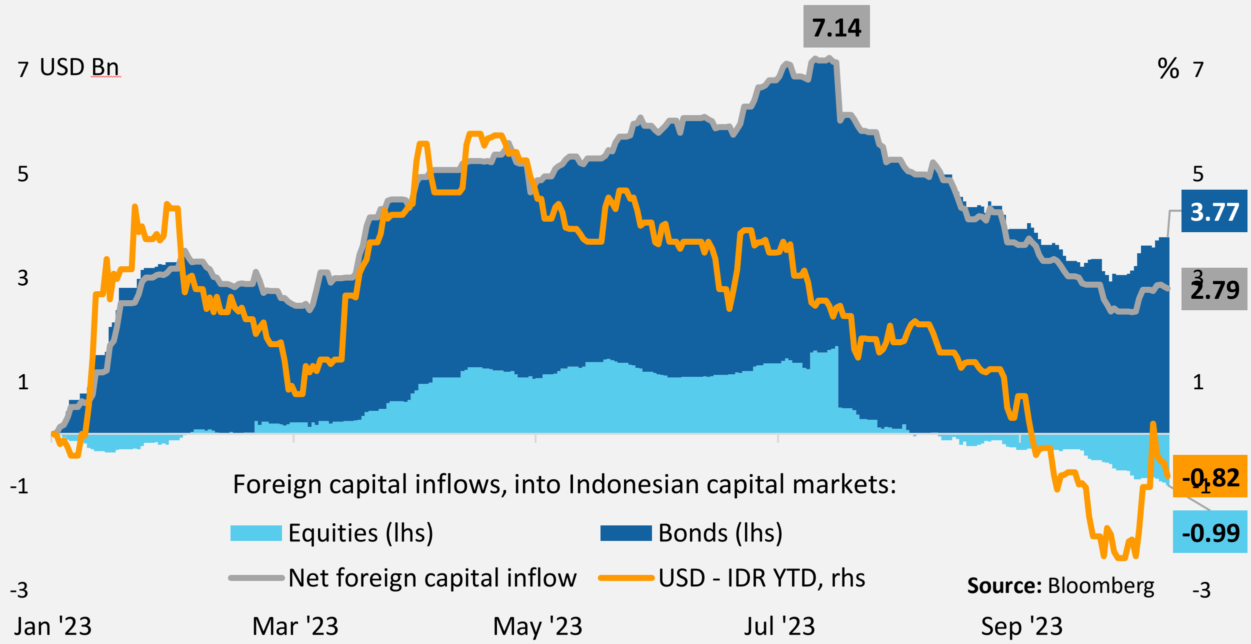


Chart 2

Calm weather

The pressure facing the domestic bond and money market continues to recede recently, thanks to improving investors' sentiment following the underwhelming US economic data

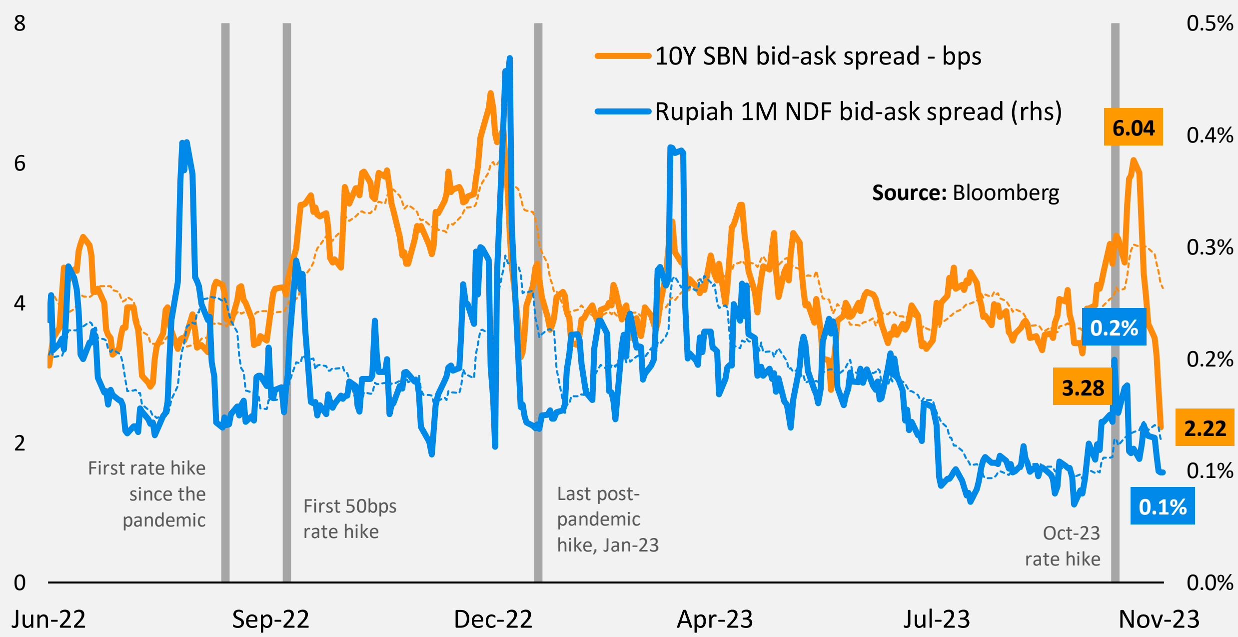


Chart 3

Getting less real

The expectation for real policy rates seems to have declined recently following the underwhelming US economic data, encouraging investors to return to higher-yielding markets

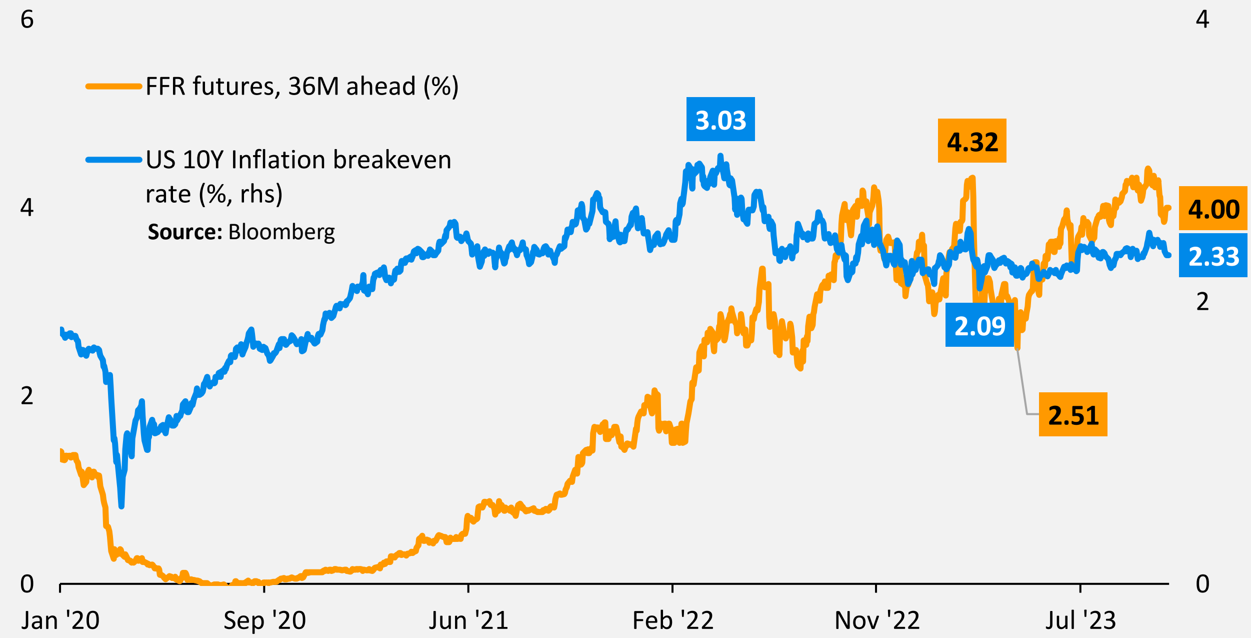
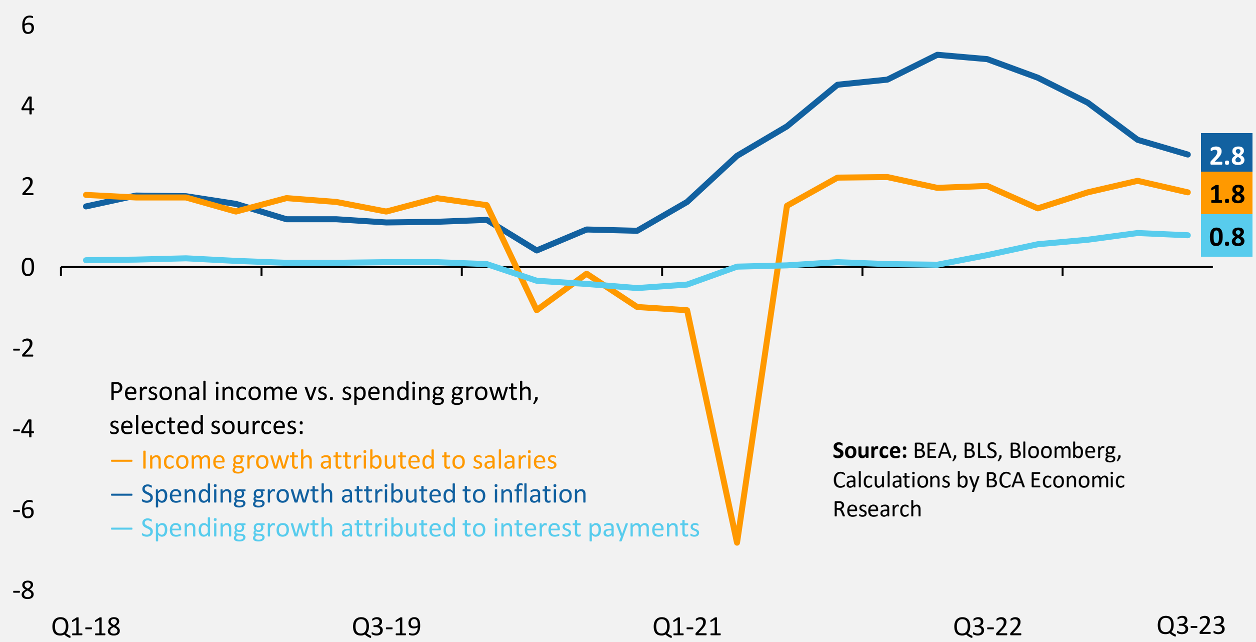


Chart 4

The lesser of two evils

The Fed may continue to err on the side of tightening as unanchored inflation might hurt the US real sector more than a tighter real rate environment



Economic Calendar

		Actual	Previous	Forecast*
1 November 2023				
ID	S&P Global Manufacturing PMI	51.5	52.3	52
CN	Caixin Manufacturing PMI	49.5	50.6	50.7
ID	**Inflation rate YoY**	**2.56%**	**2.28%**	**2.4%**
US	ISM Manufacturing PMI	46.7	49	49.5
US	JOLTs Job Openings (USD Mn)	9.55	9.6	9.2
2 November 2023				
US	**Fed Interest Rate Decision**	**5.5%**	**5.5%**	**5.5%**
3 November 2023				
US	Unemployment Rate	6.5%	3.8%	3.8%
US	Non-Farm Payroll ('000)	150	336	190
6 November 2023				
ID	**GDP Growth Rate YoY**	**4.94%**	**5.17%**	**5.1%**
7 November 2023				
CN	Balance of Trade (USD Bn)	56.53	77.7	81.0
US	Balance of Trade (USD Bn)	-61.5	-58.3	-59.5
ID	**Foreign Exchange Reserves (USD Bn)**	**133.1**	**134.9**	**133.0**
8 November 2023				
ID	Consumer Confidence	124.3	121.7	-
ID	Motorbike Sales YoY	-4%	-0.9%	-
ID	Car Sales YoY	-13.9	-20.1%	-
9 November 2023				
CN	Inflation Rate YoY	-0.2%	0.0%	0.0%
ID	Retail Sales YoY	1.5%	1.1%	2.9%
14 November 2023				
US	Inflation Rate YoY	-	3.7%	3.8%
ID	Property Price Index YoY	-	1.92%	2.4%
15 November 2023				
ID	Balance of Trade (USD Bn)	-	3.42	-
EU	Balance of Trade (EUR Bn)	-	6.7	22.3
21 November 2023				
ID	Current Account (USD Bn)	-	-1.9	-0.9
23 November 2023				
ID	Loan Growth YoY	-	**8.9%**	**-**
ID	**Interest Rate Decision**	-	6%	6%

*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	Nov-23	1.80
UK	5.25	Nov-23	-1.45
EU	4.50	Nov-23	1.60
Japan	-0.10	Jan-16	-3.10
China (lending)	2.50	Oct-23	4.55
Korea	3.50	Oct-23	-0.30
India	6.50	Oct-23	1.48
Indonesia	6.00	Oct-23	3.44
Money Mkt Rates	**10-Nov**	**-1 mth**	**Chg (bps)**
SPN (1M)	6.51	5.89	61.3
SUN (10Y)	6.84	6.93	-9.2
INDONIA (O/N, Rp)	5.82	5.61	20.7
JIBOR 1M (Rp)	6.66	6.40	25.5
Bank Rates (Rp)	**Aug**	**Jul**	**Chg (bps)**
Lending (WC)	8.96	8.95	0.65
Deposit 1M	4.29	4.24	5.00
Savings	0.66	0.67	-0.53
Currency/USD	**10-Nov**	**-1 mth**	**Chg (%)**
UK Pound	0.818	0.814	-0.49
Euro	0.936	0.943	0.76
Japanese Yen	151.5	148.7	-1.85
Chinese RMB	7.286	7.294	0.12
Indonesia Rupiah	15,695	15,735	0.25
Capital Mkt	**10-Nov**	**-1 mth**	**Chg (%)**
JCI	6,809.3	6,922.2	-1.63
DJIA	34,283.1	33,739.3	1.61
FTSE	7,360.6	7,628.2	-3.51
Nikkei 225	32,568.1	31,746.5	2.59
Hang Seng	17,203.3	17,664.7	-2.61
Foreign portfolio ownership (Rp Tn)	**Oct**	**Sep**	**Chg (Rp Tn)**
Stock	2,895.1	2,833.3	61.89
Govt. Bond	810.4	823.0	-12.62

Trade & Commodities	10-Nov	-1 mth	Chg (%)
Baltic Dry Index	1,643.0	1,983.0	-17.1
S&P GSCI Index	558.0	585.1	-4.6
Oil (Brent, $/brl)	81.4	87.7	-7.1
Coal ($/MT)	129.5	152.0	-14.8
Gas ($/MMBtu)	2.71	3.34	-18.9
Gold ($/oz.)	1,940.2	1,860.4	4.3
Copper ($/MT)	7,954.7	7,945.0	0.1
Nickel ($/MT)	17,025.5	18,399.0	-7.5
CPO ($/MT)	779.4	750.4	3.9
Rubber ($/kg)	1.47	1.39	5.8
External Sector	**Sep**	**Aug**	**Chg (%)**
Export ($ bn)	20.76	22.00	-5.63
Import ($ bn)	17.34	18.88	-8.15
Trade bal. ($ bn)	3.42	3.12	9.61
Central bank reserves ($ bn)*	134.9	137.1	-1.63
Prompt Indicators	**Oct**	**Sep**	**Aug**
Consumer confidence index (CCI)	124.3	121.7	125.2
Car sales (%YoY)	-13.9	-20.1	-8.3
Motorcycle sales (%YoY)	-4.0	-0.9	1.8
Manufacturing PMI	**Oct**	**Sep**	**Chg (bps)**
USA	46.7	49.0	-230
Eurozone	43.1	43.4	-30
Japan	48.7	48.5	20
China	49.5	50.6	-110
Korea	49.8	49.9	-10
Indonesia	51.5	52.3	-80

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

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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	5.1
GDP per Capita (US$)	3927	4175	3912	4350	4784	5285
Consumer Price Index Inflation (% YoY)	3.1	2.7	1.7	1.9	5.5	2.6
BI 7-day Repo Rate (%)	6.00	5.00	3.75	3.50	5.50	6.25
USD/IDR Exchange Rate (end of the year)**	14,390	13,866	14,050	14,262	15,568	16,114
Trade Balance (US$ billion)	-8.5	-3.2	21.7	35.3	54.5	32.8
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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