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WEEKLY REVIEW SERIES

Fed Tapering : This Time would be Different for Indonesia

Indonesia Macro Data Forecast

Macro Indicators	2020	2021F
Real GDP (%YoY)	-2.07	3.76
Average Inflation (%YoY)	2.04	1.87
BI-7 DRR (%)	3.75	3.5
Budget Deficit (%GDP)	6.09	5.73
USD/IDR	14,500	14,400
10 Year Indo GB (%)	5.89	6.46
JCI	5,979	6,320
EPS Growth (%)	-30	20

Source : BI, MoF, BPS, MNCS Estimate

Global & Domestic Key Rates

Rates (%)	Dec-20	Aug-21*
BI-7 DRR	3.75	3.50
Lending Facility	4.50	4.25
Deposit Facility	3.00	2.75
10 Year Indo GB	5.89	6.30
FFR	0.25	0.25
ECB Rate	0.00	0.00
BoE Rate	0.10	0.10
BoJ Rate	-0.10	-0.10

Source : Bloomberg, BI as of August 20, 2021

Tirta Widi Gilang Citradi
Economist & Fixed Income Analyst

Plans on Fed Tapering Drives Market Sentiment

On August 18-19, policy meeting Bank Indonesia (BI) decided to keep its 7-day reverse repo rate unchanged, in line with market expectation. However the value of Indonesian rupiah depreciated against USD and domestic equity market tumbled, meanwhile the 10 year Indo GB yield stayed flat.

This time, market sentiment is largely driven by the Fed's plan to taper asset purchases that began more than a year ago. The Fed officials debated mainly on the timing of when to start adjusting the pace of asset purchases.

Rationale for Fed Tapering

The policymakers did not reach consensus as reflected in minutes of meeting. Views were splitted up. Some argued that the first step to roll back the stimulus needs to be taken by the end of this year. Some are supporting the idea to adjust in early 2022.

Despite ongoing concern on Delta variant widespread across U.S. and globally, persistent high inflation and solid job market have opened the room for taper discussion among policymakers.

2013 Fed Tapering Impact to Indonesia

In 2013, markets reacted negatively on Bernanke's tapering announcement. USD strengthened and as a consequence EM currencies value were depreciated. Tapering announcement also triggered equity market sell off in EM.

Indonesia was no exception at that time. Only in a matter of month JCI market capitalization dropped by 18% from its highest level. The benchmark 10 year Indo GB yield rose more than 330 bps in a year. Rupiah that was negatively affected by widening current account deficit was extremely vulnerable. Rupiah depreciated by 26.5% in that year and continued its downtrend declining more than 50% September-15.

Why the Fed Tapering would be Different this Time?

This time we expect a different story for Indonesia. We believe the impact of tapering off would be insignificant and only lasting temporarily. Both external and internal factors play a role.

From the external factors clear guidance and communication from the Fed has helped market to better understand the policy framework. In addition a structural change in domestic financial assets, attractive asset valuation, better macro data, as well better equipped policy makers have increased our confident, that this time Indonesia would be more resilient. Now investors needs to keep an eye on the Fed guidance, prior to tapering investors can rebalance their portfolio to a less volatile and impacted assets. Should the correction occur during taper announcement it would be great opportunity for buying this time.

Contents

Reminiscing 2013 Fed Tapering

On September 13, 2012 the Fed announced the third round of quantitative easing (QE). At that time, monthly asset purchases value were at USD40bn. On December 12, 2012 the FOMC decided to increase the QE value to USD85bn per month. Shortly after that, the FOMC began to debate the fate of QE in January-13. In March-13 policy meeting the Fed officials agreed to return central bank's balance sheet to a more normal size through gradual process of allowing bond to run off as they matured, rather than selling them. In April-13 policy meeting, some Fed officials agreed to the idea that June-13 would be a good time to start tapering the bond purchases.

It took nearly a year for FOMC to agree on bond taper timing in 2013

Later on in May-13, Fed Chair Bernanke appeared on congress and revealing the Fed plans to taper off. This has resulted to a bond yield to skyrocket and stock prices decline. In response to the negative market reaction, Bernanke used a press conference to point out what markets had misunderstood about tapering decision. In that occasion Bernanke said the Fed would still committed to its pledge accommodative policy even though unemployment rate fell below 6.5%. The Fed officials concerned on how to communicate to the market effectively on asset purchases trims plan. Up until December-13, the Fed finally announced to reduce its monthly pace of QE to USD75bn or reducing about USD10bn per month. The Fed also stated would reduce even further if the economy strengthened. The historical timeline of 2013 tapering is outlined in Exhibit 3.

Exhibit 3. Historical Timeline of 2013 Tapering

Period	The Fed's Agenda	Notes	U.S. Macro Indicators		
			Unemployment Rate (%)	PCE Inflation (%YoY)*	The Fed BS (USD Tn)**
Jan-13	Policy Meeting	Policymakers debated on the fate of QE3 that began in September-12 but FOMC deciced to keep the program going	8	1.58	3.01
Mar-13	Policy Meeting	The Fed officials agreed to return the central bank's balance sheet to a more normal size through a gradual process of allowing bonds to run off as they matured, rather than selling them	7.5	1.57	3.21
Apr-13	Policy Meeting	Some Fed officials agreed to the idea that June-13 would be a good time to start tapering the bond purchases	7.6	1.43	3.32
May-13	Fed's Chair Congressional Appearance	Bernanke revealed the FOMC's thinking on plans for a taper triggering bond yields to skyrocket and stock prices decline	7.5	1.41	3.40
Jun-13	Policy Meeting	No change to policy was made, but Bernanke used his press conference to hone the point the markets were missing which was bond taper would depend on economic outlook	7.5	1.51	3.47
Jul-13	Fed's Chair Testimony to Congress	Bernanke told lawmakers the Fed remained committed to an accommodative policy even after tapering and it could keep interest rates near zero even after unemployment rate fell below 6.5%	7.3	1.56	3.54
Jul-13	Policy Meeting	Policymakers continued to discuss how best to communicate any decision to trim the asset purchases. No change to policy was made at that time	7.3	1.56	3.54
Sep-13	Policy Meeting	No change to policy was made at that time. Powell was among those advocating to make the move at that time	7.2	1.54	3.72
Oct-13	Policy Meeting	No change to policy was made at that time.	7.2	1.55	3.84
Dec-13	Policy Meeting	After the long debate, the Fed took a small step to taper asset purchases. The Fed said would reduce its monthly pace of asset purchases to USD75bn from USD85bn	6.7	1.68	4.01

Note : (*) Trimmed Mean PCE inflation ; (**) the Fed total assets
Source : Reuters, Bloomberg, FRED

The 'Tantrum'

The impact of tapering off was pushing up the DXY index triggering outflow from EM and downward pressuring safe haven asset like gold. During 2013-2015, the aggregate return of DXY was 23.6%, MSCI EM declined by 24.7% and gold dipped 36.6% (Exhibit 4).

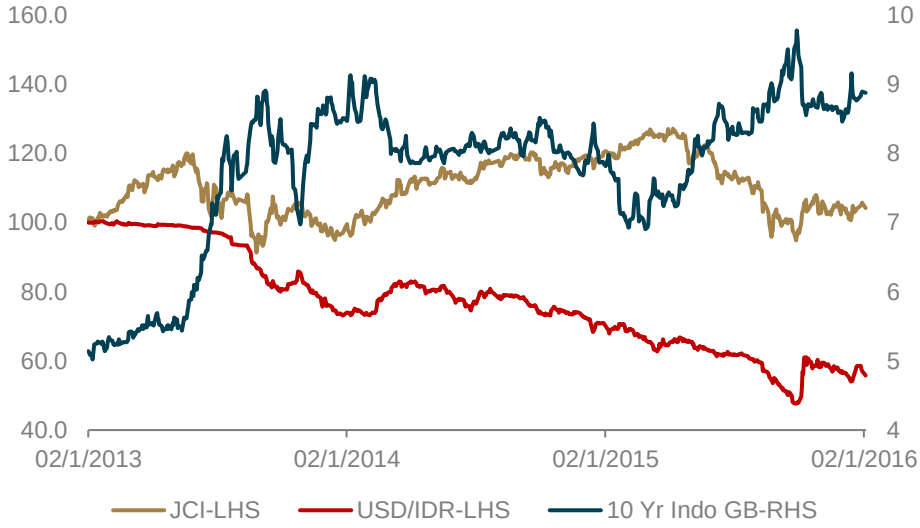
2013 Fed tapering triggered a 'tantrum' from financial markets, EM were among the hardest hit by Fed policy normalization

Exhibit 4. 2013 Fed Tapering Impact on DXY, Gold & MSCI EM

Note : Dec 2012=100
Source : Bloomberg

As an emerging market the impact of 2013 tapering off was also felt by Indonesia. Although the stock market rebounded relatively quick, rupiah continued to depreciated. During two year period since the debate on bond taper began rupiah dropped by 44.22% and the 10 year Indo GB rose more than 350 bps (Exhibit 5). Massive outflow has induced bond yield to rise. Further depreciating rupiah was the current account deficit which stood at 3% of GDP. Overall 2013 Fed tapering has a negative impact on EM financial assets.

Exhibit 5. 2013 Fed Tapering Impact on Indonesia's Financial Asset



Note : Dec 2012=100, except 10 Yr Indo GB yield in %
Source : Bloomberg

The Signs & the Time

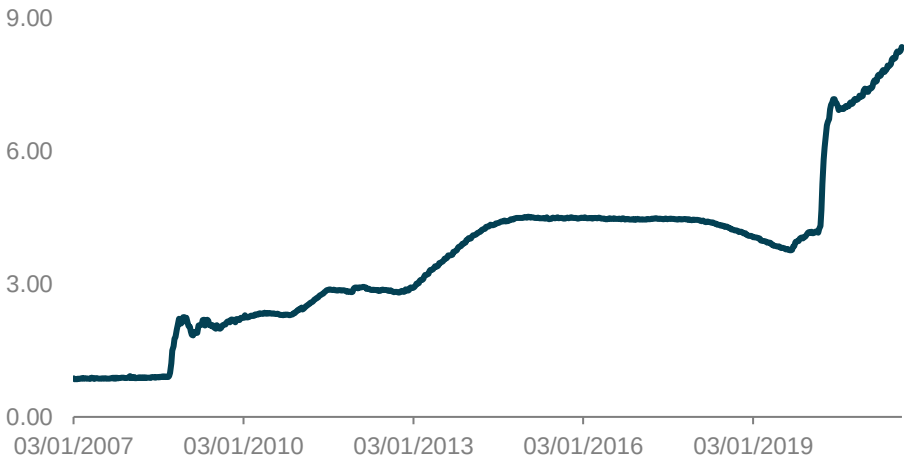
Covid-19 induced economic downturn and market turmoil once again made the central bank to step in as the lender of the last resort. When infection cases spread all over the world very fast, government from major economies announced a lockdown measures. The collapse in economy was inevitable. Fiscal authority set up a countercyclical policy measures and central bank aggressively cut rate while at the same time injecting liquidity to economy through QE.

QE was not only taken among DM central bank. Some EM central bank like Indonesia also followed the strategy. The Fed has cut 150 bps the FFR and leaving the interest rate at zero lower bound. Understanding that cutting rate was not enough, the Fed took another step by buying U.S. treasury note and MBS making its balance sheet to expand.

The pace of asset purchases pledged by the Fed was at USD120bn per month or nearly 50% higher than QE3. If 2007-08 GFC was followed by the increase of more than USD2.25tn in more than 5 year, due to Covid-19 the Fed balance sheet grew even larger now. Since the pandemic strike the Fed balance sheet has expanded by more than USD3.09tn only in a year (Exhibit 6).

The Fed aggressively cut the interest rate and inject a massive liquidity to the economy during Covid-19

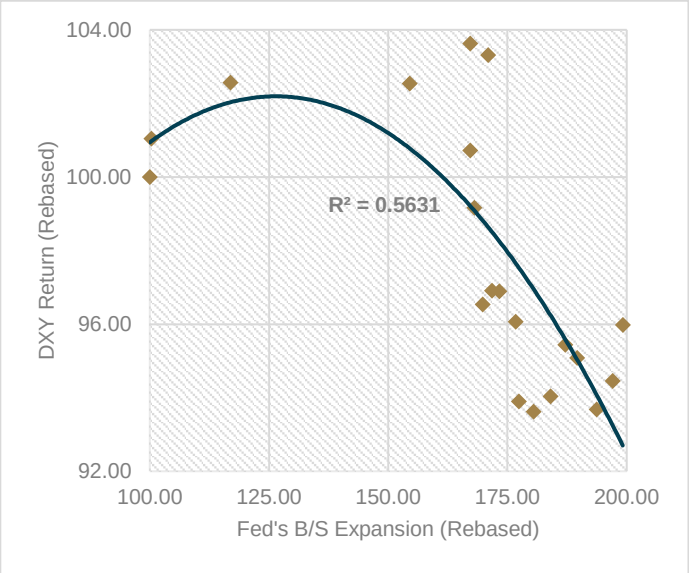
Exhibit 6. The Fed Balance Sheet (USD Tn)



Source : Bloomberg

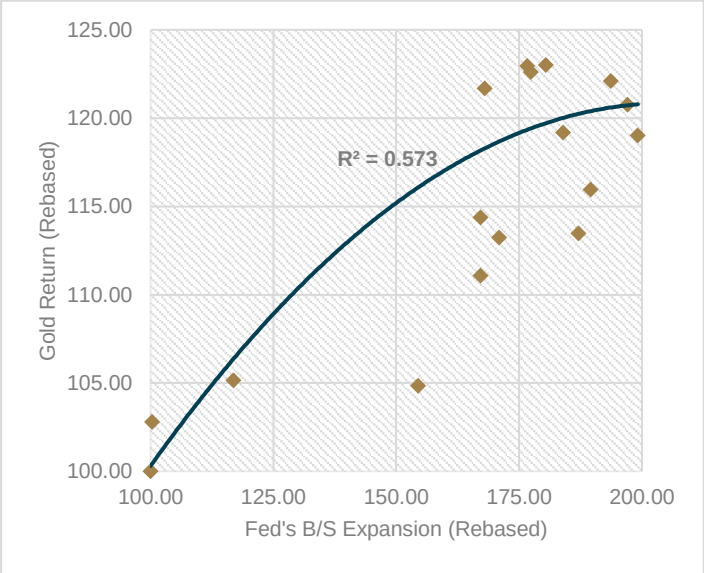
The expansionary monetary policy through QE is expected to influence market through portfolio rebalancing on top of lowering long term interest rates. Easy monetary policy has driven up risk sentiment. We already witnessed that asset purchases program or simply QE has a negative correlation and significant with USD movement. With the Fed's total assets nearly doubled, DXY index dropped nearly 5%. QE also drove equity prices up. After a sharp correction during market sell off in April-20, the stock market rebounded and as of July-21 S&P 500 has soared 31% from early January-20. Gold and Bitcoin were also affected significantly by the Fed's QE. For the first time since its launching, institutional investors were pouring money into cryptocurrency assets to hedge against potential high inflation amid ample liquidity in the economy and lower yield environment globally. The impact of QE on various asset prices is outlined in Exhibit 7-10.

Exhibit 7. Impact of QE on DXY



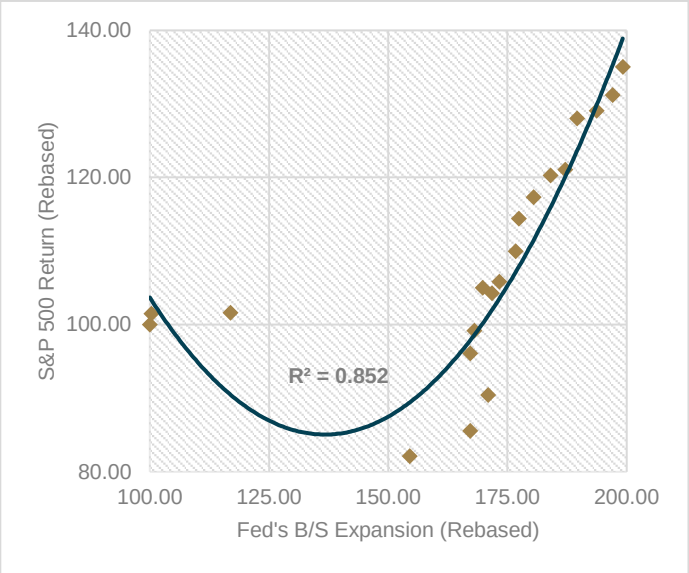
Source : Bloomberg, MNCS Calculation

Exhibit 8. Impact of QE on Gold



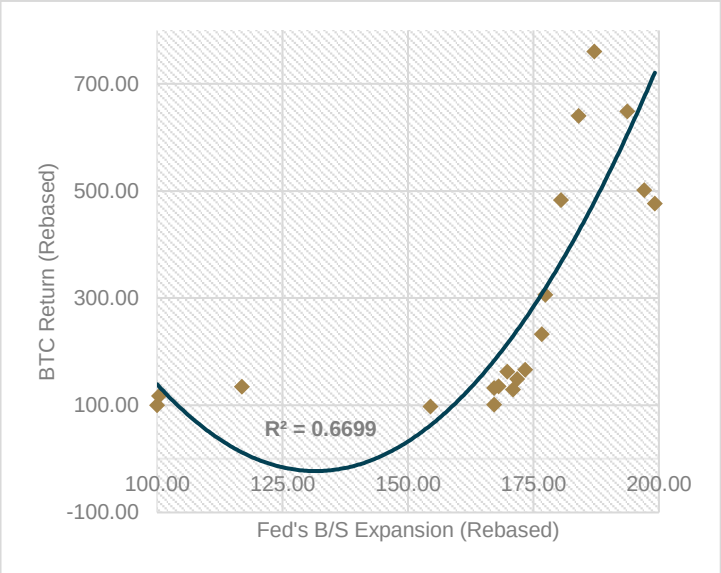
Source : Bloomberg, MNCS Calculation

Exhibit 9. Impact of QE on S&P 500



Source : Bloomberg, MNCS Calculation

Exhibit 10. Impact of QE on Bitcoin



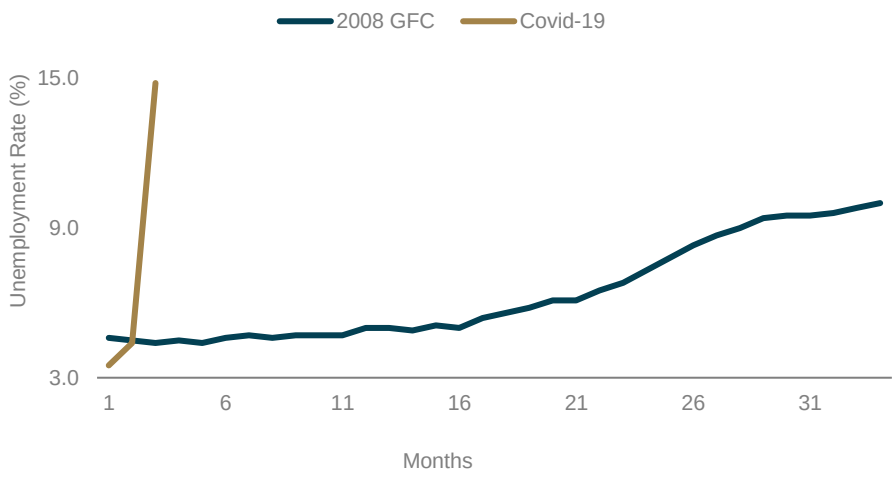
Source : Bloomberg, MNCS Calculation

Strong Job Market and Hot Inflation Trigger Tapering

The combination of vaccination rollout, fiscal expansion and easy monetary policy have proven to support U.S. economy. A faster recovery means a faster policy normalization. However one that should be noted, the nature of this crisis from the previous ones is different. Large scale social restriction and lockdown disrupted the job market. Unemployment rate skyrocketed to a decade high of 14.8% in May-20. This level has not been seen since 2008 GFC. With appropriate policy responses, job market rebounded along with easing large scale social restriction. It took only 5 months for unemployment rate to fall below 10%. Based on FOMC's latest projection the unemployment rate will reach pre-pandemic level in 2023 or taking only 45 months from the peak. In comparison it took nearly 90 months for unemployment rate to reach pre-crisis level (Exhibit 11-12).

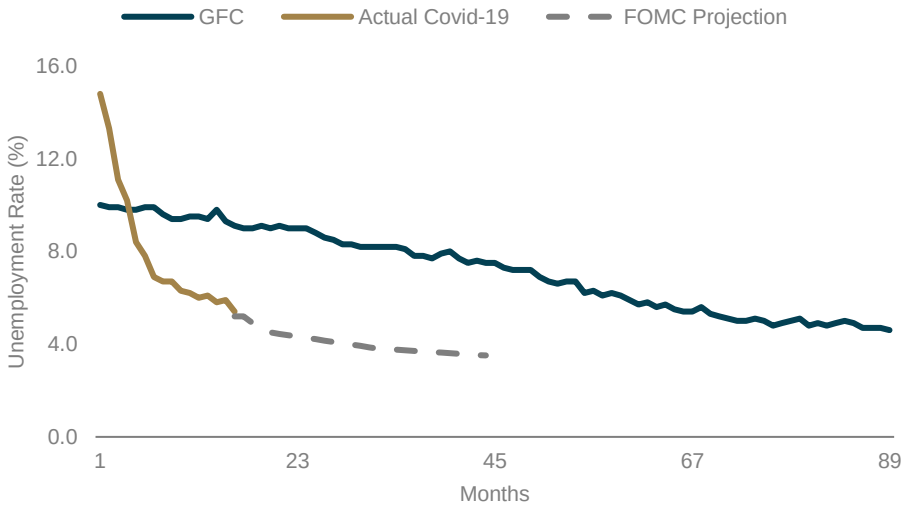
With appropriate policy response, massive vaccination rollout, fiscal expansion and easy monetary policy support job and expected to reach pre-pandemic level by 2023

Exhibit 11. How Long it Takes for Unemployment Rate to Reach the Peak?



Source : FRED

Exhibit 12. How Long it Takes for Unemployment Rate to Fall Back to Pre-Crisis Level?



Source : FRED, FOMC Projection

The job market gradual recovery is also followed by rising prices. This time QE impact is seen as an inflationary. Nevertheless, rising prices are not only affected by the amount of money printed by the Fed through QE. Large fiscal stimuli such as social aid package via direct cash transfer, gradual easing of lockdown measures, pent up demand, supply chain disruption and low based effect also play a role in triggering inflation.

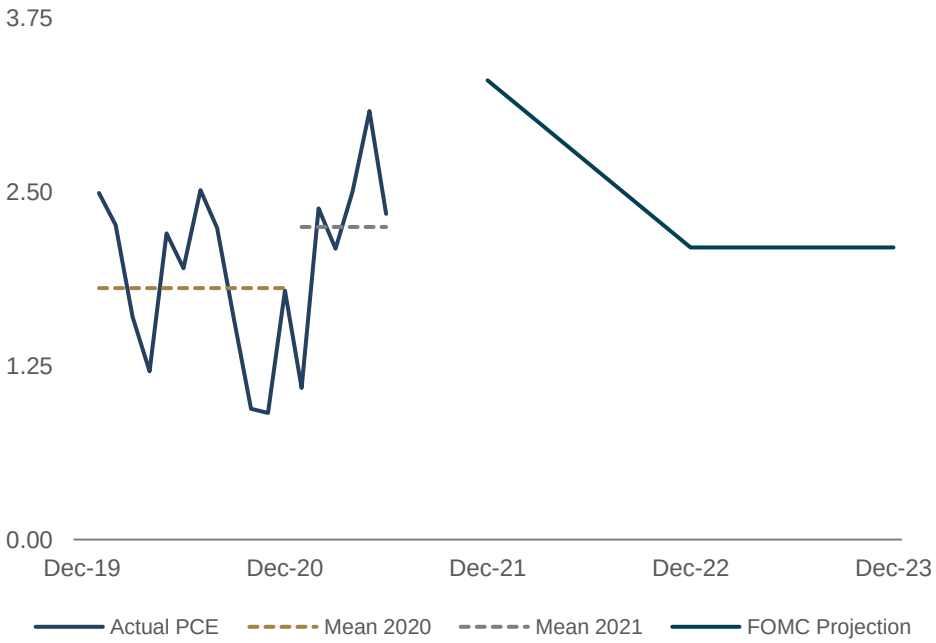
U.S. CPI recorded a consistent increase since January-21. In the last 3 months U.S. CPI rose more than 5% annually. This was higher than what had central bankers expected. A PCE inflation which the Fed oftenly refer to gauge price stability also running hot. Average PCE inflation in the 1H21 was at 2.25% YoY. The Fed expect inflation to be above 2% this year. Recent FOMC projection showed that 2021 inflation would likely at 3.3% before normalizing in 2022 and 2023.

The Fed will let inflation to overshoot temporary to offset the pandemic induced low inflationary pressure. Under this new 'inflation averaging' framework, the central bank will let inflation to hike as long as medium to long term inflation average remain at 2%.

Should the higher than expected inflation to persist in the coming months, the Fed would take a step of tapering by the end of this year.

Should high inflation persist and solid job market data released in the coming months, the Fed would likely to taper by the end of this year. Current constraint on whether to adjust the amount of asset purchases is due to the spread of Delta variant which outweigh economic outlook, so that end year 2021 tapering is seen as a hasty move.

Exhibit 13. PCE Inflation and FOMC Projection



Source : FRED, FOMC Projection

Do We Need to Worry this Time?

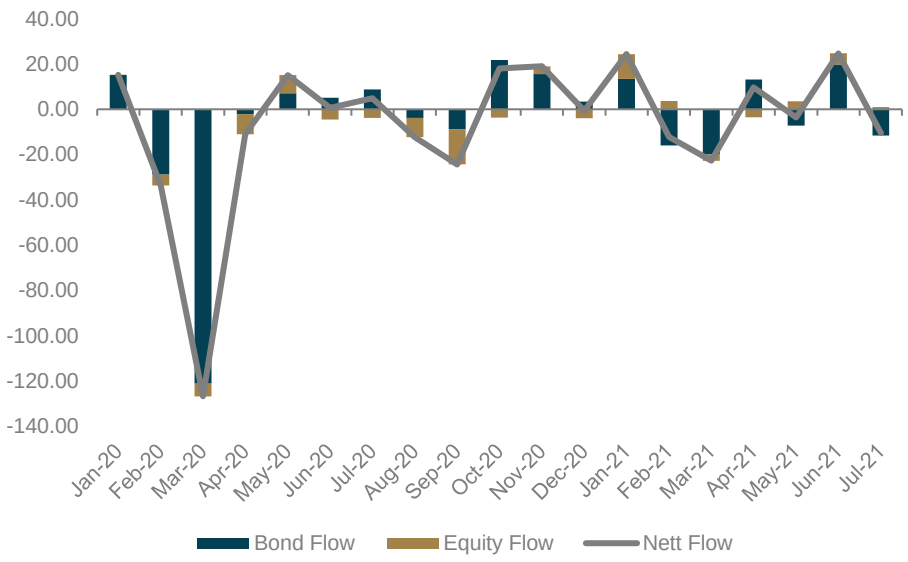
Considering the Fed officials have opened up the debate on the timing of tapering, whether it would be enacted by the end of this year of early 2022, tapering is coming. Investors need to be prepared, but in our view, there is nothing to worry about. We are confident that this time, Indonesia is more resilient than before. We outlined reasons why we are optimistic that Fed tapering would be insignificant to Indonesia.

To begin with, earlier this year, market has already priced in the potential of monetary policy normalization by sending the 10 year U.S. treasury yield higher, from below 1% to above 1.7% in the mid of March-21. Yields began to normalize subsequently despite continuously rising inflation. At that time, the Fed tried to clearly communicate its new policy framework and keep on maintaining accommodative policy to support growth while also maintaining price stability. Even with the persistent inflation, U.S. treasury showed a very limited reaction. We believe that this has indicated that markets somewhat gaining more understanding on how the Fed policy framework would work.

We expect the outflows pressure would be minimum as domestic financial assets ownership structure changed

What we worry so far about tapering is massive capital outflow due to flight to quality phenomenon. As of the end of July-21, Indonesia capital market booked a net foreign flow of IDR9.57tn. However if we take a longer period until the beginning of 2020, Indonesia still posted a net outflow of more than IDR100tn both from bonds and equities (Exhibit 14).

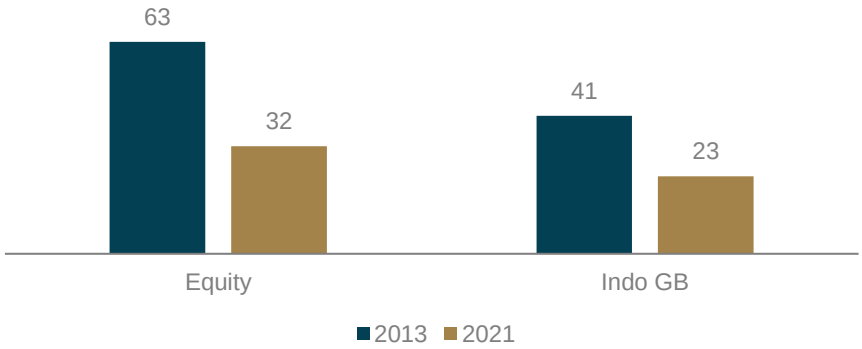
Exhibit 14. Foreign Fund Flow to Indonesia (IDR Tn)



Source : CEIC

This event has changed the structure of financial assets ownership in domestic market. Back in 2013, foreign investors dominate the ownership of Indo GB and equities each 63% and 41%. In 2021 the pictures look so different. Foreign ownership on equities was only 32% meanwhile ownership on Indo GB was only 23% (Exhibit 15), thanks to retail investor growth in stock market and central bank intervention government bond market. With this data in mind we expect that the outflow would not be as huge as in 2013.

Exhibit 15. Foreign Ownership in Domestic Financial Assets (%)

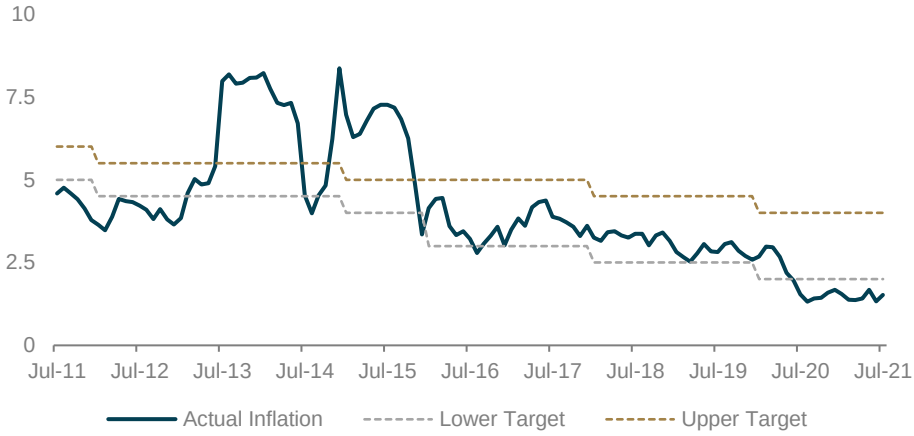


Source : KSEI, DJPPR

With a manageable inflation, the Indo GB offer a positive real yield, make it attractive for investors

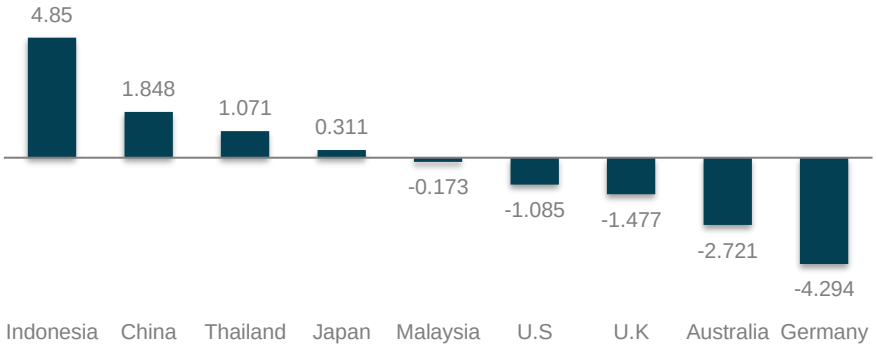
Indonesia's manageable inflation (Exhibit 16) is another strong point. Rising inflation in U.S. gave an investors negative real yield when holding government bond. Suppose that yield in the 10 year treasury now stood at 1.25%, with the PCE inflation at 3% the real yield would be negative 1.75%. Compared to DM and EM peers (Exhibit 17), Indonesia still offer attractive real positive rates with investment grade rating. This is also another strong point that we believe to differ from 2013 as Indonesia sovereign credit rating was affirmed as investment grade in 2018. Even with the ongoing concern of Covid-19 outbreak Indonesia's rating remained maintained (Exhibit 18).

Exhibit 16. Indonesia Actual Inflation vs Target (%)



Source : BPS, Bank Indonesia

Exhibit 17. Real Yield Comparison Across DM & EM (%)



Note : as of August 20, 2021
Source : Bloomberg, Trading Economics, MNCS Calculation

Exhibit 18. Indonesia Historical Credit Rating

Period	Rating				
	S&P	Fitch	Moody's	R&I	JCRA
2011	BB+	BBB-	Ba1	BB+	BBB-
2012	BB+	BBB-	Baa3	BBB-	BBB-
2013	BB+	BBB-	Baa3	BBB-	BBB-
2014	BB+	BBB-	Baa3	BBB-	BBB-
2015	BB+	BBB-	Baa3	BBB-	BBB-
2016	BB+	BBB-	Baa3	BBB-	BBB-
2017	BBB-	BBB	Baa3	BBB-	BBB-
2018	BBB	BBB	Baa2	BBB	BBB
2019	BBB	BBB	Baa2	BBB	BBB
2020	BBB	BBB	Baa2	BBB+	BBB+
2021	BBB	BBB	Baa2	BBB+	BBB+

Source : DJPPR

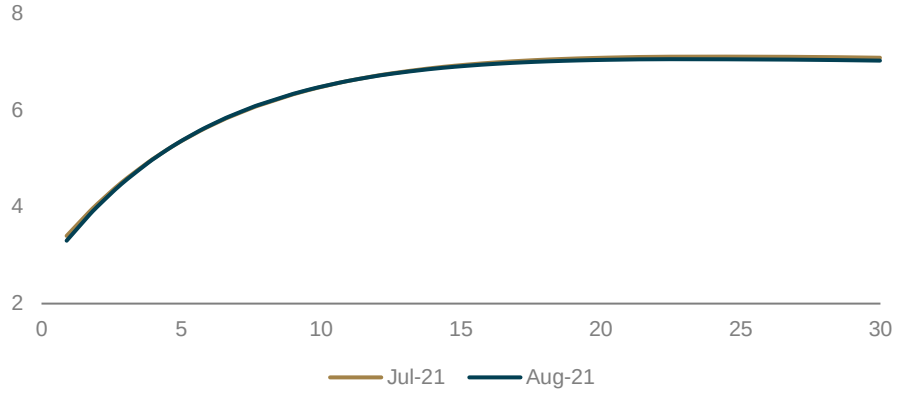
On a valuation perspective, we see that the rupiah denominated government bond is currently traded at its fair yield (Exhibit 19-20) with a narrowing spread after adjusting for the risk premium (Exhibit 21).

From a Valuation Perspective, the 10 Year Indo GB is traded at it fair yield

Exhibit 19. The 10 Year Indo GB Fair Yield Valuation (%)

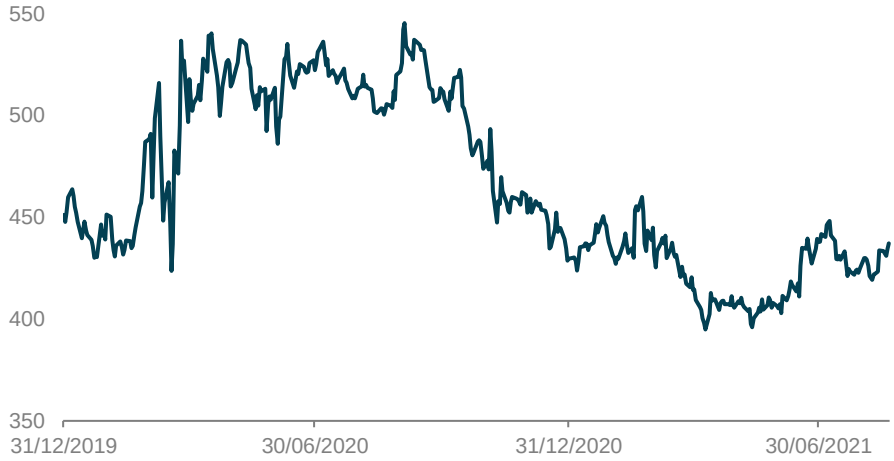
Note : as of August 20, 2021
Source : Bloomberg, MNCS Calculation

Exhibit 20. Indo Government Bond Yield Curve



Note : as of August 20, 2021
Source : Bloomberg, MNCS Calculation

Exhibit 21. The US-Indo 10 Year Note Spread Adjusted for Risk Premium (bps)



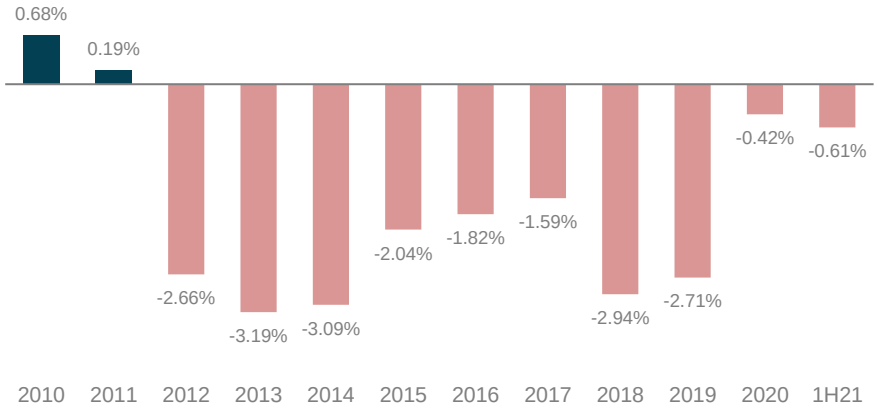
Note : as of August 20, 2021
Source : Bloomberg, MNCS Calculation

Rupiah fundamental and stability are supported by a manageable CAD and adequate FX Reserves

We also understand that what markets worry during tapering period is pressure on domestic currency which is rupiah. Besides, we expect the relative outflow to be minimum, rupiah's fundamental and stability are also supported by a manageable current account deficit and adequate FX reserves for intervention. Also the DNDF market provide a greater support for BI to maintain the stability of the domestic currency.

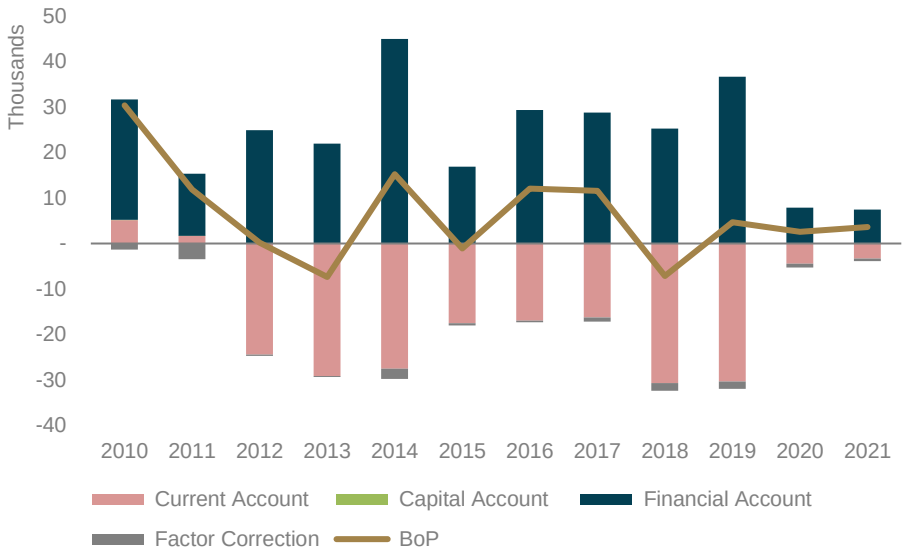
In 2Q21 CAD widened as the domestic economy condition improved. In the 1H21 the CAD stood at 0.61% GDP. This was relatively low compared to 2013-2015 as the CAD was more than 2% GDP (Exhibit 22). Narrowing CAD was also followed by a surplus in BoP. During the 1H21, Indonesia successfully managed a surplus USD3.62bn BoP (Exhibit 23). Together with fifteenth month straight of trade surplus which spurred FX reserves to USD137.3bn in July-21 (Exhibit 24), we see a strong fundamental of rupiah. Therefore we expect the shock due to tapering would be minimum and would not last longer.

Exhibit 22. Indonesia Current Account Balance (%GDP)



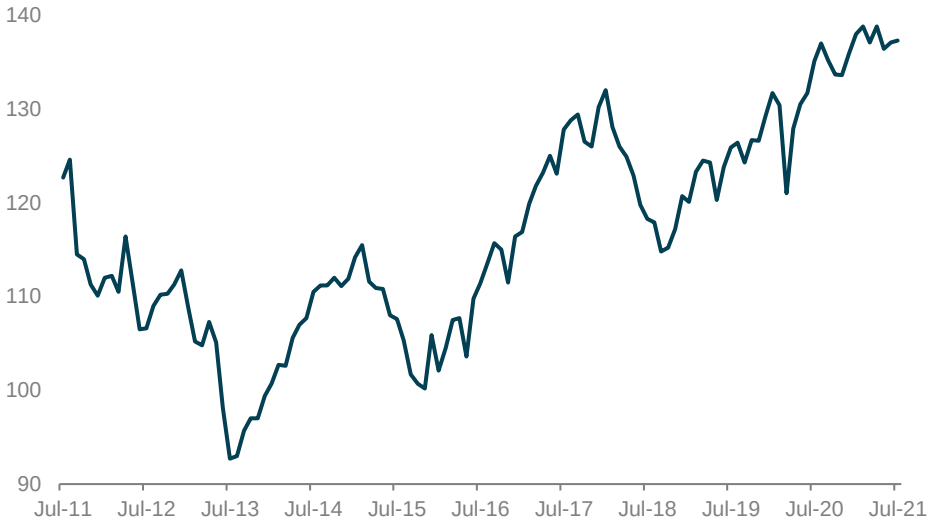
Source : Bank Indonesia

Exhibit 23. Indonesia Balance of Payments (USD mn)



Source : Bank Indonesia

Exhibit 24. Indonesia FX Reserves (USD bn)



Source : Bank Indonesia

MNC Research Industry Ratings Guidance

OVERWEIGHT: Stock's total return is estimated to be above the average total return of our industry coverage universe over next 6-12 months

NEUTRAL: Stock's total return is estimated to be in line with the average total return of our industry coverage universe over next 6-12 months

UNDERWEIGHT: Stock's total return is estimated to be below the average total return of our industry coverage universe over next 6-12 months

MNC Research Investment Ratings Guidance

BUY : Share price may exceed 10% over the next 12 months

HOLD : Share price may fall within the range of +/- 10% of the next 12 months

SELL : Share price may fall by more than 10% over the next 12 months

Not Rated : Stock is not within regular research coverage

PT MNC SEKURITAS
MNC Financial Center Lt. 14 – 16
Jl. Kebon Sirih No. 21 - 27, Jakarta Pusat 10340
Telp : (021) 2980 3111
Fax : (021) 3983 6899
Call Center : 1500 899