A lower yield trend : the nexus of macro-factors

Key Takeaways

- Domestic LCY government bond started 2023 with the strong rebound and buoyed by offshore investors fund flows. We believe lower yield trend may be elaborated from the macro points of view
- Disinflation and global slowdown to potentially ending the aggressive tightening. Moreover BI also signaled the 25 bps hike in Jan-23 to be the terminal rate citing a sufficient yet accommodative enough backing a stable price
- Recent IDR appreciation was driven by foreign inflows to SBN market and coupled with BI monetary operation through DHE FX TD to overcome FX liquidity and stabilize IDR.
- Fiscal consolidation to ensure supply side risk remain manageable while at the same time liquidity in the banking system stays adequate
- BI intervention namely through operation twist causes yield to flatten making short-term yield more competitive, yet maintaining long-term yield to spike less. This should provide opportunity for investors to optimize return
- A lower yield is likely and reasonable, we revise down our target for 10-year LCY benchmark at 6.58%/7.09%/7.68% implying a best to worst scenario, lower than our previous forecast

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Starting off with a strong rebound. The 10-year benchmark LCY yield even fell 30 bps to 6.61% in just 3 weeks, supported by massive inflows from foreigners of up to > IDR 36 trillion. Financial market conditions in early 2023 seemed to reverse last year's trend when the stock market benefited from massive portfolio inflows. The question now is whether this trend will be sustainable or only depicting a short-term rebound. Despite the looming uncertainties, some factors may playout to drive yield lower this year.

Disinflation and global slowdown to potentially ending the aggressive tightening. Softening commodity prices, slowing trade, contraction of manufacturing activity and the weakening of the USD is likely to send the world's economy entering a period of disinflation. And thus, a hope for ending the aggressive rate hike cycle sparks. In spite of dissenting opinion among FOMC participants on what should be a peak rate at above or lower 5.5%, either way, the risks are still tilted to the downside. On the other hand, BI has made a cumulative increase in interest rates by 225 bps since August-22, most recently in January-23 by 25 bps in line with consensus. BI views that this increase is sufficient to anchor inflation if there are no extraordinary conditions sending a signal of the terminal rate. Besides the not-so-hawkish statement from domestic central bank, inflation is indeed manageable. Note that headline peak at 5.95% whist core inflation remained below 4.00%. The signal has sent government bond to rally.

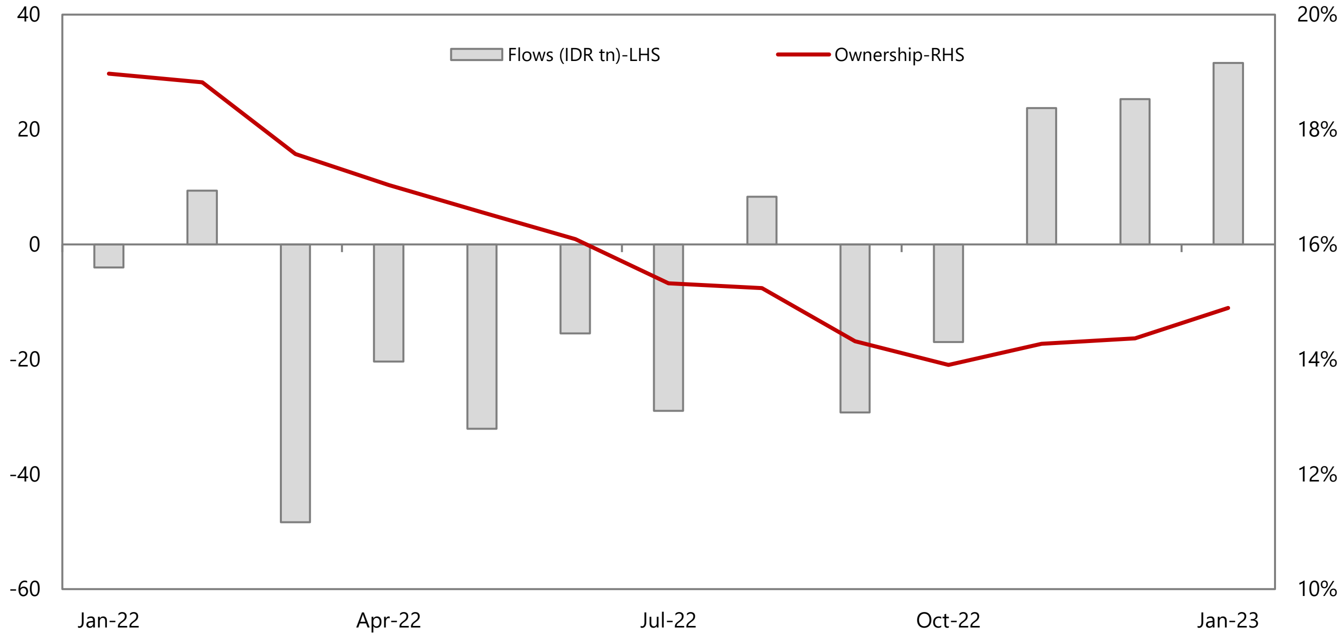
What's behind recent IDR appreciation is much awaited policy response. Apart from being supported by massive inflows to the SBN market, IDR has also strengthened in response to monetary operations through DHE Forex TD aimed at bringing back liquidity generated from international trading activities. Indonesia recorded a surplus of USD54.46bn throughout 2022 and became the highest record in history. With this DHE FX TD policy, exporters can place their funds domestically and obtain competitive rates as well as special tax treatment. This policy response is objected to overcome any domestic FX liquidity constraint that may weaken IDR and thus worsening inflation outlook through exchange rate pass-through.

Manageable supply and sufficient liquidity. Fiscal consolidation plays a key role in managing government bond supply risks in 2023. Based on the provisional 2022 realization figures, the budget deficit is IDR464tn (-2.38% GDP) or much lower than the outlook -3.92% GDP. In 2023, the deficit is targeted at IDR598tn (-2.85% of GDP). Please note that in 2023 there will no longer SKB III policy. The value of the gross issuance of SBN is estimated to be in the range of IDR 1,000-1,200tn. However, given the estimated SAL position at IDR285tn at the end of 2022, its use will reduce supply side risk. On the other hand, liquidity in the banking system is also remaining ample. With an estimated credit growth of 9-11% and Third Party Funds growth at 7-9%, banking LDR this year will be in the range of 85-86% and thus banks will still have liquidity space of IDR470-480tn after taking into account reserves requirement. Not to mention the OJK regulation which requires banks to have a minimum core capital of IDR3tn. The fulfillment of these regulations by small banks through rights issues has added liquidity in banking at least IDR 13tn which can be placed in BI or SBN instruments.

Flattening yield curve open up opportunity for investors. The abundant liquidity in the banking sector has made the policy rate is transmitted quite slowly to lending and deposit rate. Meanwhile, foreign selling pressure and monetary operations through the operation twist caused short-term yields to increase in response to rising inflation and interest rates. On the other hand, intervention by buying long-term tenors minimized excessive increases in yields. Even though BI will no longer buy on the primary market in 2023, intervention in the secondary market that flattens the yield curve, apart from reflecting a temporary increase in inflation, also provides an opportunity for short-term investors to optimize returns due to competitive rates. Meanwhile, long-term investors such as insurance and pension funds do not need to worry about excessive yield spike.

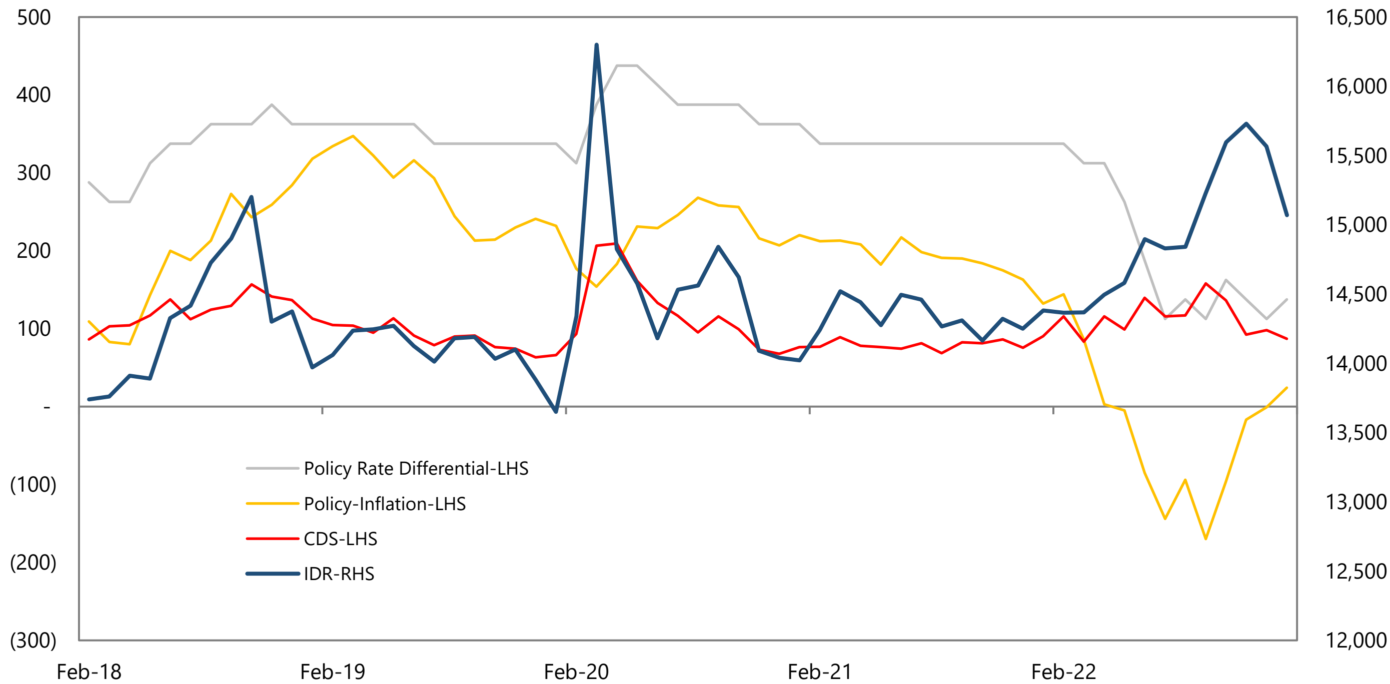
A more reasonable lower yield now. After considering the various factors aforementioned, our view on lower yields movement in 2023 is very likely. We estimate the benchmark 10-year LCY yield for 2023 in the range of 6.50-7.68% with a midpoint at 7.09%. Our new projection revises our previous forecast at 7.00-7.96%. Risk remains on the policy surprise after all the market price-in.

Exhibit 1. Foreign net bought government securities aggressively amounting >IDR30tn in early 2023 increasing its holding position and reverting last year's trend



Sources : DJPPR, MNCS Research

Exhibit 2. After depreciating last year due to outflows and rate parity concern, the IDR strengthen on the back of monetary operation through DHE FX TD which could bolster domestic FX liquidity given a record high of trade surplus



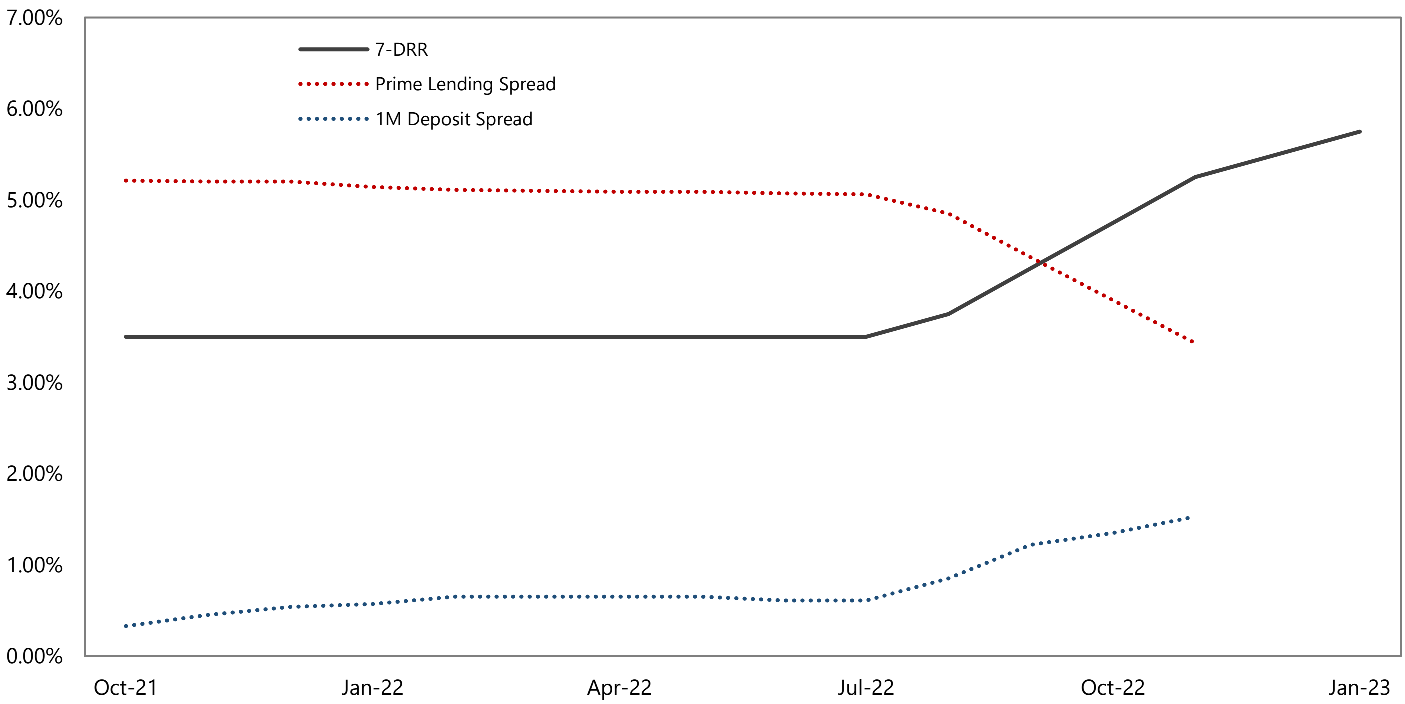
Sources : Bloomberg, Statistics Indonesia, MNCS Research

Exhibit 3. Fiscal consolidation will ensure lower government supply amidst still ample banking liquidity

	FY19	FY20	FY21	FY22E	FY23F
Budget Deficits	349	948	775	464	598
%GDP	-2.20%	-6.14%	-4.57%	-2.38%	-2.85%
Government Securities (Net)	446	1,177	878	659	713
Maturing & Buyback	475	364	475	395	480
Government Securities (Gross)	922	1,541	1,353	1,054	1,193
Auction	681	761	1,269	585	854
Avg Issuance/Auction	28.4	31.7	52.9	24.4	35.6
SAL Balance (Beginning)	175	213	388	338	
SAL Usage	15	71	144	172	
SiLPA/SiKPA	53	246	97	119	
SAL Balance (Ending)	213	388	338	285	

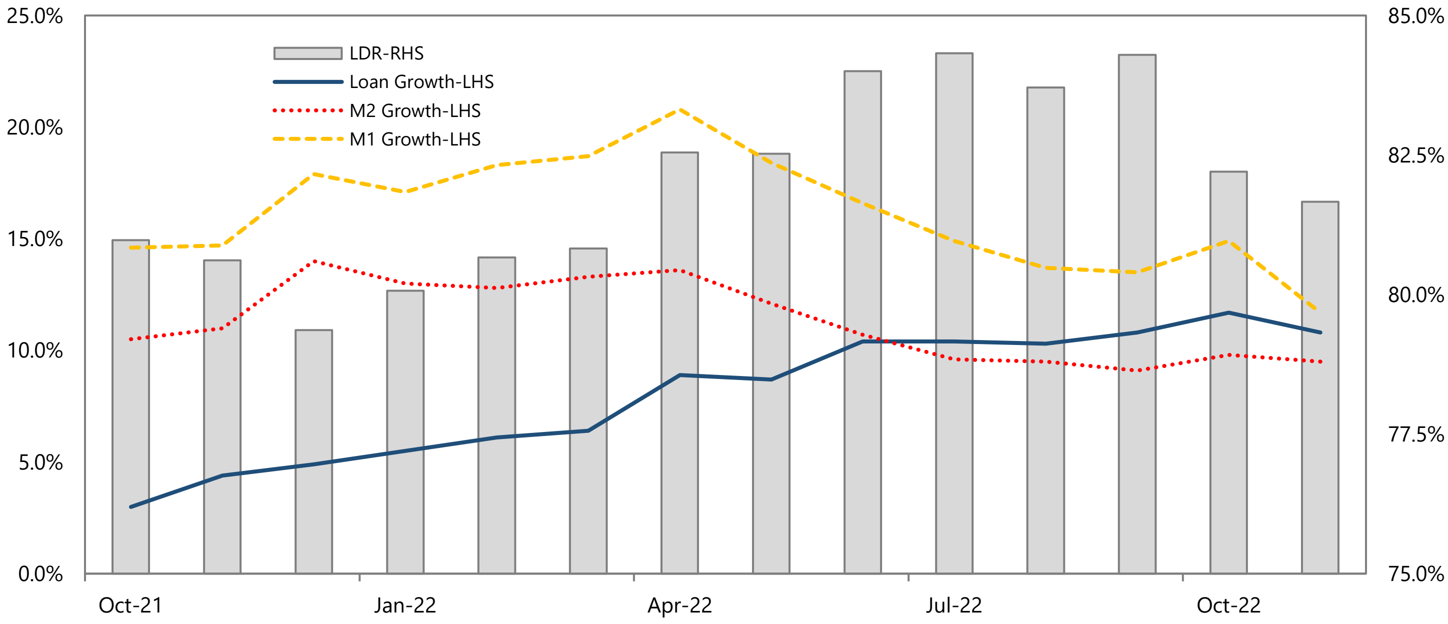
Sources : DJPPR, MNCS Research

Exhibit 4. The increase of policy rate is transmitted quite slowly in the banking funding and lending rate given its ample liquidity



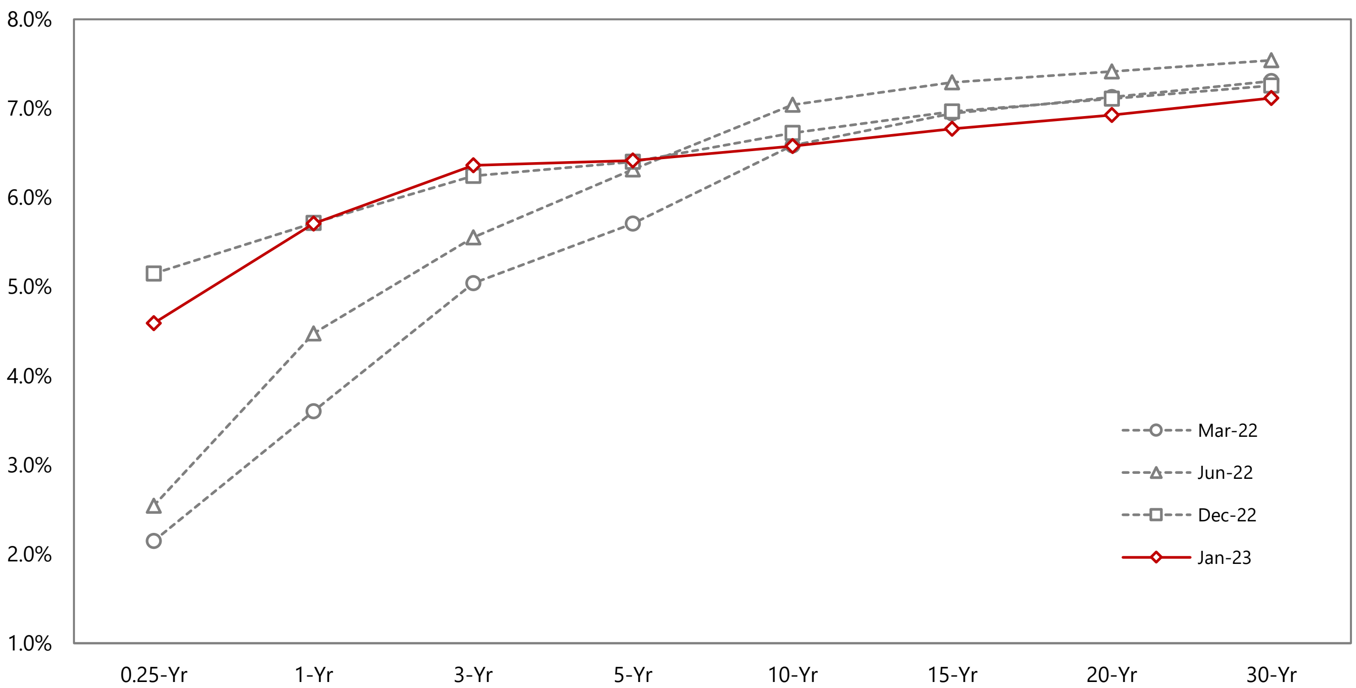
Sources : Bank Indonesia, MNCS Research

Exhibit 5. Even if third party fund grow at a slightly lower pace than loan in FY23F, banking LDR shows liquidity to remain adequate to buy government bond



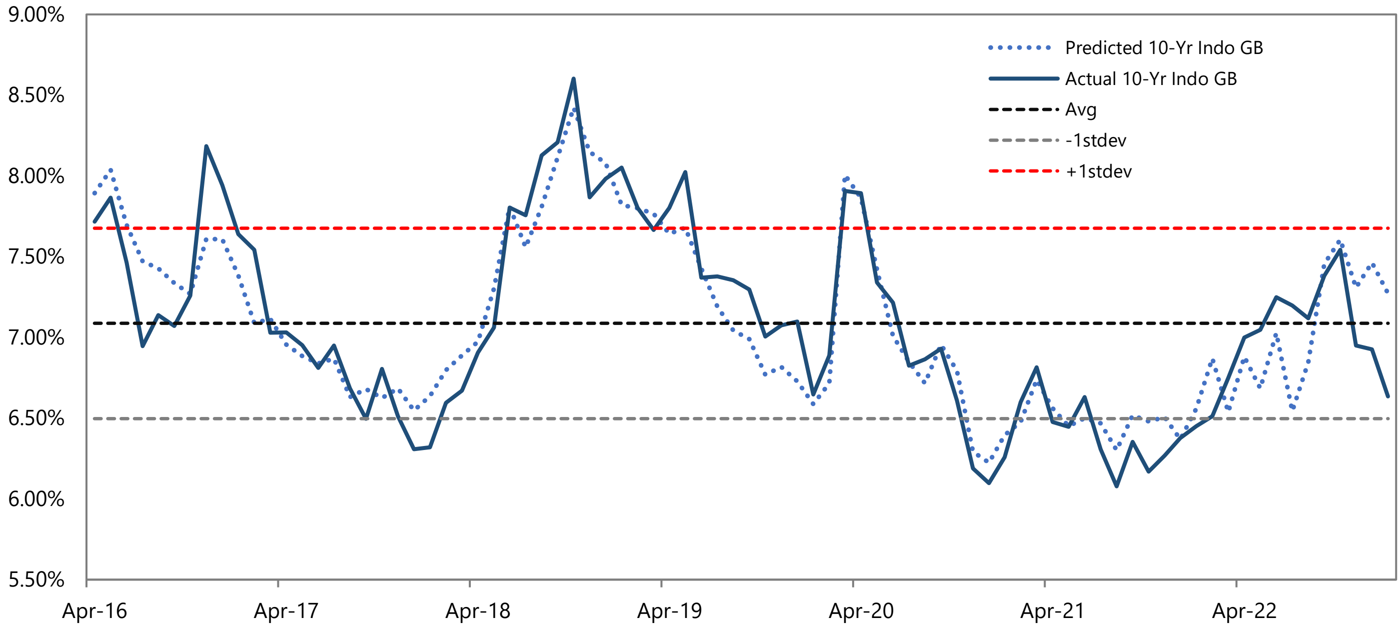
Sources : Bank Indonesia, MNCS Research

Exhibit 6. Yield curve flattening should provide opportunity for investors to gain a more competitive short-term rate and yet having a lower volatility of the longer-end at the same time



Sources : Bloomberg, MNCS Research

Exhibit 7. We revise down our 10-year yield target for FY23F to move within range of 6.50-7.68% with the base scenario (midpoint) at 7.09%, lower than our previous forecast



Sources : Bloomberg, MNCS Research

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

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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

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