Economics

DBS Flash

Indonesia: Government bonds with high quality carry

Strategy/Rates

DBS Group Research January 16, 2020

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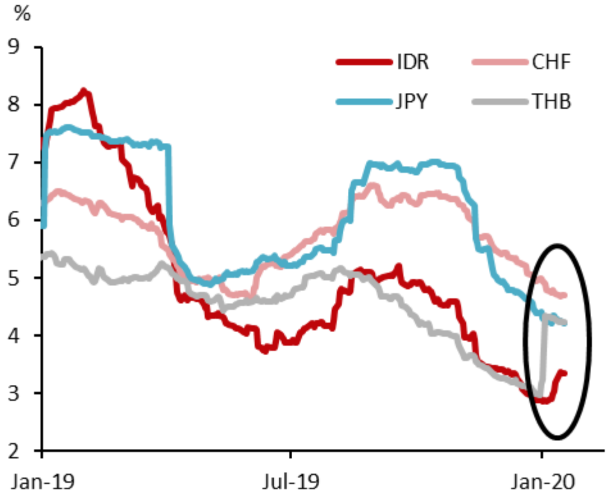
- *Within the Asian bond space, high-quality carry opportunities could outperform in 2020.*
- *IndoGBs score well across various carry criteria, notably its high yields and low FX volatility.*
- *Bond valuations are not extended; 10Y IndoGB yields can stay below 7%.*
- *Rich IDR valuations represent the main risk to our view.*
- ***Implications for investors** – IndoGBs are an attractive carry play over the next 3-6 months.*

In 2020, we expect the external environment to be supportive of EM assets amid an improving global outlook. Short-term US interest rates are expected to be rangebound and while the USD should be less supported. Within the Asian bond space, scope for large duration returns are probably limited after 2019's outsized gains. Accordingly, we think high-quality carry opportunities will likely outperform in 2020.

In our view, the Indonesia Government Bond (IndoGB) scores well across various carry criteria. Absolute yields are high with the 10Y just below 7%. IDR volatility is low, largely a result of Bank Indonesia's focus on FX stability. Monetary policy easing, in terms of extent and pace of rate cuts, has been measured. Fiscal policy has been prudent with small but manageable slippages. Domestic inflation is subdued and unlikely to be a source of pressure on yields. From a flows perspective, Indonesia's high weights in key EM bond indices (e.g. GBI-EM) ensure healthy foreign demand, as long as global risk sentiments stay positive. In our base case scenario of US rates drifting slightly higher in 2020 on a more constructive global outlook, IndoGB's steep curve would offer more buffer/protection relative to Asia low-yielders.

3M FX volatility - IDR volatility has kept falling, now below some DM and Asia LY currencies



Source: CEIC

When we compare IndoGBs to peer EM high-yielders, IndoGBs clearly rank well. In short, we think IndoGBs possess superior carry qualities and would be an attractive carry play over the next 3-6 months.

	Indonesia	India	Brazil	Mexico
10Y yields (%)	6.868	6.627	6.794	6.849
Rank	1	4	3	2
FX volatility (%)	3.36	3.97	10.62	6.77
Rank	1	2	4	3
Inflation (%) *	3.5	4	3.7	3.3
Rank	2	4	3	1
Fiscal + Current Account deficits (% of GDP) *	-4.5	-5.3	-8.2	-3.6
Rank	2	3	4	1

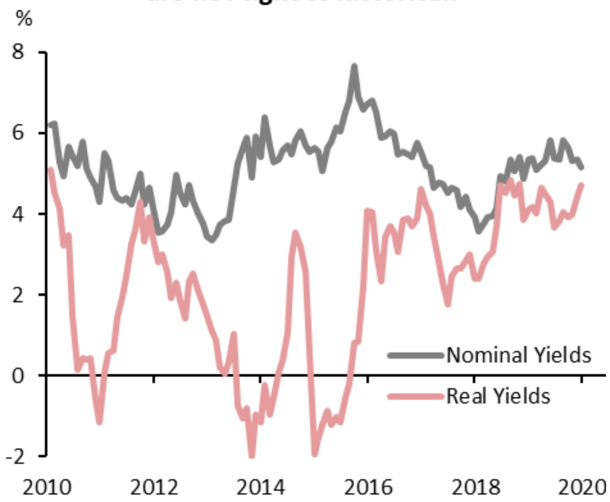
* 2020 Bloomberg Consensus

Can 10Y yields stay below 7%?

10Y IndoGB yields recently broke below 7%, a level which has historically proven to be a floor. Understandably, there have been concerns within markets that bond valuations could be getting too extended. In our view, 7% is just an absolute level. In a world of low global rates and ample liquidity, looking at IndoGB yields on a relative basis would make more sense.

From the perspective of foreigners - largest owner group at 39% - spreads to US Treasuries are far from tight.

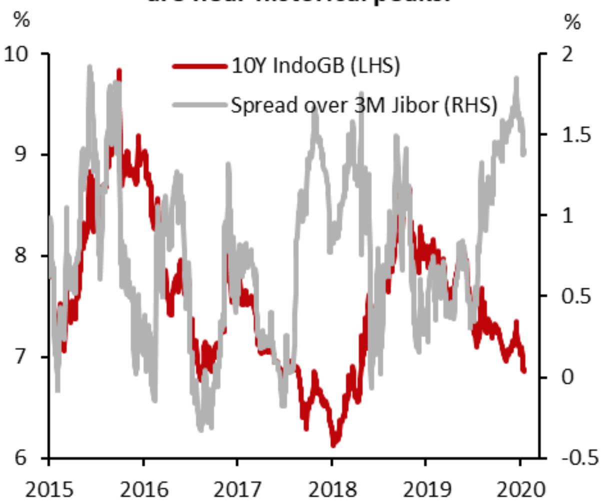
10Y IndoGB-UST yield differentials are not tight vs historical.



Source: Bloomberg

From the perspective of local banks - 2nd largest owner group at 24%, IndoGBs are attractive relative to funding cost (we use Jibor as a proxy). Notably, spreads are at wide levels (~1.5%) which typically precedes IndoGB rallies.

10Y IndoGB-3M Jibor spreads are near historical peaks.



Source: Bloomberg

Stress-testing our view - 3 key risks

When we consider the key risks to our constructive view of IndoGB as a carry play, they appear to be presently low in aggregate.

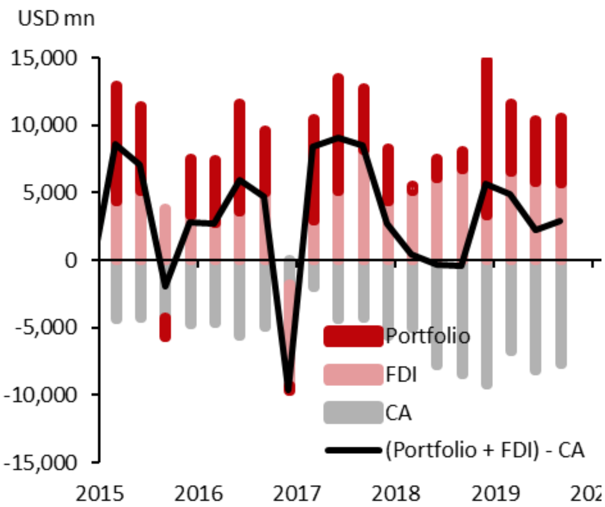
1. Much higher US rates (10Y UST > 2.75%) – Low risk

The carry attractiveness of IndoGB relies on offering a competitive yield differential over US Treasury. In the near term, US rates could drift slightly higher via modest reduction in Fed cut pricing and some lightening of term premium. However, with the Fed on a prolonged hold and major central banks like ECB and BOJ committing to "present or lower levels" of interest rates, the prospects of US rates breaking into much higher ranges are slim.

2. Current account deficit and external funding risks – Low risk

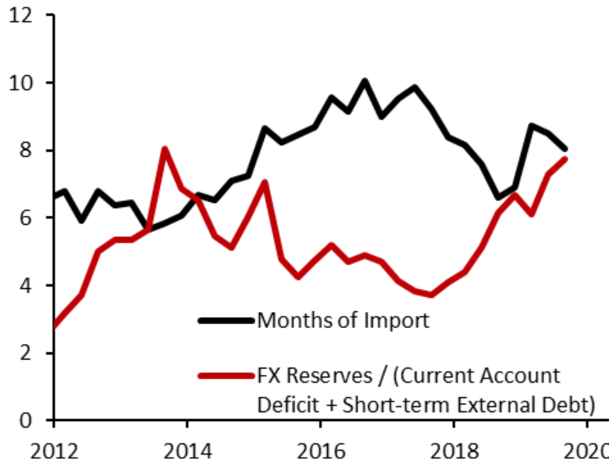
The high dependence on foreign inflows to finance the current account deficit is always a perennial concern amongst investors, due to its implications for IDR volatility and IndoGB yields. In our view, Indonesia's external funding and FX reserves positions have seen consistent improvements over recent quarters and thus, we are not overly concerned. Though there could be some pressures on the current account from increased infrastructure spending in President Jokowi's second term, we expect some offsets from recent policies aimed at tightening the deficit, such as the launch of B30 biodiesel policy and the banning of nickel ore exports.

Funding of Current Account Deficit



Source: CEIC

FX Reserves Adequacy



Source: CEIC

3. IDR valuations quite rich – Medium risk

The sharp 2.2% rally vs USD over the last one month has likely push IDR valuations further into rich territory. Based on REER and our DEER models (link), IDR appears to be ~4-7% above fair value. We are not discounting the possibility that IDR could give back some of its recent gains but feel that with the current external environment supportive of EM high-yielders and 1Q being a seasonally strong quarter for the IDR, any depreciation in the short term is likely to be modest rather than large/sharp.

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Sources: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations).