Panin Asset Management
Subsidiary of PT Panin Sekuritas Tbk.

QUARTERLY REVIEW

March 2013

ECONOMIC REPORT

Global Euphoria – How good is the underlying data?

Global economy witnessed a reversal in sentiment during the first quarter of 2013 as evident by stellar performance in global stock markets. Improved sentiment across many regions has led to an increase in global risk appetite, and thus lifted liquidity in the market. The S&P500 was up 10% in Q1, whereas Japan NIKKEI booked a staggering return of 19%. Emerging Markets ASEAN also benefitted from slower economic activities in the BRIC nations, with countries such as Indonesia and Philippines enjoyed large foreign inflows into their equity markets, boosting the return of the two markets to 15% and 18% respectively. Recent Bloomberg article highlighted an interesting phenomenon, stating that a number of central banks in different parts of the world have increased their holdings in equities, something that we like to call ‘search for yield’.

This raised a question whether the positive sentiments in the past couple of months were driven by real improvements in global economic data or merely expectations accommodative central banks’ policies that is taking place simultaneously across different parts of the world. To us, it is pretty clear that growth in *financial assets* in the first quarter has been to a large extent driven by central banks’ accommodative policies as opposed to improvements in the underlying economic data. From US to Japan, we believe that the central banks have played a critical role in driving asset prices up. Nevertheless, it is still too early to say how successful the policymakers are in turning those monetary expansion programs into the real sector and how sustainable these policies are in driving the real economy going forward.

In the US, the latest data suggests that economic activities are indeed showing some signs of improvement, facilitated by the FED’s support for the housing market and all-time low mortgage rates. This has clearly helped the recovery in the US housing market, which in turn drives consumption. In other regions however, the underlying data remains quite weak, particularly in Europe and BRIC to some extent. Key economic data coming from Europe has not shown much improvement since the ECB announced its commitment to do ‘whatever it takes’ to save the euro-nation (August 2012). The region has experienced five straight quarters of contraction and the most recent Purchasing Manufacturing Index in April remained as low as 45.6 and also not to forget that unemployment rate rising to a record high of 12.1% in March. This has prompted the ECB to cut rate to record low of 0.5% and we are not surprised to see another round of monetary action to stimulate the economy.

Moving to Asia, Japan surprised many investors and has joined their counterparts in the US and Europe in embarking a significant monetary expansion plan to boost economic growth and inflation target of

2%. While the new Japanese central bank governor is the same guy who called for a 3% inflation back in 2002, yet inflation never reached above 0.5% until 2008, this time the mandate is slightly different. Bank of Japan has now set up a clear target as opposed to a more general objective.

Looking at the bigger picture on recent developments, one thing is clear to us. The three main economic giants, US, Europe, and Japan, are on a mission to boost economic growth through unconventional central bank policies. And this has boosted investors' confidence in the search for yield and hence, drove global liquidity in the equity markets over the past couple of months.

Indonesia's Economy – One step backward

In Indonesia, recent economic data has shown a bit of pullback highlighted by slowdown in investments to 7.3% in Q4 2012 and inflation accelerated to 5.9% in March before pulling back to 5.6% in April. In addition, the USD 7.0 billion reduction in Bank Indonesia's FX reserve to USD 105 billion in April raised some eyebrows in terms of the central bank's role in intervening in the FX market. We have underscored some of these concerns in the previous *Quarterly Review (December 2012)*, particularly in relation to slowdown in investments as well as rise in inflation. Interestingly but not too surprising, this view was shared by the World Bank on their latest economic report on Indonesia titled *Pressures Mounting*. Although they remain optimistic in terms of Indonesia maintaining a solid pace of growth, the bank highlighted the upcoming pressures in relation to moderating investment growth and quality of domestic policies in the run-up to 2014 elections. What is more important in our view, the World Bank stressed that without progress on policy reforms and its implementations, Indonesia may miss a room for growth at a time when the economy is benefiting from a growing labor force.

Investment Growth – Reliant on the strength of domestic economy

In terms of slowdown in investment growth in the fourth quarter last year, we expect this to somewhat recover in the course of the year as evident from the increase in FDI of 27% in Q1 2013 compare to the same period last year (BKPM data). One reason why we remain quite optimistic on investment growth is the strength of our domestic economy. Majority of foreign direct investments comes to cater domestic economy as opposed to export oriented. This makes a lot of sense considering the size of the economy and weak domestic policies which are not always accommodative towards export oriented companies. As a consequence, we need to pay very close attention to the strength of our domestic consumptions. Softening domestic consumptions will likely lead to slower investments, and hence impact GDP growth considering these two components account for more than three-quarter of Indonesia's economy.

Inflation - Recent spike was temporary, but inflation expectation is rising on the back of fuel policy

The recent spike in consumer prices was mostly driven by flooding in January, as well as import restrictions. We are quite confident that this kind of spike should be temporary in nature. The latest April figure was quite encouraging with consumer prices recorded a deflation of 0.1%, bringing down headline inflation to 5.6%. In addition, we view core inflation which has been relatively stable at below 4.5% to a good sign of improvements in our economic structure. Nevertheless, we do not undermine the potential pressure in inflation in the next couple of months as a result of the potential increase in fuel price. The latest sensitivity analysis from Bank Indonesia shows that for IDR 1,000 increase in fuel price will contribute to an increase in inflation of 1.6% (direct impact +0.62%, increase in public transportation +0.78%, and indirect impact +0.23%). We believe Indonesia's economy is strong enough to weather this temporary increase in inflation. Even so, we believe an increase of IDR 1,000 is too little as we favor for higher increase considering the longer-term impact to our state budget is much more important than the temporary spike in consumer prices.

Domestic Policy – The weakest link

At times when Indonesia's economy is on the sweet spot to grow at its optimal level, it is unfortunate to see that weak domestic policies are stalling the process. Similar with the view from the World Bank, we have argued for a long time that the government must be more decisive and less political when making critical calls including the issue on fuel subsidy. At the writing of this report, the S&P has just downgraded the outlook on Indonesia's sovereign rating from positive to stable on the back of weakened policy environment. This is not surprising considering the latest developments on Indonesia's fiscal policy.

Outlook

Our view has not changed that much since our latest *Quarterly Review*. We have witnessed increasing stability in global economy, although it is fair to say that the underlying economic data has not picked-up as much as we would like to. Nevertheless, with simultaneous central banks accommodative policies across different parts of the world set to continue, we expect to see gradual recovery in global economy in the coming quarters. As for Indonesia, we continue to be bullish on the long-term outlook as fundamentally we have relatively strong economic pillars. Nonetheless, the challenges in the short-term are increasing and we need to be careful not to enter into this trap where our economy is unable to grow at its optimal level. Domestic policy is one thing that our government should not take for granted. The recent downgrade by S&P may have been avoided if the government had been more decisive. In a way, we have no one else to blame since the problem is of our own making. It is fair to say that we just shot our self in the foot!

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