QUARTERLY REVIEW

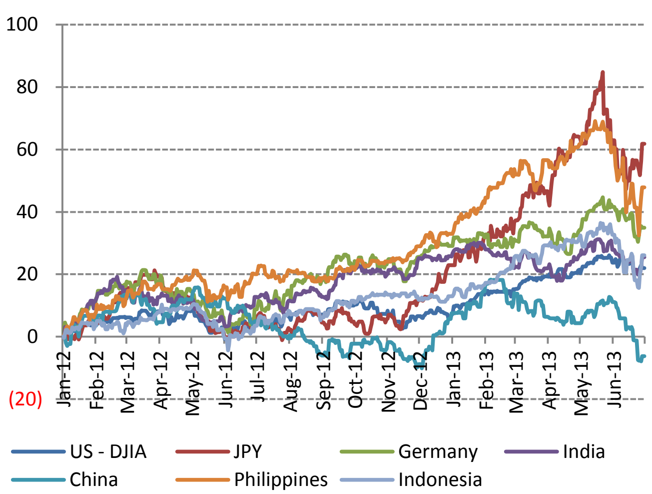
June 2013

ECONOMIC REPORT

The End of Euphoria – Perception vs. Reality

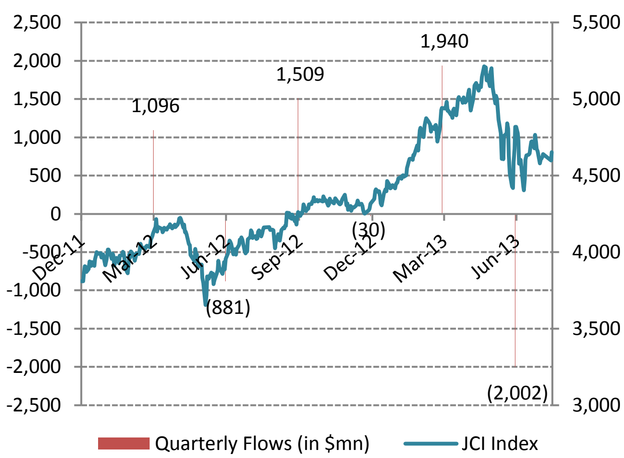
A strong reversal in sentiment was seen across global capital markets following Ben Bernanke's comment on May 22nd that signals the central bank is contemplating to reduce the monthly USD 85 billion bond purchase program in the US. The news triggered massive outflows from global stock and bond markets, particularly Emerging Markets, sending monthly returns of these two asset classes into the negative territory. Data from EPFR suggests that total outflows from Emerging Markets equities were USD 19.9 billion in June alone, outstripped the previous record of USD 18.7 billion in January 2008, and wiped out the entire inflows booked from January to mid-May 2013. After enjoying a positive run during the first couple of months of the year, all Emerging Market equities with the exception of Malaysia reported negative performance in June (see Figure 1 below).

Figure 1: Global Equity Market (2012: Index)



Data: Bloomberg, Panin Asset Management

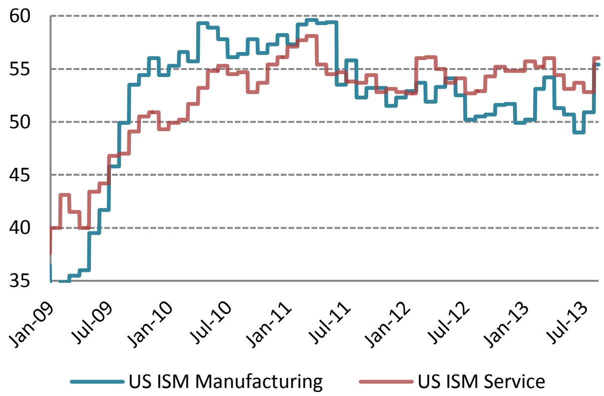
Figure 2: JCI Index and Foreign Flows



Data: Bloomberg CS Research, Panin Asset Management

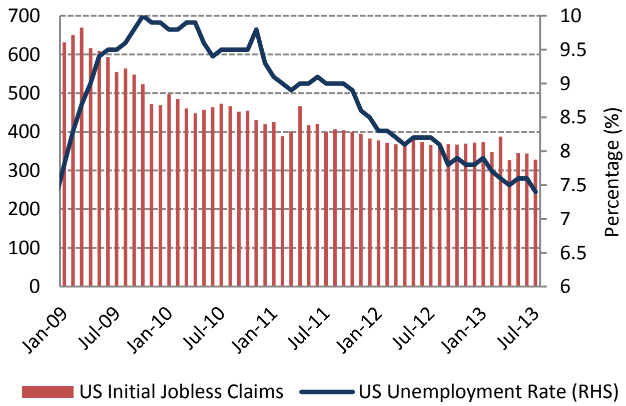
Global investors were caught off-guard during the latest corrections as they did not anticipate the US Fed to come out with such statement as early as they did. Over the past few months, the US economic data is consistently turning more positive as suggested by pick-up in consumer spending (Figure 6), improvements in jobs number (Figure 4), and manufacturing data finally started to accelerate quite strongly in July 2013 (Figure 3). The US economic recovery has been boosted by the housing markets and to some extent gains in stock market (S&P500 ytd +19.5%) – a central-bank led recovery. With inflation still running well below Fed's target of 2.0% over the past 14 months, the recovery remains vulnerable in our view, and it may take several more quarters before we see stronger evidence of a sustained pick-up in the real sectors and more consistent manufacturing data. Nonetheless, it is clear that Fed is getting more comfortable with the outlook of the US economy, and of the view that they are ready to *adjust* its bond purchase program during the second half of this year (first tapering is predicted to take place in September 2013) - assuming the US economic data will not deteriorate in the coming months. We do not necessary view this as tightening by the policy makers, but merely as lifting its life support to the US economy.

Figure 3: US Manufacturing Data Accelerated



Data: Bloomberg, Panin Asset Management

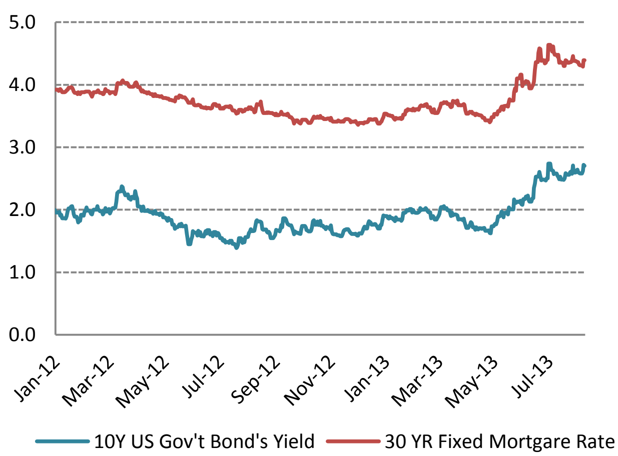
Figure 4: US Labor is Picking Up



Data: Bloomberg, Panin Asset Management

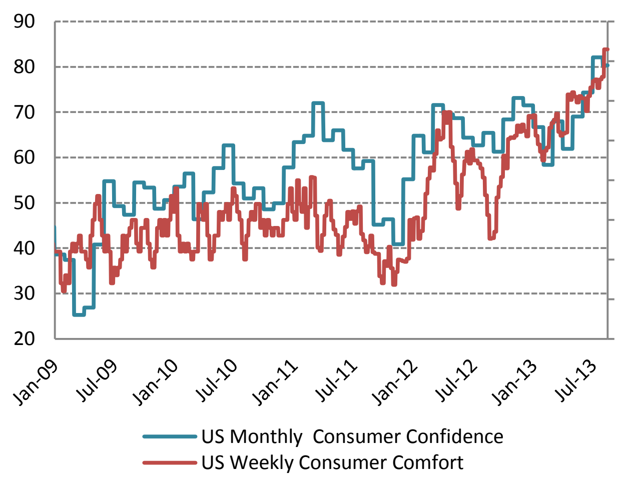
Meanwhile, Bernanke's comment in May sent the US 10-year government bond yields skyrocket to 2.6% as end of June, an increase of almost 100bps from its 2013 lowest level of 1.6% at the beginning of May (Figure 5). As a consequence, 30-year fixed mortgage rates also jumped from an average of 3.6% in Jan-Apr 2013, to 4.6% in July. We believe the sharp increase in mortgage rates could undermine the recovery in the US housing market, as a big portion of home buyers still rely on mortgages. It will be interesting to see how this plays out in the next few months, as it is critical for the Fed to maintain consumer confidence high through a sustained recovery in the housing markets.

Figure 5: US Yields (in %)



Data: Bloomberg, Panin Asset Management

Figure 6: US Consumer Confidence is Rising



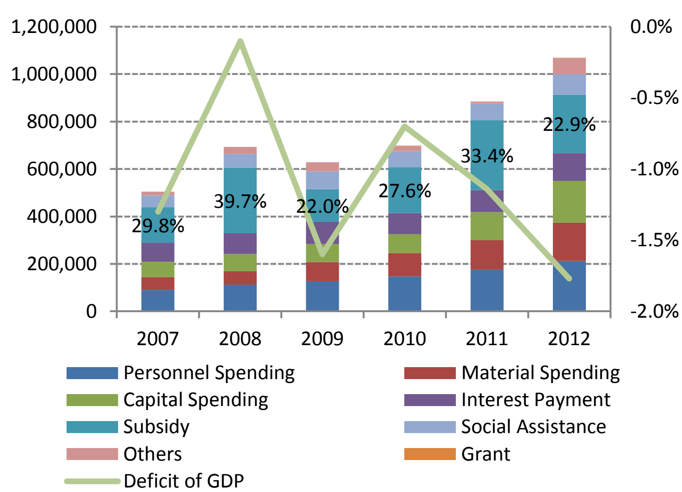
Data: Bloomberg, Panin Asset Management

The heavy corrections in May/June shows that the remarkable gains in global capital markets during the first quarter of 2013 *(see Quarterly Economic Review March 2013)* were fueled by central banks' easy money – thus, driving positive perceptions in the capital markets. With hindsight, it is quite clear that price of certain financial assets prior to the corrections were somewhat detached from economic reality. The underlying global economic fundamental is not as strong compared to what was suggested by the gains in the in capital markets prior to the corrections. Recent economic report published by the World Bank (June 2013) highlights that the bank has revised 2013 global economic growth downward, both for Developed and Emerging economies, against its earlier projections published in January 2013. Despite the downward revisions, it is somewhat comforting to notice that Indonesia remains one of the fastest growing countries globally, with growth of 5.9% this year and 6.2% in 2014.

Indonesia Economy - Inflation, GDP, and Currency Heading in the Wrong Directions

It was a busy period in the domestic market during the second quarter. The long-waited fuel-price hikes finally took place in June with subsidized petroleum price increased by 44% and diesel by 22%. The move will help ease pressure on government's budget given fuel subsidies account for 14.3% (Figure 7) of total budget in 2012. The reform is clearly credit positive for Indonesia in the longer-term, however, not without short-term pain. Inflation accelerated to 3.29% in July driven by food price and transportation tariff, and yearly headline inflation surged to 8.61%. With the timing of the fuel-price hike coincided with Ramadan and back to school period, July inflation came out considerably higher than Bank Indonesia's prediction. Nevertheless, the spike should be one-off in our view, as seen during the previous fuel hikes in 2005 and 2008. Assuming the government is successful in containing second round inflation, we expect inflation to moderate in 2014, returning to central bank's long term target range of 4.5% +/- 1%.

Figue 7: Govt Expenditures Breakdown (IDR trillion)



Data: BPS, CEIC, Panin Asset Management

Figure 8: Indonesia's GDP Composition

YoY	3Q12	4Q12	1Q13	2Q13
GDP	**6.16%**	**6.11%**	**6.03%**	**5.81%**
Consumptions	4.50%	3.91%	4.70%	4.70%
Private Cons	*5.57%*	*5.36%*	*5.17%*	*5.06%*
Govt Cons	*-2.81%*	*-3.34%*	*0.42%*	*2.13%*
Investment	9.80%	7.29%	5.78%	4.67%
Export	-2.56%	0.50%	3.57%	4.78%
Import	-0.17%	6.79%	-0.06%	0.62%
Net Export	-2.38%	-6.28%	3.63%	4.16%

Data: CEIC, Panin Asset Management

Turning into currency, interestingly Indonesian rupiah was one of the strongest currencies in the region during the early stage of the heavy corrections in May/June 2013. This was no surprise given the heavy intervention from Bank Indonesia to keep USD/IDR below 10,000 levels. The central bank supplied a large amount of USD to the market to help finance capital outflows. The move came at a hefty price, a reduction in FX reserve by USD 7.0 billion in June to USD 98.1 billion and another USD 5.4 billion in July to USD 92.7 billion. An imbalance between supply and demand for FX (limited FX supply from exports & capital inflows vs. high FX demand to finance imports, external debt, and dividend repatriation) has led the central bank to step in the market. However, it is clear from rupiah stand of point, the heavy currency intervention from the central bank in earlier months has not allowed the rupiah to move according to its fundamental, and unsurprisingly, over the past couple of weeks, we see the rupiah weakening to USD/IDR 10.300, a level which we believe is closer to Indonesia's economic condition.

Indonesia printed GDP growth of 5.8% in Q2 2013, the weakest in the past 11 quarters (Figure 8). The result raised some concerns, particularly looking at Investment growth, one of the main engines of the economy, coming down from 9.8% last year to 4.7% in the second quarter this year. On a positive note, private consumptions, the largest component of the economy remains quite healthy, growing at 5.1% year-on-year. While some argued that the recent increase in fuel price may weigh down on private consumptions, we believe the impact should be manageable, considering the sharp increase in minimum wage at the beginning of this year. All in all however, Indonesia's GDP may still face some pressures in the coming quarters as export of commodity will likely to remain sluggish, while it is hard to predict growth in Investment. Looking at the short/medium term macro headwinds, as well as uncertainties on government regulations such as next year's minimum wage increase and impact from upcoming elections, we think the outlook of Investment growth may stay uncertain in the near future.

Is Bank Indonesia Turning Hawkish?

Bank Indonesia's newly elected governor, Agus Martowardojo, surprised the market with a 25bps hike in June, followed by another 50bps in July, lifting the benchmark rate to 6.5%. While it was initially hard to understand the reason behind such policy tightening, considering Indonesia is currently experiencing slowdown in GDP, we see the nature of the tightening is temporary. It is clear that part of the tightening is to contain weakening in currency and capital outflows, given the current spike in inflation led by fuel-price hike should not be long lasting. Even with an increase in benchmark rate by 75bps, rupiah continues to deteriorate, trading at USD/IDR 10.300 level as of Aug 13th. This suggests that in current market environment, the rupiah could have gone much weaker had Bank Indonesia not intervene in the market.

Looking ahead, we argued that the central bank will start to ease again once inflation normalizes, albeit at a slower pace compare to the recent tightening considering Indonesia's current account issue will continue to haunt the economy and thus, the currency. Nonetheless, we do not think that Bank Indonesia is turning hawkish under the new regime. It is simply that Indonesia's economic fundamentals have slightly weakened, and combined with external instability, there are certain measures that the central bank needs to take to mitigate the impact to the economy.

Conclusion – Indonesia is Temporarily Out of Favor

It is clear that Developed Market economies are showing signs of gradual improvements with US and Europe slowly coming out of recessions, whereas Emerging Markets, particularly the four BRIC nations are coming off the boil and heading in the opposite direction. Emerging Markets are facing their own domestic issues, with countries such as China and Brazil may need to structurally adjust their economic models, whereas Indonesia and India should address its policies in order to increase its economic output to the optimal level. Structurally, Indonesia's economy still has very large potential, however, without harmonization in government policies, it might be challenging to maintain growth above 6.0% in the coming years in the absence of export recovery. With GDP slowing down, inflation peaks, current account deficit remains, and recent corporate earnings were just modest, it is quite easy to understand why Indonesia is currently out-of-favor – as seen in reduction in foreign flows to the capital market and also foreign investments. Nonetheless, with only very few economies in the world still growing consistently above 5%, coupled with public debt to GDP below 25% and healthy banking sector, it is hard to ignore Indonesia as a whole. We therefore believe that it is just a matter of time before Indonesia returns to the radar screen.

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