18 March 2025, 08:21AM UTC
Chief Investment Office GWM
Investment Research

JCI hits circuit breaker amid domestic uncertainties

Blog

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What happened?
The Jakarta Composite Index slumped as much as 7.1% on 18 March—the worst intra-day drop in 14 years. The sell-off was triggered by rumored changes to the cabinet and revisions to military law, as well as ongoing concerns over the fiscal outlook. Trade on the Indonesian stock exchange was halted for 30 minutes after an initial 5% slide tripped circuit breaker rules. The index ended the day down 3.8%. The currency saw little movement, however, with the Indonesian rupiah falling by around 0.5% against the US dollar amid reported central bank intervention.

Local media reports that veteran finance minister Sri Mulyani Indrawati may stand down in a cabinet shake-up were a key trigger point for the market slump. Sri Mulyani told reporters later on Tuesday she would not stand down and said investors remained confident in the government's fiscal stance. Indonesia's legislature has fast-tracked discussions to revise the military law to potentially allow active soldiers to hold civilian positions, extend the retirement age, and place TNI (Indonesian military) under the coordination of the Ministry of Defense.

Tuesday's volatility also follows news that the Indonesian government plans to consolidate its ownership of all state-owned enterprises (SOEs) under a single investment holding company, called Danantara, which reports directly to the president.

What do we think?
While growing domestic risks will likely hang over Indonesian assets and induce a temporary period of capital outflows and exchange rate weakness, we do not think this bout of uncertainty will worsen into a broader crisis.

Economic growth is still on track to hit 5% this year, according to our estimates, a level below the new administration's targets (of 8%) but in line with previous quarters. Inflation remains well-behaved and below pre-COVID lows. We think the central bank has room to lower rates down the road, but it may delay cuts for now to help ease IDR weakness.

Potential changes to the cabinet will be closely watched by foreign investors, though Sri Mulyani's denial late Tuesday may help quell concerns in the near term.

How to invest?

Equities: A higher risk premium is now warranted
With external headwinds already elevated, investors must now contend with domestic uncertainties in Indonesia around the role of the sovereign wealth fund and its governance, concerns over fiscal discipline, and potential cabinet changes.

Valuation multiples have tumbled to a 10x forward P/E, compared to a 5-year mean of 14x, while the dividend yield has risen to 6.5%, the highest among major Asian markets. Historically, such valuations have only been seen during the global financial crisis of 2008-09 and in August 2005, when surging oil costs undercut confidence.

In the banking sector, elevated US interest rates will likely continue to suppress onshore deposit growth, which in turn limits the loan growth potential of local banks. These banks are already facing a loan-to-deposit ratio (LDR) approaching 100%, indicating constrained liquidity.

Furthermore, state-owned banks are at risk of being tasked with funding projects with low returns on equity that are essential for economic growth. Despite these uncertainties likely continuing to pressure valuation multiples, it is noteworthy that the current return-on-equity ratios of these banks are approximately 3 percentage points higher than their ten-year average. This demonstrates their ability to deliver shareholder returns while navigating the challenges posed by an infrastructure-driven economic backdrop.

Into this backdrop, we rebalance our equity preferences for Indonesia to names with defensive earnings such as sharia banking firms, select consumer stocks with strong pricing power, and select logistic and supply chain companies. We note that fiscal slippage risks have risen, given the unexpected budget deficit in the first two months of 2025, the roll-back of the value-added tax hike, and the anticipated re-routing of SOE dividends to Danantara.

While not our base case, we cannot rule out a downside risk scenario where fiscal issues worsen or leadership changes spur a similar loss of confidence. In a bear case scenario, Indonesian equities could revisit 2005 levels, which would imply an additional 13% decline from current valuations.

FX and rates: Range-bound and a near-term pause
With Tuesday's move, the USDIDR spot rate has now risen by 4.6% since last November. Looking ahead, we expect the IDR will trade within a range of 16,200 to 16,600. Given lingering US tariff risks, we remain cautious about a rebound in the USDIDR back to 16,600 in the coming month.

We think the central bank may seek to moderate exchange rate weakness, which could see official FX reserves drop modestly this month and delay policy rate cuts in the near term. We think Bank Indonesia will ultimately have space for at least two rate cuts later this year.

Local 10-year bond yields have risen 20-30bps to around 7.3%—a spike that may yet extend beyond recent ranges. Limited buying via the central bank may serve to dampen this rise, with much still hanging on the policy direction going forward.

Credit: Material weakness is an opportunity
Sovereign and quasi-sovereign bonds tend to be the most liquid in the Indonesian USD credit space, and credit spreads of these issuers were largely unchanged in the wake of the equity market sell-off. However, in the lead-up to Tuesday's equity rout, we had seen modest weakness (+10-15bps) in spreads for the long-dated bonds, as the market started pricing in a more challenging fiscal backdrop.

We believe the planned consolidation of Indonesian SOEs under Danantara should not impact SOE issuer ratings, as state support should remain intact. But it could signal increased "national service" commitments and may be credit negative in the event of higher dividend payments. For now, we do not expect a material repricing in Indonesian quasi-sovereign bonds.

For Indonesian banks, credit fundamentals remain broadly healthy, capital positions are strong, and asset quality looks benign. Net interest margin (NIM) compression and liquidity pressures remain risks to watch, but we do not anticipate a material impact. Majority government ownership for our covered Indonesian banks also suggests they could tap state support, if needed.

Any fiscal changes must be closely monitored, though we don't see the deficit slipping beyond the legislated 3% level. Indonesia's fundamental metrics like debt-to-GDP compare favorably versus BBB rated sovereign peers, and we believe adequate headroom remains for its credit rating (Baa2/BBB).

With this in view, we think any material cheapening in investment grade rated bonds from here would present an opportunity. Sovereign and quasi-sovereign five-year bonds offer yields of around 4.8% and 5.1%, respectively. We also remain comfortable owning select subordinated bonds of Indonesian banks, whose yields screen wide among regional peers.

Appendix

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Version D/2024. CIO82652744