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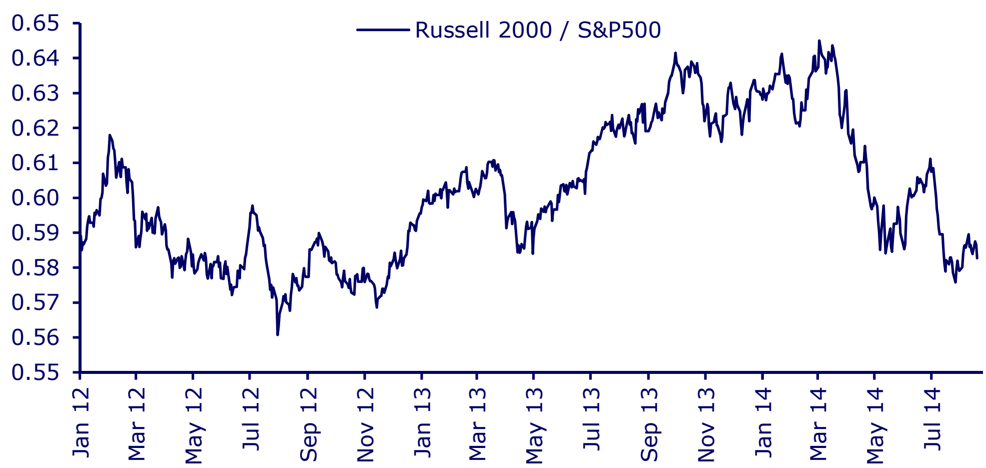
Jokowi update

Jakarta

Wall Street equity benchmarks are back near record highs on relief stemming from America's renewed military involvement in Iraq, however limited, and the, for now, seeming lack of escalation in Ukraine. Still *GREED & fear* continues to view the Ukraine situation as one likely to trigger more stress for markets since there is, so far as *GREED & fear* can tell, no concrete evidence that Russian President Vladimir Putin has backed down.

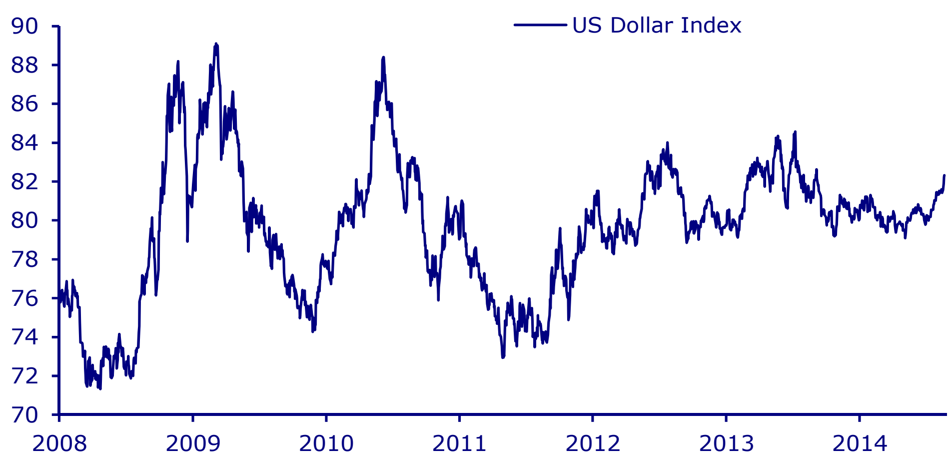
As for US equities, the incremental reduction in tapering represents a rising risk as does the fact that the US Treasury bond market is still not confirming the narrative of the consensus, namely an assumed cyclical acceleration in the American economy. Still the coming days of central bank speech making at Jackson Hole, with related deliberations on the labour market, should make markets even more sanguine as Chairwoman Janet Yellen is likely to remind investors further, if such a reminder is needed, that she is the uber-dove. Meanwhile, aside from the bond market, the rising fundamental risk to the US stock market is perhaps best illustrated within the equity universe by the fact that American small caps have been underperforming since March. Thus the Russell 2000 Index peaked in early March and has since underperformed the S&P500 by 9.7% (see Figure 1).

Figure 1
Russell 2000 relative to S&P500



Source: CLSA, Datastream

Figure 2
US dollar index



Source: Bloomberg

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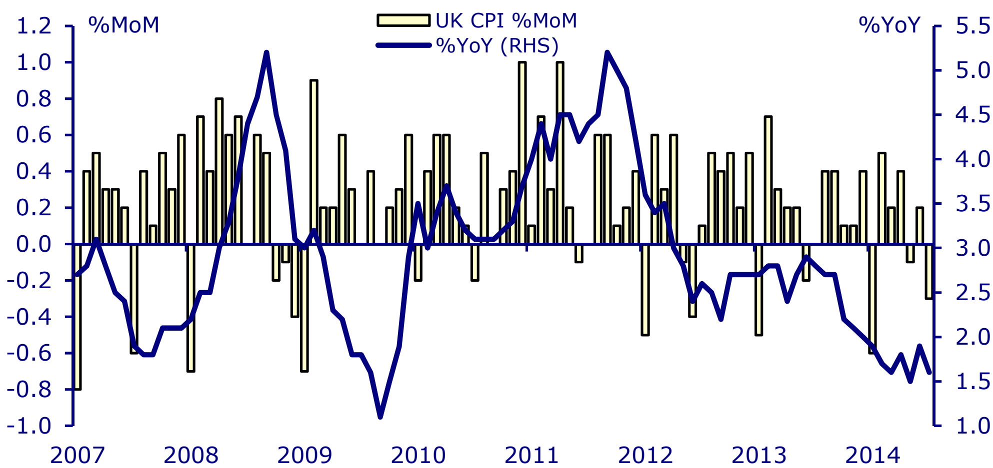
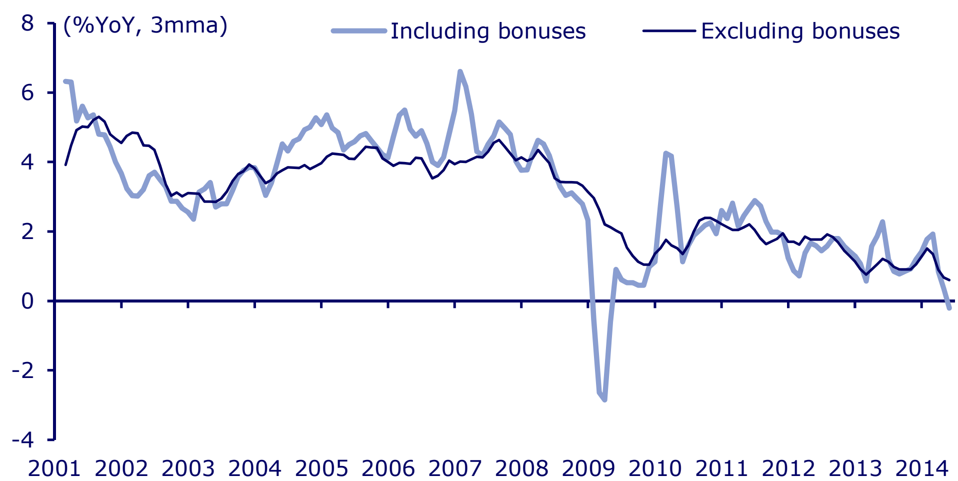
It is true that the stronger US dollar trend of late, with the US dollar index up by 3.2% since the start of July (see Figure 2), could be construed as a vote of confidence in America's cyclical momentum. But *GREED & fear* is not convinced. *GREED & fear* would rather view US dollar strength as primarily driven by changing perceptions elsewhere. Thus, in the case of the euro, the probability is growing that Flexible Mario will be embarking on quanto easing sooner rather than later. In the case of sterling, the foreign exchange markets are having second thoughts about the imminence of Bank of England tightening given recent inflation and wage data. Thus, UK CPI inflation slowed from 1.9%YoY in June to 1.6%YoY in July (see Figure 3), while average weekly total earnings, including bonuses, fell by 0.2%YoY in 2Q14, the first decline since 1Q09 (see Figure 4). Excluding bonuses, average weekly regular pay growth also slowed from 1.4%YoY in 1Q14 to 0.6%YoY in 2Q14. And in the case of the yen, the inflation data reported in late July may have disappointed Bank of Japan governor Haruhiko Kuroda which increases at the margin the chances of more BoJ activism. Thus, core CPI inflation, adjusted for the sales tax hike effect, slowed to 1.3%YoY in June from 1.4%YoY in May.

Figure 3
UK CPI inflation



Source: Office for National Statistics

Figure 4
UK average weekly earnings growth



Source: Office for National Statistics, CEIC Data

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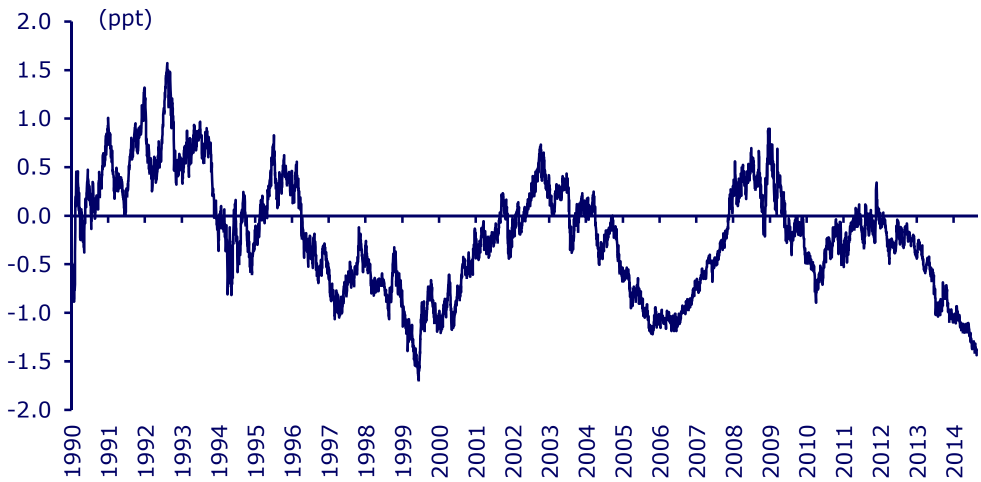
Figure 5

German 10-year bund yield less US 10-year Treasury bond yield

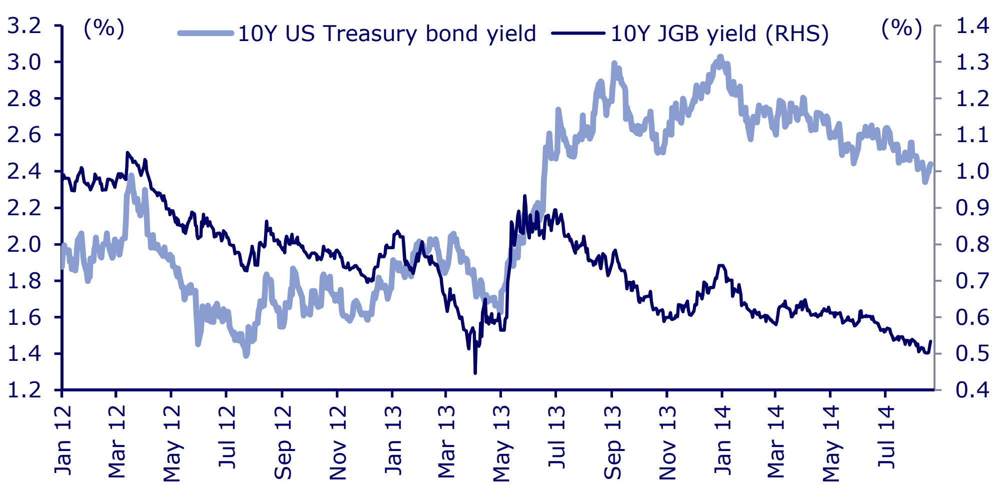


Source: CLSA, Bloomberg

The other development which has been helping the dollar of late is rising government bond yields relative to European counterparts. Thus, the German 10-year bund yield has fallen to 144bp below the US ten-year Treasury yield, the lowest level since June 1999 (see Figure 5). If this is a signal that the Eurozone is heading in the deflationary direction of Japan, it also raises the potential that US Treasury bond yields have the potential to decline significantly from current levels if the hopes for accelerating cyclical momentum are dashed. As for the Japanese government bond market, *GREED & fear*'s recommended short of the JGB is for now not working given that the 10-year JGB yield is now at 52p, or 10bp below where the trade was first recommended in early March (see Figure 6). Still in *GREED & fear's* partial defence it was stated at the time that the biggest risk to this trade was a rally in the Treasury bond market (see *GREED & fear - China property and JGBs*, 6 March 2014), which is what has since happened. This is why the best way to play the JGB trade, for those like *GREED & fear* sceptical about US cyclical momentum, is to hedge the JGB short by being long the 10-year Treasury.

Figure 6

US and Japan 10-year government bond yield



Source: CLSA, Bloomberg

Meanwhile, the fact that the JGB yields are still so low is not exactly sending a signal to Japanese institutional investors that there is an urgent need to reallocate from bonds to equities. This is why the BoJ will need to allow the yield curve to steepen gradually by incrementally reducing its purchases at the long end, if and when it becomes convinced that its policy is working. In the meantime, the best reason for Japanese institutional investors to raise

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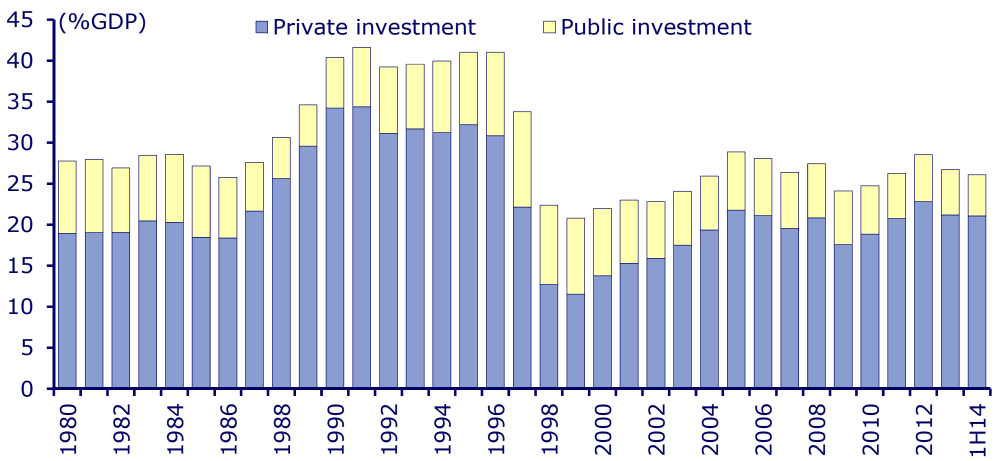
equity allocations, aside from cheap valuations, is mounting 'evidence' of a change in corporate governance in terms of a growing focus on return on equity which is clearly now being pushed by the Abe Government. But it is also encouraging, from a retail investor perspective, that the number of Nippon Individual Savings Accounts (NISA) have been growing though it is far from clear if all the accounts have invested in equities. A total of 6.5m NISA accounts had been opened in Japan as of the end of March, but only 27% of them had at that point in time actually invested in 'risk assets', according to the Financial Services Agency.

Elsewhere in Asia, the latest quarterly economic data for Thailand has caused CLSA's Asean economist Anthony Nafte to raise significantly his forecast for Thai real GDP growth this year and next. Thus, Thai real GDP rose by an annualised 3.5%QoQ in 2Q14, following the 7.3% contraction in 1Q14, and is up 0.4%YoY. Nafte has this week revised up his Thai real GDP forecast from 0.8% to 1.7% for this year and from 2.7% to 4.5% in 2015 (see CLSA research *Infofax Daily – Thailand GDP: Private investment is key*, 19 August 2014).

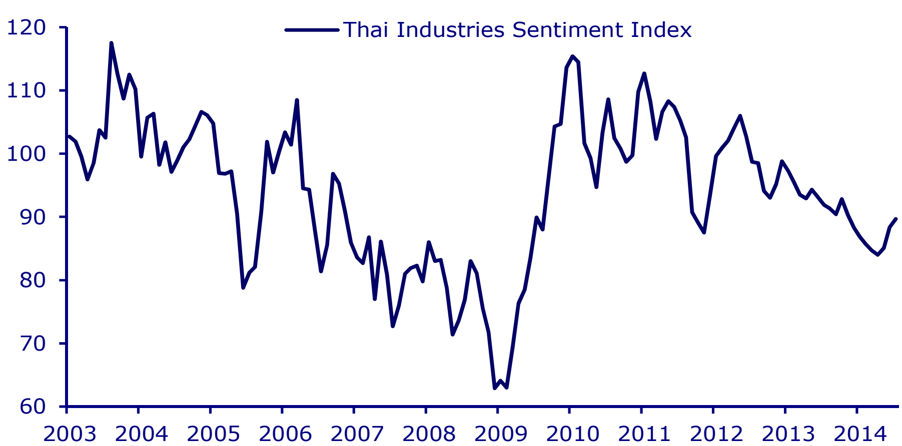
With the military firmly in charge for now public sector investment will be relied upon to drive GDP growth in 2015. Still Nafte notes that the key variable for the macro outlook will be whether the private sector is sufficiently confident to increase its own investment since the private sector comprises 80% of total investment (see Figure 7).

Figure 7
Thailand gross fixed capital formation as % of nominal GDP



Source: CLSA, CEIC Data

Figure 8
Thai Industries Sentiment Index



Source: The Federation of Thai Industries, CEIC Data

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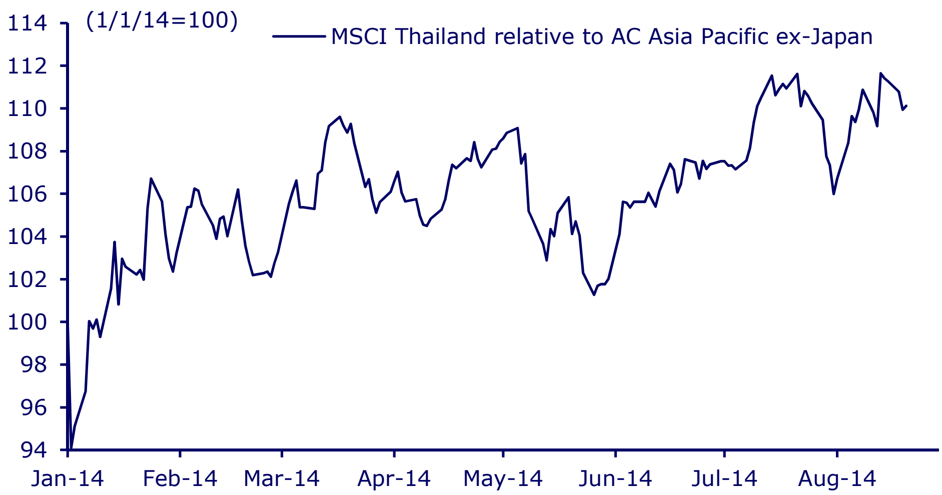
So far as the attitude of the private sector is concerned, the evidence is initially encouraging in the sense that business confidence has bounced in recent months. The Thai Industries Sentiment Index has risen from a low of 84 in April to an eight-month high of 89.7 in July (see Figure 8). Still it would be naïve in the extreme to assume that Thailand's political issues are behind it even though military head Prayuth Chan-ocha was named as prime minister today. This is one reason why *GREED & fear* shaved the overweight in Thailand two weeks ago after the market's strong outperformance and given the fact that valuations are quite extended. The MSCI Thailand Index has outperformed the MSCI AC Asia Pacific ex-Japan Index by 10% so far this year (see Figure 9), while CLSA's universe of 49 Thai companies now trades on 13.8x 2014 forecast earnings and 12x 2015 earnings.

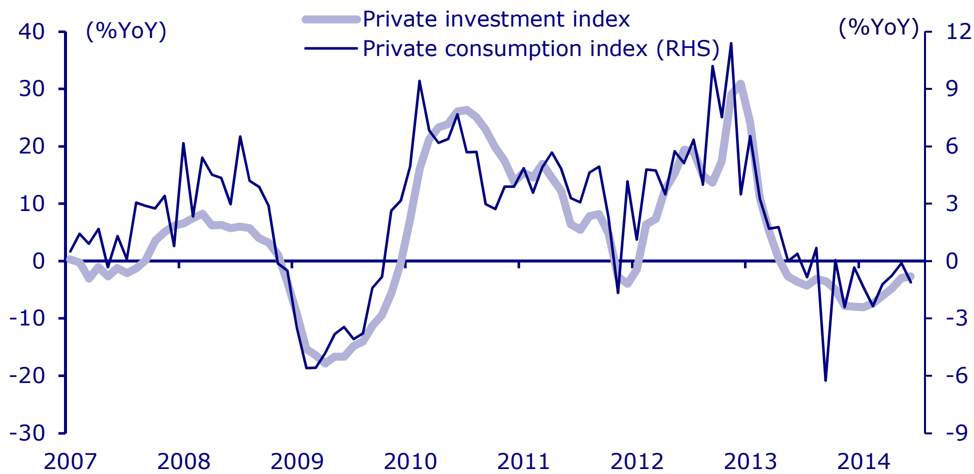
Thailand's renewed cyclical momentum is also far from guaranteed. Reported domestic demand data remains weak as does credit growth. The private consumption index and the private investment index declined by 1.1%YoY and 2.7%YoY respectively in June (see Figure 10), while bank credit growth slowed to a four-year low of 6.4%YoY in June (see Figure 11). It is also the case that the current account surplus has been improving sharply, and the baht has remained strong, precisely because domestic demand has been weak. Thus, the current account has turned from a deficit of 0.5% of GDP in 2013 to an annualised surplus of 3.4% of GDP in June (see Figure 12).

Figure 9
MSCI Thailand relative to MSCI AC Asia Pacific ex-Japan Index



Source: CLSA, Datastream

Figure 10
Thailand private consumption index and private investment index growth



Source: Bank of Thailand, CEIC Data

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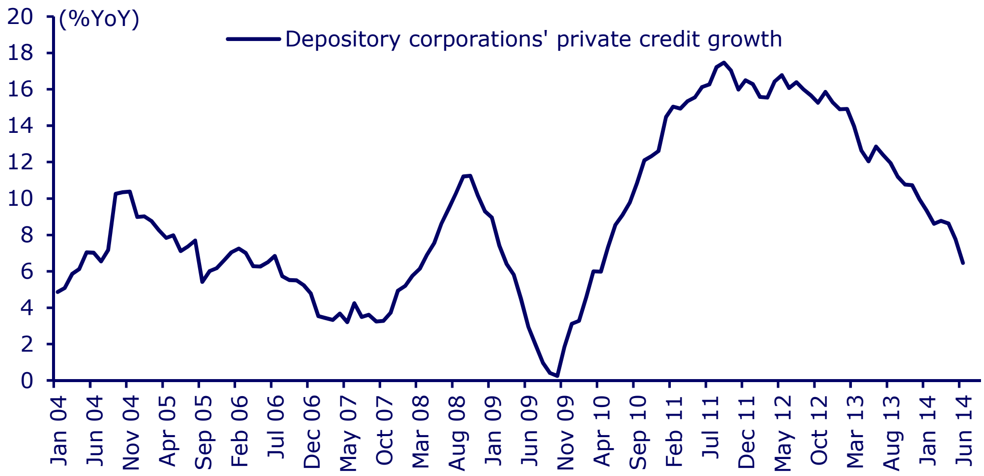
Figure 11

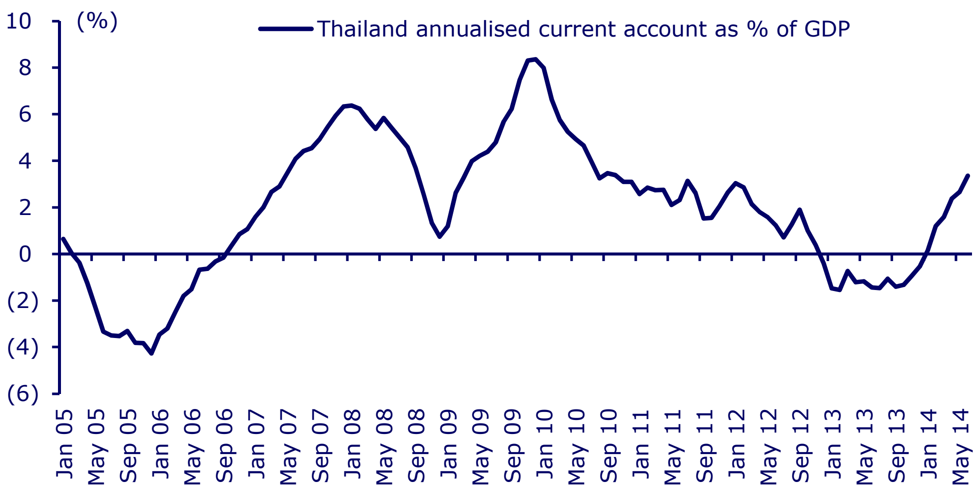
Thailand depository corporations' private credit growth



Source: Bank of Thailand, CEIC Data

Figure 12

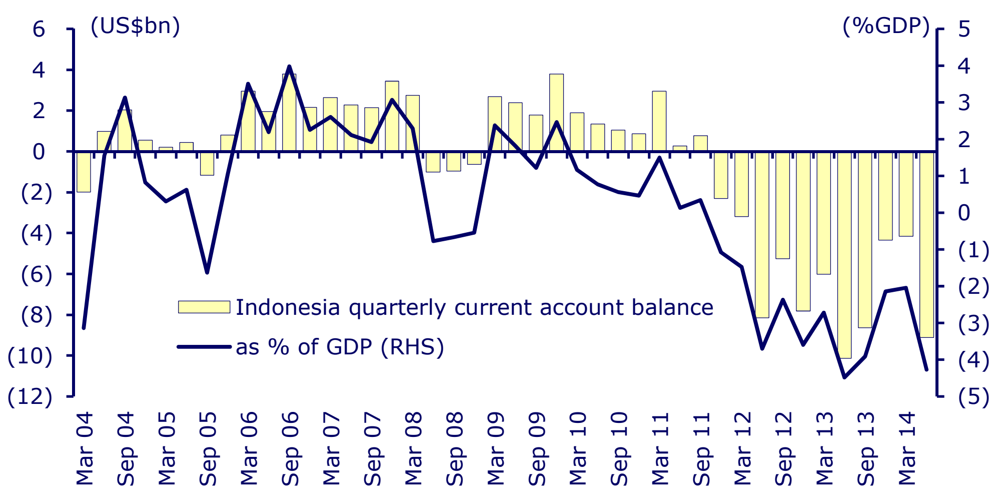
Thailand annualised current account as % of GDP



Source: CLSA, CEIC Data, Bank of Thailand

Figure 13

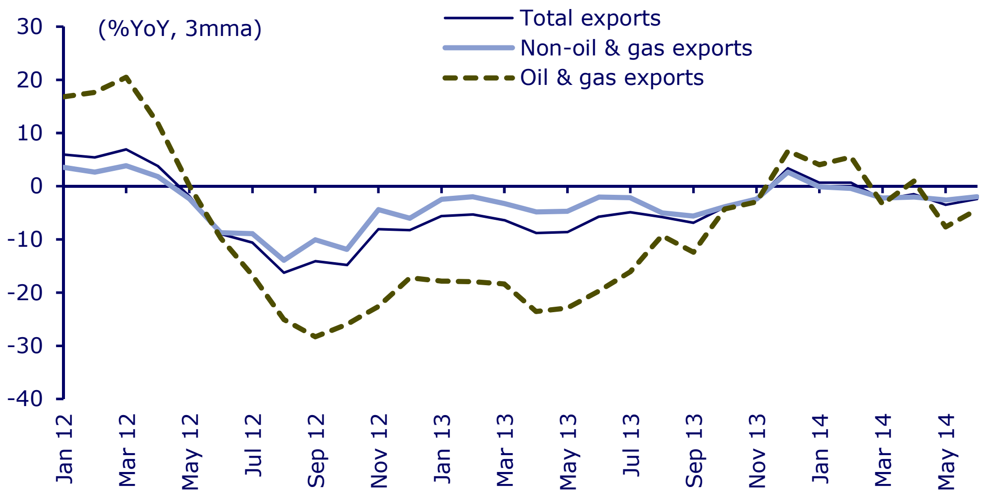
Indonesia current account balance



Source: CLSA, CEIC Data

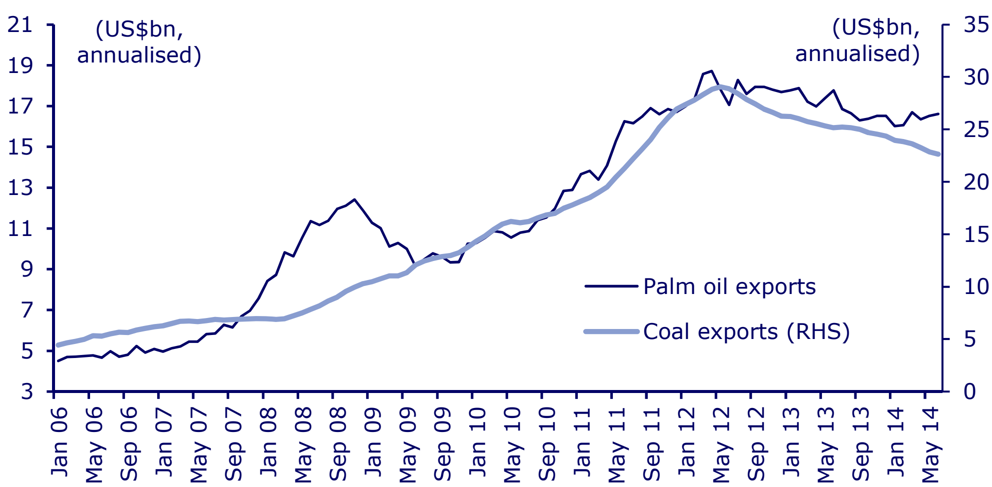
By contrast, the country in Southeast Asia where the current account has not been improving is Indonesia which, in stark contrast to Thailand's relative prowess in the export of manufactured goods, remains far too reliant on the export of commodities. The market has again been reminded of this negative fact with the latest trade data. Thus, Indonesia's current account deficit deteriorated from US$4.2bn or 2% of GDP in 1Q14 to US$9.1bn or 4.3% of GDP in 2Q14 (see Figure 13), with oil and gas accounting for 18% of total exports and coal and palm oil accounting for another 22%. For the second quarter, total exports declined by 2.5%YoY with oil and gas exports falling by 4.4%YoY (see Figure 14).

Figure 14
Indonesia export growth



Source: CLSA, CEIC Data

Figure 15
Indonesia annualised palm oil and coal exports in US$ terms



Source: Bank Indonesia

This is why it remains critical, with the decline in coal and palm oil exports in recent years with the peaking out of the China-driven commodity boom (see Figure 15), that President-elect Jokowi implements energy reform given that Indonesia is on course to become a net importer of energy (including oil, gas and coal) in three years (see CLSA research *Energizers - How sector reform is essential for growth*, 5 May 2014 by deputy head of Indonesia research Jayden Vantarakis).

GREED & fear is hoping Jokowi will address energy reform, just as *GREED & fear* is also hoping that he will phase out energy subsidies and implement infrastructure programmes. The latter two are directly connected since, if Jokowi phases out the fuel subsidy over three years as he

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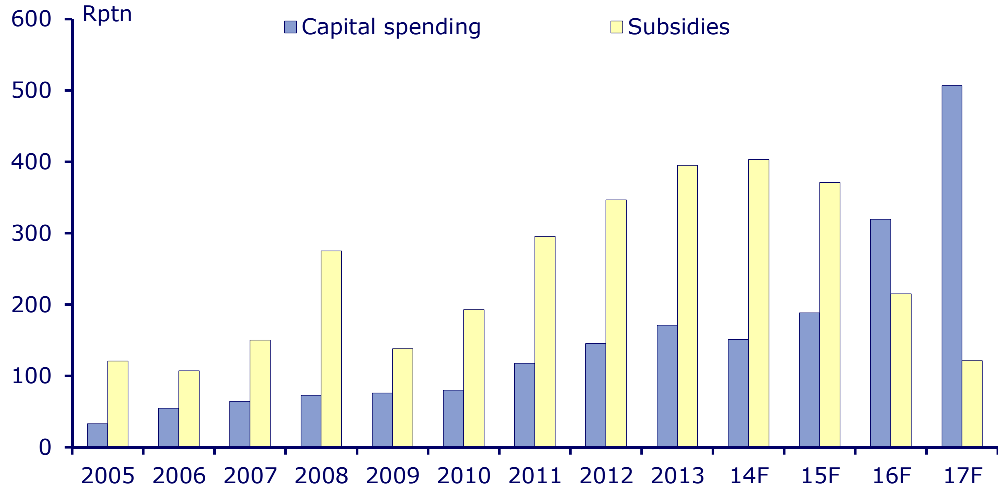
has advocated, it will provide savings on the budget of more than US$50bn over a three-year period according to estimates made by CLSA's Jakarta office, freeing up funds to be spent on infrastructure (see CLSA research Indonesian Market: *Jokowi - a multi-year story*, 21 August 2014 by head of Indonesia research Sarina Lesmina). Note that the central government has consistently spent more on subsidies than on infrastructure development (see Figure 16).

Figure 16

Indonesia capital spending vs subsidies budget trend



Source: CLSA, gov

If it is to be hoped that Jokowi does all these things it will not be easy, given his lack of a decisive majority parliament and given that, for now at least, his opponent in the presidential campaign Prabowo Subianto is still not conceding defeat as was only too evident from demonstrations held in central Jakarta today. The front page of the *Jakarta Post* on Wednesday contained two articles highlighting both the risks and opportunities in the current situation. The main story headlined "*Prabowo won't go quietly*" is self-explanatory. But next to it was a report about how the government plans to pass next year a so-called implementation law for land procurement for public infrastructure projects (see *Jakarta Post* article "*No more land acquisition problems next year*", 20 August 2014). Under the new law people will be forced to sell their property if it is deemed necessarily for public sector infrastructure projects at fair compensation, subject to a 60-day public consultation process.

This issue of land procurement is the key hurdle, rather than money, that needs to be overcome if Indonesia is to address properly its infrastructure problem, with all the resulting benefits in terms of improved logistics and the like. *GREED & fear* is hopeful given Jokowi's evident intention to prioritise the infrastructure issue. Still successful execution cannot be taken for granted given Indonesia's woefully inadequate legal system which is why political leadership is all important. As for the questionable issues raised by the Prabowo camp, this distraction will hopefully diminish with the passage of time with most people in Indonesia viewing the former general as a bad loser.

Meanwhile, *GREED & fear* was reminded recently of the lack of progress made by Indonesia in manufacturing reading a report by a Jakarta-based think tank which focuses on the unfortunate longer term consequences of Indonesia's continuing devotion to economic nationalism which has left it outside the supply chain of global manufacturing (see *Transformasi* report – *Economic Nationalism and Globalization: Old Political Ideologies and New Patterns of World Trade*, 25 July 2014). Thus, in the case of the automotive industry, Indonesia remains heavily dependent on imported components which make up about 70% of vehicle content. This is in stark contrast to Thailand's success as a major exporter of cars and auto components (see Figure 16).

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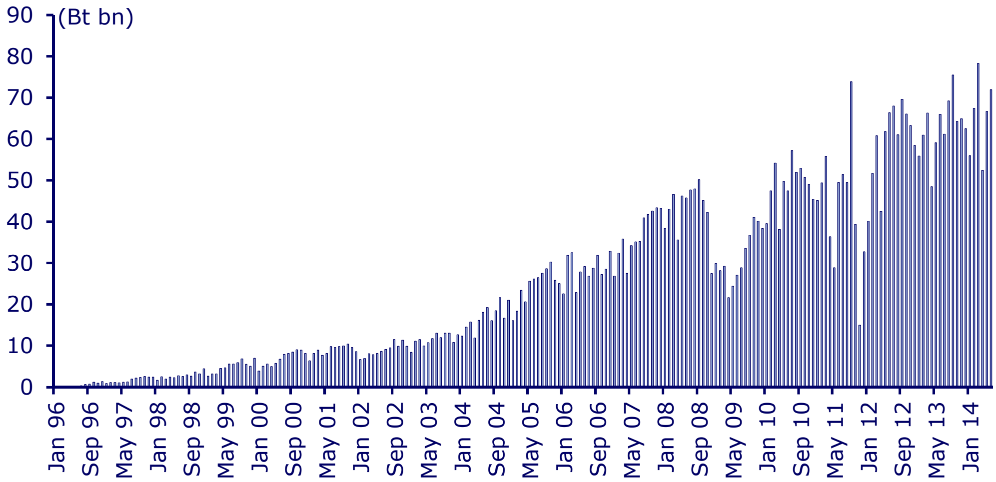
Figure 17

Thailand motor vehicle exports



Source: CEIC Data

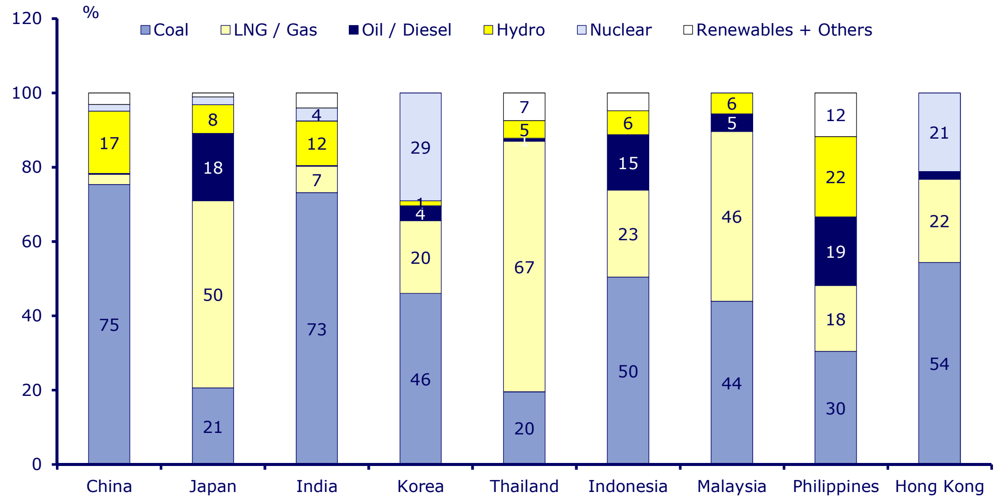
Still *GREED & fear* is of the view that all of the above is understood by Jokowi who, remember, has practical experience as a small businessman exporting furniture. But what is perhaps most positive about the 53-year-old President-elect, who will assume office on 20 October following the Constitutional Court's rejection today of Prabowo's appeal alleging vote rigging, is that he is a new face in a country where politics has for too long been dominated by the same old elite but one with a proven track record in local government. Meanwhile, it should be viewed as a signal of Jokowi's intent to execute that he moved quickly after the election to form a transitional team tasked with coming up with detailed policy recommendations.

Finally, as an example of the potential beneficiaries of Jokowi's plan to increase substantially the use of coal in the generation of electricity, investors are recommended to read a CLSA research report published at the start of this week on Bukit Asam, a state-owned coal miner that is also developing power plants (see CLSA research *Bukit Asam – The Answer*, 17 August 2014 by Jakarta-based resources analyst Abdullah Hashim).

Indonesia is expected to go on a massive expansion of coal fired powers. Bukit Asam should benefit in two ways. First, it will likely build power plants with foreign joint venture partners. Second, it will benefit from a surge in coal volumes to domestic power plants. At present only 50% of Indonesian power is generated from coal, compared with 75% and 73% for China and India (see Figure 18), even though coal is now much cheaper than imported oil and even though Indonesia still has huge coal reserves and remains the biggest exporter of coal in the world.

Figure 18

Power generation by energy source across select countries in Asia



Source: CLSA

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