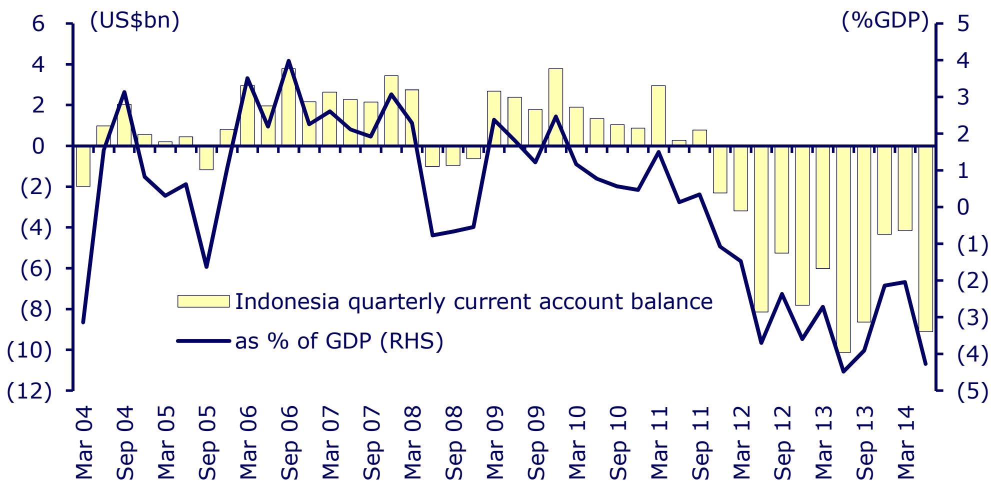
Christopher Wood christopher.wood@clsa.com +852 2600 8516

Subsidy focus

Jakarta

There is a growing sense of anticipation in Jakarta in the run up to the swearing in of the next president, Jokowi, on 20 October. Remember that the Jakarta governor defeated the odds by prevailing in the July presidential election over a vastly better funded candidate, former general Prabowo Subianto. Still he will face immediate challenges given his continuing lack of a clear parliamentary majority and given the challenging macroeconomic backdrop, most particularly a large current account deficit. The current account deficit rose from US$4.2bn or 2% of GDP in 1Q14 to US$9.1bn or 4.3% of GDP in 2Q14 (see Figure 1).

Figure 1
Indonesia current account balance



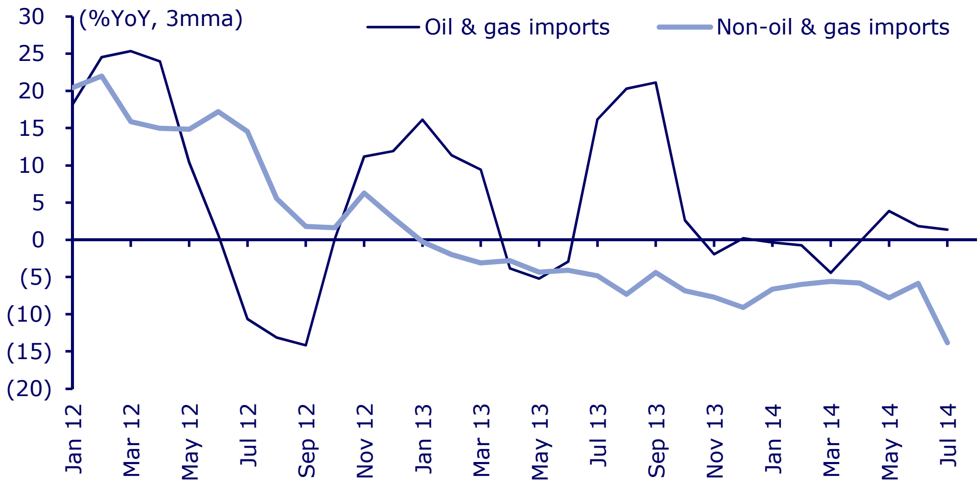
Source: Bank Indonesia, CEIC Data, CLSA

With the decline in coal and palm oil exports in recent years as a consequence of the peaking out of the China-driven commodity boom, energy reform has now become the critical issue for the economy given that Indonesia is on course to become a net importer of energy (including oil, gas and coal) in three years. In this respect, hopes are high that Jokowi will address reform of the sector, including the long overdue phasing out of energy subsidies, as well as implement badly needed infrastructure programmes.

GREED & fear will, for now, continue to give the president-elect the benefit of the doubt on both fronts. Jokowi's senior economic advisor, Luhut Binsar Pandjaitan, seemingly committed in public statements at CLSA's Hong Kong Forum last week to the incoming administration raising the subsidised domestic fuel price by Rp3,000/L or 46% in November, with a further increase of 16% or Rp1,500/L proposed for 2015. There are also plans for a massive expansion of coal-fired power stations. At present, only 50% of Indonesian power is generated from coal, compared with 75% and 73% for China and India, even though coal is now much cheaper than imported oil and even though Indonesia still has huge coal reserves. That this perverse situation has persisted existed for so long highlights the power of the vested interests profiting from the import of subsided fuel, now described by the local media as the "oil mafia". And it is this inelastic demand for imported subsidised fuel which explains the stubborn nature of Indonesia's current account deficit. For other categories of imports have slowed as the economy has slowed as the central bank has tightened monetary policy over the past five quarters. Thus, non-oil & gas imports declined by 13.8%YoY in the three months to July, while oil & gas imports rose by 1.4%YoY over the same period (see Figure 2).

Christopher Wood christopher.wood@clsa.com +852 2600 8516

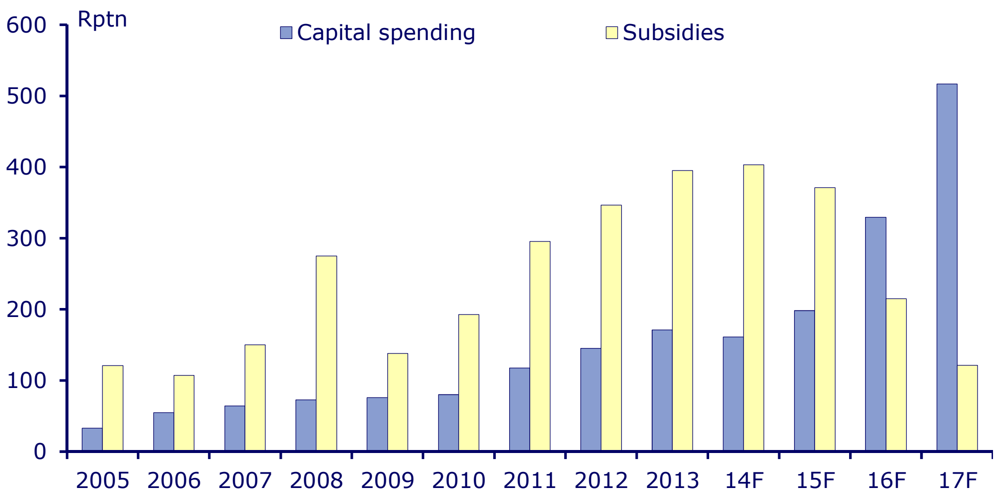
Figure 2
Indonesia import growth



Source: CLSA, CEIC Data

Raising domestic fuel prices by the amount indicated above would put Indonesia much closer to market-based pricing with, hopefully, a formula introduced linking domestic fuel prices going forward to international prices. Such a drastic reduction in subsidies would also free up government funds for infrastructure. It should be noted that the central government has consistently spent more on subsidies than on infrastructure development in terms of the annual budget. Thus, this year the government is projected to spend US$30bn on energy subsidies, compared with US$16bn in capital spending. As CLSA's head of Indonesia research, Sarina Lesmina highlighted in her presentation at the CLSA Forum in Hong Kong last week, US$30bn can finance a lot of infrastructure.

Figure 3
Indonesia government expenditure: subsidies and capital spending



Source: CLSA, Government of Indonesia

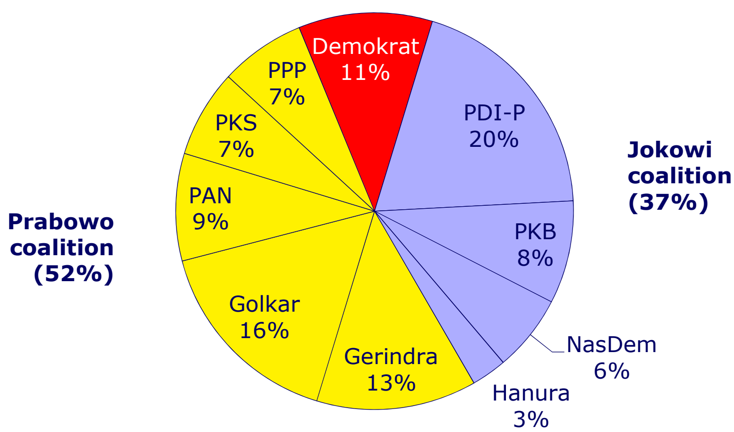
But addressing the infrastructure bottlenecks is not just about money. Land procurement is another key hurdle. On this point, the government still plans to pass next year a so-called implementation law for land procurement for public infrastructure projects. Under this proposed new law people will be 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. Still given the lack of legal due process in Indonesia, to *GREED & fear* perhaps the most important attribute needed to implement infrastructure is the political will to push through with a project. This is where Jokowi scores well. Jokowi was only in the governor's seat in Jakarta for two years but already a Japanese financed MRT project, which had been on the drawing boards

Christopher Wood christopher.wood@clsa.com +852 2600 8516

for more than 20 years, is now finally under construction with the first phase due to be finished by the end of 2017. Similarly, six elevated toll road projects of 70km will soon start construction in the capital with completion due in 2018, while the Jakarta municipal government is also embarking on a mega project to build a 30km seawall both to counter flooding and to serve as a water reservoir. There is even a Dubai-like plan to create 17 man-made islands for property construction. Such projects will be overseen by Jokowi's effective deputy governor Ahok, a Chinese and a Christian, who will become Jakarta governor in coming weeks despite protests from a motley crew.

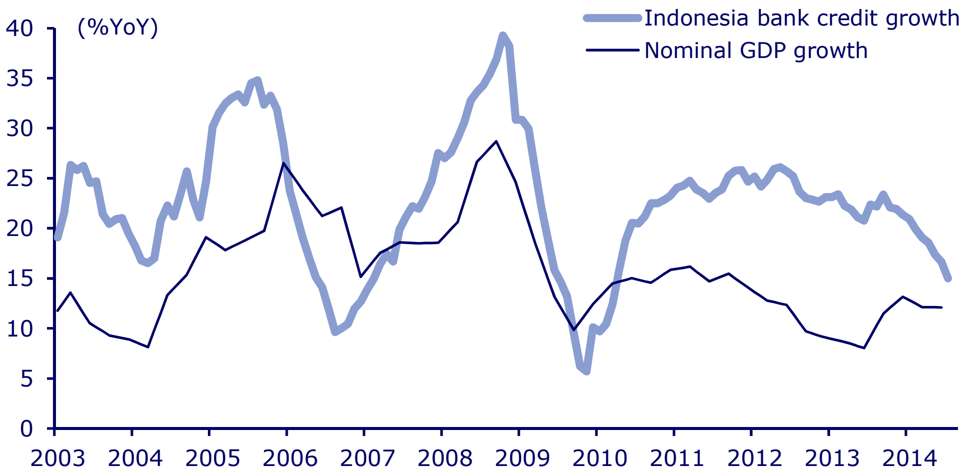
Meanwhile, the political challenge facing Jokowi is that he does not as yet control the parliament. As a result of the incompetence of the campaign conducted by the PDI-P party during April's parliamentary election, Jokowi's coalition has only 207 or 37% of the 560 parliamentary seats (see Figure 4). While it can be assumed that political parties supporting losing presidential candidate Prabowo will engage in spoiling tactics, the situation is extremely fluid with the 11% of so far unaligned seats held by the Demokrat Party of outgoing President Yudhoyono one obvious swing factor. Golkar, whose *raison d'etre* as a party is all about being part of government given its origins in the Suharto era, also accounts for 16% though as yet it has not formally joined the Jokowi camp. Meanwhile, it should be noted that many important decisions facing Jokowi, most particularly cutting energy subsidies, do not require legislation.

Figure 4
Indonesia parliament composition



Source: Government of Indonesia

Figure 5
Indonesia bank credit growth and nominal GDP growth

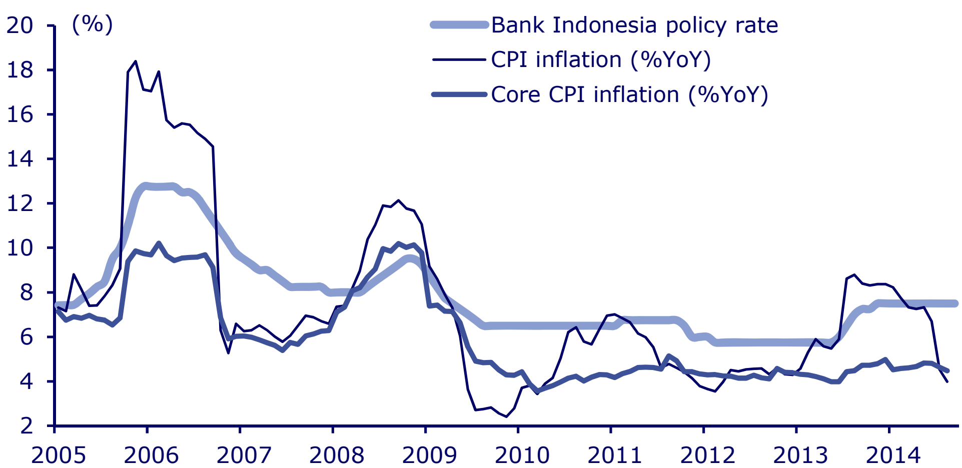


Source: CLSA, CEIC Data, Bank Indonesia

Christopher Wood christopher.wood@clsa.com +852 2600 8516

At the macroeconomic level in Indonesia, credit growth continues to slow. Bank credit growth has decelerated from 23%YoY in September 2013 to 15%YoY in July (see Figure 5). This is a positive in the sense that it is resulting in the previously mentioned reduction in imports, excluding subsidised energy. Inflation also declined to a benign 4%YoY in August (see Figure 6), within the central bank's 2014 target range of 4.5%, plus or minus one percentage point. True, a domestic fuel price hike later this year will lead to a one-off jump in the overall price level but this will be a massive positive, not a negative, most particularly from a current account standpoint given the incentive to import fuel will have been removed if subsidies are removed. On that point, Bank Indonesia Governor Agus Martowardojo issued a public warning last month that if the subsidy issue was not addressed sooner rather than later, he might be forced to carry out further monetary tightening which could cause a "hard landing" given that borrowing rates are already high in real terms. The average mortgage rate is currently 12%. Meanwhile, the central bank plans to lower its inflation target in 2015 to 4%, plus or minus one percentage point.

Figure 6
Bank Indonesia policy rate and CPI inflation



Source: CLSA, CEIC Data, Bank Indonesia

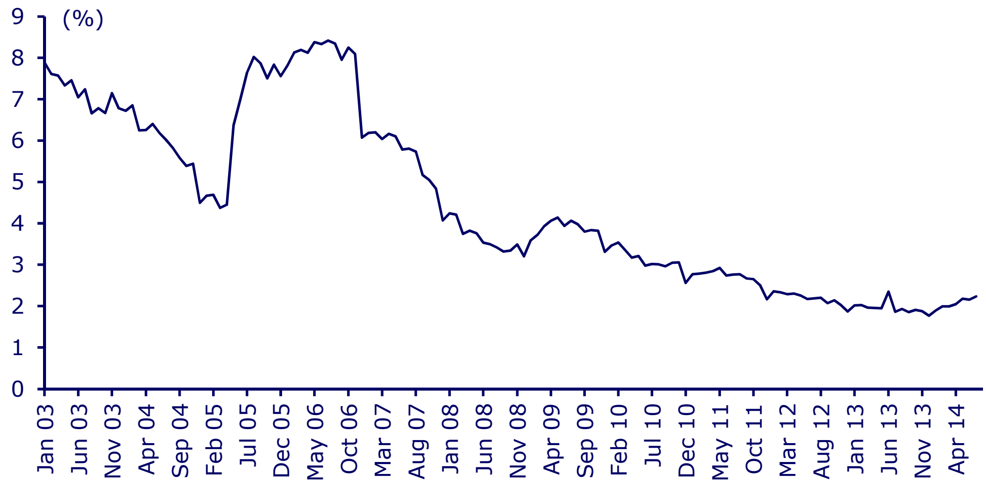
The Indonesia story is, then, for the next three months all about what happens, or does not happen, on energy subsidies. For those who believe action will be taken, buying rupiah-denominated assets now looks sensible with the rupiah at Rp11,947 to the US dollar. The fiscal position of Indonesia, which is already solid, will improve significantly. That makes the 10-year rupiah bond yielding 8.2% highly attractive. As for the banking sector, the NPL ratio for the system has risen from a low of 1.8% in December 2013 to 2.2% in July (see Figure 7). This would seem a benign outcome given the rapid credit growth in the last ten years if monetary tightening is peaking. This should be the case if Jokowi addresses subsidies and if the Fed does not raise interest rates in 2015, which remains *GREED & fear*'s base case for next year if not that of the consensus.

Finally, it is worth noting again that Indonesian banks continue to enjoy the highest net interest margins in Asia, with the average NIM of the quoted banks covered by CLSA running at 6.9%. While CLSA"s Indonesia's universe of 58 companies under coverage continues to have the highest RoE of all the markets covered by CLSA in Asia, reflecting primarily the dominant position of incumbents. Thus, the CLSA Indonesia universe has a forecast 2014 ROE of 20%, compared with 14% for the Asia Pacific ex-Japan region (see Figure 8). These bottom-up positives are a fundamental reason to remain structurally overweight Indonesia in an Asian equity portfolio unless there are macroeconomic reasons not to do so. They are indeed why Indonesia has outperformed the regional benchmark in 8 of the last 12 years (see Figure 9).

Christopher Wood christopher.wood@clsa.com +852 2600 8516

Figure 7

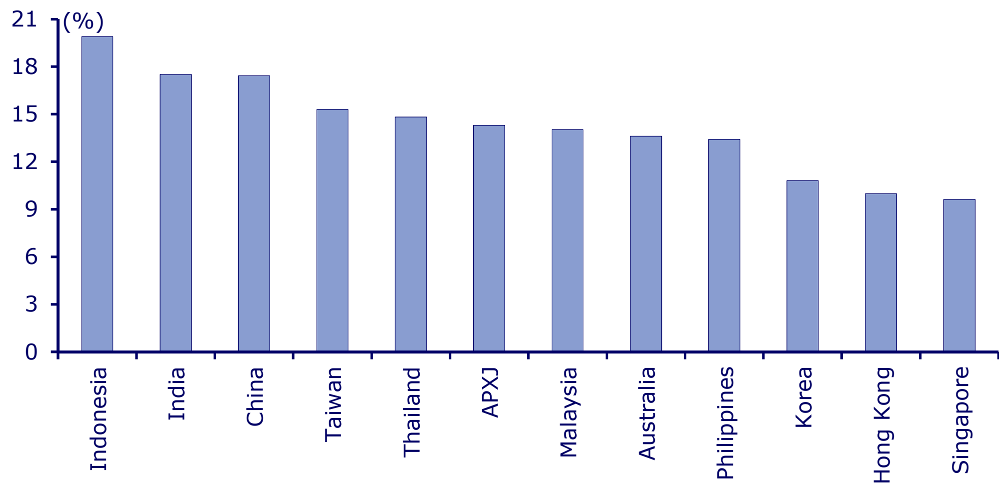
Indonesian commercial banks' NPL ratio



Source: CEIC Data, Bank Indonesia

Figure 8

CLSA Asia Pacific ex-Japan universe 2014 return on equity



Source: CLSA evaluator

Figure 9

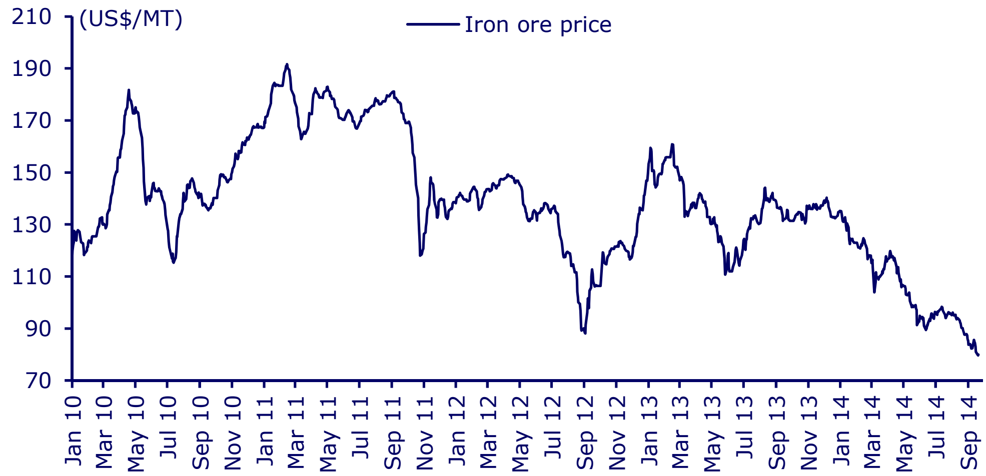
MSCI Indonesia relative to MSCI AC Asia Pacific ex-Japan

Source: CLSA, Datastream

Christopher Wood christopher.wood@clsa.com +852 2600 8516

Figure 10

Iron ore price



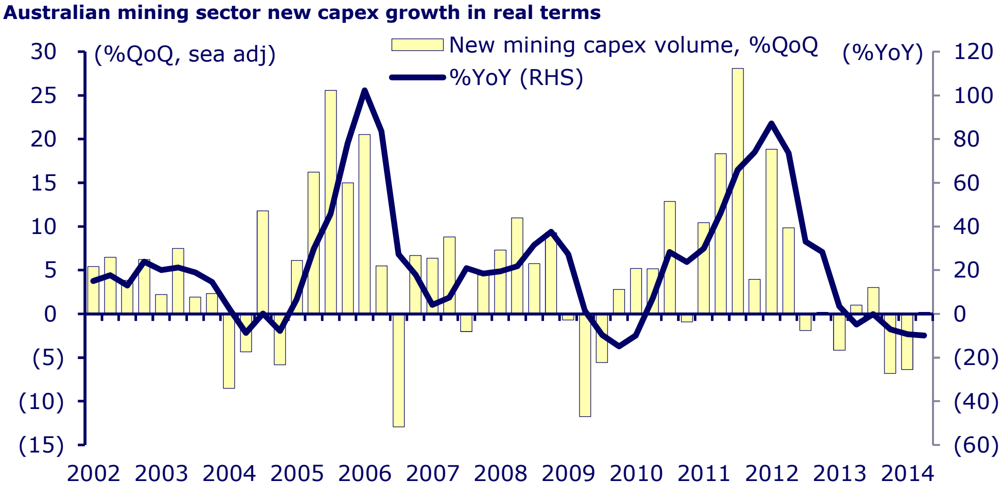
Source: Bloomberg

The continuing decline in the iron ore price has been making headlines this week (see Figure 10). This is a reminder, if it were needed, that the Australian economy faces a structural challenge in terms of the projected ongoing downturn in mining sector capex. Australian mining companies expect nominal private new mining capex to decline by 10% this fiscal year ending 30 June 2015, following a 5% decline last fiscal year, according to the latest private capex survey by the Australian Bureau of Statistics. While in real terms, mining capex declined by 9.9%YoY in 2Q14 (see Figure 11).

This helps explain why Australian consumers remain cautious and why business sentiment remains subdued, most particularly as there has not been much relief on the currency front, a phenomenon which is best explained by the fact that the Australian dollar still pays 2.5% while most G7 currencies pay zero or nearly zero.

Figure 11

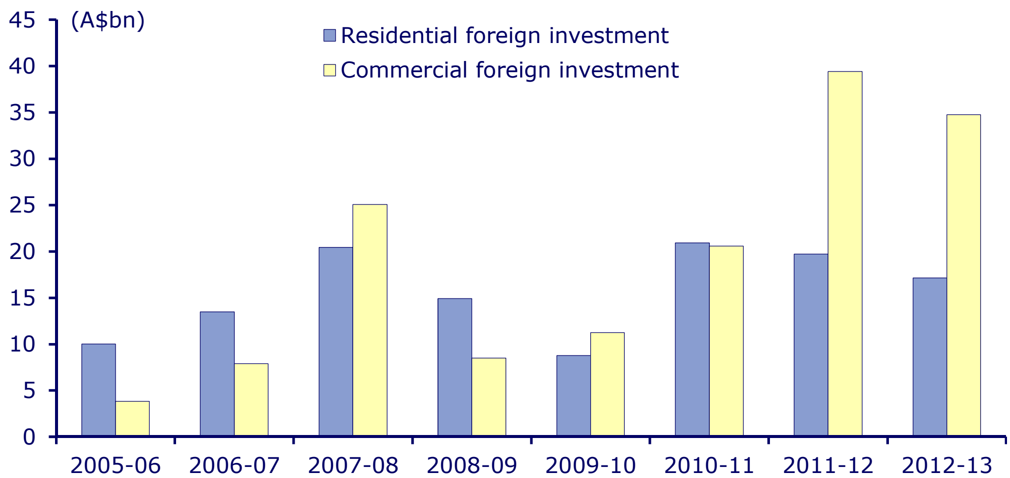
Australian mining sector new capex growth in real terms



Source: Australian Bureau of Statistics

Christopher Wood christopher.wood@clsa.com +852 2600 8516

Figure 12
Foreign investment in Australian commercial and residential property

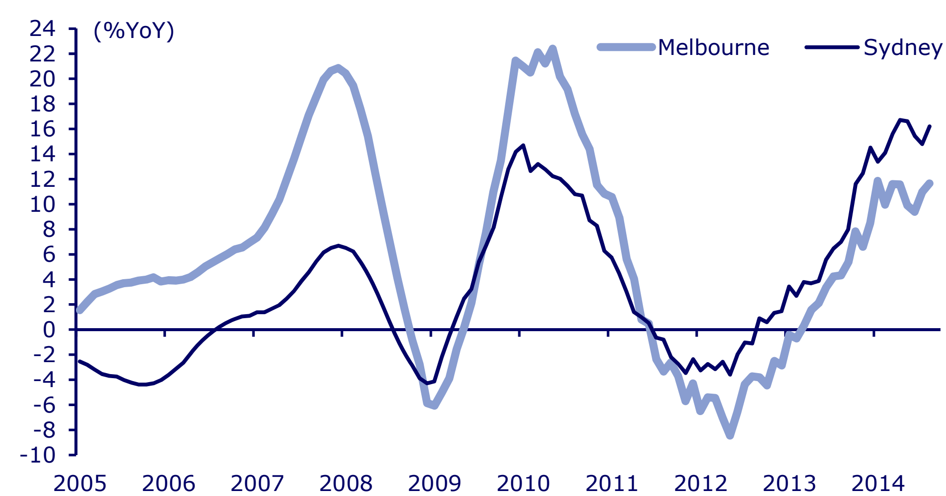


Note: Financial years ending 30 June. Source: FIRB, CLSA

The obvious next move for the Reserve Bank of Australia is to cut interest rates again. But the central bank faces a dilemma. It is reluctant to cut rates further because of the continuing renewed momentum in the Australian housing market where the main catalyst has been an external one, namely property developments in Australia undertaken by mainland Chinese property companies and pre-sold in China. Australia's Foreign Investment Review Board reported in March that the Chinese had invested A$5.9bn in Australian property during the fiscal year ended June 2013, up 42%YoY, making it the biggest source of foreign-capital investment in Australian real estate. Total foreign investment in Australian commercial property has also increased substantially, rising from A$8.5bn in FY09 to A$35bn in FY13 (see Figure 12). For more on this subject read a recent research by CLSA's Sydney-based analyst Andrew Johnston (*The magic dragon - Chinese investment and Oz housing*, 5 August 2014).

The result is that Sydney and Melbourne property prices are up 16.2% and 11.7% respectively YoY (see Figure 13) while loans to property investors are surging again. Thus, loans for investor housing rose by 8.9%YoY in July, up from 6.9%YoY at the end of 2013 (see Figure 14).

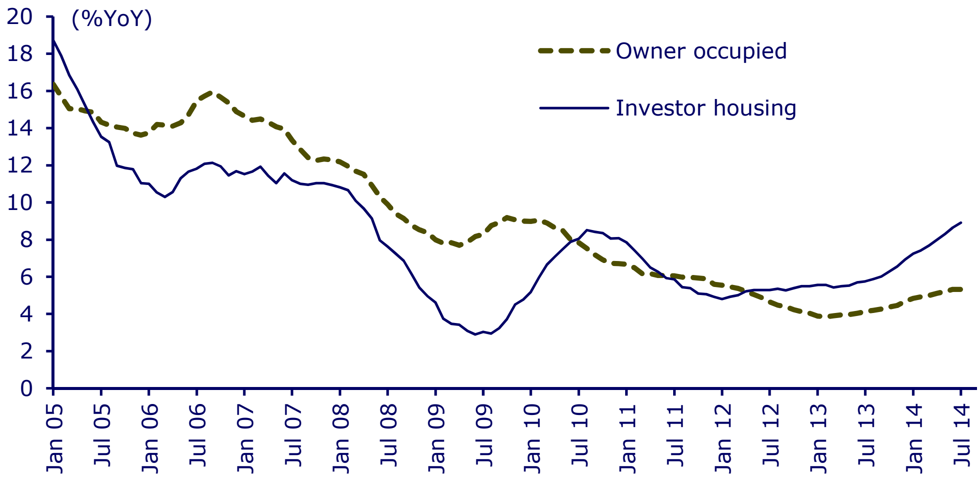
Figure 13
Home price growth in Sydney and Melbourne



Source: RP Data

Christopher Wood christopher.wood@clsa.com +852 2600 8516

Figure 14
Australia credit growth for owner occupied property and investor housing



Source: Reserve Bank of Australia

As a consequence, there is now a growing likelihood that a reluctant Australian central bank will be forced to introduce macro prudential controls on the property sector. Thus, in its semi-annual review of financial stability released on Wednesday, the RBA said that it is discussing "additional steps that might be taken to reinforce sound lending practices, particular for lending to investors." The RBA also noted that "a broader risk remains that additional speculative demand can amplify the property price cycle and increase the potential for prices to fall later, with associated effects on household wealth and spending".

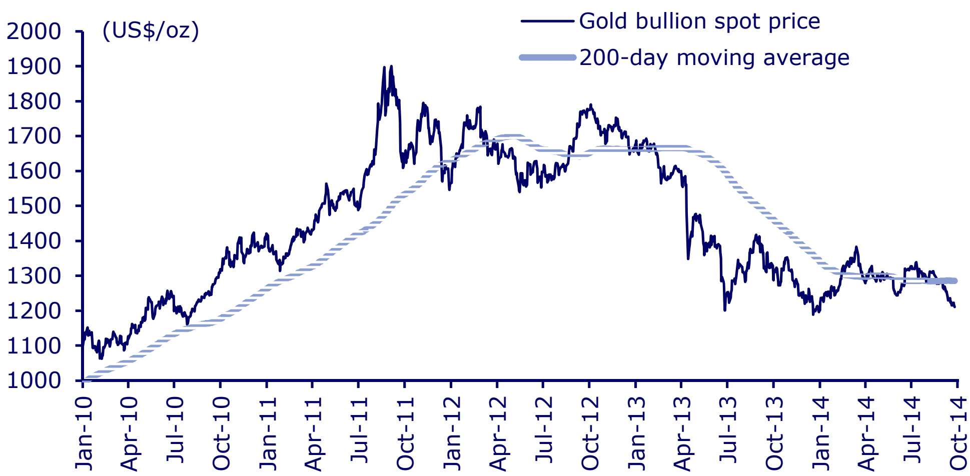
Clearly, the RBA's dilemma would be eased considerably if the Fed normalises monetary policy in 2015 as the consensus expects, since higher US interest rates should lead to a weakening in the still clearly overvalued Australian dollar as interest rates converge. But if that does not happen, investors should expect more rate cuts from the RBA sooner or later. That will increase the prospects for a boom-bust cycle in Australian property down the road unless effective macro prudential regulation can be introduced. Meanwhile, Australian banks, the world's most overvalued banking sector with an aggregate market capitalisation of US$351bn at current exchange rates, have 60% of their loan books in mortgages. But they will stay ridiculously overvalued so long as there is no evidence of a credit cycle and so long as continuing zero rates in the US make their high dividend yields look so attractive in a QE world. Australian banks have a forecast FY15 dividend yield of 5.9% and dividend payout ratios of 70-75%.

Still regulatory change is also a growing risk. CLSA's Australian banking analyst Brian Johnson noted yesterday that should the regulators (FSI/RBA/APRA) further increase housing risk weightings to a rumoured 20% floor, CBA and WBC could have to raise more than A$9.5bn and A$7.2bn respectively given their housing loan exposure, particularly to investment property, and low housing risk weightings (see CLSA research *Australian Banks: RBA FSR + FSI = BCR????*, 24 September 2014).

If *GREED & fear* does not believe a Yellen-run Fed will be raising interest rates next year the market consensus does. This is why gold bullion remains under pressure with gold having declined to the US$1220 level in recent days (see Figure 15).

Christopher Wood christopher.wood@clsa.com +852 2600 8516

Figure 15
Gold bullion price

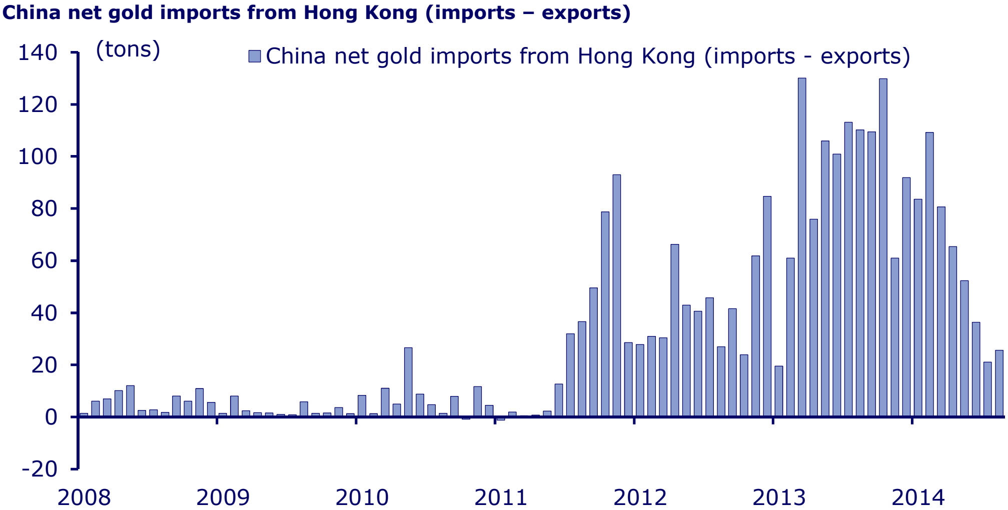


Source: Bloomberg

There is certainly a real and growing risk that gold breaks the 2013 low of US$1180/oz on a monetary tightening scare hitting financial markets in coming weeks or months. On this point it should be noted that, while *GREED & fear* does not anticipate a US rate hike in 2015, a monetary tightening scare in the markets is much more likely. Such a technical breakdown in gold could see the price decline to the US$1050-80 level. That in turn would present a great buying opportunity in gold and gold mining stocks as it will soon become clear that American monetary policy is not going to normalise in 2015 in the manner anticipated at which point market participants will start to realise that quanto easing under a Yellen-run Fed is resuming, not ending.

Obviously *GREED & fear* hopes, with 70% of the global portfolio invested in gold and gold mining stocks, that bullion holds above last year's US$1180 level. But this is far from a certainty in the short-term even if *GREED & fear* proves to be fundamentally right on the outcome of US monetary policy in 2015. What is clear is that if the Fed tightens at a time when the American economy is not really achieving escape velocity, then deflationary pressures will be growing which is bullion negative. But it is precisely those increasing deflationary pressures which will prompt an activist Fed chairwoman like Yellen to turn to quanto easing again in a situation where inflation remains below the Fed's 2% target.

Figure 16
China net gold imports from Hong Kong (imports – exports)

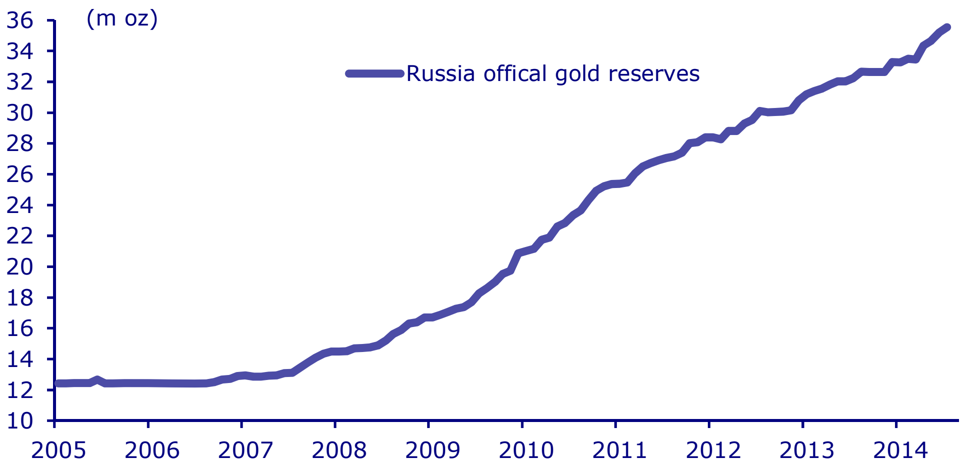


Source: CEIC Data, CLSA

Christopher Wood christopher.wood@clsa.com +852 2600 8516

Meanwhile, another negative for gold this year has been continuing weak demand from China. Thus, China net gold imports from Hong Kong declined by 77%YoY to 25.6tons in August and are down 34%YoY to 474tons in the first eight months of this year (see Figure 16). As gold has become ever more out of fashion, it is interesting to note that not everyone has given up on the yellow metal. Thus, recent data has confirmed that the Russian central bank has continued to add to its gold holdings. Thus, Russia's official gold reserves rose by 10.2%YoY to 35.5m oz at the end of July (see Figure 17).

Figure 17
Russia official gold reserves



Source: IMF