Matthews Asia

Matthews Asia Perspective
Indonesia's Green Shoots

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Investments involve risk. Past performance is no guarantee of future results. Investing in international and emerging markets may involve additional risks, such as social and political instability, market illiquidity, exchange-rate fluctuations, a high level of volatility and limited regulation.

Green shoots of growth are becoming evident in Indonesia, despite relatively downbeat current sentiment and weak spending activity. During a recent research trip we observed a striking trend—an apparent disconnect between macro consumption growth indicators and more conservative consumer spending.

Among President Joko Widodo's early successes was fiscal budget reform. In 2015, he removed most of Indonesia's budget-draining fuel and electricity subsidies—historically about 20% of government spending. In 2017, fuel and electricity subsidies represented only about 4% of government spending. Subsidies targeting low-income segments are set to increase again in 2018, however, following the significant negative impact of rising oil prices on consumer purchasing power.

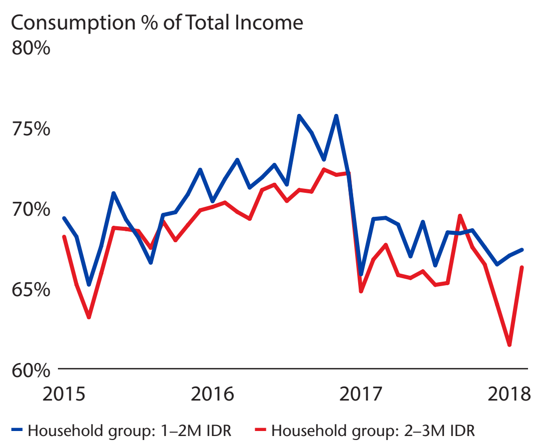
Discussions we had with Nielsen Indonesia, which collates fast-moving consumer goods (FMCG) sales data, confirmed this trend among the lower to middle class demographic. Nielsen noted that in 2017, FMCG volumes were lower, with items such as powder laundry detergent seeing a shift to smaller sachets—an indication of more conservative spending patterns. It appears that rising energy prices pressured households to save as the government scaled back the energy subsidies it has offered for years. In contrast, the latest Bank Indonesia survey indicated that low income segments have been seeing a steady increase in their spending rates since the end of 2017, reversing a trend that had been in place for most of 2017. A possible explanation for the disconnect is that households are shifting their spending allocations to "new" necessities like data plans for smartphones, which is supported by rising data revenues at local cellular telecom service providers.

While lackluster domestic demand led Indonesian equities to be eclipsed last year by equity markets in North Asia, we hold a more constructive view on Indonesia given recent signs of growth.

Corporations and industry watchers appear concerned with job creation and real incomes on Java—Indonesia's most populous island with over 141 million resIdents. The concern suggests that growth is perhaps weaker than official data indicates. That said, with many Indonesians involved in agriculture and mining activities, higher commodity prices should help employment, wages and ultimately purchasing power. Government spending is rising, meanwhile, as local, regional and national elections are set for this summer and next spring.

Employment levels are improving as commodities-related sectors start to expand following an extended price rally in commodities. In March, Finance Minister Sri Mulyani Indrawati also announced that the government would be doubling the subsidy for diesel, and has been pushing consumption-driven spending by accelerating disbursement of its welfare spending scheme. Meanwhile, a gradual recovery in retail and vehicle sales growth as well as residential property take-up suggests that middle and upper income earners are shrugging off concerns over government tax enforcement that curtailed spending last year.

Figure 1. Shifts in Household Allocations
Household consumption allocations fell in 2017 but data in 2018 indicate looser purse strings in low-income segments.



Source: Bank of Indonesia

Stability indicators are improving, with the current account deficit narrowing as exports rise, while core inflation is contained. This enables an accommodative monetary policy that is easing asset quality stresses in the country's banking system and should help improve credit supply as demand recovers. A conservative fiscal stance, with the 2018 programmed budget deficit at just 2.2% of GDP compared to a mandatory deficit ceiling of 3% of GDP, provides elbow room for government spending in the event of revenue shortfalls in 2018.

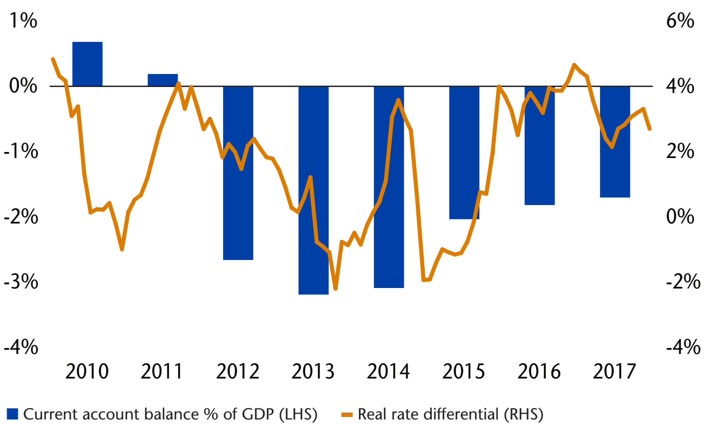
As Indonesia's election cycle begins, politics poses a (manageable) risk, in our view, while significant foreign ownership in the bond market could spark volatility in the Indonesian rupiah as external rates rise. That said, Indonesia's 10-year yield differential with the U.S. has widened from recent lows and its recent inclusion in the Bloomberg Barclay's Global Aggregate Index should help generate up to US$5 to US$7 billion in flows in June 2018, helping to mitigate downside pressures.

Positive momentum of private consumption should be supported when a number of factors, such as increased spending by central and local governments, take shape. In addition, Indonesia will host the 2018 Asian Games—a pan-Asian sporting event. The games are being co-hosted by two cities: the Indonesian capital of Jakarta and Palembang, the capital of South Sumatra. We expect some benefit to employment and income as the cities continue to ramp up in preparation for the Games.

While Indonesia's domestic demand indicators remain fragmented, these green shoots of growth appear to be picking up and we see incrementally supportive changes in activity levels. This should in turn drive positive earnings revisions, helping to re-ignite interest in Southeast Asia's second-largest stock market (and largest economy).

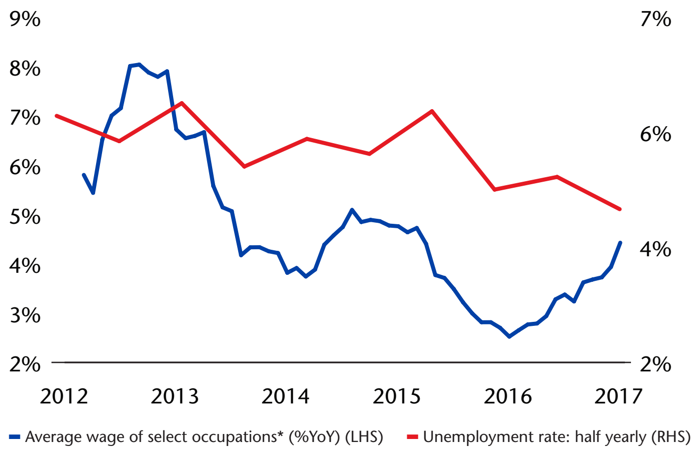
Figure 2. Indonesia's Stability Indicators Improving

Current account deficit narrowing as exports rise and 10-year differentials with the U.S. widened from recent lows.



Source: CEIC

Figure 3. Wages Have Risen Modestly For Lower Income Segments



*farmer, construction worker, barber, housekeeper

Source: Central Bureau of Statistics

Important Information