July 16, 2020

Macro | FX Research and Strategy

Global

FX Flash

IDR - Rocky Path to Recovery

BI Cut Policy Rate Today, Net Impact on IDR Modest

In its policy meeting today, BI cut its 7 day reverse repo rate from 4.25% to 4.00%. It emphasized that the decision was consistent with expectations of soft inflation, and that further monetary easing would better support the post-pandemic economic recovery. Overall, it was arguably a close call, with a slim majority of economists polled by Bloomberg looking for a 25bps cut (18/30). Actual rate cut announcement by BI did not seem to move IDR pricing much (intraday softening was in line with broad moves in risk assets). On net, BI's rate cut today may lower carry appeal and dampen IDR sentiments a tad, but net impact on IDR may be modest/gradual.

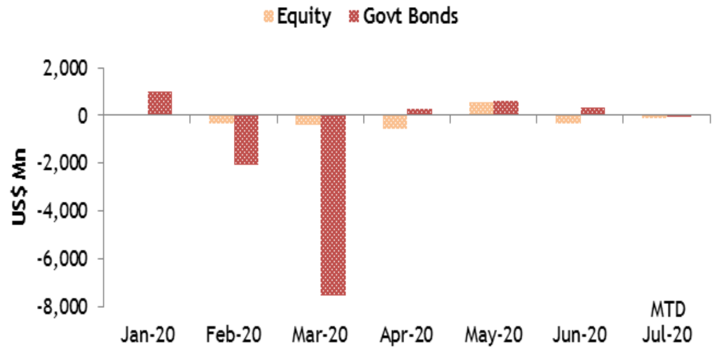
Prior IDR Recovery "Too Fast, Too Furious"

After peaking at near-17,000 in late March, 1M USDIDR NDF had pretty much embarked on a one way recovery through to early June, touching near-14,000 at one point. Arguably, the recovery was "too fast, too furious", especially if we consider the swathe of domestic/external risk factors facing IDR then (uncertain global recovery, rising domestic contagion, fiscal stresses). More recently in July, markets also grew concerned over the announcement of a "debt sharing" scheme between BI and MoF, to fund the large financial burden associated with Covid-19 stimulus. Authorities took pains to emphasize that such "burden sharing" is a one-off policy action and is unlikely to be repeated in 2021. Supply risks in Indo bonds could also be reduced going forward. Concerns over debt monetization have likely been priced in to a large extent in IDR.

Near-Term Risks, But 12-18 Month Recovery View Intact

Sentiments are currently caught in two-way swings driven by domestic restrictions/contagion trends, global vaccine developments and geopolitics. If sentiments on these fronts sour, we do not rule out further upswings in the 1M NDF, but 15,000 and 15,400 are likely to be strong resistances. At this point, NDF is unlikely to revisit the near-17,000 readings seen in late Mar. Our 12-18 month view that IDR can strengthen back to pre-Covid levels of ~13,600-800 remains intact for now. Broadly, BI has also been attempting to jawbone IDR stronger, reiterating that the IDR is "fundamentally undervalued". Besides attractive domestic yields, narrower current account deficits and reduced risk premiums are also factors supporting IDR. In-house fair value model based on longer-term structural factors estimate that IDR could be 3-5% undervalued at this point, but we note that such valuation gaps could take time to narrow, especially in current challenging domestic/external macro environment.

Drags from Portfolio Outflows Dissipated, But External Investors Still Hesitant



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BI Cut Policy Rate, Immediate IDR Reaction Mild

In its policy meeting today, BI cut its 7 day reverse repo rate from 4.25% to 4.00%. It emphasized that the decision was consistent with expectations of soft inflation, and that further monetary easing would better support the post-pandemic economic recovery. It was arguably a close call, with a slim majority of economists polled by Bloomberg looking for a 25bps cut (18/30). *House view had initially looked for BI to stand pat this round, with further cuts to only come by later in 2H. IDR had softened modestly (by more than -4%) since the last policy meeting in mid-Jun, and there were likely still residual debt monetization concerns among foreign investors.*

Intraday, the 1M USDIDR NDF was largely on a modest climb (+0.6%) in the lead-up to the policy meeting, in line with more cautious sentiments across most AxJ FX, partly on mixed China data. Actual rate cut announcement by BI did not seem to move IDR pricing much. On net, **BI's rate cut today may lower carry appeal and dampen IDR sentiments a tad, but net impact on IDR may be modest and gradual**. Admittedly, Indonesian sovereign bonds still offer one of the highest nominal yields in the region, with 10-year bond yields still hovering around 7%.

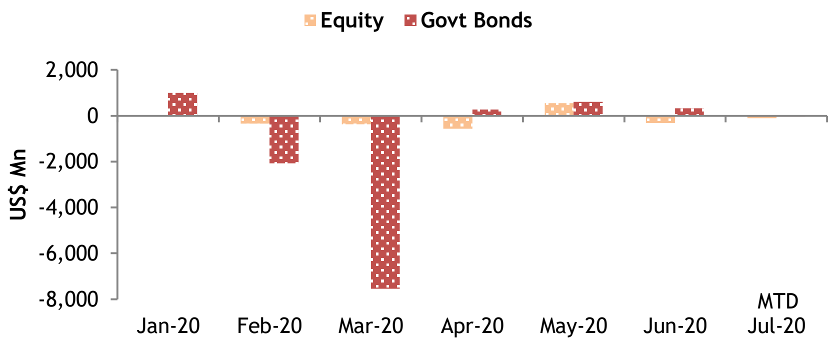
Prior IDR Recovery: Too Fast, Too Furious

After peaking at near-17,000 in late March, 1M USDIDR NDF had pretty much embarked on a one way recovery through to early June, touching near-14,000 at one point. **Arguably, the recovery was "too fast, too furious", especially if we consider the swathe of domestic/external risk factors facing IDR then.**

In our *monthly FX report* released on 1 June, we had touched on several of these—including (i) an uncertain global recovery narrative, (ii) increasingly strained domestic fiscal conditions, (iii) Covid contagion not coming off meaningfully vs. need for reopening to manage deepening toll on jobs and businesses, (iv) domestic labor and tax reforms side-lined in the wake of the Covid-19 pandemic—which we cautioned could weigh on the pace of the IDR recovery. **Indeed, the IDR recovery grew more hesitant by the second week of June and USDIDR has been on a gradual climb since.**

Trends in portfolio flows since early-Jun validate this sense of hesitation in markets. Equities saw modest net foreign outflows in Jun (-US$318mn) and Jul (-US$102mn MTD, as at 15 Jul). Government bonds flows also saw mixed outcomes—small net inflows were recorded in Jun (+US$329mn) but this reversed to a negligible outflow in Jul (-US$29mn MTD, as at 14 Jul). In any case though, magnitudes of bond inflows/outflows are a far cry from the +US$1bn inflow in Jan (pre-Covid) or the huge -US$7.5bn outflow recorded in Mar.

Earlier Drags from Portfolio Outflows Largely Dissipated, But External Investors Still Hesitant



Source: Bloomberg, Maybank FX Research & Strategy Estimates
Note: "Jul-20" refers to MTD data as of 15 Jul (for equity flows) and 14 Jul (for bond flows).

Debt Monetization Concerns Surfaced in Early July

More recently in July, markets grew concerned over the announcement of a "debt sharing" scheme between BI and MoF, to fund the large financial burden associated with Covid-19 stimulus. Key points of the finalized scheme are as follows:

- BI will shoulder an estimated IDR575trn, out of around IDR904trn increase in gross financing faced by the government.
- BI will purchase around IDR398trn of government securities, to be issued at a coupon rate corresponding to the benchmark BI 7-day reverse repo rate, to fund the "public goods" stimulus package via private placement.
    - BI will return 100% of arising coupon payments to the government.
    - These bonds are tradable. I.e., BI can use them for its monetary operations going forward, including draining of market liquidity if necessary.
- For a separate tranche of "non-public goods" financing, i.e., IDR177trn of bonds issued via regular auctions, BI will bear part of the interest cost, amounting to "market yield minus *[*7 day reverse repo rate minus 1%*]*".

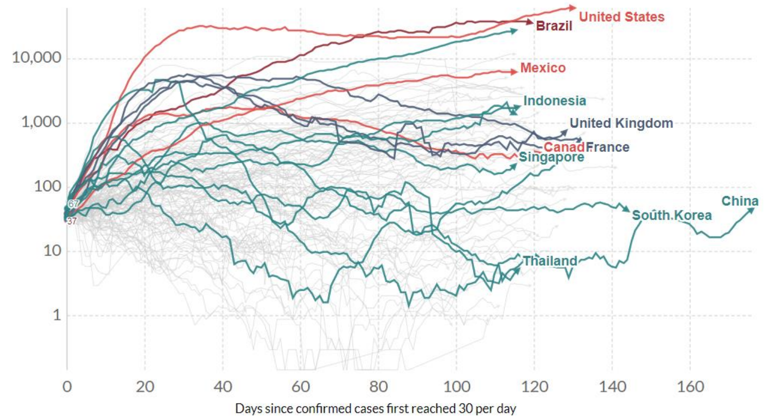
Aware that markets might view such direct debt financing or debt monetization efforts negatively, authorities took pains to emphasize that such fiscal-burden sharing is a one-off policy action and is unlikely to be repeated in 2021. The tradable nature of the bonds will also give BI some flexibility later on, including unwinding of these purchases from its balance sheet when broad macro and market conditions are appropriate.

With BI shouldering almost two-thirds of the expected increase in gross financing, supply risks in Indo bonds could be reduced going forward and portfolio flows may be less of a drag on IDR.

Still a Rocky Path to Recovery for IDR

In the near-term, sentiments are still caught in two-way swings driven by domestic Covid-19 contagion trends, as well as developments in geopolitics and vaccine news.

7-Day Rolling Avg of New Cases Still Rising in Indonesia



Source: ourworldindata.org, European CDC

In terms of contagion trends, the 7-day moving average of newly confirmed Covid-19 cases has risen from around 1,180 in end-June to around 1,760 in mid-Jul. This recent surge has induced speculation that Jakarta may need to re-impose some of its earlier curbs. Concerns that disruptions to reopening plans (i.e., further drags on jobs and business activities, particularly in the services sectors) from such recurring waves of contagion, not just in Indonesia, but also in large economies such as US and India, could lead to an reassessment of the overall global recovery trajectory (i.e., much more U than V).

Intuitively, a large part of sentiment swings will also depend on whether recent positivity in vaccine developments are brought to fruition in the form of ready-to-use, scalable, effective vaccines, as well as the associated development timelines. The US Food & Drug Administration said earlier that to win regulatory approval, any covid-19 vaccine will have to prevent disease, or decrease its severity, in at least 50% of the people who receive it. Meanwhile, some studies suggest that this figure may have to be higher than 70% or even 80% for populations to safely stop relying on social distancing measures. So vaccine efficacy is also a key consideration.

Geopolitics-wise, we have seen increased mini bouts of tit-for-tat actions by US and China on issues relating to Hong Kong autonomy, China’s treatment of Uighurs in Xinjiang, Huawei etc. But it is also evident that both sides are trying to avoid an escalation in tensions, with most of the sanctions introduced so far focused on individuals or small pockets of business entities, rather than broad-based trade channels etc.

On net, if sentiments on these fronts sour, we do not rule out further upswings in the 1M USDIDR NDF, but 15,000 and 15,400 are likely to be strong resistances. At this point, the NDF is unlikely to revisit the near-17,000 readings seen in late Mar and early Apr.

Some key development-markers which would aid the IDR recovery include:

(i) Indonesia's contagion profile; whether it tapers off in the months ahead alongside greater social awareness, fines on social distancing violators.

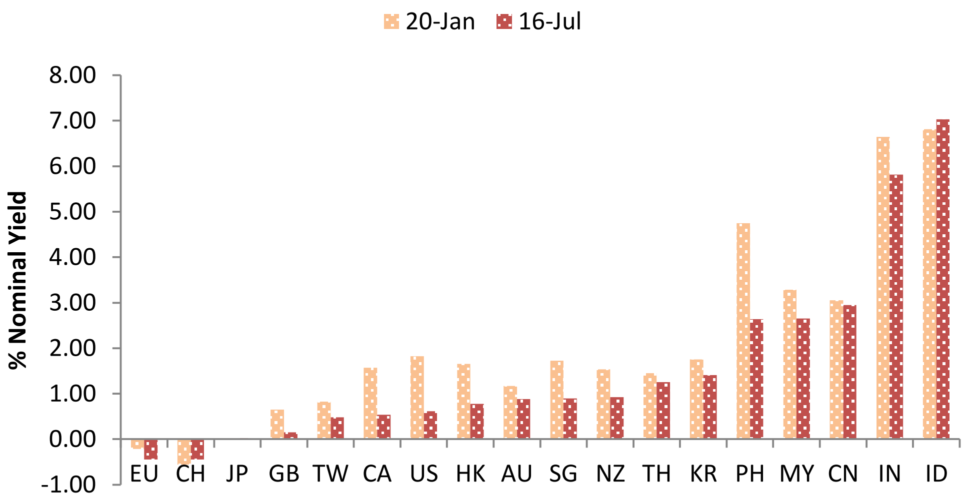
(ii) Global vaccine development; if vaccines look to be ready for widespread usage by potentially 1H 2021 or earlier.

(iii) Geopolitical tensions; if interim US-China actions are viewed as market "noise" with key cornerstones such as the phase 1 trade deal intact.

Our 12-18 month view that IDR can strengthen back to pre-Covid levels of around 13,600-800 at some point remains intact for now. As we get more clarity on second/recurring waves of contagion as well as the extent of accompanying macro drags, and market volatility eases, we could see a more discernible recovery in carry trade flows.

In particular, aggressive Fed easing could keep US yields soft—in June, the Fed projected the US benchmark rate at near zero through 2022—and IDR yields could be attractive in comparison. After 100bps of rate cuts this year, pace of further monetary easing via policy rate cuts could slow discernibly in Indonesia. This supports a strengthening of IDR vs. USD over time.

<u>**IDR 10-Year Sovereign Bond Yields Still Attractive in Post-Covid World**</u>



Source: Bloomberg, Maybank FX Research & Strategy Estimates

Broadly, BI has also been attempting to jawbone IDR stronger, reiterating that the IDR is "fundamentally undervalued". Besides aforementioned attractive domestic yields, they also point to narrower current account deficits as a supporting factor. Current account deficit is expected to be lower than 1.5% of GDP in 2Q and around 1.5% of GDP for the full year, vs. 2.9% of GDP in 2019. 5-Year CDS spreads have also declined from around 210bps at end-Apr to around 128bps now, indicating reduced risk premiums.

In-house fair value model based on longer-term structural factors such as net foreign assets, trade openness, productivity differentials and real interest rate differentials do estimate that IDR could be 3-5%

undervalued at this point, but we note that such valuation gaps could take time to narrow, especially in current challenging domestic/external macro environments.

Potential Bullish Crossover in 1M USDIDR NDF?

On daily chart, momentum is modestly bullish while stochastics are on a gradual climb towards near-overbought conditions. We note that the 21-DMA is on track to cut the 200-DMA to the upside, a potentially bullish signal.

Support at 14,530 (200-DMA), 14,000. Resistance at 15,000 (61.8% fibo retracement from Jan low to Mar high), 15,420 (50.0% fibo). On net, risks may be skewed modestly to the upside at this point even as technical signals are somewhat mixed.

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Malayan Banking Berhad
(Incorporated in Malaysia)

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