

# COMMENTS ON INDONESIA'S INVESTMENT GRADE RATING UPGRADE BY S&P

## Asian Fixed Income Note

### Market Review

#### Indonesia's rating upgrade and economy

On 19 May 2017, S&P upgraded Indonesia's sovereign rating to BBB- with a stable outlook from BB+ with a positive outlook. Among various reasons for the upgrade, S&P cited "reduced risks to Indonesia's fiscal metrics" as the "government's new focus on realistic budgeting reduces the risks that budget deficits will widen significantly when government revenue disappoints". The rating agency also noted that the risk of a rising net general government debt ratio and debt servicing burden has receded, and that the country has "exhibited effective policymaking in recent years to promote sustainable public finances and balanced economic growth."

Indonesia's macroeconomic outlook remains on the improving trend and economic growth is likely to remain healthy in 2017. In 1Q2017, GDP growth came in at 5.0%, which was up from 4.9% in Q4 2016<sup>1</sup>. In the coming quarters, growth is expected to remain supported by investment spending and private consumption while fiscal pressures could continue to abate. With the success of the tax amnesty programme and subsidy reforms, the fiscal deficit is likely to remain under the 3% GDP limit and net government debt below 30% of GDP.

Additionally, Indonesia's external vulnerability has declined in recent years. The current account deficit, currently at less than 2% of GDP<sup>2</sup>, has been improving and is likely to remain at manageable levels. FX reserves has also been increasing steadily. Reserves are currently at USD 123bn<sup>3</sup>, up from around USD 93bn in mid-2013 during the taper-tantrum.

### Outlook

#### Indonesian Local Bonds and Currency

Although the rating upgrade has been long-awaited by markets, the news led to an appreciation of currency and forwards as well as a drop in local bond yields by about 10-20 basis points (bps). In the longer term, the market is expecting that this rating upgrade will result in inflows of as much as USD 5bn into the bond market, particularly from Japanese investors who require a full investment grade rating from the three rating agencies. Certain indices, such as the JP Morgan Government Bond Index – Emerging Market Global Diversified IG (GBI-EM GD IG), also require all three ratings at IG. Following the upgrade, Indonesia will be included at an estimated weight of about 15%. An estimated USD 10bn<sup>4</sup> of assets is benchmarked to the GBI-EM GD IG.

The long-term implications include increased foreign direct investments (FDI) and lower funding costs for local corporates. This could ultimately spur growth as improved inflows allows for a stable Indonesian Rupiah (IDR) as well as an accumulation of foreign reserves. It is also likely that the central bank will allow for a stronger currency over the medium term. Meanwhile, Indonesia has recently seen a basic balance surplus (stable current account deficit and strong FDI), and this upgrade will further support the surplus. We remain overweight on the IDR and local IDR bonds.

#### Indonesian Hard Currency Credits

The Indonesian sovereign complex already trades largely in-line with other similarly rated Emerging Market (EM) sovereigns. Hence, from a valuation perspective, significant upside is less likely going forwards. On the other hand, the quasi-sovereign complex which is trading at the tight-end of the historical range versus the sovereign curve, is expensive. Hence we have been holding and continue to hold an underweight view of the Indonesian complex on valuation grounds. Within the Indonesian complex, we prefer exposure to the sovereign curve versus quasi-sovereign curve.

1. The Financial Times, 5 May 2017

2. The Jakarta Globe, 13 May 2017

3. The Jakarta Globe, 8 May 2017

4. J.P. Morgan, 23 May 2017

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