Keeping it cool with the SBN market

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Lazuardin Thariq Hamzah
lazuardin_hamzah@bca.co.id

Barra Kukuh Mamia
barra_mamia@bca.co.id

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Summary

- Still-robust domestic demand and the current dovish shift in global rate expectations have created an ideal condition for the government to issue more SBN while keeping the yield stable.
- However, the government has signalled a significant cut to net SBN issuance, opting to lean on the side of caution given the risk of higher volatility amidst the ongoing US political cycle.
- The government may need to balance between SAL financing, external loans, and net SBN issuance rather than depriving the SBN market of new supply altogether.

- As before, US politics still dominated the news flow in the last week. US President Biden has opted to abandon its re-election bid, endorsing his Vice President instead due to his shrinking donor base. The recent political manoeuvre in the US defenestrates the Trump camp's strong vs. frail rhetoric, but his still-stronger poll result (YouGov puts former president Trump at 3% above Vice President Harris in the latest national poll) keeps the debate on economic consequences of a second Trump presidency alive.
- The effect of this debate, however, is yet to spill over to the macroeconomic realm. The USD index has been largely unchanged in the past week, hovering around its Q3-2024 low following the Fed's increasingly dovish signals. A stable US monetary condition is a net positive for riskier markets such as Indonesia, as the Rupiah has strengthened by 0.81% since the end of June 2024 (the USD index weakened by 1.42%). However, the Rupiah recorded a slim 0.12% depreciation in the last week, given the meagre foreign capital inflows to the domestic financial market (USD 43.94 Mn inflows in the last week including inflows to the SRBI market).

The case for a more balanced act

- Despite the now less volatile global interest rate expectation, the still-limited foreign capital inflows to the Indonesian financial market are not too surprising. First, the expected global manufacturing slowdown (especially in China) has resulted in low expectations for the global commodity market, which seems to resonate negatively with the foreign demand for Indonesian stocks given the strong relationship between commodity prices and the domestic corporate sector revenue.

- Second, the largely stable Rupiah has allowed Bank Indonesia to reduce its SRBI issuance. Indeed, the central bank limited SRBI issuance to around USD 1.54 Bn in its most recent auction, its lowest amount since late April 2024. **Despite their strong demand, foreign investors are now finding less room to park their capital in the SRBI market**, explaining the continuous climb in SRBI's subscription ratio throughout July 2024 (2.71 in the recent auction).
- Foreign investors are already on two strikes in their quest to enter the Indonesian financial market. The final pitch will be thrown by the SBN market, but the curveball may not be so easy to hit either. Similar to the problem faced in the stock market, **the SBN market may not be too attractive for foreign investors given its lower yields (especially relative to SRBIs), while the supply issue in recent SRBI auction could also be found in the SBN market *(see Chart 1)***.

"The robust demand for SBN from the household sector may help to keep the yield stable, but the crowding out effect will negatively affect banks and the aggregate demand condition"

- Given the limitation with SRBI and the narrowing spread between the domestic bond market and the UST market, the continuous stream of foreign capital outflows between May and June 2024 has led us to argue that policymakers in Indonesia should solve the problem by allowing the domestic bond market to move in a bear steepener pattern (long-term rates rising higher than short-term rates); effectively a trade-off between a higher lending rate and a stable Rupiah. The government, as we know, chose to keep their loan rates stable, which led to the recent decision to reduce SBN issuance and switch to bilateral/multilateral loans and SAL (excess budget balance) financing.
- The now higher 10Y SBN yield relative to the 2024 macroeconomic assumptions (6.98% vs. 6.70%) explains the government's decision to keep the lid on SBN supply. However, **given the recent condition *(see Chart 2)*, it could be argued that the current government should not shy away from the SBN market, at least to a degree.**
- From the domestic side, **the upper-middle-income households' higher savings rate (as indicated by their slowing BCA spending index growth) present a ready buyer for the SBN market *(see Chart 3)***. It is important to note, however, that higher issuance of retail bonds may exacerbate the crowding out effect from banking products to the sovereign bond market, while the high opportunity cost of not investing in bonds (as indicated by the high coupon) may also suppress the aggregate demand condition, especially for big-ticket items.
- **Another factor that limits the upside risk in the benchmark SBN yield due to a higher supply of SBN is the now-stable global interest rate expectation.** Indeed, many in the market are now moving towards a 50-75 bps FFR cut scenario, a rather significant shift compared to the FOMC's 25 bps rate cut projection released in June 2024. It is not impossible, then, for the government to normalise its SBN issuance in 2024 while also keeping the SBN yield stable, given the seemingly improving demand condition for Indonesian government bonds.

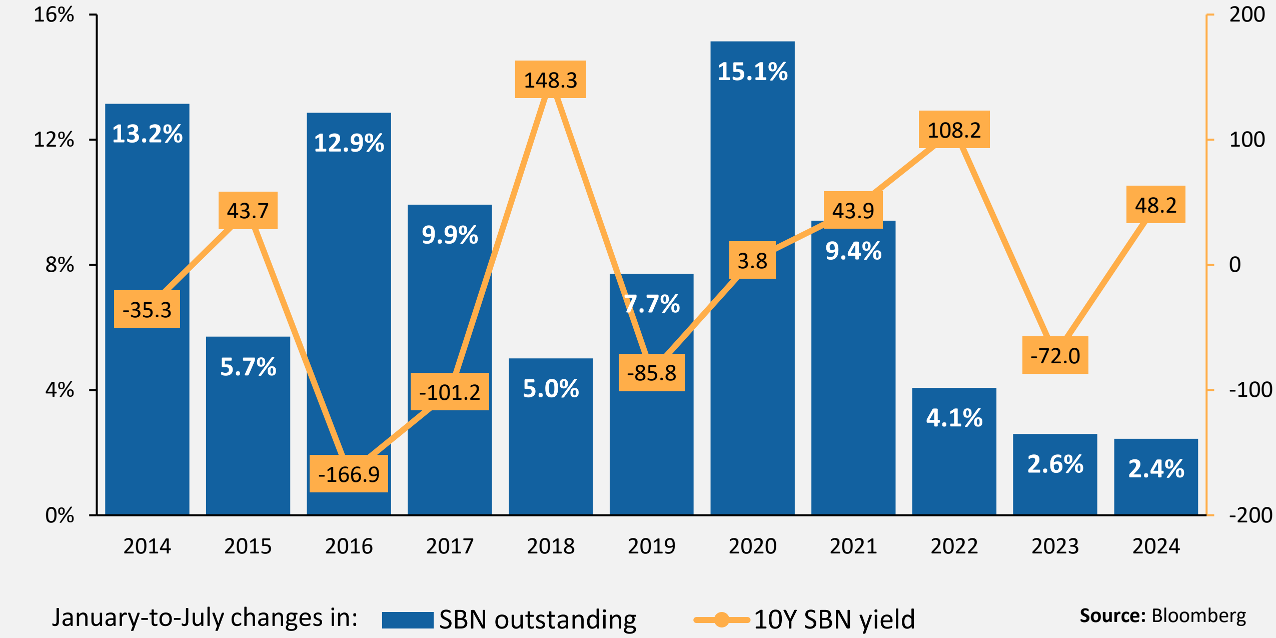
- However, as are the rules in the world of business and finance, a higher-return strategy is accompanied by higher risks. **The current climate may be ideal for the government to add supply to the SBN market, but there is no guarantee that the wind will continue to flow in favour of the SBN market in the upcoming months.** For instance, it remains uncertain whether the higher demand from the household sector will be enough to offset the risk that may arise from the higher amount of maturing bonds in Q3-Q4 2024.
- The US Treasury Department's upcoming quarterly refunding announcement (QRA) may also pose a risk should the Indonesian government decide to be more adventurous in the SBN market ***(see Chart 4)***. The US budget deficit is expected to jump to USD 1.92 Tn in 2024, 12.98% higher than the deficit in 2023 and 27.07% higher than the Congressional Budget Office's previous forecast. An upward revision to the USD 847 Tn US financing need in Q3 2024 (and potentially higher-than-expected financing need in Q4 2024) may keep the UST yield elevated, reducing the demand for other, more risky bonds such as the SBN.
- The final pothole in the road, of course, is the limited signal on the Fed's rate cut schedule itself. Apart from Fed Chairman Jerome Powell's recent comment on the cooling relationship between the labour market and inflationary pressures, **FOMC members are yet to provide more definitive answers on whether the Fed will deem it appropriate to start cutting the FFR in September 2024**, which is only 48 days before the US presidential election.
- Hence, **the Indonesian government's decision to be more prudent with its debt issuance remains understandable, despite the dovish turn in global interest rate expectations at the moment**. However, the decision to drastically suppress SBN issuance (with the decline in SBN issuance could reach as much as IDR 200 Tn according to estimates) may be too strong a reaction. **Over-reliance on foreign loans may not drastically resolve Indonesia's growing interest burden**, and the current government's already limited term may make it difficult to negotiate new loans at favourable terms.
- Meanwhile, a complete turnaround from the SBN market and into SAL is also tantamount to kicking the can down the narrow road, as **a depleted SAL balance may not allow the incoming government to be more flexible with its fiscal posture**, which is often crucial in the early period of a new administration. It might be better, then, for the current administration to find a balance between the use of SAL and other debt financing with its net SBN issuance, especially since BI is expected to maintain its presence in the SBN market given the still obscured path towards a BI-Rate cut scenario and the need to support the SRBI instrument.

"The government may still need to increase its net SBN issuance, given that higher external debts may not help to lower the interest burden while a depleted SAL balance will kneecap the upcoming administration"

Chart 1

Taking the supply off the market

SBN issuance is at its slowest YTD pace in 2024 as the government tries to keep its interest rate stable by relying more on other financing means (SAL, bilateral/multilateral loans)

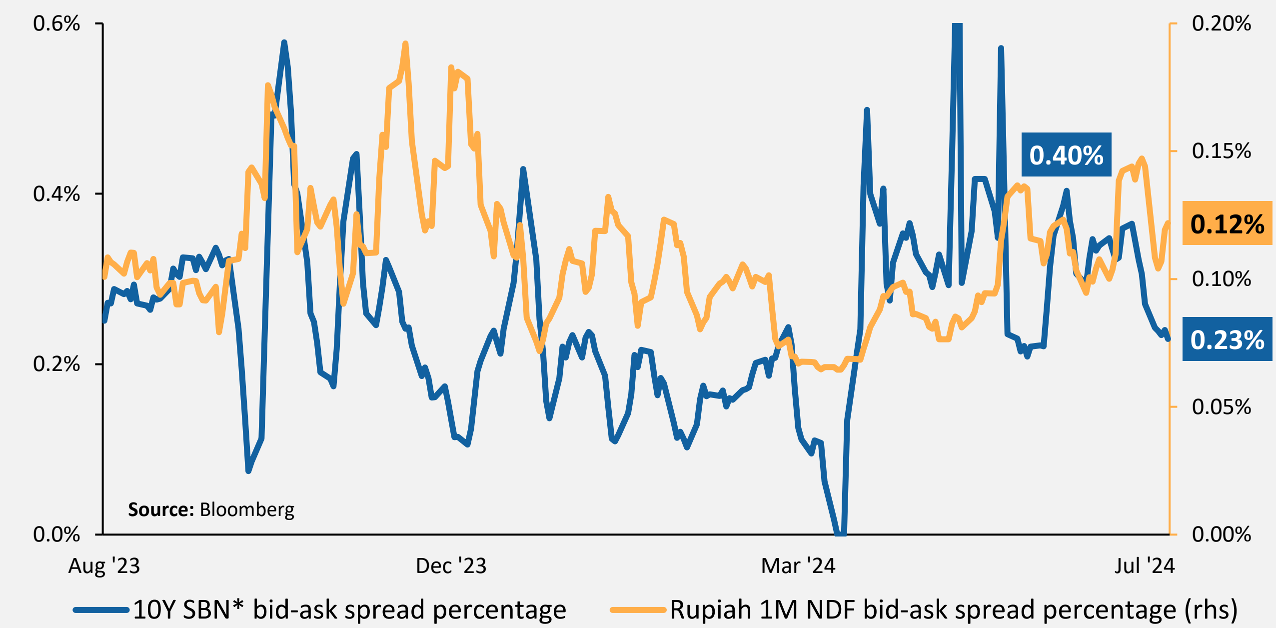


Source: Bloomberg

Chart 2

Calmer seas

The dovish shift in the global rate expectation and the government's signal to issue fewer SBNs help to keep the benchmark yield stable despite the higher amount of maturing bonds.



Source: Bloomberg

Chart 3

Willing buyers

The household sector may continue to drive the demand for SBN, despite its negative impact on banks' liquidity condition and the demand for big-ticket items.

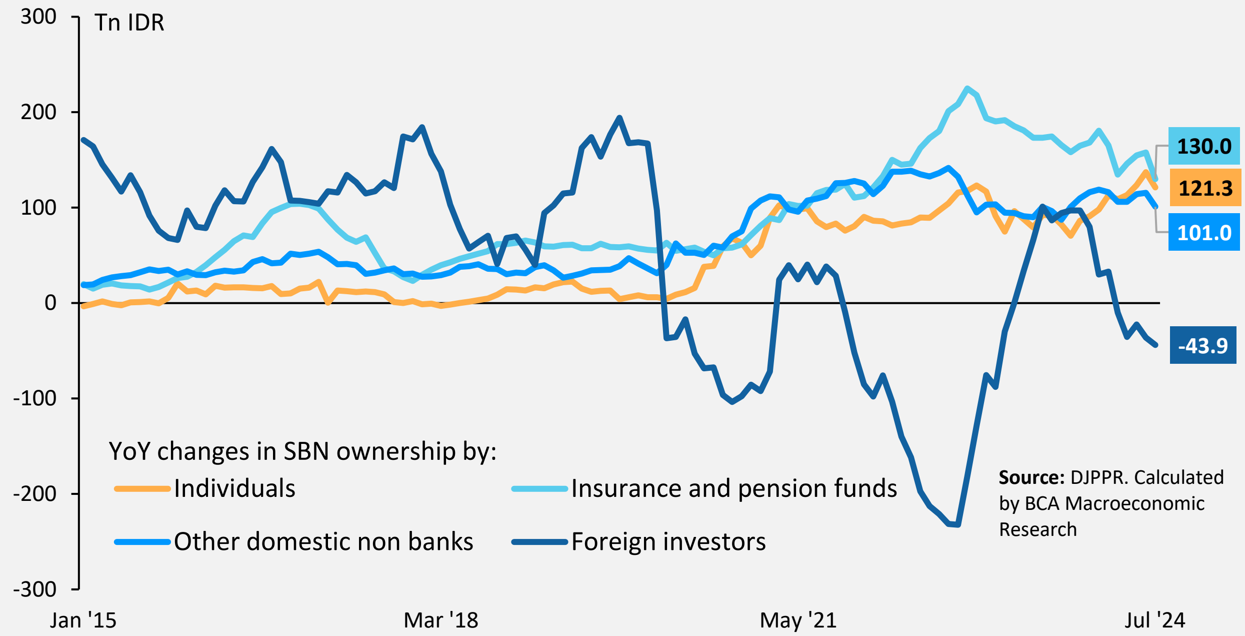
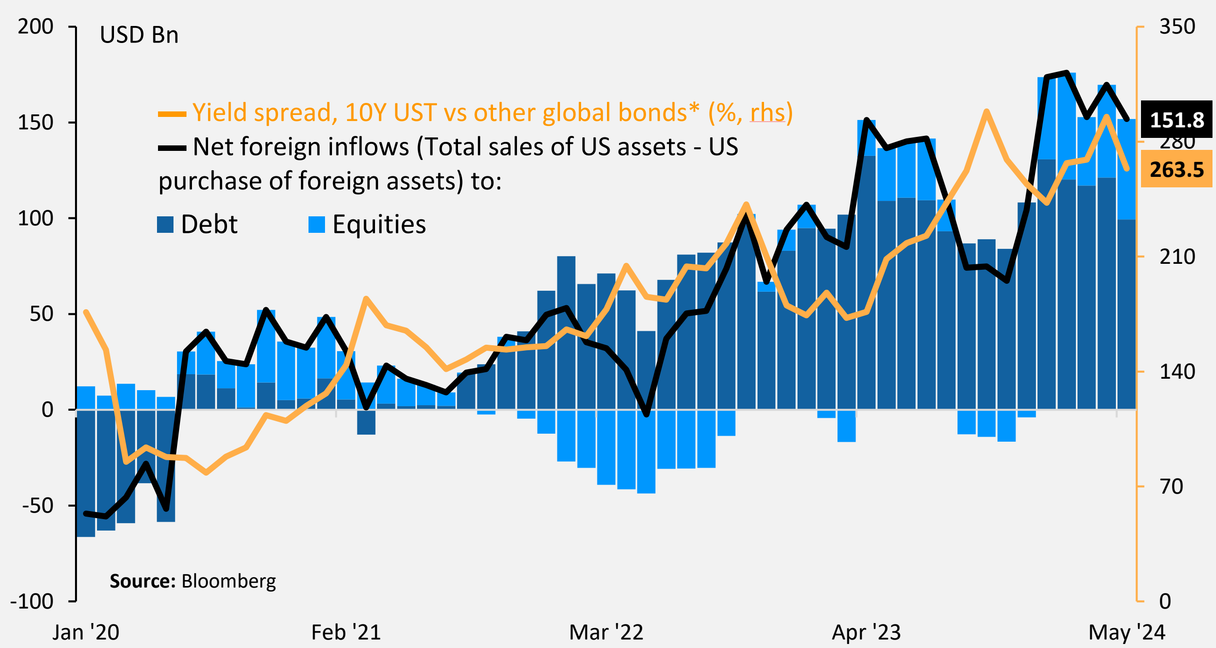


Chart 4

Potholes on a straight road

Despite the strengthening Fed cut signals, an upward shock to the upcoming QRA may keep the yield on the UST high which could keep foreign inflows to the US financial market



Economic Calendar

		Actual	Previous	Forecast*
05 July 2024				
ID	**Foreign Exchange Reserves, (Bn)**	**140**	**139**	**148**
US	Unemployment Rate, %	4.1	4	4
US	Non-Farm Payrolls, (Th)	206	218	160
07 July 2024				
CN	Foreign Exchange Reserves, (Tn)	3.222	3.232	3.25
08 July 2024				
ID	Consumer Confidence	123.3	125.2	125.5
09 July 2024				
ID	Retail Sales YoY, %	2.1	-2.7	-0.5
10 July 2024				
CN	Inflation Rate YoY, %	0.2	0.3	0.3
ID	Motorbike Sales, %	3.5	-4.5	-
11 July 2024				
US	Inflation Rate YoY, %	3	3.3	3.1
12 July 2024				
CN	Balance Of Trade, (Bn)	99.05	82.62	85
ID	Car Sales YoY, %	-11.8	-13.3	-
15 July 2024				
ID	**Balance Of Trade, (Bn)**	**2.39**	**2.93**	**2.49**
CN	Retail Sales YoY, %	2	3.7	3.2
16 July 2024				
EA	Balance Of Trade, (Bn)		15	-
17 July 2024				
ID	**Interest Rate Decision, %**	**6.25**	**6.25**	**6.25**
23 July 2024				
ID	**Foreign Direct Investment, %**		**15.5**	**-**

*Forecasts of some indicators are simply based on market consensus
Bold indicates indicators covered by the BCA Monthly Economic Briefing report

Selected Macroeconomic Indicator

Key Policy Rates	Rate (%)	Last Change	Real Rate (%)
US	5.50	Jul-23	2.50
UK	5.25	Aug-23	3.25
EU	4.25	Jul-23	1.75
Japan	-0.10	Jan-16	-2.90
China (lending)	2.50	Aug-23	4.15
Korea	3.50	Jan-23	1.10
India	6.50	Feb-23	1.42
Indonesia	6.25	Apr-24	3.74

Money Mkt Rates	19-Jul	-1 mth	Chg (bps)
SPN (1M)	5.88	5.80	7.6
SUN (10Y)	6.94	7.17	-23.2
INDONIA (O/N, Rp)	6.13	6.15	-2.0
JIBOR 1M (Rp)	6.90	6.90	0.0

Bank Rates (Rp)	Apr	Mar	Chg (bps)
Lending (WC)	8.85	8.83	2.01
Deposit 1M	4.65	4.62	3.47
Savings	0.68	0.68	0.22

Currency/USD	19-Jul	-1 mth	Chg (%)
UK Pound	0.774	0.787	1.61
Euro	0.919	0.931	1.32
Japanese Yen	157.5	157.9	0.24
Chinese RMB	7.270	7.254	-0.22
Indonesia Rupiah	16,190	16,400	1.30

Capital Mkt	19-Jul	-1 mth	Chg (%)
JCI	7,294.5	6,734.8	8.31
DJIA	40,287.5	38,834.9	3.74
FTSE	8,155.7	8,191.3	-0.43
Nikkei 225	40,063.8	38,482.1	4.11
Hang Seng	17,417.7	17,915.6	-2.78

Foreign portfolio ownership (Rp Tn)	Jun	May	Chg (Rp Tn)
Stock	3,273.1	3,115.0	158.05
Govt. Bond	805.6	807.0	-1.38
Corp. Bond	8.2	8.2	-0.06

Trade & Commodities	19-Jul	-1 mth	Chg (%)
Baltic Dry Index	1,902.0	1,961.0	-3.0
S&P GSCI Index	555.8	582.3	-4.5
Oil (Brent, $/brl)	82.6	85.3	-3.2
Coal ($/MT)	139.6	141.3	-1.2
Gas ($/MMBtu)	2.00	2.43	-17.7
Gold ($/oz.)	2,400.8	2,329.5	3.1
Copper ($/MT)	9,179.3	9,532.3	-3.7
Nickel ($/MT)	15,985.5	17,025.7	-6.1
CPO ($/MT)	856.2	835.6	2.5
Rubber ($/kg)	1.66	1.71	-2.9

External Sector	Jun	May	Chg (%)
Export ($ bn)	20.84	22.33	-6.66
Import ($ bn)	18.45	19.40	-4.89
Trade bal. ($ bn)	2.39	2.93	-18.36
Central bank reserves ($ bn)*	140.2	139.0	0.87

Prompt Indicators	Jun	May	Apr
Consumer confidence index (CCI)	123.3	125.2	127.7
Car sales (%YoY)	-11.8	-13.2	-17.4
Motorcycle sales (%YoY)	3.5	-4.5	18.3

Manufacturing PMI	Jun	May	Chg (bps)
USA	51.6	51.3	30
Eurozone	45.8	47.3	-150
Japan	50.0	50.4	-40
China	51.8	51.7	10
Korea	52.0	51.6	40
Indonesia	50.7	52.1	-140

Source: Bloomberg, BI, BPS
Notes:
*Data from an earlier period
For changes in currency: **Black indicates appreciation against USD, **Red** otherwise
***For PMI, **>50** indicates economic expansion, **<50** otherwise

Indonesia – Economic Indicators Projection

	2019	2020	2021	2022	2023	2024E
Gross Domestic Product (% YoY)	5.0	-2.1	3.7	5.3	5.0	5.0
GDP per Capita (US$)	4175	3912	4350	4784	4920	5149
Consumer Price Index Inflation (% YoY)	2.7	1.7	1.9	5.5	2.6	3.2
BI 7-day Repo Rate (%)	5.00	3.75	3.50	5.50	6.00	6.25
USD/IDR Exchange Rate (end of the year)*	13,866	14,050	14,262	15,568	15,397	16,218
Trade Balance (US$ billion)	-3.2	21.7	35.3	54.5	37.0	32.6
Current Account Balance (% GDP)	-2.7	-0.4	0.3	1.0	-0.1	-0.5

*Estimation of the Rupiah's fundamental exchange rate

Economic, Banking & Industry Research Team

David E.Sumual
Chief Economist
david_sumual@bca.co.id
+6221 2358 8000 Ext:1051352

Agus Salim Hardjodinoto
Head of Industry and Regional Research
agus_lim@bca.co.id
+6221 2358 8000 Ext: 1005314

Barra Kukuh Mamia
Senior Economist
barra_mamia@bca.co.id
+6221 2358 8000 Ext: 1053819

Victor George Petrus Matindas
Senior Economist
victor_matindas@bca.co.id
+6221 2358 8000 Ext: 1058408

Gabriella Yolivia
Industry Analyst
gabriella_yolivia@bca.co.id
+6221 2358 8000 Ext: 1063933

Lazuardin Thariq Hamzah
Economist / Analyst
lazuardin_hamzah@bca.co.id
+6221 2358 8000 Ext: 1071724

Keely Julia Hasim
Economist / Analyst
keely_hasim@bca.co.id
+6221 2358 8000 Ext: 1071535

Elbert Timothy Lasiman
Economist / Analyst
Elbert_lasiman@bca.co.id
+6221 2358 8000 Ext: 1074310

Thierris Nora Kusuma
Economist / Analyst
thierris_kusuma@bca.co.id
+6221 2358 8000 Ext: 1071930

Nicholas Husni
Economist / Analyst
nicholas_husni@bca.co.id
+6221 2358 8000 Ext: 1079839

PT Bank Central Asia Tbk

Economic, Banking & Industry Research of BCA Group
20th Grand Indonesia, Menara BCA
Jl. M.H Thamrin No. 1, Jakarta 10310, Indonesia
Ph : (62-21) 2358-8000 Fax : (62-21) 2358-8343