Monetary Review

The game changer

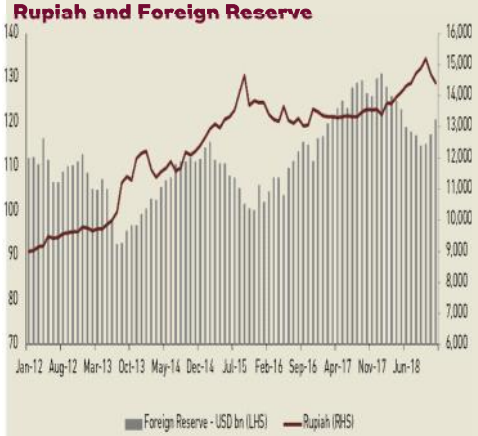
Policy rates' outcome

	Feb 2019	Mar 2019	Est.	Cons.
BI 7DRRR (%)	6.00	6.00	6.00	6.00
Deposit facility rate (%)	5.25	5.25	5.25	
Lending facility (rate) (%)	6.75	6.75	6.75	

Inflation & policy rate

Source : BPS & Bank Indonesia

Rupiah and Foreign Reserve



Source : Bloomberg

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Fed becomes more dovish

The Federal Reserve (Fed) is no longer in any rush to raise US interest rates. Fed proved its dovish stance after it cut its FFR hike projection in 2019 from 50 bps to no hike at all. Moreover, Fed plans to end its tapering off policy in September. It will start reducing the cap on Treasury securities monthly redemptions from the current USD30 bn to USD15 bn in May. The move denotes Fed's concern of US slowdown risk in 2019. Fed also revised PCE inflation projection to 1.8% YoY (vs 1.9% YoY in Dec meeting), unemployment rate to 3.7% (vs 3.5%) and GDP growth at 2.1% YoY (vs 2.3% YoY).

How trade war to affect Fed's decision?

We noted three major factors that restrain US economic growth and inflation recently: 1) US – China trade war; 2) Fed's monetary tightening policy and 3) declining tax cut effect. From those 3 factors we have mentioned, trade war has the highest uncertainty. Fed's policy has turned dovish in March meeting and declining tax cut effect has been priced in by Fed and investors. Trade war will become the key as different outcomes may lead to different Fed's monetary stance. If a trade deal to lift up previous tariff sanction is reached, it may give a boost to US and China economic. However, better economic outlook can be seen as an opportunity for another FFR hike cycle even though we see the maximum magnitude will only be at 25 bps in 2020. On the other side, if trade deal is not achieved and even both countries add new tariff sanctions, it will lead to even lower growth and FFR cut opportunity will start to emerge.

How trade war affect Indonesia's CAD and BI's policy rate decision?

Previously, we expect CAD to reach 2.8% of GDP due to trade war impacting global slowdown in 2019. How trade war ends will affect both China and US, leading to sluggish Indonesia's export demand and CAD. Non oil and gas export to US and China reached 25% proportion, making their growth strongly affect Indonesia's export. Then, how will it impact the BI's policy rate decision in 2019? The main reason of BI maintaining policy rate is because of external stability, mainly from CAD and capital flow due to global volatility. Better CAD will lead to better balance of payment (BoP) and more stable Rupiah which will open opportunity of policy rate cut in 2019-2020. On the other hand, high CAD will lead to sluggish BoP and more volatile Rupiah which will make central bank to maintain high policy rate or even raise it if necessary. We will follow our base case as stated below.

Base case: Trade war ends with peace, BI cut rate 50 bps in 2019 and 75 bps in 2020 (page 5 onwards)

Our base case assumes there will be a trade deal between US and China that will alleviate previous tariff sanction burden from both countries. Slowing down economies in both countries (mainly China) will give a pressure to both countries to settle their differences immediately. In this base case, China's growth should reach above 6.2% and favor Indonesia's export demand. We revised our CAD forecast back to 2.5% of GDP. Healthier CAD and less global volatility will bring Rupiah to Rp13,980 in 2019 average, bringing confidence for BI to cut policy rate by 50 bps in 2H19. However, better US macroeconomic figure (growth, inflation and unemployment rate) may lead to another FFR hike. In our opinion, Fed will raise FFR by only 25 bps in 2020 in order to maintain inflation on target at 2.0% YoY. On Indonesia's side, we believe BI will still continue rate cut of 75 bps in 2020 as the CAD will be healthier at 2.2% of GDP in 2020 and Rupiah will still remain below Rp 14,000.

Alternative case: more severe trade war, no rate movement in 2019 (page 7 onwards)

The alternative case contains the risk of trade deal failure that leads to another tariff increment. Higher tariff will drag down the growth forecast of China and US to below 6.0% YoY and 2.0% YoY, respectively. On this case, Indonesia's export can be hurt significantly as its main export destination's demand will decline and CAD will remain high at 3.0% of GDP. As the consequences, we see Rupiah will move around Rp 14,329 in average and Rp 14,550 in YE 2019, preventing BI to cut the rate in 2019. However, sluggish US growth will encourage FFR cut of 50 bps in 2020. We see BI to follow Fed's movement by higher magnitude of 100 bps due to: 1) sluggish growth at 4.8% YoY; 2) Low inflation at 2.0% - 2.5%; 3) Healthier CAD at 2.5% of GDP due to lower domestic demand. Other risks to our call can be seen in page 8.

We see Rupiah will be at Rp 13,980 in 2019 average with healthier CAD at 2.5% of GDP

Exhibit 1: Macroeconomic Indicator

Year-end 31-Dec	14A	15A	16A	17A	18A	19F	20F
Nominal GDP (Rp tn)	10,543	11,541	12,407	13,588	14,837	16,061	17,387
Nominal GDP (USD bn)	888	861	974	1,015	1,065	1,149	1,252
GDP/capita (USD) - Nominal	3,530	3,377	3,605	3,877	3,927	4,271	4,619
Real GDP (%YoY)	5.0	4.8	5.0	5.1	5.2	5.1	5.1
Private Consumption (%YoY)	5.1	5.0	5.0	4.9	5.0	5.1	5.0
Government consumption (%YoY)	2.0	5.4	-0.1	2.1	4.8	5.2	2.5
Gross Fixed Capital Formation (%Yo\	4.1	5.1	4.5	6.1	6.7	5.3	6.0
Exports (%YoY)	1.0	-2.0	-1.7	9.1	6.5	-0.5	5.5
Imports (%YoY)	2.2	-5.8	-2.3	8.1	12.0	1.2	4.6
Inflation rate (%YoY) - year end	8.4	3.4	3.0	3.6	3.1	3.2	3.0
Core inflation rate (%YoY) - year end	5.5	4.0	3.1	3.0	3.0	2.8	2.9
BI Rate	7.75	7.50					
BI 7 Days Reverse Repo Rate - year end			4.75	4.25	6.00	5.50	4.75
Rupiah / US Dollar - average	11,878	13,398	13,473	13,380	14,246	13,980	13,850
Rupiah / US Dollar - year end	12,440	13,788	13,346	13,555	14,390	13,720	13,975
Current account as % of GDP	-2.9	-2.1	-1.8	-1.7	-2.5	-2.5	-2.2
Fiscal balance as % of GDP	-2.4	-2.8	-2.5	-2.5	-1.8	-1.7	-1.5

Source: BI, BPS, MoF and Ciptadana Estimates

Our base case forecasts 50 bps BI's policy rate cut in 2019 and 100 bps in 2020. It will encourage 10 yr bond yield to be lower at 7.3% in YE 2019 and 6.7% in YE 2020

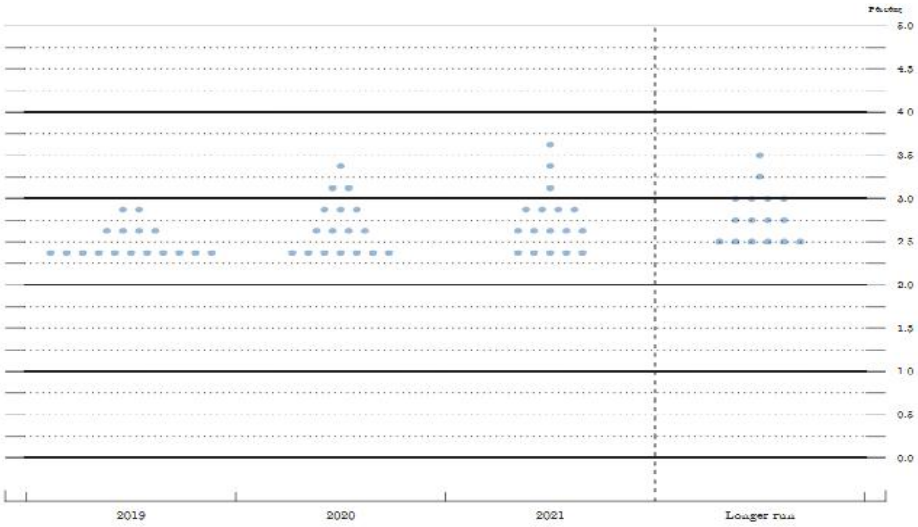
Exhibit 2: Ciptadana Forecast for Some Macro Indicators

Indicators	Base Case		Alternative Case	
	2019	2020	2019	2020
GDP Growth	5.1	5.1	5.0	4.8
CAD (% to GDP)	2.5	2.2	3	2.5
Rupiah - average	13,980	13,850	14,329	14,250
Rupiah - year end	13,720	13,975	14,555	14,100
BI 7DRRR - year end	5.50	4.75	6.00	5.00
10 yr Bond Yield - year end	7.30	6.70	7.80	7.10

Source: Ciptadana Estimates

Fed newest projection sees no FFR hike in 2019 and 25 bps hike in 2020.

Exhibit 3: Fed's March 2019 Meeting FFR Projection



Source: Federal Reserve

Weakening US economic estimation brings down FFR hike estimation to no hike at all

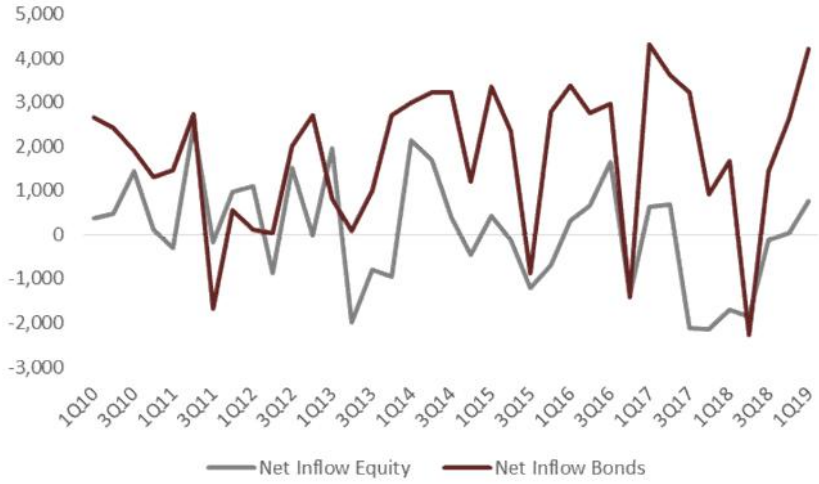
Exhibit 4: Differences of Fed's New Macroeconomic Assumption

	GDP Growth	PCE Inflation	PCE Core	Unemployment	FFR hike
Fed (Dec Projection)	2.30%	1.90%	2.00%	3.50%	50 bps
Fed (Mar Projection)	**2.10%**	**1.80%**	**2.00%**	**3.70%**	**0 bps**
Bloomberg Consensus (Jan Survey)	2.50%	1.90%	2.00%	3.60%	50 bps
Bloomberg Consensus (Feb Survey)	2.50%	1.80%	2.00%	3.70%	25 bps
Bloomberg Consensus (Mar Survey)	**2.40%**	**1.80%**	**1.90%**	**3.70%**	**0 bps**

Source: Federal Reserve, Bloomberg

Foreign Inflow to both equity and bonds market improved in 4Q18 and 1Q19 as Fed becomes more dovish

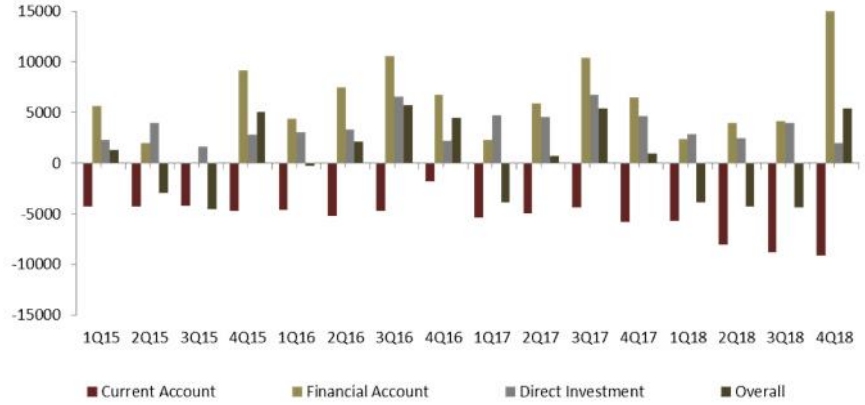
Exhibit 5: Foreign Inflow to Equity and Bonds Market



Source: Bloomberg

Improving foreign inflow positively affects financial account and overall balance of payment

Exhibit 6: Indonesia's BoP and Its Component



Source: BPS

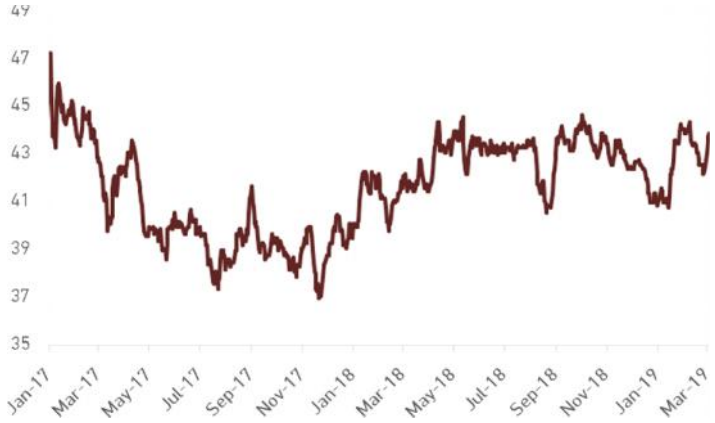
Our Base Forecast: Rate Cut 50 bps in 2019 and 75 bps in 2020

Our base forecast sees trade wars ends with a peace deal

In previous trade balance review report, we stated having a call of 50 bps rate cut in 2H19. Central bank may start it in 2nd semester because it will need proof of more manageable CAD and also trade war settlement between US and China. Our base case assumes there will be a trade deal between US and China that will alleviate previous tariff sanction burden from both countries. Slowing down economies in both countries will give a pressure to both countries to settle their differences immediately. The latest development, China is seen to be more comply of US demand of intellectual right and it also offers significant amount of US product purchase. Moreover, US will have a presidential election in 2020. A deal that gives US a growth pain will deflate Trump's and Republican's electability.

Positive development about trade war will increase Trump's approval rating like in 1H18 and Feb-19

Exhibit 7: Real Clear Politics Trump's Approval Rating Average



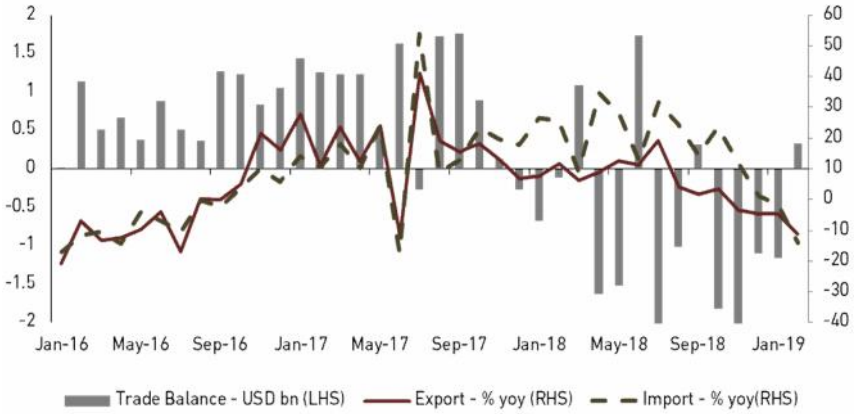
Source: Bloomberg, Real Clear Politics

US-China Trade deal favors Indonesia's CAD, Rupiah and policy rate cut

In this base case, China's growth should reach higher than IMF's projection of 6.2% and favor Indonesia's export demand. Moreover, China is seen to proceed with its tax stimulus to boost growth even more. We also see US growth will meet IMF's 2.5% projection if trade war ends with peace deal. On domestic side, Indonesia's import control policy from government and central bank is seen to bear fruits as the import growth declined significantly in 2M19 (sees exhibit 8) and even creating trade surplus for Indonesia in February 2019. We revised our CAD forecast back to 2.5% of GDP. Manageable CAD and global volatility will bring Rupiah to Rp13,980 in 2019 average, bringing confidence for BI to cut policy rate by 50 bps in 2H19.

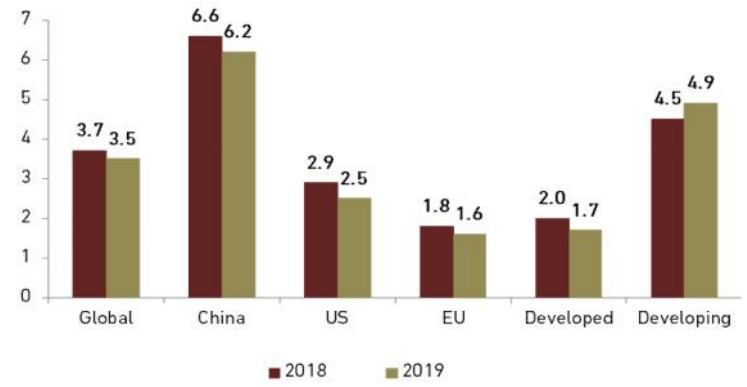
Fall of import growth helped Indonesia to gain trade surplus in 2019

Exhibit 8: Indonesia Trade Balance Position



Source: BPS

Exhibit 9: IMF Global Growth Forecast



Source: IMF

Better US and global growth may lead to another FFR hike

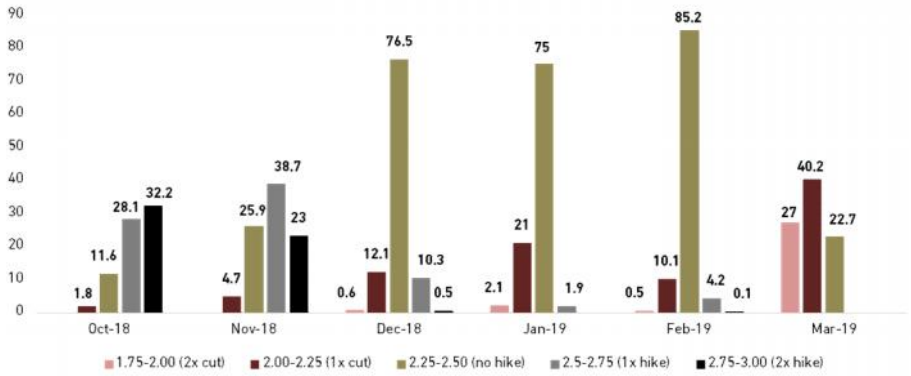
However, the settlement of trade war will also favor US growth. Better US macroeconomic figure (growth, inflation and unemployment rate) may lead to another FFR hike. PCE Inflation should be back to 2.0% level due to better demand. Nevertheless, we do not see the growth will as strong as in 2018 at 3.1% YoY, as 2018 growth got some boost from tax cut implementation in December 2017. In our opinion, Fed will raise FFR by only 25 bps in 2020 in order to maintain inflation on target at 2.0% YoY.

Better fundamental to encourage 2020 FFR hike, BI to continue 75 bps rate cut in 2020

How will it affect Indonesia's central bank decision? There will be a small volatility because investor is seen to price in FFR cut in 2020 according to Bloomberg world interest rate probability (see exhibit 10). However, Indonesia's fundamental facing FFR hike volatility should be different than 2018 case. We expect CAD declining to 2.20% of GDP in 2020, much lower than 2018 position at 2.98% of GDP. Better CAD fundamental will favor Indonesia immune system facing FFR hike. Furthermore, inflation should align to new government and central target 3.0% in 2020-2021, bringing some room for further rate cut. Although Rupiah may depreciate from Rp 13,720 in YE 2019 to Rp 13,975 in YE 2020 because of FFR hike, we see there will be still enough room for BI cutting rate at 75 bps in 2020.

The median of FFR probability sees FFR cut of 25 bps untill YE 2019.

Exhibit 10: Bloomberg's FFR Probability for YE 2019



Source: Bloomberg

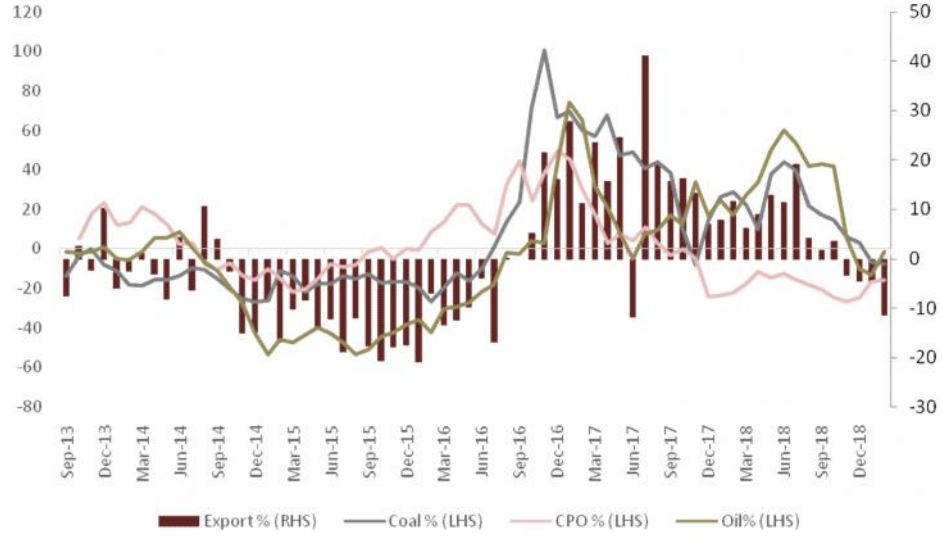
Alternative Forecast: Rate on hold in 2019 and cut 100 bps in 2020

Our alternative forecast assumes trade war continue with higher tariff

In this report, we also include our calculation whether the trade talk failed and US increased its tariff of USD 250 bn import from China from 10% to 25%. The increment of tariff will drag down the growth forecast of China and US to below 6.0% YoY and 2.0% YoY, respectively. On this case, Indonesia's export can be hurt significantly as its main export destination's demand will decline. Moreover, slowing down global growth will make commodities price declining trend (esp. coal and CPO) even worse. The fall of import growth due to BI and government policy mix will not help much and CAD will remain high at 3.0% of GDP and preventing BI to lower the rate in 2019. As the consequences, we see Rupiah will move around Rp 14,329 in average and Rp 14,550 in YE 2019. The depreciation magnitude will be insignificant because the global slowdown should increase FFR cut odds that we will discuss in next paragraph.

Weaken global growth will lead to lower commodities price and even worse Indonesia's export growth

Exhibit 11: Indonesia's export and its main commodities price growth



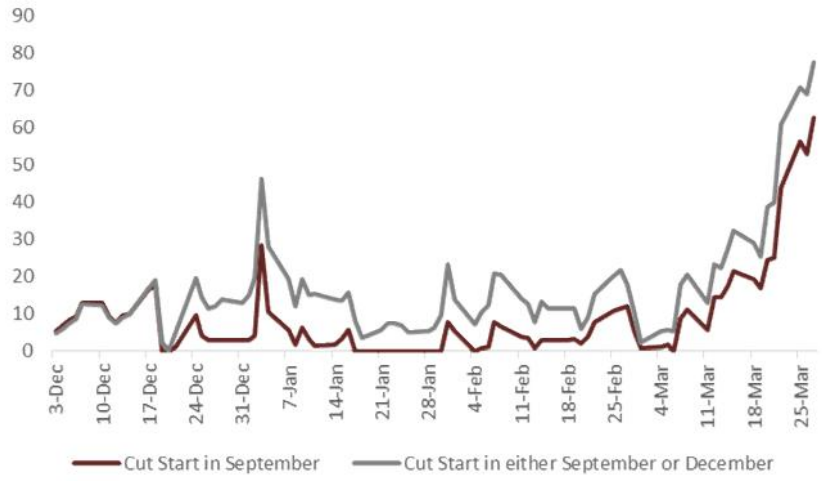
Source: BPS, Bloomberg

Sluggish US growth will lead to FFR cut in 2020.

If US macroeconomic figure worsen due to increasing trade war escalation, Fed should start considering FFR cut. In current situation, even market already predict for FFR cut starting 2H19 according to Bloomberg world interest rate probability. Probability of rate cut has increased to around 70% for Dec meeting after March FOMC meeting when Fed put more concern on slowing down US growth. This projection is believed to have further downside risk if trade war worsen, forcing Fed to be dovish even more. We predict Fed to cut rate in 2020 by 50 bps in the alternative case.

The probability of FFR cut in 2019 increased significantly after Fed indicated no FFR hike for 2019 in March meeting

Exhibit 12: Probability of FFR Cut in 2H19



Source: Bloomberg

BI to cut 100 bps in 2020 because of Fed's move

With Fed's move to cut rate, we believe it may encourage Bank Indonesia moving to similar direction. Bank Indonesia may also start rate cut in 2020 but we see the cut magnitude will be higher than Fed's. In this alternative case, Indonesia faced high CAD (3.0% of GDP) and also high policy rate (6.00%) in 2019 which affect negatively to growth in 2020. Should trade war becomes more severe, we predict Indonesia's growth declining to 4.8% YoY in 2020, as there will be no boost from consumption anymore due to election and government's populist program as in 2019. Inflation may also move to 2.0% - 2.5% or lower end target of government and central bank[1]. The positive side is weakening growth will lead to fall of import growth in 2020 which make CAD better at 2.5% of GDP. Sluggish growth, weak inflation and healthier CAD may encourage central bank to cut policy rate by 100 bps, higher than our estimate of FFR cut at 50 bps.

Other risks to our call

We also have other risks to be considered affecting our call in 2019-2020

1. Fed to raise FFR more than our expectation if US economy growth is much better after the trade deal.
2. Brexit uncertainty
3. Trump's new policies near the 2020 election
4. Recession potential in both US and China
5. Indonesia's political uncertainty if opposition wins the 2019 election.

[1] **Government and BI plans to lower the inflation target to 2.0% - 4.0% from 2.5% - 4.5% starting 2020.**

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