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Indonesia and the Emerging Markets Crisis

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IN 2017 EMERGING MARKETS WERE THE BEST PERFORMING major asset class rising +33% and in 2018 it is the worst equity market segment with -21%. What a difference a year can make.

Over the past decade, a lot of capital has flowed into emerging markets thanks in part to excessive liquidity of QE (Quantitative Easing) in advanced economies foremost the US.

Now that the United States is raising interest rates and moved to QT (Quantitative Tightening) it is causing pressure on emerging markets and also on Indonesia.

Despite last year's stellar performance, emerging-market stresses have been building since at least 2013. Investors may have forgotten the effect of the "taper tantrum" on the so-called Fragile Five – Brazil, India, Indonesia, Turkey and South Africa – a term coined by Morgan Stanley to describe their vulnerability to capital outflows when interest rates in the U.S. rise.

Monetary accommodation, lower current-account deficits and growth disguised the underlying challenges, attracting more capital to emerging markets.

Indonesia's external vulnerability indicators including foreign exchange reserves, external debt, net international investment remain elevated in comparison to the rest of ASEAN and India, even if they may look better in comparison to taper tantrum of 2013. Indonesian assets may remain under pressure, albeit less volatile than in 2013, if the emerging markets sell-off continues. The valuation on the MSCI Indonesia gauge isn't "overly compelling" at a 16% premium compared with Asia ex-Japan stocks.

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Overseas investors who have pulled around USD 3.7 billion from the Indonesian equity market this year may be wary of jumping back in amid worsening sentiment toward emerging- market assets. Foreigners are unlikely to return to Indonesian equites without a credible policy to stabilize the rupiah and a recovery in corporate earnings.

The rupiah was hitting its lowest against the dollar in over twenty years last month and prompting Bank Indonesia to intervene in the market as the currency hit its lowest since the Asian financial crisis in 1998, according to Reuters data.

A combination of weak trade data and high external debt relative to other Asian markets makes the rupiah vulnerable to volatility in emerging market currencies.

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Increasingly the analysts community "consensus view" seems to imply that Indonesia equity valuations haven't become overly compelling yet and consensus still needs to factor in rupiah weakness even after the drop in the in Jakarta Composite Index this year.

Valuations have improved with the decline in the stock market. Currently the Indonesia Investable universe of

539 stocks trades at a forward P/E (Price-earnings ratio) of 14.7x, but the growing question for investors in Indonesian stocks is whether EM "contagion" could lead to further selling pressure on IDX.

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The line of thinking goes like this: while the emerging market asset class may offer value over the long haul, investors will sell relatively safe holdings to cover losses in more vulnerable markets or, worse, treat all emerging markets the same and sell indiscriminately. A herd mentality has taken over, meaning no matter what the relative risks and potential returns are in individual countries, investors who choose to buy run the risk of being trampled.

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Global trade tension, a strengthening dollar and the prospect of more U.S. interest-rate increases led portfolio flows into emerging markets to slow to USD 2.2 billion last month from USD 13.7 billion in July, according to the Washington-based Institute of International Finance.

As long as trade wars are front and centre and the Fed is hiking interest rates versus the rest of the world, we are in an environment that leads to much stronger U.S. dollar and potential for further emerging market weakness.

Over time the Emerging Markets sell-off is an opportunity to buy on the basis of stronger fundamentals, such as easing inflation, trade surpluses and widening growth differentials between emerging and developed markets, but for now the downtrend seems firmly in place.

Indonesia's key stock index may be down 15% from its February peak but it still isn't time to get back into equities (yet). The rupiah's weakness may still keep global investors away from Indonesia as emerging-market turmoil deepens.

Markets are as efficient as the people within them and financial crises always take longer to arrive and unfold more quickly than people expect. ■