Turning Tides

Strategic Moves in 3Q 2024 Indonesian Fixed Income

2Q 2024 saw increased volatility in the Indonesian fixed-income market. Elevated yields and fluctuating exchange rates have been dominant themes, influenced by both domestic and international economic conditions.

Throughout 2Q 2024, the 10-Year Indonesian Government Bond yield saw significant fluctuations. After spiking from 6.7% to 7.2% by May, the yield began a steady decline, closing the quarter around 7.0% in July. This downward trend was driven by easing inflation, a potential pause in US Federal Reserve rate hikes, and a stronger Rupiah. Bank Indonesia’s unexpected rate hike to 6.25% underscored its commitment to stabilizing the Rupiah despite a resilient domestic economy.

Market Fluctuations

In May, the 10-Year Indonesian Government Bond yield held steady at 6.9-7.2%. The Rupiah appreciated slightly to 16,200 (USD/IDR) amid high US Treasury yields (4.6%) and Fed rate cut delays, keeping the 10-Year yield near 7.2%.

In June, strong foreign inflows lowered the 10-Year yield to 7.1% from 7.2% in May. This yield drop aligned with reduced inflation, falling from 2.84% in May to 2.51% in June.

By July, the yield fell further to 6.9% due to easing inflation, a potential slowdown in US rate hikes, and a stronger Rupiah, ending the quarter around 7.0%. Bank Indonesia’s unexpected rate hike to 6.25% highlighted its commitment to the Rupiah amid overall economic stability.

2Q 2024 underscored the importance of precise Bond Duration management in the face of fluctuating yields and volatile exchange rates. While Indonesia's domestic economic indicators remained largely positive, the broader market was characterized by continued volatility and selling pressures, largely driven by global uncertainties. In response to these conditions, our strategy has centered on focusing our portfolio on short-term government bonds, offering a more defensive positioning. The Federal Reserve's cautious stance on rate cuts, driven by persistent inflation above target levels, has further complicated the landscape. The inversion in segments of the Indonesian Sovereign Yield Curve indicates that short-to-mid duration bonds may present more favorable risk-adjusted returns.

Yield Curve Steepening

- **Yield Curve Steepening Signals Shift:** The Indonesian Sovereign Yield Curve shows signs of steepening, with the 2Y and 10Y spread widening from 35 to 55 basis points in 3Q 2024. This shift highlights increased long-term yield demand, driven by persistent global rate pressures and domestic inflation risks.
- **Strategic Duration Management:** At the time of investment, our strategy emphasized a balanced allocation between short-to-mid duration bonds (3- to 5-Year yields of 6.8%-7.1%) and selective exposure to longer maturities (10- to 15-Year yields of 7.3%-7.6%). This approach mitigates interest rate risk while capitalizing on the steepening curve. We have focused on short-to-mid duration bonds, particularly 2- to 5-Year Indonesian Government Bonds, which offer yields ranging from 6.6% to 6.8%, providing a favorable risk-return profile with reduced exposure to long-term volatility.
- **Navigating Volatility with Agility:** In the face of currency fluctuations, global uncertainties, and evolving inflation trends, we focus on high-quality, liquid assets. Our data-driven strategies aim to optimize risk-adjusted returns in a dynamic and unpredictable market landscape. We are also concentrating on bonds with high current yields and elevated coupons, which deliver returns surpassing those of time deposits. Additionally, we are selectively increasing exposure to the 10- to 15-Year tenor, where yields remain attractive, positioning ourselves to potentially benefit if the yield curve flattens further amid improving economic conditions.

Our outlook emphasizes the strategic value of these bonds in navigating the current market environment. We are positioning ourselves to capitalize on the opportunities within the Indonesian fixed-income market by focusing on assets that balance risk and reward effectively. As we move forward, careful selection and timing will be key to maximizing returns in a landscape that demands both agility and deep market insight.

The events of 2Q 2024 have highlighted the dynamic and often unpredictable nature of the Indonesian fixed-income market. As such, the need for agile and well-informed investment strategies has never been more apparent. Navigating the complexities of this market requires a keen understanding of both local and global factors, enabling investors to not only manage risks but also to capitalize on emerging opportunities with precision and confidence.

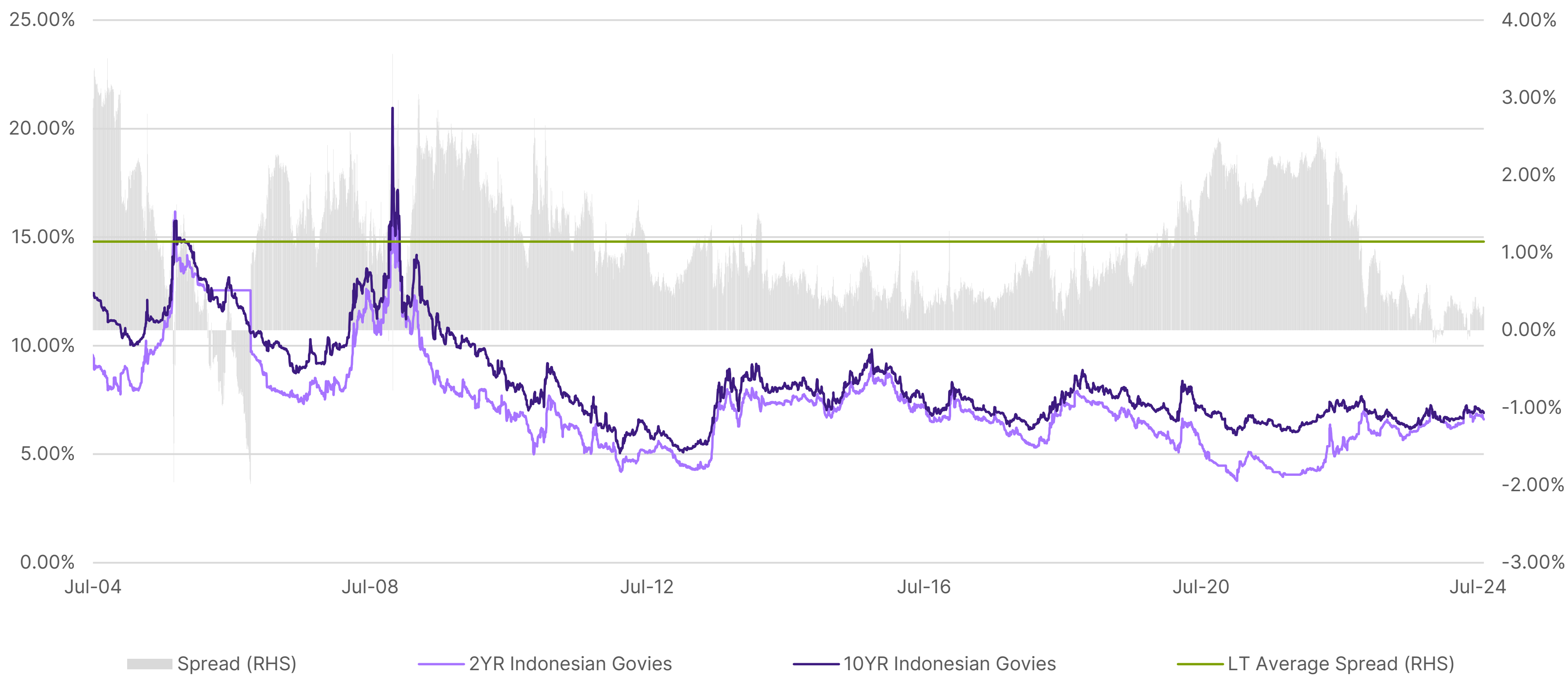
Risk Factors

Interest rate risk from global and domestic changes impacts bond prices and yields. Currency risk arises from Rupiah fluctuations affecting foreign returns. Inflation can erode real returns. Political instability and policy shifts may alter market perceptions. Liquidity issues could affect bond transactions. Credit risk includes potential downgrades of Indonesia's sovereign rating, impacting yields and prices. Global economic conditions, like trade tensions, also influence bond markets.

Source: Simpan Asset Management, Bloomberg, Bank Indonesia, Federal Reserve System. Data as of August 2024.

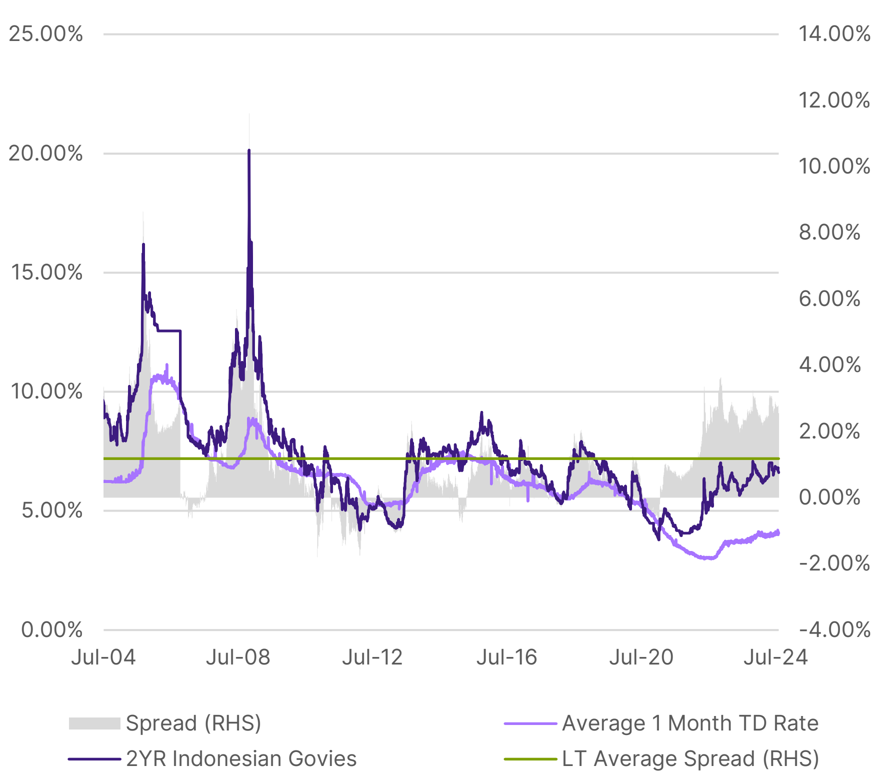
Indonesian Government Bonds: Balancing Long-Term Gains with Short-Term Yield Prospects

Simpan ASSET MANAGEMENT



While we maintain a cautiously optimistic outlook on Indonesian yields, it is challenging to fully commit to long-duration bonds at this time. Currently, the yield difference between 2-year and 10-year Indonesian government bonds is just 0.30%, compared to the long-term average spread of 1.14%. This discrepancy suggests that 2-year Indonesian government bonds should trade at around 5.76%, down from their current level of 6.60%. Nonetheless, considering potential capital appreciation, longer-duration bonds (such as 10-year bonds and beyond) still offer higher capital gains if yields compress further.

Is there potential for short-tenor yields to decrease? The answer is yes. **When comparing the current 2-year yield to 1-month Time Deposit (TD) rates, the spread remains too high, making the government bond market attractive.** Given the current TD rates at 4.05%, the 2-year yield should be around 5.23%. This suggests that there is room for short-tenor yields to decrease, enhancing the appeal of short-duration government bonds.



Furthermore, we must consider whether Time Deposit rates themselves might decrease. Historical average spreads between TD rates and inflation suggest that a reduction is indeed possible. With the current CPI increasing by 2.51% year-over-year in July 2024, the spread between TD rates and the CPI is still too high at 1.54%. **This spread should ideally decrease to only 0.73%, implying that TD rates offered by banks should be around 3.24%.** Even if Indonesian CPI were to rise to its 5-year average of 2.91%, the appropriate TD rate should be 3.64%, still reflecting a decrease of around 42 basis points.

Moreover, Indonesia's fiscal and monetary policies remain supportive of lower yields. Bank Indonesia has maintained an accommodative stance, and the government's commitment to prudent fiscal management bolsters investor confidence. **As Indonesia continues to demonstrate strong economic fundamentals and political stability, the outlook for both short and long-duration bonds remains favorable, albeit with the aforementioned caveats.**

Therefore, while the yield curve dynamics suggest caution, the broader macroeconomic factors and potential for rate adjustments present opportunities for strategic positioning in Indonesian government bonds.

Source: Simpan Asset Management, Bloomberg, Bank Indonesia, Federal Reserve System. Data as of August 2024.

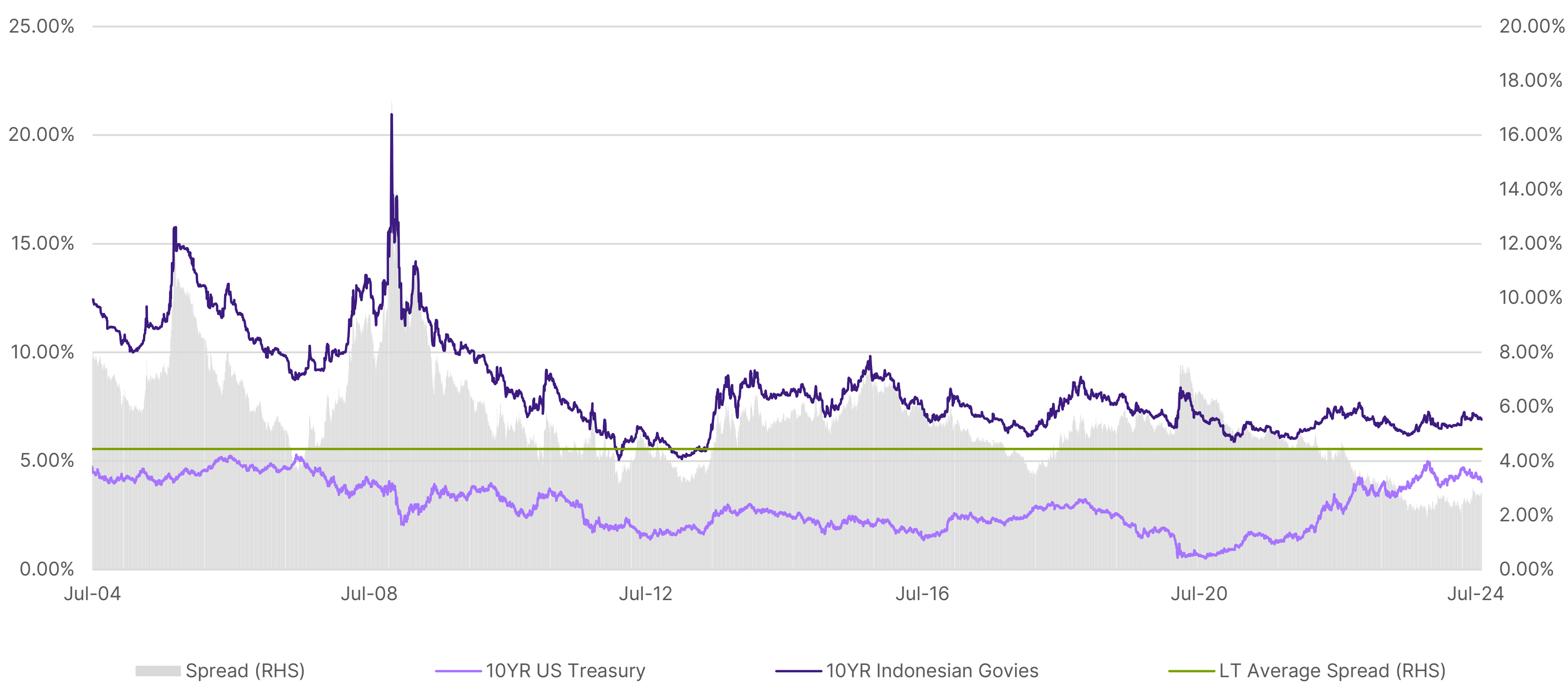
Widening UST-Indonesian Yield Spread Highlights Investment Challenges

The spread between UST yields and Indonesian government bond yields presents a complex and challenging scenario. Currently, this spread is 2.87%, indicating that Indonesian government bonds need to offer better yields to remain competitive and attractive to investors. If UST yields were to fall to the previously discussed level of 3.59%, Indonesian yields, based on the historical average spread over the past 10 years, should be around 8.42%. This substantial spread underscores the necessity for higher yields on Indonesian government bonds to draw investment.

In October 2023, the spread between UST yields and Indonesian government bond yields reached an all-time low of 1.89%. At that time, UST yields were at 4.99%, while Indonesian yields were at 6.88%. This narrow spread resembled a similar situation in February 2012, when Indonesian yields hit a record low of 5.05% and UST yields were at 2.04%, resulting in a spread of 3.01%. **The current conditions echo this historical spread, highlighting the challenges for global investors considering a return to the Indonesian bond market given the relatively high appeal of current UST yield levels.**

For Indonesian yields to become attractive to foreign investors again, UST yields would need to drop significantly, reaching at least 2.07%. This level corresponds to a US CPI of about 2.66%, based on the long-term average relationship between US CPI and UST yields. However, achieving such a decrease in UST yields may be difficult in the current economic climate, making it challenging for Indonesian government bonds to regain their former attractiveness to global investors.

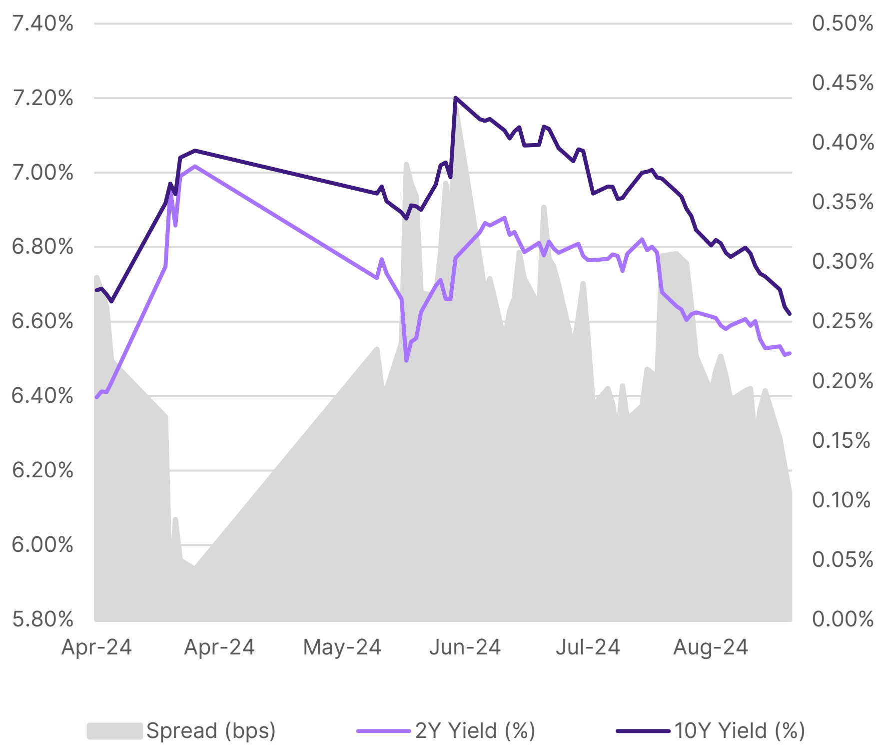
Despite these challenges for foreign investors, **it is clear that Rupiah-based investors find Indonesian yields more attractive than their non-Rupiah counterparts.** The value of the Rupiah is currently depreciating at a rate of 2.51%, yet risk-free investments in 10-year Indonesian government bonds still offer a substantial spread of 4.39%. This spread is notably better than the long-term average difference of 3.05%. If Indonesian CPI remains at its current level and the spread reverts to its historical average, Indonesian yields could potentially decrease to around 5.56%. Even if Indonesian CPI increases to its five-year average of 2.91% or its ten-year average of 3.59%, Indonesian government bonds still have room for appreciation, with yields potentially dropping to 5.96% or at least 6.64%, respectively.



Source: Simpan Asset Management, Bloomberg, Bank Indonesia, Federal Reserve System. Data as of August 2024.

Indonesian Sovereign Yield Curve: Yield Curve Steepening Presents a Shift

As we progress through 3Q 2024, the Indonesian Sovereign Yield Curve is displaying signs of steepening, which represents a notable shift from the flatter curve observed earlier this year. The 2Y and 10Y spread, measuring the difference between the 2-Year and 10-Year Government Bond yields, has widened from 35 bps in Q2 to 55 bps by mid-August. This increase suggests that investors are demanding higher yields for longer-term bonds, reflecting expectations of future inflation normalization, potential growth deceleration, and rising credit risk premiums.



In the short end, the 2-Year Indonesian Government Bond yield has remained relatively stable, hovering around 6.5%, supported by Bank Indonesia's consistent monetary policy and robust domestic liquidity. Conversely, the 10-Year yield, after peaking at 7.3% in April, has since declined, particularly in mid-August, dropping as low as 6.6% due to easing inflation, a stronger Rupiah, and increased foreign inflows.

Several factors drive the steepening of the curve:

- **Global Monetary Policy:** Despite the rate cut sentiment, the Federal Reserve's persistent stance on maintaining higher interest rates remains. The Fed Funds Rate is expected to remain above 5% through year-end has still pressured long-term yields globally, including in Indonesia.
- **Domestic Inflation:** While headline inflation in Indonesia eased to 2.51% in June, core inflation remains above 3%, fueling expectations of longer-term price pressures that could lead to further yield adjustments.
- **Currency Movements:** The Rupiah's recent volatility, despite recovering from its four-year low, continues to pose risks, particularly for long-term foreign investors.

<u>Simpan View</u>: Strategic Implications of Yield Curve Steepening

The steepening of the Indonesian yield curve, marked by a widening spread between the 2-Year and 10-Year Government Bond yields, from 35 basis points in Q2 to 55 basis points by mid-August, presents both opportunities and challenges for investors. The 10-Year yield, which peaked at 7.3% in April, has since declined to approximately 6.6% in mid-August, reflecting a shift in market dynamics. This drop in the 10-Year yield opens up opportunities for capital appreciation in longer-dated bonds, particularly within the 10- to 15-Year segment, where continued easing of inflation and increased foreign inflows could further bolster bond prices. However, the risks associated with long-term exposure remain significant, especially as the initial curve steepening indicated rising long-term yields. This necessitates a balanced strategy to manage potential mark-to-market losses if yields rebound unexpectedly.

In response, our strategy emphasizes short-to-mid duration bonds, particularly 2- to 5-Year Indonesian Government Bonds, which now offer yields ranging from 6.5% to 6.6%. This provides a favorable risk-return profile with reduced exposure to long-term volatility. **We are also focusing on bonds with high current yields and high coupon rate bonds, which deliver returns exceeding those of time deposits**. Additionally, we are **selectively increasing exposure to the 10- to 15-Year segment (benchmark and off-benchmark)**, where yields remain attractive. This positions us to potentially benefit if the yield curve flattens further amid improving economic conditions.

Reksa Dana Simpan Bond Fund

Bond Fund
Reksa Dana Pendapatan Tetap

Asset Allocation	IDR Fixed Income
Investor Rationale	IDR Bond Index Exposure
Return Profile (Net p.a.)	**5-7%**
Risk Profile	Low

Simpan Bond Fund is a Fixed Income mutual fund investing in a diversified basket of IDR Indonesian Government Bonds.

The strategy aims to deliver stable returns above inflation, with reduced volatility. The Fund is complementary for clients who earn and spend in IDR and wish to harvest higher yield that is daily liquid.

Source: Simpan Asset Management, Bloomberg, Bank Indonesia, Federal Reserve System. Data as of August 2024.

Information & Disclosures

These materials have been prepared by Simpan Asset Management (including any of its affiliates “Simpan”) for Simpan’s client or potential client to whom such materials are directly addressed and delivered in connection with an actual or potential mandate or engagement and may not be used or relied upon for any purpose other than as specifically contemplated by a written agreement with Simpan. These materials are based on information provided by potential transaction participants, from public sources or otherwise reviewed by Simpan. Information herein also does not constitute professional advice or recommendations regarding any securities or investments. No investment decisions should be based on the information herein. Nothing in this document constitutes accounting, legal, regulatory, tax or other advice. Although the information herein has been obtained from sources that Simpan believes to be reliable, no representation or warranty (express or implied) is made as to the accuracy, completeness, reliability or fairness of the information, opinions or projections herein, all of which are subject to change without notice. This document is for the internal use of the recipient only. These materials were designed for use by specific persons familiar with the business and affairs of the Company and are being furnished and should be considered only in connection with other information, oral or written, being provided by Simpan in connection herewith. These materials are not intended to provide the sole basis for evaluating, and should not be considered a recommendation with respect to, any transaction or other matter. Simpan does not provide tax advice. Accordingly, any statements contained herein as to tax matters were neither written nor intended by Simpan to be used and cannot be used by any taxpayer for the purpose of avoiding tax penalties that may be imposed on such taxpayer. Accordingly, any taxpayer should seek advice based on such taxpayer’s particular circumstances from an independent tax advisor. These materials do not constitute an offer or solicitation to sell or purchase any securities and are not a commitment by Simpan to provide or arrange any financing for any transaction or to purchase any security in connection therewith. Simpan assumes no obligation to update or otherwise revise these materials. These materials have not been prepared with a view toward public disclosure under state or federal securities laws or otherwise, and may not be reproduced, disseminated, quoted, summarized or referred to, in whole or in part, without the prior written consent of Simpan. These materials may not reflect information known to other professionals in other business areas of Simpan.