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INDONESIA INVESTMENTS

“Losing Its Growth Momentum”
Indonesia Investments Research Report

*Losing Its Growth Momentum*

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Preface

The monthly research reports of Indonesia Investments are written and published by Van Der Schaar Investments B.V. - located in Delft, the Netherlands. These reports aim to inform the reader of the latest, most relevant, political, economic and social developments in Indonesia as well as those key international developments that impact on the Indonesian economy or politics.

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Lastly, we would like to emphasize that - although we strive to present accurate, up-to-date, and objective information to the reader - Indonesia Investments cannot guarantee the accuracy of all data that is included in this report.
Introduction

The Global Environment

The global environment has not improved in August 2019. In fact, it has deteriorated as reflected by declining stock indices in most parts of the world as well as a record-setting trend for the price of gold (known for being one of the world’s crucial safe haven assets). Unlike money or currencies, central banks cannot print gold, while the value of gold is not affected by interest rate decisions. In other words, gold cannot become worthless, and thus this precious metal acts as a key safe haven in times of global economic or political uncertainty. And the recent record-setting trend of the gold price (with the price increasing steeply since mid-May 2019) surely shows that demand for gold is currently huge. This may very well persist in the coming weeks.

So what happened in the month of August 2019 that made investors – around the world – concerned and seek safe(r) assets? Well, there is plenty: an escalating tariff war between the United States and China, ongoing trouble in Hong Kong, Argentina being on the brink of default, rising chances of seeing a “no-deal Brexit” after the House of Commons was suspended by UK Prime Minister Boris Johnson, and contracting economies in Germany and the United Kingdom, while policymakers are split on whether the European Central Bank (ECB) needs to come up with a new major package including an interest rate cut as well as the restart of quantitative easing to encourage growth.

Escalating Tariff War between the United States and China

In August we witnessed a serious escalation in the ongoing tariff war between the United States (US) and China. Although nothing new (tensions have been simmering for almost one-and-a-half years now) it does make investors nervous. And being the world’s top two economies, hiccups that occur in these giant economies are surely felt across the globe.

At the start of August 2019 US President Donald Trump said he would impose a fresh 10 percent tariff on another USD $300 billion worth of Chinese goods per 1 September 2019, effectively ending the cease-fire that was agreed upon by both sides at the G-20 summit in July 2019.
Towards the end of August, Beijing responded by announcing to slap retaliatory duties (ranging between 5-10 percent) on USD $75 billion of US imports, while also resuming a 25 percent tariff on US cars and a 5 percent tariff on auto parts and components.

Shortly after Beijing had announced these retaliatory duties, Trump took it up a notch and said the existing levies on USD $250 billion of Chinese goods are to be raised from 25 percent to 30 percent, while the planned tariffs on another USD $300 billion of imports (set to start taking effect on 1 September) were raised from 10 percent to 15 percent.

What was also quite remarkable was Trump’s rant on Twitter – directed at China – on 23 August 2019. In a series of tweets Trump made the following statements:

“Our Country has lost, stupidly, Trillions of Dollars with China over many years. They have stolen our Intellectual Property at a rate of Hundreds of Billions of Dollars a year, & they want to continue. I won't let that happen! We don't need China and, frankly, would be far better off without them. The vast amounts of money made and stolen by China from the United States, year after year, for decades, will and must STOP. Our great American companies are hereby ordered to immediately start looking for an alternative to China, including bringing your companies HOME and making your products in the USA. I will be responding to China’s Tariffs this afternoon. This is a GREAT opportunity for the United States. Also, I am ordering all carriers, including Fed Ex, Amazon, UPS and the Post Office, to SEARCH FOR & REFUSE all deliveries of Fentanyl from China (or
anywhere else!). Fentanyl kills 100,000 Americans a year. President Xi said this would stop - it didn’t. Our Economy, because of our gains in the last 2 1/2 years, is MUCH larger than that of China. We will keep it that way!”

And while there emerged some optimism after Trump decided to postpone part of the US tariffs in mid-August, optimism proved to be short-lived as the White House did indeed slap tariffs (15 percent) on roughly USD $112 billion of Chinese imports per 1 September 2019, with the targeted goods being over 3,200 consumer goods ranging from apparel and footwear to Apple Watches. Meanwhile, a separate batch of about USD $160 billion of Chinese goods – which includes laptops and mobile phones – are to be imposed on 15 December 2019.

The US and China are preparing for a new round of negotiations in September 2019 (to take place in Washington). It is unclear, however, what the impact of the latest escalation is on these planned negotiations. Earlier, Trump had stated that the talks may be cancelled. Later, however, Trump said the September talks are still on. But it has been reported in media that Chinese and US officials struggle to find a suitable date to continue trade talks.

There are, however, no indications that the US-China tariff war will be settled anytime soon, with Trump and his counterpart Xi Jinping seemingly refusing to surrender. In fact, the tariff war could continue for years to come as Trump has good chances of being re-elected in 2020.

**Escalating Conflict between Trump and Federal Reserve Chairman Powell**

Besides the attack on China, Trump also – again – criticized the policy of the US Federal Reserve (Fed) as, according to Trump, this institution has failed to help the US economy by keeping interest rates too high, too long. The US economy is currently struggling due to the global slowdown and escalating uncertainty related to the US-China tariff war.

In late-August 2019 the Fed released the minutes of its July 2019 meeting (when it cut the benchmark interest rate by 25 basis points), while Fed Chairman Jerome Powell made a statement. Both the minutes and Powell’s statement depicted the July rate cut as a “mid-cycle adjustment”. This phrase immediately made many market participants believe that
the Fed may not be preparing for a series of interest rate cuts to support the US economy. The minutes actually showed that the Fed is divided over whether it should ease monetary policy further, or not.

Also at Jackson Hole – where each year Federal Reserve officials are joined by academic economists and central bankers from around the world – Fed Chairman Powell did not have any clear information about future rate cuts. Powell did say, however, that Trump’s trade war has complicated the Fed’s ability to determine interest rates and has contributed to the global economic slowdown.

Trump immediately ‘retaliated’ through the following tweet:

“As usual, the Fed did NOTHING! It is incredible that they can “speak” without knowing or asking what I am doing, which will be announced shortly. We have a very strong dollar and a very weak Fed. I will work “brilliantly” with both, and the U.S. will do great. My only question is, who is our bigger enemy, Jay Powell or Chairman Xi?”

In the tweet Trump labels both Federal Reserve Chairman Powell and China’s leader Xi Jinping ‘enemies of the USA’. Again, it is a highly unusual statement, and an example of highly unusual diplomacy. But with Trump in office since January 2017, nearly four years now, the world has somewhat become used to the style of this controversial president.
Trump also to Paralyse the World Trade Organization?

There has also emerged concern about the World Trade Organization (WTO) as the Group of Seven leaders pledged to reform this trade body and to address some key gaps that have been detected in the international trading system, including tougher intellectual-property protection, a more efficient system for the settling of disagreements, and new checks and constraints on unfair commercial practices.

Trump, however, is not satisfied yet with the proposals that have been made to update the WTO, and this could have some serious consequences. If Trump decides to continue to block appointments to the WTO appellate body (the standing body of seven persons that hears appeals from reports issued by panels in disputes brought on by WTO members), then no new rulings can be issued by this body after 10 December 2019. This would then undermine the WTO’s ability to resolve trade conflicts, thereby exacerbating international economic instability and uncertainty. It could become the start of an era where economic power prevails over international law.

Concern about the Inverted Yield Curve

Another concern for investors is the “inverted yield curve” which occurs when the interest rates on short-term bonds are higher than the interest rates that is paid by long-term bonds. In normal conditions it are the long-term bonds that carry higher interest rates as investors demand more compensation to hold a bond for a longer period (given the risk of inflation and other uncertainties). However, with the yield on the US ten-year Treasury note having extended its drop below the yield on the US two-year note, it means that investors are so concerned about the near-term conditions that they prefer to invest into safer long-term assets.

Market participants are concerned seeing the inverted yield curve because it could point at a recession. Each of the past seven recessions in the US, including the most recent one in 2007-2009, was preceded by this inverted yield curve of the two-year note/ten-year Treasury.
Persistent Protests in Hong Kong; Political Unrest Continues

For the past five months Hong Kong has been the center of ongoing protests. Initially, the protests were aimed against an extradition bill that had been proposed by the government of Hong Kong. If enacted, this bill would allow local authorities to detain and extradite those who are wanted in territories that Hong Kong does not have extradition agreements with, including mainland China and Taiwan. The bill is regarded as placing the people of Hong Kong under mainland Chinese jurisdiction, thereby undermining the autonomy of the region and citizens' rights and freedom. While the Hong Kong government has put the bill on hold, protests have not ceased. Instead, protests have evolved beyond their original goal.

Also in August 2019 protests continued with the protesters causing major disruptions by blocking roads and the city’s international airport. On several occasions it led to violent clashes between the protesters and police. Reportedly, more than 1,000 people have been arrested so far.

The protests are also taking a toll on the economy of Hong Kong as they disrupt business, scare off tourists, and threaten Hong Kong’s international reputation as a stable financial hub (the withdrawal of deposits and investors would be a huge blow for the city). And as a result of the protests, many nations have issued travel warnings for Hong Kong. In the second quarter of 2019 the economy of Hong Kong only expanded 0.6 percent year-on-
year (y/y), a much slower pace than most had predicted. Without any breakthroughs, the economy of Hong Kong is bound for contraction.

But interestingly enough, (mainland) Chinese investors continue to pour capital into Hong Kong stocks as they are attracted by the cheap valuations of these stocks while they simply ignore the worst deterioration in Hong Kong’s corporate net income in three years.

**Argentina on Brink of Default; Contracting Economies of Germany and UK**

Other economies are also experiencing trouble, thereby making the international investor community nervous. The government of Argentina imposed capital controls in an effort to halt a slump in its foreign exchange reserves and the peso as the country is on the brink of default. Argentina’s central bank has set a limit of five days for exporters to repatriate foreign currency, while institutions need central bank authorization to buy dollars in the foreign exchange market (except in the case of foreign trade).

Argentina’s peso collapsed in mid-August 2019, while stocks and bonds crashed as voters – in a primary vote – showed their preference for a return to interventionist economics. Alberto Fernández (the opposition candidate whose running mate is Cristina Fernández de Kirchner, Argentine’s former president) dominated this vote by a 15.5 percentage point margin. Investors, however, prefer incumbent President Mauricio Macri to win the race due to his pro-business or market-friendly approach.

The latest capital controls are needed as billions of US dollars are drained out of foreign currency reserves as Argentina’s currency crisis spirals out of control and the government struggles to repay short-term debt. Argentina is now at risk of exhausting its net reserves, which recently fell below USD $15 billion. If this trend is not changed, then it will soon be without foreign exchange reserves.

Meanwhile, economic conditions within the European Union (EU) are also giving rise to concern, with the economies of Germany and United Kingdom (UK) both contracting in the second quarter of 2019. The economy of Germany shrank by 0.1 percent quarter-on-quarter (q/q) in Q2-2019 as German manufacturers, who rely heavily on exports to China and the USA, have been affected by the ongoing tariff war.
Germany is the world’s fourth-biggest economy and the biggest one in Europe. As such, its economy is critical for the EU. This explains why there emerged new support for the launch of a monetary or fiscal policy stimulus package (from the European Central Bank) in response to the slowdown in Germany. However, European policymakers are divided about the benefit of new stimulus in the EU.

Also the UK economy contracted – by 0.2 percent (q/q) – in the second quarter of 2019. This result was mainly attributed to the Brexit turmoil as companies had been stockpiling in the run-up to the original Brexit deadline (at the end of March 2019). This then dragged economic activity forward into the first quarter of the year (when the UK economy grew by 0.5 percent q/q).

In the third quarter we can, again, expect economic growth for the UK as local companies are assumed to build up stocks once more in anticipation of the new Brexit deadline (now set at 31 October 2019). The big question mark, however, is the period after 31 October 2019. A “no-deal Brexit” could become a big problem for the UK economy. A recent survey shows that UK consumer confidence has hit a six-year low, with people becoming more worried about the state of the economy and their own financial wellbeing.

Deal or No-Deal Brexit?

The UK and the EU are scheduled to ramp up Brexit talks in September 2019 in search of a breakthrough. However, UK Prime Minister Boris Johnson has repeatedly stated that he wants Britain’s exit from the European Union (the so-called “Brexit”) per 31 October 2019, with or without a deal. But many oppose such “no-deal Brexit” in the UK.

The UK is yet to ratify the divorce deal that was negotiated between former UK Prime Minister Theresa May and the EU. In theory, the UK could, again, request for more time to work on legislation to formally let the UK leave the EU. However, Johnson has refused to do so. If the UK leaves the EU without a deal, then it causes major uncertainties about trade flows (some claiming that parts of Britain will quickly run out of food or medicines) and the citizenship status of Britons abroad as well as the treatment of EU nationals who are living and working in the UK.
Prime Minister Johnson has many enemies among opposition lawmakers and even within his own party who want to prevent a “no-deal Brexit” at all costs. In a very controversial move, Johnson announced to suspend the House of Commons for five weeks starting from 12 September 2019, thereby narrowing the window for those lawmakers who are opposed to a “no-deal Brexit” to derail Johnson’s plans. The suspension leaves very limited time for members of the House to pass legislation that would force Johnson to delay the Brexit until 31 January 2020 (unless he can manage to sign a new agreement with the EU before mid-October 2019). A number of urgent legal challenges have already been filed in an attempt to prevent the suspension of the House. Moreover, a crucial parliamentary vote is scheduled for 3 September 2019 through which the House could block a “no-deal Brexit”, in which case Johnson is likely to put forward a motion calling for general elections.

**Indonesia in an Uncertain Global Environment**

The text above portrays the (highly) complex and uncertain external environment that is being faced by all nations across the globe. In the remainder of this August 2019 edition we focus – as usual – on Indonesia.

Indonesia too has been feeling the impact from abroad as its economy grew at a somewhat disappointing pace in the second quarter of 2019, being dragged down by weak exports and subdued direct investment realization.

But there are also several important domestic topics – related to the Indonesian economy, politics and social matters – that need to be discussed in this August edition, most notably the violence that flared up in Papua, or, the lack of adequate electricity infrastructure to supply power to the people and companies in Indonesia.

Lastly, we would like to take this opportunity to thank you for buying this August 2019 edition of our monthly report, titled ‘Losing Its Growth Momentum’. We hope that it contains valuable information for you!

Indonesia Investments

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