بنك أبوظبي التجاري ADCB

Turning overweight on Indonesia sovereign dollar bonds

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- **We are selectively overweight on emerging markets with strong domestic fundamentals, reform momentum and potential for credit rating upgrade**
- **Indonesia is one of the markets that could first see an upgrade to full-investment status this year**
- **Sovereign dollar bonds have room to outperform given the improvement in credit outlook**
- **We recommend to take exposure ahead of the S&P June review meeting**

Indonesia on track to full-investment grade status

Emerging markets debt has been one of the best performing asset classes since the beginning of the year. Recent softening of the Trump reflation rally, weaker dollar and consolidation in US rates has been proven favorable for emerging market hard currency bonds.

While we stay wary of the risks emerging from the potential resurgent dollar strength and still possible impact of any protectionist trade policies on these economies, we reiterate our selective bias on economies that could weather these external risks.

As highlighted in our previous *note*, we particularly favor markets with relatively sound fundamentals within the EM bond space. Due to the strong domestic story and positive reform momentum, the credit dynamics of these economies is slated to improve. Rating agencies have applauded macroeconomic development in these economies and their increased resilience to external headwinds. These economies include but are not limited to Russia, Indonesia and Brazil.

We turned overweight on Russia dollar sovereign and quasi-sovereign bonds in January. In addition, we recommend adding exposure to Indonesia dollar bonds and sukuks. Amongst the emerging markets, Indonesia is in the forefront to enjoy a rating upgrade by S&P in the first half of the year. An S&P rating upgrade will make Indonesia achieve its full-investment grade status, paving way for an increase in the weighting of the dollar bonds in the world indices.

Below you find a short list of Indonesia US dollar bonds. These bonds have not been selected based on any micro or company (issuer) analysis, but solely screened on the basis of quantitative criteria, such as maturity (5-10 years), minimum issue size of 1.5 billion, and S&P rating not inferior to the sovereign (BB+).

ISIN number	Bloomberg ticker	Coupon	Maturity
US71567RAF38	INDOIS	4.55%	3/26
USY20721BN86	INDON	4.75%	1/26
US71567RAD89	INDOIS	4.33%	5/25

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Indonesia- Potential for credit rating upgrade

Economic fundamentals in Indonesia have been showings signs of improvement with more growth stability, favourable current account conditions and fiscal outlook. The government's efforts of introducing new reforms like tax amnesty and subsidy reduction in the past years have been commendable. In addition, economic outlook is expected to remain positive in the coming year with higher commodity prices to help lift exports growth and private investment.

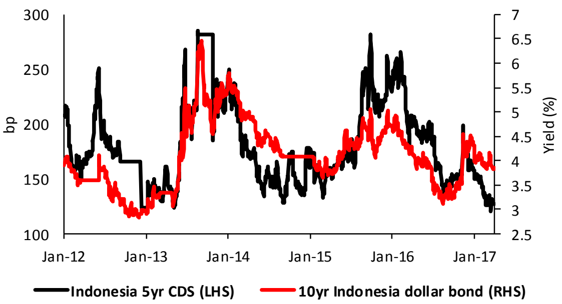
Government's better policy making has been cheered by rating agencies lately. Fitch was the first agency to raise its outlook on Indonesia from stable to positive (BBB-) in December 2016. This was followed by Moody's which lifted its outlook to positive in February citing improved external buffer, strong track record of macroeconomic stability and fiscal discipline.

Amongst the emerging markets, Indonesia is top in line to receive a rating upgrade this year. The country was last upgraded five years ago by Moody's and Fitch to investment grade (IG) category. However, S&P is lagging behind in lifting the sovereign to IG category. Given the ongoing reform momentum, an S&P rating upgrade is now long due and is highly likely to take place in the upcoming S&P review meeting in June 2017.

Dollar sovereign bonds not fully pricing in the positive credit outlook

The sizeable drop in the sovereign CDS spreads is indicative of the improving credit dynamics and increased likelihood of a rating upgrade. The sovereign dollar bonds which came under pressure in the aftermath of the US elections, have also benefitted from the positive credit outlook. However, compared to the CDS spreads, the drop in bond yields has been limited. The CDS spreads have dipped to the lowest level in ten years whereas the 10yr dollar bond yield is still above the levels seen in 2013. As such, we believe the dollar bonds are not fully pricing in the possibility of the rating upgrade, providing more scope for bond yields to decline.

Dollar bonds not fully pricing the positive credit outlook

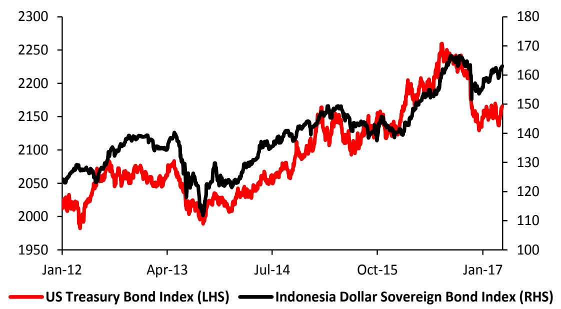


Source: Bloomberg

Decoupling from external risks

Being a high beta country, Indonesia has historically been susceptible to external headwinds. This is mainly on account of high foreign ownership of local government bonds which makes the country vulnerable to offshore liquidation in case of any spike in global volatility. As indicated in the chart below, the dollar sovereign bonds has been strongly correlated to the US Treasuries. However, this correlation has been wearing off since the beginning of the year. Investor confidence has been building as external vulnerabilities have eased with narrower current account deficit and better FX coverage ratio. In fact, this was also one of the main rationale for the Moody's rating outlook upgrade.

Indonesia bond holding up well

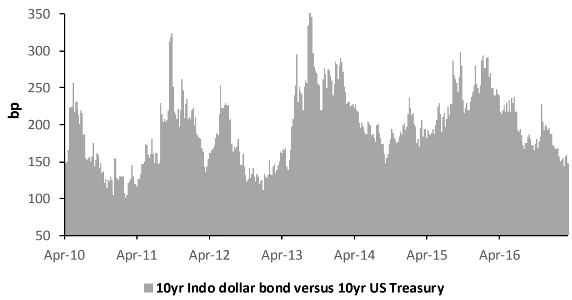


Source: Bloomberg

Valuations remain attractive

Indonesia hard currency sovereign bonds have posted a return of almost 5% since the beginning of the year. This outperformance has been in line with the country's improving growth outlook and better external position. As such, valuations do not appear stretched and there is scope for further spread tightening versus US Treasuries.

Attractive valuations in dollar sovereign bond



Source: Bloomberg

Thus, in our selectively overweight stance on emerging markets, Indonesian bonds look attractive given the strengthening domestic fundamentals and positive credit outlook.

Sources

All information in this report has been obtained from the following sources except where indicated otherwise:

1. *Bloomberg*
2. *Wall Street Journal*
3. *RTTNews*
4. *Reuters*
5. *Gulfbase*
6. *Zawya*

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