Equity Strategy

Much ado about nothing

- Economy still far from overheating.
- Negative trade balance was caused by imports of raw materials and capital goods as Indonesia is entering into an industrialization phase.
- Expect CAD and Rupiah to weaken for some periods although inflation should remain soft.
- Anticipating BI's measure to trim down mortgage loan growth.

JCI	Neutral
Current	4,060
Total Market cap (US$ b)	373.9
No. of Constituents	452

JCI Performance

	3 M	6 M	12 M
Absolute (%)	8.0	2.4	6.8
52-WK range	3,218 – 4,235		

JCI Chart

Source: Bloomberg

Top Picks

Stock	Price (Rp)*	TP (Rp)	Mkt Cap (Rp t)	P/E (x)	P/B (x)
BBRI	6,950	8,300	168.3	8.2	2.0
BMRI	7,800	9,000	181.9	11.2	2.1
BTPN	4,825	4,700	27.3	11.6	2.8
INTP	20,250	22,700	74.5	12.0	3.2
TLKM	9,300	10,800	185.6	11.0	3.1
TBIG	3,875	4,500	18.6	14.1	3.5

Source: Bloomberg, IndoPremier
*(Price per 31/08/2012)

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We saw the street expects that Rupiah will be further depreciated due to current account deficit (CAD). However, we think Indonesia's CAD is driven by healthy factors: purchasing power recovery and fixed capital formation. It is normal for a country to go through CAD when it is entering industrialization but before it reaches a full scale productivity that will boost exports once fixed capital formation subsides. Currently, we are still comfortable with the output gap as well as the manageable inflation. Nevertheless, we anticipate that BI may issue some measures, but we believe it will lean toward mortgage loans. Hence, the impact will be more specific to property sector and relatively minimal on other sectors.

Far from overheating. We do recognize the warmth of Indonesia's economy at the moment, but it remains far from overheating on the back of some reasons: 1) benign inflation (CPI inflation at below 4.8% yoy since July 2011, wholesale-price inflation at 21-month low in June, and the least annual gain of GDP deflator in 2Q12 in almost three years); 2) manageable output gap (0.5% of potential output in 2Q12, the lowest in a year); and 3) strong direct investment (average yoy growth of gross fixed capital formation at 8.9% since 2004), which will boost productive capacity of the economy.

A normal phenomenon for a country with high fixed capital formation. We saw CAD that is due to higher imports of raw materials and capital goods as a normal phenomenon for a country that is entering industrialization. We found identical situation in other economies such as China in the second part of 1980s, Malaysia in 1990s, as well as Thailand in 1980s and 1990s. These countries attracted large amount of FDI in the period which they used to transform from agriculture/resources-based exports to manufacture, before regaining its current account surplus.

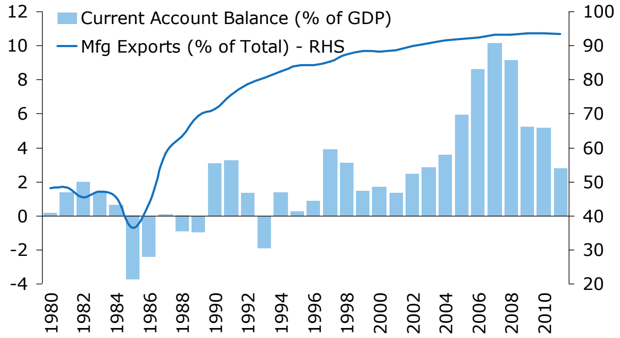
Under-pressure Rupiah but inflation remains soft. Despite large imported portion in the production, the impact of Rupiah depreciation on inflation appears to be limited due to decreasing commodity prices, in our view. Currently, Rupiah is trading at about 5% lower than end 2011 against US dollar and 3% lower in nominal term against a basket of currencies. If deteriorating balance of payments is the culprit, we consider the depreciation as a consequence of the industrialization process in Indonesia. Weaker currency is also preferable at the moment on account of mild inflation and the need to hamper imports and promote exports. Additionally, concern on CAD will also limit the impact of US Fed's QE, if occurs, on the exchange rate.

Cautious on the market. As inflation is expected to remain low, we are still comfortable with the macro factors. However, we are cautious with the market due to global factors and the impacts from any new BI's measure. Furthermore, the street may read the economic data different from us. On the potential US Fed's QE program, we think the impact should be positive, but less than the previous QEs. In the meantime, we anticipate BI's measures to curb mortgage loan growth and its impacts on the housing property sector rather than on the banking sector. We pick stocks which are US$ neutral, have stability in term of performance and small exposure to potential BI's measure: Bank Rakyat (BBRI), Bank Mandiri (BMRI), Bank Tabungan Pensiunan (BTPN), Indocement (INTP), Tower Bersama (TBIG) and Telekomunikasi Indonesia (TLKM).

Asian countries experienced CAD to industrialize their exports

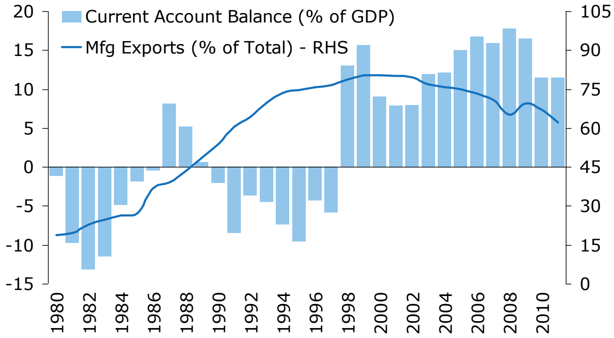
- China's current account ran at deficit in the second part of the 1980s. Malaysia also experienced the same in 1990s, whereas Thailand had the shortfall in 1980s and 1990s.
- CAD was accompanied by large FDI in these countries.
- China, Malaysia, and Thailand were able to regain its current account surplus when the share of manufacture exports reached around 70%. In Indonesia, the portion was only 34% last year, according to the WTO.
- Investment was needed to transform their export orientation to manufacture. In 1980, the share of manufacture exports was 48.14% in China, 18.8% in Malaysia, and 25.02% in Thailand. In 2011, the portion became 93.34%, 62.04%, and 69.59%, respectively.
- As high imports of raw materials and capital goods are the side effects of strong domestic demand, in the short-medium term, we expect Indonesia to experience CAD, before the new investment starts to boost manufacturing exports and reduces the country's reliance on imports.

China's Current Account and Manufacture Exports



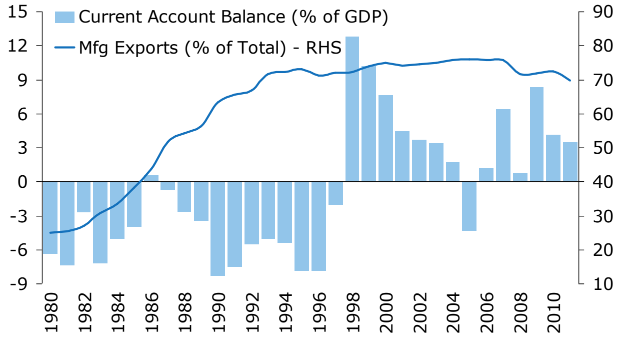
Sources: IMF, WTO

Malaysia's Current Account and Manufacture Exports



Sources: IMF, WTO

Thailand's Current Account and Manufacture Exports

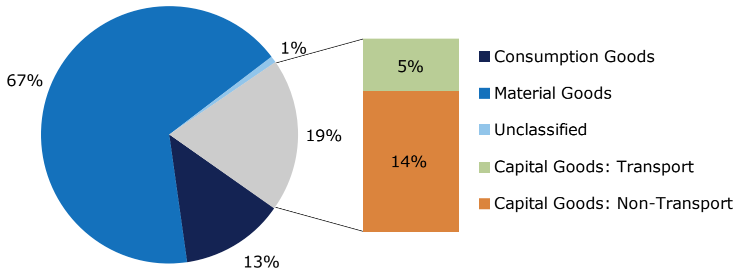


Sources: IMF, WTO

Spillover effect of strong investment on imports

- Currently, Indonesia's imports are still dominated by material goods. In 1H12, it accounted for 66.75% of total imports, according to Bank Indonesia. The largest portion of material goods imports are processed supplies for manufacturers.
- However, strong willingness to invest in the country has underpinned the demand for capital goods, causing its imports to soar. Capital goods imports surged 33.7% yoy in 1H12, outpacing growth of consumption and material goods imports at 12.94% and 9.16%, respectively. As such, the share of capital goods imports increased to 19.29% from 16.46% in 1H11.
- Around 70% of capital goods imports in 1H12 were non-transport equipments (e.g. machines for industries). However, there was sharp increase (more than 85% yoy) in land and air vehicles imports for businesses.

Imports by Broad Economic Category in 1H12 (% of Total)

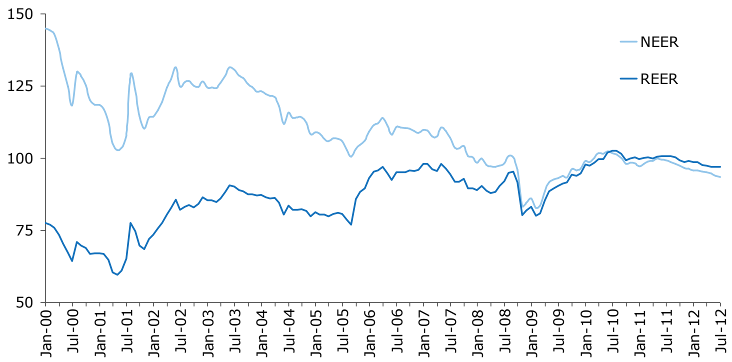


Source: BI

Rupiah remains under pressure

- Indonesia's balance of payment has been in deficit since 3Q11. In 2Q12, the deficit amounted US$2.81b, coming from US$6.94b of shortfall in the current account and US$5.48b of surplus in the capital and financial account.
- Rupiah weakened amid the external imbalance, making it as an outlier among regional currencies. Currently, it remains under pressure.
- The depreciation is explained by decreasing nominal and real effective exchange rates (NEER and REER, the latter is inflation adjusted). In July, rupiah's NEER and REER were about 3% and 2% lower than in end 2011.

Rupiah's Nominal and Real Effective Exchange Rates*

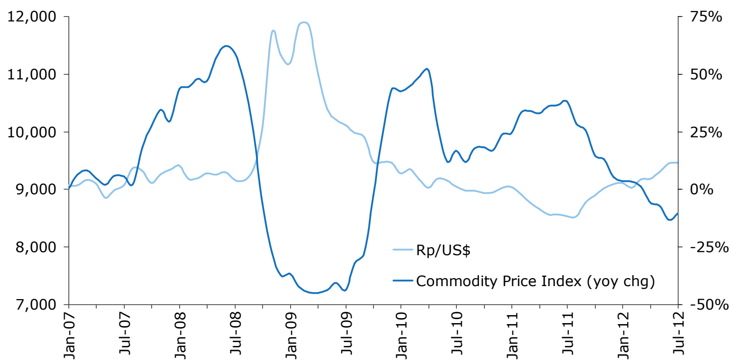


** 2010 = 100. Source: BIS*

… but declining commodity prices ensure soft inflationary pressure

- The impact of Rupiah depreciation on inflation has been offset by declining commodity prices.
- According to the IMF, the commodity price index in July was 3.38% lower than in December. From a year ago, the index tumbled 10.6%.
- No wonder that inflationary pressure remains mild at the moment. Consumer-price inflation has stayed below 4.8% in more than a year. In June, wholesale prices gained 4.63% yoy, the lowest in 21 months. In addition, the GDP deflator –the broadest measure of price level– rose 5.69% yoy in 2Q12, the smallest in almost three years.
- Higher commodity price is the main risk for inflation. But we believe the impact of high commodity prices will be offset with the expected recovery in exports as we believe commodity price movement will be driven by expected recovery in the global economy.

Exchange Rate and Commodity Price

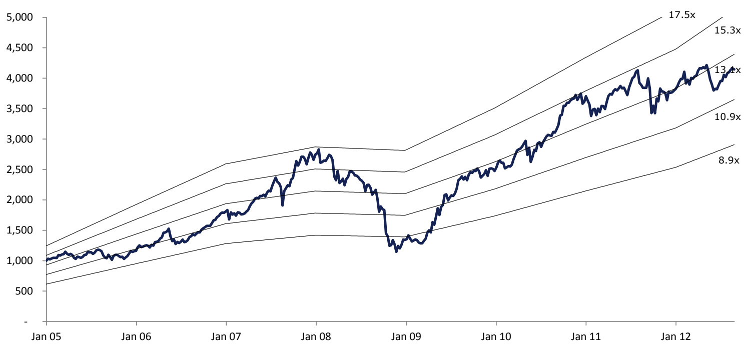


Sources: BI, IMF

Fundamental intact, but cautious on the market

- At 12.0x 12m-forward PER, the Index is trading at below its 5 years average of 13.1x PER.
- Without improvement in Euro zone crisis, we do not expect a re-rating in JCI.
- Weakening Rupiah and lack of short-term catalysts worsen the sentiment. But long-term catalysts may come from the investment such as Foxconn and acceleration of infrastructure development.
- US Fed QE may give positive impact although it may be smaller than previous QEs.
- Lowered year-end JCI estimate to 4,400-4600 at 12x-13.1x FY13 PER.

JCI PE Band



Source: Bloomberg, IndoPremier

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INVESTMENT RATINGS
Buy : Expected total return of 10% or more within a 12-month period
Hold: Expected total return between -10% and 10% within a 12-month period
Sell : Expected total return of -10% or worse within a 12-month period

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