

Economic Fundamentals Lift Indonesian Market Outlook

IN RECENT YEARS, Indonesia has emerged as one of Asia's fastest growing economies. Strong domestic demand, a low reliance on export earnings and increasing economic and political stability form a strong foundation for its long-term potential. Investors would be well-advised to keep a close eye on this market.

Indonesia was able to recover quickly from the debilitating 1997 Asian financial crisis, and in the last five years, its nominal gross domestic product (GDP) has doubled in US-dollar terms. In real terms, GDP growth is forecast at 6.5 percent this year. If this is sustained, Indonesia's economic expansion will be the third strongest in Asia, exceeded only by the economies of China and India.



Jakarta skyline: Urban population is swelling by 4 million a year

Indonesia is the world's fourth most populous nation behind China, India and the US. It is a vast archipelago of 240 million people with a median age of 27, which means the country will have a strong and productive workforce in years to come, as well as an

enormous base of increasingly affluent and aspirational consumers. Two thirds of its GDP is currently generated by private sector consumption.

In 1950, around 80 percent of the population lived in rural areas. Today, there is an equal split between rural and urban populations. Each year, around four million people move to the cities in search of a higher standard of life.

Growth of consumer spending

Tied to this rapid urbanisation is a commensurate rise in consumerism. For example, in the five years leading up to 2008, the number of mobile phone subscribers saw a whopping seven-fold increase, up to 134 million. One in four Indonesians now owns a car, compared to one in every 20 three decades ago.

Indonesia is rich in highly sought after natural resources. As one of the world's top three producers of palm oil, rubber, cocoa, coffee and rice, it is a major supplier to the vast populations of China and India. Each of these giant emerging markets accounts for 25 percent of global palm oil consumption. To fuel their exponential growth, they will continue to need commodities such as coal, of which Indonesia is also a major producer.

The Indonesian stock market is relatively small, comprising about 420 stocks, but it offers exposure to the resources, financial, telecoms,

consumer goods and automobile industries – sectors that will surge as the country's economy grows. Last year, the stock exchange was the best-performing equities market in the region, gaining 46 percent, while the rupiah also ended the year 4.6 percent higher, following gains of 87 percent and 16 percent respectively in 2009.

While investors may have perceived risk in the past, the outlook on investments has improved. The country's healthy external account and rising foreign reserves put the central bank in a stronger position to manage exchange rate volatility.

Inflation will remain a challenge, as it tends to be driven by rising food and energy prices, which make up a large proportion of the consumer price index. Over the past 40 years, inflation has averaged above nine percent annually. But since the central bank was given independence in 2004 with a mandate to achieve price stability, it has successfully curbed inflation and brought interest rates down to manageable levels through more disciplined monetary policy.

Incentive to invest

The country is now targeting an inflation rate of between five and six percent a year. This means it has become less expensive for companies to borrow money, making them more willing to invest in expanding their operations.



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While the recent run-up in share prices means local stocks are no longer considered cheap, and must be selected with care, the overall market still incorporates a material risk premium due to earlier political instability and sustained inflation. As economic fundamentals continue to improve, investors' worries and the risk premium may decline, which would drive a new round of increases in equity prices.

International credit rating agencies are already recognising the improving economic outlook. In January, Moody's upgraded the government's foreign and local currency bond ratings to Ba1 from Ba2, while last year the Japan Credit Rating Agency raised the country's creditworthiness to investment grade.

To sum up, Indonesia is well-positioned to deal with evolving economic challenges and potential shocks. Its long-term prospects are positive and the government is committed to its investor-conscious reform programme. Investors with a long-term, bottom-up, valuation-driven approach will find that Indonesia continues to offer what they are looking for: the potential of remarkable returns.

