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- ❑ **US, EU Jul ISM Services Resilient**
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- ❑ **ID July Inflation Disrupts ID Growth Momentum**
- ❑ **ID LT Re-risking of ID's Banking System**
- ❑ **ID Betting on Commodities**

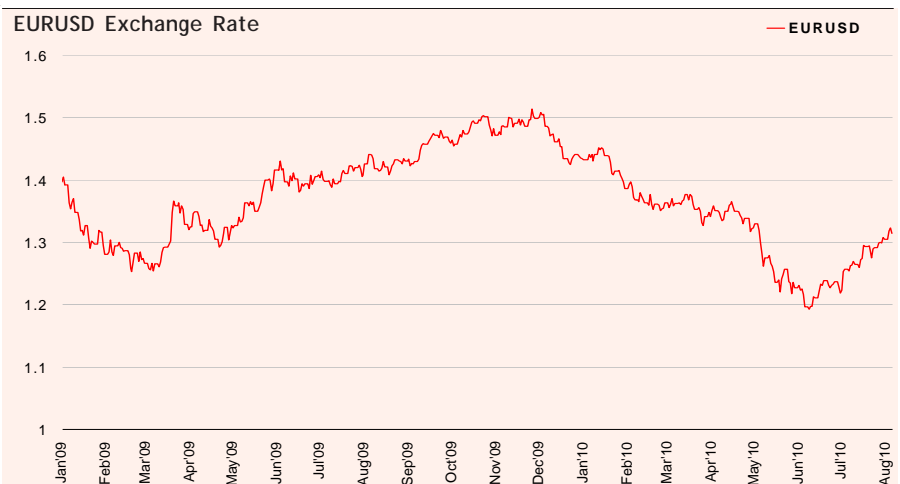
July data is starting to confirm a mellower 2H10 global growth outlook. A second dip or "W" risk is still not on the betting table yet, and should not be for the visible future. Potential reversal of tight China policy should reverse some hot money flows from ID. ID inflation is another risk to "catalyze" ID's relative underperformance. Considering that ID banking system is currently >20% of JCI market cap, a reversal in banking valuations should deter JCI from breaking new highs quite so readily in the intermediate term. Buy on JCI on Weakness; Relatively Short Banks, Long Commodities to ride inflation news flows in the intermediate term.

US, EU Jul ISM Services Resilient

US Jul ISM came in at 54.3, higher than 53.8 in Jun and 53.0 expected. This is still lower than 55.4 recorded for the three months prior to Jun (Mar to May). EU Jul ISM came in at 55.8, vs. 56.0 last month and 56.0 expected. These readings seem to suggest that growth in the services sector seems to be ploughing on. The bet here is that the risk of a 2008 style, liquidity & deleveraging driven economic contraction seems to be somewhat over. I am growing comfortable assuming US growth of 2.0% and EU of 1.0% forming an "L" shaped recovery.

US, EU Shifting Manufacturing Supply

Jul EU ISM Manufacturing jumped to 56.7, from 56.5 last month while Jul US ISM Manufacturing slumped to 55.5, from 56.2 last month. The best way to explain this is that with the recent weakness in the EURUSD exchange rate, the relative competitiveness of exports have shifted in favor to that in the EU and hence, indicator for manufacturing output in the EU has outperformed that of US in the past month.



Source Bloomberg

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As such, some major economies in the EU are manufacturing and exports based (for example German). This is the reason why the recent reversal of the USD weakness had uplifted sentiments. As such all but one (ISM Services) economic data from EU came in better than expected throughout the whole week last week. The base bet here is still for the EU to grow at 1.0%, assuming that deficits remain at these "elevated" levels of around 6% to GDP.

28th July to 4th Aug EU Data Better Than Expected

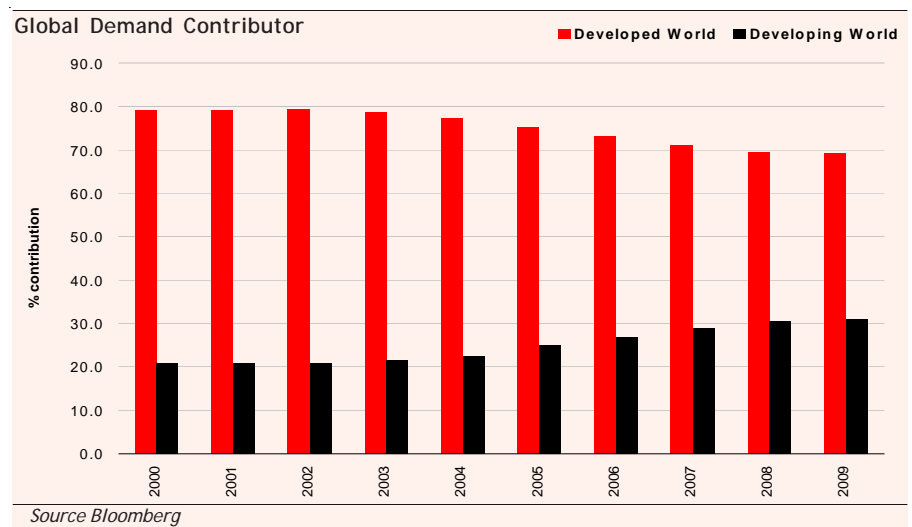
	Survey	Actual	Prior	Revised
JUL Business Climate Indicator	0.39	0.66	0.37	0.4
Euro-Zone Indust. Confidence	-5.0	-4.0	-6.0	--
Euro-Zone Consumer Confidence	-14.0	-14.0	-14.0	--
Euro-Zone Economic Confidence	99.1	101.3	98.7	99
Euro-zone Services Confidence	5.0	6.0	4.0	--
Euro-Zone Unemployment Rate	10.00%	10.00%	10.00%	--
Euro-Zone CPI Estimate (YoY)	1.70%	1.70%	1.40%	--
PMI Manufacturing	56.5	56.7	56.5	--
Euro-Zone PPI (MoM)	0.40%	0.30%	0.30%	--
Euro-Zone PPI (YoY)	3.10%	3.00%	3.10%	--
PMI Services	56	55.8	56.0	--
PMI Composite	56.7	56.7	56.7	--
Euro-Zone Retail Sales (YoY)	0.10%	0.40%	0.30%	0.60%
Euro-Zone Retail Sales (MoM)	0.00%	0.00%	0.20%	0.40%

Source: Bloomberg

This trend however, should stop in the next few month data, as EURUSD bottomed out on 1.1923 on 6th Jul'10. This reversal of EURUSD will also mean that the relative competitiveness between EU and US will reach a new equilibrium and that this new equilibrium should equally divide the supply side of things somewhat in favor to both US & EU.

BRIC+Asia Developing World Demand

If this is the supply side scenario, then the next issue to discuss here will be the demand side. 10 years pre-crisis, US + EU + JP + UK combined they contributed about USD1.3tr in new demand every year, on average for the past 10 years; while BRIC + Asia contributes about USD1.0tr during the same period. Post crisis US, EU and JP is still stuck with 1.0% real GDP growth; Asian and BRIC countries have returned to pre crisis growth levels. World demand contributor is quite clear and is shifting to the developing world.

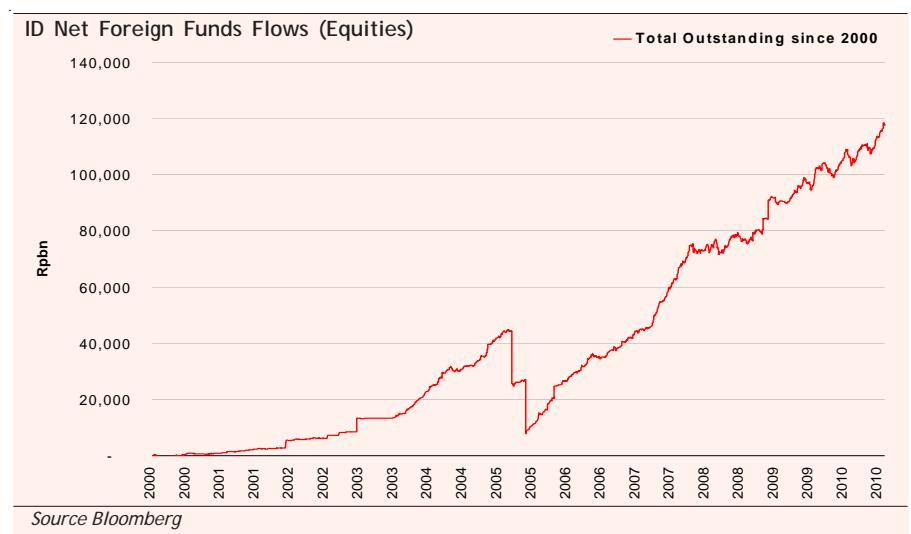


Be reminded that this pace of demand side growth from the developed world is despite the easy monetary and fiscal programme that the current developed world is running. Austerity programme in EU has not even kicked in yet. Discussion with a renowned economist friend yesterday also concludes that the austerity programme that EU is promising may just turn out to be an empty one. It is politically impossible to pull through a real diet programme in an environment when the economy itself is already half limping.

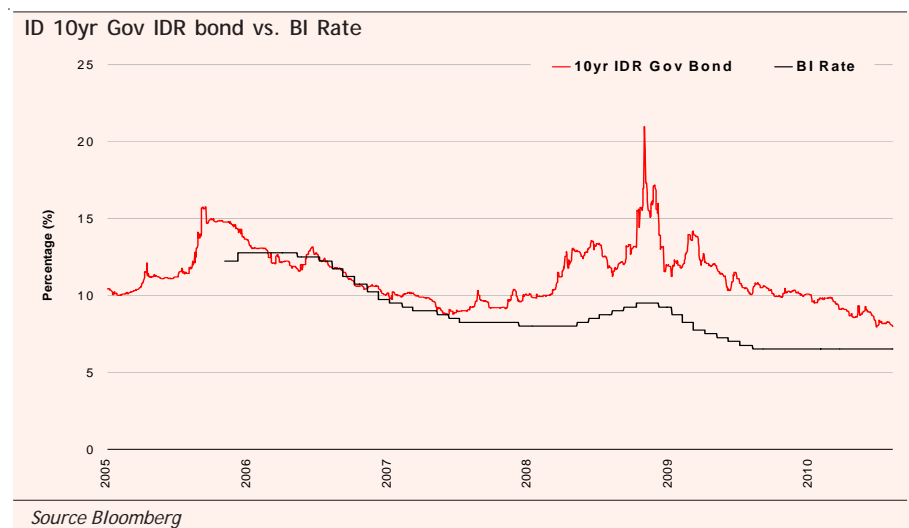
If this is the demand side picture, then it will not be difficult to expect that money will continue to be abundant and easy for the next few years in the west. It will not be difficult to continue to expect a weakening USD, EUR and even JPY against Asian currencies going into the next few years. As such, USD has weakened 2.5% against major Asian currencies YTD. EUR also weakened 11.7% during the same period.

ID Hot Money Flows

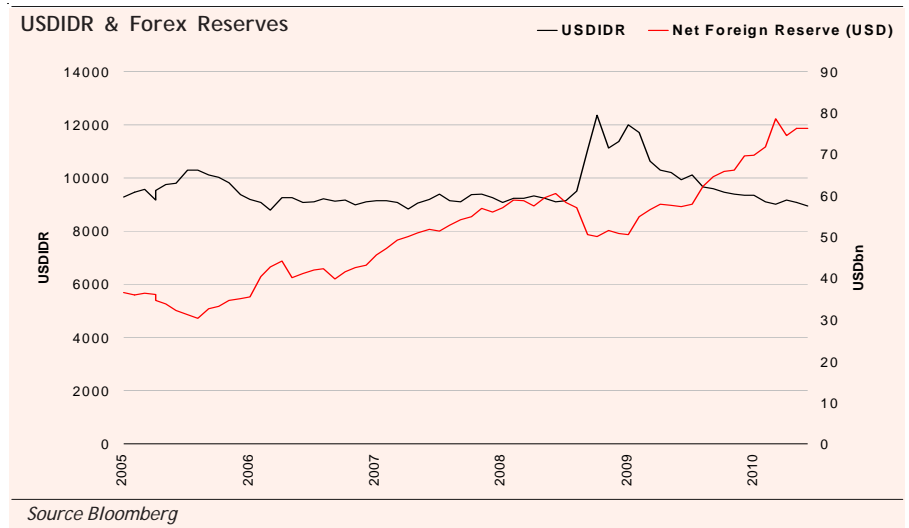
As such, easy money from the developed west will continue to chase the sexy growth stories in BRIC and Asia. Take Indonesia for example, YTD net foreign funds flows has totaled Rp11.4tr. This is compared to Rp13.9tr recorded for the whole of 2009.



As such, foreign funds have also chased both the long and short ends of the yield curve in ID. Net foreign ownership of government securities in ID has risen by Rp74tr. Pushing ID 10yr government bonds prices up 15.8% YTD, or yields to 7.98% or 1.48bps away from 6.5% BI rate. The smallest spread ever recorded between 10yr Gov IDR bonds is -103bps in 2007 when the commodities boom sent our GDP growth beyond 6.6% in 3Q07.

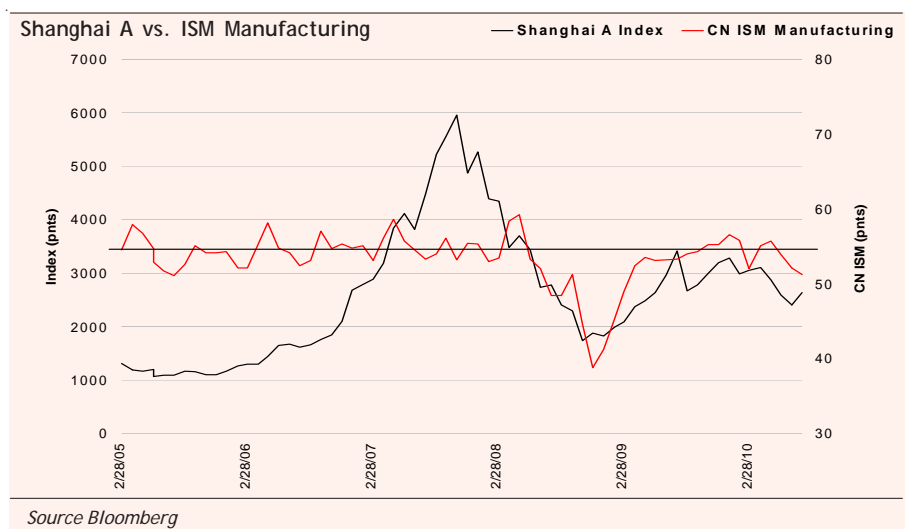


A good indicator as to how much money is flowing into the country, net of trade and current account flows is the accumulation of reserves, as excess foreign currencies after adjusting for trade and capital flows are stored in the foreign reserve account. As such the speed of which money is flowing into Indonesia is somewhat fast. Indonesian YTD foreign reserve growth is at 9.7%, vs. BRIC peers Brazil (6.8%), Russia (5.8%), India (0.7%) & China (1.6%). The interesting thing here is that as % to GDP, Indonesian reserves grew the most in recent months with respect to BRIC nations, perhaps brought about by the resilient and sustainable outlook growth for Indonesia. This is one reason why BI will have trouble keeping the rupiah below USDIDR 9000 mark. In fact recently, USDIDR broke its new recovery high to USDIDR at 8940 yesterday.



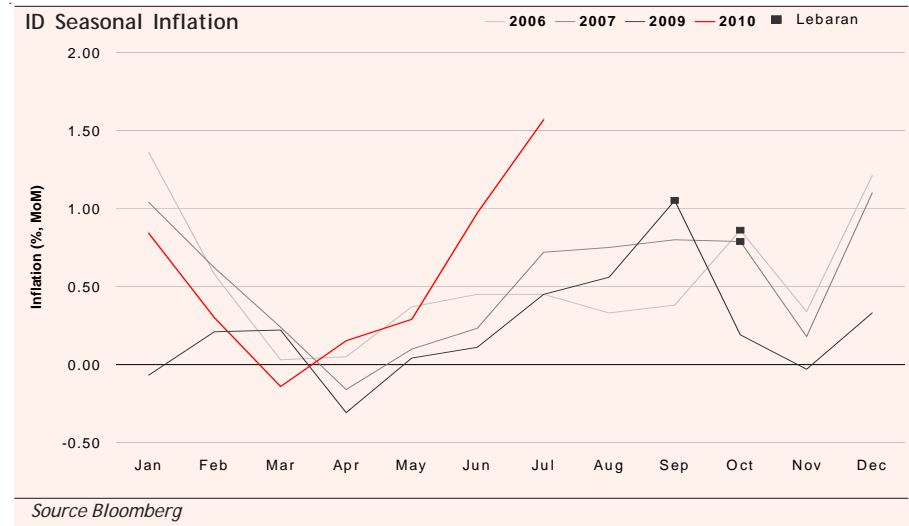
As such, the question here is whether hot money will continue to chase Indonesia, or will it rather pause for a while, and chase after China, which is catching up in terms of YTD performance. The last news being that July Chinese PMI manufacturing reading came in at 51.2, below last month of 52.1 and expectations of 51.4. This number is very near 50, the number defining expansion (>50) and contraction (<50). In fact, HSBC China Manufacturing PMI came in below this 50 reading, at 49.4 indicating contraction for the month of July, lower than last month's 50.4.

As such, Shanghai A investors are increasingly betting that policy tightening in China is over in view of the quickly weakening market. As such, the itchy hand wanting to bet of Shanghai A bottoming out when June NDRC housing prices showed the first signs of MoM decline turned out to be a right bet. In the medium term, this China outperformance will provide a stage for JCI to continue its outperformance against its regional peers. In the short term however, the picture remains cautious.



ID July Inflation Disrupts ID Growth Momentum

ID July inflation came in at 1.57% MoM or 6.22% YoY. Considering that Ramadan has not started, and that rise of electricity has not been fully reflected in the recent July reading, risks is that 5.5% government target for inflation becomes quite unattainable. I wrote last week that any reading above 1.0% MoM for the next few months threatens 5.5% target and should elevate risks to our investment theme.



A net inflation reading beyond 6.0% for 2010 have many implications. (1) The higher than expected inflation will eat into Indonesia's purchasing power (2) Credit growth will slow, as cost of funds rose. Cheap money or expectations of cheap money, which drove credit driven consumption (i.e. auto and cement sales) are over. The above two spoils our consumption driven GDP growth and that expectations will normalize. Those who are betting on >6.0% GDP growth without contributions from "I" - Investments which in turn depends on "G" Government reform will be largely disappointed. Fundamental earnings growth expectations should normalize from here.

(3) Analyst hoping to upgrade their target prices by adjusting their risk free rate and or expected return will have trouble justifying a low number if bond yields reverses due to high inflation. (4) As highlighted in my previous thoughts, MoF has acted early to combat increasing food prices by working with the department of logistics (Bulog) to make sure prices do not rise above 10%. Rice drove a bulk of the inflation numbers in July, and that newspaper has reported that government will start market operations for rice soon. Failure to curb inflation reflects badly on the government and risk premium, at current low levels reflects a lot of expectations and that such news is potentially risk our Indonesia assets for profit taking at the regional level. Risk premium should normalize from here.

The view on inflation remains. Any reading above 1.0% MoM will be viewed negatively. Either the market remains resilient and hope for a better Aug number or it starts to fully discount the fact that inflation of 5.5% will be missed is still unknown; but my bet is still for investors to be careful for the next three months on negative news flows that BI may fail to uphold its 5.5% target, and that it not wanting to move its interest rates will prove market negative as BI may continue to argue that seasonal food driven inflation does not warrant aggressive interest rate hikes.

ID LT Re-risking of ID's Banking System

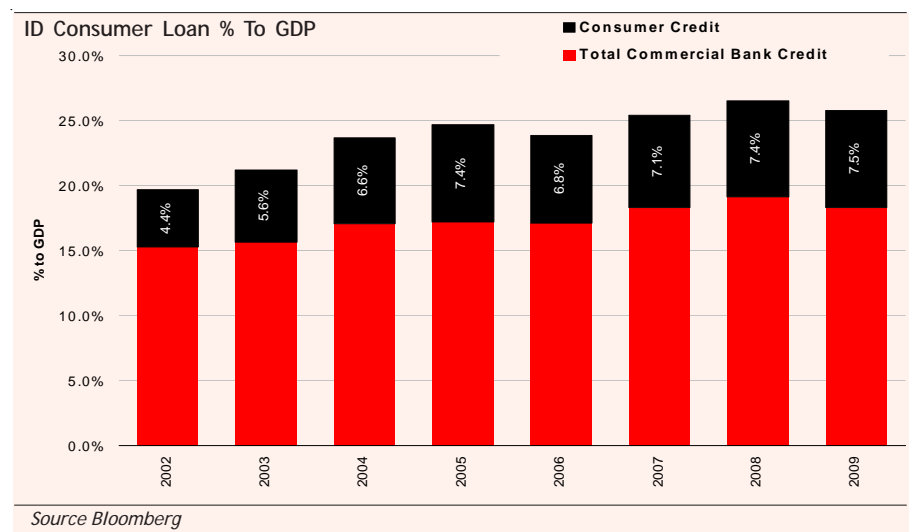
ID's banking system currently trades at 3.3x 2010 and 2.8x 2011 PBV. Such valuation puts our banks at a serious 100% premium over our regional peers, which are currently trading at 1.6x 2010 and 1.5x 2011 PBV. Even after ROE adjustment, our banks are still trading at 15% 2010 and 13% 2011 premium to regional.

ID Banking Valuation									
8/5/2010	Last Px (Rp/shr)	M. Cap (Rptr)	YTD (%)	P/E (x)		P/BV (x)		ROE (%)	
				2010	2011	2010	2011	2010	2011
BBCA	5,750	142	18.6	17.3	14.9	4.3	3.7	25.1	24.8
BMRI	5,800	122	23.4	14.0	12.1	3.0	2.6	21.3	21.4
BBRI	9,200	113	20.3	12.6	10.3	3.4	2.8	26.8	27.0
BDMN	5,200	44	14.3	15.4	12.3	2.5	2.2	16.1	17.8
BBNI	2,975	45	50.3	12.1	10.0	2.0	1.8	16.9	18.1
BBTN	1,860	16	121.4	20.8	14.6	2.7	2.4	12.9	16.4
Trim Banks		482	26.2	14.8	12.4	3.3	2.8	22.5	22.9
Regional Banks			5.9	12.9	11.0	1.6	1.5	12.5	13.3

Source: Bloomberg

The whole basis for our banks to be trading at a premium is that we have a safe and sound banking system. Low interest environment, good GDP growth, relatively conducive monetary policy should help keep liquidity flush and NPL low. Deposits growth matches loans growth, and creates little funding costs to banks in Indonesia. LDR also remains stable and keeps the sector within a long-term sustainable state. Asset buyers will be willing to pay a premium for an asset like these.

The risk here is that valuations have reached an all time high for Indonesian Banks. Recent BI decision to upgrade its loans growth target to boost credit driven growth from 18% to 22% in my opinion is a mistake. As such, consumer loans have grown from 4.4% of GDP in 2002 to 7.5% of GDP in 2009. This trend will continue to trend higher, albeit still at a low level.



However, if projected into a longer term perspective, BI's strategy to re-leveraging of the economy and consumer sector through credit is exactly the mistake that US committed since 1982 to land itself into the Great Financial Trouble of 2008. Bank Indonesia should be weary in forcing lending within the system. It creates inflation, which leads to NPL and increased cost of funds. What BI or the government should do is figure how to improve productivity of each factor in the economy, through education, reducing red tape and much needed legal reform to improve certainty, hence risk and costs to the private and public sector.

The honeymoon period for our banking sector where legacy loans made during 2008 yielding high asset returns, while low interest rate environment created an opportunity to squeeze depositors on their cost side, is over. Loans demand was ample, and risks to loans were improving from a depressed 1H09. Lending costs are pressured on the downside by banks. Loans growths are growing faster than deposit growth as of 2Q results generally show. Deposit war will again happen like in 2008 / 2009 pushing cost of funds higher. Valuation cap should make banking stocks unattractive for the intermediate term. LT re-risking trend of the ID banking system is a blind spot that all investors should keep in mind at all times.

Also worthy of mention, although this is the trend in Indonesia, the same occurs in China and India. China re-risking of its banking sector is occurring at breakneck speed as they disbursed 30% of GDP of loans to its SOEs to support growth in 2009 and 2010. These loans are also somewhat concentrated within the property sector. That is why Chinese government is actively doing stress testing of its banking sector in these few weeks.

ID Betting on Commodities

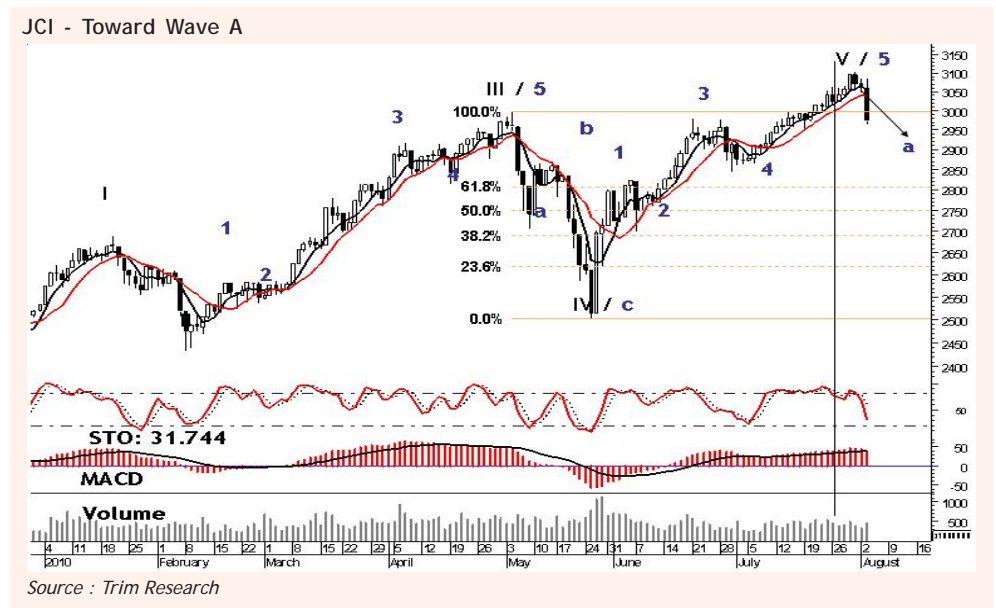
On the other hand, as oil revisits its USD80/brl levels, commodities have also performed well. As such CRB index gained during 2H10 so far. A reversing tightening policy in China should also be commodities positive since China is a major consumer of many commodities right now, including oil, coal, and CPO which are Indonesia's main commodity exports. Indo listed commodities players has also lagged banks and ASII in terms share price appreciation and valuation since Aug.

CRB and members 2H10 performance		
8/5/2010	Last Px	1H10 Performance (%)
Indices		
CRY	277	10%
SPGSCI	541	12%
Energy		
Oil	82	13%
Coal (Daily)	95	7%
Coal (Weekly)	95	-1%
Metals		
Gold	1,194	-3%
Nickel	21,665	6%
Tin	19,850	12%
Soft Commodities		
CPO Malaysia	2,641	4%
CPO Rotterdam	868	7%
Soybean	1,054	13%
Wheat	685	52%
Corn	390	10%
Rice	10.9	-6%

Source: Bloomberg

Andrian, our commodities sector analyst, identified two interesting commodities plays. DEN (Dewan Energy National) adjourned their 5th members' meeting and concluded the following; (1) that incentives should be established to encourage the construction of mine mouth power plants, especially those mines with low rank coals which cannot be monetized due to their relatively low selling prices with regards to extraction cash costs. PTBA will be a clear winner in this story. (2) Gas distribution infrastructure must be sped up to support diesel / petroleum fuel to gas usage conversion. PGAS will be a clear winner in this regard.

Market Strategy



ST JCI slacked more than 85.32 points to close 2973.66 yesterday on bad inflation data and BI's announcement to conduct a "redenomination" in the next ten years. We still see some downside for JCI as it completes its wave "A", targeting 2920 to 2950. This wave completion should also push JCI to test its 61.8% Fibonacci retracement support and into oversold area. As such, JCI should have 1.2% to 1.8% of downside risks to go, before JCI starts its short term rally wave "B" and should bring JCI to test its 3050 resistance level again.

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Happy Investing

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