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Global Emerging Markets

Letter from Indonesia

We recently returned from a trip to Indonesia we provide our insights on this populous and vast archipelago, which has been one of worst performing EM countries over the past two years. Our insights follow a thorough review of the country, which included a very recent visit to Jakarta, meeting with wide range of companies and various government authorities.

Jakarta is a city that has always seemed to regard traffic as a form of civic theatre. Cars advance by inches, motorcycles discover improbable new geometries between them, and from the back seat one has time to contemplate a peculiar habit of markets: they are often most concerned about a country just when the investment case for country is becoming potentially more attractive.

Exhibit 1: Jakarta Traffic – August 2026
(Source: Northcape Capital)



We were in Indonesia in August, moving between government ministries, company offices and meeting rooms in a week that was less an investor tour than an attempt to take the temperature of an equity market that has been running a fever. As usual with our EM research trips, it was a busy schedule with meetings traversing the Ministry of Finance, Bank Indonesia, the financial sector regulator OJK, the Indonesia Stock Exchange, Danantara, APINDO and a range of corporate management teams across banks, telecommunications, cement producers and one of the country's great retail networks.

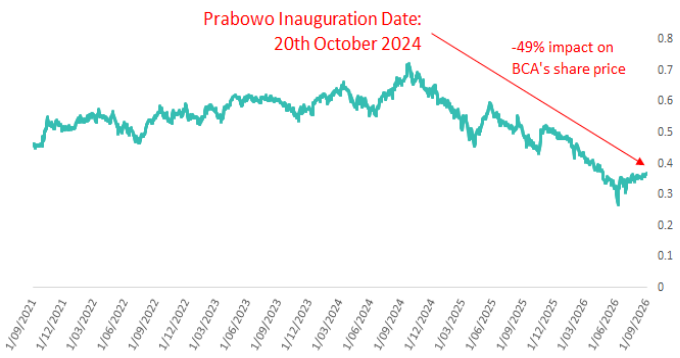
The key question was: has Indonesia genuinely become a worse place in which to own good companies, or has worrying about the country simply become the default investor position?

To be sure, the election of Prabowo Subianto has supplied the market with no shortage of things to worry about. The new administration is more interventionist, more comfortable with central planning and less instinctively reassuring to foreign capital than the government it replaced. Whilst we were in the country, Ahmad Muzani, speaker of the People's Consultative Assembly, opined that "[the Indonesian Constitution] affirms that the economy is organised as a collective endeavour...this mandate underscores that Indonesia's economic development must not be left to free-market competition".

Investors, as the adage goes, prefer an old uncertainty to a new one and have responded in the usual fashion: they have sold first and arranged their rationale afterwards. IDX estimates that foreigners have sold roughly US$3 billion of Indonesian equities since Prabowo's inauguration in October 2024. The

damage is visible in Bank Central Asia, BCA (see Exhibit 2). BCA is the sort of bank that usually causes analysts to reach for superlatives, arguably the best large bank in EM that earns a 4% return on assets, has a very long history of strong shareholder value creation and runway for growth which looks exceptional, yet its US dollar share price has fallen dramatically from its 2024 peak. A great company has not suddenly become an ordinary one. What has changed is the price investors demand for living with Indonesia.

Exhibit 2: The Impact of Prabowo on BCA's Share Price (USD) (Source: Bloomberg)



There is a point at which investor anxiety ceases to be merely a mood and becomes ingrained. Counterintuitively this point can often mark a bottom, and Indonesia appears to be approaching it. Five years ago, the local market commanded roughly 18 times earnings and yielded about 2.7% in dividends. Today the multiple is a little above 11 times, and the dividend yield exceeds 5.7% (see Exhibits 3 and 4). In the space between those two ratings lies a considerable rise in risk premium. Some of our Indonesian holdings now trade near valuations associated with the Global Financial Crisis. PT Telkom offers a dividend yield of about 8%. BCA trades on roughly 12 times forward earnings. There is always a danger in describing a share as cheap: cheap things can become even cheaper. But valuation becomes more interesting when investors are overly focused on short-term downside risks and missing the broader fundamental story.

Exhibits 3 and 4: Jakarta Composite Index (JCI) – P/E and Dividend Yield – A Profound Derating (Source: Bloomberg)





MSCI Downgrade scare from EM to Frontier

The most dramatic short-term risk relates to Indonesia's place in the EM indices following MSCI's January announcement of an immediate freeze on index additions, upward size-segment migrations, and Foreign Inclusion Factor increases due to transparency and governance concerns. A demotion to Frontier Market status would not simply be an academic indignity. The stock exchange IDX estimates that it could produce some US$45 billion of additional foreign selling. Against that figure, the US$3 billion sold since Prabowo took office looks almost irrelevant.

What surprised us in Jakarta was not that officials understood the problem, but the intensity with which they appear to be trying to solve it. IDX is holding bi-weekly calls with MSCI. The minimum free-float requirement has been lifted from 7.5% to 15%; the

threshold for shareholder disclosure has been cut from 5% to 1%; ownership classifications tightened; and a concentration test will remove a stock from the Jakarta Composite Index (JCI) when the top ten shareholders control 90% of it. Indonesia's financial regulator, OJK, is expected to take criminal action against some of the institutions implicated in the coordinated trading that helped provoke MSCI's concerns.

There is even discussion of retiring the JCI itself and attaching the market to a globally recognised index partner such as S&P or FTSE. Bureaucracies are often accused of responding to crises by producing committees. In this case the response appears to include rules, enforcement and potentially the replacement of a venerable index. We left Jakarta less worried about a downgrade than when we arrived. With the "black swan" risk of index removal largely off the table, we think, the potential for permanent capital loss is greatly reduced and investor concerns about Indonesia begin to look more like standard emerging markets fare.

Surveying the Macroeconomic Landscape

The curious thing about Indonesia's political risk premium is that it has expanded while the country's macroeconomic foundations have, in several respects, improved, and rate well on a global basis (see Exhibits 5 and 6). Consider these facts:

- Growth remains around 5%.
- Reported inflation is below 3%.
- Government debt is roughly 41% of GDP.
- The fiscal deficit remains contained.

Emerging markets are often at their most appealing when the statistics are boring. Indeed, none of the above numbers are thrilling, which is partly their virtue, but on average each of these observations are better than the EM, and indeed G20 averages (see Exhibit 5).

The main caveat is the reported inflation rate; we had the sense from several meetings that inflation is likely somewhat understated (and hence whilst nominal GDP figures are likely reliable, real GDP growth is slightly overstated). We note that Indonesia is by no means unique in this regard: the same dynamic has been observed by some in developed countries, particularly in recent years.

The real risk would be runaway inflation of the likes we have seen in Turkey, but we believe this to be very unlikely. At her confirmation hearing in late August, new central bank governor Destry Damayanti assured lawmakers that she would preserve the central bank's independence and noted that she would make decisions in a "pre-emptive and forward-looking" way, consistent with her highly regarded predecessor, Perry Warjiyo.

The other caveat relates to some clear backsliding in Indonesia's democratic processes (checks and balances) under the Prabowo regime. Key of which is government coalition itself which has virtually absorbed every party in Indonesia, as such there is limited effective opposition since October 2024, and as such an over concentration of power with the executive branch (i.e. Prabowo's office). At this stage we are not seeing material overreaching of power by Prabowo, but nonetheless risks of policy missteps are undoubtedly higher when opposition parliamentary checks and balances are heavily diluted.

Exhibit 5: Indonesia Compared to Selected G20 by Various Macro indicators
(Source: Indonesia Ministry of Finance)

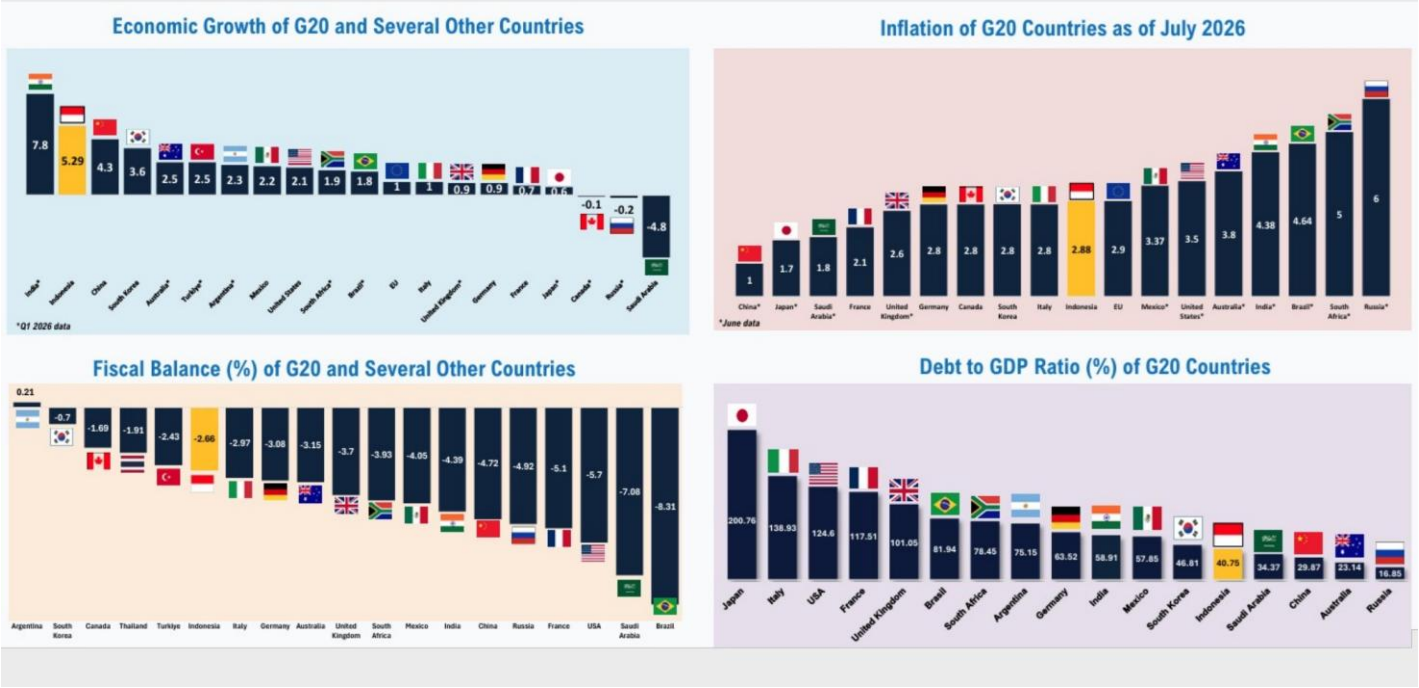
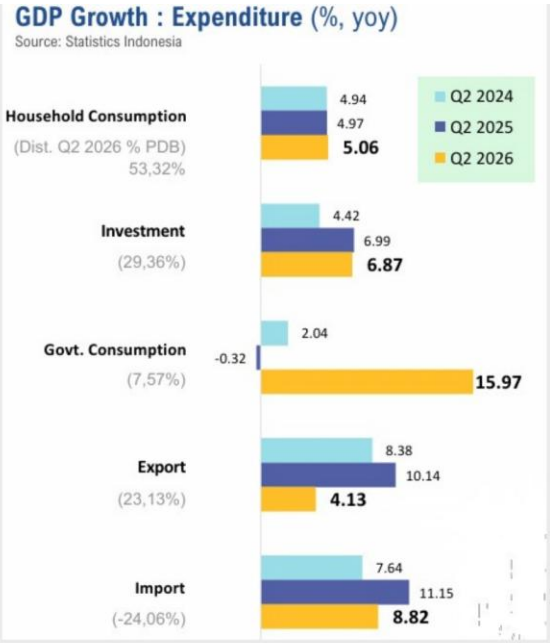


Exhibit 6: Indonesia Q2 2026 GDP components & gross fixed capital formation growth
(Source: Statistics Indonesia / Ministry of Finance)





A Sustainable Engine for Growth

There was another data point that stayed with us from our macro-focused meetings. In the second quarter, household consumption grew a little above 5%, which is roughly what one expects from Indonesia. Investment, however, grew 6.9%, while government consumption rose 16% (see Exhibit 6). The acceleration in capital formation is important because it hints at a broader base for growth than the familiar story of a young population steadily buying more things.

Undoubtedly, government spending is doing some of the work, and investors should resist the temptation to confuse public expenditure with productivity. Still, investment running close to 7% growth rate is a more encouraging accompaniment to 5% GDP growth than consumption alone.

The Ghost of 2013

Every emerging country has a year that foreign investors keep in a drawer and take out whenever they wish to frighten themselves. For Indonesia it was 2013. During the so called "taper tantrum". The phrase was coined to reflect the tapering of post GFC liquidity support to global capital markets by US Federal Reserve. Specifically, the Fed announced in mid-2013 that it would soon slow down its vast quantitative easing program (QE – i.e., bond purchases funded by printing money). Bond prices dropped, and US Treasury yields (long term interest rates) shot up, which saw funds quickly repatriate from global markets back into US dollar assets. Especially vulnerable were countries running large current account deficits, funded by cheap rates from the US money printing machine. Indonesia was caught right in the firing line with its large current-account deficit of 4.3% of GDP in the second quarter 2013. Indonesia became a key member, rather memorably, of the 'Fragile Five' – five EMs all with large current deficits (India, Turkey, Brazil, South Africa and Indonesia).

The phrase was unfair in the way that good slogans often are too neat to be forgotten and too useful to be retired. Between May and the end of December that year the Jakarta Composite Index fell a painful -33% in US dollar terms.

In current account dynamics at least, today's Indonesia is a different proposition. Monthly trade surpluses have become the norm, and the external financing requirement is far smaller with a current account deficit of a mere -0.1% in 2025. That distinction matters. Indonesia's old vulnerability was not simply slow growth or high inflation; it was the feedback loop between the current account, the Rupiah and foreign capital. A country that needs less foreign money has more flexibility when foreign money decides to head for the exit.

Summary Investment implications

Taking everything into account from our desk top work and our recent research trip to Indonesia, in our recent Sovereign Risk review we increased the risk premium for investing in the country.

This reflects the positives of limited risk of Indonesia being downgraded to Frontier by MSCI and better economic observations on growth and deficits, offset by higher inflation risks and backsliding in democratic checks and balances under the Prabowo regime.

However, even after applying the higher discount rate, we are finding our Indonesia stocks (which in our opinion are high-quality companies) are still trading at attractive valuations. Hence, we have recently been adding to these positions.

For more information, please contact our distribution team:

Katie Orsini
Client Director

p: +61 2 8234 3629
e: katie.orsini@northcape.com.au

Wendy Hammond
Client Manager

p: +61 2 2 8234 3638
e: wendy.hammond@northcape.com.au

Eliza Clarke
Client Manager

p: +61 2 2 8234 3606
e: eliza.clarke@northcape.com.au

Northcape Capital

Sydney
Level 24, 45 Clarence
Street Sydney NSW 2000
Australia
P: +61 2 8234 3600

Melbourne
Level 18, 90 Collins Street
Melbourne VIC 3000
Australia
P: +61 3 8626 8000

ABN: 53 106 390 247
AFSL: 281767

www.northcape.com.au

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