Making sense of JCI valuation in the midst of recent macro environment

Key Takeaways

- JCI return +7.65% YTD turned out to be the best performing equity index in APAC despite unfavorable macro-environment.
- Rising inflation followed by the increase in risk free rate historically followed by JCI valuation de-rating, particularly when inflation overshoot BI's ITF.
- Our macro model showed that risk free rate & inflation have significant & negative impact on JCI valuation.
- Given inflation rose +4.94% YoY in Jul-22, overshooting BI's upper target by +94% and with risk free rate at 7.20% we expect the fair value for JCI should be at 6,898 (-2.70% from current position) implying 14.3x FY22E P/E for Aug-22.
- Macro factors that favor JCI valuation are : government and foreign deficit balance meaning that there is a net inflow of money into private sector as a saver building their financial asset position. This also should justify inflows to equity market (>IDR50tn) vs outflows from govt. bond (>IDR130tn) YTD.
- Key downside risks for 2H22 JCI valuation : 1) higher than expected inflation; 2) a more normalized or even lower commodity prices & 3) fiscal consolidation agenda.

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Rationalizing JCI valuation

JCI successfully to record a return of +7.65% YTD, despite challenging global macro environment as stagflation risk increases (Exhibit 1). JCI turned out to be the best performing stock index in APAC with energy & transportation sectors lead the gain reflecting the wind fall effect from recent commodity boom (Exhibit 2). Given such impressive performance, JCI is currently traded at 14.65x FY22E P/E or yielding 6.82%, less attractive than the benchmark government bonds (vs risk free rate 7.00-7.30%.). In addition, pressure from rising domestic consumer prices also open up possibility of valuation de-rating in the stock market. Here we outlined our view on how resilience is JCI in the midst of unfavorable condition for valuation from a macro perspective.

Rising inflation and risk-free rate to cause JCI valuation de-rating

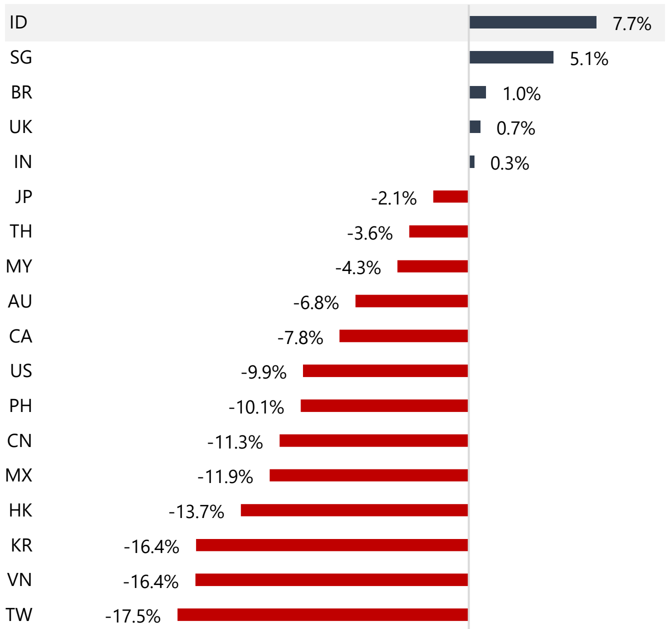
Domestic inflation has persistently rise since May-21. In July-22, CPI rose +4.94% YoY above consensus/MNCS estimate at +4.82%/4.89% YoY. Last month inflation figure was the highest since Oct-15, overshooting upper target of ITF by +94 bps. On the other hand, 7-day reverse repo maintained at 3.5% bringing the real rates to be -144 bps. Albeit the core CPI remained <3% YoY, going forward it may surpass 3% YoY threshold as : 1) oil prices hovering around USD100/bbl and 2) IDR depreciation (>4% YTD). Even with +2.86% YoY core CPI increase in July-22, the spread between 7-day reverse repo narrowed to 64 bps, the lowest in the last 5 years. Given the recent development, we think that BI will soon to raise interest rate by +25 bps by early in Aug-22.

In the last 15-years, there were period where inflation significantly overshot BI's ITF (+3% from target). First in Sep-05 until Sep-06. The second during global financial crisis (May-08 up to Mar-09) and the third during taper tantrum (Jul-13 until Feb-14). Historically, in those period of high inflation, risk free rate rose and JCI 1-year forward P/E dropped (Exhibit 3). Our macro model also confirmed that CPI and risk-free rate have significant negative impact on JCI in the long run (please see the methodology). And hence, with the upcoming possibility of higher inflation followed by interest rate hikes, this may also cause JCI de-rating. Based on long run sensitivity of stock market index to risk free rate and inflation, JCI could fall to 6,898 by the end of Aug-22 (-2.71% from current position/-0.29% MoM) implying 14.27x FY22E P/E (Exhibit 4).

Yet there is another macro factor that favor JCI valuation

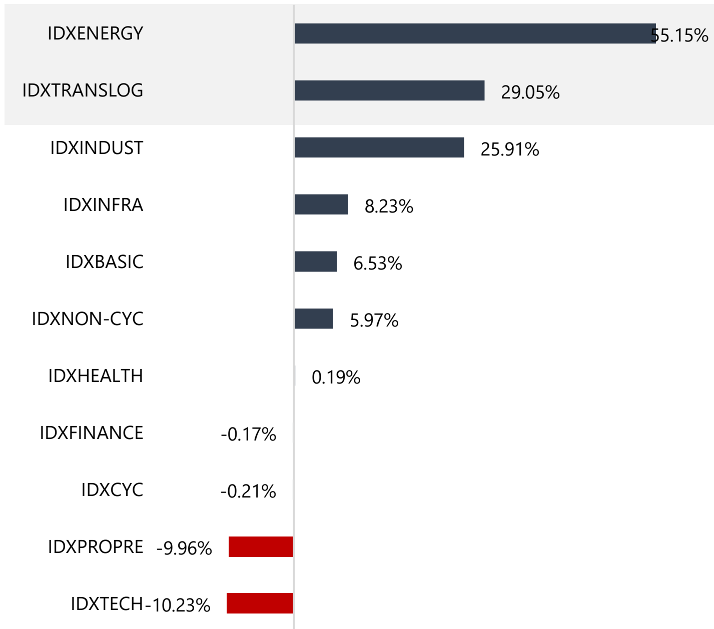
Even with the potential loss of -2.71% from recent position due to rising inflation, JCI still recorded an increase of +4.82% since the start of the year. From sectoral balance perspective, current JCI valuation is favorable due to a deficit balance posted by government and external sectors. Note, that with budget deficit to be at ~4.00% GDP and current account balance at 0.11% GDP for FY22E meaning that there is a net inflow of money into private sector as a saver building their financial asset position (Exhibit 5). Such circumstance also justified recent inflows in stock market (+IDR54.60tn including flows to negotiation market/+50.85tn in regular market only YTD) (Exhibit 6) and in contrast to massive outflows from government bond market (-IDR132.27tn YTD) despite having lower risk (Exhibit 7). A surplus balance recorded by private sector occurred since the beginning of Covid pandemic as government widened budget deficit and 26-months of trade surplus helped lower Indonesia's external vulnerability. Besides that, domestic investors base in the stock market also increased significantly adding another inflow to equity market. Hence, the likelihood of JCI to fall into bearish zone (-20% decline) is relatively small should those condition persist, in our view. Key downside risks for 2H22 JCI valuation are : 1) higher than expected inflation; 2) a more normalized or even lower commodity prices and 3) fiscal consolidation agenda.

Exhibit 1. JCI became the best performing stock index in APAX



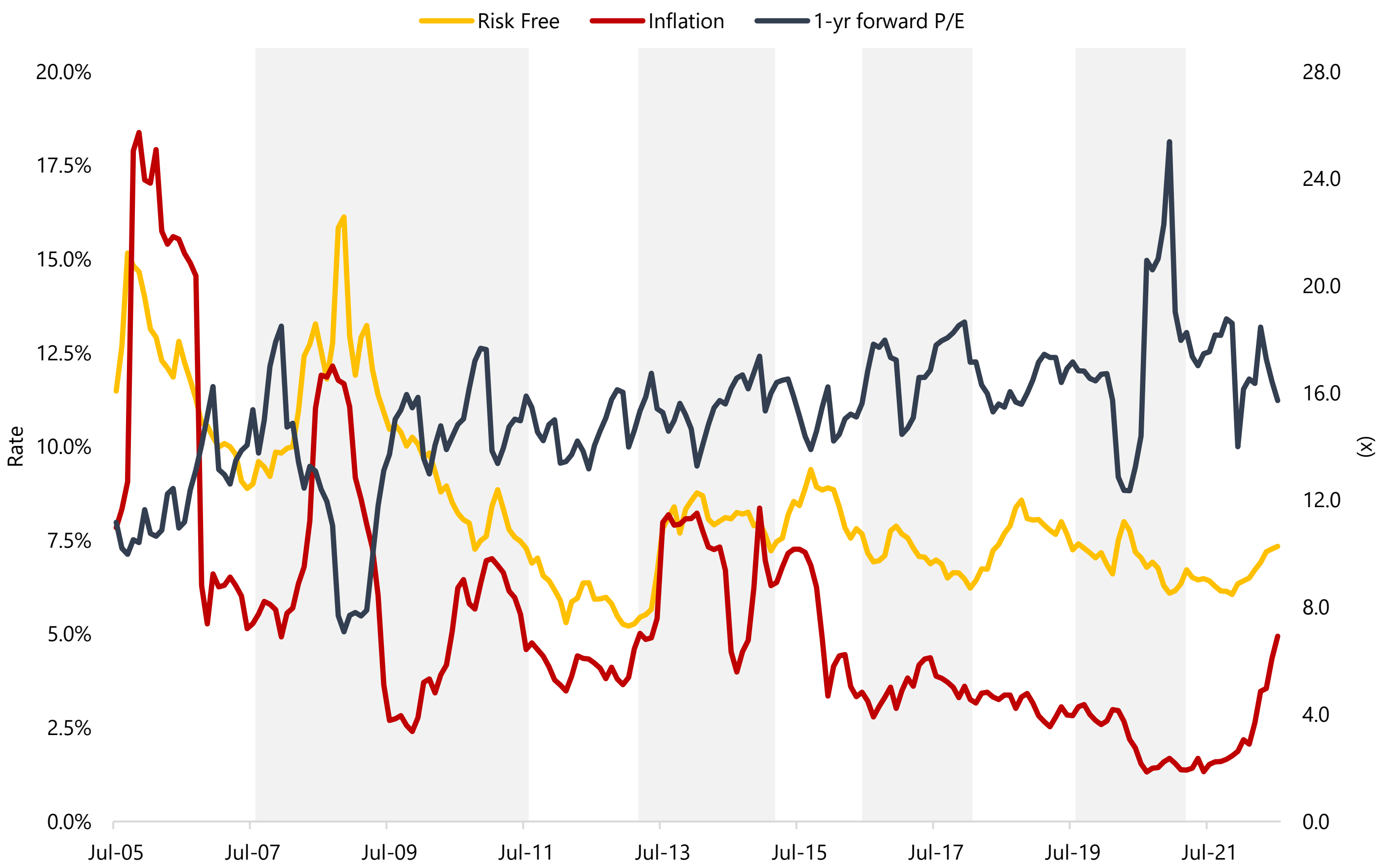
Sources : IDX, MNCS Research

Exhibit 2. Energy and transport & logistic sectors outperformed



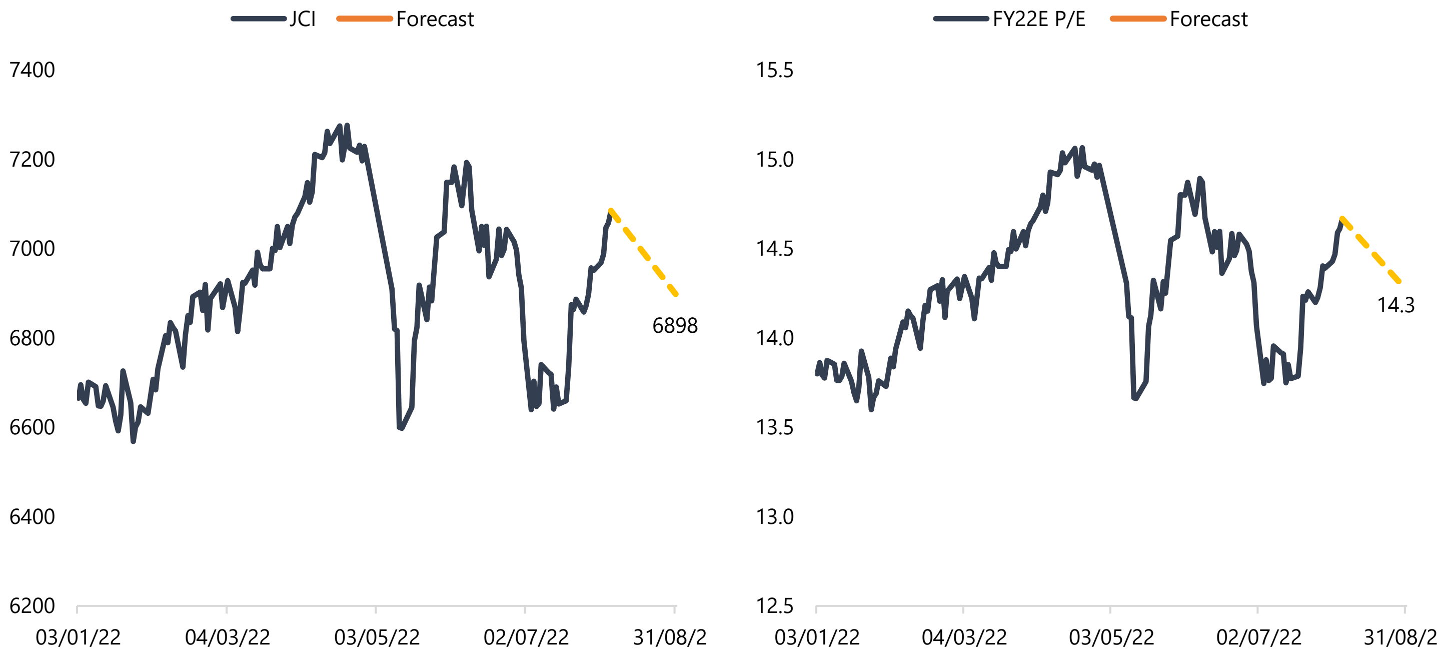
Sources : IDX, MNCS Research

Exhibit 3. The relationship between JCI, risk free rate & inflation



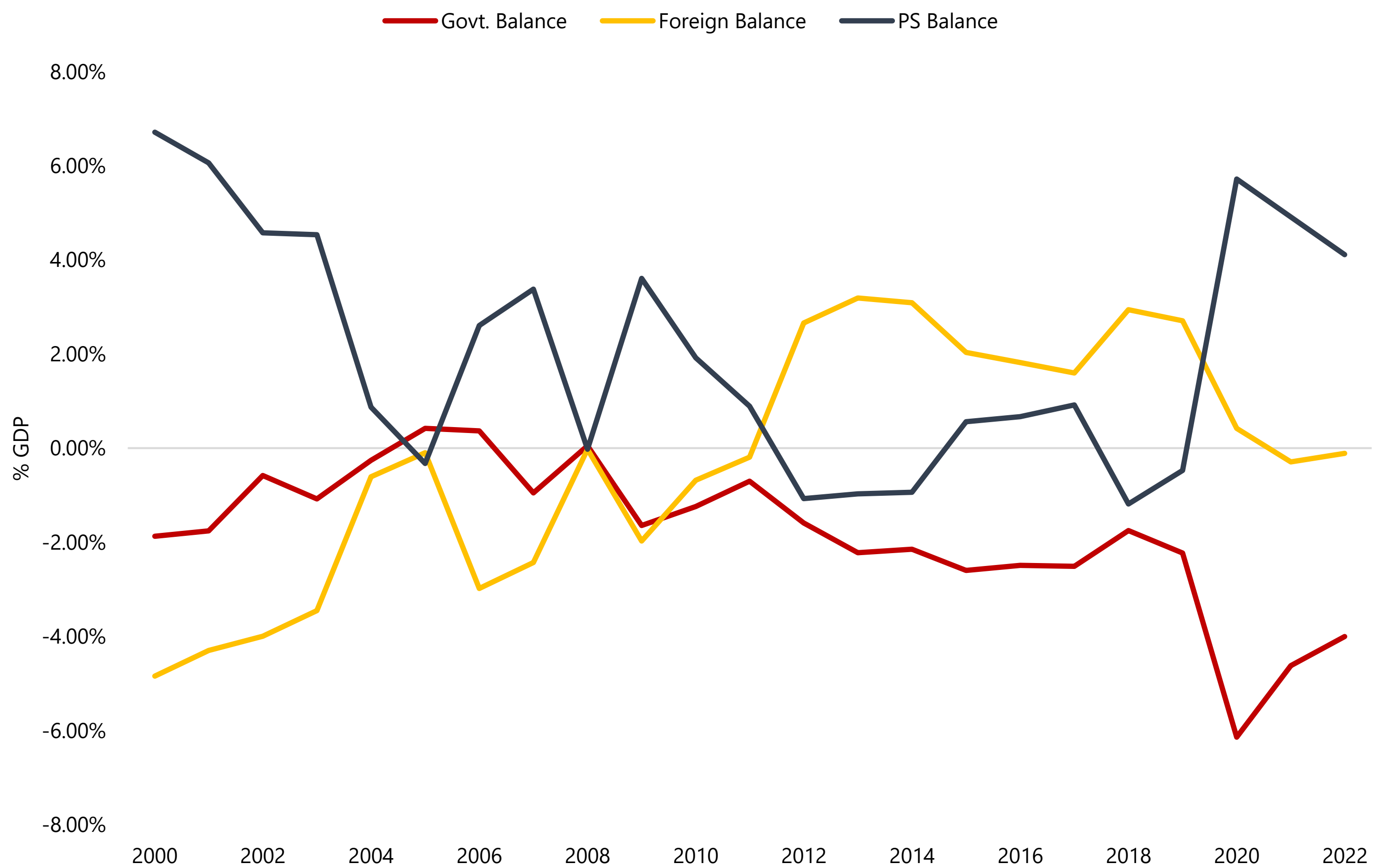
Sources : Bloomberg, Statistics Indonesia, MNCS Research

Exhibit 4. MNCS Aug-22 estimate for JCI



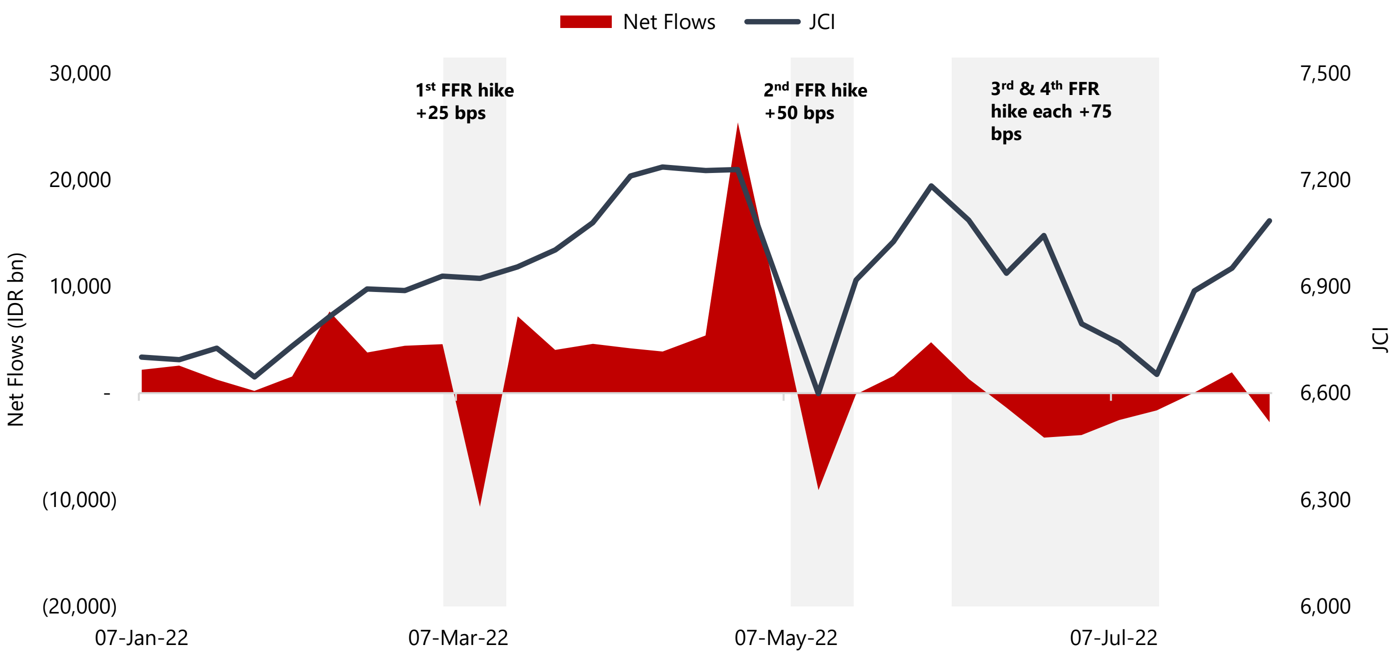
Sources : Bloomberg, MNCS Research

Exhibit 5. Money is flowing to private sectors



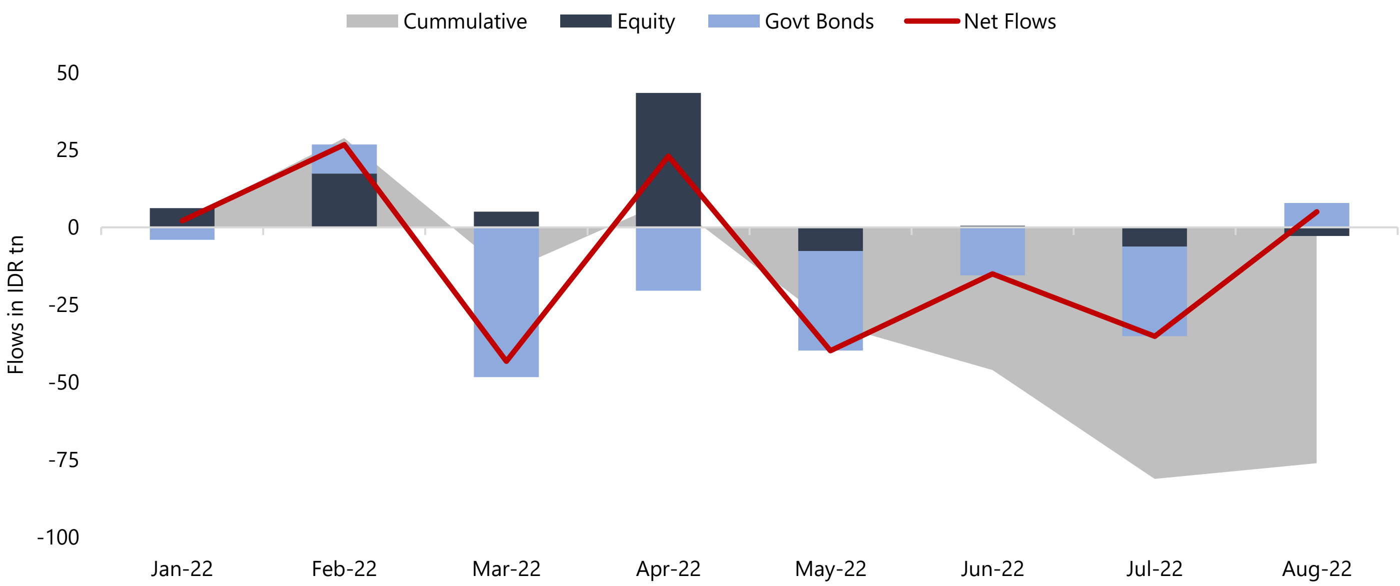
Notes : 2022 figures are MNCS estimates, assuming sum of sectoral balance to be 0% Sources : World Bank, Bank Indonesia, MNCS Research

Exhibit 6. JCI vs foreign fund flows YTD



Sources : Bloomberg, IDX, MNCS Research

Exhibit 7. Foreign fund flows to equity vs government bond YTD



Sources : IDX, DMO, MNCS Research

Macro Model for Long Run Relationship between JCI, CPI & Risk Free Rate

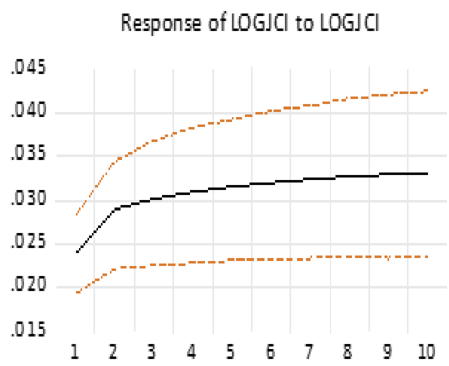
- Data for JCI, IDR, & risk free rate are collected based on the end date of each month from Jul-05, while CPI is collected monthly and rebased to 100 in Jul-05. All data, except for risk free rate are transformed into log function.
- Stationarity test using Augmented Dickey Fuller (ADF) & Phillip-Perron (PP) test indicate that all data are stationary at 1st difference at confidence level 1%, 5% & 10%.
- The optimum lag period for Vector Auto Regression is at lag 2, and then followed by Johansen Cointegration Test that indicate all the variables are cointegrating reflected by the significance prob <0.05 for the Trace Test & Eigen Value suggesting VECM method to be appropriate.
- The equation for long run & short run relationship derived from the VECM model is stated below :

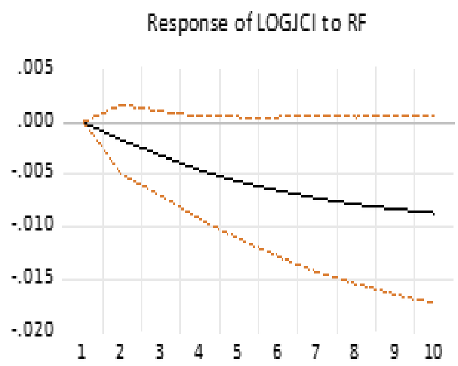
$$\Delta LogJCI = -0.006694(LogJCI_{t-1} - 15.961LogER_{t-1} + 20.018LogCPI_{t-1} + 54.389Rf_{t-1} + 11.846) + 0.242\,\Delta LogJCI_{t-1} + 0.256\Delta LogER_{t-1} + 0.155\Delta LogCPI_{t-1} - 0.076\Delta Rf_{t-1} + 0.03$$

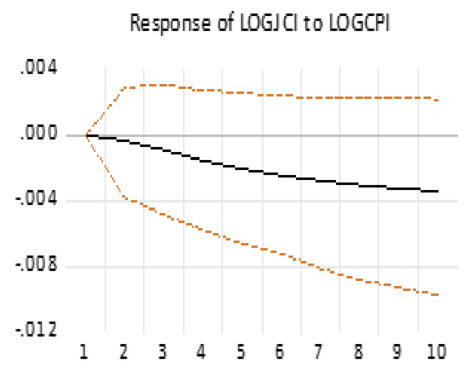
- Long run cointegration equation has negative sign and is significant with prob <0.05.

	Coefficient	Std. Error	t-Statistic	Prob.
Long Run Coint Equation	**-0.006694**	**0.003109**	**-2.153169**	**0.0325**
Short Run JCI	**0.24182**	**0.093687**	**2.581156**	**0.0106**
Short Run ER	0.255949	0.181039	1.413782	0.159
Short Run CPI	0.154486	0.363237	0.425302	0.6711
Short Run Rf	-0.076357	0.261547	-0.291944	0.7706
Constant	0.002587	0.001895	1.3651	0.1738

- Impulse Response Function (IRF) :







Sources : MNCS Research

MNC Research Industry Ratings Guidance

OVERWEIGHT: Stock's total return is estimated to be above the average total return of our industry coverage universe over next 6-12 months

NEUTRAL: Stock's total return is estimated to be in line with the average total return of our industry coverage universe over next 6-12 months

UNDERWEIGHT: Stock's total return is estimated to be below the average total return of our industry coverage universe over next 6-12 months

MNC Research Investment Ratings Guidance

BUY : Share price may exceed 10% over the next 12 months

HOLD : Share price may fall within the range of +/- 10% of the next 12 months

SELL : Share price may fall by more than 10% over the next 12 months

Not Rated : Stock is not within regular research coverage

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