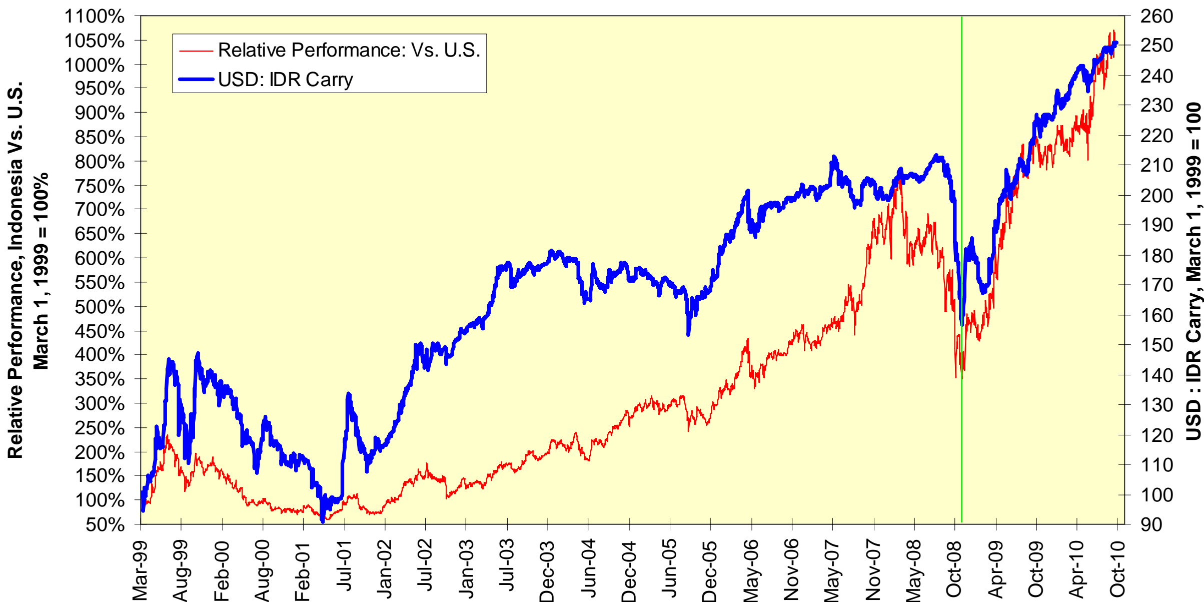
That's Not Indonesian Junk Anymore

While referencing the lyrics from rock songs might be nothing more than a cheap trick, investors need to sit up and take notice of just how much the Federal Reserve's acid trip – money for nothing, upticks for free – is propelling the world's emerging markets.

Some, like Indonesia, seem to be amped-up on too-strong java, but the source of these river-deep, Bali-high returns is nothing other than the American printing press. This is easy to illustrate by mapping the relative performance of the Indonesian market against the American market in U.S. dollar terms against the excess carry return of borrowing three-month USD and lending in three-month Indonesian rupiah (IDR). The returns have paralleled each other exceptionally closely since November 2008, marked on the chart below with a green line. This was the nadir for many high-yield and emerging-market credits.

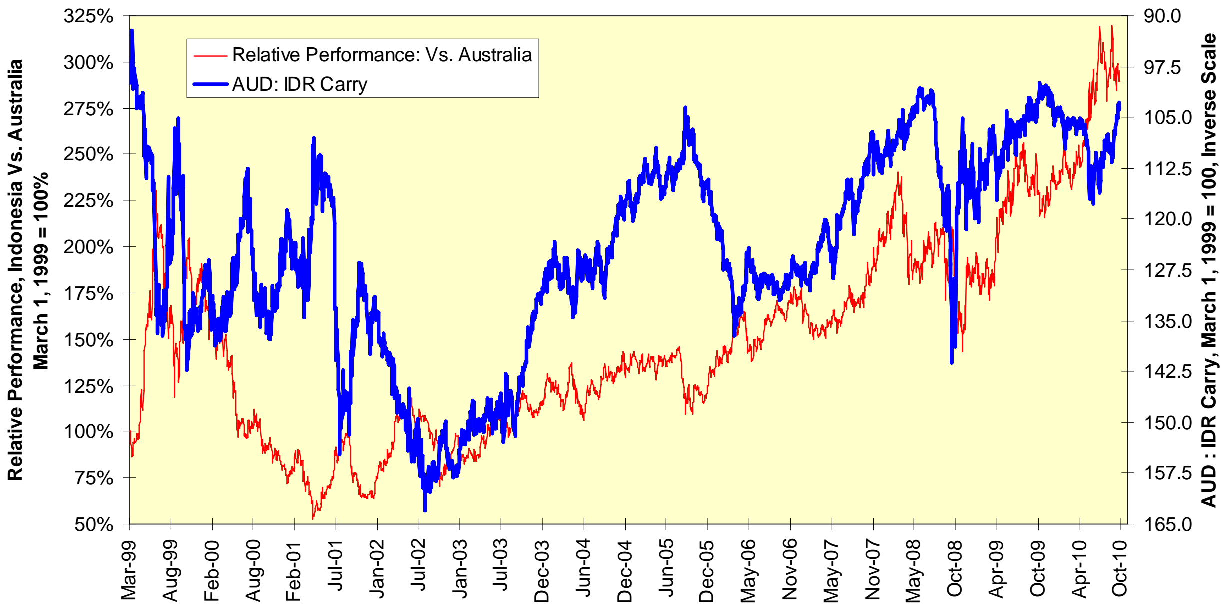
USD Carry Into Rupiah Rising Parallel To Relative Stock Performance



The currency carry trade is going to be open for a while; three-month IDR are yielding 6.91% at the time of this writing, about 23 times more than three-month USD. The fault is not high rates in Indonesia; historically those are not high rates at all, but low rates in the U.S. The two risks to this trade are higher short-term interest rates in the U.S. (yeah, right) or a collapse in the rupiah greater than the interest rate differential. That latter trade has been moving in the opposite direction during 2010; the IDR has gained 5.25% against the USD.

Charlie Don't Surf, Matilda Don't Waltz

Both trade patterns and geography provide us with a control of sorts to measure the effect of the dollar carry trade into the rupiah. We can compare the Australian dollar carry into the rupiah and the relative performance of Indonesian stocks to Australian stocks to see if these patterns differ from the U.S. case, and they do. First, we need to remind ourselves the Reserve Bank of Australia began raising short-term interest rates in October 2009, and this lowered the carry return significantly until the Chinese yuan was allowed to revalue in June 2010. This pushed the IDR higher and expanded the carry from Australia into Indonesia. Even so, Indonesian equities have stalled against their Australian counterparts over this period.



This last point cannot be emphasized enough: Australian equities are more than keeping pace with a torrid emerging market such as Indonesia even as short-term interest rates rise. There is a lesson here for all central banks who think ultra-low interest rates and monetary ease are necessary for both economic growth and healthy financial markets.

If you are interested in a straight play on Indonesia you might want to try the Aberdeen Indonesia Fund, a closed-end fund that has returned almost 55% so far in 2010, or the Market Vectors Indonesia Index ETF; it has returned close to 39% year-to-date. The key question here as elsewhere in emerging Asia is what will happen when the money spigot closes; there is a long history of carry trades leaving the last investor holding the bag.