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***“ Courage is not the absence of fear, but rather the judgment
that something else is more important than fear. ”***

- Ambrose Redmoon



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What We Learned This Quarter

Not Afraid to be Afraid

“We are also prone to be afraid of being afraid, and the conquering of fear produces exhilaration... When we have been afraid that we may panic in an air-raid, and, when it has happened, we have exhibited to others nothing but a calm exterior and we are now safe, the contrast between the previous apprehension and the present relief and feeling of security promotes a self confidence that is the very father and mother of courage”

- Canadian psychiatrist J.T. MacCurdy, in explaining why the panic in London never came when in the fall of 1940, the long-anticipated German Blitz in the WW2 finally happened.

The bombing of London was everything the British government officials had feared. German bombers thundered across the skies, dropping tens of thousands of high-explosive bombs. Forty thousand people were killed and another forty-six thousand were injured. A million buildings were damaged or destroyed.

However, contrary to expectations, the psychiatric hospitals built on the outskirts of London saw no one showing up. As the Blitz continued, the Londoners showed not just the courage in the face of bombing but something closer to indifference.

MacCurdy had a theory that when a bomb falls, it divides the affected population into three groups. The first group is the people who got killed. The next group is the near misses. This group felt the blast and saw the destruction. They survived but were deeply shocked. The third group is the remote misses.



Source: AP Photo

This smiling girl, dirtied but not injured, courage during 1940 London Blitz

After experiencing a remote miss for a second or a third time, the emotion associated with the attack is an “*excitement with a flavor of invulnerability*”. A near miss leads to trauma, a remote miss leads to the feeling that one is invincible.



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The above story on the London bombing and remote misses phenomena were loosely taken from Malcolm Gladwell's latest book *David & Goliath*. Both the book and the story of how Londoners dealt with the WW2 hardship are indeed very inspiring. We feel like we can topple giants when we read this book/story.

Of course it is good to have this feeling but as investors, we have to remind ourselves that our job is also to worry. Well, the healthy kind of “*analytical worry*”. As such, the story above also serves as a good reminder that it's probably time to have a little fear when others feel invincible.

After all, we wonder if most of us suffer from the feeling of being invincible nurtured by remotes misses such as the “ends” of money printing or perhaps even life threatening events such as SARS.



QE has, for now, ended and scant evidence of real GDP growth but investors are calm. Remote misses?

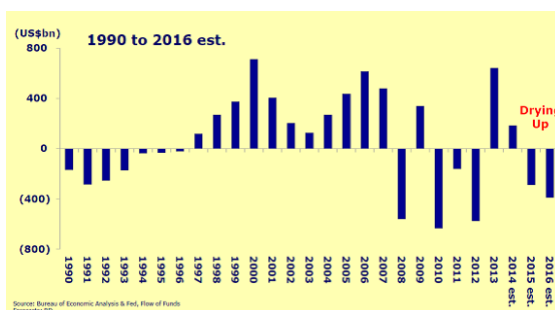
3Q 2014 Reporting Period

In the 3Q of 2014, with the new government coming, we saw the bullish sentiment driven by potential reforms.

However, going forward into the 4Q 2014, we think a more cautious stance is justified given:

1. The end of Fed QE
2. The fear of a further spread of Ebola
3. The macro challenges to Indonesia

The End of QE (for now?)

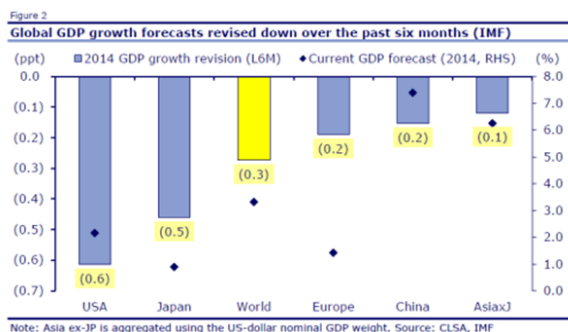


Liquidity gauge, including QE



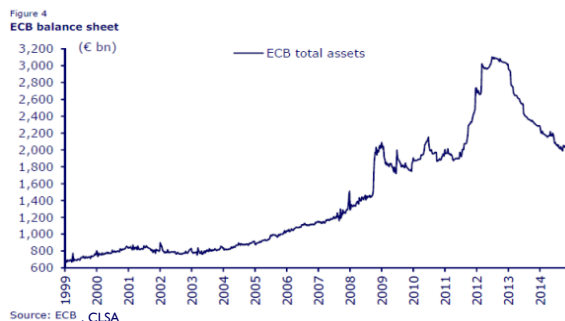
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History shows that when QE ends, liquidity will tighten, asset prices will eventually fall and the global economy will weaken thanks to QE withdrawal symptoms. It is worth noting that the US economy grew by only 0.5% during the first half of this year, or by 1.0% annualised.



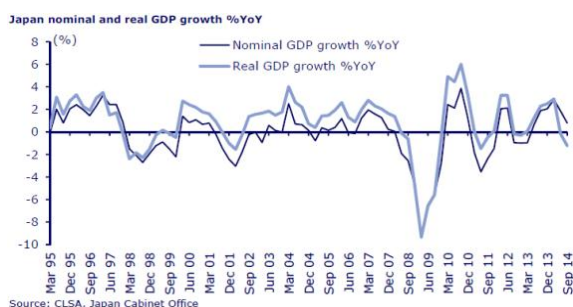
Deflation still an eminent threat

More importantly, the Eurozone economy has grown by only 0.7% over the past year. The implication is that the dollar was given a further boost by Draghi's verbal commitment at the ECB to increase the ECB balance sheet by about €1tn towards the €3tn level reached in March 2012.



Another remote miss?

Meanwhile in Japan, Kuroda has followed up his surprise easing at the last BoJ meeting, with a speech strongly defending his latest policy move and containing more than a hint of the “whatever it takes” type of language made famous by Draghi.



“Whatever it takes” to exit deflation

“In order to completely overcome the chronic disease of deflation, medicine should be taken until the end. A half-baked medical treatment will only worsen the symptoms.”

“Inflation expectations are expected to follow an uptrend and gradually converge to around 2% - the price stability target.”

- Haruhiko Kuroda



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What Does This All Mean For Emerging Markets Like Indonesia?

While money printing in Europe and Japan might trickle down into smaller markets, we would like to note that historically a stronger US dollar is negative for commodities and resource-driven economies like Indonesia.

History might not repeat itself, but the historical correlation between US\$ Index (DXY Index) and Commodity Index (CRY Index) from Jan 1994 to Nov 2014 is -0.66 and it is statistically significant.



Trend is the friend of the dollar now

Ebola “Fear” or The Lack of Fear?

According to a World Health Organization (WHO) report in Sept, the Ebola virus has infected 5,864 people and killing 2,811. So far the spread in Guinea, Sierra Leone and Liberia shows limited sign of slowing down. While we are hopeful that this unfortunate event in Africa gets under control, we feel that the feel from small cases popping up is enough to induce a lot of fear in markets and the real economy.

To put things in perspective, SARS has killed 916 people worldwide, mainly in the China (PRC) and Hong Kong Special Administrative Region (HKSAR), and infected 8,422 others.



Source: AP Photo

Afraid to be afraid

In the case of Hong Kong, the ADB estimated that SARS knocked four percentage points off economic growth in 2003, taking it down more or less to zero. It is fair to say the vibrant city turned into a ghost town overnight. Restaurants, hotels, entertainment venues were all empty. Hotels saw a drastic plunge of average occupancy rates from 83 percent to 18 percent.



Source: AP Photo

Eventually afraid



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Indonesia: Is The Time Cover Story An Indicator of A Market Peak?



Source: Time

Classic contrarian? Is this an indicator of a top?

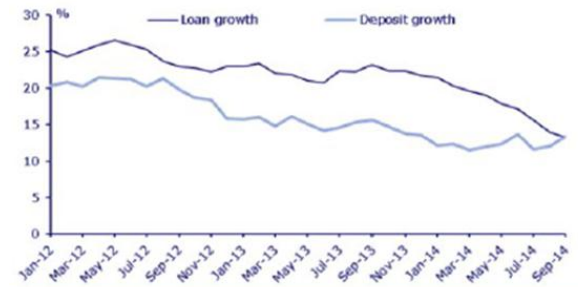
When we see something like the picture above, the contrarian spirit in us starts to wonder whether this marks the top of the Indonesian market.

Hopes are certainly high on the President elect Jokowi and his VP elect Jusuf Kalla. On the other hand, challenges are massive given their continuing lack of a clear parliamentary majority and tough macro backdrop.

For a start, we are seeing third quarter slowdown across the board. Interesting to note first time in years, deposit growth has exceeded loan growth in 2014.

While this will ease the banks deposit war, slower loan growth suggest the economy is slowing down. Not entirely surprising given the loan deposit ratio in the system has already breached 90% putting a constraint on growth.

Loan growth vs. deposit growth



Source: BI, CLSA

2014: an anomaly year, deposit growth > loan growth

A slow-down is already being felt in consumer and media companies. Advertising spend will be the first consumer companies cut when they feel the pinch from macro slow down. Media companies have reported worse than expected 3rd quarter results and guiding at least another weak quarter ahead.



Source: CLSA

Empty billboards everywhere



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EBIT margin of staples companies



Source: Companies, CLSA

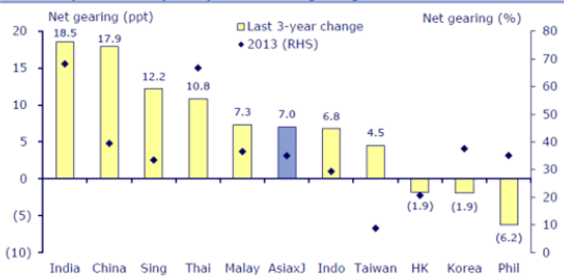
Profitability continues to trend down for Indo consumer

What's even more interesting is that apparently it is not just the middle class that feels the pinch. Our conversation with luxury car dealers tells us that their inventory is hardly moving these days.

Despite all the above, we continue to be bullish on Indonesia in the longer run.

Figure 81

Asia ex-Japan markets (ex-fin) - Current net gearing and addition since 2010



Source: CLSA, Factset

Indo corporate net gearing still below the average in Asia

The rise of President Jokowi from successfully running a small city of Solo to a higher profile post as the governor of Jakarta and now as the leader of the world's 4th most populous country is an important historical event. Jokowi is the first directly elected President that has no link to President Suharto era. He is the result of pure democracy. The message is clear and simple: Jokowi is a different kind of leader.

He is simple and down to earth, he can relate to people from all walk of life. He comes to serve the people instead being served. His background is not politician/military, nor does he come from a political dynasty. In fact, he comes from a very simple beginning where he was a businessman before he entered politics. In short, he is an underdog who has turned disadvantages to advantages.



Source: Internet

Running governor to running president



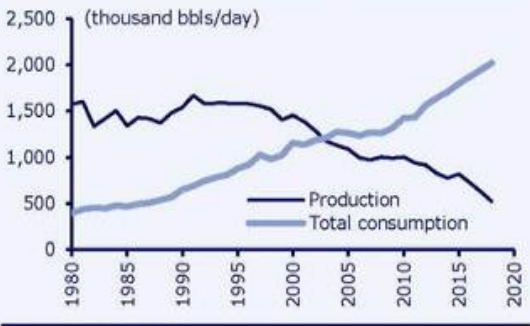
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While there has been a lot of concern with regards to his coalition lacking a majority in the Parliament, we believe that there is no such thing as a permanent coalition. Politics is politics and it can change anytime. We also don't think that the opposition-led parliament will be a big obstacle to Jokowi-Kalla, as Jokowi's previous experience (lack of parliament majority) in Jakarta demonstrates.

Understandably, there is a lot of scepticism about whether the new government will be effective in implementing tough reforms. It is worth pointing out, however, that there are plenty of low hanging fruits, such as phasing out long-overdue fuel subsidies (the government has recently delivered on this) and bureaucracy reform (on-going process now).

One key area for reform is the oil and gas sector. We view that the potential reform in the oil and gas sector will present investors with opportunities. The fact is that if nothing is done, Indonesia's energy balance will be heading towards a net energy importer position by 2017. This is an irony as Indonesia is blessed with vast resources.

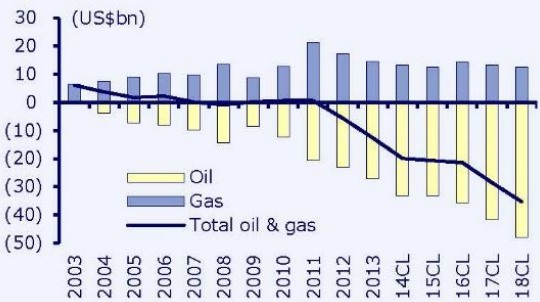
Oil production and consumption



Source: BP, CLSA

Indo net oil input since 2004

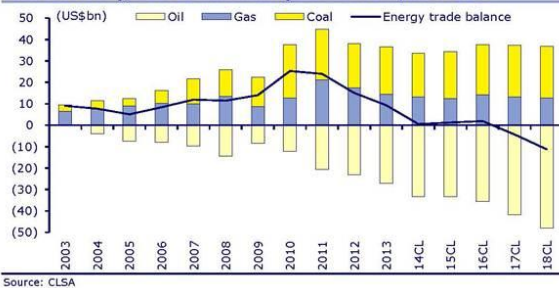
Oil & gas trade balance



Source: Gov't of Indonesia, CLSA

Indo oil & gas deficit since 2011

Indonesia's energy trade balance: Heading towards net imports in 2017



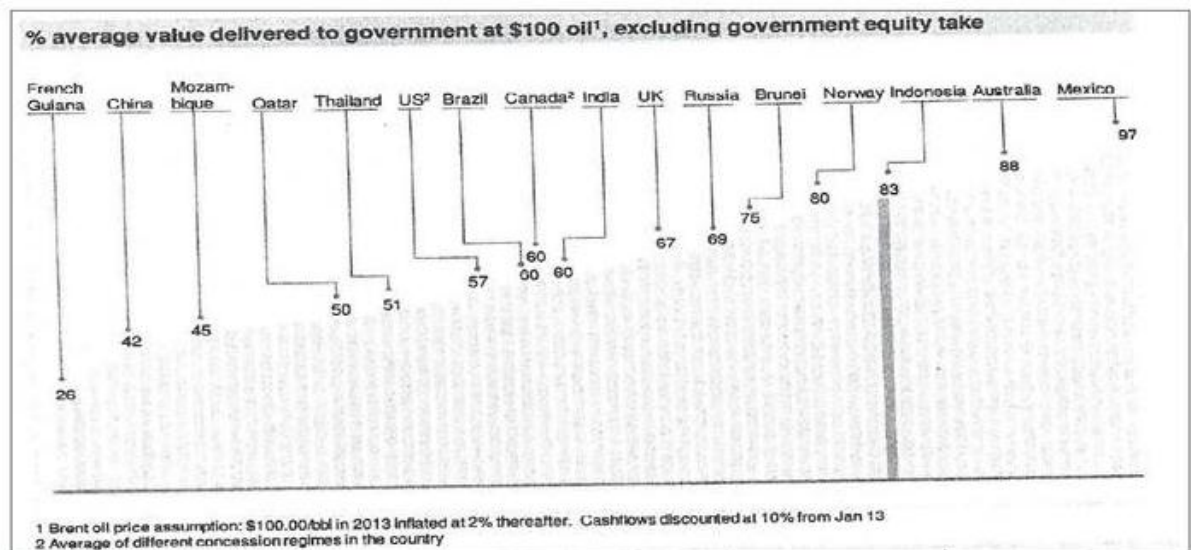
Source: CLSA

Indo net energy import by 2017?



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The following chart's format is not exactly beautiful but it tells a thousand words about how uncompetitive our current oil fiscal regime is.



Source: McKinsey

On a lighter note, coming from a low base means there is only upside. This is especially true for Infrastructure developments in Indonesia. Rather than presenting more charts and numbers, we opt to use the following picture to illustrate the huge upside from infrastructure development in Indonesia.

We took the picture in North Bali (not exactly a poor area in Indonesia) recently. It shows the daily struggle that these kids have to face every day just to go to school. There is no such thing as a bus stop, these kids had to literally jump on the bandwagon. Just imagine how far infrastructure reform can take us to.



Source: Author

Daily struggle of kids going to school