GENERALI
ASSET MANAGEMENT

Indonesia: Political risks but attractive opportunities

Vladimir Oleinikov, Guillaume Tresca

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Our Focal Point series explores topical issues on macro, markets and investment

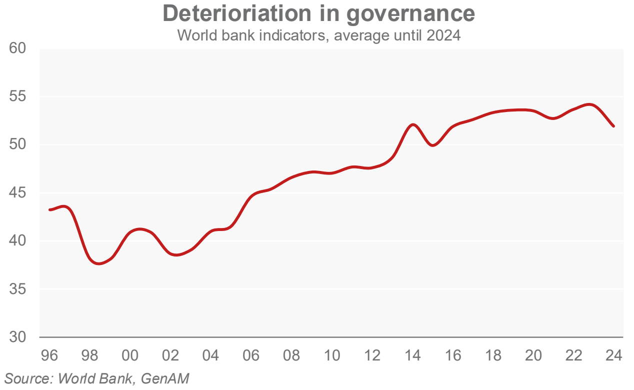
- **Indonesia is back on investors' radar as policy visibility and governance have weakened under President Prabowo, with fiscal policy the main concern.**
- **The macro framework remains resilient but the direction of travel has turned less favourable. We see limited HY downgrade risk on buoyant growth, low debt and sound external accounts.**
- **We recommend a tactical overweight in equities given excessive underperformance, attractive valuations and limited risk of an MSCI downgrade to Frontier Markets, with risks coming from weak policy visibility.**
- **Fixed income valuations have improved on rising risk premium. Technicals, high carry and the central bank policy support the case for local debt. We like the IDR in the medium term and see value in the belly of the IndoGBs curve but avoid the front-end. We adopt a slight positive stance on external debt.**

Indonesia has moved back into investors' focus — not because its macro fundamentals have broken down, but because policy visibility has deteriorated. The Prabowo administration has introduced a more interventionist and less predictable policy mix, raising questions about fiscal discipline, governance and the investment outlook. For investors, the key question is whether the recent repricing in Indonesian assets already reflects this higher policy-risk premium, or whether markets still need to adjust further.

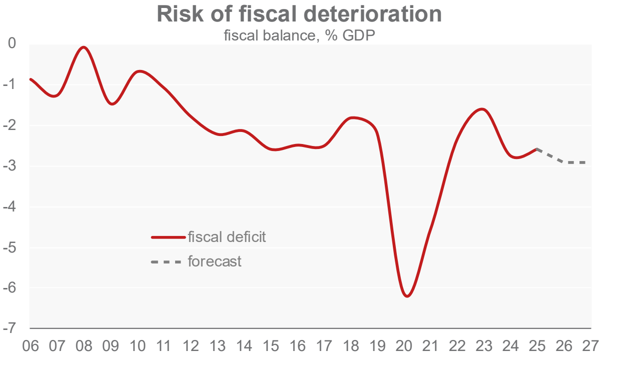
Rising policy uncertainty tests Indonesia's macro framework

President Prabowo's administration has fuelled investor concerns about the predictability of the policy mix, its coherence and the growing centralisation of the policymaking process. Since his election in February 2024, President Prabowo has adopted a more populist policy stance than his predecessor, with several unexpected decisions and unclear communication.

The deterioration started with the 2025 protests, which responded to Prabowo's new policies: austerity, the free-meals financing model, and an expanded military role. More precisely, Parliament passed revisions to the military law that allowed active officers to hold more civilian posts, while critics argued that this risked reviving the old "New Order" pattern of military dominance. In parallel, these developments coincide with a decline in Indonesia's scores in the Worldwide Governance Indicators for government effectiveness and regulatory quality, with the country ranking in the 44th percentile on the composite governance score.



Source: World Bank, GenAM



Source: Bloomberg, GenAM

In parallel, the fiscal policy drift has become the main focus of investor concerns. Indonesia's long-standing fiscal discipline has underpinned its economic stability and sovereign credit rating. However, the government now risks weakening the 3% fiscal rule enacted in 2003. The new administration is expected to increase spending, notably through the Free Meal programme, despite low tax revenues and a structurally low tax ratio. The decision to abandon a VAT rate hike also reinforced these concerns.

Fiscal policy has also gradually fragmented across institutions, moving some fiscal activity outside the conventional budget framework. The establishment of the Danantara Sovereign Wealth Fund provides the clearest illustration. It operates in ways that resemble an additional arm of fiscal policy and raises uncertainty about its financing, governance, and investment priorities. The fund aims to improve SOE efficiency and support growth through off-budget commercial investments, with plans to invest USD26 billion, or 1.7% of GDP, in 2026.

Other developments, such as the control and centralisation of commodity exports, have raised concerns about the centralisation of authority and its risks to private investment prospects. President Prabowo has effectively set up a new state-controlled export mechanism through a new agency that shifts power from private exporters and foreign buyers to the Indonesian state.

Stability remains: contained credit risk with high growth prospects

Beyond these new governance concerns, Indonesia's economy remains resilient, supported by structural strengths and significant medium-term growth prospects. Moody's and Fitch have placed Indonesia on a negative outlook, and S&P should follow suit (BBB/Baa2/BBB). However, Indonesia is still far from being downgraded to high yield, making this a remote risk. Rating agencies continue to expect fiscal stabilisation in 2026 at 2.9%, in line with the Bloomberg consensus, after 2.9% in 2025.

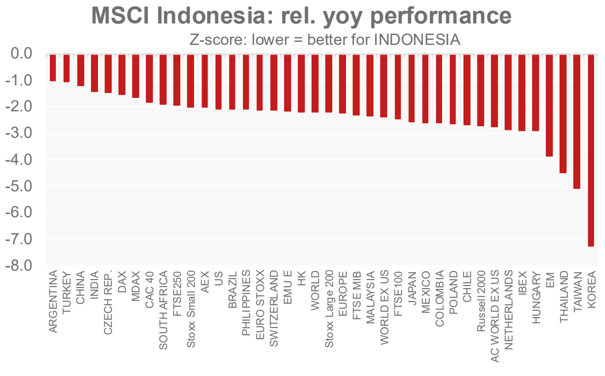
Growth remains Indonesia's major strength, with forecasts around twice the level expected for peers. It should stay above 5% over the near to medium term from 5.1% in 2025, with domestic demand as the key driver, supported by higher public spending. However, the government's 8% growth target for 2030 will be difficult to achieve without structural reforms. The main risk is that new policy uncertainty weighs on the investment cycle, especially private capex.

Likewise, the government debt should stay below peers at around 41% of GDP. We expect a modest deterioration, but long-term projections still point to a roughly stable debt-to-GDP ratio. On the other hand, interest payments remain high, at around 17% of government revenues in 2025.

Equities: tactical OW

Indonesian equities have remained under pressure since MSCI's mid-January 2026 warning over investability concerns, particularly ownership transparency and free float. Sentiment was further hit by rising policy uncertainty, falling earnings (-10.7%), a weaker currency (-5.7% in trade-weighted terms) and oil prices, which initially rose after the outbreak of the US-Iran conflict and added pressure, given Indonesia's status as a net oil importer. As a result, MSCI Indonesia fell 36.8% (-31.0% since the outbreak of the US-Iran conflict), sharply underperforming EM peers (+13.5%) and developed markets (+7.4%), despite solid growth.

Source: Datastream, GenAM calculations



Source: Datastream, GenAM calculations

Indonesian earnings for 2026 and 2027 were revised down until recently, with consensus growth now around 0% for 2026 and 8% for 2027. However, stock prices appear to have undershot 12-month forward earnings, which have started rising on a 3-month change basis. Earnings revisions also have scope to improve further, as the manufacturing PMI for May rose to 50 from April's ten-month low of 49.1, signalling broadly stable factory conditions.

The MSCI Indonesia looks attractive on valuation from several angles: it ranks 4th in our aggregate country valuation approach, while the US ranks 32nd, and EMU 36th. It trades at a notable discount to other markets, with its 12-month forward PE relative to MSCI EM 2.1 standard deviations below its historical average. Its dividend yield (DY) is 7.8% – the highest across all markets. Considering market multiples in aggregate (price/earnings, dividend yield, price/book value and price/cash flow), the MSCI Indonesia is trading at a significant discount to its history of -61.8%, while the MSCI EM is at a premium of +14.3% (EA at +27.7%, and the US at +40.8%): Indonesia's market multiples are therefore 3.7 standard deviations below their historical average relative to the MSCI

EM. The Shiller PE, which uses inflation-adjusted earnings averaged over 10 years, points to longer-term value, with Indonesia trading 55% below its historical level, compared with premiums of 10% for EM, 23% for EMU, and 51% for the US.

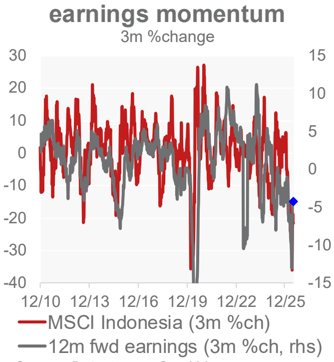
MSCI Indonesia: 2026 consensus earnings

Source: Datastream, GenAM calculations

MSCI Indonesia: price vs earnings

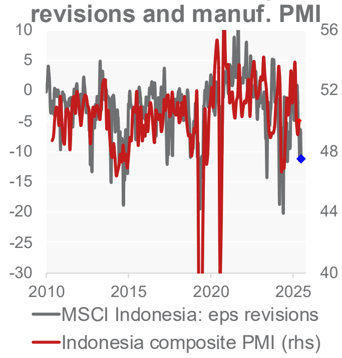
Source: Datastream, GenAM

MSCI Indonesia: earnings momentum



Source: Datastream, GenAM

Indonesia: earnings revisions and manuf. PMI

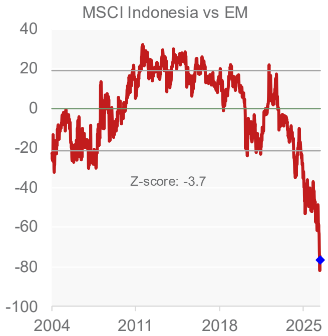


Source: Datastream, GenAM

That said, when we take the current expected consensus long-term (LT) earnings growth (over the next 3–5 years) into account and look at the PEG ratio (PE divided by the LT EPS growth), further adjusted by the COE/ROE ratio (which reflects the ability to produce a return on capital (ROE) higher than its cost (COE)), Indonesian equities do not look attractive. On this adjusted PEG measure, MSCI Indonesia looks somewhat stretched at 2.0 compared with 0.9 for MSCI EM, 1.6 for MSCI EMU, and 1.1 for the S&P 500. Still, the metric has edged lower over the past two weeks, pointing to a tentative improvement in relative valuation.

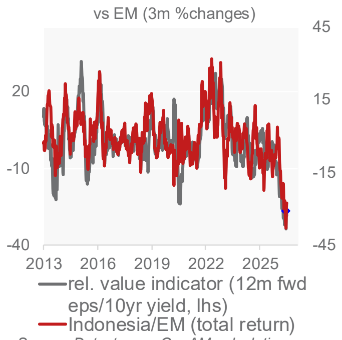
The fundamentals-implied value, based on 12-month forward earnings and 10-year yields, also suggests MSCI Indonesia is undervalued. This value has only just started to increase modestly after falling since Oct. 2025 — leaving further downside risk should it decline significantly due to either a sharp drop in earnings and/or a rise in yields. However, its relative value versus the MSCI EM, based on 3-month changes, appears to be bottoming out, while equities also look cheap versus Indonesian bonds, based on the earnings-yield/real-bond-yield spread (with the spread currently one standard deviation below its average). Historically, similar equity-risk-premium extremes — when equities looked cheap versus domestic real bond yields — have tended to be followed by strong equity recoveries (see the third chart below). Finally, the M2 impulse, close to past peaks, appears to be quite supportive.

Rel. market multiples premium/discount (in pp)



Source: Datastream, GenAM calculations

MSCI Indonesia: rel. value indicator



Source: Datastream, GenAM calculations

MSCI Indonesia (yoy) vs EY-real BY

Source: Datastream, GenAM calculations

Indonesia: M2 impulse and stock market

Source: Datastream, GenAM calculations

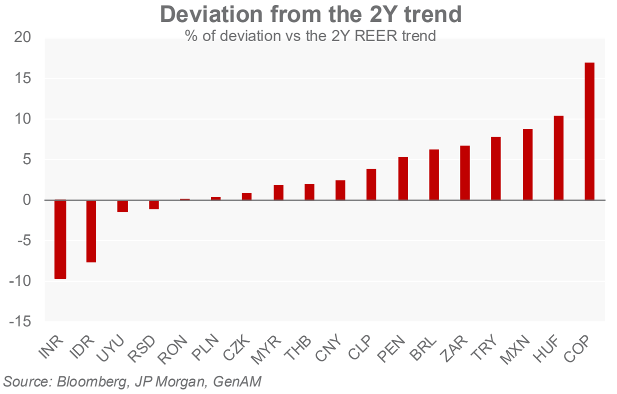
Overall, we recommend a tactical overweight in Indonesian equities: it reflects our judgement that the market has already over-discounted the deterioration in policy visibility relative to still-resilient macro fundamentals: the recent underperformance appears excessive, there are tentative signs of improving near-term earnings momentum, and valuations are increasingly attractive versus EM peers and domestic bonds. Across several metrics, the discount is unusually large: MSCI Indonesia trades well below its historical valuation range, its relative PE versus MSCI EM is 2.1 standard deviations below average, aggregate valuation metrics are 3.7 standard deviations below their historical relationship with EM, and the Shiller PE is 55% below its historical level. Historical episodes in which Indonesian equities traded this cheaply versus domestic real bond yields have typically been followed by strong rebounds, supporting a tactical entry point. Importantly, MSCI downgrade risk now looks limited. The authorities have responded to MSCI's investability concerns by raising the minimum free float requirement towards 15%, improving shareholder disclosure, introducing a framework to address high shareholding concentration and encouraging broader market ownership through greater institutional participation from insurers and pension funds. At the same time, MSCI has already reduced Indonesia's index representation by removing less liquid and more concentrated stocks, which lowers the risk that remaining constituents fail investability tests. We therefore expect Indonesia to retain its EM status in the MSCI review in November 2026 (postponed from June to assess whether the recently announced market reforms are implemented consistently and have a sustained effect on investability). That said, the governance deterioration, weaker policy visibility and still-soft long-term earnings outlook argue for disciplined position sizing and close monitoring. Positive catalysts that could justify increasing the overweight further include: 1) faster and more credible policy reforms that lift corporate and investor confidence; and 2) a stronger investment upturn, led by public capex and eventually supported by private investment.

Attractive fixed-income valuations

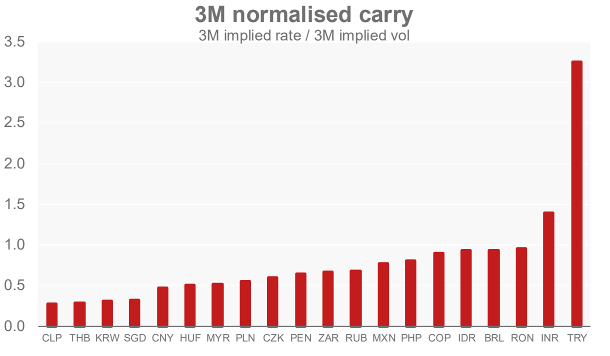
The IDR and local rates have sold off since President Prabowo's election, with the move accelerating since early April. The IDR has reached attractive valuation levels, while IDR rates offer an attractive pickup to US Treasuries.

Indeed, the central bank has enacted an aggressive tightening cycle, with 100bp of cumulative hikes since May 2026, including an emergency 25bp rate hike in early June. This provides welcome support and confirms the policy pivot towards FX defence. As a result, the 3M real yield is one of the highest across the EM complex while the 3M normalised carry is close to those observed in Brazil and Romania. In the short term, there is a risk of further depreciation related to equity outflows in the event of an MSCI exclusion decision, but central bank intervention and high carry should put a floor under the currency. The carry and the cheap valuations are enough to take a long IDR position.

On the local bond side, the IndoGBs sell-off has been more limited but together with Turkey and Colombia, they offer a significant spread to US Treasuries. Technicals are also positive. Foreigners' outflows were limited at the peak of the political crisis and, with the central bank stabilisation policy, we see limited room for further outflows. The risk, if any, is more on the equity-outflow side. In addition, the share of foreigners in the local bond market is historically low, at around 15%. We like the belly of the curve and avoid the front end as we see a risk of further yield increases if the central bank continues tightening to raise carry attractiveness.

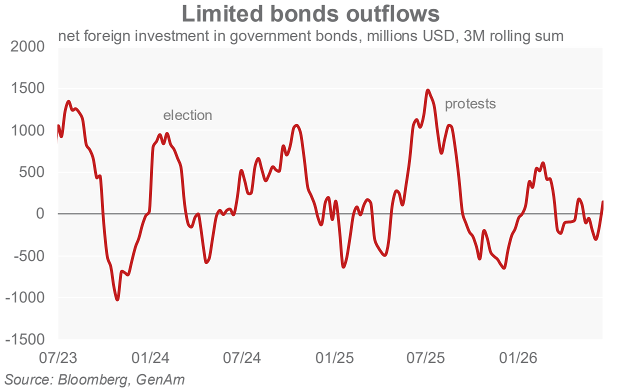


Source: Bloomberg, JP Morgan, GenAM

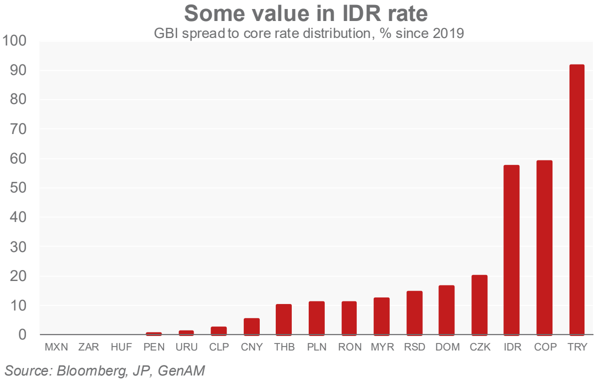


Source: Bloomberg, GenAM

External debt has also underperformed, and the move looks justified given the risks related to fiscal deterioration and a slight weakening of the external position. However, markets have already priced in a lot, with spreads widening by 30-50bp. Indonesia now trades in line with BBB- peers and debt-to-GDP remains lower than the BBB average. Further spread widening remains possible during risk-aversion spikes, but the downside looks limited compared with the move already delivered and the remote risk of a downgrade to high yield. Likewise, in a tight spread environment, wider Indonesia spreads now offer some buffer. Therefore, we adopt a slight positive stance.



Source: Bloomberg, GenAm



Source: Bloomberg, JP, GenAM

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Società di gestione del risparmio, Research Department

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