Following our previous note, 'A Brief Appraisal of Indonesia' on the 28th of April, which highlighted the merits of investing in Indonesia, the local stock market initially rose 11.5%, only to lose close to 15% in value during the subsequent nine weeks. So, what has caused this?

As a result of the worst credit/solvency crisis the US has witnessed in the last 50 years, virtually the only long position on which investors and speculators alike have made any money during the past year is in the commodity space. The sector was generally perceived to provide a safe haven against a falling dollar at a time of rising inflation, and as well as being underpinned by strong emerging markets demand.

As highlighted on several occasions in our monthly newsletters, commodity companies account for a sizeable portion of the Indonesian stock market and have dictated its direction for the better part of the last two years. This continued to be the case up to the beginning of July.

Following our note, the various soft and hard commodity stocks listed on the Indonesian exchange initially continued their ascent into mid May. During the subsequent six weeks they generally traded sideways, with global investors not being able to make up their minds if the parabolic move in the energy complex would lead to demand destruction and a subsequent swift price correction.

With the oil price finally recording its biggest weekly drop ever, last week, it was therefore little wonder that all commodity stocks listed on the Jakarta exchange received a drubbing. As the pendulum swung back viciously, many local speculators and momentum traders caught off guard, ended up suffering the consequences of wide-spread margin calls, adding to the damage.

During this three month period, the banking, construction and consumer sectors initially continued to sell off 'in sympathy' with what was happening in the US, irrespective of strong domestic demand dynamics or reasonable valuations. Still, as concerns over high inflation started to recede, these previously shunned sectors began to find a bid and recouped some of their recent losses. Overall however, the price increases in these sectors were not able to offset the sharp corrections in the commodity-heavy index.

So how has Komodo Fund fared during this recent period, and what do the Indonesian stock market fundamentals look like at this juncture?

As mentioned on previous occasions, we have generally been agnostic with regard to the medium term outlook for base metal producers, and ambivalent about much of the palm oil stocks given the strong correlation to oil prices.

As such, Komodo Fund avoided the thrashing that those stocks received in recent days. Still, we were not entirely immune to the recent market downturn as a result of our exposure to the coal sector, for which we believe a strong investment case can be made.

Despite recent noise and some negative sentiment surrounding a domestic market obligation for Indonesian coal producers, aimed at assuring the Indonesian power industry of sufficient future coal supplies, we remain of the view that regional demand/supply dynamics allow for significant upside to Indonesian coal producer stocks over the medium to longer term.

With average 1-year contracted coal prices less than half that of international spot prices, the Indonesian listed coal producers are fundamentally safe investments and virtually assured of strong future profit growth given increasing production volumes and expected pricing power. Trading at steep discounts to regional peers, local coal stocks will likely do well once sentiment recovers and reason prevails once more. With fuel a significant production cost factor, margins should expand along with lower oil prices.

Beyond the commodity stocks, we have long argued that the Indonesian stock market does not properly reflect the Indonesian economy, which is still heavily geared to consumption. However, it is worth noting that the high commodity prices have been behind much of the strength in consumption.

For all Indonesia's advances during the past decades, it is still very much an agriculture-based society, with nearly 50% of Indonesians living in rural areas and making a living, directly or indirectly, from farming.

However, with higher commodity prices, and more widespread use of hybrid seeds, today's farmers are making significantly more than the couple years ago. Even though farming is still done on a small scale, an efficient farmer is now able to earn double the national average GDP/capita of US$1,800 per year.

Estate farming of CPO, rubber, sugar cane, coffee, tobacco, etc is even more profitable and employing an increasing number of Indonesians. With incomes rising, money is being spent on cellular phones, motorcycles, clothing, etc. Brick houses, significantly augmenting cement demand, are gradually replacing wooden dwellings. It is therefore of little surprise that cement consumption rose 20% YoY for the first five months of the year, with month on month sales accelerating, despite several rounds of price increases.

In essence, the global commodity boom is benefiting resource rich regions of Indonesia, creating and redistributing wealth on an enormous scale. This has led to outer-lying regions growing much faster than the island of Java, the historical center of economic activity. Various regional governments' incomes are surging on the back of rising production of commodities such as coal, nickel, oil, etc. and some of this is finding its way back into the system in the form of infrastructure spending.

As such, listed companies that benefit from this regional boom are witnessing surprising growth in spite of much recent doom and gloom relating to rising inflation rates and expected higher interest rates.

Still, with respect to inflation, it is worth putting this in context. During the past 20 years, Indonesia has typically experienced double-digit inflation. As such, companies and individuals have learned to cope with this. However, consumer financing has only become available to the average person during the past few years. With banks generally experiencing excess liquidity, financing rates dropped quickly on the back of healthy competition.

For example, car financing rates dropped from 20%+ a mere 18 months ago to a low of 9%. The recent increase in financing rates to 11-12% is therefore hardly a catastrophic deal-breaker to consumers who previously had no access to financing at all. As such, business continued to be brisk at the recently concluded annual one-week Jakarta Auto Show, were an estimated Rp2 trillion (US$220m) in transactions were concluded, up 33%YoY.

Simply put, the Indonesian commodity-heavy index has sold off aggressively on sentiment as opposed to underlying fundamentals. Certainly, lower prices of selective commodities may have a mild effect on Indonesia's export performance in the medium term. Longer term however, Indonesia could become the global marginal supplier of selective commodities in high demand, such as coal, palm oil, tin, copper and gas. On the other side of the equation, lower oil prices would significantly help the government budget by reducing fuel and electricity subsidies.

That said, the feeling on the ground is anything but gloomy. First half realized investment increased by 56.2% YoY, and despite a 28% increase in fuel prices, motorcycle sales were up 45% YoY with most of the growth coming from resource rich regions. Meanwhile, January-June car sales were up 48% YoY. This underscores the increased wealth outside Java, combined with the availability of financing that supports strong momentum.

Average net debt levels of listed companies hover around 13% and is expected to drop to less than 1% by the end of 2009 on the back of continued strong Free Cash Flow, which is expected to increase 50% next year after doubling in 2008. Banks are very well capitalized, LDR ratios and NPL levels are generally low and provisioning high. Personal debt levels are not high, credit card penetration is increasing from a low base, and only 2% of Indonesians have a mortgage loan outstanding. Little wonder that Bank Rakyat Indonesia, the world's largest micro-finance provider, witnessed 30% YoY deposit and loan growth during the first half of the year.

Separately, an amended tax law will be enacted next month, which will go into effect next year. Under the new tax system, the income tax rate will drop to 28% in 2009 and 25% in 2010, from 30% currently. Meanwhile, SME's will only pay 14% in 2008 and 12.5% in 2010. Publicly listed companies with a free-float of >40% will enjoy an additional 5% cut, inheritance tax will be scrapped, and the personal taxable threshold will be raised by 20% to Rp15.9m/pa vs the current Rp13.2m. This should all have a positive effect on corporate earnings growth, and by extension, the stock market.

In conclusion, we think the correction in the commodity stocks was long overdue, but also note that current negative sentiment and momentum is indiscriminate. This will present opportunities as selective share prices overshoot negatively.

Beyond the commodity sector, there are plenty of bargains to be had for investors with a 12-month investment horizon. These can be found in the banking sector where P/BVs have halved since late last year, in the property sector where stocks are selling an average of 60% below NAV, in the construction/cement sector which is benefiting from increasing demand, pricing power and expected pre-election infrastructure spending, and in the consumer sector which has not been this cheap in living memory.

Smart investors should be taking a much closer look.