

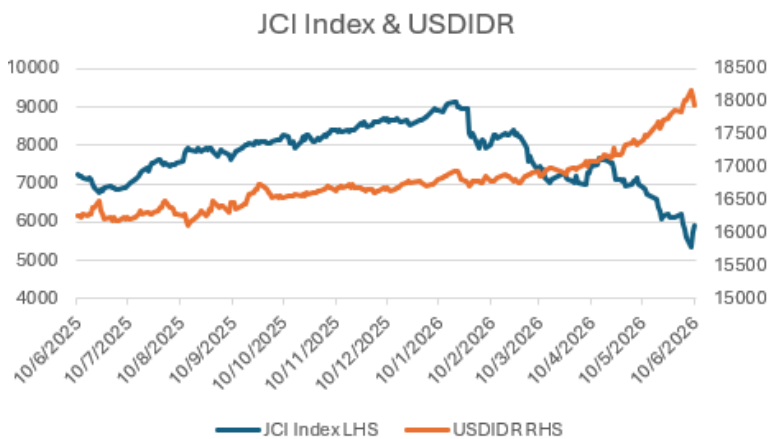
Valverde ASEAN Fund

INVESTMENT LETTER

Indonesia: From Stability to Stress – and the Conditions for Recovery

Indonesia, Southeast Asia’s largest economy by GDP, has made a terrible start to 2026. Over the period to the end of May, equity markets declined in local currency terms by 12% for the month and 29% year to date, whilst the rupiah also weakened against the US dollar by 3% for the month and 4% year to date (*Chart 1*). Financial conditions have continued to deteriorate rapidly in June. What initially appeared to be a cyclical correction is now evolving into a broader confidence crisis, marked by rising volatility and accelerating capital outflows.

Chart 1: Indonesia – Equity and Currency Weakness



Indonesia’s recent reversal stands in sharp contrast to the progress achieved under the presidency of Joko Widodo (“Jokowi”) from 2014-24. At that time, Indonesia successfully transitioned away from a reputation for economic crises and market fragility. Macroeconomic credibility improved, policy discipline strengthened, and the country earned a stability premium in global markets. Under his successor, Prabowo Subianto, that progress appears to be unravelling. Policy signals have become less predictable, investor confidence has weakened, and markets are increasingly questioning the credibility of Indonesia’s reform trajectory.

The purpose of this newsletter is twofold. First, we seek to analyse what has gone wrong, examining the policy, macroeconomic, and market forces behind the current stress. Second, we seek to identify what would be required to restore investor confidence, allowing Indonesia’s many long-term strengths to reassert themselves.

1. What Went Wrong: From Stability to Fragility – and Back Again

i) From “Asian Tiger” to “Fragile Five”

Investor sentiment towards Indonesia has long oscillated between extremes. In the early 1990s, when this analyst first began to work in Southeast Asia, the country was often the most loudly proclaimed of the “Asian Tigers”, only to be shunned for more than a decade after the Asian Financial Crisis of 1997-98. Then it was derisively labelled one of the “Fragile Five” emerging economies during the 2013 taper tantrum, when global liquidity tightened abruptly. At that time, the country was characterised by a sizeable current-account deficit, dependence on short-term portfolio inflows, limited foreign-exchange buffers, chaotic politics, a large fiscal deficit, and a currency that weakened sharply during any period of stress. For investors, Indonesia was viewed at best as a high-beta emerging market prone to sudden capital flight.

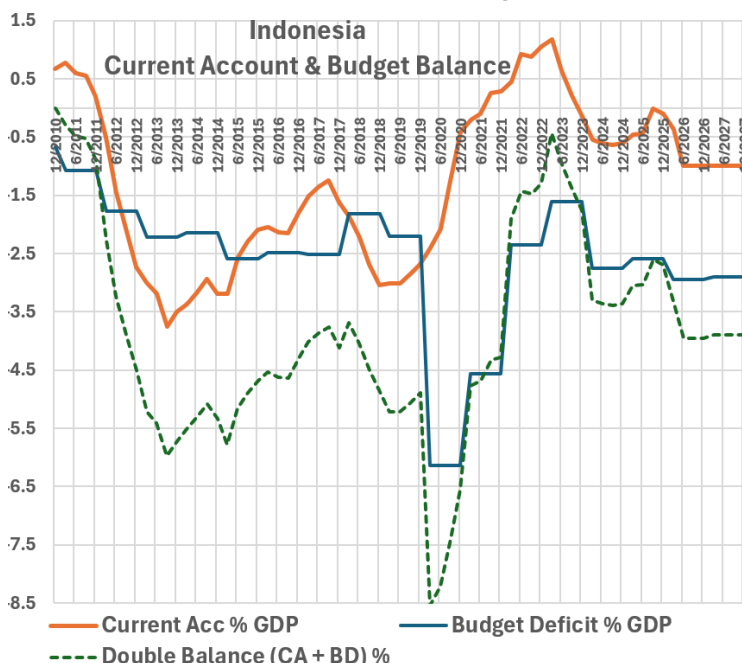
ii) Jokowi and Sri Mulyani

Over the following decade, this perception changed materially, with Indonesia being gradually rehabilitated under the reforms of President Joko Widodo and his long-term Finance Minister Sri Mulyani Indrawati. Fiscal discipline improved, inflation was better contained, foreign-exchange reserves rose, and external balances became more resilient. Policy coordination strengthened, and Indonesia ultimately achieved full investment-grade sovereign status, broadening its investor base and reducing perceived tail risks. By the late 2010s, Indonesia was once again regarded as a lower-beta, reform-oriented emerging market.

iii) Prabowo Subianto

Unfortunately, that stability premium is now eroding fast. Since October 2024, under the new administration of President Prabowo Subianto, markets have become increasingly concerned that fiscal discipline, policy orthodoxy, and institutional constraints are weakening (Chart 3). Risk premia have risen, capital has exited, MSCI and FTSE have announced that they are considering reclassifying Indonesia from emerging to frontier-market status, and both Fitch and Moody’s revised Indonesia’s credit outlook from stable to negative in Q1 2026. Indonesian assets have once again begun to trade in line with more fragile emerging and frontier market peers.

Chart 3: Indonesia: Current Account & Budget Balance



Source: Bloomberg, Valverde Investment Partners

2. Policy Slippage and the Return of Populist Risk

i) *The Suharto-Era Echo*

The loss of confidence reflects growing concern that Indonesia is shifting away from the technocratic, market-oriented approach of the previous decade toward a more populist and nationalist policy framework. Prabowo was the son-in-law of former President Suharto (1967-98), and whilst investors were willing to give him the benefit of the doubt for his first 12-18 months in office, they increasingly see in him the seeds of a return to his father-in-law's statist and interventionist tendencies. Under Suharto, three decades of weakening institutions, increasing cronyism and unaddressed systemic financial fragility were finally exposed in the Asian Financial Crisis of 1997/8 and a violent transfer of political power.

ii) *Danantara and Governance Risk*

The creation in 2025 of a quasi-sovereign wealth fund, Danantara Indonesia, has been instrumental in unsettling investors. Officially positioned as a development and strategic investment platform that will consolidate and professionally manage state-owned assets, Danantara controls assets valued at not far off US\$1 trillion. This raises a great many legitimate questions around transparency, accountability, and political oversight. One concern is that state capital may be deployed in opaque ways, crowding out private investment and blurring the boundary between policy and commerce.

iii) *"Patriot" Bonds and Strong-Arm Selling Techniques*

A new class of rupiah-denominated bonds was issued by Danantara in late-2025, reportedly raising approximately US\$3.6 billion from Indonesian tycoons and conglomerates at around a 2% coupon for 5- and 7-year tranches, significantly below the prevailing market rates. These so-called "patriot bonds" were, we can safely assume, taken up with little enthusiasm. Reports of follow-on issues in the pipeline can only lead to an increased risk of capital flight. Even the perception of quasi-compulsory financing for state priorities risks undermining business confidence and raises concerns about financial repression.

iv) *The Free School Meals Programme*

A flagship initiative of the new administration is an extraordinarily ambitious nationwide free school meals programme. Whilst improved nutrition for all children is an admirable objective, and politically popular, the programme carries an immense fiscal cost for Indonesia, conservatively estimated at around US\$22 billion in 2026. That is more than 1.5% of Indonesian GDP, and 8% of total public spending. Investors' concerns centre not so much on social spending itself, but on governance (the first head of the programme, Dadan Hindayana, has already been fired and then arrested for corruption), and on scale, given the huge numbers involved.

Taken together, Prabowo's two most important economic initiatives, Danantara and the free school meals programme, evoke uncomfortable parallels with the Suharto era. Once again, economic management is becoming increasingly centralised, and ever more closely intertwined with political power. Whilst today's institutions are arguably stronger than under late-Suharto, markets are always highly sensitive to the direction of travel, as well as to current conditions.

3. Strategic Commodities and the Return of State Control

A further source of concern is the government's declared intention to centralise control over commodity exports. Prabowo has at times seemed to flirt with effective nationalisation in the resource sector, specifically through a mechanism of revoking the licences of United Tractors' Martabe Gold Mine, although recently he has backed away from this step. Now Danantara is being advanced as the mechanism for exerting state control over the sector, whilst avoiding outright nationalisation. Under a 20th May decree, exports of designated strategic commodities (initially coal, crude palm oil and nickel-based alloy products) will be handled only by Danantara from 1st January 2027.

The stated rationale is to centralise pricing oversight, improve transparency, prevent under-invoicing, and retain export proceeds domestically. Given Indonesia's importance in global markets for coal (~30% of global production), nickel (~60%), palm oil (~60%), and many other resources, this has significant implications for global customers, as well as for domestic governance and capital allocation. For investors, the risk lies in the high level of ambiguity, which will increase uncertainty around pricing, investment returns, and contract sanctity. Even the perception of renewed resource nationalism has been sufficient to raise risk premia across sectors.

4. Macro and Market Transmission: From Policy Shock to Financial Stress

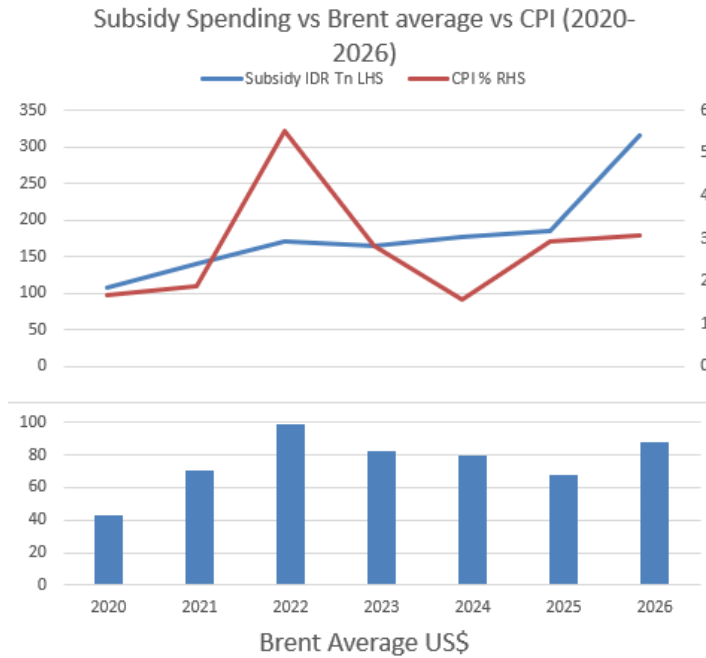
Whilst internal policy decisions under Prabowo have set investors' nerves on edge, external macroeconomic factors have also deteriorated sharply in 2026, creating a "perfect storm" for Indonesia.

i) *Rising Energy Costs*

Higher global fuel prices since the start of the US-Iran war in February have exposed Indonesia's structural sensitivity to energy costs (*Chart 4*). There are many variables involved, but if we assume that the price of Brent crude averages ~\$100 per barrel for the rest of 2026, that government fuel subsidies are maintained at their current level, and that the rupiah stabilises at ~18,000 to the US\$,

then the total cost to the Indonesian government of the fuel subsidy alone would be likely to rise from a budgeted IDR 210 trillion (~\$12.5 billion), or ~1.5% of GDP in 2026, to something closer to IDR 315 trillion (~\$17.5 billion), or ~2.25% of GDP.

Chart 4: Higher Fuel Prices – Inflation or Fiscal Stress 2020-26

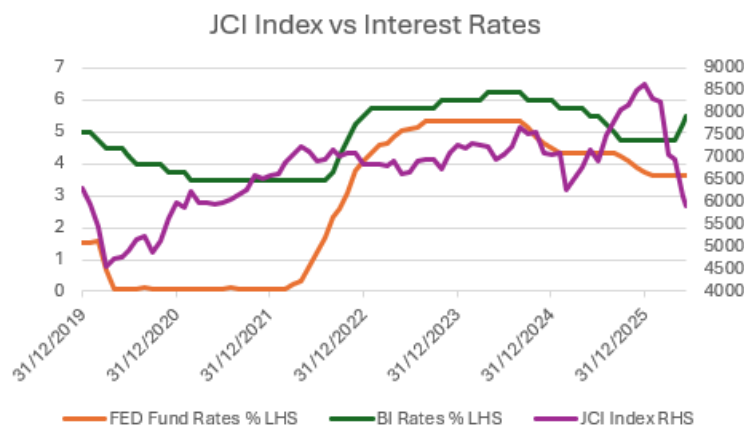


Source: Bloomberg, Valverde Investment Partners

ii) Inflation, Interest Rates and the US Dollar

When the potential impact of the fuel subsidy is added to that of free school meals, it becomes clear that the combination seriously threatens Indonesia’s fiscal arithmetic. On the other hand, any attempt to reduce the fuel subsidy would feed into inflation. Currency weakness has recently amplified imported inflation, with CPI running close to 4% in Q1, against an official central bank target of 1.5 – 3.5%. This has forced a policy response from Bank Indonesia, which raised its benchmark policy rate by 50 basis points on 21st May and then another 25 basis points on 9th June, to defend the rupiah and to anchor inflation expectations (Chart 5).

Chart 5: Currency Weakness and Forced Monetary Tightening



Source: Bloomberg, Valverde Investment Partners

While we applaud the central bank’s orthodox monetary policy, it will weigh on credit growth and domestic demand, increasing the risk of a slowdown in GDP growth. At the same time, higher subsidies, rising interest costs, and ambitious spending plans are testing Indonesia’s long-standing 3% of GDP fiscal deficit ceiling. This was introduced in 2003 to restore investor confidence in the wake of the Asian Financial Crisis and has been maintained in all non-emergency years since ... i.e. with the exception of the Covid years in 2020 and 2021. Investors will be watching closely to see what happens in 2026.

iii) **Feedback Loop**

Externally, higher energy import costs and softer global demand have eroded Indonesia’s recent current account strength, increasing reliance on external financing at a time when foreign investors are withdrawing. The resulting feedback loop (currency weakness, tighter policy, slower growth, fiscal strain and back to currency weakness) has driven Indonesian assets back into high-beta EM territory.

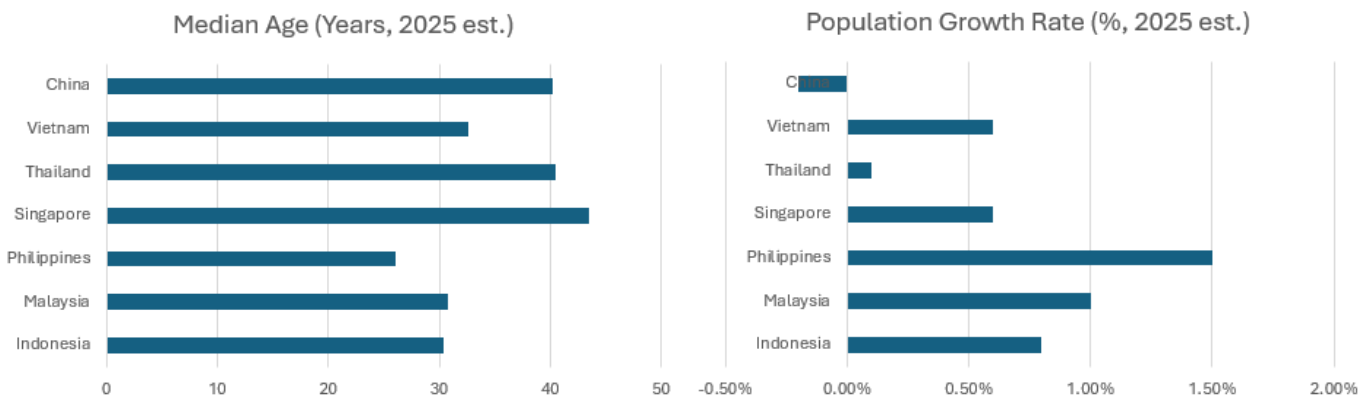
5. Long-Term Structural Positives: Why Indonesia Still Matters

Despite near-term stress, Indonesia retains some powerful long-term advantages. It is by far the largest economy in ASEAN, with GDP of approximately US\$1.45 trillion in 2025, compared to next-largest Singapore at \$604 billion and Thailand at \$577 billion. Its population also dominates at 282 million, compared to the Philippines at 117 million and Vietnam at 101 million.

i) **Demography**

Demographic trends in Indonesia remain among the most favourable in Asia, according to World Bank and UN statistics. With a young population, median age ~30, it compares favourably with China (~39-40) and Thailand (~41-42), whilst lagging slightly behind India (~28) (Chart 6). Indonesia is still in a demographic sweet spot, with a large working age cohort, without the rapid ageing evident in North Asia and Europe. Total fertility rate is ~2.1, around replacement rate, and ahead of India (~2.0), Vietnam (~1.9), Thailand (~1.3) and China (~1.0-1.2).

Chart 6: Indonesia’s Demographic Advantage



Source: Bloomberg, Valverde Investment Partners

While consumption growth has stalled cyclically, the expansion of the middle class remains a durable long-term theme, driven by industrialisation and urbanisation. Measures such as bank account ownership and car ownership suggest a long runway for growth in these and other industries. There are approximately 90-100 cars per 1000 people in Indonesia, compared to 450-500 in Malaysia, 240-270 in Thailand and 220-250 in China.

Indonesia’s young population and fragmented geography also positions it well to become a leading digital economy, with rapid adoption of e-commerce, digital payments, and fintech, supported by high smartphone penetration and a young population. Approximately 55-60% of adults have a bank account in Indonesia, compared to 80-95% in Thailand, 80-85% in India, 80% in China and 70-75% in Vietnam.

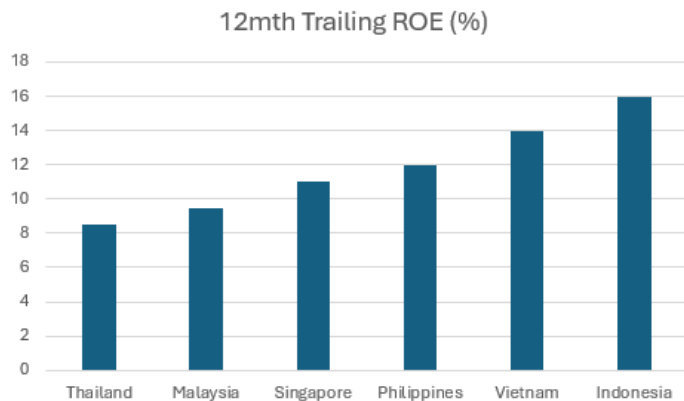
ii) **Resource-based Economy**

Indonesia’s resource endowment, including coal, nickel, copper, and palm oil, will remain strategically important in a more fragmented global economy shaped by tariffs and supply-chain realignment. While many observers, ourselves included, may deplore the fact that the world appears to be moving away from free trade and the WTO “rules-based” system, it now feels like an incontestable fact. Indonesia, with resources that are critical to the developed world’s emerging energy and materials intensive economy, will be better placed than many other emerging economies in this new environment.

6. Bottom-Up Opportunities and Portfolio Positioning

Our underweight position in Indonesia reflects macro and policy risk rather than a lack of corporate quality. From a purely bottom-up, stock-picking perspective, management teams in Indonesia are among the most impressive in the region. Indonesian companies have historically generated higher returns on equity than many Southeast Asian peers, reflecting less crowded markets, meaningful scale advantages, and relatively high barriers to entry (Chart 7). Conservative balance sheets and disciplined capital allocation have further supported returns.

Chart 7: Indonesia’s Structurally Higher Returns on Equity



Source: Bloomberg, Valverde Investment Partners

With a more supportive domestic agenda, and a calmer international situation that permitted lower energy prices and a weaker US dollar, Indonesia would be the cornerstone of any Southeast Asia portfolio. The demographic characteristics outlined above will continue to underpin bottom-up opportunities, particularly in the consumer, digital, infrastructure and financial services sectors tied to domestic demand. There remains no shortage of compelling bottom-up opportunities in Indonesia.

7. Case Study: Kalbe Farma

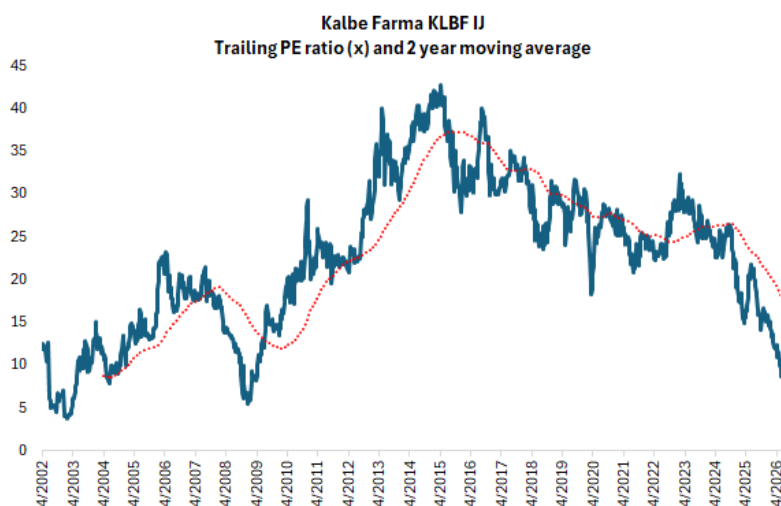
One example is Kalbe Farma, one of just two Indonesian holdings in our portfolio currently. In our view, the company displays many of the characteristics that add up to an attractive long-term EM holding. With a strong management team, Kalbe is the country’s leading pharmaceutical and consumer healthcare company, with broad exposure to long-term healthcare demand, as well as a dominant distribution network, resilient margins, and a conservative balance sheet.

Kalbe has consistently delivered long-term, high-single-digit revenue growth as an emerging middle class, growing healthcare insurance and urbanisation have raised penetration of the healthcare sector. According to the World Bank, annual per capita healthcare spending in Indonesia at ~\$132 lags far behind Thailand at \$300 and Malaysia at \$450. Kalbe has net cash on its balance sheet, has consistently achieved net margins above 10%, and return on equity in the mid to high teens.

In our view, further margin growth is possible over the medium term, as the company shifts its product mix to higher-value specialty drugs and wellness products. Recently, Kalbe’s stock has sold off alongside the broader Indonesian market, amidst fears of weak consumer demand and rising raw material costs. We believe that the company’s well-diversified product range, dominant distribution network and strong balance sheet are a defensive moat that will help to support earnings through difficult times.

Recent market weakness has made Kalbe’s valuation increasingly attractive. Now selling on a price to book ratio of 1.25x and an historic price to earnings ratio of 8.4x, the company is at the bottom of its historic valuation range (*Chart 8*). In our view, this represents an exceptionally attractive entry point into a high-quality Indonesian healthcare franchise for a long-term investor.

Chart 8: Kalbe Farma (KLBF IJ) Valuation



Source: Bloomberg, Valverde Investment Partners

8. What is Required to Restore Investor Confidence?

Restoring investor confidence in Indonesia will require progress on both external and internal fronts. Externally, an end to conflict in the Gulf, lower fuel prices, and a weaker US dollar would ease pressure on inflation, subsidies, and the currency. Internally, markets are looking for a clear return to orthodox fiscal policy. In our view, having been pushed into a corner by markets, the government has few credible options other than to reaffirm fiscal discipline. This would include an unequivocal commitment to the 3% budget deficit ceiling. The alternative is prolonged instability, policy paralysis, and further capital flight.

The challenge is that investors will require *both* improved global conditions and restored domestic credibility before re-engaging seriously with Indonesia. It is hard to see these aligning in the near term, but when they do, the country's strengths will reassert themselves. Export resilience can help to restore a virtuous circle of employment growth, rising incomes, fiscal strength, improved confidence, a firmer currency, and eventually lower interest rates. In that scenario, investors might once again judge it safe to go back into the water!

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