

China Economy

Deflation entrenched as demand remained weak

China's CPI growth dropped further in June to a lower-than-expected 0% amid weak consumer demand and tough supply competition. CPI in durables continued to decline as housing sales and durable consumption further weakened. Healthcare, tourism, recreational service and social-activity-related items were the few bright spots in China's consumption recovery as CPI in those sectors continued to rebound despite easing momentum. China's PPI further declined as domestic economy weakened and commodity prices corrected amid expectations of additional Fed tightening. Chinese enterprises continued to reduce inventory and remained cautious on capex expansion. Looking forward, the deflation pressure may last longer than our expectations with negative output gap in most sectors. We maintain forecast on CPI growth in 2023 at 0.8% and lower the forecast for 2024 CPI growth from 2.4% to 2.1%. The forecast for China's PPI growth in 2023 and 2024 is lowered from -2.3% and 1.7% to -2.7% and 1.3%, respectively. The deflation will increase debt burden and hurt durable consumption and capex demand. China is likely to further loosen credit policy and property policy to boost the growth momentum in the second half year.

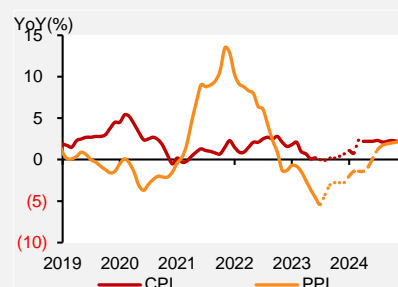
■ **CPI growth became flat as consumer demand weakened.** CPI stayed flat YoY in June after rising 0.2% YoY in May. The lower-than-expected CPI is mainly driven by the non-food variables while food CPI picked up 2.3% YoY in June after rising 1% in May. Energy sector continued with the deflation trend as fuel CPI further declined 17.6% YoY in June after dropping 11.1% YoY in May. Core CPI growth edged down to 0.4% YoY in June as overall consumption remained weak. Breaking down by sectors, CPI in transport vehicles and home appliances further declined as durable demand remained weak and supply competition was tough. But CPI in telecom equipment narrowed the YoY declines as the demand may have improved thanks to technology upgrade. Employment condition especially for the youth remained challenging as housing rent continued to decline in June. Medicines, medical services, travel services, recreational services and apparel experienced a mild refutation as demand in these sectors continued to recover although the momentum is fading.

■ **PPI further declined due to weak domestic demand and expectations of additional Fed tightening.** PPI further declined 5.4% YoY in June after dropping 4.6% YoY in May. The decline in PPI was largely resulted from sharp price declines across a wide range of raw materials. For one reason, domestic demand continued to weaken as housing market and durable consumption remained sluggish and fixed asset investment further slowed. For another, US core inflation remained high with strong labor market and service economy. The Fed may continue to tighten monetary policy, hurting the sentiment in commodity market. PPI in coal mining, oil & gas mining, ferrous metal and non-ferrous metal respectively fell 19.3%, 25.6%, 16%, and 7.2% after dropping 13.1%, 19.1%, 16.8%, and 8.4 YoY in May. From the MoM perspective, PPI declined 0.8% in June after dropping 0.9% in May. Prices of textile apparel and liquor & beverage increased 0.2% and 0.1% MoM in May. However, prices of coal, chemical materials & products, petroleum & other fuel processing and ferrous metals declined by 6.4%, 2.6%, 2.6% and 2.2% MoM in May.

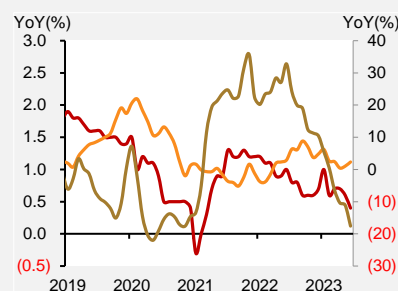
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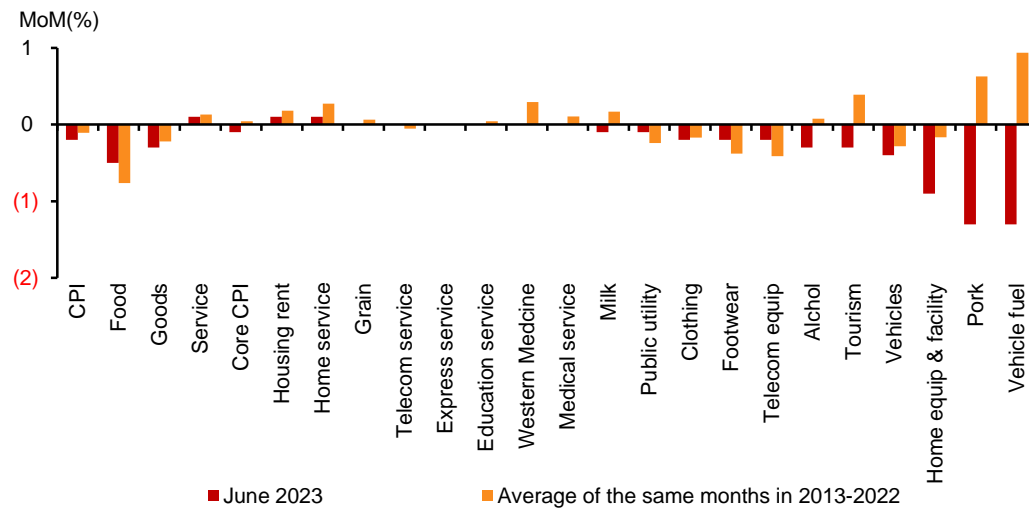


Forecast numbers from July 2023
Source: Wind, CMBIGM

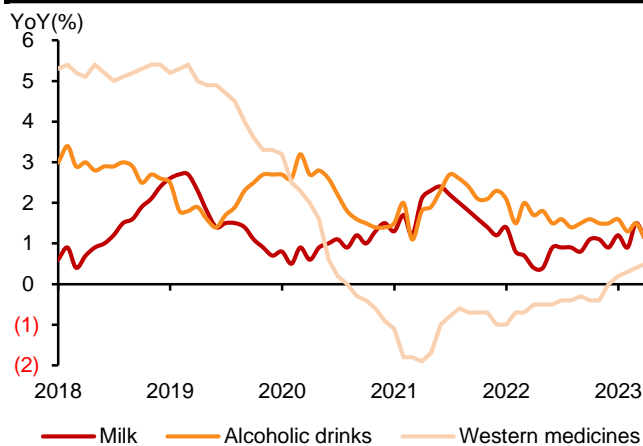


Source: Wind, CMBIGM

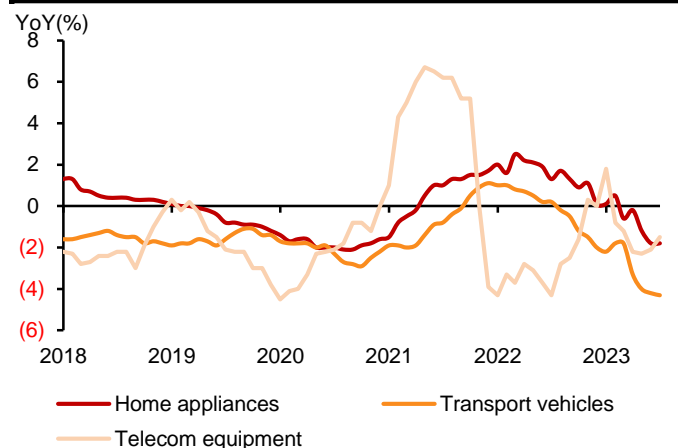
- **Deflation pressure may last longer than our expectations.** China's GDP growth may continue to run below the potential growth with negative output gap in most sectors into next year. Uncertainty in economy, policy and geopolitics should continue to restrain confidence in China's private business community. Private entrepreneurs absorb 80% of urban employment. Their weak confidence indicates employment condition may remain challenging, which is not good for consumption recovery. Meanwhile, overseas demand especially for goods may further slow down as the monetary tightening condition may last longer than expected due to sticky service inflation. Therefore, the reflation should be quite mild in China as we maintain the forecast for CPI growth in 2023 at 0.8% and lower that in 2024 from 2.4% to 2.1%. We cut the forecast for PPI growth in 2023 and 2024 from -2.3% and 1.7% to -2.7% and 1.3%, respectively.
- **China may further loosen credit policy and property policy to boost the growth.** The deflation will hurt durable consumption and capex and increase debt burden for borrowers. China may further loosen credit policy to defy the deflation risk and boost growth momentum. We expect additional moderate cuts in deposit rates and LPRs in 2H23. The authority may guide banks to further expand their credit supply to real sector. Meanwhile, most cities may loosen property policy with declines of down-payment ratio and mortgage rates for first-home and second-home buyers. In addition, credit and fiscal support for hard-technology and high-end manufacturing sectors may further increase.

Figure 1: MoM Changes of China CPI in May

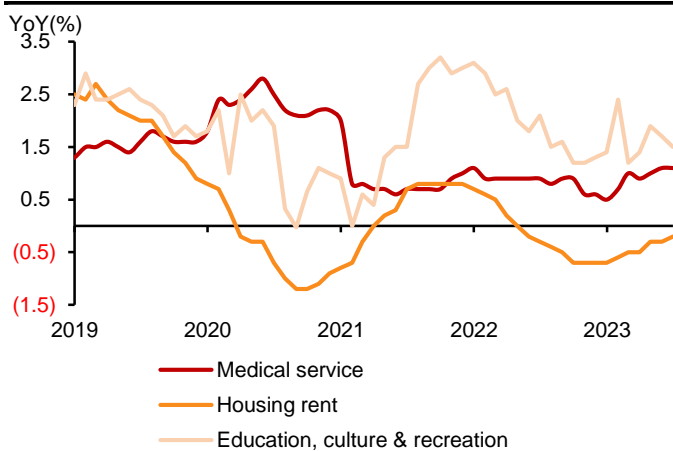
Source: Wind, CMBIGM estimates

Figure 2: China CPI Growth in Staples

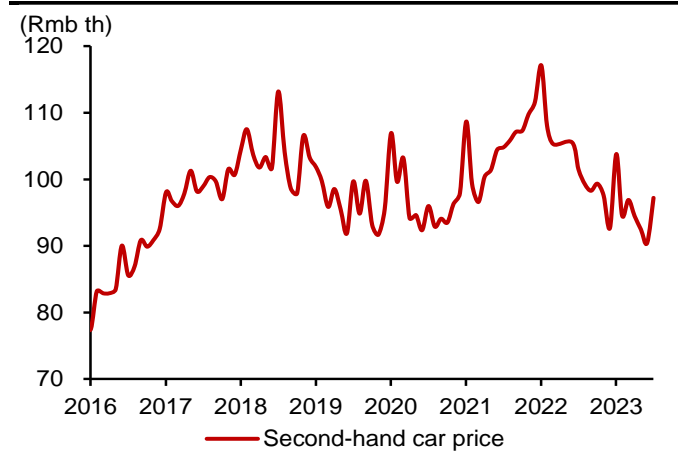
Source: Wind, CMBIGM

Figure 3: China CPI Growth in Durables

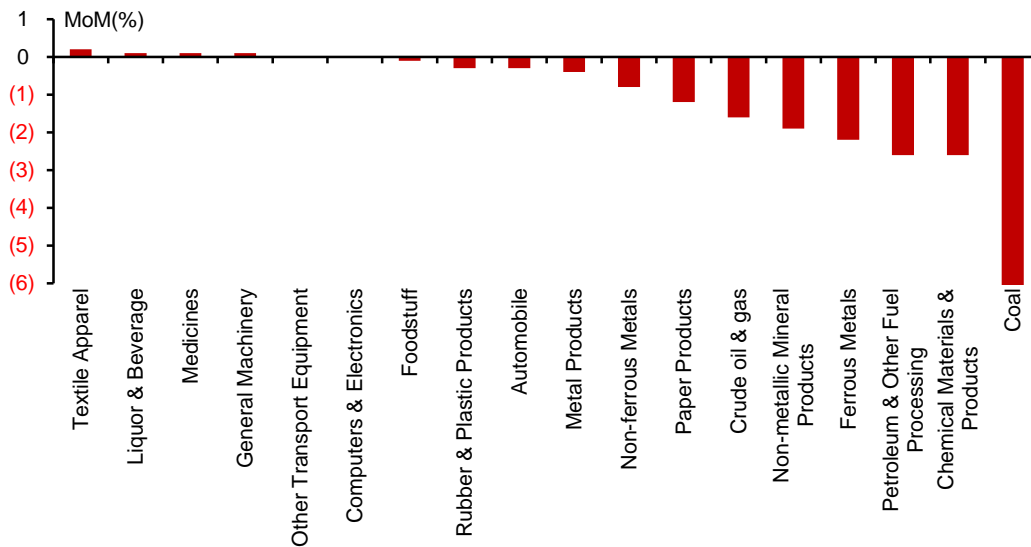
Source: Wind, CMBIGM

Figure 4: China CPI Growth in Services

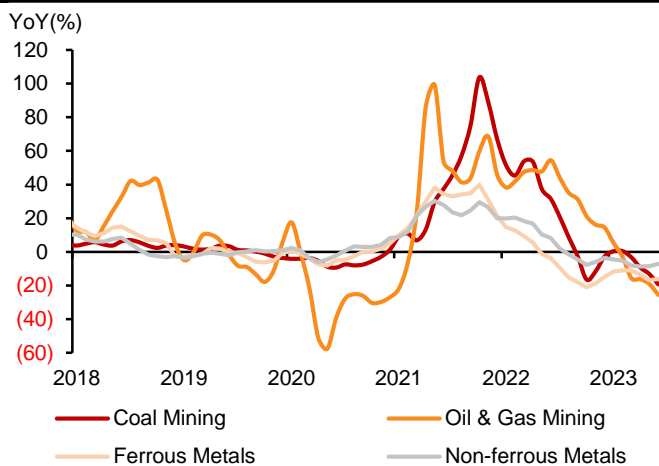
Source: Wind, CMBIGM

Figure 5: Second-hand Car Price in Shanghai

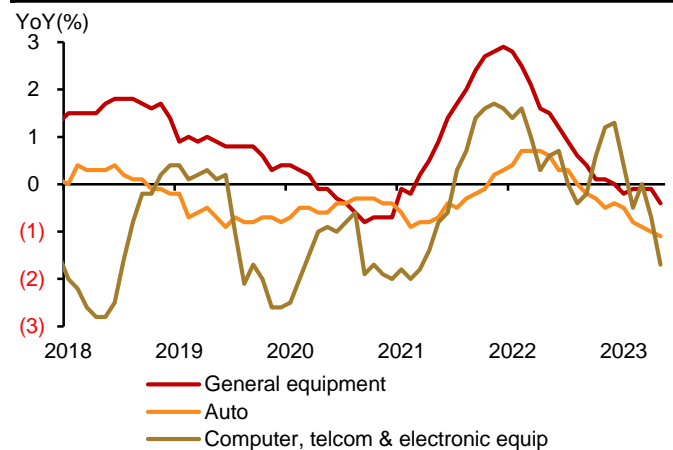
Source: Wind, CMBIGM

Figure 6: MoM Changes of China PPI in May

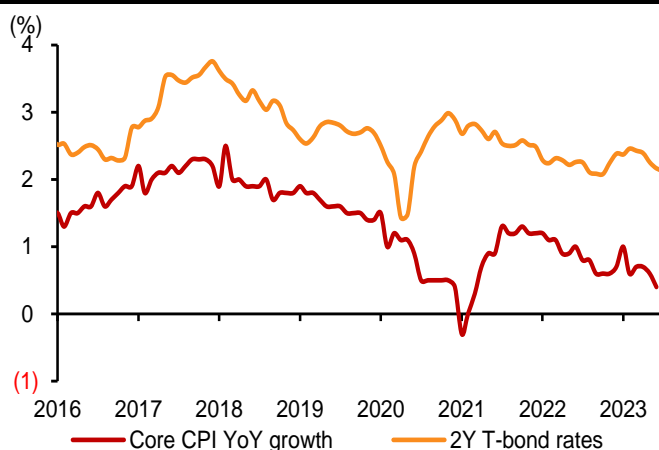
Source: Wind, CMBIGM estimates

Figure 7: China PPI in Energy & Metal

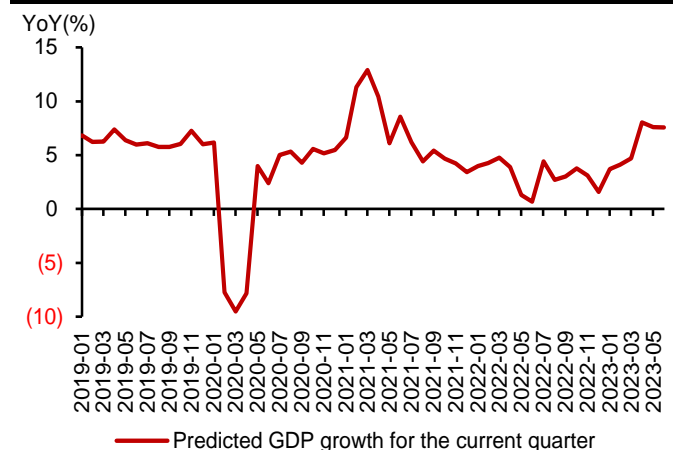
Source: Wind, CMBIGM

Figure 8: China PPI in Equipment

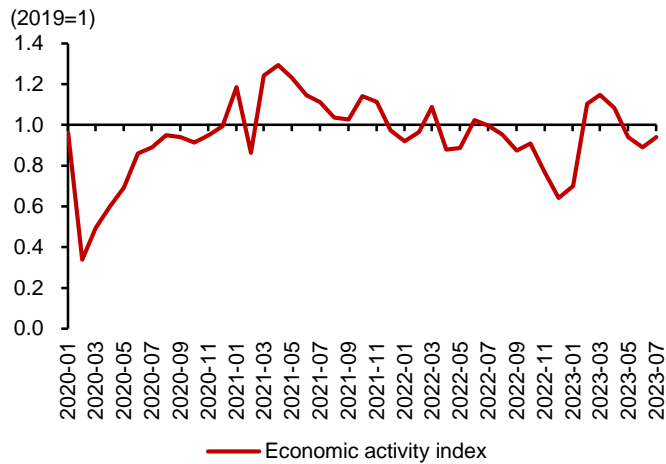
Source: Wind, CMBIGM

Figure 9: China Core CPI Growth & 2Y T-bond Rates

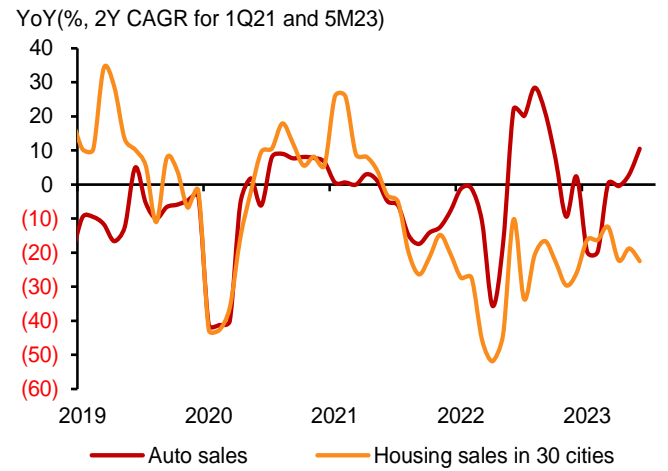
Source: Wind, CMBIGM

Figure 10: China Predicted GDP Growth

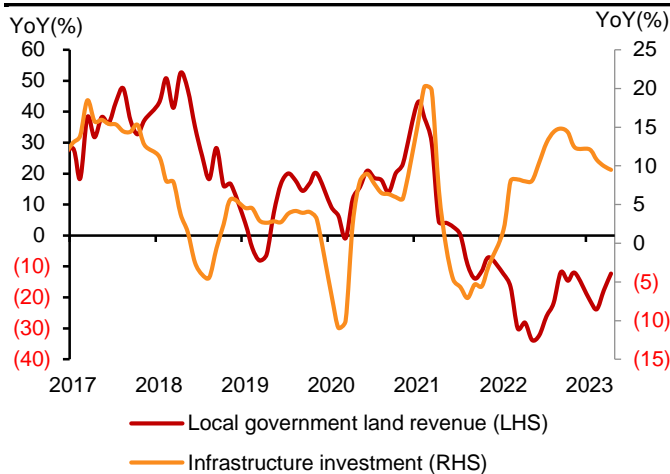
Source: Wind, CMBIGM

Figure 11: China Economic Activity Index

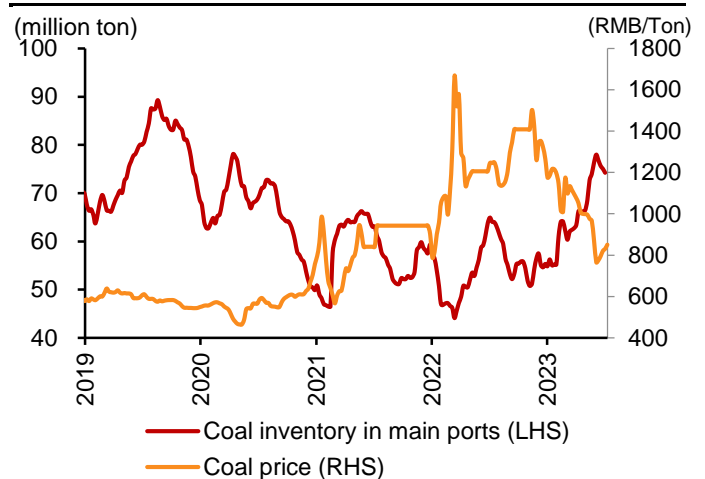
Source: Wind, CMBIGM

Figure 12: China Auto & Housing Sales

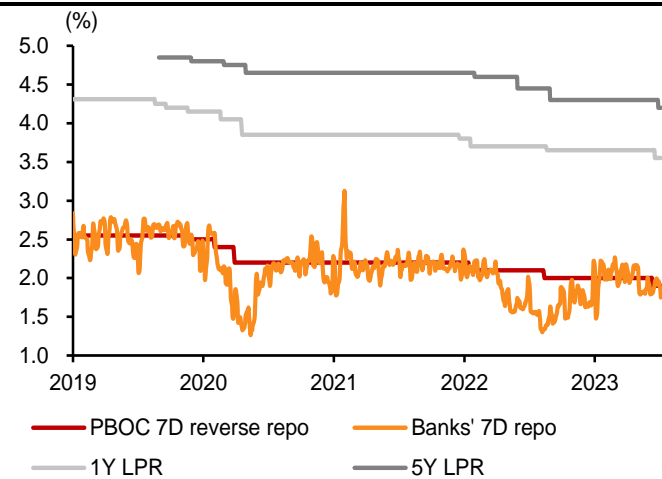
Source: Bloomberg, CMBIGM

Figure 13: Infrastructure Investment in China

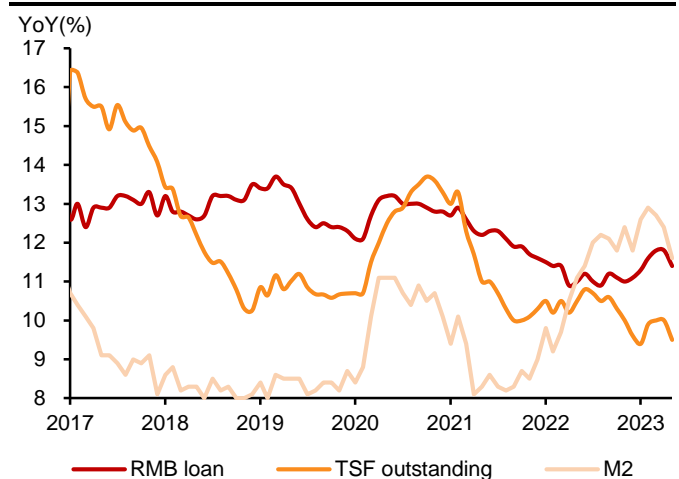
Source: Bloomberg, CMBIGM

Figure 14: China Coal Inventory & Price

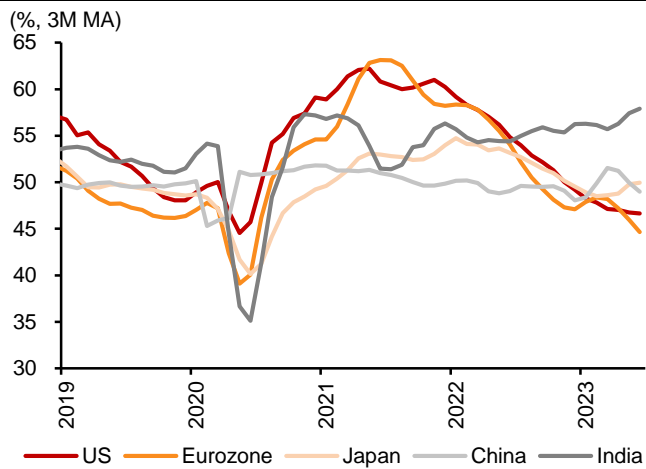
Source: Wind, CMBIGM

Figure 15: PBOC Policy Rates & Liquidity Condition

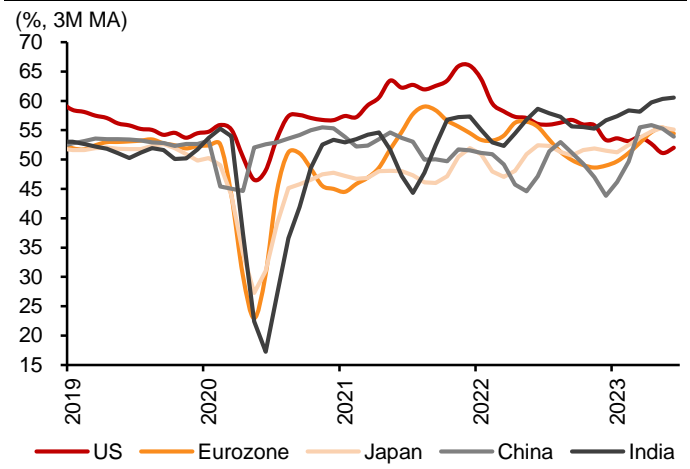
Source: Bloomberg, CMBIGM

Figure 16: China Credit Growth

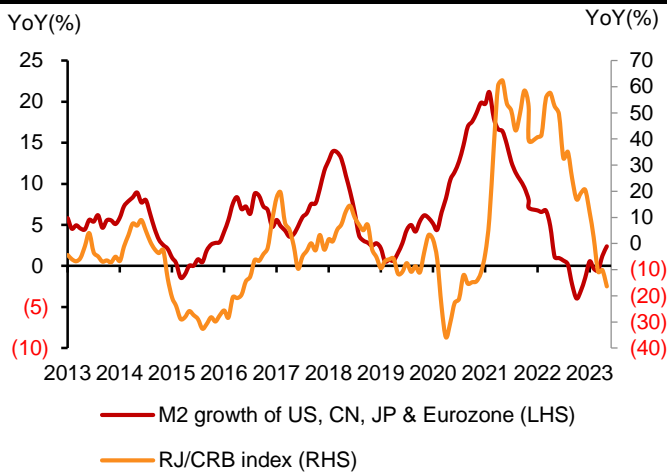
Source: Wind, CMBIGM

Figure 17: Manufacturing PMI of Major Economies

Source: Bloomberg, CMBIGM

Figure 18: Service PMI of Major Economies

Source: Wind, CMBIGM

Figure 19: M2 Growth & Commodity Inflation

Source: Bloomberg, CMBIGM

Figure 20: Copper-to-gold Ratio

Source: Wind, CMBIGM

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