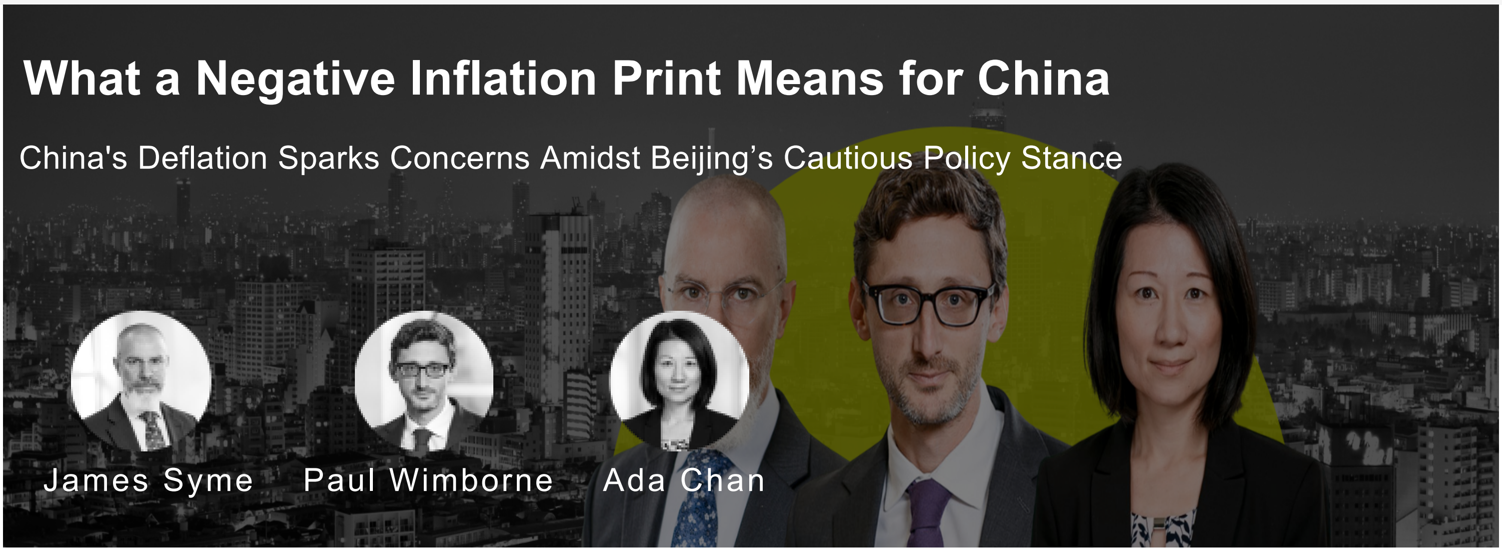
J O Hambro
Capital Management Group

News



05 Sep 2023

China’s July CPI inflation print came in at -0.3%, showing the economy has reached deflation. This reflects lower commodity prices and weakened demand in the economy. It’s a sharp fall from the rate of 2.1% seen only six months earlier. What does this mean for China and Chinese equities?

Deflation is particularly problematic for two reasons. Firstly, the deflation process makes it rational for consumers and companies to defer purchases to wait for lower prices. When weak demand drives deflation, these decisions exacerbate the demand weakness, accelerating the deflationary impetus. Secondly, in economies with high levels of debt, there is the risk of a debt-deflation spiral, in which incomes deflate, but debt does not.

The debt-deflation risk is particularly relevant for China, where non-financial sector credit/GDP has increased by over 100 percentage points in the last ten years, to nearly 300% of GDP (for context, in India those numbers are -7 percentage points and 173% of GDP; for Brazil, 45 percentage points and 173% of GDP). Serious deflation in China would pose a substantial economic risk to borrowers and, hence, also to lenders.

One key consideration is the relative rarity of deflation in emerging markets (where high inflation is more often seen as a key weakness). For the 23 key emerging markets with data available, the last twenty years have seen only 272 months with negative CPI prints out of the total 5,520 data points. An analysis of where and when these have occurred is instructive. Taiwan emerged from the 2001-2 dot-com bust in deflation as exports struggled. The 2009 slump following the Global Financial Crisis

(GFC) saw falling prices in many export-driven economies, including Chile, China, Malaysia, Taiwan and Thailand. Greece, Hungary and Poland all slipped into deflation following the Eurozone crisis in the 2010s. And the Covid slowdown in 2020-21 saw sustained deflation in many countries, notably Greece, Malaysia, Thailand, Taiwan and Qatar. In short, deflation tends to be seen in export-driven economies facing severe economic and financial conditions. It is bad news for citizens and bad news for investors.

This fits with other data releases in China, including exports which are down -14.5% in the year to July, year-to-date property investment have fallen -8.5% and weak YoY rail freight volumes (2.6% in the year to July but negative in the previous three months). The unemployment rate for 16–24-year-olds rose from 16.7% at the start of the year to 21.3% in June (at which point Beijing ordered that it not be calculated any more).

What remains unusual compared to other emerging markets is the policy response. In both 2009 and 2020, many emerging market governments adopted aggressive fiscal and monetary policies to support demand and stave off deflationary slowdowns. Some emerging markets have seen strong policy responses to even the threat of deflation – in 2019, as Korean CPI inflation approached zero, the government prepared a fiscal easing of 9.1% of GDP to ensure that the debt-laden Korean economy did not face a debt-deflation spiral. Instead, Beijing continues to merely tinker at the edges, with policy rates cut by 15bps in August.

These comparisons are further evidence of the basic problem in China, which is a political one rather than an economic one. The policies have created serious financial stress for private sector real estate developers and confidence crises for consumers and companies. The policies have also led to a slow-burning trade war with the United States and the underwhelming monetary and fiscal responses to the slowdowns are all political choices. In the last few years, and particularly since President Xi Jinping achieved a dominant political position in October 2022, the direction of Chinese policies has not been favourable to economic growth or financial markets. Without a major change in the direction of those political choices, China's economy will remain at risk of slowdown, deflation and increasing risk. We remain underweight Chinese equities in the portfolio.

Source for all data: JOHCM & Bloomberg (unless otherwise stated.)

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