



J.P. Morgan's
Hands-On China Series

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HANDS-ON CHINA REPORT
November 30, 2010

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Can China Put a Cap on Inflation?

Since Chinese policymakers fired the opening salvo in their campaign to tackle inflation, talk of price levels has become part of everyday discourse and policy debate in China. In the ten-day period since the State Council announced its sixteen measures to restrain price increases, numerous administrative steps have been taken to steady supplies of food and energy. Authorities appear to have achieved a measure of success in arresting the uptrend in vegetable prices (which had soared 29% in October) and limiting the activities of speculators in other areas of the food economy. The upcoming release of November CPI figures will be closely scrutinized by investors weighing the prospect of further tightening and possible price controls.

We recently spoke to representatives of food, supermarket, coal, IPP and oil refining companies to understand how the new policy climate has affected their operations. Based on company feedback, we believe there is little likelihood that strict price controls of the variety experienced in 2008 will be introduced in the near-term. Policymakers have instead targeted areas of supply-side concern that relate to basic necessities – from vegetables to grain to diesel. The government is likely to make progress in containing food inflation, reflecting the fact that there is no actual shortage in most major food categories. However, looking to the medium-term, we expect inflationary pressures to remain in the economy in 2011 reflecting the 47% expansion in money supply since 2009, quantitative easing in developed economies, and the trend of rising resource prices and domestic wage growth.

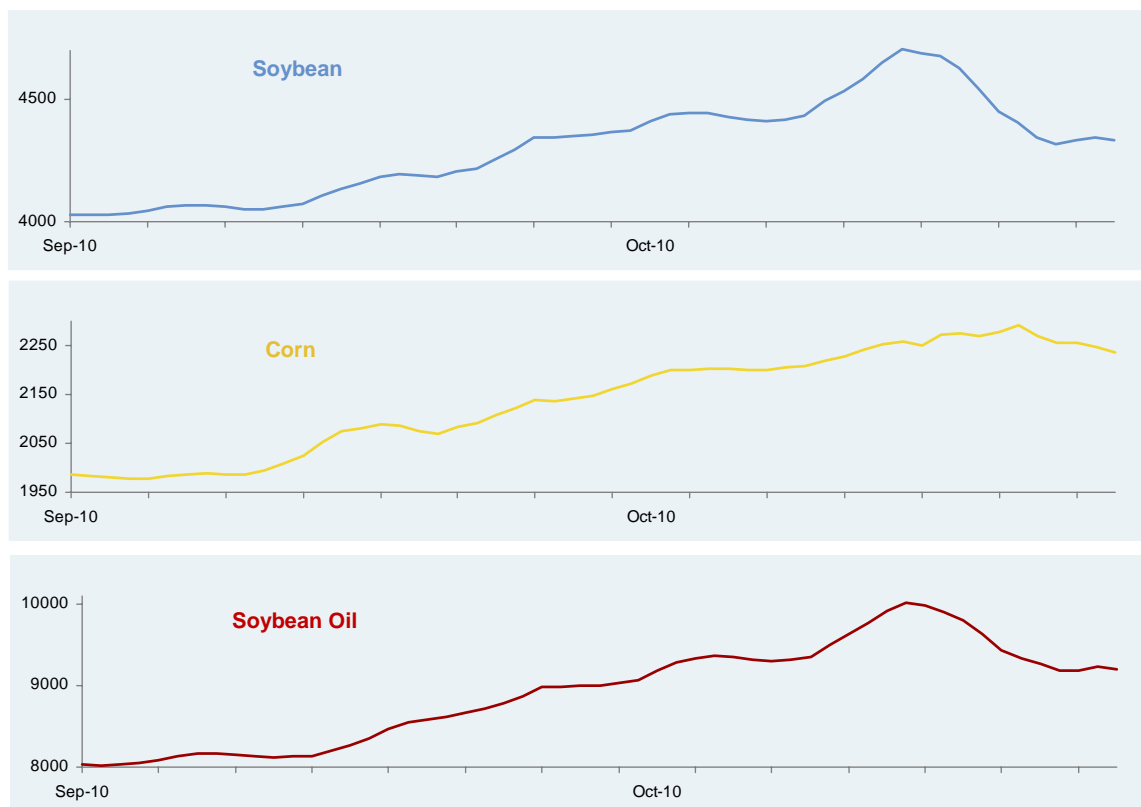
For the moment, the government is focusing on i) stabilizing the supply of foodstuffs and agricultural products, ii) increasing subsidies for vulnerable segments of society, and iii) waging a general campaign against speculation and hoarding. Indeed, Chinese authorities have put much of the blame for surging food and commodity prices on speculators and are trying to limit their activities in markets. For instance, transaction fees for trading agricultural and metal futures have been increased on the Shanghai, Zhengzhou and Dalian futures exchanges, with the latter increasing daily price limits and minimum margin requirements for all contracts.

The following note reviews the anti-inflation measures that have so far been implemented and examines how the new policy climate is affecting companies in some key sectors that are exposed to policy risk.

- **The current policy backdrop – industry-level impact.** Under an environment of moderate inflation and a rising interest rate cycle, beneficiaries include insurance companies, since they are able to take advantage of higher yields, with a high proportion of fixed-income investments in their portfolios. Retailers such as supermarkets and department stores that are able to pass rising costs to the consumer are well positioned, as are banks, which generally thrive in a mildly inflationary environment. In general, mid-stream industries such as power generation face the highest risk of margin erosion, while upstream producers and retailers have better pricing power.
- **Prices show some signs of cooling.** According to the NDRC, the focus on deterring speculation has borne some success, as prices of certain necessities are already showing signs of cooling, while domestic futures prices for many commodities have fallen notably. The NDRC recently pointed out that cotton futures have fallen some 24% from their

highs on November 10-11, copper futures by 10.9%, while corn, wheat and soybeans futures had fallen by 6.9% on average (see Figure 1). For the week ending Nov 19, almost all of the 18 vegetables tracked by the MOF saw prices decrease at the wholesale level, with the price of the entire basket falling almost 4%. However, fruit prices have yet to correct, meat prices have also remained resilient, with beef and mutton both rising modestly (< 1%) and pork rising 2.2% last week, on a WoW basis.

Figure 1: Prices of domestic soft commodities futures (RMB, most liquid 10-month contract)



Source: Dalian Commodities Exchange

- **Views from corporates – strict price controls do not appear imminent.** With food prices being responsible for much of the recent increase in CPI, authorities are mindful that monetary tools are not an expedient means of taming food price inflation. At the same time, strict price controls do not take account of dynamics that occur at the level of intermediaries and often result in market dislocations. As a sign that price controls are not considered a tactic of first resort, an official of the National Development and Reform Commission (NDRC) was recently reported by the *Economic Observer* newspaper as saying that China will not impose strict price controls on commodities in the near-term, but that the government would influence commodity prices through the nation's Price Law, which prohibits the manipulation of market prices through collusion. It is also important to note that much of the recent inflationary pressure has been more specifically concentrated in vegetable prices, following a string of weather disruptions this year. The high degree of fragmentation in this industry results in poor transparency and allows profiteers to capitalize on market uncertainty.

Gauging the Policy Climate – Views from Corporates

- **Food.** Food prices (and especially vegetable prices) have been the main culprit behind CPI increases in recent months, and have thus become the immediate focus of the government's

policies to tame inflation. In contrast to grains, for which the supply and demand picture is relatively transparent, the vegetable market is characterized by a much higher degree of fragmentation: about 95% of vegetable production lies in the hands of small-scale farmers. The high degree of fragmentation in this industry results in poor transparency and allows profiteers to capitalize on market uncertainty.

We spoke to Wumart and to contacts in the vegetable industry to acquire more clarity on the production and retail aspects of the vegetable market:

- Following the government's intervention in recent weeks, prices have generally stabilized. The company is restricting purchases of storable/on-sale items such as cooking oil to prevent hoarding.
- In the aftermath of numerous weather disruptions this year, price increases originated from the producer level. These increases propagated through the retail chain (usually consisting of 5-6 layers of intermediaries before reaching retail), but have been amplified at each stage, resulting in highly inflated price levels for consumers.
- **Petroleum.** On November 26, the NDRC released the results of a round of price inspections at gas stations, in which many exceeded central pricing guidelines. The resulting penalties were the second round given out within three days for gasoline-related violations. The gas stations were all privately-owned, and had sourced gasoline at wholesale prices that exceeded retail price guidelines. Under such scrutiny, the gas stations must either sell at a loss or hold the fuel in inventory and risk accusations of hoarding. As this example illustrates, although price caps can bring immediate relief to consumers, they often fail to take account of dynamics that occur at the level of intermediaries.

According to Sinopec, refiners, not retailers, have experienced the biggest negative impact on profits as crude prices rose. Since Jan 1, 2009, the government has begun implementing a new pricing mechanism that provides limits for all downstream prices based on the refinery output price set by the government. Specifically,

- The differential between the refinery and retail price cannot be greater than RMB 800/ton.
- Between the first-level wholesale price and retail price, the differential cannot be greater than RMB 500/ton.
- Between the immediate wholesale price-level and retail price, the differential cannot be greater than RMB 400/ton.

This structure aims to ensure the profitability of each intermediary. Recent reports of retailers selling at a loss have been the result of wholesalers raising output prices beyond the stipulated guidelines. In actuality, refiners have experienced the biggest squeeze as crude prices have increased, but output prices mandated by the government have not kept up. On the current diesel shortages, we also learned from Sinopec that:

- The impact of recent power cuts on smaller companies prompted the widespread use of diesel generators for electricity. Diesel demand has increased, but the resulting shortages have had no real impact on retail prices.
- The current diesel shortage should end by December as local governments cease to impose power restrictions levied on smaller enterprises (and sometimes even residential areas) due to central government directives.

- **Coal and IPPs.** Coal prices have staged a very strong rally since the summer, crimping the profitability of IPPs – in 3Q10, 70% of listed IPPs were in the red. In the last two months, spot coal prices at Qinhuangdao port have gained more than RMB100/ton. In addition to rising input prices, IPPs have been affected by lower generating hours due to power cuts in downstream industries. In response to the previous bout of inflation in 2008, coal companies were required to cap thermal coal prices at the June 20th level. However, the subsequent month saw price increases of more than 10% on the spot market. This stemmed mainly from the fragmentation of the coal industry, where smaller privately-owned coal producers were highly inclined to inflate prices under little regulation.

The recent run-up in coal prices has reflected a moderately tight supply and demand picture, seasonal factors, as well as replenishing of inventories at the IPP-level. According to our discussion with China Shenhua, coal inventories at the IPP-level currently stand at 18 days, 50% higher than seasonal norms, partly due to the earlier onset of colder temperatures. This early stocking likely contributed to elevated prices. Given the current outlook on inflation, electricity prices are unlikely to be raised, although on-grid prices may be adjusted. With spot coal prices gaining RMB100/ton in the last month, IPP margins have been further squeezed. According to Datang International Power:

- In 1Q11, there will likely be a sudden surge in electricity usage as companies compensate for lower output in 4Q10 and delayed production.
- In 3Q10, 10 provinces posted aggregate losses in the IPP industry and 70% of listed IPPs were in the red

Despite the recent government directive towards coal producers to keep prices down, we continue to favor the coal industry since the tight supply and demand picture benefits producers these companies.

Impact on companies

Under an environment of moderate inflation and a rising interest rate cycle, beneficiaries include insurance companies, since they are able to take advantage of higher yields, with a high proportion of fixed-income investments in their portfolios. Retailers such as supermarkets and department stores that are able to pass rising costs to the consumer are well positioned, as are banks, which generally thrive in a mildly inflationary environment. In general, mid-stream industries such as power generation face the highest risk of margin erosion, while upstream producers and retailers have better pricing power.

According to J.P. Morgan's consumer research team, if price controls similar to those implemented in 2008 on food items were to be enacted, companies such as Tingyi and Uni-President could see margin erosion if their noodle sales prices came under control. The second most affected consumer industry would be the dairy companies – i.e. Mengniu, Yili, Bright Dairy, as current raw milk prices are already up about 23% YoY. In the coal space, we view near-term price controls as less likely. J.P. Morgan analyst Nathan Zibilich favors Yanzhou Coal for its relatively large exposure to spot market sales, which puts it at less policy risk compared to its peers (for instance, 75% of China Coal's sales volume is sold to IPPs under NDRC-regulated contracts, making it more vulnerable to price controls). The directive for toll-road stations nationwide to waive fees from vehicles carrying fresh produce is expected to have little impact on expressway operators, with J.P. Morgan infrastructure analyst Karen Li noting that the majority of companies covered have had similar policies in place since China's 2008 snowstorms.

The Government's Flurry of Administrative Measures

Although China's State Council has indicated that price control measures may be introduced if necessary on downstream products, the government so far has favored a targeted administrative

approach. On one hand, price controls are an expedient means by which to counter inflationary pressure. But on the other hand, the use of price controls can cause future market dislocations, and where foodstuffs are concerned, they are difficult to implement beyond the level of consumer staple producers and large retailers. This is because i) the government does not want to cap the earning potential of China's upstream agricultural community, and ii) many Chinese consumers traditionally buy fresh foods from wet markets.

The NDRC has already claimed some early successes in curbing price increases of staple commodities, which it has attributed to the broad-based crackdown on speculation and market manipulation, as well as commodity price corrections on the international market and profit-taking by speculators. On November 25, the NDRC detailed price declines across major commodity futures prices, pointing out that cotton futures have fallen some 24% from their highs on November 10-11, copper futures by 10.9%, while corn, wheat and soybeans futures had fallen by 6.9% on average. For the week ending Nov 19, almost all of the 18 vegetables tracked by the MOF saw prices decrease at the wholesale level (see Figure 2), with the price of the entire basket falling almost 4%. However, fruit prices had yet to correct and meat prices also remained resilient, with beef and mutton both rising modestly (< 1%) and pork rising 2.2% last week, on a WoW basis.

Figure 2: Weekly average price of a basket of 18 vegetables at the wholesale level (RMB/kg)



Source: CEIC

Chinese officials have also gone to lengths to point out that the nation has recorded its seventh-consecutive bumper harvest for the full-year. Winter wheat output totaled 108.8mmt, up 1mmt – the seventh annual increase in a row. Supply and demand were said to be in relative balance, with factors such as rising production costs, inflationary expectations, surplus liquidity, speculation and international market effects blamed for recent price pressure.

As mentioned above, the government's sixteen measures for countering inflationary pressure have thus far translated to administrative measures along three fronts:

i) Stabilizing the supply of foodstuffs and agricultural products

- Chinese authorities have been selling corn, wheat and rice from state reserves since mid-year, and have more recently held state auctions for edible oils, soybeans, sugar and pork as part of efforts to augment supply and counter price pressure.
- China's Minister for Agriculture stated recently that the nation aims to increase its vegetable acreage in the winter and spring planting seasons by 7% over 2010 levels, and expects to raise its production of vegetables by 7.5% in 2011.

- The China Banking Regulatory Commission (CBRC) has instructed banks to increase credit in support of agricultural production, processing and distribution, as well as enhance credit support to logistics and transportation companies so that the transportation of food can be streamlined. The CBRC asked banks to extend special loans to step up production in corn, cotton, sugar and rice.
- To safeguard the domestic supply of fertilizer and reduce export volumes, China is imposing a “high-season” 110% duty on urea and phosphate shipments between November and mid-2011. Under normal circumstances, the 110% rate applies between February and June, with a 7% rate applied during the “low season.”
- In an effort to rein in cotton prices, the Ministry of Railways and the Xinjiang Economic and Trade Council are requiring 300 railroad cars a day from the Xinjiang Region to carry cotton to the rest of the country, while the Ministry of Transportation has ordered toll-road stations nationwide to waive fees from vehicles carrying fresh produce (effective December 1, 2010). J.P. Morgan infrastructure analyst Karen Li believes there will be a very limited impact on the toll-road sector from this policy, since the majority of companies have had similar policies in place since the 2008 snowstorms.

ii) Increasing subsidies for vulnerable segments of society

- Following a directive from the State Council urging local governments to ensure the basic livelihood of the general public, China's Ministry of Civil Affairs has instructed local governments to develop temporary subsidy plans for low-income groups to assist them in coping with food inflation.
- Various local governments are now taking measures to assist low-income segments of the population and other vulnerable groups. As an example Beijing intends to extend a one-time RMB100 subsidy to 223,000 low-income earners within November. Other local governments such as Chongqing municipality and Shaanxi Province have reportedly increased food subsidies for university students.
- Local governments have been instructed to establish mechanisms to link minimum living allowances for low-income groups with changes in CPI, while gradually increasing basic pension, unemployment insurance and minimum wage payments. As of October 2010, over 74 million people in China were reportedly receiving minimum living allowances.

iii) Waging a general campaign against speculation and hoarding

Chinese authorities have put much of the blame for surging agricultural prices on speculators, and on producers and traders who have hoarded farm produce in anticipation of price increases. On November 22, authorities banned the hoarding of oil and coal and local NDRC agencies have been directed to “severely investigate and punish speculative activities” (six companies, including the local units of state-owned oil majors, recently named and shamed by the planning agency). Meanwhile the CBRC has said that it will clamp down on the use of credit for speculation in agricultural products.

- A recent statement by the NDRC pointed to cotton, diesel oil and mung beans as markets for which speculation lay behind sharp price increases this year. However, the role that farmers themselves play by holding grain off-market should not be underestimated. A recent report by *cngain.com* suggested that farmers in a major wheat and corn-producing region of Henan Province continue to expect higher prices in future and many were holding their corn off the market. Similarly, farmers have come to expect regular increases in the government's minimum price for wheat. The rise in non-farm wage opportunities in recent years has meant that farmers do not need to sell their grain immediately to generate cash.
- The government has also ordered higher transaction fees for trading agricultural and metal futures, according to the Dalian, Zhengzhou and Shanghai futures exchanges. The Dalian

Commodity Exchange (DCE) has increased daily price limits for all contracts to 6% (from as much as 5%) and minimum trading margins to 10% (from as much as 7%) as of November 29, in a move aimed at deterring speculators. Contracts traded on the DCE include soybean, soybean meal, soybean oil, corn, palm oil and PVC.

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