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NDRC Expects Higher Inflation in June, comments by Jing Ulrich, Chairman of Global Markets, China

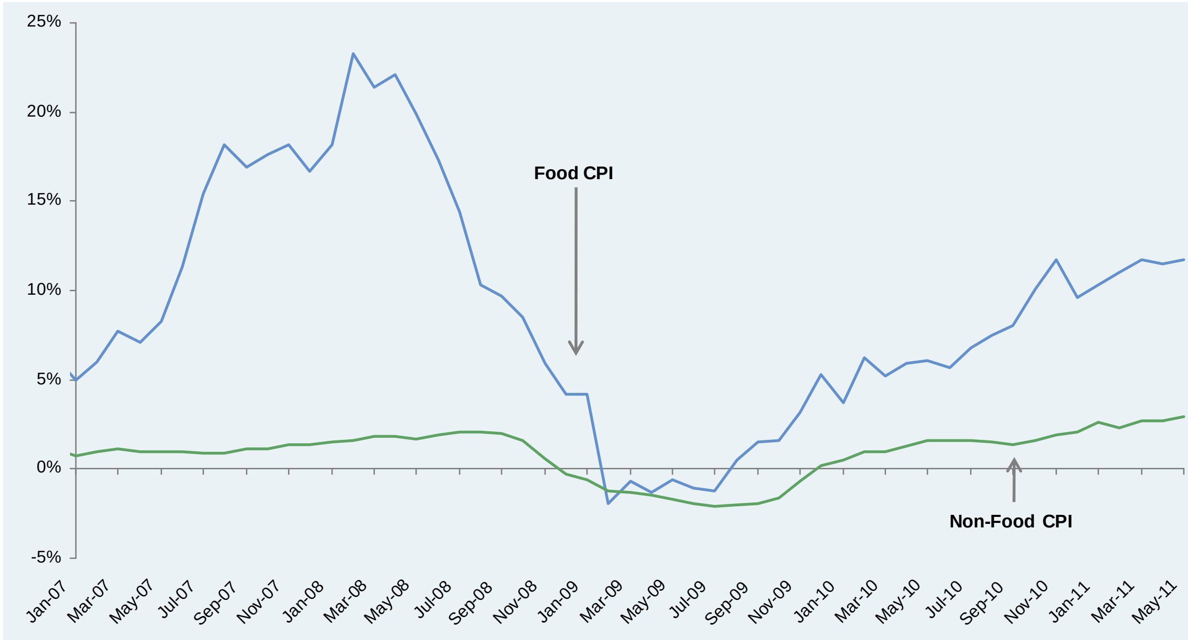
The National Development and Reform Commission, China's top economic planning agency today indicated that inflation will accelerate in June, according to a notice posted on its website. The NDRC noted that the overall level of prices remains high and that inflation will remain elevated for some months, although the overall situation is under control. This broadly supports consensus expectations for CPI inflation to accelerate in June, from 5.5% in May. J.P. Morgan's economics team expects headline CPI inflation to peak at about 5.8% YoY in June or July. Starting from September, inflation is expected to moderate to levels below 5%, reflecting the lagged impact of tightening policies and the higher base effect. Risks to this scenario include persistent drought, which may bring upward pressure on headline CPI inflation and delay the expected moderation. At the end of May, off-grid electricity tariffs were raised for 15 provinces. While commercial users have been affected, home users' electricity rates were left unchanged. This move came after the last hike of on-grid tariffs, and further demonstrated the government's resolve to minimize direct inflationary pressures.

So far this year, the People's Bank of China has raised interest rates twice to 3.25% and reserve requirement ratios (for both large- and mid-sized banks) 6 times, reaching 21.5% and 19.5% respectively. In 2010, interest rates were raised twice and the reserve requirement ratio five times. The impact of interest rate adjustments usually become evident following a lag of at least two quarters, implying that CPI figures for 2H11 may reflect the impact of the sequence of hikes over the past several months. However, real deposit rates remain in negative territory. Bank lending fell sharply in May to RMB551.6 billion, about RMB100 billion lower than consensus expectations, while money supply (M2) grew at 15.1%, lower than 15.3% the previous month and the consensus of 15.5%. This indicates that government measures to curb liquidity and control inflation are beginning to take effect.

Imported inflation, on the other hand, continues to provide a source of concern. Soaring international grain prices and oil prices have made the task of restraining inflation more difficult in recent months. Brent crude has risen 16% this year. The active contract for corn on the CBOT has registered price growth of more than 22% since the beginning of this year. The price of grain feeds, such as corn, is increasingly becoming relevant to Chinese inflation as the growing consumption of meat has tipped the nation from being self-sufficient to being dependent on imports. Corn net imports have grown steadily over the last several years, and China became a net importer once again in 2010 after being a net exporter for over a decade.

Food prices have again come to the fore as a culprit for higher inflation (see Figure 1). In May, pork prices have reached the highest point since 2008, after rising for four consecutive weeks. According to the Ministry of Agriculture, sow count in April was 436 million, down 4.15% year-on-year. In May, the figure further dropped to 434 million. Rising prices reflect rising costs of breeding on one hand, as grain feed costs continue to climb, with reports putting the increase at some 15% since the beginning of the year. However, the feed price ratio is at 7.92:1, far above the break-even point of 5.5:1, implying part of the price inflation has been driven by tighter supply and demand.

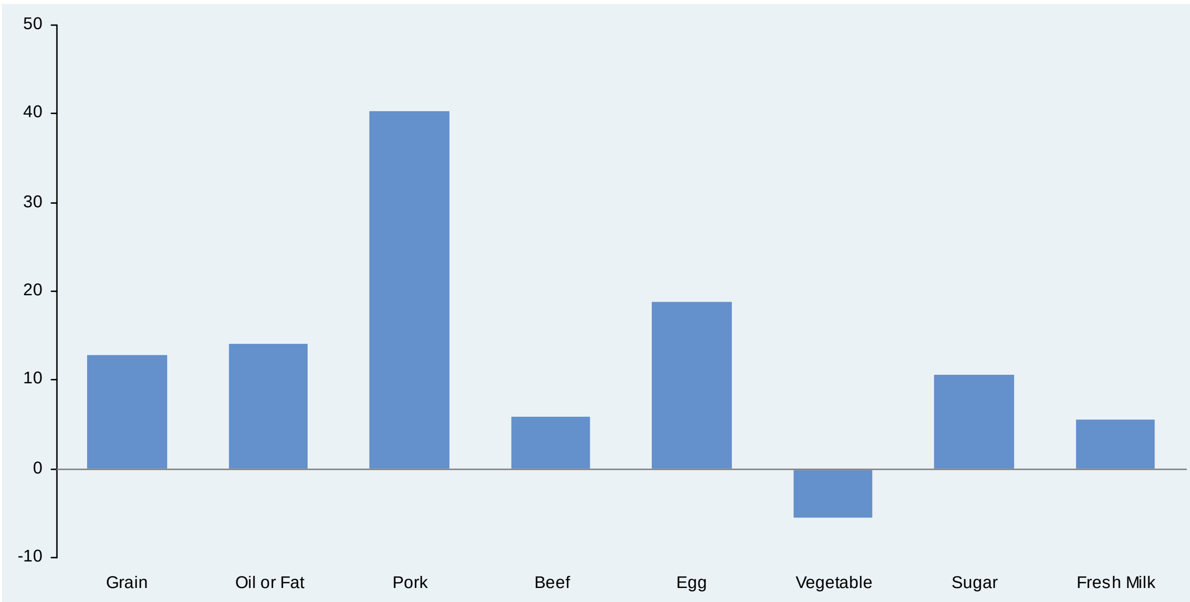
Figure 1: Food and Non-Food CPI Inflation (%)



Source: CEIC

Higher food prices are still the most obvious manifestation of heightened liquidity, contributing more than two-thirds to consumer price inflation. The current situation is further exacerbated by a drought in Central China, deemed the worst in 50 years, followed quickly by serious floods that brought damage to crops. While the extreme weather has mainly affected planting and the autumn harvest, it has helped stoke inflationary fears. This time around, food inflation has reached a high of 11.7% and pork prices are again on the rise, currently 40% above the year-ago level. Prices of poultry and eggs are also elevated (see Figure 2). On the non-food side, transport, fuel and residential prices have been on the rise.

Figure 2: Food Inflation - Select Categories (Year over year, May, 2011)



Source: CEIC

Likely beneficiaries of higher food and consumer goods prices are companies with strong pricing power and the ability to maintain costs. In this regard, we favor large scale operators downstream in the supply chain such as supermarkets and department stores. Vertically integrated players are at an especially advantageous position. Companies in dairy and edible oils are also vulnerable to possible further price controls if food price inflation persists. Investors continue to view Chinese inflation as one of the most significant determinants of market behavior, and so Chinese stocks are unlikely to stage a sustained rebound until the market sees clear signals that inflation has peaked.