

China's Rate Hikes ending as Price Pressures Peak

Summary

Over the weekend, China reported that its consumer price index for June rose 6.4 per cent from a year earlier, slightly above economists' forecasts for a 6.3 per cent increase, with sharp rises seen in food, consumer goods and property.

The latest figures showed that food prices, and in particular the pork price, continued to be a source of consumer price inflation.

The latest numbers have already prompted talk that Beijing may hike interest rates further in the second half of 2011 to bring the inflation numbers down. While we acknowledge that possibility, our view is that Beijing is more likely to resort to further reserve requirement ratio (RRR) hikes rather than interest rate tightening to mop up the liquidity in the system. Another tool is clearly to appreciate the Chinese yuan.

Already, the tightening has begun to weigh down on China's manufacturing as production purchasing managers' index came in at 50.9 in June – down from 52 in May, and below the market consensus of 51.5.

If CPI inflation does trend lower from here, then this is a clear positive for the market, since it will ease market fears of draconian measures in the pipeline to rein in prices. More importantly, it will also help anchor inflation expectations and possibly ease wage pressures and costs in China.

Granted, there's still debate over the precise timing of when consumer price inflation will peak, but there's broad consensus that price change will likely trend lower from here. Although we still urge caution on Chinese market, our view is that investors may wish to position for a bottom in the market as near-term overhangs are removed.

China's rate hikes ending as price pressures peak

Over the weekend, China reported that its consumer price index for June rose 6.4 per cent from a year earlier, slightly above economists' forecasts for a 6.3 per cent increase, with sharp rises seen in food, consumer goods and property.

In fact, it is likely that the higher-than-expected CPI inflation was a main reason behind the 25 basis point rate hike last week, as the People's Bank of China sought to tame inflation expectations ahead of the CPI release.

The latest figures showed that food prices, and in particular the pork price, continued to be a source of consumer price inflation. Last month, pork prices soared 57 per cent, while egg prices surged 23 per cent.

Non food inflation has a more mixed outlook. On a year on year basis, non food prices climbed three per cent, the biggest jump since records began in 2002. However, the pace of increase appears to have slowed from the level seen in the second half of 2010. On a month on month basis, the June non food inflation rate actually dropped to zero and had been moderating for several months.

The latest numbers have already prompted talk that Beijing may hike interest rates further in the second half of 2011 to bring the inflation numbers down. While we acknowledge that possibility, our view is that Beijing is more likely to resort to further reserve requirement ratio (RRR) hikes rather than interest rate tightening to mop up the liquidity in the system. Another tool is clearly to appreciate the Chinese yuan. Indeed, since October last year, China has raised rates five times, along with nine other RRR hikes. Given the extent of the tightening and its frequency, it looks like China is already close to the tail end of its tightening cycle.

Additionally, headline inflation in China is expected to come off in the second half of the year largely due to base effects and possibly new food supplies in the market. Some Chinese food companies have indicated that pork prices should stay elevated in the third quarter of this year, but the high prices will also trigger higher supply of meat and poultry in the last quarter of 2011. If that happens, then further interest rate hikes may be not be necessary, as consumer price inflation eventually comes off the boil.

Furthermore, we note that Beijing is trying to strike a fine balance between growth and inflation objectives. While high inflation is clearly not acceptable, but low prices at extremely slow growth is hardly seen as positive either.

Already, the tightening has begun to weigh down on China's manufacturing as production purchasing managers' index came in at 50.9 in June – down from 52 in May, and below the market consensus of 51.5.

Meanwhile, both external and domestic demand weakened in June with new order and new export order sliding to 50.8 and 50.5 in June, from 52.1 and 51.1 in May respectively.

If CPI inflation does trend lower from here, then this is a clear positive for the market, since it will ease market fears of draconian measures in the pipeline to rein in prices. More importantly, it will also help anchor inflation expectations and possibly ease wage pressures and costs in China.

Granted, there's still debate over the precise timing of when consumer price inflation will peak, but there's broad consensus that price change will likely trend lower from here. Although we still urge caution on Chinese market, our view is that investors may wish to position for a bottom in the market as near-term overhangs are removed.

Contact Details

Address 80 Raffles Place UOB Plaza 2 Level 3 Singapore 048624

24-hour Hotline 1800 222 2228 (Local) • (65) 6222 2228 (International)

Fax (65) 6532 3868

Email uobam@uobgroup.com

Website uobam.com.sg

Business Offices

Singapore

Institutional Business

Dennis Siew

Senior Director

Retail Business

Norman Wu

Senior Director

New Strategic Markets & Private Banks

Rachel Ong

Director

Structured Investments

Chong Jiun Yeh

Executive Director

Brunei

Kamal Muhd

General Manager

Japan

Masashi Ohmatsu

Chief Executive Officer

Malaysia

Lim Suet Ling

Chief Executive Officer

Greater China/Taiwan

William Wang

Chief Executive Officer

Thailand

Vana Bulbon

Chief Executive Officer

Important Notice & Disclaimers

This publication shall not be copied or disseminated, or relied upon by any person for whatever purpose. The information herein is given on a general basis without obligation and is strictly for information only. This publication is not an offer, solicitation, recommendation or advice to buy or sell any investment product, including any collective investment schemes or shares of companies mentioned within. Although every reasonable care has been taken to ensure the accuracy and objectivity of the information contained in this publication, UOB Asset Management Ltd and its employees shall not be held liable for any error, inaccuracy and/or omission, howsoever caused, or for any decision or action taken based on views expressed or information in this publication. The information contained in this publication, including any data, projections and underlying assumptions are based upon certain assumptions, management forecasts and analysis of information available and reflects prevailing conditions and our views as of the date of this publication, all of which are subject to change at any time without notice. UOB Asset Management Ltd ("UOBAM") does not warrant the accuracy, adequacy, timeliness or completeness of the information herein for any particular purpose, and expressly disclaims liability for any error, inaccuracy or omission. Any opinion, projection and other forward-looking statement regarding future events or performance of, including but not limited to, countries, markets or companies is not necessarily indicative of, and may differ from actual events or results. Nothing in this publication constitutes accounting, legal, regulatory, tax or other advice. The information herein has no regard to the specific objectives, financial situation and particular needs of any specific person.

You may wish to seek advice from a professional or an independent financial adviser about the issues discussed herein or before investing in any investment or insurance product. Should you choose not to seek such advice, you should consider carefully whether the investment or insurance product in question is suitable for you.

UOB Asset Management Ltd Co. Reg. No. 198600120Z