China ups reserve requirement ratio to nip inflation in the bud

Summary

On 15 June, China's central bank took the market by surprise by raising its reserve requirement ratio (RRR) by 50 basis points, demanding that banks keep a record 21.5 per cent of their deposits in reserves.

This marks the sixth RRR hike so far this year, and the aim is primarily to sterilize foreign reserves as a result of its strong currency, but also to curb lending and quell run-away prices.

However, we believe that the PBOC is not likely to over-tighten as Beijing is just as concerned about growth and employment. What is more likely to happen is that China will employ other tools to deal with the inflation problem.

Looking ahead, we think that Inflation in the near term could surprise the market on the upside. And although economic growth will slow, the country will still grow at healthy levels. Also earnings downgrade could continue due to cost inflation and macro slow down.

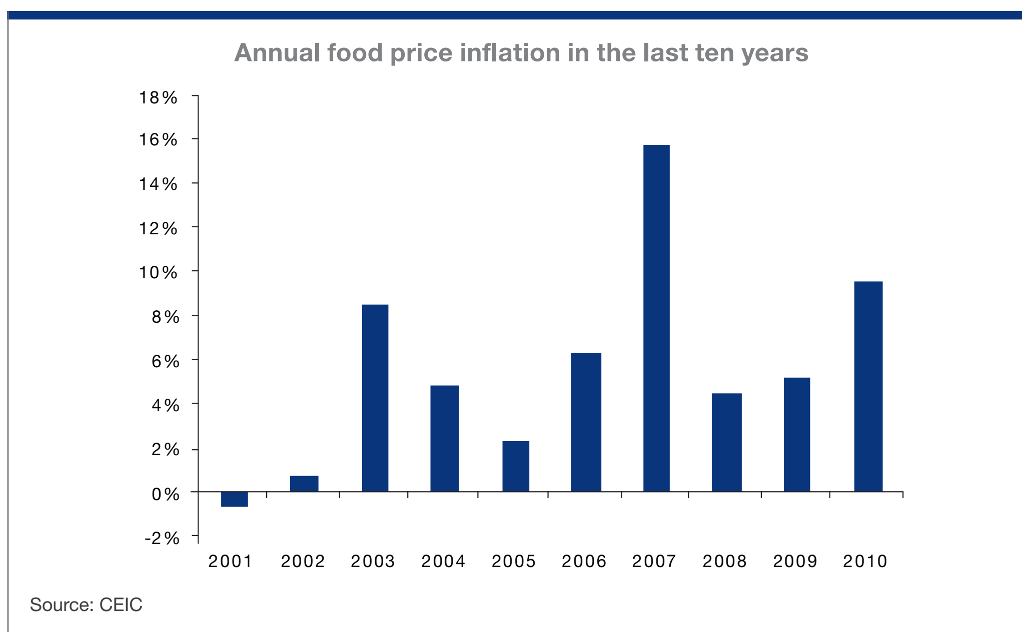
In this environment, we are overweight in secular growth plays with little inflation or policy risks. The obvious victims of tightening are the property players, and therefore, we are underweight in this sector. Also, we think that overall growth will slow slightly and therefore, there could be lower activity levels in telecommunications and energy.

China ups RRR to nip inflation in the bud

On 15 June, China's central bank took the market by surprise by raising its reserve requirement ratio (RRR) by 50 basis points, demanding that banks keep a record 21.5 per cent of their deposits in reserves.

This marks the sixth RRR hike so far this year, and the aim is primarily to sterilize foreign reserves as a result of its strong currency, but also to curb lending and quell run-away prices. By compelling banks to lock up cash which they otherwise would have lent, China hopes to drain the excess money in its system, a key driver of its price pressures. Accordingly, Hong Kong equities sold off, as investors feared a serious slowdown in the world's fastest growing economy.

Indeed, the latest economic data suggest that inflation, rather than growth, is still the predominant concern, as consumer price index (CPI) inflation increased from 5.3 per cent to 5.5 per cent in May. Meanwhile, producer price index rose 6.8 per cent from a year ago, up from 0.3 percentage points from April. Also, data on 14 June showed that food and property prices are still fuelling inflation, with the price of pork leaping over 40 per cent in the year to May on tight supply affected by diseases in pig farms. As the country experiences pockets of protests in poorer districts, the spectre of social unrest hangs over the country as issues on income inequality and living costs persist.



However, we believe that the PBOC is not likely to over-tighten as Beijing is just as concerned about growth and employment. To the central government, jobs and price affordability are broadly of equal importance that makes substitution between both almost impossible.

What is more likely to happen is that China will employ other tools to deal with the inflation problem. One tool is clearly to let the Chinese yuan appreciate. Not only will that make foreign goods much more affordable, but it also helps slow the pace of export growth. This will take some price pressures off imports, and curb the strong demand for Chinese goods.

Secondly, China will probably see more RRR hikes rather than rate hikes going forward. The reason is because foreign reserves continue to build up and the RRR hikes can help drain the increases in liquidity that come from the reserves build-up.

Additionally, CPI inflation has come off slightly on a monthly basis and we see this as evidence that PBOC's various tightening measures are working, and that given sufficient time, inflation will come down to a level that is acceptable to the Chinese citizens. Based on our internal estimates, China's inflation should peak out by next month or so, before declining in the second half of the year. If that happens, aggressive tightening at this stage is likely to be an over-reaction, and the policy makers in China are unlikely to take up this option.

Impact on China equity markets and outlook

Looking ahead, we think that Inflation in the near term could surprise the market on the upside. And although economic growth will slow, the country will still grow at healthy levels. Also, earnings downgrade could continue due to cost inflation and macro slow down.

In this environment, we are overweight in secular growth plays with little inflation or policy risks. These sectors include water/waste management, consumer discretionary and healthcare. Selected material stocks may also benefit from the country's policy measures to improve the welfare of the common people.

However, we are slightly more underweight on financials, but acknowledge that China banks are now trading at attractive valuations. Also, insurance companies are potential beneficiaries of interest rate rises.

The obvious victims of tightening are the property players, and therefore, we are underweight in this sector. Also, we think that overall growth will slow slightly and therefore, there could be lower activity levels in telecommunications and energy.

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