

China: overcapacity reform continues to push up PPI inflation

In the coming months, overcapacity reform in cement and glass could continue to push up these material prices. Potential tariffs have yet to affect inflation. Mild inflation numbers will allow the central bank to focus on financial deleveraging reform. We expect the PBoC to follow most of the Fed's rate hikes this year but only by 5 basis points each time



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Overcapacity reform keeps driving up material prices

Headline PPI rose 3.4% YoY in April, up from 3.1% in March.

The main increase was in the category of building materials and non-metals (10.7% YoY), which in our view are cement and glass.

These two materials are the key reform sectors of this year's overcapacity cut plan. It would indeed not be surprising if this increase in the price trend of building materials would continue for the rest of the year.

Potential tariffs from the US have yet to be reflected in PPI, though if the tariffs are implemented then it would push up PPI. But the tariffs would not be fully reflected in metal prices as there would be substitutes of imports from other locations.

CPI inflation was milder but we see more volatility from food prices from the coming adverse weather

Headline CPI inflation was 1.8% YoY in April, milder than the 2.1% in March.

Egg prices continued to go up (14.9% YoY) due to external demand for Mainland China's eggs as there was a large-scale egg recall by the US in April.

On the other hand, we note that there is an on-going increase in healthcare inflation (5.2% YoY), which has been broad-based from Chinese medicines and Western drugs to healthcare services. This could reflect that (1) the population requires more healthcare services as the population has started to age; and (2) the rise of the middle-income class is more aware of their healthiness and this has increased the demand for healthcare services.

In the coming months, we expect fruit and vegetable prices to be higher as the adverse weather season is about to start.

Mild CPI gives room for PBoC to exercise flexibility

Mild inflation is good for the central bank, as it frees up the PBoC to focus on reform.

Nowadays, the central bank is heavily engaged in handling financial deleveraging reform. There is already a case that a local government financial vehicle is defaulting on its debt. This is certainly the result of financial deleveraging. But the central bank would need to skillfully manage liquidity so that the case does not fuel a series of defaults, which would make the market nervous.

We expect the central bank will be able to manage the rising credit risks in China, which is a by-product of financial deleveraging.

Having said that, we still expect the central bank to follow the Fed for most of the rate hikes this year, but only by 5 basis points each time to reflect the already tightened liquidity conditions in China.