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What a negative inflation print means for China

Deflationary challenges arising in China, its rarity in emerging markets, and the influence of political decisions on shaping the economic landscape.

KEY POINTS

- China's July CPI inflation print came in at -0.3%, showing the economy has reached deflation.
- Deflation has asymmetric risks for emerging economies, particularly ones with high financial leverage like China. Deflation tends to be associated with crisis periods in the history of emerging markets.
- Beijing's fiscal and monetary response has been weak. This represents a deliberate policy choice and is unlikely to change any time soon.

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In July, China's CPI inflation print came in at -0.3%, indicating the economy has entered a deflationary phase. This reflects lower commodity prices and the demand weakness in the economy, marking a sharp fall from the 2.1% rate seen only six months earlier. What does this mean for China and Chinese equities?

One key consideration is the relative rarity of deflation in emerging markets, where high inflation is more often seen as a key weakness. Over the last twenty years, among the twenty-three key emerging markets with data available, there have been only 272 months with negative CPI prints out of a total of 5,520 datapoints.

An analysis of where and when these have occurred provides valuable insights. Taiwan, for example, experienced deflation emerging from the 2001-2 dot-com bust as exports struggled. The 2009 slump following the global financial crises saw falling prices in many export-driven economies, including Chile, China, Malaysia, Taiwan and Thailand. Greece, Hungary and Poland all slipped into deflation following the Eurozone crisis in the 2010s. And the Covid slowdown in 2020-21 saw sustained deflation in many countries, notably Greece, Malaysia, Thailand, Taiwan and Qatar. In short, deflation tends to manifest in export-driven economies facing severe economic and financial conditions, and it carries negative implications for both citizens and investors.

This aligns with other data releases in China, including -14.5% for exports in the year to July, -8.5% year-to-date property investment and weak year-over-year rail freight volumes (+2.6% in the year to July but negative in the previous three months). Additionally, the unemployment rate for 16-24 year olds rose from 16.7% at the start of the year to 21.3% in June, at which point Beijing ordered that it not be calculated any more.

Deflation is particularly problematic for two reasons. Firstly, declining prices make it rational for consumers and companies to defer purchases in anticipation of lower prices. When weak demand is driving deflation, these decisions exacerbate the demand weakness, accelerating the deflationary impetus. Secondly, in economies with high levels of debt, there is the risk of a debt-deflation spiral, where incomes deflate but debt remains constant.

The debt-deflation risk is particularly relevant in China, where non-financial sector credit/GDP has increased by over 100 percentage points in the last ten years, reaching nearly 300% of GDP. In comparison, India's numbers are -7 percentage points and 173% of GDP, while Brazil's are 45 percentage points and 173% of GDP. Serious deflation in China would pose a substantial economic risk to borrowers, and consequently, lenders as well.

What remains unusual compared to other emerging markets is the policy response. In both 2009 and 2020, many emerging market governments adopted aggressive fiscal and monetary policies to support demand and stave off deflationary slowdowns. Some emerging markets have seen strong policy responses to even the threat of deflation. In 2019, as Korean CPI inflation approached zero, the government prepared a fiscal easing of 9.1% of GDP to ensure that the debt-laden Korean economy did not face a debt-deflation spiral. Beijing continues to merely tinker at the edges, with policy rates cut 15bp in August.

These comparisons are further evidence of the basic problem in China, which is more political than economic in nature. The policies responsible for generating significant financial stress in private sector real estate developers, instilling confidence crises in consumers and companies, the policies that have led to a slow-burning trade war with the United States, and the underwhelming monetary and fiscal responses to the economic slowdowns are all products of political choices. In the last few years, and particularly since President Xi Jinping achieved a dominant political position in October 2022, the direction of Chinese policies has not been favourable to economic growth or financial markets. Without a substantial shift in the direction of these political choices, China's economy will continue to be susceptible to slowdowns, deflation and increasing risk. Therefore, we remain underweight Chinese equities in the portfolio.

Source for all data JOHCM/Bloomberg (unless otherwise stated). Portfolio holdings are subject to change at any time and are not recommendations to buy or sell any security. A list of all holdings during the period is available upon request.

RISK CONSIDERATIONS:

The Fund invests in international and emerging markets. International investments involve special risks, including currency fluctuation, lower liquidity, different accounting methods and economic and political systems, and higher transaction costs. These risks typically are greater in emerging markets. Such risks include new and rapidly changing political and economic structures, which may cause instability; underdeveloped securities markets; and higher likelihood of high levels of inflation, deflation or currency devaluations.

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