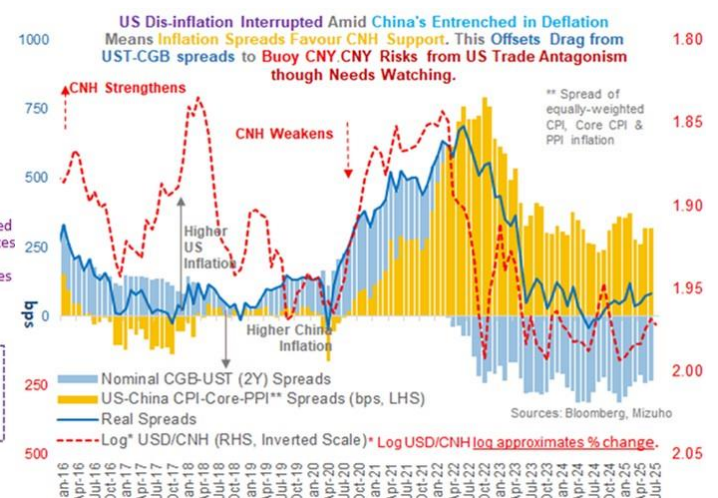
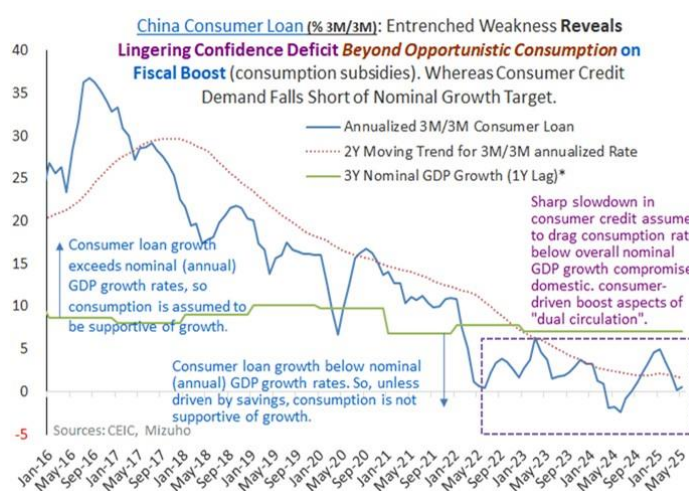


China Drenched in Deflation

“An optimist will tell you the glass is half-full; the pessimist, half-empty; and the engineer will tell you the glass is twice the size it needs to be.” – Oscar Wilde

In a Nutshell:

- Despite the unexpected positive turn in China's CPI, backed by improved in consumer spending, **China remains drenched in deflation.**
- This is **merely a function of industrial (capacity), household, and geo-economic realities/risks conspiring.**
- For a start, **consumer confidence is flattered by fiscal support**, whereas underlying income/job prospects remain tentative at best.
- What's more, the **balance sheet blow to confidence from property is far from resolved.**
- **Crucially**, industrial deflation has only deepened.
- And with **massive over-capacity exacerbated by US assaults on Chinese industry**, deflationary forces threaten to entrench.
- **CNH though ought to be backstopped** on *constructive inflation spreads offsetting the drag from persistent UST-CGB gap.*
- **But US geoeconomic risks** remain the **biggest bugbear that can threaten CNH stability** materially. *Especially if the bearish USD cover from “Sell America” is blown.*



- Granted. **China's CPI for June unexpectedly turned positive** (albeit at a glacial 0.1% YoY pace) *flipping expectations of a contraction* of similar magnitude.

- Taken **alongside anecdotal evidence of more enthused consumption** activity, an **optimist might be tempted to stretch the relief of averting deflation to a narrative sustainably attaining inflation**.
- This is *understandable*. *But* it is **flawed**. For all intents and purposes, **China remains drenched in deflation**.
- To be sure, there is **nascent potential to sustain modest consumer inflation**. *But only if fiscal stimulus manages durably revive consumer animal spirits*.
- **But for now**, it is **hard to isolate bona fide confidence** that can independently endure **from opportunistic exploitation of consumption stimulus/subsidies** (e.g. trade-in programs, vouchers, etc.)
- What's more, **wider evidence of self-sustaining job market confidence**, underpinned by *optimism about robust job creation* and *expectations of rising pay* is **some ways off**.
- **Certainly not to the extent** that the **adverse balance sheet shocks from the property market slump may be offset**.
- Crucially, **deepening industrial deflation*** amid **worryingly burdensome excess capacity**), **exacerbated by US assault on China's industry and exports**, speaks to **entrenched deflationary forces**..
- Especially as **squeezed profit margins cascade down to wages and jobs security**, to **permeate consumer confidence**, and **attendant inflationary tendencies**.
- Which also means **consumers will still need low prices to be enticed**, **dampening** (if not hobbling) **efforts to reflate the economy**.
- Finally, **consumer loans struggling well below nominal GDP growth**, *despite having bottomed*, **warn of fragile consumer confidence in spite of fiscal stimulus**.
- What this means is that **consumption will not be the dominant growth driver** of the economy, nor determinant of underlying demand pull,
- Instead, **consumers** remain susceptible to **be swayed by deflationary pressures** from *knock-on effects from growing industrial headwinds* and *lingering property woes*.
- **China's entrenched deflation juxtaposed against US dis-inflation** that is stalling (if not potentially overturned depending on tariff impact) *suggest China-US inflation spread ought to be of CNH* at the margin.
- Especially **more so if the drag on CNH from widening** UST-CGB spreads** are **partially offset by "Sell America"** narratives (that dampen the USD).
- But that said, **left-tail risks threatening CNH stability from US geo-economic antagonism** cannot be dismissed lightly.
- *Especially without the benefit of a bearish USD from "Sell America"*, which is **not guaranteed to sustain** if the US focuses geoeconomic attacks on Beijing.

* June PPI printing -3.6% from -3.3% previously and -3.2% expected.

** Especially as UST yields remain buoyant and/or rise in contrast to sustained pressures on CBG yields.

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