Mizuho Brief: China

Economics & Strategy | Asia ex-Japan

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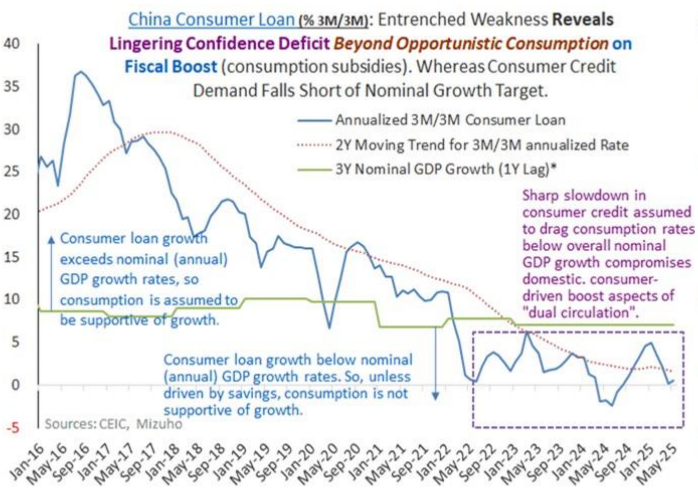
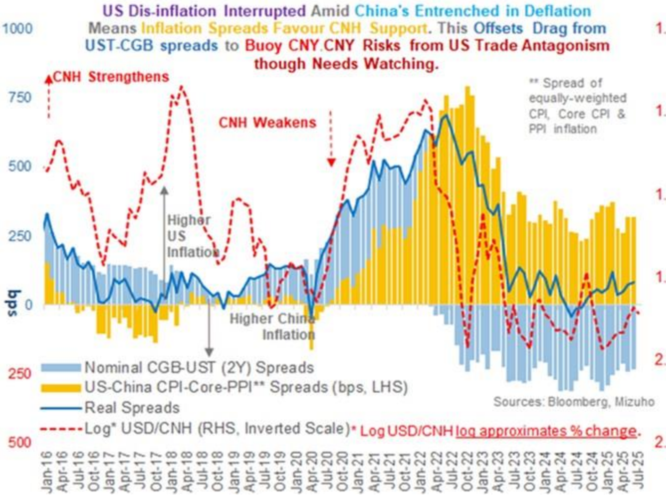
China Drenched in Deflation

"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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