

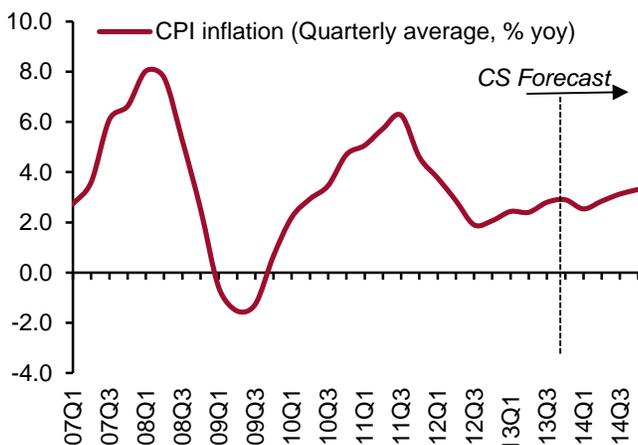
China: We expect lower inflation now

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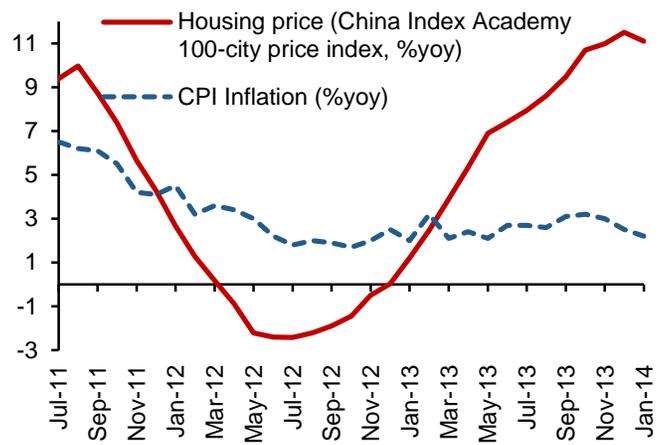
- We revise down our 2014 inflation forecast to 3.0%, from our previous forecast of 4.0%. On the demand side, weaker domestic demand was the main driver behind our recent downward GDP growth revision. Weaker domestic demand should reduce the demand-pull inflation pressure.
- On the supply side, the UN Food and Agriculture Organization forecasts a 6.5% increase in cereal supply for 2013/14 based on the harvest in 2013. This is the highest supply growth since the data were first made available in 2003. This should help to reduce the cost-push inflationary pressure not only on cereal and grain, but also on the down-stream goods in the Chinese consumption basket.
- The PBoC, in latest quarterly monetary policy report, toned down its inflation outlook despite being hawkish on inflationary pressure throughout last year. We are in agreement with the central bank's softer outlook on price pressure.
- The central bank painted a picture of "steady growth, with less inflationary pressure now". In our view, this means the PBoC is in no hurry to ease its stable but tightening biased policy stance, but it does have greater room to ease in the future if necessary.
- Housing prices have seen sequential increases in the past 20 months, with the annual growth rate standing at 11.1% in January. The divergence between CPI and housing prices puts the central bank in a dilemma. A softer inflation outlook is unlikely to change the already reversed credit growth cycle. China is likely to remain on a gradual deleveraging path in 2014.
- We no longer expect hikes in our 2014/15 forecast horizon. But it is important to note that commercial interest rates have already moved beyond our most aggressive expectation of 12 months ago. We expect them to rise further against the backdrop of movement towards a more market-based interest rate framework.

Exhibit 1: We revise down our full year inflation forecasts



Source: NBS, Credit Suisse estimates

Exhibit 2: The divergence between CPI and housing prices puts the PBoC in a dilemma



Source: NBS, Credit Suisse estimates

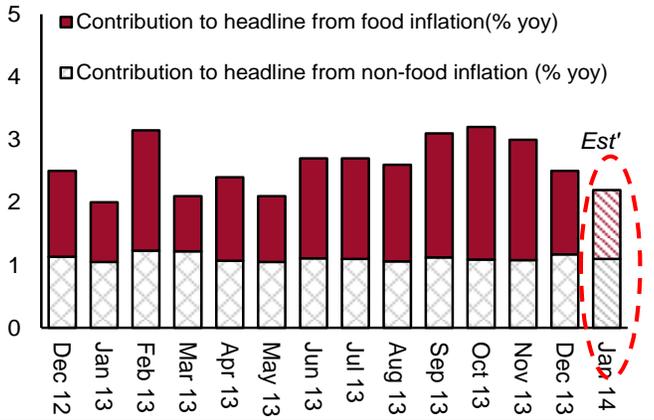
DISCLOSURE APPENDIX AT THE BACK OF THIS REPORT CONTAINS IMPORTANT DISCLOSURES AND ANALYST CERTIFICATIONS.

We expect lower inflation

Start with January

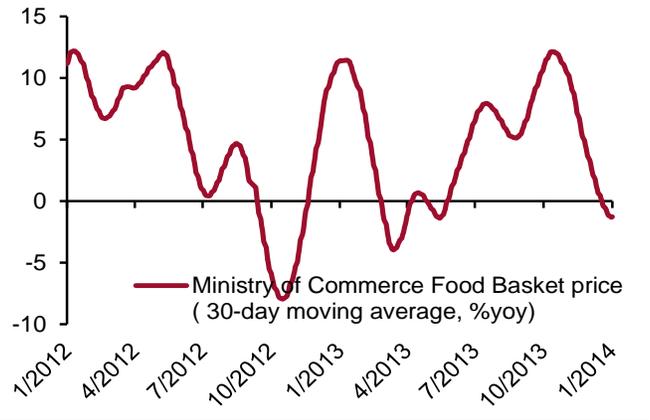
We believe it is likely that January headline CPI inflation will be 2.2% yoy, lower than the prior month's 2.5% yoy and our previous expectation of 3.0% yoy. Such a downward adjustment in headline consumer inflation is being driven by both demand-side and supply-side factors, in our view.

Exhibit 3: Headline inflation is likely to soften to an 8-month low



Source: NBS, Credit Suisse estimates

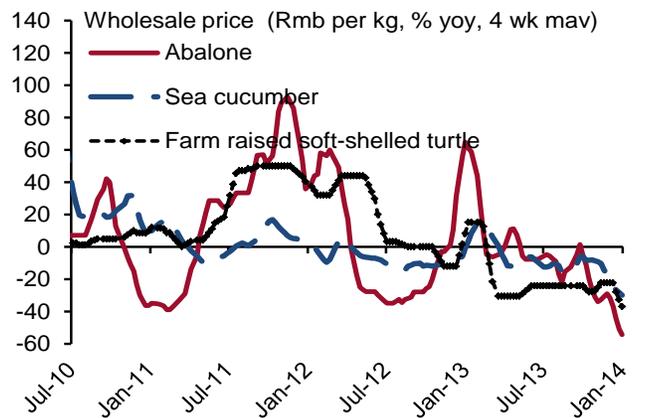
Exhibit 4: Food price inflation remained soft during the festival month



Source: NBS, Credit Suisse

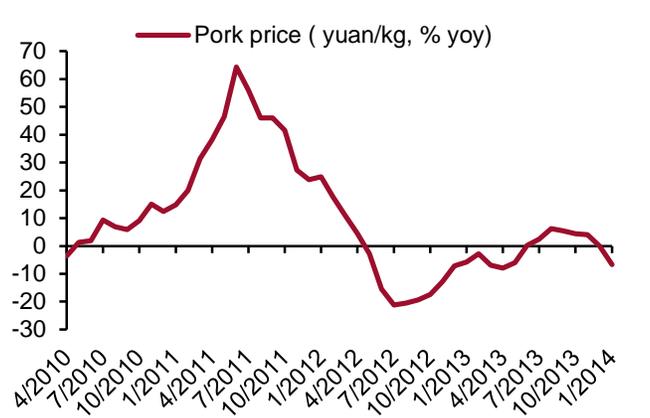
In our recent note [China: Themes for 2014: R³ - Retreat, Reform and Risk](#), we made the observation that sales were particularly weak during the spring festival month. Exhibit 7 shows that Chinese New Year catering and retail sales growth in 2014 hit its lowest level since 2007. **Weak sales should keep overall demand-pull inflation at ease.** The renewed outbreak of H7N9 flu has also hindered meat consumption. On the supply side, farms were expecting the usual pork price increases in the festival season. The rare price drop in the early part of the holiday caused farms to sell off pork stocks, pushing down pork prices further. A warm spring festival has substantially helped the supply of fresh vegetables – the most volatile CPI component. Furthermore, favorable weather and the subsequent improved transportation conditions also helped the supply of consumer goods overall. Thus we expect the inflation to hit an 8-month low of 2.2% yoy in January.

Exhibit 5: Anti-corruption campaign's impact is not only on high-end consumption...



Source: WIND, Credit Suisse

Exhibit 6: ...it was also a key factor behind the rare fall in pork prices during the festival season



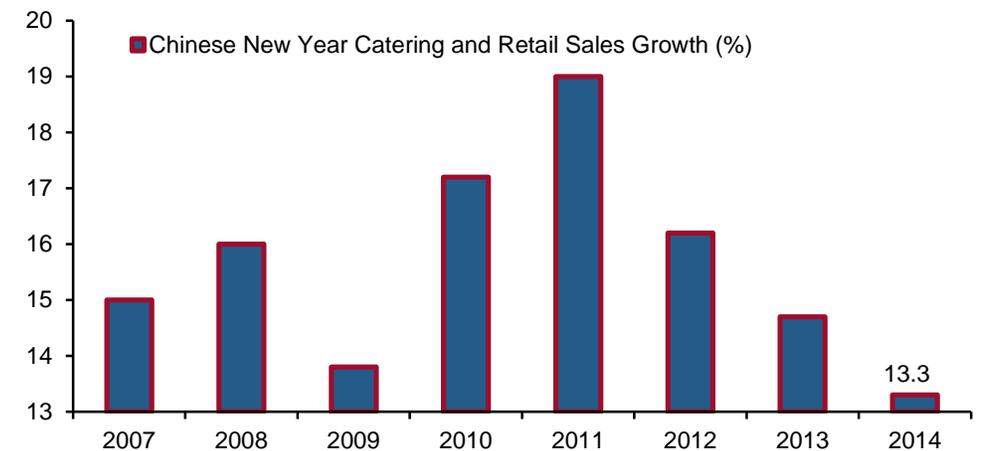
Source: NBS, Credit Suisse

Downward revision to full year inflation forecast

On the demand side: The ongoing anti-corruption campaign is likely to continue to weigh on sales. The downward price impact from the campaign is not only on high-end consumption – its effects have also spilled over to some basic consumer items. On the ground, we used to hear plenty of reports that, in previous years, many SOE and local government employees received actual basic consumer goods as part of their benefits during festival seasons. The anti-corruption campaign has put a ban on this type of hidden benefit in SOEs and government institutions. This year, anecdotal evidence suggests substantial slumps in bulk buying orders from SOEs and government units. Below, we attempt to explain how the anti-corruption campaign has affected the most basic consumption good – pork.

The shift of focus from growth stabilization to reform initiatives is likely to lead to softer investment activities by SOEs and local governments. Recently, we revised our 2014 GDP growth forecast to 7.3% from our previous forecast of 7.7%. Weaker domestic demand was the main factor behind the GDP revision, and should also mean less demand-pull inflation pressure in the economy in 2014.

Exhibit 7: Sales growth this Chinese New Year was particularly weak



Source: The Ministry of Commerce, Credit Suisse

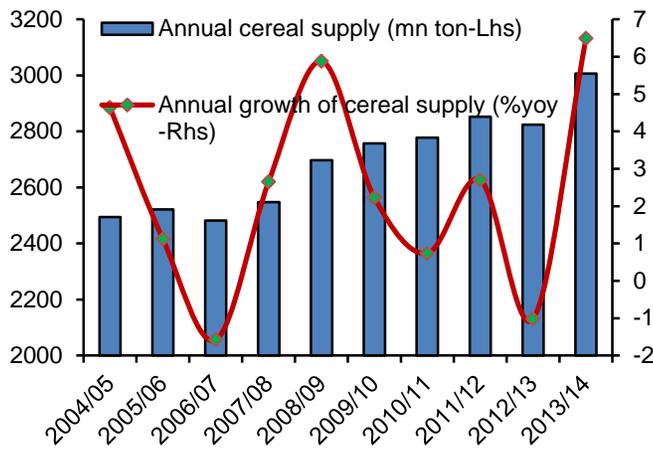
Exhibit 8: Our weaker domestic demand expectation led to our recent downward revision to our GDP growth forecasts, but it should help to reduce demand-push inflationary pressure

China – GDP growth forecasts (%)

	YoY		QoQ SA		SAAR		Annual	
	Previous	After	Previous	After	Previous	After	Previous	After
1Q14	7.7	7.3	1.8	1.5	7.4	6.0		
2Q14	7.7	7.3	1.9	1.8	7.9	7.4		
3Q14	7.8	7.4	2.1	1.9	8.6	7.8		
4Q14	7.7	7.4	1.8	1.9	7.6	7.8	7.7	7.3

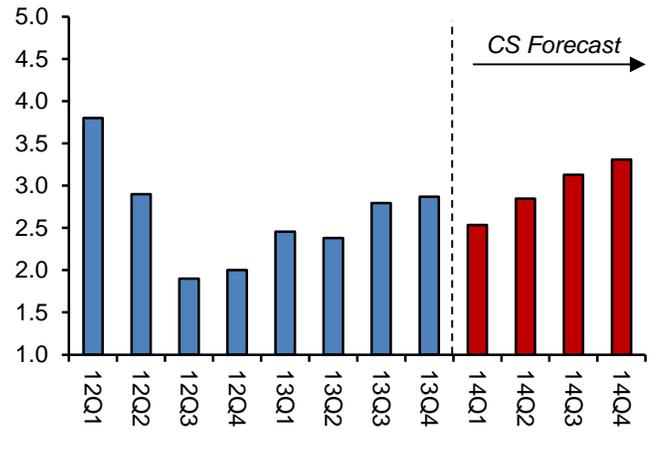
Source: Credit Suisse estimates

Exhibit 9: Cereal supply is expected to jump to its highest growth rate, helping food supply in general



Source: The UN Food and Agriculture Organization, Credit Suisse

Exhibit 10: On balance, we expect lower annual inflation



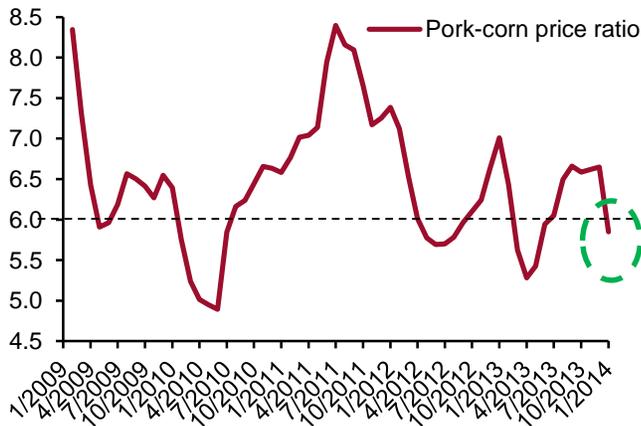
Source: NBS, Credit Suisse

On the supply side: We have seen a year of record global cereal harvests in 2013. Based on the 2013 full year realized harvest and the early prospects for crops to be harvested in 2014, the FAO forecasts a 6.5% increase in cereal supply. This would be the highest supply growth since the data were first made available in 2003. The surge in supply given a relatively stable demand dynamic is likely to help to keep cereal prices stable. Directly, grains and cereals count for about 4% of China's CPI basket. Indirectly, cereals provide the key upstream input for animal husbandry. Thus, we believe the good global harvests are likely to help meat production and stabilize meat prices.

The pork factor: Pork prices are a key factor behind Chinese inflation volatility. In 2013, pork prices saw a 13.3% increase from June to December, contributing to the higher headline inflation in 2H13. But we saw a 2.2% mom (6.6% yoy) drop in pork prices in January. This was the first festival decline in pork prices in 10 years. The usual pattern of the pork cycle seems to be changing.

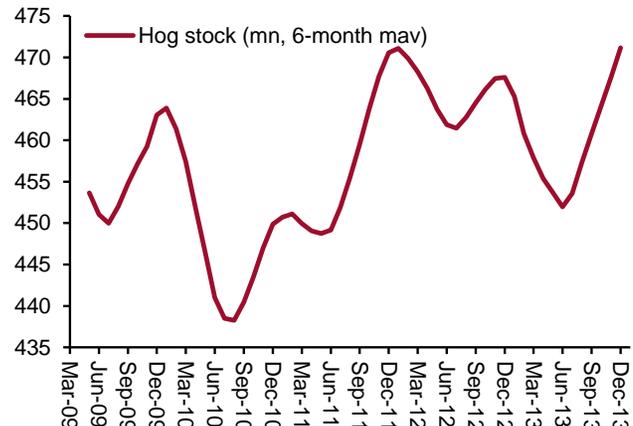
In our view, the spill-over effects from the anti-corruption campaign are one of the most significant factors behind the change in pork price dynamics. On the ground, we have heard reports suggesting a substantial slump in bulk buying orders from SOEs and government units for the traditional festival goods of 'La Chang' (Chinese preserved pork sausage) and 'La Rou' (Chinese preserved pork). This pulled down demand for pork substantially in our view. In addition, the renewed outbreak of H7N9 cases also hindered the appetite for meat consumption. Thus, pork prices failed to increase as the festival period started. Given the poor price performance in what is usually the best month, pork farms started to 'sell off' their stock. This increase in supply pushed down prices further. The first half of the year usually is the low demand season for pork, assuming no external supply shock, and it is unlikely that we will see a significant increase in pork prices in 1H14. Demand for pork is likely to pick up again in 2H14, in which case it is likely that pork prices will increase again. But we expect the anti-corruption campaign to continue to weigh on downstream demand for pork related products and catering services from SOEs and government units. Thus, assuming no external shocks, such as diseases, we are unlikely to see a surge in pork price inflation and volatility this year, in our view.

Exhibit 11: Farms were forced into loss as pork prices did not increase during the usual high season



Source: The NDRC, Credit Suisse

Exhibit 12: Hog stocks stayed high entering the festival month



Source: The Ministry of Agriculture, Credit Suisse

PBoC's 4Q monetary policy report: The central bank appears to be de-emphasising inflationary pressure in its latest report (for details, please see: [Asian Daily: China Economics - Higher emphasis on local debt and less on inflation in the 4Q PBoC report](#), published on 10 February 2014). It did point to agricultural products and the service sector for the pricing pressure and warned about the rise in housing prices, but the central bank seems to be tuning down its concerns over rising inflation, compared to previous reports. It cited stable growth, a steady monetary environment, the output gap and the statistical base as factors in favour of a “broadly stable CPI outlook”. The PBOC was more hawkish on the inflation outlook throughout last year, but that view seems to be wavering now. We are in agreement with the central bank's softer outlook on price pressure.

Inflation forecast change: We revise down our 2014 inflation forecast to 3.0%, from our previous forecast of 4.0%. We expect headline inflation to stay below 3.0% in the coming few months. Headline CPI may start to rise above 3.0% towards the mid-year. For 2015, we revise down our inflation forecast from our previous expectation of 4.1% to 3.5% yoy. On the other hand, rental cost inflation and service inflation are likely to stay on their upward trends. This makes overall inflation sensitive to external supply shocks, especially from the food basket. Recently, the US has reported diseases on some of its pork farms. If pork supply side shocks occurred in China, CPI inflation could still surge to a persistent high level, as we observed in previous cycles.

Exhibit 13: Revisions to inflation forecasts

	Previous forecasts	Current forecasts
1Q14	3.9	2.5
2Q14	4.0	2.8
3Q14	3.8	3.1
4Q14	4.0	3.3
2014 Full Year	4.0	3.0
2015 Full Year	4.1	3.5

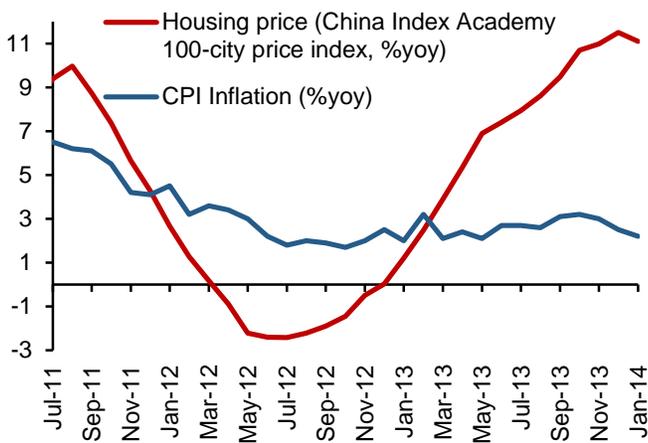
Source: Credit Suisse

Policy implications

In its latest quarterly (4Q13) monetary policy report, the PBoC maintained a tone similar to that of the 3Q report which stated it was following a stable policy stance (neutral) but also indicated a desire to drain liquidity mildly to maintain a balance in the monetary environment. It cited stable growth, a steady monetary environment, the output gap and the statistical base as the factors in favour of a “broadly stable CPI outlook”. **Overall, the PBoC painted a picture of "steady growth, with less inflationary pressure now"**. In our view, this means the PBoC is in no hurry to ease its stable but tightening biased policy stance, but it does have greater room to ease in the future if necessary.

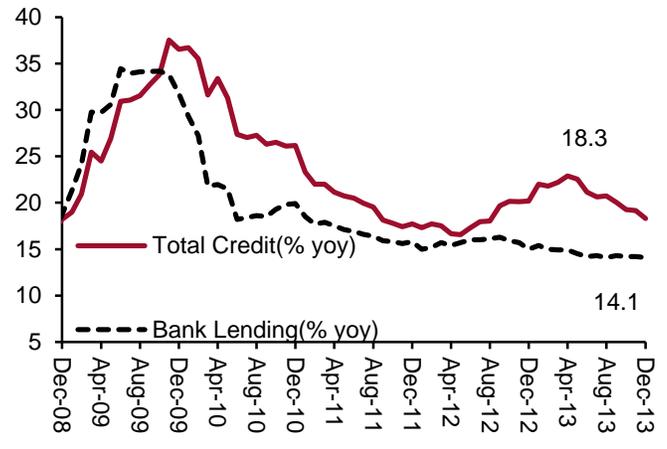
Housing prices have seen sequential increases in the past 20 months, with the annual growth rate standing at 11.1% in January. The divergence between CPI and housing prices puts the central bank in a dilemma, in our view. However, we believe that, despite this, the central bank might have the room to slow down its pace of liquidity withdrawal if necessary. But the softer inflation outlook is unlikely to change the already reversed credit growth cycle. China is likely to remain on a gradual deleveraging path in 2014, in our view.

Exhibit 14: The divergence between housing prices and inflation puts the central bank in a dilemma



Source: NBS, China Index Academy, Credit Suisse

Exhibit 15: We expect credit growth to stay in a down-cycle



Source: Credit Suisse

Upward adjustments in interest rates might be pushed further down the road, and we no longer expect policy rate hikes in our 2014/15 forecast horizon. But it is important to note that commercial interest rates have already moved up to a level beyond our most aggressive expectation of 12 months ago. We expect commercial interest rates to stay high against the backdrop of movement towards a more market-based interest rate framework.

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