



China and India's contrasting inflation front

One faces deflationary pressures, while the other copes well with elevated inflation

We explore the opportunities and risks emanating from China's near-zero inflation and India's above-average consumer prices.

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The implications of inflation

Inflation—the increase in the general price level of goods and services in an economy over a timeframe—has become one of the most closely watched economic gauges in recent years as consumer prices hit record highs.

Besides bearing significant influence on standards of living, economic growth and the direction of interest rates, inflation also has significant implications on the top-down development of countries as well as the bottom-up fundamentals of companies.

On a top-down basis, inflation signals the strengths and weaknesses in the overall economy and drives the policies and responses of governments and central banks, either being supportive or restrictive. From a bottom-up perspective, inflation signals whether certain industries have the pricing power to pass on the changes in costs and to generate sustainable returns from future investments.

In other words, inflation encapsulates changes in both the overall economy and the operating metrics of a company. Moreover, inflation can have political implications, particularly in the developing world, as it is often a key issue in elections and can impact the popularity of elected politicians. That is why investors in the emerging markets often pay close attention to the general development of consumer prices, plus the outlook of inflation. Indeed, how a government navigates inflation often affects future investment returns.

In this article, we compare and contrast two of emerging Asia's largest economies, China and India, through the lens of inflation. Today, China and India face opposite inflationary pressures, which could alter the outlook for these two large emerging economies. Inflation in China is close to zero, while that of India is above 6% (as of August 2023).

Year-to-date (YTD), as at end-September 2023, the renminbi has depreciated more than 5% against the US dollar (USD), whereas the India rupee is flat versus the greenback. Equity markets also seem to be rewarding one and punishing the other; Indian equities (as measured by the MSCI India Index) were up 8.0%, in USD terms, on a YTD basis (as at end-September 2023), while China stocks (as measured by the MSCI China Index) were down 7.3% YTD.

China faces deflationary pressures

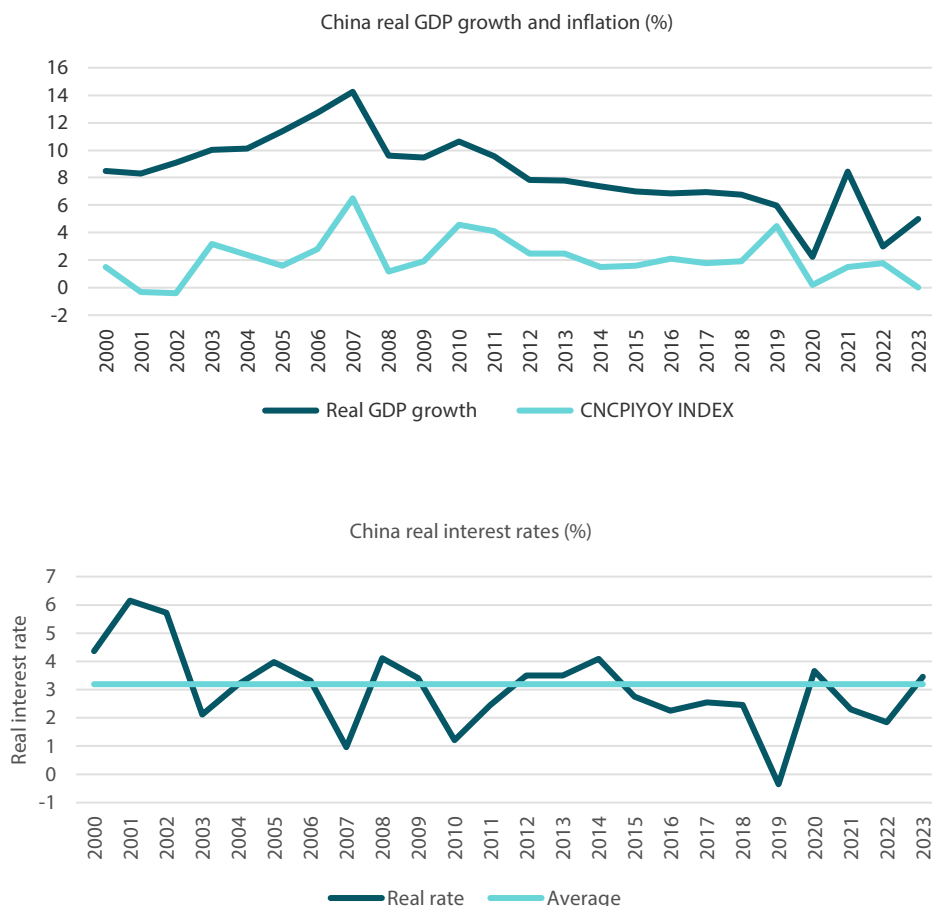
Let us begin with a close look at China. Concerns that China could be facing a deflationary spiral arose when the country reported that consumer inflation dropped by 0.3% YoY in July, the first decrease since February 2021. Since then, consumer prices in the world's second largest economy have moved higher, rising by 0.1% YoY in August, allaying fears a persistent deflationary trend in the nation.

Headwinds from falling property prices and the decline in construction activity due to its ailing real estate sector are likely to cause more lingering deflationary pressures, in our view.

Very low inflation or deflation can directly impact consumer behaviour. First, it can lead to a decrease in consumer spending as consumers may delay purchases in anticipation of lower prices in the future. This can lead to decreased economic growth and job creation. Second, low inflation can compound the debt burden. As the real value of debt increases due to the lack of inflation, this could lead to increased financial stress for households and businesses. At the same time, low inflation can discourage investments as investors may seek higher returns in other countries with higher inflation rates. And if subdued inflation persists for an extended period, it can lead to a deflationary spiral where prices continue to fall, potentially leading to a long-term economic stagnation.

The big picture is that Chinese economic growth has been on a declining trajectory since the 2008 Global Financial Crisis (GFC). Having said that, if China were to achieve its government's targeted GDP growth of 5% for 2023, that would still be a decent result for a maturing economy (see Chart 1 for China's real GDP growth, inflation and real interest rates).

Chart 1: China's real GDP, inflation and real interest rates



Source: Bloomberg, August 2023

More broadly, China currently faces several structural issues. It has negative population growth, a heavy debt burden in certain areas (namely property), an oversupply of goods, weak export markets and tight monetary policy.

China's monetary policy has historically been on the tighter side, averaging 3% in real interest rates. Despite its recently flagging economy, China's current real interest rates still stand at 3%. There have been times when real rates in the country were lower, such as during the GFC and around the period of global economic weakness of 2015.

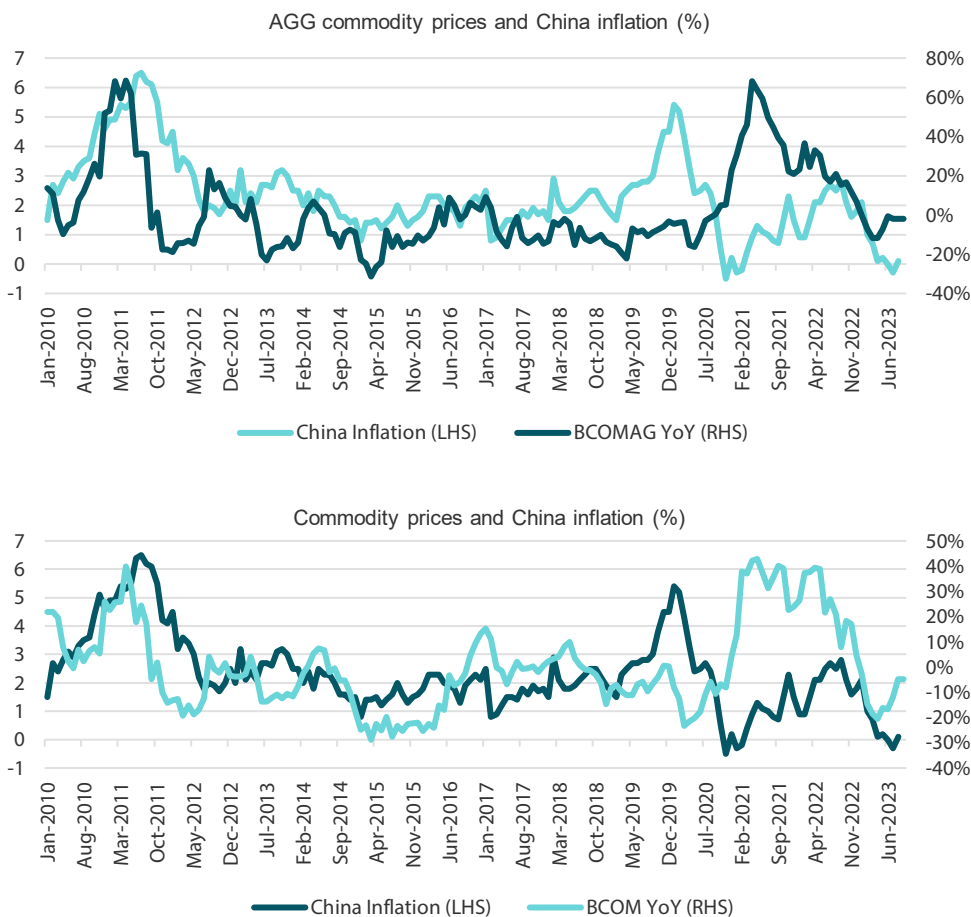
This time around, the People’s Bank of China (PBOC) is using alternative measures, like cutting mortgage rates incrementally and reducing banks’ reserve requirements to boost overall liquidity. In our view, the Chinese government and the PBOC need to do more to stimulate the economy. Monetary policy loosening at a drip-feed speed is not creating a positive environment for the Chinese markets. Indeed, consumer and investor confidence in China is fading. Portfolio flows are negative and foreign investors are net sellers of Chinese equities.

Nonetheless, it is not all bad for the world’s second largest economy on the inflation front. One of the positives is that China is still seeing some inflation on the services side, which accounts for 40% of the inflation basket. Services-related inflation is rising at 1.3% on average, compared to overall consumer inflation at 0.1% YoY (as at August 2023). Historically, China’s services-related inflation had hovered between 2–3%. During the COVID-19 lockdowns, it fell below zero. A rise in services consumer price index (CPI) is good for the overall inflation picture in China, which is growing more slowly in recent years and whose growth is largely due to government spending. All in all, China needs inflation to move higher.

Higher commodity and agriculture prices could lead spur Chinese inflation

Going a step deeper into the drivers of inflation in China will show that agriculture prices (namely those of soybean and pork) and commodity prices (including hydrocarbons, which are the main components of oil and natural gas) are closely related to the direction of inflation in the country (see Chart 2). As such, rising commodity prices and higher agricultural prices could pose an upside risk to inflation in China. A surge in China’s inflation in 2019, for instance, was partially attributed to the outbreak of swine flu in 2018, which caused an increase in pork prices amid a drop in supply.

Chart 2: China’s inflation and commodity prices move in tandem



Source: Bloomberg, August 2023

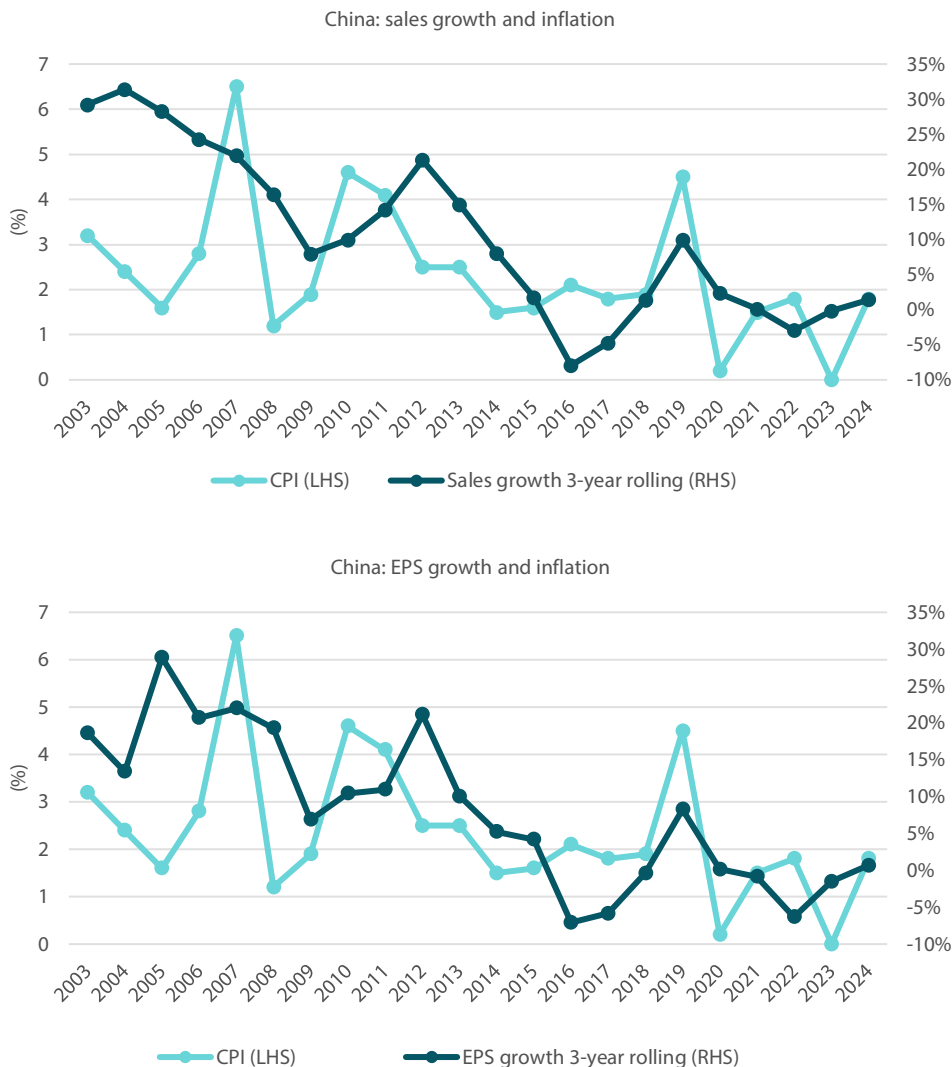
COVID-19 further distorted the time series of inflation in China. Since the country’s re-opening earlier in 2023 (and the absence of disease or other disruptions to supply), agriculture consumer prices look to have bottomed. Agriculture inflation in China is trending around 2% and could lift overall Chinese CPI. The same is true of rising commodity prices.

Oil prices have recently risen above USD 90 per barrel. China imports around 59% of its oil needs, making it the largest oil importer globally, and higher oil prices will support inflation in the country. There is, however, a risk of stagflation if rising commodity-driven inflation is accompanied by low growth. Indeed, without productivity gains or other spending increases, inflation without growth for China may be problematic for the world's second largest economy.

Chinese inflation and its impact on equity markets

The Chinese equity market, as measured by the MSCI China Index, is trading close to the lowest price earnings (PE) multiples in 20 years, with very low growth priced in by the market. During the 2010-2015 period, equity valuations in China fell with declining inflation. Over that period, the market return in China averaged 1.5% on an annualised basis. Without dividends, it was negative. Today, China is once again experiencing a period of low and declining inflation, which coincides with the downturn of its equity market. However, if Chinese inflation starts to rise due to higher agriculture and commodity prices and looser monetary policy, we do expect a better showing for China stocks. This is because corporate sales and earnings per share (EPS) growth rates tend to have a positive correlation with inflation (see Chart 3).

Chart 3: China's corporate sales and EPS growth are positively correlated with inflation



Source: Bloomberg, August 2023

Earnings growth in China has been decelerating since 2005 and hit bottom in 2016, when China implemented a massive monetary stimulus that lifted global equity markets and Chinese earnings. The effects of that stimulus have worn off, and the Chinese equity markets are now back to the lows of 2016. Chinese earnings growth is in a difficult position; it needs a forthcoming and large stimulus, which, in turn, will help lift inflation in the country.

After China’s last set of quarterly results, earnings revisions for 2023 and 2024 were negative; growth expectations, though positive, are also falling. We have looked at the annualised three-year sales growth of corporate China, working under the assumption that it takes time for inflationary pressures to work through a company’s operations. Our expectations are for Chinese inflation to rise to 2% in 2024 and sales growth to follow suit. If that materialises, it would be a good result for Chinese earnings growth. All things considered, the Chinese equity market needs a source of higher profitability, and rising inflation, amongst other factors, could be key to invigorate profit levels.

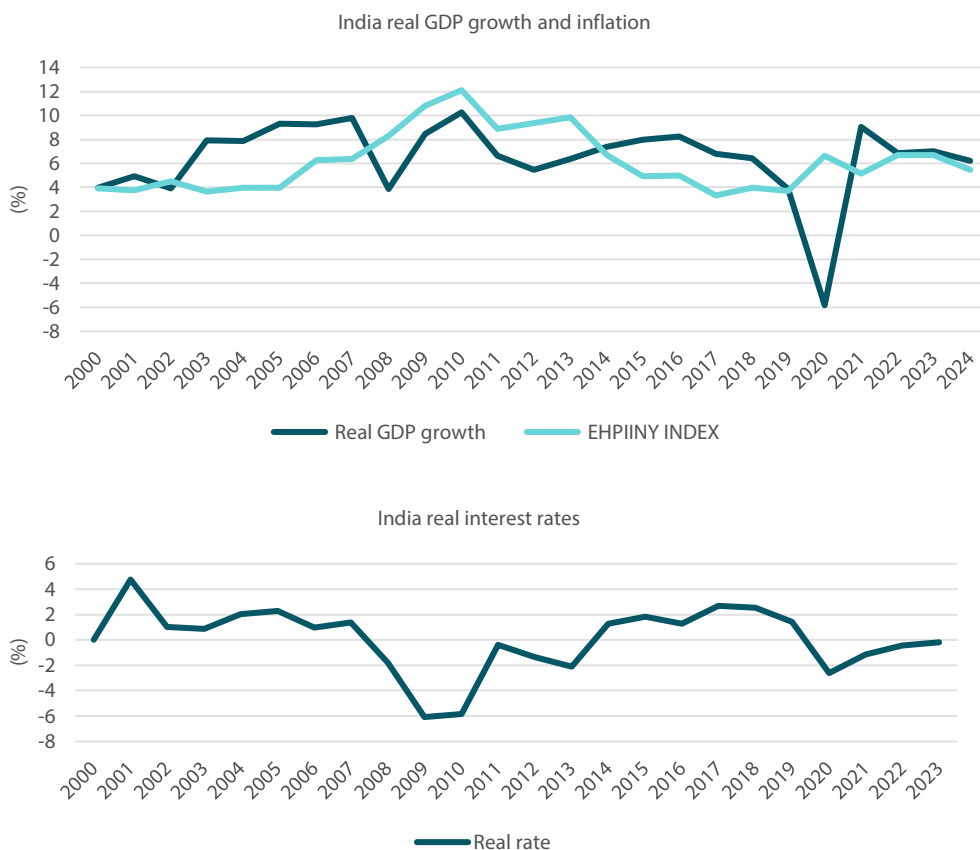
India at a sweet spot

Viewed through the lens of Inflation, India is at the opposite end of where China is. India’s Inflation, while above the Reserve Bank of India (RBI)’s target of 4%, isn’t looking too elevated, as compared to its historical averages. Inflation in India has slightly eased to 6.83% YoY in August (from 7.44% in July) and is currently in line with the country’s average annual inflation rate, which over the past few decades has been around 6–7%.

As we see it, the Indian central bank remains accommodative, keeping real rates close to zero. The country’s political climate is pro-business. The government of Indian Prime Minister Narendra Modi is in its third year of running large budget deficits, and with the coming general elections in 2024, the administration is unlikely to tighten its budget strings in the foreseeable future.

At the same time, high oil prices have yet to hit the Indian economy, which is still relying on cheap Russian oil. India’s annual GDP growth has hovered steadily in recent years, generally between 6% and 10%, while inflation has moved around the same levels as GDP growth (see Chart 4). India is in a sweet spot at the moment as inflation is trending lower, yet it is at a faster rate than GDP growth.

Chart 4: India’s real GDP, inflation and real interest rates



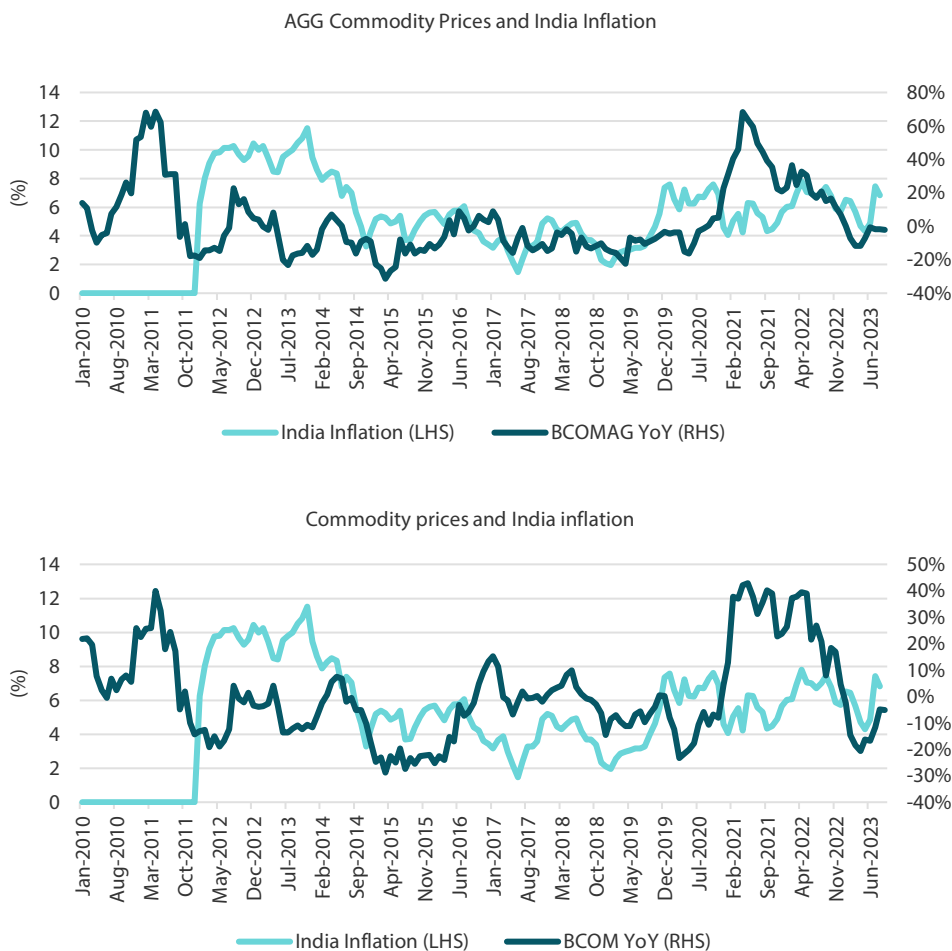
Source: Bloomberg, August 2023

The RBI tends to keep a closer eye on real GDP growth than inflation. In times of rising real GDP growth, the central bank has tightened monetary policy and loosened policy during periods of declining GDP growth. Expectations are for the RBI to continue to be accommodative, given that there are elections in 2024.

Future agriculture prices key to India’s inflation

India’s inflation basket is heavily weighted towards food, which makes up almost 37% of the CPI basket, while fuel comprises 5–6% of the total. Agriculture prices, on a YoY basis, have flattened, giving respite to inflationary pressures in India (see Chart 5). If there are any shocks to the global food supply, from either an escalation of the Ukraine-Russia war or from weather-related events, that could be a potential risk to inflation in India. Overall commodities, though rising largely because of higher oil prices, do not have that much of an impact on inflation in India.

Chart 5: India’s intertwined Inflation and commodity prices



Source: Bloomberg, August 2023

The Indian equity market and its link with inflation

In India, the earnings yield, which is the inverse of the PE multiple, tends to move in tandem with inflation. During the commodities super cycle at the turn of the century, the Indian stock market did very well as inflation trended higher and valuations rose. Today, the environment looks similar. Inflation is high, growth expectations are rising and the market is starting to perform well.

India’s earnings growth, which is reaching historic highs, could mean persistently higher inflation. However, stand-alone valuations in the country are not excessive and rising rates haven’t dampened investor sentiment. Relative to cash, equity valuations look fair, our view.

Likewise, sales and earnings growth in India, historically, have had a fairly good relationship with inflation. In the post pandemic period, we have seen a divergence, however. Inflation has flattened and is expected to decline over 2024,

while both sales and earnings are expected to continue to rise. Still, we reckon that if the country's sales and earnings were to remain strong in 2024, that would be supportive of higher rather than lower inflation.

All in all, the Indian equity market looks well-placed with inflation under control, supportive monetary and fiscal policies. And with investors looking for alternatives to China, the uptrend in the India equity market could last for a while. Overall, the Indian equity market is pricing in a longer growth cycle; earnings growth expectations remain high, while strong macro tailwinds should continue to support the corporate sales and earnings rebound.

Key takeout



- In China, inflation is at near-zero levels, and the country faces deflationary pressures.
- We believe that earnings expectations need to be adjusted lower in China, while the debt-fuelled growth and debt-supported return on equity is a thing of the past.
- In our view, the Chinese government and the PBOC need to do more to stimulate the economy, and China needs inflation to move higher.
- If inflation in China starts to rise due to higher agriculture and commodity prices and looser monetary policy, we do expect a better showing for China stocks.
- In India, inflation, while above the RBI's target of 4%, is not looking too elevated, as compared to its historical averages.
- Strong macro tailwinds are expected to continue to support the sales and earnings rebound in India.
- Government policies, both fiscal and monetary, are accommodative, with the RBI keeping real rates close to zero.
- But higher commodity and agriculture inflation could pressure earnings growth by late 2024.

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