

Inflation Pressure Rising Amid Output Gap Closing

- **China's Mfg PMI (CFLP) rose to 56.6 in December from 55.2 in November. HSBC Mfg PMI rose to 56.1.**

The input prices sub-index jumped 3.3 points to 66.7 in December, indicating the prices of industrial materials are rising rapidly. In addition, backlog of orders also rose to 52.4 in December from 50.9 in November, signaling labor cost may continue to rise. Inflation in China may start to accelerate soon.

- **China's Service PMI (CFLP) surged 5.2 points to 57.5 in December.**

Led by the heating up of the construction sector, the new order sub-index jumped to 53.4 from November's 49.1. In addition, both the inter-mediate input price and entrepreneurs' expectation sub-indexes rose above 60, raising concerns about possible economic overheating.

Date	Data to be released in the coming week
1/4/2010	HSBC Mfg PMI
1/5/2010	Production Material Market Distribution Price Index (PMMPI) Agri-food Price Index
1/6/2010	China Coastal Bulk Freight Index
1/8/2010	China Containerized Freight Index



Dan Zhou

dzhou@cebm.com.cn

Robert Zhang, CFA

rzhang@cebm.com.cn

Steve Chen

ychen@cebm.com.cn

Han Wang, Ph.D.

hwang@cebm.com.cn

Yongyuan Qiao, Ph.D.

yqiao@cebm.com.cn

Disclosure

CEBM research reports are published solely for informational purposes for qualified investors. Nothing in this report constitutes a representation that any investment strategy or recommendation contained herein is suitable or appropriate to a recipient's individual circumstances or otherwise constitutes a personal recommendation.

Summary

Under PBoC's "relatively loose" monetary policy, China's domestic loans have surged by almost 35% and M1, M2 by 34% and 30% respectively over the past 12 months. Historically, China's money supply leads CPI by 6-9 months. However, up to now the inflation is still in a relatively low level thanks to the existence of output gap especially in the export sector.

The general consensus is that the over-capacity problem in the export sector will last for a considerable long period of time during the post-crisis era, which in turn will hold the domestic labor cost at a low level and contain the inflation in a controllable range.

However, we argue that because the production capacity of the export sector stopped expanding since the outburst of the global financial crisis, it will only take another 1 to 2 quarters before the capacity utilization in the export sectors reaches maximum. With the capacity utilization in heavy industries already at maximum, China's overall output gap will disappear very soon. The Linkage between the surging of money supply and the rising of consumer prices will re-open soon.

According to our quantitative model, China's CPI could breach 5% Y/Y by the end of first half in 2010. **The risk of possible high inflation may force the government to tighten its monetary policy sooner than expected.**

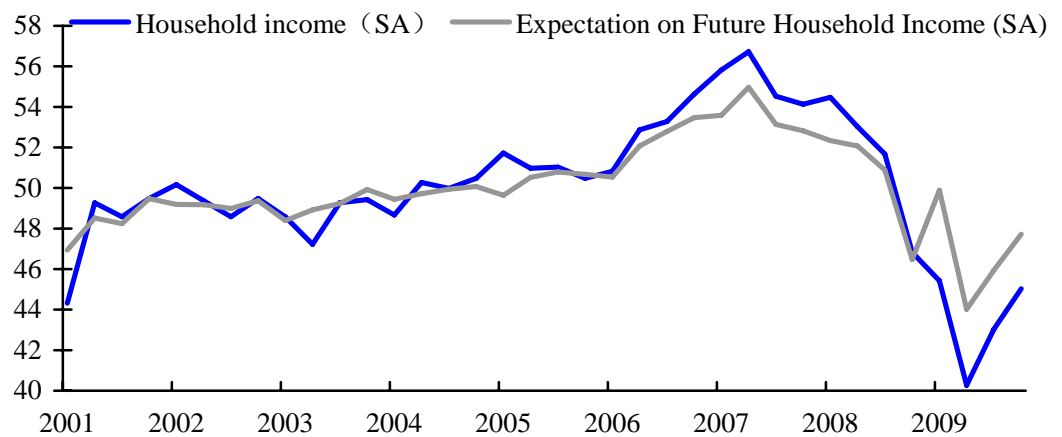
	4Q09F	1Q10F	2Q10F	3Q10F	4Q10F	Y2009F	Y2010F
Urban FAI (YoY, %)	30.0	24.2	26.3	24.6	21.8	33.0	24.0
Export (in USD, YoY, %)	-5.6	22.5	22.5	17.5	17.5	-16.0	20.0
Import (in USD, YoY, %)	2.0	37.0	23.3	16.0	21.3	-15.2	24.0
Consumer Retail Sales (YoY, %)	15.2	15.0	17.7	17.7	15.0	15.1	16.4
VAI (YoY, %)	14.5	15.5	14.7	14.1	13.5	10.2	14.5
CPI (YoY, %)	0.4	1.5	3.7	4.2	3.0	-0.8	3.0
PPI (YoY, %)	-1.5	4.2	5.4	4.2	4.0	-5.2	4.4
Loan Interests Rate (1yr, %, End of Period)	5.31	5.31	5.31	5.58	5.85	5.31	5.85
Deposit Interests Rate (1yr %, End of Period)	2.25	2.25	2.25	2.52	2.79	2.25	2.79
GDP (Real, YoY, %)	10.5	11.8	10.5	9.5	8.5	8.5	9.9

Survey Show Rising Inflation Expectation

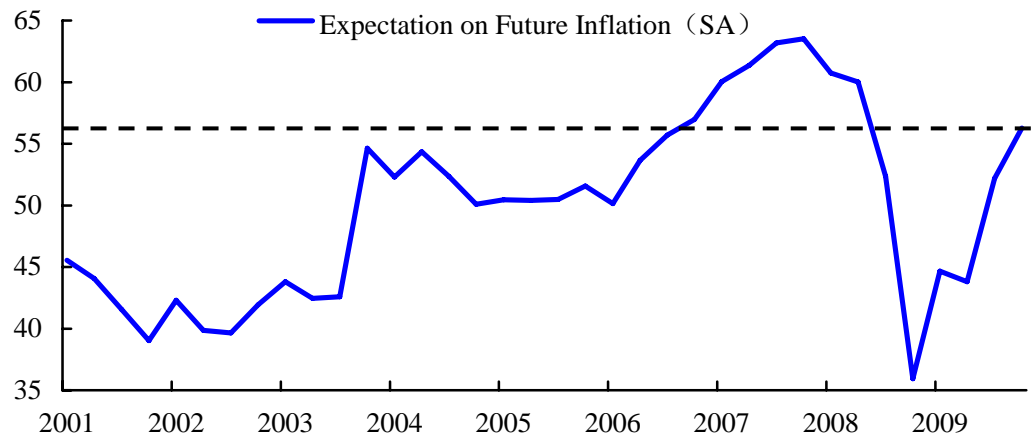
According to the survey conducted by PBoC, 45% of the families surveyed reported increasing household income and 47.7% expect the household income will continue to rise in the future. In addition, the percentage of families expect price to rise jumped above 56%, a level that was first reached in 4Q06 which was followed by a 15-month-long CPI hiking.

The astronomical domestic loans offered by banks have started to raise concerns since the beginning of 2009. However, because of the existence of output gap mainly caused by the capacity utilization in the export sector, China's inflation has been contained in a low level up to this point. In order to make forecast the future movement of consumer prices, we need to know just how long it will take until the output gap to close.

Survey conducted by PBoC suggests that household income may continue to rise.



Consumer's inflation expectation has jumped to a level first reached in 4Q06, which was followed by a 15-month-long CPI hiking.

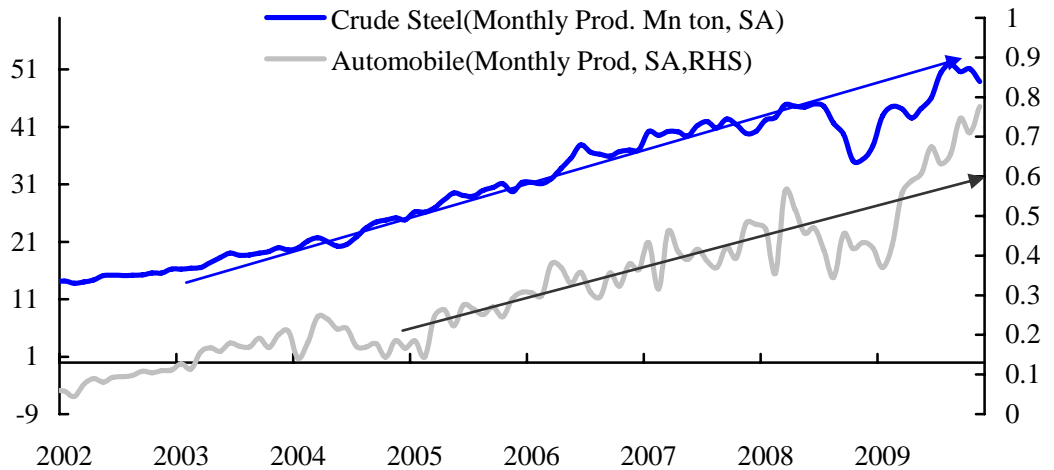


Heavy Industry Back to Trend Line

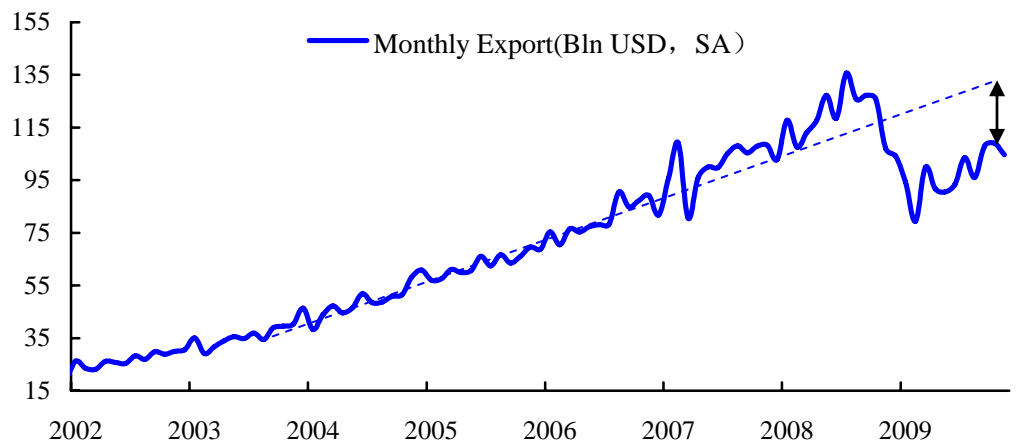
Since the beginning of 2009, China's heavy industry has bounced back strongly thanks to the government's 4-trillion-yuan stimulus package. Crude steel production has rose back to its trend line thanks to the large amount of government-led infrastructure investments, and the production of automobiles has grown above its long-term trend line under the purchasing tax cut.

On the other hand, because of the weak external demand, the recovery of China's export sector is much slower. The monthly export value is still way below its long-term trend. However, we believe that the capacity utilization in export sector will reach maximum much earlier than the export value returns to its long-term trend.

Crude steel production has returned its long-term trend. Automobile production has been above trend.



Monthly export still way below long-term trend. But it doesn't necessarily mean we are far away from capacity utilization recovery.



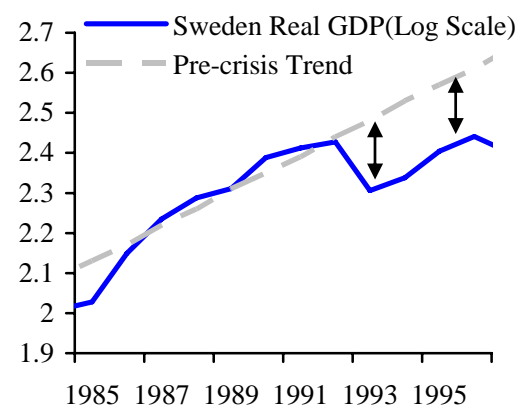
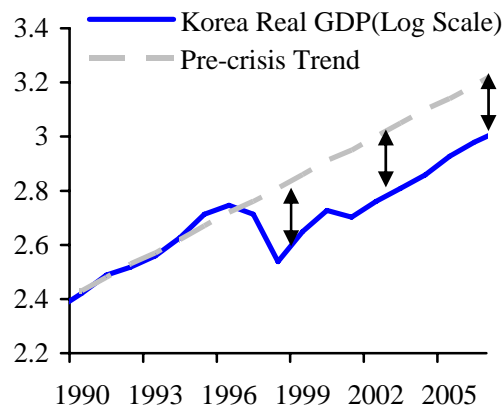
Export Sector May Experience “Output Loss”

Historically, recessions usually have two different kind of impacts on a nation’s economy :

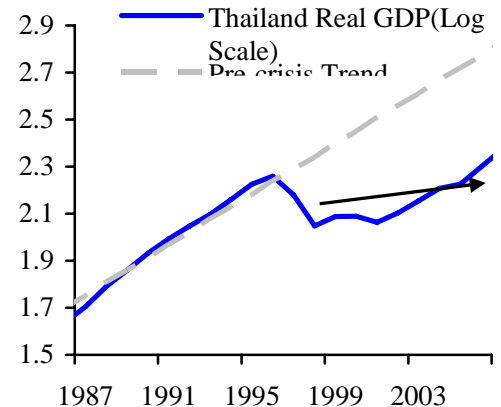
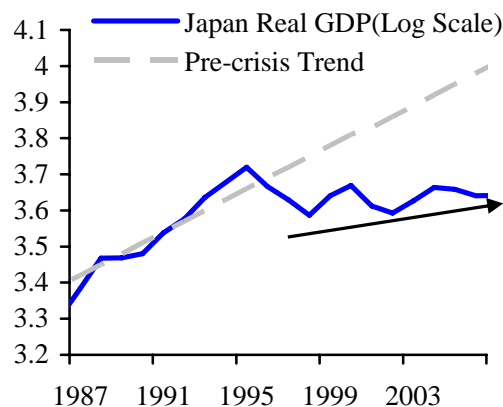
- 1) Output Loss: This is the most common one. During a recession, when production capacity utilization declines, enterprises stop investment which in turn causes pause of production capacity expansion. As a result, even though the economic growth in many cases can return to its pre-crisis level, the path of output tends to be depressed and is less likely to return to its pre-crisis trend.
- 2) Growth loss: This is a situation that happens less frequently. In this case, the economic growth rate declines after the crisis. As a result, the gap between the post-crisis output and the pre-crisis trend tend to increase over time.

The current economic crisis has caused the export-oriented Chinese firms to stop investing. Therefore we believe **China’s export sector is likely to suffer an output loss after the crisis.**

Output loss: The gap between post-crisis output and the pre-crisis trend remains as a constant in the mid-term run.



Growth Loss: Slope of output path (economic growth rate) declines after crisis.

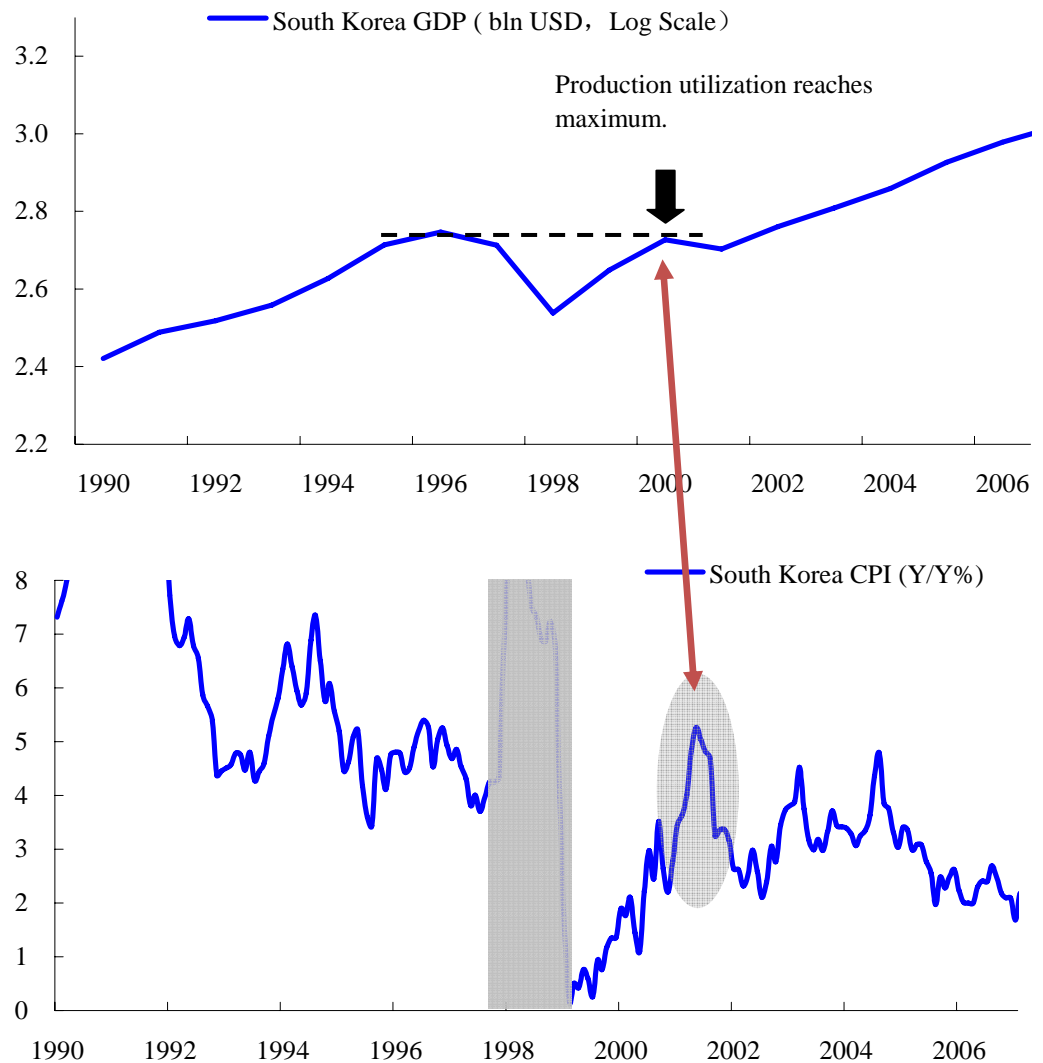


Output Loss and Inflation: The Korean Case

From the analysis above, we can see that the real cause of output loss is that the “potential output” stops expanding during the crisis. As a result, the post-crisis production capacity remains unchanged from its pre-crisis level. Therefore, the production capacity utilization would reach maximum as soon as the absolute value of output reaches its pre-crisis maximum. The rising of capacity utilization often means the hiking of labor cost and new hiring by enterprises, which, if combined with surging of money supply, may lead to high inflation pressure.

Historically, output loss has happened to South Korea during the 1997-1998 financial crisis, and CPI in Korea started to accelerate in late 2000 when Korea’s total output reaches its pre-crisis level.

The Korean Case: Inflation starts to accelerate as soon as the overall output reaches pre-crisis maximum.



Possible Inflation Above 5% by 2Q10

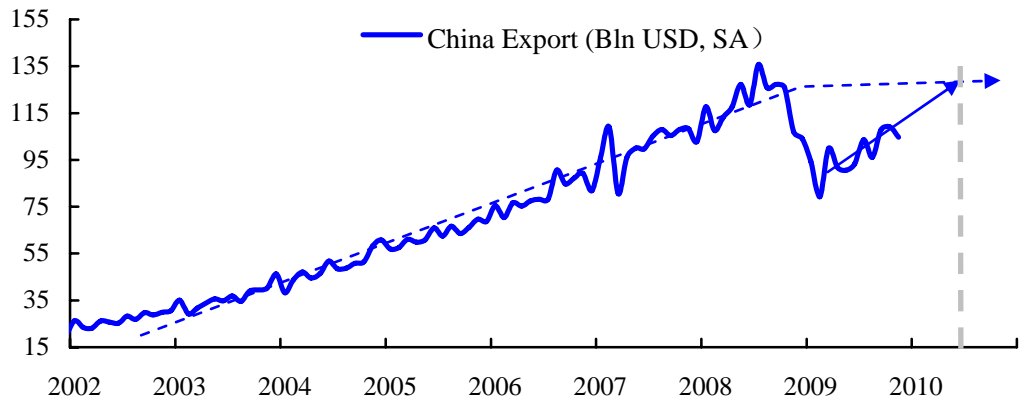
Under the “relatively loose” monetary policy, China’s domestic loans have expanded at a pace that has never been seen in the past two decades. As a result, China’s M2 has grown by almost 30% in the past 12 months, and M1 by 34%. The main reasons that China’s CPI is still at a moderate level are:

- 1) Historically there is a 6 to 9-month lag between the surging of money supply and rising of consumer prices;
- 2) Output gap has held the labor cost at a low level.

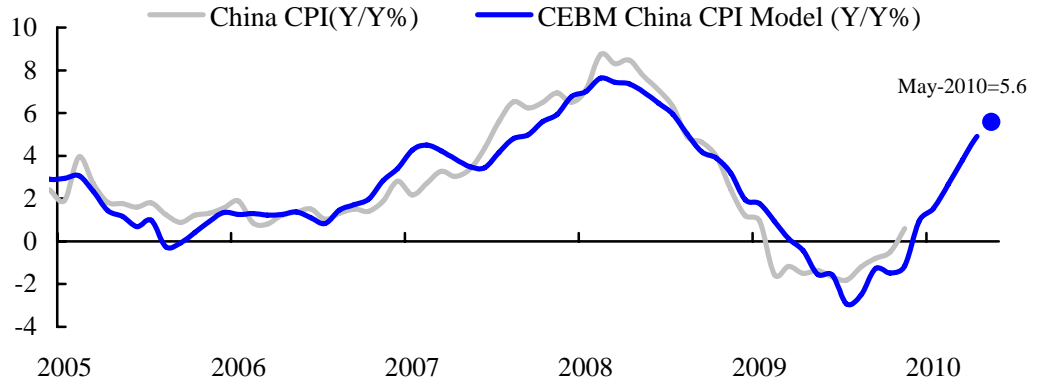
The capacity utilization in heavy industries has reached maximum in 2Q09, and we estimate the output gap in the export sector will also disappear in the next 1-2 quarters. Therefore, we believe China will face rising inflation pressure in the coming quarters.

Based on the historically data, we constructed a quantitative which indicates that China’s CPI could breach 5% year-on-year by the end of 2Q10. **The risk of possible high inflation may cause the government to tighten its monetary policy sooner than expected.**

Output gap in export sector will close in the next 1-2 quarters.

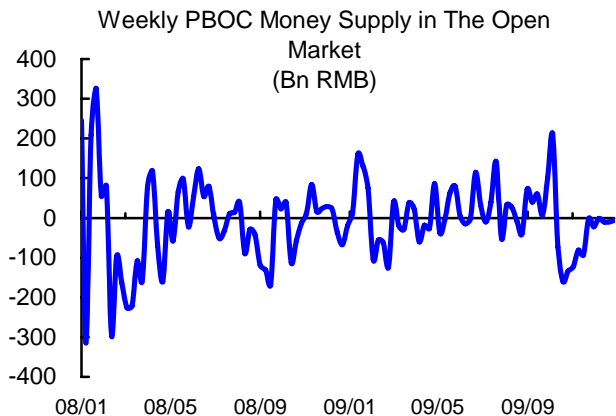
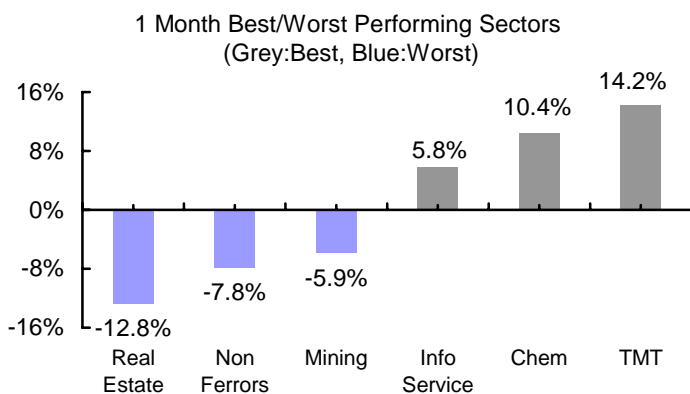
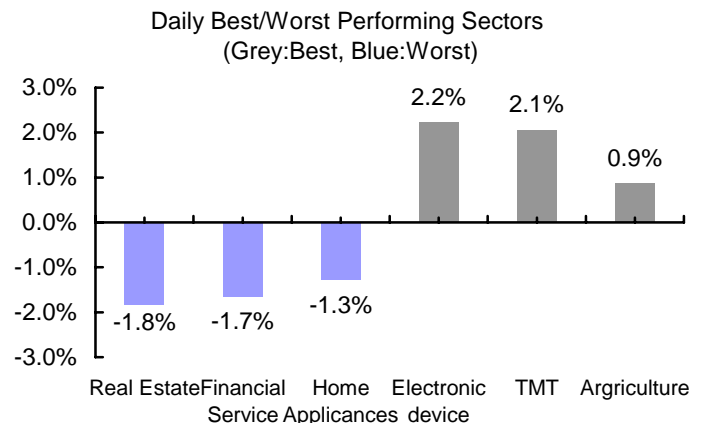
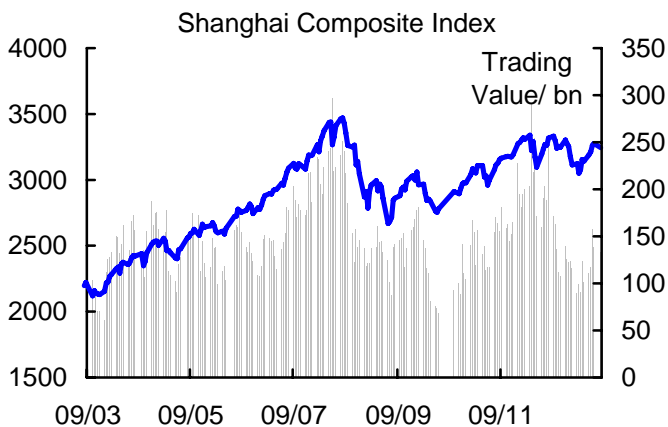


Quantitative model suggest China’s CPI could breach 5% by 2H10



Daily China A-Share Market Review

- As it seems there has been nothing to worry for the double dip risk, China domestic investors tend to care more about the inflation and overheating. PMI published last Friday rise to 56.6, higher than 55.2, indicates China's manufacture industry continue expanding. Rumors on stock index futures haven't yet been confirmed. Blue chip stocks retreat today, leading the Shanghai Composite index drop by 1.02%.
- Agriculture sector rises as President Hu promised favorable agriculture policies would be included in the No. 1 policy paper in 2010 during the New Year holiday. The No. 1 policy has always be the key reason for the agriculture boom in Jan since 2004.
- Real estate sector is the worst performing sector in the past month, as the government keep tightening liquidity and credit to the housing market, keeping it from overheating. During the recovery period in 2009, China house sales reached its record high in July. Many cities see the prices break their record as well.



Disclosure: CEBM research reports are published solely for informational purposes for qualified investors. Nothing in this report constitutes a representation that any investment strategy or recommendation contained herein is suitable or appropriate to a recipient's individual circumstances or otherwise constitutes a personal recommendation.

Beijing

No. 35 Dongzhimenwai Avenue
6/F, Tower C
Beijing, 100027
China, People's Republic of
Tel: +86 10 8448 6606
Fax: +86 10 8448 0366

Shanghai

Suite 1506, Azia Center
No. 1233 Lujiazui Ring Road
Pudong New Area, Shanghai, 200120
China, People's Republic of
Tel: +86 21 6165 2588
Fax: +86 21 6165 2599

New York

Suite 3538
1285 Avenue of the Americas
New York, NY, 10019
United States
Tel: +1 212 809 8800
Fax: +1 212 809 8801

Beijing: No. 25 Dongzhimenwai Ave., 6/F, Tower C, Beijing, 100027, China.

Shanghai: Suite 1506, Azia Center, No. 1233 Lujiazui Ring Road, Pudong, Shanghai, 200120, China.

New York: 1285 Avenue of the Americas, New York, NY 10019, United States

Tel: +86 10 8448 6606 Fax: +86 10 8448 0366

Tel: +86 21 6165 2588 Fax: +86 21 6165 2599

Tel: +1 212 809 8800 Fax: +1 212 809 8801