Inside this issue

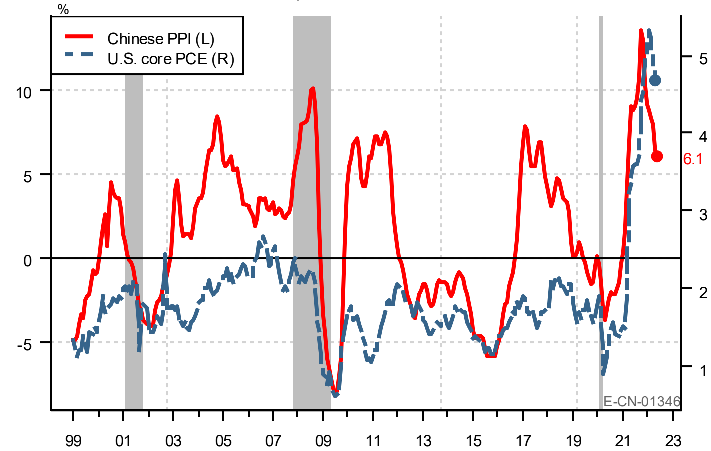
Help, Superman: We have often alluded to China as the global economy's Superman. Usually, this is in the context of China's ability to spur global reflation. Today, we look at the channels by which China could spur global disinflation and examine a few tangents.

strategy@pgmglobal.com
+1 514 932 7171

Chinese PPI: A hero of our time

Chinese Producer Prices (PPI) are an important indicator for DM equities and, indeed, for global inflation. Since China joined the WTO in 2001 and became the world's workshop, Chinese PPI has tended to lead U.S. CPI.

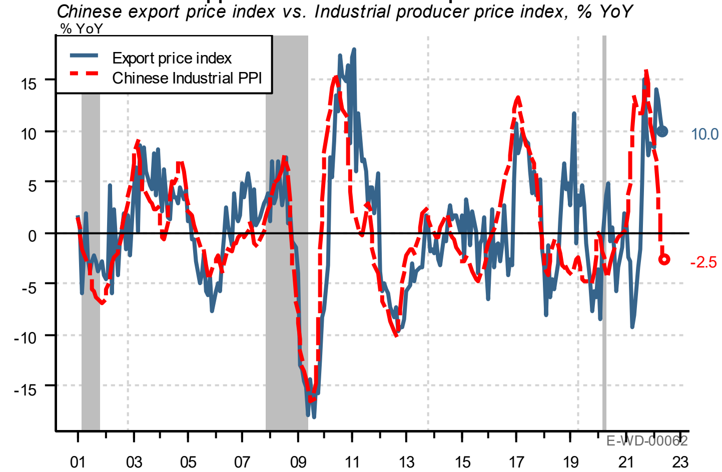
Chinese PPI tends to lead U.S. inflation
China PPI vs. U.S. Core PCE, % YoY



PGM Global (data via Bloomberg)
Shaded areas = U.S. recessions

It may come as a surprise, but for various reasons, PPI in China's industrial sector is actually in deflation! Chinese industrial producer prices are strongly linked to Chinese export prices, which then filter into the rest of the world's CPI. If President Xi relaxes his zero-COVID policy, the resurgence of Chinese exports could help dampen global inflationary pressures and support corporate profit margins. This, in turn, would help the Fed and other DM central banks engineer the elusive soft landings they are all striving for.

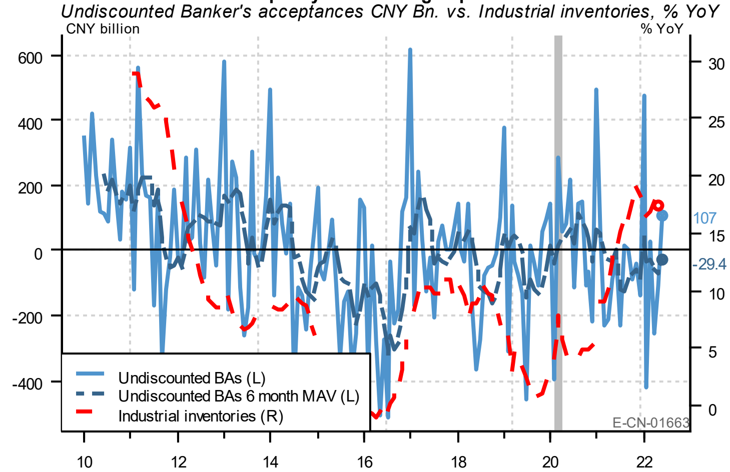
What happened to China's main export: disinflation?
Chinese export price index vs. Industrial producer price index, % YoY



PGM Global (NBS data via Datastream)
Shaded areas = U.S. recessions

Chinese industrial inventory growth has surged as working capital (proxied by undiscounted bankers' acceptances) grew strongly in 2020. This suggests that the portion of inflation that supply chain disruptions have driven can be mitigated if China were to open up more fully. Low vaccination rates and the poor efficacy of China's COVID vaccines will delay any re-opening. However, the spectacle of Chinese households refusing to pay mortgages for unbuilt properties is a sign of fatigue, if not protest over the combination of slower growth and COVID restrictions.

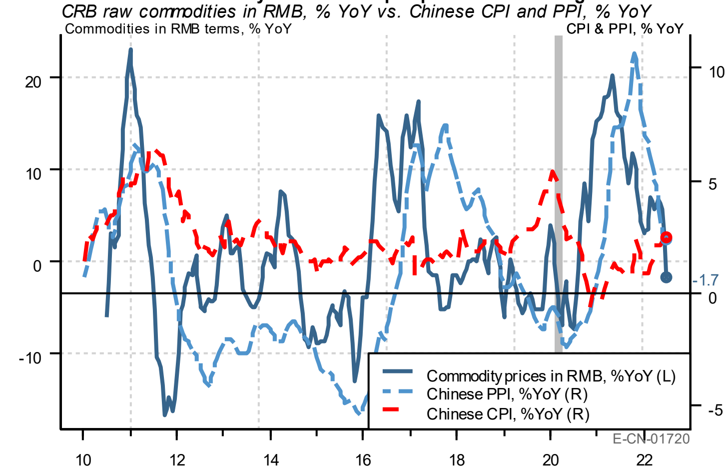
A proxy for working capital
Undiscounted Banker's acceptances CNY Bn. vs. Industrial inventories, % YoY



PGM Global (PBOC data via Bloomberg)
Shaded areas = U.S. recessions

Part of the slowdown in Chinese PPI is a function of lower commodity prices as investors fret over demand destruction due to the global economic slowdown. To a certain extent, this seems misplaced, particularly concerning energy prices (see: *"Re-examining the Energy trades"*, July 8). Increased backwardation in oil futures suggests looming shortages, despite the decline in front-month prices.

Commodity and other input prices are cooling
CRB raw commodities in RMB, % YoY vs. Chinese CPI and PPI, % YoY



PGM Global (data via Bloomberg)
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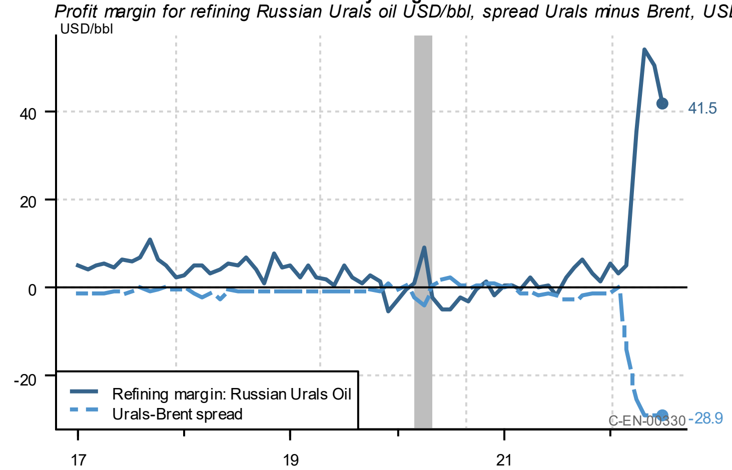
While we think oil prices should be fundamentally higher, this view doesn't necessarily suggest that Chinese PPI will rise and the country's ability to export disinflation will falter. China benefits from the sharp discount in Russian Urals crude vs. benchmark oil prices. In addition, Chinese refiners—including the two largest, state-owned ones—have fat profit margins due to the discount and can ensure producer prices remain muted.

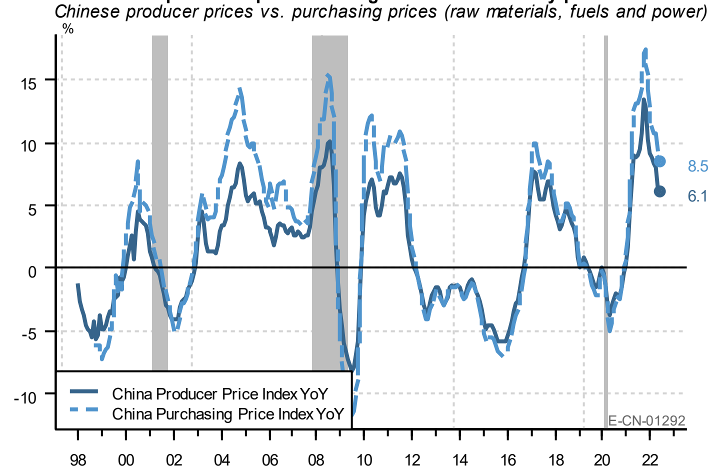
Cash Rules Everything Around Me
Profit margin for refining Russian Urals oil USD/bbl, spread Urals minus Brent, USD/bbl



PGM Global (Oxford Economics data via Datastream)
Shaded areas = U.S. recessions

Relatively cheap energy prices and the broad downturn in industrial commodity prices should continue to weigh on Chinese PPI.

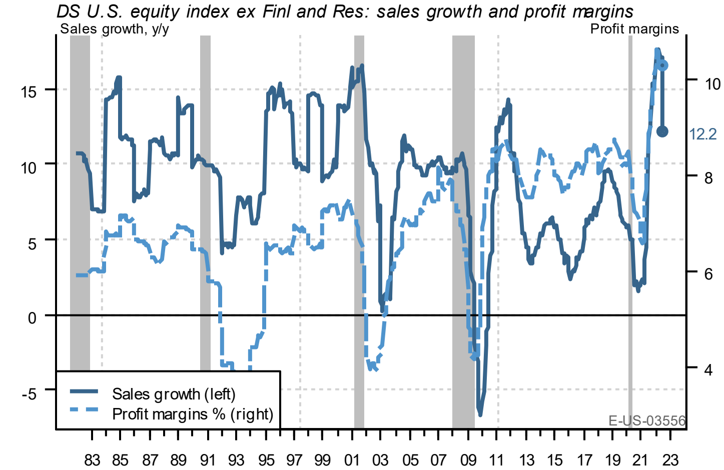
Chinese producer prices rolling over as commodity prices fall
Chinese producer prices vs. purchasing prices (raw materials, fuels and power)



PGM Global (data via Bloomberg)
Shaded areas = U.S. recessions

There are two main reasons why investors should care about Chinese PPI. International and especially U.S.-focused equity investors are fretting over the outlook for corporate earnings. Earnings can be decomposed into profit margins and sales growth. Sales growth is now rolling over sharply. Profit margins remain at near four-decade highs; there are good reasons to ask how long this can persist.

Uh oh?
DS U.S. equity index ex Finl and Res: sales growth and profit margins



PGM Global (data via Datastream)
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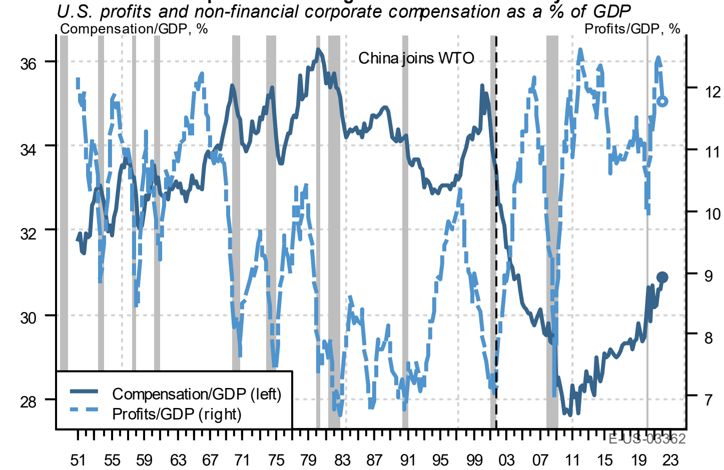
Between 1950 and China's ascent to the WTO in 2001, U.S. profit margins tended to peak before wage gains, and precipitated recessions. This changed—coincidentally or not—when China joined the WTO and became the world's factory. China exported disinflation, pushing down prices for U.S. consumers and widening the profit margins of U.S. firms. If Chinese lockdowns ease, the country can spur another round of disinflation, which would help both U.S. firms and the Fed (see: *"Breaking down the breakdown in equities"*, July 5).

Profits peak before wages do... or at least they did
U.S. profits and non-financial corporate compensation as a % of GDP



PGM Global (BEA data via Datastream)
Shaded areas = U.S. recessions

Perhaps a more interesting reason investors should care about Chinese PPI is the nexus of China's industrial plans and global competitiveness. China's desire to become a world leader in high-tech products is hardly news; however, its strategy might be. China has been using its large, tech-hungry domestic market to scale production and boost its global competitiveness. Chinese firms have a dominant market share at home. Lower energy costs and PPI, in general, will help Chinese tech hardware firms compete internationally.

China's room to grow

Market share of Chinese firms in China & ROW

	Market Share in China (%)	Market Share in ROW (%)	% of compents from Chinese suppliers
Solar Panels	100	50	70-85
High-Speed Rail	100	5	75-90
Digital Payments	95	10	>85
Wind Turbines	80	5	60-75
Electric Vehicles	95	5	60-75
Cargo Ships	90	45	40-50
Agri Machinery	88	19	60-80
Smart Phones	85	25	30-50
Cloud Services	70	8	<35
Robotics	50	15	25-45
Semiconductors	5	5	<10
Aircraft	5	1	<20

Pavilion Global Markets (data via McKinsey Global Institute)

Europe's tough stance on Russia and impractical energy policies have exacerbated the bloc's broader economic malaise. This is particularly true of Germany, which is inching ever closer to an energy catastrophe and electricity rationing. As recently as 2020, the UN had ranked German Industry the world's most competitive, with China in second place. The current macro trajectory suggests China can close that gap.

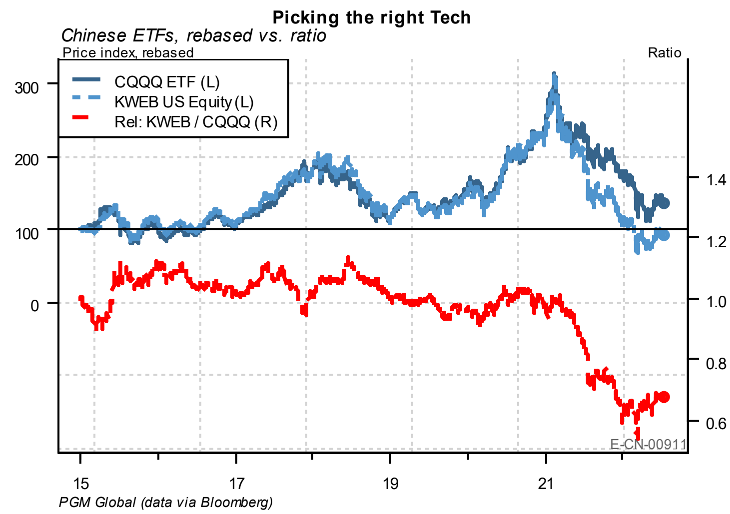
Battle of the Industrial Titans

UN Competitive Industrial Index (2020)

Rank	Country	Score
1	Germany	0.4709
2	China	0.3716
3	Korea	0.3488
4	USA	0.3454
5	Japan	0.3445

PGM Global (data via United Nations)

We have been fairly optimistic about Chinese tech for a few months now. Recently, the internet platform companies, which have a heavy weighting in the KWEB ETF, have done relatively better than the tech-hardware heavy firms (CQQQ). This makes sense given the government has been relaxing, however unevenly, regulation on the platform companies. However, as far as future growth is concerned, we continue to think the hardware-focused firms will do best, as they are of strategic importance to the CCP and continue to benefit from increased investment.



Bottom line: Chinese producer prices are easing, in what could be a boon for global consumers, profit margins and DM central banks. A lot will depend on President Xi's commitment to the zero-COVID policy. The PPI trends are also supportive of Chinese equities, and especially Chinese tech hardware firms. This is particularly true when contrasting the outlook for China with that of Germany.