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China Macro Strategy

Start of a rate hike cycle

The PBOC announced this evening that it had decided to raise the benchmark deposit and lending rates. We view this move as the beginning of a rate hike cycle that may involve two more rate increases (each 25bps) in the coming 12 months, and which should pave the way for accelerated deposit rate deregulation. In our view, it is a very important signal that a policy consensus has been reached to tolerate lower GDP growth, and we believe it demonstrates the government's determination to resolve the negative interest rate issue and to use interest rate policy to contain speculative property demand. We think this policy move is most negative for the property sector and other highly leveraged industries, broadly negative for commodities, but may be mixed for banks.

Today's PBOC decision to hike rates, which surprised most market observers, is broadly consistent with our expectation (see China section of our Asia Economic Monthly published on 11 October and our macro commentary published on 13 October). However, the decision to symmetrically raise both the one-year lending and deposit rates by 25bps is a surprise to us (as we thought the one-year lending rate should go up 18bps and the one-year deposit rate should rise 27bps).

We see several key messages from today's decision:

First, this rate hike decision is confirmation that a policy consensus has been reached to tolerate lower growth. Note that this rate hike (especially the lending rate hike) is taking place at a time when yoy GDP growth is obviously decelerating (the consensus among government economists is that yoy GDP growth will decline towards 8-8.5% in Q4 from nearly 12% in Q1).

Second, the government is now convinced that negative real interest rates need to be corrected, as they tend to exacerbate inflation expectations, property bubbles and over-investments. As we have argued for a long time, the root causes of the property bubbles are excessive monetary growth and very negative real mortgage rates. Today's decision raises the five-year deposit rate by as much as 60bps, which obviously signals that the PBOC is attempting to attract speculative funds from the property market back to bank deposits. As long-term bond yields will also rise as a result of the deposit rate hikes, the increased attraction of bonds should also help limit property speculation.

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Third, we see today's move as the beginning of a rate hike cycle. We think next year's CPI target will likely be set at 3%, and the upward pressure from the recent rise in global commodity prices and the need to more aggressively implement resource pricing reforms suggest that the risks to CPI inflation will be on the upside. This means that to ensure positive real interest rates, the benchmark one-year deposit rate will likely be raised twice in the coming 12 months (each 25bps). We have therefore raised our 12-month projection for the one-year benchmark deposit rate from the current 2.5% to 3%.

Fourth, we think the PBOC will likely accelerate the pace of deposit rate deregulation. Although the NIM of banks has expanded marginally following today's symmetric rate hike (and therefore earnings are boosted by 1-3% for most banks), the improved margin should also reduce banks' opposition to interest rate liberalization. This would permit an acceleration of deposit rate deregulation, which could be modestly negative for NIMs going forward. Note that interest rate deregulation is not only justified on the basis of correcting negative real rates, but is also needed to prepare for RMB internationalization and improving the monetary policy transmission mechanism.

Fifth, this rate hike decision reinforces the probability that China will shift to a "prudent" monetary policy stance next year from a "relaxed" one this year. This means that loan growth will likely slow to 16% next year from 18.8% this year.

Sixth, considerations of the timing of this rate hike may include: 1) end of the Party Congress; (2) the September CPI figure, to be released next week, will likely be higher; (3) the pace of the stock market rally in recent weeks has becoming worrying to some policy makers.

We see the following market implications:

1) Today's decision (and the likely further rate hikes) will be most negative for properties. On the one hand, lending rate hikes will increase mortgage rates; on the other hand, following the deposit rate hikes, deposits and bonds will become meaningful alternatives to property investments and should thus further reduce speculative demand for properties.

2) Rate increases will also be negative for commodities, as their demand growth is highly sensitive to overall investment and loan growth.

3) Rate hikes are negative for highly leveraged sectors, such as power and selected commodities and property companies (see Figure 1).

4) On banks, we think the market reaction may be mixed. On the one hand, the asymmetric rate hikes marginally increase the NIMs. On the other hand, as we discuss above, the broader macro concerns on GDP and loan growth deceleration, as well as the signals from the PBOC for further rate hikes and deposit rate deregulation imply increased uncertainties on banks over the medium term.

Figure 1: Companies with high debt-to-equity ratio in DB China universe

Company	Ticker	Sector	Rating	18-Oct Price local	M. cap (US$m)	Net debt/equity 2010	PE 2010	PE 2011	PB 2010	EPS CAGR 10-12
Huadian Power	1071.HK	Utilities	Hold	2.1	1,599	362%	NA	NA	NA	NA
Datang Int'L Power	0991.HK	Utilities	Buy	3.4	5,096	359%	15.6	9.8	1.2	39%
Huaneng Power Intl	0902.HK	Utilities	Hold	4.9	7,615	285%	11.9	12.7	1.2	2%
China Power Int'L	2380.HK	Utilities	Hold	1.8	752	249%	13.1	12.2	0.6	28%
China Gas Holdings	0384.HK	Utilities	Hold	4.6	2,055	173%	33.7	28.3	4.3	18%
Beijing Cap Int'L Airport	0694.HK	Transportation	Buy	4.2	2,322	155%	33.0	17.9	1.2	67%
CNBM	3323.HK	Materials	Buy	20.0	6,325	135%	12.1	9.3	2.4	24%
Shanghai Forte Land	2337.HK	Real Estate	Buy	2.4	773	131%	8.3	6.8	0.8	NA
China Yangtze Power	600900.SS	Utilities	Buy	8.6	21,208	126%	18.5	17.8	2.1	6%
Shenzhen Expressway-H	0548.HK	Transportation	Hold	4.4	2,447	117%	14.0	12.3	1.1	NA
China Resources Power	0836.HK	Utilities	Buy	16.0	8,621	117%	13.2	12.2	1.8	10%
China Medical Tech	CMED.OQ	Health Care Equipme	Buy	11.7	434	111%	15.8	7.4	1.4	39%
Longyuan Power	0916.HK	Utilities	Buy	8.2	8,044	87%	31.3	19.9	2.2	48%
Galaxy	0027.HK	Consumer Services	Hold	6.9	3,508	81%	23.4	17.6	3.6	62%
Brilliance China	1114.HK	Automobiles & Com	Hold	6.6	4,300	79%	31.7	25.6	4.8	17%
Renesola	SOL.N	Semiconductors & S	Buy	13.4	1,147	78%	7.5	5.4	2.1	23%
China High Speed Trans	0658.HK	Capital Goods	Buy	16.9	2,748	73%	14.1	12.2	3.4	12%
Yuexiu Property	0123.HK	Real Estate	Buy	2.1	1,876	72%	12.5	7.8	0.9	39%
Guangzhou R&F Prop	2777.HK	Real Estate	Hold	12.2	5,051	71%	10.7	8.4	1.8	NA
China Shipping Developm	1138.HK	Transportation	Buy	11.4	5,021	70%	17.5	10.9	1.5	48%

Source: Deutsche Bank estimates

Appendix 1

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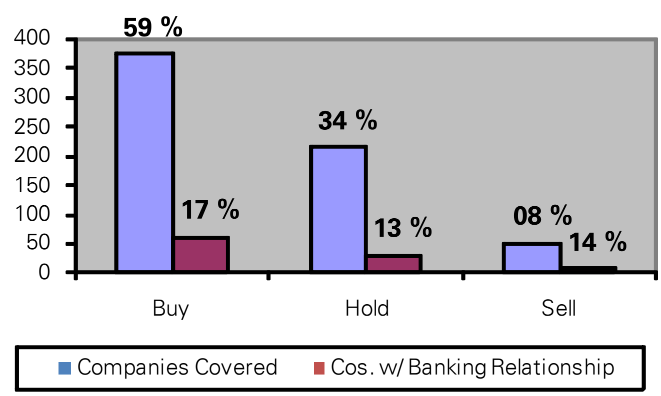

Asia-Pacific Universe

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