China SMEI – A softer reading in May

- **The headline SMEI moderated to 56.9 in May from 58.0 in April on weaker demand and tighter credit**
- **Most current activity sub-indices fell, but new export orders improved**
- **SME's credit conditions turned tougher and their financing costs increased in May**
- **More SMEs forecast appreciation in the CNY exchange rate; the majority expected flat energy costs**

SME activity moderates for the second month

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Our proprietary *Small and Medium Enterprise Confidence Index* (SMEI; Bloomberg: SCCNSMEI <Index>), which tracks SME activity in China, weakened further in May. The headline reading moderated to 56.9 in May from 58.0 in April. The growth momentum index, however, rebounded to 14.0 from 12.4 prior due to a drop in finished goods inventory (Figure 1).

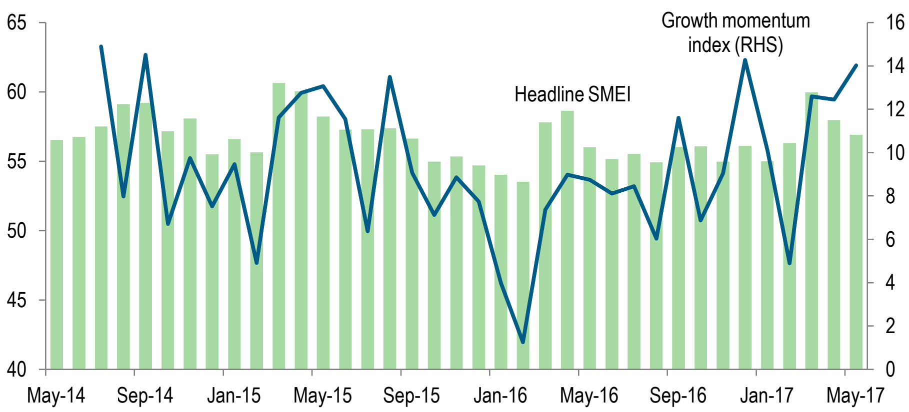
The current performance sub-index fell 0.8ppt to 57.2 in May (Figure 2), with sub-components weakening across the board. Sales and production eased, affecting profitability, the labour market and capacity usage. The only exception is export demand, which picked up on the back of strong foreign demand. By region, SMEs in southern China continued to outperform those in other regions. Only the southern China region witnessed acceleration in May. By industry, the IT and services sectors remained the best performers, but also moderated.

The downturn in current performance seems to have had a negative impact on business expectations. The current and prospective investment sub-indices declined, and the expectations sub-indices for sales, production, employment and capacity usage softened. Raw-material inventory growth edged up in May, but finished-goods inventory eased.

SMEs' access to credit turned tougher this month. Tighter monetary policy and stricter financial regulations may continue to restrict SMEs' access to bank and non-bank funding. SMEs' funding costs also deteriorated, according to the survey. More surveyed SMEs predicted CNY appreciation than those that predicted depreciation, while the majority expected stable energy costs in the coming months.

Figure 1: Headline SMEI moderated, but growth momentum rebounded

China headline SMEI reading (LHS), growth momentum index (RHS)



Source: Standard Chartered Research

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Both current performance and expectations fell in May

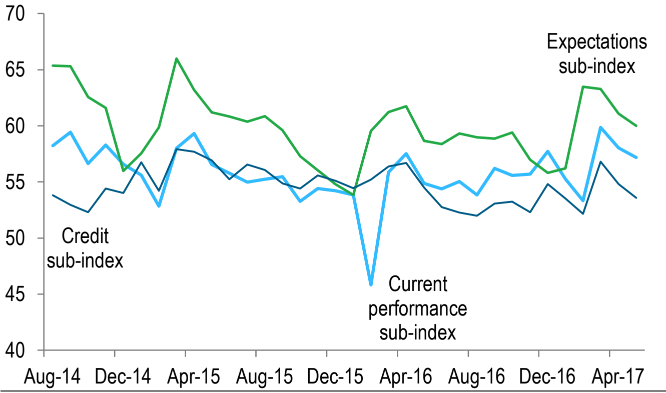
The current performance sub-index declined to 57.2 in May from 58.0 in April on account of a weaker market and tight credit conditions. The expectations sub-index also fell 1.1ppt to 60.0, suggesting weaker prospects in the coming months.

Sales and production further weakened in May, putting pressure on the labour market and on profitability

- **New orders weakened, but export demand remained strong.** The current performance reading for new orders slowed further to 62.4 in May from 63.9 in April, but the reading for new export orders picked up 1.5ppt to 57.7 (Figure 4). These declines reflected weaker demand at home, but strong overseas demand. The outlook reading for new orders also declined to 66.6 in May from 68.4 in April, implying a cautious demand outlook.
- **Production continued to slow down.** The current performance reading for production ticked down to 62.0 in May from 62.9 in April (Figure 4), reflecting softer production activity during the month. Furthermore, production may continue to slow, as the production expectations reading fell 0.6ppt to 68.1 in May, implying a less optimistic outlook for growth.
- **Both prospective and current investment weakened.** The current performance reading for investment fell to 54.5 in May from 55.9 in April (Figure 5). The investment outlook reading also declined by 0.6ppt to 55.3, pointing to weaker investment appetite down the road.

Figure 2: All the current performance and expectations sub-indices weakened

Current performance, expectations and credit sub-indices



Source: Standard Chartered Research

Figure 3: Medium-sized enterprises improved but small enterprises weakened

Current performance, expectations and credit sub-indices

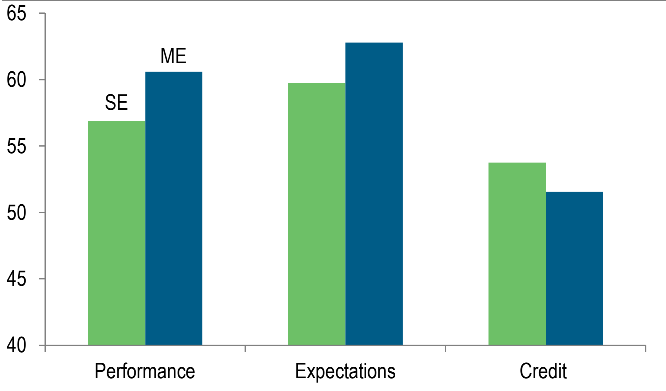


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Figure 4: Sales and production eased, but export orders picked up

Current performance readings

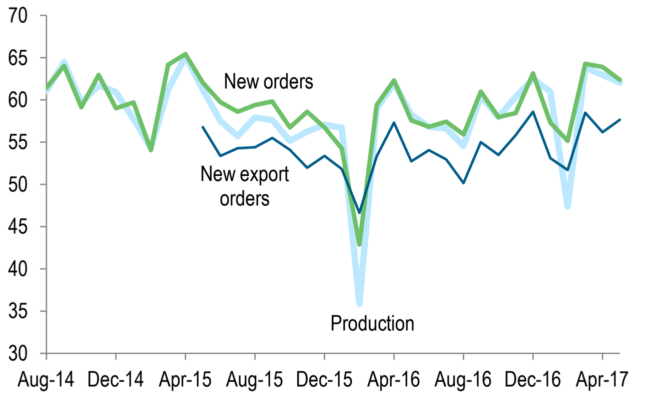

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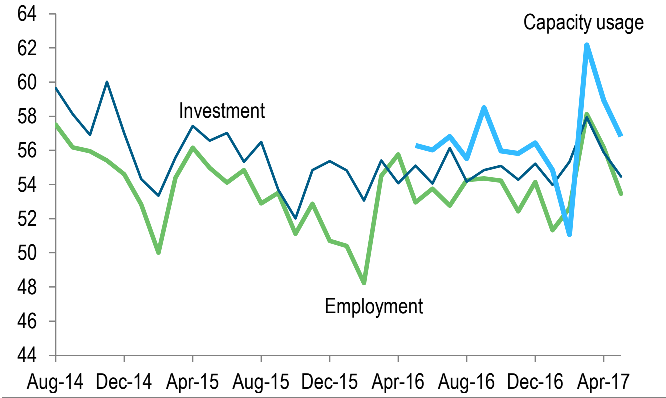
Figure 5: Employment, capacity and investment indices declined

Current performance readings



Source: Standard Chartered Research

- **Labour market softened as production lost steam.** The current performance readings for employment and capacity usage retreated 2.7ppt and 2.1ppt, respectively, in May as a result of cooling production during the month (Figure 5). Their forward-looking readings also softened 1.4ppt and 1.9ppt, respectively, from April. Weaker demand may continue to weigh on the labour market and lead to overcapacity this year.
- **Raw-material inventory continued to grow.** The current performance reading for raw-material inventory rose to 55.2 in May from 52.6 in April (Figure 6), confirming stronger inventory growth during the month. The outlook reading for raw-material inventory also grew to 57.2 from 56.9 in April, indicating a recovery in raw-material inventory in the coming months. Both current and prospective indicators suggest that SMEs' confidence remains strong.
- **Finished-goods inventory fell in May.** The current performance reading for finished-goods inventory weakened to 48.4 in May from 51.5 in April. The outlook reading rose 1.4ppt to 52.9 in May (Figure 6), but was still low compared to past months. Both readings suggest that industrial inventory re-stocking may slow down in the coming months.
- **Profitability is trending down.** Despite a falling input price index and a rising output price index, the current performance index for profitability weakened to 59.9 in May from 61.9 in April, probably as a result of higher financial costs or weaker market demand (Figure 7). This trend is set to continue, as the outlook reading for profitability moderated by 3.4ppt in May.

Figure 6: Raw-material and finished-goods inventories diverged; outlook strengthened

Current performance readings

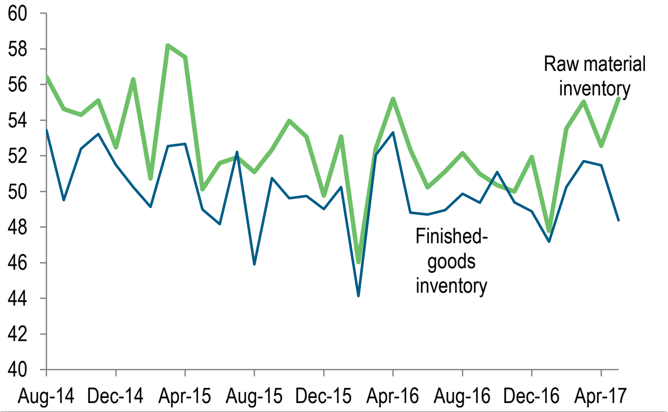


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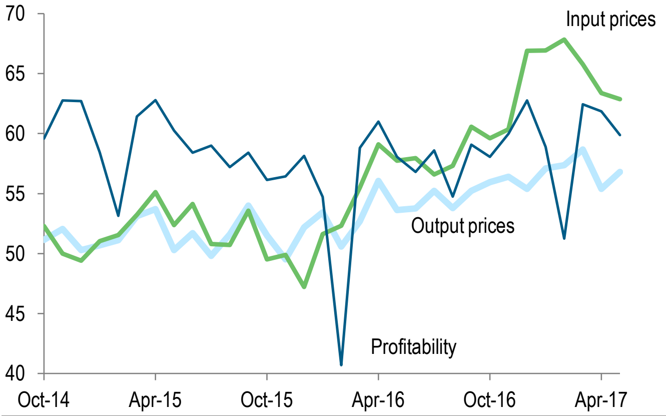
Figure 7: Profitability continued to slow

Current performance readings



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Credit conditions turned less favourable for SMEs

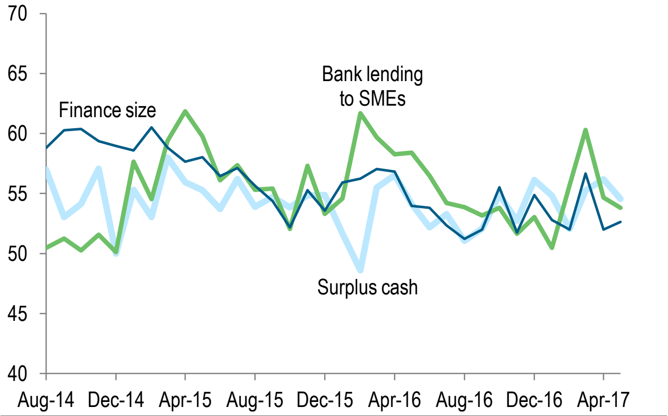
Tighter liquidity and heightened financial regulations have raised SMEs' funding costs in May

The credit conditions sub-index fell to 53.6 in May from 54.8 in April. This partly reflects the recent tightening of monetary policy and more rigorous financial regulations aimed at encouraging financial deleveraging. Funding costs for SMEs rose in May as a result of tighter credit conditions.

- **Credit access for SMEs is tougher.** The reading for banks' attitude towards lending to SMEs dropped to 53.8 in May from 54.7 in April, suggesting weaker funding support from banks amid tighter liquidity conditions (Figure 8). M2 growth was 10.5% in April, hitting an eight-month low and falling significantly below the annual target of 12%. As a result, the sub-index for surplus cash fell 1.6ppt to 54.6, reflecting tighter cash positions. The reading for SMEs' total financing size edged up to 52.6 in May from 52.0 in April (Figure 8). The sub-index for receivables turnover also rose 1.3ppt to 50.6 in May. Despite a mild recovery, both indicators remained at relatively low levels, implying tough credit access for SMEs.
- **SMEs' funding costs worsened.** The readings for bank and non-bank financing costs fell, respectively, to 45.1 and 46.6 in May from 46.5 and 47.6 in April; this indicates elevated financing costs (Figure 9; a reading below 50 indicates worsening conditions, i.e., rising costs). Rising financial costs suggest that the recent monetary policy tightening by the People's Bank of China (PBoC) and increased regulation of shadow banking have raised SMEs' borrowing costs substantially.

Figure 8: SMEs' credit demand subsided on tightened monetary policy

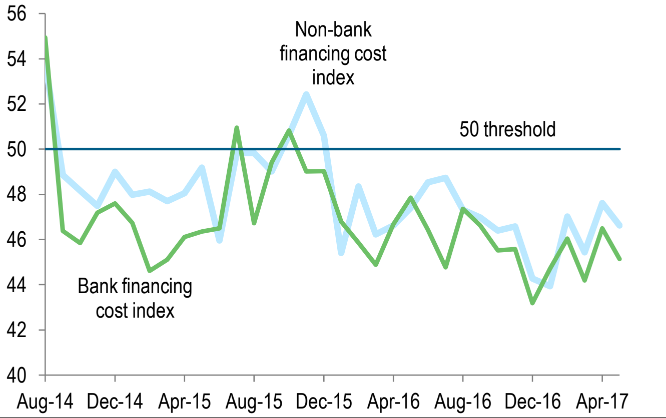
Components measuring credit conditions



Source: Standard Chartered Research

Figure 9: Financing costs for bank loans and non-bank financing have risen

Bank and non-bank financing cost components (above 50 = improving conditions/falling costs; below 50 = worsening conditions/rising costs)



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More SMEs expect CNY appreciation

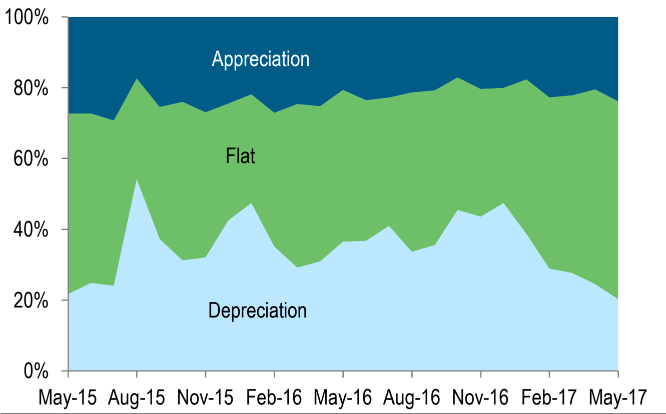
More SMEs expect CNY appreciation than deprecation; the majority expects flat energy costs

Our survey shows that the proportion of SMEs expecting CNY appreciation has exceeded that expecting deprecation, while the majority of SMEs said they expected stable energy costs.

- **The proportion of SMEs expecting CNY depreciation dropped to the lowest in three years.** 20.3% of respondents predicted further CNY depreciation against the USD – a further drop from 24.5% in April and 27.7% in March, hitting the lowest since we first surveyed this indicator in May 2015. Those expecting CNY appreciation (23.8%) exceeded those expecting depreciation, for the first time since the CNY fixing reform in August 2015. 55.9% of the 500+ survey respondents expected USD-CNY to be flat near-term (Figure 10). Our calculations show that non-FDI capital outflows stayed low (USD 24.2bn) in April, suggesting a continued improvement in China's international balance of payments. The USD has weakened recently on domestic policy uncertainty, reducing the need for CNY intervention. China's tighter monetary policy has also supported confidence in the exchange rate.
- **Majority expect flat energy costs.** Only 6.1% of respondents – the least this year – said they expected lower energy costs in the near future. 26.7% of respondents predicted higher energy costs, up from 26.0% in March. This left 58.4% of respondents forecasting flat energy costs, 1ppt higher than in April.

Figure 10: Expectations of CNY weakness eased

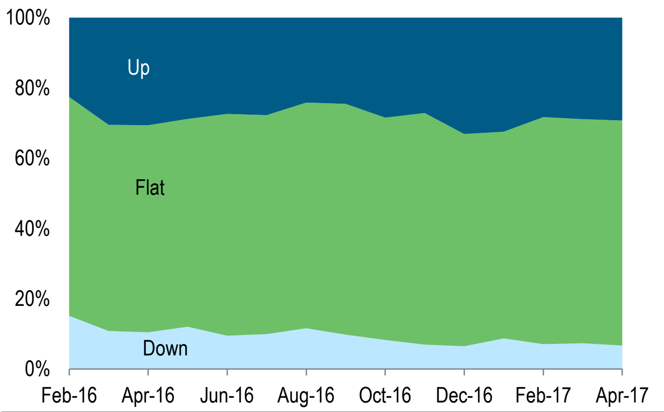
% of responses



Source: Standard Chartered Research

Figure 11: The majority expects stable energy costs

% of responses



Source: Standard Chartered Research

Figure 12: SMEI headline index and sub-indices

	May-16	Jun-16	Jul-16	Aug-16	Sep-16	Oct-16	Nov-16	Dec-16	Jan-17	Feb-17	Mar-17	Apr-17	May-17
Headline index	56.0	55.2	55.5	54.9	56.0	56.1	55.0	56.1	55.0	56.3	60.0	58.0	56.9
Performance sub-index	54.9	54.4	55.0	53.8	56.2	55.6	55.7	57.7	55.3	53.3	59.8	58.0	57.2
Expectations sub-index	58.7	58.4	59.3	59.0	58.9	59.4	57.0	55.8	56.2	63.5	63.3	61.1	60.0
Credit sub-index	54.5	52.8	52.3	52.0	53.1	53.3	52.3	54.8	53.5	52.1	56.8	54.8	53.6

Source: Standard Chartered Research

Disclosures appendix

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