China SMEs – Headwinds gathering in Q4

- **Headline SMEI moderated to 55.2 in October from 56.2 in September; all three key sub-indices eased**
- **Weaker demand and supply-side disruption weighed on production activity; destocking started**
- **Financing conditions remained tough; expectations of two-way CNY movement are forming**

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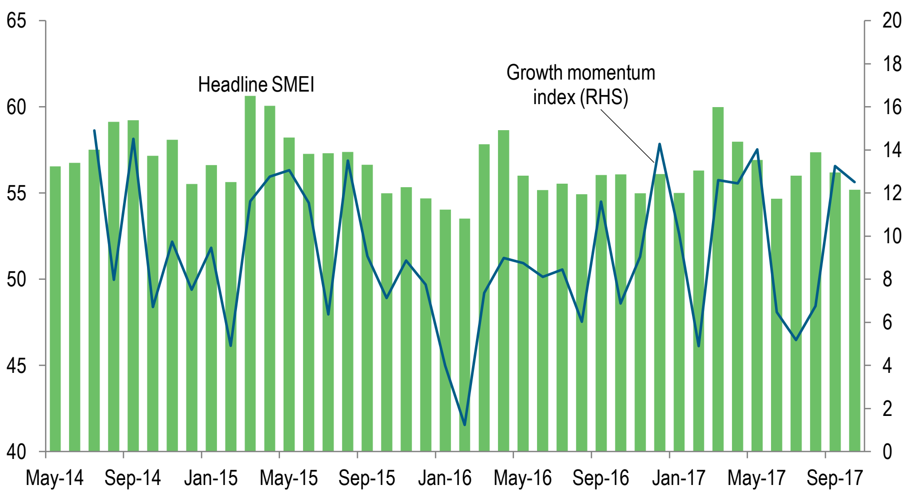
SMEI shows signs of weakening in October

China SMEs' activity moderated in October for the second consecutive month, according to our proprietary *Small and Medium Enterprise Confidence Index* (SMEI; Bloomberg: SCCNSMEI <Index>), a survey-based diffusion index gauging sentiment at more than 500 SMEs nationwide. The headline eased to 55.2 in October from 56.2 in September, with the growth momentum index moderating on a decrease in new orders (Figure 1). SMEs in the IT sector saw some improvement, while those in the manufacturing sector underperformed (Figure 3); small-sized enterprises generally outperformed medium-sized enterprises during the month.

The three key sub-indices – current performance, expectations and credit – all eased in October, with the expectations sub-index falling most notably (Figure 2), indicating downward pressure ahead. This is in line with our view of a gradual slowdown in the economy in Q4-2017. The components in the current performance sub-index showed that weaker demand and supply-side disruption weighed on production activity. The increase in raw-material prices appears to have been passed through to finished goods. We expect CPI inflation to trend up in the next 12 months, limiting room for monetary loosening.

Financing conditions remained tough overall, with SMEs' surplus cash squeezed and receivables turnover slowing. However, we expect the recently announced tax cuts and targeted reserve requirement ratio (RRR) cuts for SMEs to provide support over time. Expectations of two-way Chinese yuan (CNY) volatility heightened; the outlook for energy costs turned slightly more bullish.

Figure 1: Headline SMEI eased in October; growth momentum moderated
China headline SMEI reading (LHS), growth momentum index (RHS)*



*Growth momentum index = new orders index minus finished goods inventory index
Source: Standard Chartered Research

Real activity moderated; outlook worsens

The current performance sub-index moderated to 55.7 in October from 56.6 in September, dragged down by slower sales and production. The sub-index for three-month expectations eased to 57.7 in October from 59.0 in September, with an increasingly cautious outlook on production and investment.

Weaker demand and supply-side disruption weighed on production activity

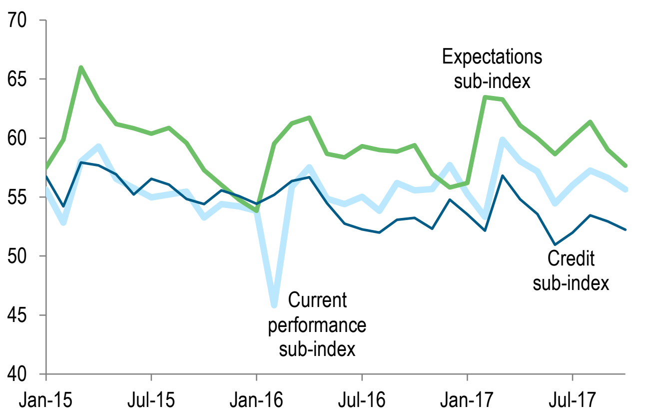
Slackening domestic demand was seen in October and is likely to continue in Q4. The current performance and expectations readings for new orders fell 4.2ppt and 3.3ppt, respectively, after the pick-up in September; new export orders held up (Figure 4). This is in line with our view of moderate growth in the near future on a cooling housing market, softening infrastructure investment and less accommodative policies.

Production activity also slowed due to the disruption in supply and weaker demand. The current performance readings for production and capacity usage fell 3.5ppt and 2.3ppt, respectively (Figure 5). China's environmental code has weighed on production, especially small-sized enterprises. The outlook readings for production and capacity usage also retreated in October, as stricter environmental control during the winter may further reduce capacity.

SMEs' investment appetite stabilised at a relatively low level. The current performance reading for investment slid 0.8ppt, while the expectations reading remained flat (Figure 6). Recovering industrial profits and easing industrial

Figure 2: All three sub-indices dropped in October

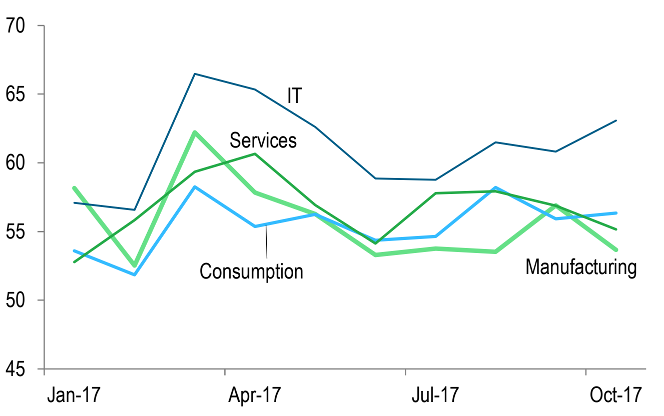
Current performance, expectations and credit sub-indices



Source: Standard Chartered Research

Figure 3: IT outperformed; manufacturing underperformed

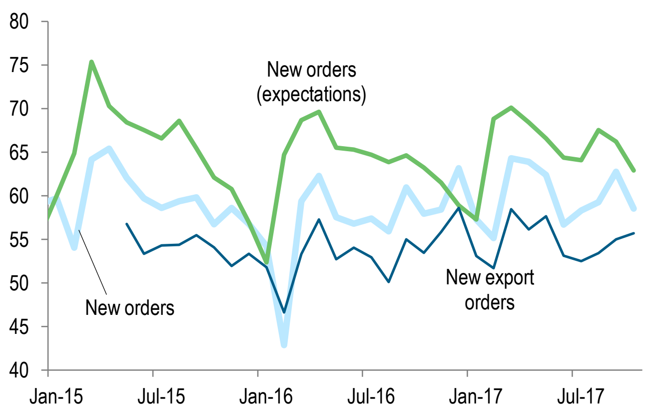
Current performance sub-indices



Source: Standard Chartered Research

Figure 4: Domestic demand weakened

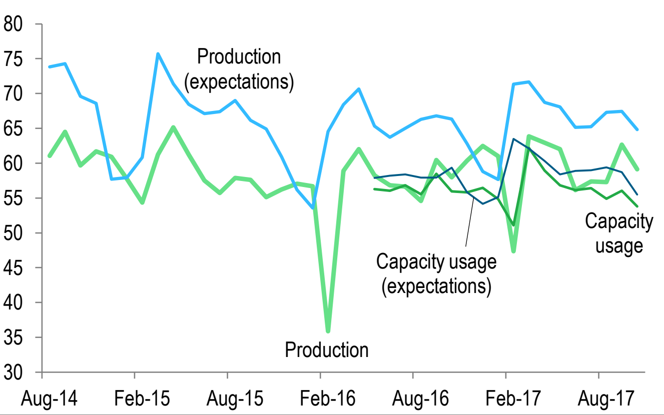
Current performance and expectations sub-indices



Source: Standard Chartered Research

Figure 5: Capacity reduction weighed on production

Current performance and expectations sub-indices



Source: Standard Chartered Research

overcapacity pressure towards the end of the year could result in manufacturing investment stabilising, in our view. However, broad expansionary appetite may face a growing risk of slowing given moderating growth momentum. Echoing this, the readings for current and prospective financing and employment softened in October, pointing to a slower pace of expansion in the foreseeable future (Figure 7).

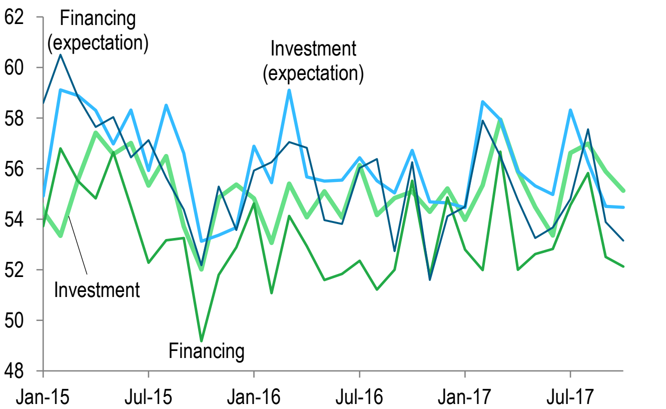
Destocking appears to have started; input price inflation passed through to output prices

There were more signs of destocking in October as the current and expectations readings for both raw-material and finished-goods inventory fell into contractionary territory (Figure 8). Raw-material and finished-goods inventory has fallen for two consecutive months, indicating the start of the destocking process. We believe the inventory cycle will turn into a headwind from a tailwind, with the boost from inventory restocking in H1 likely to fade in H2, which is likely to weigh on industrial production growth.

The surge in input prices appears to have been passed through to output prices. Both the current performance and expectations readings for finished-goods prices rose 2.6ppt, whereas input prices rose at a slower pace in October than in September (Figure 9). This adds evidence to our view that higher PPI inflation may gradually pass through to consumer prices and drive up CPI inflation towards 3% in 2018. Profitability has held up so far.

Figure 6: Investment stabilised at a low level

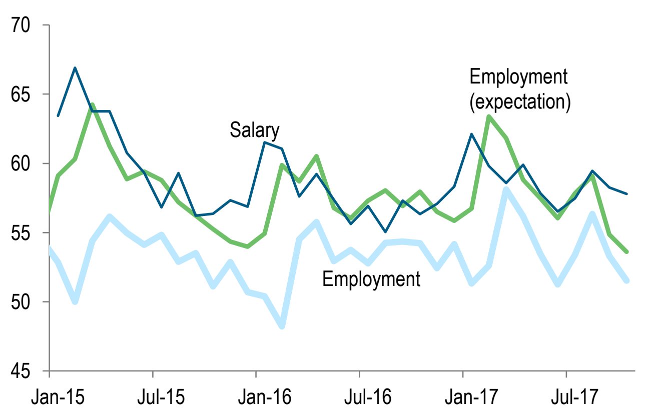
Current performance and expectations sub-indices



Source: Standard Chartered Research

Figure 7: The labour market cooled in October

Current performance and expectations sub-indices



Source: Standard Chartered Research

Figure 8: Raw-material and finished-goods inventory fell

Current performance sub-indices

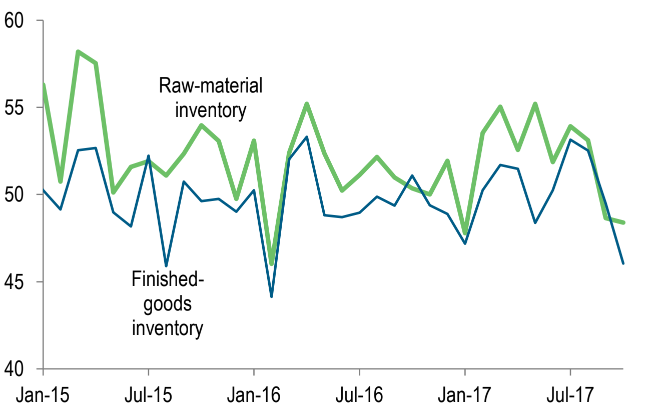


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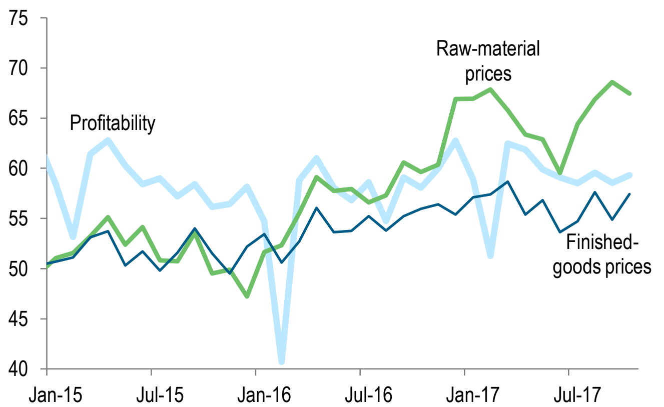
Figure 9: Input price gains passed through to output prices

Current performance sub-indices



Source: Standard Chartered Research

Banks' lending to SMEs set to improve

The credit conditions sub-index edged down 0.7ppt to 52.2 in October, indicating that SMEs' financing conditions remained tough. That said, the State Council decided to support SMEs through tax cuts and targeted RRR cuts in late September, which are likely to provide some support to SMEs' financing conditions over time.

The targeted RRR cuts provide incentives for banks to lend to SMEs

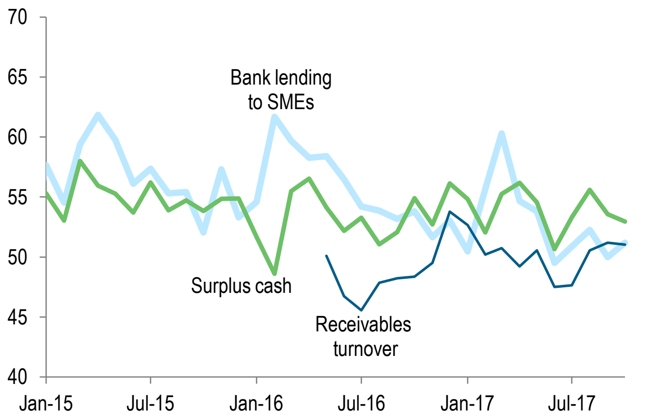
Banks' lending to SMEs saw a mild increase. The sub-component reading for bank lending edged up 1.2ppt to 51.2 in October (Figure 10), suggesting a marginal improvement in bank credit access among SMEs. The central bank announced targeted RRR cuts on 30 September for commercial banks that meet the "inclusive finance" criteria (lending to SMEs, agriculture, poverty reduction projects and innovative activity). Given the RRR cuts will be effective only from 2018, this provides incentives for commercial banks to extend credit lines to SMEs over the rest of this year to enjoy a favourable reserve ratio next year.

SMEs' financing conditions generally worsened. Despite the improvement in bank lending access, the component readings for surplus cash and receivables turnover edged down by 0.6ppt and 0.2ppt, respectively, in October (Figure 10), reflecting slightly tighter financing conditions for SMEs.

Funding costs for SMEs remained high. The survey results showed that non-bank financing costs started to rise again in October after a pause in September, while bank financing costs continued to rise, albeit at a slower pace (Figure 11). We believe the authority will continue to keep liquidity tightly balanced and constrain off-balance-sheet lending to strengthen financial stability and deleveraging. This is likely to keep funding costs high for SMEs. However, the proposed reduction in taxes and fees should help lower the financing burden to some extent.

Figure 10: SMEs' credit access improved, but financing conditions generally worsened

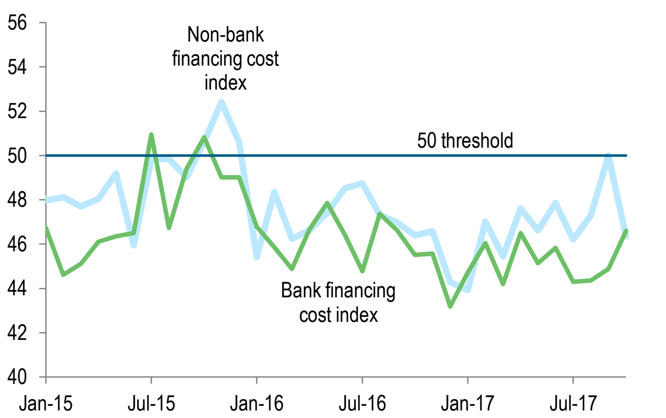
Components measuring credit conditions



Source: Standard Chartered Research

Figure 11: Funding costs for bank financing rose at a slower pace

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



Source: Standard Chartered Research

Expectations of two-way CNY movement are forming

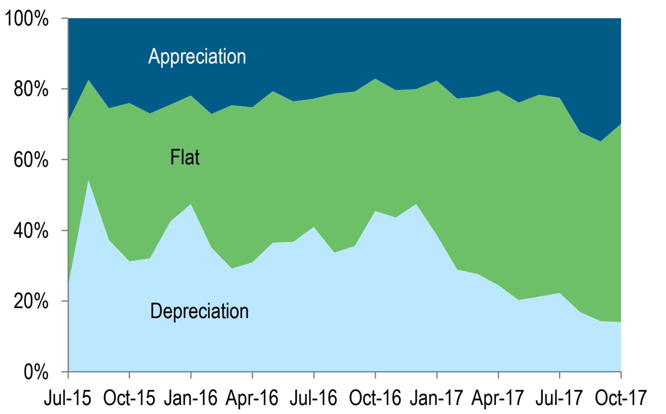
Enterprises are getting used to two-way CNY volatility

The CNY saw heightened two-way volatility in September and October, which diversified market expectations. Of over 520 respondents in our October survey, 30% were bullish on CNY appreciation, down from a historical high of 35% in September. Only 14.1% expected CNY depreciation in the near term, slightly up from 14.0% in our last survey. The remaining 56.1% of respondents did not specify either direction or expect two-way swings. As two-way CNY movements have not caused panic in recent months, we believe market conditions are supportive for promoting further exchange-rate reform.

While the majority of SMEs still expect stable energy costs, the outlook appears to have a slightly bullish bias. 28.1% predicted higher energy costs in the near future, up from 27.5% in September, while respondents expecting lower energy costs fell to 7.6% in October from 9.0% in September.

Figure 12: Expectations of two-way CNY movement are forming

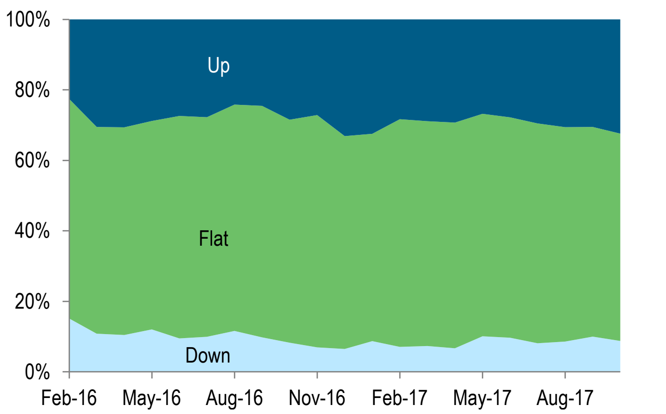
% of responses



Source: Standard Chartered Research

Figure 13: Expectations of energy prices turned slightly bullish

% of responses



Source: Standard Chartered Research

Figure 14: SMEI headline index and sub-indices

	Oct-16	Nov-16	Dec-16	Jan-17	Feb-17	Mar-17	Apr-17	May-17	Jun-17	Jul-17	Aug-17	Sep-17	Oct-17
Headline index	56.1	55.0	56.1	55.0	56.3	60.0	58.0	56.9	54.7	56.0	57.4	56.2	55.2
Performance sub-index	55.6	55.7	57.7	55.3	53.3	59.8	58.0	57.2	54.4	56.0	57.3	56.6	55.7
Expectations sub-index	59.4	57.0	55.8	56.2	63.5	63.3	61.1	60.0	58.6	60.0	61.4	59.0	57.7
Credit sub-index	53.3	52.3	54.8	53.5	52.1	56.8	54.8	53.6	51.0	52.0	53.5	52.9	52.2

Source: Standard Chartered Research

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