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China SMEI – Big jump in March

- **Headline SMEI reading strengthened to 60.0 in March from 56.3 in February; momentum improves**
- **All current activity sub-indices improved, while the investment outlook softened**
- **Credit conditions turned favourable for SMEs, although financing costs rose**
- **CNY stability has become a consensus view due to policy rate hikes, capital controls and USD correction**

A strong month for China's SMEs

Our proprietary *Small and Medium Enterprise Confidence Index* (SMEI; Bloomberg: SCCNSMEI <Index>), which tracks SME activity in China, recorded the highest reading in almost two years in March. The current performance index jumped to 59.8 from 53.3 in February (Figure 2); the growth momentum index rose to 12.6 from 4.9 on improved orders and lower finished-goods inventory (Figure 1). The credit index also improved substantially to 56.8 from 52.1 prior (Figure 2). The expectations index ticked down 0.2ppt to 63.3 but remained strong, suggesting that the SME activity boom may continue in the coming months.

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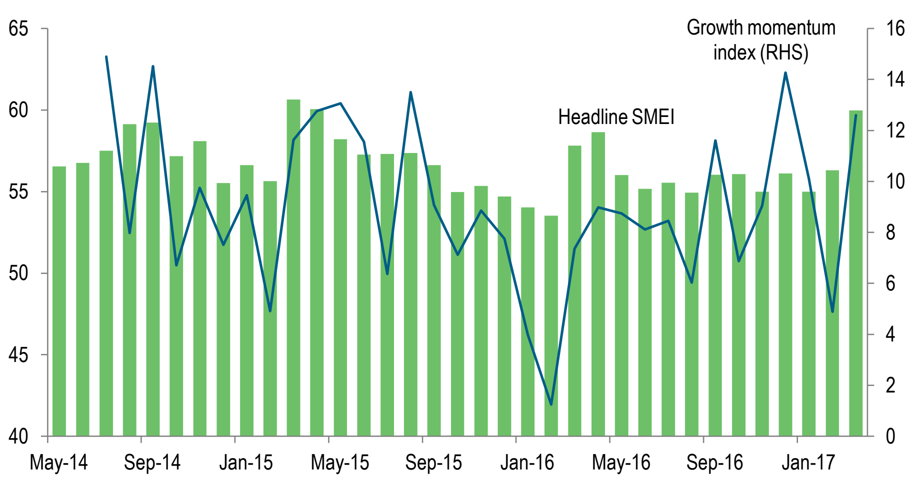
All sub-indices improved significantly. Sales and production rose strongly (both the current and forward-looking indicators), suggesting that the SME activity boom will continue in the near term. As a result, SME profitability rose markedly. The investment sub-index also improved, but the outlook softened. SMEs in southern China continued to outperform those in other regions. By sector, the IT, manufacturing and services sectors performed better than wholesale/retail sales.

SMEs' financing demand rose significantly, and financing costs increased. Tighter monetary policy and stricter credit regulation may continue to push up funding costs for SMEs. More than half of our surveyed SMEs expected USD-CNY exchange rate stability, while views on future energy costs diverged.

Figure 1: Headline SMEI reading rose modestly, driven by strong expectations



Source: Standard Chartered Research

Current performance surged; expectations are stabilising

The current performance sub-index rebounded strongly to 59.8 in March from 53.3 in February due to significantly improved market sentiment and a boom in domestic and overseas demand. The expectations sub-index ticked down 0.2ppt to 63.3, but remained at a high level.

Sales and production surged in March due to much stronger sentiment and an economic activity boom

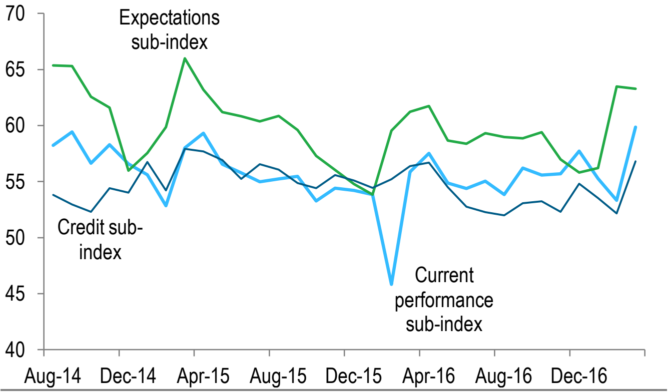
- **Current and prospective orders improved substantially.** The current performance reading for new orders surged to 64.3 in March from 55.2 in February, and the new export orders reading rose 6.8ppt to 58.5 (Figure 4). These increases reflect stronger demand from China and abroad. The outlook reading for new orders also picked up to 70.1 from 68.8 in February, reflecting confidence in near-term sales prospects.

- **Production rebounded strongly.** The current performance reading for production surged to 63.8 in March from 47.4 prior (Figure 4), reflecting more working days and a strong rebound in production activity during the month. We expect the rebound to continue: the production expectations reading edged up 0.3ppt to 71.7 in March, implying a more optimistic growth outlook.

- **Investment picked up and may stabilise.** The current performance reading for

Figure 2: Current performance sub-index rebounded, expectations sub-index softened

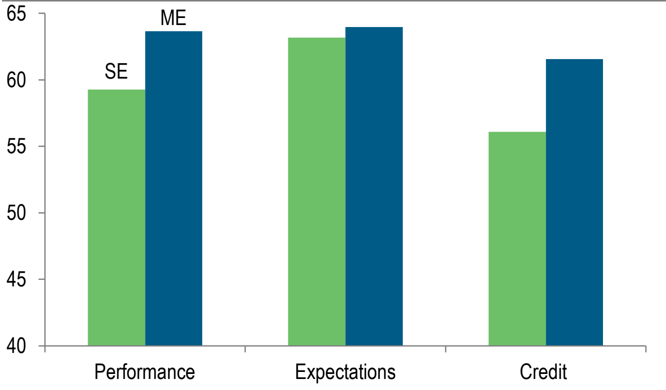
Current performance, expectations and credit sub-indices



Source: Standard Chartered Research

Figure 3: Performance of medium-sized enterprises (MEs) and small enterprises (SEs)

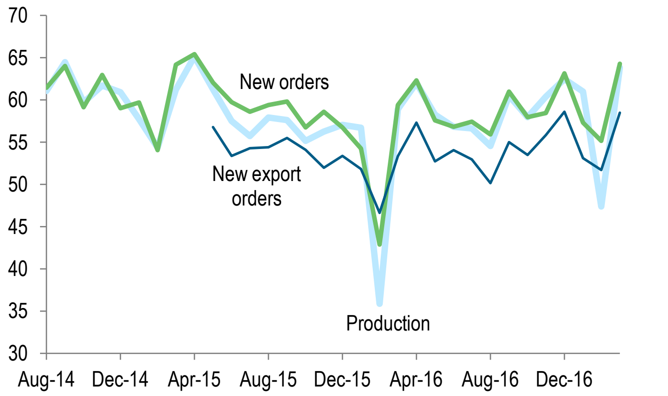
Current performance, expectations and credit sub-indices



Source: Standard Chartered Research

Figure 4: Sales and production rebounded strongly

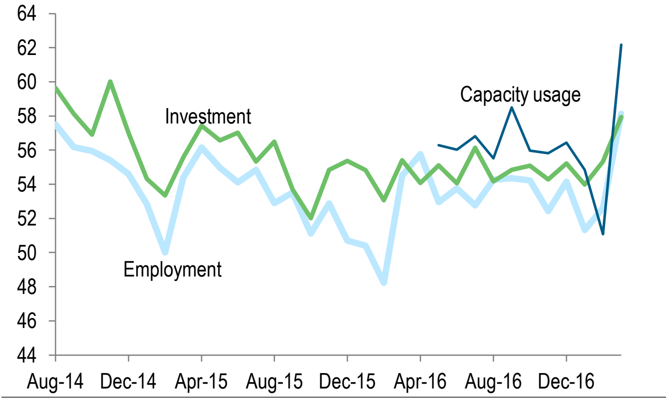
Current performance readings



Source: Standard Chartered Research

Figure 5: Employment, capacity usage and investment soared

Current performance readings



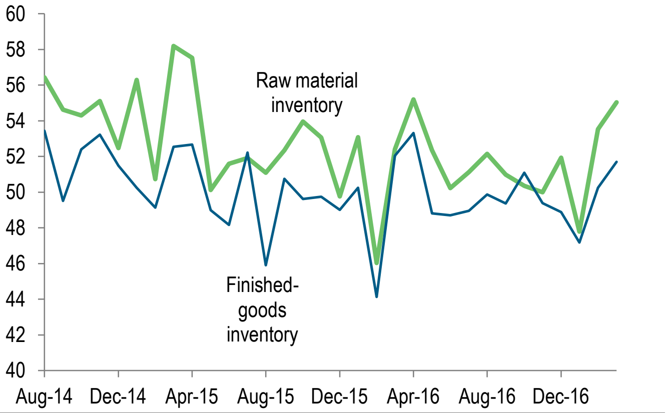
Source: Standard Chartered Research

investment edged up to 57.9 in March from 55.3 in February (Figure 5). The investment outlook reading softened 0.7ppt to 57.9, but remained high, suggesting stabilising investment appetite in the near term.

- **Employment and capacity usage surged.** The current performance readings for employment and capacity usage jumped 5.5ppt and 11.1ppt in March, respectively, reflecting higher production in the month (Figure 5). However, the respective forward-looking readings softened mildly from February, suggesting that production may be levelling off.
- **Raw-material inventory is stabilising.** The current performance reading for raw-material inventory picked up to 55.0 in March from 53.5 in February (Figure 6), indicating an increase in inventories during the month. The outlook reading for raw-material inventory, however, moderated to 59.1 in March from 59.6, suggesting a stabilisation in raw-material inventory in the coming months.
- **Finished-goods inventory started to level off.** The current performance reading for finished-goods inventory continued to recover, strengthening to 51.7 in March from 50.3 prior, but the outlook reading fell 1.1ppt to 53.6 (Figure 6). This likely indicates that finished-goods inventory is gradually levelling off.
- **Rising output prices boosted profitability.** The profitability reading rebounded strongly to 62.5 in March from 51.3 in February as output prices rose more than input prices (Figure 7). We expect the trend to continue as outlook readings for input prices continue to fall and readings for output prices continue to rise.

Figure 6: Raw-material and finished-goods inventories both increased; outlook is moderating

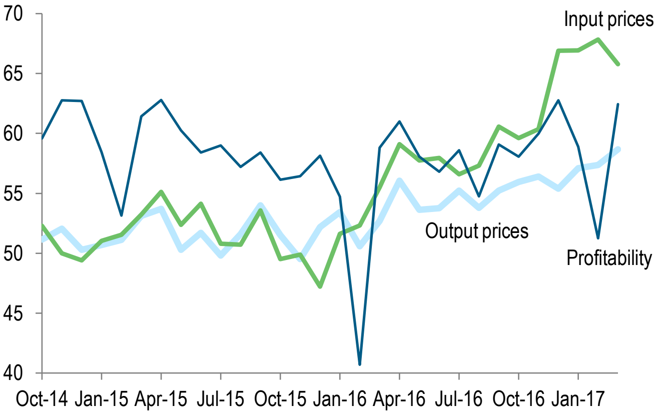
Current performance readings



Source: Standard Chartered Research

Figure 7: Profitability is rising

Current performance readings



Source: Standard Chartered Research

SMEs' credit conditions improved substantially on higher credit demand and better access

Credit conditions turned favourable

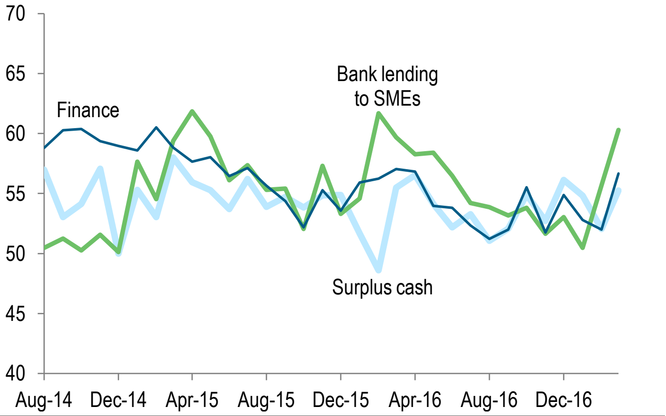
The credit conditions sub-index rose sharply to 56.8 in March from 52.1 in February. The positive trend in credit conditions is consistent with the SME production boom.

- **Financing demand rebounded.** The reading for SMEs' total financing strengthened to 56.7 in March from 52.0 in February (Figure 8) partly due to improved sentiment on better economic fundamentals. The reading for bank lending to SMEs improved 4.6ppt to 60.3 in March. Also, the sub-indices of surplus cash and receivables turnover rose 3.3ppt to 55.3 and 0.5ppt to 50.7, respectively, in March on stronger sales and production (Figure 8). We expect SMEs' financing demand to remain high in the coming months due to the likely activity boom.

- **SMEs' financing costs continued to rise.** Readings for bank and non-bank financing costs fell (to 44.2 and 45.4 from 46.0 and 47.0, respectively), indicating a worsening cost environment (Figure 9). The People's Bank of China (PBoC) raised reverse repo and medium-term lending facility (MLF) rates for a second time after the Fed rate hike, indicating the authorities' intent to contain credit growth and financial-market leverage. We expect the PBoC to maintain moderately tight liquidity conditions, and policy rates to be raised further in 2017. In addition, tighter regulation of off-balance-sheet lending and the asset management sector will likely put increased pressure on SMEs' financing and raise their non-bank financing costs.

Figure 8: SMEs' credit demand rebounded substantially on the post-holiday production boom

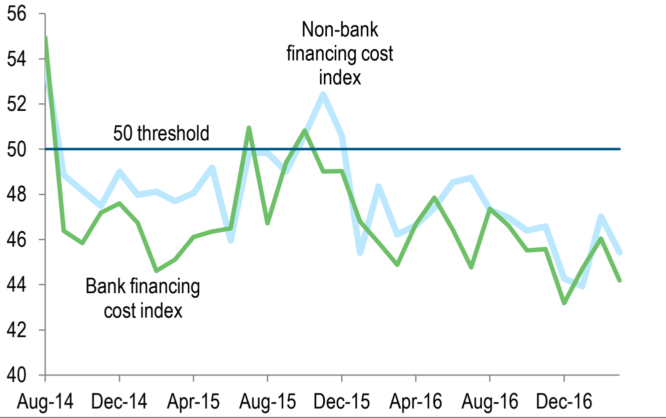
Components measuring credit conditions



Source: Standard Chartered Research

Figure 9: Financing costs for bank loans and non-bank financing continued to rise

Bank and non-bank financing cost components (positive reading = falling costs; negative = rising costs)



Source: Standard Chartered Research

CNY stability has become a consensus view

Our latest survey shows that a stable USD-CNY exchange rate was a consensus view in March, while views on future energy costs diverged.

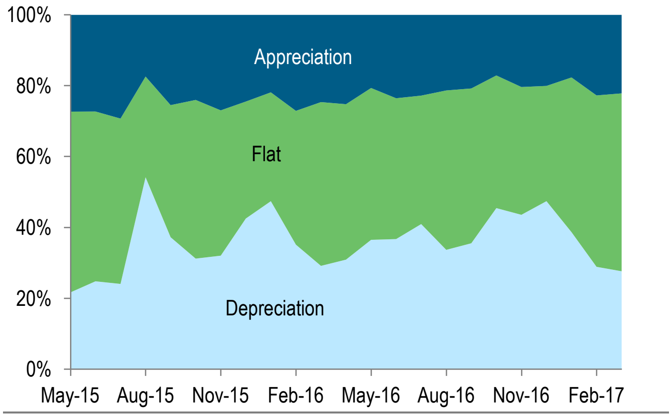
More expect a stable USD-CNY exchange rate due to recent monetary policy moves and a stable USD after the Fed rate hike

- **CNY exchange rate outlook became more balanced in March.** 27.7% of the respondents expect further Chinese yuan (CNY) depreciation against the USD – a drop from 28.9% in February and 38.7% in January. The number expecting CNY depreciation still exceeded those expecting appreciation (22.1%). But more than half (50.2%) of the 500+ survey respondents expect a flat CNY exchange rate against the USD in the near term (Figure 10). The recent Fed rate hike did not lead to a substantially stronger USD, helping to stabilise SME expectations for the CNY exchange rate. The authorities' management of the CNY basket and MLF and reverse repo rate hikes support USD-CNY as well. Against this backdrop, our survey results suggest that corporate expectations onshore have turned from one-way CNY depreciation to a more balanced view, with greater acceptance of two-way volatility.

- **Views on energy costs diverged.** 26.0% of respondents expect higher energy costs in the near future, up from 25.6% in February; this is the highest level since the start of 2016. In sharp contrast, only 6.6% of respondents expect lower energy costs, only slightly higher than in February (6.4%). This leaves 57.4% of respondents forecasting flat energy costs, 1.0ppt less than in February. The government recently lowered the retail price of petroleum slightly, in response to declining international oil prices. But we continue to expect higher crude oil prices in 2017, posing upside risk to corporates' energy costs and China's inflation.

Figure 10: Expectations of CNY weakness eased

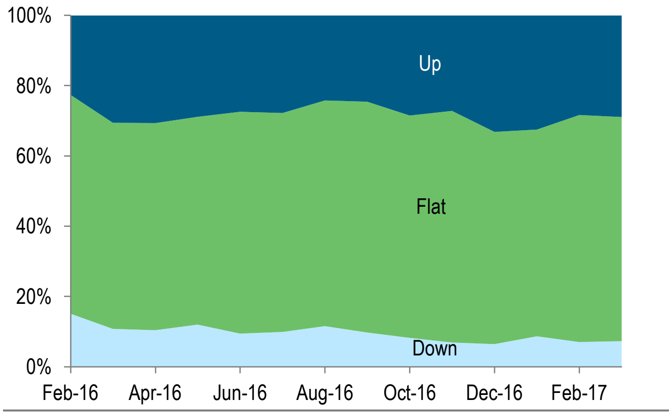
% of responses



Source: Standard Chartered Research

Figure 11: Expectations for energy costs diverged

% of responses



Source: Standard Chartered Research

Figure 12: SMEI headline index and sub-indices

	Mar-16	Apr-16	May-16	Jun-16	Jul-16	Aug-16	Sep-16	Oct-16	Nov-16	Dec-16	Jan-17	Feb-17	Mar-17
Headline index	57.8	58.7	56.0	55.2	55.5	54.9	56.0	56.1	55.0	56.1	55.0	56.3	60.0
Performance sub-index	55.9	57.5	54.9	54.4	55.0	53.8	56.2	55.6	55.7	57.7	55.3	53.3	59.8
Expectations sub-index	61.2	61.7	58.7	58.4	59.3	59.0	58.9	59.4	57.0	55.8	56.2	63.5	63.3
Credit sub-index	56.4	56.7	54.5	52.8	52.3	52.0	53.1	53.3	52.3	54.8	53.5	52.1	56.8

Source: Standard Chartered Research

Disclosures appendix

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