DBS Flash

China: PMI highlights need for further policy support

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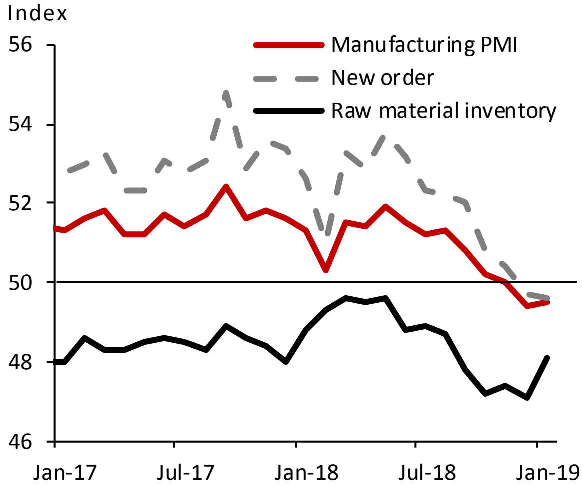
Chinese factory output contracted for a second straight month in January. According to the National Bureau of Statistics, manufacturing PMI inched up fractionally to 49.5 from 49.4 in December due to a pick-up in inventory ahead of the Lunar New Year holiday. New orders, an indicator of future activity, shrank further to 49.6 from 49.7 amid weakening domestic demand (Chart 1). By firm types, small and medium enterprises PMI mired deeply in contraction territory.

It was no coincidence that industrial profits contracted for a second straight month by 1.9% YoY in December; November's 1.8% drop was the first contraction in nearly three years. Together, the contraction in output and profits showed how industrial enterprises have suffered from subdued domestic demand and faltering global growth. Global manufacturing PMI slipped in December to its lowest level for over two years. Expect China's manufacturing activities to be further dampened by a worsening world trade outlook.

Another major culprit was the funding squeeze. The financial strain on companies has deepened from the multi-year deleveraging campaign. New corporate loans have halved to RMB1.2tn in 4Q18 from the first three quarters (Chart 2). Shadow lending, an alternative financing channel to private firms with less access to formal bank loans, declined a tenth straight month in December to the lowest since end-2016. The weakening credit impulse has pointed to a further decline in output ahead.

Chart 1: Manufacturing PMI



The stress was compounded by the ongoing US-China trade dispute. Notably, some technology gadget brands have relocated production to other Asian nations in response to the squeeze in profit margins from US tariffs amidst ebbing growth of industrial values in computer, communications and other electronic equipment manufacturing (December: 10.5%, the lowest since November 2016). We see little sign of this trend reversing in the near term.

Chart 2: New increase in corporate loan and off balance sheet lending

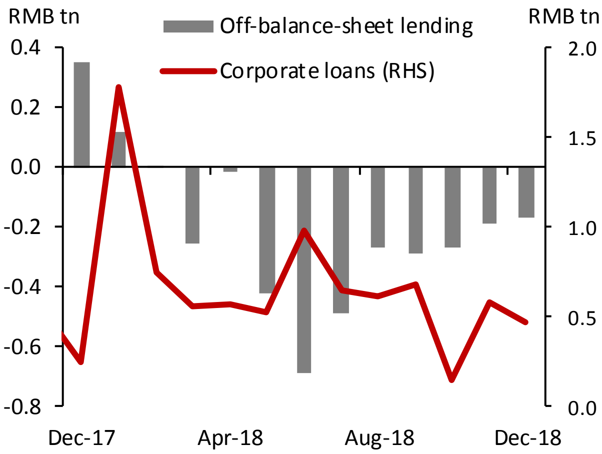


Chart 3: PPI and Manufacturing PMI PPI

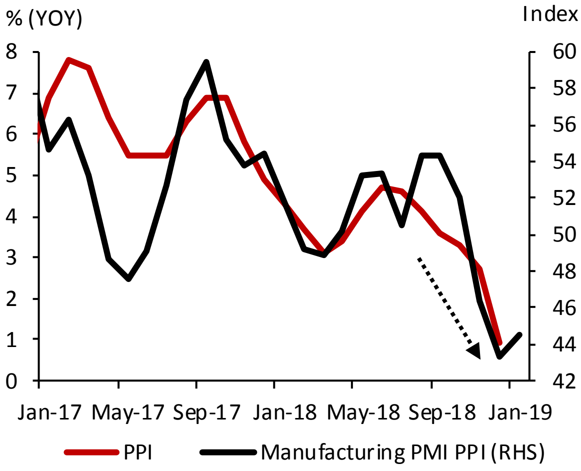
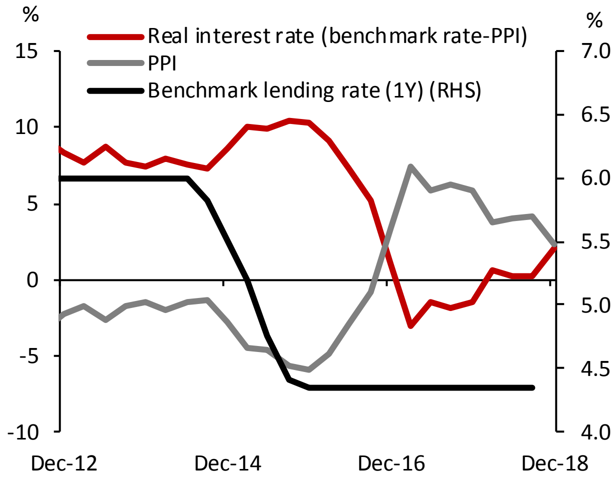


Chart 4: Interest rates and PPI



A bigger concern has been the descent in PMI output charges (December: 44.5) that mirrored the fall in producer price inflation (December: 0.9% vs. November: 2.7%) (Chart 3). Slowing factory-gate inflation usually associates with lower earnings growth. Rising real interest rates and tighter monetary conditions have intensified financial distress, particularly in sectors (e.g. the upstream industries dominated by state-owned enterprises) with high leverage and maturity mismatches. Already, the real interest rates (benchmark lending rate minus PPI) have shot up to 2.1% in Q4 2018 from as low as -3.1% in Q1 2017 (Chart 4).

In retrospect, real funding cost have soared 300bps over 2014 and 2015. The People's Bank of China slashed interest rates by 165 bps in response to avoid widespread defaults and keep deflation at bay. **Looking ahead, an interest rate cut is probable if the PPI pushes into and remains in negative territory in the coming months.**

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Sources: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations).