

| Global Research | 24 August 2017

China SMEI – Gathering momentum

- **Headline SMEI strengthened to 57.4 in August from 56.0 in July, with all three key sub-indices picking up**
- **Production is likely to resume on solid demand; investment appetite increased in August**
- **SMEs’ cash position and credit access improved, although funding costs remained elevated**
- **Recent strengthening of the CNY against the USD fuelled market expectations of CNY gains**

SMEs’ confidence improved further in August

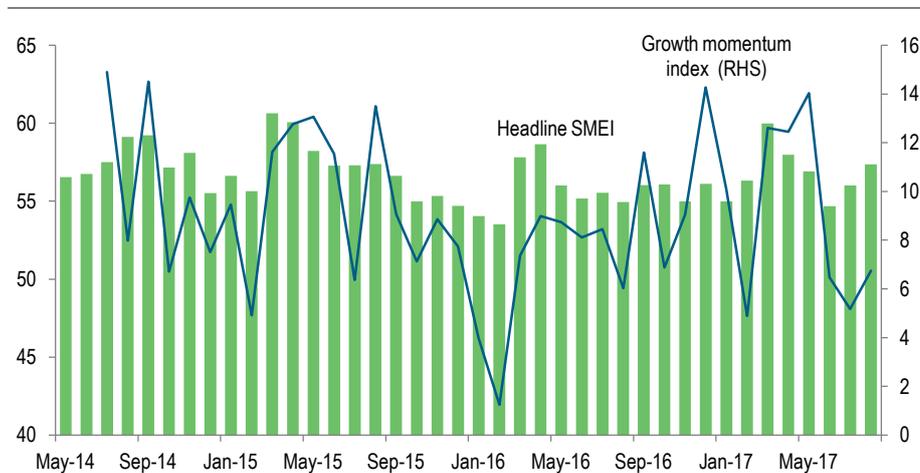
SMEs’ activity in China accelerated in August after touching a low in July, according to our proprietary *Small and Medium Enterprise Confidence Index* (SMEI; Bloomberg: SCCNSMEI <Index>), a survey-based diffusion index gauging more than 500 SMEs nationwide. The headline reading rose to 57.4 in August from 56.0 in July. The growth momentum index also picked up to 6.8 from 5.2 as new orders grew faster than finished-goods inventory (Figure 1). The three key sub-indices – current performance, expectations and credit – all improved in August, rising by 1.3ppt, 1.3ppt and 1.5ppt, respectively (Figure 2). The manufacturing sector, China’s mid-western region and medium-sized enterprises underperformed, while the IT sector, China’s southern region, and small-sized enterprises outperformed (Figure 4).

The current performance sub-index improved on increased employment and financing, and better profit margins with higher output prices. The sub-index for three-month expectations was boosted by an improved outlook for sales and production. Both sub-indices reinforced the recovery in July, reflecting accelerating activity and an expansionary appetite among SMEs.

SMEs’ overall financing conditions improved, although the index reading remained low. Credit access for SMEs improved and receivables turnover accelerated; however, financing costs stayed high. Expectations of Chinese yuan (CNY) appreciation against the USD rose on recent CNY strengthening.

Figure 1: Headline SMEI picked up further in August

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



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

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Current performance and expectations both improved

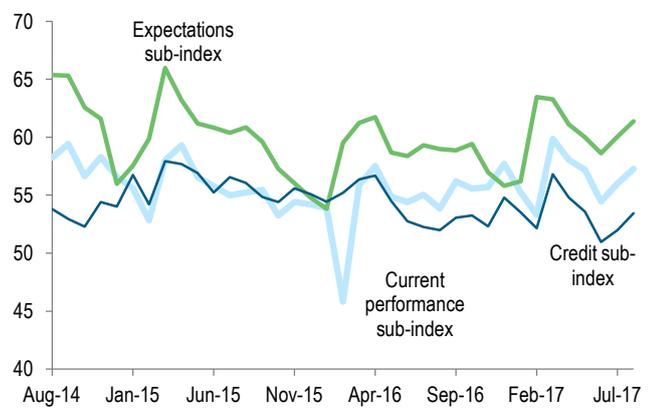
The current performance sub-index rose to 57.3 in August from 56.0 in July, with the employment and output price components growing the fastest. The sub-index for three-month expectations rose 1.3ppt to 61.4 on an improving outlook for sales and production. Both sub-indices continued the July uptrend momentum in August, reflecting an acceleration in activity and an expansionary appetite among SMEs.

Production slowed on temporary disruptions, while demand remained solid; investment appetite also improved

An improving outlook for demand bodes well for production. In August, the current performance readings for production stayed flat and that for capacity usage fell 1.6ppt, partly on disruptions from hot weather and the summer holidays. However, the outlooks for production and capacity usage strengthened on the prospect of improving demand (Figure 5). The current performance reading for new orders and new export orders picked up 1.0ppt and 0.9ppt, respectively, and the expectation reading for new orders rose more evidently to 67.6 from 65.2 in July (Figure 4), suggesting solid demand growth.

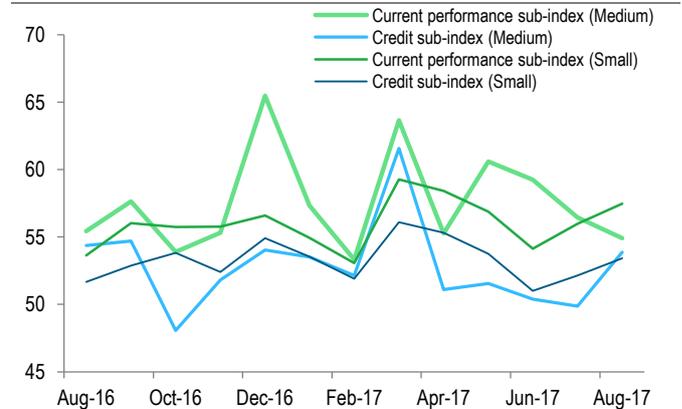
SMEs' expansionary appetite increased in August. The current performance sub-index for investment gained momentum, rising to a five-month high of 57.0 in August, with both the current and prospective financing sub-indices improving (Figure 6). Echoing this, the readings for current and prospective employment also strengthened in August, pointing to increasing investment (Figure 7).

Figure 2: All three key sub-indices picked up
Current performance, expectations and credit sub-indices



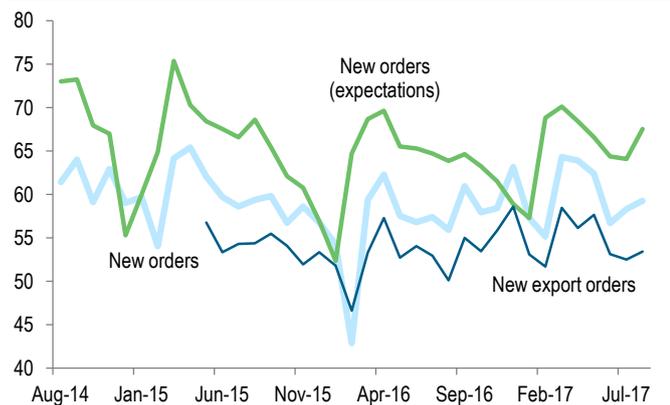
Source: Standard Chartered Research

Figure 3: Medium-sized enterprises underperformed
Current performance and credit sub-indices



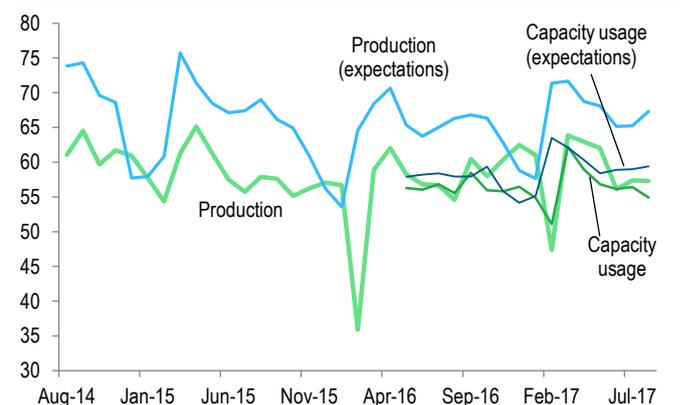
Source: Standard Chartered Research

Figure 4: Pick-up in both domestic and external demand
Current performance and expectations sub-indices



Source: Standard Chartered Research

Figure 5: Capacity usage had a setback in August
Current performance and expectations sub-indices



Source: Standard Chartered Research

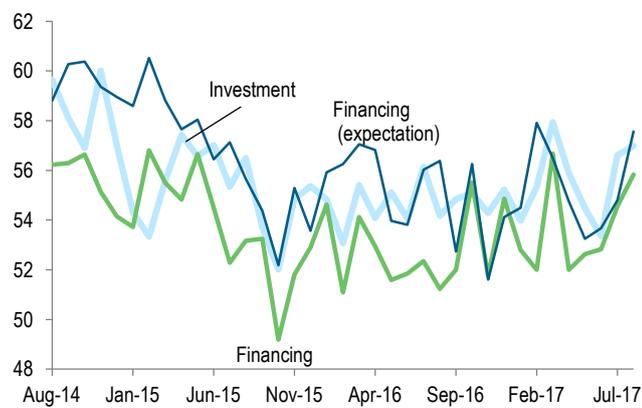


Inventory of both raw materials and finished goods expanded, but at a slower pace (Figure 8). The current readings for raw-material and finished-goods inventory fell 0.8ppt and 0.6ppt, respectively, in August. The expectations reading for finished goods inventory eased 1.9ppt, indicating that the positive inventory cycle is probably running out of steam.

A pick-up in output prices lifted profitability, but rising input prices remain a concern

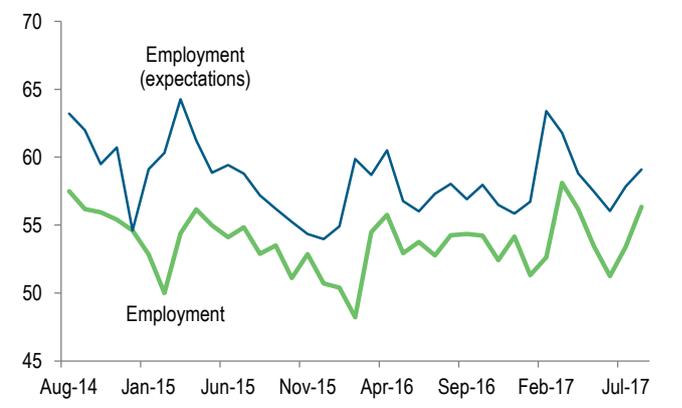
Current profitability improved as output prices rose faster relative to input prices. The current performance index for profitability rebounded to 59.6 in August from 58.5 in July. The sub-indices for input and output prices both picked up in August: output prices rose 2.9ppt, while input prices rose 2.5ppt. SMEs expect the uptrend in both input and output prices to continue, based on the forward-looking indices. However, as most SMEs operate in downstream industries, elevated raw-material prices may undermine their profit margins over time (Figure 9).

Figure 6: Expansionary appetite resumed among SMEs
Current performance and expectations sub-indices



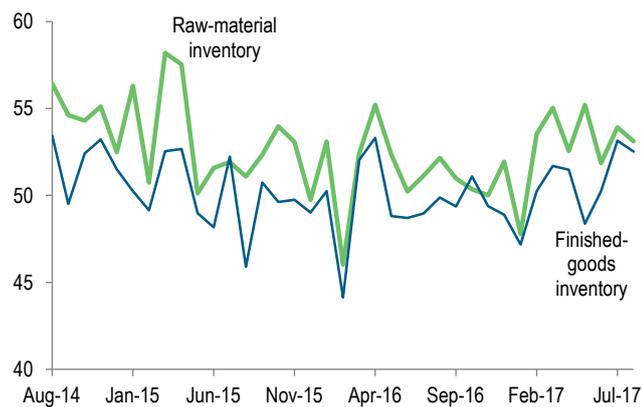
Source: Standard Chartered Research

Figure 7: The labour market improved in August
Current performance and expectations sub-indices



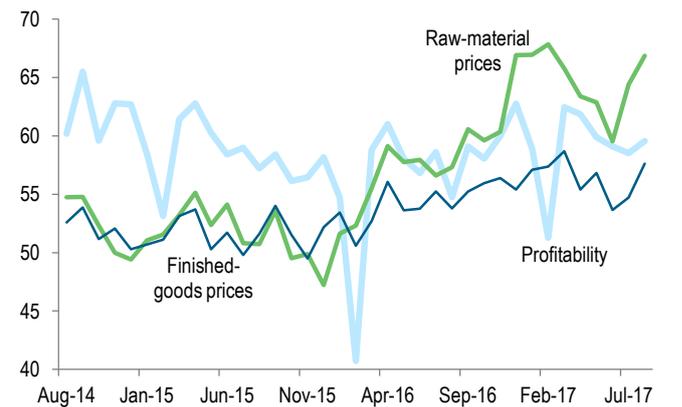
Source: Standard Chartered Research

Figure 8: Restocking cycle may be nearing an end
Current performance readings



Source: Standard Chartered Research

Figure 9: Higher output prices lifted profitability
Current performance and expectations sub-indices



Source: Standard Chartered Research



Credit conditions improved, but funding costs stayed high

The credit conditions sub-index increased 1.5ppt to 53.5 in August, but stayed at a relatively low level. This indicates that SMEs' credit conditions improved slightly, although they remained tough. In the Q2-2017 Monetary Policy Implementation Report, the People's Bank of China (PBoC) pledged that it would continue to implement a prudent and neutral monetary policy, and carry out the three key tasks of (1) serving the real economy, (2) guarding against financial risks, and (3) deepening financial reforms. While financial-market deleveraging has led to higher lending rates, we believe the authorities' efforts to channel credit to real activity and maintain steady growth are likely to benefit SMEs eventually.

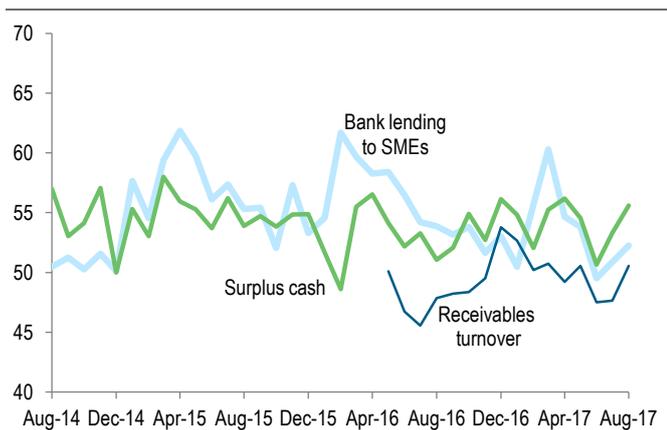
SMEs' access to bank credit improved; receivables turnover accelerated

SMEs' financing conditions improved in August. The reading for banks' attitudes towards lending to SMEs rose to 52.3 in August from a low of 49.5 in June, suggesting easing credit access for SMEs. Surplus cash at SMEs also improved, with the reading rising to 55.6 from 53.3 in July. Receivables turnover accelerated again in August as the sub-index rebounded to 50.6 after two consecutive months of readings below 50.

Funding costs remained high for SMEs, however. The readings for bank and non-bank financing costs both stayed below 50, indicating rising costs. The bank financing cost index was unchanged at 44.4, while the non-bank financing cost index improved to 47.3 from 46.2. This suggests slower deterioration, possibly due to a pick-up in corporate-bond financing. However, we believe rising financing costs will weigh on SMEs' activity in H2-2017.

Figure 10: SMEs' credit access improved and their surplus cash recovered

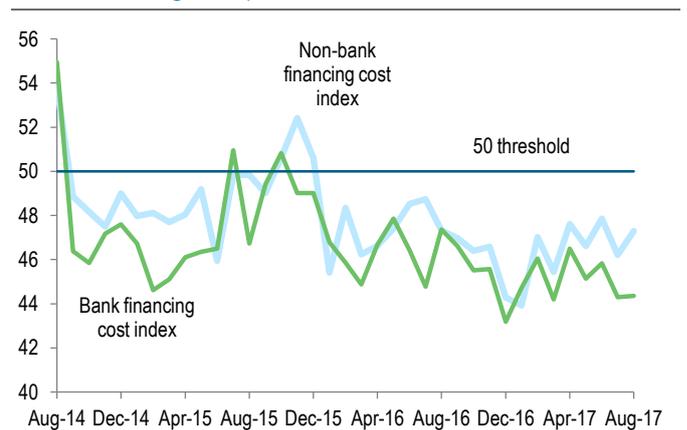
Components measuring credit conditions



Source: Standard Chartered Research

Figure 11: Financing costs for non-bank financing rose less than for bank financing

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



Source: Standard Chartered Research

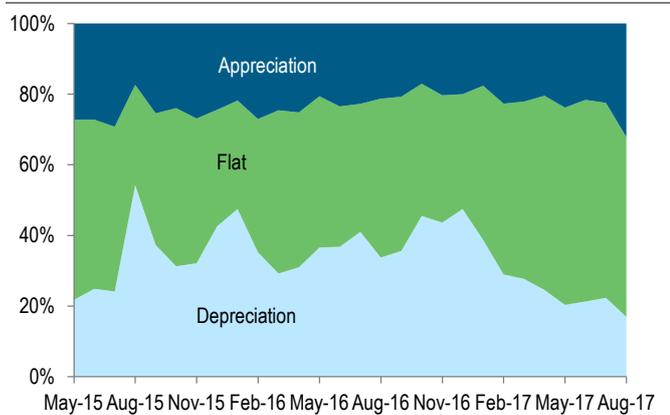
More SMEs expect CNY to appreciate against USD

More respondents expected the CNY to strengthen further against the USD

Recent CNY strengthening against the USD has fuelled market expectations of CNY appreciation, although half of our surveyed SMEs maintained a stable outlook. Of over 540 enterprises that we surveyed in August, 51% expected USD-CNY to be flat near-term (Figure 10), down from 55.2% in July. Those expecting CNY appreciation accounted for 32% of all respondents, marking a historical high, while only 17% expected CNY depreciation, down from 22.3% in July. Compared with the balanced views of the past few months, the August survey result showed a clearly stronger bias towards a rising CNY against the USD.

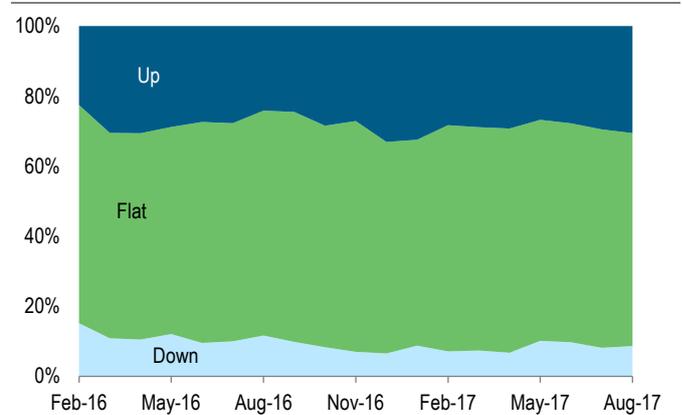
While the majority of SMEs continued to expect stable energy costs, more predicted higher energy costs than in July. 28.1% of respondents predicted higher energy costs in the near future, up from 26.8% in July – much higher than the proportion of respondents expecting lower energy costs (7.9%).

Figure 12: CNY appreciation expectations rose on the recent USD-CNY trends
% of responses



Source: Standard Chartered Research

Figure 13: More SMEs expect higher energy prices
% of responses



Source: Standard Chartered Research

Figure 14: SMEI headline index and sub-indices

	Aug-16	Sep-16	Oct-16	Nov-16	Dec-16	Jan-17	Feb-17	Mar-17	Apr-17	May-17	Jun-17	Jul-17	Aug-17
Headline index	54.9	56.0	56.1	55.0	56.1	55.0	56.3	60.0	58.0	56.9	54.7	56.0	57.4
Performance sub-index	53.8	56.2	55.6	55.7	57.7	55.3	53.3	59.8	58.0	57.2	54.4	56.0	57.3
Expectations sub-index	59.0	58.9	59.4	57.0	55.8	56.2	63.5	63.3	61.1	60.0	58.6	60.0	61.4
Credit sub-index	52.0	53.1	53.3	52.3	54.8	53.5	52.1	56.8	54.8	53.6	51.0	52.0	53.5

Source: Standard Chartered Research



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