

| Global Research | 22 September 2017

China SMEs – Rising concern over input prices

- **Headline SMEI moderated to 56.2 in September from 57.4 in August; all three key sub-indices eased**
- **Production momentum stayed positive on solid demand; investment appetite weakened slightly**
- **Elevated raw-material prices impeded restocking of raw materials and eroded profitability**
- **Small-sized enterprises' credit access deteriorated, although funding costs improved**

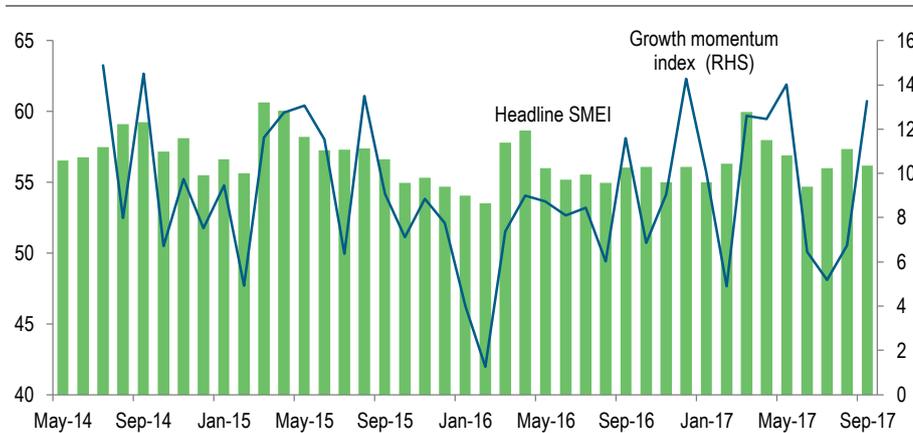
SMEs' confidence softened in September

China SMEs' activity moderated in September after touching a high in August, 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 56.2 in September from 57.4 in August, but the growth momentum index picked up on a decrease in finished goods inventory (Figure 1). SMEs in the manufacturing sector saw some improvement (Figure 3); medium-sized enterprises generally outperformed small-sized enterprises.

The three key sub-indices – current performance, expectations and credit – all eased in September, with the expectations sub-index falling most notably (Figure 2). The components in the current performance sub-index showed that demand remained solid, supporting production momentum, while surging raw-material prices were a concern as they impeded raw-material inventory restocking and eroded profitability. As SMEs' expansionary appetite eased, all components of the expectations sub-index retreated, except the production outlook, which was flat.

Financing conditions remained tough overall, with no improvement in SMEs' credit access. Banks appeared to have squeezed lending to small-sized enterprises in September, while credit extended to medium-sized enterprises remained intact. Financing costs stayed high, but non-bank financing costs stopped rising. Expectations of Chinese yuan (CNY) appreciation against the USD increased.

Figure 1: Headline SMEI eased in September; growth momentum stayed strong
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, expectations sub-indices softened

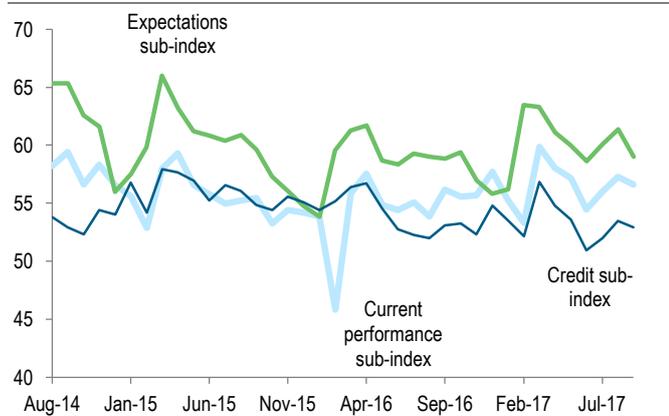
The current performance sub-index moderated to 56.6 in September from 57.3 in August, dragged down by a decline in raw material inventory, while sales and production remained firm. The sub-index for three-month expectations eased to 59.0 in September from 61.4 in August, the broad-based retreat reflecting a more cautious outlook among SMEs.

Sales and production remained resilient; investment appetite eased

Demand remained strong, supporting production activity. The current performance reading for new orders and new export orders picked up 3.5ppt and 1.6ppt, respectively (Figure 4). This led to an acceleration in the current performance readings for production and capacity usage, which rose 5.4ppt and 1.2ppt, respectively (Figure 5). The near-term outlook for sales and production also stayed resilient, indicating solid demand and active production ahead.

However, SMEs' expansionary appetite eased in September. The current performance readings for investment and financing slid 1.1ppt and 3.3ppt, respectively, and their expectations readings also retreated from August levels (Figure 6). Echoing this, the readings for current and prospective employment dropped, pointing to a slower pace of expansion among SMEs (Figure 7).

Figure 2: Expectations sub-indices led the drop
Current performance, expectations and credit sub-indices



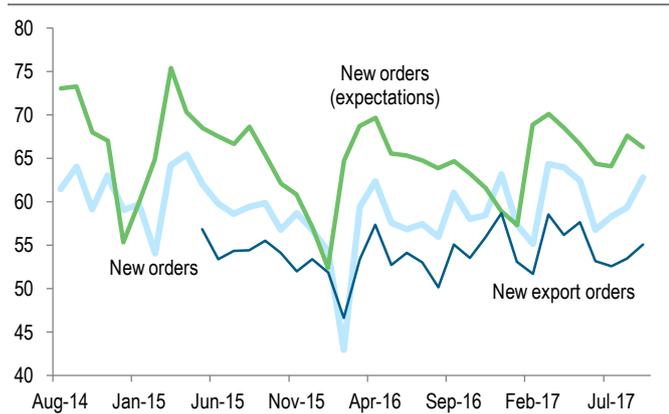
Source: Standard Chartered Research

Figure 3: Manufacturing sector saw accelerated activity
Current performance sub-indices



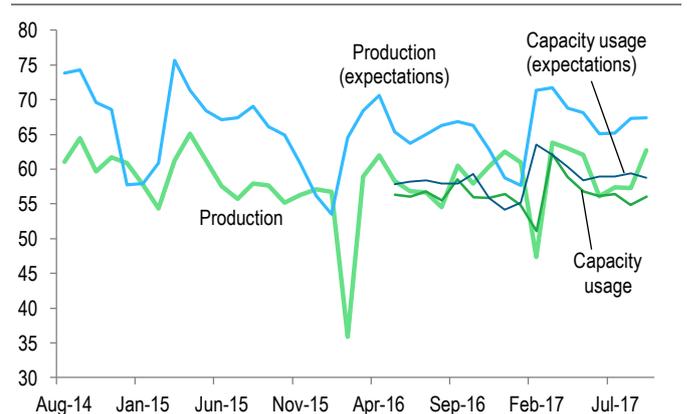
Source: Standard Chartered Research

Figure 4: Demand remained solid; export orders rose
Current performance and expectations sub-indices



Source: Standard Chartered Research

Figure 5: Production picked up with higher capacity usage
Current performance and expectations sub-indices



Source: Standard Chartered Research

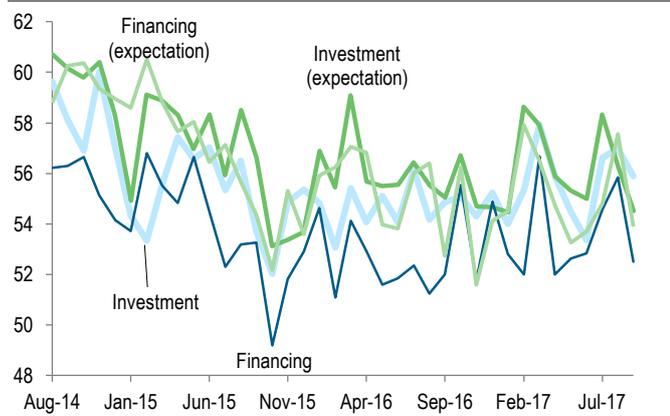


The surge in raw material prices impeded SMEs' raw material restocking and eroded profitability

Both raw-material and finished-goods inventories decreased in September (Figure 8). The current reading for raw material inventory dropped 4.5ppt into contractionary territory, and the expectations reading slid 4.3ppt, suggesting weaker raw material restocking momentum. We think this was due to a surge in raw material prices (which rose to a historical high of 68.6) and a less expansionary appetite (indicated by a lower investment reading). Finished goods inventory retreated 3.0ppt to below 50 in September and the expectations reading eased 2.2ppt. This indicates that the positive inventory cycle is probably running out of steam, providing less support for production ahead.

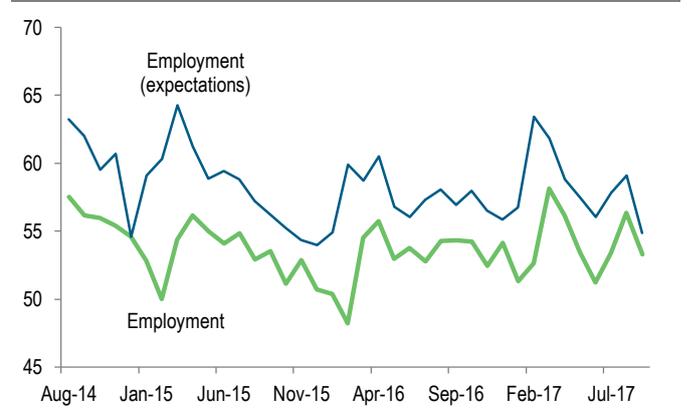
Profitability deteriorated on higher input prices. The current performance index for profitability slid 1.0ppt as input prices rose faster relative to output prices (Figure 9). SMEs expect a continued acceleration in raw material prices and a further moderation in finished goods prices, according to the forward-looking indices. This will likely continue to undermine SMEs' profitability in the coming months. The expectations reading for profitability fell 2.2ppt in September.

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



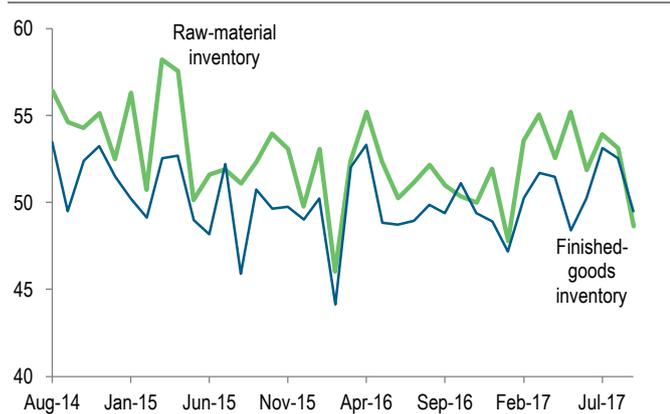
Source: Standard Chartered Research

Figure 7: The labour market cooled in September
Current performance and expectations sub-indices



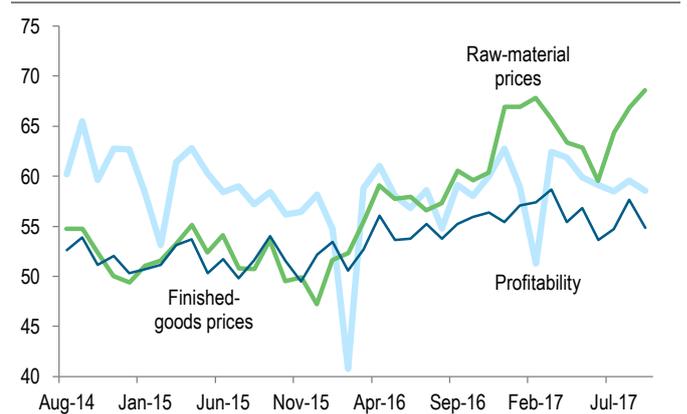
Source: Standard Chartered Research

Figure 8: Raw-material and finished-goods inventories fell
Current performance sub-indices



Source: Standard Chartered Research

Figure 9: Higher input prices eroded profitability
Current performance sub-indices



Source: Standard Chartered Research



Credit conditions showed no improvement

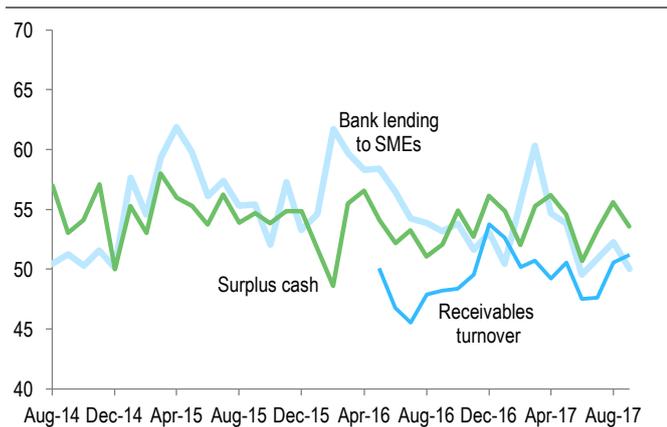
The credit conditions sub-index edged down 0.5ppt to 52.9 in September, indicating no improvement in SMEs' credit conditions, while the sub-indices showed tougher bank credit access for small-sized enterprises. The average credit conditions sub-index was at 52.8 in Q3-2017, down from 53.1 in Q2, reflecting continued implementation of a prudent and neutral monetary policy.

Banks appeared reluctant to lend to small-sized enterprises

Banks' lending to small-sized enterprises decreased. The reading for banks' lending to all SMEs dropped 2.3ppt to 50.0 in September (Figure 10), suggesting no improvement in bank credit access. However, the sub-indices showed that banks' lending to small-sized enterprises fell to 49.5, while their lending to medium-sized enterprises remained at 55.3. This indicates that commercial banks have squeezed lending to small-sized enterprises this month.

While funding costs remained high for SMEs, non-bank financing costs stopped rising in September. The reading for non-bank funding costs rose 2.7ppt to 50.0, meaning non-bank borrowing costs did not increase further. This was in line with the recent decline in the discount bill and private lending rates. The reading for banks' funding costs also improved marginally, suggesting that the average interest rate on bank loans rose at a slower pace.

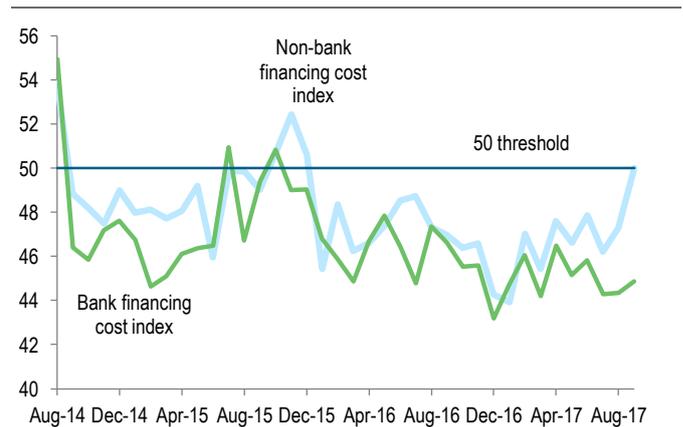
Figure 10: SMEs' credit access generally worsened
Components measuring credit conditions



Source: Standard Chartered Research

Figure 11: Funding costs for non-bank financing stopped rising

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 a stronger CNY against USD

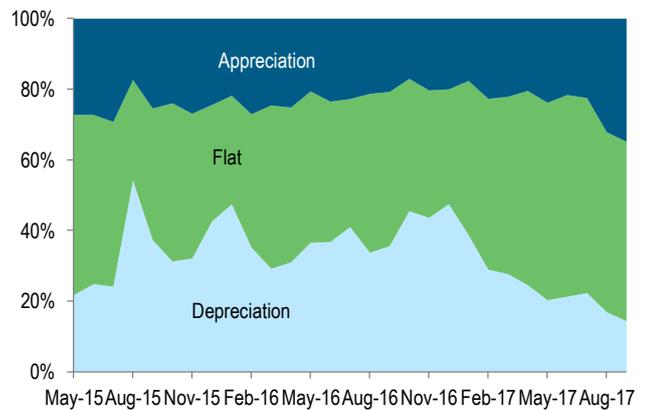
Our SME survey showed a stronger bias toward a rising CNY against the USD

Recent strengthening of CNY against the USD and the rebound in the CNY's onshore basket value have fuelled market expectations of CNY appreciation. Of over 540 respondents in our September survey, 35% were bullish on CNY appreciation, marking a historical high. Only 14% expected CNY depreciation near-term, down from 17% in our last survey. However, the recent removal of the FX forward reserve ratio and the adjustment of counter-cyclical factors in the CNY daily fixing may help to anchor market expectations in late September.

While the majority of SMEs still expect stable energy costs, the outlook appears to have become slightly more balanced. 27.5% predicted higher energy costs in the near future, down from 28.1% in August, while respondents expecting lower energy costs rose to 9.0% in September from 7.9% in August.

Figure 12: CNY appreciation expectations rose to a record high

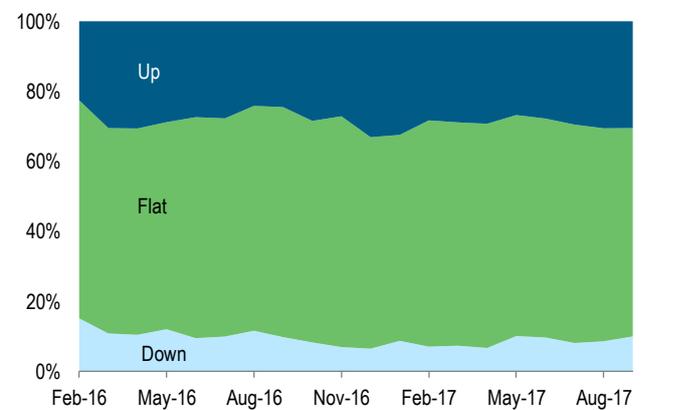
% of responses



Source: Standard Chartered Research

Figure 13: Expectations of energy prices turned slightly more balanced

% of responses



Source: Standard Chartered Research

Figure 14: SMEI headline index and sub-indices

	Sep-16	Oct-16	Nov-16	Dec-16	Jan-17	Feb-17	Mar-17	Apr-17	May-17	Jun-17	Jul-17	Aug-17	Sep-17
Headline index	56.0	56.1	55.0	56.1	55.0	56.3	60.0	58.0	56.9	54.7	56.0	57.4	56.2
Performance sub-index	56.2	55.6	55.7	57.7	55.3	53.3	59.8	58.0	57.2	54.4	56.0	57.3	56.6
Expectations sub-index	58.9	59.4	57.0	55.8	56.2	63.5	63.3	61.1	60.0	58.6	60.0	61.4	59.0
Credit sub-index	53.1	53.3	52.3	54.8	53.5	52.1	56.8	54.8	53.6	51.0	52.0	53.5	52.9

Source: Standard Chartered Research



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