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CNY/CNH – Caixin Zigged while NBS/CFLP Zagged

8 March 2018

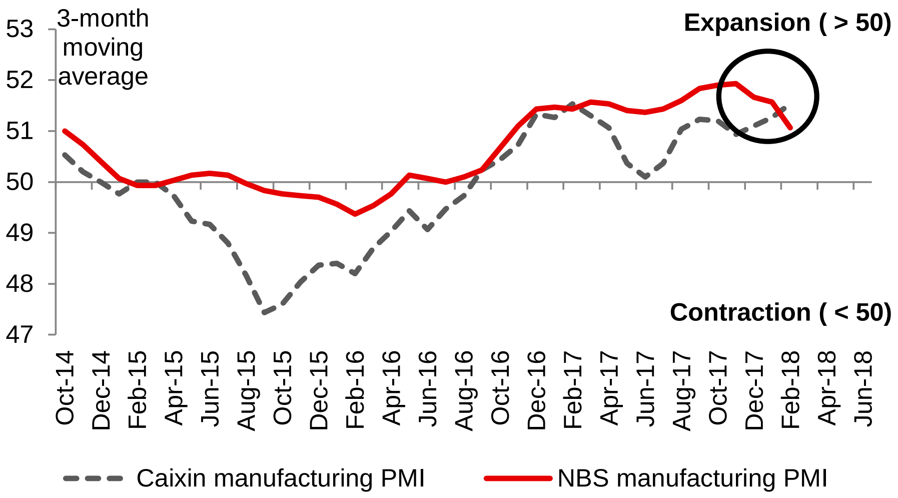
Key Points:

- **There are indications in China's February PMIs that is slowing**
- **But before we can confirm our expectations for growth moderation to begin in early 2018, we will need to see more than one month of data**
- **As noted before, Caixin PMIs have been more constructive on Chinese growth of late**
- **Technical differences in Caixin/NBS survey designs may help explain the divergence**
- **We generally prefer the NBS/CFLP measure as a better correlate to actual economic data**
- **One key common trend to watch is weakening new export orders, giving rise to questions about external demand**
- **Chinese steel corporates may face a challenging year, in light of both domestic policies and Trump tariffs**
- **Non-manufacturing continues to offer the economy support**

Caixin zigged and CFLP zagged, again

China's Caixin manufacturing PMI for February (51.6, highest reading since August 2017 > consensus 51.3 > last 51.5) appeared at odds with the official CFLP PMI released earlier by the National Bureau of Statistics (NBS) (50.3, lowest reading since July 2016 << consensus 51.1 and last 51.3). This was not the first time Caixin zigged and CFLP zagged; and probably won't be the last, partly due to technical differences in the two survey designs (see the Appendix).

DIVERGENT MANUFACTURING PMIS: NBS VS. CAIXIN



Source: Bloomberg, MUFG Bank

We prefer the NBS manufacturing PMI

NBS figures imply a softer start to the year for manufacturing

Monthly changes in the NBS manufacturing PMI seems a slightly better proxy than Caixin when **predicting monthly deviations of the %YoY growth of value added in industry**, a key monthly economic indicator. As such, optimistic operating conditions in manufacturing as conveyed by the Caixin manufacturing PMI in January and February have not alter our views for **a softer start to the year for the manufacturing economy**, as implied by NBS manufacturing. In the latter PMI, both the average January-February figures for headline and production and business expectations (intended to be a forward-looking indicator) declined from their 4Q averages and were lower than last January-February readings a year earlier.

In general, sometimes we suspect the analyst community spends a little too much time on China's PMIs, which may sometimes reflect sentiment. We sometimes prefer looking at harder numbers (actual data).

NBS PMI sub-indices revealed a broad-based slowdown

A second straight monthly contraction in new export orders is worth noting

For new orders and production, the slowdown was broad-based. **In particular, new export orders contracted a second straight month.** Manufacturing hiring remained weak, as employment (a key concern of Chinese leadership) declined to a 20-month low of 48.1 and has remained below 50 eleven months in a row. Meanwhile, inventory destocked at a slower pace, possibly due to **moderating producer price gains.**

NBS MANUFACTURING PMI: MOMENTUM

NBS manufacturing PMI	2018 Jan-Feb	2017 4Q	2017 3Q	2017 Jan--Feb
Headline	**50.80**	**51.67**	**51.40**	**51.45**
Production and business expectations	57.50	57.87	59.33	59.25
Production	52.10	53.90	54.10	53.40
New orders	51.80	53.30	53.57	52.90
New export orders	49.25	50.93	50.87	50.55
Employment	48.20	48.77	49.10	49.45
Finished goods inventory	46.85	46.00	45.27	46.30
Purchasing price	56.55	61.80	63.87	64.35
Producer price	50.50	54.47	56.50	55.50

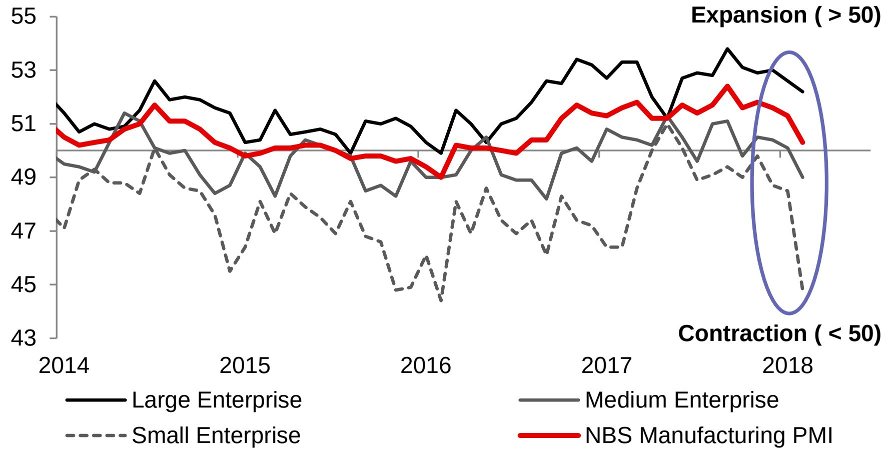
Source: NBS, MUFG Bank

Remarks: A light red (green) box represents a decline (increase) from last quarter; while a red (green) figure represents a figure below (above) 50.

Larger manufacturers continue to outperform small and medium-size manufacturers

Manufacturing weakened across all scales of enterprises. State-owned enterprises (SOEs) are expected to reduce their leverage, possibly weighing somewhat on their productivity, while the manufacturing activity level of both small and medium enterprises were in a contractionary space. With the on-going mixed ownership reform and the supply-side reform continuing to benefit SOEs, **SOEs are expected to continue to lead the expected moderating manufacturing economy.**

LARGE ENTERPRISES CONTINUE TO OUTPERFORM SMALL & MEDIUM ONES



Source: Bloomberg, MUFG Bank

Both Caixin and NBS reported softening new export sales

Some early signs of softening external demand, even before the latest Trump tariffs

Despite the divergence in headline figures, both Caixin and NBS reported softening new export sales, signalling **the possibility that external demand may be softening.**

- Caixin's new export sales rose by *the softest extent for three months in February*, while growth in new export sales had also softened to a modest pace in January.
- NBS's new export orders contracted for a second month and declined to a 22-month low of 45.9, while the January-February average of new export orders was 48.0, below both its 4Q average of 51.03 and an average of 48.25 set last January-February.

On a more positive note, South Korea (the first country in the region to report) showed solid export growth of 12.8%YoY in January-February, though it was slower than 15.6% growth in the same period last year. This came in line with our expectations for export growth moderation as world trade growth normalizes from a high base effect. Meanwhile, China's export growth (USD) of 24.4%YoY in January-February exceeded our and consensus expectations. Yet, **recent US trade policy developments, such as the imposition of tariffs on steel and aluminum that could also possibly trigger retaliation** (*Asia Cross Current: CNY - The Limitations of Donald Trump in China, Part 1*, 2 March 2018) may have yet to be factored in.

A challenging time for Chinese steel with Trump's latest tariffs

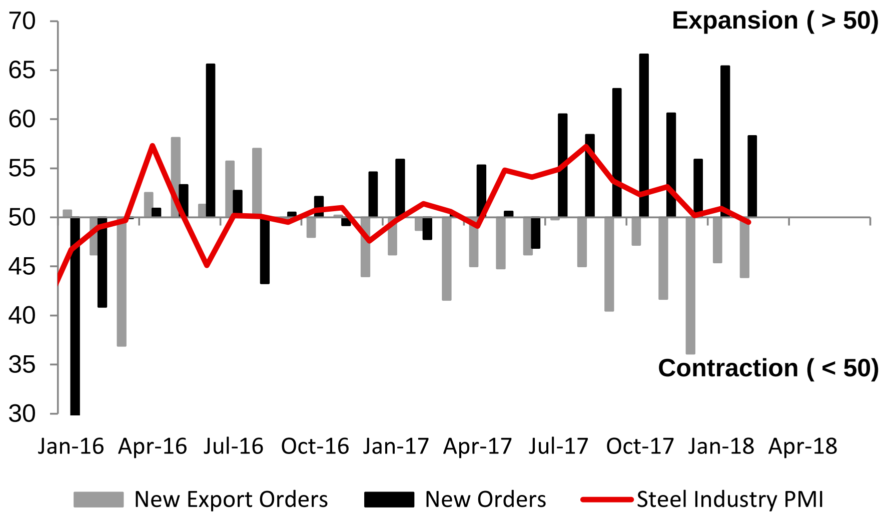
China's steel corporates will probably have a challenging year ahead, against the backdrop of domestic policies plus Trump's tariffs

On the domestic front, Chinese government policies, such as the **environmental clean-up campaign and reduction of outdated and excessive production capacity in steel** (and coal)[1] will probably continue to restrain the steel industry. The NBS steel industry PMI declined to a January-February average of 50.2 from 51.87 in 4Q, also lower than 50.57 in the same period last year. Externally, EU anti-dumping duties and existing US tariffs will weigh on new export orders which have stayed below 50 for 15 straight months through February, with some domestic steel production having been shifted offshore. **Trump's latest tariff plan on steel and aluminium will probably have a muted direct impact on Chinese exports** as

[1] *China plans to eliminate 100 million to 150 million tons of crude steel capacity and 500 million tons of coal in the five years from 2016. The country completed its 2017 tasks for capacity cuts in both sectors, according to the National Bureau of Statistics. (China's steel industry profits improve, 3 January 2018, Xinhua)*

steel, iron and aluminium represent only 2.2%[2] of total merchandise exports; **nevertheless, Chinese steel corporates with offshore manufacturing may face challenges, contributing to the challenges outlined above.**

CHINA STEEL RECOVERY DEPENDS MORE ON DOMESTIC DEMAND



Source: Bloomberg, MUFG Bank

Non-manufacturing still counter-balancing growth

Non-manufacturing, on a positive note, has a rather solid start to the year

On a positive note, **NBS non-manufacturing activity appeared to have revived, despite apparently softer construction** (January-February construction PMI 59.0 < 4Q average 61.27 < last January-February 60.6).

The average January-February headline non-manufacturing PMI of 54.85 (> 4Q average 54.7 and last January-February 54.4) and production and business expectation sub-index, a forward looking indicator, on average 61.45 (> 4Q average 61.03 and last January-February 60.65) suggest **a solid start for the year in non-manufacturing**. Other sub-indices, from new orders, employment to selling prices, were steady. **There was again some early signs of softening external demand, as new export orders declined to a 22-month low of 45.9** (January-February new export order 48.0 < 4Q average 51.03 < last January-February 48.25).

To sum up

March figures awaited; our expectation had been for a growth moderation from early this year

NBS PMIs for February came in weaker than expected, but not the Caixin manufacturing PMI. The Lunar New year timing effect does cloud the underlying picture, so it will be crucial to see if there is a notable rebound in March or not, including monitoring softening external demand. This would probably pose downside risks to the growth outlook in China, especially should the US apply further impose trade remedy measures (protection) to other industries. A reminder our view is for softening growth in China from early this year (2017 GDP grew 6.9%).

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[2] *The estimate is made using 12-month rolling sum of monthly trade figures in USD, published by NBS.*

Appendix

Differing LNY adjustments

The press release for the Caixin manufacturing PMI said explicitly **headline Caixin manufacturing PMI, adjusted for seasonal factors including the Chinese New** Year (also known as the Lunar New Year, LNY), is *a composite indicator designed to provide a single-figure snapshot of operating conditions in the manufacturing economy*. By contrast, **the explanatory notes for the NBS February PMIs[3] accounted for the notable February decline in its PMIs *as* a LNY timing effect,** as *adjustment would mostly appear in the month of LNY, based on historical observations* (*从历史数据看，春节所在月份的PMI大多会出现一些调整*). That latter seemed to contradict NBS's Q&A on PMI statistics[4] which stated **adjustments related to seasonal factors including LNY would be made PMI**. We might surmise differences in LNY adjustments for Caixin and NBS manufacturing PMIs might contribute to the February divergence.

Different sample size, industry and geographic coverage may be other reasons behind divergence

Sample size wise, **Caixin surveys *over 500 manufacturing companies* while NBS *3000***. According to Caixin's article entitled *Light Manufacturers Post Ninth Straight Month of Activity Expansion,*[5] ***"The Caixin PMI focuses more on light industry, while heavy industry makes up a larger proportion of the NBS survey. The geographic distributions of the companies covered in the two polls are also different."*** All these could contribute to the divergence.

Disclaimer

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[3] The explanatory notes of NBS for February PMIs (28 February 2018): http://www.stats.gov.cn/tjsj/sjjd/201802/t20180228_1585596.html (simplified Chinese)

[4] NBS Q&A related to services industry and PMI statistics (5 January 2018): http://www.stats.gov.cn/tjzs/cjwtjd/201311/t20131105_455943.html (simplified Chinese)

[5] Light Manufacturers Post Ninth Straight Month of Activity Expansion (1 March 2018, Caixin) https://www.caixinglobal.com/2018-03-01/light-manufacturers-post-ninth-straight-month-of-activity-expansion-101215155.html