



## China Macro

### Input prices and PMI point to declining industrial profits to follow

- China's Jun-16 PMI points to a modest expansion in manufacturing activity, but the shrinking orders suggest that weakening productivity is likely to follow. The declining input prices indicate a slowdown in price recovery, which could have negative impacts on industrial profits, in our view.
- Prices in upstream and midstream sectors are more likely to see upward pressure given the substantial fall in input prices in June.
- De-stocking continues in the manufacturing sector, in particularly in the upstream that had seen a short rebound in 1Q16 triggered by increased private FAI.
- Declining FAI in the property sector would add to pressure on industrial profit growth, in our view.
- In conclusion, declining input prices may ultimately, passing through PPI and upstream profits, lead to declining industrial profits.

**1, PMI:** The official PMI for June, which came in slightly lower than May at 50, suggests a modest growth in manufacturing activity, in light of the better-than-seasonal rise in production post the peak season. However, the shrinking PMI orders, which may be a precursor to weaker productivity going forward, together with the largely falling raw material prices are clear indications that demand recovery will remain sluggish.

**2, Price:** The PMI input price in June plummeted to 51.3 from 55.3 in May. In view of its correlation with the industrial price, we expect the recovery of the PPI is likely to slow down in the future, as the recovery has been primarily led by the prices in upstream and midstream sectors in recent months, the upstream resource products prices are most likely to remain on a downtrend in the near-term.

**3, Inventory:** The Manufacturing sector is still going through the active de-stocking phase, upstream sectors like energy and commodities have posted short-term re-stocking due to the price hikes since the beginning of this year and have led some companies to resume production that are supposed to be shut down in accordance with the supply-side reform, especially within the private FAI sector.

**4, Investment:** With regards to fixed asset investment, the growth in manufacturing investment has declined since the beginning of this year, whilst property investment has dropped slightly following the ramp-up in 1Q and infrastructure investment has increased at a relatively slower pace. Considering that FAI in property is highly correlated with the growth in industrial profits, we expect overall industrial profit growth will be less supportive in the foreseeable future, in view of the sluggish FAI property growth.

**5, Profit:** Total industrial profit growth started to slow down after hitting the peak in March albeit the upstream sector is still under recovery. However, if the PMI input price continues to decline, the possible scenario would be: lower input prices would lead to a decline in the PPI, in turn resulting in lower upstream prices and reduced industrial profits, thereby resulting in total profits to come down further. As such, further recovery in upstream profits may be capped when there is a pullback in the resource product prices.

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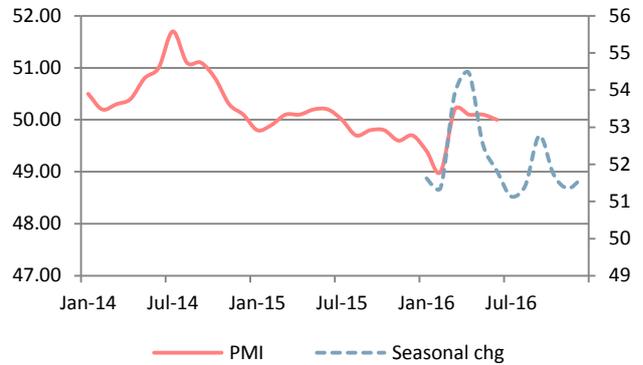
## Charts

**Figure 1: PMI orders weaker than seasonal change**



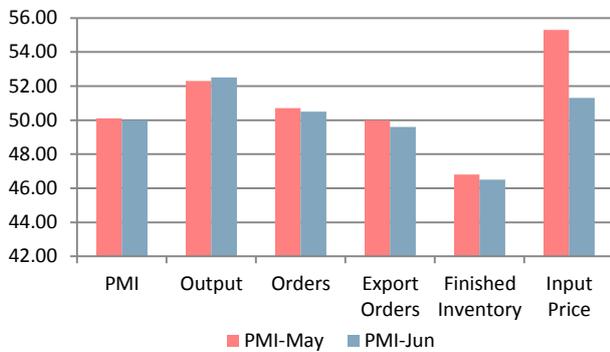
Source: Wind, CSCI Research estimates

**Figure 2: PMI index vs historical average**



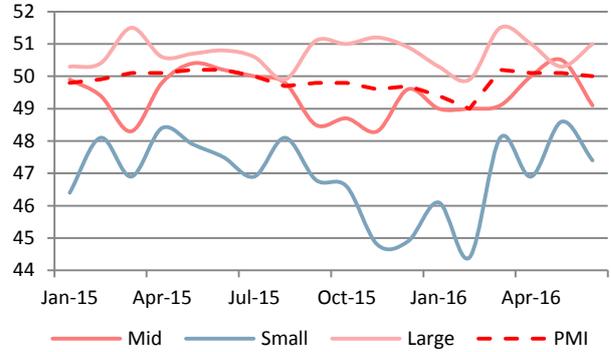
Source: Wind, CSCI Research estimates

**Figure 3: June PMI breakdown**



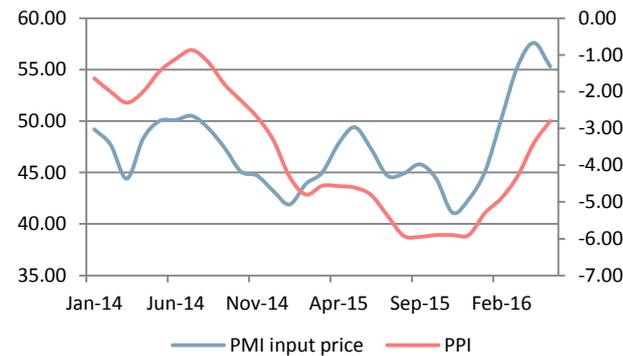
Source: Wind, CSCI Research

**Figure 4: PMI in large/medium/small sized companies**



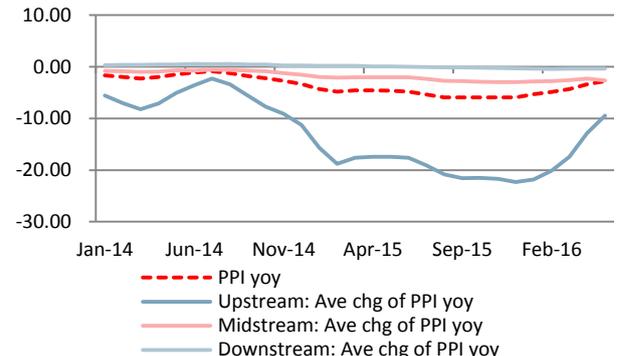
Source: Wind, CSCI Research

**Figure 5: PMI input price leading PPI**



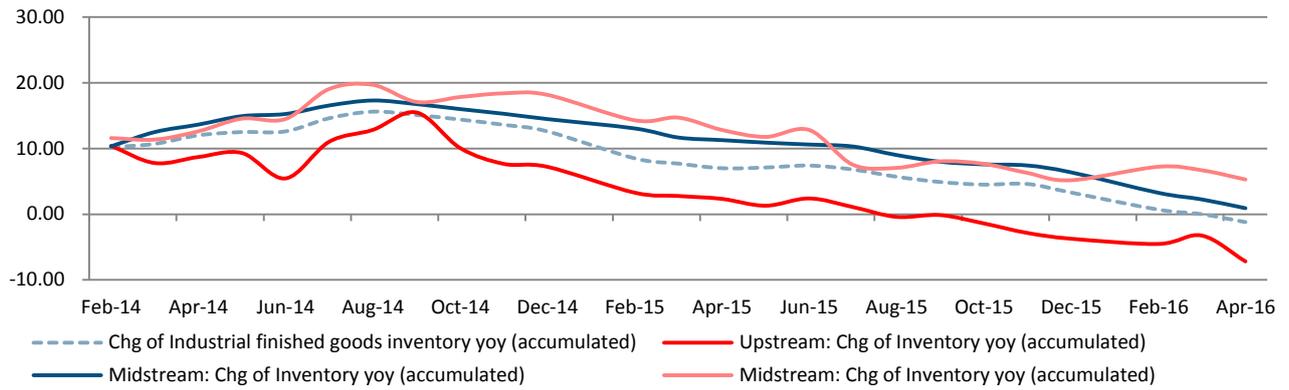
Source: Wind, CSCI Research

**Figure 6: Upstream price going up with PPI**



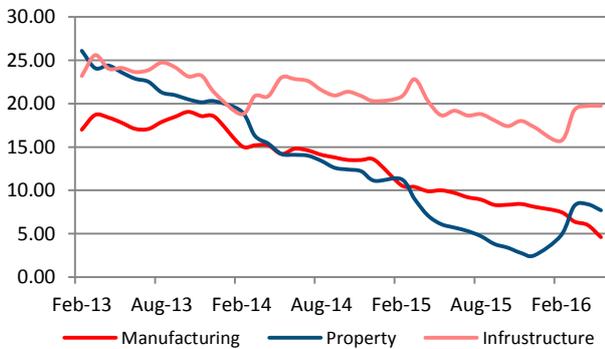
Source: Wind, CSCI Research

**Figure 7: Manufacturing finished-goods inventory growth yoy (accumulated)**



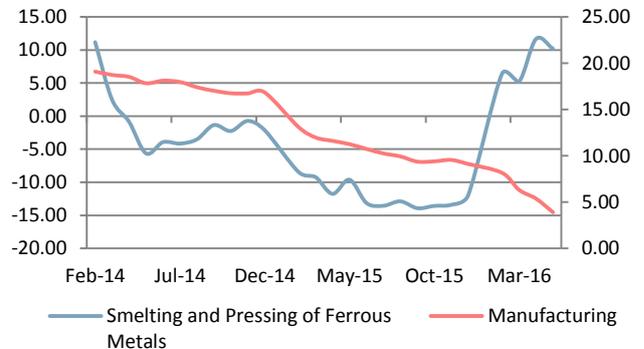
Source: Wind, CSCI Research

**Figure 8: FAI growth yoy**



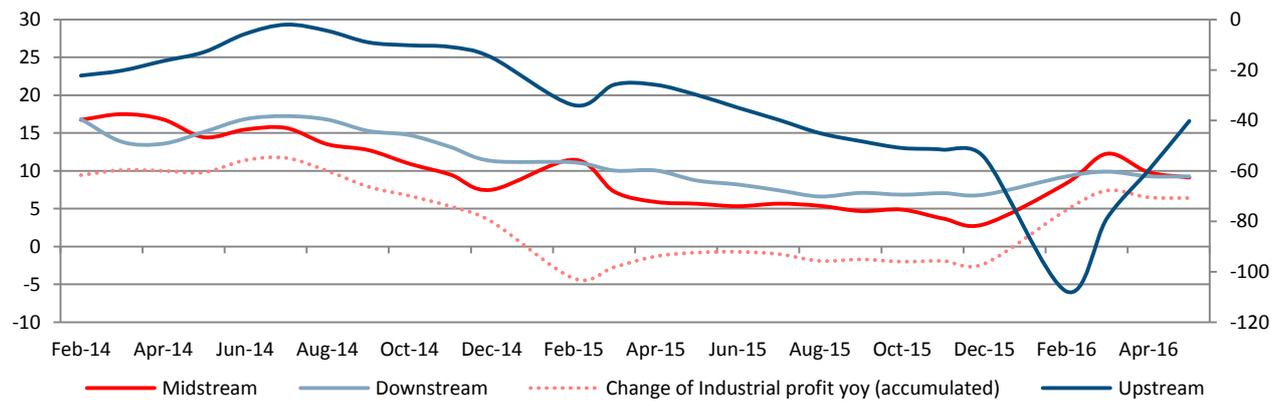
Source: Wind, CSCI Research

**Figure 9: Private FAI growth yoy**



Source: Wind, CSCI Research

**Figure 10: Total industrial profit growth yoy (Accumulated)**



Source: Wind, CSCI Research



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## Company Rating Definition

The Benchmark: Hong Kong Hang Seng Index; Time Horizon: 12 months

<b>Buy</b>	12-month absolute total return: $\geq 10\%$
<b>Hold</b>	12-month absolute total return: $> -10\%$ but $< 10\%$
<b>Sell</b>	12-month absolute total return: $\leq -10\%$

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