1 December 2015

Flash Comment

Chinese PMIs a mixed bag but still in line with stabilisation - more rate cuts in the pipeline

- **Chinese manufacturing PMI for November was a mixed bag with the private Caixin PMI strengthening, whereas the official PMI from NBS fell to the lowest level in three years.**
- The Caixin PMI manufacturing rose to 48.6 (consensus 48.3) from 48.3 in October. It was the second monthly rise. The new orders index, however, slipped a bit to 47.8 from 48.0 but it still above the low in October at 46.4. The order-inventory level improved further as the inventory index fell from 50.2 to 49.0. Hence the Caixin numbers are overall well in line with the story of a tentative bottom in the Chinese industrial sector.
- In contrast, the official PMI manufacturing from NBS fell from 49.8 in October to 49.6 in November, which is the lowest level in three years. The details were also poor with the new orders index falling to 49.8 from 50.3. It was lower in September, though, when it hit 49.7. On a positive note, the inventory index fell further and has reached a very low level. Hence, the order-inventory level, while slightly lower in November, is still pointing to some recovery.
- When it comes to exports the picture is even more confusing. The NBS PMI export orders index is showing a sharp decline, whereas the Caixin PMI export orders index increased for the second month in a row.
- **What to make of these different pictures? The official PMI tends to have smaller swings and captures the underlying development more accurately. From this point of view it would suggest that the Caixin PMI points to a small short-term rebound but that the underlying development is still one of weakness. However, there is some light to be seen in the higher levels of order-inventory balances** (see charts on page 2), which underpin that stabilisation and slight recovery are still in the pipeline. The actual industrial production data in China have yet to show improvement, although there has been some stabilisation in the past months.
- Two opposing forces are affecting the Chinese business cycle currently. On the one hand, a high degree of overcapacity in many sectors, continued deleveraging and a difficult rebalancing process are weighing on activity. On the other hand, stimulus from the Chinese government and PBoC should work to push up activity somewhat in the industrial sector.
- **The data today suggest that the Chinese economy needs more stimulus to counterweigh the structural drags as the improvement is still only very tentative. We now look for three more interest rate cuts** of 25bp over the next six months in order to underpin activity and ease the debt burden for Chinese companies. This would take the 1-year lending rate to 3.6 by mid-2016. China has already cut interest rates six times over the past year corresponding to 25bp every second month and we believe this pace will continue the next couple of quarters. We also look for a further reduction of the reserve requirement ratio of 100bp over the next six months

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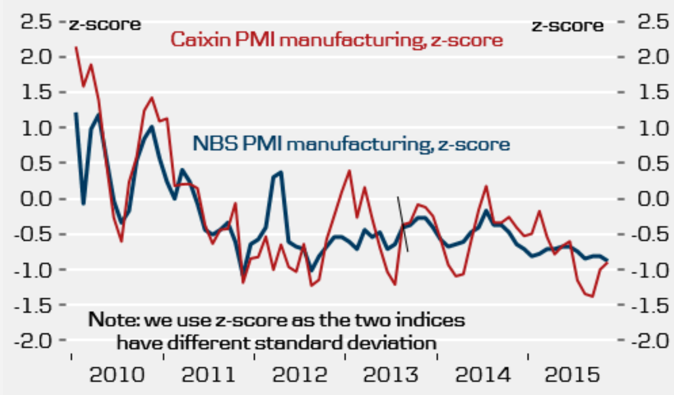
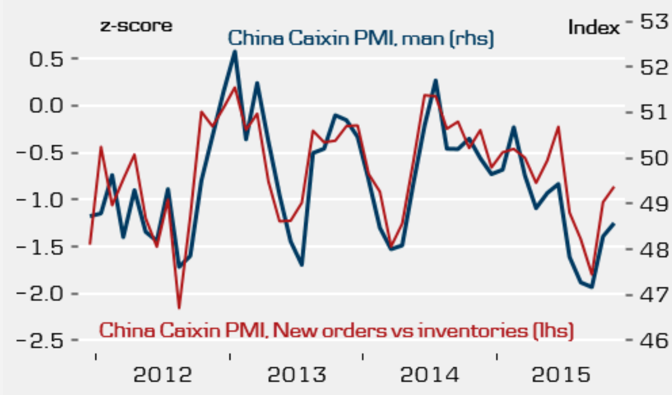
- The need for stimulus also depends on how much the service sector is able to take over from the industrial weakness. PMI non-manufacturing from NBS did in fact increase from 53.1 in October to 53.6 in November. It is still a fairly weak level, though, as the average for the series since 2009 has been 55.7.
- **For the CNY we expect the depreciation pressure to continue.** First, further interest rate reductions while the Fed starts raising rates are set to lead to a weaker CNY versus the USD. Second, China's inclusion into the SDR (decision was taken yesterday by IMF) is likely to fuel expectations that China will allow the CNY to weaken further after aiming to keeping it stable ahead of the IMF decision. Hence, we are likely to see renewed speculation against the CNY.
- We do not expect China to allow the CNY to depreciate rapidly as this would trigger more rapid capital outflows and would be destabilising. Hence, **PBoC will likely need to intervene again to manage the move and we could easily see FX reserves fall again in coming months** after having stabilised recently. This in turn could imply selling of US and euro bonds adding to upward pressure on yields when the Fed starts hiking and we get what we believe is the last easing from the ECB on Thursday.

Caixin PMI increases while the official PMI slips further to three-year low



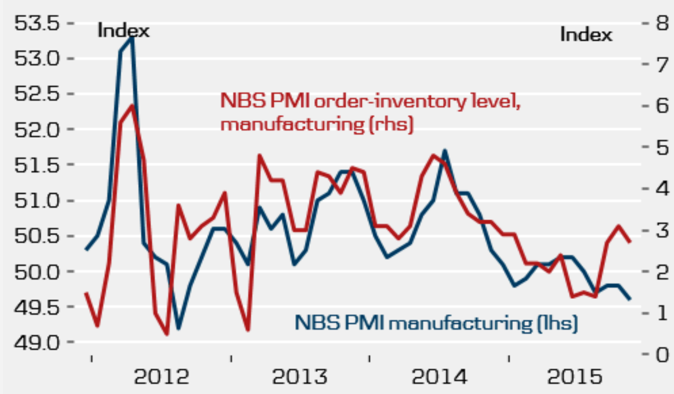
Source: Macrobond Financial

Caixin order-inventory level points to short term rebound



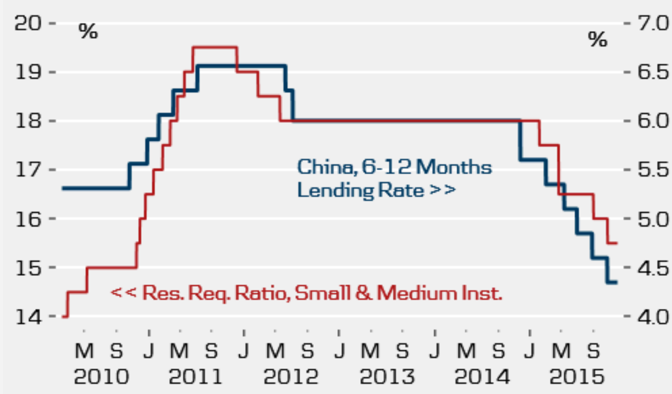
Source: Macrobond Financial

NBS order-inventory index also points to improvement as inventory index has fallen a lot



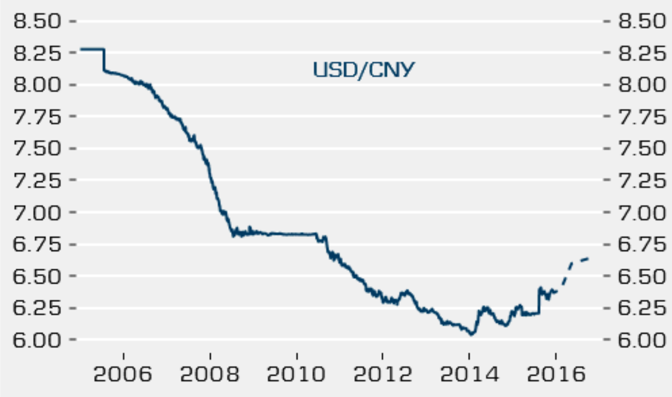
Source: Macrobond Financial

More cuts in interest rates and reserve requirement ratio in store



Source: Macrobond Financial

CNY to weaken further but a big devaluation is not likely



Source: Macrobond Financial

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