PICTET 1805

Flash Note

China: PMIs continue to edge higher

Still strong momentum but headwinds ahead

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The Purchasing Manager Indices (PMIs) in China continued to move higher in March, extending the rebound evident since early 2016. The official manufacturing PMI came in at 51.8, compared to 51.6 in February, and the non-manufacturing PMI rose to 55.1 from 54.2 in February

Most of the sub-indices of the manufacturing PMI remain on an upward trend. For the non-manufacturing activity, both construction and services showed solid performances in March.

Overall, China's March PMI report points to solid momentum in the Chinese economy in the near term.

Looking further ahead, however, we are not convinced that the economy can continue to defy gravity in the face of a likely property market slowdown and the PBoC's tightening policy bias in a bid to curb financial risks.

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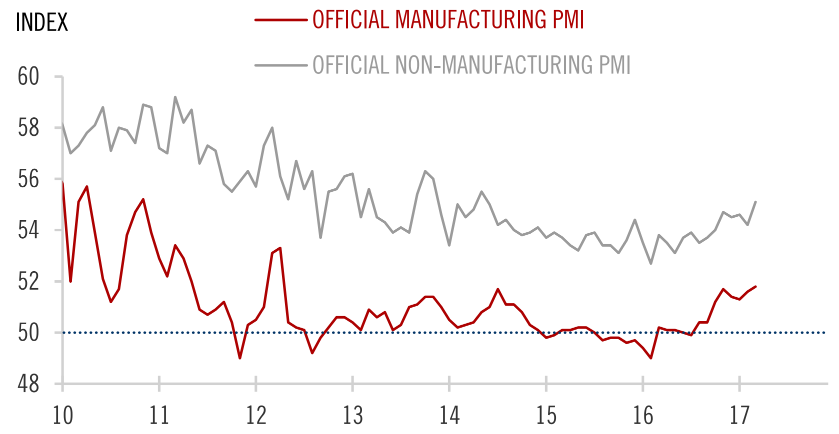
The Purchasing Manager Indices (PMIs) in China continued to move higher in March, extending the rebound since early 2016. The official manufacturing PMI came in at 51.8, compared to 51.6 in February and the non-manufacturing PMI rose to 55.1 from 54.2 in February (*Chart 1*).

Chart 1: Chinese manufacturing and non-manufacturing PMIs

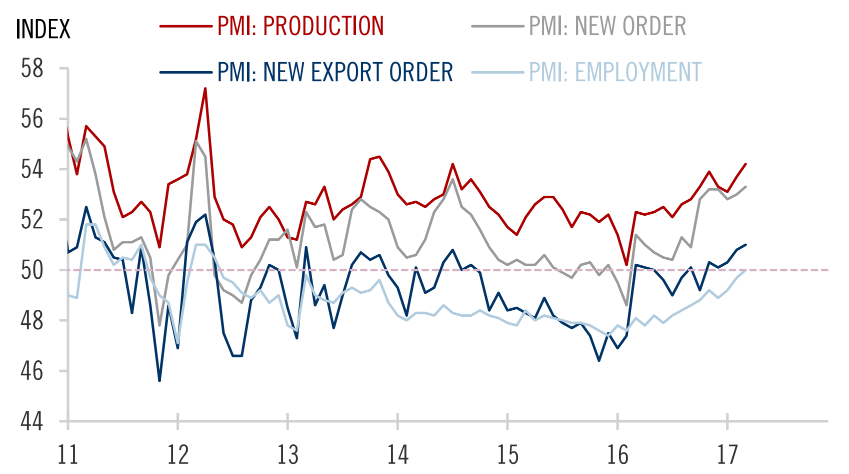


Source: Pictet WM - AA&MR, National Bureau of Statistics of China

Most of the sub-indices of the manufacturing PMI remain on an upward trend. The Production and New Order sub-indices came in at 54.2 and 53.3 in March, their respective highest levels since mid-2014. The Employment sub-index came in at 50, which is the first time this measure reaches the 50 threshold level since May 2012. The New Export Order index continued the recent rise, climbing to 51, which is also the highest reading since March 2012, reflecting improving global demand (*Chart 2*).

By contrast, the Input Price sub-index declined in March to 59.3, compared to its recent peak of 69.6 in December 2016, marking the third consecutive month that this indicator has been dropping. As we highlighted in a previous reports, the drop in the Input Price sub-index suggests that the surge in China's Producer Price Index (PPI) probably has come to a stop and we expect the year-over-year (y-o-y) change in PPI to start to moderate going forward.

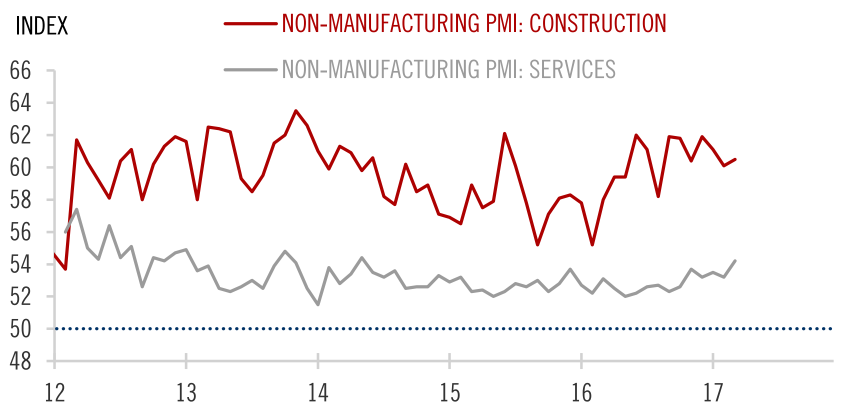
Chart 2: Sub-indices of Chinese manufacturing PMI



Source: Pictet WM - AA&MR, National Bureau of Statistics of China

In terms of non-manufacturing activity, both construction and services are showing solid performances (*Chart 3*). The Construction index rose slightly in March to 60.5 from 60.1 in February. Since its rebound in early 2016, construction activity has remained resilient thanks to strong fixed-asset investment (FAI) in both the infrastructure and the property sectors. The hard data for January and February showed that FAI still has momentum, rising 8.9% y-o-y in the first two months of the year, compared to 6.5% in December 2016 and 8.1% in 2016 as a whole. The latest PMI figures provide further confirmation of this. The service sector has also continued to improve since last year, although at a more moderate pace. The latest reading of the Service sub-index of the non-manufacturing PMI (54.2) is the highest since mid-2014.

Chart 3: Chinese non-manufacturing PMIs



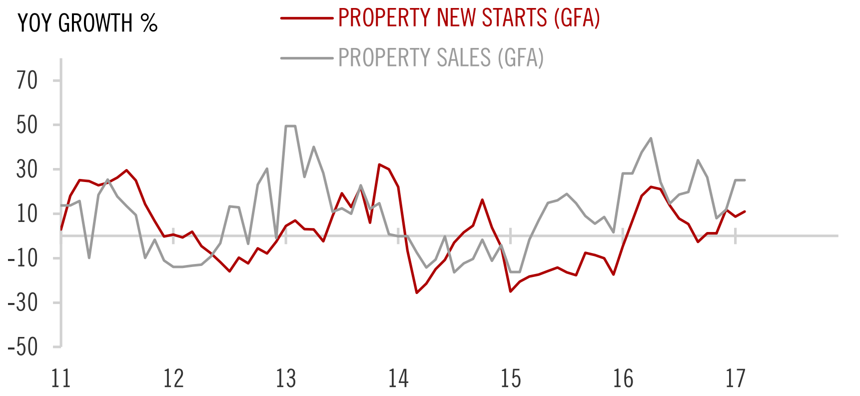
Source: Pictet WM - AA&MR, National Bureau of Statistics of China

Overall, the March PMI report points to solid momentum in the Chinese economy in the near term, despite the government's stepping-up efforts to cool the housing market and rising interest rates in recent months.

Looking further ahead, however, we are not convinced that the economy can continue to defy gravity in the face of a likely property market slowdown and the People's Bank of China's (PBoC) tightening policy bias in a bid to curb financial risks.

After a massive rise in property prices in 2016, the government has stepped up measures to curb speculation in the housing market. The home purchase restrictions that were previously applied only to the first-tier and some second-tier cities have now been extended to almost all second-tier cities and even some third-tier ones. While property sales were still buoyant as of February, these newly-introduced tightening measures will likely lead to a significant correction in transactions in the near term *(Chart 4)*. We expect the cooling of housing transactions will likely eventually have an impact on property investment, possibly starting in H2 2017.

Chart 4: YOY growth in property sales and property new starts



Source: Pictet WM - AA&MR, National Bureau of Statistics of China

At the same time, the PBoC will likely maintain a tightening bias in its monetary policy through 2017. As the Fed has embarked on its own rate tightening, the room for the Chinese central bank to ease its monetary policy is limited. Indeed, we are already seeing signs that the PBoC is moving in tandem with the Fed by pushing Chinese interest rates higher to contain capital outflows and to alleviate depreciation pressure on the renminbi. In addition, the concerns about rapidly rising financial leverage has led the PBoC to put more restrictions on inter-bank businesses, which has resulted in a surge in inter-bank interest rates in recent weeks. The tightening monetary conditions will likely weigh on China's growth going forward. With these considerations in mind, we are maintaining our forecast of 6.2% GDP growth for China in 2017.