

China

China cooling continues at start of the third quarter

- **PMI signals further drop in manufacturing output in July, but annual rate of growth likely to have remained robust.**
- **Weakening driven by cooling domestic demand, exports and stock cycle.**

HSBC China PMI dips below 50.0 in July

At 49.4, the HSBC China Manufacturing PMI™¹, produced using the same methodology used by Markit for PMIs in 20 countries, fell below the 50.0 mark that separates expansion from contraction for the first time in 16 months.

The PMI has fallen 8.0 points from a series-record high of 57.4 at the start of the year (the survey began in 2004), suggesting that growth in the world's largest emerging nation continued to lose further momentum at the start of the third quarter, albeit from strong growth earlier in the year (official data recently showed that GDP growth cooled from 11.9% in Q1 to 10.3% in Q2).

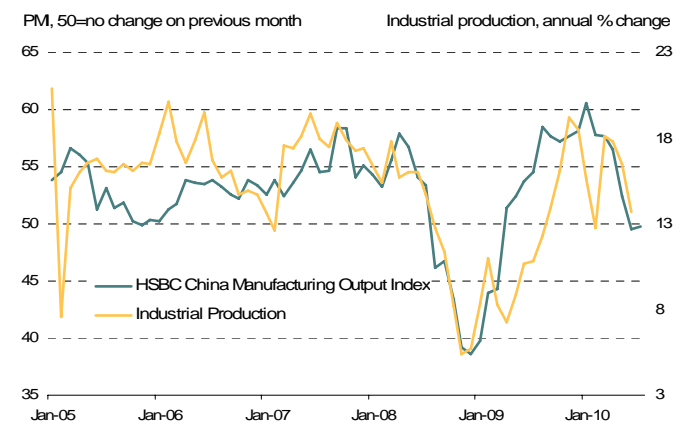
Output and orders fall

The drop in the PMI reflected second successive month-on-month declines in both manufacturing output and new orders, suggesting that forthcoming official data will show a further moderation in the rate of growth of industrial production from strong rates seen earlier in the year. However, with the latest data from the National Bureau of Statistics (NBS) signalling that industrial production growth slowed to an annual rate of 13.7%² in June, compared with a 16.5% increase in May and a near 20% rate late last year, the annual growth rate is likely to have remained in double-digits in July.

New orders (including both domestic and export sales) fell at the fastest rate since March of last year, with the increased rate of decline reflecting a steeper fall in

domestic demand compared to June. This most likely reflected measures implemented in recent months by the authorities designed to cool the economy.

Industrial production

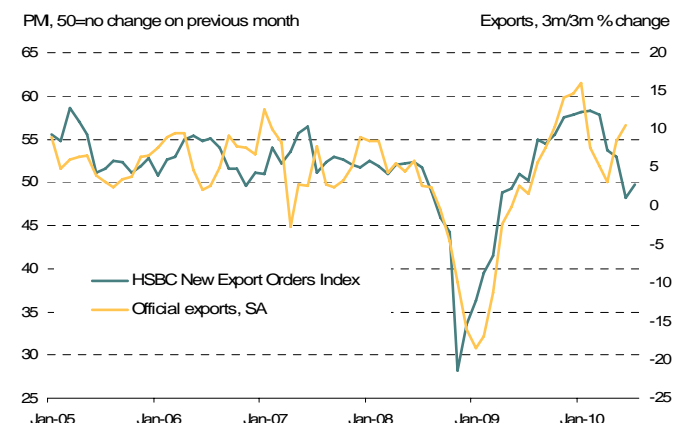


Source: Markit, NBS.

Export growth set to weaken in H2 2010

However, at the same time, export orders fell for the second successive month in July (albeit at a slower rate than June). At 49.8 in July, the seasonally adjusted New Export Orders Index pointed to a second successive monthly reduction in new business received from foreign customers. The annual rate of growth of exports is therefore set to slow from a quarterly rate of growth of around 15% earlier in the year to perhaps less than 5%.

New Exports Orders



N.B Official export figures from the National Bureau of Statistics have been seasonally adjusted using the widely-used X12 programme.

¹ The manufacturing PMI is based on five survey variables (output, new orders, employment, pre-production inventories and supplier lead times).

² Statistical analysis shows that June's PMI Output Index for China was consistent with a 13.3% rise in industrial production (analysts had forecast a 15.3% increase).

Inventory-led stimulus starts to fade

The weakened export trend in part reflects a peaking in global trade flows, which is in turn being driven by the inventory cycle. While still supportive of growth, the temporary stimulus to manufacturing created by the restocking of factories has shown signs of fading in recent months.

An indicator of the stimulus from inventory rebuilding is the ratio of new orders to inventories of finished stock. For China, this ratio has fallen from a peak in January to a 16-month low in July. The lower ratio reflects both a decline in inflows of new orders for the second successive month and a survey record rise in stocks of finished goods, in part due to weaker than expected sales. The low level of the orders:inventory ratio therefore suggests that stock building is providing little impetus to growth.

Output and the inventory cycle



Manufacturing order books and purchasing



The peaking in the stock cycle is also reflected in survey indices relating to manufacturers' input buying. Companies contributing to the manufacturing PMI survey responded to the latest deterioration in new orders by barely adding to their purchases of inputs in July.

The likely easing in stock-building is also indicated by official import data, which showed that Chinese imports rose at a much slower rate than in previous months during June, suggesting that the surge in demand for raw materials is abating and that manufacturers are preparing for a lower intake of new business in the months ahead.

Chris Williamson

Chief Economist

Markit

Tel: +44 20 7260 2329

Email: chris.williamson@markit.com

For further information, please visit www.markit.com

Alex Hamilton

Economist

Markit

Tel: +44 1491 461 076

Email: alex.hamilton@markit.com

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