

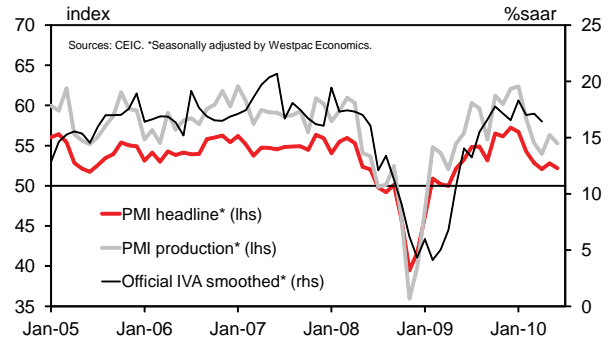
5 July 2010

- The NBS PMI fell to 52.1 from 53.9 (consensus 53.3) and the HSBC measure fell to 50.4 from 52.7. **Phat Dragon's** seasonally adjusted estimate of the NBS headline is 52.2, which is down from 52.8 in May. In seasonally adjusted terms, the NBS series has now fallen in 5 of the last 6 months, with the net move being 5.1pts from the December peak. New orders were steady at 52.9 while production is still quite robust at 55.3, even if it came off a full point in the month. Finished goods inventories are now on the rise, hitting 51.3, the first reading in the expansionary zone since (gulp) Sep-Nov 2008.
- There are two basic points to take away from this update. One, there is nothing here to dissuade **Phat Dragon** from the view that the industrial sector is decelerating in a significant way. And two, a *material slowdown in the official data is unlikely to come through as soon as the June/Q2 round that is due in mid-July*. A resilient set of June data releases would be out of synch with increasingly bearish sentiment towards China among the investor community.
- On the point of near term resilience, despite softness in both the imports and new export orders sub-indices of the PMI, it is too early to expect a capitulation in export growth: imports into special economic zones (SEZs) have a very strong relationship with total export growth. The 3mma of imports to SEZs rose 48.8% in April - running that through **Phat Dragon's** model yielded a May estimate of 3mma export growth of 34.9%, against the actual of 34.3% (spot was 48.5%yr). The pure prediction for June based on SEZ import growth of 51.7% in May is a jump in the 3mma to 41%, implying a spot outcome of 44%yr.
- The iron ore spot price has fallen beneath \$US140/t, materially below the rumoured September quarter contract prices, and Dampier to Qingdao freight rates are below \$US10 from a recent peak of \$US21.05 in late 2009. **Phat Dragon** made a number of points on the ferrous complex last week. This space bears very careful watching.
- If the PBoC's liquidity management is anything to go by, the monetary stance remains highly accommodative. The Bank issued 55 billion yuan of 1 year bills last week against maturities of 144 billion (bills and repo) implying an easing of liquidity conditions. The amount of sterilisation instruments outstanding rose to 43% of reserve money in April, versus rates in the low 60% area back in 2007 when all forms of capital inflow were booming and policy was designed to be restrictive in aggregate.
- Sticking with financial matters, bank lending is now tracking below target after a reasonably abrupt slowing in recent months. Recall that **Phat Dragon** spent a great deal of time scaling the new lending figures earlier in the year to assess the credit policy stance. In January and February, new lending was tracking well above target. March brought things back closer to plan, while April/May have pulled things back appreciably. Taken together with stronger growth expectations, first half lending is on track for a relatively modest 28.5% of GDP outcome, versus an original target of 31%. Money/credit measures lead economic growth by 3 to 4 quarters.
- **Stats of the week:** 60% of China's 211 million internal migrants (workers & dependents) receive no assistance with medical expenses.

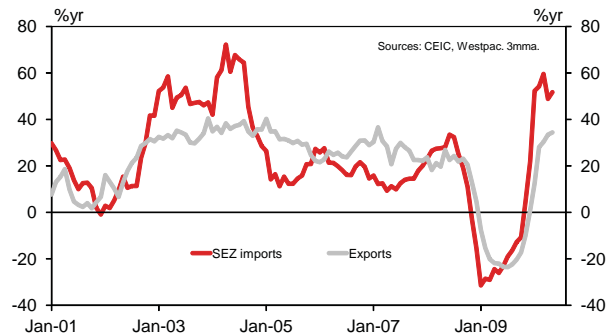
Phat dragon

a weekly chronicle of the Chinese economy

The official PMI & industrial value added



SEZ imports & total exports



FX reserve growth & sterilisation issues

