China’s industry profit data is scary, but look past the headlines

China's headline industrial profit numbers unexpectedly fell deeply on a yearly basis, despite the help of a low base effect. However, looking at the details, we see there's a significant divergence on profitability between infrastructure-related manufacturers and those related to trade. The picture reflects how China has grown its economy in 2019

Headline industrial profit data is so scary

Falling by 9.9%YoY in October after a 5.3% contraction in the previous month, China's headline industrial profit numbers look scary. It is the worst year-on-year growth since the data release began in 2011. It hints that manufacturers have been suffering a lot. But the details paint a different picture, some industries are earning big profits.

The promising industries

Infrastructure related industries are the most profitable:

- Mining of ferrous metals (+189.5%YoY YTD),
- Mining activities (+154.9%), and

- Railway, ship, aerospace and other transportation equipment manufacturing (+131.1%).

All these are highly related to the production stage of infrastructure projects. We will continue to see these industries being particularly profitable when compared to others as more infrastructure projects have moved from the investment to the production stage.

The dismal industries

Trade-related manufacturers have suffered from the trade war. Not surprisingly, their profits have been heavily squeezed.

- Chemical fibre manufacturing (-26.3%YoY YTD),
- The paper industry (-17.0%),
- Automotive (-14.7%), and
- The textile industry (-6.4%).

As we expect the trade war will continue even if there is a 'Phase 1' deal, these industries will continue to suffer from shrinking profits.

The degree of damage depends a lot on whether there will be a tariff rollback. Not only that, such a rollback could alleviate the burden shared by Chinese exporters and manufacturers. US consumers too would share less of the tariff burden and would recover some of the lost consumption demand.

The in-between businesses

The above mainly touch on the trade war's impact on Chinese manufacturers from the angle of fiscal stimulus and export damage. Domestic demand is in between the two.

Domestic demand should hold up quite well as shown from the profitability of consumer goods manufacturing industries:

- Beverages (+17.6%),
- Sports and entertainment (+10.8%), and
- Pharmaceuticals (+10.6%)

These reflect the fact that domestic demand has continued to enjoy double-digit growth even though the trade war has affected some employees' salary and job security.

This could be a sign that the supportive effect from fiscal stimulus is working, and the trade war has not had too much impact on the consumer services industry in China.

Divergence will stay

This divergence of profitability among different industries will remain until there are big improvements in the trade negotiations. And we will gauge this on the degree of tariff rollbacks.

If those are significant, for instance taking us back to the situation in May 2019, then exporters should be able to win more export orders and trade-related manufacturing activities will obviously increase. At the same time, the government can slow down the pace of infrastructure investment.

That could significantly paint a completely different picture regarding industrial profitiablity. However, it is too early to make such a call. And I'm afraid we remain sceptical about the prospects of any significant progress on tariff rollbacks.

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