China: Industrial profits show recovery

Industrial profits had a U-turn to growth from a falling trend. This could be the first sign that China's manufacturing sector is recovering. But there are risks to future profit growth

Passengers cheer up for Wuhan while waiting to take train K81 at Wuchang Railway Station in Wuhan, central China's Hubei Province, late April 7, 2020.

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Industrial profits finally show signs of recovery

Profits in the industrial sector finally showed growth in May of 6.0% year-on-year after falling since the beginning of 2020 due to Covid-19.

Costs have been lowered, loss-making firms made smaller losses than before and sales of inventories also helped.

Profitable industries are technology related

The most profitable industries are computers, telecommunications, and other special equipment manufacturing. Profits grew 34.7% YoY year-to-date in May. Such firms also recorded the largest revenues (CNY4.02 trillion YTD) in the sample of the National Bureau of Statistics (overall profits of the sample were CNY36.88 trillion YTD in May).

This is easy to understand as technology-related manufacturing is a high-value-added industry that can withstand production cost increases in China. At the same time, due to increasing costs in land and workers, lower profit margin industries, including textile and garments (profit fell 29.2% YoY YTD in May) and toys (no longer in the sample), have started to move away from China to other Asian economies. This movement trend was in motion even before Covid-19, or the trade/technology war and precedes current talk about diversification of production lines.

But there are hidden risks

One of the reasons behind profit growth in May was lower costs, which is a combination of lower energy costs and wages. This highlights that:

1. global demand is still weak and therefore energy costs are lower;
2. labour earns less than before Covid-19, which could hurt domestic consumption.

Another risk is that the core of profits comes from technology-related industries, which is at risk of a possible re-escalation of the technology war between China and the US. China is trying to become a more self-reliant technology economy, but before that is achieved the technology war continues to be a risk to the industry’s profits.

There is hope but not enough to upgrade our GDP forecast

Profit growth is the first sign of the recovery of China's economy. If profits continue to rise, the positive trend could help redundant labour find new jobs and the entire labour market should enjoy higher wages later when the recovery becomes more solid.

Covid-19 clusters have begun to re-emerge in major cities globally, including the US and some European economies, which should continue to put pressure on global demand and therefore China’s export sector. We will continue to monitor whether China's recovery can become a trend, instead of just a data point, before we revise our GDP forecasts.

As of now, our GDP forecast for China is -1.5% for the full-year 2020.

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