GUINNESS ATKINSON FUNDS

Asia brief

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Malaysia's forthcoming General election is likely to be closer than it's been for many years, with the opposition led by Anwar Ibrahim possibly able to upset the ruling coalition, Barisan Nasional. The leading party of the current government has been in power since independence in 1963, and losing upsets investors' calculus about Malaysia. This comes at a time when the economy has been doing well, with real GDP growth on track and the Economic Transformation Programme and Iskandar Development Zone starting to bear fruit. The only certainty is more uncertainty, with the months leading up to the election likely to be difficult for Malaysian equities. However, Malaysia's fundamentals remain strong, and whoever wins the election inherits one of the healthier economies in Asia.

Malaysia has long been viewed by international investors as a safe, if dull, option in the Asian region. Hailed in the 1990s as one of the Asian Tiger economies, Malaysia has failed to capture investors' imagination since the Asian crisis of 1997/8, and it has lost ground to its more attractive neighbors, such as Thailand and Singapore. Its economy is a good example of one which fell into the 'middle income' trap, where household incomes stop growing once a reasonable level of attainment has been achieved. There have been many theories as to why Malaysia has failed to re-accelerate its growth, the most credible being a lack of competitiveness for its export products and political sclerosis based on its dominance by the United Malays National Organisation (UMNO) since independence in 1963. Factor in a reputation for corruption and recurring tensions between the various ethnic communities, and it is clear why Malaysian equities have lost ground to regional peers. But 2013 may be the year when Malaysia again faces interesting times, as a General election to its parliament is due that is likely to be the closest in years.

The protagonists are the Barisan Nasional, a coalition of parties around the UMNO, led by the current reformist Prime Minister Najib Razak, and a group of opposition parties led by Anwar Ibrahim of the People's Justice Party (PKR). Given the UMNO has been in power for so long, the conservative view is that they will win re-election, even if with a reduced majority. This is probably the public base case of most analysts covering the country, with the status quo carrying the day. This does not necessarily mean that Najib will be the next Prime Minister, with the deputy Prime Minister Muhyiddin Yassin likely to challenge his boss unless Najib wins a resounding victory.

Privately, there is a growing sense that the Anwar-led opposition may make a breakthrough at this election and could possibly even win outright victory. The government's lead has been falling in recent polls, with support from the crucial group of ethnic Malays falling from 65% in May 2012 to 58% by June 2012, and its support is already much lower among ethnic Chinese (13%) and Indians (42%). It could be that the government's position is even weaker than publicly stated. It is possible that Malaysians, particularly those in finance and public life, are unwilling to offer an honest view of the opposition's chances for fear of inflaming those currently in power. Already this year, a strategist from a Malaysian bank, who was a member of the opposition party and who suggested the opposition had a realistic chance of victory, was suspended for 'breaching the bank's internal policies'. Although this is the 13th general election to be held since independence, the two rounds of questionable charges against Anwar in 1999 and 2008 suggest that those in power may be tempted to cross the line again to remain in power.

There have been substantial changes in Malaysian politics since the last election to suggest that an outright win for Anwar's opposition is possible. The opposition now holds 5 out of 13 states, which is more than it has ever held and gives it a decent power base to go for government. In the national parliament of 222 seats, the opposition holds 75 seats compared to the 139 held by the current government. The Chinese and Indian communities could be fertile ground for the opposition, although Najib has abandoned many of the Malay-centric policies which were historically in place. There is also anecdotal evidence that the turnout at opposition rallies has been much better than even a year ago and that they have been successful at raising funds in the southern state of Johor, which is a core territory for the ruling party. The timing of the election should work in the opposition's favor, with Najib seeming to lose his nerve over calling the election last year having heavily trailed it for spring 2012. This helped the opposition to gain momentum, particularly in the East Malaysian states of Sabah and Sarawak. Even a giveaway budget in the autumn of 2012 has done little to pull the polls back in Najib's direction.

The opposition's trump card may be the new voters registered since the last general election in 2008. There are 2.9 million new voters on the rolls for this election, and 80% of the new voters are under 30 years old. For these voters the old issues of economic advancement for ethnic Malays may be less significant, with anti-corruption and anti-establishment policies possibly more of a vote winner.

The market is starting to react to the uncertainty over the election, and it has had some poor days when evidence emerges that the opposition are realistic contenders. If Barisan Nasional win the election comfortably, this is likely to be good for equities, especially the government-linked conglomerates which make up a reasonable chunk of the Kuala Lumpur Composite Index. Should the Barisan Nasional fail to win the poll conclusively, this is likely to be the signal for a period of horse-trading and uncertainty while the new administration is formed. If this happens, the behavior of the domestic and government-linked fund companies could be crucial, with support for the current governments most likely. The King is believed to favor stability, and could ask Barisan Nasional to form the new government, even if they fail to win an outright parliamentary majority. This is perhaps the worst case scenario, with the opposition feeling cheated and the Barisan Nasional likely to replace its leader, further adding to the uncertainty. Should the opposition win comfortably, this would certainly be negative for the market in the short-term, but in the long-term, could help Malaysia to release greater growth potential.

Anwar's manifesto looks sensible but radical and reflects his experience in government, having served as deputy Prime Minister under Mahathir from 1993 to 1998. Anwar's key rallying call is to deal with the networks of corruption that have dogged Malaysian politics and business for decades. The opposition has fielded a number of revelations relating to Najib's two periods as Defence Minister in the 1990s and 2000s which have illustrated the scale of the challenge. The opposition will attempt to make Malaysian business more competitive by breaking up monopolies and cosy oligopolies in industries such as telecoms, airline services and the import of goods such as auto parts and rice. The opposition also plans to scrutinize compulsory land acquisition policies and will abolish toll charges on the Penang Bridge, which connects Peninsula Malaysia to the manufacturing hub of Penang Island.

Whichever side is able to win, the economic outlook for Malaysia is as good as it has been in some years. This is in no small part due to the Economic Transformation Programme (ETP), initiated by Najib, which has directed investment to some key development projects which had been languishing and has helped to reform and streamline the bureaucracy of Malaysian government and its regulations. Focus sectors include Wholesale & Retail, Oil & Gas and Tourism, with infrastructure investment forming much of the spending. Public investment from the ETP could be as much as 4.4% of GDP between 2011 and 2020, not huge, but certainly significant. The ETP seems to have had the desired effect of pump-priming the economy, and private investment has been growing even faster than ETP spending since 2010.

The other significant project is the Iskandar Development Zone, which aims to develop part of the South Johor region at the tip of Peninsula Malaysia to act as an effective economic hinterland to Singapore. The closest parallel to this project is between Shenzhen's Special Economic Zone and Hong Kong, where manufacturing, port services and financial services have grown up to support a developed but space restricted neighbor. Since 2006, Iskandar has been successful at attracting a range of activities, such as port services, chemicals and finance and continues to attract capital to the area. The success of Iskandar is in no small part due to Najib's efforts to improve relations with Singapore, with a thawing between the two sides now yielding tangible economic benefits. There could be more growth to come from Iskandar with a new luxury resort development on the east coast of the zone now under discussion.

The aim is to improve Malaysia's potential GDP growth rate and to make the country an attractive destination for foreign investment. There has been success on both fronts under Najib, with impressive real GDP growth in recent years at 7.2% in 2010, 5.1% in 2011 and 5.3% for the first nine months of 2012. Foreign direct investment has also recovered impressively since 2009, and Malaysia is considered a solid, if unspectacular, destination for overseas investment. Services and construction are likely to lead economic growth in the coming years, with both as beneficiaries of the ETP-driven spending and reductions in regulation.

Malaysia's indebtedness has been rising, but it remains under control both at the government and household level. Public debt reached 53.8% of GDP at the end of 2012, which is reasonable and partly reflects the fact that the individual states are not allowed to borrow separately from the Federal government, helping to keep national borrowings controlled and transparent. This is despite a government subsidy regime focused on sugar and fuel which is relatively expensive and out of step with a market-led country. Despite their expense, subsidies are likely to be retained regardless of who wins the election, as they offer a straightforward way to bribe the support of Malaysian voters. Household debt reached 76.7% at the end of the third quarter of 2012 with around 53% of this used for the purchase of property. Malaysia also scores well on a range of softer indicators, such as growth in consumer spending, income inequalities and on the IMD's competitiveness ranking which marks Malaysia as 14th in the world. Despite the decent economic background, the movement for change may yet be too strong to keep Najib in power.

The implications of this political climate for the equity market are that the fundamental strength of the Malaysian economy makes it a good place to invest for the coming years. If the ETP and the developments in Iskandar are supported after the election, they could have a material impact on Malaysia's potential growth rate, which is already impressive. A win for the opposition would be a seismic event for the country, and potentially for the equity market. The Malaysian equity market is already jittery even before the election has been called, and could pull back further once the campaigning begins. In any event, the election must be held by June 27th this year, and tensions are likely to build until Najib asks to dissolve parliament. Equity markets abhor uncertainty and the next six months until the new parliament is known will be difficult for Malaysia. Unlike Thailand, Malaysia has been known for its stability, and equity investors are unlikely to respond well to a result which is anything less than clear. An opposition win could create further uncertainty as Malaysia's cosy corruption comes under attack. Sweeping away decades of single party rule and its associated power networks will be tough but could unlock further growth in Malaysia and help this country to finally reach its potential.

Market Review

Market Performance Ending December 31, 2012

	Dec 2012	2012	2011	2010	2009	2008
Australia	3.03%	22.25%	-10.77%	14.69%	73.87%	-49.47%
China	4.83%	22.69%	-18.36%	4.59%	62.06%	-50.43%
Hong Kong	0.89%	28.26%	-15.78%	23.28%	60.48%	-50.46%
Indonesia	1.74%	6.11%	5.19%	35.47%	136.12%	-57.87%
Korea	5.47%	20.99%	-13.55%	25.84%	74.44%	-56.36%
Malaysia	4.21%	14.54%	0.11%	37.67%	51.26%	-41.15%
New Zealand	2.20%	31.54%	5.90%	8.73%	49.89%	-53.54%
Philippines	2.79%	47.52%	0.04%	35.24%	67.34%	-52.02%
Singapore	3.07%	30.98%	-17.54%	22.03%	73.18%	-47.21%
Taiwan	0.90%	17.43%	-20.18%	23.14%	80.23%	-46.04%
Thailand	6.20%	35.01%	-2.72%	56.67%	76.59%	-48.21%
MSCI AC Far East Free ex Japan	3.45%	22.06%	-14.75%	19.41%	68.56%	-50.34%
MSCI AC Pacific ex Japan *	3.31%	22.72%	-13.59%	17.95%	71.51%	-50.00%

*MSCI AC Pacific includes Australia & New Zealand
(MSCI Indices were used for regional & individual market performance)

December was a good finish to the year, with all markets ending in positive territory and significant outperformance from China, South Korea, Malaysia and Thailand. For 2012 as a whole, some of the South Asian markets were notable performers, with the Philippines, Singapore and Thailand particularly strong. By contrast, political uncertainty in Indonesia and Malaysia led these markets to finish well behind the regional benchmarks, while Taiwan underperformed as a result of a slowdown in demand for technology goods in the developed world. The Taiwanese government made two notable changes last month to improve the island as an investment destination and encourage greater capital expenditure. The Taiwanese financial regulator eased the limits on the amounts banks could lend for plant and construction-related loans, while the parliament, the Executive Yuen, loosened the restrictions on foreign investment approvals.

Thailand was an investment success story in 2012, driven by growth in middle-class spending and rising sales of homes. The consumption theme could continue there in 2013 as the Thai cabinet recently approved cuts in personal income tax rates, which will fall from 37% to 35% for incomes above THB 4 million per annum ($131,000). Infrastructure spending could also improve in 2013, as the government is seeking new investment projects in the utility sector.

Indonesia once again underperformed the broader Asian markets in December, and the central bank was in line with consensus expectations when it kept its reference interest rate on hold at 5.75%. 2013 could be a difficult year for this market, as the influence of the forthcoming Presidential election in 2014 is likely to keep foreign investor sentiment balanced. Inflation seems under control, but the full impact of the recent minimum wage increase and the planned electricity tariff rise are still to be felt. This year the Indonesian government needs to be seen to deliver on its long-trailed infrastructure projects, or market confidence will wane in its ability to deliver on its promises.

Major Indices total returns for the five years ending December 31, 2012

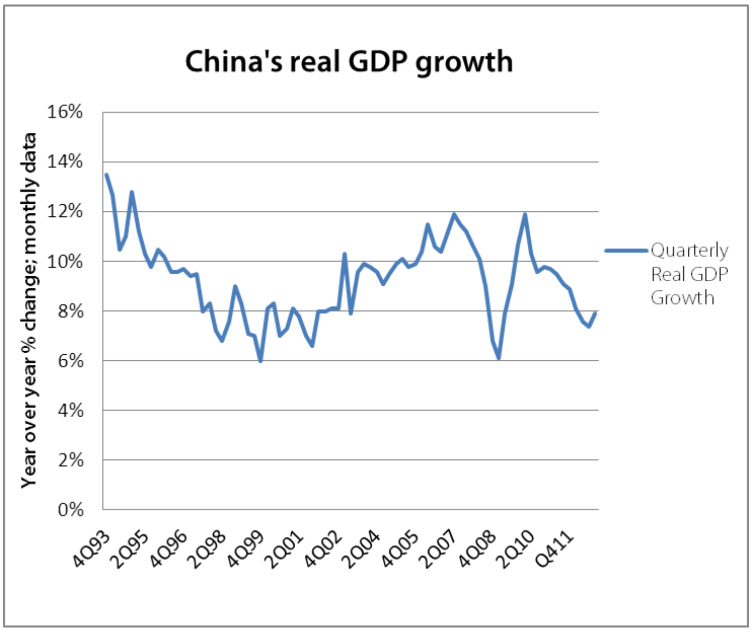
Source: Guinness Atkinson, Bloomberg

China Economic Monitor

There are early signs that growth in China is now stabilizing, and the 'soft landing' scenario for growth is starting to play out. Fourth quarter GDP growth strengthened to 7.9%, up from 7.4% in the third quarter, suggesting that a recovery is now in progress. This is also reflected in reasonable electricity production numbers, and the growth is despite a particularly cold winter in the north of China. We anticipate that the recovery will continue in the quarters to come but would caution that the recovery in growth to date remains tepid.

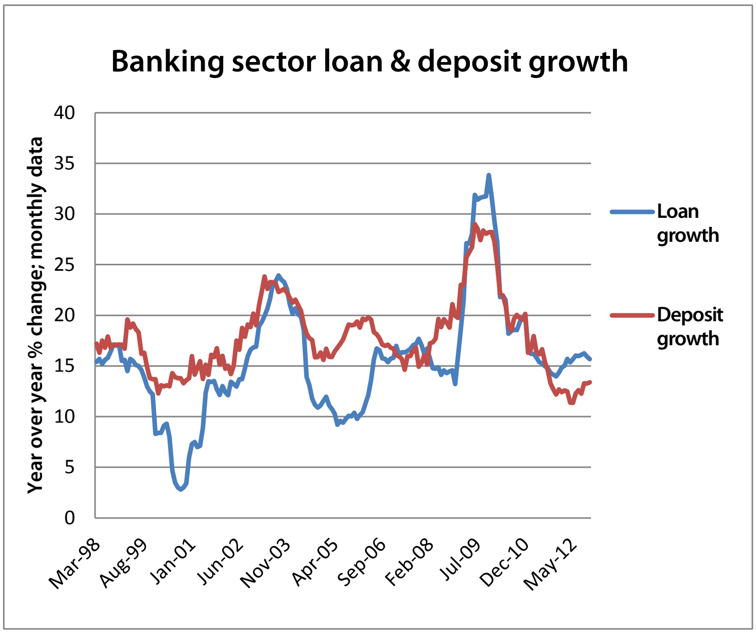
Following the change of government at the People's Congress in October, the policy logjam is starting to ease, and fiscal stimulus is back on the agenda. Unlike in 2009, the stimulus is likely to be much smaller than the roughly 20% of annual GDP back then, and it may not be promoted publicly to avoid the potential for a return to damaging speculation in the property sector. Urbanisation as a driver of development is a key policy thesis of the new administration, and infrastructure spending is an enabler of this process.

Railway investment has increased in recent months, and in December the Ministry of Rail planned to spend CNY 100 billion, up from CNY 81.8 billion in November. Housing and construction remain key sectors for the Chinese economy, and we would hope to see some policy stimulus in these areas in the coming months. Cement prices came under pressure in the final weeks of the year, despite a decent price pick-up in most regions in October and November. We would hope to see cement demand improve in 2013 as a reflection that the government was engaged in supportive policies towards construction, even if these were not widely reported.



Source: National Bureau of Statistics, Bloomberg

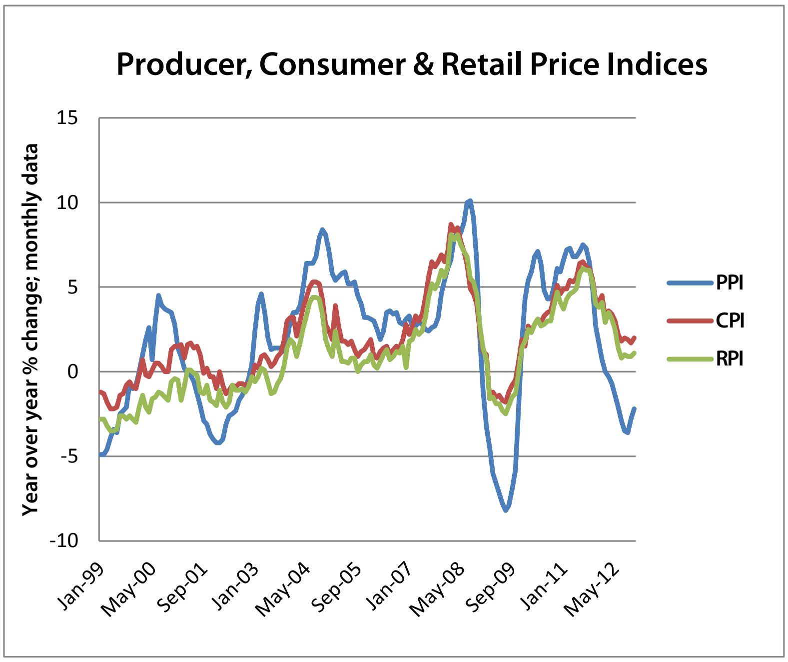
Monetary stimulus remains the focus of Chinese policymakers' efforts to keep economic growth on track, and this is reflected in the acceleration in loan growth over the course of 2012. However, in November this process slowed, with a slight fall in loan growth. This is probably a healthy sign as there are early signs of a pick-up in inflation, and it is conservative to avoid pumping too much money into an economy before it is clear that the real demand for it is improving. On a positive note, bank deposit growth continues to accelerate, reversing the trend of contraction from mid-2009 until mid-2012. In previous cycles deposit growth has run ahead of loan growth, and this pattern could re-establish once GDP growth settles on its new trend.



Source: National Bureau of Statistics, Bloomberg

There was some unwelcome news on November's inflation with a pick-up in the Producer Price Index (PPI), although the Retail and Consumer price indices remained relatively stable. We hope this is a temporary effect, but it is likely that the monetary stimulus of the past eighteen months will find its way into prices. So far there has been little policy response to these figures, but if they develop into a trend of re-acceleration of inflation, this could lead to some credit restrictions being imposed by the central bank.

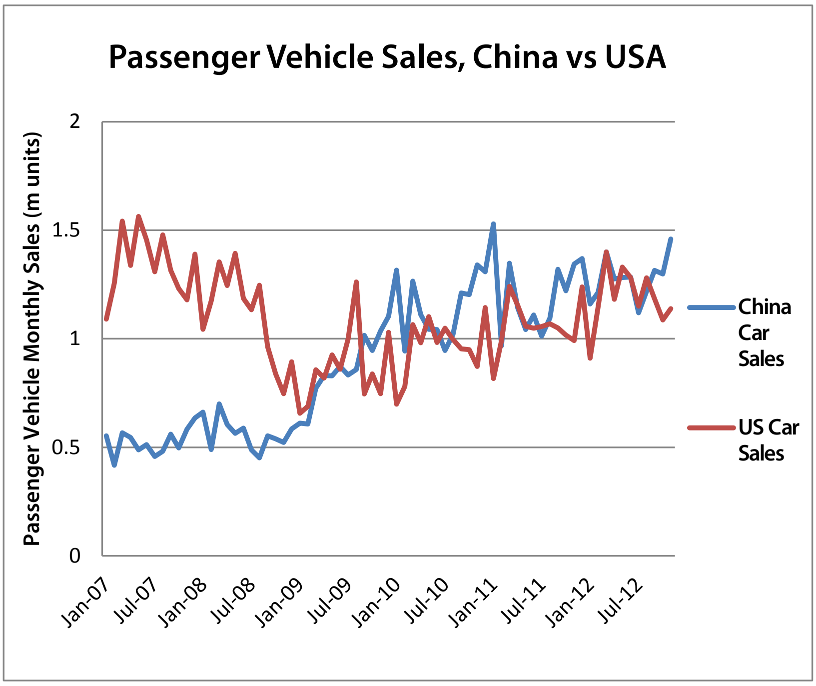
There was some potentially significant news for future inflation from the coal industry in December, given most of China's electricity is produced from coal. Given the slowing economic growth, coal inventories have been rising at China's power stations during 2012, and benchmark coal prices have fallen sharply. The government has responded by abolishing price controls on thermal coal and allowing coal and power producers negotiate directly on long-term contracts. This is likely to be good for power producers in the short-term, but in the medium-term, it allows the more efficient low-cost coal producers to negotiate more competitive contracts and could possibly lead to coal prices, and potentially electricity tariffs, falling overall in the future.



Source: National Bureau of Statistics, Bloomberg

Chinese passenger vehicle sales were robust in November and are approaching the level of 1.5 million vehicles per month. By contrast, there is little acceleration in US car sales, and these remain below the level of sales in China. The decent sales in China is a reasonable indicator that the middle-class remains willing to spend on consumer durables, and the absolute level of monthly sales is almost three times that at the beginning of 2009. During 2012 there was a noticeable change in sales mix, with higher sales growth of luxury brands and Sports Utility Vehicles (SUVs), with the buyers of these cars seemingly less affected by the overall slowdown in economic growth. There was also a marked slowdown in sales of Japanese-branded vehicles, with the dispute over the sovereignty of the Senkaku/Diaoyu islands affecting car buying patterns.to move to the cities in the west and center of China.

Looking forward, the new administration's policies on urbanisation could have an impact on auto sales, although no specific plan has yet been announced. Car ownership remains much lower in the central and western regions of China, relative to the more affluent east coast provinces. As currently framed, policies supportive of urbanisation could push greater car sales volume growth by supporting rural incomes and encouraging farmers to move to the cities in the west and center of China.The underlying trend of urbanization is likely to keep pushing growth in vehicle sales in the coming years, with urban workers having the resources and desire to have a vehicle of their own. There is also a marked improvement in the sales mix of vehicles in China, with Sports Utility Vehicles (SUVs) likely to be the fastest growing sub-segment in 2012. This is positive for the manufacturers as SUVs typically attain higher selling prices than sedans, but it also suggests that buyers are making more than just a utilitarian purchase, and want better quality, more stylish vehicles also.



Source: China Automotive Information Net, Bloomberg

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