GUINNESS ATKINSON FUNDS

Asia brief


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Commentary and Review by portfolio managers
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While developed nations are happy to keep monetary policy loose to reflate away their debts, the developing world is dealing with the consequences of capital inflows. Japan's new government has allowed the Yen to depreciate against the US Dollar, and in doing so, may have released the genie of competitive currency devaluation. Any possibility of better economic growth or inflation, and hence rising interest rates in the developed world could lead to an unruly exit from developing market bonds. This could have global implications, but Asia is in better shape than its peers to weather any storm.

The contradictions of the global economy which culminated in the financial crisis of 2008/9 are in many ways still in place, and the re-adjustments are on-going. The developed world remains heavily indebted by historical standards, while the emerging world, and Asia in particular, has been able to recover its economic growth despite events elsewhere. However, it is clear that the system of emerging world exports encouraged by favorable exchange rates and low labor costs, which drove growth from 1990 until the crisis, is ending. This has given rise to the paradoxical situation where the developed economies are trying to deleverage and reflate away their debts through printing money, and the emerging world is the recipient of the excess capital. The pressure is on emerging world currencies to appreciate while the major economies seem to be striking up a currency war in an unseemly race to escape their obligations.

Japan is the latest nation to tread this path, with the new government of Shinzo Abe planning to explicitly target 2% inflation and allow the Yen to depreciate. Developed nations are now playing the role of the feckless borrower, while the leading developing nations now have better growth prospects and improved governance, especially in regions such as developing Asia.

The loose monetary conditions in the developed world gave rise to capital that was designed to reflate western economies, but it has instead flowed to the highest-growth developing regions of the world. Emerging markets' sovereign debt has been one of the most successful asset classes since the 2008 financial crisis, as investors chased yield in the face of quantitative easing in the developed world. For example, in US Dollar terms the JP Morgan Emerging Markets Bond Index has returned 64%, the S&P has done 38% and the Commodity Index has returned -13%. This has changed the developing world's terms of trade, as capital inflows have caused currency appreciation, which is unhelpful to export-led nations.

Now that it looks as though economic growth in the developed world is beginning to stabilize, there are concerns that interest rates will rise in the relatively near future, helping to attract capital back to the developed world. Rising interest rates are likely to be negative for bonds, although some capital could switch to equities. The worst possible outcome might be loose money and austerity-driven stagflation in the developed world, which could catalyse a switch from fixed income into equities into a flood. Given the lack of depth of some developing world capital markets, anything other than a gradual withdrawal of capital could be a concern. Although developing nations have a requirement to develop infrastructure and a need to invest for the long-term, it does not follow that this necessarily has to be financed externally, particularly for nations with little export business and small foreign currency reserves. The question uppermost in our minds is how strong are developing world finances, and what would be the impact on Asia if capital were to begin flowing out of its bond markets?

A major fear for bond investors in emerging markets is that of 'original sin', commonly described as the imperative for borrowers in the developed world to take loans from external sources, as their local debt markets are unable to provide the capital they need. Problems can arise if borrowings are denominated in foreign currencies and local issuers lack the foreign currency earnings to meet their obligations. It is a real problem for sovereign issuers whose tax revenues are by definition mostly in local currency. There is an issue if assets, for example capital investments, pay out over the long-term but debts to external sources fall due in the short-term, which leads to liquidity problems.

A sudden capital withdrawal can put pressure on an emerging market's currency, in turn offering policy-makers a choice as to either allow currency devaluation, which harms domestic purchasing power, or use reserves and higher interest rates to try and offset the impact of the outflow. Capital controls are also an option, but policymakers trying to fight the market tend to lose eventually, and this can lead to a period of volatility, loss of official credibility (as in Vietnam's case in recent years), and the loss of valuable foreign currency reserves. This negative feedback loop is well known to Asian policy-makers, as in a nutshell this is what drove the Asian crisis of 1997/8. The received wisdom is that significant changes have taken place over the last 15 years, but given the scale of the inflows in recent years, some commentators are concerned that history could repeat itself. In our view, this is most unlikely to happen again in Asia, but the real threat is to Eastern Europe and Central Asia.

The originators of the 'original sin' thesis, Eichengreen and Hausmann[1], highlight a number of factors which make emerging economies more vulnerable to the threat of capital flight, but few of these currently apply to Asia. These indicators include size of the economy, low levels of development, weak institutions, low monetary policy credibility, weak fiscal fundamentals, low trade openness and a small percentage of lending from domestic lenders. Of these, size is deemed to be by far the most important variable. Compared to its emerging markets peers, Asian economies score highly on these measures, and in terms of size, the largest Asian borrowers are amongst the largest by GDP of the emerging markets borrowers. Looking at data on capital flows into emerging markets in recent years, a number of trends emerge which support our view that capital flight from bonds does not represent a threat to Asia on the scale of the Asian crisis.

The growth in developing world borrowing which has taken place in recent years has been focused on the top ten emerging markets[2], and these commanded on average 70% of annual aggregate net capital inflows to developing countries between 2000 and 2010. These nations also took on much more of the equity inflows over that decade, relative to other emerging markets. Out of the top ten, the BRIC (Brazil, Russia, India and China) nations have been the biggest capital recipients, with China by far the largest, taking 30% of aggregate net inflows to developing countries in 2010, according to the World Bank.

This leaves a long tail of nations which have taken the remaining 30% of external capital flows. These are the nations where 'original sin' really applies, and even then, there are big differences in the risk which international investors feel they are taking on. Of the emerging market countries there are some outliers, and removing Venezuela and Argentina would help to bring down the required yield of this group of nations substantially. Mongolia has also issued significant external debt relative to its exports, and its exports are driven by commodities with cyclical future prices. Some of the very smallest nations have also been removed from this list, with a number of sub-Saharan African nations having wiped out international debts through the IMF (International Monetary Fund) and World Bank's HIPC (Highly Indebted Poor Countries) Program.

Another key point about the World Bank data[3] is that the rebound in lending after the financial crisis was led by private sector lending to private sector, rather than directly to sovereign issuers. This is a notable difference from the developed world, where much of the concern about credit quality has now shifted to the public sector, as it has assumed the private sector debts from the housing and finance industries. However, Emerging Europe and Central Asia bucked the trend, with growth in both sovereign and corporate debt issuance between 2009 and 2010.

[1] Debt Denomination and Financial Instability in Emerging Market Economies; August 2003; Barry Eichengreen (with Ricardo Hausmann), editors' introduction to Other People's Money: Debt Denomination and Financial Instability in Emerging Market Economies (University of Chicago Press 2005).

[2] The top ten developing nations in order of magnitude by external debt stock at 2010 according to the World Bank Debtor Reporting System were China, the Russian Federation, Brazil, Turkey, India, Mexico, Indonesia, Argentina, Romania and Kazakhstan.

[3] From Global Development Finance; External Debt of Developing Countries, The World Bank, 2012

In the East Asia and Pacific region, net capital inflows jumped in 2010 to $447 billion, almost 50% above their pre-crisis level, increasing the stock of external debt by 21%. However, the key IMF health metrics improved, with a jump in export earnings taking the ratio of outstanding debt to export earnings to down from 40% to 37%. Although short-term debt was relatively high at 46% of total debt, international reserves were 333% of external debts. Size was also on Asia's side, with China being by far the leading borrowing nation amongst emerging countries, taking 76% of the regional borrowings in 2010. Malaysia, Indonesia and the Philippines also borrowed significantly more in 2010. The majority of external borrowings to the region went to private sector borrowers with the Chinese power and construction sectors leading the pack.

Contrast this picture with Emerging Europe and Central Asia, which after 2010 was the most heavily indebted of all developing countries in terms of debt outstanding to gross national income at 43%. This compares unfavorably to Asia at 13.5% by the same metric. By debt outstanding to exports, the region scored 121.6%, much worse than Asia. The countries to watch in this region are Turkey, Russia and the Ukraine, which accounted for the majority of the net inflows. There were also a number of first-time sovereign issuers in 2010 from this region, with Albania, Belarus, Georgia and Montenegro all issuing their first government bonds. Kazakhstan also showed what was possible, with a sharp fall in net inflows as investment in the hydro-carbon sector sharply slowed.

Japan's change of policy direction heralds a new phase in the financial crisis, and this could be the catalyst for the currency instability that may threaten the financial health of some emerging markets. A number of political leaders, for instance in the UK and European Union, have also called for further quantitative easing, partly in the hope that this could help to lower their currencies and make their exports more competitive. This is not a one-way street, and some emerging markets' central banks have become concerned about the scale of capital inflows in the event they reverse when developed world interest rates rise. The next phase is likely to be the Canute-like imposition of controls to stop the inflow of capital, with South Korea a possible candidate given the importance of its export economy. South Korea is also unlikely to be happy about the rapidly-improving terms of trade of its neighbor and rival, Japan. If this leads to a loss of confidence in emerging markets generally, it will likely be the smaller sovereign issuers, and those corporates in the most indebted regions such as Emerging Europe and Central Asia who will suffer the most.

The currency market is the place where the tension between the growth of developing nations and the de-leveraging of the developed world will be resolved. Asian investors should take comfort from the fact that the region's debt metrics look reasonable relative to emerging market peers and history. Investors should also recognize that China, as the largest emerging markets user of external debt, already has capital controls in place and has significant foreign exchange reserves which can buffer against the impact of any currency volatility.

We don't think any region will escape the impact of a currency war between the developed nations, but Asia's secular trends of urbanization and industrialization can help its nations sustain economic growth in the face of bond market volatility.

Market Review

Market Performance Ending January 31st, 2013

	January 2013	2012	2011	2010	2009	2008
Australia	5.56%	22.25%	-10.77%	14.69%	73.87%	-49.47%
China	4.12%	22.69%	-18.36%	4.59%	62.06%	-50.43%
Hong Kong	5.84%	28.26%	-15.78%	23.28%	60.48%	-50.46%
Indonesia	2.67%	6.11%	5.19%	35.47%	136.12%	-57.87%
Korea	-4.31%	20.99%	-13.55%	25.84%	74.44%	-56.36%
Malaysia	-4.91%	14.54%	0.11%	37.67%	51.26%	-41.15%
New Zealand	9.80%	31.54%	5.90%	8.73%	49.89%	-53.54%
Philippines	7.65%	47.52%	0.04%	35.24%	67.34%	-52.02%
Singapore	1.48%	30.98%	-17.54%	22.03%	73.18%	-47.21%
Taiwan	0.22%	17.43%	-20.18%	23.14%	80.23%	-46.04%
Thailand	5.74%	35.01%	-2.72%	56.67%	76.59%	-48.21%
MSCI AC Far East Free ex Japan	1.27%	22.06%	-14.75%	19.41%	68.56%	-50.34%
MSCI AC Pacific ex Japan *	2.44%	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)

Asian equities continued to rebound in January, although the regional indices were dragged down by notable underperformance from South Korea and Malaysia. The weakness in Malaysian equities was driven by market concerns ahead of this year's general election. There is an increasing possibility the opposition parties will poll well, and investors are concerned about the potential for the first change of government since independence in 1957. The election must be called by the end of April.

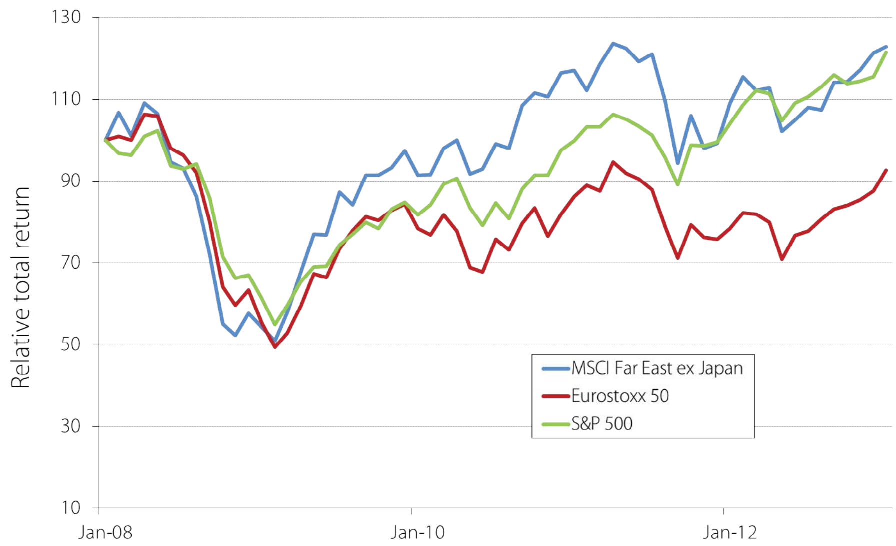
South Korea also underperformed the wider Asian market in January as a result of currency strength against the US dollar which makes the country's exporters less competitive. In January, the Korean deputy finance minister Choi Jong-Ku said that the government was considering curbing capital inflows through taxation, although formal proposals have not yet been made. The strength in the Korean Won was compounded by the stated policies of the new Japanese government of Shinzo Abe, which aims to break the cycle of deflation and wants to depreciate the Japanese Yen against the US Dollar. Abe has been successful so far in talking down the Yen, and this is negative for the competitiveness of South Korean companies compared to their Japanese peers.

The top performances came in the smaller markets such as New Zealand, the Philippines and Thailand. There were also good returns from equities in China and Hong Kong in January. Indonesian equities did okay despite heavy flooding in Jakarta which flooded the Presidential Palace and disabled the central business district. These floods are unlikely to have a lasting impact, but may provoke further investment in water management as part of the current round of infrastructure spending. There was also some good news for Indonesian coal producers as thermal coal inventories have begun to fall both there and in China, with inventory at Chinese power utilities down from over 30 days to a more manageable 20 days. This matches with the recovery in Chinese electricity production over the last two months, suggesting that economic activity in China is recovering.

Taiwanese equities were flat in January, as investors became concerned on the prospects for the technology sector in Q1, which is the traditional low season. There was good news in the financial sector as a result of an agreement between the Chinese and Taiwanese financial regulators. The deal allows for Taiwanese brokers to hold 51% stakes in Chinese brokerage firms, while allowing Chinese brokers to set up in Taiwan. In addition, the investment quotas for institutional investors in each market have been substantially increased and direct retail investment will be allowed in future. Taiwanese individuals will also be allowed to hold renminbi deposits which can be invested in renminbi-denominated funds in China.

Results season has so far held few big surprises, with most of the large Asian firms which have reported so far matching or beating consensus estimates. However, guidance for the first quarter and the coming year has not been over-optimistic, suggesting that earnings growth in 2013 could be solid, rather than spectacular.

Major Indices total returns for the five years ending January 31, 2013

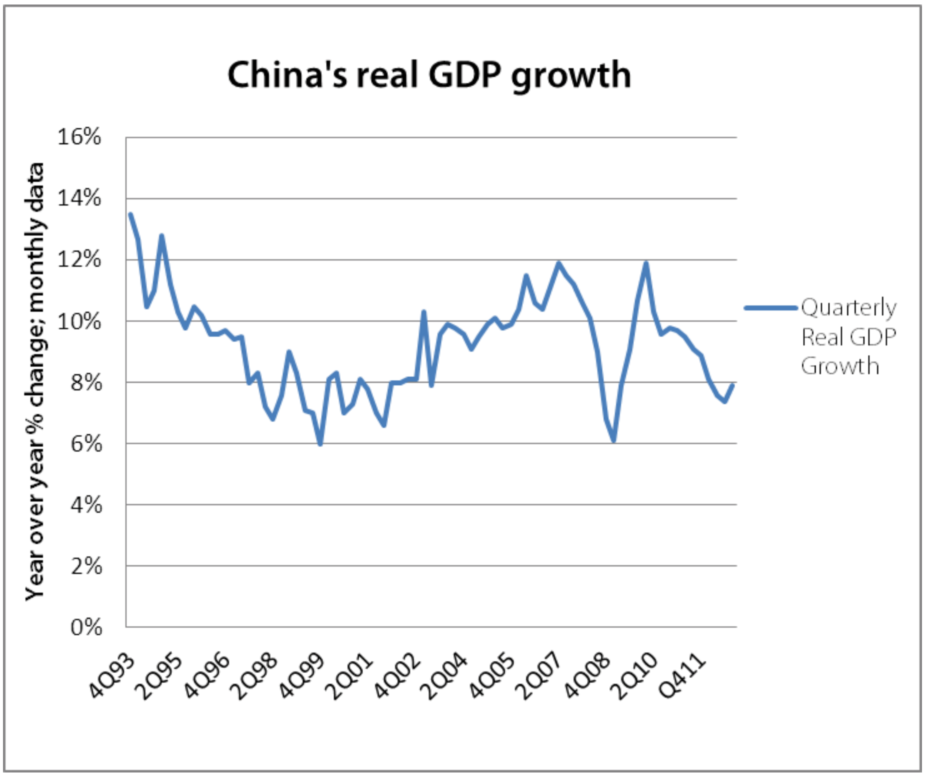


Source: Guinness Atkinson, Bloomberg

China Economic Monitor

Chinese GDP growth remains relatively strong, and the economy grew at 7.8% in real terms for 2012. This was in line with the Chinese government's forecast for the year, and keeps the economy on track to double real GDP between 2010 and 2020. Industrial production data for December was also good, up 10.3% compared to the same period of 2011. This was slightly ahead of electricity production growth at 7.4% in December, but this is much better than the summer months of 2012 when growth was running at less than 2%.

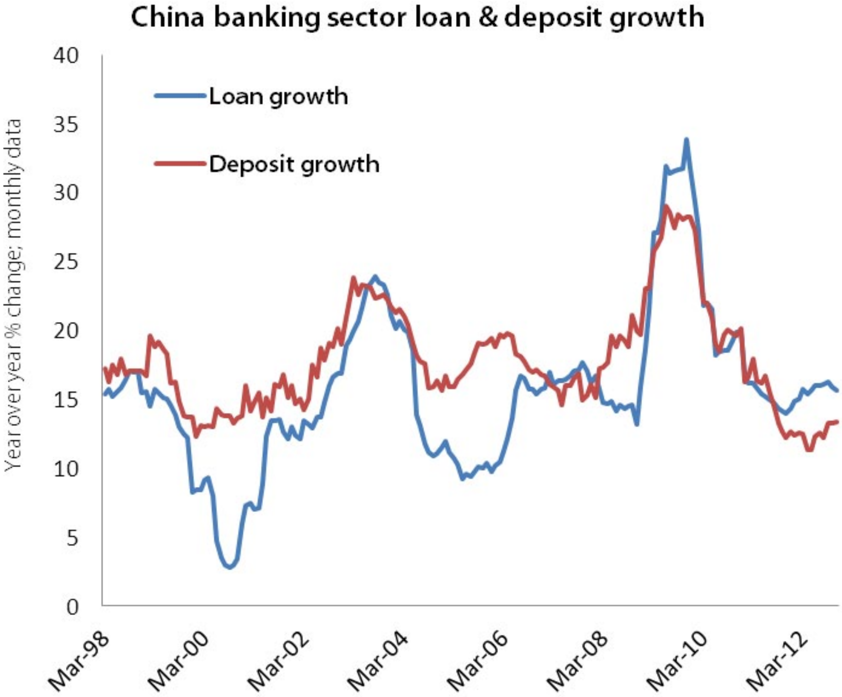
Infrastructure spending has been helpful in keeping growth on track in the last two quarters, and a number of new projects have kicked off. In January, the Ministry of Rail held its national conference to set spending priorities for 2013 and agreed on CNY 650 billion of fixed asset investment in the network. Of this, CNY 520 billion will be spent on extending the network by around 5200 kilometers, while CNY 130 billion is earmarked for rolling stock. Railway spending for 2012 came in CNY 114 billion ahead of the original plan at CNY 630 billion, although the network underspent significantly in 2011 at CNY 591 billion compared to the plan of CNY 850 billion following the high-speed rail crash.



Source: National Bureau of Statistics, Bloomberg

The mismatch between banking sector loan and deposit growth rates in recent months has been a conundrum for investors, and the full details have not yet been uncovered. However, there was greater clarity in January with the news that one of the smaller banks was under scrutiny due to the failure of a wealth management product which it had sold to its private banking customers. These products have been sold by some banks as a higher-yielding alternative to bank deposits, but it seems that some banks were opaque about the actual source of their returns. Although some of the products invested in relatively low risk assets, it seems that some were invested in higher risk collective trusts and real estate trusts. Based on the issued size of these products, it seems unlikely to cause systematic risk to the banks, but it could lead to some uncomfortable write-downs if regulators force the banks to cover losses to retail clients. So far only one product has publicly broken down, but there may be more to come.

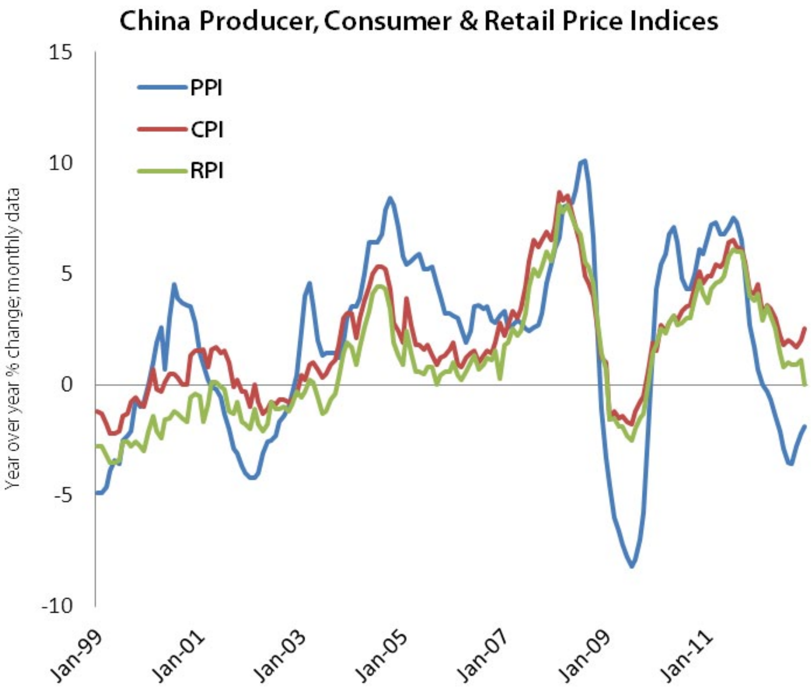
It was reported in the Chinese media that major banking groups have instructed their employees to stop selling these trust investment products. This may be positive news for both growth in regular bank deposits and for equities, as clients look for alternative places for their capital and higher return instruments.



Source: National Bureau of Statistics, Bloomberg

Inflation has begun to tick up in China, and there are signs that food prices are also on the rise again. This is not at worrying levels, and may well be as a result of a particularly cold winter in northern China, which has pushed up the prices of fresh goods, such as cabbage. Pork prices rose just over 5% during January, although prices for chickens, ducks and strong flour fell slightly over the course of the month.

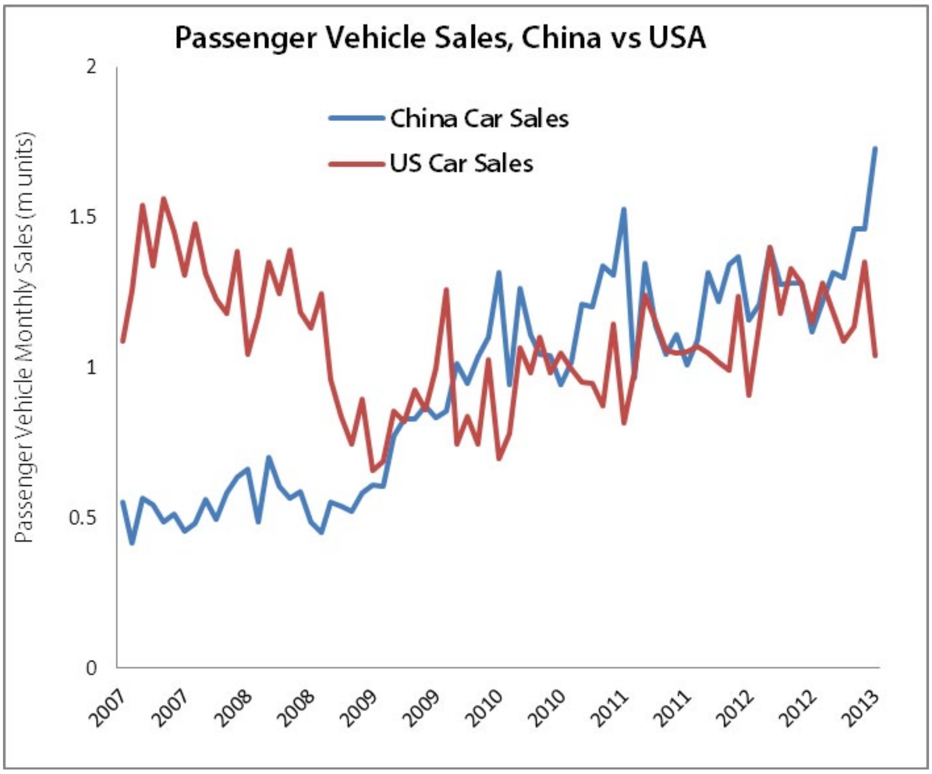
The People's Bank of China (PBOC) has not cut the banks' reserve requirement ratio since April 2012, and if inflation does accelerate, it will be difficult for further cuts to take place. Although loan growth accelerated during 2012, it has not yet grown substantially, but further monetary stimulus may not be helpful if inflation picks up.



Source: National Bureau of Statistics, Bloomberg

There was a sharp pick-up in passenger vehicle sales in China in January, with sales at 1.73 million units compared to 1.46 million in December and 1.1 million in January 2012. By contrast, sales in the US fell to 1.03 million units in January, down from 1.35 million units in December.

Although these figures are striking, there may be extenuating circumstances which mean these impressive Chinese figures may not be all they seem. The Chinese numbers may be boosted by the run-up to the Chinese New Year holiday season, which has traditionally seen better consumer spending in China. There is also a base effect with respect to 2012's numbers as the timing of the holiday is based on the lunar calendar and moves from year to year. Given this, it is wise to wait until February's figures are released to take a view on the underlying demand for cars in China.



Source: China Automotive Information Net, Bloomberg

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JP Morgan Emerging Markets Bond Index is a benchmark index for measuring the total return performance of international government bonds issued by emerging market countries that are considered sovereign (issued in something other than local currency) and that meet specific liquidity and structural requirements.

Commodity Index is an index that tracks a basket of commodities to measure their performance.

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