GUINNESS ATKINSON FUNDS

China brief


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China stock and currency markets improved in the second quarter on improving economic momentum. There have been no significant announcements and dramatic moves, and we feel investors should be encouraged by this. China's economic challenges have been well documented, and policy response to them has been measured, prudent and above all, they look to be having the desired results. While there is still plenty that could go wrong, the government is clearly making serious efforts to address excesses of debt and industrial capacity in a fashion that ought to give ground for optimism, especially when Chinese stocks still trade at depressed valuations.

China Overview in the Second Quarter of 2014

Economic growth appears to have stabilized this year. Fixed asset investment growth has slowed but is still growing at over 17% year on year while vehicle sales grew 11.8% and industrial production grew 8.8%. Exports have been supported by a recovery in European demand which has seen growth of 12% in the first six months of this year. Overall Purchasing Managers' Index figures have expanded each month since February. Money supply growth (as measured by M2) has slowed from last year, but growth has been maintained around target at 13%. Credit growth in the system grew 3.9% in the first half of 2014 compared to the same period last year. This consisted of growth in ordinary bank lending of 9.8% and a 3.4% contraction in shadow bank lending, led most notably by a 62% drop in trust loans.

Further examination of credit conditions shows that following tight conditions in the first quarter and a 14% contraction in total system finance, the central bank has responded to slowing growth momentum with easier money conditions. In the second quarter overall financing grew 28% year on year and shadow banking activity expanded by 40%. But, and it is an important 'but', the central bank has not taken its eye off the worrying elements of shadow banking. Trust loans contracted 65% in the first quarter and 58% in the second quarter. Shadow banking growth, in fact, came from renewed corporate bond issuance which the government is encouraging to promote market pricing of credit and greater transparency.

It is most important for current and potential investors into China to look carefully at the way the government goes about the business of economic reform and management. We have seen little in the way of big 'blockbuster' initiatives but rather a steady stream of smaller targeted moves which are proving effective. The pressure remains on banks to bring lending back onto the balance sheet; growth in bank lending funded by interbank borrowing remains firmly under the control of the central bank. State-owned enterprise reform and restructuring has picked up with more detail provided following a recent state council meeting. Petrochina, Datang Power and Anhui Jianghuai are the three most recent examples.

China & Hong Kong stock markets

This steady improvement in the economic environment has been reflected in the stock markets of China and Hong Kong. In the first quarter Chinese domestic stocks fell 10% while Chinese stocks traded internationally were down 5% on average. In the last quarter this has changed with domestic Chinese share rising approximately 2% and internationally traded share up around 5%. In a further encouraging development, the domestic stock markets have once again opened to new companies wishing to float, and in response, we have seen improved domestic liquidity coupled with rising markets in both Shanghai and Shenzhen. To some degree this may reflect the relative unattractiveness of Chinese real estate, but it can also be taken as an indication of improved domestic confidence too.

Amongst sectors performing well there have been bright spots in both 'old' and 'new' economy sectors. The old economy can be seen as including those businesses most closely associated with the investment-led model of economic growth. Many of these have little pricing power and rely on scale (i.e. growth-led) economies to grow profits. At a time when China seeks to lower its dependence on credit-fueled investment, this sector looks vulnerable. However, within these areas there are some that dominate and have pricing power (such as Anhui Conch Cement), those whose business models are better suited to carving out new niches (such as China Merchants Bank), and those who are focused on current investment priorities, such as water and gas.

At the same time the new economy sector has continued to be a bright spot. Computers, smartphones, mobile games and e-commerce are all burgeoning areas in China. Online retail is clearly an exciting segment, but it is still at an early stage. Large headline numbers are quoted, but government drives to tackle fake/poor quality goods sold online indicate further difficulties. Virtual money presents challenges not only in the form of Bitcoin but also in payment systems adopted for online gaming and small scale transactions. Many online 'verticals' such as Leju for housing and auto sites such as Autohome and Bitauto are still refining their business models while all the time competition intensifies. For the present the most profitable areas are internet search, social media, with related advertising, and online gaming, both PC and increasingly mobile, are the most profitable segments.

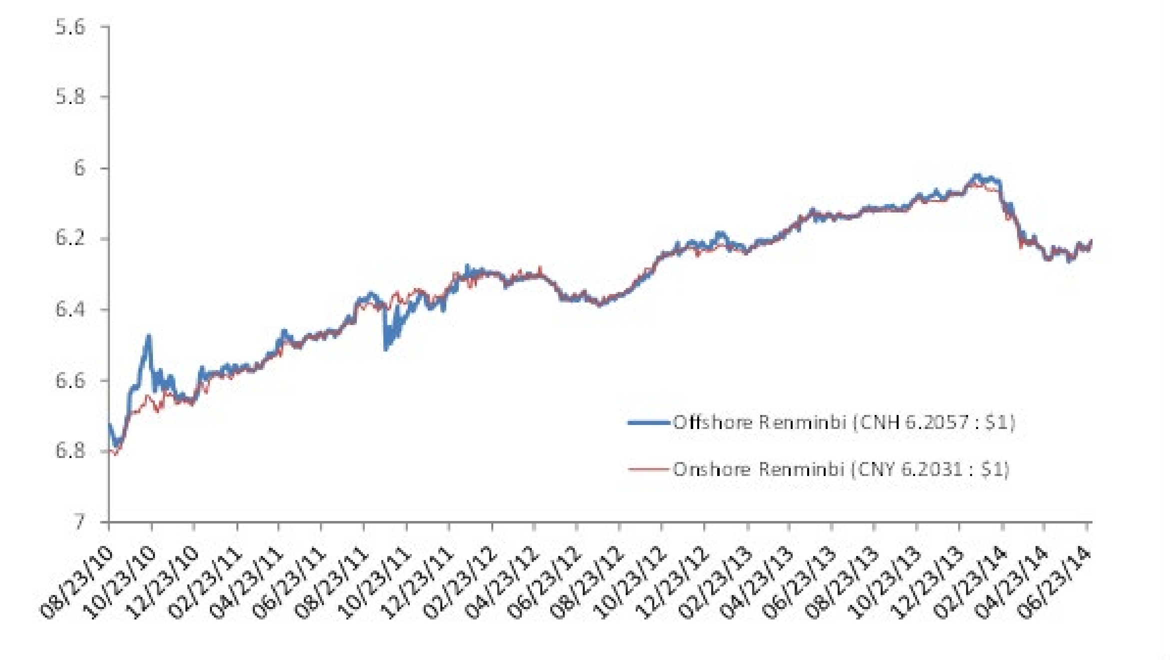
Investors are still cautious about China and seem much happier placing their money into the developed markets. While this last quarter has seen improved stock performance, this has left China still looking cheap on 8-9x forecast earnings while the consensus forecasts corporate profits to grow 10.09% for those companies included in the MSCI China Index.

China Renminbi Yuan (RMB) & Bond markets

The development of the RMB into an internationally used currency is closely tied to the reform of China's financial system and capital markets before opening up the capital account and currency convertibility are possible. Exercising greater control over credit expansion may be the most pressing problem, and as discussed above, the Central bank has continued to limit Trust Loans and lending funded by volatile interbank borrowing. At the same time, they have been encouraging greater use of the bond markets. Most recently, a municipal bond pilot program has been launched. (Almost all new initiatives in China begin with a pilot program.) Key features include an expansion of the list from six to 10 provinces/cities, which combined accounted for 45% of 2013 GDP; maturities will be 5, 7 and 10 years; and most importantly, the local governments themselves and not central government will be responsible for servicing and repayment. This is a major step toward resolving the murky world of local government finance.

The other news concerns the progress of Shanghai's Free Trade Zone. More detail has now been given on who is eligible to participate, in what types of business activity and now crucially, on how these activities are to be funded and the terms on which money can move between the Zone, other offshore markets and back into the mainland. Evidence of concrete activity was seen by a shift in short term interest rates in the offshore RMB market in Hong Kong as funds were moved out of Hong Kong into the Free Trade Zone to meet funding requirements there. The interbank curve is now flat at just over 3% across all maturities out to twelve months.

Exchange rate of the Renminbi Yuan in the onshore and offshore markets to June 30, 2014



The currency has recovered from its lows during the past three months, assisted by improved economic news. The central reference rate has remained stable for the past two months and the spot rate remains approximately 1% below the reference rate.

Yields in the offshore bond market have moved 0.2% higher to 4.09% with a duration of 2.65 years as measured by the HSBC Offshore RMB Bond Index as of June 30, 2014. All the improvement is attributable to a 0.54% fall in yields (and therefore a rise in prices) of high yield bonds. Yields rose 0.1% (and prices fell a little) in the investment grade sector. New issuance over the past three months has been the strongest yet at RMB 89 billion (bn) / $14.3 bn. The market capitalization of the market now stands at over $115 billion in bonds and certificates of deposit.

Commentary for our views on Asia, Dividends and Energy markets is available on our website. Please click here to view.

Mutual fund investing involves risk and loss of principal is possible. Investments in foreign securities involve greater volatility, political, economic and currency risks and differences in accounting methods. Non-diversified funds concentrate assets in fewer holdings than diversified funds. Therefore, nondiversified funds are more exposed to individual stock volatility than diversified funds. Investments in smaller companies involve additional risks such as limited liquidity and greater volatility. The Fund may invest in derivatives which involves risks different from, and in certain cases, greater than the risks presented by traditional investments. Funds concentrated in a specific sector or geographic region may be subject to more volatility than a more diversified investment. Investments focused in a single geographic region may be exposed to greater risk than investments diversified among various geographies.

The MSCI China Index is a free float-adjusted, capitalization-weighted index that is designed to measure equity market performance of Chinese stocks available into international investors traded in China and Hong Kong. The Index is made up of Chinese stocks listing in Hong Kong and in the B share markets in Shanghai and Shenzhen.

The HSBC Offshore RMB Bond Index is a benchmark for renminbi yuan denominated bonds in the international market.

The Purchasing Manager's Index is an indicator of the economic health of the manufacturing sector. The PMI Index is based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment.

You cannot invest directly in an index.

Duration is a measure of the sensitivity of the price (the value of principal) of a fixed-income investment to a change in interest rates and is expressed as a number of years

Shadow banking is a term for the collection of non-bank financial intermediaries that provide services similar to traditional commercial banks

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