# Guinness Atkinson
# China & Hong Kong Fund
Review of February 2020

### Summary Review & Outlook

**Fund & market**

- Consensus earnings estimates for the portfolio are for average annual earnings growth over the 2019-21 period of 8.1%, largely unchanged compared to the beginning of the year. We have seen earnings estimates revised down for stocks such as Galaxy Entertainment, Noah Holdings and Shenzhen Expressway. But these have been offset by rising demand for online gaming, benefiting Tencent and Netease, as well as expectations for rising public infrastructure investment, benefiting Anhui Conch Cement and Weichai Power.
- In February, MSCI China rose 1.0% while MSCI Hong Kong fell 1.4%. Onshore markets were mixed, with the Shenzhen Component Index rising 1.5% and the Shanghai Stock Exchange Composite Index falling 4.5%.
- In MSCI China, the strongest sectors were Health Care (total return of +5.5%), Real Estate (+5.2%) and Materials (+5.1%) the weakest were Energy (-7.8%), Utilities (-6.4%) and Financials (+0.1%).
- In Hong Kong, the Financials and Real Estate sectors, which are by far the largest parts of the local index, were down -0.9% and 1.9% respectively.

### Events in February

- Based on the data coming out of China, the spread of coronavirus there seems to be under control. As of March 4th, there have been 80,270 cases in China with 2,981 deaths. What is less mentioned is that there have been 49,928 recoveries. The number of daily new cases has dropped to the low hundreds. As people get back to work, we will be watching whether there is a spike in cases.
- Though there are valid concerns over the quality of data, it does seem economic activity is slowly recovering. Coal consumption, traffic congestion and daily property sales began gradually recovering in the second half of February, though all are well below normal levels.
- A Joint Mission from the World Health Organization (WHO) visited China and noted several developments which suggest the situation is improving e.g. fever clinics are reporting "we used to have a line out of the door, and now we see a case once per hour" while physicians report they now have empty beds to treat patients.
- However, coronavirus is now spreading outside of China with cases clustered in South Korea, Iran and Italy. The OECD lowered its global growth forecast from 2.9% to 2.4%, and it is likely global demand for Chinese exports will be weak in the foreseeable future.
- The Chinese government is now trying to restart the economy with a combination of fiscal and monetary policy. Many small and medium enterprises (SMEs) are facing liquidity pressure and so the PBOC allocated CNY 300bn in refinancing funds. The quota was raised to CNY 500bn at the end of the month and the refinancing rate was also lowered by 0.25% to 2.5%. The PBOC cut the

one-year loan prime rate by 0.1% to 4.05%. Qualified small and medium enterprises (SMEs) with principal or interest due in the first six months of the year can potentially delay their repayments.

- Fiscal policy has also been loosened. Toll fees have been temporarily waived for all vehicles. Gas and electricity prices have been temporarily cut. Employer contributions were waived from February to June for pensions and unemployment schemes in Hubei. This also extends to SMEs in other regions, while larger companies will see their contributions halved.
- To stimulate the housing market, the central government announced the system of issuing corporate bonds would move from an approval-based system to a registration-based system, allowing companies to issue debt more easily. The 40% cap on outstanding corporate bonds to net asset ratio was lifted, allowing property developers to issue more corporate bonds to repay existing debt.
- Numerous local governments put out additional policies including subsidies on home purchases, loosening pre-sale requirements and increasing the length of time payments developers can defer their payments for.
- The local government in Guangzhou is planning on subsidizing purchases of New Energy Vehicles (NEVs) by CNY 10,000 per vehicle and purchases of vehicles that meet new "National VI" emission standards by CNY 3,000 per vehicle. It would not surprise us if this is replicated in other provinces.

**Market Update**

The public news flow on the Coronavirus as governments seeks to show they are "doing something" and news outlets compete for attention has created a climate of fear which finally took hold in financial markets in February. There is great enthusiasm for creating and lingering over worst case scenarios. However, it is also evident by a look at the data, rather than the myriad opinions of what might be, that the spread is coming under control. In China, the rate of new infections continues to slow and is now at a daily rate of 0.1%. Net of recoveries, infections were down 37% week on week. China appears to have passed the high-water mark.

In Korea, as of March 4$^{th}$, the daily growth in infections has slowed. Korea has been one of the best at releasing data (twice a day) on testing and infections. Korea's Centre for Disease Control and Prevention reported last week that the virus barely mutates and shows the same behavior when transmitting form one person to another. The journal *Scientist* also published an article saying the genetic sequences among patients around the world are similar and that any mutations are likely of little consequence.

Why is this important? Because it means that the virus is likely to behave similarly worldwide so studies of the spread, risks and treatments will be similar. It means also that potential vaccines should be widely effective. A key concern has been the potential for mutation, and this will be unstoppable. This fear is not supported by evidence.

From an investment standpoint this aligns with comments from the Governor of the Bank of England who described this as a significant economic shock, but ultimately temporary. Economic shocks such as the financial crisis of 2008 or the oil price shock in the 1970s had long term structural implications. Unless this leads to a global economic shutdown for an extended period, which would then have financial solvency implications, we expect this to manifest in economic terms with a significant curtailment of economic growth in the first quarter followed by a rebound later in the year.

How does this happen? We expect this to be driven by a combination of manufacturing output to accelerate with first quarter output pushed into the second with increased work shifts. We expect to see incentives to boost consumption and efforts to reinvigorate the real estate and construction market. China's growth rate for 2020 may end up closer to 5% (some forecasts say less, though we probably won't see a published figure of less than 5%) but there is no doubt there will be maximum effort made to restart activity.

The path of equity markets will follow shifts in expectations. The return to work in Asia is happening but perhaps more slowly than was expected in early February. Nevertheless, Hon Hai Precision which is the largest assembler of iPhones has stated that it expects its operations to be in full production by the end of March. The new challenge is the impact of the spread in the rest of the world and efforts to contain it. This may lead to a "W" shaped recovery in stock markets as expectations are adjusted.

The sharp falls we have seen in share prices around the world have been some of the steepest 10% drops from a market peak, ever. It is worth noting, however, that in February Chinese markets held up relatively well. While the MSCI World Index fell 8.5% in February, MSCI China rose 1.0%. In the first two months of the year, MSCI World fell 9.0% while MSCI China fell by 3.9%. This perhaps has more to do with run up in markets over recent months in which earnings revisions played almost no part.

**Portfolio Update**

We are cautious into reading too much into consensus earnings estimates because analysts can be slow to revise their expectations. Additionally, the spread of coronavirus abroad is developing quickly and so analyst estimates may currently be too optimistic. That being said we do still find it useful to break down our stocks' total return into the contribution by earnings estimates and price multiples.

In the first two months of the year, the average reduction in 2020 earnings estimates for the companies in the Fund was 1.8%. The average reduction in price multiple was 8.6%. This can be interpreted in many ways. This could mean that the market is pricing in a reduction in earnings that analysts have not yet factored in, or that analysts are simply too optimistic right now. Or, on the other hand, that the market is being too pessimistic on valuations. This will become clearer as coronavirus develops.

The Fund saw weak performance from its component suppliers: Tongda Group, AAC Technologies and Qualcomm. Even if companies have resumed production, not all workers have come back and so factories are running at less than normal levels. This prompted Apple to warn sales will be weaker than expected in the first quarter given the supply bottlenecks, and because most of its stores in China were shut for an extended period of time (though 29 of its 42 retail stores in China have since re-opened). Nevertheless, Hon Hai Precision, which is the largest assembler of iPhones, has stated that it expects operations will be in full production by the end of March. Given the spread of coronavirus, the outlook for demand and earnings it uncertain and this may be why some of these component suppliers saw their price multiples fall sharply in February.

The biggest reduction in earnings estimates were to Noah and Galaxy Entertainment. Noah is a wealth and asset manager. Though it does have an online presence, most of its revenue is derived from offline sales where clients meet Noah in person to discuss their investment decisions. We do not think many meetings are going to go ahead, at least in the short-term. Additionally, many of Noah's clients are high net worth individuals who themselves may be facing liquidity or cash flow issues because of the slowdown of the economy. Galaxy Entertainment operates casinos and hotels in Macau, where the government ordered all casinos had to shut for two weeks to help combat the spread of coronavirus. The company's casinos re-opened on Feb. 20th and while business is clearly weak, it is slowly improving.

The government's drive to restart the economy may have effects on some of our holdings, such as China Resources Gas (CRG). At the beginning of the month, the local government in Zhejiang announced a 10% reduction in industrial gas tariffs, lasting three months. This was offset by a 5% cut in the city-gate price, which is the input cost, thus lowering the hit to margins. 3-4% of CRG's revenue comes from Zhejiang Province, not all of which is to industrial customers. To judge the importance of industrial customers to CRG, the best we can do is to look at the overall business. In 2018 sales by volume to the industrial sector accounted for 32% of CRG's total volume and if we apply that same rate to Zhejiang, it is likely 1.0%-1.3% of overall revenue will be affected by the lower tariff in the province. Hubei Province followed by also announcing a 10% cut to industrial gas tariffs lasting for six months - CRG's exposure to Hubei is approximately 5%. CRG think the impact to prices will be less than implied as they normally discount prices to industrial customers anyway because of the high volumes they bring, meaning prices are normally already below the official tariff. At the end of the month, the National Development and Reform Commission (NDRC) bought forward the date the gas industry is regarded as in the off-peak season, effectively cutting gas prices in industries that follow government-led pricing, such as the agriculture industry. Where prices are negotiated with customers, the NDRC encouraged prices to be cut but did not specify by how much.

**Portfolio Switches**

We sold our holding in TravelSky. TravelSky supplies data for China's aviation industry. Its services include real-time flight reservation information and ticket prices, inventory control and airport passenger processing. The number of people travelling in China has fallen significantly and TravelSky's earnings are likely to decline as a result. We felt the fall in the share price did not reflect this and so sold the position.

Summary view & outlook

The following comments may well be overtaken by events but at present we are looking for China and Asia to begin a return to work. Restrictions on movement are being lifted in measured fashion and policy efforts are directed toward macro-economic support. There is clearly some reluctance in China to deploy a massive stimulus package as we saw in 2009, the legacy of which is still with us. We see the greatest focus needs to be on the provision of liquidity and fiscal flexibility to allow companies to manage their working capital. Debt/equity for the portfolio, excluding the three banks, is 48% i.e. the Fund is not highly geared. If we look at net debt/equity, which subtracts cash from debt, the figure is -8% i.e. our companies could in theory pay back all of their debt with cash. We measure bank leverage by comparing total assets to total equity. We would consider assets that are 20x the size of equity to be the maximum we would accept for a bank and for an emerging markets bank with their more highly concentrated loan books we think we should be looking at 12-13x. China Merchants Bank is the most leveraged at 12.1x and BOC Hong Kong the least at 10.1x.

The recent US interest rate cut of 0.5% has divided opinion. In our view, while attention grabbing, it does not really address the problems businesses will face if economic disruption is extended. The issue will be one of access to credit rather than the pricing of it, in our opinion. While it seems to us the high-water mark has passed in Asia, the unknowable piece is the extent of the spread in the rest of the world, the measures taken to contain it and the resultant impact on demand. We proceed on the basis that this is a significant but ultimately temporary economic shock.

Edmund Harriss (portfolio manager)

**Performance**

| As of 2/29/2020 | YTD | 1 Year | 3 Year | 5 Year | 10 Year |
|---|---|---|---|---|---|
| China & Hong Kong Fund (ICHKX) | -9.07% | 4.41% | 7.87% | 5.15% | 3.22% |
| Hang Seng Composite Index TR | -5.74% | -2.44% | 6.87% | 4.56% | 5.55% |

| As of 12/31/2019 | YTD | 1 Year | 3 Year | 5 Year | 10 Year |
|---|---|---|---|---|---|
| China & Hong Kong Fund (ICHKX) | 30.00% | 30.00% | 15.58% | 8.00% | 3.91% |
| Hang Seng Composite Index TR | 15.36% | 15.36% | 12.00% | 6.78% | 4.92% |

All returns over 1 year annualized. *Source: Bloomberg, Guinness Atkinson Asset Management.*

Expense Ratio: 1.54%

*Performance data quoted represents past performance; past performance does not guarantee future results. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance of the Fund may be lower or higher than the performance quoted. Performance data shown is current to the most recent month and quarter end. To obtain performance as of the most recent month end, please visit* *www.gafunds.com or call 1-800-915-6565. Performance data does not reflect the 2% redemption fee for shares held less than 30 days and, if deducted the fee would reduce the performance noted.*

***The Fund's investment objectives, risks, charges and expenses must be considered carefully before investing. The statutory and summary prospectus contains this and other important information about the investment company, and it may be obtained by calling 800-915-6566 or visiting gafunds.com. Read it carefully before investing.***

**Investments in foreign securities involve greater volatility, political, economic and currency risks and differences in accounting methods. These risks are greater for emerging markets countries. The China and/or Hong Kong stock markets in which the Fund invests may experience periods of volatility and instability. These fluctuations may cause a security to be worth less than it was at the time of purchase. Market risk applies to individual securities, a particular sector or the entire economy. China and/or Hong Kong stocks may fall out of favor with investors, the value of Chinese currencies may decline relative to the U.S. dollar and/or China or Hong Kong stock markets may decline generally. The Fund invests in invest in small-cap or mid-cap, which involve additional risks such as limited liquidity and greater volatility, than investments in larger companies.**

One cannot invest directly in an Index.

Hang Seng Composite Total Return Index is a market capitalization weighted index that monitors the performance of stocks listed in Hong Kong.

The MSCI Zhong Hua Index is a composite index that comprises the MSCI China and MSCI Hong Kong Index. The index captures large and mid-cap representation across all China securities (B shares, H shares, Red Chips, PChips and foreign listed shares) as well as Hong Kong securities.

MSCI China Index captures large and mid cap representation across China A shares, H shares, B shares, Red chips, P chips and foreign listings (e.g. ADRs). With 703 constituents, the index covers about 85% of this China equity universe.

MSCI Hong Kong Index is a capital weighted stock index designed to measure the performance of the large and mid cap segments of the Hong Kong market. It has 48 constituents and covers approximately 85% of the free float-adjusted market capitalization of Hong Kong equity stocks.

Shanghai Composite Index, also known as SSE Index, is a stock market index of all stocks that are traded at the Shanghai Stock Exchange.

Opinions expressed are subject to change, are not a guarantee and should not be considered investment advice. Past performance is not indicative of future results.

Top Fund Holdings as of 2/29/2020:

| | |
|---|---|
| 1. China Lesso Group Holdings Ltd | 4.41% |
| 2. Tongda Group Holdings Ltd | 3.84% |
| 3. Anhui Conch Cement Co Ltd - H Shares | 3.81% |
| 4. Alibaba Group Holding Ltd | 3.74% |

| | |
|---|---|
| 5. Tencent Holdings Ltd | 3.70% |
| 6. New Oriental Education & Technology Group Inc | 3.66% |
| 7. Sino Biopharmaceutical Ltd | 3.66% |
| 8. Weichai Power Co Ltd - H Shares | 3.66% |
| 9. NetEase Inc – ADR | 3.33% |
| 10. Shenzhen Expressway Co Ltd - H Shares | 3.32% |

Fund holdings and sector allocations are subject to change and are not recommendations to buy or sell any security.

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