

**Asia Brief**  
**October 2007**

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Welcome to the October 2007 Guinness Atkinson Asia Brief.

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The past month has been a euphoric period for equity markets in Asia as investors shrugged off concerns about falling house prices, poor credit and fears of recession. The decision by the U.S. Federal Reserve to cut interest rates by 0.5% on September 18<sup>th</sup> propelled Asian markets to new records.

The story in Asia over the last few years has been concentrated on two main themes: China and Exports. After four years of strong market returns investors could be forgiven for asking what happens now.

In contrast to the U.S. and European markets which have enjoyed years of domestic economic growth, Asia (excluding China and India) has been flying on the single engine of exports. But now after a long absence there are signs of a growing domestic growth story in Asia which is also beginning to attract attention. Investment at both the country and company level appears to be gaining momentum after a long absence and although still far below pre-1998 levels it does in our opinion represent a new theme that will propel Asia in coming years.

**A Capital Recovery**

Strong and rising commodity demand from Asia has been a much discussed theme in markets over the past few years with eyes cast toward China and India as the major growth drivers. However, there is another theme that has been overlooked that we believe provides investors with another long term opportunity.

For many years, since the 1960s, Asia was a huge net buyer of heavy industrial goods such as machinery, chemicals and industrial materials. Then in 1998 these orders suddenly ceased and Asia turned from being a buyer to becoming a seller of these goods. The reason of course, was the Asian crisis. Years of rapid growth, cheap credit and creation of new capacity finally caught up and the region crashed. Domestic spending in

construction and infrastructure collapsed as did corporate spending on new equipment; and the orders stopped.

The years since then have been a long period of recovery and rebuilding. The involvement of the International Monetary fund in Indonesia, Korea, the Philippines and Thailand was much resented in those countries but spurred a rapid period of reform and restructuring. Asia's economic policies were directed toward returning to solvency and to generate economic growth. This growth primarily came from exports and the hope was that this would eventually translate into increased domestic activity. This is what now appears to be happening.

Construction began to increase once again in 2003 having contracted by 15% in 1998/99 and then stagnating. Since 2003 there has been an increase in property prices and since 2005 there has been a steady acceleration in the rate of construction growth to 6-7% compared to the same period last year. This is still lower than the growth rates achieved in the years before 1998 but the trend is clear and has been sustained.

Estimates of the Dollar spending on infrastructure investment are exceptionally hard to make because definitions of "infrastructure" vary so widely. But UBS has made an attempt to quantify spending in order to gain some sort of measure of demand from Asia for materials and other heavy goods. They estimate that in 2006 Asia excluding Japan, spent approximately \$900 billion on total construction activity and that excluding China and India the number comes to \$300 billion.

The extent of Chinese infrastructure investment has been widely discussed in the market place. New proposals include investment of \$50 billion to construct 32 nuclear electricity generating plants. There is an intention to quadruple investment in railroads with plans to spend \$160 billion expanding the existing 76,000 kilometre rail network by adding a further 17,000 kilometres in central and western China. Substantial additional investment is also being made in water supply, port development, metropolitan railways, conventional electricity generation and road building. All of this is required to sustain China's rapid growth and has been underway for the past ten years.

Contrast this with the smaller Asian countries such as Indonesia, Malaysia, the Philippines and Thailand. In these countries new investment stalled in 1998 with banks unable to lend and property prices stagnant until 2003. Exports growth, company and bank restructuring has allowed these countries to rebuild their capital bases. National accounts are now in surplus, increased tax revenues have improved budget positions and a pick up in property prices has boosted regional wealth. This has allowed a number of projects to be re-started.

In Indonesia, projected infrastructure spending is forecast to grow rapidly, from \$6.1 billion or 2.1% of GDP in 2005 to \$23 billion (4% of estimated GDP) in 2010. The bulk of this spending has been concentrated on electricity production and transmission, telecommunications and roads. In Malaysia the target in 2007 is to spend approximately \$12 billion on development which represents almost 20% growth over 2006 or 7% of GDP. In the Plan there are a number of substantial infrastructure projects with rail

projects including the Ipoh-Padang Besar double tracking project in Northern Malaysia and the Eastern Dispersal Link in Johor, as well as road projects including the West Coast Expressway and Second Penang Bridge. More projects in Penang will come with the construction of the Penang Outer Ring Road, the Penang Monorail project and in central peninsular Malaysia there is a proposal to construct a 45km tunnel to transport water from Pahang to Selangor.

### **Asia finds its feet**

In recent years, Asian investors have had only the twin themes of exports and China on which to focus their attentions. (There has also been an additional recovery theme but this was largely played out in 2003 and 2004, in our opinion.) We still believe that Chinese growth is set to continue for some time yet, in spite of worries in some quarters about the current pace, and we also believe that exports growth could be sustained even through a slower period of global growth.

But the theme we expect to play out over the next few years is one that is largely unfamiliar because it has been absent for so long. That theme is one of renewed domestic activity fuelled by Asian investment within the region for domestic economic development. For investors this has a number of implications.

Firstly, it brings back into focus Asia's domestic companies in the construction, financial and real estate sectors which have been largely sidelined over the past five years. Secondly, whereas it might be argued that easy gains in earnings growth may be the past in some of the North Asian markets, it does appear to us that in southern and southeast Asia the profits cycle is still at a trough. Thirdly, impending turnaround capital investment in materials and machinery, if the twenty years prior to 1998 was any guide, provides a new theme that is not being talked about much at present. Fourthly, we believe that the strength we have seen in commodity and materials prices, including oil, metals, steel and cement is unlikely to subside soon.

The revival that is gradually getting underway within Asia addresses the very valid question, after four years of good returns what happens next? Perhaps here we can see the beginnings of a genuine fall in the reliance on global growth and the seeds of self-sustaining growth as we have seen in China.

## Market Performance September 2007

	September 2007	2007 YTD	2006
Australia	14.52%	31.11%	27.09%
China	19.31%	69.48%	78.13%
Hong Kong	14.79%	28.94%	26.27%
Indonesia	12.13%	28.39%	69.44%
Korea	7.45%	36.25%	11.17%
Malaysia	7.92%	26.98%	33.11%
New Zealand	12.93%	8.89%	10.02%
Philippines	8.25%	28.57%	55.30%
Singapore	11.74%	29.12%	41.91%
Taiwan	5.94%	14.17%	16.30%
Thailand	4.96%	33.51%	6.76%
MSCI AC Far East Free ex Japan	11.46%	38.84%	31.89%
MSCI AC Pacific ex Japan*	12.76%	37.87%	32.56%

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

### Market Review

The decision by the U.S. Federal Reserve to cut interest rates had the most dramatic effect on Asian markets and share prices rallied sharply. The interest rate itself has very little material impact on underlying economic conditions because liquidity in the region is ample and local interest rates are not high. However, it gave a boost to short term sentiment and attracted money back to the region.

The strongest performing market by some way was China. Higher food prices drove consumer price inflation up to 6.5% in August although core inflation is still flat running at 1%. This prompted the central bank to increase interest rates for the fifth time this year raising the benchmark lending rate to 7.29% and the benchmark deposit rate to 3.42%. The purpose, as has been the case on every other occasion, appears to have been in the first instance to keep deposit rates up in order to discourage money from leaving the banking system and secondly, to maintain the spread of lending rates above deposit rates so as to secure banks' profitability. The central bank appears to be hoping that food prices will subside, but it also appears that the strength in food prices has caught them by surprise and is beginning to cause some alarm.

In spite of the inflation and interest rate news, Chinese equities continued to advance both in the Mainland and in Hong Kong. The Hong Kong listed Chinese shares have been driven by the expectation that Mainland investors will shortly be allowed to trade outside Shanghai and Shenzhen; and with Hong Kong listed shares trading at a discount to their Shanghai-listed counterparts of 40% and more momentum has built. There is still some

uncertainty about the mechanism and the extent to which mainland money will be allowed to flow into Hong Kong, but for the present the optimists are in the ascendant.

For many markets the performance in September represented a recovery from falls in August, in spite of the region's lack of direct exposure to the credit crunch. Underlying developments remained positive. In Korea, falling unemployment in Korea seems to point toward a mild domestic recovery. In Taiwan, interest rates were raised modestly by 0.125% to 3.25% in a move that was widely expected. Politics remains a drag on domestic stock market performance but elections are due soon and a subsequent improvement in relations between mainland China and Taiwan appears probable. In Indonesia inflation rose slightly to 6.5% on higher food prices but interest rates are likely to remain steady. The trade picture is also encouraging with exports of \$9.6 billion being matched by imports of \$6.8 billion, up 20% over the same period last year. The higher value of exports tells us Indonesia is still accumulating foreign exchange reserves but imports growth also shows a buoyant domestic economy.

	Price/Earnings Ratio (x)		Earnings Growth (%)	
	2007Estimated	2008Estimated	2007Estimated	2008Estimated
MSCI AC Far East Ex Japan Index	17.51	15.62	12.07	12.09
China	25.46	21.62	25.60	17.75
Hong Kong	19.40	21.14	-8.17	-8.25
Indonesia	15.97	14.03	39.50	13.86
Korea	13.86	12.12	13.02	14.42
Malaysia	17.92	15.75	9.35	13.77
Philippines	18.67	15.98	-10.39	16.85
Singapore	18.60	16.43	-2.21	9.88
Taiwan	15.80	13.52	24.57	16.79
Thailand	12.90	11.47	0.33	12.46

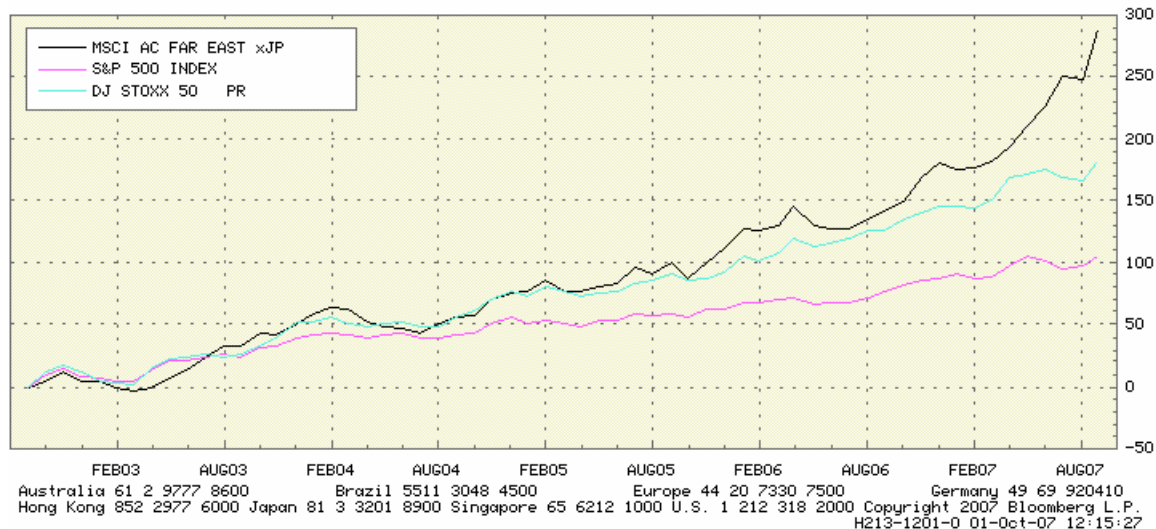
Source: Bloomberg

The comparative returns over five years for Asia ex Japan versus the U.S. and Europe are shown in the chart below.

**COMPARATIVE RETURNS** Page 1/ 6

Securities	Range	Crcny	Prc Appr	Total Ret	Difference	Annual Eq
1 MXFEJ Index	9/30/02 - 9/28/07	USD	240.32 %	288.03 %	183.02 %	31.17 %
2 SPX Index		USD	87.27 %	105.01 %		15.45 %
3 SX5P Index		USD	137.81 %	181.75 %	76.74 %	23.03 %

(\* = No dividends or coupons)



Source: Bloomberg

## Market Outlook

We expect Asian economies to remain sound with inflation under control, current accounts in surplus and government revenues growing. The program of new government investment is underway and we expect this to provide a long term driver to domestic Asian growth. It should also be likely to support domestic demand and earnings of domestically oriented businesses.

In the short term, stock markets (as opposed to the economies) will be affected by volatility in global markets. Central bankers have been saying for some time that markets have been placing lower weight on pricing for risk. The on-going problem in the lower quality lending segment in the U.S. appears finally to have risen to prominence in investors' minds and in the last few days we have seen stock markets fall back.

However, we do not believe that this marks the start of a global economic meltdown but instead is a roller-coaster period as markets re-adjust valuations to reflect the present availability and costs of financing. Issues that would make us more concerned about

market prospects are falling profit margins or rising inflation. At present margins remain healthy and inflation, with the exception of food prices, is well behaved.

Our strategy remains focused on companies that have a history of generating consistent and rising returns on investments that are cheap and where profit prospects are improving.

Edmund Harriss

October 8, 2007

Commentary for our views on Asia Pacific and energy markets is available on our website. Please [click here](#) to view.

**Performance data quoted represents past performance and does not guarantee future results. Index performance is not illustrative of Guinness Atkinson fund performance and an investment cannot be made in an index. For Guinness Atkinson Fund performance visit [gafunds.com](http://gafunds.com).**

**Mutual fund investing involves risk and loss of principal is possible. The Fund invests in foreign securities which involves greater volatility, political, economic and currency risks and differences in accounting methods. The Fund is non-diversified meaning it concentrates its assets in fewer holdings than diversified funds. Therefore, this Fund is more exposed to individual stock volatility than diversified funds.**

The MSCI All Country Far East Free ex-Japan Index (MSCI AC Far East free ex-Japan Index) is a free float-adjusted, capitalization-weighted index that is designed to measure equity market performance in the Asia region excluding Japan. The Index is made up of the stock markets of China, Hong Kong, Indonesia, Korea, Malaysia, Philippines, Singapore, Taiwan and Thailand.

The MSCI All Country Pacific Free ex-Japan Index (MSCI AC Pacific Index) is a free float-adjusted, capitalization-weighted index that is designed to measure equity market performance in the Pacific region. The Index is made up of the stock markets of Australia, China, Hong Kong, Indonesia, Korea, Malaysia, New Zealand, Philippines, Singapore, Taiwan and Thailand.

The MSCI World Index is a capitalization-weighted index that monitors the performance of stocks from around the world.

The S&P 500 Index is a broad based unmanaged index of 500 stocks, which is widely recognized as representative of the equity market in general.

The Dow Jones STOXX 50 Index is a capitalization-weighted index of 50 European blue-chip stocks using free float shares in the index calculation.

One cannot invest directly in an index.

The Price to Earnings multiple reflects the multiple of earnings at which a stock or group of stocks in an index, sells. It is equal to the market capitalization of a stock, or group of stocks in a index, divided by the after tax earnings for that stock or index.

This information is authorized for use when preceded or accompanied by a prospectus for the Guinness Atkinson Funds. The prospectus contains more complete information, including investment objectives, risks, fees and expenses related to an ongoing investment in the Funds. Please read the prospectus carefully before investing.

Opinions expressed are subject to change, are not guaranteed and should not be considered investment advice.

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