

Asia Brief
September 2008

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Welcome to the September 2008 Guinness Atkinson Asia Brief.

In this issue:

This month's Asia Brief comes to you in the middle of a financial drama whose immediacy sweeps all before it. Treasury bond yields hit their lowest level since 1941 as safety becomes paramount. The US government is borrowing to provide extra liquidity (and with yields as low as that they should be borrowing a lot more) while banks look at each other wondering who will be the next fall. The Bears are having a field day.

They do, of course, have a case. The world's largest economy has been living beyond its means for many years now making many in it, and in the rest of the world, rich as a result. However, the growth in asset prices and debt which it supported is now in the process of being unwound – a process which will not be quick.

For the Asian economies the most immediate impact will be felt in the export sector as demand for consumer goods weakens. But it is also apparent that banks and financial institutions in Asia have much less direct exposure that might be expected. Indeed, whether looking at domestic liquidity conditions, external funding requirements, a financial crisis in the US or heavy Asian stock market falls there has been very little effect on the underlying economies in Asia.

The stock market sell-offs in Asia have seen indices falling faster than those of the developed world as investors have flown to the safety of US Treasury stock but markets are still up relative to developed markets over 18 months not to mention the big gains over the past five years. Importantly though, the sell-off has been orderly, driven not by crisis in Asia but events elsewhere.

We can also see this in the behavior of Asian currencies which have weakened somewhat over the past two months. Their decline against the Dollar has been more pronounced than against a currency basket of Dollar, Yen and Euro suggesting no particular pressures from outflows. Central Banks in Asia have indicated their willingness to allow currencies to fluctuate with the market.

So when we look at Asia we see no signs of crisis. The views of those in the region are unsurprisingly tinged with pessimism but we believe the region is a long way from anything approaching a crisis.

The big story in Asia is still China

China's economy continues to present a conundrum for investors. Falling property prices, slower construction and slowing headline economic growth are being treated as signs that China's expansion is about to hit the buffers and a housing recession, similar to that of the US, is already underway.

But just pause a moment and consider.

A breakdown of China's economic growth shows that the domestic economy has been and remains in rude physical health. Domestic demand is the most important factor driving growth in China at a rate of 9-10% at least since 2001. And this domestic demand is not driven by exports. When we look at where investment in China is growing fastest it is in the Central and western regions where exports make the lowest contribution to growth. This investment is driven by domestic factors, not export growth.

The domestic story is being propelled in rural areas by rising food prices. Rural incomes languished for most of the 1990's and only began to see faster growth than urban incomes after 2004. Wage growth is now also accelerating in urban areas both as a result of supply constraints in certain geographical areas but also because of legislative changes such as the new employment law that protects workers' rights. The combined effect of rising wages as well as employment growth in higher end manufacturing looks set to support consumption.

The property market in China is, in our opinion, the key variable. Concerned observers point to falling property sales and a decline in floor-space under construction in a number of cities. They ask whether this means Chinese real estate is about to experience a bust and if so what does this mean for banks and broader economic growth. The concern is valid given the importance of real estate to overall investment and growth but the answers are complicated, hence the uncertainty.

The aggregate figures do not look worrying. In the year to August (the latest data available) real estate prices in the 70 largest cities are up 5.3%, though the pace of growth is slowing. However, there has been a huge variation in fortunes. The cities which experienced the fastest price growth, where there was a higher concentration of higher end properties and speculators played a much more prominent role are the ones where price falls have been most significant. The listed developers are mostly concentrated in these cities and thus the outlook for them is not too bright in the short term.

In other parts of China where mid to low end property has been the staple the picture is much better. Income growth continues to outpace property prices making housing more affordable. There is good structural underlying demand and developers have seen strong buyer responses when new property launches are accompanied by incentive packages.

The risks of a sharp housing downturn in our view are low because with the exception of one or two of the major cities there has been little sign of speculative fervor. For example, it is worth noting that loans for property account for no more than 12% of total bank loans. The down payment by borrowers is normally at least 30%, often more, and home equity withdrawal is very unusual. In China, house purchases are largely funded by savings. Total outstanding mortgages equate to approximately 10% of GDP in China. In the US, outstanding mortgage debt of \$10.6 trillion equates to 74% of GDP. Between 1990 and 2000 US mortgage debt equated to 44.5% of GDP, on average.

We do not wish to downplay the importance of property because it is central to our view of China's prospects. Land sales may account for as much as 30% of local government revenues (even Beijing does not know the exact amount) while property related activity accounts for the bulk of fixed asset investment. The outlook for construction has big implications for steel and materials output and, by extension, demand for commodities which will affect countries from the Middle East to Latin America. But it seems to us that what is taking place is a cyclical adjustment which the government has sought since it began its policies of restraint in 2006.

And this last point is important. The underlying demand for property is well-recognized by government and when prices in cities like Beijing and Shanghai began to spiral upwards there was increasing concern that prices may move out of reach of the many. This threatened to undermine the "harmonious society" which Wen Jiabao has pledged to work towards, hence the imposition of more restrictive policies in this sector with regard to bank lending, borrowing and taxation on second homes. Now that rising price pressures are easing there is scope to ease, and if necessary reverse, some of these policies.

In fact China, in contrast to the developed world has huge scope to respond to weaker markets. Interest rates, as we have said before are not much a guide because China does not use the price of money to control supply; China controls the quantity available directly. And therefore there is room to adjust this. The banks have been restricted from lending by the requirement to lodge 17.5% of deposits with the Central Bank up from 7.5% in the middle of 2006. The increase equates to around Rmb (Chinese Ren Min Bi) 3 trillion (US\$440 billion). Total new loans in 2007 amounted to Rmb 3.6 trillion.

There is also the option of increasing government spending. The country has been running a fiscal surplus at last since 2002 and is therefore able to afford new spending programs. It is also able to offer tax breaks and incentives which it has done so successfully to stimulate demand in rural areas which has substantially increased rural incomes and consumption spending. And lest we forget, China is sitting on \$1.8 trillion in foreign exchange reserves. China has a lot more flexibility than it is being given credit for.

There are a lot of scare stories out there. The ones pertaining to China relate to the risks of economic growth slowing to 8-9%, an increase in bad debts in a slower growth environment and also (in contradiction to the foregoing) the risk of explosive growth, higher asset prices and higher inflation in the event of 'premature' monetary easing. The

scare stories relating to the US and other developed markets, well we know about these. Which should we be more worried about?

China stocks are now looking cheap in our opinion, trading on a multiple of 11.18 times 2008 estimated company earnings and 9.58 times 2009 estimated earnings. Company profits are estimated to grow 12.9% this year compared with 2007 and by 16.7% in 2009. Profit forecasts have remained steady for most sectors with the exception of real estate where most *listed* property development companies are concentrated in those areas where property prices are falling back from the highs.

Market Performance Ending August 31st, 2008

	August 2008	2008 YTD	2007	2006
Australia	-5.09%	-18.24%	29.38%	32.28%
China	-8.17%	-30.73%	66.01%	82.91%
Hong Kong	-5.45%	-27.40%	42.04%	30.29%
Indonesia	-6.72%	-17.08%	55.81%	73.79%
Korea	-13.84%	-32.86%	32.14%	11.17%
Malaysia	-8.83%	-25.82%	46.56%	37.01%
New Zealand	-6.53%	-30.00%	8.95%	16.27%
Philippines	1.63%	-31.27%	41.60%	59.48%
Singapore	-8.24%	-16.34%	28.54%	47.05%
Taiwan	-0.89%	-12.77%	9.16%	19.67%
Thailand	1.81%	-28.48%	64.08%	11.88%
MSCI AC Far East Free ex Japan	-7.53%	-25.87%	36.82%	31.73%
MSCI AC Pacific ex Japan*	-6.61%	-23.59%	34.96%	32.54%

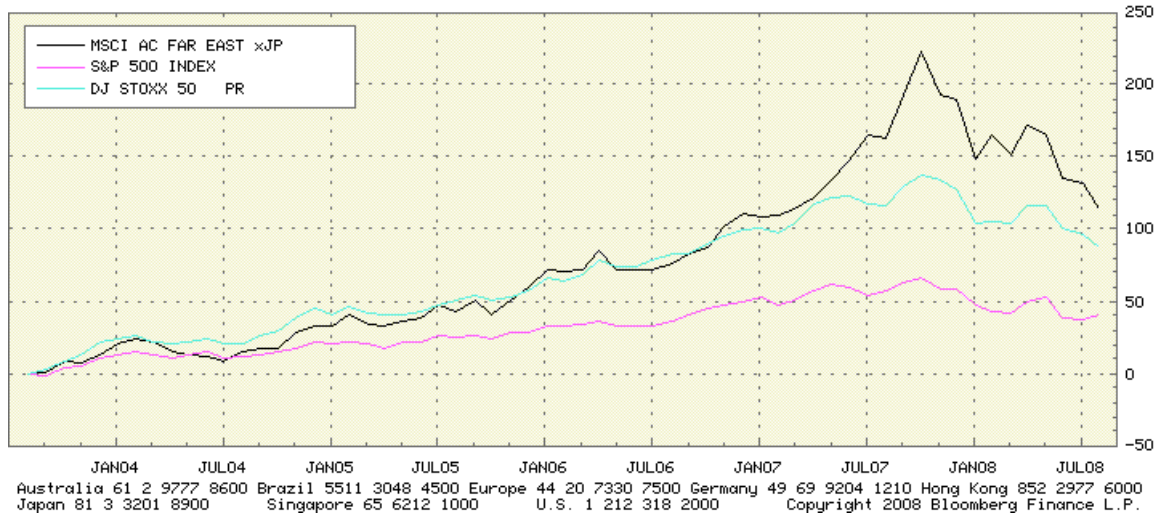
*MSCI AC Pacific includes Australia & New Zealand
(MSCI Indices were used for regional & individual market performance)

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

Range		8/29/03 - 8/29/08		Period	Monthly	60 Mo. Period
Securities	Crcny	Prc	Aprr	Total Ret	Difference	Annual Eq
1 MxFEJ Index	USD	88.63 %		114.53 %	74.82 %	16.47 %
2 SPX Index	USD	27.26 %		39.71 %		6.91 %
3 SX5P Index	USD	56.96 %		87.45 %	47.74 %	13.38 %

(* = No dividends or coupons)



Source: Bloomberg

Market Outlook

We feel recent events make this the most volatile period in financial markets since the Great Crash. Market conditions across the world will likely continue to be dogged by uncertainty and imperfect information. Of course, markets should settle and stock prices should reflect a longer-term view of companies' prospects.

We continue to believe that Asian economies, while hurt by an inevitable slow down in trade growth, are still resilient and are a world away from crisis. Deterioration in economic fundamentals seems unavoidable: current account surpluses falling into deficit, falling foreign exchange reserves and slower overall growth. But it would be a huge leap to suggest that herein lie the seeds of crisis.

Debt levels in Asia are not high and external debt is well below the levels which precipitated the Asian crisis of 1997/8. Inflation pressures in Asia are coming down as commodity and food prices fall which we expect to have the twin effects of increasing monetary policy flexibility at the national level and ease margin pressures at company level.

Dire warnings from some investment banking strategists that liquidity conditions in Asia will tighten as the world economy slows are, in our opinion, less likely to become an issue. It is hard to see how liquidity conditions in the global financial system could get much worse and if Asian banks can cope now, which short term money market rates in Asia suggest they can, then we expect that they will continue to do so.

The challenge for the region therefore, is to try and encourage more domestic consumption and reduce the reliance on exports. Asia has not made great progress here as trade remained the main growth driver. But as we have discussed in Asia Briefs in 2006 and 2007, domestic activity is gradually picking up but for it to become a significant alternate engine of growth would take two or three years rather than a couple of quarters.

China has the most obvious potential as does India. Korea also has a significant domestic economy but it is now beginning to feel the effects of a major consumer spending boom that outpaced income growth and thus was largely debt funded. This is expected to unwind and thus we cannot look to Korea for a strong domestic story. But in the first two, we believe there is opportunity.

China has been looking at ways to support rural income and spending and has been rewarded by a significant pick up in consumption which has seen retail sales grow by more than 20% compared to last year, which in turn were 16.7% above 2006. Economists have pointed to the need for China to bolster welfare, retirement and healthcare benefits to unlock some of the vast savings pool.

We would agree and the recent implementation of the new labor law which came into effect at the beginning of this year is the latest policy move in this direction. The law obliges companies to offer formal contracts and provide compensation when these are terminated. It provides workers with greater security and rights. Companies are also obliged to have regard to retirement benefits. The effects of this law in the form of higher labor costs can be seen in recent reported interim statements of listed companies and so we can see that the law is being adhered to.

India too has a similarly sizeable domestic economy which is not wholly dependent on the rest of the world. In India the biggest outside factor is the weather – a good monsoon means a good harvest which in turns drives consumption. The harvest this year was good. At the same time India benefits from falling commodity prices and with inflation set to ease in coming months we can also see a prospect of falling interest rates. (The Indian central bank was very quick off the mark to address inflationary pressures.) While there is a cyclical slowdown in consumption and investment to contend with India also offers the structural positives of rising purchasing power, a young population, easing access to bank credit a growing middle class.

So our market outlook favors looking at those economies with a strong domestic story, which has the reserves and resources to support that story in the midst of highly uncertain global conditions. We would look for companies that directly and indirectly benefit from this domestic story and this is how the Guinness Atkinson Funds are, and have been,

positioned. Stock markets right now are not interested in much beyond the next announcement from the Federal Reserve or the Treasury. But when there has been a glimmer of light beyond the current storm it has been stocks in those areas that have led the rally.

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

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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 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.

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