

**Asia Brief**  
**January 2009**

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Welcome to the January 2009 Guinness Atkinson Asia Brief.

The last three months have witnessed a sea-change in the economic cycle across the world. Previous economic downturns have arisen from severe monetary tightening designed to combat inflation and overheated demand, or from overcapacity leading to bloated inventories. Downturns of that sort tend to be self correcting as businesses cut production and run down inventories while reduced money supply cools business and consumer spending.

In contrast, what we are faced with today is the aftermath of a long period of increasing leverage both by households and in the financial system. This leverage has been allowed to build up at least partly in consequence of a long period of financial stability, low inflation and accommodative monetary policies. Between 1950 and 1992 American households saved between 7% and 10% of their disposable income each year. From 1993 that proportion fell steadily reaching a nadir of 0.5% in 2005. At the same time consumers boosted their spending capability by re-mortgaging their homes as house prices increased. In 2007 US consumer spending accounted for an estimated 25% of the combined GDP of the 31 countries that make up the Organisation for economic Co-operation and Development (OECD). The reversal of these trends is what threatens the US and the world economy today, as we find the limits of the capacity of our economy to absorb more debt and are being forced to pay it back.

Unlike the self-correcting nature of 'normal' downturns the de-leveraging process is self-reinforcing. Banks are reducing their balance sheets, marking down assets, curbing lending and rebuilding capital. Households are unable and unwilling to borrow and thus are cutting their spending. Both processes occurring simultaneously combine to increase financial instability as well as reduce economic activity causing banks to retrench further...and so on.

The process needs to run its course and it is likely to be a long one, measured in years not months. Even when the period of economic contraction has passed it is likely to give way to a period of slower economic growth. In the short term we may see the odd quarter of economic growth but this should probably not be read as recovery. Businesses have slashed production in recent months and it is likely to undershoot demand, even at lower levels, prompting a short term increase in production. But a sustained recovery in

consumer demand, which accounted for 70% of US economic activity in 2007, is still some way off.

The process of unwinding debt has been, and will likely continue to be, accompanied by falling asset prices, rising unemployment and falling capacity usage as debt liquidation and asset sales feed off each other. The manner in which this process takes place is important. Left to its own devices the market will make this adjustment but it is likely to do so in a fashion that it is too painful to contemplate, which prompts government intervention, unorthodox policies and perhaps a jettisoning of dearly held principles of what a free-market economy should be.

As well as this, Western consumers, in the US and UK particularly, need to learn again the virtues of saving.

It is in this light – the need to soften or mitigate the worst effects of this process – that we should view the efforts of the US Government and governments around the world to offer stimulus packages, additional capital and additional liquidity.

### **Asia's Role**

In addition to the need to unwind debt and prevent the world economy from falling into depression some thought also needs to be given to how global economic equilibrium can be restored. For many years now there has been an imbalance between indebted consumer economies of the west and high-savings producer economies in the east – to put it at its crudest. A return to this pre-crisis imbalance any time soon seems unlikely as well as probably undesirable. Instead, we believe that an equilibrium must be reached which involves western economies borrowing less, and Asian ones saving less.

A first move towards this equilibrium can be achieved through reduced Asian trade surpluses as Western demand for goods falls. Next, Asian countries will have to look to generate internal demand in order to fuel economic growth; to do this the reserves built up over the last few years should be mobilised. This will mean not only increasing activity through government spending but also unlocking household savings to boost private spending. The country on whom the greatest hopes are placed is of course China, which has an estimated household savings rate of 27% and an overall savings rate of around 50%, as well as the largest trade surpluses in the world through recent years.

### **Economic Responses**

The flow of data coming from economies around the world show just how bad things got by the end of last year and markets are far from convinced that 2009 is going to be much better. The next major hurdle for markets will be the company reporting season. But policy makers and Central Banks have been moving rapidly in the past few months and although economists are divided over the speed, method and likely success of these measures (where there are two economists there are at least three opinions) there is going to be a response.

Since October there has been a raft of stimulus packages announced in all the leading economies. The US response is well known but it is complemented by:

Japan	\$117 billion announced in August followed by \$50 billion in October
Germany	\$16 billion in November followed by \$65 billion in January this year
France	\$33 billion announced in December
UK	\$40 billion announced in November
Spain	\$16 billion in April followed by \$15 billion in November

And in Asia excluding Japan

China	\$586 billion announced in November
Korea	\$78 billion announced between September and December

This list is not exhaustive; there have been additional moves to increase liquidity, reduce interest rates, guarantees for business loans, capital injections, tax reductions/rebates and other fiscal measures either proposed or already implemented. However, most of these are very recent and will not have had time to have any effect in 2008. Indeed we should not expect to see these measures begin to have much effect until later in 2009.

In the meantime the slew of weak data continues and efforts are ongoing to free up credit. Most recently, Ben Bernanke has urged the incoming Obama administration to combine further capital injections with a plan to remove troubled assets from bank balance sheets.

In Asia, countries are looking to stimulate internal demand to offset the sudden and sharp falls in exports. China's huge spending programme becomes ever more important as the effect of the slow down in the construction and export sectors becomes apparent. There are an estimated 45 million people employed in export-related industrial businesses and a further 35 million in the construction sector out of total estimated non-farm workforce of 450 million. It is estimated that job losses in these two sectors could reach 15 million, putting pressure on urban income growth. The effect will also be felt in rural areas as wages from migrant workers sent back to their families also fall.

So China's programme includes not only infrastructure investment (especially in railways and water) but also fiscal support to the rural economy and assistance for the property sector through increasing availability and reducing the cost of finance while also reducing the transaction taxes. One of the most important leading indicators that government efforts are having an effect on is new lending by banks, and in this respect the signs are good. There has been a sharp jump in new loans extended in November and December and we shall continue to monitor this over the next few months.

China is not the only country in Asia responding to the slowdown. India too has been cutting interest rates, now at 4.5% from 7.75% earlier last year and has also been injecting liquidity through cutting banks' reserve requirements down to 5% from a peak of 9% (just as China has done). India however, is more constrained than China in its range of responses. The country, almost alone in the region, is running a fiscal deficit which, at an estimated aggregate 7% and rising, is the region's largest. India's banks are

also less liquid; they have similar loan to deposit ratios to Chinese banks, but remaining bank assets are tied up in government debt whereas other assets in Chinese banks are held in central bank paper and required reserves which can be and are being turned into effective liquidity.

While India's monetary options are more limited there are aspects that favour the country. Its international exposure is much lower and so the country is less affected by the global downturn. India's story is much more concentrated on domestic demand. There is also an extensive list of additional items ranging from extra government expenditure to expanding financing options for companies and adjusting taxes and tariffs to target particular sectors.

In South-East Asia, Indonesia and Thailand have announced stimulus packages. Indonesia has cut interest rates by 0.75% in the past month to 8.75% and with inflation now coming down there is room for more. The government has also announced a spending package of \$4.5 billion on infrastructure projects although details remain vague. Lower inflation, however, is largely down to cuts in fuel prices which are controlled by government. Other parts of the inflation basket including food, housing, clothing and healthcare are still seeing upward pressure. Nevertheless, conditions are improving reflected by lower government bond yields that have halved to 10.9% from three months ago. Parliamentary elections are due in April this year followed by Presidential elections in September. President Susilo Bambang Yudhono (known unsurprisingly, as SBY) is hugely popular at present and is expected to win.

The situation in Thailand remains dominated by political uncertainties. The new Thai Prime Minister, Abhisit Vejjajiva took office after prolonged and violent street protests but appears more securely established following a recent by-election of 29 parliamentary seats twenty of which were won by his own party or his allies. Similar to Indonesia a stimulus package of \$3.3 billion, or just over 1% of GDP has been announced. The bank of Thailand has been cutting interest rates, reducing them by 1% in December and by a further 0.75% to 2% in mid-January. Like China, Thailand has a significant manufacturing sector accounting for a third of Thailand's GDP and which relies heavily on migrant workers. The latest industrial production figure shows a fall of 7.7% led by electronics. Rising unemployment, under-employment and returning migrant workers to rural areas pose social problems at a time when rural incomes are also under pressure from falling food prices.

Malaysia announced a spending package of approximately \$2 billion in November funded by savings of an estimated \$4 billion when fuel subsidies were cut earlier in the year. The spending is intended to focus on upgrading transport systems as well public amenities and rural projects. Malaysia's exposure to exports (10.5% of GDP) and its high commodity exposure leave the economy vulnerable to a sharp slowdown but as is the case with many of its neighbours, a well-capitalized banking sector and sizeable current account surplus makes the country better able to avoid instability. Singapore has yet to announce its plans but with the budget due soon, a package of around 8% of GDP seems likely if past history is any guide. The response will likely focus on reducing business

costs, transfer payments to individuals and support to the property sector so as to prevent undermining banks' asset quality.

### **How successful will these responses be?**

There are signs that China's economy is responding to government efforts. Banks are still lending and in the last two months have accelerated their loan growth, in marked contrast to western banks. We can debate the virtues of this – whether the loans are going to 'good' projects and to where they are really needed or merely funding 'bureaucrat-capitalist' projects of doubtful value. But if China's economy is to pick up then we need to see loan growth picking up.

A recovery in Chinese demand for steel is going to be important. Last year the country accounted for 35% of world consumption of the material and a recovery will have a significant impact across a range of commodities – iron ore and coking coal (key steelmaking inputs), nickel (for stainless steel), zinc (for galvanized steel). So far demand strength in China is limited to Sichuan Province that was devastated by an earthquake in May 2008. Reconstruction is now underway and shortages of cement, concrete and other building materials are already apparent.

But it is still too early to be able to demonstrate that a recovery is underway. The synchronised global shock we have experience requires a synchronized global response. However, we also need to be realistic about what can be achieved. American spending programmes are targeted to supporting American consumers to take up domestic capacity that has become under-utilized as the economy has slowed. It is not realistic to expect these programmes to generate enough to absorb all domestic capacity and then some of Asia's (through increased imports of Asian-made goods). That, in effect, would be to ask American tax payers to bail out the rest of the world and not unreasonably, they are likely to resist.

So Asian countries have to look to their strengths: high savings, stable financial systems and young populations. They need to use these to generate internal markets. The process is likely to be a long one, but it is not really a new one. In fact the development of genuine domestic markets as an engine for economic growth is precisely the development that Asia has been working towards anyway; this crisis is now forcing the pace of change.

### Market Performance Ending December 31st, 2008

	December 2008	2008	2007	2006
Australia	6.72%	-49.20	30.92%	33.93%
China	10.51%	-50.43%	66.02%	82.91%
Hong Kong	3.81%	-50.75%	42.06%	30.37%
Indonesia	23.66%	-56.63%	55.81%	73.79%
Korea	16.49%	-57.11%	32.14%	11.17%
Malaysia	6.53%	-41.11%	48.02%	38.26%
New Zealand	4.45%	-53.26	11.20%	19.43%
Philippines	-1.21%	-52.04%	41.60%	59.48%
Singapore	7.34%	-47.20	28.86%	47.89%
Taiwan	5.04%	-46.04%	9.16%	20.73%
Thailand	13.81%	-54.01%	64.08%	11.88%
MSCI AC Far East Free ex Japan	10.11%	-50.56%	36.91%	31.86%
MSCI AC Pacific ex Japan*	8.95%	-50.32%	34.96%	32.54%

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

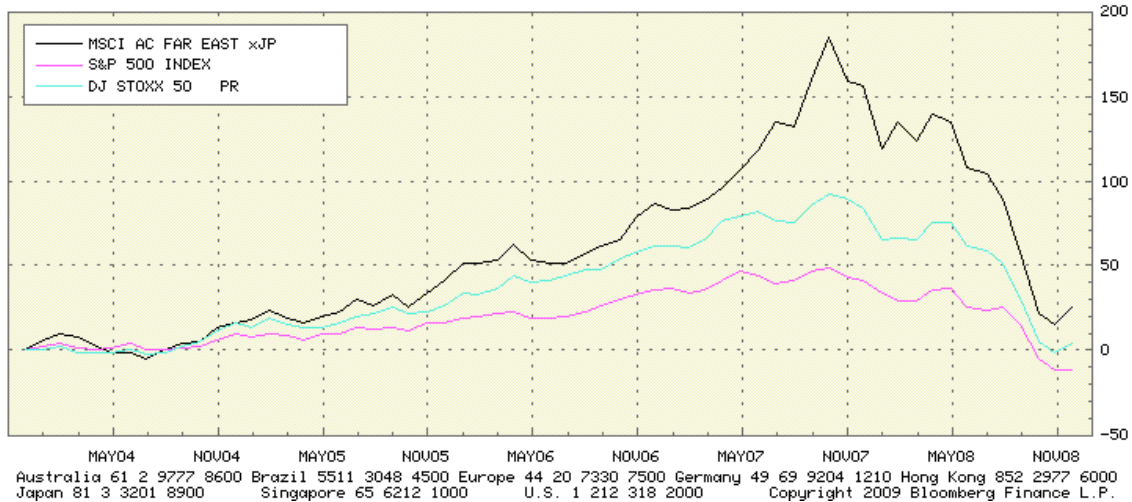
The comparative returns over five years for Asia ex Japan versus the U.S. and Europe are shown in the chart below.

### COMPARATIVE RETURNS

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Securities	Range	12/31/03 - 12/31/08	Period	Monthly	60 Mo. Period	Annual Eq
	Crcncy	Prc Appr	Total Ret	Difference		
1 MXFEJ Index	USD	10.82 %	26.44 %	36.93 %	4.80 %	
2 SPX Index	USD	-18.77 %	-10.49 %		-2.19 %	
3 SX5P Index	USD	-13.01 %	4.60 %	15.09 %	.90 %	

(\* = No dividends or coupons)



Source: Bloomberg

## Market Outlook

We expect that markets will continue to oscillate on changes in sentiment as to the likelihood of an economic recovery. The data flow, as we have said, is likely to remain poor for a while yet with indicators unlikely to show signs of stabilizing until mid-year at the earliest. Even then there will be arguments over whether say, a recovery in Industrial Production is due to an inventory correction following an earlier production undershoot or whether it is a sign of underlying demand recovery.

The path to a global recovery does, in our opinion, rest on a continuation of coordinated efforts to ensure the flow of credit, capital and trade. There is a significant risk that as time goes on and recovery appears elusive that there will be a retreat to protectionism. In this respect China's attitude toward currency policy will be important. Indications so far suggest a stable Yuan/Dollar exchange rate rather than continued appreciation.

Valuations in Asia appear attractive but these are contingent on the outlook for earnings both in Asia and outside (where relative valuations might then appear too stretched). We expect that the 2008 earnings season will trigger more cuts to profit forecasts because, as seems likely, 2008 profits will be awful as companies take the opportunity to make significant asset mark downs and write offs.

However, we expect that Asian economies will do much better this year than some might be expecting. Jim O'Neill writing in the Financial Times earlier this year forecasts world GDP growth of 0.6% with the advanced economies of the world contracting 1.2% and the so-called BRIC economies (of Brazil, Russia, India and China) expanding 4.7% providing the only source of domestic demand globally. The bulk of that is going to come from China and India.

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Commentary for our views on Alternative Energy 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 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.

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.

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