



**GUINNESS
ATKINSON**
F U N D S

Asia brief



Edmund Harriss

October 2011

Commentary and Review by portfolio manager Edmund Harriss

After a difficult month for stock markets generally and for Asia especially, we review our thinking behind our current allocation and provide some perspective on the difference between stock market behavior and underlying macro-economic and corporate performances. The new offshore Renminbi market has also felt the effects of global volatility, and we therefore offer our views on that market's operations and outlook.



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- ➔ Asian Equity Market View
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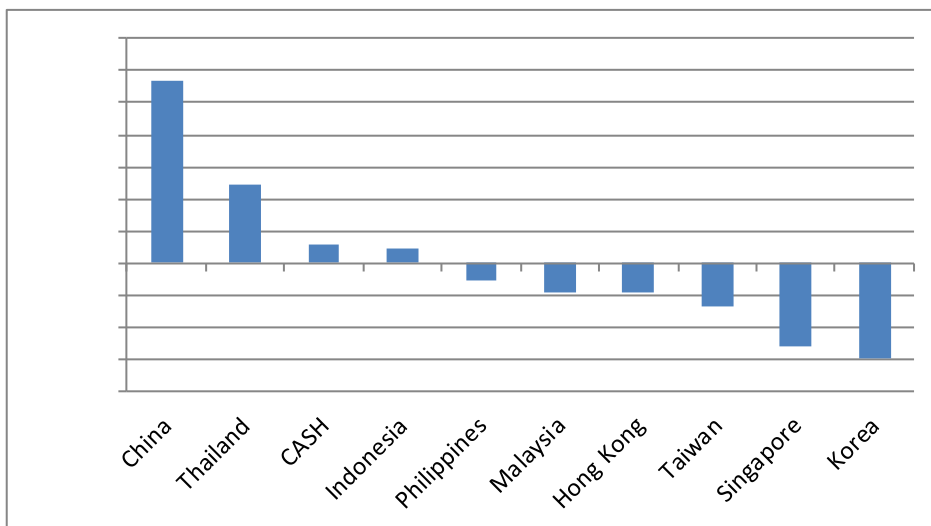
Asian Equity Market View

Stock market conditions in the past month have been particularly difficult as the crisis in the Euro zone reached a crescendo. This was accompanied by fears of a hard landing in China and the possibility of recession in America. Asia is looking heavily oversold against a macro-economic backdrop in the region that looks substantially better than the developed economies. Export exposure is still an issue, but it is not as great as it was and domestic economic growth is considerably more supportive. Valuations are very low in our view, and while earnings forecasts may need to be adjusted lower, nevertheless corporate cash flows and debt levels make Asian companies look resilient.

The US would love to have the problems China has. The US (and Europe) has very little room to maneuver and have fired a lot or most all of their bullets. China has a lot more options and a much more manageable set of issues. Their stock market is cheaper, their growth rate is higher (a lot higher) and they have tools to manage their inflation problem. For example, one of the tools at their disposal is to increase the value of the RMB. The markets appear to have been behaving in a perverse manner, in that investors are fleeing “risky” assets to buy US (treasury) assets and even gold. We might suggest that the low risk investments they are buying are likely to disappoint. But, more to the point, the selling of assets around the globe, and in particular Asia, have caused these markets to decline significantly, when in fact, these might be the more optimal markets to be in.

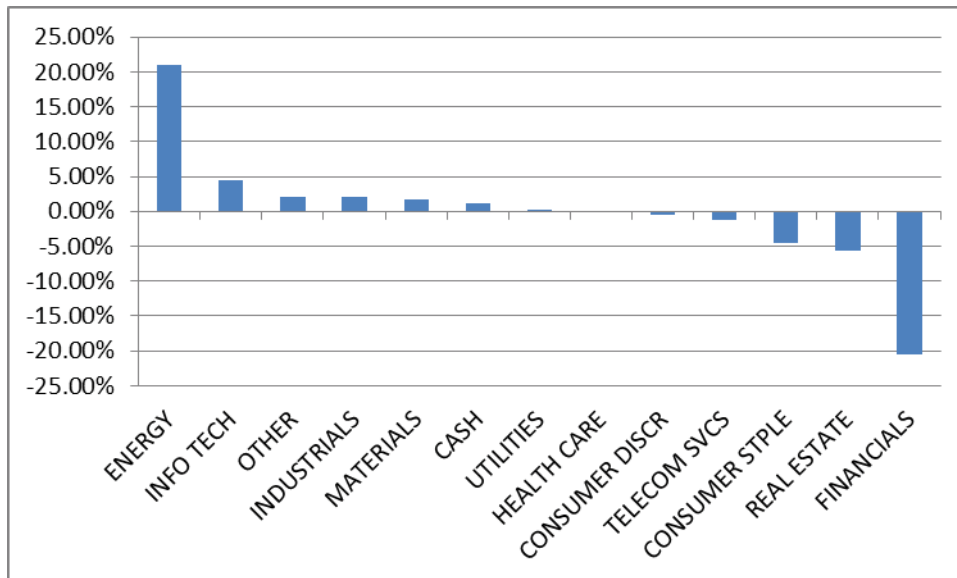
The Asia Focus fund is positioned against the benchmark on a geographic basis as follows:

Asia Focus Fund vs. MSCI Far East ex Japan by Country



And against the benchmark on a sector basis as follows:

Asia Focus Fund vs. MSCI Far East ex Japan by Sector



Geographic and sector weightings are as of 9/30/11 and are subject to change and should not be considered a recommendation to buy or sell any security.

Asia Focus Fund Position

On a country basis the Fund has significant overweight positions in China and Thailand. We are underweight in the markets of Korea and Taiwan and those of Malaysia and Singapore. The underweight position in Hong Kong is just a matter of categorization and should be viewed in the context of an overall China/Hong Kong allocation where we are positive on China but less enthused by the pure Hong Kong businesses that include Hong Kong banks, real estate developers, conglomerates and utilities.

The sector allocation provides more insight into our thinking. The Asia Focus Fund has a particular bias toward China and the growth we have seen and expect to see in its domestic economy. A central feature of the economic development is the growth in domestic activity as opposed to exports and the increase in consumption versus investment. These two elements represent the greatest focus of China's economic policy over the next few years. The intention is to increase the domestic consumption spending from the current 35% of Gross Domestic Product (GDP) back toward 45% of GDP.

This rebalancing is a major undertaking, requiring a shift in consumer behavior away from high levels of saving and toward spending both by reducing the need for precautionary saving on the one hand and by giving people a reason to spend, on the other. There are many factors that go into this mix:

- Large scale industrialization has moved people from low value-added into higher value-added activities with the result that incomes, and disposable incomes, have now risen;
- By actively encouraging rising wages, at the expense of inflation, China is maintaining the trend of income growth, while at the same time driving out (or inward to less affluent areas of the country) more labor-intensive and less efficient manufacturers;

- Improvements in workers' rights and labor contracts to increase job security and the introduction of pension reforms and basic health coverage all contribute to lowering the pressure to save;
- The current plan to increase social housing provision over the next five years by 36 million units provides a platform to broaden consumer spending. Homeownership, rather than urbanization, is the big driver behind spending on consumer durables and household goods. The recent report that 98% of targeted housing starts in the social program has now been reached is a positive sign that this is underway.

Our sector allocation with its overweight position in energy (including oil, coal, and electricity generating equipment) reflects our belief that China's approach is best played through the materials, resources and equipment required for power and construction. This demand is felt across China, Indonesia, South Korea and Singapore. This, in our view, is the single biggest story in Asia.

We also have an overweight position in technology. This may appear modest on a headline basis, but underneath, it focuses on consumer electronics (phones, tablet PCs and their components) and internet businesses, which play on the growth in the spending power of younger consumers.

Overall, the stories behind the portfolio allocation reflect:

- A belief that China's recasting of its economy presents investment opportunities across the region in resources, materials, industrials and technology;
- Thailand represents a value opportunity where companies have distinguished themselves not only in a difficult operating environment but have done so in a way that has improved cash flows and delivered steady dividend streams;
- Our understanding that while the banking sectors across the region (even those of China) are in good shape, especially when compared to the developed world, the stock valuations leave little upside in our view;
- Our perception that the domestic economies of South Korea and Taiwan are fundamentally unattractive, and this is manifested by the often poor returns on invested capital generated by businesses with an exclusively domestic focus. The companies whose operations have performed best were generally found amongst the export manufacturers.

A word on the process of stock selection and portfolio construction

Guinness Atkinson selects stocks on the basis of four criteria which have an equal weighting in our mind. We look for good quality stocks, that are cheap, where market estimates of future earnings are rising and where the stock price action has started to reflect this. We run through an initial screening process to identify a list of possible target ideas with these characteristics and then structure our due diligence and analysis to support or knock down each factor.

The strength of this is that:

1. The application of these four elements marries together fundamental analysis and a market assessment;
2. The approach is structured and methodical, defining the questions we ask and types of stock we look at which means it is applied consistently in how the analysis is performed and how buy and sell decisions are reached;
3. It gives the portfolio a distinctive set of characteristics that we believe means its performance can be anticipated: the momentum element means it should under-perform during harsh market conditions but is likely to out-perform on the recovery and rise. This is what happened in 2008-9.

Is the thesis flawed?

We don't think so.

- **Asian Macro story**

Our assessment of Asia from a top-down perspective is that the region is in good financial health at a national, corporate and household level. There are areas of stress, to be sure. Inflation pressure is a concern and so too are some of the unwelcome side effects of China's credit expansion in 2009 with increased debt levels, the expectations of higher non-performing loans and real estate prices that are still too high. The export manufacturing sectors in South Korea, Taiwan, Malaysia, Singapore and China too are also vulnerable to slower demand out of Europe and the US.

However, there is a big difference between saying that Asia is going to find life more difficult over the coming twelve months and saying that a collapse is imminent. Asia is pricing in crisis valuations now that appear to be driven more by funds flows in response to Europe's sovereign debt crisis rather than any articulated concerns about Asia.

At the aggregate level

- China looks set to grow GDP by 8.3% in 2012 (with next exports being a drag rather than a net contributor to growth), while the rest of Asia looks likely to grow between 3% and 4.5%. This compares to consensus estimates (at the moment) of 1.8% in the developed world.
- Monetary policy in the region has yet to be loosened since in the region it is inflation rather than the lack of growth that is seen as the main threat. This makes sense where inflation in the region is running at around 5% compared to 2.5% in the advanced economies.
- Current account balances as a percentage of GDP remain resolutely negative for much of the world, excepting the Nordic countries, and have been so for a number of years. By contrast, Asia has been running surpluses and increasing reserves since the 1998 financial crisis. While it is undeniable this focus on reserve accumulation has contributed to the problems we now face, it does leave the region in a comparatively strong position.

Even when we drill down into China, at the macro-level the concerns do not seem as severe as they are painted. As we are discovering now (again) the dynamic of a debt crisis comes in two parts: the size of the debt pile is one part and the ability to service it in timely fashion is the other.

The US downgrade did not spook investors significantly, because as the downgrade itself made clear, the problem at the moment is the size and trajectory of America's debt pile not its ability to service it today. That is tomorrow's problem and the downgrade was meant as an early signal of that.

In the case of China, there is ample liquidity and capital within the system. Banks have Tier 1 capital of around 12% in anticipation of non-performing loan (NPL) write-downs, which we expect to occur in steady fashion over the next few years. Local government debt can be refinanced and banks can be shored up. There are no significant outside forces that can force a debt crisis on China. This is not to say a crisis cannot happen; it came in 1994/5, but it is not imminent, in our view, and thus a hard landing scenario is not our thesis.

- **Asian Stocks**

At the end of the quarter stocks in the region were trading on an average ratio of Price to Earnings (PE) of 9.13 x consensus earnings estimates for 2011 and 8.06 x 2012. Earnings' growth is forecast to be 9.95% in 2011 and 13.28% in 2012. In China and Hong Kong where stocks have been hit particularly hard the PE ratios are 7.51 x 2011 and 6.66% x 2012 with growth of 11.27% and 12.76%.

These valuations are attractive even if we assume that estimates will need to come down a bit, which is something that we believe the market is already pricing in.

Outlook

From a global perspective it is clear that the crisis in Europe has cast a long shadow. Investors do not know how to respond to the Greek debt crisis and how it may translate into a more widespread funding crisis for the European banks. It is apparent that recent events have prodded European policymakers into action, although we have some way to go before we see what a resolution might look like. The recent announcement by Merkel and Sarkozy that they intend to announce a plan by month end ahead of the G20 on November 4 follows on from undertakings to recapitalize banks and the break-up of Dexia. The policy decisions that need to be made are certainly onerous but not impossible. What has been lacking so far is the political will.

Markets have looked brighter in the first half of October. Signs of action from Europe have slowed the flight from risk, while a steady stream of better data from the US has shown that growth has been better relative to expectations. The recent employment number was not enough to close the output gap, but when looking at production and Institute of Supply Management (ISM) data, it does at least suggest that growth in the US is bumping along rather than weakening.

We are still looking for an easing in monetary policy in Asia, especially China. This might not actually take place until early next year but our company contacts there suggest that policy is unlikely to get any tighter. In the short term there may be measures to move liquidity into areas currently starved of short term funding, but the desire right now is to get inflation on a downward track from 6% down toward 3.5% to 4%. However, while we do not expect a stimulus equivalent to 2009, there is scope for Asian economies to ease policy should circumstance require.

As we said at the outset, Asia is looking heavily oversold against a macro-economic backdrop in the region that looks substantially better than the developed economies. Export exposure is still an issue, but it is not as great as it was and domestic economic growth is considerably more supportive. Valuations are very low in our view, and while earnings forecasts may need to be adjusted lower, nevertheless, corporate cash flows and debt levels make Asian companies look resilient. Asia may be more volatile than the US market, but we could argue it is less risky on an absolute basis, or at least offers much better return possibilities than US equities or bonds.

Offshore Renminbi Market View

Within the last month, the offshore Renminbi (CNH) market saw unusually large fluctuations, weakening against the dollar, while the onshore Renminbi rate remained relatively stable. The onshore and offshore Renminbi rates have previously been very close. The recent moves put offshore rate at a discount of over 2% to the onshore rate.

How these markets work:

The onshore rate is tightly managed by the People's Bank of China. On the flip side, the offshore rate moves freely, determined by supply and demand, and while it generally responds closely to the rate prevailing in the mainland, the market is still separate. The moves in the CNH that have happened reflect the independent market dynamics.

Why these movements have taken place:

- The sell-off in CNH was partly driven by sales of underlying securities (RMB-denominated bonds) with the proceeds converted back into USD.
- This move was in line with sell-off across Asian currencies and other emerging market bonds. It appeared to reflect a belief in the dollar as a safe haven in the short term rather than a belief that the Chinese currency will now depreciate.

This action was exacerbated by two other factors:

1. The immediate upward pressure on dollar, as investors moved away from 'risk', exposed other positions by traders who had gone short-dollar and long-CNH. These needed to be covered
2. A statement from Bank of China (BOC) Hong Kong branch that its quota for the quarter was full and that it would no longer be buying Renminbi at the onshore rate for trade settlement.

This last point needs some explanation:

The BOC has a quarterly quota of RMB 4 billion allowed for it to Buy and Sell renminbi for trade settlement purposes. The imbalance of cross-border settlement between importer and exporters is a problem at present. Currently 80-90% of the cross-border CNH transactions are done by Chinese importers. International corporations get paid in CNH and sell this CNH to BOC for USD. As BOC's quota gets filled, some of the flow has to go through interbank dealer market. This, unfortunately, met with general squeeze in in the Asian foreign exchange markets.

At the beginning of October the quota for the fourth quarter was expanded from RMB 4 billion to RMB 8 billion to avoid a repeat of this situation.

What to expect going forward:

We believe that the gap between the onshore and offshore rates will close once again, and we think that it will happen by a strengthening of the offshore rate against the dollar. It seems unlikely to us that China will weaken the onshore rate materially, since all the reasons for allowing a stronger currency (inflation, imbalances etc) remain in place. The process of arbitrage that takes place with Chinese corporates able to access both rates is also still in place. This does not happen instantaneously because of the controls in place to regulate capital flows between the onshore and offshore markets.

Market Performance Ending September 30, 2011

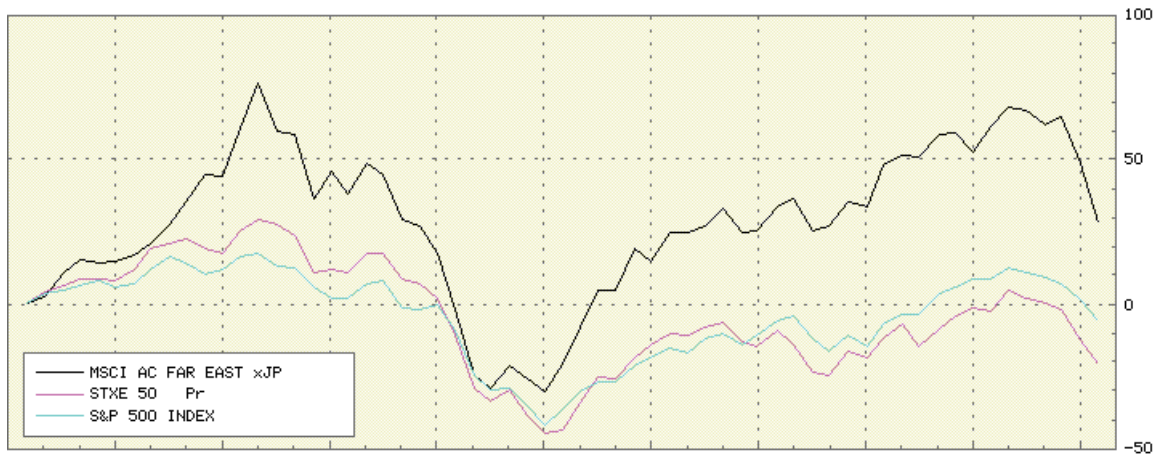
	Sept 2011	2011 YTD	2010	2009	2008	2007
Australia	-14.56%	-17.00%	14.69%	73.87%	-49.47%	29.38%
China	-16.83%	-24.49%	4.59%	62.06%	-50.43%	66.01%
Hong Kong	-16.38%	-20.84%	23.28%	60.48%	-50.46%	42.46%
Indonesia	-11.60%	-2.00%	35.47%	136.12%	-57.87%	55.34%
Korea	-13.34%	-18.27%	25.84%	74.44%	-56.36%	32.14%
Malaysia	-10.15%	-10.47%	37.67%	51.26%	-41.15%	46.56%
New Zealand	-8.34%	8.47%	8.73%	49.89%	-53.54%	8.95%
Philippines	-9.14%	-6.80%	35.24%	67.34%	-52.02%	41.60%
Singapore	-13.68%	-16.66%	22.03%	73.18%	-47.21%	28.52%
Taiwan	-10.55%	-19.87%	23.14%	80.23%	-46.04%	9.15%
Thailand	-17.35%	-12.86%	56.67%	76.59%	-48.21%	46.29%
MSCI AC Far East Free ex Japan	-13.86%	-19.07%	19.41%	68.56%	-50.34%	36.82%
MSCI AC Pacific ex Japan *	-14.03%	-18.43%	17.95%	71.51%	-50.00%	34.96

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

COMPARATIVE RETURNS

Securities	Range	Crcncy	Prc Apr	Total Ret	Difference	Annual Eq
1 MXFEJ Index	9/29/06 - 9/30/11	USD	12.69 %	28.54 %	49.28 %	5.14 %
2 SX5P Index		USD	-35.52 %	-20.74 %		-4.54 %
3 SPX Index		USD	-15.30 %	-5.75 %	14.99 %	-1.18 %

(* = No dividends or coupons)



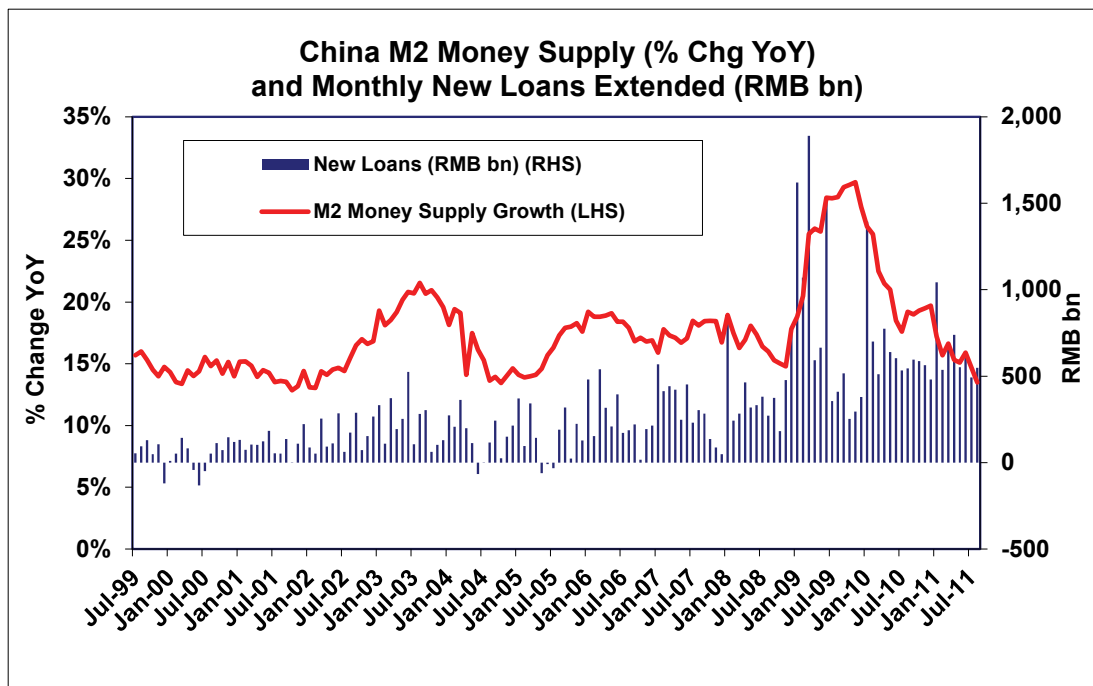
FEB07 AUG07 FEB08 AUG08 FEB09 AUG09 FEB10 AUG10 FEB11 AUG11
Australia 61 2 9777 8600 Brazil 5511 3048 4500 Europe 44 20 7330 7500 Germany 49 69 9204 1210 Hong Kong 852 2977 6000
Japan 81 3 3201 8900 Singapore 65 6212 1000 U.S. 1 212 318 2000 Copyright 2011 Bloomberg Finance L.P.

Source: Bloomberg

China Economic Monitor

Policy on bank lending remains restrictive as China seeks to counter the effects of the credit expansion in 2009. Money supply growth has come down to what we believe is the Central Bank's targeted level, but China's economy has become more sophisticated in the last few years and other channels of credit are still open. As a result, policymakers are actively looking to close loopholes such as the various forms of off-balance sheet lending that are still channelling credit into overheated sectors.

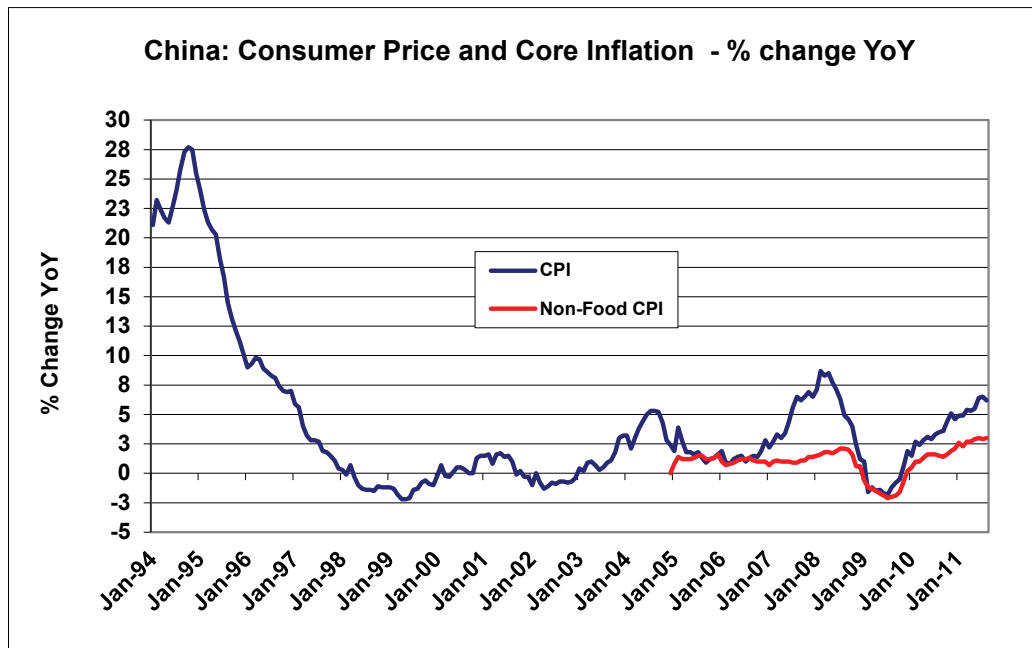
There are indications that the efforts are paying off and that policy is unlikely to become any tighter. However, it is also true that smaller businesses are feeling the strain and further adjustments will be needed to ensure credit reaches sectors where it is needed. We expect to see such adjustments in coming weeks, but these should not be mistaken for a general move to loosen policy, yet. Inflation needs to move lower more decisively and there needs to be clearer indication that housing prices and, more particularly, land prices have stabilized.



Source: The People's Bank of China

Consumer price inflation at the headline level has moved down a little below its peak to 6%, while core inflation, which excludes food, is roughly unchanged at 3%. This serves as a reminder that one of the major drivers of headline inflation in recent months has been food prices, and pork prices in particular. While food prices have remained at elevated levels, they are at least not moving up any faster, and this should make comparison numbers easier; which is to say, the headline rate of inflation should continue to fall.

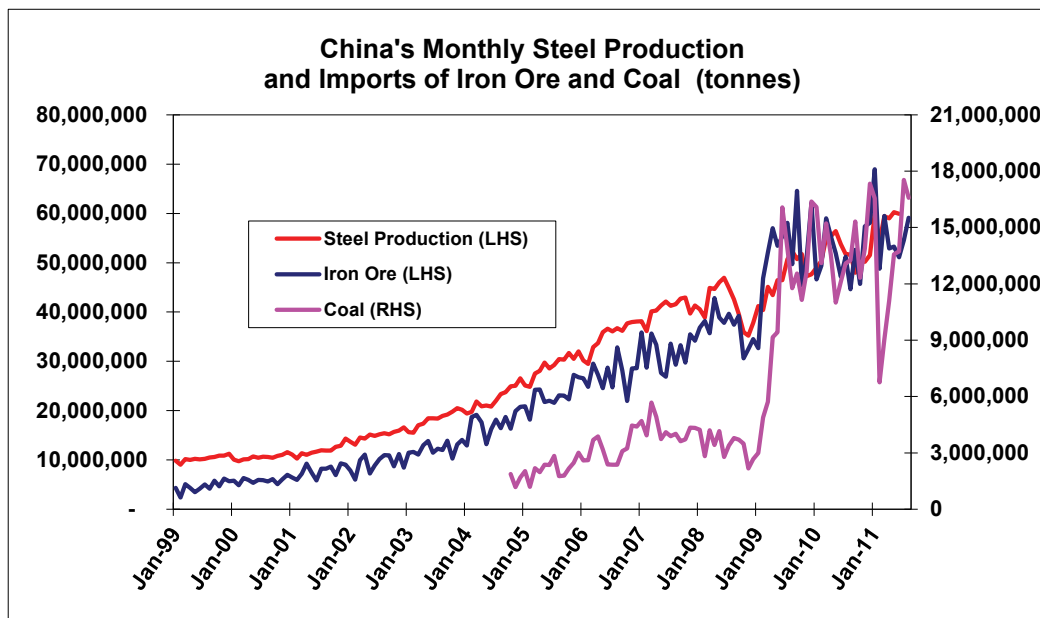
Policymakers, in private, appear to be confident that prices are under control, but they are wary of moving too soon to adjust monetary policy. Core inflation of 3% is something which we believe the authorities find acceptable, driven by rising wages costs (good for consumption) and rising import costs of materials. Rising import costs are an issue, given China is by and large a price taker, but there are ways of mitigating the impact either by seeking to improve efficiency of resource usage and also by allowing the renminbi to appreciate.



Source: Bloomberg, China Economic Information Net.

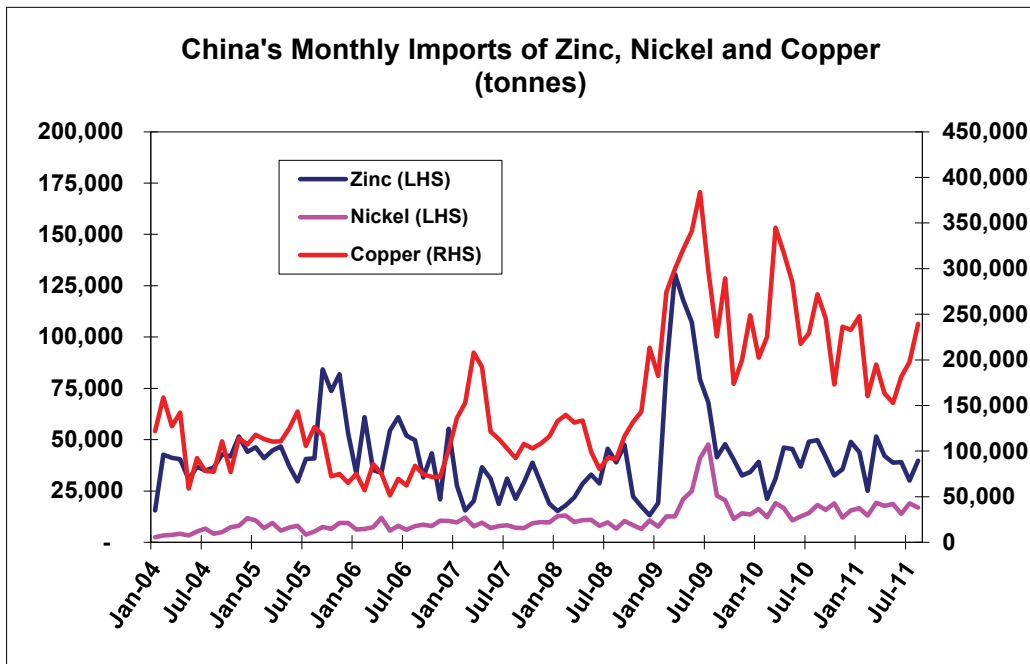
The summer months generally saw a 'soft patch' in resource consumption and steel output, and China was no exception. Recent signs are that this period of de-stocking is coming to an end and is reversing. Imports of iron ore (for steel production) picked up again in August and look to have been strong in September. The price of iron ore has held firm, indicating decent underlying demand.

We have been encouraged by the progress made so far on China's social housing program with 98% of targeted housing starts achieved. This suggests to us that this program will provide a steady source of demand for steel, cement and building materials over the next few years.



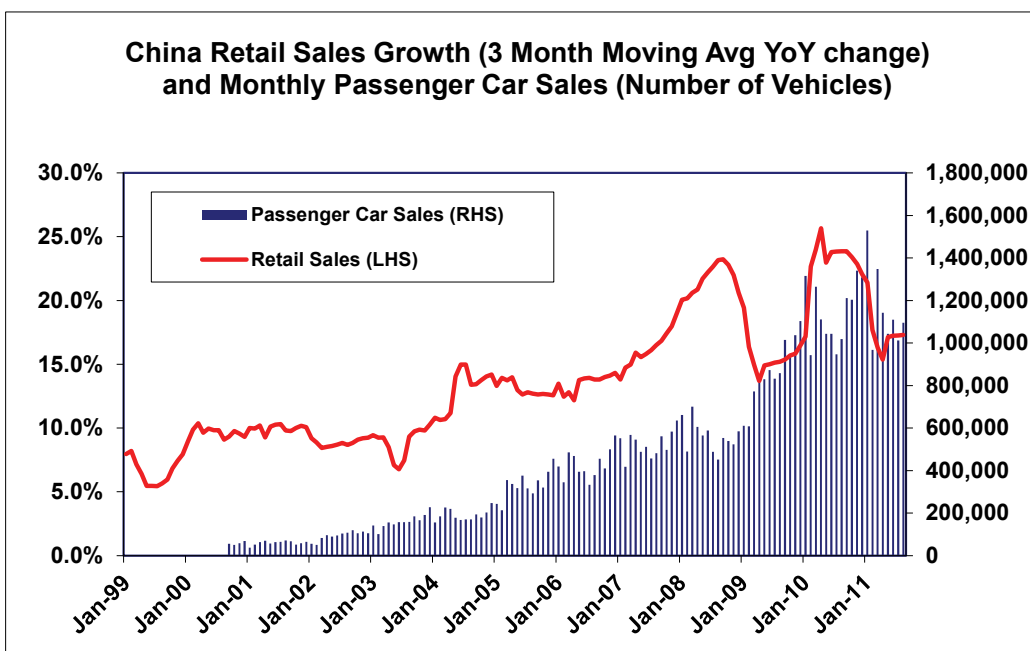
Sources: National Bureau of Statistics, China Customs General Administration

Imports of industrial metals have been moving sideways for the last couple of years, albeit with varying volatility. Copper imports rebounded last month, which we take to mean there is demand for the metal but that China is not prepared to pay the sky-high prices we have seen at times over the past year. Weaker copper prices have seen Chinese buyers re-stocking. Zinc and Nickel imports, generally associated with higher grade steel products, have been stable but may see further pick up as the social housing program gains momentum, new units are delivered and associated consumption picks up.



Source: China Customs General Administration

Retail sales have been holding well in spite of tighter macro conditions. The first week of October is a national holiday in China, and retail sales over this period are keenly watched. Across the retail sector there were no signs of an overall slowdown. Luxury consumption is particularly strong. In the auto sector higher-end cars saw strong sales growth, especially for German models at the expense of the Japanese. Sales of basic passenger cars are likely to come under pressure as subsidies for smaller engine cars have been phased out to be replaced by a more demanding fuel efficiency subsidy for which only 10% of existing models are eligible.



Sources: China National Bureau of Statistics, China Automotive Information Network

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.

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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.

The Price to Earnings (P/E) 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 an 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.

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