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**Asia**  
brief



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**Commentary and Review by portfolio manager  
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*This month we look forward for opportunities in 2012 and highlight China, South Korea and Indonesia as the markets to watch. Reasonable domestic demand in China means there is still a good opportunity for these nations to grow well this year, even if the external environment is mixed. Monetary easing in China should help to catalyze growth there, but we are aware of the potential for a further slowdown in the construction sector.*

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## China

China's economic policy priorities have now shifted toward supporting growth through monetary easing, business incentives and extension of subsidies. Falling inflation has given the government the room to adjust policy while the effects of the global slowdown, falling exports and the resultant slower industrial activity have provided the impetus for change. We believe that there is the scope to support domestic growth without resorting to the type of stimulus package of 2009. Domestic demand and confidence remain firm; liquidity that has been tied up can be released; and resources are available to support the government's substantial affordable housing construction program. This last point is important because it is our view that construction activity should be the critical factor for China's overall prospects for the next year or two.

The government appears to be targeting economic growth of 8% to 8.5%, which is generally regarded as the minimum rate required to maintain job creation and social stability. While no formal monetary targets have been set, it is believed the Central bank regards growth of 13.5% to 14% in the broad money supply (M2) to be sufficient to support this growth target. It seems likely that this should be achieved through a new lending target of RMB 8 trillion (\$1.27 trillion) in 2012 as compared to RMB 7.5 trillion in 2011. Further measures to boost liquidity in the economy may also come in the form of cuts to the Reserve Requirement Ratio, which, rather than interest rates, has been the preferred means to control money supply since 2006.

We are attracted to Chinese equities in 2012 because we believe that conditions should prove to be more supportive as policy becomes more overtly pro-growth. Furthermore, we believe that current stock market valuations mean Chinese stocks, the ones traded in Hong Kong and available to international investors, are among the cheapest in Asia and, we believe, are at a meaningful discount to global averages.

- Offshore Renminbi currency & bond market

The growth in the offshore renminbi market has slowed in recent weeks, although renminbi deposits are still growing and the share of Chinese trade settled in renminbi is rising. Following a wobble in September when the offshore Renminbi (CNH) exchange rate moved to a 2% discount to the onshore Renminbi (CNY) rate, the two exchange rates have converged once again. In 2011 the offshore CNH rate appreciated 3.71% against the dollar while the onshore CNY rate appreciated 4.72%.

In the coming year we believe some of the pressures for an accelerated appreciation of the onshore CNY have abated as inflation and money flows have subsided. However, the longer term arguments for the currency being undervalued remain in place, and the desire for greater internationalization of the renminbi remains undimmed, we believe. The yields on renminbi denominated bonds and certificates of deposit in the offshore market have moved higher in recent weeks. Unrated bonds have already seen yields go up in the last three months of the year, but sovereign and investment grade yields have also risen by approximately 1%, suggesting an expectation of greater volatility in the offshore renminbi exchange rate.

We believe that the recent volatility in the exchange rate and the rise in yields are healthy developments. Investors are no longer blindly chasing renminbi-denominated assets but are beginning to pay more attention to credit-worthiness and the structure of bond issues, although they have yet to become more demanding on covenants which apply some restrictions onto the bond issuer in order to give comfort to bondholders that the cash flows required to service and repay the debt will be protected.

We expect the development of the offshore renminbi market to continue; we expect there to be greater usage of renminbi in trade settlement and that the channels through which renminbi can move between onshore and offshore will continue to develop. Reduced inflationary pressures mean we think the currency could appreciate by around 3% this year. In the offshore bond market there are bonds worth RMB 30 billion due to mature in the first half of the year and RMB40 billion in the second half. We believe that there is substantial new issuance to come this year, and the combination of somewhat tighter liquidity and more discernment by buyers should lead to more attractive yields for investors.

## South Korea

South Korea is no longer a 'Tiger' economy with economic growth and broad money supply growth in the 3%-4% range. However, in recent years South Korea has grown closer to China as growth in exports to the US has slowed. China was the destination for 23% of South Korean exports, compared to the 10% going to the US and 7% to Japan, which resulted in a trade surplus with China of \$45 billion. South Korean exports have held up relatively well by comparison to other countries in Asia in part due to a weaker currency and partly by the breadth of products. In the first half of 2011 the top six exports by dollar value were Ships, Semiconductors, Petroleum products, Petrochemicals, General Machinery and Automobiles. The range of destinations, especially the high proportion going to emerging markets (excluding China), has also provided support.

South Korea's domestic economy is also holding up relatively well, although there are now signs that retail sales growth is slowing. Approximately 80% of South Korea's workforce is employed by small and medium sized businesses, which are closely linked to the health of the export sector. Industrial production, which has slowed since the middle of 2011, is still encouraging and growing over 5% per annum while inflation is coming down and unemployment is at an all-time low.

While South Korea could likely feel the effects of slowing external demand, there is some resilience that makes current equity valuations look attractive on the basis of forecast earnings growth and on earnings multiples compared to the Asia region. Longer term we believe that sentiment could be supported by discussions to establish a Free Trade Agreement between South Korea and China alongside existing agreements with the US and EU. Some think tanks believe that such an agreement could add two percentage points to South Korean GDP given the increasing level of trade between the two and the scale of tariff reduction that could follow an agreement.

## Taiwan

Taiwan is looking much more exposed to the global slowdown with 75% of the economy linked to exports. Trade with Asia accounts for 54% of Taiwan's total exports, half of which go to China. Trade with the US and Europe accounts for a further 44%. Unlike South Korea, Taiwan has a narrow industrial base, and its trade is more concentrated in electronics. Slower demand out of the US and Europe has been reflected in a sharp fall in industrial production and modest retail sales growth.

The recent re-election of President Ma means that warming relations with Mainland China look set continue, but fundamentally, the investment story in Taiwan is about technology and electronics and the outlook is not compelling. Taiwan also has to struggle with the prospect in ten years of a population in decline, in the way of Japan, and it is something for which the country appears unprepared. This leaves us with lower confidence in earnings forecasts and with caution on this market.

## Indonesia

In South-East Asia the strongest macro-economic story remains Indonesia. Economic growth has averaged 6.5% for the first nine months of 2011, and while it is expected to slow to perhaps 6.3% in 2012, this is nothing like the slowdown expected for more open economies such as Singapore and Malaysia. By 'open' we mean exposed to international trade. Indonesia's exports, excluding oil and gas, are equivalent to only 19% of GDP. Inflation is a risk to the outlook. While Indonesia's rate of inflation has been slowing, the picture is complicated by an extensive program of subsidies, especially on fuel. The government is planning to reduce this program by restricting sales of subsidised fuel (thereby forcing people to buy some of their fuel needs at full market price) rather than going for a straight price hike. Some official estimates put the impact of this move on inflation at an extra 0.7% to 0.9%, but because of the method chosen, it is not clear how fast this will materialize.

The Indonesian stock market is among the best performers in Emerging Markets since the crisis, and this appears to be on the back of rising expectations that Indonesia has achieved structural improvements that should allow faster growth without risking inflation. Investment now stands at 26% of GDP, which is an increase on ten years ago, but it is still less than it could or should be. The ten year master plan, the Land Acquisition Act and a raft of incentives for investment across sectors, including commodities and infrastructure, are designed to maintain the flow. There are signs that capacity is being used up; although Indonesia has a favorable demographic profile, in some areas we have seen wage agreements that have pushed up wages by 20%.

As we have already intimated, the stock market has performed well and a large proportion of the re-rating may be behind us. The risks are that inflation could start to pick up prompting earlier tightening and, given the yield on Indonesian bonds is very low with a high proportion of foreign ownership, there is a risk of a sell-off and associated currency weakness. Nevertheless, we believe there is still value to be found.

## Summary

This year is going to be no less challenging than 2011. European travails have yet to be resolved, and a disorderly breakdown of the European debt and currency markets would have widespread ramifications. This outcome is not our central case and neither is it the consensus, not least because no one really knows how it would play out, but all agree that it would be awful.

Assuming that the Eurozone does not implode still leaves us with the expectation of slower demand growth from the EU bloc, and this will be felt by Asian exporters. We believe that China and South Korea will be able to offset some of these effects, either by the strength of their domestic economy or by the breadth of products and markets with which they are linked. Indonesia, with its low reliance on trade combined with the positive effects of recent structural reforms looks likely to have some protection, too. By contrast, countries such as Malaysia, Singapore and Taiwan have high trade exposure, which is relatively concentrated leaving them vulnerable to lower exports and slower manufacturing growth.

The key call in our minds remains China where we are looking for monetary easing to continue this year. However, we are cognizant of the balancing act that is being performed by supporting the domestic economy as the external one slows and simultaneously avoiding another liquidity-fuelled expansion akin to 2009/10.

Market Performance Ending December 31st, 2011

	Dec 2011	2011	2010	2009	2008	2007
Australia	-1.30%	-10.77%	14.69%	73.87%	-49.47%	29.38%
China	2.41%	-18.36%	4.59%	62.06%	-50.43%	66.01%
Hong Kong	1.98%	-15.78%	23.28%	60.48%	-50.46%	42.46%
Indonesia	2.35%	5.19%	35.47%	136.12 %	-57.87%	55.34%
Korea	-2.24%	-13.55%	25.84%	74.44%	-56.36%	32.14%
Malaysia	4.01%	0.11%	37.67%	51.26%	-41.15%	46.56%
New Zealand	3.23%	5.90%	8.73%	49.89%	-53.54%	8.95%
Philippines	3.63%	0.04%	35.24%	67.34%	-52.02%	41.60%
Singapore	-2.50%	-17.54%	22.03%	73.18%	-47.21%	28.52%
Taiwan	2.97%	-20.18%	23.14%	80.23%	-46.04%	9.15%
Thailand	1.33%	-2.72%	56.67%	76.59%	-48.21%	46.29%
MSCI AC Far East Free ex Japan	1.26%	-14.75%	19.41%	68.56%	-50.34%	36.82%
MSCI AC Pacific ex Japan *	0.49%	-13.59%	17.95%	71.51%	-50.00%	34.96

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

December was a reasonable month for Asian equities with a broad-based bounce in the markets. The top performing market was Malaysia, which has done well in recent months ahead of elections in 2012. Based on Malaysia's parliamentary calendar, an election is due in the coming year, and the government has been taking steps to improve sentiment ahead of its re-election attempt. Taiwan also did well in December ahead of its Presidential election on January 14th, 2012. Incumbent Ma Ying-jeou is standing for re-election for the Kuomintang, with his record on improving relations with mainland China under scrutiny. Although Ma has cut corporation taxes during his term in office, Taiwan's economic performance in recent years has been less than stellar, and this could be a real weakness for him.

His main challenger is Tsai Ing-wen from the Democratic Progressive Party (DPP), which favors a more cautious approach to engagement with China. Polls in December suggested that President Ma was ahead of the Tsai Ing-wen, but the polls were closer than in recent elections, and Ma's re-election is by no means a foregone conclusion. If Ma were to lose to the DPP candidate, it is possible that the equity market would react negatively, as Ma is seen as the more pro-China and pro-business of the two candidates.

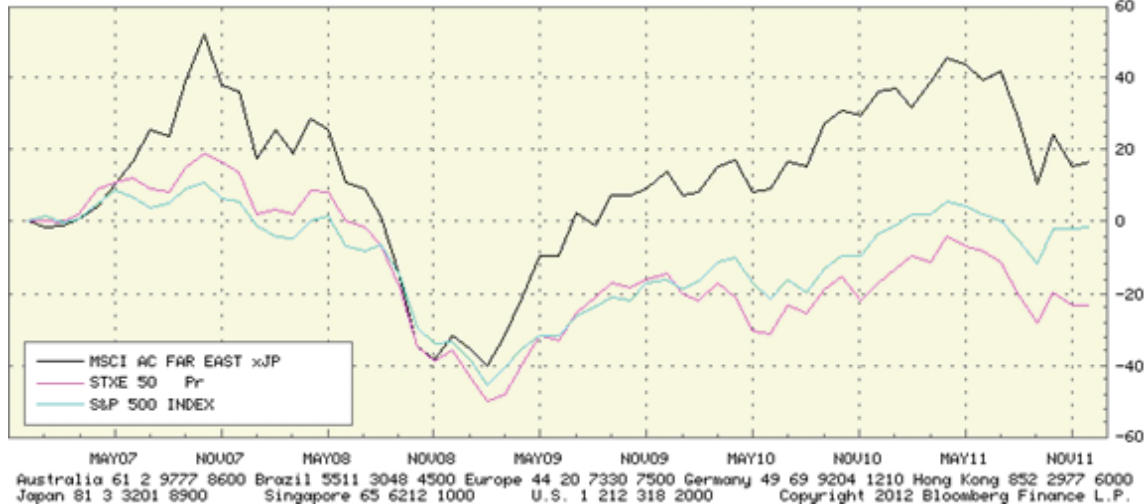
Some of the smaller markets also did well in December, with good returns from the Philippines, Indonesia and New Zealand. Thai equities also continued to recover reasonably well from volatility due to the widespread flooding.

The worst-performing markets were Singapore, South Korea and Australia, and this dragged down the benchmark overall, as these are amongst the larger markets by market capitalisation weighting. Singapore's exports began to slowdown, and its Industrial production contracted in November compared to the prior month, suggesting that the fourth quarter of 2011 might be a slower period for economic growth. This was borne out by the figures as Q4 real GDP fell 4.90% on an annualized basis. As a relatively small, open economy, Singapore is exposed to slowdowns in global growth and trade. The Singapore government's GDP growth forecast for 2012 is 1.00% to 3.00%, which is slow by historical standards. South Korea also suffered due to a slowdown in global trade, as it is also quite dependent on exports.

**COMPARATIVE RETURNS**

Securities	Crncy	Prc	Aprr	Total Ret	Difference	Annual Eq
1 MXFEJ Index	USD	2.66 %		16.60 %	39.89 %	3.12 %
2 SX5P Index	USD	-37.02 %		-23.30 %		-5.16 %
3 SPX Index	USD	-11.33 %		-1.24 %	22.06 %	-0.25 %

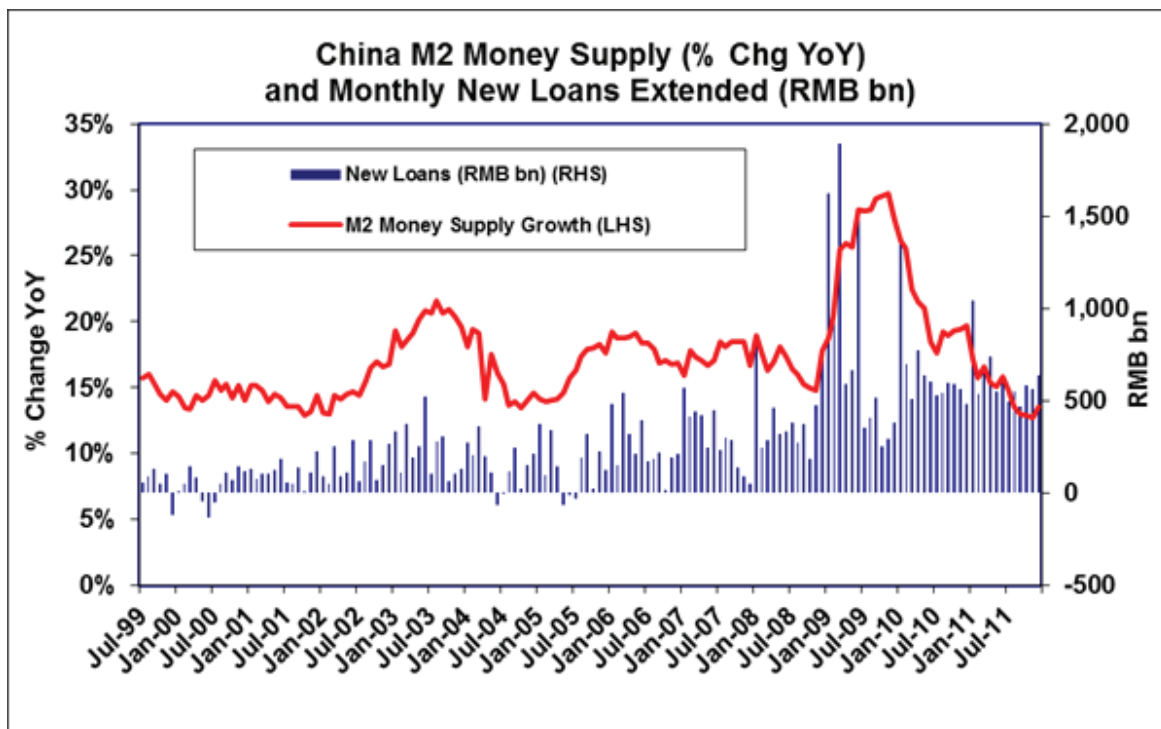
(\* = No dividends or coupons)



Source: Bloomberg

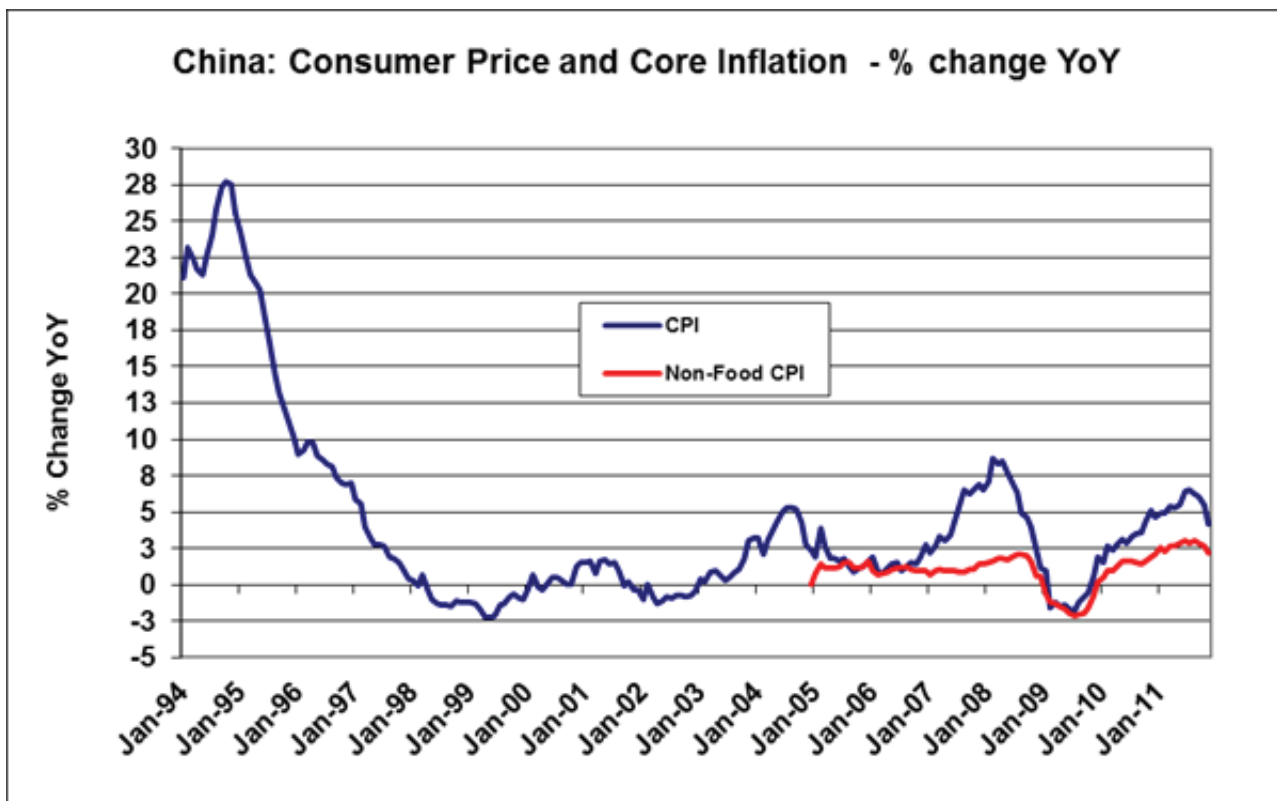
**China Economic Monitor**

December was a significant month for monetary policy in China, as the People’s Bank of China cut the reserve requirement ratio from 21.5% to 21.0%, suggesting a shift to a looser policy stance. Although this change is still at an early change, recent economic data supported the move, and both new loan growth and money supply growth, as measured by M2, accelerated slightly in December. If this is the beginning of a new trend, then it could certainly help to stimulate the Chinese economy generally and the property market in particular, which has suffered over the last two years due to a lack of sufficient credit. We anticipate that new loan growth could continue to be strong in January 2012, but caution that Chinese New Year is relatively early this year, on January 23rd, and loan growth is likely to slow after the holiday period.



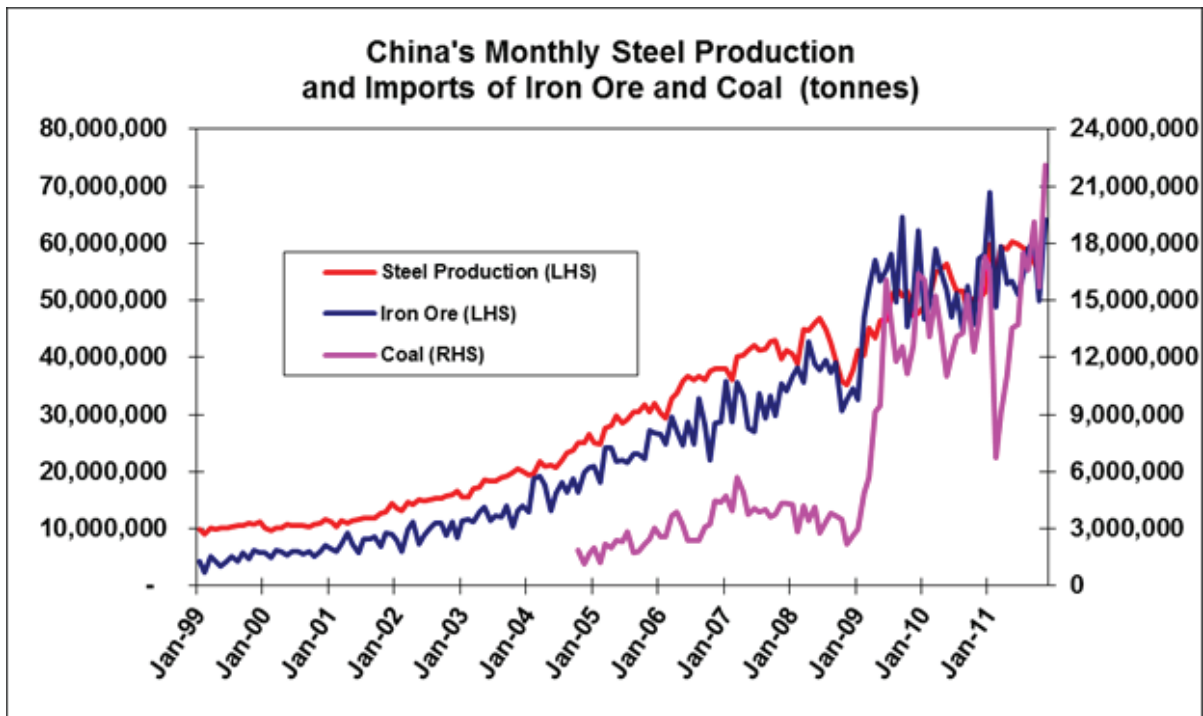
Source: The People’s Bank of China

The Consumer Price Index (CPI) slowed again in November with the growth in headline CPI at 4.2%, and the non-food CPI at 2.2%. This is well below the levels of recent months and suggests that inflation may finally be coming under control. It is striking that the food portion of the CPI is decelerating quicker than the overall CPI. The underlying data suggest that while meat and grain prices are still rising, that fresh vegetable prices have been falling for two months now. The price rises of other household goods in the basket seem to be under control, with below headline inflation on, for example, transport, utilities, education and clothing. Urban and rural price rises have also come back into balance this month, following an almost two year period where rural prices were rising more swiftly than urban prices. This is positive for social cohesion, given the lower incomes in rural areas and hence higher negative impact of inflation.



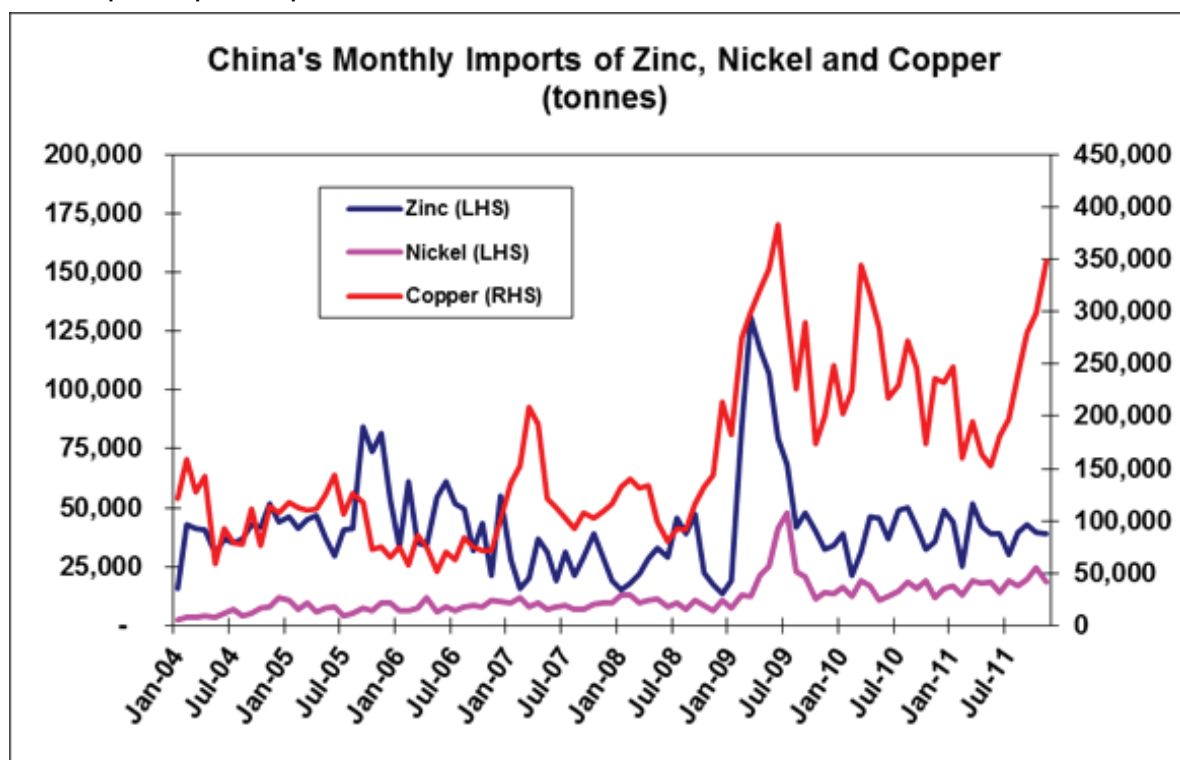
Source: Bloomberg, China Economic Information Net.

There was a strong rebound in coal imports in November with volumes up to 22.14 million tons, which is a new record high for this commodity. This reflects some winter restocking demand by the thermal power utilities, but we have been surprised by the strength of the move. Iron ore imports have also been relatively firm, up at 64.20 million tons in November, also a new record high. These data suggest to us that the idea that China is close to the limits of its growth are not right and there is still ample demand for energy and industrial commodities. However, it is fair to say that the growth in steel production has been mixed since the removal of export tax rebates in 2010, but it remains close to its all-time-high level.



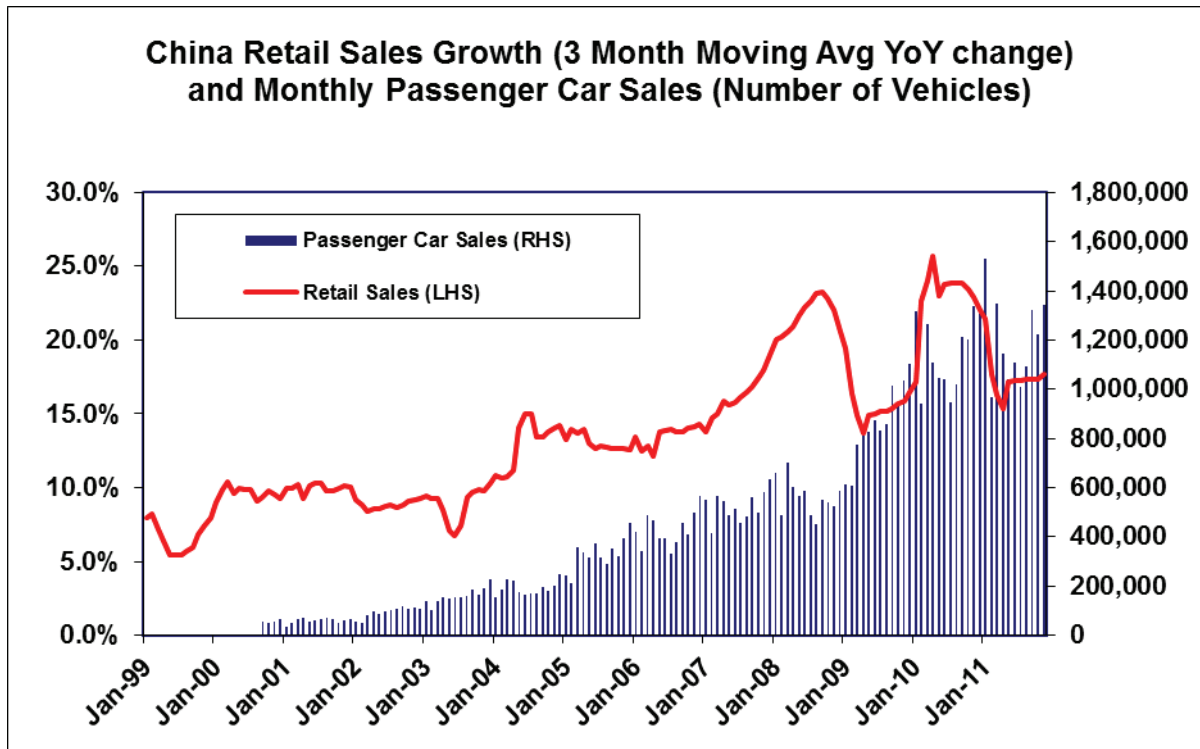
Sources: National Bureau of Statistics, China Customs General Administration

The increase in Copper imports we have tracked for some months continued this month, and the rebound in this commodity has been striking. The Copper market is notoriously difficult to predict, but the strength of growth in the import volumes speak for themselves. In November, Copper imports reached 348,276 tons, which is the highest monthly level since June of 2009. We are cautious, however, given this recent pattern is not reflected in imports of Zinc and Nickel. Imports of both Zinc and Nickel fell in November 2011, and there has not been a strong recovery in recent months in either commodity. We will continue to track the copper imports figure, and we hope there is not a technical reason for the pick-up in import volumes.



Source: China Customs General Administration

Passenger car sales remained firm at the end of 2011, and November's sales figure was for 1.34 million vehicles. Although this is not a high for the year, it is the highest level since March 2011 and suggests that the demand for vehicles remains firm. This year's data suggest that there could be a new plateau for vehicle sales of around 1 million units a month. Retail sales accelerated slightly in November, but remain locked around the 17% annual growth rate. Although this is lower than it was in 2010, it is still reasonably fast, and suggests that the consumer sector has been one of the fastest growing parts of the Chinese economy.



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.

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