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**Commentary and Review by portfolio manager
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In this first Asia Brief of 2010 we review the progress China has made in 2009, and discuss what might be in store in the coming year. China's economic growth has been much greater than expected at the start of 2009 and the strength of consumer spending has been encouraging. But the truth is that investment, rather than consumption, has been the major driver and China faces considerable challenges to keep the economy on track and to prevent imbalances turning into outright booms driven by excess liquidity. China is not the only country faced with the problem of how to withdraw liquidity and stimulus without triggering the very thing they have sought to avoid and the debate in the US and Europe is likely to be played out just as keenly. We at Guinness Atkinson wish all our readers a very happy New Year.

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Highlights

Co-ordinated efforts around the world to keep the developed world's banking systems afloat and the flow of credit moving have been successful in their basic aim, which was to prevent financial and economic collapse. However, it is also clear to us that progress toward equilibrium – banks resuming normal lending, consumer savings at higher levels, stable asset prices, and global trade balances – is still some way off. The purchase by governments of so-called toxic assets from banks and the supply of liquidity through quantitative easing reminds us that the problem of leverage has not gone away but has been shifted from the private to the public sector. And these public sector debt levels are going to have to be reduced before normal service can resume.

In this context the health of the Chinese economy matters very much. It cannot be argued with consumption to Gross Domestic Product (GDP) of 35% and per capita GDP of \$5,000 that the Chinese consumer is anywhere close to replacing his US or European counterpart but nevertheless, the impact of Chinese demand this year has been unmistakeable. Commodity prices for metals and materials as well as oil and coal have remained firm as China's effort to mobilize investment and by extension, heavy industry, have gathered pace.

In 2008, as the credit crisis deepened and consumer demand in the developed world slumped it was argued by some that China's 'export dominated' economy would be hurt. The size of China's export-related manufacturing sector is indeed substantial and the ubiquity of goods 'Made in China' together with a trade to GDP number of over 30% lend support to that view. What tends to be forgotten is that China's export trade is primarily processing – the import of components and materials for assembly in China for onward export. The increasing localization of component production is increasing the integration of export manufacturing in the economy but the value-added component, which is the most important measure, is still well below the headline trade to GDP number.

From a macroeconomic perspective the slump in export demand has not had anything like the impact on China's economic health as some had predicted. It has presented a significant problem, though: what to do about the estimated 25 million people employed in this sector and the resulting reduction in their incomes.

The solution has been to mobilize investment in areas that will benefit the other major industrial employers, which means heavy industry. The importance of this sector has grown from a policy standpoint as export-manufacturing employment has fallen.

The fact that the success of heavy industry depends on the supply of cheap dirty energy in the form of China's vast coal reserves should be borne in mind when looking at China's stance at the recent climate summit in Copenhagen. China's need for fast growth in heavy industry far outweighs its (genuine, we think) desire to control emissions and improve energy efficiency over the long term.

In the course of 2009 the progress China has made in its primary aim of mobilizing investment has been successful. Construction activity has surged firstly in infrastructure and more recently in residential real estate. Steel production has reached record levels and while inventory levels appear to have picked up we believe that the growth in demand that we can see and expect to see means this does not signal a problem. Policy measures to boost consumption, both in the form of cuts in transaction taxes and new-for-old schemes, have boosted sales of cars and household appliances. Indeed, China's car sales have surpassed those of the United States on a monthly basis since March, especially in the smaller engine (sub 1,600cc) category.

However, all this growth comes at a price and 2010 is going to be as important a year for China's policy makers as 2009.

Economic growth of near 10% in the past year has been fuelled by domestic growth, almost all investment, on the back of huge injections of liquidity and increased debt. Over \$1 trillion of new credit has been extended and while we can see that the bulk is intended for medium- and long-term investment rather than short-term there is no doubt that money has found its way into the stock and real-estate markets. The appearance of state companies at land auctions (those who have had no prior interest in buying land) is significant. This has contributed to soaring land prices and helped a recent land sale in Guangzhou to achieve a record price of \$852 per square meter (\$78 per square foot), some 54% above the offer price.

The challenge now for China is to continue its balancing act without the economy running out of control. On the one hand there is still a need to ensure that there is work for as many people as possible, to absorb those put out of work from the export sector as well as to absorb the twelve million people or so who enter the workforce every year. This is why GDP growth of 7-8% per annum is considered so important. At the same time there is a recognized need on the part of policymakers to address the dependence on investment for economic growth and to encourage greater private consumption. On the other hand, the vast quantity of credit that has been injected into the economy in such a short space of time runs the risk of creating the conditions that could lead to a painful bust.

A number of measures have already been considered and addressed in the last few weeks. Pro-consumption policies have been extended such as the countryside subsidy scheme that provides for a 13% sales tax rebate on purchases of air-conditioners, fridges, washing machines, TVs and mobile phones. The new-for-old scheme for these products that provides for a 10% subsidy (up to Renminbi 400/\$60) is to be extended in duration, beyond May 2010 and extended geographically. The car purchase tax for vehicles below 1,600cc is to rise from 5% to 7.5% but is still less than the 10% level in 2008. The car scrappage scheme subsidy of Renminbi 3,000 to 6,000 (\$440-\$880) is to rise to Renminbi 5,000 to 18,000 (\$730-\$2,635) depending on the vehicle, according to reports in the China Daily.

Longer term structural measures that have been discussed already this year are China's health plan and proposals to reform agricultural land ownership rights. The healthcare plan has a proposed budget of \$120 billion with the aim of providing a basic level of healthcare to 90% of the urban and rural population by 2012. The hope is that by providing this form of welfare, which was effectively abandoned in the mid-1990s with the wholesale reform of the state enterprise sector, individuals will be more willing to unlock savings and consume. The land reform proposals are much more vague since they touch on one of the last fundamental socialist principles of common ownership, that of agricultural land. By treating this land as leasehold of sufficient length and allowing individuals to transfer those leasehold rights it might be possible to unlock value that also might boost rural wealth and spending power.

In December there were a couple of interesting announcements both of which introduce another element of flexibility into the economy which was sorely lacking, that of the mobility of labor. The Central Economic Work Conference announced plans to relax Hou Kou restrictions. Hou Kou is a permit that restricts people to a certain area by giving them access to local services such as schools, medical benefits and certain pension rights. While it is possible when buying a house in a city to acquire Hou Kou for that area, this is only practical for the rich and rural migrants are effectively locked out. An easing here could have a material impact on urban migration.

A related development lies in proposed changes to pension arrangements. Although somewhat arcane it is significant.

Under the current arrangements a Chinese worker has two pension accounts: a Basic Account and an Individual Account. The Basic Account operates on a Pay As You Go system whereby the employer pays in 20% of his payroll and on retirement will receive 20% of his wages for 20 years.

So if the worker does not make his full 15 years' contributions because he moves to another area then he loses a substantial portion of his pension benefits. The proposal that these rights will now become 'portable' in whole or in part (as yet unclear), could make a big difference.

However, China's pressing problem is how to keep the economy growing while preventing excesses building up. The real estate market is an area of potential concern. On an income adjusted basis, real estate prices have not yet exceeded 2007 levels. That said prices have been moving fast and there are new entrants into the sector. Industrial companies, flush with cash, have been making appearances at land auctions and are dabbling in commercial real estate. The government has so far responded cautiously, not wishing to de-rail the market as they did into the lead up to the global downturn. The business tax exemption on property sales which had been shortened to two years has been restored to five years from this year. But the deed tax cut to 1% from 3%-5% has been maintained for first-time buyers as have the preferential mortgage terms allowing for a lower down payment of 20% and a 30% discount on the standard mortgage interest rate.

We believe that at present China's economy is growing strongly, that real estate prices are not out of control and that the increased levels of debt taken on this year are affordable. But just as the Central Banks in the developed world have some delicate choices to make about when to remove stimulus and support measures, so too does China. Draining liquidity from the system through open market operations and raising banks required reserve requirement are likely tools as they were in 2006-7. Higher nominal interest rates are also a possibility but this is more likely to be directed toward keeping deposit rates higher as inflation picks up, to reduce the possibility of an additional liquidity surge caused by depositors switching from bank savings in search of higher returns.

We enter 2010 with China's economy growing strongly but still unbalanced. The developed of the world is looking at lacklustre growth and also unbalanced. It's not getting any easier.

Happy New Year!

Market Performance Ending December 31, 2009

	December 2009	2009	2008	2007	2006
Australia	1.90%	74.98%	-49.20%	30.92%	33.93%
China	0.47%	62.38%	-50.43%	66.02%	82.91%
Hong Kong	2.18%	59.87%	-50.75%	42.06%	30.37%
Indonesia	5.51%	136.14%	-56.63%	55.81%	73.79%
Korea	8.66%	74.28%	-57.11%	32.14%	11.17%
Malaysia	0.36%	51.87%	-41.11%	48.02%	38.26%
New Zealand	4.09%	50.72%	-53.26%	11.20%	19.43%
Philippines	2.72%	67.28%	-52.04%	41.60%	59.48%
Singapore	5.39%	73.18%	-47.20%	28.86%	47.89%
Taiwan	8.54%	80.23%	-46.04%	9.16%	20.73%
Thailand	7.16%	76.59%	-54.01%	64.08%	11.88%
MSCI AC Far East Free ex Japan	4.47%	68.57%	-50.56%	36.91%	31.86%
MSCI AC Pacific ex Japan *	3.61%	71.06%	-50.32%	34.96%	32.54%

*MSCI AC Pacific includes Australia & New Zealand

(MSCI Indices were used for regional & individual market performance)

Market Review

In December there was some reversal in some of the trends which have driven the financial markets in the second half of 2009. The most important amongst these is the weakening of the US Dollar against the Euro and the Japanese Yen, and the related strengthening of 'hard' assets such as Oil and Gold. This month, the US Dollar reversed the trend and strengthened against the Euro and against the Yen. This may be a short-term reversal, but reflects an increased mood of optimism in the markets towards the US Economy, and the consequent increased likelihood of the end of quantitative easing.

One possible source of turbulence from November was lessened this month, as Abu Dhabi decided to step in and bail-out Dubai. Abu Dhabi gave a \$10bn government to government handout to Dubai on undisclosed terms. Of this money, \$4.1bn was used to bail out Dubai World, and its property development arm Nakheel which had payments due on some Islamic debt. This is a positive step for confidence, but it will take a long time for Dubai to regain its credibility as a financial centre.

Following the strong loan growth in China in the first half of 2009, there have been questions as to whether the banking sector is adequately capitalised. As a response, the China Banking Regulatory Commission this month raised the capital adequacy ratio from the international standard of 8% to 11%. For the Chinese banking sector as a whole, the level of capital adequacy at the end of the third quarter was above this new level which is very healthy by international standards. However, officials were reported as saying that some Chinese banks would need to raise additional capital this year to meet the new requirement.

Looking at the growth outlook, we note that the Asian steel market remains healthy. In China production fell slightly in November, while exports picked up, which should help to bring the market back into balance. Looking at pricing, Asian steel mills are reporting a positive outlook for December, and a positive outlook for volumes in the first quarter of 2010. Given the importance of steel as an indicator of both infrastructure and industrial demand we think this trend is positive for growth overall, and hope it is sustained well into 2010.

The consensus at the end of December 2009 put Asian equities on multiples of 14.26 times projected 2010 earnings and 12.21 times projected earnings in 2011. Analysts are forecasting overall profits in Asia to grow 29.81% in 2010 and 16.62% in 2011. In 2010 the fastest earnings growth is expected to come from Korea, Taiwan and China. Among sectors the best growth is expected to come from Information Technology, Industrials, Financials and Materials.

Market Outlook

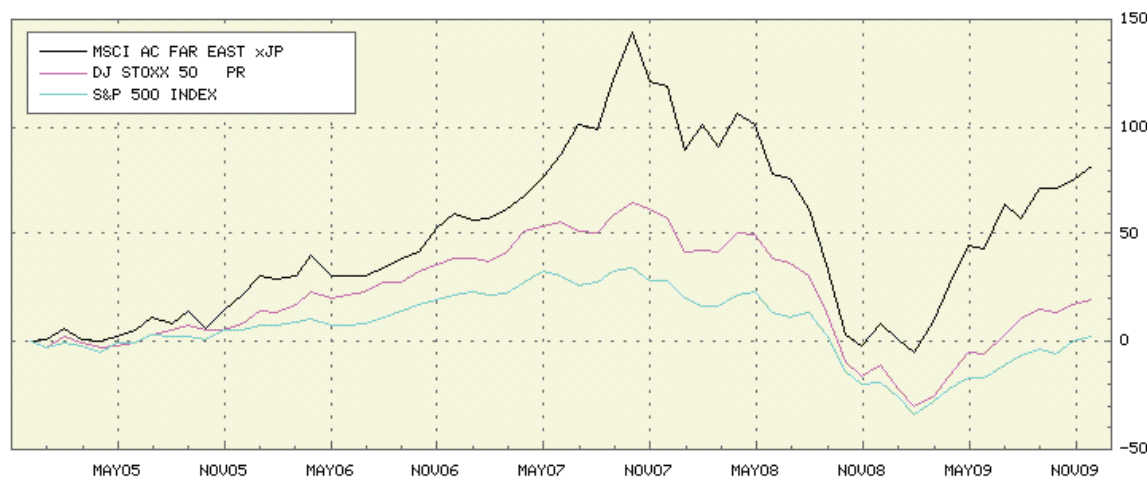
We believe that conditions in Asia are far better than those prevailing in the developed world when looking at financial health, levels of debt and corporate profitability. Asia also looks better when looking at the potential offered by the structural story of improving levels of wealth driving increased consumption over the long-term.

However, as we have discussed in the context of China earlier in this Asia Brief the outlook remains highly uncertain in respect of the unprecedented government and central bank intervention around the world to stave off collapse. How and when we extricate ourselves from this without either triggering the slump we sought to avoid on the one hand, or on the other avoid staying too long and allowing inflation taking hold are both matters of huge debate.

Chinese policy is going to be particularly relevant. The current growth rates in real estate prices, construction activity, steel production and money supply will need to slow to a more sustainable rate. This is something investors are going to have to come to terms with at some point in the coming year. If rates of growth do not slow, then a painful drop in Chinese economic growth maybe in the cards for 2011.

Range 12/31/04 - 12/31/09		Period	Monthly	60 Mo. Period	Period
Securities	Crcncy	Prc Appr	Total Ret	Difference	Annual Eq
1 MXFEJ Index	USD	60.07 %	82.25 %	63.02 %	12.75 %
2 SX5P Index	USD	-2.08 %	19.22 %		3.58 %
3 SPX Index	USD	-7.99 %	2.10 %	-17.12 %	.42 %

(* = No dividends or coupons)

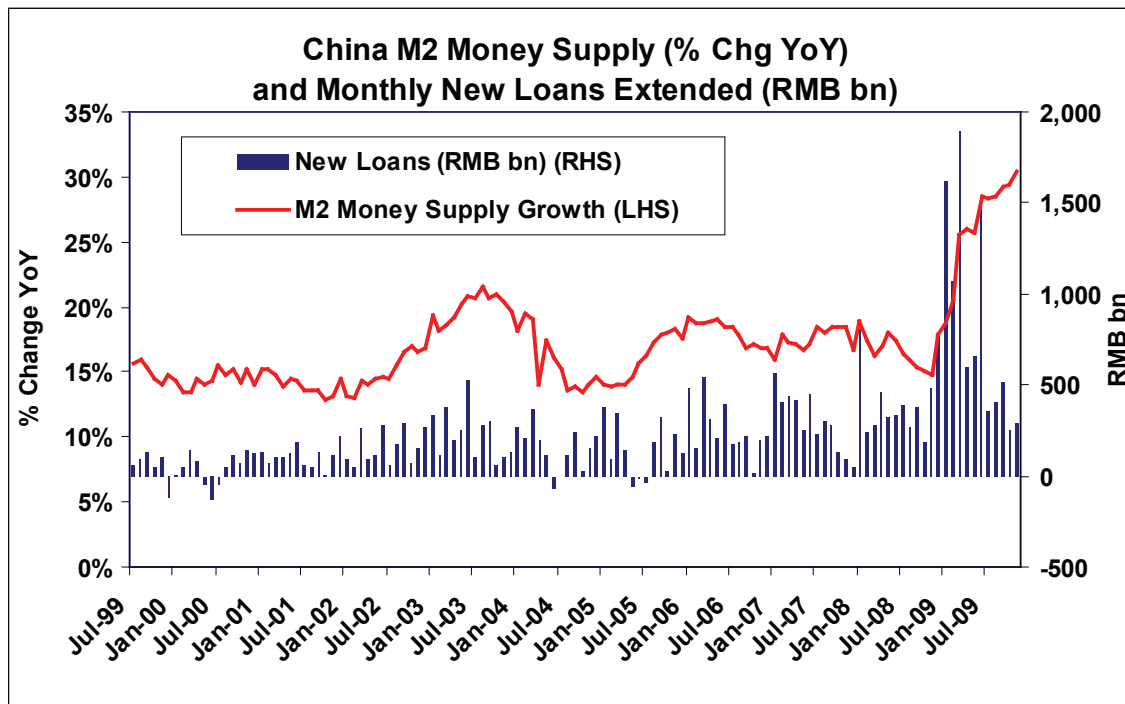


Source: Bloomberg

China Economic Monitor

New loans extended tailed off markedly towards the end of 2009 as we expected. As we can see from the bar chart below, the bulk of new lending tends to occur in the first half of the year and in spite of the scale, 2009 was no different. In the coming year we are expecting to see a similar pattern and we are also expecting another year of substantial credit expansion, but it is unlikely to exceed that of 2009.

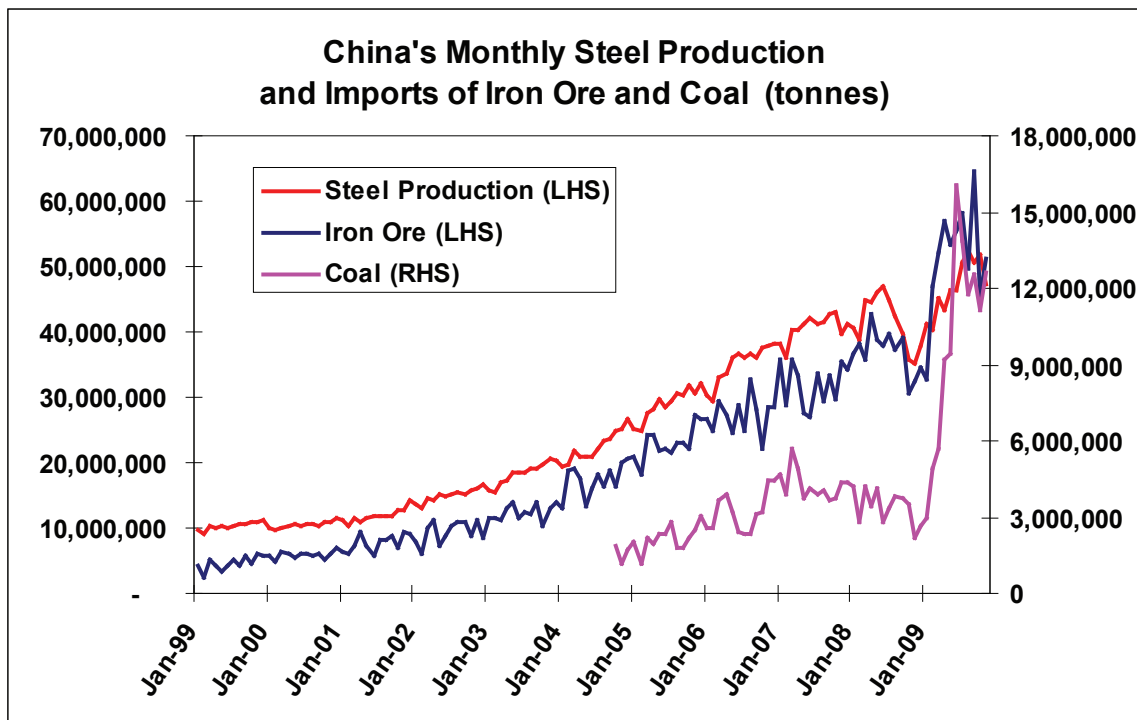
Our focus naturally enough is on the money supply growth number which remains at historic highs. We would expect that in the course of the year this number will come down. However, a wild card remains inflation, which if it were to push real deposit rates negative (i.e. when the growth in your deposit plus interest does not keep pace with inflation) then savers are likely to look for better returns elsewhere, causing another liquidity boost.



Source: The People's Bank of China

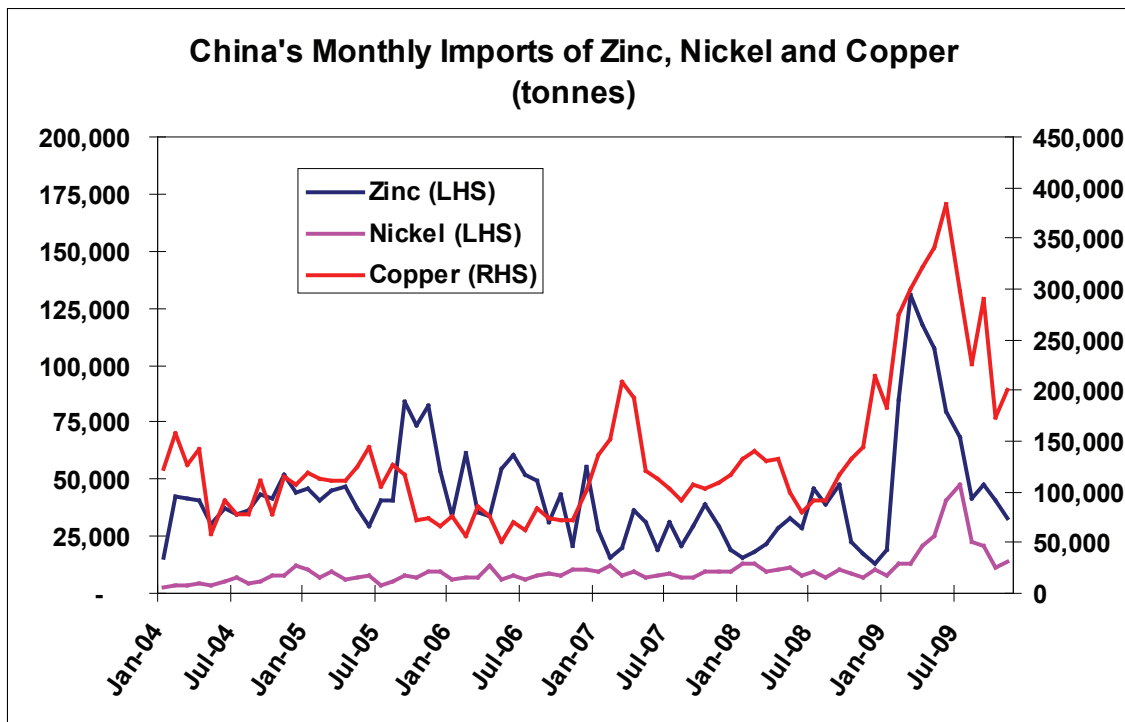
Our expectations for consumer price inflation remain modest but it is Chinese inflation expectations and the implications for their savings that carries the most weight. We do not believe that we are in for a bout of surging inflation that would necessitate major tightening beyond what might be needed to keep savers happy.

Steel production is still high and we think it is likely to remain so as residential real estate construction picks up pace. New land sales, new floor-space under construction as well as rising real estate prices and transaction volumes all point to renewed activity after eighteen months in the doldrums. Iron ore imports are also likely to remain high and ahead of the annual contract pricing negotiations the consensus is for a 10% increase in the price of ore. The price of coal is also moving higher both internationally and domestically. High demand coupled with a drive to consolidate production in China are the twin drivers.



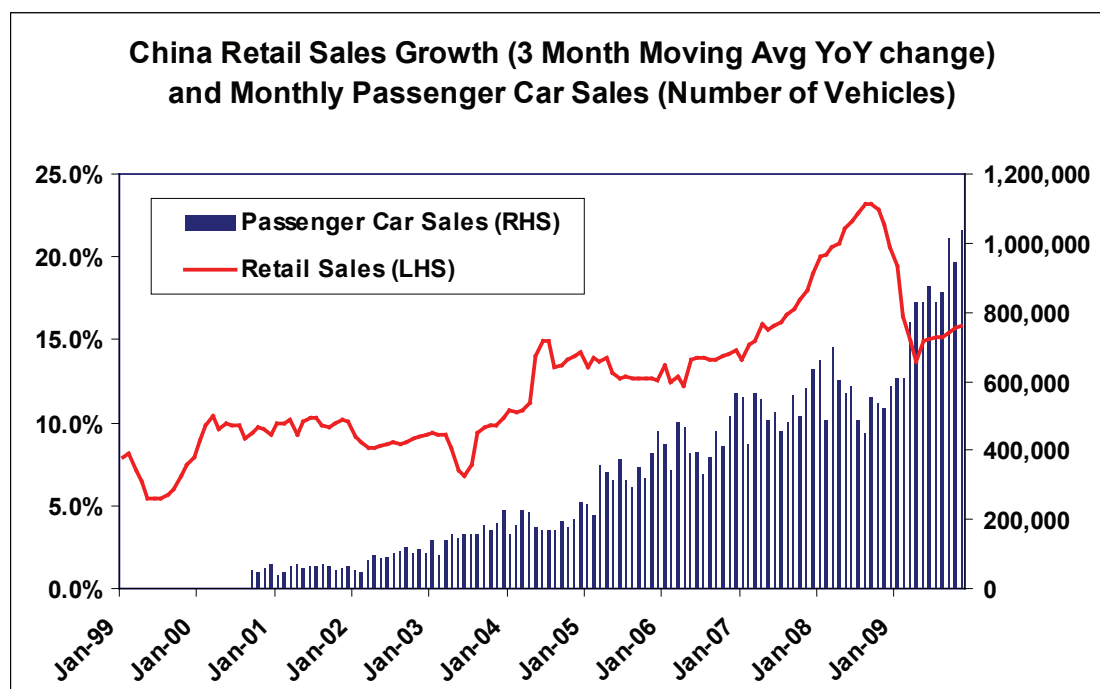
Sources: National Bureau of Statistics, China Customs General Administration

The imports of basic metals began to roll over in October although imports of iron ore rebounded again in November. So far, this is not concerning in light of the rapid pick-up in imports for the year to date. If these volume figures continue to drop we may become concerned, but Nickel and Copper both stabilized in November while China's domestic production of Zinc is rising. So far this looks to be a healthy normalization of imports.



Source: China Customs General Administration

Car sales in China remain strong and it appears the government wishes them to remain so with its willingness to extend the various subsidy and taxation incentives for another year. The presence of foreign brands in joint ventures with Chinese partners mean that there is no bias away from foreign brands with both local and foreign made vehicles enjoying significant increases in sales. Broad retail sales also remain encouragingly strong again, boosted by incentives to buy home appliances, which have also been extended.



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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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.

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