GUINNESS ATKINSON FUNDS

Asia brief

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Commentary and Review by portfolio managers Edmund Harriss and James Weir

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The leadership transition in China is a significant event, but we do not believe this will be accompanied by a change or reversal in the direction of policy. Political stability and legitimacy in China depends on delivering continued growth in incomes and in the standard of living. The challenges of unbalanced growth between investment and consumption and unequal wealth distribution have not gone away. The solutions will continue to test the resolve of China's political elite. Now the transition is done we see policy turning supportive for growth. Stocks look cheap to us, and the stronger renminbi exchange rate also indicates to us greater confidence among domestic Chinese. After a long period of slowing growth, adverse policy and political uncertainty, we now see China turning the corner, and we are bullish.

- Bullish on China
- Market Review
- China Economic Monitor

There have been two significant political events this month with leadership changes (alas, we cannot use the word 'elections' to apply equally) in the United States and China. In the US, the priority is for an agreement on the budget and to avert the automatic tax rises and spending cuts that run the risk of tipping America into recession. Even if we assume that the fiscal cliff can be avoided, America is looking at the prospect of fiscal policies that will drag on growth.

In China we do not expect a change in direction following the leadership. Too much is made of China's 'communist' party leadership when the national debate heats up. Communist philosophy is antithetical to that of capitalism and free markets, but China has long since abandoned that ideology. Political stability in China depends on economic growth to deliver improved standards of living and prospects of further improvements. Therefore, government policy is ultimately geared toward creating opportunity for the acquiring wealth. And the growing army of Chinese urban dwellers know it.

A telling example of how far political ideology has moved in China came with the events surrounding Bo Xilai in Chongqing earlier this year. He sought to build a popular power base by appealing to earlier memories of the communist movement – unity, common goals and an idea of a grand shared future. No matter that this was emphatically not what he actually practised, this was the message he sold, encouraging rallies, the use of old communist slogans and reappearance of the little red book. These greatly disturbed the Beijing leadership who fear popular movements, even those which embrace those very elements to which their party notionally subscribes. Bo Xilai's political career is now over.

The problem for China, and investors too, is not one of communism but one of single party rule. The interests of the party and people are served by growth, wealth, disposable income and consumption, all of which we recognize in our own country. The problem in a one party system, to a greater extent than in a democracy, is that of fairness. In China the system is dominated by political, legal and administrative structures which interfere with competition and market forces. Those on the inside track gain substantial advantage with access to land, resources, capital and contracts. After 30 years of growth (excluding the effects of inflation) of 10% a year, the full force of this inequality can be seen in the massive wealth gap between rich and poor.

The challenge for China's policymakers remains just as it was before: to rebalance the economy to ensure its sustainability. The imbalances between investment and consumption, in wealth distribution and access to capital, are well known. The solutions are not so straightforward. The task of increasing consumption can only really be achieved by giving people the confidence to spend. This means creating conditions of greater job security, income growth and underpinning those with adequate pension and health provision. Major reforms in all these areas are required: to labor laws, to pension provision and portability and to the grossly economically distorted healthcare system that makes it far more expensive than it needs to be.

Perhaps the greatest obstacle to economic re-balancing remains China's financial system. The current system of central and local government funding is fundamentally unstable. Local governments collect the taxes that are remitted to the center which then re-allocates funds back to the regions. When local governments find themselves short of funds (when they fulfil central government policies to generate growth, for example) they resort to asset sales or borrowings that are not always sound by means of special purpose vehicles. The unwillingness of the center to allow local governments greater financial autonomy is because it is the one significant way in which the center can exercise control over the provinces. However, more ambitious central policies in respect of social housing provision and infrastructure spending combined with long-term pension, healthcare and education provision, make current short term local government financing solutions (such as sale of land) unsustainable.

China's banking and monetary system is the other area that is showing every sign of being unable to keep pace with the broad economy. The banks provide the major source of commercial finance, but they tend to favor state over private borrowers. There are variations in interest rates charged for loans, but the overall structure does not take true account of risk. State-backed borrowers take the lion's share of new lending, and their status allows them to borrow at a lower rate than would otherwise be the case. Growing non-performing assets from state-backed borrowers and the crowding out of possibly more productive borrowers is one example of how capital can be misallocated in a system in which the state plays such a significant role.

We have seen a number of moves on the part of the central bank to prepare the ground for reform in this area. Commercial banks have been required to boost capital ratios, acknowledging the underlying weaknesses in asset quality regardless of the levels banks actual report, and also preparing for increased competition. The introduction of greater competition has been flagged by recent changes in benchmark interest rates which were accompanied by greater permitted flexibility around those rates which will have the effect of compressing margins. These reforms can only be negative for bank stocks as interest rate reform, competition and disintermediation can only serve to depress bank profits. But it should make the banks healthier, more efficient and more useful participants in the next stage of economic development. They may even develop other sources of fee income like real commercial banks.

Away from the banks in the capital markets there have been considerable strides in the development of the domestic bond markets. The growth in the China Interbank Bond Market (CIBM) has been significant and has provided an alternative source of capital. Not only are we starting to see banks losing their interest margin protection, but we also see a route to greater bank disintermediation and another way for capital to be priced. However, these are early days for the bond market – no bond has ever been permitted to default and local credit ratings do not provide much differentiation between credits. However, the growth and depth of that market together with permitted overseas participation has created a significant alternate source of corporate funding.

What does all this mean for investors?

There has been no change in the government's goal of increasing the overall standard of living in China. The task is to generate growth that is more evenly balanced between investment and consumption and wealth that is more evenly distributed. Reforms to legal, administrative, fiscal, financial and political structures are all still in progress and the challenges should not be under-estimated. However, the obstacles that stood in path to this point once appeared insuperable. China has already redefined the art of the possible.

In the short term, policy is likely to be directed toward supporting domestic growth while the external environment remains so weak. Spending on infrastructure and construction is expected to have the most immediate impact. Efforts to boost consumer spending through incentives and subsidies may also be made. Over time, and building on what is already underway, we expect to see rising wages and disposable income combined with welfare related moves on pensions and health to reduce precautionary spending.

For equity investors we still look at the industrial, materials and energy sectors together with highly cash generative consumer businesses as the best way to play this. Real estate developers still remain subject to higher levels of policy risk as China continues to cap further price rises. Nevertheless, with overall policy now supportive, economic growth is likely to recover (from a trough rate of 7.4%!). Stock valuations are near 2008 lows and this combination makes us bullish on Chinese stocks.

For bond and currency investors, the outlook also looks good in our view. The renminbi has resumed its appreciating trend with the onshore policy rate (the daily fix) moving higher. This appreciation is magnified by the onshore spot rate which is trading at the top end of the permitted range of +/- 1% of the daily fix. The offshore renminbi, in which we are able to invest, is tracking the onshore spot rate higher. At the same time, renminbi deposit rates have moved up to around 3% from around 1% a year ago. A steady stream of new issuance by both Chinese and international corporations have also come to the market with higher yields. At the end of October investment grade corporate bonds, as measured by the HSBC Offshore Renminbi Investment Grade (ex-Government) Bond Index, were yielding 3.65% with a duration of only 2.72 years.

After a long period of slowing growth, adverse policy and political uncertainty we think China is turning the corner and we are bullish.

Market Review

Market Performance Ending October 31, 2012

	Oct 2012	Year to date	2011	2010	2009	2008
Australia	2.89%	17.53%	-10.77%	14.69%	73.87%	-49.47%
China	5.74%	14.91%	-18.36%	4.59%	62.06%	-50.43%
Hong Kong	1.48%	23.18%	-15.78%	23.28%	60.48%	-50.46%
Indonesia	3.06%	7.92%	5.19%	35.47%	136.12%	-57.87%
Korea	-2.72%	11.85%	-13.55%	25.84%	74.44%	-56.36%
Malaysia	2.70%	12.96%	0.11%	37.67%	51.26%	-41.15%
New Zealand	1.50%	27.15%	5.90%	8.73%	49.89%	-53.54%
Philippines	3.06%	36.26%	0.04%	35.24%	67.34%	-52.02%
Singapore	-1.54%	25.09%	-17.54%	22.03%	73.18%	-47.21%
Taiwan	-6.06%	8.71%	-20.18%	23.14%	80.23%	-46.04%
Thailand	-1.72%	25.18%	-2.72%	56.67%	76.59%	-48.21%
MSCI AC Far East Free ex Japan	0.10%	15.01%	-14.75%	19.41%	68.56%	-50.34%
MSCI AC Pacific ex Japan *	0.79%	16.14%	-13.59%	17.95%	71.51%	-50.00%

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

Asian equity markets were almost flat in aggregate in October, but underlying this, we saw a strong month in Chinese stocks and an especially weak month in Taiwan. Stronger performance in Chinese names came with improving sentiment, stronger economic data and a strong currency. While the rising currency does nothing to help exporters, it is a benefit to importers of materials and commodities. The greater optimism has come from anticipated policy support for growth as well as substantial efforts on the part of the central bank to keep monetary conditions loose and to hold down short term interest rates.

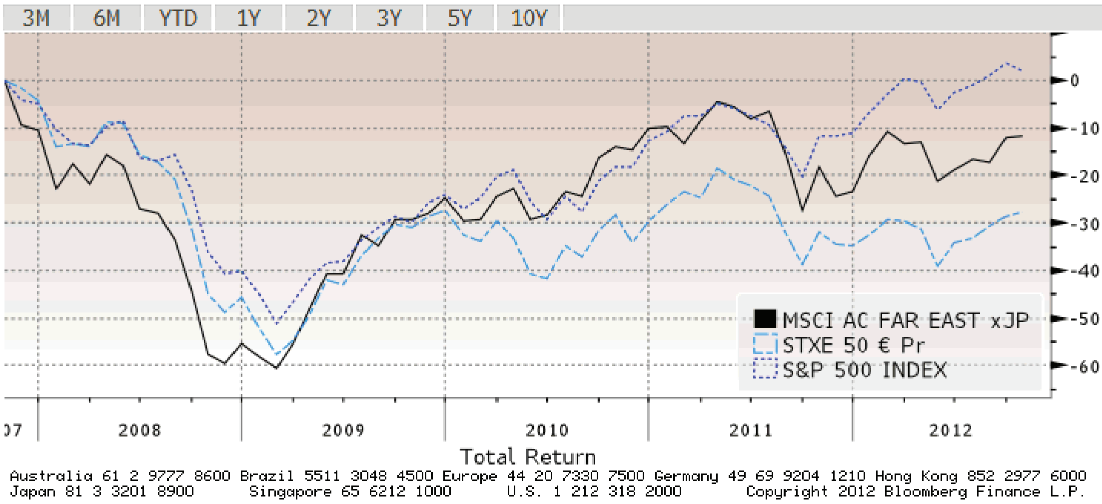
In Taiwan, stock market conditions have been more difficult. Foreigners have become very negative on technology names with intensifying competition in telephone handsets and weakness from the likes of Hewlett Packard and the lukewarm reception given to the iPad mini. Domestic conditions in Taiwan remain lacklustre, and hence, the weakness in the technology sector, which is such an important part of Taiwan's economy, has spilled over into domestic names, and local investors have also pulled back.

South Korea also had a weaker October. The South Korean economy (and the stock market) is more broadly based than that of Taiwan with exposure not only to technology but also to autos, ship building and engineering & construction. The Korean Won strengthened 2% against the dollar, but more crucially, for Korea's auto-makers by 4.5% against the Yen which duly under-performed. The engineering & construction sector also had a poor month on a poorer domestic outlook. However, Korea's technology sector continues to thrive led by Samsung which is dominant in smartphone handsets, memory and LCD displays.

Major Indices total returns for the five years ending October 31, 2012

Range 10/31/2007 - 10/31/2012 Period Monthly No. of Period 60 Month(s)

	Security	Currency	Price Appreciation	Total Return	Difference	Annual Eq
1.	MXFEJ Index	USD	-22.89%	-11.82%	15.89%	-2.48%
2.	SX5P Index	USD	-41.72%	-27.70%		-6.28%
3.	SPX Index	USD	-8.86%	1.82%	29.52%	.36%

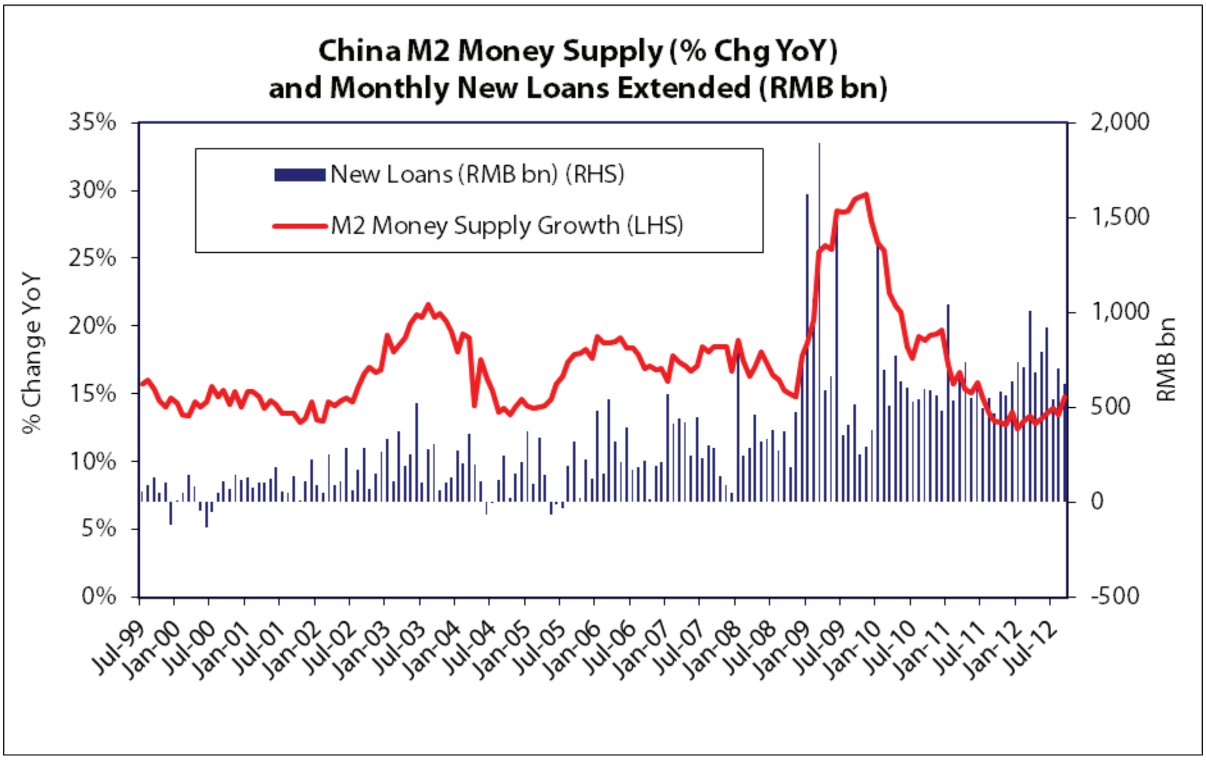


Source: Bloomberg, Guinness Atkinson

China Economic Monitor

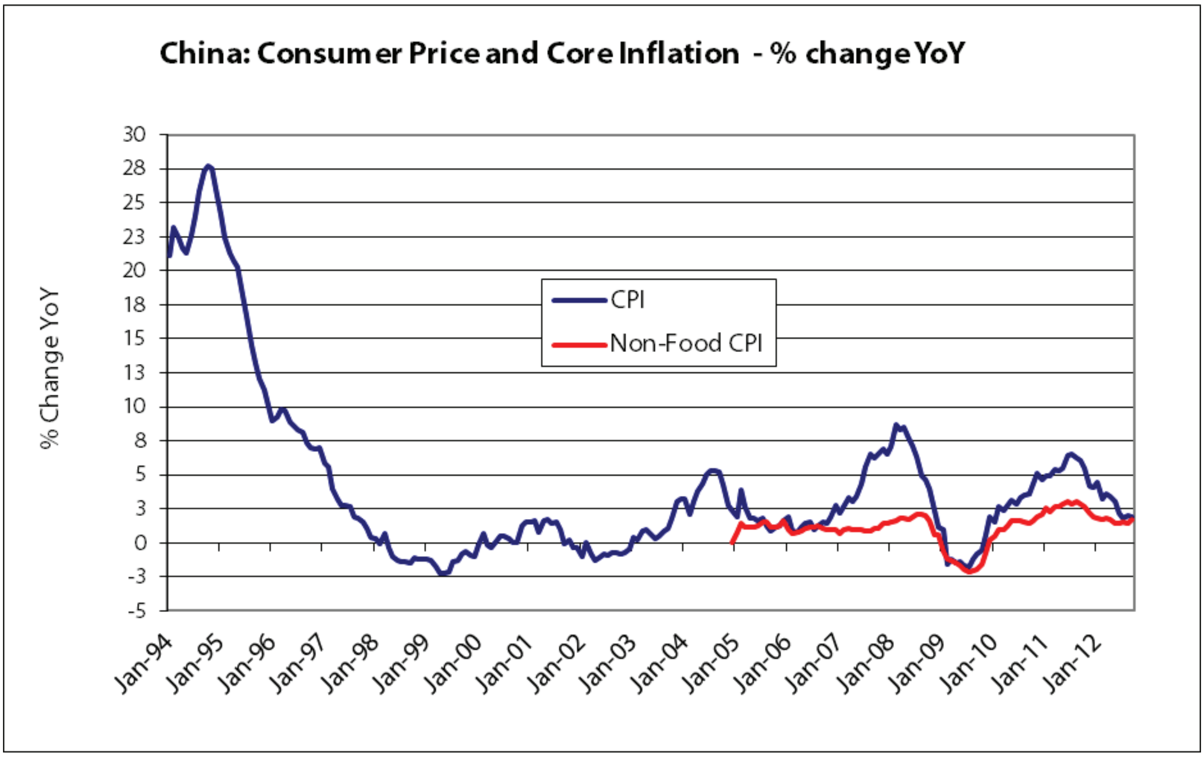
Recent economic data indicates that growth rates have stabilized and are now starting to recover, albeit slowly. The official Purchasing Managers Index has moved back into expansion, but only just. It has been driven by output which in turn has increased in response to declining inventories, but we have yet to see a clear move in new orders. Trade figures also looked more encouraging. Exports to Europe are still contracting, but exports to the US are growing as is China's trade with Asia and Emerging markets.

New loan growth is running at RMB600-700bn per month, which is line with expectations, and we have also seen a steady recovery in broad money supply growth. There has been a concerted effort made by the central bank in recent months to ensure money conditions are loose enough to be supportive of growth. Open market operations, as opposed to administrative cuts in required reserve ratios, have been the preferred method and these have been quite substantial in recent weeks.



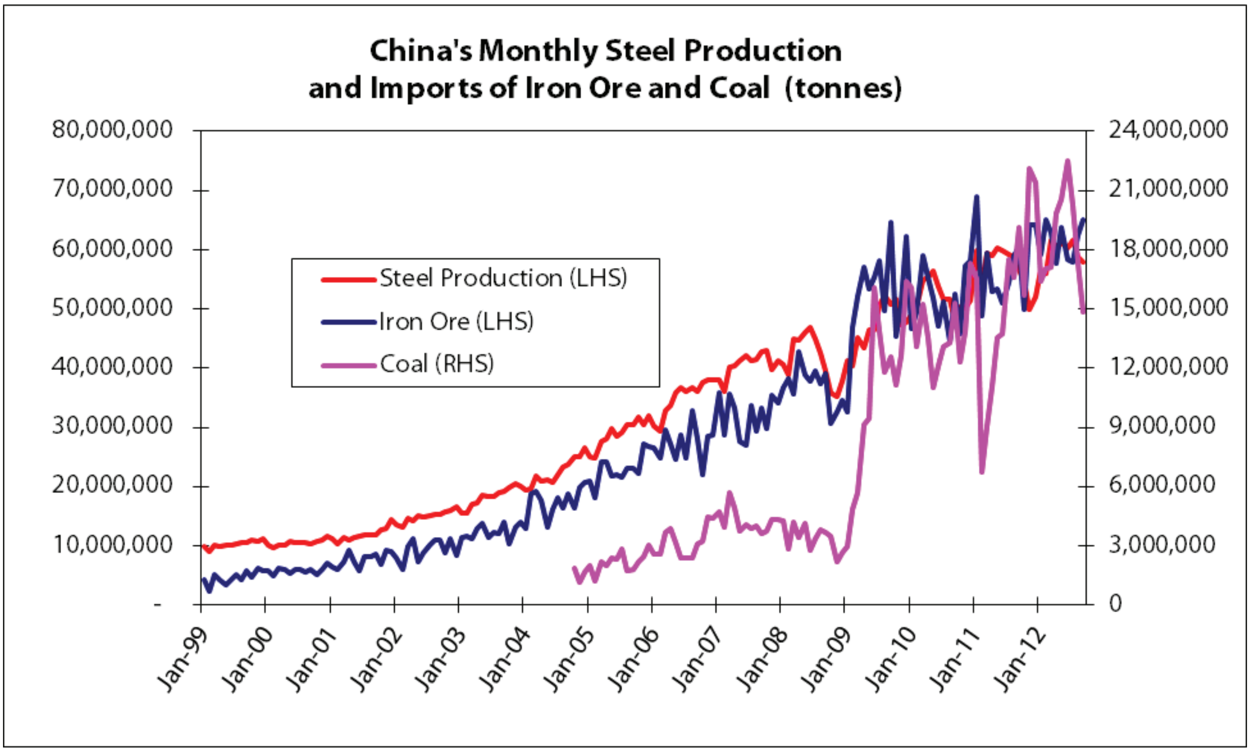
Source: The People's Bank of China

Consumer price and non-food inflation remains stable and is at levels with which policymakers clearly feel comfortable. Last year the control of inflation was a policy priority. Now efforts are concentrated on specific areas and sub-sectors where price pressures remain, most notably in real estate.



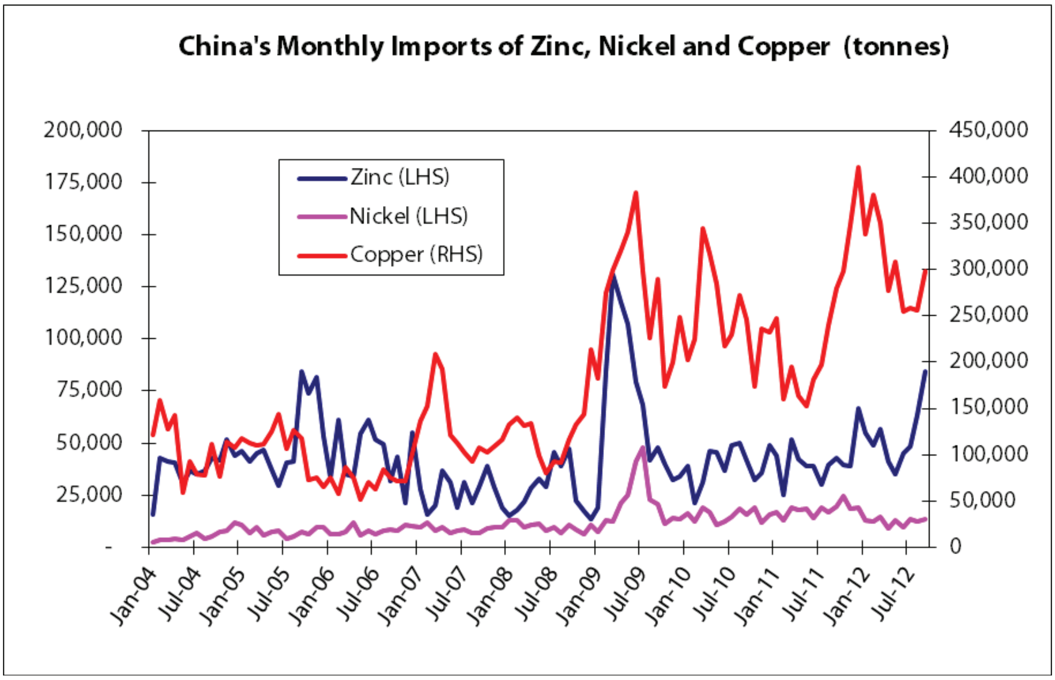
Source: Bloomberg, China Economic Information Net.

Steel production fell a little over the past month, but aggregate production over the past 12 months still shows increased output. There are still questions over where the final demand for the extra output will come from. We have seen a number of credit downgrades amongst Chinese and South Korean steelmakers in response to weaker conditions. Much depends on the level of Chinese construction activity in coming months. Chinese cement prices, for example, have been stronger than the market was expecting over the past six weeks.



Sources: National Bureau of Statistics, China Customs General Administration

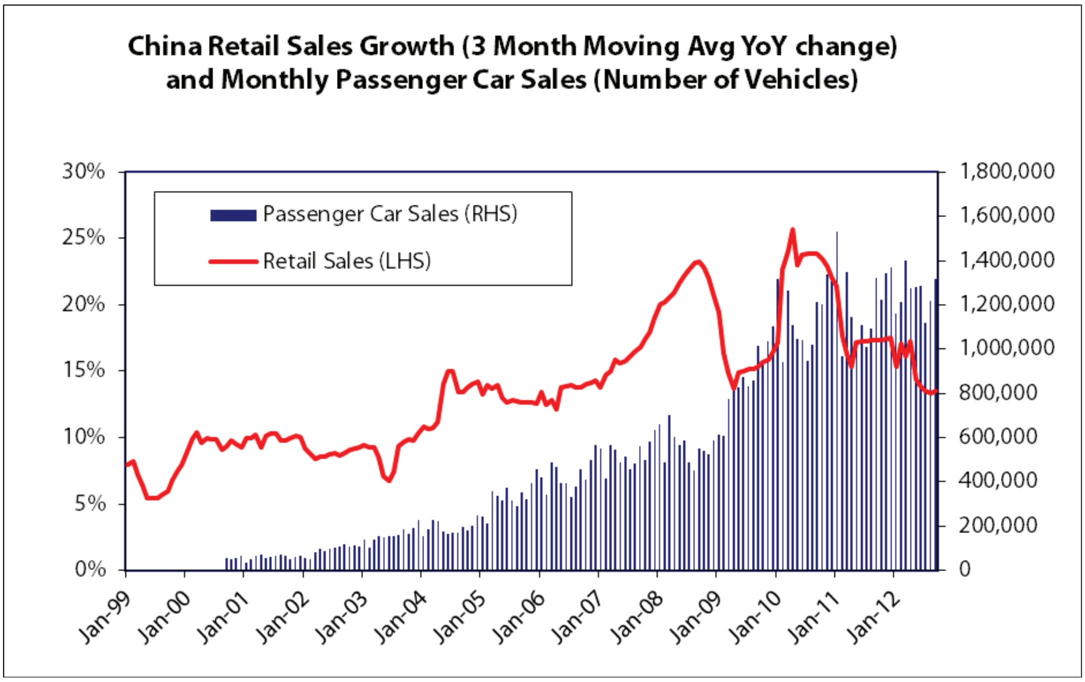
Zinc import volumes rose sharply again in September to 84,626 tonnes following August imports of 63,336 tonnes and 48,201 tonnes in July. This is within the long-term bounds for zinc imports, but it could suggest activity is picking-up in consumer durables and other users of galvanized steel. The pattern of rising import volumes is not reflected in significantly higher copper or nickel imports.
If the pick-up in house pre-sales follows through, we would expect this to be reflected in an improvement in construction activity this autumn. That should then drive higher imports of both copper and nickel, as these metals are associated with the late-stage of the construction process.



Source: China Customs General Administration

Retail sales growth continued to be weak, and fell again slightly to 13% in August from 14% in July. This is a concern to us, and this pattern was also reflected in mixed interim results from Chinese retailers, apparel and footwear makers. So far, we see little sign of a change in direction of this trend, and although food inflation is picking up slightly, price rises for household goods or clothing are not accelerating.

By contrast, passenger vehicle sales remained robust, and accelerated back to 1.22 million units in August. This is a positive sign as it flies in the face of the rising sedan inventories which were identified earlier this year. If vehicle sales remain above 1 million units per month, we believe this remains a firm base for Chinese consumption. Chinese vehicle sales remained at about the same level as US vehicle sales, which came in at 1.28 million for the month of August.



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.

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 STOXX Europe 50 Index (STXE 50), Europe's leading Blue-chip index, provides a representation of supersector leaders in Europe. The index covers 50 stocks from 18 European countries: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland and the United Kingdom.

China's Purchasing Managers Index is set up by the China Federation of Logistics & Purchasing and National Bureau of Statistics and was first launched in July 2005. PMI reading above 50 points indicates that the manufacturing economy is generally expanding and that the economy is generally declining when the reading fells below 50 points. The manufacturing PMI is a composite index based on the diffusion indices for the five major components with the following weightings: new orders (30%), output (25%), employment (20%), supplier delivery times (15%), and inventories (10%).

HSBC Offshore Renminbi Investment Grade Bond Index is an index of offshore bonds invested in China's renminbi currency

One cannot invest directly in an index.

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