



**GUINNESS
ATKINSON**
FUNDS

China brief



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**Commentary and Review by
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We have continued to see a significant mismatch between the operating performance of Chinese companies and the stock market's perception and expectation. The result has been profit growth and valuation compression, pushing down stock market valuations to multi-year lows. At this point investors should be asking themselves whether China really is on the edge of catastrophe, because if not, stocks at these levels could, in our opinion, offer a significant multi-year investment opportunity. We think the recent 2% decline in the Renminbi (RMB) against the dollar should be seen in the context of ongoing financial liberalization, not as a depreciation ploy to boost exports. Here too, investors have an opportunity to diversify their fixed income and currency exposure.

China Overview in the First Quarter of 2014

The economy was reported to have grown 7.4% in the first quarter, which was higher than expected but is still clear that domestic growth is slower than in the past. China is seeking to create a new model that will turn China into a consumer dominated high income economy. However, the legacy of the old investment driven model, which has delivered such success, is one of overcapacity in heavy industry and debt. As China seeks to drive growth in the new economy, policymakers have to cope with the drags on growth exerted by closing down obsolete factories and winding down debt.

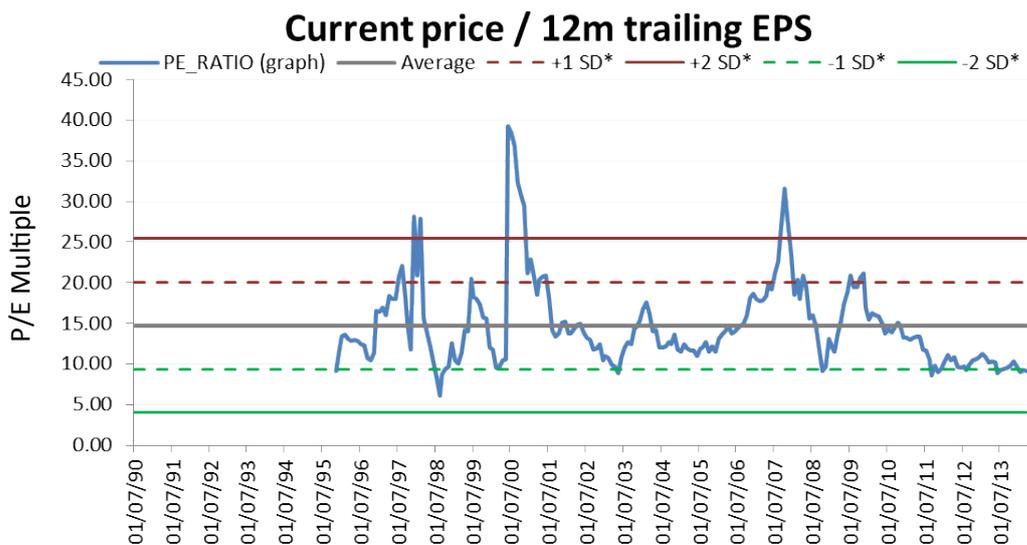
The process so far has, in fact, been orderly. Steel and cement prices have been supported as inefficient producers have been closed down. The program has been gradual so as not to cause unemployment to rocket, but it has been effective. Credit creation has also slowed with a contraction in overall credit for three quarters since June 2013. In shadow banking credit creation has contracted by over 25% year over year for the last two quarters.

Investors haven't been liking it when they look at the monthly data, but China is doing exactly what it said it would do and what almost everyone said it needed to do. But clearly there are risks.

China & Hong Kong stock markets

The stock markets are dominated by companies most exposed to the old economy; that is, by companies most sensitive to investment growth. Approximately 70% of the market capitalization is accounted for by companies in these sectors which include industrials, materials, energy, utilities and bank stocks. Against a backdrop of slowing investment and debt reduction, these sectors have suffered most, pushing the aggregate stock market valuation down to decade lows.

The price/earnings multiple of the **MSCI China Index** is shown in the chart below.



*SD = Standard deviation
EPS = Earnings per share

Source: Guinness Atkinson, Bloomberg

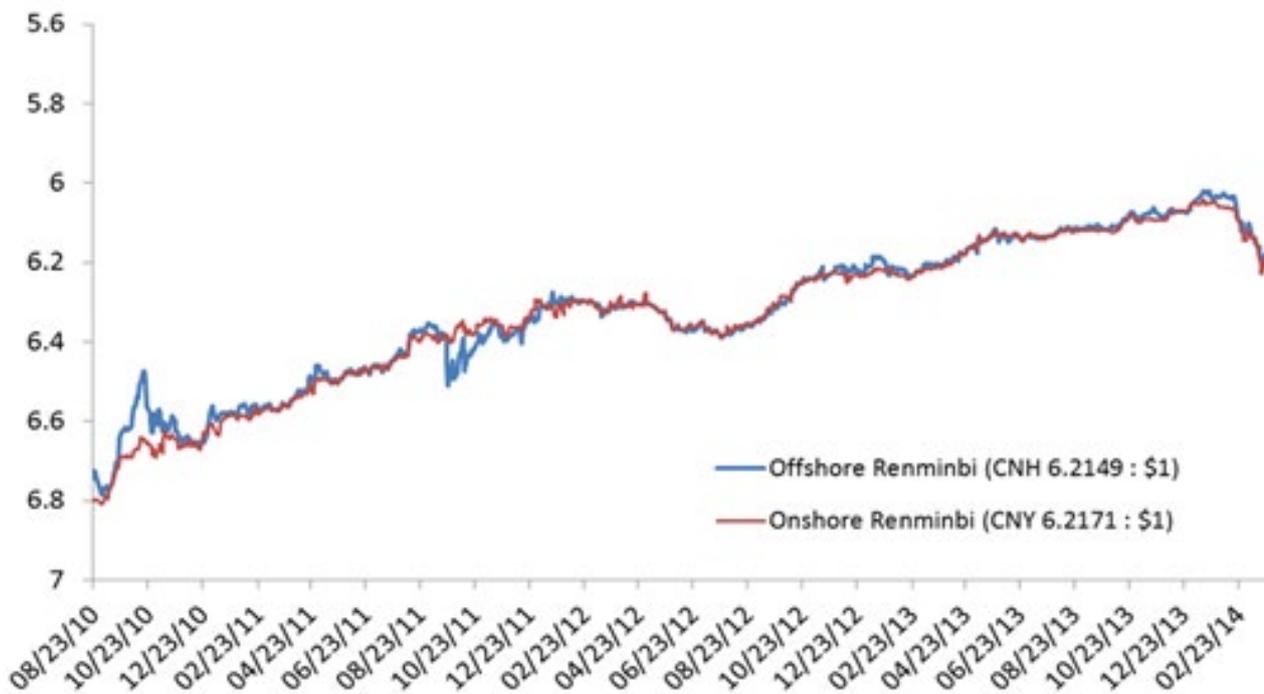
We believe that this represents a significant opportunity. Since 2010 we have seen company profits grow and valuation multiples decline. Not all companies have reported this year, but the 66% that have point to earnings growth of over 15%. If investors truly believe that China will fail to restructure, then they should stay away. Otherwise, at these valuations Chinese stocks are very attractively priced, in our opinion.

China Renminbi Yuan (RMB) & Bond markets

Financial restructuring is centered on interest rate liberalization, capital account opening and currency reform. During the first quarter China moved to widen the daily permitted trading range from +/-1% of the daily reference rate to +/-2%. But before they did this, the central bank needed to change some market perceptions.

For the past two years there has been a common perception that the Renminbi would likely strengthen against the dollar, and only strengthen. As a result the exchange rate had been trading at the top end of the trading band for months, even as the currency continued to rise. This made the RMB look like a one-way bet and such a market view was not conducive to China’s desire to introduced greater currency flexibility by widening the band. The central bank intervened and the exchange rate fell back to the middle of the band, the band was widened and the RMB is now 2% lower than at the start of the year.

Exchange rate of the Renminbi Yuan in the Onshore and Offshore Markets to 3/31/14



The current level of the RMB is the same as it was at the start of 2013, and the rate has been stable since the end of the quarter. In our opinion it is likely that RMB appreciation will resume driven by China's ongoing trade surplus, inbound foreign investment and rising domestic incomes, probably from the middle of the year.

The offshore RMB bond market has been untroubled by the currency moves. Supply of new issues did slow in March, although the first quarter was a new record for bond issuance and there are now 466 bonds outstanding with a market capitalization of \$62 billion. If we include certificates of deposit the market capitalization of all renminbi denominated fixed income securities outside China tops \$110 billion compared to \$60 billion at the end of 2012. The duration of the market is less than three years, and the average yield to maturity is 4.36% (as measured by the HSBC Offshore RMB Bond Index).

Commentary for our views on Asia, Dividends and Energy markets is available on our website. Please [click here](#) to view.

Mutual fund investing involves risk and loss of principal is possible. Investments in foreign securities involve greater volatility, political, economic and currency risks and differences in accounting methods. Non-diversified funds concentrate assets in fewer holdings than diversified funds. Therefore, nondiversified funds are more exposed to individual stock volatility than diversified funds. Investments in smaller companies involve additional risks such as limited liquidity and greater volatility. The Fund may invest in derivatives which involves risks different from, and in certain cases, greater than the risks presented by traditional investments. Funds concentrated in a specific sector or geographic region may be subject to more volatility than a more diversified investment. Investments focused in a single geographic region may be exposed to greater risk than investments diversified among various geographies.

Diversification does not assure a profit nor protect against loss in a declining market.

Earnings growth is not representative of the fund's future performance.

The MSCI China Index is a free float-adjusted, capitalization-weighted index that is designed to measure equity market performance of Chinese stocks available to international investors traded in China and Hong Kong. The Index is made up of Chinese stocks listing in Hong Kong and in the B share markets in Shanghai and Shenzhen.

The HSBC Offshore RMB Bond Index is a benchmark for renminbi yuan denominated bonds in the international market

You cannot invest directly in an index.

The Price to Earnings 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.

Yield to maturity is the expected return on a bond if is held until the maturity date.

Shadow banking is a term for the collection of non-bank financial intermediaries that provide services similar to traditional commercial banks.

Standard deviation is a statistical measure of the historical volatility of a mutual fund or portfolio, usually computed using 36 monthly returns.

Duration is a measure of the sensitivity of the price (the value of principal) of a fixed-income investment to a change in interest rates and is expressed as a number of years.

EPS or Earnings Per Share is calculated by taking the total earnings divided by the number of shares outstanding

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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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