Commentary and Review by portfolio manager
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This month we take a look at two hot topics in China: Inflation and Local Government debt. In both cases we believe that there is insufficient attention being paid to underlying trends, and in the case of local government debt, we believe that enormous publicity has been given to the results of some poor analysis. Inflation numbers in China at present are being driven particularly by a shortage of pork whose surging price has added almost 1.5% to the current rate of inflation. In the case of Chinese government debt, a recent Moody’s report dismisses a detailed Chinese study asserting it might have understated local government borrowing by $540 billion – an assertion based on a methodology that lacks both depth and rigor, in our view.
Highlights

Inflation

Understanding the sources of inflation is important since different price pressures require different responses. Since January 2010, Consumer Price inflation (CPI) has risen from a rate of 1.5% to 6.4%. The non-food component has risen from 0.5% to 2.9%. The food element, which is estimated to account for 30% of the overall calculation, has risen from 3.7% to 11.7%. Furthermore, within the food component, pork prices account for around one third of the rise, and they have been rising sharply. If pork prices were excluded from June’s inflation calculation, it is estimated that the headline rate would not be 6.4% but 4.7%.

In the manufacturing sector we have also seen price pressures with the Manufacturing component of the Producer Price Index recording a rise from a rate of 0.8% in January 2010 to a peak rate of 6.6% in February 2011, which has now subsided somewhat to 5.4% in May. So, when we try and understand whether or not inflation has peaked, and what kind of policy response is required it is worth taking a moment to look under the hood.

• The pig problem

The pig-problem is the result of a number of factors, some of which are related to economic cycle that can be addressed by a monetary solution and some of which are specific to the industry and that are subject to nature, which is to say, the pig breeding cycle that takes about a year. The macro issues first. Rural households are the big marginal consumers of pork and household spending in this group – up 16% in the first six months of 2011 compared to the same period last year, lifting demand. At the same time, costs for pork producers in the form of animal feed have risen. Commercially produced pigs are fed on a mixture of corn and soy and corn prices are rising at a rate of around 20% year on year. Transport costs are also an issue with rising diesel prices, although the rate of increase is fading.

However, the biggest problem relates to an absolute shortage of pigs. This is partly due to disease (a gastroenteritis outbreak) last year and inefficiencies. But the real problem stems from state meddling in the market. Back in 2008 when pork prices last surged, the government provided subsidies for farmers to increase production. As a result, pork supply soared in 2009, and when pork prices plummeted (while the price of feed continued to rise), these farmers exited the market, leaving a shortage. The government is now talking about introducing subsidies (RMB100/$15.50 per sow) to be seen to be doing something, while also showing they have not learned much from the last time.

However, whether we are talking about monetary tightening or the introduction of subsidies, there is little policy makers can do but wait for new supply to come into the market. The good news is that new supply is expected to reach the market by around August, causing prices at least to stabilize. For those unfamiliar with the breeding and production cycle, it takes around 12 months: 3 months for a piglet to grow into a sow, 4 months pregnancy and then another 5–6 months to feed them up to 100kg (220 pounds).
Monetary policy

Pigs notwithstanding, there have clearly been other inflationary pressures in China, stemming from the massive lending program in 2009/10 as well as the rising raw materials prices. China's policymakers have steadily tightened their grip on money supply, and its growth has now subsided from its peak at near 30% to a more sustainable 15.9% growth rate. This has been brought about by administrative measures, such as increasing banks' required reserve ratios (the proportion of their deposits that commercial banks must lodge with the central banks), to restrict the flow of new lending.

The impact has been felt across the economy but particularly amongst the small and medium sized business sector, which has given rise to concerns that smaller businesses have been paying a disproportionately high price for the sins of the big state owned enterprises. Recently, the Chinese vice-premier Wang Qishun called for an improvement in credit distribution and for more lending to smaller businesses. This may not translate into much immediate action since there is little incentive for banks to take on the increased risks with lending to this sector, but it does indicate an awareness of the problem and suggests that policy makers are alive to the risk that the battle against inflation brings other problems up in its wake.

We believe that monetary policy efforts are close to having achieved their aim in slowing the economy. There is usually a lag of around 6-9 months before such actions take effect, and looking back we can see that the process of restricting liquidity through the required reserve ratio mechanism began gradually in the first nine months of 2010 before picking up in earnest from October. Thereafter, we have seen a rise of 0.5% each month until June; each 0.5% move in the ratio has accounted for $55-60 billion of deposits. Since October an additional $510 billion of deposits has been tied up in these central bank deposits and therefore not available for lending, bringing the total number of tied deposits to $2.6 trillion (based on a 21.5% required reserve ratio and a total bank deposit base of $12.2 trillion).

The required reserve ratio has been the most effective tool to bring down money supply and slow the economy because in China so much investment funding (around 90%) comes from bank lending. As China’s economy matures and the financial system becomes more complex as alternative funding sources develop then this tool is unlikely to be so effective on its own. For now, we see inflation likely to fall without the worst predictions of economic bust coming to pass. Indeed, GDP growth of 9.6% year on year in the second quarter and purchasing managers' indices down but still showing expansion suggest that while operating conditions have been difficult, a crunching slow down has been avoided.

Debt

In addition to inflation, there has also been an increased focus on China’s sovereign debt position, especially as it relates to local government and, specifically, local government financing vehicles (LGFV). The interest has been increased following a recent report by Moody's on Chinese banks and the sector's exposure to local government debt. Moody's asserts that the report from China's National Audit Office (NAO) underestimates the debt figure by some $540 billion. Furthermore, the report takes a very gloomy view on potential delinquencies where they estimate losses of 50%-75%.
While it is true that outside access to government finance numbers is not easy in any jurisdiction, nevertheless, analysis of Chinese local government debt is not wholly a dark art. It is possible to form a view from the data published from multiple sources, which is what Moody’s has done, and it is fair to say that the Moody’s report can be criticized on the basis of methodology, breadth of analysis and interpretation. Samuel Chen at JP Morgan has produced an excellent piece on this subject.

• How much debt is there?

The NAO study estimated that at the end of 2010 local governments had debt of RMB10.7 trillion ($1.65 trillion) of which RMB8.5 trillion ($1.32 trillion) is in the form of bank debt. Out of the total RMB10.7 trillion, RMB9.6 trillion has been spent and RMB1.1 trillion remains in cash and deposits. Local governments are explicitly on the hook for RMB6.7 trillion inasmuch as they are directly responsible for interest and repayment while the balance of RMB4 trillion is debt guaranteed by local governments or in some form of implicit liability where local governments would be called upon in the event of financial difficulty.

This study was based on a three month audit involving over 40,000 personnel who checked over 25,000 government bureaux, 6,570 LGFV bodies, 54,000 other institutions and over 370,000 projects. Moody’s argues that that the figure of RMB8.5 trillion in bank debt may be understated by RMB3.5 trillion ($540 billion). Its suspicion is based on its reading of two other reports: one from the Central Bank whose Regional Finance Report talks of RMB14 trillion of debt and another by the China Banking Regulatory Commission which focused on LGFV loans of RMB9.1 trillion. Moody’s appears to have taken an average of the two figures to arrive at RMB12 trillion to arrive at a ‘truer’ figure and then took the difference between this and the NAO’s RMB8.5 trillion figure to arrive at an ‘under-estimated’ number of RMB3.5 trillion (or $540 billion), which has been widely quoted.

Apart for the obvious contrast between the NAO and Moody’s in depth of their studies, there is also an issue with Moody’s approach of taking the average of two very different numbers ($760 billion different) and claiming this to be a more accurate assessment. They are clearly the outputs from different studies. The Central Bank study, for example, went much wider and included loans to healthcare, education and RMB2 trillion to the central government Ministry of Railways. The China Banking Regulatory Commission study just looked at LGFVs but has also calcified that of the RMB9.1 trillion of debt they identified, RMB2.8 trillion is regarded as normal corporate loans to commercial entities linked to local government and therefore no longer regarded as LGFV loans.

This illustrates the importance of looking behind some of the more headline grabbing numbers that come out about China. Some of the analysis we see often consists of worrisome arguments constructed on perhaps a flimsier base than one might expect. The NAO report gives breakdowns of debt by size, by classification of borrower, repayment schedules, areas where funds have been used by both sector and geography and even gives a sense of when the loans were originated. For example, according to the NAO, approximately RMB3.2 trillion of debts were drawn down prior to 2008 and a further RMB2.28 trillion were drawn down after 2009 for projects that were already underway by 2008.

Chen also makes the important point that between 2008 and 2010 local governments paid back RMB2.4 trillion ($371 billion) of debt, based on the difference in the end balances in 2008 and 2010 and accounting for the new loans taken on during the period.
China's central government debt stands at around 20% of GDP and if the amount of historical non-performing assets taken on by the government in the course of bank restructuring that number rises to around 30%. Local government debt, using the RMB10.7 trillion figure, amounts to 27% of GDP. In aggregate, total public debt amounts to 50-60% of GDP once double counting is stripped out. In our opinion this is not a big number, especially when we consider high savings rates, nominal economic growth of around 15% and interest rates around 6%. China could cope with higher debt levels without a strain.

There is a concern that, notwithstanding overall debt levels, there is still the risk of a crisis at the local government level because of the limitations on local government revenues. The argument goes that local governments are dependent upon land sales. However, this is not the case. Around 70% of local government financing comes either from local tax revenues or from central government transfers. Indeed, the way government financing works is that Central Government collects over half the budget revenue and transfers around 70% of it to local governments for their budget spending. The issue is not that there is a limitation of revenues which could precipitate a crisis; the revenue is there. However, its distribution needs to be reformed and put onto a more regular footing.

Having attempted to put the government financing issue into context, we are still left with the strong likelihood that non-performing loan amounts could go up from current levels and that the banking sector may have to bear some of the burden. Some of the lending that was made under the stimulus plans falls under government responsibility, but where banks went outside that, then the responsibility will be borne by them and their shareholders.

We believe that banks non-performing loan levels are surprisingly low at present, although the amount of money they have set aside to cover them is between 1.5x and 2x, which we believe gives banks a useful cushion. Furthermore, we believe that recovery rates should be better than was the case in 1994/5, which Moody’s takes as its example. In part this is because in 1994 the bad debts were corporate loans that went bad following the wholesale restructuring of the state-owned enterprise sector that involved the closure of thousands of businesses, so recovery rates were poorer. In part, we can see that many of these loans are extended to ventures that have a value and cash flow associated with them and that while the cash flow may not be substantial now, economic growth should address that problem.

**Conclusion**

We have seen considerable space devoted to these twin topics of inflation and debt and we would remind our readers that a look behind the headlines, especially where China is concerned, can often change substantially the picture with which we are presented.
Market Review

June was a mixed month for Asian markets, with most of the major markets finishing down for the month but remaining in positive territory for the year to date. Equity investors continue to be concerned about macro issues, such as the potential for unruly sovereign defaults in the Eurozone and the delay in Congress agreeing to an extension of the US Federal borrowing limit. Both these issues illustrate how the issues of over-leverage, which began in the private sector, have now infected public sector and central bank finances. This comes against a background of slow economic growth globally, and signals from the US Federal Reserve that it does not favor further quantitative easing.

Although these issues have affected risk appetite towards Asian equities, the fundamentals in Asia remain at odds with the situation in the rest of the world. By contrast to the US or European Union, Asian economic growth remains good, and most sectors and governments are at very comfortable levels of leverage. The exception is the property sector in China, wherein prices in the major cities have risen quickly in the last two years, since loan growth accelerated quickly in the first half of 2009 in a government-led attempt to catalyse growth in the economy. This is now being dealt with through monetary tightening to deal with the demand side, and through a plan to build 10 million affordable homes in 2011 as part of the current five year plan to ease the supply side of the property market.

Chinese growth has slowed somewhat, but probably needs to slow further to come into line with the government’s medium-term target of 7% GDP growth per annum. The official impetus to slow the economy has meant that Chinese equities have been under pressure for all of this year so far, and this has also pressured China’s Asian trading partners.

In June, the weak sectors in China were generally related to the industrial and materials sectors, as there were some rumours that the affordable homebuilding program was running behind schedule. However, this seems to be a short-term issue and is likely to be immaterial relative to the gigantic size of the homebuilding plan. Elsewhere in Asia, the top performing stocks were the防守性, such as consumer staples, utilities and telecoms. Information technology names underperformed, particularly in the handset sector where there were some concerns over the potential for weaker than expected volume growth in the third quarter of the year.
Market Outlook

The interplay of inflation and economic growth remains important for Asian equities for the remainder of this year. Chinese Premier Wen Jiabao declared victory over inflation in China during June\(^1\), suggesting that monetary control policies had now worked. This may be slightly premature, given the consensus is that the consumer price index might continue to rise in June, but the direction of travel is becoming clear. It seems that China may well be closer to the end of its interest rate cycle than the beginning, and towards the end of June, Chinese equities responded positively with this in mind. The issue of over-leverage in local government special purpose vehicles continues to loom in the minds of investors, but the low levels of leverage in the banks and public sector as a whole suggest that this issue could be dealt with without drama.

Elsewhere in Asia, the general election in Thailand was won handsomely by the Puea Thai party, which won 265 out of 500 seats in the House of Representatives\(^2\). Puea Thai was fronted by Yingluck Shinawatra, a sister of Thaksin Shinawatra, the exiled former Prime Minister of the country, and patron of the red shirt movement which has caused periodic disruption in the country since the military coup of 2006. Puea Thai’s policies are likely to be populist, and the party has decent support in the farmers and rural poor who have traditionally fallen outside the mainstream of power in Thailand. From an investment point of view, the resounding nature of the victory lessens the likelihood of upset and disruption from the defeated parties in the short-term, but in the long-term this cannot be ruled out. However, if this victory does lead to an extended period of political calm, this could be positive for economic growth and fixed asset investment.

Over the last five years, Asia has well outperformed the major indices of Europe and the US, but in recent months it has suffered from great volatility, as risk appetite has fallen on macro concerns.

\(^1\)“Chinese Premier declares inflation victory”; Jamil Anderlini, *Financial Times*, June 23, 2011

\(^2\)“Pheu Thai MPs-elect to meet July 12”; *Bangkok Post*, July 7, 2011
China Economic Monitor

China’s monetary tightening policies continued to take effect in June, and new loans extended and money supply growth, as represented by M2, both fell. The new loans figure was perhaps the biggest surprise of the monetary data this month, given that June’s new lending was well below the central bank’s target. This suggests that end demand for new credit is certainly waning, and suggests that we could be close to the point where the government will look to accelerate economic growth. M2 growth of 15.10% was slow relative to the last two years, but was in the range for ‘normal’ M2 growth for the last 10 years.

The other side of the monetary equation is inflation, and the Chinese authorities are now beginning to believe that the worst is over for inflation in China. However, the consumer price index does remain elevated relative to recent history, and a further re-acceleration in the consumer price index would be quite negative for investor sentiment. Looking at the components of the consumer price index, it is clear that food inflation remains an issue in China, with meat prices continuing to rise sharply. However, May marked the second consecutive month of deflation in fresh vegetable prices, while grains prices have begun to decelerate.
There was encouraging data from the basic materials sector, with steel production rising month on month in May, and hitting a new high of just over 60 million tons during the month. Iron ore imports have been recovering from their setbacks in the first quarter, and it does seem that in this key sector China may be getting back on a growth footing. Coal imports have picked up sharply since their low of 6.76 million tons in February, and were back into the teens at 13.56 million tons in May. The bulk of the increase in coal imports in May came from Indonesia, and there looks to be still some pent-up import capacity to come for Australian coal, which remains well below pre-Queensland flooding levels.
The pattern is less rosy in imports of upstream metals, with only nickel increasing in volume month on month in May. Although import growth for both Zinc and Copper remains anaemic, they are now back down at levels which were considered standard before 2009. There is also an inflation aspect to this, in that as the marginal demander of these metals, China does not want to be seen to be buying at elevated prices if it can at all avoid it. Should the emphasis return to economic growth and away from tightening in China, we would hope that this would be reflected in improving import volumes of all of these metals.

In line with our thesis about the importance of new household formation and improving consumption growth in China, passenger car sales and retail sales growth are both key variables. Passenger car sales remained above 1 million units in May, suggesting that underlying consumer demand is still reasonable. Retail sales growth actually picked up slightly in May, which is unusual given the degree of monetary tightening in the economy. This is another variable which has now returned to pre-2009 levels, suggesting that this could be a sustainable baseline level of growth.
Commentary for our views on Alternative Energy and Energy markets is available on our website. Please click here to view.
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