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**Commentary and Review by portfolio managers  
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*South Korea's new President, Park Geun-hye, faces a challenge to re-catalyse economic growth at a time when Japan is devaluing its currency and Korea's domestic economy remains sluggish. Park appealed both to voters who hanker for the certainties of her father's time as President, and to those who see her as an agent of social change by virtue of her gender and support for pro-welfare policies. North Korea also presents an early problem for Park, although there are early signs that China's support for the regime may be waning.*

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- ➔ South Korea at the Crossroads
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South Korea's recently-inaugurated President, Park Geun-hye, faces challenges to catalyse economic growth on her return to the Presidential mansion, the Blue House. Park was formerly resident of the Blue House as the eldest daughter of Park Chung-hee, who was third President of South Korea from 1961 to 1979. Park Chung-hee was a divisive figure who seized power from a democratically-elected government in 1961 and in 1972 suspended the country's constitution, imposed martial law and declared himself president for life. He was assassinated in 1979 after which democratic rule was re-established in autumn 1980. Despite his anti-democratic credentials, Park Chung-hee was not universally unpopular, and he is credited with laying the foundations of South Korea's modern industrial society. Park Chung-hee's economic policies centred on export-led growth, and under his rule the industrial conglomerates known as Chaebol came to dominance in the economy.

Aside from her heritage, Park Geun-hye is also set apart as the first female President in an otherwise relatively conservative society where gender imbalance in professional life is the norm. It is relatively rare to find women taking senior positions in the political or business worlds, and women often do not return to work after having children.

Park has taken power at an important moment for South Korean society, with a resurgent political and military threat from the new leadership of Kim Jong-un in North Korea, and social and demographic changes in South Korea contributing to slow domestic output growth. Exports are also of central importance to Korean economic life, and Japan's weak Yen policy is a direct challenge to South Korea. Park's early responses to these challenges is likely to define her Presidency, with other recent Korean presidents rapidly losing political capital after failing to respond appropriately to the challenges facing them.

### *Business as usual?*

Park Geun-hye represents the right-leaning Saenuri (New Frontier) party, and is known for her open-markets and conservative approach to policy. Her election platform was more nuanced, however, containing a good measure of social policy designed to appeal to older voters in South Korea. Despite solid economic growth over the past 30 years sufficient to bring South Korea into the developed group of nations, the economy's growth rate has been slowing (see chart 1), in part due to its dependence on exports, and in part due to its falling birth rate and low levels of immigration. This has led to an aging population which is now exposing some of the pitfalls of South Korea's rapid industrialisation.

**South Korea Real GDP growth**



Source: Bank of Korea Bloomberg

Industrialization and economic development have worked to erode some of the traditional Korean social structures, which in the past supported older members of the society. As more Koreans now live in nuclear families in urban areas, the older generations have been increasingly left behind, and economic inequalities have opened on the basis of age. Older voters at the recent presidential election seemed to appreciate her more patrician style of politics, especially when coupled with her plans to widen the social security net and increase benefit levels for seniors. This helps to explain why Park Geun-hye's popularity is partly because of, rather than in spite of, her family background.

To help combat the slowing birth rate, Park Geun-hye has the opportunity to mobilize two constituencies to help drive economic growth. As part of her pre-election campaign, the issue of reducing youth unemployment was highlighted, and she can also set policies to encourage more women into the workforce. South Korea has one of the worst records for gender inequality in the workplace in the OECD (Organisation for Economic Co-operation and Development) nations, with well below the average number of women in managerial positions and one of the largest gender pay gaps in the developed world. Park Geun-hye has suggested that the government should offer free childcare for children under the age of 5, and this would go some way to help encouraging women back into the workforce after having children. However, even if youth unemployment, as seen in the chart below, can be tackled, the issues that have kept women out of the workforce are not insurmountable, but they are likely to take longer than a Presidential term to resolve.



Source: Korea National Statistical Office, Bloomberg

However, there may be some conflict with the other side of Park Geun-hye's policies to improve life in Korea, that of economic liberalisation to reduce the power of the Chaebol conglomerates and introduce free market economics to more areas of Korean life. Given her family association with those same Chaebol which helped to build modern South Korea, it is difficult to see how she can then champion the reform of those same companies. There is no doubt that the Chaebol are a necessary evil of the economy for the time being, but they do stifle creativity and hurt corporate governance, with the interests of the Chaebol often placed above the interests of public shareholders. Related to this is the network of cross-shareholdings, whereby the controlling interests, often families, can control greater voting rights than their economic interest should allow. This puts South Korea at a disadvantage to its Asian neighbours and its firms often have poorer disclosure, worse capital structures and pay lower dividends. This makes it more difficult to attract long-term foreign capital to the market.

*Noisy neighbors*

In her inaugural speech, Park Geun-hye referred to the threat posed by North Korea, and urged them to give up nuclear weapons. In light of the more aggressive stance taken by North Korean leader Kim Jong-un, who has himself only taken power relatively recently, this is a priority issue for the new President. Aside from the naval skirmishes of recent years, Kim seems even keener than his father to press forward the development of North Korea's ballistic missile and nuclear weapon capabilities, and this will inevitably lead him into further dispute with South Korea and the West. Kim's most recent gambit has been to threaten to withdraw from the 1953 armistice which ended the Korean War. North Korea does pose a serious military threat to South Korea, given the proximity of Seoul to the border, and the fact that South Korea as a modern state is more geared up to export mobile phones than to take up arms against the North. Successive South Korean Presidents have taken a relatively soft line on the North, allowing Japan and the US to rattle the sabre against the North. The difference under Park Geun-hye is that South Korea is now a major trading partner with North Korea's sponsor, China, and could bring pressure to bear on the Chinese to encourage a toning down of Kim's rhetoric.

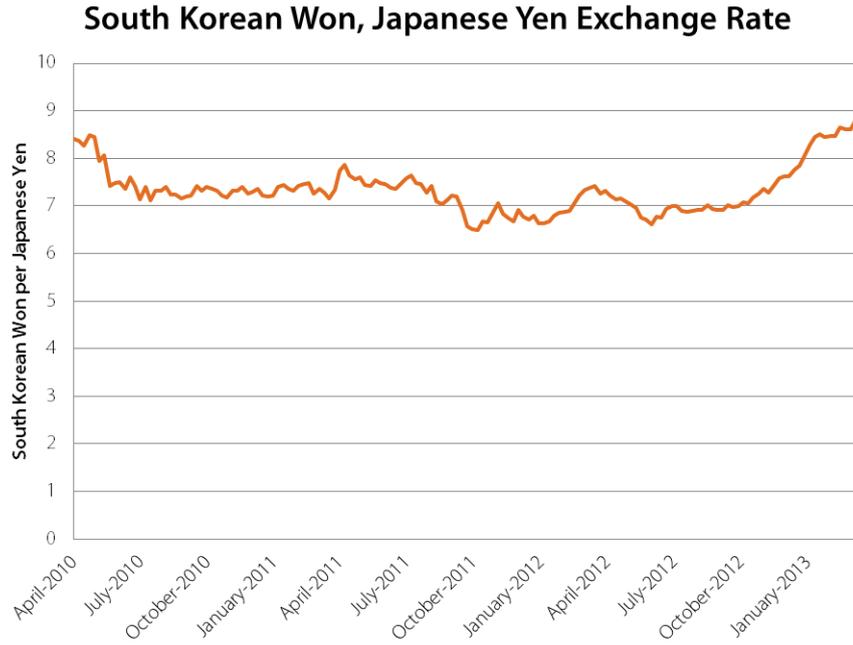
North Korea's rhetoric about withdrawing from the armistice is unlikely to be backed-up by real action, and the country has threatened to withdraw from the armistice five times in the last 10 years. The long-term solution could be re-unification of the two Koreas, although this is likely to take some time to transpire. The closest parallel for eventual re-unification could be Germany after the end of the cold war, with a difficult and expensive stage of re-adjustment followed by the unlocking of huge economic growth potential.

The key to changing the situation is weakening Chinese support for North Korea, and the willingness of China to allow US-influenced South Korea to share a border with it. There have already been public statements from researchers connected to the new Chinese leadership calling for a re-appraisal of their relationship with the North. China has also recently voted in favor of a United Nations Security Council resolution to tighten financial restrictions on the Pyongyang regime and to mandate other nations to inspect North Korean cargo. Although China remains a supporter of North Korea, there are early signs that the new leadership's support is not a blank check for aggressive behavior.

*The War for the Won*

The most immediate conflict for Park Geun-hye is the battle with Japan over the future of the Japanese Yen, which represents a direct threat to South Korea's export competitiveness. By explicitly targeting looser monetary policy, the new Japanese government of Shinzo Abe has encouraged a devaluation of the Yen (Chart 3), and this has been felt in Korea's export-led business community. Exports account for around half of South Korea's GDP, and any move in the Won/US Dollar or Won/Japanese Yen exchange rates directly impact upon profitability and the Government's tax take.

Even before the inauguration, Park Geun-hye had already stated her willingness to act 'pre-emptively' to help weaken the Won and improve the competitiveness of Korean exports. In the short term, this is likely to mean leaning on major Korean corporations to reschedule or delay their currency repatriations to avoid currency strength. However, in the long-term it is difficult to see what policies a supposed believer in free markets can enact to effectively manage the exchange rate.



Source: Bloomberg

In her favor, the South Korean industrial base is strong and relatively well-diversified, certainly compared to regional peers such as Taiwan. However, the economy is still too dependent on exports and there has been a neglect of the services side of the economy. It is also clear that South Korea's major firms have focused too heavily on hardware developments and reverse engineering, to the detriment of the software side of the economy.

*The challenge ahead*

Park Geun-hye's inbox is certainly full this spring with challenges both at home and abroad. Economic growth is a priority for all South Korean Presidents, but the structural and demographic changes in the economy make re-igniting economic growth harder than ever. Add to the list relatively high levels of household indebtedness by regional standards and a broad, but unfavorable, business and industrial structure, and the task gets yet harder. Park's balancing act is to retain the support of the conservative older generation which played a significant part in putting her in office, while being radical enough in her policies to reform the Chaebol and enhance women's status in the workforce.

## Market Review

## Market Performance Ending February 28th, 2013

	February 2013	Year to date	2012	2011	2010	2009
Australia	3.87%	9.65%	22.25%	-10.77%	14.69%	73.87%
China	-3.92%	0.04%	22.69%	-18.36%	4.59%	62.06%
Hong Kong	-0.61%	5.19%	28.26%	-15.78%	23.28%	60.48%
Indonesia	9.56%	12.49%	6.11%	5.19%	35.47%	136.12%
Korea	4.08%	-0.41%	20.99%	-13.55%	25.84%	74.44%
Malaysia	1.49%	-3.49%	14.54%	0.11%	37.67%	51.26%
New Zealand	-0.24%	7.90%	31.54%	5.90%	8.73%	49.89%
Philippines	8.65%	16.99%	47.52%	0.04%	35.24%	67.34%
Singapore	0.16%	1.65%	30.98%	-17.54%	22.03%	73.18%
Taiwan	0.55%	0.77%	17.43%	-20.18%	23.14%	80.23%
Thailand	2.39%	8.27%	35.01%	-2.72%	56.67%	76.59%
MSCI AC Far East Free ex Japan	0.55%	1.83%	22.06%	-14.75%	19.41%	68.56%
MSCI AC Pacific ex Japan *	1.55%	4.03%	22.72%	-13.59%	17.95%	71.51%

\*MSCI AC Pacific includes Australia & New Zealand

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

February was a mixed month for Asian equities, with continued good performance in the south Asian and ASEAN (Association of South East Asian Nations) markets, whilst China and Hong Kong equities finished the month in negative territory. Chinese equities finished down 3.92% in an unexpectedly poor performance following some months of recovery. The fall was due to some retrenchment after January's Chinese New Year celebrations, and as a result of investor fears about inflation and the potential for new policy tightening on the property market. The government believes new controls are needed due to secondary property market price rises in recent months, with particular price momentum in Beijing and Shanghai. In February the State Council announced that the 20% capital gains tax on home sales would be strictly enforced, and asked local governments to devise new control policies for the property market, to be announced by the end of March. This comes at a time when the supply-side of the property market is improving, with cement demand improving and selling prices increasing compared to recent months.

Indonesia was the best-performing market in February, up 9.56% compared to a return in the benchmark of only 0.55%. The Indonesian government has been issuing record amounts of Islamic bonds (Sukuk) during February, and is offering a higher coupon on Sukuk than on non-Islamic debt. The Sukuk sales help achieve two aims for the Indonesian government; by selling the instruments to individual investors the government broadens out the investor franchise, and it also diversifies the debts of the government away from US dollars.

Thailand was a decent performer in February, up 2.39% and in early March the country's debt was upgraded to three levels above junk with a stable outlook. The upgrade reflects good and consistent economic conditions in Thailand, following a period of political and social stability. The upgrade should help to lower borrowing costs for the government and Thai companies, and Prime Minister Yingluck Shinawatra's plans for spending 2 trillion Thai Baht (USD 67 billion) on transport infrastructure over the next 7 years should help to support future growth.

**Major Indices total returns for the five years ending February 28, 2013**

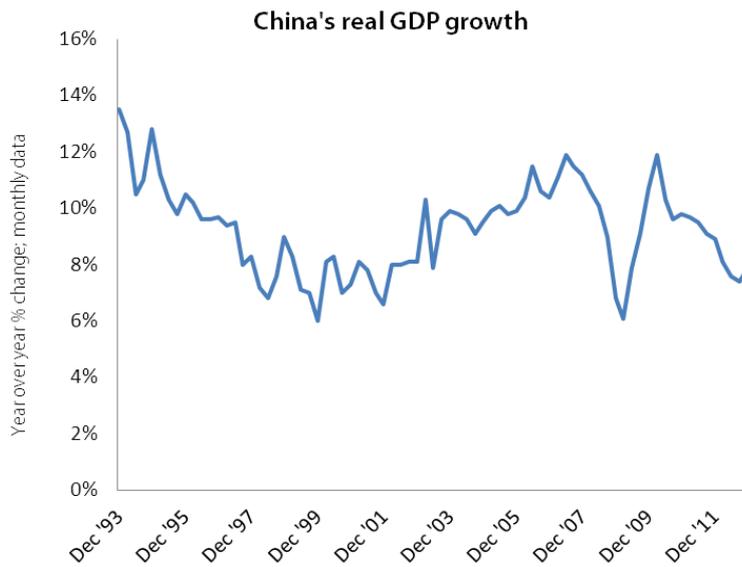
Source: Guinness Atkinson, Bloomberg

**China Economic Monitor**

China's economic recovery remains in place, but the evidence suggests that it is milder than anticipated. There has been a pause in significant policymaking while the new government is installed, and this long process ends during March with the National People's Congress (NPC) in Beijing. The National People's Congress is China's legislature, and it meets for two weeks annually in the Spring. Given the change of leadership in the Communist party, this meeting is an opportunity for the outgoing Premier, Wen Jiabao, to present his final 'work report', and for the new President, Xi Jinping, to be formally adopted as the new national leader.

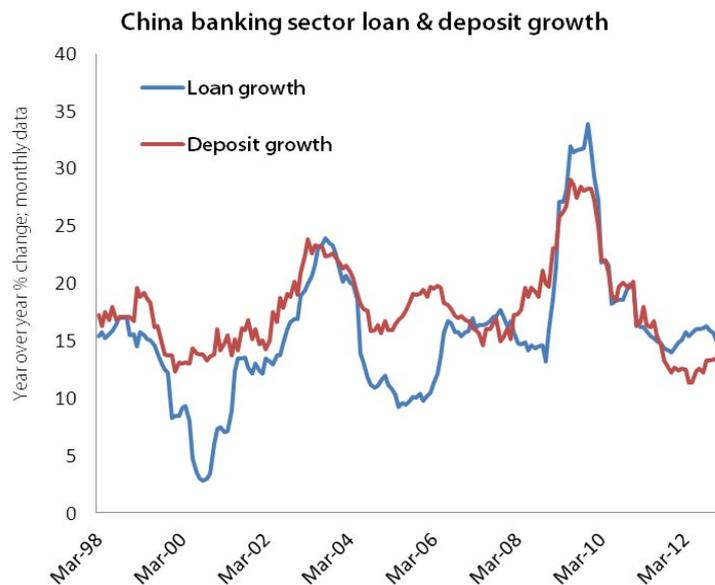
Although the Congress is merely a routine endorsement of the transition, policy announcements are made, most significantly in the area of the budget. The Ministry of Finance announced a defense budget of CNY 720 billion (USD 115 billion) for 2013, a 10.7% increase over 2012, while government spending on healthcare is to increase 27.1% this year. There was some surprising news about the Ministry of Railways, which is a huge organization with around 2 million employees. The Ministry of Railways is to be split into operational divisions under the Assets Supervision and Administration Commission and an administrative and regulatory body, which will be merged with the Ministry of Transport.

Wen's final report was also of interest, re-affirming the government's commitment to urbanization as a driver of economic growth. Wen highlighted the need for reform of the 'Houkou' household registration system, and for greater emphasis on delivery public services to migrant workers in urban areas. This direct support of living standards for migrant workers should encourage greater financial stability and smoother consumption patterns for this group.



Source: National Bureau of Statistics, Bloomberg

Following a period where loan growth was running ahead of deposit growth, deposit-taking has accelerated in recent months. Deposit growth picked-up sharply in January, up 16% compared to January 2012. However, loan growth has decelerated, and was up 15% in January compared to January 2012. This perhaps suggests that the impact of the monetary stimulus in China is now beginning to wane, and that households are turning more conservative. However, in the context of the government's medium-term GDP growth target of 7-8%, mid-teens loan and deposit growth are reasonable.



Source: National Bureau of Statistics, Bloomberg

The price indices suggest that there has been a pick-up in inflation in China, although CPI (Consumer Price Index) growth remains below the government's target level for inflation in 2013 of 3.5%. Based on these data, we would not yet expect policy action to be taken against inflation. However, if these trends extend, this could be a concern for the market as tighter monetary policy is unwelcome in the context of the mild recovery in economic growth.

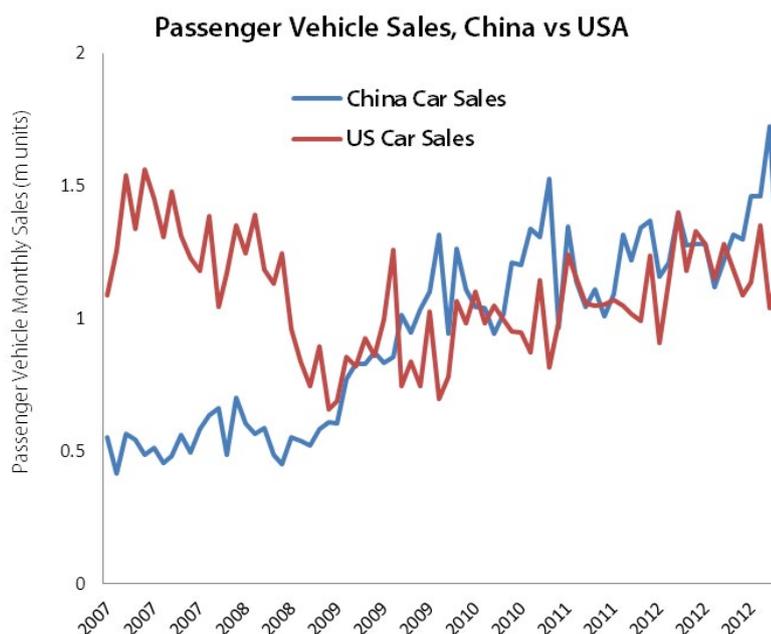
Both producer and consumer price indices accelerated sharply in February, although there could be some impact from the Chinese New Year holidays. It should be recognised that the producer price index remains in deflation, and industrial product prices contracted 2.4% year on year in February. There has been some recovery in materials prices, with cement and some of the industrial metals picking up over recent months.

The main sources of the consumer element of inflation are food prices, and this is a fairly typical pattern after the end of the winter season. This is reflected in an acceleration in fresh vegetable prices, while meat and poultry prices also accelerated at their fastest rate since April 2012. By contrast, the non-food CPI was slower at 1.9% compared to 3.2% for the overall CPI. Urban and rural CPI remained in balance, with urban prices up 3.2% year over year in February and rural prices up 3.3% year over year in February.



Source: National Bureau of Statistics, Bloomberg

Vehicle sales in February pulled back sharply to 1.11 million units, and US sales were slightly higher than Chinese sales at 1.18 million units. Although this is a sharp fall compared to January 2013, the shifting of the Chinese New Year holiday in line with the lunar calendar means that it is better to consider January and February's figures together. Looking at the first two months of the year, there were 2.83 million cars sold in China this year, compared to 2.37 million over the same period of 2012, an increase of 19%. By contrast, there were 2.23 million cars sold in the US in January and February 2013, compared to 2.06 million in the same period of 2012.



Source: China Automotive Information Net, Bloomberg

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