GUINNESS ATKINSON FUNDS

Asia brief

Edmund Harriss

James Weir

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Commentary and Review by portfolio managers Edmund Harriss and James Weir

The impending arrival of McDonald's in a Communist country usually heralds the beginning of huge economic, political and social change, but in Vietnam's case, this process has been underway for some time. The opening of a striking symbol of capitalist culture should raise eyebrows in any Communist country, and in Vietnam the historical resonance is huge. Vietnam's growth has been driven by foreign direct investment, but there is a real danger that Vietnam could begin to suffer from the under-consumption which has bedevilled other developing Asian nations.

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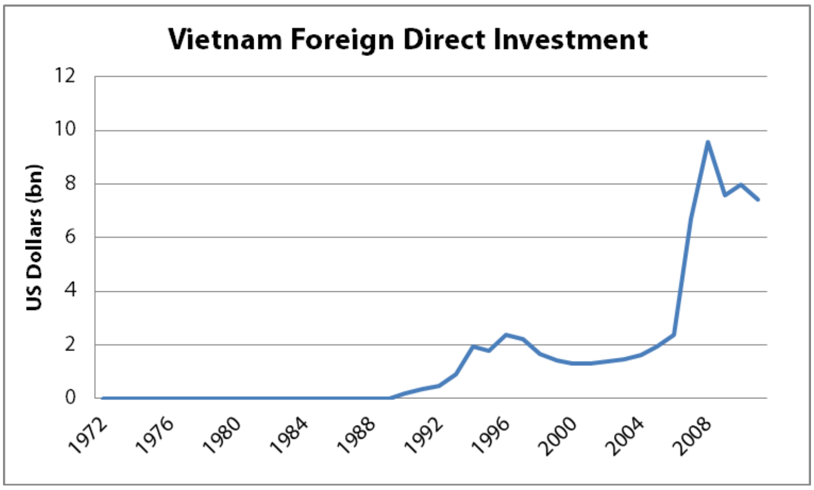
The impending arrival of McDonald's in a Communist country usually heralds the beginning of huge economic, political and social change, but in Vietnam's case, this process has been underway for some time. The opening of a striking symbol of capitalist culture should raise eyebrows in any Communist country, and in Vietnam the historical resonance is huge. However, Vietnam's centrally planned past is not entirely escaped, and the first franchise in Vietnam is to go to Henry Hguyen, the son-in-law of Vietnam's Prime Minister, Nguyen Tan Dung. The first McDonald's restaurant should open in Vietnam in 2014, ironically placing the burger chain behind brands such as KFC, Burger King, Subway, Starbucks and Pizza Hut, which have been trading in the country for some time.

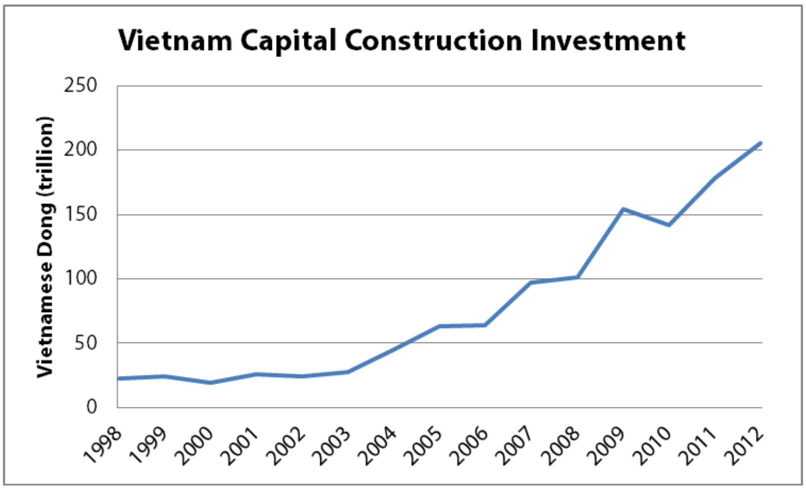
Foreign direct investment has been the catalyst for Vietnam in recent years, and foreign capital continues to set the pace of change. The nation has brought in over $7 billion (bn) per annum for the last five years, which has been hugely significant in an economy with nominal gross domestic product of $141.66bn in 2012. Vietnam's attraction for foreign investment is based on its lower wage costs relative to more developed Asian nations, its good location between North and South East Asia and its stable government and politics. Although corporate taxes are reasonable in Vietnam at 25%, the government does not charge additional tax on profits remitted outside of the country, which adds to the attraction for foreign firms. This makes the country a good export base in Asia, and makes it very competitive against higher-cost nations such as Taiwan or South Korea. Indeed, as wage costs have risen in China, the Chinese authorities have been keen to allow less lucrative activities such as electronics assembly, textiles and footwear manufacture, to move to Vietnam.



Source: World Bank, Bloomberg

*Chart data ends 12/31/2011

Although the foreign fast-food outlets are eye-catching, manufacturing has pulled in the bulk of the foreign capital, with electronics manufacturing firms, such as Samsung Electronics and Foxconn, taking advantage of Vietnam's favorable conditions. The growth in foreign direct investment has been matched by rapid growth in capital investment by the government in Vietnam, as the government has worked to develop the infrastructure needed to support the development of the country. However, Vietnam has not yet suffered from the over-investment seen in some other Asian nations, and indeed, infrastructure is still lacking in some crucial areas, such as in energy, where the nation is short of refining capacity despite having a favorable endowment of oil and gas. Indeed, the government has suffered from consistent fiscal deficits, and if growth does not accelerate in the economy, it may not be able to afford to continue even the investment it is making at present.



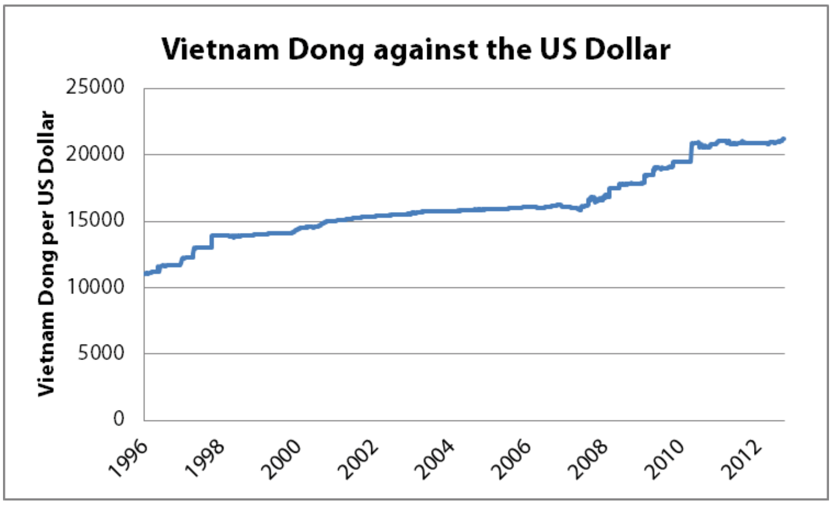
Source: Vietnam General Statistics Office, Bloomberg

Although reform began in Vietnam in the mid-1980s, the 2005 Investment Act accelerated its development as an investment-led nation. This Act set the legal framework for foreign investment by creating structures that allowed foreign investors to feel comfortable investing their capital. The Act also explicitly ruled out nationalization of assets and set foreign ownership limits for some types of company, such as stock exchange-listed companies, which can only be up to 49% foreign-owned. Listed financial sector companies are even more closely guarded, and these can only be up to 30% foreign-owned. Vietnam also joined the World Trade Organization (WTO) in 2007, which set the government tasks for structural reform and greater transparency, while allowing greater market access for foreign firms to export to Vietnam.

As well as allowing foreign investment into private firms and projects, Vietnam has also allowed significant portfolio investment, and state-owned enterprises have been central to this process. Rather than allowing full privatizations, the government has preferred a policy of conversion to joint stock enterprises followed by limited equity investment in these businesses, initially through tender to auctions for investors. This process has achieved some eye-watering valuations for the government as vendor of the stakes, given the limited stock available and the high levels of foreign capital chasing it. This has perhaps not served Vietnam well as an investment destination, although it has been favorable to the government's coffers.

Source: Bloomberg

The mixed success of the privatization program is reflected in the mixed performance of the nation's stock index over the last 13 years, which has not really impressed despite a strong run between 2006 and 2007. Communist revolutionary Ho Chi Minh did not live long enough to see his name put to a stock index, but this index is very much a foreign affair, with the portfolio flows of international investors the decisive factor in driving it. However, central control lives on in the form of the currency, which is still closely controlled in value against the US Dollar.



Source: Bloomberg

*Chart data ends 07/18/2013

As with a number of other Communist and developing countries, this has led to a situation where the currency devalues if the government's finances are called into question or if foreign investors decide their capital can be better employed elsewhere. Such a situation occurred after the global financial crisis of 2008, when the credibility of the Vietnamese authorities was a relatively unsung victim in the wake of the failure of Lehman Brothers. The central bank was forced to act to devalue the currency when a gap opened up between the official currency rate and that available in the 'parallel' market. Although this is good for exporters from Vietnam, in the long-run the episode did damage to the idea the Vietnam was a stable and well-managed economy.

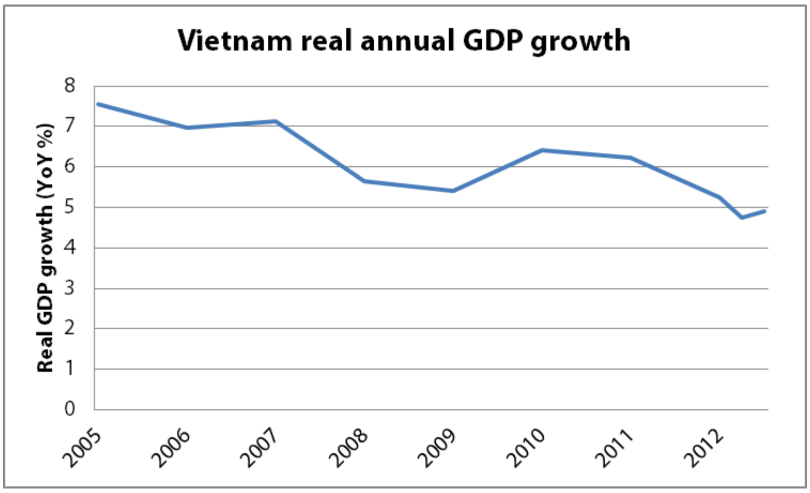
Aside from investment to make Vietnam a good place for exporters to base themselves, Vietnam is potentially a good market in its own right, and its 88 million people mean that it is regionally significant. As workers earn money in the export sector, so they look to consume part of their new incomes, and this has had a tangible impact on consumption patterns in Vietnam. Retail sales growth has been rapid over the past five years, at one stage reaching over 35% per annum. It has fallen back sharply in recent months, but its growth remains well ahead of gross domestic product growth.

Source: Vietnam General Statistics Office, Bloomberg

Vehicle sales exhibit a similar pattern, although the level of sales remains low relative to a population the size of Vietnam. Vehicle sales are also relatively volatile, highlighting that vehicle ownership remains a relative luxury in an economy where annual nominal GDP per capita is only $3440 in real terms, according to the World Bank. Tax is another limiting factor to the development of mass car ownership in Vietnam, with a 15% by value levy on new cars, although this can vary by region. However, the second-hand market is likely to see some growth, given the registration levy was recently cut from 12% to 2% of the vehicle's value.

Source: Vietnam General Statistics Office, Bloomberg

However, there are signs of trouble for Vietnam in its overall GDP growth figures, which have been slowing in recent years. Even though 5% growth in real terms is acceptable, it does not suggest a dynamic economy taking full advantage of its human and natural endowments. Even in the context of a period of slowing growth, Vietnam's accomplishment overall has been meager, particularly set against the huge investments, foreign and domestic, which have been made.



Source: Vietnam General Statistics Office, Bloomberg

*Chart data ends 06/30/2013

As in most Communist countries, the roots of central planning run deep, and it is clear that the private sector has been much more dynamic at grasping opportunities than the government and state-owned enterprises. Unless greater structural reform takes place, it is not obvious that Vietnam's growth rate will re-accelerate, particularly if growth in the developed world, which is such an important consumer of Vietnam's export goods, fails to recover.

In the long-term, the McDonald's factor of greater middle-class consumption may win through, but currently Vietnam could run the risk of falling into the trap of under-encouraging consumption and seeing its GDP growth plateau.

Market Review

Market Performance Ending June 30th, 2013

	June 2013	Year to date	2012	2011	2010	2009
Australia	-6.83%	-6.38%	22.25%	-10.77%	14.69%	73.87%
China	-6.95%	-10.94%	22.69%	-18.36%	4.59%	62.06%
Hong Kong	-5.38%	-1.21%	28.26%	-15.78%	23.28%	60.48%
Indonesia	-4.69%	6.06%	6.11%	5.19%	35.47%	136.12%
Korea	-8.15%	-13.95%	20.99%	-13.55%	25.84%	74.44%
Malaysia	-2.22%	4.65%	14.54%	0.11%	37.67%	51.26%
New Zealand	-3.23%	-0.63%	31.54%	5.90%	8.73%	49.89%
Philippines	-7.99%	8.91%	47.52%	0.04%	35.24%	67.34%
Singapore	-4.73%	-3.50%	30.98%	-17.54%	22.03%	73.18%
Taiwan	-2.17%	1.48%	17.43%	-20.18%	23.14%	80.23%
Thailand	-5.04%	0.38%	35.01%	-2.72%	56.67%	76.59%
MSCI AC Far East Free ex Japan	-5.57%	-5.53%	22.06%	-14.75%	19.41%	68.56%
MSCI AC Pacific ex Japan *	-5.79%	-5.42%	22.72%	-13.59%	17.95%	71.51%

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

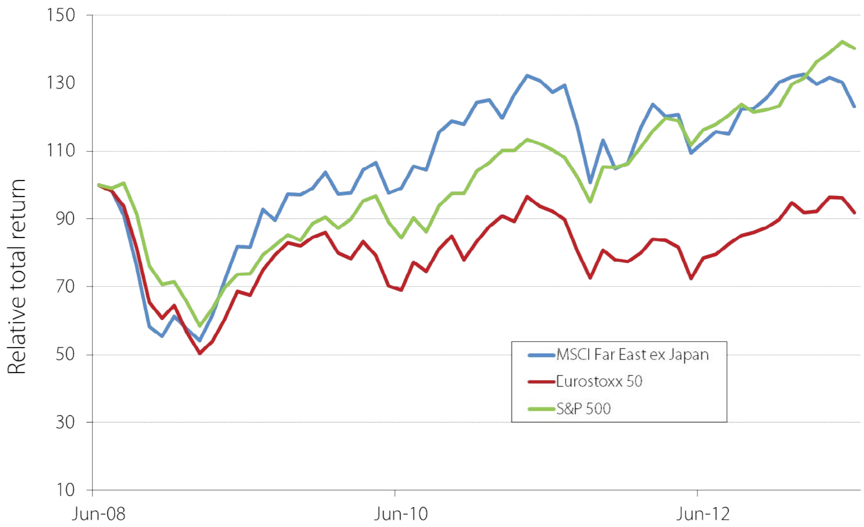
June was a choppy month for Asian equities, as the market interpreted that the potential tapering of quantitative easing in the US would likely be negative for emerging markets equities. Unusually, though, it was not the shallower, more liquidity-sensitive, markets which performed worst, but rather the major markets such as South Korea and China. In these two cases there were also some other issues that contributed to the falls. In South Korea, one of the major US index-driven mutual fund investors performed a rebalancing, which negatively affected the overall index, while in China, there was a short-term liquidity squeeze in the short-dated wholesale money market that unsettled the equity market. The underlying cause of the liquidity squeeze was a desire by the Chinese central bank to put the banks on notice that it would tighten monetary policy as a response to what it viewed as unhealthy lending behavior as a result of excess liquidity.

There were also moves on monetary policy elsewhere in the region, as policymakers worked to contain the impact of the potential change in US policy. The Bank of Indonesia increased its overnight interbank policy rate by 0.25% to 4.25% in an attempt to stabilize capital outflows, while the Vietnamese central bank devalued its currency slightly and cut the interest rate cap on US dollar deposits.

The best-performing market in June was Taiwan, which fell only 2.17% over the month. Taiwanese exports picked-up ahead of consensus expectations in June, led by machinery and electrical equipment. The growth was led by exports to China and the Euro-area, while exports to the US fell slightly.

Malaysia also performed relatively well, finishing down only 2.22% for the month. This was as a result of a continued improvement in investor confidence in the equity market as a result of the incumbent government's win in the recent general election.

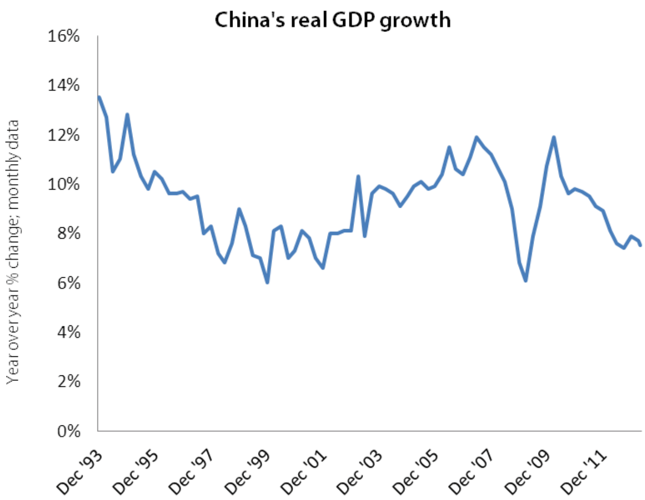
Major Indices total returns for the five years ending June 30, 2013



Source: Guinness Atkinson, Bloomberg

China Economic Monitor

China's real GDP growth of 7.5% in Q2 highlights the slower growth path experienced by the economy and there is little in the data to suggest that growth will rebound sharply in the short term. Looking at the underlying macroeconomic data for China paints a picture of an economy still struggling to grow coherently, and the new government seems willing to trade-off short-term slower growth for structural reform. One important development in June was the State Council's announcement of reform of the system of residency permits, known as Houkou. The report stated that Houkou restrictions will be released altogether in small cities, with a slower release of restrictions as the size of urban area increases. This is a significant step, as it offers hope of faster urbanization in the future by giving migrant workers access to basic social benefits, education, healthcare and social housing. Although this is just a first step, and full reform will take time, it suggests that the government is serious about its vision of urbanization-driven growth.

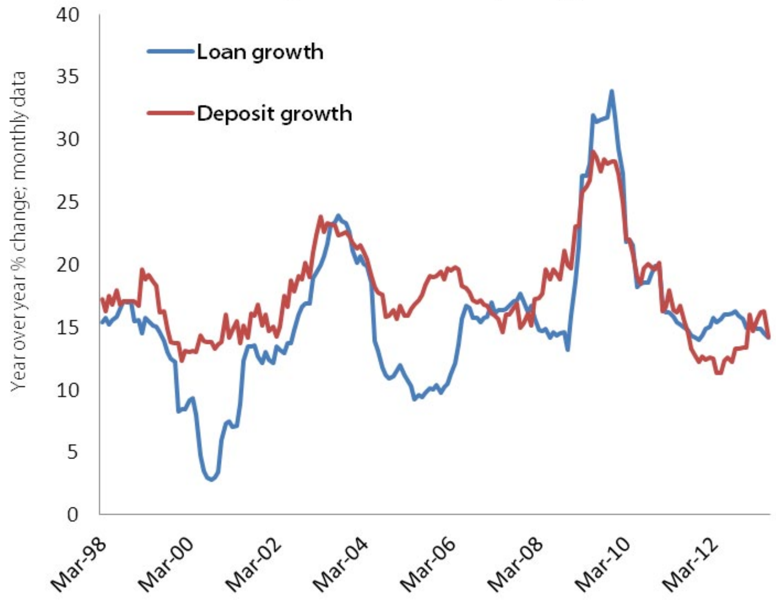


Source: National Bureau of Statistics, Bloomberg

Following the recent change of government, it seems that the authorities are taking a tougher line on monetary policy than their predecessors. This partly reflects the fact that earlier in their mandate they had the luxury of taking a tougher line and partly reflects a desire to control excess liquidity which may have gone into unhealthy lending and practices. During June the new Premier, Li Keqiang, stated that credit for construction projects will be restricted in industries facing overcapacity, and that credit should supply the 'real economy's needs'.

Ultimately, it is clear that there is sufficient liquidity in the system, but the central bank wishes to curb some of the recent excesses. This fits with the pattern of recent months with loan growth slowing while deposit growth improves as banks look to improve their funding sources.

China banking sector loan & deposit growth

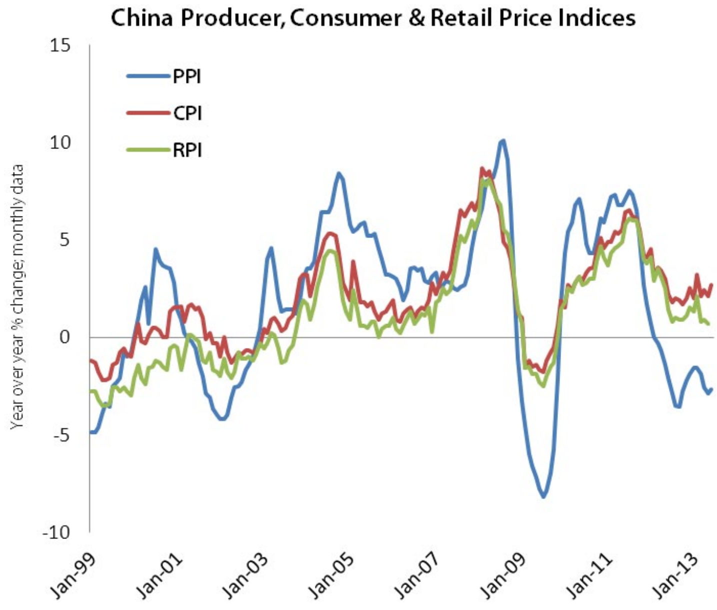


Source: National Bureau of Statistics, Bloomberg

Chinese inflation remains well under control, and there is little sign of risk, despite a slight rise in CPI and PPI growth in June. These are consistent with relatively subdued economic activity, and there are indications of building inventories in some industries, such as coal.

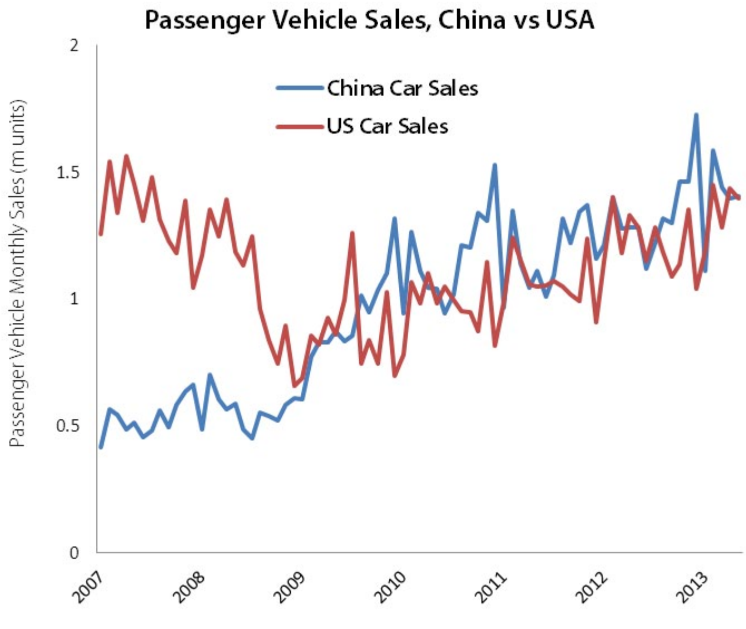
There has been some pick-up in underlying food prices, with a monthly increase in wholesale pork prices of 3.62%, while similar increases have also been seen in prices of chicken and duck. Cabbage prices have also increased slightly over the last month, although both cooking oil and rice prices were flat.

In June, the National Development and Reform Commission (NDRC) announced a significant change to the pricing of natural gas prices with a price increase of 24% on non-residential sectors, and an expansion of the net-back pricing mechanism. Given relatively low usage of natural gas, this should not have a significant impact on CPI growth. However, it should provide some encouragement to natural gas suppliers to extend their exploration and production investment and further increase domestic gas supplies.



Source: National Bureau of Statistics, Bloomberg

Passenger vehicle sales in China impressed again in June, reaching 1.40 million units, marginally ahead of sales in the US of 1.39 million units. Car sales continue to be a bright spot in an otherwise slowing retail environment, with overall retail sales growing 13.0% year over year in June. The sales growth of commercial vehicles and trucks was faster than overall passenger vehicle sales, and luxury and sports utility vehicles grew slightly faster than basic passenger vehicles.



Source: China Automotive Information Net, Bloomberg

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.

Consumer Price Index (CPI) is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care.

Producer Price Index (PPI) is a family of indexes that measures the average change in selling prices received by domestic producers of goods and services over time.

Retail Price Index (RPI) is a measure of consumer inflation produced by the United Kingdom's Office for National Statistics.

Ho Chi Minh Stock Index, or The Vietnam Stock Index or VN-Index, is a capitalization-weighted index of all the companies listed on the Ho Chi Minh City Stock Exchange.

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