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Asia brief

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**Commentary and Review by portfolio managers Edmund Harriss and James Weir**

*Cambodia's recent national Assembly elections offer hope that the country may be able to achieve a peaceful political transition in the coming years. The country's political turmoil has held it back behind its neighbors, but tourism and garment assembly are driving an acceleration in economic output growth. However, Cambodia is at risk from inflation through imported petroleum, and its youthful population will want to see improving GDP per capita feeding through into higher living standards, rather than a higher hydrocarbon bill.*

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The progressive opening up of hitherto closed South East Asian nations is creating opportunities for foreign investment. Although neighbors, such as Thailand and Vietnam, have moved down the path to development, Cambodia has remained resolutely stuck in the late 20th century, but now the country is starting to open up. Cambodia suffered more than its local peers following the end of the Vietnam War, when in 1975 the Khmer Rouge, an offshoot of the Vietnamese Communist movement, came to power.

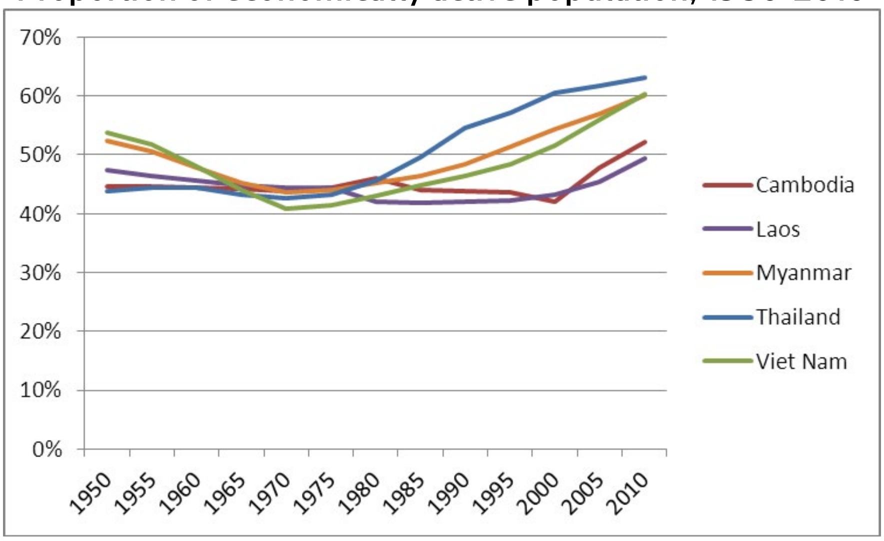
Between 1975 and 1979 the Khmer Rouge enforced a brutal policy of social engineering based on self-sufficiency which led to famine and widespread suffering across the nation. Although the Khmer Rouge's rein ended in 1979 as a result of a Vietnamese invasion, the group remained influential as an armed resistance movement until Pol Pot's death in 1998. The period from 1975 until Pol Pot's death has left lasting scars on the country and in economic terms, the country has missed out on the long period of growth enjoyed by much of the rest of Asia from the 1980s onwards.

In 1993 the political situation began to stabilize with the restoration of the monarchy to Cambodia and the introduction of a new constitution based on parliamentary democracy. The ruling party since 1985 are the Cambodian People's Party (CPP), which is a socialist party led by Hun Sen. Although the structure of politics in Cambodia is better than it has been in recent decades, Hun Sen is a former Khmer Rouge commander with close links to Vietnam. Despite this, Cambodia has been stable for some years, and National Assembly elections are held every 5 years, with the most recent on July 28, 2013.

The official results of the election suggest that the CPP won 68 of the 123 seats available, while the leading opposition party, the Cambodian National Rescue Party (CNRP) won 55 seats. Independent observers have expressed doubts about the results of these elections and Hun Sen has said that the National Election Committee will look into reports of irregularities. Although the opposition has claimed that it in fact won more seats, the fact that it now controls 40% of the National Assembly offers hope that they will be able to form a government in the future and a peaceful transition of power is possible in Cambodia.

Although Cambodia is a relatively small country with a population of just over 14 million, according to the World Bank, its demographics are very much in its favor. Even at 2010, only 52% of Cambodia's population were participants in the workforce, well below most of its neighbors such as Vietnam (60%), Thailand (63%) or Myanmar (60%). This compares very favorably with regional peers, such as China (65%) or South Korea (65%), which are already beginning to face the pain of aging populations. The experience of the rest of Asia is that nations with low labor force participation and young populations can achieve sustained real GDP growth, given the right structural conditions.

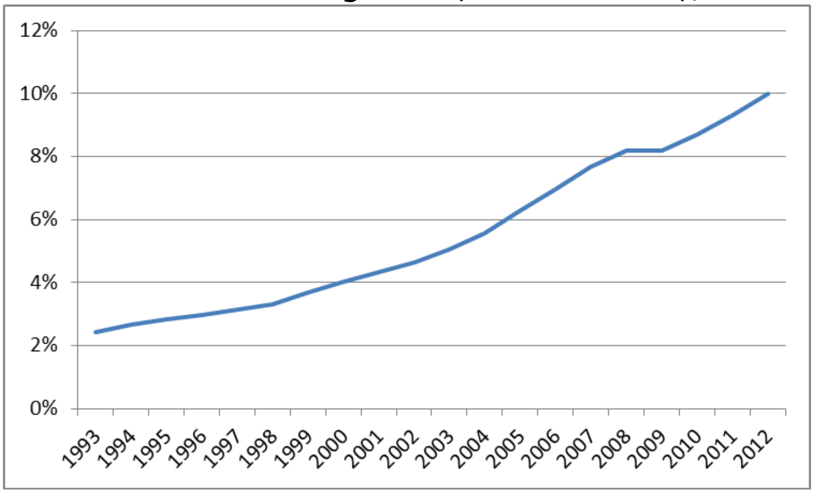
**Proportion of economically active population, 1950-2010**




Source: United Nations, Department of Economic and Social Affairs. Data are total dependency ratios (<19 and >65 aged / 20-64 aged population)

Setting politics aside, the economy of Cambodia has been growing quickly in recent years, reaching 9.98% in real terms for 2012. It is difficult to see how Cambodia could achieve such acceleration in GDP growth over the next 19 years, but at least this illustrates that relative political stability has had an economic payoff for Cambodia. This has been achieved so far with manageable levels of inflation, with the year over year change in the consumer price index reaching 2.54% in 2012.

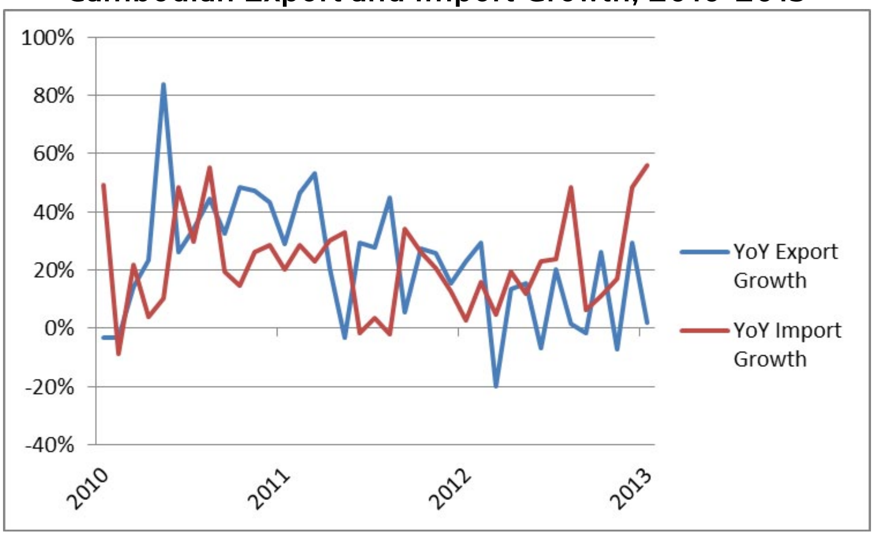
**Cambodian annual real GDP growth (Year over Year), 1993 to 2012**




Source: World Bank, Bloomberg

International trade has been a major driver of development for Cambodia, with both imports and exports growing quickly in recent years. Contrary to the experience in other developing Asian nations, imports have grown quicker than exports, with petrol as the largest single import item, by value. This is of some concern for Cambodia's future, as despite a number of basins identified as being capable of holding hydrocarbons, relatively little exploration work has so far taken place. Smaller developing nations tend to be relatively heavy users of hydrocarbons, and a shortage of refined fuels can quickly lead to inflationary pressures, as has been the case in Malaysia, Indonesia and Vietnam.

**Cambodian Export and Import Growth, 2010-2013**




Source: National Bank of Cambodia

Tourism is a vital foreign currency earner for Cambodia, and the government recognizes that social stability is important to keep this revenue stream going. The government has allowed foreign investment in this sector, with, for example, a major license being awarded to a Malaysian consortium to develop a casino in the center of Phnom Penh. The temples of Angkor Wat are also a big selling point for the country with an estimated 640,000 visitors every three months. The country's major export earner is textiles, accounting for 82% of exports by value in February 2013. The growth driver for textile exports was the removal of the Multi-fibre agreement in 2004, which allowed for quota-free access to the US and European Union. Cambodia is distinct from other textile producers in the region given it generally uses imported cloth, and is principally a final assembly location.

The final piece of the puzzle for Cambodia is improving its GDP per capita to ensure that the work and ambitions of its youthful population are rewarded with material improvements. According to the World Bank, Cambodia's 2012 GDP per capita was a mere $946 in constant US Dollars, ranking the nation alongside Chad ($885), or Kenya ($862), and well behind neighbors Vietnam ($1596) and Thailand ($5474). This represents a risk to the political stability which has finally allowed Cambodia to thrive. The key may be replacing imported petroleum with domestically produced and refined hydrocarbons, as this imported energy could lead to inflation as the economy grows. For a developing nation, allowing inflation to eat away at improvements in income tends to be regressive and the alternative of energy subsidies can be a huge drag on the government's finances.

## Market Review

### Market Performance Ending July 31st, 2013

| | July 2013 | Year to date | 2012 | 2011 | 2010 | 2009 |
|---|---|---|---|---|---|---|
| Australia | 3.06% | -3.51% | 22.25% | -10.77% | 14.69% | 73.87% |
| China | 4.04% | -7.34% | 22.69% | -18.36% | 4.59% | 62.06% |
| Hong Kong | 4.15% | 2.89% | 28.26% | -15.78% | 23.28% | 60.48% |
| Indonesia | -6.64% | -0.98% | 6.11% | 5.19% | 35.47% | 136.12% |
| Korea | 3.59% | -10.84% | 20.99% | -13.55% | 25.84% | 74.44% |
| Malaysia | -2.34% | 2.20% | 14.54% | 0.11% | 37.67% | 51.26% |
| New Zealand | 3.09% | 2.40% | 31.54% | 5.90% | 8.73% | 49.89% |
| Philippines | 2.07% | 11.17% | 47.52% | 0.04% | 35.24% | 67.34% |
| Singapore | 3.67% | -0.37% | 30.98% | -17.54% | 22.03% | 73.18% |
| Taiwan | 0.89% | 2.39% | 17.43% | -20.18% | 23.14% | 80.23% |
| Thailand | -2.76% | -2.35% | 35.01% | -2.72% | 56.67% | 76.59% |
| MSCI AC Far East Free ex Japan | 2.31% | -3.28% | 22.06% | -14.75% | 19.41% | 68.56% |
| MSCI AC Pacific ex Japan * | 2.45% | -3.12% | 22.72% | -13.59% | 17.95% | 71.51% |

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

There was a good bounce in Asian equities in July, and it was evident that investors were beginning to turn more positive on China and Hong Kong. These were the best-performing markets over the month, and investors seemed to appreciate the positive policy moves from the Chinese administration in recent weeks. There seems to be an official recognition that Chinese economic growth must not be allowed to fall below 7% in real terms, and the government is now taking tangible steps to ensure this. There have also been concerns about the ability of the Chinese economy to continue creating new jobs, as this is important for social stability in the country.

In response to these issues, the Chinese State Council has removed operating and value-added taxes on the 6 million companies in China with monthly sales up to CNY 20,000 (USD 3,250). The National Development and Reform Commission (NDRC) will also extend a pilot programme to improve access to capital for small firms using collective corporate bonds. There was also a guarantee of funds for railway construction.

The worst-performing markets in July were in South Asia, with Indonesia, Thailand and Malaysia falling the most. Economic growth is beginning to moderate in Indonesia, and in the second quarter it fell to 5.81% year on year in real terms, which is the first time it has fallen below 6% since 2010. The on-going weakness in seaborne coal prices is weighing on Indonesian export earnings, while spot wholesale rice prices rose 1.2% month on month in June. This is also reflected in rising inflation across the economy, with the overall Indonesian consumer price index up 8.61% year over year in July.

Thailand's equity market underperformance last month was more as a result of politics than economics, with the economy remaining on track. The royalist yellow faction mobilized street protests in recent weeks in response to an amnesty bill currently being debated in the Thai parliament.

The ‘yellow shirts’ are concerned that although the bill is aimed at low-level political activists, once enacted it could allow former Prime Minister Thaksin Shinawatra to return to the country a free man, and potentially re-take power.

**Major Indices total returns for the five years ending July 31, 2013**

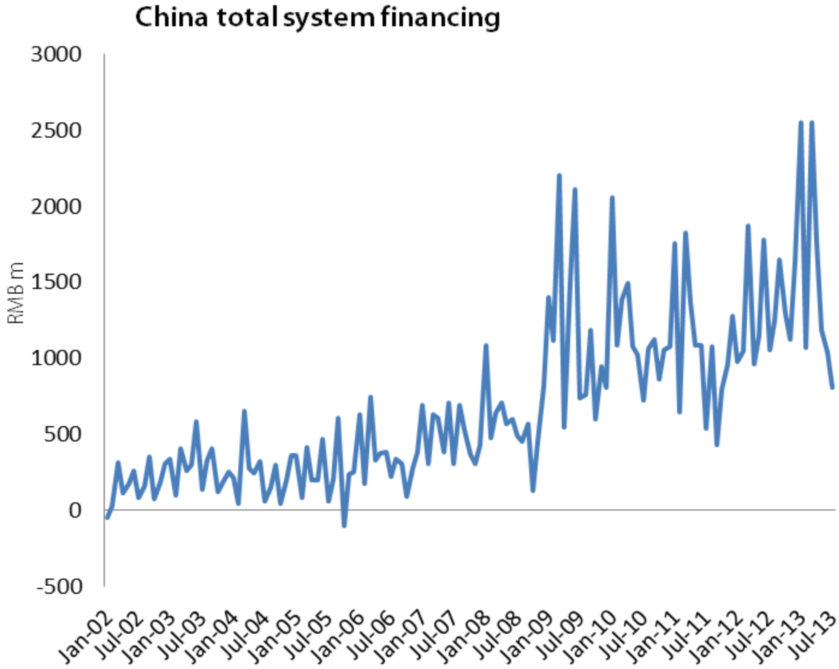

Source: Guinness Atkinson, Bloomberg

## China Economic Monitor

The new leadership in China, in contrast to their predecessors, has clearly decided to take action on economic rebalancing, overcapacity, excess credit growth and over-investment. Possibly the most important is excess credit growth. There is more than enough credit available in China, but under the current structure of majority state-owned banks and majority state-owned heavy industry, credit flows disproportionately toward the state-owned industrial sectors while the more dynamic small and medium enterprises are starved.

The chart below shows the absolute quantity of total system credit month by month. The change in tempo pre- and post-crisis is clearly visible. The aim in 2009 was to provide a wave of liquidity to support investment spending. Efforts since then to rein back credit growth have not been successful as banks have used non-bank lending to extend credit, so-called shadow banking. The lack of success in slowing shadow banking activities has less to do with banks' deviousness and more to do with a lack of effort on the part of the authorities. So long as the central bank kept pumping in liquidity into the short term money markets the banks could continue quite happily.

In June this changed when the expected liquidity injection from the Central bank did not happen. Panic ensued in the short term money markets, though it did not spill over into the real economy, and for ten days or so banks were given a painful lesson in the need to manage their own liquidity needs and to take more care. The result has been a slowdown in credit growth on the shadow banking side, most notably in foreign currency lending, corporate bond issuance, bank acceptances and trust loans (mostly to real estate).



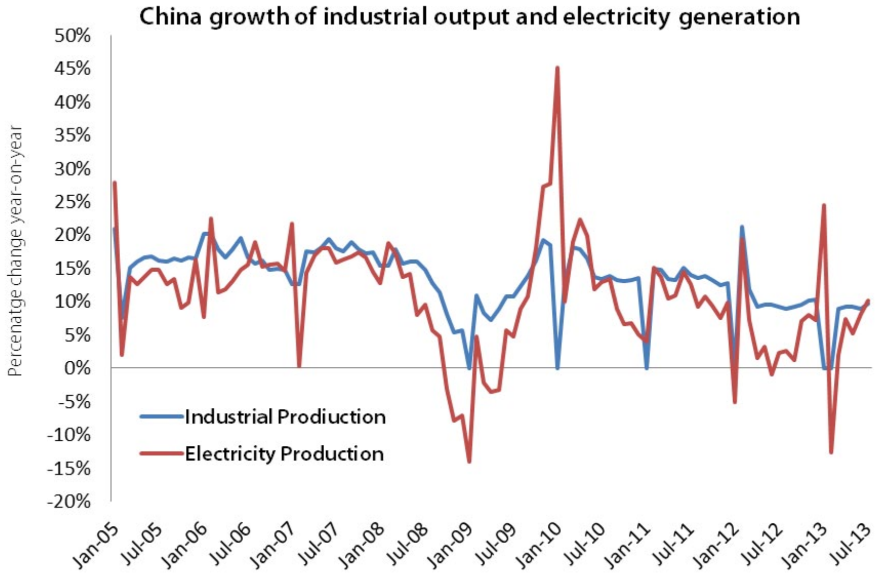

Source: National Bureau of Statistics, Bloomberg

The efforts to slow down and re-direct credit to more productive areas has caused overall growth to decelerate. The main source of this slow-down has been in investment especially by local governments who are largely responsible for much infrastructure as well as real estate spending. As many have argued, a material proportion of this investment is unnecessary and will not generate returns. This element of growth was therefore unprofitable growth its absence should not be mourned. That is not how markets have taken it, however.

China stocks look very very cheap. The markets have viewed China's slowing economic growth with concern with comparisons to Japan in the 1990s being made with increasing frequency. However, such comparisons are premature. China's economy wants to grow and it is China's policy settings that restrain it. Income growth is still running at 12%-15% in the cities and higher than that in rural areas. Urbanization growth is still a goal and this can be a significant long term growth driver coupled as it is with a complementary goal to boost services from 41% of GDP to 47% by 2015.

There are signs in the latest data that economic growth is stabilizing:


Source: National Bureau of Statistics, Bloomberg




Source: National Bureau of Statistics, Bloomberg


Source: National Bureau of Statistics, Bloomberg

Chinese stocks traded both in China and outside have been given a lift by the recent economic figures. We shall examine the recent policy trends and the possible impact on sectors and stocks in next month's Asia Brief.

Commentary for our views on Alternative Energy and Energy markets is available on our website. Please click here to view.

**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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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.

One 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.

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