GUINNESS ATKINSON FUNDS

Asia brief

Edmund Harriss

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Commentary and Review by Portfolio Manager Edmund Harriss

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A wave of pessimism has settled over China investing in the past few months. We argue that China's growth looks to have stabilized at around 7.5% and is starting to enjoy a cyclical recovery. That recovery will likely be mild because that is what is required to form a platform on which to enact the reforms that are required which will directly address the warnings of the bears – debt, pollution, corruption and stagnation. As we indicate below, these are concerns that the government are acting upon now. The warnings come amidst advice that changes need to be made and soon. They may well come faster than people think. If China can deleverage and rebalance while at the same time defending a 7% growth rate 'floor' we'd take that, wouldn't we?

The resolve of China investors has been sorely tested over the last couple of years. Economic growth which previously was running hot and sparking concerns has now slowed significantly, sparking concerns. The consensus if you read the papers is that the Chinese have made an almighty mess of things, and the consensus in the markets is that perhaps the newspapers are right. The subject of China is one that provokes passionate debate – world economic domination versus ignominious collapse and stagnation. Who's right? Neither probably. And are investors right to be so chilled on China, as stock valuations suggest they have become, or should they just chill?

That glib remark notwithstanding, there are of course serious issues that China needs to address to sustain their economic rise, but it is also quite possible that in China's case an over-pessimistic view dominates, just as in the past an over-optimistic view prevails. The situation today appears to show an economy whose growth rate has stabilized and a stock market that looks very cheap. The question remains over whether this stabilization marks a pause, a turning point or a sustainable rate of growth.

A welcome recovery

Economic stabilization seen in July and August appears to be reasonably broad-based. The official data for China's Purchasing Managers Indices, which are weighted toward heavy industry, point to expansion as do those of the HSBC/Markit survey which have a bias toward export manufacturers. Both surveys indicate an expansion both in output and in new orders. Other official Chinese data series such as industrial production, investment and retail sales also point to stabilization or faster growth.

There is justifiable skepticism shown by many toward official economic data. Even the current Chinese Premier Li Keqiang was said to have admitted to the US ambassador in 2007 that the GDP data for Liaoning province was unreliable and his preference was to look at rail cargo volume, electricity consumption and bank loans as a more useful measure of activity. On these measures nationally, rail cargo volumes just returned to growth of 0.6%, electricity consumption grew 8.6% (the fastest rate for eighteen months) and bank lending was steady at 14.3%. Another measure of activity is to look at industrial production by looking at volumes of individual industrial products. Credit Suisse has constructed an Industrial Production monitor using 13 industrial products in four categories – automobiles, electronics, power generation and energy/chemicals/materials. These point to an overall recovery with the biggest changes in electronics and electric power generation supported by a mild pick up in energy/chemicals/materials.

There are other signs that conditions in China are not so bad. Steel production has been pushing record levels as have imports of iron ore. These appear to be underpinned by better end-user demand than was expected. Social housing is perhaps the biggest reason with over 4 million units due to be completed this year, and a further 6 million to start construction. Infrastructure spending which has been slower than in recent years appears to be accelerating.

Following a government meeting at the end of July we learned that six new areas of urban infrastructure including urban rail, water and sewage are to be a focus; the target for railroad investment in 2013 was lifted to RMB 690bn ($113 bn). We can see this following through at ground level. Cement prices are stable and beginning to rise again as rural and urban projects are getting underway. A recent meeting with West China Cement indicated too that local governments were paying their bills again – they were not because they had not received money from Beijing. This money has started to flow once again because now projects are to re-start.

While the investment climate in China has been subdued, consumer confidence has been and remains relatively robust. There are no encompassing confidence surveys, but we can look at spending on discretionary items such as cars or on technology-related items such as smartphones and we see that foreign brand car sales such as BMW and Ford as well as domestic marques, especially SUVs have held up well. On the technology side Lenovo continues to grow market share and margins in spite of slowing PC sales while online gaming businesses like NetEase also reported better than expected earnings. Macau's gaming revenues are viewed as highly sensitive to changes in domestic Chinese confidence yet these too have held up this year and latest data are ahead of expectations.

Macro-data, government policy announcements and corporate contacts all point to better economic conditions now which are likely to follow through in the months ahead. At the same time, we also need to recognize that not all sectors will benefit evenly. The real estate market is still problematic and government policy lacks clarity. The chief executive of SOHO China has called for a clear statement of position from the government without which she is unwilling to commit to significant new investment.

Finally, company results in the domestic A share market for the first half of the year are also encouraging. The last three quarters have reported earnings growth of over 12% with resilient net and operating margins, following four quarters of contraction since 4Q 2011. Operating cash flow improved but in a sign that conditions are still mixed, working capital grew faster than sales and capital expenditure was lower by about 7% compared to the same period last year. It would appear that those companies that rely on scale/operating leverage found the conditions most onerous, while those that do not flourished.

The message for investors right now is that economic momentum has returned. The government has set a floor rate of 7% growth and target for this year of 7.5%. Market forecasters are revising up their growth estimates, and with stock market valuations still beaten down in the current mood of pessimism Chinese stocks look cheap especially in the energy materials and industrials sectors.

Longer term – food for Bears

The longer term challenges are what make it easy to construct a bear case for China and they are indeed daunting. The solutions to these issues mean that a strong rebound in economic growth is unlikely. Strong rebounds in growth in the past have been associated by renewed investment fuelled by credit expansion, and this is precisely what the government seeks to avoid. The issues now are to address the immediate problems of high levels of debt, excess capacity in certain regions and sectors and to rebalance the economy away from its dependence on investment to a more self-sustaining model of higher value-added manufacturing, services and consumption.

Debt

The debt burden in China has reached around 200% of GDP with the bulk of it in the local government and corporate sectors. The major concern is not the absolute level but the rate of accumulation. Nevertheless, the government has commissioned a new nationwide debt audit which should be an advance on that of 2010, not least because following the change of leadership some 70% of senior public officials have changed posts so unattractive numbers can be disclosed safe in the knowledge that the previous incumbent can be blamed, just like our politicians do.

The solution to the debt issue however it is presented is to deleverage. The way in which this happens will have a big impact on China's future prospects and forms the basis for the argument that China's collapse is all but inevitable. There is the scope for missteps but before we all agree that China's officials have 'blown it' we might just note the following: China is tackling the leverage problem before a crisis occurs rather than creating one and then responding (i.e. Lehman Brothers followed by trillions of dollars in bailouts); and they are tackling it gradually by slowing growth from over 10% and then working to stabilize growth at 7.5%. Now that growth has stabilized, we expect to see reforms come through and possibly quite quickly.

Financial system

The financial system as it stands is not fit to support China's transformation into a high income economy. Even with the recent deregulation of lending rates the banks have stuck close to the benchmarks. Of total bank loans HSBC estimates that 65% are priced above the benchmark, 24% at benchmark and only 11% below the benchmark. So there's not much sign of competition there. Furthermore, those that are above the benchmark are still fairly close to it and there appears to be little pricing for risk. Risk is more often determined by reference to the identity of borrower rather than the purpose of loan. A deregulation of deposit rates is essential because it will be a market-based mechanism for pricing deposits that will determine the cost of bank funds which will in turn drive lending rates and ultimately capital allocation.

However, the banks are not yet ready for this de-regulation. They have come to rely on interbank funding to fund their marginal lending and have assumed that the government will always be there for them. They were disabused of this in June when the Central Bank decided not to inject liquidity ahead of the quarter end that prompted a scramble for short term funds causing money market interest rates to spike and giving some sleepless nights to bank executives. Moral hazard is also evident amongst depositors.

In the competition for deposits (not permitted for straightforward deposits under the current framework) banks have been packaging loans and selling them as Wealth Management Products. A recent survey by Credit Suisse is instructive here. The total balance of these products in June was RMB 9.08 trillion ($1.48 trillion). (Total bank deposits in June stood at RMB 100.9 trillion – $16.49 trillion). The bulk of these are sold by banks and there are some restrictions on how these are invested and to whom they can be sold. But importantly, 57% of those who bought one of these products in June had no idea what were the underlying investments. 35% claimed to know a bit while only 3% were confident. And of course the reason most don't know is because they don't care. And they don't care because the majority (94%) believe banks should help out in the event of a default – 68% think banks should help recover losses while 26% think banks should simply pay them back as though they were deposits.

A similar picture is also evident in the corporate bond market where bond defaults are made good by the banks, and while coupon rates distinguish between issuers they do not adequately reflect variations in credit quality. Ultimately, the financial system – banks, depositors, credit markets - allocate and price capital on the implicit understanding that the government will step in if times get tough. This is a major obstacle to overcome without causing a panic, to achieve the goal of a market-based financial system. The recent liquidity squeeze was a step in that direction as was the liberation of lending rates. The de-regulation of deposit rates, the opening of the capital account and further loosening of the exchange rate are all to come and may well come faster than people expect. For investors, this warrants caution on the banks because it is they that will be squeezed by de-regulation, disintermediation and intensified competition.

Industry

The industrial base is currently being given an overhaul. The first problem is one of excess capacity and inefficient production facilities that are accompanied by environmental problems, wastage of resources, low profitability and economic disruption through pricing. At the end of July a government statement specified nineteen industries including steel, aluminum, copper smelting, paper and cement where excess capacity needs to be cut. In contrast to earlier efforts, deadlines have been set and individual production lines within factories have been identified. We should not oversell this because the identified tonnage is still small. 92 million tonnes of cement capacity compared to China's overall output of 2.2 billion tonnes is not going to shake the market but the specificity on timing and equipment is new.

There are also moves in industrial policy to improve the quality of production. Cement makers talk of higher investment in waste heat recycling units to reduce their coal consumption while coal miners are spending more on mine safety and environmental issues. This comes against a backdrop of an overall drive to improve energy efficiency and reduce consumption. National aims are to cap cola consumption at 4 bn tonnes by 2015 (versus ~3.3 bn tonnes today) and energy consumption per unit of GDP to be cut by 16% from 2010 levels. At a city level Beijing just announced its aim to cut annual average PM2.5 particulate concentration by 25% in 2017 from 2012. Given the appalling smog that has covered Beijing this year, this seems to be a sensible aim. As a practical matter this calls for the building of 11 gas-fired electricity plants and to almost eliminate coal consumption anywhere within the fourth ring road. For investors, providers of energy efficient equipment and environmental services look like good places to be. Other companies are going to see increased costs from investment or relocation.

Consumption

The effort to increase consumption is a subject we have tackled before so we will not do so again extensively here. In brief, plans for increased urbanization are designed to help raise incomes. However, significant administrative changes are required to the system of individual registration, the Hu Kou system, which determines individuals' entitlements to healthcare, education and pension. Greater flexibility is required to encourage flexibility in the labor market but such a change implies increased costs to those administrations where labor is moving, hence the opposition to this change at a local government level.

Graft

Graft and corruption is another area that many have focused on inside and outside China. There are serious efforts being made here both to cut down on the 'entertainment' of government officials as well as taking on high profile cases of out and out corruption. The oil industry is currently under the spotlight and given its historical importance is yet another sign of governmental determination.

Conclusion

The conclusion I think for investors is that China is undergoing yet another series of economic changes necessary to give China a shot at moving into the realm of a high income economy. Demographic and institutional structures are weighed against them and it is therefore not hard to construct an ultra-bearish argument. As we have said before, what is not included in the econometric models is the will and determination to make the changes. The results of the past thirty years are testament to that – no econometric model in 1983 would have put China where it is today.

In the short term, China's economy is experiencing a cyclical recovery. A rebound would be too strong a word because that is not what is wanted. A base of steady growth on which to enact the reforms required is what is needed. The bears anticipate crisis in China at a volume that was notably absent in the developed economies right up to the global financial crisis. The flipside of that argument is to observe that anticipation of crisis does not mean there is one, and that action is being taken to try and prevent one. This will put a break on any sharp acceleration of growth but should not prevent a gradual recovery which we see continuing for the rest of this year and into next. Stocks are cheap and investors should not allow themselves to be browbeaten by the bears, or the perennial bulls!

Market Review

Market Performance Ending August 31, 2013

	August 2013	Year to date	2012	2011	2010	2009
Australia	1.66%	-1.91%	22.25%	-10.77%	14.69%	73.87%
China	2.41%	-5.1%	22.69%	-18.36%	4.59%	62.06%
Hong Kong	-1.28%	1.57%	28.26%	-15.78%	23.28%	60.48%
Indonesia	-18.23%	-19.03%	6.11%	5.19%	35.47%	136.12%
Korea	3.93%	-7.31%	20.99%	-13.55%	25.84%	74.44%
Malaysia	-4.28%	-2.18%	14.54%	0.11%	37.67%	51.26%
New Zealand	-1.73%	0.67%	31.54%	5.90%	8.73%	49.89%
Philippines	-11.36%	-14.46%	47.52%	0.04%	35.24%	67.34%
Singapore	-5.23%	-5.19%	30.98%	-17.54%	22.03%	73.18%
Taiwan	-0.12%	2.24%	17.43%	-20.18%	23.14%	80.23%
Thailand	-10.86%	-12.98%	35.01%	-2.72%	56.67%	76.59%
MSCI AC Far East Free ex Japan	-0.65%	-3.98%	22.06%	-14.75%	19.41%	68.56%
MSCI AC Pacific ex Japan *	0.03%	-3.08%	22.72%	-13.59%	17.95%	71.51%

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

Economic Monitor

The biggest event market event in August has been the sell-off in the ASEAN (Association of South East Asian Nations) markets namely, Indonesia, Malaysia, the Philippines, Singapore and Thailand. Singapore and Malaysia are the biggest markets and broader based while of the smaller markets, Thailand is the most liquid and has suffered outflows on the back of a more general ASEAN sell-off. The withdrawal from these markets has in part been triggered by declining risk appetite but there are also market concerns.

Indonesia's economy for example, has grown strongly in the past two years and has attracted substantial foreign inflows (relative to its size) into both the stock and debt markets. However, in recent months inflationary pressures have built, the current account deficit has widened, most recently to 4.4% of GDP and as money has left the currency has weakened and foreign reserves have dropped by $12.5 billion in the last two months to $92 billion. Investors await central bank moves to raise interest rates to stabilize the currency.

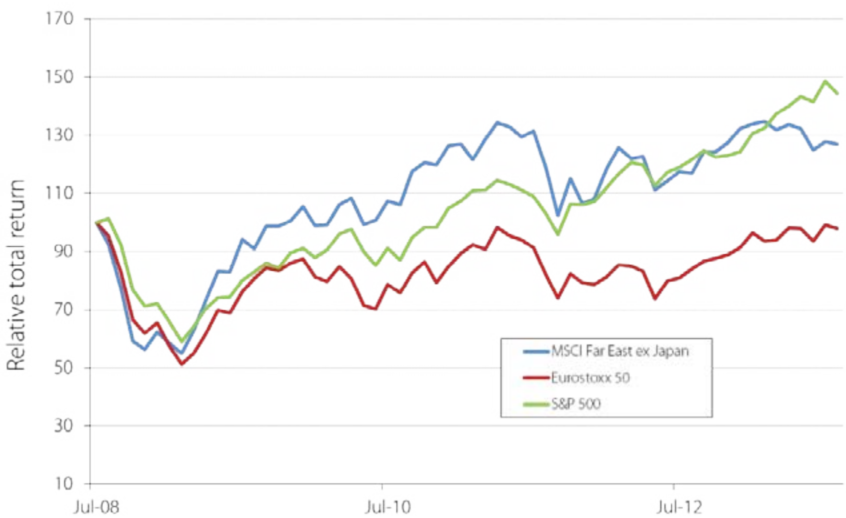
Singapore and Malaysia have their own issues. In Singapore, tougher rules on immigration are part of efforts to move from a labor-led to a productivity-led economy. The effect in the short term is to push wage costs higher. Also in Singapore, the government has imposed measures to cool the residential real estate market. While there was welcome news from an upward revision in official forecast for GDP growth to a range 2.5%-3% for this year, the drivers of this are amongst unlisted firms, especially biotech. Malaysia's economy is looking increasingly sluggish too with high household debt requiring 45% of household income required for debt servicing, a budget deficit of 5.3% that is proving sticky and falling export earnings which halved the current account surplus in the first quarter of the year.

Nevertheless, these macro data and consequent market sentiment have not yet been reflected on the ground. While Indonesia does indeed look less attractive growth in the Philippines is well supported by outsourcing and foreign remittances. The economy there reportedly grew 7.5% year on year in the second quarter. In Thailand too it seems that it is business as usual. Banks and real estate have sold off heavily but underlying operations still look fine and it appears that the combination of a macro-call to sell ASEAN combined with the fact that Thailand had a heavier weighting in the allocation in the first place, explains the market fall. We see opportunities in these markets.

In South Korea, the recent reporting season was not terribly bright overall with net profits missing estimates by 8% although this was an improvement on the first quarter. The strongest areas were technology while auto makers had a very strong second quarter on record volumes leaving them flat at the half year stage compared to the same period last year. Refiners, construction companies and shipbuilders were the weakest areas and banks too were below expectations on higher provisioning costs against bad debt.

In Taiwan, earnings forecasts are also coming down. In contrast to South Korea, the technology sector did less well. The difference lies in the relative exposure to consumer products such as smartphones, tablets and displays versus computers and components. TSMC for example did well with much of its foundry volumes going into the consumer products. The intense competition in the smartphone sector and the rapid shifts are evident in the weakness shown by HTC which has recently lost ground to Apple and Samsung. Largan, a lens maker, is enjoying rapid growth as smartphone and tablet cameras continue to improve.

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



Source: Guinness Atkinson, Bloomberg

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