GUINNESS ATKINSON FUNDS

Asia brief

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Commentary and Review by Portfolio Manager Edmund Harriss

China recorded some decent economic numbers last month that point to stable growth. We believe this gives greater confidence to the leadership ahead of the big Party meeting in November where the government is expected to give its roadmap for reform over the next few years. For investors, there is dynamism of China's developed economy to set against the burdens of development in the poorer regions. Concerns about the pace of economic transition and aggregation of debt have kept China stocks at modest multiples. But we believe this market still remains a structurally attractive one over the long term.

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Over the past month we have seen China's economic momentum continue. Industrial production rose 10.4% year over year, fixed asset investment was up 24%, retail sales up 13%, exports up 7% and industrial profits up 24%. All this is welcome after a longish period of decelerating growth. Market forecasters certainly appear to be more comfortable although having revised down growth estimates fairly significantly in April/May and then revised them up again in July/August, we'll leave it to you the reader to decide how much weight to attach to that.

For those less interested in the twists and turns of the data month by month we would remind you of the government's aims in coming years: for economic growth in 2013 of 7.5% and to maintain a floor around 7%; to effect an economic transition away from investment toward increased consumption; to reduce energy consumption per unit of growth and cut pollution and to open up the financial system. These are big tasks and China's approach leaves some unimpressed.

The Wall Street Journal greeted the launch of the new free trade zone in Shanghai, The China (Shanghai) Pilot Free Trade Zone, thus:

> BEIJING—A day after Chinese officials opened a free-trade zone in Shanghai that they said was a milestone for economic change, the government announced nearly 200 restrictions on foreign investment, which could make the venture far less attractive to global companies. (WSJ Sept 30, 2013)

Balanced overall but sniffy in tone, the article leaves the reader with the sense that this lacks substance. But China's gradualist approach has always begun with 'pilot' schemes. The Special Economic Zone in Shenzhen was a pilot scheme established in 1980 but opened up to foreign involvement from 1992. China is now the world's largest exporter and importer of goods with a value of over $3.8 trillion.

A more recent example of a pilot scheme was the one established in 2009 based in five cities to allow trade settlement denominated in renminbi (RMB). This scheme appeared to work and so in June 2010 the scheme was expanded to 20 provinces. This underpinned the launch of the offshore renminbi market which went from next to nothing in 2010 to trading around $5-6 billion per day and an offshore bond market that grew from $6 billion in size in 2010 to $50 billion today (October 2013). In March 2012 the scheme was deemed as success and trade settlement in RMB can be used by any firm in the country.

The two most recent schemes are the Qianhai-Shenzhen Hong Kong Modern Service Industry Co-operation Zone and the Shanghai Free Trade Zone. The Qianhai Scheme is designed to focus on services and financial reforms with respect to international trade and international currency usage. It covers onshore/offshore lending and currency movements. The Shanghai Scheme is more extensive in its scope. While there is a list of 200 restricted sectors (which will be revised next year) we also point out that still leaves over 800 sectors that are permitted. The aim here again is de-regulation and reducing bureaucratic interference. Not all bureaucrats like this because it represents a diminution of power and influence – and it is this above all else that represents the biggest obstacle to China's reforms.

What to look out for coming up in China

- Macro level events

The Chinese government recently commissioned a nationwide audit of local government debt that seeks to be more comprehensive than that conducted in 2010. The suggestion both inside and outside China is that debt levels are higher than current official estimates. The new government has sought to address with the latest audit and numbers trailed in the past week suggest double the previous estimate. The market is now expecting a number of RMB18-20 trillion ($3-3.5 trillion) or 32%-38% of GDP.

The aggregate number is one thing but it is the location of that debt, the channels and who is exposed that will provide the information on how to address the problem. Not all the debt will be bad and for those debts that are, we need to consider recovery rates and collateral values before reaching conclusions about write-offs. Recovery rates during the toughest period of bank restructurings in the late 1990s ended up around 40% and the situation today is not believed to anything like as severe.

The **3rd Plenary Session of the 18th Party Congress** will take place in November. Far reaching economic reforms are expected by some. Don't expect them, not at the meeting in any case. This type of meeting happens once every ten years and is the time when the government sets out its stall for the coming ten years. We look for a government roadmap; evidence that they are ready to address the pressing issues. We expect to see commitments to social, financial, environmental, energy and administrative reforms as well as urbanization. But we do not expect to see details. The nationwide debt audit and the early warnings as to the scale of the issue are likely an effort to build a consensus ahead of the plenum to address this. And this will mean taking on local government vested interests and as we pointed out earlier, this is a substantial obstacle.

- Micro level events

These are the areas where investors may need to focus if they are to identify opportunities. For example, the overarching commitment to energy and environmental reform has taken shape recently with announcements relating to policies on air quality in tier 1 cities first and then nationally. To achieve this, coal consumption will likely be capped and natural gas consumption encouraged. The mechanism governing the pricing of gas is moving in stages toward wholly market based so that by the year after next the wholesale price of gas will likely be linked to the price of crude oil at the Shanghai hub.

Knowing this, we are seeing more investment in the transportation and transmission of gas from inland china into the cities. The market for compressed natural gas vehicles is also taking shape. Today around 8 billion cubic meters of gas is used to power a fleet of 1 million vehicles. The aim is to take this to 20bn cubic meters of gas by 2020 which implies a vehicle fleet of 3.5 million vehicles or 17% growth a year on average. For investors, opportunities lie in gas transmission, transmission equipment and vehicle makers.

The commitment to environmental improvements can also be seen in the emphasis on gas fired electricity generation. There is also a requirement for truck makers to adopt the Euro IV standard for engines – gasoline powered this year and diesel fuelled in 2014. For diesel trucks this will reduce carbon monoxide emissions by 22% and particulate matter by 50%. This move is expected to add 9%-10% to the purchase price of a heavy duty truck. For those converting their trucks to compressed natural gas fuel, the payback period at current prices is 9.6 months.

Policies relating to urbanization and social reforms take shape in construction and redevelopment of social housing. The program still calls for some 10 million units a year for the next 2-3 years and has positive implications for constructors as well as suppliers of building materials. This does not equate to a call to buy real estate developers who are mostly concentrated in the private market, and this area is still overshadowed by efforts to limit rising property prices in the private sector.

Administrative reforms including that to the urban registration system which governs access to welfare, pensions and education are what will likely underpin the urbanization program that seeks to increase consumption and the growth of service industries. The growth in the middle class segment and rising disposable incomes is already obvious not least in the growth of smartphone and tablet penetration. The effects of this are evident not only amongst the equipment manufacturers but also in the data volumes and revenues in the telecom sector and in the growth of internet gaming companies and internet portals that become aggregators.

Conclusions

The conclusions are relatively straightforward: China is an economy in transition away from investment-led to a more balanced consumption and investment model. The transition will take time to prevent dislocation and to allow the various components of the world's second largest economy to keep pace with one another.
In the meantime it is worth remembering that china's economy is still dynamic. We think growth of around 7% can be sustained over the next ten years; the middle class is growing rapidly and is forecast to reach over 300 million by 2020. Spending by this group is likely to focus on housing, cars, and electronics, on health and on insurance. In our opinion, on any investment horizon rather than a trading one China looks a good prospect.

Market Performance Ending September 30, 2013

	Sept 2013	Year to date	2012	2011	2010	2009
Australia	7.10%	5.06%	22.25%	-10.77%	14.69%	73.87%
China	5.27%	-0.11%	22.69%	-18.36%	4.59%	62.06%
Hong Kong	5.90%	7.56%	28.26%	-15.78%	23.28%	60.48%
Indonesia	-0.35%	-18.75%	6.11%	5.19%	35.47%	136.12%
Korea	6.66%	-1.14%	20.99%	-13.55%	25.84%	74.44%
Malaysia	4.43%	-2.18%	14.54%	0.11%	37.67%	51.26%
New Zealand	16.47%	17.25%	31.54%	5.90%	8.73%	49.89%
Philippines	4.60%	3.07%	47.52%	0.04%	35.24%	67.34%
Singapore	6.61%	1.08%	30.98%	-17.54%	22.03%	73.18%
Taiwan	2.87%	5.18%	17.43%	-20.18%	23.14%	80.23%
Thailand	10.04%	-4.24%	35.01%	-2.72%	56.67%	76.59%
MSCI AC Far East Free ex Japan	5.15%	0.96%	22.06%	-14.75%	19.41%	68.56%
MSCI AC Pacific ex Japan *	5.80%	2.55%	22.72%	-13.59%	17.95%	71.51%

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

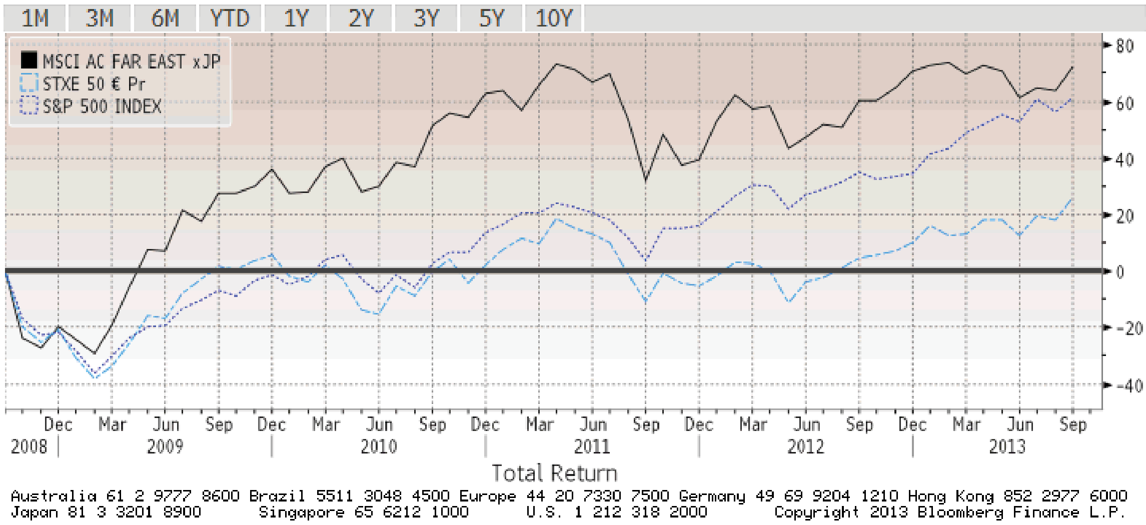
September was a good month for stock markets in the region, but the story was just as much about currencies as about stocks. New Zealand in particular saw its currency rise 7.4% while the Australian dollar rose 4.7%. These moves followed declines earlier in the year while the world worried about the impact of a China slowdown. Attention in New Zealand has now switched to expectations of interest rate rises as GDP rose faster than expected. In Australia the story is different, as the central bank kept interest rates at a record low of 2.5% and maintained asset purchases. Nevertheless, Australia appears to be storing up future problems with a buoyant real estate market, prompting advisory warnings to buyers from the central bank.

Indonesia remains problematic. The market rose 2% in the month and is down 3% for the year in local currency terms but in dollar terms the market is down 18.75% this year. The currency weakness is the result of capital flight, a reversal of Indonesia's position as most favoured destination for emerging market bond investors over the past two years. The commodity slowdown and the widening current account deficit are mainly responsible. The weakness in the currency now appears to be showing up in inflation data suggesting further weakness ahead.

Thailand remains one of our favored markets. Growth momentum has slowed this year but the picture still appears stable. Exports are rising especially to China reminding us that Thailand is an unheralded part of the global manufacturing supply chain. Household credit growth of 12.9% is still solid, tourism grew 28% and manufacturing appears to be faring best among the domestically oriented sectors. Since one of the most attractive features of Thai stocks have been the dividend yields, we feel comfortable maintaining our exposure.

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

Range 09/30/2008 - 09/30/2013		Period Monthly	No. of Period		60 Month(s)
Security	Currency	Price Change	Total Return	Difference	Annual Eq
1. MXFEJ Index	USD	48.95%	72.24%	46.47%	11.48%
2. SX5P Index	USD	1.35%	25.77%		4.69%
3. SPX Index	USD	44.17%	61.08%	35.31%	10.00%



Source: 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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Mutual fund investing involves risk and loss of principal is possible. Investments in foreign securities involve greater volatility, political, economic and currency risks and differences in accounting methods. Non-diversified funds concentrate assets in fewer holdings than diversified funds. Therefore, non-diversified funds are more exposed to individual stock volatility than diversified funds. Investments in smaller companies involve additional risks such as limited liquidity and greater volatility. The Fund may invest in derivatives which involves risks different from, and in certain cases, greater than the risks presented by traditional investments. Funds concentrated in a specific sector or geographic region may be subject to more volatility than a more diversified investment. Investments focused in a single geographic region may be exposed to greater risk than investments diversified among various geographies.

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.

One cannot invest directly in an index.

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