GUINNESS ATKINSON FUNDS

China brief

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February 2015

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In our outlook for 2015 we believe that Chinese economic growth is likely to slow further to 6.5%-7%. We believe the government will now tolerate, and perhaps welcome, this slower growth rate, regarding this as sufficient to maintain stability while at the same time continue the process of reducing investment and raising consumption. However, the sheer size of investment compared to consumption as a share of the economy should make this a drawn out process. Consumption will not take the place of investment tomorrow, so investment will continue to play a role. In the meantime, we anticipate ongoing efforts to support liquidity and money supply.

China – Review & outlook

China's macro-economic backdrop remains difficult because of its interconnectedness, but we do not think it is critical. The effort to reduce investment and boost consumption is bound up with debt growth over the past few years, which in turn is the result of poor capital allocation itself, stemming from a financial system sorely in need of reform. The process of unpicking this, deleveraging, reducing excess capacity, re-pricing capital on a market basis all combine to slow economic growth. The government therefore faces the challenge of how to support growth in the short term without undermining its core efforts over the long term.

Domestic market sentiment has clearly been boosted by recent policy moves that have been perceived as market friendly, but on closer inspection, the central bank can be seen to be acting with some subtlety. The interest rate cut that sparked the rally was asymmetric – it will likely compress bank margins and may also force banks to move assets from the financial (interbank) sector into the real economy. The move to allow deposits from non-financial institutions to be included in the loan to deposit ratio calculation will allow that switch to happen. Importantly, neither move constitutes an additional liquidity injection but is instead a reallocation of capital.

Recent economic data report that China's economy grew 7.4% in 2014, which is, as press commentators have been quick to point out, the slowest rate in 25 years. But it should also be noted that China's economy is over nine times larger than it was 25 years ago. A reduction in the rate of growth is inevitable. The government is keen to show that it is unworried by this number and that we are now in "the new normal". From a practical perspective, we believe this means that calls for aggressive monetary easing, big cuts to required reserve ratios and new stimulus packages are unlikely. The problem the government faces is well known: the inefficiencies in the financial system mean that the benefits of broad monetary stimulus do not appear in the places they ought.

We believe that economic support efforts are likely to remain measured and targeted. The recent interest rate cut, for example, was structured in such a way as to leave deposit rates unchanged, even though the headline rate was reduced by 0.25%, to support savers and pass on the benefits of falling inflation and therefore rising real deposit rates. We should therefore see ongoing Short-term Lending Operations (SLO) to keep short-term rates stable, Medium-term Lending Facilities (MLF) to support base money and liquidity management and Pledged Supplementary Lending (PSL) operations to support infrastructure development as the main monetary tools. We may see further interest rate cuts as inflation has fallen to help with the debt burden, but pressure will remain to prevent renewed growth in credit.

In sum, following the policies of 2014 we expect to see more of the same. State-owned enterprise reforms will likely be promoted to consolidate and reduce excess capacity in industries such as steel, aluminum and cement. The anti-corruption campaign looks to be increasingly entrenched; on the one hand viewed as an attempt to clear away political opposition, and on the other as an honest drive to improve the operational and moral position of the Party. The emphasis on the promotion of consumption, evident in the recent interest rate cuts, has been further bolstered by plans to increase the wages of 40 million civil servants by 60%-100%.

The risks posed by the property sector remain evident. High leverage, production ahead of demand and the need to sell inventory to support cash flows should remain issues in 2015. The intersect between the property sector and the battle against corruption adds to the risks. However, given the importance of the property sector to the economy at large we expect considerable official efforts to be made to maintain stability.

In the coming year it seems probable that growth could slow further with signs that the government now sees 6.5% - 7% as tolerable, in contrast to the view under the heavy industrial model that 8% was the minimum needed to sustain job creation and social stability. The economy also see benefits from the lower oil price; with imports of around 6 million barrels per day, China could save over $107 billion (bn) (equivalent to 1.04% of 2014 GDP) at a price of $50 per barrel, compared to the average price of $101.6 paid in 2014.

China & Hong Kong stock markets

In the last three months of the year China's domestic stock markets staged a dramatic rally. The Shanghai Shenzhen CSI 300 Index of domestic Chinese A shares rose 39.6%, with the bulk of gains generated since the announcement of an interest cut on November 20, 2014. Their Hong Kong listed (H share) counterparts rose a more modest 15.0%, moving A shares from a 6.6% discount to H shares at the start of the year to a 28.1% premium. Hong Kong shares, as measured by the Hang Seng Index rose only 2.9% over the same period.

The strength in the Chinese stock markets has been primarily a domestic phenomenon with little impact on the outside world. International investors have been preoccupied by macro-concerns ranging from weakness in Europe, a falling oil price and instability within Russia as well as its relations with the outside world. Investors in emerging markets have had to contend with the impact of falling commodity prices, a stronger dollar (and its impact on dollar-denominated debt burdens) and a slowing economy in China. The sudden Chinese stock market take-off looks to be a reflection of domestic sentiment associated with monetary easing, as well as being driven by a switch away from real estate investment. There has been significant retail participation and trade volumes have been high.

China Renminbi Yuan (RMB) & Bond markets

The behavior of the Chinese domestic market, particularly Chinese exporters, indicates that they expect the currency to weaken, and are holding more remittances in USD instead of Renminbi. When looking at China's current account and capital accounts, in order to see what flows are doing and whether there is capital flight, we have seen a preference for holding US dollars onshore, inside China's borders. Market participants are allowed to bring in dollars and are not required to convert them immediately into Renminbi, as they once were.

Is the central bank happy to see a weaker yuan, or would they like to see the yuan weaken? We see no evidence of that – the central fixing rate has been held and has been moved higher in recent days, indicating the bank's stance. The Yuan has been trading at the lower end of the band, and we assume that the central bank is intervening where necessary in order to keep the currency within the trading range.

The central bank has both domestic and international priorities. On the domestic front, we believe the central bank views a weaker currency as doing more harm than good. On the international front, a weaker currency creates friction with trading partners. More fundamentally, a weaker currency results in an implicit transfer from households to firms, and the central bank wants this to stop and for the direction to be reversed.

On the wider policy issue of the Renminbi being a reserve currency, particularly as a new currency, the central bank wants to maintain credibility and wants the currency to be demonstrably a store of value. Hence, interfering in the currency (as in the example of the Japanese Yen) is likely to be counterproductive. The International Monetary Fund's (IMF) recent twice-decade review of reserve currencies indicated the prospect that the Renminbi could be included as a reserve currency.

In support of its use as a reserve currency, the Renminbi is now the fifth most used currency according to Swift, just behind the Yen. The four reserve currencies used for Special Drawing Rights (SDR) are US dollars, Euros, Japanese yen, and Sterling, so the Renminbi becoming as commonly used as some of the currencies in this group strengthens the case for it to be considered a reserve currency. From a policy perspective, the central bank will look to maintain stability in the currency, while allowing markets to move the currency within the trading band.

The recent movement in the currency has been mainly due to dollar strength rather than Renminbi weakness. Looking at the performance of the Renminbi on an effective basis against a basket of currencies, it has appreciated by 7-8% over last 12 months, despite weakening against the dollar. Dollar strength will subside in time.

The heart of the task that the Chinese authorities have is to move the economy from investment to consumption, which is ultimately very bullish in the long-term for the Renminbi.

If one takes the view that savings are too high in China and should be much lower, then the currency is significantly undervalued on a long term basis, despite looking fairly valued at present. The changes implied by a shift in the share of consumption from 36% to 45-50% imply that the currency should be considerably stronger. Our long-term position on the currency is underpinned by our belief in the ability of the authorities to implement this change.

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

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Shanghai Shenzhen CSI 300 Index is a capitalization-weighted stock market index compiled by the China Securities Index Company, designed to replicate the performance of 300 stocks traded in the Shanghai and Shenzhen stock exchanges.

Hang Seng Index is a freefloat-adjusted market capitalization-weighted stock market index in Hong Kong. It is used to record and monitor daily changes of the largest companies of the Hong Kong stock market and is the main indicator of the overall market performance in Hong Kong.

You cannot invest directly in an index.

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