GUINNESS ATKINSON FUNDS

China brief

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China is gathering momentum in its domestic reform program, international investment program and in its international diplomacy while the strength of its domestic stock market performance has now spilled over into Hong Kong and internationally traded Chinese stocks. The weaker headline economic data are well understood, if not by outsiders then certainly by policy makers, and have not slowed the number of reforms coming through. Domestically, financial sector reforms are gathering pace and the anti-corruption program is designed both to strengthen domestic institutions and also to undermine opposition from vested interests. Internationally, China has announced a strategic plan of outbound investment and international engagement through its One Belt, One Road policy that will provide a framework for the next twenty years. The stunning diplomatic success Chain has achieved over the Asian Infrastructure Investment Bank has left the US looking flat-footed and isolated on its China policy. After years or worrying about debt, overcapacity and Chinese economic collapse it looks as though momentum is starting to swing behind China once again.

China – Review

Macro-economic data for China continues to be weak and will likely remain so for some time yet. The official growth target this year has been set at 7%, the lowest rate for 15 years. Sluggish domestic indicators have prompted monetary policy reactions, not least a further interest rate cut.

However, policymakers are not caught in the headlights. Investors should be aware that policy adjustments are coming through quickly that cumulatively, represent a fundamental shift is underway. The financial sector remains critical to China's economic future: Relaxing constraints on interest rates, the use of market mechanisms to adjust the money supply, increased completion, the introduction of deposit insurance, further opening of the capital account and establishment of new Free Trade Zones all add up to a swiftly changing operating environment.

The recent interest rate cut was asymmetrical with a cut in the lending rate while allowing greater competition on deposit rates, moving China further toward interest rate de-regulation. Most recently there has been a substantial cut in the required reserves ratio, the amount banks are required to deposit with the central bank to curb lending. This move is not simply a blunt instrument to stimulate growth by boosting credit as under the old model. This is associated with moves to tackle local government debt by allowing municipalities to issue bonds. These bonds will bring the debt back onto the balance sheet, will lengthen maturity and increase financial transparency; and banks will be the major buyers enabled by the additional funds released by central bank.

On a broader policy front China has developed further its One Belt One Road policy. This is a medium to long term national strategy and forms the basis of a more systematic foreign strategy. "One Belt" refers to the Silk Road Economic belt and "One Road" is the 21st Century Maritime Silk Road. These concepts and their definitions were first introduced by Xi Jinping in 2013 and have since been written into national policy. In March 2015 President Xi said in a speech entitled "Asia's New Future: Towards a Community of Common Destiny" that he expected ultimately more than 50 countries to be involved in the plan and that annual trade between those countries would surpass $2.5 trillion in the next 10 years. The announcement of the Central Bank debt to equity swap has boosted the capital bases of the two big policy banks, China Development Bank and Export Import Bank of China, by $32 billion and $30 billion respectively is related to this.

This strategy is important and China watchers should take note because it provides a unifying framework within which to understand and map China's path over the next twenty years.

At home China is working on strengthening its domestic institutional framework – tackling corruption, breaking up vested interest in powerful industries such as banking, oil and heavy industry, deregulating money markets introducing market-based mechanisms, increasing banks' financial strength by raising capital requirements and formalizing local government financing.

The channels through which domestic China engages with the outside world are both increasing in number and broadening. They can be seen through more direct trade flows, easing restrictions on inbound and outbound investment, the establishment of new Free Trade Zones and most recently through further easing of portfolio flows between China and Hong Kong, in both directions.

Outside, China is making its presence felt through the growing use of its currency and establishment of clearing centers across Asia, Europe, South America and Canada. China is now hoping that the International Monetary Fund (IMF) will include their currency in the basket for IMF Special Drawing Rights. The proposed creation of the Asian Infrastructure Investment Bank has created a stir as it is perceived by some as a rival to the IMF, World Bank and the Asian Development Bank. Notwithstanding such concerns there are 28 prospective founding members in Asia a further seven non-Asian members, including five members of the G7. Conspicuous by their absence are the US and Japan.

China & Hong Kong stock markets

In the first quarter domestic Chinese markets (The Shanghai Shenzhen CSI 300 Composite Index) outperformed Hong Kong (The Heng Seng Composite Index) ones as they have since the middle of 2014. Where companies have their shares listed in both markets, the premium of domestic Chinese shares over their Hong Kong listed equivalents opened to 30% having been at a 5% discount a year ago. A big change at the end of the quarter has since triggered a significant rally in Hong Kong. A move by Chinese regulators to allow domestic mutual funds and high net worth individuals to invest in Hong Kong shares under the Shanghai-Hong Kong Stock Connect scheme brought a wave of money and pushed daily turnover above the 2007 high.

For the present the activity appears to be largely confined to domestic Chinese investors while foreigners have remained on the sidelines. Many uncommitted investors who had expected the valuation gap between Hong Kong and China to close via a collapse in the domestic A share markets are having to digest the latest moves.

From our perspective we believe that international investors are likely to increase their weightings. They have been cautious on China because of economic concerns. However, it is clear that the Chinese know they have a debt problem, they know they have a real estate problem, they know there is an overcapacity problem, they know there is a corruption problem and they are tackling all of them while seeking to manage and support economic growth in the process. Chinese policymakers are reconciled to slower economic growth and are instead focused on long term sustainability and wealth creation. We think investors are catching up.

China Renminbi Yuan (RMB) & Bond markets

The yuan continued to weaken against US dollar during the first quarter before strengthening in mid-March which coincided with a period a relative dollar weakness against a basket of currencies. Although the yuan/dollar cross rate showed yuan weakness, China's effective exchange rate continued to strengthen at the Japanese Yen and in particular the Euro continued to lose ground against other major currencies.

Against such a backdrop there has been little incentive to push the yuan higher. China's policy is to keep the yuan stable and as a consequence there has been little change to the central reference rate around which the onshore yuan is permitted to trade.

In the offshore bond market yields have moved higher by 0.70% on average, according to the HSBC Offshore Renminbi Bond index. The two sovereign yield curves, onshore and offshore, have now converged. New issuance and secondary market activity also slowed before picking up again following the end of the quarter when we have seen yields fall (and therefore prices rise) by 0.40%.

The improvement in local sentiment toward China, the rally in the exchange rate and slowdown in capital outflows point to an improved offshore bond market in coming months. China continues to push the use of the yuan outside China and hopes to have the currency included in the IMF's basket of official reserve currencies this year. China's push toward greater engagement and integration into the world financial system is receiving warm support from almost everyone, except the US, as we have seen by the rush to sign up to the new Asian Infrastructure Investment Bank.

China's progress on domestic reform, overseas investment and successful diplomacy make it hard for us to see how China can fail to make its currency one of the world's major medium of exchange within the next three to five years.

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

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, nondiversified 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.

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.

The MSCI China Index is a free float-adjusted, capitalization-weighted index that is designed to measure equity market performance of Chinese stocks available into international investors traded in China and Hong Kong. The Index is made up of Chinese stocks listing in Hong Kong and in the B share markets in Shanghai and Shenzhen.

G7 is a group consisting of the finance ministers and central bank governors of seven major advanced economies as reported by the International Monetary Fund: Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States meeting to discuss primarily economic issues.

HSBC Offshore Renminbi Bond Index tracks total return performance of renminbi-denominated and renminbi-settled bonds and certificates of deposit issued outside the People's Republic of China.

Heng Seng Composite Index is a free-float capitalization-weighted index comprised of H-Shares listed on the Hong Kong Stock Exchange.

The Shanghai Shenzhen CSI 300 Composite Index is a capitalization-weighted stock market index designed to replicate the performance of 300 stocks traded in the Shanghai and Shenzhen stock exchanges.

Yield to maturity is the expected return on a bond if is held until the maturity date.

This information is authorized for use when preceded or accompanied by a prospectus for the Guinness Atkinson Funds. The prospectus contains more complete information, including investment objectives, risks, fees and expenses related to an ongoing investment in the Funds. Please read the prospectus carefully before investing.

Click for a list of current holdings for the Guinness Atkinson China Hong Kong Fund.

Click for a list of current holdings for the Guinness Atkinson Renminbi Yuan & Bond Fund.

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