Guinness Atkinson

Asia Pacific Dividend Builder Fund

Review of November 2018

GUINNESS ATKINSON FUNDS

Summary Review & Outlook

Fund & Market

- November saw Asian markets bounce 3.94% in USD terms (as measured by MSCI AC Pacific ex Japan net return Index).
- Leading sectors were Real Estate, Industrials, Information Technology and Financials. Laggards were Energy, Materials, Consumer Staples and Health Care.
- The best-performing countries were Indonesia, Hong Kong, China and the Philippines; the weakest were Malaysia, Taiwan, Thailand and Australia.
- In the fund the outperformers were to be found amongst the Real Estate Investment Trusts (Capital and Mall Trust and The Link REIT) and amongst our Financials holdings including banks in China, Hong Kong and Singapore as well as Aflac, the insurer. Our Australian positions JB Hi-Fi, Sonic Healthcare and Corporate Travel Management also outperformed.
- Our Technology names, with the exception of Elite Material, all underperformed in November. Our exposure is focused in hardware and chip manufacturing rather than internet services. These stocks are facing the twin headwinds of trade uncertainty and the outlook for consumer electronics, especially smartphones.

Events in November

- US-China trade tensions continued to dominate headlines. The Asia-Pacific Economic Cooperation (APEC) forum in Papua New Guinea concluded without agreement on a joint communiqué.
- The US continued to apply pressure with a report from Trade Representative Robert Lighthizer alleging continued intellectual property theft by China.
- Attention then turned to the G20 talks in Argentina at the end of the month.
- US midterm elections resulted in the Democrat party taking control of the House of Representatives.
- Elsewhere, the UK Cabinet backed an agreement covering Britain’s exit from the European Union. The deal is yet to be approved by the UK parliament.
- Talks between North Korea and Mike Pompeo on the subject of denuclearization were postponed.

As we come to the end of the year, we make some observations on our views of the 'state of play' in Asia.

Trade

Progress on China trade talks has been as expected: the G20 summit produced a limited truce to allow a period for substantive talks to take place. The key negotiators from each side are now involved and the initial truce will last until March 1st 2019.

The most recent talks leading up to Christmas have produced a timetable of discussions in January. The US side will be looking for a timetable of reforms on the Chinese side that consist of steps that are measurable and verifiable. This position elicited a response form Xi Jinping that China will not be dictated to. In spite of this, China has already been active in implementing some of the easier demands. China has resumed purchases of US soy; market deregulation and intellectual property protections have advanced.

The recent arrest of Huawei's CFO and the daughter of the company's founder in Canada and at the request the US authorities has certainly complicated matters. Trump's assertion that he could become involved if it would help trade issues is strange because it illustrates again uncertainty on his true position. My personal view remains that Trump wants to do a deal; the initial complaint on trade imbalances was the area he wanted to address with some tough talk and then a deal. Along the way, however, it all became much more complicated as the focus shifted to unfair industrial policy and technology acquisition. In this area, it is his officials and Congress that have made the running. Indeed, during this process Trump has faced accusations from all sides that he is 'soft' on China.

The economic effects are becoming evident as the trade issues drag on. The first couple of months in 2019 will be important and it seems likely that we shall see some more public bust-ups before March 1st. We should, however, keep an eye on what the two sides actually do: in this respect, China's statements have been robust but their actions have all, without exception, been conciliatory and responses where required have been kept to a minimum.

China's economy

Clearly there is a slowdown underway. All the data point to slower investment, retail sales and industrial production. However, it is nowhere near the case that the economy is about to slump. We know that domestic economic confidence is a concern because of policymakers' efforts to combat it. The brighter side to this is that policymakers still have plenty of firepower in reserve. The most positive aspect in our view, is the nature of the policy responses falls within the larger framework of domestic reform.

The Chinese are not throwing money at the economy as they did in the past. Changes to tax rates and allowances are accompanied by changes in the way they are collected with a shift away from central to

local government collection (the structure of central government versus local government financing has long been an issue). Banks are encouraged to lend to small and medium enterprises as well as private sector companies rather than to the big state-owned monoliths. But the encouragement comes in the form of market-based incentives, not through administrative edict. The main method is to offer access lower-cost funds either by releasing back to commercial banks deposit reserves which they have been required to place with the central bank or by broadening the use of the central bank's Medium Term Loan Facility, providing an attractive rate for three-year money (3.15%) so long as it is applied to 'approved lending'. Banks are likely still to make their margins but the liquidity flow is re-directed to support the wider policy aim.

The Chinese currency has been stable through all this period. There has been some evidence of intervention when the exchange rate has approached RMB7 to the US dollar (7 renminbi to 1 US dollar), but that has subsided of late and we have seen little evidence of capital outflows. Rather, it has been the offshore RMB, traded in Hong Kong, that seems to have set the tone. Weakness in offshore trading has spilled back into the onshore exchange rate. This makes tight RMB liquidity in the Hong Kong offshore RMB market, which is tiny by comparison to the mainland, of outsized importance. The tail is wagging the dog in this case. In response, China's central bank issued two bills of RMB 10bn ($1.5bn) each with maturities of three months and one year at rates slightly above market specifically to help manage liquidity and limit volatility in the offshore exchange rate. This is another example of a market-based response to a market problem.

Regional macro conditions

We have argued, and continue to argue, that Asian valuations reflect poor sentiment rather than a sober reflection of underlying conditions in Asia. In a series of charts (which were produced by JP Morgan) we show how national accounts are for the most part in surplus; how exposure to US dollar debt in the region is limited and thus sensitivity to a strong dollar is that much less; and how banks' capital positions are not only high but have improved in the five years since 2012.

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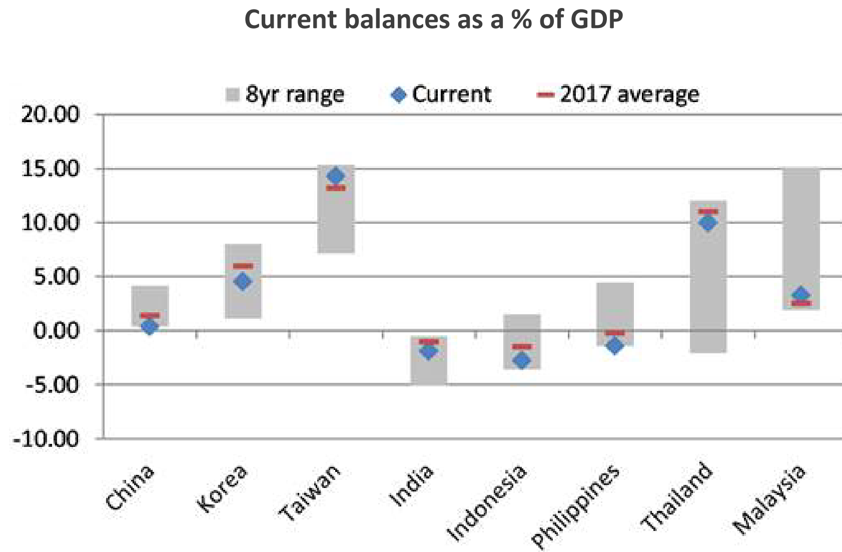
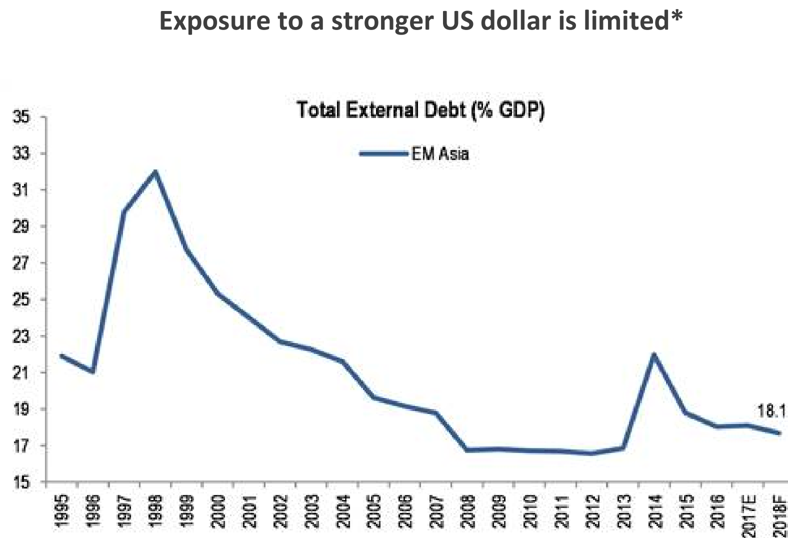
Current balances as a % of GDP



Source: JP Morgan, November 26 2018

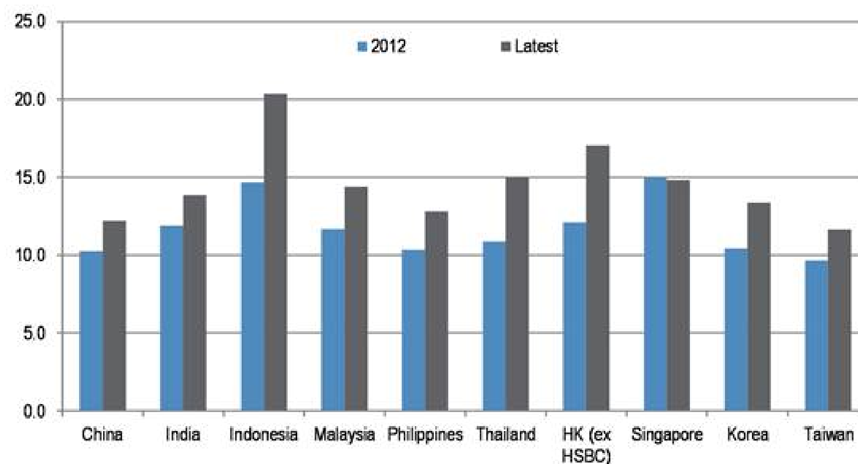
Exposure to a stronger US dollar is limited*



*EM (Emerging Markets) Asia consists of China, India, Indonesia, Korea, Malaysia, Philippines, Taiwan and Thailand. Expressed as a percentage of GDP.

Source: JP Morgan, November 26 2018

Banks' capital positions (expressed as a percentage of total assets) have improved*



* Largest banks Tier 1 capital, weighted by market capitalization. Latest reported figures as of November 26 2018.

Outlook

In the short term, the noise is unlikely to let up. Uncertainty about trade, the Federal Reserve, the outlook for global growth and developed market valuations are all likely to persist. Asian equities are, however, already trading at depressed multiples. Investors as a group still appear to consider Asia as a 'warrant' on global growth. What is neglected is the scale of change that we have seen in the last 10-15 years. Manufacturing skills, quality and volume output mean that Asian sourcing is no longer simply a 'nice-to-have' option for western companies but is now a core component of complex supply chains. This manufacturing upgrade provides the basis for the growth in domestic Asian consumer demand which makes the regional economies more diversified and also less cyclical.

We all know that we ought to buy into Asia and emerging markets when they are cheap; and we also know that when they are cheap it is the hardest time to buy. Our offering is based on good quality businesses that have been profitable for years and whose valuations are currently depressed by sentiment which we argue is excessively gloomy on Asia overall – but especially on these quality businesses.

Edmund Harriss and **Mark Hammonds** (portfolio managers)
Sharukh Malik (analyst)

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The Fund's investment objectives, risks, charges and expenses must be considered carefully before investing. The statutory and summary prospectus contains this and other important information about the investment company, and it may be obtained by calling 800-915-6566 or visiting gafunds.com. Read it carefully before investing.

Investments in foreign securities involve greater volatility, political, economic and currency risks and differences in accounting methods. These risks are greater for emerging markets countries. 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 debt securities typically decrease in value when interest rates rise, which can be greater for longer-term debt securities. Investments in derivatives involve risks different from, and in certain cases, greater than the risks presented by traditional investments. Investments in smaller companies involve additional risks such as limited liquidity and greater volatility. 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. Investments focused on the energy sector may be exposed to greater risk than investments diversified among various sectors.

MSCI AC Pacific Ex-Japan Net Return Index is a market capitalization weighted index that monitors the performance of stocks from the Pacific region, excluding Japan consisting of Australia, China, Hong Kong, Indonesia, Korea, Malaysia, New Zealand, Philippines, Singapore, Taiwan, and Thailand. It reflects deductions from reinvested dividends for withholding tax but reflects no deduction for fees and expenses.

One cannot invest directly in an Index.

Tier 1 capital consists of shareholders' equity and retained earnings. Tier 1 capital is intended to measure a bank's financial health and is used when a bank must absorb losses without ceasing business operations.

Opinions expressed are subject to change, are not a guarantee and should not be considered investment advice. Past performance is not indicative of future results.

Top Fund Holdings as of 11/30/18:

1	PTT PCL /Foreign	3.03%
2	Public Bank Bhd	3.01%
3	Aflac Inc	3.00%
4	Yangzijiang Shipbuilding Holdings Ltd	2.98%
5	Industrial & Commercial Bank of China Ltd - H Shares	2.95%
6	DBS Group Holdings	2.90%

7	KT&G Corp	2.90%
8	Elite Material Co Ltd	2.90%
9	Li & Fung Ltd	2.90%
10	St Shine Optical Co Ltd	2.88%

Fund holdings and sector allocations are subject to change and are not recommendations to buy or sell any security.

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