Guinness Atkinson

Asia Pacific Dividend Builder Fund

Review of May 2019

Summary Review & Outlook

Fund & Market

- After a strong first four months markets turned in May. The story was all about trade.
- Asian markets, as measured by the MSCI AC Pacific ex Japan NR Index, fell -7.6% in USD terms making it the weakest region in May.
- Unsurprisingly, China was the weakest market followed by Korea. Australia, Philippines, and Malaysia were the most defensive.
- On a sector basis Consumer Discretionary, Communication Services and Information Technology were hardest hit, closely followed by Energy.
- The weakest stocks over the month were concentrated in the technology area together with Corporate Travel, Janus Henderson, China Lilang and banks DBS, BOC Hong Kong and China Construction Bank.
- We should remember that the first four months went well and that on a year to date basis we still have technology, financials, consumer discretionary, health care and real estate names in Australia, China, Hong Kong, Singapore, Taiwan and Thailand among the top performers.
- This past month has been about markets adjusting to the idea that the mercurial 'Trump factor' is ever present and trying to work out an appropriate valuation level (or discount rate) to apply.

Events in May

- It all began, of course, with a Tweet: US-China trade negotiations were not going well.
- Additional US tariffs would be applied to Chinese goods; China retaliated with higher tariffs on US goods. Huawei was blacklisted and discussions were put on hold until the G20 meeting in Osaka, in June.
- Mexico came into the firing line (immigration and the Wall) and once again trade tariffs were the weapon of choice – a 5% rate rising in 5% increments per month up to 25%.
- Preparation for US-EU trade talks began. The US requires agriculture to be part of any agreement; a centerpiece of the EU has been, and remains, the protection of farmers. EU member countries gave their negotiator permission to begin but "strictly focused on industrial goods, excluding agricultural products". After the 'gilets jaunes' upheavals this year we would not expect the French to compromise on this point.
- China is accelerating the roll-out of 5G networks, with Huawei at the center.
- India election results showed a decisive victory for Modi.
- The political scene in Thailand is notoriously fragmented and the military looms large in this young democracy. May brought greater stability with a new government being formed and was further cemented by the King's coronation.
- As an aside, Thailand moved up 5 places to number 25 in the 2019 International Institute for Management Development (IMD) World Competitiveness ranking due to improved economic

performance, government efficiency and infrastructure. Singapore took the No.1 spot, knocking the US back to 3rd with Hong Kong holding on to 2nd.

Tariffs and Trade

Well if we didn't know before, we do now: The US election is underway. The three main elements of President Trump's 2016 election campaign were Jobs, Trade and Immigration. The first has not been a notable success. Tax cuts of $1.5 trillion in 2018 were supposed to provide 'rocket fuel' to the US economy by stimulating greater corporate investment (in turn leading to job creation) but companies have been unwilling to do so. But Jobs remain the focus through the connection to Trade and Immigration, which are the two hot-button issues that play well to President Trump's core support.

We have argued before that the trade 'deal' the US made with the world over 40 years ago was one which exchanged access to the US consumer market in return for global reach. This was a deal born out of Cold War realities. The mechanism originated through the granting of Most-Favored-Nation status under the General Agreement on Tariffs and Trade (GATT), to which the US signed up in 1948. However, the granting of Permanent Normal Trading Relations to China in 2000 just prior to its entry to GATT's successor, the World Trade Organisation (WTO) changed things dramatically. In an article "A Tariff for a Tariff: Trump's crusade against China, two decades in the making" for the University of Florida International Review, Spring 2018, Gregory Barber describes what happened next: Three years after China's entry into the WTO, the US had a bilateral trade deficit with China of $130 billion (for comparison, the second largest deficit was $50 billion with Japan).

At the same time, there were significant changes to US manufacturing employment. Barber, citing US Bureau of Labor figures, shows that between 2000 and 2004, manufacturing jobs decreased from 12,400,080 to 10,128,200, a drop of 2,271,880 employees or 18.3%. The loss of manufacturing jobs over the 20 years prior to China WTO entry was 12%.

The impact of China's arrival on the global scene has been profound. The socio-economic impact in the form of factory closures is easy to see; the benefits are not so readily visible, but they are there. In a staff report from the Federal Reserve Bank of New York June 2017 (Revised July 2018), Amiti et al. studied the impact on US prices in the same period (2000 to 2006) following China's WTO entry. Their conclusion was that the 290% growth of China's exports to the US, by value, had the effect of lowering prices of US manufactured goods by 7.6%. WTO entry brought down Chinese tariffs on intermediate goods which was passed through to the prices of finished goods bought by US consumers. This forced other countries exporting to the US to cut their own prices, or exit. The paper shows that the "key mechanism underlying the China WTO effect on US prices is China lowering its own tariffs on intermediate inputs… [which] not only directly reduced Chinese firms' costs but also increased the value and range of its firms' imports of intermediate inputs, boosting their productivity."

However, the arguments surrounding China trade and industrial policies are intensely political and carry wide support across the political spectrum. The impact on the US labour market and its political importance is made clear in Barber's paper (where we should note that 270 electoral college votes out of a total of 538 are required to secure the Presidency):

> *"Using employment data from the National Association of Manufacturers (the nation's largest manufacturing trade association) the five states with the highest share of manufacturing employees as a percentage of the national total were Indiana (17.3%), Wisconsin (16.4%), Michigan (13.8%), Iowa (13.8%), and Alabama (13.2%). Together, these states are home to 74.3% of manufacturing employees (National Association of Manufacturers). In the 2012 U.S. presidential election, two of these states – Indiana and Alabama – gave their twenty electoral votes to Mitt Romney, and the remaining three states – Wisconsin, Michigan, and Iowa – gave their thirty-two electoral votes to Barack Obama. In the 2016 election, all five states gave their combined fifty-two electoral votes to Donald Trump (Federal Elections Commission). These manufacturing states were drawn to one of then-candidate Trump's many controversial campaign pillars: restricting trade with China."*

It is hard to gauge just how far President Trump wants to push this dispute. Tariffs, and the threat of them, gives him powerful leverage in the short term but it is clear this comes at an economic cost. Tariffs provide protection for producers at the cost of higher prices to consumers. Will companies use the protection afforded to invest and make themselves more competitive? History says not and the absence of renewed investment that the recent tax cuts might have afforded suggests this time will be no different.

Recent calculations of the impact of tariffs on households do not make for happy reading. Research from the New York Federal Reserve estimates the current tariffs cost the average household an extra $831 (in higher import taxes and through 'deadweight' efficiency losses that push up prices); the Urban-Brookings Tax Policy Center estimates middle earners received $930 in tax breaks following the 2017 tax overhaul, so tariffs have wiped out all but $99 of the gain. If tariffs are imposed on another $300 billion of Chinese goods, that will lift the household cost from $831 to $2,294 (for a family of four) according to a business group coalition "Tariffs hurt the Heartland". Finally, Gary Hofbauer at the Peterson Institute for International Economics calculates that if 25% tariffs are reached on Mexican goods, then households will bear an incremental $1,700 cost. If all this plays out and if these numbers are correct (and that's an 'If…') then US households could find themselves $930 better off in taxes and $3,994 worse off in indirect costs through tariffs - net $3,014 worse off. That, or anything approximating it, is not an election winner.

Will Trump make a deal? Or will he overplay his hand? The US economy is already looking less buoyant and the Federal Reserve appears to be leaning toward an interest rate cut… Markets may yet force the issue.

Impact on Asia and the Portfolio

The reversal in China-US trade talks and the subsequent blacklisting of Huawei has re-injected macro uncertainty into the region but valuations, even after the strong run in the first part of the year had not become significantly stretched. On a forward Price/earnings (P/E) multiple basis the region is trading on 13.3x consensus estimated earnings, which is in line with the average since 2005. Earnings estimates for the region have also had to come down. May saw the aggregate forecast drop 1.9%, led by technology. Consensus estimates are for profits to grow 4.6% in 2019 and by 12.2% in 2020.

The impact on stocks was heaviest on those with most China-related exposure especially in the Consumer Discretionary, Communications Services and Information Technology sectors. On a country basis, China and Korea were the most affected but so too was Singapore. The immediate thought is to look at those most exposed to trade but the widening use of tariffs as a diplomatic weapon soon begins to be felt on a global basis as trade, then investment plans and then wage growth all begin to slow. This effect is what the stock market is trying to quantify, and the unpredictability of the key player brings a low level of confidence to macro forecasting and any portfolio positioning based upon any such analysis (which, fortunately, we avoid).

The stocks in our portfolio have also seen their fair share of earnings' downgrades, predominantly in the technology segment but the overall picture for them has not deteriorated by much. Largan Precision, Hon Hai Precision and Elite Material have all seen earnings forecasts come down by 3%-4% but even after that are still expected to post 2019 growth of 12%-30%. Novatek Microelectronics which recently fell 10% following a company statement that management was looking more cautiously at the second half of 2019 (hardly a surprise) has seen its earnings estimates rise 9% in May. For balance, we should note that both AAC Technologies and Catcher Technology are expected to see at least 20% earnings contraction in 2019: these forecasts have been in the market for months and are more closely tied to Apple. Overall, we have a sense that macro-surprise and its effect on sentiment rather than earnings gloom has been the main driver of performance.

Even the blacklisting of Huawei does not spell disaster. As a supplier of smartphone handsets, it is not the only game in town: OnePlus, Vivo, Oppo, Xiaomi are all building a presence inside and outside China. (The first three are all owned by BBK Electronics, a Chinese multi-national that rivals Huawei in Android handsets.) OnePlus 7 Pro was recently ranked in the UK's Guardian newspaper as the best super-phone. OnePlus has developed its customised version of Android, OxygenOS; it uses the latest Qualcomm Snapdragon 855 processor; has a refresh rate of 90Hz (versus 60Hz for the competition); has 6GB of RAM, 128GB of storage… and so on. China technology is not going to stop. This blacklisting of Huawei will just spur China to move faster in developing its own solutions and cut dependence on foreign companies – something of which Google, for example, is acutely aware.

The overarching point is that the stocks we hold in the technology area (Catcher, Elite Material, Hon Hai, Largan, Novatek, TSMC, Qualcomm) have a diversified range of customers that serve growing markets in both the developed and emerging world. These businesses have all displayed superior skills in product development and management ability which mean these disruptions should be transitory. Superior quality electronic devices will continue to be sought and it is Asian companies that will make them.

Outlook

In the short term, market sentiment will be dominated by US-China relations. Treasury secretary Mnuchin recently had discussions with Yi Gang of China central bank which he described as “candid” and “constructive”. He held out the prospect of a resolution to the Huawei issue as part of a trade deal. At the time of writing President Trump has just reiterated that point. So we expect markets will continue to be pushed and pulled. Our view remains that a focus on strong businesses rather than macro positioning is the way forward.

We feel confident enough to look through recent events. Without wishing to sound glib or complacent, Asia is still a growing manufacturing center with labor, capital, infrastructure and supply networks all in place that suggest this is not going to knock Asia off course. There may be disruptions and supply chains within the region may have to be reorganized, which will take time but will happen. We believe that domestic consumption growth in the region may be slower than it would otherwise be, but it will still probably grow faster than in developed markets.

At time of writing, the portfolio trades on a valuation of 10.6x 2019 earnings and 9.8x 2020 earnings. The portfolio forecast 2019 dividend yield is positive. All are at levels that we feel are very attractive

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

Performance

As of 5/31/2019	YTD	1 Year	3 Year	5 Year	10 Year
Asia Pacific Dividend Builder Fund (GAADX)	**6.88%**	**-7.66%**	**9.26%**	**6.10%**	**8.03%**
MSCI AC Pacific ex Japan Net Return Index	**5.30%**	**-10.10%**	**9.72%**	**3.04%**	**7.54%**

As of 3/31/2019	YTD	1 Year	3 Year	5 Year	10 Year
Asia Pacific Dividend Builder Fund (GAADX)	**13.43%**	**-5.15%**	**10.97%**	**7.96%**	**12.52%**
MSCI AC Pacific ex Japan Net Return Index	**11.88%**	**-4.33%**	**11.23%**	**5.12%**	**11.04%**

All returns over 1 year annualized. *Source: Bloomberg, Guinness Atkinson Asset Management*.

Expense Ratio: 1.12% (net); 3.27% (gross)

Performance data quoted represents past performance; past performance does not guarantee future results. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance of the Fund may be lower or higher than the performance quoted. Performance data current to the most recent month end may be obtained by calling 800-915-6566 and/or visiting www.gafunds.com. Performance data does not reflect the 2% redemption fee for shares held less than 30 days and, if deducted the fee would reduce the performance noted. Total returns reflect a fee waiver in effect and in the absence of this waiver, total returns would be lower.

The Advisor has contractually agreed to reduce its fees and/or pay Fund expenses (excluding Acquired Fund Fees and Expenses, interest, taxes, dividends on short positions and extraordinary expenses) in order to limit the Fund's Total Annual Operating Expenses to 1.10% through June 30, 2020. To the extent that the Advisor absorbs expenses to satisfy this cap, it may seek repayment of a portion or all of such amounts at any time within three fiscal years after the fiscal year in which such amounts were absorbed.

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.

Price/Earnings Ratio (PER) is an equity valuation multiple. It is defined as market price per share divided by annual earnings per share.

Forward Price/earnings (P/E) differ from trailing earnings, which is the figure quoted more often, as they are a projection and not a fact.

One cannot invest directly in an Index.

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 05/31/19:

1.	Sonic Healthcare Ltd	2.99%
2.	PTT PCL /Foreign	2.93%
3.	China Medical System Holdings Ltd	2.92%
4.	Elite Material Co Ltd	2.92%
5.	CNY Minsheng Banking - H Shares	2.90%
6.	The Link REIT	2.89%
7.	Luk Fook Holdings International Ltd	2.89%
8.	Industrial & Commercial Bank of China Ltd - H Shares	2.89%
9.	KT&G Corp	2.88%
10.	Public Bank Bhd	2.87%

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

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