China Equity Strategy Review- First Quarter 2013

Market over view

MSCI China index was down by 4.98% during the first quarter of 2013. Utilities sector including gas, electricity and water was big outperformer with over 20% gain year to date. Healthcare and consumer staples also recorded positive returns. On the negative side, telecom service, consumer discretionary and materials were the bottom three performers in the quarter.

After staying at its two years low during August and September 2012, the market had a strong rebound during the 4th quarter. The momentum has turned and the market experienced high volatility in the first three months. The concerns on disappointing 4th quarter 2012 corporate earnings have driven the market lower in March. The Market still overestimates corporate earnings growth and the earnings estimate need to be lowered for the first and second quarter.

PMI data in Jan, Feb and March were 50.4, 50.1 and 50.9 respectively, showing a trend of slower economy recovery if excluding seasonal factors. NPC and CPPCC were held in March, successfully completing the leadership transition. Aiming to avoid bubbles in the economy, regulations on property and shadow banking were announced during the quarter. On Feb 20th, 2013, central government issued new measures on property tightening to further suppress investment/speculation demand, to prevent property prices from rising too fast, while intending to protect end-user demand in the property market. On March 27th, 2013, CBRC announced regulatory rules on investment of fund raised by bank wealth management products. We believe such a policy would help to improve transparency and reduce the credit risks of the off balance sheet products. However liquidity will be moderated accordingly and we will closely monitor its impact.

Portfolio positioning

As a long only and focused portfolio, the fund hold 20 stocks as of March month end. We still believe that Chinese economy has structural issues after high growth in past 20 plus years. The miss allocation of the resources and slower productivity improvement will make the continued high growth difficult. As a central planning economy and government corporations dominated in resource control, China still has to rely on investment for growth. The difference will be where in the country and which sectors will be the focus. We are concerned on the property market as a whole. We less worried the property market in the first tier cities, the property in the third tier and smaller cities are our concerns in regarding both the affordability and the supply. As a result, the portfolio will less invest in capital expenditure led cyclical sectors; it will focus on those sectors that we believe will have better earnings visibility and stable earnings growth for the next two to three years. The fund is over weighted in consumer, transportation, selective capital goods (telecom equipment, agriculture machinery, railway machinery and electrical equipment) and health care; it is underweighted in financials (including property), energy and materials. The short comings of this portfolio is that if the monopoly sectors such as energy, telecom services and banks perform in the near future, the fund will underperform in the near term. But we believe in a one to three year time window, the midcap companies should out-perform the index by a big margin.

Our view in the past three years that China clean technology, energy savings and industrial automation and services will be benefited from government investment has becoming consensus. While we still like those industries, we will pay close attention to the stock valuations.

Politics

The Chinese government and communist party leadership have successfully transited to a new team of leaders during the last quarter in 2012 and first quarter of 2013. We view it as positive in general as it has been much more serious in crack down on corruptions within the government. The new leadership is clearly showing their willingness to do some level of government and economic reform. The challenge is that they are constrained by the massive corruption that has been built up during the past years since economic reform. Any reform or anticorruption activities will impact some of the core political and economic interest groups. We believe the first signal the new leadership sent out is strong enough to those that were going too far on corruption and calm the general public that are unhappy about the government corruption. We do not believe that there will be any more actions besides taking a few high profile cases public. The new leadership needs two years for a smooth transition, but we need to closely watch the directions they are heading, even though we are not expecting Mr.Xi Jin Ping (the Communist Party head and the president of the country) will introduce an independent party to monitor the communist led government. China will not make progress in political reform unless the "old men" (older generation leadership) influence is removed.

We expect the new leadership will focus on below reforms as long term directions:

1. Income redistribution to reduce the gap between the rich and the poor and increase the government spending in social welfare areas.

2. Interest rate and capital account liberalization to increase the efficiency of capital allocation

3. Reduce environment pollution and encourage energy saving by launching resources pricing reform and resources tax.

Chinese Economy out look

The down cycle of the economic growth after the high growth in the past years has not completed. The slower economic growth will last longer due to the government corporation dominant in the economy. Consolidation in the overcapacity industries is very difficult. The over capacity will stay longer. We believe that the actual GDP growth was slower than the government reported in 2012. It is evidenced that the corporate earnings growth were less than the market consensus. We expect the weak earnings will stay for the first two quarters in 2013. Street analysts have to lower their earnings forecast. The inventory situation is expected to improve in third quarter of this year and corporate earnings should improve in the 4^{th} quarter on year on year basis.

The government has to continue investing money to keep the growth and maintain the level of the capacity utilization. However, the liquidity will still be tight. Both the central and local government is facing difficulties in revenue income. They are hungry for tax revenue which will impact household consumption and small business investment which are most needed at this moment. In order to have a stable longer term growth for the next three to five years, the current government has to work on balancing its budget, investment and promote consumption. The positive side of this tight money is that the government will try to improve the efficiency of the capital spending.

The true demand on commodities has not recovered. Steel and coal inventory is still at historical high. Copper and cement inventory were continuing going higher during the first quarter. The companies in those industries will be very challenging to have earnings improvement in the near future.

We will stay with the theme that mass consumer sector, health care and technology sectors will have better earnings growth visibility in the next three to five years.