

Market commentary by Edmund Harriss and James Weir, Investment Managers for the Guinness China & Hong Kong Fund and Guinness Asia Focus Fund.

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Amidst the sensational, recent news stories, we still see the China story being as strong as ever. The political noise continues but in reality the story has moved on. A controversial hardliner has been removed and is discredited and the reform program goes on. We expect that economic growth data from China will continue to improve over the year and that equities still offer value even after the rebound in the first quarter.

The news coming out of China has become a lot more interesting, enthralling even, during the past few weeks. First China rattled markets by announcing an economic growth target of 7.5% that was lower than expected. The steady appreciation of the onshore renminbi stopped as China argued that fair value has been reached. Then, sensationally, after dark warnings by Wen Jiabao of corruption and indiscipline, came the fall of Bo Xilai, the hardline nationalist yet charismatic leader of Chongqing who appeared to be on a path to the top of China's leadership. Rumours (wholly unfounded) circulated on Chinese blogs of a coup by Bo's supporters. Then came a story that a British businessman who died in Chongqing in November last year, apparently of excess alcohol, had in fact been murdered, poisoned with cyanide. Bo Xilai's wife has been arrested and accused of complicity amid suggestions they had been engaged in syphoning assets abroad.

This is all gripping stuff in which truth plays only a cameo role. It's a power struggle, more akin to those of the Roman Republic than to what we have been accustomed to see in China in recent years, which has sought to portray an image of serenity, order and stability. What it reveals is a struggle between factions that is ferocious in its intensity. What it also reveals is that the forces of reform and progress are winning.

Politics

The fall of Bo Xilai has sent out a powerful message. His career has been a controversial one and has been most notable by his mobilisation of popular support in Chongqing, a municipality with a population of more than 32 million. His method has been to instil a sense of return to 'core values': crackdowns on crime, reviving Mao-era slogans, pushing for greater state involvement in the economy and championing the poor against those who have done so well out of China's economic transformation. His greatest crime in a Chinese context was perhaps his populist appeal and playing on nationalist sentiment. But his greatest threat came in his desire to roll back reforms and reassert centralised control.

A recent report produced jointly by The World Bank and a Chinese think-tank, the Development Research Centre of the State Council, attracted particular ire from Bo's supporters. In it the authors propose further and far reaching reforms in the financial sector including the banks, capital markets and the currency. These are precisely the reforms that China needs to push through in order to sustain growth. But the loss of central control entailed by the 'hand-over' of such matters to market forces is what the forces of reaction are so keen to prevent.

The swiftness and completeness of Bo's fall puts the initiative firmly back with the current leadership and their chosen successors, who are likely to continue along the reform path.

The Economy

The announcement in early March that the government expects the economy to grow 7.5% came as a shock to some investors who have been concerned that China's slowdown could become a hard landing. Our opinion, quite apart from the fact that 7.5% growth is still attractive, is that this is both realistic (given lower demand for Chinese exports) and also still an environment in which investments can do well.

Slower external demand has had a dampening effect on China's industrial output as exports have slowed. The US economy is doing much better than many had expected a year ago and exports to the US have held up well. But the crisis in Europe has drained consumer confidence and the European export market is now just as important as the US. The contribution to growth from net exports has now disappeared both as a function of slower demand but also because of stronger growth in imports.

The rise in imports and the shrinking trade balance have been striking. China's import bill is up as a result of rising commodity prices (particularly oil) and also higher volumes. In the last three months we have seen near record levels of copper, oil and iron ore imports. To us this points to heightened domestic activity, both current and anticipated. The most significant activity we believe will come in the mass residential housing programme. This policy is one of the most significant developments, in our opinion; affordable housing would enable growth in household formation which in turn tends to drive consumer spending.

It is also true, however, that slower economic growth is the result not only of external factors but is also the consequence of domestic policy moves to counteract some of the undesirable effects of the 2009/10 credit boom. Now that headline consumer price inflation has stayed below 4% for the past three months and non-food price, or core, inflation is down below 2%, policymakers feel more comfortable about shifting their focus from inflation-fighting toward supporting growth. We have not seen any sign that they intend to launch another stimulus programme; moves appear to be more modest and targeted while at the same time being sustained. Indications of a change in stance are visible in new lending data, which ticked up in March, as well as in the pattern of short-term money market rates. These moves have been complemented by selective easing of required reserve ratios for some banks and encouragement/support for lending to smaller and medium sized enterprises.

Currency

The reductions of the rate of inflation and the trade surplus have together taken some of the heat out the currency. Higher inflation was partially attributable to higher import prices and a

stronger currency was one means of offsetting this pressure. Now, commodity prices have largely stabilized and this reason has become less pressing. The decline in the trade surplus since 2008 from 6.0% of GDP to 2.5% now has removed another source of pressure, although the political pressure within the US is still high.

Since March China has maintained its exchange rate at around renminbi 6.30 to the US Dollar. Since 2007 the policy has been to allow the currency to trade in a 0.50% band either side of the daily fixing. Within the last few days the band has been widened to +/-1%. The immediate economic impact of this is near zero but what it does do is allow the authorities to observe how much extra volatility there is in the exchange rate. The reason for this move, we believe, is to bring forward the time when financial instruments to allow currency hedging are introduced, which is a necessary precursor to allowing more market flexibility into the exchange rate.

The offshore renminbi (CNH) market rate has reflected the stability in the onshore exchange rate. Greater volatility in the onshore rate is likely to be similarly visible offshore. The initial excitement that greeted the arrival of the offshore renminbi from market makers and journalists has worn off, and this is a good thing. The liquidity in the currency market is still good; the difference between onshore and offshore as well as the rates for buying and selling the currency have all narrowed. Bond issues are now coming to the market with more attractive coupons and more transparent structures. And banks now have to compete for deposits to fund their growing renminbi lending business, resulting in improved deposit interest rates.

But the lowering of initial excitement is only a matter of sentiment, which is fickle. The underlying story and its importance have not changed. China's merchandise trade is still well over \$3 trillion and less than 10% of it is settled in renminbi. There is value to China in having the renminbi used internationally, and in turn we would expect that demand will push the value of the currency higher. However, there are also changes to the financial sector that must happen domestically before we see this occurring on any great scale. Such changes include: interest rate reform, development of government and corporate bond markets, the creation of currency hedging instruments and reforms to the banking sector that would allow them to withstand greater opening of the capital account. All of these issues are under active discussion within China.

Stock, Bond and Currency markets

In 2011 the performance of Chinese stocks traded in Hong Kong and internationally was poor as investors worried about the extent of China's slowdown. We believe that the first quarter of 2012 probably marked the trough, and that, from hereon, positive policy moves will continue to support an economy that wants to grow. Stock valuations in 2011 were left looking very cheap as earnings were not hit the way that some had feared, and in the first quarter stock prices rebounded. We still believe that there is value to be had and that China's strength will come as a welcome surprise this year.

The offshore currency and bond market will continue to develop. We still expect that a modest currency appreciation will come this year but probably later on when growth, output, and construction activity numbers show some sequential pickup. We are still looking for an appreciation of 2% - 3% this year.

The offshore bond market is developing but activity at present is mostly focused on international issuers rather than un-rated Chinese names. The government issues, as well as Baosteel's bond issues in December and March, have provided some benchmark curves that serve as reference points for investment grade bonds. However, the market is still quite small with around 175 bonds in issue, 80% with 3 year maturities and still a smaller issue size than in the dollar bond market. Corporate investment grade debt, the bulk of which is rated A+ to A-, presently yields 3.25% to 4.5% at a 3 year maturity. 2 year paper similarly rated is trading on 2% to 4%. We are seeing value emerging in a market that is now established.

Equity Market Performance to 31st March 2012

	March 2012	Year to date	2011	2010	2009	2008
Australia	-2.4%	9.1%	-10.8%	14.7%	73.8%	-49.5%
China	-6.9%	9.9%	-18.4%	4.6%	62.1%	-50.4%
Hong Kong	-4.6%	13.4%	-15.8%	23.3%	60.5%	-50.5%
Indonesia	1.2%	4.7%	5.2%	35.5%	136.1%	-57.9%
Korea	-0.7%	14.9%	-13.6%	25.8%	74.4%	-56.4%
Malaysia	-0.2%	8.5%	0.1%	37.7%	51.3%	-41.2%
New Zealand	5.9%	16.6%	5.9%	8.7%	49.9%	-53.5%
Philippines	4.8%	21.6%	0.0%	35.2%	67.3%	-52.0%
Singapore	-0.5%	19.3%	-17.5%	22.0%	73.2%	-47.2%
Taiwan	-2.2%	14.5%	-20.2%	23.1%	80.2%	-46.0%
Thailand	0.5%	21.3%	-2.7%	56.7%	76.6%	-48.2%
MSCI AC Far East Free ex Japan	-2.9%	12.9%	-14.8%	19.4%	68.6%	-50.3%
MSCI AC Pacific ex Japan *	-2.9%	11.9%	-13.6%	17.9%	71.5%	-50.0%

*MSCI AC Pacific includes Australia & New Zealand

MSCI Indices were used for regional & individual country market performance.

Source: Bloomberg

Market Review and Outlook

This was a mixed month for Asian equities, with some retrenchment in the major markets following on from a strong start to the year. China and Hong Kong were particularly weak, whilst there was also weakness in Australia and Taiwan.

There was a continued pause in monetary policy loosening in a number of countries, with Thailand and Taiwan pausing their rate cuts. This was partly due to some fears about inflation driven by higher international energy prices, but also because economic growth has held up well in Asia, and further monetary stimulus may not be necessary at present. Although Taiwanese equities were relatively weak this month, there was some unexpected good news in shipments of electronics, with notebook computer shipments holding up reasonably well in the first quarter.

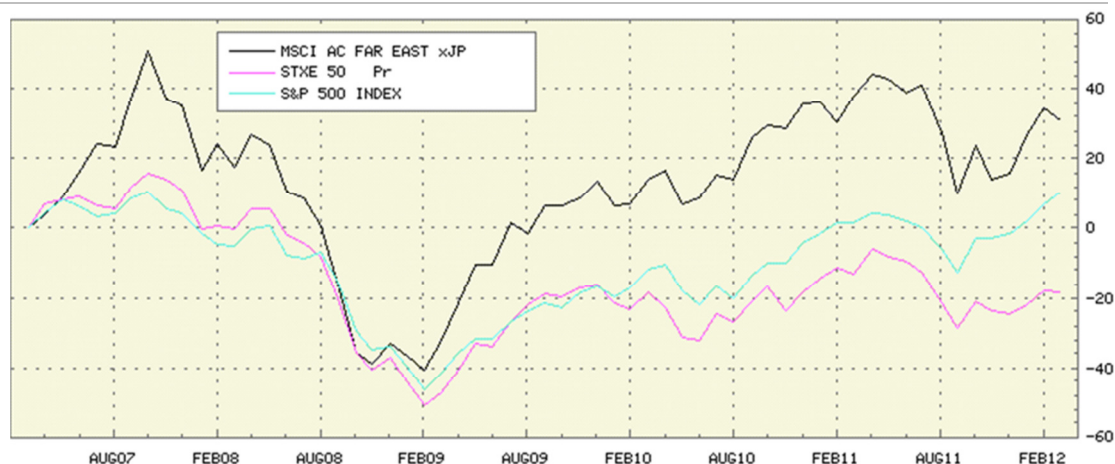
South Korean equities also had a mixed performance this month, with the benchmark finishing slightly down for the month. South Korea held legislative elections this month, which resulted in an unexpected victory for the conservative Saenuri (New Frontier) Party. Saenuri won 152 of 300 seats in the legislature, and this provides a springboard for its leader, Park Guen-Hye in December's Presidential election.

There was some negative news in politics in Indonesia, where this month the government moved to cap foreign holdings in mines at 49%, from the previous maximum of 80%. This

created some confusion in the market, but it was later clarified that the new regulations would not apply to mines regulated under existing 'contracts of work'.

Developed and Emerging Market Index performance, 5 years to 31st March 2012

% returns	Price return	Total return	Annualised return
MSCI AC Far East ex Japan	14.75	30.76	5.50
EURO STOXX 50	-33.90	-18.32	3.96
S&P 500	-0.87	10.48	2.01

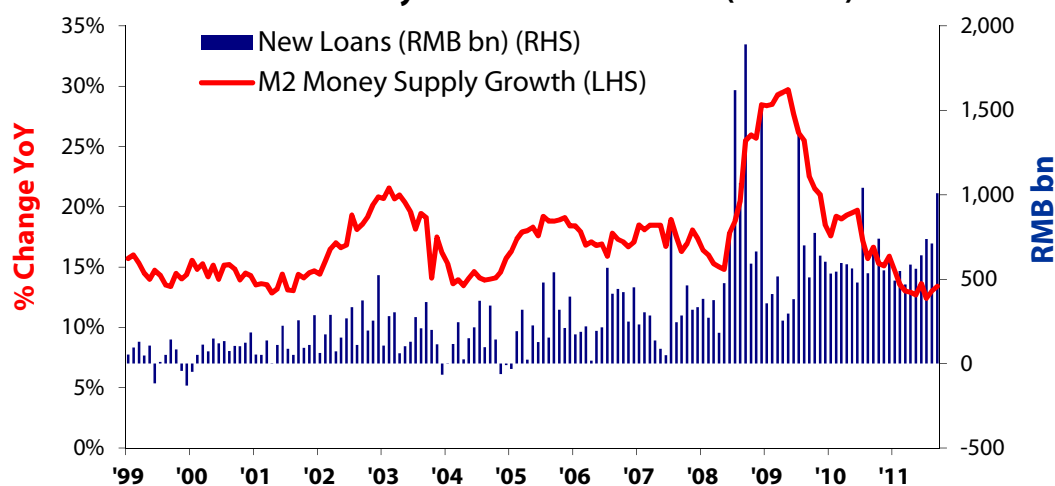


Source: Bloomberg

China Economic Monitor

We continue to watch new loan data and money supply growth as policy indicators. The March new loan number exceeded rmb 1 trillion for the first time in a year which we think is encouraging. It supports the more anecdotal evidence we have been hearing that the policy stance has indeed shifted.

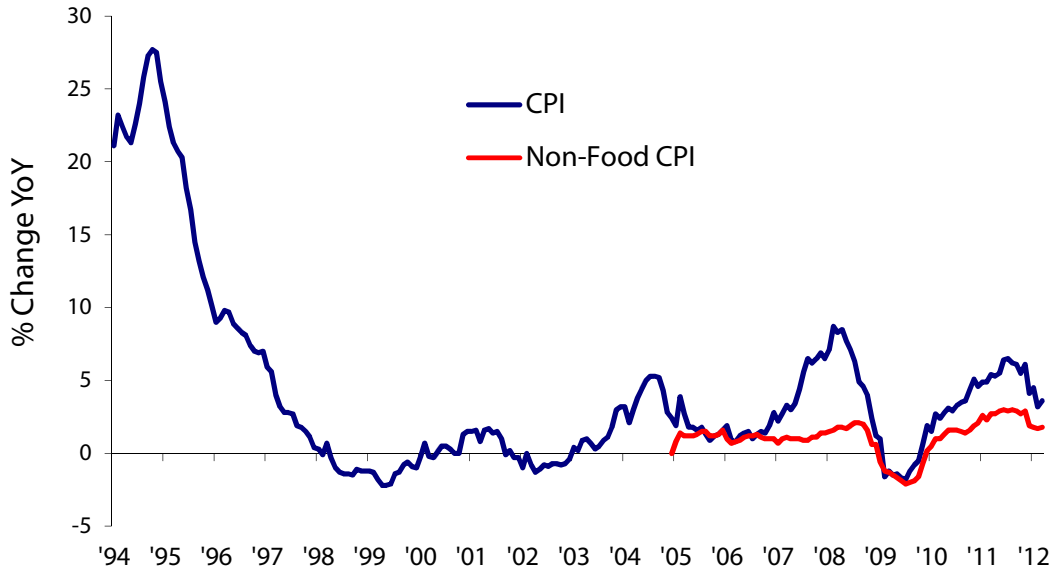
China M2 Money Supply (% Chg YoY) and Monthly New Loans Extended (RMB bn)



Source: The People's Bank of China

Inflation has now come down to levels with which the government appears comfortable, which fits with our belief that 3%-5% inflation is acceptable from a policy standpoint. This may mean that at current levels the government may be more willing to engage in price reform in fuel, electricity and water over time.

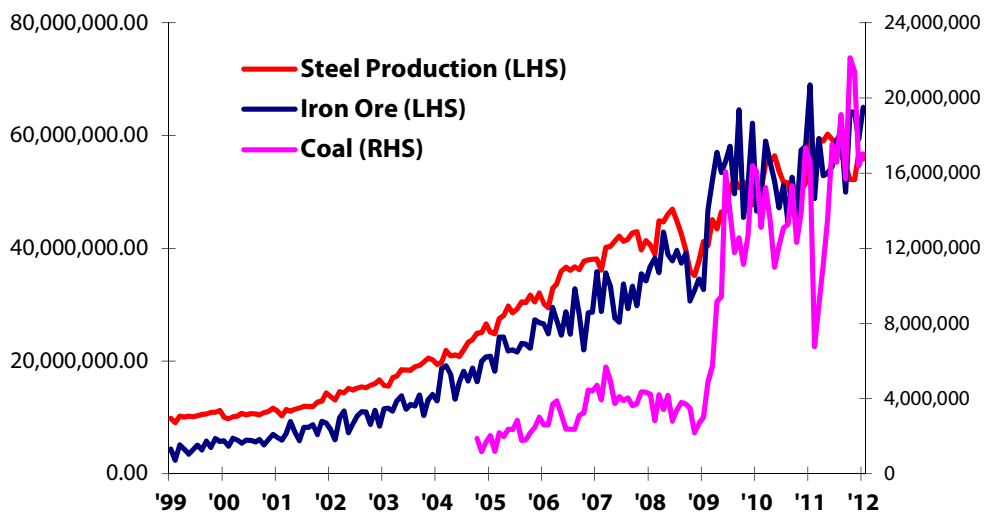
China: Consumer Price and Core Inflation - % change YoY



Source: Bloomberg, China Economic Information Net.

Steel production remains high amidst concerns that it is running ahead of domestic needs. However, if construction is sustained through the residential housing programme (as we expect), then Chinese demand is likely to remain firm for steel and iron ore, if not growing.

China's Monthly Steel Production and Imports of Iron Ore and Coal (tonnes)

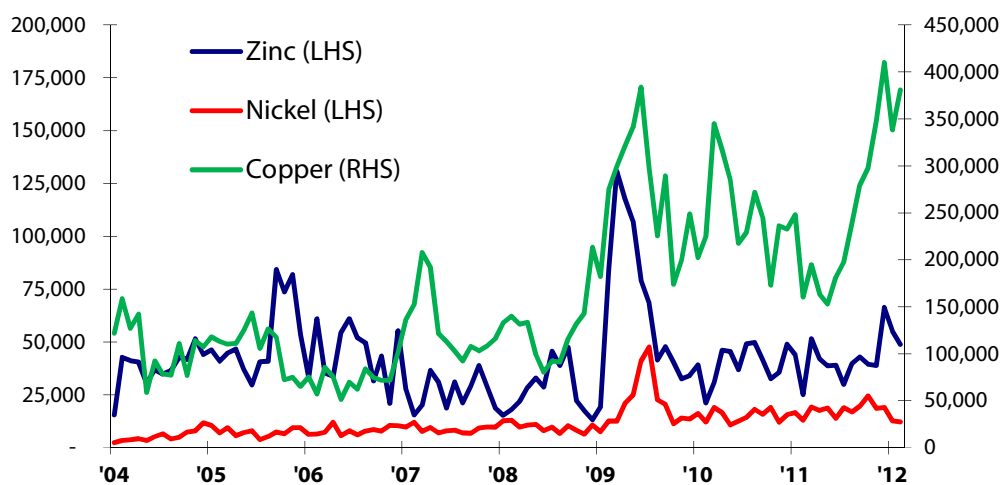


Sources: National Bureau of Statistics, China Customs General Administration

Chinese imports of copper have caused some concern in the global copper market over the outlook for the copper price, but it appears that the Chinese have been playing a more canny game. All too aware that they are the big marginal buyer of a commodity that is notoriously volatile, the Chinese have stepped back and allowed prices to fall before stepping in.

Last year, with prices below \$8,000 per tonne, they bought aggressively. This quarter, they have again stepped back before buying more aggressively as prices dipped. It is now speculated that Chinese inventories are around 3 million tonnes, including the government's strategic stocks, and copper traders estimate that imports could fall from here to around 200,000 tonnes per month for the rest of the year.

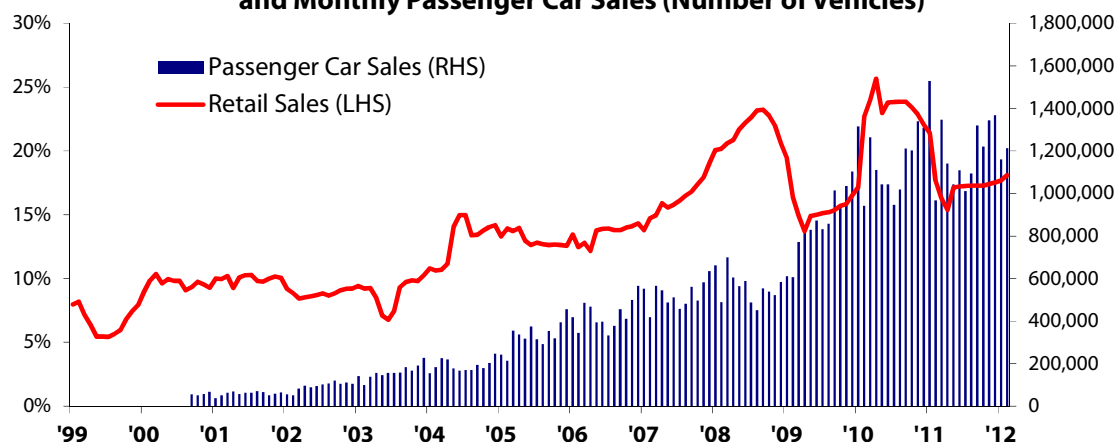
China's monthly imports of Zinc, Nickel and Copper (tonnes)



Source: China Customs General Administration

Retail sales growth has stabilised and resumed a rising trend, and car sales are still around 1 million units per month. Car manufacturers still have a bullish outlook with a forecast that China will be a 30 million a year car sales market by 2020. To that end Ford has just announced plans to double its manufacturing capacity to 1.2 million cars per year. According to the Company, that will bring its total investment in China to \$4.9 billion. At the same time Ford plans to bring 15 new models and 20 new engines and transmissions to China by 2015. Interestingly too, the Company recently issued a bond in the offshore renminbi market.

China Retail Sales Growth (3 Month Moving Avg YoY change) and Monthly Passenger Car Sales (Number of Vehicles)



Sources: China National Bureau of Statistics, China Automotive Information Network

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