NOESIS CAPITAL MANAGEMENT

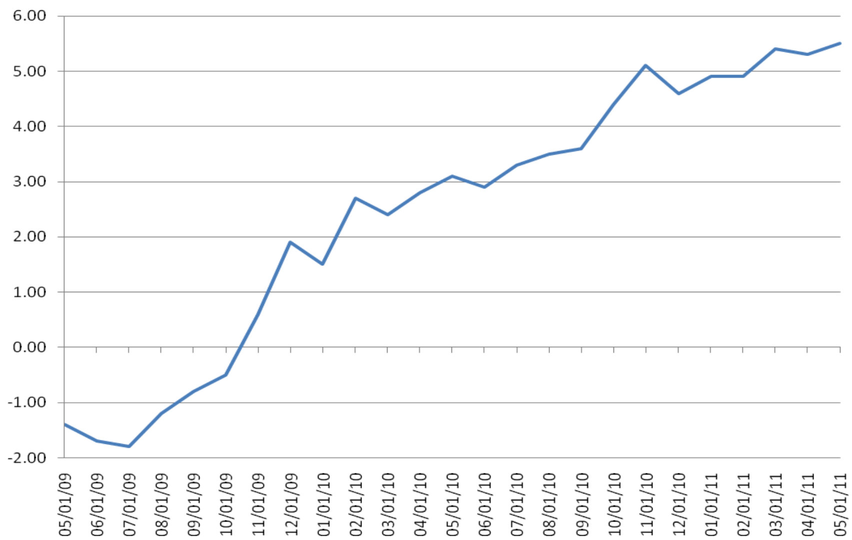
A REGISTERED INVESTMENT ADVISOR

July 15, 2011

Dear Client:

On July 6th, China's central bank announced its fifth interest rate increase in eight months amid concerns over accelerating inflation. As shown in the chart below, China's inflation has indeed risen to an alarming level.

Chart 1: China's Inflation – Consumer Price Index (CPI)



Source: Bloomberg

As the second-largest economy in the world and a leader in global economic growth, China deserves attention. Could China's economy collapse? That's the question many investors have been asking recently. In order to gain a better understanding, I revisited the country in mid-June, this time focusing on Xiamen (廈門), Zhangpu (漳浦), and Shenzhen (深圳) in southeastern China (Chart 2). I would like to invite you on a brief trip to these three cities.

Xiamen is an island city inside the Fujian Province on the southeast coast of China, facing the Taiwan Strait. Opened as one of the four original Special Economic Zones to foreign investment and trade when China began economic reforms in the early 1980s, Xiamen has become prominent in economic development. Many companies founded by overseas Chinese have located their business in Xiamen, whereas many Western

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companies have their headquarters in Shanghai or Beijing. The city is recognized in China as the number one or two most-livable city.

Chart 2: China

During my visit to Xiamen, I took a ninety-minute drive to a rural city, Zhangpu, where I stayed for two days. The road to Zhangpu is a newly-constructed, mostly six-lane wide and clean highway. But besides some occasional pedestrians or bicyclists, it was relatively free of traffic. As our car approached Zhangpu, I started to see some large residential communities with tall buildings. I asked my local driver what kind of people live in these buildings and he replied with a smile: "Mosquitoes". This confirmed what I read before – that there are new buildings, empty highways, and even cities in China, which are under-utilized.

I visited an old friend who is in charge of his family business together with his three siblings. Their key activity is manufacturing umbrellas, hats, scarves, and handbags for Japanese, Italian, and British luxury brands. In addition, he decided to move up in the value chain and to create his own proprietary brand which is now recognized as one of the best in China and sold through company-owned stores. During the two-day stay he gave me a tour of their six factories, told me the twenty plus-year history of their company on the mainland, explained the business models and strategies, and gave me his views on the Chinese economy at large.

This is one of the successful stories of Taiwanese businesses relocating to mainland China. My friend's family business originated in Taiwan and became one of the largest umbrella manufacturers in the world. Twenty-some years ago, his parents realized that labor costs in Taiwan had become too high for them to be competitive and they started to search for alternatives. After several visits to countries such as Vietnam, Malaysia, and the Philippines and many prolonged family discussions, they decided to relocate to mainland China. Key to the move was China's economic reform and opening to foreign investments. China and Taiwan also share the same culture and language. As a result, the company gained access to great business opportunities and an abundant supply of cheap labor.

As the political and social environment in China was unstable, their father insisted from day one on running the business very conservatively. For example, they:

- Target top-end markets to avoid cut-throat price competition
- Expand the retail business cautiously and selectively by opening eighty shops in only foreign-run top-quality malls, instead of rushing to thousands of locally-owned malls
- Take good care of employees, leading them to call the founder "Ba Ba" (Daddy)
- Keep their balance sheet clean and transparent, even though it results in paying high taxes
- Maintain good relationships with local governors without bribing.

The risk of doing business in China is high. Many entrepreneurs have failed and lost their business or even their freedom. My friend's family does not want to be caught by surprise.

The most serious concern my friend has right now is the potential for an economic bubble.

Later, I flew to Shenzhen. For your information, the flight was delayed by two hours. I shared this experience with my Chinese friends and they were amused by my surprise. To them, this was nothing out of the ordinary.

Shenzhen, situated just north of Hong Kong, was China's first Special Economic Zone. It immediately attracted foreign investment. It has grown fast and has become one of four tier-one cities in China, in addition to Beijing, Shanghai and Guangzhou. Like Hong Kong, Shenzhen is full of skyscrapers. With many high-tech and industrial companies located here, most of its infrastructure is new and advanced. As with many other cities in China, there is construction everywhere making it noisy and unclean. Since it is close to H.K. and most of its residents are ex-pats, Shenzhen's cost of living is very high, behind only that of Beijing and Shanghai. I wonder how the majority of local residents can survive there.

Based on what I saw and heard during my trip, China is facing a shortage of electrical power, rising labor costs, rising raw material costs, rising interest rates, a strengthening Renminbi, and a decreasing demand from overseas, at least in the short term. The business environment is less friendly than it used to be. In fact, the number of bankruptcies has increased in recent months and more can be expected.

While the near-term picture is quite uncertain, the long-term prospects remain bright. China's economic growth remains in an early stage, even though it is the world's second-largest economy. As I mentioned earlier, China's infrastructure looks advanced, but in certain cases there seems to exist overcapacity. In fact, China's economic growth has so far relied heavily on investment. Its consumption has to pick up steam in order to make the growth sustainable. We believe that, as discretionary income continues to grow fast, consumption power will show its strength sooner or later.

In terms of Noesis' investment strategy, we continue to favor top-quality global corporations over local Chinese companies, which may face a tough time ahead. Global companies have experience and corporate structures in handling various markets. Often they command only a small share of the Chinese market and can easily expand their territory. For example, Wal-Mart is growing quickly, but remains relatively small compared to a few local competitors; HSBC is a clear leader among global banks in China, but also remains small relative to Chinese state-owned banks; Walt Disney is building a new theme park in Shanghai; Nike remains the market leader in China and continues to gain market share.

Generally speaking, this logic can be applied to other emerging markets: high growth, high inflation, and less competitive local companies. We believe that many global companies could benefit from strong demand, not only from China but also from other emerging markets thus gaining geographic diversification across many markets.

RECENT PURCHASE

Honda Motor Company (HMC)

Honda is a leading manufacturer of automobiles (76% of 2011 sales), motorcycles (14%), power products, and financial services (3% and 6% respectively). The company's manufacturing facilities are located worldwide with a high proportion outside of Japan. It has a 12% share of the Japanese automotive market, 10% in the US, 5% in China and 2% in Europe.

Thanks to its engineer-led culture and disciplined growth strategy, Honda has grown rapidly over the past decades by introducing high-quality and hugely popular cars and is now the world's seventh largest carmaker. Its lean cost structure and flexible production capabilities allowed the company to remain profitable throughout the financial crisis, in contrast to many of its competitors. Honda is participating in the growth from emerging markets like China, Brazil, India, and Southeast Asia. The company was the very first carmaker to offer a mass-production hybrid model and continues to lead in new technologies like hydrogen-powered fuel cells, plug-in electric vehicles and natural gas-powered engines. We believe the output issues caused by the March earthquake leading to a shortage of supplier parts and power outages could be temporary. Honda has already indicated a return to full global production by the end of this year or beginning of the next.

As always, we thank you for your referrals and your trust. Please contact us if you have any questions or wish to discuss your portfolio.

Sincerely,

Joseph Lai, CFA
Chief Investment Officer

Our most recent Form ADV, Part II is available upon request