MATTHEWS INTERNATIONAL CAPITAL MANAGEMENT

ASIA REPORT

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Regional Overview:

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What will the second half of the year hold in store for Asia? It certainly will not be a boring time for this region. Already in 1997 we have watched Hong Kong's return to China and Thailand remove its currency peg to the U.S. dollar. Floating the Thai baht is exciting as a major cloud has been lifted over South East Asian markets.

The second quarter of 1997 was generally positive for investors in Asia ex-Japan with the Hong Kong stock market performing particularly well. The handover of sovereignty to China put Hong Kong under the world's microscope and to the surprise of many the market hit an all time high on the eve of the transition. Not all of Asia fared so well in the quarter however, with South Asian markets continuing to pay the price for their currency management policies of the last ten years. Unlike Hong Kong, which makes only a minimal attempt to control domestic monetary policy under its "currency board" system, countries such as Thailand have attempted to both peg their currencies and manage domestic money supply which are two incompatible goals. The recent recognition by both the Thai and Philippine authorities that these policies were unsustainable was clearly the right thing for them to do. One of the key attributes of the successful Tiger economies in the last two decades has been their ability to adapt rapidly to changing external conditions. Generally speaking, the markets that have been the weakest in recent months have responded favorably to these shifts in currency policy.

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Three weeks after the handover, business in Hong Kong is very much back to usual. The hordes of journalists have left, but every move of the new legislature is closely monitored. So far the only significant move has been confirmation of a more aggressive policy towards providing land to Hong Kong's massive property developers. With net inward migration surprisingly continuing to rise, Hong Kong authorities are fully aware that property demand assumptions have been overly conservative and are determined to correct this position. Meanwhile, the recent inclusion of a second "Red Chip" company in the Hang Seng Index again suggests that Hong Kong's role as China's major stock market continues to develop. Hong Kong's access to international capital remains unparalleled on the mainland even though the Shanghai and Shenzhen markets are now growing rapidly.

South Korea and Taiwan enjoyed relatively strong stock market performance in the second quarter, helped by improving external demand for many of their key exports, particularly in electronics.

China's Stock Market Overview:
by Richard Gao, Research Analyst

By now most investors who follow Asia are quite familiar with "Red Chips" – Hong Kong- listed companies principally controlled by a mainland enterprise with mostly mainland assets. This group of stocks has outperformed the Hang Seng index by 54% so far this year, showing investors' enthusiasm towards the huge potential of China.

With an average P/E of around 30x* compared to the 14x average P/E of the Hang Seng index, most red chips are becoming relatively expensive. To participate in China's future, investors may want to take a look at the domestic stock markets in China. Stock market development there has been extremely fast in recent years. For example, the daily dollar amount of turnover in the domestic A share market has already surpassed that of total turnover in Hong Kong. This article will give a brief overview of the Chinese stock market.

Basic Facts

China's domestic stock market has a short history. It has two stock exchanges: the Shenzhen Stock Exchange and the Shanghai Stock Exchange. These two exchanges were set up in 1991 with a total combined market capitalization of around $2 billion and a total of only 14 listed companies. There are two types of stocks in the domestic market: A shares and B shares. **A shares are for domestic investors and B shares are for foreign investors.** A share prices are quoted in local currency RMB. B shares are quoted in the Hong Kong dollar for Shenzhen stock exchange and in the US dollar for Shanghai stock exchange.

Although B shares are theoretically for foreign investors only, local participants are often the driving force in the B share market. It is estimated that in 1996 local Chinese participants in Shenzhen and Shanghai accounted for 70% and 50% of turnover respectively. This is because foreign investors were not active in the early days of the B share market. In order to increase liquidity, the government loosened its control and allowed local participants to open accounts, although it did not encourage them to do so.

Stock Market Development

The stock markets expanded modestly during their first several years. It was not until 1996 that the domestic market, especially A shares, underwent a substantial expansion. From 1991 to 1995, total domestic market capitalization increased from US$2 bn to US$42 bn, while at the end of 1996, market cap reached US$114 bn. Total trade volume increased from $820 mn shares per in 1991 to $50 bn in 1995 and reached an astonishing $256 bn in 1996. There are now more than 20 million officially registered

A Closer Look at the B Share Market

- ***Closely-related to A share market***

With most of B share liquidity coming from local investors, B share market performance is closely related to the A share market. Sentiment in the A shares has a spill-over effect on B shares.

- ***Improving regulation***

The Chinese government realizes that China's stock market is still in its initial stage. The government's main priority is to discourage stock speculation and stabilize the market.

- ***B Share rally not fully-supported by fundamentals***

The B share rally has little to do with fundamentals. After 3 years of austerity programs, most companies were hit by the economic slowdown. Although it ended last year, few companies have yet to realize the benefits of a stronger economy. Earnings reports in the past were usually disappointing to investors.

- ***Huge Gap between A and B Shares***

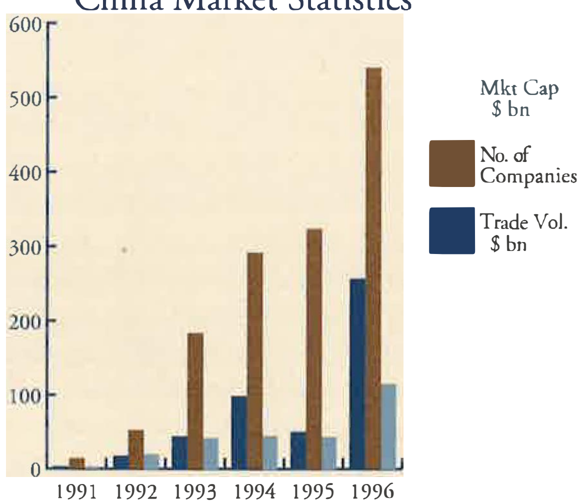
Most B shares also have A share listings. Of the 45 B share companies on the Shanghai Stock Exchange, 39 have A share listings. In Shenzhen, 34 out of 49 B shares have A share listings. As of July 14, 1997, Shanghai B shares were trading at a 69% discount to their A share counterparts. Shenzhen B shares were trading at an average 64% discount to A shares counterparts.

* PER= 1997 average estimates PER

stock investors in China. Latest surveys show that in the southern city of Guangzhou, around 40% of all families own stocks. In just six years the stock market has grown dramatically in China.

Stock market conditions have reflected economic conditions in China. Shortly after the set-up of two stock exchanges, China's economy began to slow down and the government adopted an austerity program in 1993 to control inflation. Stock prices dropped substantially and have been in the doldrums ever since. The turnaround came in 1996 when China achieved an economic soft landing: inflation fell to below 10% after years of double-digit rises, economic growth stabilized, and the money supply began to expand. The soft landing gave investors reason to feel confident in the stock markets. In addition, the markets were also helped by the government's call to hasten development of the securities market and by the limited investment opportunities open to local investors.

China Market Statistics



Source: International Finance Corporation

B Share Valuation

	Mkt Cap	# of Cos.	PER '97	PER '98
Shanghai B	3.4 bn	43	13	12
Shenzhen B	3.0 bn	44	12	10

Source: IFC, TED

Looking Ahead

B shares performed exceptionally in 1996. The Shenzhen B share index was up 147% in 1996, among the best performing markets in the world, while the Shanghai B share index also saw a rally of 38%. Looking ahead, we are quite positive regarding the long-term potential of the B share market based on the following reasons:

• The possibility of an eventual merger of A and B shares

Chinese government officials have been implying privately that there would be an eventual merger of A and B shares, although a timetable was not established. We believe this is quite possible, especially after the full convertibility of RMB, which officials have made clear will be done before the year 2000. Movement towards a merger will almost certainly raise the price of discounted B shares.

• Easing credit conditions

China's real GDP growth was 9.7% in 1996 while its inflation was kept below 6%. This June, retail prices were only up by 0.8%, a six year low. Strong economic growth and low inflation has put pressure on the central bank to further ease credit, lifting the interest rate burden from state-owned-enterprises.

• Corporate restructuring – SOE reform

China's state-owned-enterprises (SOE) are experiencing wide-spread reform in an effort to increase efficiency. The government is encouraging mergers and acquisition among enterprises. Bankruptcies and lay-offs, which were unimaginable in the past, are becoming more and more common. Although the results are not yet evident, we believe this will definitely increase SOE's efficiency and competitiveness to the benefit of China's economic future.