ASIA INSIGHT

www.matthewsfunds.com

Matthews Asian Funds | Four Embarcadero Center, Suite 550 | San Francisco, CA 94111 | 800.789. ASIA [2742]

OCTOBER 2006

CONTENTS

Coups, Kings and Airports

Landing at Thailand's brand new airport less than two weeks after a military coup, one didn't have to travel far to get a sense of the local undercurrents. The polished hotel representative that led the way to transportation informed me that she hated the former Prime Minister Thaksin and that the new regime would be a big improvement. She represents the general sentiment of the educated class of Thailand's capital, Bangkok. Thaksin was seen as arrogant and corrupt, undermining democracy by winning votes through government handouts to the poor. As I sped away from the ultra-modern construction of glass, steel and concrete, the other voice of Thailand emerged from the driver's seat. Much older, with limited English, the driver spoke with more vehemence than I have heard in fifteen years of traveling to the Land of Smiles. To this member of Thailand's less fortunate class, the "mafia" was back in charge. Thaksin had provided him with reduced medical and housing costs and for that the ex-prime minister was loved. The military action was described as a dark return to a Thailand where the rich get richer and the poor suffer along.

The coup is a sad and surprising outcome to the political stalemate of the last year. Fifteen years of democratic rule had given one the sense that Thailand had moved on from its long history of military involvement in politics. Thaksin pushed things further than was wise, behaving in an autocratic and self-serving – and ultimately unThai-like – fashion. His years as a powerful tycoon bred a level of ego that led to critical errors of judgment. The coup was possible because of the intense resistance to his government from Bangkok's middle-class. Months of disturbances in the first half of the year had shown a country profoundly divided between an educated urban core and a large rural population. While Bangkok may represent over half the economy of the nation, the ballot box is clearly dominated by the country's rural areas. Thaksin's well oiled Thai Rak Thai Party, formed out of the dust of the Asian crisis, has thoroughly dominated recent elections. In the face of a profound standoff, Thailand's elite opted for the old solution of tanks in the street. Power has been hastily pushed into the hands of a credible retired general, but an unelected general nonetheless. How much real power the interim prime minister has remains to be seen, but he is trusted by many people to return the country to full democracy.

2005 Thailand Statistics

GDP	US$bn 168.8
GDP growth	4.5%
GDP per capita	US$2628
Population	64 million

Source: CLSA

Bangkok is pleased with the new regime and the new airport. Its residents are confident that the country will see better economic days and a return to a democracy in the next year. Their nemesis will see his party dismantled and his personal dealings called into question. Out in the countryside, it is hard to say how much frustration and anger exists, but it is there and it had best not be ignored. My driver sounded quite capable of driving his car into a tank as one taxi driver was rumored to have done. The glue that holds it all together remains Thailand's revered King. King Bhumibol,

Continued on page 2

Coups, Kings and Airports

Continued from page 1

the longest reigning monarch in the modern world, celebrated his sixtieth year on the throne in June. The coup leaders are very closely associated with the King, and they received his support almost immediately. Without him, there could have been a civil war, but then the army might not have dared to overthrow an elected government in the first place.

Thailand's democracy has taken a severe blow, but the country continues to move forward. Despite his shortcomings, Thaksin did get things done, including the new airport which had been planned for literally decades. Thais are very proud of their new port of entry and the terminal has been clogged with sightseers who go out to the airport just for a visit. Bangkok is gradually becoming a modern city with highways, rail and subways. The horrible traffic of the mid-nineties where one expected to miss many meetings due to gridlock is long gone.

Development and democracy have never been easy partners. Countries without strong domestic institutions and mature legal systems often fail to make timely progress in the hard work of physical infrastructure. Strongmen have sadly often been the answer. Thaksin was not a reformer, but he knew how to run a country. His ego may have undone him for now, yet in a free election in Thailand today, he would undoubtedly win, with my driver at the front of the voting line.

Asia's poor will naturally respond to a populist approach to politics. Suharto's patronage system across the thousands of villages of Indonesia won him support for decades. Malaysia's Mahathir supported his native racial group and pushed a nationalist agenda that enriched his friends and supporters. Both countries have moved forward from under the shadow of these powerful, visionary and ultimately corrupt men, but both countries continue to face a challenging future in building a firmly democratic environment. Singapore exults in its "one party democracy" when less-established democracies suffer setbacks, but still there is a profound desire across Southeast Asia to see a more stable future. Can democracy provide it? Not without a lot of support from global institutions and a lot of patience from foreign investors.

ASEAN is something of the forgotten entity in Asia these days as investors obsess over China and India. Still it is a very large region with many unique strengths and we remain focused on its long-term potential as a home to many excellent Asian companies. Thailand is one of the world's great tourist destinations and one of the largest agricultural exporters. It has quietly built a significant automotive industry in recent years. Singapore has come out of a long slump and is enjoying the lowest unemployment rate in over a decade. Indonesia has been a darling of global investors and its very young democracy continues to make progress against a host of challenges. The region is finding a way to provide goods and services to China, Japan and India, with entrepreneurs as the real driving force, not the politicians or generals.

Mark W. Headley
President and Portfolio Manager
Matthews International Capital Management, LLC

Thailand Exports/Imports

Major Exports	Major Imports	Top Three Export Destinations		Top Three Import Sources	
Textiles	Machinery	U.S.	15.5%	Japan	22.0%
Footwear	Intermediary goods	Japan	13.7%	China	9.4%
Automobiles	Consumer goods	China	8.3%	U.S.	7.4%
Computer and electronic appliances	Crude oil				

Source: CLSA

INVESTOR DISCLOSURE

Investing in foreign securities may involve certain additional risks, including exchange rate fluctuations, less liquidity, greater volatility and less regulation.

Single country and sector funds may be subject to a higher degree of market risk than diversified funds because of concentration in a specific sector or geographic region.

Technology stocks may be very volatile and mutual funds that concentrate in one market sector are generally riskier than more diversified strategies.

Mutual fund shares are not deposits or obligations of, or guaranteed by, any depository institution. Shares are not insured by the FDIC, Federal Reserve, or any other government agency, and are subject to investment risks, including possible loss of the principal amount invested.

The subject matter contained herein has been derived from several sources believed to be reliable and accurate at the time of compilation. Matthew International Capital Management, LLC does not accept any liability for losses either direct or consequential caused by the use of this information.

Distributed by PFPC Distributors, Inc., 760 Moore Road, King of Prussia, PA 19406

REGIONAL OVERVIEW

Political issues captured the headlines in September, with the coup in Thailand and a new prime minister in Japan. At the time of writing, the North Korean nuclear test looks certain to carry that political focus into October. But the more important story for regional investors in September was a continuation of the more benign outlook for inflation and interest rates, the rally in U.S. bonds and the fall in the oil price. It sustained the rotation away from the energy and materials sectors, back to consumer and technology companies. The Indian market almost fully recovered from the steep declines in the second quarter, while China extended its gains. It is notable that enthusiasm for the China/India development story is growing, and while we share the long term optimism, valuations now leave less room for near term disappointment.

Japan struggled to keep up with its emerging brethren, as the MSCI Japan Index fell 1.61% in September. Small companies fared worse, with the JASDAQ down 4.76% for the month and 30.92% year-to-date. Once again a small company was under regulatory scrutiny, unnerving domestic investors. For different reasons, Japanese small caps and Thai stocks are inexpensive relative to many other parts of Asia; in both cases value is evident, but catalysts for improvement are slow to emerge, testing investors' patience.

There are many indicators to measure the growing impact of Asian companies on the world stage – a recent article in the Economist highlighted yet another: the region's technology companies are increasingly global leaders. The OECD league table of the largest 250 technology companies now has entrants from China and India, while Taiwan and Korea continue to gain at the expense of the U.S. The breadth of the industry is also increasing, as India's software prowess complements the hardware expertise of its eastern neighbors.

David Harding, CFA
Managing Director
Matthews International Capital Management, LLC

CHINA/HONG KONG

The Hong Kong equity market rallied again in September, reaching a new six-year high during September. The market was volatile during the first half of the month as concerns over U.S. interest rates re-emerged after data showed strong U.S. labor costs. However, the market recovered quickly on the back of accelerating renminbi appreciation and positive sentiment towards Chinese financial stocks with the successful IPO listing of a major Chinese bank. For the entire month, the Hang Seng Index was up 1.27% and the MSCI China Index gained 3.72%.

Macroeconomic numbers continued to show solid growth in Hong Kong's economy. August total export growth was 9.9% year-on-year, driven by strong demand from China. Imports growth of 12.3% reflected strong internal demand on the back of economic recovery. Meanwhile, the unemployment rate was at 4.8% and the number of employed persons reached a record high of 3.5 million. In China, the latest industrial production rose at the slowest pace in 17 months, showing that the government's measures to moderate economic growth are finally having some impact.

The month of September saw a record high of the renminbi against the U.S. dollar. The Chinese currency has appreciated an additional 2.5% against the dollar since the 2.1% appreciation in July of last year. While it is quite unlikely that the central government would allow the currency to trade in a wide range in the near term, it seems that the upward pressure on the currency may persist due to China's rising trade surplus, foreign reserves and domestic savings.

INDIA

The Indian equity market remained firm in September although volumes were still subdued. Stocks in the banking sector rebounded sharply, perhaps reflecting a more benign interest rate environment, and a moderate decline in the long bond yield. The wholesale price index (WPI) was contained within the 4.5-5.0% range, though growth momentum remains strong. The first quarter of the fiscal year saw GDP growth of 8.9%, exceeding most expectations and marking two consecutive quarters of almost 9% growth in the economy. The industrial sector showed some sequential acceleration helped by a record pace of growth in manufacturing. However, the acceleration in the manufacturing sector led to higher imports of intermediate and capital goods. Coupled with high oil prices, India's import bill increased sharply, pushing the trade deficit to a record high of $18.5 billion. However, increasing borrowings by commercial banks in overseas markets were a major factor, offsetting the widening trade deficit, such that there was slight accretion to India's foreign reserves.

Meanwhile, corporate India is starting to get more active in building a global platform through cross-border acquisitions. To date, the value of announced cross-border deals total approximately $7 billion, almost 50% higher than all of last year. Thus far, the transactions have been concentrated in a few sectors like pharmaceuticals, information technology and energy, although the base is beginning to widen. Some of the increase in mergers and acquisitions is being facilitated by greater availability of capital, both from public and private equity investors. The upcoming earnings season, and the Reserve Bank of India's decision on interest rates are likely to be key factors influencing market direction in the medium term.

Continued on page 4

Continued from page 3

JAPAN

In September, TOPIX and the MSCI Japan Index declined 1.99% and 1.61%, respectively. The large-scale correction for small-cap markets that began at the beginning of this year continued. The month saw the second-tier markets such as JASDAQ, MOTHERS and Hercules down 4.92%, 7.15%, and 4.95%, respectively. On a year-to-date basis, these three markets have fallen 31.45%, 52.26%, and 48.65%, respectively. However, the overall market regained some ground after Shinzo Abe—who has espoused an emphasis on reinvigorating importance on economic growth—was elected the new prime minister on September 26. Individual investors were the biggest net buyers during the first three weeks of September becoming net buyers for the first time since May. Foreigners, Japanese investment trusts and non-financial companies continued to be net buyers. Meanwhile, trust banks were the biggest net sellers. The yen depreciated further to 118 against the dollar. The JGB yield was stable, ending the month at 1.67%.

Capex for April to June grew 16.6% year-on-year, expanding for the thirteenth consecutive quarter. The weaker yen and rising land prices continued to support exporters and real estate companies, respectively. Condominium sales in the Tokyo metropolitan area in August were down 40.5% year-on-year, as sellers held off sales in anticipation of further price appreciation. At the same time, the suburbs of Tokyo saw a significant increase in condominium sales. The decline in energy prices helped transporters, but hurt the mining sector. Meanwhile, July machinery orders were down 16.7% year-on-year, substantially weaker-than-expected. Household spending continued to be weak, declining for the eighth straight month, posting a 4.3% year-on-year decline.

KOREA

In September, the Korean market gained more ground as crude oil prices continued to decline and geopolitical risks eased. The KOSPI gained 2.99% during the period and the KOSDAQ gained 6.49%. Domestic fund flows into equity-related funds in Korea remained steady and selling pressure from foreign investors eased in September. The Korean won continued to strengthen during the month.

The industrial and telecommunication services sectors broadly outperformed the KOSPI Index while the information technology and consumer staples sectors underperformed. The financials, energy, and utilities sectors also declined. Among other factors, concerns over a larger-than-expected decline in liquid crystal display prices contributed to weakness in the information technology sector. The KOSDAQ rebounded strongly in September but ended down 8.75% year-to-date compared to the KOSPI's gain of 6.03% during the same period.

Despite concerns over a strong currency, South Korean exports remained strong in September, rising 22.1% to a record level after automobile shipments almost doubled. Steel, petrochemicals, semiconductors, and liquid crystal displays also helped export growth during the month. Consumer prices rose an unadjusted 0.2% month-on-month; a slower-than-expected pace that reduces the need, we believe, for the central bank to further increase interest rates. Companies will begin announcing their third quarter results in October, and those results are likely to dictate the market's direction for the remainder of the year.