ASIA INSIGHT

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The Evolving Asia Pacific

as of 11/30/07

2007 has been a banner year for Asia. As the two fastest growing economies in the world, China and India have combined forces in a way never seen in past bull markets. When the world looks flat, it's good to be big. Populations were once the curse of developing nations (and, of course, still can be), but now size is in style. Every poor Indian and Chinese farmer or laborer is a future member of the growing Asian middle class—that much needed replacement for the potentially winded American consumer.

It isn't just that China and India have exhibited a number of consecutive years of exceptional economic development; it is also that the world's corporations and investors are cheering for a new engine of growth—a hybrid engine of sorts that runs efficiently on millions of tiny transactions. Asia's masses remain quite poor on average, but in the aggregate are considerable. There are two billion Chinese and Indian consumers that will, in theory, soon have a credit card and a brokerage account, thanks to the massive evolutionary leap of domestic financial systems and communication technology in the last five years.

Can Asia decouple if the U.S. has a serious consumer-driven slow down? It is fair to say that Asia seems fairly well-positioned to weather a U.S. slowdown. Confidence and consumption are strong across much of the region. Most governments should be in reasonable shape to help domestic demand if a slowdown occurs. China and India have both been trying to slow their economies for some time, so some drag from the U.S. would almost be welcome. This is not to say that it would be easy on investment portfolios. Recent years have seen such strong upward momentum, that even a modest slowdown could come as a shock to markets that currently operate with a great deal of momentum psychology.

Interestingly, Asia's old dividing lines are fading away. The past generally saw portfolio managers gravitate towards only one of Asia's rising super stars. If you loved India, you saw China as a powerful but irrational force. Chinese companies couldn't even put on a decent PowerPoint presentation. If China was your fancy, you tended to see India as full of promise that would never be realized—the train wouldn't make it to the station (quite literally). At Matthews, we have had a China-bias for many years, but we are gaining more and more respect for India. Now both camps find themselves having to learn to complement each other because it is in these two markets where most of one's returns are being generated. Were boosters of both China and India right? It almost seems too good to be true. If there is a fly in this ointment, it may well reveal itself in the rapid development of the financial systems that enable the domestic consumption story to come alive. Should either country stumble into a meaningful financial crisis, the result would be very painful. And while the last several years have been marked by steady success in these systems, they have not been battle tested. That flat world philosophy that makes big look good, will also face some serious challenges from the many wrinkles that still exist in the global socio-economic fabric.

Asia is in a new world, one that reflects back to the regional order that existed before the Colonial Era. China has moved to a position of indisputable dominance, at least in terms of perception. The Middle Kingdom has no rival in Asia despite still having a smaller economy than Japan. Imperial collapse, isolationism, invasion, civil war and communism are all behind China now, and what was once the world's

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Ten Largest Companies In Asia

Company Name	Market Value (US$B)	Country	Sector	Years Since IPO
PetroChina Co. Ltd.	710	China	Energy	7
China Mobile Ltd.	393	China	Telecom Services	10
Industrial & Commercial Bank of China Ltd.	367	China	Financials	1
China Petroleum & Chemical Corp. (Sinopec Corp.)	249	China	Energy	14
China Construction Bank Corp.	247	China	Financials	2
China Life Insurance Co. Ltd.	221	China	Financials	4
Bank of China Ltd.	211	China	Financials	1
Toyota Motor Corp.	203	Japan	Automobiles	1
China Shenhua Energy Co. Ltd.	176	China	Energy	2
Mitsubishi UFJ Financial Group Inc.	120	Japan	Financials	4
Reliance Industries Ltd.	106	India	Energy	16

Source: Factset, Data as of Dec 6, 2007, Bloomberg

richest country is utterly determined to regain its wealth. There really is nothing like one hundred and fifty years of anguish as an ancient nation state and a proud people to make you hungry—and China is very hungry. Mistakes will be made. Pollution is clearly taking a terrible toll. The risks to any socio-economic system that is growing as fast as China's are many, but the determination to succeed and the lessons learned from past regional failures are keeping China on a trajectory to rival the U.S. in the not too distant future. A prediction that was greeted with derision by many not long ago and today appears to be simple math.

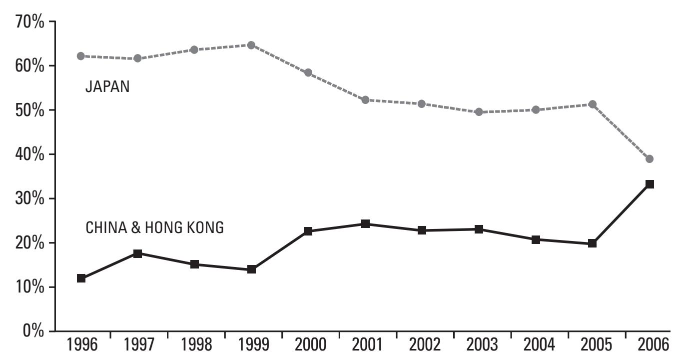
India is messier but the determination is just as keen. Where China shines in building gleaming cities seemingly overnight, India struggles, but where China can still point to few truly entrepreneurial companies of global importance, India is a rising star. The quality of Indian executive leadership is exceptional. With these entrepreneurs—relatively unfettered in trying to solve India's many domestic dysfunctions—delivering profitable business solutions, it is not unreasonable to expect the same level of success that India's exceptional software and pharmaceutical companies have found in global markets.

Both of these rising giants will trip and fall at some point. But they will get up again and hopefully be stronger for the experience. The rest of the region has been busy reengineering their economic and political positioning to deal with India's and China's rise. This hasn't been without pain, but the benefits have been significant as dependence on the U.S. has steadily fallen in Asia's export centers. China's and India's emergence as fully functioning economies rapidly normalizing to global economic and financial requirements is very good luck for Asia.

Japan seems to be having by far the hardest time in this era of transition. Holding on to the post-World War formula of relying on the U.S. as its critical ally has not served Japan well in dealing with new realities. But Japanese companies are much smarter than Japanese politicians, and a quiet move to integrate with China economically is far more advanced than is apparent from the outside. Japan may be dragged into the new Asia, but it will remain a vital part of the landscape. Should Japanese capital and manufacturing skills truly work to team up with China and India, then the U.S. economy has something to be very nervous about. In the meantime, incremental integration will be the nature of the game, with lots of nervousness between Asia's two military giants.

As someone who started an Asian investment career on the basis of Asia ex-Japan outperforming Japan during a sustained period of catch-up, it is clear to me that the majority of that change has occurred. Japan is still the biggest economy, but China's market has actually caught up when its domestic A-share market is counted. China and India are still in high-growth stages, but will inevitably slow. Japan's mature economy definitely needs a spark, but its size and the potential opportunity of change and development are significant. Japanese companies that successfully build pan-Asian businesses will have great potential for success.

Market Capitalization as a % of Asia Pacific Total



Source: World Bank and Bloomberg — Note: Inclusive of China A shares

The Asia Pacific region has taken a big stride this year towards establishing itself as one of the world's economic forces. The size of the region and its growth rate make it all too easy to extrapolate some sort of world domination. But an evolved Asia Pacific doesn't need domination, it just wants respect. While Europe and North America will continue to lead the world in numerous areas for the foreseeable future, Asia's equality in this constellation of three great global regions has finally arrived.

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December 7, 2007

all data as of 11/30/07

REGIONAL OVERVIEW

Given that volatility has become the only (near) certainty, it was no surprise that the ink had barely dried on last month's commentary before investors decided that "cheap but dull" held far more appeal than "excitement and momentum." The trigger for the reversal was further disclosure of write-downs by major U.S. and European banks related to asset-backed securities. The dichotomy between the U.S. and Asia's economic cycle remained evident as interest rates or reserve ratios were raised by several Asian central banks, while the U.S. Federal Reserve pondered over when, rather than if, they would next cut rates. The market clearly is hoping for a little Christmas cheer, both in the form of lower rates and ringing cash registers, but the longer-term impact of the U.S. housing bust remains unclear.

The petrodollar-fuelled investments by Emirate firms in the last week of the month injected some optimism, giving the market a quick caffeine jolt, at least until the next rate move or write-down.

If anything, Asia is buffeted today more by changes in global risk appetite, rather than U.S. economic growth. One month performance is little indication of anything, but it was not surprising given the frosty investment climate in November that markets and sectors with the least connection to the U.S. generally fared better. In broad index terms, the few pockets of positive performance came in areas like telecom services in Korea, utilities in Japan, and health care in Korea and Japan. While all three sectors are considered relatively defensive by U.S. investors, "defensive" isn't a term that can be applied with any dependability to the frothy Chinese markets, and double digit losses were commonplace across the board. Energy took it on the chin as oil backed off from the $100 level.

It may take a while for the markets to settle down. The economic and inflationary picture will take months to resolve, and in the meantime the key driver will be the collective answer to two questions all investors are now asking—how much do I want in risky assets, and how do I know which assets are risky?

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Matthews International Capital Management, LLC

CHINA/HONG KONG

Stock indices in China and Hong Kong plunged sharply in November on concerns over further monetary tightening measures by China's government to cool the economy, as well as the global economic impacts of the U.S. mortgage crisis. Facing rampant loan growth and soaring property and stock markets, Chinese authorities ordered banks to curb lending through the end of this year. Banks were reportedly asked to ensure that their outstanding loans at the end of the year do not exceed their total loan balance on October 31. In addition, China's central bank raised the bank reserve requirement ratio for the ninth time this year to 13.5%. For the month, the MSCI China Index dropped -13.5%, Hong Kong's Hang Seng Index declined -8.8%, and China's domestic A-share index sank -15.9%.

According to the National Bureau of Statistics, consumer prices in October surged 6.5% from a year ago, up from 6.2% in September. A rapid increase in food prices continued to be the main driver of China's accelerated inflation. Despite its high CPI (Consumer Price Index) inflation, for the first time in 17 months and effective on November 1, China raised the state-set prices of gasoline, diesel and jet fuel by roughly 10% to ease widespread shortages and to close the gap between domestic and global oil prices. In mid-November, China also increased natural gas prices by about 50% for some industrial users—such as chemical companies and power producers—which account for approximately half of the country's natural gas demand.

While China's currency, the renminbi (RMB), continued its gradual appreciation against the U.S. dollar, the Hong Kong dollar maintained its explicit peg to the U.S. dollar. The RMB has appreciated 5.2% since the beginning of the year to 7.40 RMB/USD, while the Hong Kong dollar (HKD) has remained roughly unchanged at 7.79 HKD/USD. As Hong Kong's economic cycle is becoming increasingly synchronized with China's growth cycle, the Hong Kong dollar has faced some upward pressure to appreciate against the U.S. dollar. However, the Hong Kong Monetary Authority reiterated that it would continue to fix its exchange rate with the U.S. dollar.

INDIA

India's third quarter GDP grew at an annualized pace of 8.9%, modestly better than consensus expectations, but a slight decline from the previous quarter. The agricultural sector showed improvement, growing at 3.6%, which is towards the higher end of the historical range of 2–4%, but still continues to lag the industrials and services sectors. The overall decline in the GDP growth rate was led by the industrials sector where growth fell from its near-term trend of about 11% to 9% for the quarter. This slight softness is in sync with the slowdown in credit growth in recent months. Within the industrials sector, there is a clear divergence from the trends seen in the end-user segments. More specifically, capital goods continued to grow at a rate close to 20%, but consumer durables experienced a sharp slowdown—again pointing to the early impact of rising interest rates. The government announced additional relief measures for exporters

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in the leather, marine, handicrafts and textile industries. This is the third set of measures introduced by the government since July to help exporters cope with the sharp appreciation of the Indian rupee this year.

The Bombay Stock Exchange 100 Index was down marginally during the month of November as foreign institutional investors (FIIs) became sellers while domestic mutual funds were buyers. Recent restrictions to the issuance of participatory notes (p-notes) has had the impact of reducing FIIs' volumes in the short term; however, anecdotal evidence suggests that the government has streamlined the registration process and sped up the licensing procedures for FIIs. As registered investors, FIIs can transact directly in India's equity markets. In another development, the Securities and Exchange Board of India (SEBI) has made some provisions to allow domestic mutual funds to engage in short selling, as well as lending and borrowing of securities. FIIs do not fall under the purview of these provisions and hence will not be allowed to short securities. The date on which the provisions will go live has yet to be announced by SEBI, but once in effect, they should further help improve price discovery in India's equity markets.

JAPAN

The Japanese market outperformed all other Asian markets for the month mainly due to the strength of the yen. In fact, the yen hit a year-to-date high of 107.23 against the U.S. dollar—a 7.5% increase from its monthly low of 116. The yen's rise was prompted by the expectation of another interest rate cut by the U.S. Federal Reserve Bank. One data point that suggests a U.S. economic slowdown is the country's weak demand for exports from Japan: down 1.5% year-over-year. In addition, the trade surplus with the U.S. declined by 8.5% year-over-year; however, on the whole Japan's trade surplus remained healthy as demand from Asia, the Middle East and Russia continued to be strong.

The weak sentiment regarding consumption continues as national department store sales for October were down 1.4% year-over-year. However, the October monthly household survey showed that consumption increased 0.6% year-over-year, representing three consecutive months of increases. Also non-farm income gained 0.4% year-over-year in October, which suggests a very moderate recovery trend in Japanese consumption.

Japan's core CPI (excluding fresh food) rose for the first time in the last 10 months, up 0.1% year-over-year. Taking a closer look at the breakdown by item shows continuing price declines in wireless telecom charges and digital appliances (flat panel TVs and PCs), which were more than offset by increased energy and food costs.

In general, labor data indicates a stable employment environment in Japan, however there is some softness in small-to-medium sized enterprises as they are not hiring as much as large enterprises.

KOREA

In November, the Korean Stock Price Index (KOSPI) declined -9.8%. Shipbuilders and the industrial sector underperformed, while the telecom sector outperformed the broader market on news of industry consolidation and restructuring.

During the month, Korea's foreign exchange and credit markets were volatile. The Korean won declined 1.7% against the U.S. dollar, and major interest rates rose—the three-month CD rate increased 25 basis points (0.25%) to 5.6%, and the 3-year government bond yield increased from 5.46% to 5.77%. At a press briefing held on November 29, the deputy minister of the Ministry of Finance and Economy (MOFE) cited the U.S. subprime turmoil as one cause of the recent credit market volatility. He announced that the MOFE would take action if the current market volatility continued. The next day, as an open market operation, the Bank of Korea bought 1.2 trillion won (U.S. $1.3 billion) worth of government bonds in an attempt to stabilize the market.

Unlike in the financial markets, the economic activities on "main street" were robust. Compared to the same period in 2006, year-to-date exports rose 14.2% to $339 billion and imports rose 14.4% to $323 billion. Exports to the U.S. increased just 6%, while exports to the Middle East, China and E.U. rose 38%, 18%, and 13%, respectively.

Overseas construction orders won by Korean firms, year-to-date through October 31, reached a record high of $30 billion, an 80% increase over the calendar year 2006, which was $16.5 billion.

South Korea's presidential election will take place on December 19. According to local media, Lee Myung Bak, a candidate from the opposition party (the conservative Grand National Party), is leading the race with 35–40% of potential votes, followed by Lee Hoi Chang, an independent candidate, and Chung Dong Young from the ruling United New Democratic Party.