ASIA INSIGHT

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Matthews Asia

Three Precious Commodities

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"This planet has—or rather had—a problem, which was this: most of the people living on it were unhappy for pretty much of the time. Many solutions were suggested for this problem, but most of these were largely concerned with the movements of small green pieces of paper, which is odd because on the whole it wasn't the small green pieces of paper that were unhappy." (Douglas Adams, Hitchhiker's Guide to the Galaxy).

The U.S. is in crisis—the foundation of credit on which economic activity rested is crumbling. How can it be that less than a decade ago U.S. productivity sustained 3% growth, unemployment was low and the New Economy held out a promise of many years of rapid non-inflationary growth? How could such entrepreneurial success and enthusiasm have been the preamble to a desperate crisis of confidence and the prospect of a long, nasty recession? How is it that bankruptcies, bailouts and unemployment dominate today's headlines and the capitalistic financial system is in turmoil? Can these problems be so easily dismissed by printing small green pieces of paper?

Economic moralists may believe that the boom was an illusion created by too much money and that the crash was the inevitable consequence of the "dot com" silliness. Their prescription may be to don sackcloth and ashes and lead a more economically moral life. But the pragmatists contend that holding those small green pieces of paper makes us happy—it eases our fear of the unknown. "Cash in hand" means security and confidence. Or, as Keynes put it: "Our desire to hold money as a store of wealth is a barometer of the degree of our distrust of our own calculations and conventions concerning the future." We are witnessing a shortage of three key commodities: money, time and confidence. The alternating waves of euphoria and depression exaggerate the cycles of the economy and our markets, and they have a self-feeding quality. Panicked investors, lacking confidence in their own view, look to see what others are doing, only to find them staring fearfully back. The previous day's fall in prices becomes the news that drives the market: hence, the "777-point drop" headlines. Indeed, Federal Reserve Chairman Ben Bernanke has been at pains to point out that the Fed, unique among investors, has endless supplies of cash, ample confidence and the patience to wait things out. Cash rich corporations such as Berkshire Hathaway[1] and Japanese banks are showing their confidence, too.

Focus on the Long Term

Regardless of whether the moralists or the pragmatists are right, today, if you have money, time and confidence, you own the three most precious commodities in the world. Keeping your head whilst those around you panic is not an easy thing to do. The ability to invest in times of panic is often presented as the ability to pick the bottom of the market—the ability to not lose money. Those who dive in and are immediately shaken out by further precipitous declines invariably fail in this effort. For those who have the luxury of time, the ability to not miss the upswing is paramount. But that requires the willingness to dive in and accept that it's going to hurt. On a daily basis, we are all reading about bank failures and slowing earnings growth; it is hard to be distracted from falling prices and how much it's going to hurt if you fail to "time it right." If you are trying to pick the very bottom of

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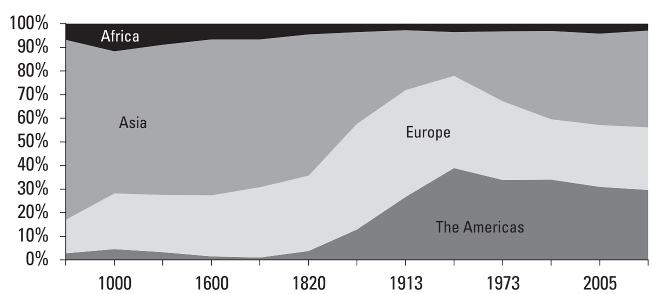
the market it is doubly difficult to ignore the swirling panic when making that split-second decision.

No one can tell when the markets will bottom. In fact, we need to distract ourselves from the short-term news of falling prices and focus on the distant long term to see if that gives us some kind of anchor. We desire ample supplies of money, time and confidence; these commodities, it seems to me, are most in evidence in Asia. Year-to-date, the fall on Wall Street has disproportionately hurt Asian stock markets. Yet there has been no serious shock to their financial systems because they are not highly leveraged. Why? They are still cautiously expanding after a long stagnation of credit growth since the 1997 Asian financial crisis. Asian companies have improved the quality of their balance sheets with net debt-to-equity ratios of non-financial companies falling from an already low 35% in 2002 to about 10% now. Cash as a percentage of total assets is also high—particularly in China and India and in telecoms, consumer services, retail and technology.

Let's distract ourselves further from today's mayhem by taking an absurdly long view of regional shares of global GDP, which suggests that time is also on Asia's side. What this reveals is the dramatic change wrought by Europe and America in the industrial revolution. There was also the long, painful stagnation of much of Africa and the resurgence of Asia, due to its own ongoing industrial and consumer evolution, to gain what is to date only a part of her historical position in terms of economic might. The forces of industrialization and urbanization coupled with the mobilization of savings into investments drove this growth; ironically, cycles in investment and savings also drive short-term panic. The two are inseparable it seems in all but the minds of day traders and speculators.

Regional Shares of Global GDP — Past and Future

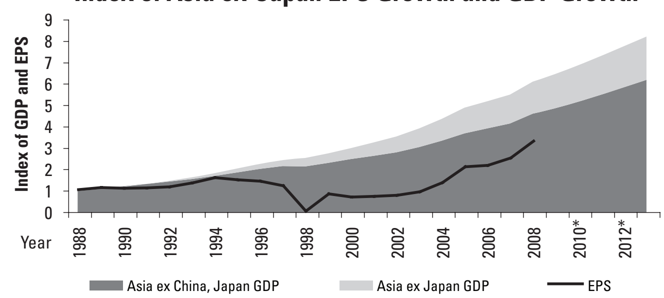


Source: Angus Maddison, IMF; Global GDP is in Purchasing Power parity terms to equalize buying power
Timeline not to scale

In taking what may still seem to some to be a ridiculously long-term view today, but which would register no more than a blip on the above chart, we can look at earnings growth and GDP growth in Asia through the last 20 years.

The graph below shows three things: an index of GDP for Asia ex-Japan, and index of GDP for Asia ex-Japan and ex-China, and an index of earnings per share (EPS) for Asia ex-Japan companies. The EPS index uses U.S. dollars and the GDP indices use international dollars, which are dollars adjusted for price levels in each economy.

Index of Asia ex-Japan EPS Growth and GDP Growth



Source: World Bank, IMF, FactSet Aggregates; GDP is in Purchasing Power Parity terms; *estimated

Asia has time on her side. For the past decade, she has lived the moral economic life that many now prescribe for the U.S. Most government debt levels remain low, foreign exchange reserves are high and currencies have broadly been strengthening over the past few years. Current account surpluses total $625 billion and most banking systems have low loan-to-deposit ratios. Corporates have strong reserves of cash and conservatively geared balance sheets. Earnings growth has been strong but unsurprising given the depths to which profits sank. Asia's population is newly affluent and ambitious.

Asia has the potential to grow—she has the money and the time. All that Asia needs now is the confidence.

Robert J. Horrocks, PhD
Director of Research
Matthews International Capital Management, LLC

[1] As of Sept. 30, 2008, Matthews Asia Funds had no holdings in Berkshire Hathaway, and the reference does not represent a recommendation or solicitation for any security.