



AFTER THE FALL: The Path Forward for China's Economy and Stock Market

Matthews Asia | October 2015

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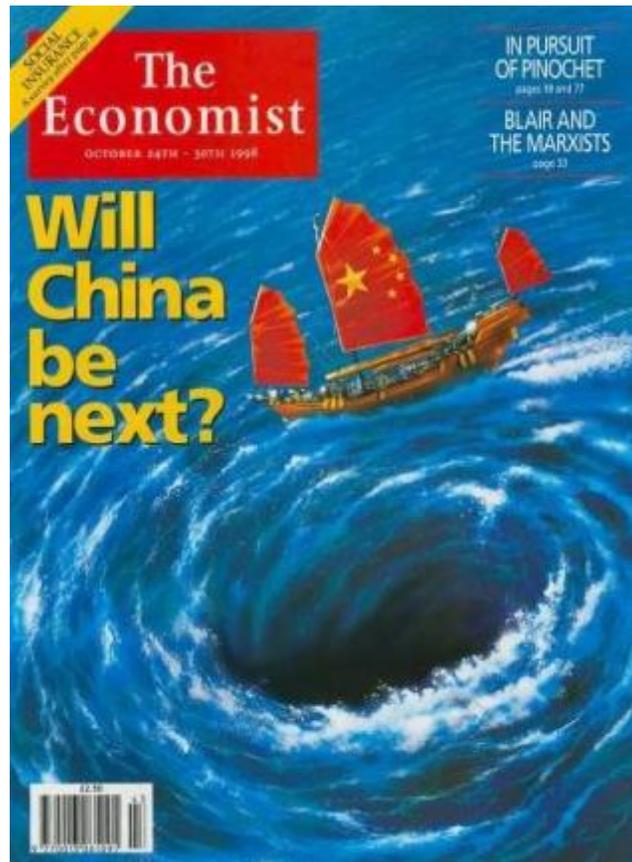
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Investing in international and emerging markets may involve additional risks, such as social and political instability, market illiquidity, exchange-rate fluctuations, a high level of volatility and limited regulation. In addition, single-country and sector strategies may be subject to a higher degree of market risk than diversified strategies because of concentration in a specific industry, sector or geographic location. Investing in small- and mid-size companies is more risky than investing in large companies as they may be more volatile and less liquid than large companies.

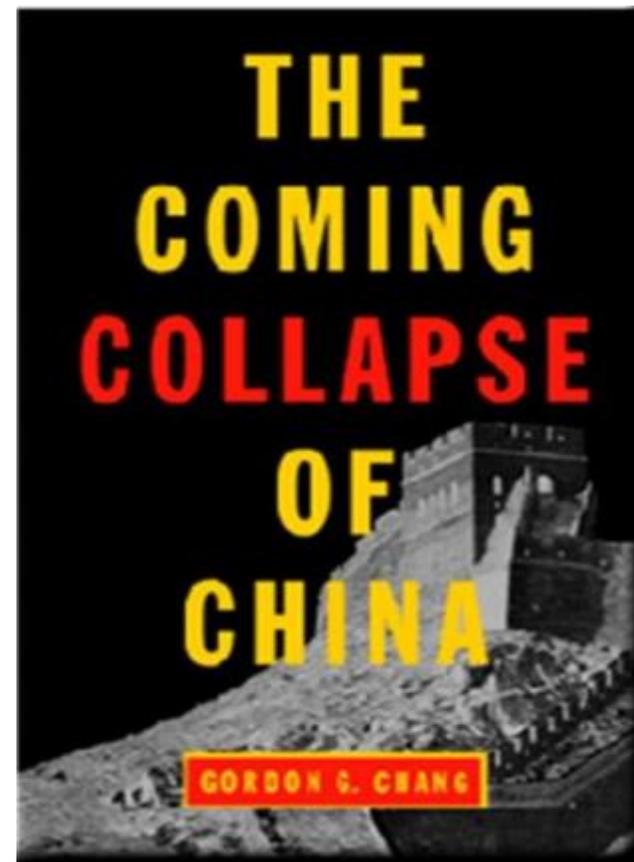
Perpetual Forecasts of Doom and Destruction

What mistakes have led so many analysts to predict imminent collapse for so many years?

1998



2001



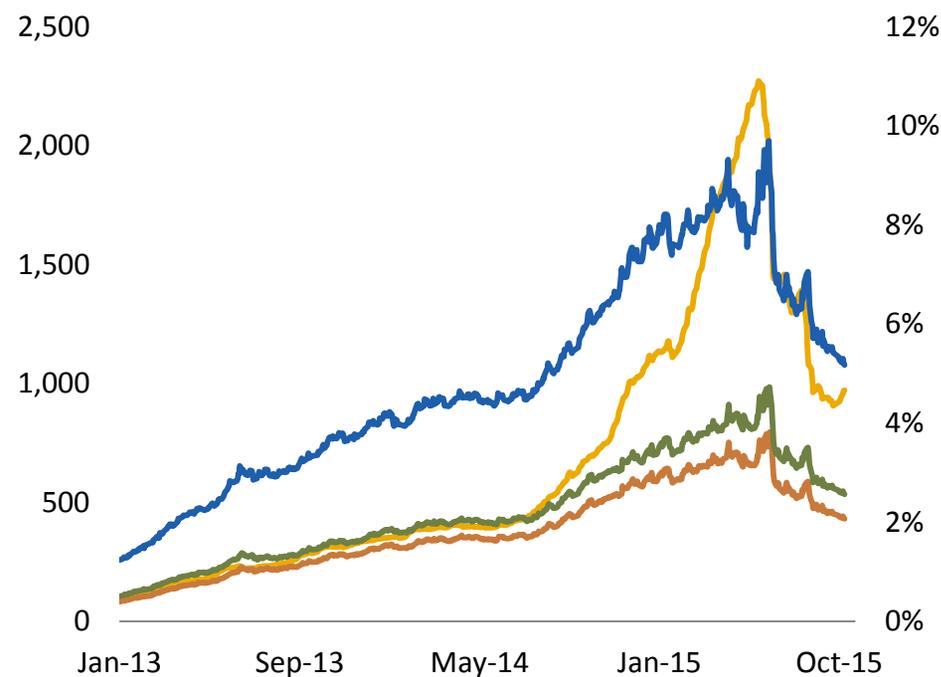
A-Shares Down Sharply, but a ‘Crash?’

- * SHCOMP down 34% from June 12 peak; but up 5% YTD and up 44% YoY (as of 19 October)
- * Margin trading balance down 57% from peak to US\$150BN

SHANGHAI COMPOSITE INDEX



MARGIN TRADE (Rmb BN)



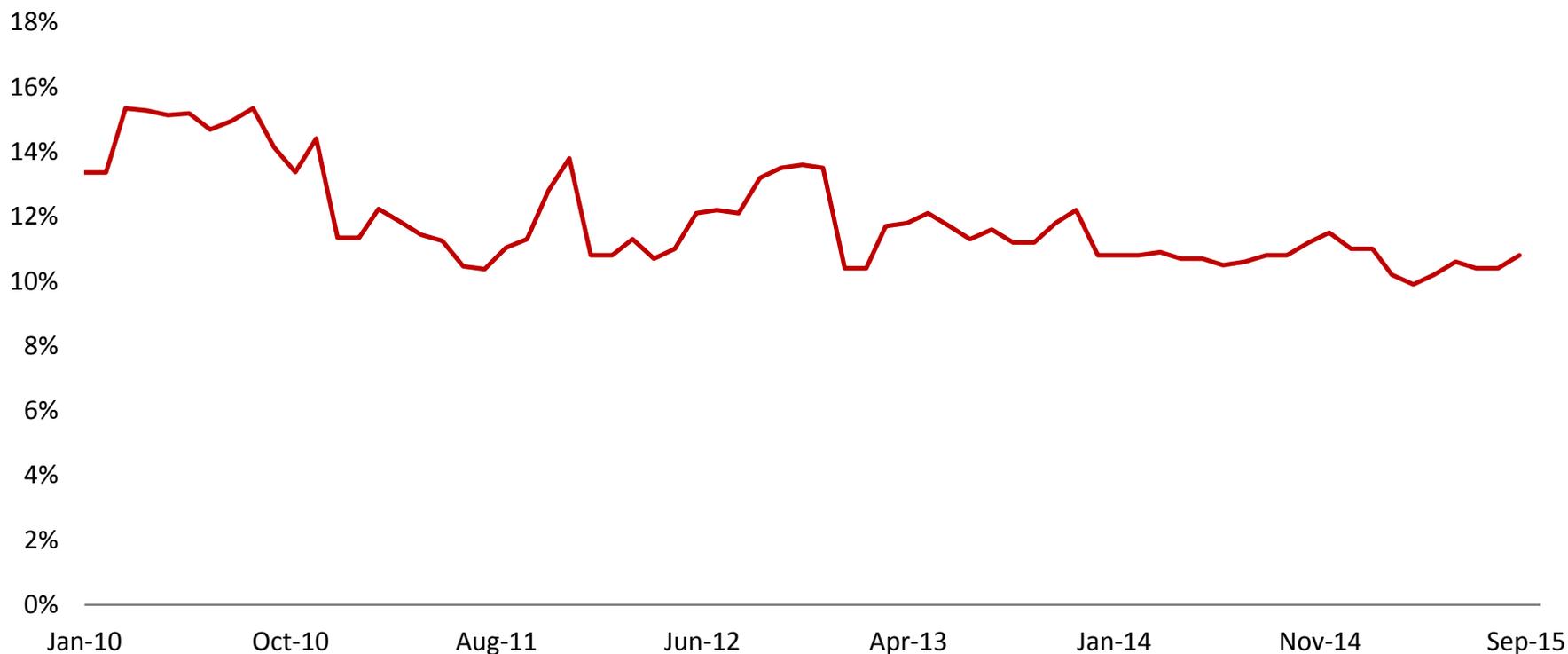
- Outstanding balance of margin trade (LHS)
- Margin trade outstanding as a share of total market cap
- as a share of market cap of free float shares
- as a share of free-float shares market cap defined by Bloomberg

Sources: CEIC, Bloomberg

Chinese Consumers Shrug Off A-share Correction

- * 50m active investors = 7% of urban population
- * 73% of active accounts have less than US\$15,000; less than 1% have more than US\$1MN
- * As the market rose (March-May 2015), bank deposits increased 10% YoY. Real retail sales rose 10.8% in September same as a year ago. Chinese tourist arrivals in Japan up 133% YoY in August

REAL GROWTH RATE OF RETAIL SALES (YEAR-ON-YEAR)



Source: CEIC

The World's Best Consumption Story

Year-on-Year changes in some consumer categories

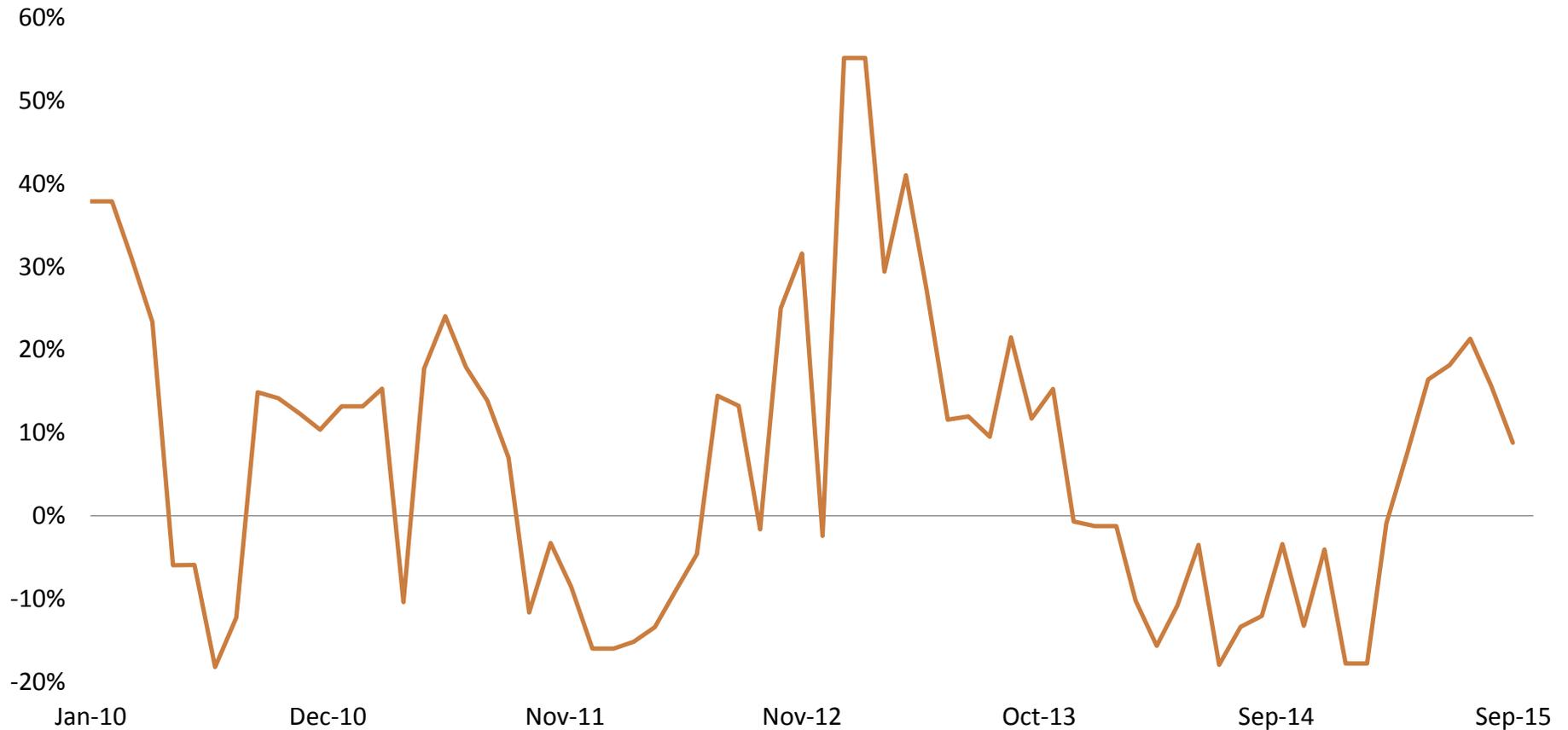
| | | |
|-------------|---|----------------------------|
| 133% | Chinese visitor arrivals in Japan | August |
| 112% | Apple's greater China revenue | 3Q 2015 |
| 76% | Spending by Chinese at tax-free shops in Europe | August |
| 59% | SUV sales | September |
| 56% | Express parcel deliveries | September |
| 54% | Movie box office revenue | 2Q 2015 |
| 30% | Nike sales in Greater China | Three months ending August |
| 19% | Furniture sales | September |
| 14% | Gasoline consumption | August |
| 11% | Household appliance and electronics sales | September |
| 11% | Inflation-adjusted retail sales | September |
| 9% | New home sales | September |
| 3% | Passenger car sales | September |

As of October 19, 2015, accounts managed by Matthews Asia did not hold positions in Apple Inc., or NIKE Inc.
Sources: Japan National Tourist Office; Company Data; Global Blue; CEIC; CNBC; National Bureau of Statistics of China

Chinese Home Buyers Shrug Off A-share Correction

New home sales up 18% in June, 21% in July, 16% in August, 9% in Sep vs -12% in Sep 2014

YOY GROWTH RATE OF NEW HOME SALES BY SQUARE METER

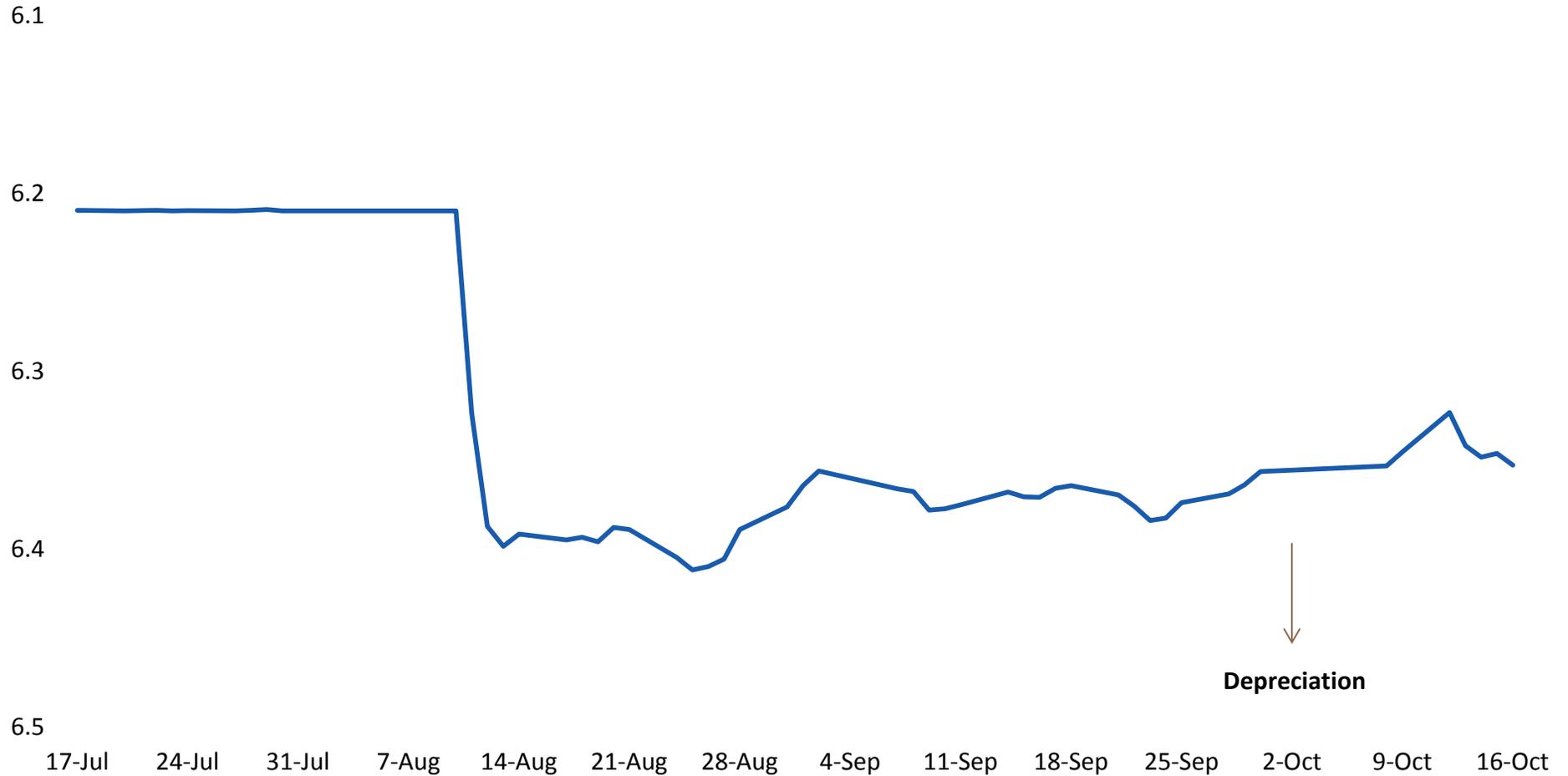


Source: CEIC

A Serious Devaluation?

The RMB has given back 2% against the U.S. dollar (as of 16 October 2015)

RMB/USD

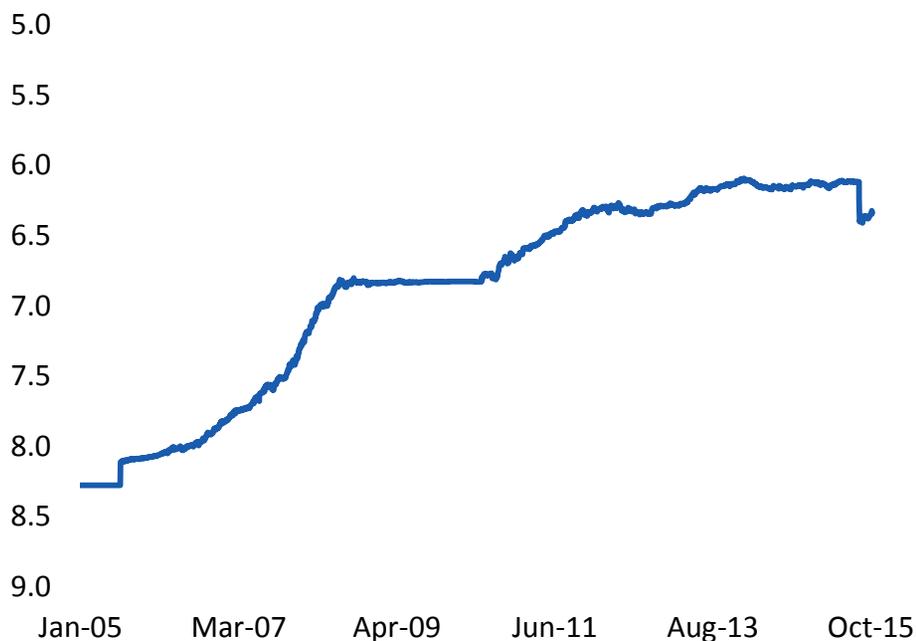


Source: CEIC

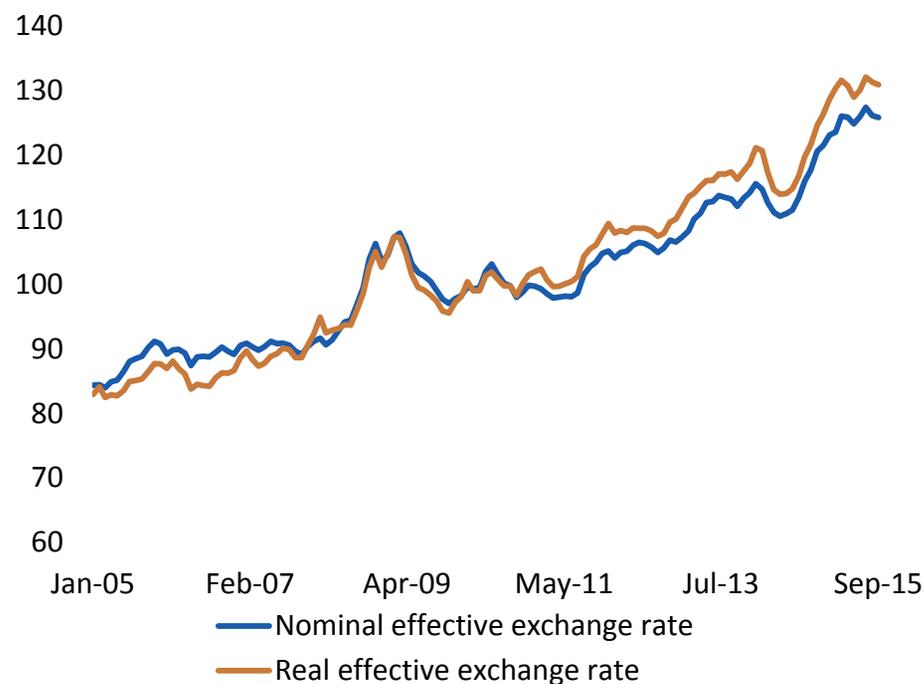
Devaluation in Context

Since July 2005, RMB has appreciated by 30% against USD as of Oct 19th; NEER has appreciated by 46%, and REER has appreciated by 57% as of September 2015

PBOC MID PRICE
RMB/USD



EFFECTIVE EXCHANGE RATE
2010=100



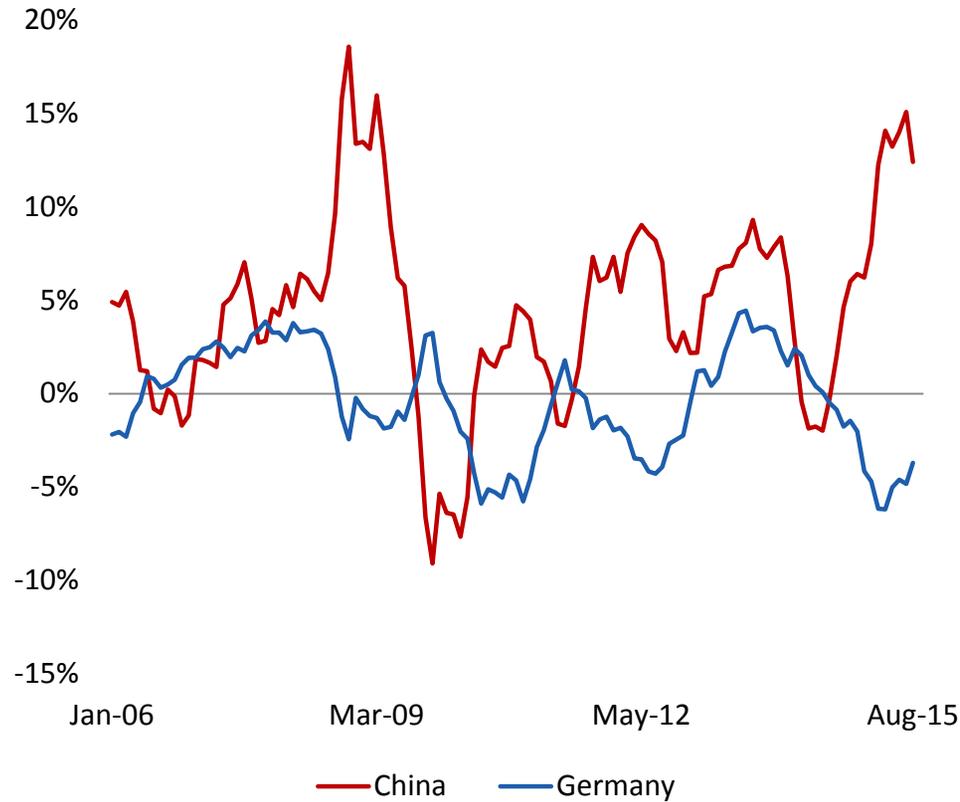
Nominal EERs are calculated as geometric weighted averages of bilateral exchange rates. Real EERs are the same weighted averages of bilateral exchange rates adjusted by relative consumer prices. The weighting pattern is time-varying, and the most recent weights are based on trade in 2008-10.

Source: CEIC

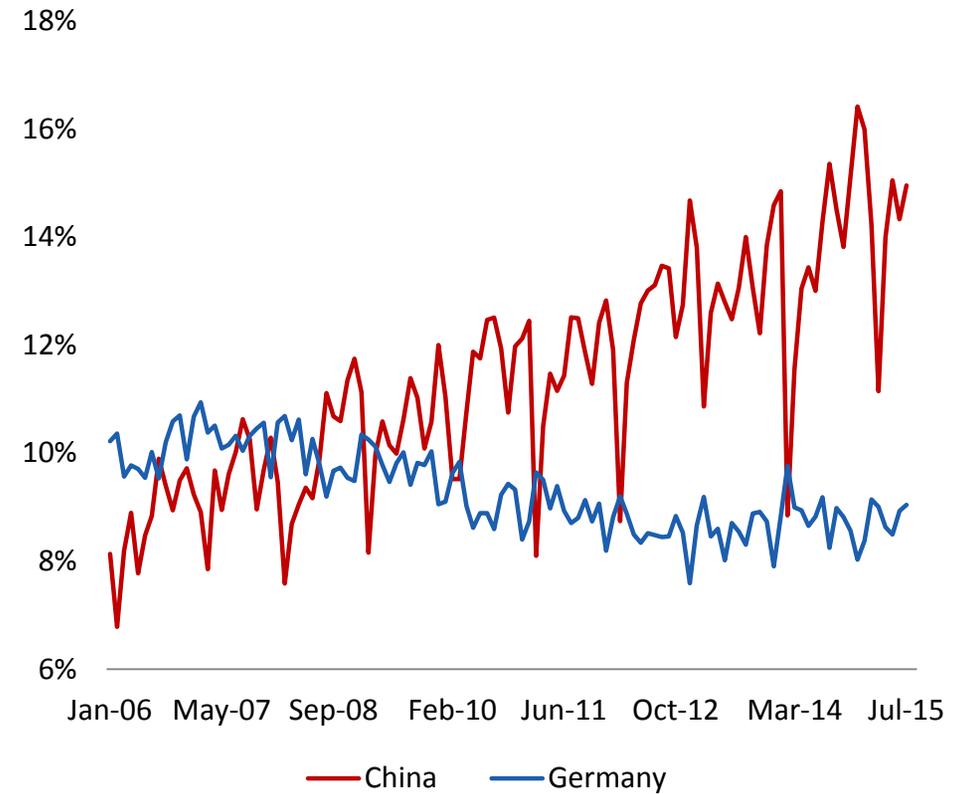
Devaluation was Not About Export Competitiveness

- * In first six months of 2015, world exports down 10.7% YoY; Germany -12.9%;China's +0.7%
- * Despite strong REER appreciation of the RMB, China's share of world exports rose from 11.6% in 2011 to 14.3% in June 2015. From 2001-2014, CAGR of global exports +9%, China exports +18.2%

YOY GROWTH RATE OF REAL EFFECTIVE EXCHANGE RATE



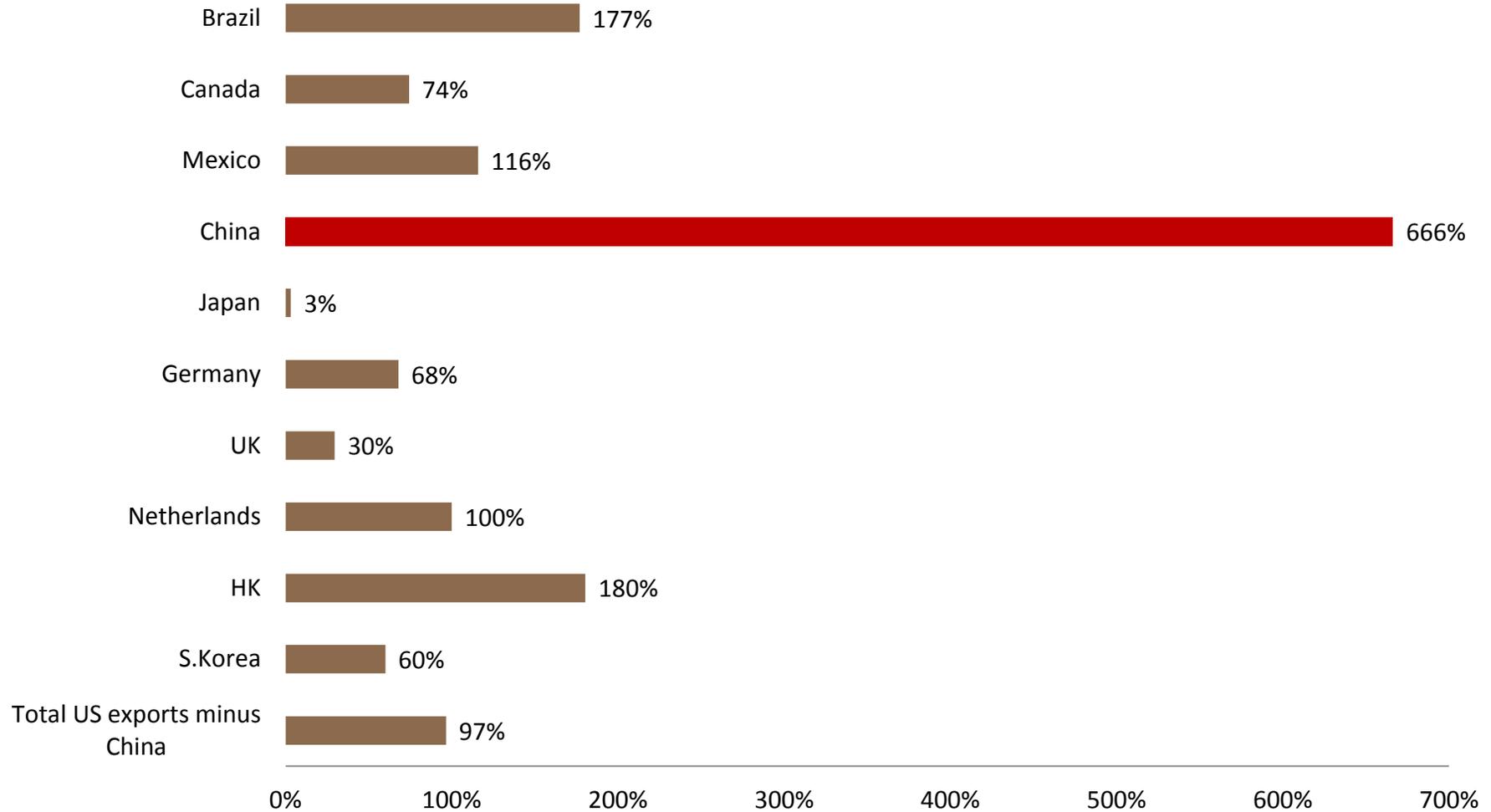
MARKET SHARE OF WORLD EXPORTS



Source: CEIC, WTO

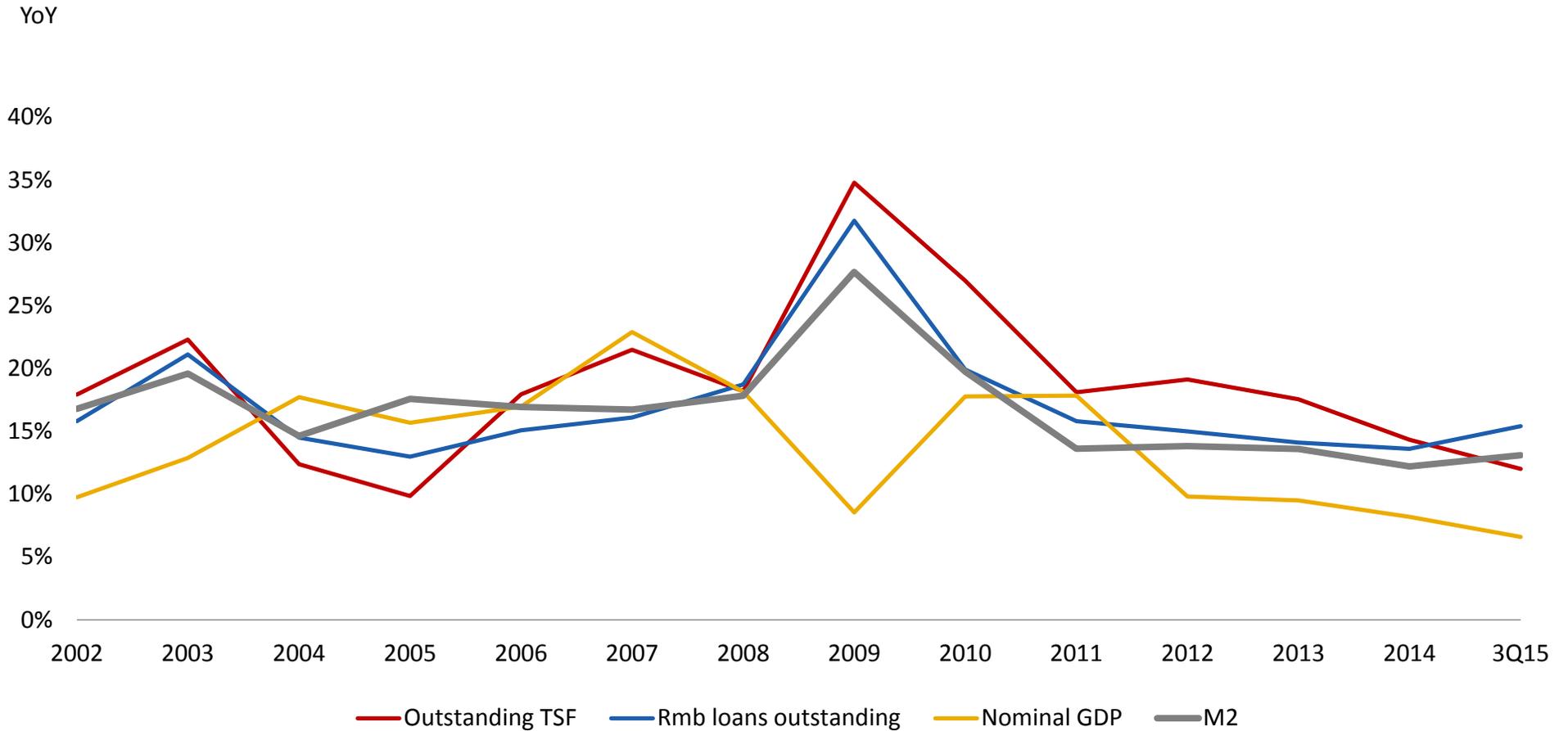
China has Been the U.S.' Fastest Growing Export Market . . . by Far

Growth rate of U.S. exports to its 10 biggest market, since China joined the WTO in 2001



Source: CEIC

Not Deleveraging, but Steadily Slower Credit Growth



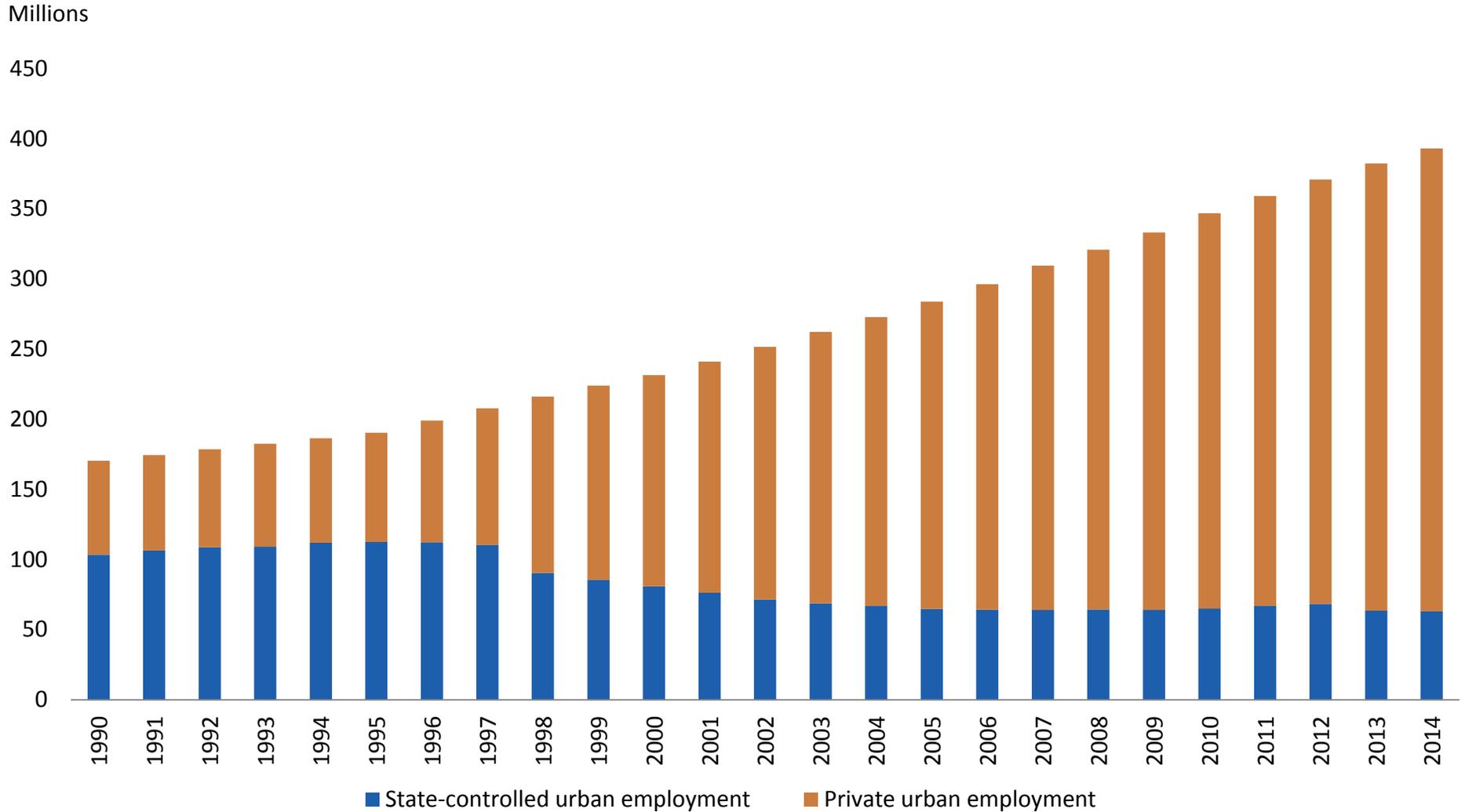
TSF=Total Social Finance, or aggregate credit.
Sources: CEIC, People's Bank of China

The Party's Top 5 Mistakes

- ✧ Putting the Party above the law
- ✧ Lack of trusted institutions, and inhibiting the development of civil society
- ✧ Blocking freedom of expression and political dissent
- ✧ Slow to fix China's environmental disaster
- ✧ Overly aggressive approach to neighbors in the South and East China seas



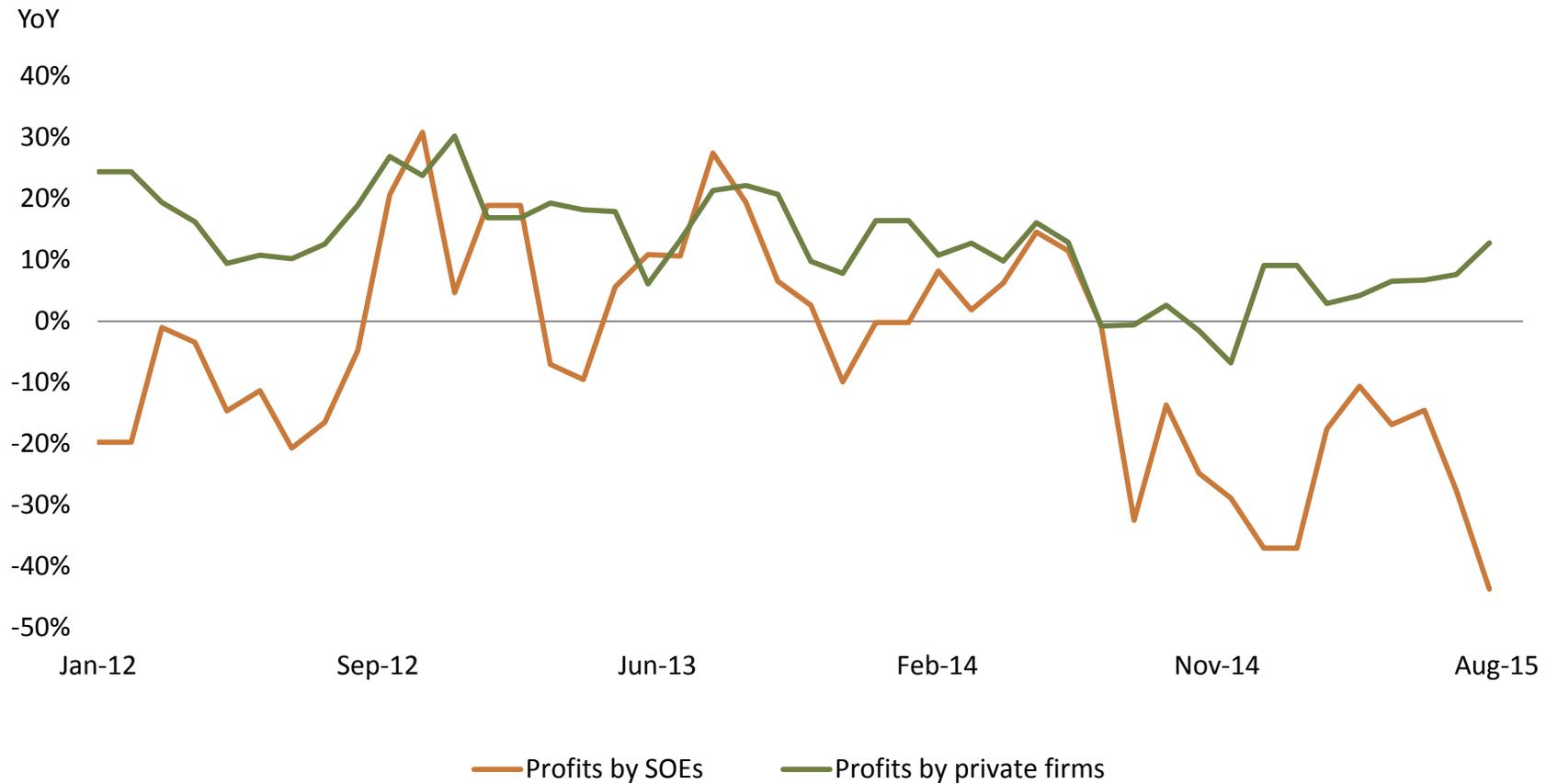
Mistake 1: Underestimating the Dominant Role of the Private Sector



Source: CEIC Data

Not Surprisingly, Private More Profitable

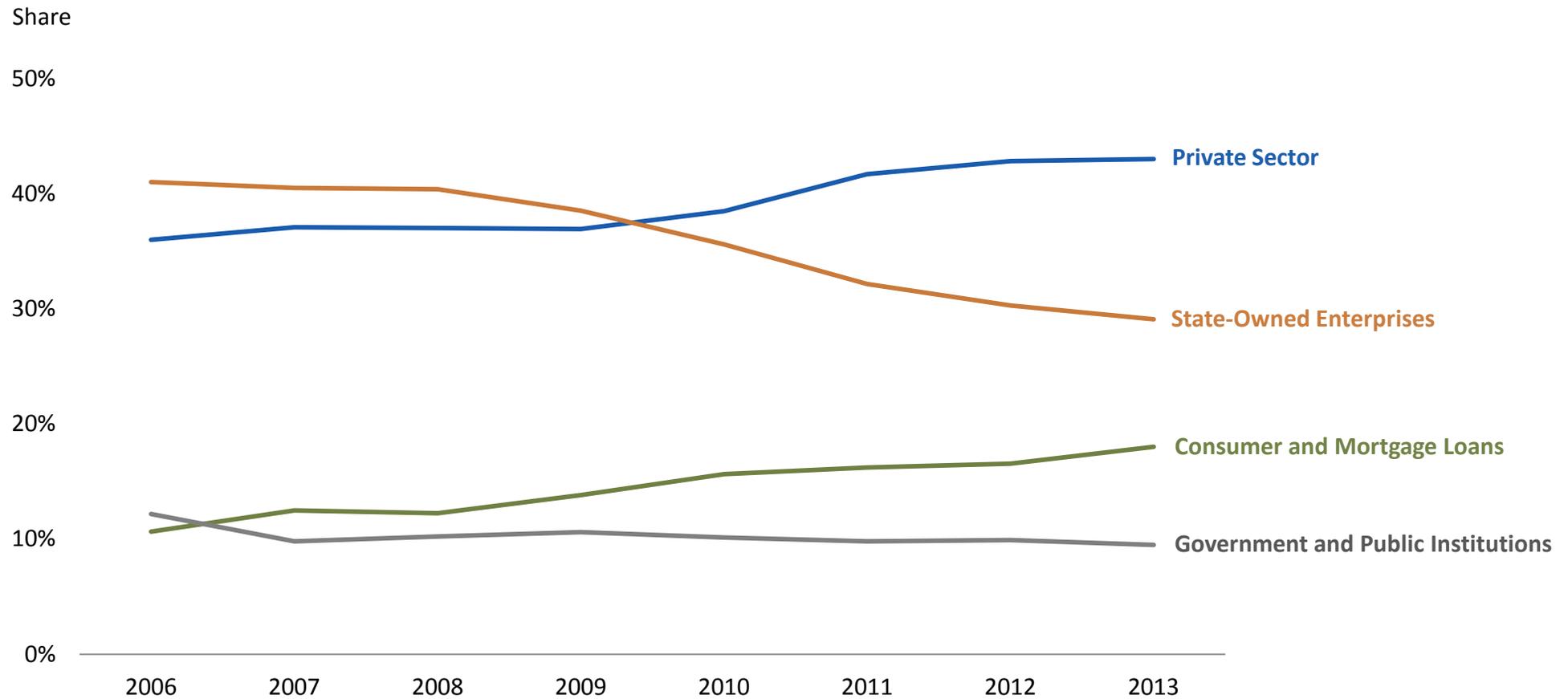
- ✦ Profits for privately-owned industrials were up 13% YoY in August, the eighth consecutive month of profit growth
- ✦ In contrast, state-owned enterprise (SOE) industrial profits were down 44% in August, the 13th consecutive month of declining profitability
- ✦ Privately-owned industrial firms now account for 35% of total profits of larger industrial firms, up from a 12% share a decade ago



Source: CEIC, MICM estimates

Most Bank Loans Now to Private Firms

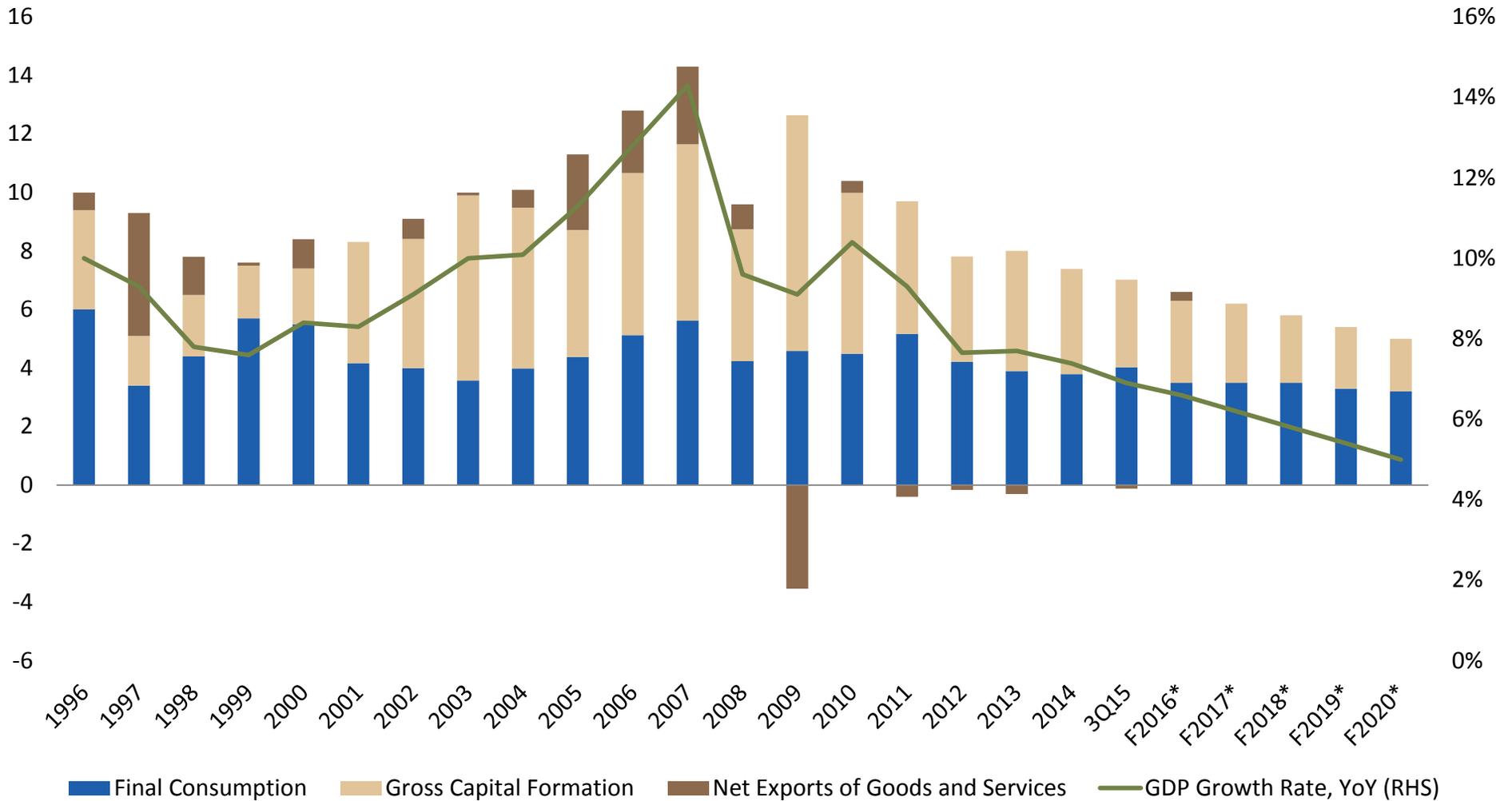
STOCK OF BANK LOANS



Sources: People's Bank of China, CEIC, MICM estimates

Mistake 2: Not Recognizing that Rebalancing is Well Underway

Percentage Points

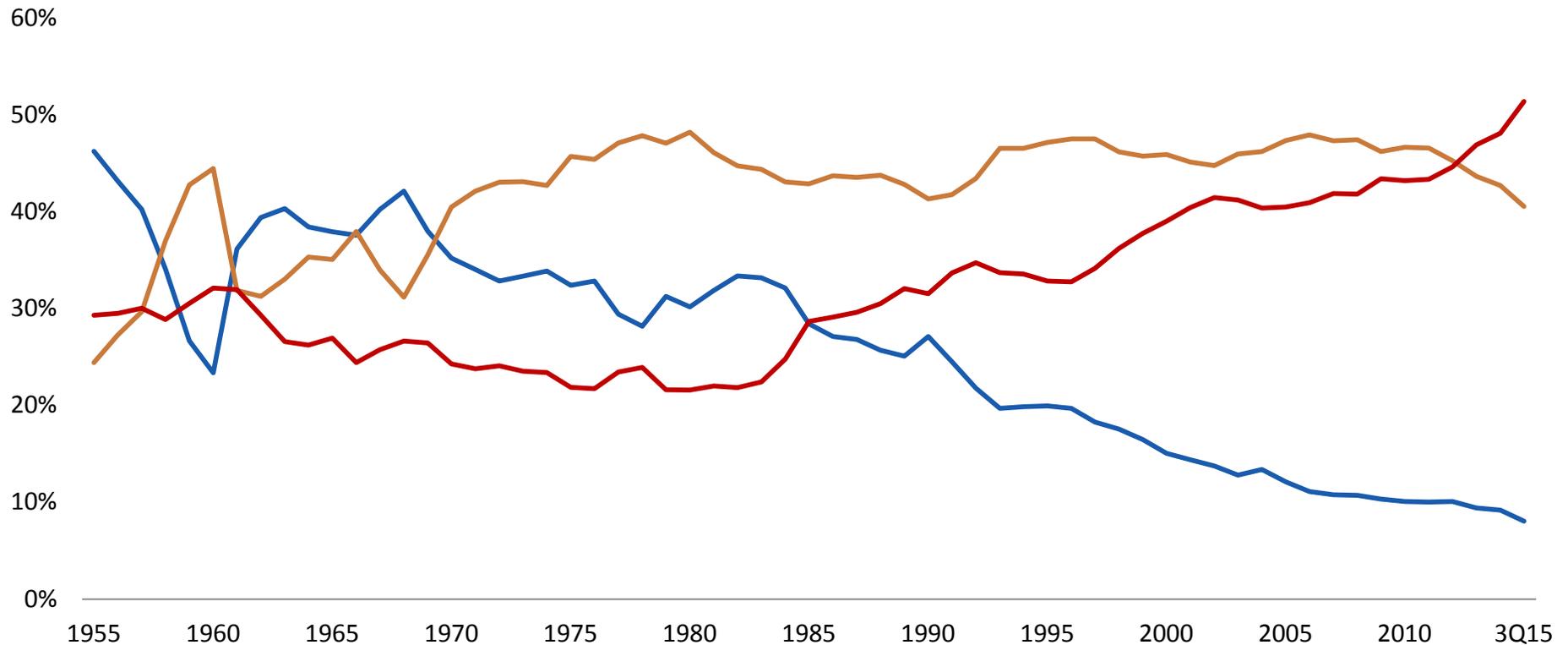


*Estimates
Source: CEIC, MICM estimates

Services Now More Important than Manufacturing and Construction

SHARE OF GDP BY PRODUCTION APPROACH

Share of GDP

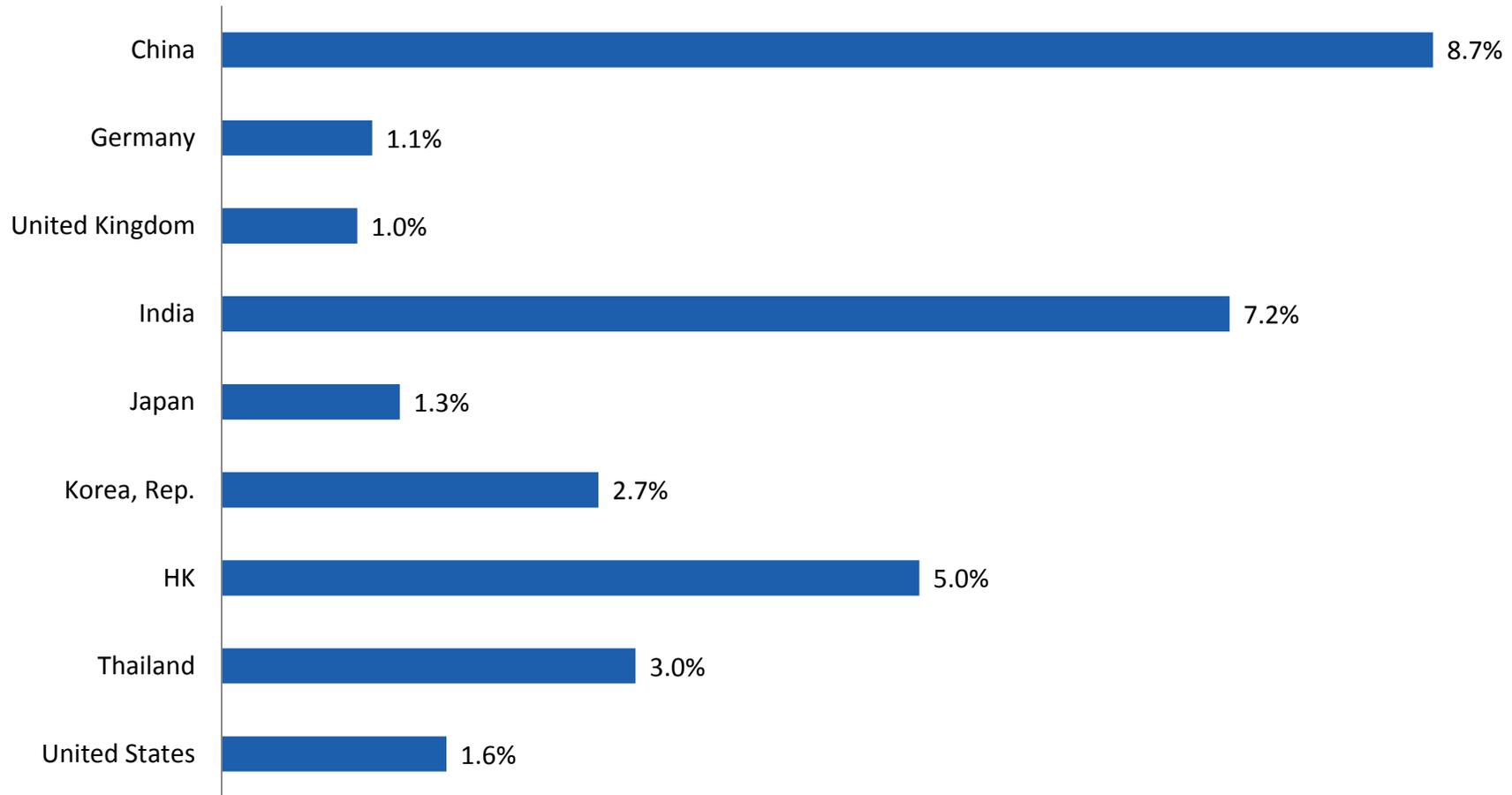


- Primary industry refers to agriculture, forestry, animal husbandry and fishery and services in support of these industries
- Secondary industry refers to mining and quarrying, manufacturing, production and supply of electricity, water and gas, and construction
- Tertiary industry refers to all other economic activities not included in the primary or secondary industries, including real estate, finance, wholesale and retail, transportation and other service industries

Source: CEIC

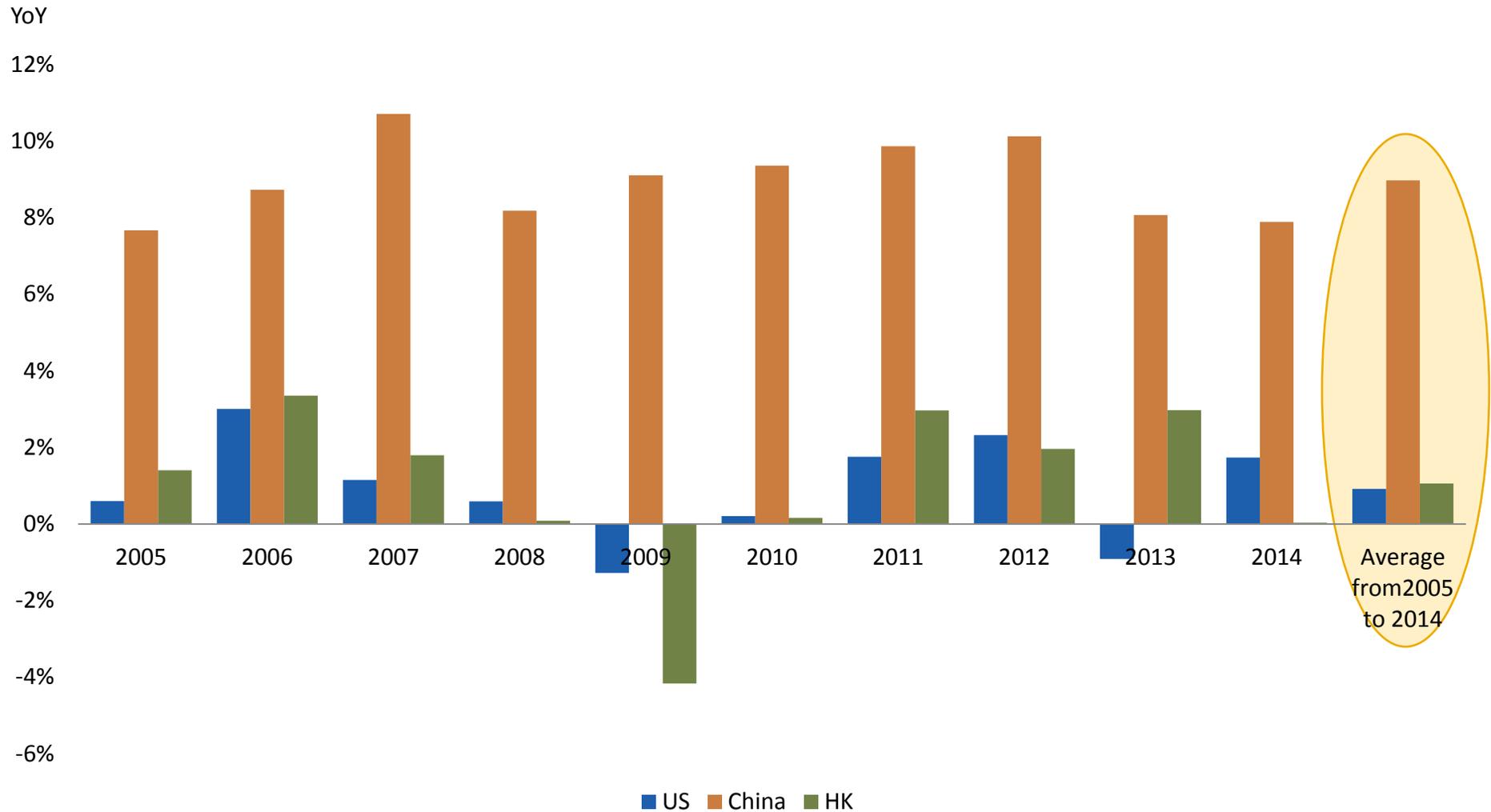
Mistake 3: Underestimating Chinese Consumers

Real compound annual growth rate of final consumption from 2009 to 2014



Sources: World Bank, International Monetary Fund (IMF) estimates

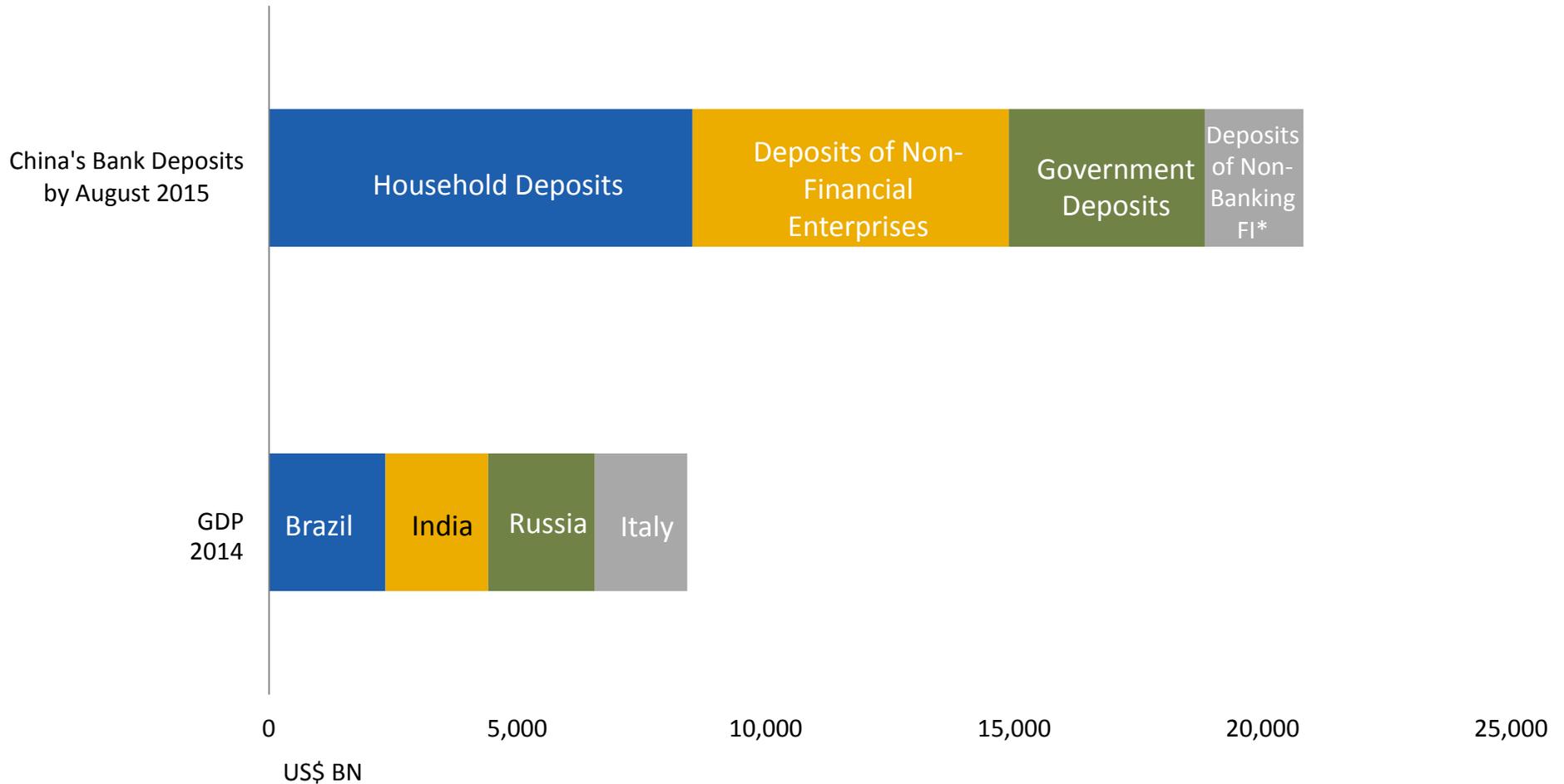
Real Growth Rate of Per Capita Household Income



Sources: CEIC, St. Louis Fed

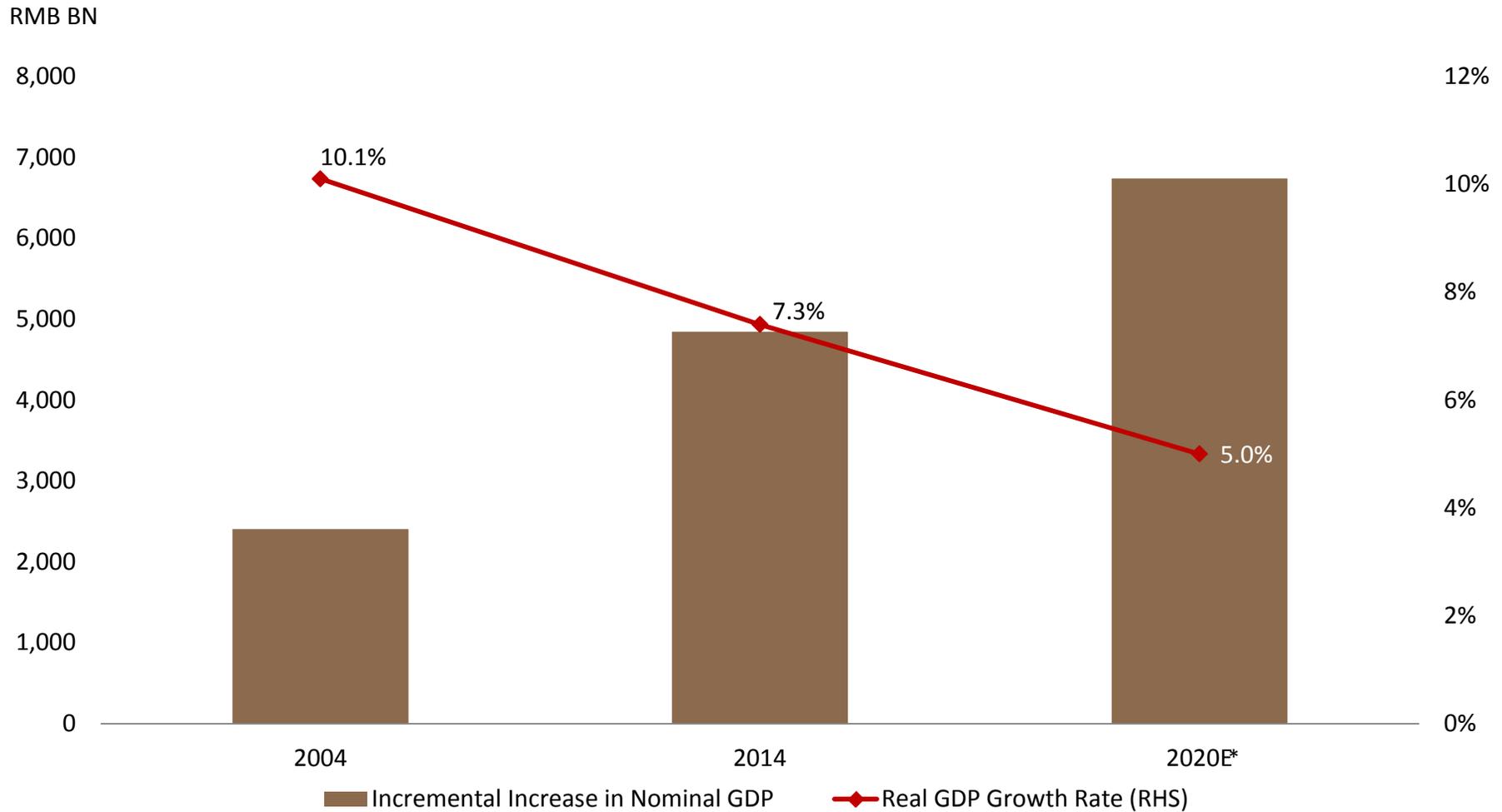
Consumer Spending Backed by Big Savings, Not Debt

Household savings greater than combined GDP of Brazil, India, Russia and Italy



*FI=Financial Institutions
Source: CEIC, World Bank

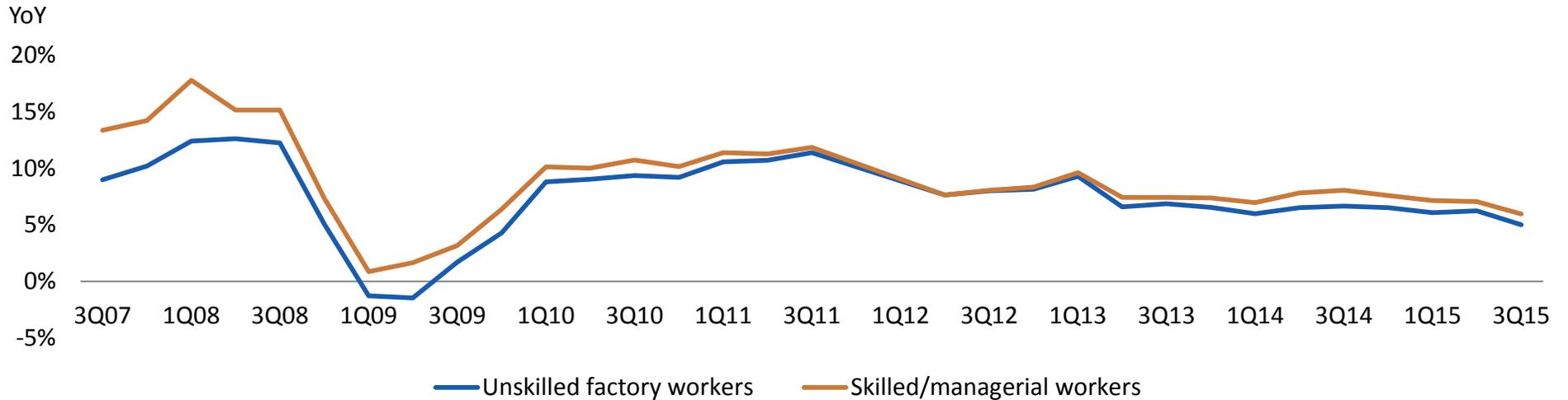
Rebalancing Means Slower Growth is Inevitable, but Remember the Base



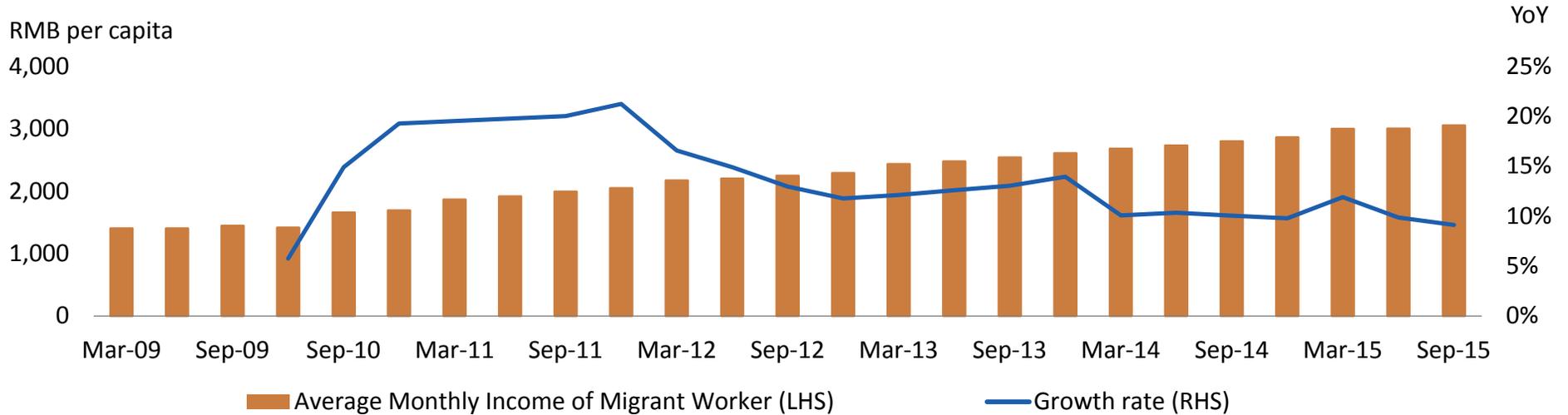
*2020 MICM Estimate
Source: CEIC

Steady Wage Growth Signals a Healthy Job Market

WAGE GROWTH OF UNSKILLED FACTORY WORKERS AND SKILLED MANAGERIAL WORKERS*



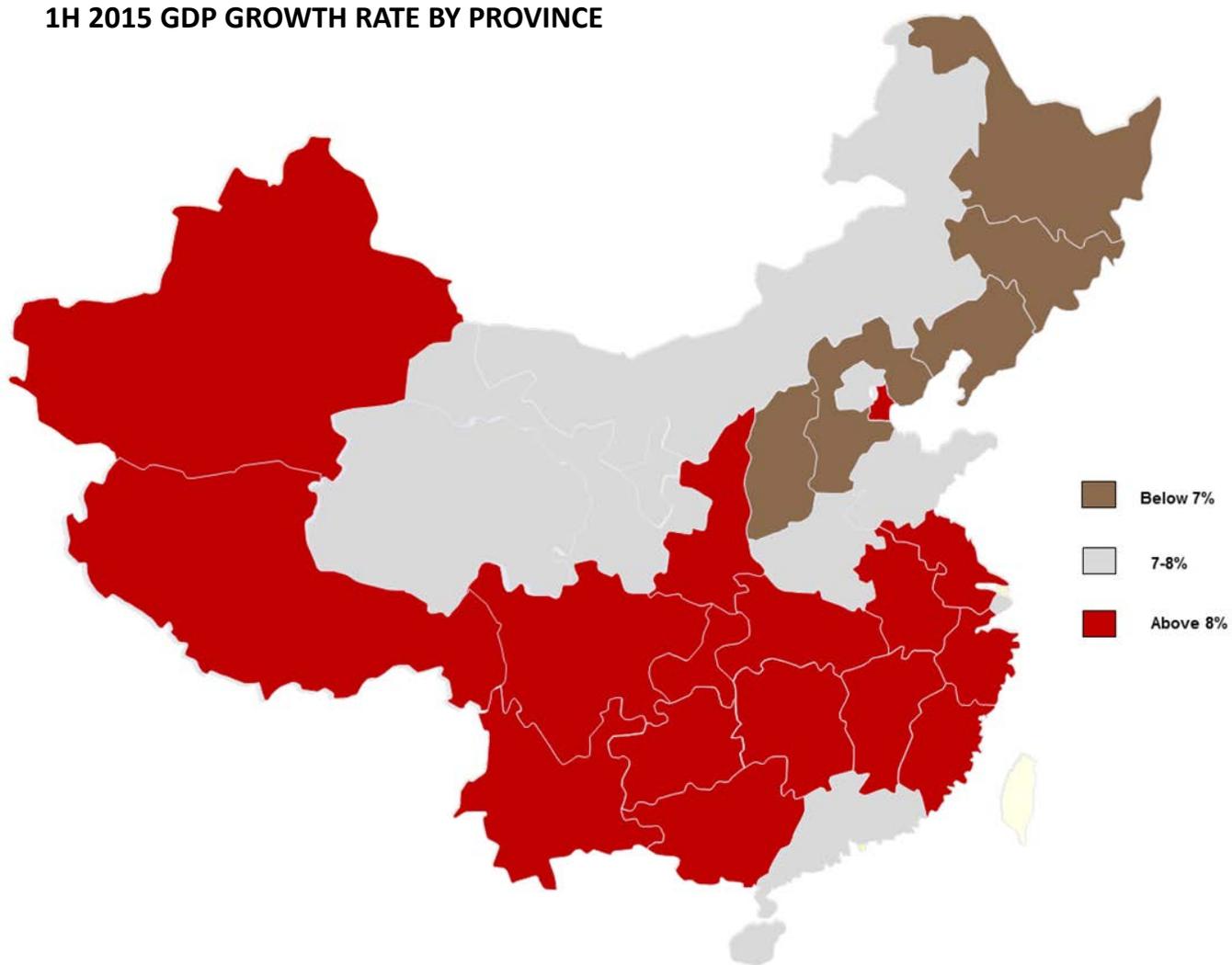
MIGRANT WORKER INCOME



*Surveys for the 4Q11 and 1Q12 time periods were not conducted.
Sources: CLSA, CEIC

Regional Variations in China's Growth Story

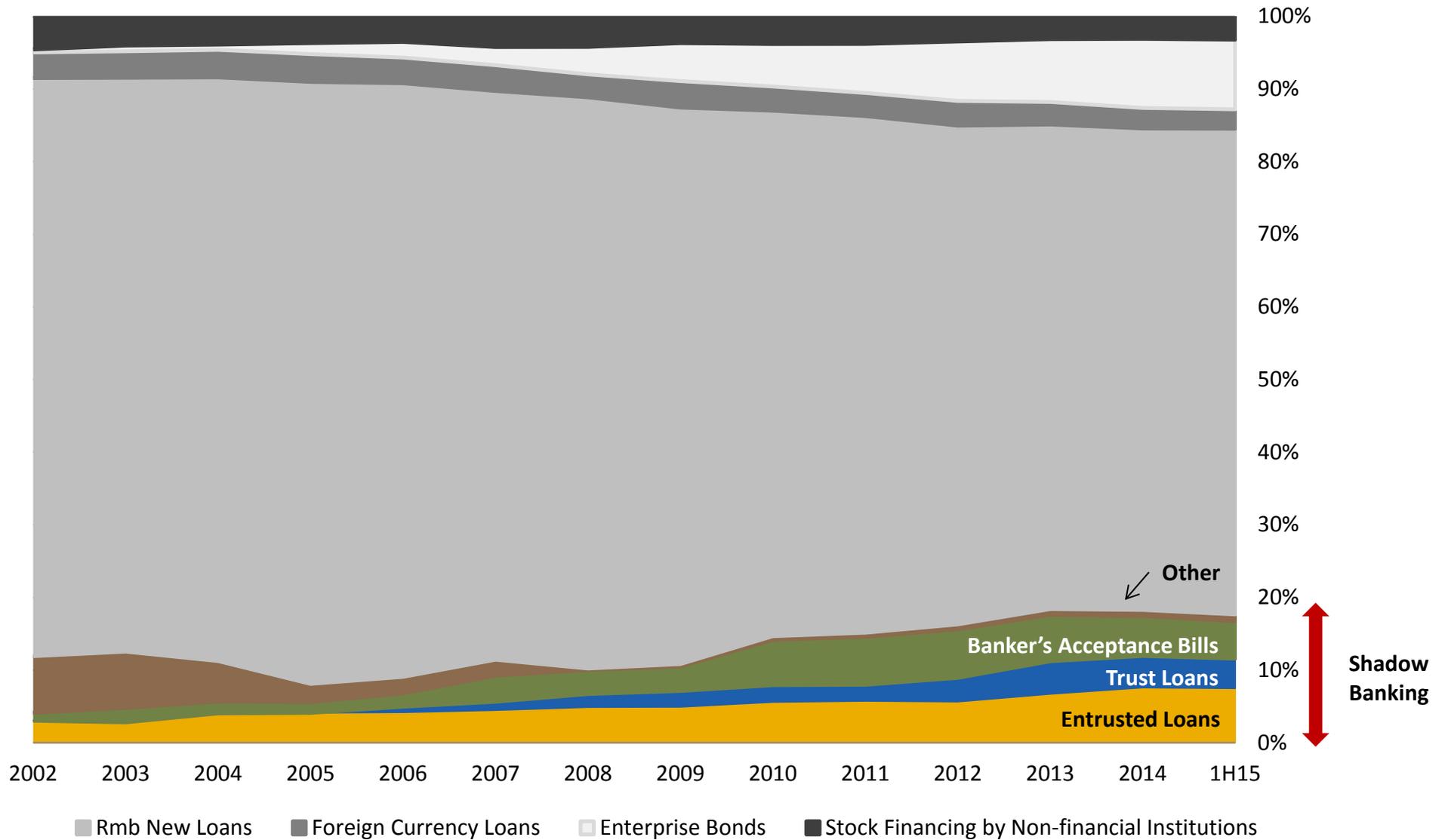
Resource extraction and heavy industry concentrated in the northeast



Source: CEIC

Mistake 4: Misunderstanding “Shadow” Banking and Debt Problems

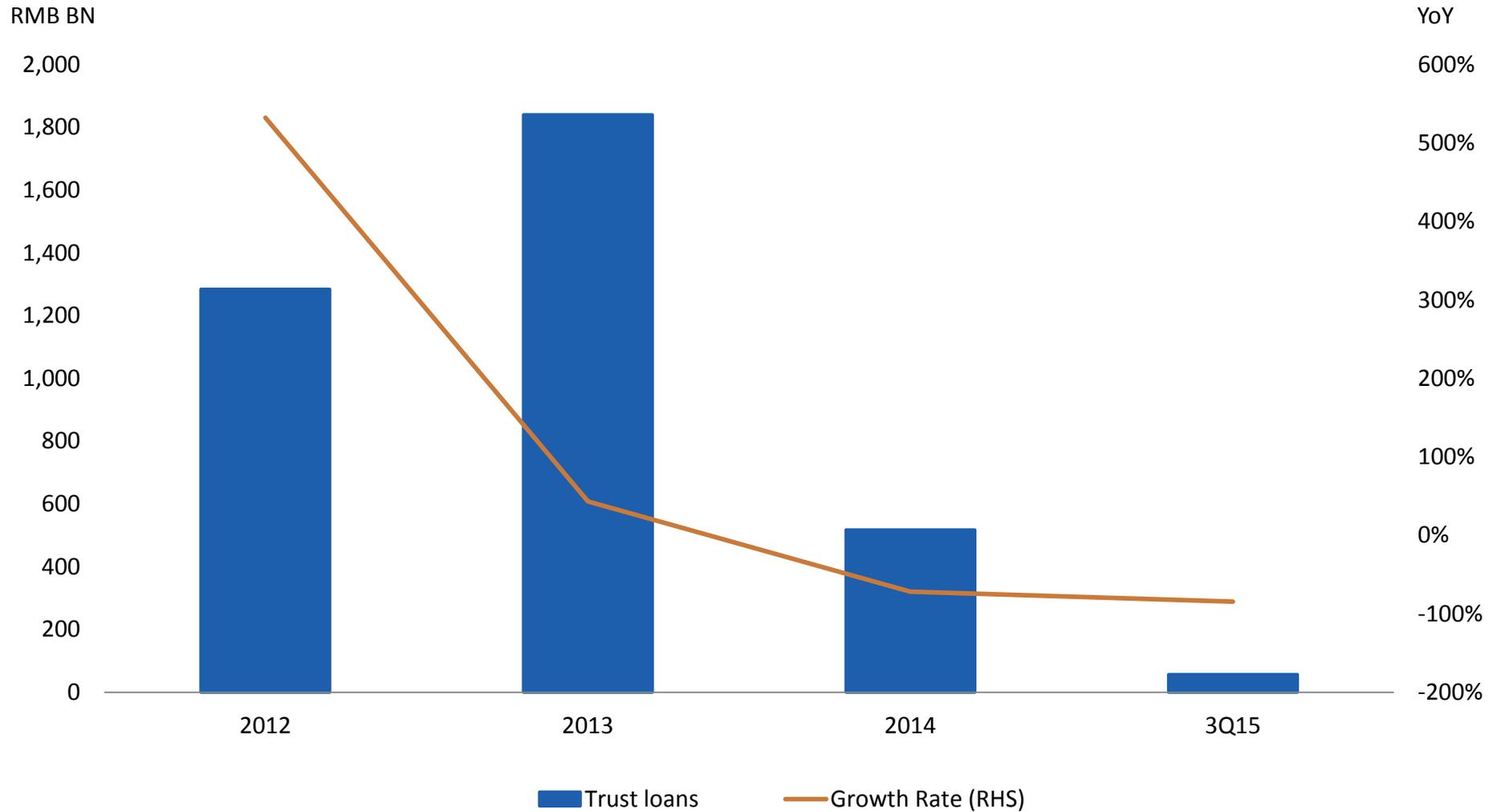
Most “shadow” credit is from party-controlled institutions



Sources: CEIC, MICM estimates

Party Control—Regulators Applied Brakes to Trust Lending

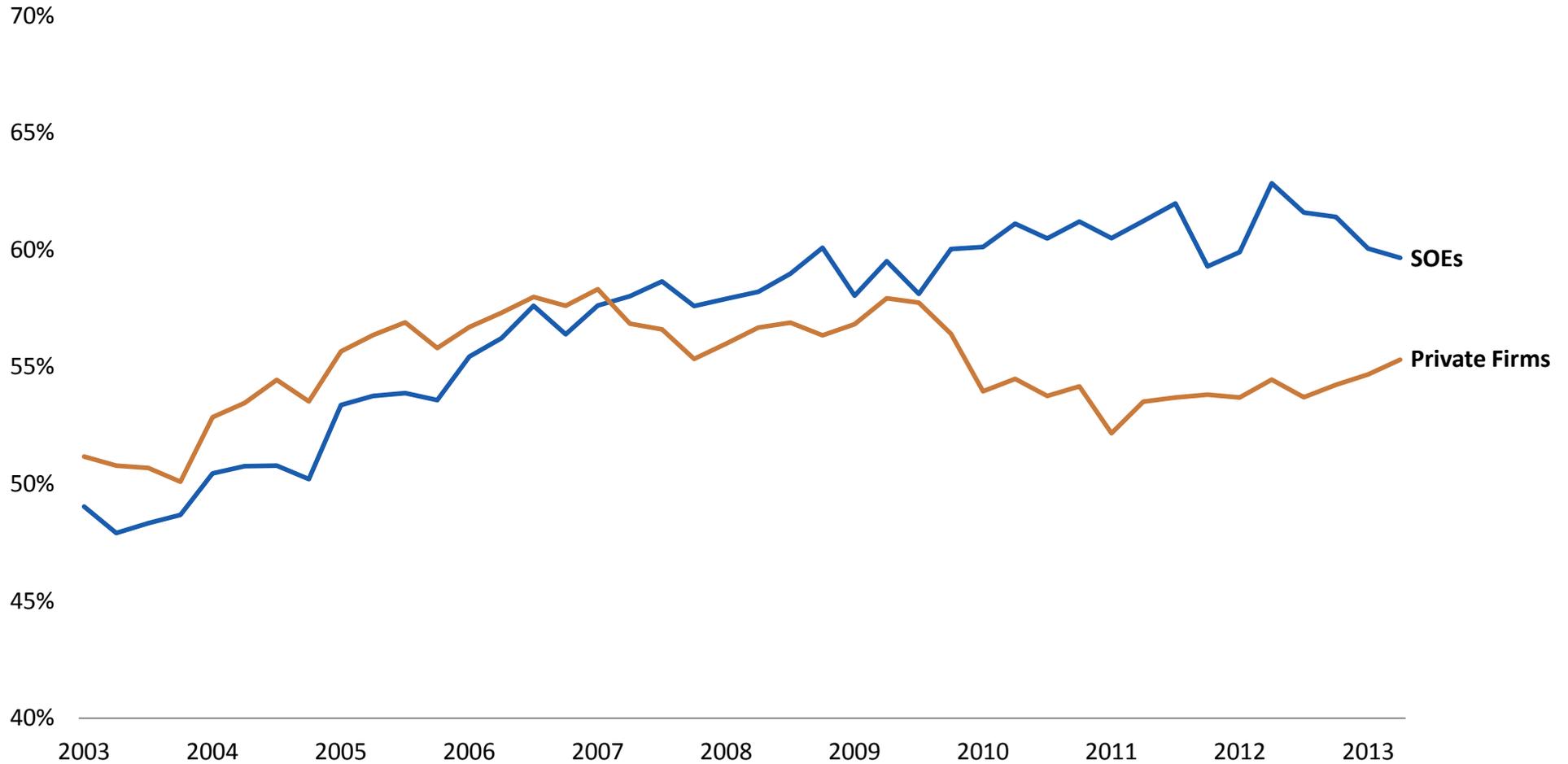
Growth rate of new trust loans slowed to -84% YoY through Sept 2015 from +532% in 2012



Source: CEIC

Debt is Concentrated Among State-Owned Enterprises (SOEs)

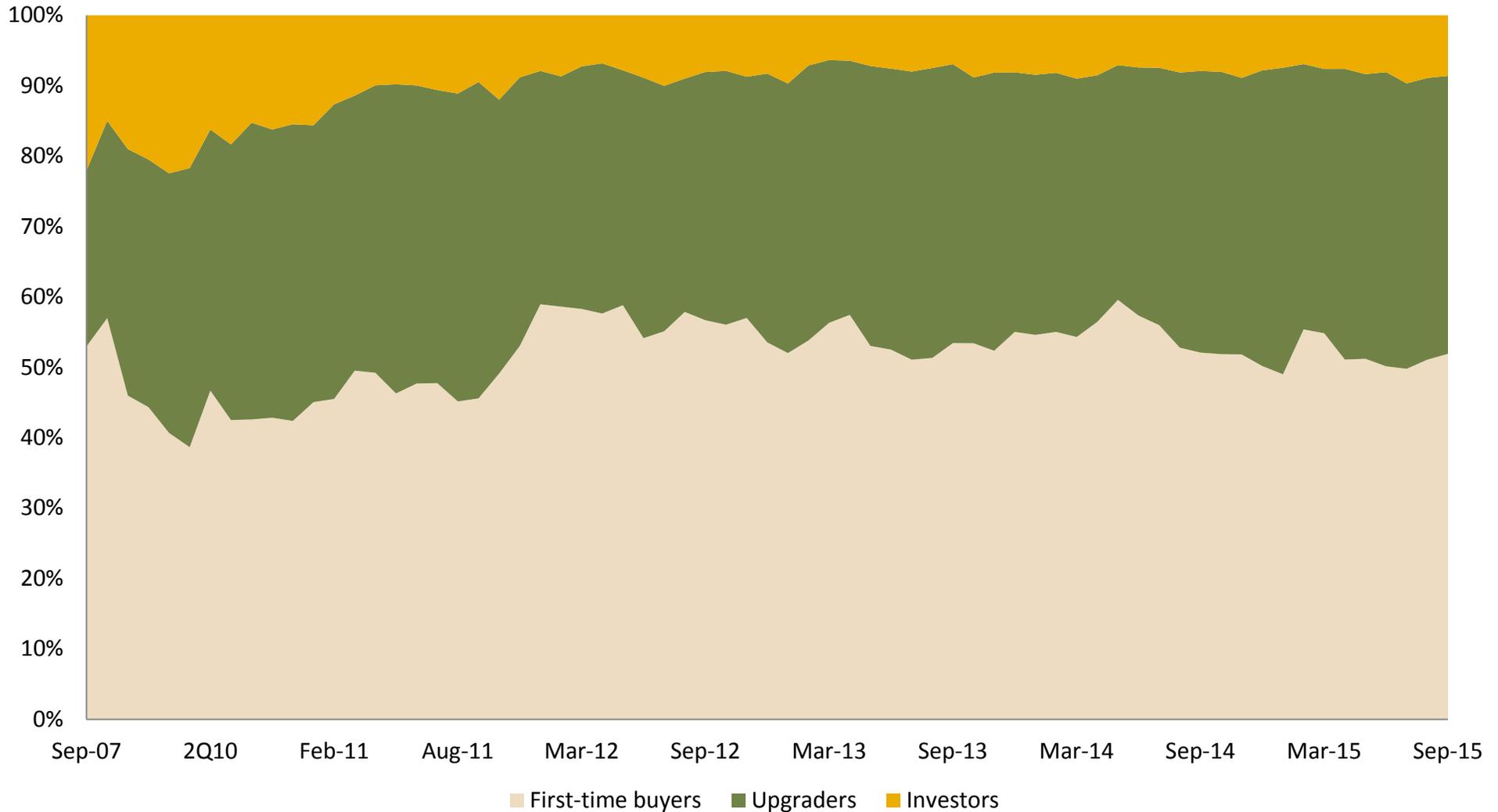
DEBT-TO-ASSET RATIO BY OWNERSHIP



Source: Hong Kong Institute for Monetary Research

Mistake 5: Misunderstanding China's Property Market

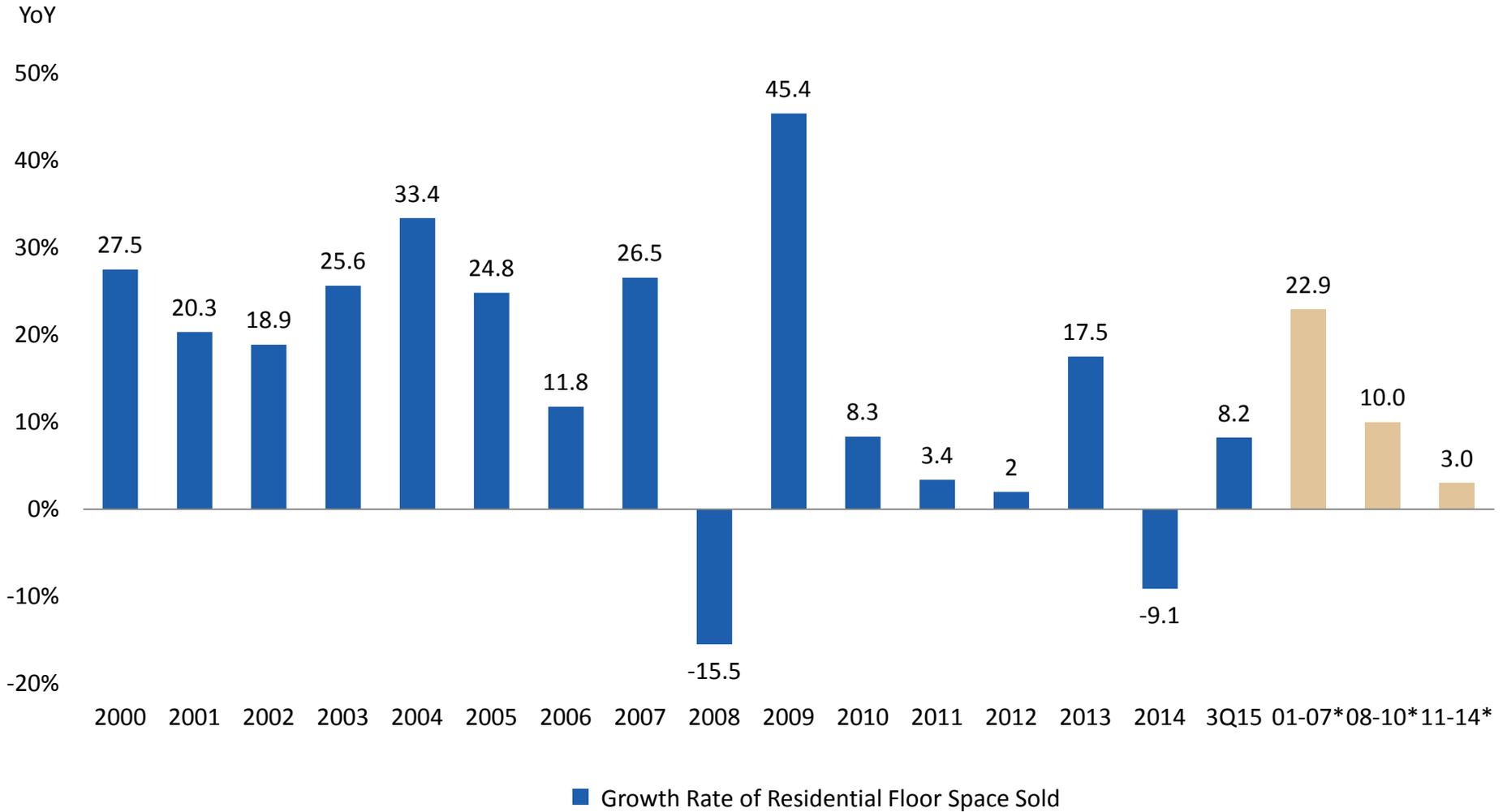
90% of new home buyers are owner-occupiers, who use a lot of cash



Source: CLSA

New home sales past peak but still healthy

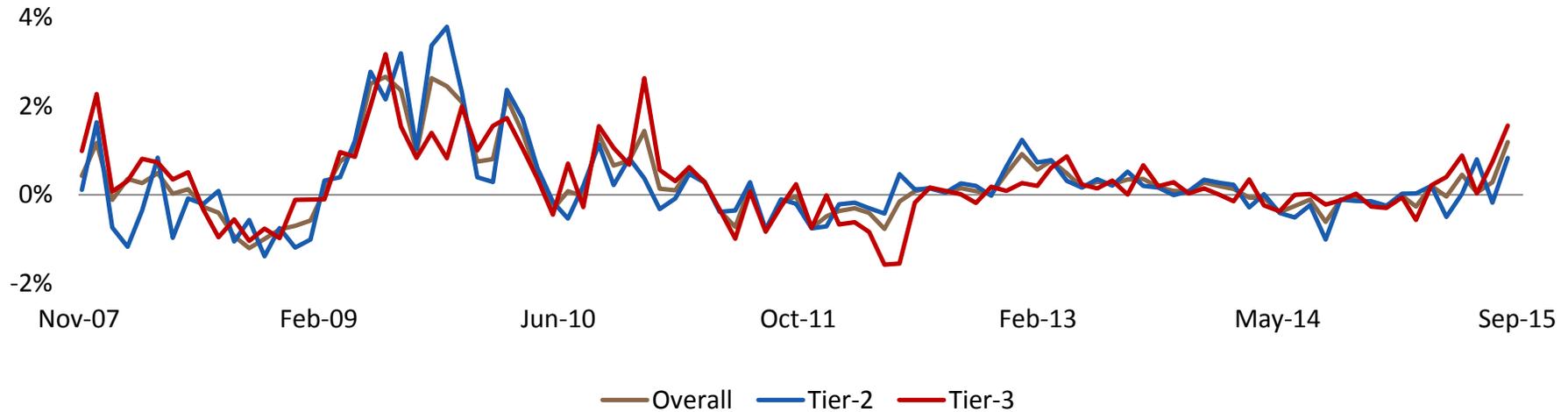
NEW HOME SALES BY SQM



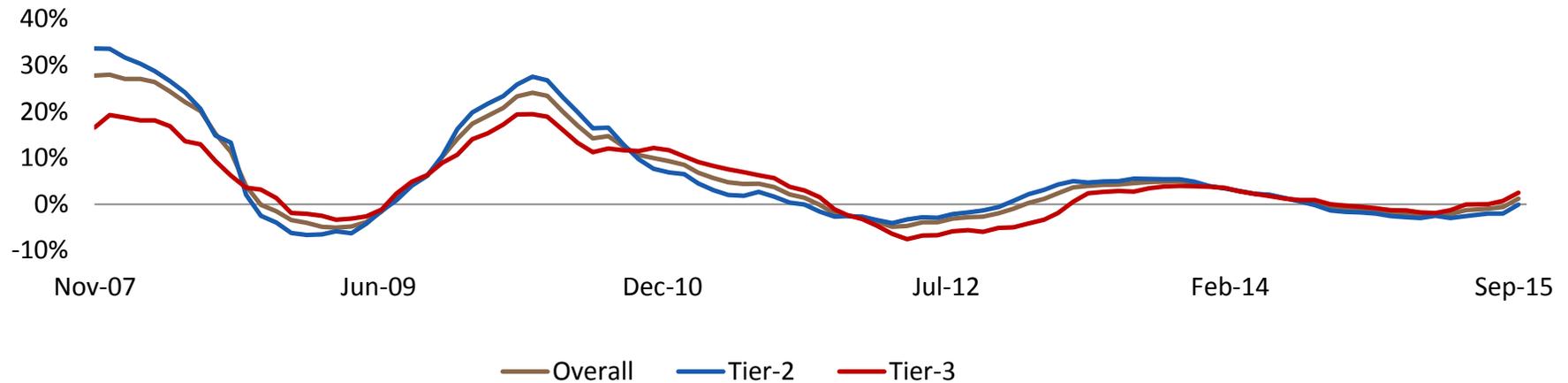
*CAGR = Compound Annual Growth Rate
Sources: CEIC, CLSA, MICM estimates

New Home Prices Softer, but Far from Collapse

CLSA NEW HOME PRICES, MoM



CLSA NEW HOME PRICES, YoY



Tier 1 cities: include Beijing, Shanghai, Guangzhou and Shenzhen
 Tier 2 cities: include provincial capital cities, plus Dalian, Qingdao, Ningbo and Xiamen
 Tier 3 cities: all other cities not included in Tier 1 and Tier 2
 Source: CLSA

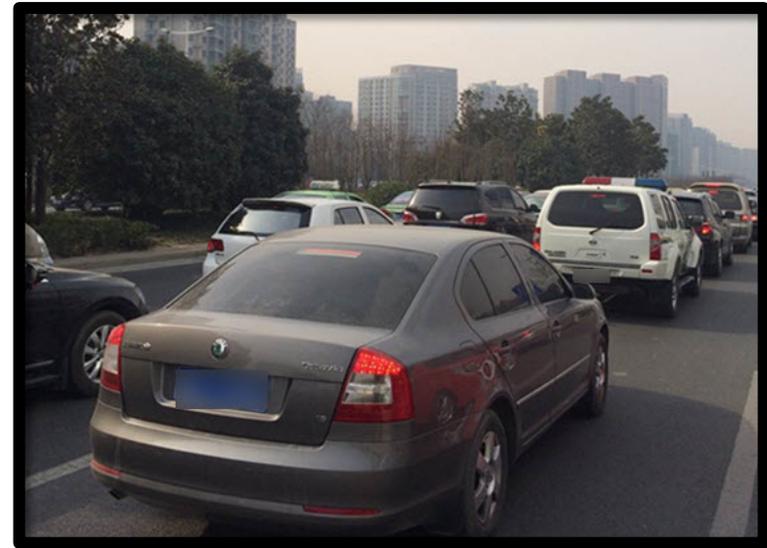
More than 150 Cities with a Population of One Million Plus

Last year, more new homes sold in Hefei than in Beijing. More in Chengdu than in Shanghai



Source: CLSA

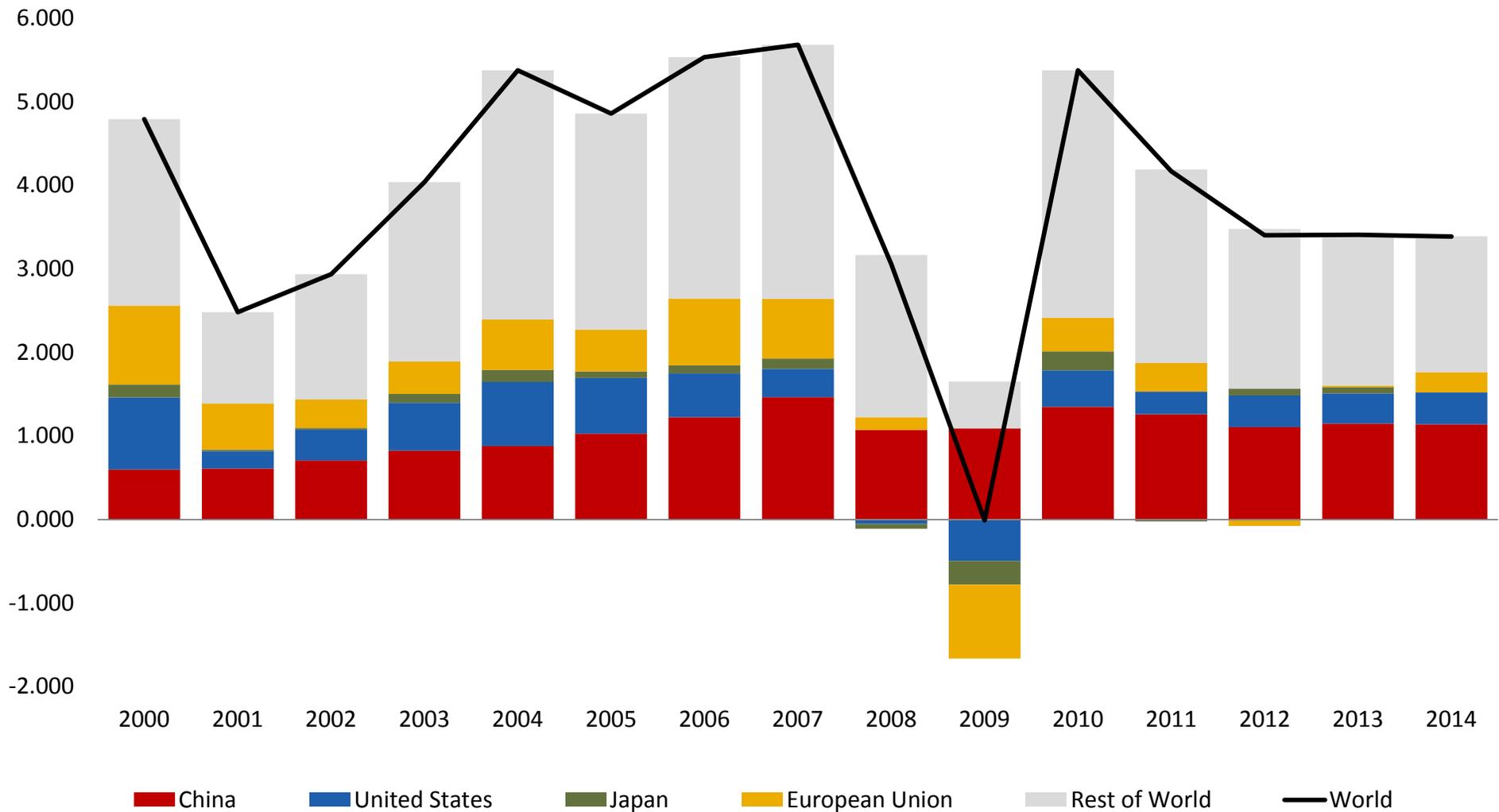
Ghostly, or a Different Business Model?



Photos on left from cbsnews.com. Photos on right by MICM. Upper right photo taken in same location as upper left. Lower right photo is not the same location as lower left, but is illustrative of traffic conditions observed in Zhengdong in February 2015.

China Will Continue to Drive Global Growth

Contribution to Global Growth (percentage points)

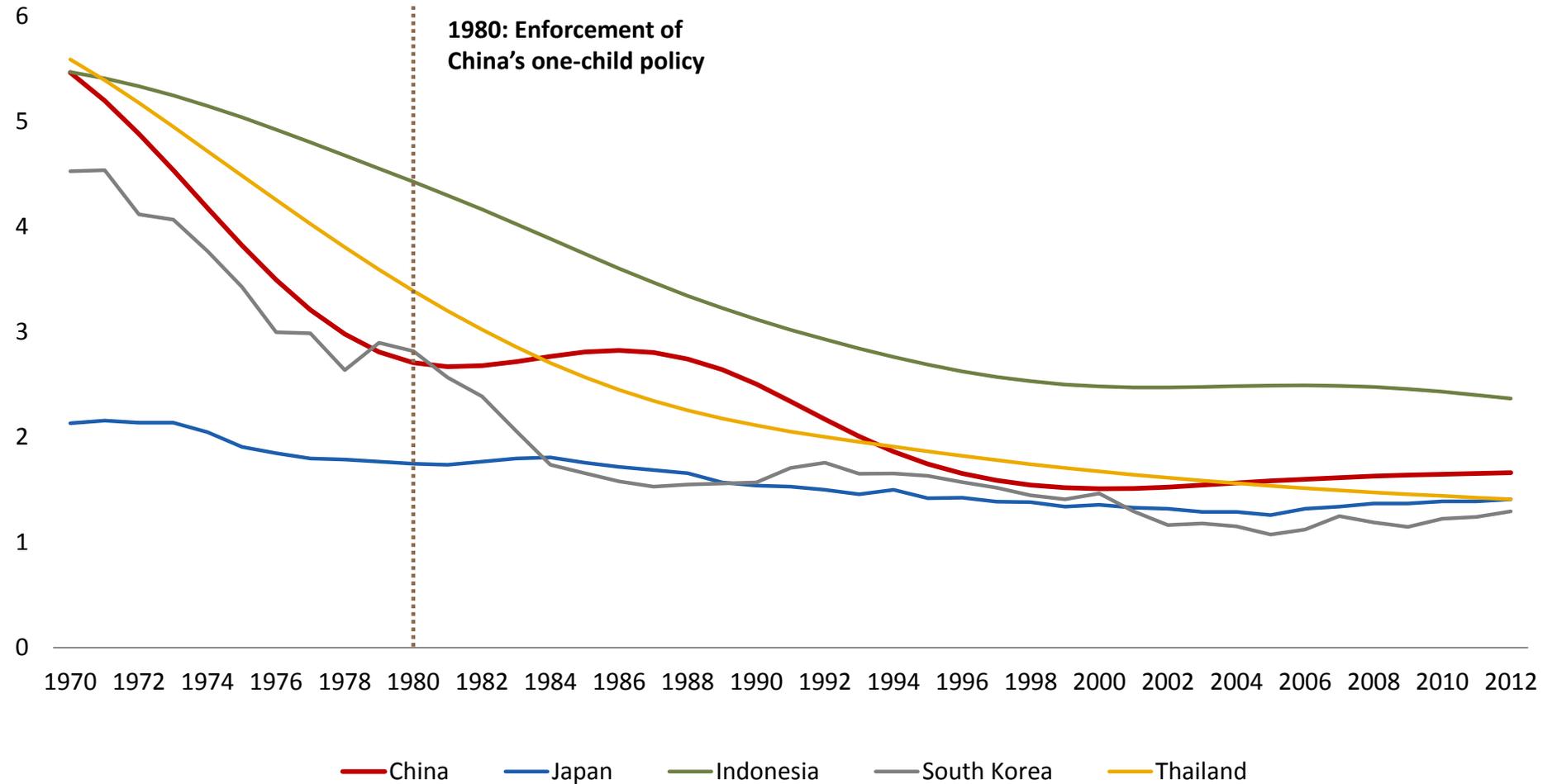


Sources: IMF, World Economic Outlook (April 2014); IMF staff calculations

End of China's One-Child Policy

Politically important, but no change to demographic trends

Births per Woman

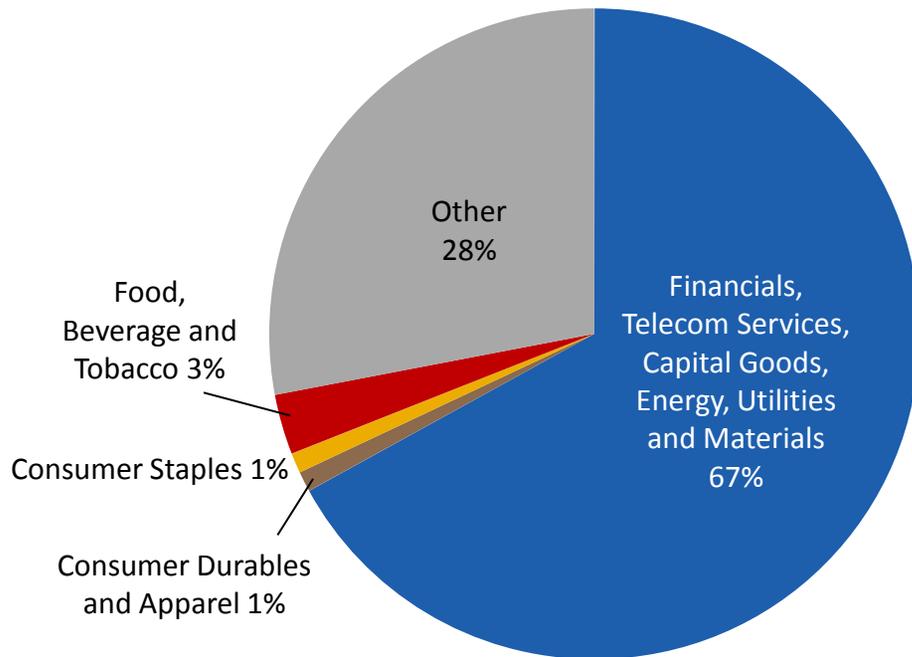


Source: World Bank

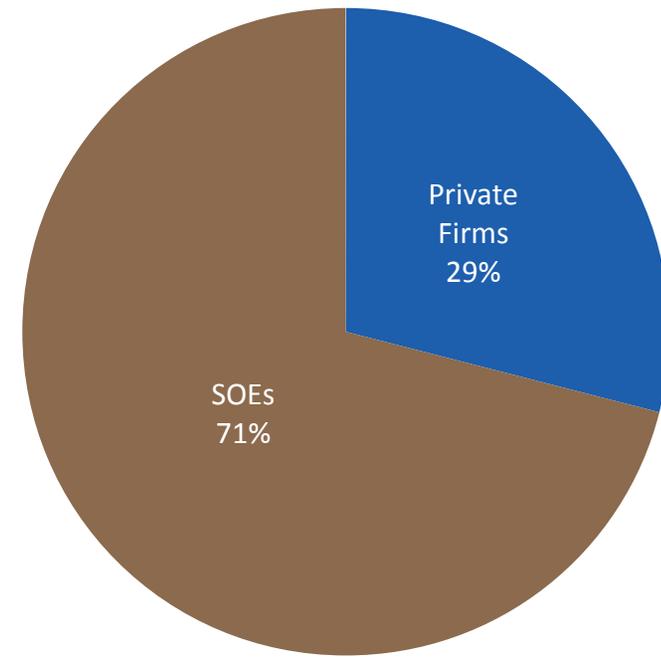
Active vs. Passive for China

Market cap of MSCI China by sector and ownership

BY SECTOR



BY OWNERSHIP

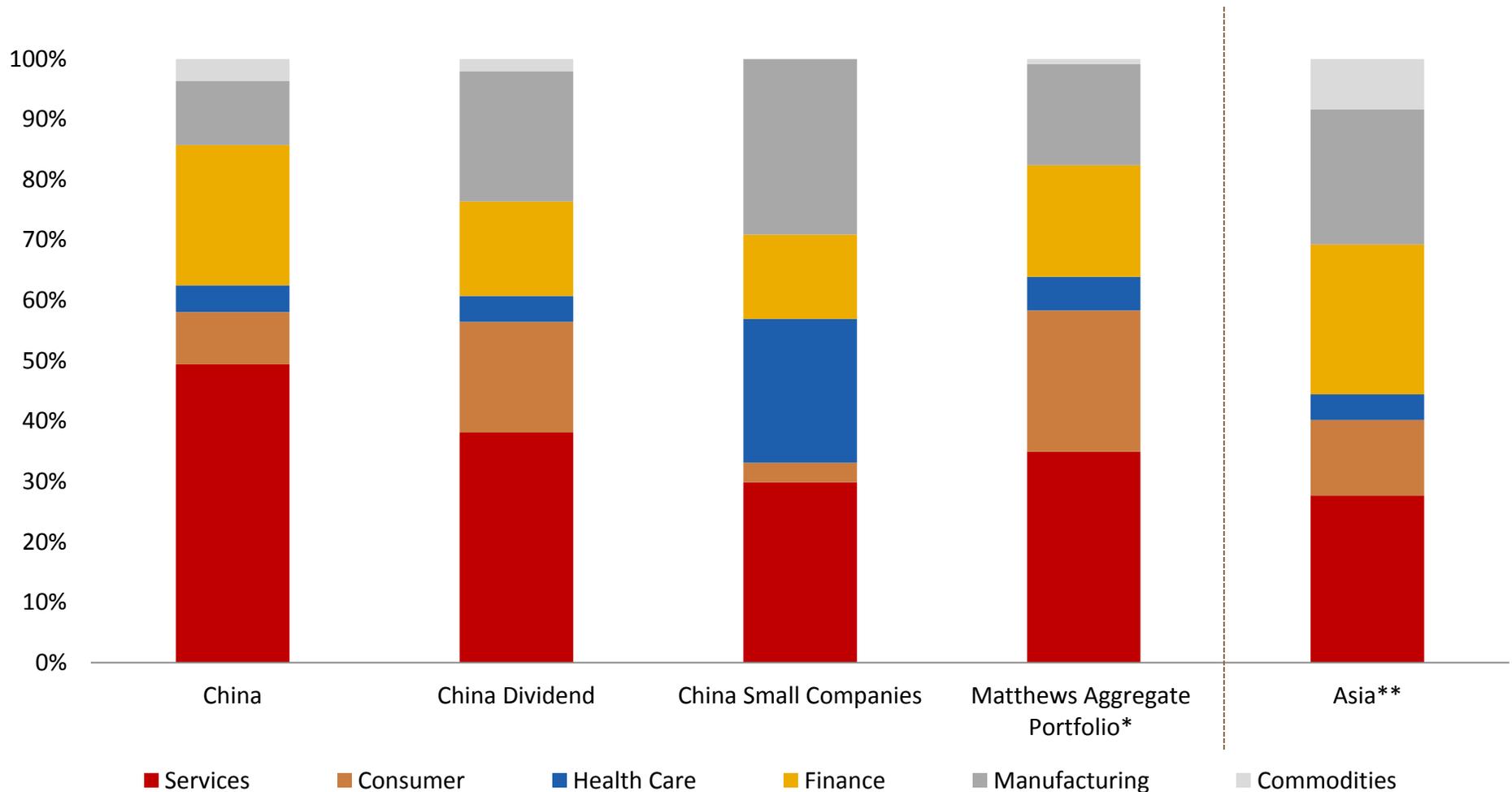


The MSCI China Index is a free float-adjusted market capitalization-weighted index of Chinese equities that include China-affiliated corporations and H shares listed on the Hong Kong exchange, and B shares listed on the Shanghai and Shenzhen exchanges. It is not possible to invest directly in an index.

Source: CLSA; data as of November 26, 2014

How We Deal With This at Matthews Asia

Exposure to sectors benefiting from secular trends



*Consists of Matthews' 15 strategies, not including the ESG Strategy which inceptioned April 30, 2015.

**Asia is a market cap weighted universe as defined by FactSet's geographic classification. Sector exposures of largest account in each strategy. Sources: FactSet, MICM; Data as of May 12, 2015

Today's Speaker



ANDY ROTHMAN
Investment Strategist

Andy Rothman is an Investment Strategist at Matthews Asia. He is principally responsible for developing research focused on China's ongoing economic and political developments while also complementing the broader investment team with in-depth analysis on Asia. In addition, Andy plays a key role in communicating to clients and the media the firm's perspectives and latest insights into China and the greater Asia region. Prior to joining Matthews in 2014, Andy spent 14 years as CLSA's China macroeconomic strategist where he conducted analysis into China and delivered his insights to their clients. Previously, Andy spent 17 years in the U.S. Foreign Service, with a diplomatic career focused on China, including as head of the macroeconomics and domestic policy office of the U.S. embassy in Beijing. In total, Andy has lived and worked in China for more than 20 years. He earned an M.A. in public administration from the Lyndon B. Johnson School of Public Affairs and a B.A. from Colgate University. He is a proficient Mandarin speaker.