Matthews Pacific Tiger Fund

Period ended 30 September 2018

For the quarter ending 30 September 2018, the Matthews Pacific Tiger Fund returned -2.52%, while its benchmark, the MSCI All Country Asia ex Japan Index, returned -1.45%.

Market Environment:

Asian financial markets performed poorly in the third quarter. Macro headwinds that began earlier in the year persisted, weakening investor sentiment. Rising U.S. interest rates and continued dollar strength led to monetary tightening across Asia. Meanwhile, an uptick in oil prices added to concerns about inflation in parts of the region, as Asia is largely an importer of crude oil. In addition, trade conflicts between the U.S. and China increased this year, weighing negatively on markets. On a positive note, the operating environment for most of our businesses remains reasonably healthy in terms of consumer demand and corporate earnings growth.

China has maintained a reasonably disciplined fiscal and monetary environment, focused on derisking the economy. Even in the face of perceived concerns around a potential slowdown, policymakers have resisted major stimulus, while seeking to moderate property prices and temper the credit cycle. In some sectors, including internet gaming, education, and health care, regulatory changes created turbulence affecting equity prices. Through the lens of our holdings, across sectors, we see secular demand holding up, especially in China's premium and mass market segments. There has been some moderation in demand growth in top-tier cities among certain segments, perhaps due to high property prices affecting discretionary income, or in the case of the auto sector, due to a pullback in tax incentives.

While India had been a bright spot in Asian markets, Indian equities got affected during the most recent quarter on currency weakness. Moreover, toward the end of the quarter, India's non-banking financials sector suffered a liquidity crunch that was sparked by the default of bond payments by a firm. Nonetheless, India's long-term economic growth remains healthy.

Performance Contributors and Detractors:

The Fund slightly underperformed its benchmark during third quarter. The Fund's overweight position in India relative to the benchmark detracted from performance, as Indian equities suffered some of the sharpest declines in the region. Also detracting from relative performance was the Fund's overweight in small company stocks relative to the benchmark. Small company stocks, defined as those with less than US$3 billion in market capitalization, experienced larger price declines than larger company stocks. We tend to maintain a higher exposure to smaller companies than the benchmark, as we believe smaller companies have the potential for more attractive long-term growth.

The Fund's holdings in the health care and real estate sectors contributed positively to performance. One of our long-term holdings in the health care sector, Sun Pharmaceutical Industries, an Indian multinational pharmaceutical company headquartered in Mumbai, got a boost in stock price on positive news from the U.S. Food and Drug Administration (FDA). Sun Pharma seems to be turning a corner in rectifying FDA concerns in one of its biggest facilities, creating an opening for possible new product approvals in the U.S.

Notable Portfolio Changes:

There were no new additions or deletions from the portfolio in the last quarter. The market volatility provided an opportunity to reallocate capital toward existing holdings in Southeast Asia, as well as China's onshore, domestic A-share market, where valuations look attractive. Our goal for reallocating capital is to enhance the portfolio's long-term risk-reward profile.

Outlook:

While trade conflicts present genuine economic challenges to the region, they have not yet shown a material impact on China's economy, which is increasingly driven by healthy, domestic sectors. Mobile data consumption is growing, premium beverages are enjoying higher sales, e-commerce activity is on the rise, and consumers in smaller cities continue to aspire toward making higher-end purchases. While trade conflicts may endure, we expect that China's large middle class is likely to continue growing. China's economy is also likely to enhance efficiency and productivity via technology investments. Accordingly, we'll continue to look for appropriate investment opportunities that align with those trends.

In India, current worries about the non-banking financials sector have created short-term liquidity concerns but should not lead to any structural dislocations in our view. These liquidity concerns, however, could cause India's economic growth to contract over the short term.

Despite monetary and fiscal tightening in many of our markets over the last few months, we remain optimistic about our portfolio holdings. In many parts of Asia, investor expectations around the impact of macro headwinds have already been priced into capital markets. Low valuations among stock prices and strong medium- to long-term economic growth potential are an attractive combination. We'll continue to look for opportunities to invest in Asia's structural growth, driven by the rising spending power and consumption of the middle class.

Sources: Brown Brothers Harriman (Luxembourg) S.C.A, Matthews Asia, FactSet Research Systems, Bloomberg