August 2019

Matthews Asia

Matthews Asia Perspective

Matthews Asia ex Japan Dividend Fund: Looking For Signs of a Cyclical Rebound

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Earlier this year the macro environment for Asian equities appeared to be improving: the U.S. Federal Reserve hit the pause button on monetary tightening, hopes remained high for a near-term resolution in trade negotiations between the U.S. and China, and the Chinese economy rebounded.

At the beginning of May, however, the U.S. reignited the trade war with China, and consequently Asian equities sold off in double-digit figures for the single month. Quality growth stocks, which had led the rally until May, collapsed.

There is no doubt that trade discussions pose a substantial headwind for Asian equities. Investors, however, should rest assured by the U.S. and Asian Central Banks' willingness to act to limit its impact on future economic growth. Once the Fed signaled the possibility of interest rate cuts, equity prices in Asia began to recover.

Asian company earnings, on the other hand, are still falling. Looking at the last ten years earnings cycle and compare previous trough and peak cycles, we may be close to a cyclical earnings bottom for Asian companies.

The market is expecting 2.8% annual earnings per share (EPS) growth for 2019 (represented by the MSCI Asia ex Japan Index), which is fairly muted. The bulk of this growth is likely to be delivered in the last quarter of the year, but investors should remain level-headed. We expect the macro environment to continue to be murky given that the struggles between the US and China are unlikely to be resolved anytime soon. Against this backdrop of uncertainty many Asian companies have paused their capital investment plans.

On the surface it doesn't look like a great time for Asia investors, but as bottom-up investors we continue to find opportunities. Our approach to dividend investing seeks to balance stable, high dividend-yielding stocks with slightly more cyclical, but higher-dividend-growth stocks. This flexible approach not only has allowed us to capture investment opportunities, but has also been protective when markets fall. For instance, the MSCI Asia ex Japan Index posted negative returns at -0.56% in the second quarter whereas the Matthews Asia ex Japan Dividend Fund (I ACC, USD) generated 1.83% during that period.

The potential U.S. interest rate cuts, China's slowing economy and with it lower expectations for inflation, have triggered some changes in the portfolio. We have increased the Fund's exposure towards interest rate sensitive businesses. We think these companies, either the underlying fundamentals or the operation of the business, could benefit from a lower rate environment. For example, real estate companies are likely to benefit as their customers willingness to take on leverage to purchase a property rises. Traditional property developers could also be aided by a more accommodative, liquid environment. We have added exposure to real estate developers to the portfolio.

The portfolio has also allocated to Real Estate Investment Trusts (REITs), which have a different business model to developers. They collect rental income and because of the way they are structured as a security, they have to pay a maximum between 90 to 100% of their cash flow to the underlying shareholder via dividends. As such they can be considered a bond proxy type of investment. When yields on bonds start to trend lower, these types of securities could act as a potential hedge against a serious slowdown on the economy.

At the same time, we added a few dividend growth stocks when they were sold off in May. Financial stocks, such as life assurance, have benefitted from a tailwind of structural growth—this includes both single country and regionally focused corporations. Before the selloff investors were willing to pay a decent price for them, so the severe fall provided a short window of opportunity to initiate positions in this sector.

Over the quarter, the Fund's exposure to China and Hong Kong has increased. The region is more and more embracing a dividend culture: Chinese companies have offered not only higher yields but also faster dividend growth than companies in many other parts of the world. This is also true for the A-share market where we have found some opportunities. As of 30 June 2019, 7.8% of the Fund is invested in A-share companies. In addition, China remains determined to reform the economy. The opening of China's financial industry, for example, could be positive for companies across the sector.

The portfolio also has increased exposure to Taiwan, where we are noticing a reshoring of manufacturing. We believe places like Taiwan and Vietnam could potentially benefit from the global supply chain realignment.

There are some pockets of weakness across the region as well. We have noted a cyclical slowdown in consumption in South Korea and India. The Fund has relatively low exposure to consumer-facing businesses in both countries, but we are keeping a close eye on the market. If we do sense a disconnect between fundamentals and valuations, then we may reconsider the Fund's positioning.

So where do we see value in the current market? Since inception the balance between stable dividend payers and fast-growing dividend payers has shifted depending on market conditions, which has helped navigate volatility and capture Asia's growth upside, as well as providing some downside protection in the past. Having started 2019 on an even balance between dividend payers and growers, at the end of the second quarter the portfolio had moved to a slightly more pro-growth stance, with roughly 55% held in dividend growers and 45% in dividend payers.

We will continue to look out for signs of a cyclical rebound. Expectations for earnings are very low, and if companies can deliver an upside on their earnings, then the market should be set up for strong performance.

Annual returns for the 12 month period ended 30 June	2019	2018	2017	2016	2015
Matthews Asia ex Japan Dividend Fund (I Acc, USD)	1.70%	18.38%	23.33%	n.a.	n.a.
MSCI All Country Asia ex Japan Index (USD)	-0.18%	10.21%	27.06%	n.a.	n.a.

All performance quoted represents past performance and is no guarantee of future results. Investment return and principal value will fluctuate with market conditions so that when redeemed, shares may be worth more or less than the original cost. Current performance may be lower or higher than performance shown. Investors investing in funds denominated in non-local currency should be aware of the risk of currency exchange fluctuations that may cause a loss of principal. Performance details provided are based on a NAV to NAV basis with any dividends reinvested, and are net of management fees and other expenses. Volatility is the standard deviation of returns. Source for 12 month period returns: Brown Brothers Harriman (Luxembourg) S.C.A.

Risk Considerations

The value of an investment in the Fund can go down as well as up and possible loss of principal is a risk of investing. Investments in international and emerging market securities may involve risks such as social and political instability, market illiquidity, exchange-rate fluctuations, a high level of volatility and limited regulation. The Fund invests in holdings denominated in foreign currencies, and is exposed to the risk that the value of the foreign currency will increase or decrease. The Fund invests primarily in equity securities, which may result in increased volatility. There is no guarantee that the Fund or the companies in its portfolio will pay or continue to pay dividends. These and other risks associated with investing in the Fund can be found in the Prospectus.

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