

September 26th 2008

Dear clients and colleagues,

This week a more negative tone weighed on the market. As Bernanke put it, the US is facing "grave threat" to financial stability. Although a few positive news did pop up, such as the proposed US\$700 billion rescue plan and Warren Buffet's US\$5 billion investment in Goldman Sachs, the market is seeking more clarity in the rescue process and stays doubtful of the outcome. As lots of uncertainties remain in the US, in this comment we would like to switch our focus to China.

The national pride from the Olympics did not reverse the downturn of Chinese stock market. CSI 300 Index has dropped about 60% this year. Investors' sentiment deteriorated significantly of late. Is "China growth story" still valid? Not being blindly optimistic, we believe so. Let's take a look at the fundamentals and policy trend.

China's GDP expanded 10.1% in 2Q08, at a slower pace but still the fastest among the world's 20 biggest economies. In Aug 08, inflation faded to 4.9%, the lowest in more than a year. Meanwhile, exports growth weakened moderately. Since exports contribute to 40% of GDP, the aggregating downside risk tends to shift China policy towards an easing mode. Will there be a hard landing? Unlikely.

First, Chinese leaders, known as cautious and pro-growth, have ample policy tools in hand. This month they cut interest rate for the first time in six years, and are ready to implement other measures, such as to slow Yuan appreciation, to relax lending restrictions, and to cut export taxes, etc. With huge trade surplus of US\$28.3 billion in Jan-Aug 08, China enjoys great flexibility in fiscal policy as well. The government is said to be preparing a back-up plan of US\$58 billion in tax cuts and spending to prevent an economic slump.

Second, latest economic data showed favorable support for domestic consumption and capital spending. Both consumer confidence and business climate in China stay firm. Fixed-asset investment and foreign investment are up 27.4% and 41.6% respectively in Jan-Aug 08.

Third, some seemingly weak data may not be that negative. Although exports grew less fast, they still increased 21.2% y/y in Aug 08. The drop of profit growth to 20% from 70% a year earlier was dramatic. But we have to bear in mind that 70% was an obviously unsustainable level boosted by an overheated domestic stock market.

In short, China is at the early stage of a long-term growth story. We are conscious that turmoil in the US certainly drags China's economy from expanding faster. Nonetheless, aggressive privatization & urbanization, massive middle-class, and increasing productivity lead us to believe a superior growth in the medium and long term.

This week the image of China was tarnished by the melamine dairy scandal. Four infants died and 53,000 have been affected. As consumers seek alternatives to milk, soymilk becomes a top choice. One of our holdings is Vitasoy (345 HK), a leading manufacturer and distributor of soy-based food and beverages based in HK.

Market cap: US\$496M, P/E: 18.2x, Yield: 3%, EV/T12 EBITDA: 9.1x, No debt, ROE: 16.5%, 1-year return: 14%.
http://www.vitasoy.com/en/cs_welcome.asp

The Vitasoy story began in 1940 with a little bean and a big idea. The little bean was soy - sometimes known as "the cow of China" - the main source of protein for the Chinese people for over 3,000 years. The big idea was the brainchild of the founder Dr. K. S. Lo, aiming to take the cow of China and literally milk it. And so VITASOY was born, a soymilk drink sold at an affordable price to the people of Hong Kong at that time.

Today, soymilk is recognized for high proteins, effectively lowering cholesterol levels, fighting cancer and building healthy bones. Vitasoy becomes one of the top 10 brands in HK, with products available in over 30 countries. Its products are marketed under two major brands: VITASOY, a nutritious soy drink and tofu, and VITA, a range of dairy milk products, juice, teas, carbonated drinks and

distilled water. In North America, Vitasoy USA Inc. also offers a wide range of soy products under the brands of VITASOY, SAN SUI, NASOYA and AZUMAYA, including tofu, natural soy-based salad dressings, mayonnaise, desserts, pasta and noodles.

Have a good week.

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