China – A Balancing Act

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Martha joined Fidelity in mid-2005 and took over management of FF China Focus Fund in May 2006. Martha has nearly 16 years experience researching Chinese companies, having worked with Indosuez WI Carr Securities, First State Investments and HSBC Asset Management.

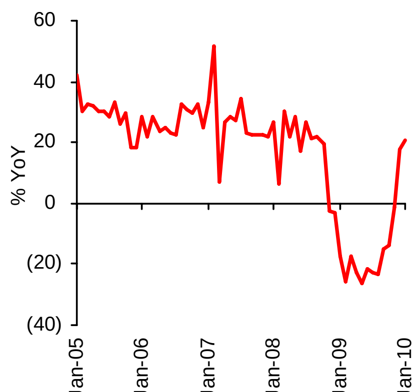
The Chinese government's recent efforts to manage inflation and control asset prices could slow China's domestic consumption which has been credited for sustaining growth levels in China during the credit crisis. The policy tightening is a balancing act that China must juggle in order to promote its long-term sustainable growth.

Martha Wang shares her insights on the possible impact of the recent reversal of stimulus policy measures.

CHINA HAS IMPLEMENTED VARIOUS TIGHTENING MEASURES OVER THE LAST FEW MONTHS. WHAT'S YOUR TAKE ON THE ECONOMY?

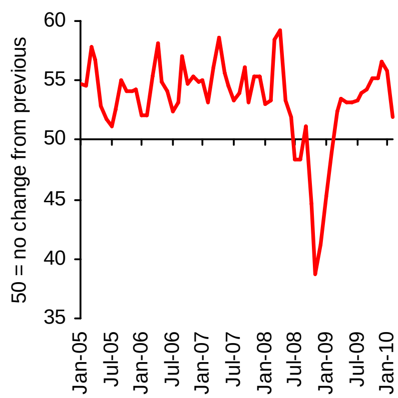
Following China's record lending of around Rmb 10 trillion last year and the Rmb 4 trillion stimulus package, China has seen a rapid recovery in 2009. On the back of the positive economic indicators, e.g. the critical year-on-year export data turning positive, robust growth levels portrayed by the recent manufacturing data and evidence of strong domestic consumption seen from the retail sales figures, the government is moving away from the crisis management policies and back towards policy normalisation. Evidence of this has already emerged with the recent Reserve Requirement Ratio hikes.

China Export Growth



Source: CEIC

China PMI on Manufacturing



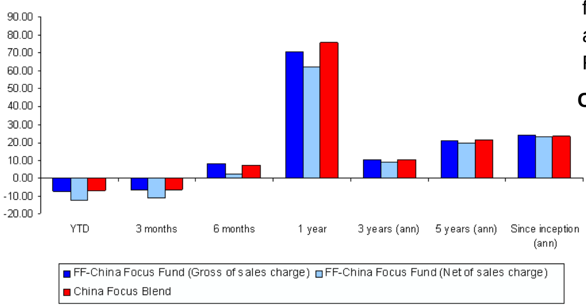
Source: Bloomberg

In terms of the markets, there could be some short-term volatility on the back of recent tightening policy given the change in underlying profit dynamics. Although there has been some concerns towards the magnitude of tightening, it is unlikely that the government will endanger the recovery. The overall intentions have not changed in that the government is still pursuing growth and the current dampening moves are more to protect the long-term growth. What the government is looking to achieve is a more controlled and sustainable growth for the next decade rather than an uncontrolled spectacular growth that could hurt China's long-term prospects.

The extreme measures that were previously undertaken to stimulate and support economic growth can gradually be scaled back as the economy has gained traction. However, the withdrawal will happen gradually to ensure domestic sources for growth are sustained. Going forward, I do not expect much of the domestic demand-boosting policies adopted since the onset of crisis to be reversed. The Government is now seeking opinions to assess whether it needs to expand the program to cover more product categories and regions for an extended period. If that goes through, it would be a major positive for the industry. Additionally, in 2010 the strength of consumption will likely come from recovering employment and income growth. There are some risks, with inflation being a key factor.

FUND RETURNS (%)

as at 28.02.10



Source: Fidelity. Performance figures are in USD terms NAV to NAV with dividends reinvested. Past Performance is not indicative of future performance

Since inception:18.08.03
Benchmark: MSCI China Capped 10% Index

TOP 10 HOLDINGS (%)

as at 28.02.2010	Fund	Benchmark
China Construction Bank	6.3	6.3
China Life Insurance	6.1	6.1
Industrial & Commercial Bank Of China	6	6
China Mobile	6	9.9
Tencent Holdings	5.9	3.3
CNOOC	4.1	5.2
Petrochina	3.6	4.4
Belle International Holdings	3.2	0.8
Ping An Insurance	3.1	1.8
Li Ning	2.7	0.4

Source: Fidelity International

Benchmark: MSCI China capped 10% Index

References to securities are for illustrative purposes and does not construe as a recommendation to transact in them.

Fidelity INTERNATIONAL

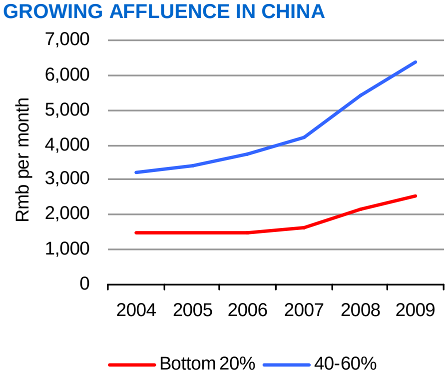
SECTOR POSITIONS (%)

as at 28.02.2010	Fund	Benchmark
Financials	37.3	37.3
Energy	12.9	17.8
Consumer Discretionary	12.9	5.2
Information Technology	11	6
Industrials	7.2	8.5
Telecommunication Services	6.1	12.5
Consumer Staples	4.5	4.6
Materials	3.5	5.8
Utilities	3.3	2.1
Health Care	0.9	0.3
Cash	0.5	-

Source: Fidelity International

Benchmark: MSCI China capped 10% Index

GROWING AFFLUENCE IN CHINA



Source: Credit Suisse China Consumer Survey

Overall, I remain positive towards China's underlying economy. To a certain extent we have seen China decouple from the developed economies, especially in terms of the speed of recovery and underlying domestic economy strength.

DO YOU THINK THERE IS A BUBBLE BUILDING IN CHINA?

I am currently not so concerned with the potential bubble risk in China. The market valuation seems quite reasonable, especially given the recent correction. The H-shares for example are currently trading at around 2x P/B and 10x P/E. I believe there was a bubble forming in some areas amid the government's stimulus last year but the government policy response has been quite pre-emptive. The economy is showing positive signs of recovery, including export growth which has turned positive. As a result, the government has moved back towards policy normalisation. The underlying economic development is also encouraging, especially the growth experienced in the inland areas.

HOW IS CHINESE GOVERNMENT ENCOURAGING CONSUMPTION?

The government has been encouraging consumption through a variety of initiatives, such as tax reduction for vehicles with smaller engines and subsidies on appliance trade-ins. These schemes will continue to encourage domestic consumption this year. Additionally, higher domestic consumption is likely to be achieved through recovering employment and income growth. Moreover, the government is keeping up infrastructure expenditure to maintain GDP growth.

On a separate note, the Chinese government has been pursuing wealth distribution policies to narrow the wealth gap for rural and needy people. The recent announcements by the government to build five million affordable houses and reconstruct two million shanty houses in 2010 and tax system reforms for the underclass are examples of such policies.

HOW INDEPENDENT IS CHINA'S GROWTH FROM WESTERN ECONOMIES?

I believe the recent credit crisis has shown China's ability to de-couple from the west during crisis times. China's GDP is expected to grow at around 10% in 2010 on the back of 16% decline in exports in 2009. The rapid urbanisation and subsequent boost in domestic consumption is deriving the growth from within. The strength of the domestic demand was portrayed during recent credit crisis, such as the example of auto sales within the inner city areas which showed resilience even at the height of credit crisis.

Given the economic recovery, I do expect some of the stimulus policies implemented during the crisis times to be wound down gradually. However, on the domestic demand front, I expect to see more pro-consumption policies from the government given China's medium/long-term strategy to shift its economic structure more towards developing the local economy. I believe the recent global crisis has been an impetus to accelerate this process.

WHAT IS YOUR STANCE ON THE REVALUATION OF RMB?

The prospect of RMB appreciation has been on the agenda for sometime now with mounting pressure from the US, Europe and Japan. China has maintained a de-facto peg to the USD since mid-2008. However, in light of the weakening US dollar and increased capital inflows into China, the RMB is facing increasing appreciation pressure to break away from the USD.

Given current inflationary concerns it is a matter of time for the Chinese government to resume the managed floating system. However, any measures for RMB appreciation would be gradual, similar to that seen between mid-2005 and July 2008, to sustain the export growth going forward.

WHAT WOULD BE THE MAIN THEMES FOR GROWTH IN 2010?

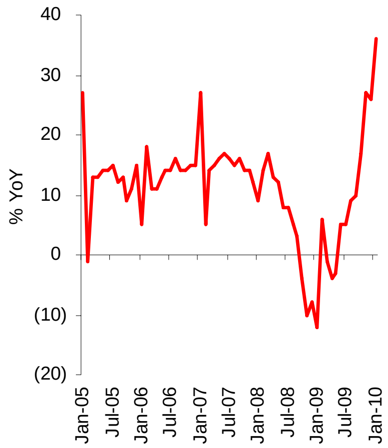
There are a number of long-term secular dynamics that I see positive towards China and have positioned the fund towards since I commenced its management.

Firstly, the opportunities rising from consumption growth, as people's lifestyles are changing as China becomes more affluent, e.g. increasing wine consumption, which is interesting. Attractive opportunities remain and it is companies with brand penetration that offer goods and services to the middle class that will benefit over the longer run.

Secondly, the dynamic of population migration from coastal areas to inland centres should boost consumption and pose new opportunities for businesses in the inland area. Urbanisation of the inland area is a key factor supporting consumption growth. The rapid rate of urbanisation continues to boost retail sales, demand for housing, electricity consumption, auto vehicles sales, mobile phones usage and food consumption. There is a considerable income and consumption gap between urban and rural areas, therefore the growth potential is clearly apparent. According to Morgan Stanley estimates, Chinese urbanisation could potentially generate Rmb3.5-5.0 trillion in aggregate incremental consumption during 2011-2020 period, approximately 10-14% of 2009's

GDP.

CHINA INDUSTRIAL PRODUCTION - ELECTRICITY



Source: DataStream

China consumption growth by category

in real RMB, base year = 2000

	2004	2025	CAGR 2004-2025
	Rmb bn	Rmb bn	
Food	1223	4786	7%
Apparel	369	1322	6%
Housing, utilities	257	2582	12%
Household product	223	857	7%
Transporation, communication	452	2920	9%
Recreastion, education	507	3415	10%
Healthcare	223	857	7%
Personal products	119	771	9%
Sub total	3373	17510	8%

Source: McKinsey

Thirdly, the industrial upgrading and consolidation shifts China's labour intensive industries to new industries offering new opportunities. The industry leaders are strongly positioned to benefit from the industry consolidation trends. Tougher markets will tend to drive out smaller inefficient players leaving the higher quality and proven companies to outperform. Furthermore, there are growing barriers to entry due to environmental and safety concerns.

On a more cyclical trend, I am positive on the export sector. With the export indicator now in positive territory since December 2009, margins on exports should improve in 2010. The recent news of labour shortage in the regions that saw heavy redundancies in China during the financial crisis indicate that manufacturing is indeed returning. Moreover, the underlying electricity usage, the ultimate indicator of economic activity, is on the increase, further supporting the increase in the manufacturing activity in China.

COULD YOU COMMENT ON YOUR STRATEGY?

I adopt a bottom-up approach to stock selection. Fidelity's proprietary research is the key input with the emphasis on in-depth fundamental analysis of individual companies. I prefer stocks that can offer growth at reasonable valuation. Valuations are particularly important in view of the cyclical nature of the Chinese stock market. As such, I emphasise valuation criteria, such as price-to-book ratios, as part of the stock selection process. I also look for companies which are industry leaders, with high entry barriers and low costs of production. I also favour companies where senior management has a flexible mindset and strategy; I regard these as essential requirements for capturing market share and driving earnings growth in China's rapidly changing environment. While there are no systematic biases in the management of the portfolio, this focus results in a growth at reasonable price style. As a bottom-up stock picker, I am free to invest outside the benchmark and will invest across the market cap spectrum. Although my investment style is unconstrained I am benchmark aware. Active sector weights are a result of bottom-up stock selection.

HOW IS THE FUND CURRENTLY POSITIONED? WHAT CHANGES HAVE YOU MADE RECENTLY?

As mentioned previously, urbanisation and the subsequent consumption factors are important stories driving holdings in my portfolio. Therefore, I am currently overweight consumer, IT, healthcare and insurance names in my portfolio.

Notably, within the consumer sector, my biggest overweight positions are in Belle International, Li Ning and Gome Electrical. For example, Gome Electrical Appliances is attractive given continuing take up of appliances helped by the domestic demand-boosting policies. I also like Ctrip.com, the leading travel agent in China, which benefits from the growth of the middle class and the subsequent travel market. In the recent months, I have added luxury department store operator Maoye International to the fund on the back of increasing demand for high-end retail products in China.

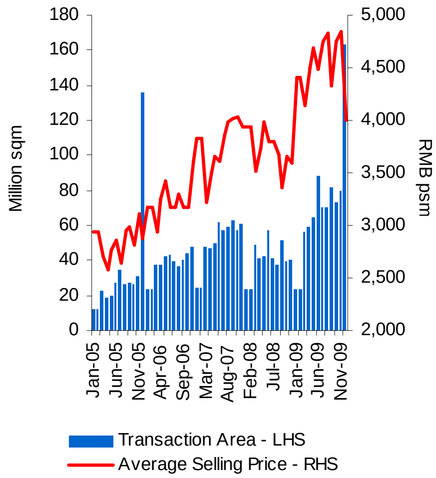
Within the IT sector, I like Tencent, a networking and internet messaging firm, which is benefiting from strong growth in its user base and improved monetization of its services. I am also overweight ZTE Corporation, a telecommunications equipment and infrastructure manufacturer. ZTE should benefit from government's policy in building domestic telecom supply chain and infrastructural growth in China.

Within the healthcare segment, I am overweight Wuxi Pharmatech. It is a clinical research organization in China with the longest history, benefiting from the global R&D outsourcing trend and the increasing outsourcing to China.

In the Insurance segment, I like Ping An Insurance. It is a part of the middle class growth story as consumers increasingly look to secure their future. Also in the short term, interest rate hike and equity market rally in China will lead to higher investment returns for the insurance companies.

I am currently underweight telecoms and energy sectors since I have found better opportunities in other sectors.

China – Commodity Housing Price Trend & Transaction Volume



Source: CEIC and Citi Investment Research and Analysis

WHAT IS YOUR STANCE ON PROPERTY VALUATIONS IN CHINA? HOW IS YOUR FUND POSITIONED FOR THE CHANGES TO COME?

The property sector was a major beneficiary of government's stimulus last year. Recent tightening moves by China to cool the property market are already having an effect on property-related equities prices with real estate-related MSCI China components suffering heavy declines for the year-to-date. I have been anticipating this reaction for some time given the rise in property prices last year and I am currently underweight property names in my portfolio and therefore relatively unaffected by the real estate-related price decline. However, I would be more interested in investing in property-related names once the valuations turn more favourable in terms of risk and reward. Although further credit tightening interventions by the Chinese government will eventually cool actual property prices, the property related equity valuation seems quite detached from physical market conditions with the actual land and property prices still at inflated prices while property-related equities now trading around 30-40% discount to NAV since the peak. Moreover, the price bubble seems to have been contained within tier 1 cities with tier 2 and 3 valuations looking healthier.