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CHINA EQUITIES – TACTICAL OR FUNDAMENTAL PLAY?

Executive Summary

A Bear Market No More – The Shanghai Composite Index resumed trading on Oct. 8 and was up 13.12 percent rise in a space of 8 trading days.

Two Telling Tales of China Equities – Locally listed shares of Chinese stocks underwent a slump in H1 2010 while their counterparts in the U.S. and Hong Kong had followed an entirely different path.

Foreign Direct Investment will be key – Foreign direct investment rose 6.1 percent in Sept from a year earlier; China remained the top destination for foreign direct investment – a title it had held since 2002.

Introduction – The China Growth Story So Far

Many would find it hard to argue against the growth story of China over the past few years had been fueled by a massive expansion of its money supply. Figures showed that over the past two years, China's M1 supply expanded by 56 percent while its M2 supply increased 53 percent. Expansion in money supply resulted in state-run banks made 9.59 trillion yuan of new loans back in 2009, contributing to the massive amount of "hot money" in the economy then. This year, new loans should hit the central bank's target in the 7.5-8.0 trillion yuan region, still twice the amount in 2008. The credit boom helped the nation's comeback from the global recession while funding speculative investment in fixed assets such as property, creating asset price inflation.

On the equity front, things were not as rosy as many had thought at the start of the year. Despite a series of strong domestic GDP numbers in H1 2010, we saw the Shanghai Index fell into a bear market, coming off 20 percent from a Nov 2009 peak on concerns the government will raise borrowing costs to combat inflation and unveil more measures to curb soaring housing prices. As early as mid-October, China's stocks entered a bull market backed by commodity producers & automakers and improving earnings prospects. The benchmark index currently trades at the highest level in five months. What a year for the Chinese equities.

Latest development on China's Interest Rate Hike and Inflation

China raised its key interest rate on Oct. 19 for the first time since the global crisis. The rate on a one-year loan was raised by 0.25 percentage points to 5.56 percent while the one-year rate paid on deposits was raised by a similar percentage point to 2.50 percent. This move was viewed by many as intended to control the asset price inflation. However, the market reacted positively to this surprise hike, as the Chinese stocks closed higher on the day of announcement.

At the same time, consumer prices rose 3.6 percent in the month of September. That's the highest rate this year, a continuation of a steady upward trend we observed since 2009. Food inflation was at 8.0 percent while prices for manufactured goods rising at a lesser extent. Despite the inflation numbers rise, we do not believe consumer inflation will be a concern, at least in the short run.



China: A Bear Market No More (A Tactical Perspective)

China's stock market was closed from end of Sept through Oct. 7 in observance of National Day. The Shanghai Composite Index resumed trading on Oct. 8 and was up 13.12 percent (as of close Oct. 20) since then. To emphasize, this was a 13.12 percent rise in a space of 8 trading days. As mentioned previously, the Shanghai composite index had gained 20 percent from the 2010 low on July 5, surpassing the threshold some investors considered the beginning of a bull market. In fact, it was not long when the Chinese equities entered a bear market in May as the government introduced measures to rein in real-estate prices and cut the annual new lending target by 22 percent this year.

Moving forward, there were good reasons to believe that this rally is sustainable, judging by the recent market price action on the Chinese equities. The 13 percent spike in recent price level was backed by a corresponding surge in volume as we observed in Chart 1 below. Price action was on the upside as the index overcame its 200-Day moving average (green line) with a convincing breakout. From the current level, it may not take long for the 50 Day moving average to catch up with the price. Therefore, we believed that the index would likely face consolidation at the important 3,000 level in the near term before making new highs. On this note, the benchmark index was still down 8.8 percent on a Year-To-Date basis and the near term technical objective will be at the 3,165 level, its previous high at the start of Apr 2010. As such, we are inclined to maintain our positive stance on Chinese equities and investors can consider buying Chinese stocks or funds on dips or short term retracement when opportunities arise.

Chart 1: Shanghai Composite Index Performance (-8.84% Y-T-D)



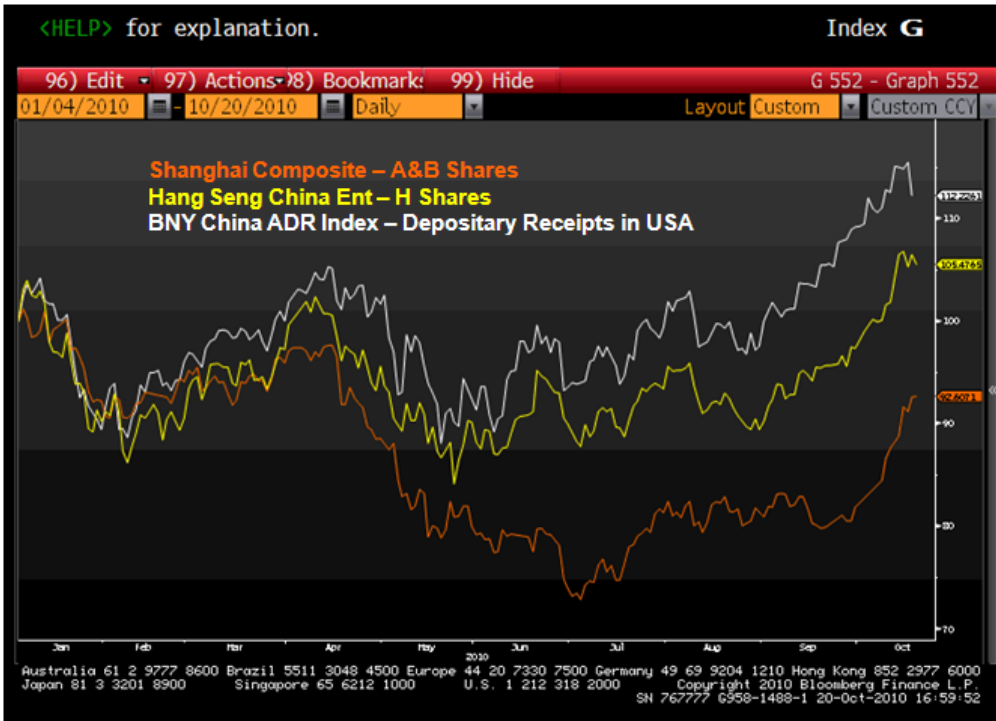
Shanghai Composite index entered a bull market in the month of October, supported by a surge in volume.

Source: Bloomberg, as of 20 Oct 2010



Two Telling Tales of China Equities: Which to Believe?

Chart 2: Chinese Equities Performance (Foreign & Locally-listed)



The locally listed China equities underperformed their counterparts listed in United States and Hong Kong since March this year.

The second reason to stay positive on Chinese equities could be from a relative performance point of view. Simply put, A-Shares and B-Shares made up the Shanghai Composite Index and the general rule is that foreign individuals cannot directly invest in the mainland shares due to Chinese government restrictions. H-Shares were companies incorporated in mainland China that were traded on the Hong Kong Stock Exchange. At the same time, the mainland companies may also prefer to list in United States as ADRs (American Depositary Receipts). Given that there is no trade restriction on the H-Shares and U.S. listed ADRs by the Chinese government, these two categories are likely to be trading at a discount to the A-Shares. As such, there existed a continuous price discrepancies among these three share categories, though referring to the same underlying company.

From Chart 2 above, we observed that while locally listed shares of Chinese stocks underwent a slump in H1 2010, their counterparts in the U.S. and Hong Kong had followed an entirely different path. Throughout the first two months of the year, both the Shanghai Composite Index and foreign listed counterparts saw similar rallies, but from there the paths began to diverge as shown in the chart. In that sense, foreign investors appeared to be convinced of the growth story more so than the Chinese themselves. Eight months on, the bets made by foreign investors looked to be paying off while the A-Shares and B-Shares played catch up. From the valuation angle, we see the greatest upside potential for the H-Shares with the forward price-earnings ratio sitting at under 14.0 and a price-to-book value under 2.4, the lowest among all three share categories.



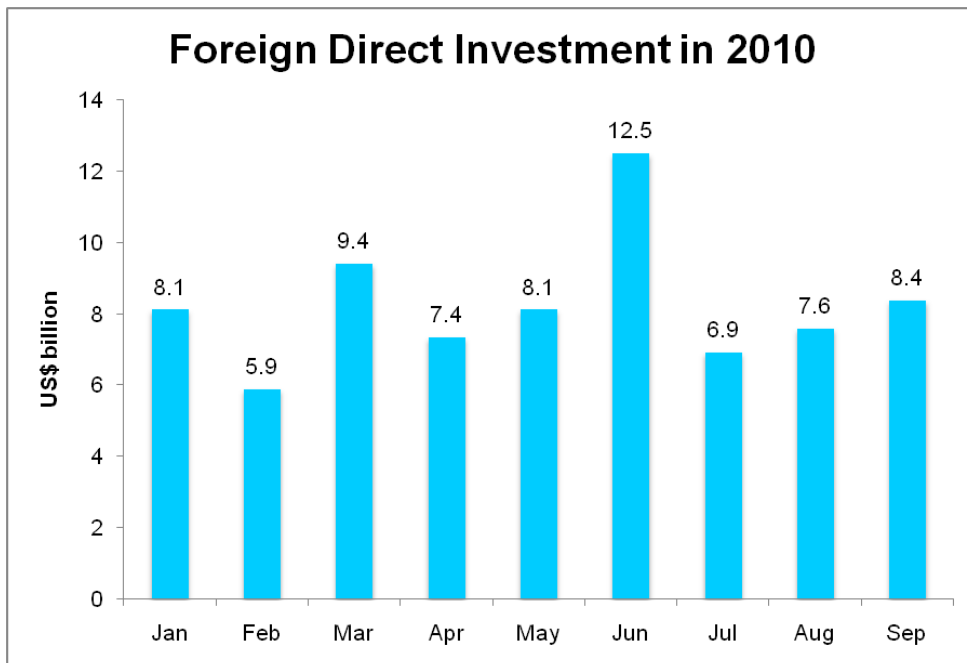
Foreign Direct Investment – A Fundamental Perspective

From a fundamental perspective, we continued to remain buoyant on China's economic outlook on the whole. A robust industrial output, rising retail sales and modest consumer price inflation would be vital to China's future economic growth. More importantly, we would prefer to highlight one single fundamental factor, which is the massive foreign direct investment flows China is experiencing at the moment. In fact, China remains the top destination for foreign direct investment – a title it has held since 2002.

The latest numbers showed that foreign direct investment rose 6.1 percent in Sept from a year earlier to US\$8.38 billion (See Chart 3 below). Total investment during the first nine months of this year climbed by 16.6 percent to US\$74.3 billion. China is now into its 14th straight month of positive foreign investment growth. Some would label this as speculative capital while others termed it as long-term investment. Judging by the trend in China's foreign direct investment inflows, global market players are poised to continue to ride on the country's growth trajectory by pouring in more "hot money". From our point of view, with the developed nations struggling to generate any growth, the world's key economic engine is resting upon China.

In conclusion, the turnaround in China equities did not come as a surprise to those who are a firm believers in the China growth story. The headwind relating to a potential domestic property bubble bursting and inflation worries should not undermine the economy's strength in the near term. For now, China looks the place to be in.

Chart 3: Foreign Direct Investment in China hit US\$74.3bn Y-T-D



China remained the top destination for foreign direct investment with an inflow of US\$74.3 billion year-to-date.

Source: Ministry of Commerce, China Daily, as of 15 Oct 2010



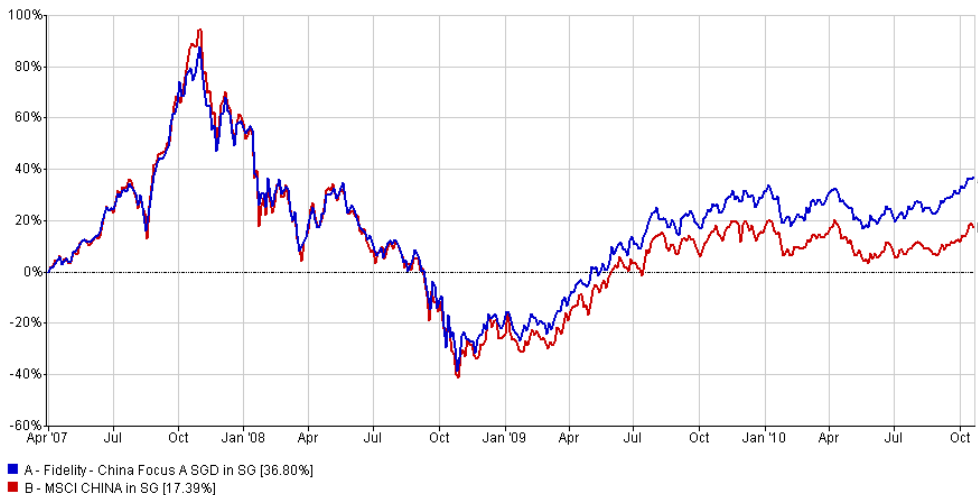
Fund in Focus – Fidelity China Focus Fund

The Fidelity China Focus Fund aims to hold 100% direct exposure to China equities. The fund's exposure include small and medium-sized companies with strong corporate fundamentals and sustainable earnings growth in the fund manager's point of view. At the same time, the overall stock weightings are driven solely by a bottom-up stock picking process.

The fund is benchmarked against the MSCI China Index and the fund had outperformed its benchmark by more than 19% over the last 5 years (See Chart 4 below). The biggest sector exposure is the Chinese financials (36%). From an earnings perspective, China's decision to raise interest rates for the first time since 2007 may be the greatest catalyst for the domestic financial sector in the near term as banks' margins on lending widen. Profit at 11 publicly traded Chinese banks may increase between 3.9 percent and 7.4 percent year-on-year, according to Morgan Stanley.

In terms of risk, this fund is in the top quartile as compared to its peers given that its above average volatility level and standard deviation on a 1-Year, 3-Year and 5-Year basis. Maximum drawdown is at 15 percent while its peer average is closer to 18 percent.

Chart 4: Fund performance against benchmark index (5-Year)



Fidelity Chian Focus fund outperformed its benchmark by 19% over the 5-Year period.

Source: Financial Express, as of 21 Oct 2010



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