

The growing cult of consumption

AT A GLANCE

- Rising consumption is one of the dominant themes of the 21st century
- The expansion of the global middle class, as emerging markets deliver strong rates of economic growth, provides the impetus
- Demand for luxury goods is also rising in emerging markets as the wealthy seek to emulate the brand-driven lifestyles of western consumers

Whether you ask an Asian sales rep at Coca Cola, an economist at the World Bank, or a market trader in Delhi, the answer is likely to be the same. Consumption is undoubtedly one of the dominant economic themes of the 21st century.

As emerging markets become more productive and wealthy, and as personal incomes grow, massive growth is expected in the number of consumers and their purchasing power. In consumer spending terms, this means growth in the basics – like food, accommodation and energy – but more so in discretionary spending, where branding plays a critical role.

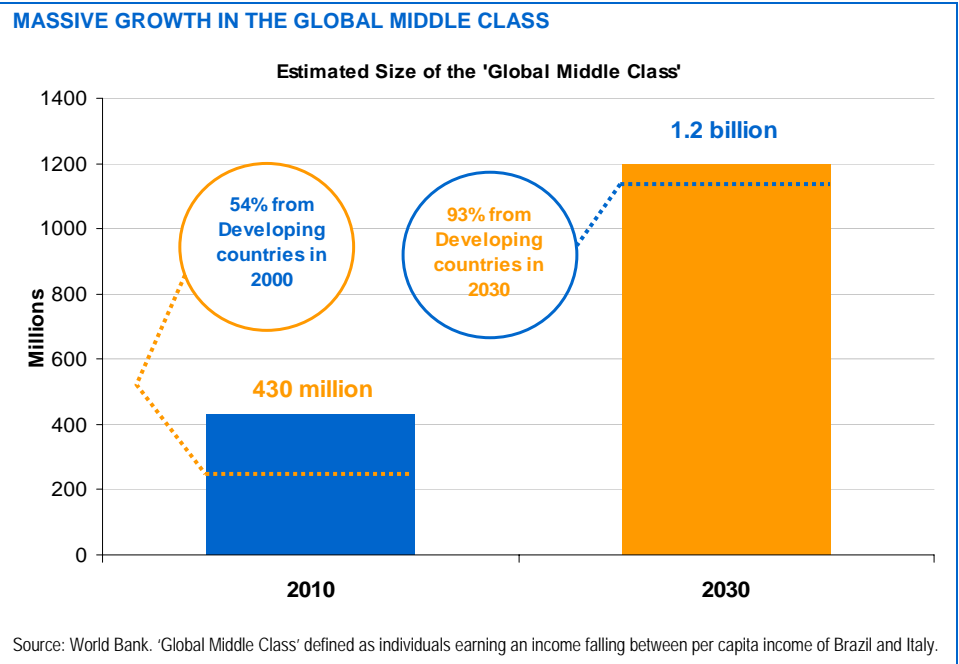
Companies in both western and emerging markets are already jockeying for position to get maximum exposure to what many expect to be one of the most enduring investment themes of our times.

EXPLODING GLOBAL MIDDLE CLASS POINTS TO MASSIVE CONSUMPTION GROWTH

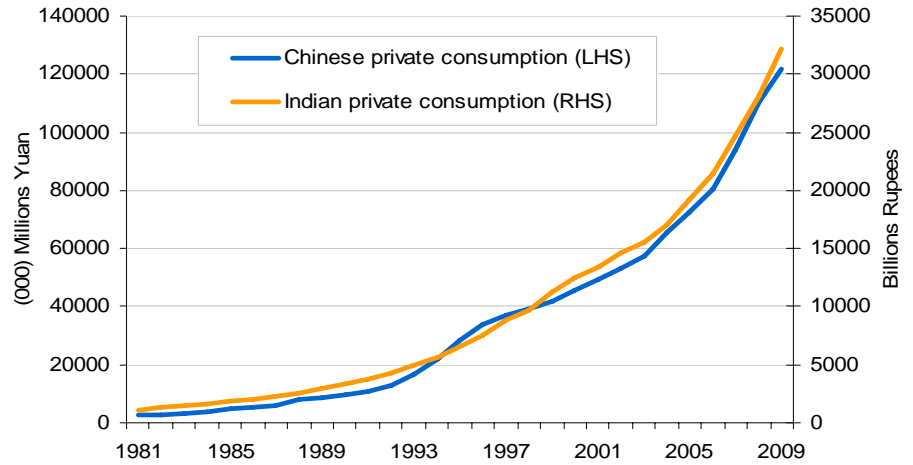
The rebalancing of global growth from advanced to emerging economies is having an unprecedented effect in terms of lifting people out of poverty. It is estimated that an incredible 135 million people escaped from poverty between 1999 and 2004 alone - more than the entire population of Japan. A population the size of Japan was added to the pool of global consumers in just a five-year period!

Over the next few decades, the number of people considered to be in the 'global middle class' is projected to more than double, from 430 million in 2000 to 1.2 billion in 2030 (or from 7.6% of the world's population to over 16%), according to the World Bank. Most of the new entrants will come from just two countries - China and India - where private consumption has been growing rapidly in recent years. In fact, to put the source and magnitude of this growth in perspective, the World Bank predict that by 2030, 93% of the global middle class will be from developing countries, up from 56% in 2000.

This bare fact alone is the reason why companies from all over the world are at pains to develop a presence in emerging markets. They want to capture rates of consumption growth that are unimaginable in mature western economies.



PRIVATE CONSUMPTION IN INDIA AND CHINA IS GROWING RAPIDLY



Source: DataStream, National Statistics.

EMERGING ECONOMIC GROWTH IS DRIVING CONSUMPTION

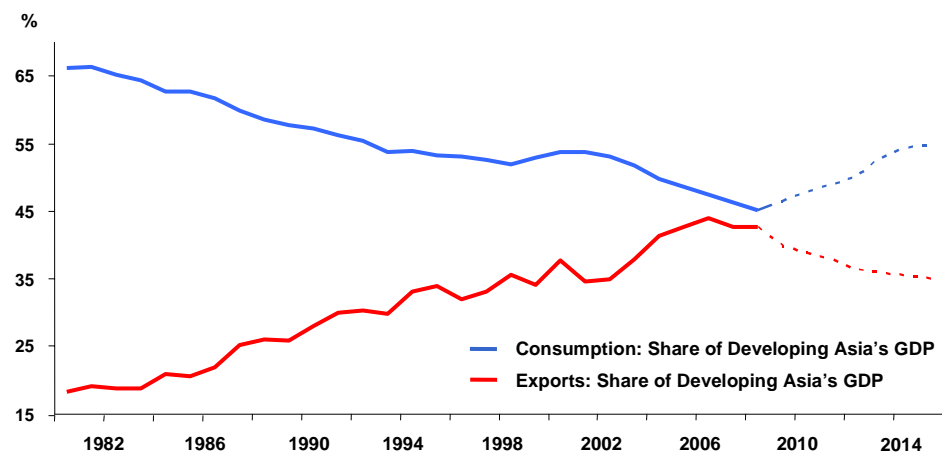
The consistently strong economic growth we have seen in emerging markets in recent years is encouraging incomes to grow from a low base. This rapid income growth is, in turn, driving a significant expansion in global aggregate purchasing power, even at a time when income growth is slowing for middle class consumers in developed economies due to raised levels of unemployment and slower economic growth.

Much of this consumption growth is predicted to occur in China, South Asia and India. However, private consumption in Brazil, Russia and parts of sub-Saharan Africa is also growing strongly. The fall-out from the credit crisis has added further impetus to the Chinese and Indian governments' commitments to increasing domestic sources of economic growth. Such a strategy recognises the significant role that exports play in their economies; increasing domestic consumption allows them to rely less on economic conditions in other (western) countries.

CHINA HAS HUGE SCOPE TO GROW CONSUMPTION AS A SHARE OF GDP

The scope for consumption growth in China is huge. However, the outlook is complicated by a preference for saving that is prevalent throughout much of Asia. The high savings rate in developing Asia can be partly explained by the lack of a social safety net. For instance, the Chinese government decided to privatise housing and the pension system in 1999 and suggested households should be responsible for their own education and healthcare needs. These factors increased the incentive to save. As the chart below shows, consumption's share of GDP has been falling steadily in developing Asia as a result of imbalanced growth that has favoured investment in the export sector.

THE ANTICIPATED REBALANCING OF ASIAN ECONOMIC GROWTH



"I see tightness in the labour markets in emerging markets, which should drive wage inflation. The recent increase in wages in China is a good example. This should prove supportive for domestic consumption in these markets and benefit companies catering to this demand."

**Nicola Stafford, Portfolio Manager,
global consumer industries**

Source: National Sources, IMF, UN, Morgan Stanley Research.

However, the tide seems to be turning. In the aftermath of the credit crunch, China implemented a massive stimulus programme, ultimately aimed at stimulating the domestic economy by building infrastructure and stimulating the banking system and the consumer via loans. Elsewhere, emerging market governments are being increasingly pressed by their own populations to implement social reforms. A combination of income growth and social reform would be a particularly potent set of catalysts for Asian domestic consumption over the next few decades.

DEMOGRAPHICS WILL UNDERPIN THE INDIAN CONSUMPTION BOOM

China may be the market that everybody is watching to see the consumer revolution take hold but, in fact, private consumption in India accounts for a higher share of GDP than in China – around 55%. Rising incomes and an increase in the availability of retail credit have encouraged consumption growth of 5-7% a year over the last decade.

The outlook for further growth is compelling thanks to India's favourable demographics. The labour force benefits from a rising proportion of young workers, which includes skilled, English-speaking workers in the outsourcing and service sectors. McKinsey has forecast that a combination of poverty reduction and these favourable demographics will see the Indian middle class grow from 5% of the overall population currently to 41% by only 2025.

As this occurs, Indian spending habits are expected to shift significantly. At present, organised retail spending in shopping malls is very small since most Indian spending takes place via small traders in public markets. The difficulty for foreign retailers is that India currently prohibits foreign investment in multi-brand retailing, so local players such as Reliance, Bata India and Pantaloon Retail are gaining a strong foot-hold in the rapidly-growing formal shopping market.

BRAZILIANS LIKE TO SPEND

While consumerism takes hold in China and India, in some emerging markets it is already well embedded in the culture. Brazil is perceived as the most western of the BRICs, something that is certainly borne out by their shopping habits. Brazilians like to spend rather than save, making them more like western consumers than their BRIC counterparts in India and China. For example, Brazil is now the third biggest market for beauty products after the US and Japan.

Much of this is down to the availability of - and willingness to use - credit and the fact that Brazil benefits from a stronger social safety net that permits this preference for spending over saving. Brazil has universal health care, education and social security. The upshot is that Brazil's saving rate is around 17% of GDP, while China's is 45%. There is still considerable scope for the poorest sections of the population to join the consumer ranks.

EMERGING CONSUMPTION PATTERNS ARE CHANGING

Meanwhile, as incomes grow, the proportion that is spent on basic necessities diminishes. As the disposable income of emerging consumers grows, so too does the allure of having the coolest fashions and the latest mobile phone. Consumption patterns in emerging markets are already changing as this trend develops.

While western consumers grow a little resistant to direct advertising, forcing companies to be ever more innovative, multinationals are using time-tested aspirational advertising to build their brands in emerging markets. For instance, Guinness is what the upwardly-mobile Nigerian man ought to be drinking, according to a national advertising campaign to that effect. And drinking it he is – in quantities that are putting even the UK and Ireland to shame. Nigeria has recently become the largest market for Guinness in the world and therefore very important to brewer Diageo.

STATUS SPENDING: THE ALLURE OF WESTERN LUXURY GOODS

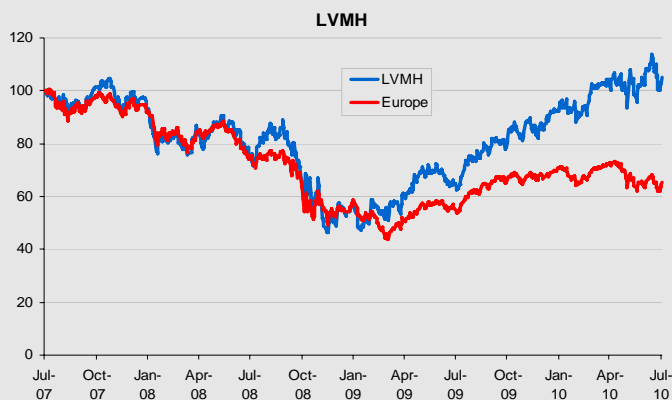
Taking aspirational spending to its natural conclusion, another area of emerging market spending that has already been growing strongly, particularly in China and Russia, is the luxury goods market. The ranks of the financial and industrial elite are happy to indulge in ostentatious purchases to underline their status and reward themselves for their endeavours. This invariably means luxury western brands are in great demand from a relatively small but high-spending portion of the population.

The western luxury goods companies have cottoned on fast and have expanded their presence in key financial centres where wealth has accumulated, such as Shanghai and Moscow. These companies benefit from the fact they have no local competition. In the low- and mid-market areas, there are abundant local competitors who can compete fiercely on price. However, the top end enjoys the exclusivity and allure that comes with high prices. Companies like Burberry, LVMH, and

Richemont all stand to benefit as the top strata of the emerging middle class continues to expand.

SHOWING OFF YOUR WEALTH WITH LUXURY BRANDS...

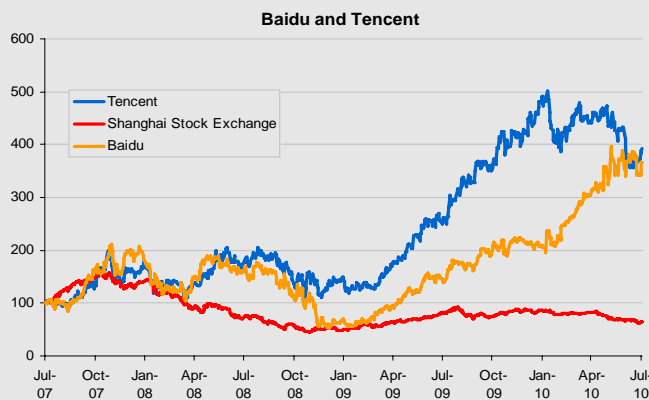
LVMH is the luxury goods conglomerate behind brands such as Louis Vuitton, Givenchy, Tag Heuer, Glenmorangie and Dom Perignon. They are rolling out new stores in China to benefit from the 'status spending' of the top Chinese earners.



Source: DataStream, 09.07.10. References to specific securities are for illustrative purposes only and subject to change without notice. They should not be construed as a recommendation or an advice to transact in the securities.

...AND BEING EARLY-ADOPTERS OF THE LATEST TECHNOLOGY

Technology spending is one of the fastest growing areas of consumption in emerging markets. **Baidu** is the leading search engine in China. **Tencent** is China's leading social networking site, generating strong advertising and gaming revenues.



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THE TRAPPINGS OF WESTERN CONSUMPTION: FAST FOOD, TOURISM AND LEISURE

Another area that is already growing strongly in emerging economies is western-style fast food. Yum! Brands, whose portfolio includes Pizza Hut and KFC, has opened 200 restaurants throughout India that are producing revenue growth of 40% a year. In China, the company has around 3,000 KFC outlets and 500 Pizza Hut restaurants. Incredibly, it sees the potential for 20,000 restaurants in mainland China.

Tourism and leisure are classic areas of discretionary spending that are set to surge alongside the growth in the middle class. Although slightly impacted by the global economic slowdown, tourism is expected to grow strongly in the coming years. Companies like Ctrip.com, which has established itself as China's dominant online and telephone travel booker, stand to benefit greatly. Li Ning has established itself as a leading player in sports apparel in the mid-end segment, just below the high end names of Nike and Adidas. The company is well positioned to capture demand from consumers trading up from the low-end of the sports clothing market.

WESTERN COMPANIES WITH A STRONG FRANCHISE...

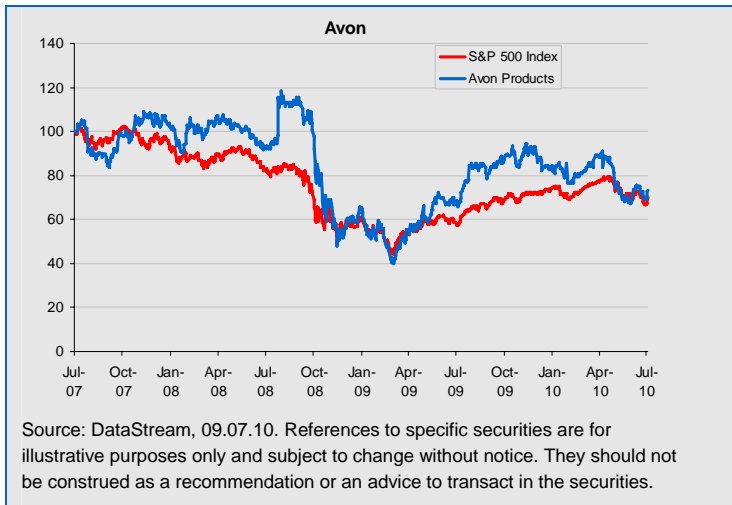
"Avon may be perceived as a relatively boring western cosmetics firm. However, the company has expanded in emerging markets, particularly in Latin America, and already derives a large proportion of its revenues from these new markets. The company is now expanding its presence in China, yet it trades at a discount to many of its competitors."

Nicola Stafford, Portfolio Manager, global consumer industries

...VERSUS WELL-POSITIONED DOMESTIC PLAYERS

"Sa Sa International is a discount retailer of branded cosmetics based in Hong Kong that specialises in products specifically formulated for Asian skin colouring. The company experienced resilient sales growth in 2009 despite the economic slowdown."

David Urquhart, Portfolio Manager, Asian equities



CONCLUSION

While industrial investment themes may reward investors only over specific parts of the investment cycle, the steady growth in consumption represents a compelling and enduring theme that deserves long-term inclusion in any equity investor's portfolio.

One of the most significant effects of the rebalancing of economic growth from mature, developed economies to fast-growing emerging markets is the explosion we are about to witness in the global middle class and the consumer boom that comes with that. The idea may be simple, but the investment implications are many-faceted. Nimble and focused local players offer the best opportunities in some areas, while western companies with strong brands and big advertising budgets are best placed to benefit in others.

"While infrastructure developments can provide excellent investment opportunities, the real long term growth story that investors should be getting excited about is consumption. Strong and consistent GDP growth in recent years is seeing rising incomes and a developing middle class in many economies. There is considerable scope for consumption growth throughout the emerging markets universe."

Nick Price, Portfolio Manager, emerging markets equities



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