

The Two-Speed World

Implications for investors
in a Two-Speed World

For Professional Investors Only

December 2011

Executive summary

The Two-Speed World

We are living in unusual times. A massive shift in economic power, at a scale usually only seen after a world war or catastrophe, is reshaping the world economy. This shift is having a profound impact on the investment landscape.

This change heralds the formation of a "Two-Speed World", where economic growth rates in the developed and emerging world continue to diverge dramatically. The growth of much of the developed world, burdened by rising deficits and debt and weak demographic profiles, is noticeably moderating; by contrast, Asia and many parts of the emerging world are enjoying rapid growth. These developments are so pronounced that developed economies can expect a growth outlook of only 1% - 2% per annum (and potentially lower in some cases) while their counterparts in the emerging markets could see growth rates of around 3% - 4% and possibly even higher in some regions. This creates a picture whereby less developed countries will be benefiting from life in the economic fast lane, while developed ones will be more often than not in the equivalent slow lane.

These events are well-documented. However, in terms of their effects on investment and asset allocation, we have, until now, only seen the tip of the iceberg. While economic growth rates are running at two speeds, market performance has not, so far, necessarily demonstrated the same characteristics, and correlation between economic growth and market performance is not always straightforward. But the investment outlook can change unexpectedly: what we know today may not be true tomorrow.

This paper outlines the drivers behind the Two-Speed World, and the implications for investors. We argue that the global finance crisis of 2007–2009 has undoubtedly widened the gap between developed and emerging market growth, but it was by no means the only reason for this divergence, and that the seeds of the current developments were sown in some of the economic and political decisions made in previous decades.

We also analyse the constituent elements behind the development of the Two-Speed World: in particular, issues of deficits, debts and demographics. We then ask how these issues came to be so problematic for developed countries and how they will affect different countries and regions in varying ways. We argue that the path for many developed economies will be one of consolidation resulting in low growth rates while, in contrast, the less-indebted emerging economies will enjoy higher growth rates due to an abundance of credit, commodities and consumption.

Following on from this, we examine the implications of the Two-Speed World for investors. To come to terms with these tectonic shifts, investors need to question many of their previously held assumptions. In particular, asset allocation strategies and perceptions of risk and safety need to be reassessed and amended.

Finally, we put forward various alternatives: investors should significantly raise their weighting of Asian and emerging markets equities sooner rather than later. Opportunities are available in developed markets, particularly among some of the leading global companies with good business models and solid income streams, but investors need to contemplate more selective strategies here to sort out the winners from the losers. In the Fixed Income arena, investors should consider increasing their weighting to emerging market debt at the expense of developed market debt because of the better outlook, while also allocating more to developed market corporates at the expense of developed market government bonds because of their relatively stronger balance sheets.

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Chapter 1: Decline and fall

“It has been my view for some time that we are living in a Two-Speed World. In this world, the different rates of growth of developed and developing economies will increasingly make investing in Asia and other emerging markets relatively attractive. Growth in the developed world, especially in the US and Europe, will continue to be held back by policymakers’ attempts to restore the health of economies in which sovereign debt increased substantially after the financial crisis. Emerging markets cannot expect to be unaffected by this lower growth, particularly those that are dependent on exports or commodity prices. However, in a Two-Speed World, their higher relative growth will look very appealing. In particular, I remain of the view that China looks to be one of the better places to invest as its economy remains reasonably insulated from the rest of the world. Besides emerging markets, other areas that should do well in a Two-Speed World include companies that can show steady predictable growth and this includes a number of developed world stocks that have dividend yields above the relevant government bond yield. In a low interest rate, low growth environment, I think these higher growth companies could become very valuable and, at some stage, be rewarded with much higher valuations.”

Anthony Bolton, President and Portfolio Manager

Introduction

The “Two-Speed World” refers to a world in which the structural growth rates of developed and emerging countries are significantly diverged: in developed economies, growth is moderate; in emerging economies, growth is rapid.

The origins of the term “Two-Speed World” are difficult to pinpoint. However, it has been used by Fidelity Fund Manager Anthony Bolton on several occasions in recent times. Many other commentators have noted these imbalances in the growth rates of developed and emerging economies, without using the term directly. The concept of a Two-Speed World is, therefore, relatively new; although some of the factors causing it have been around for a while.

We've been here before, so why are we here again?

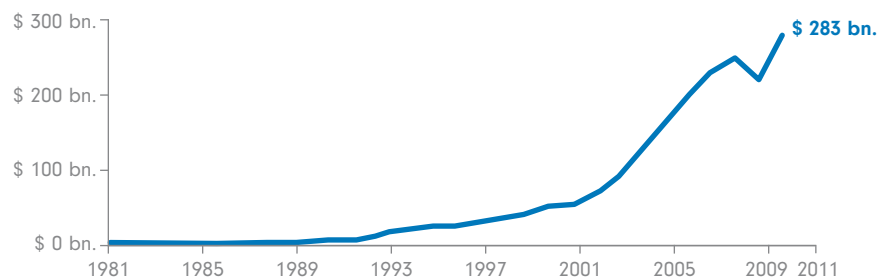
Sir Winston Churchill once noted, "The farther backward you look, the further forward you are likely to see". Indeed, if we cast a glance at Ancient Rome through to the Spanish Empire of the Sixteenth and Seventeenth century, right up to the years of the British Empire and even the United States in the Twentieth century, major world powers have repeatedly been weakened by a deadly combination of spiralling debts and overreach, as much as by anything done to them by their enemies. It could be argued that it is often friends and allies who play a key role in the downfall of an Empire: by offering cheap and easy credit, especially in the period while they are building and expanding; followed by escalating interest payments when the going gets tough. In short, it is cheap credit that helps create empires; but rising debt payments that cause their decline.

What is the relevance of this today and what lessons can be learned? While neither the US nor Europe view themselves as empires, they display many of the characteristics in some of their behaviour. The world economic order has been dominated by the US for the last fifty years, but this appears to be fading into a new set of rules. We are currently seeing the emergence of new economic superpowers, including Brazil, Russia, India and China. Together, they are forcing a rebalancing of the global economy.

Emerging markets open up

The story of how China and other emerging markets have risen to being economic powerhouses is an informative one. The US and China only established diplomatic relations in 1979. Since that time, trade between the two countries has risen from being practically non-existent to the point where China is the second-largest trading partner of the US.

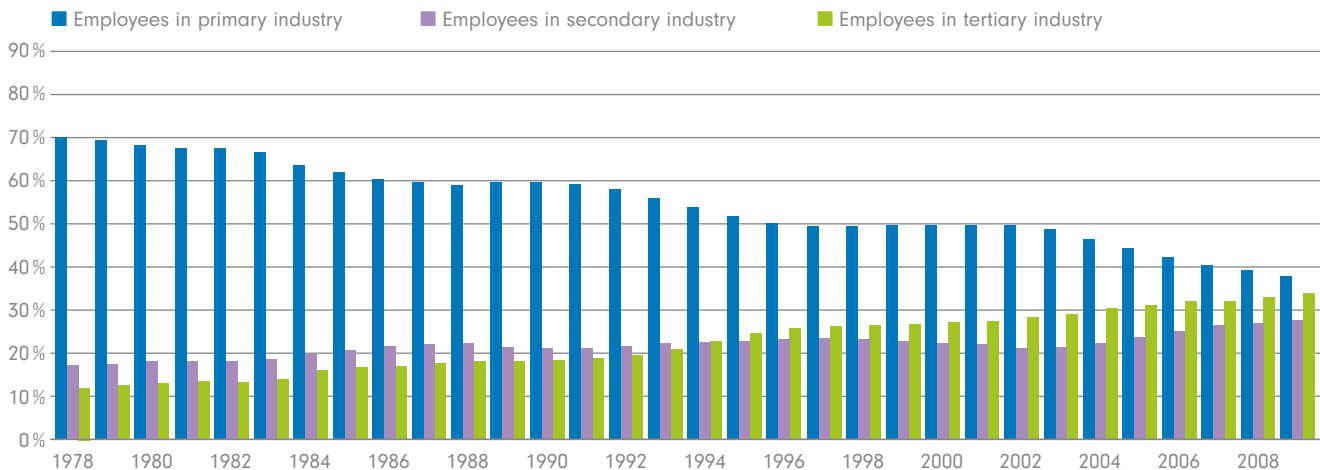
China's exports to US over a 30-year period



Source: DataStream, October 2011.

Around the same time (early 1980's), other large emerging markets, such as Brazil, India, Indonesia and, later, Russia started to reduce protectionism and open up their economies. This resulted in a massive increase in the supply of cheap labour, roughly doubling the amount of workers in the world. This also effectively integrated these countries into the global economy. China, in particular, found that it could be competitive in low-end manufacturing, where its labour costs were significantly cheaper than those of developed nations. As a consequence, developed countries, and particularly the US, eagerly transferred manufacturing jobs to these emerging markets. This has led many emerging markets to compete on a more level footing with their developed counterparts, and meant that these emerging countries have increased their share of global production significantly. China's success over the last thirty years, for example, provides evidence that its economy is reaching towards developed nation status: tertiary industries are growing quickly, while low-end manufacturing is moving out of China to more competitive countries, such as Vietnam.

Changing make-up of China's economy

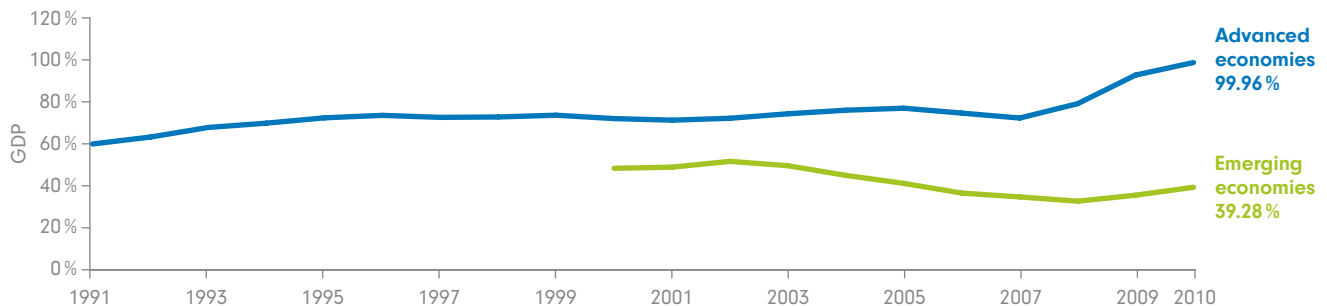


Source: China's National Bureau of Statistics, 2009.

Asia learns fast

The recent success of Asia has not just been based on the largesse of developed nations. Asia could well have gone down the same route as developed nations, into excessive debts and deficits. The crucial difference is that Asia learned important lessons from its own financial crisis in 1997, and this was in many ways a defining moment for the region. As in the developed world today, many Asian countries and businesses at the time were happily increasing their debts, seemingly unconcerned about the consequences. Then, in 1997, things came to a head as high debt levels, currency issues and asset bubbles caused Asian markets to crash, bringing the world to the edge of a financial meltdown.

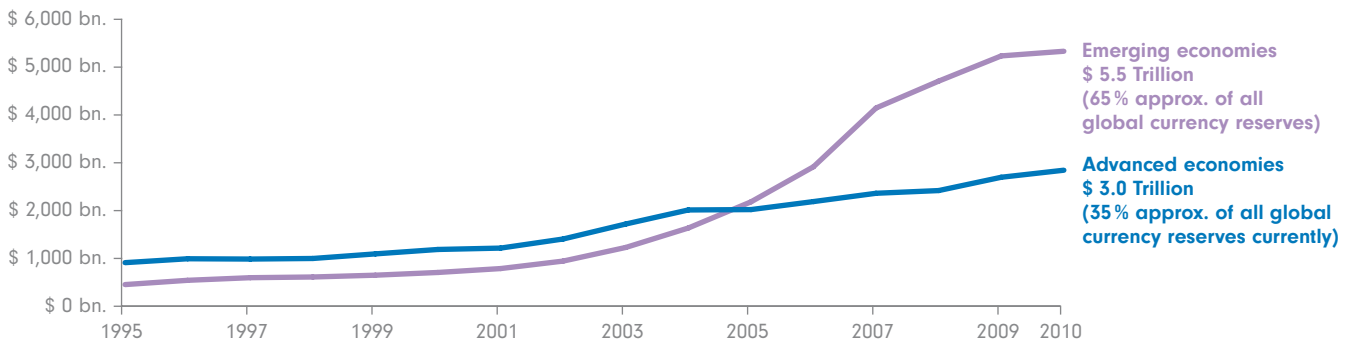
General government debt for emerging and developing economies



Source: International Monetary Fund, World Economic Outlook Database, September 2011. Data for emerging economies is available only after 1999. Gross debt figures.

The vital lesson that Asian policymakers and business leaders learnt during this period was that excessive leverage, whether at the country or company level, can have serious implications. Policymakers in the region abhorred the idea of the International Monetary Fund taking control and making painful decisions on their behalf. Instead, following this embarrassing experience, both countries and companies started building up significant currency reserves and strengthening their balance sheets. This resulted in large surpluses, which were mainly invested in US financial assets, such as treasury bonds.

Global currency reserves



Source: International Monetary Fund 1995 – 2010 (Q2).

There are two lessons here for developed markets. Firstly, excessive debt and deficits will eventually result in unsustainable pressure, as markets will at some stage call an end to the party. Secondly, in little over a decade, some of the countries in Asia, which were most badly affected by the crisis in 1997, have transformed their economies from being little more than basket cases into solid, healthy economies. In fact, they have been so successful that most investors would view such a crisis as being much more likely to happen now in the developed markets.

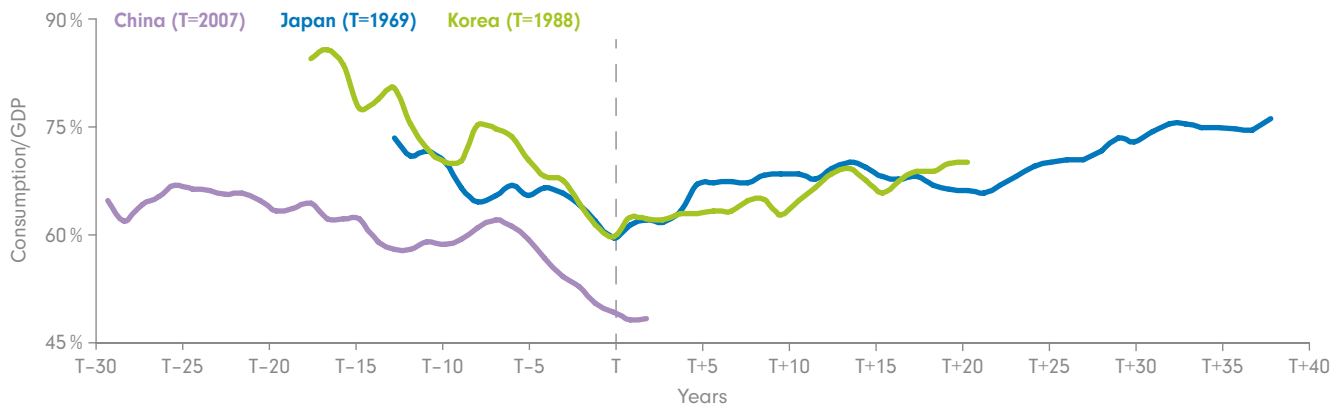
The West trails behind

Only a few years ago, markets lauded ex-US Federal Reserve Chairman Alan Greenspan as an economic guru. Times have changed: it is now almost de rigueur to blame Greenspan for the current asset bubbles and debt problems we face. In hindsight, markets recognise that many of the problems we are currently enduring may have their roots in the loose monetary policy he advocated. That said, other factors also played a role: the increase in cheap labour from the emerging markets led to effective deflation in some developed countries. In turn, the Asian savings glut led to a perception of “easy money” always being readily available, which meant that many workers in the developed world borrowed money to boost their living standards, while savings rates dropped over time in the US to nearly zero. The huge amount of borrowing meant that the US consumer at one time represented an astonishing 20% of entire global GDP. The combination of these factors contributed to a misguided allocation of resources in the US, the UK and the PIIGS states and, in time, housing booms developed in many of these countries. This laxness helped produce the illusion of wealth, an illusion that was shattered in the credit crunch in 2007.

2007 and beyond

The resilience of Asia and other emerging markets since 2007 suggests that the region is genuinely becoming more independent from Western demand. While exports still matter a great deal to economies such as China, the key point is that they matter less than they used to. Many Asian economies (China being a prime example) have reached a stage of economic development where they are seeing a gradual structural rebalancing towards domestic demand and furthermore have established themselves as end markets in their own right.

China's economy is at a turning point – following the path of some of its Asian predecessors



Source: Morgan Stanley Research, 8 November 2010. Turning Point at \$ 7,000 earnings rate.

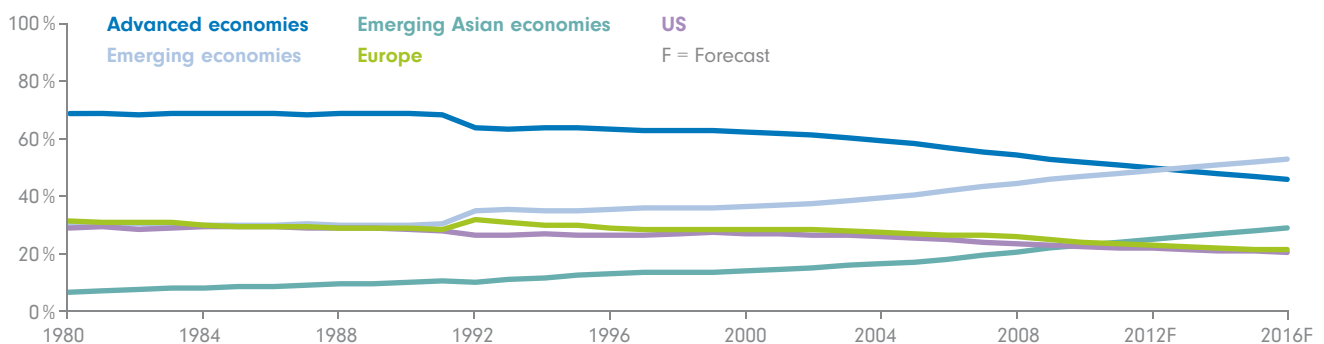
Meanwhile the core issue faced by policymakers in the developed world post 2007–2009 has been how to deal with the legacy of these historical issues. In many cases, their immediate response has been to increase their debts to try to buy time and to buy their way out of the crisis. There seemed to be little alternative, but it now means that the problem is structurally much worse than it was before.

As a result, the developed world also now finds itself at its own inflection point and needs urgently to decide how to solve the issues it faces. How this can be effectively achieved against the backdrop of slowing economies has been the matter of some debate. It will need to put in place austerity measures as well as increasing revenue collection, and this will mean that the path of slower growth lies ahead.

So where are we today?

For generations, the share of GDP attributable to advanced and emerging economies was relatively stable, with advanced economies enjoying over a 60% share from 1980 to nearly 2000. In little over a decade, this share has now fallen to a historic low of around 40%. This indicates a very dramatic shift in a short time.

Percentage of global GDP by region



Source: IMF, September 2011.

In terms of growth in the aftermath of the global finance crisis of 2007 – 2009, the emerging economies also lead the way. In 2010, the economies of emerging countries grew around 7.0% on average: China and India produced 10.3% and 9.7% growth respectively, while Brazil grew by 7.5%. By contrast, the economies of developed world countries grew on average by 2.8% in 2010, with the US growing by 2.9% over the year and the eurozone 2.7%. The figures are telling: what is clear is that the divergence in growth rates is significant and ongoing.

Summary

There is without doubt some truth in Mark Twain's saying that "History doesn't repeat itself but it does rhyme". Throughout time, excessive debt has brought nations and empires to their knees. The seeds of the issues currently faced by developed economies were sown in their lax attitude towards debt, as well as having an overly loose monetary policy, and, as a result, we have now reached an inflection point.

Asia learned the lessons of debt burdens during the crisis of 1997 and both countries and companies in the region have since been careful about leverage. The global finance crisis of 2007 – 2009 was not in any respects the cause of the developed world's problems but, rather, a late-developing symptom of a long period of unsustainable borrowing. Nevertheless, it sharpened the divide between emerging and developed economies still further, as the debt burden of developed countries increased significantly as a result.

Chapter 2: A 3D world

“It is yet to be seen just how serious developed market governments are about tackling the thorny issues of debts, deficits and demographics. Investors should take this into account when considering asset allocation strategies, as current notions of risk are fast-becoming outdated. It would seem sensible therefore for investors to move early into areas where growth opportunities lie, and look to good research and active management as a guide.”

Dr. Christian Wrede, Managing Director Germany & Austria

Introduction

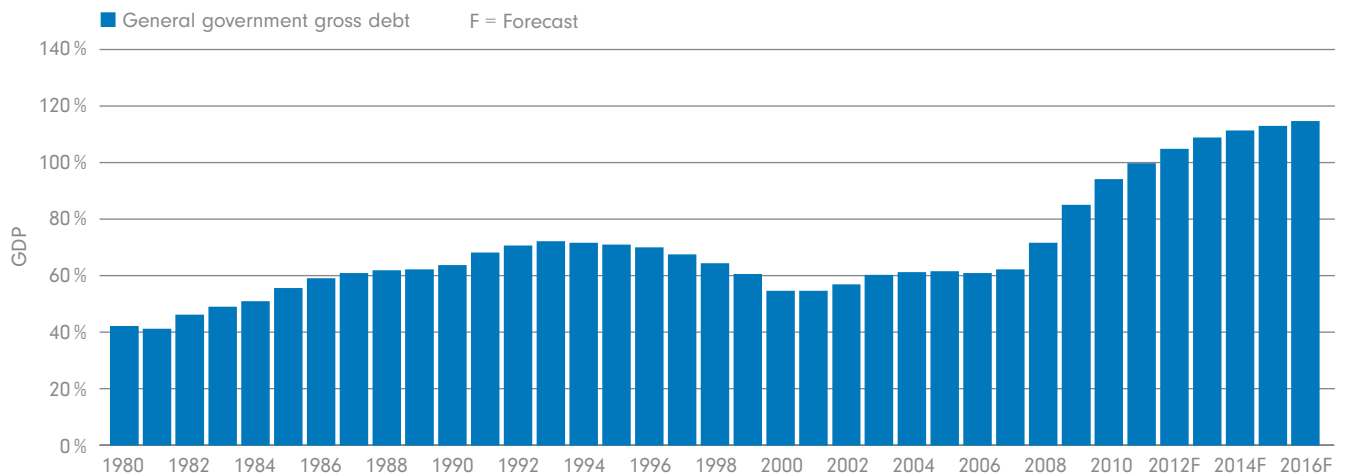
In this chapter we argue that there are three key causes behind the Two-Speed World: we call these “the 3D’s”. The 3D’s consist of two shorter term interrelated issues – debts and deficits – plus one structurally longer term issue: demographics. Other issues have played a part in the creation of the Two-Speed World, but these three issues are the primary drivers.

Debt

The savings glut in emerging markets provided an easy route for developed economies to increase their debts. The US made itself the home for the emerging world’s excess savings. The Chinese, in particular, put their spare cash in US Treasuries, considering them to be the safest (apparently risk-free) investment on offer. The US Bond market was the only market large and liquid enough to cope with such huge amounts of money; it is estimated that China owns more than \$ 1 trillion of US debt.

All this money was both a blessing and a curse. It allowed developed countries, which were in receipt of these inflows, to run large government deficits, and it also meant that people borrowing money for mortgages in many developed markets were doing so at relatively low interest rates. This undoubtedly played a part in the subsequent housing booms in some developed countries. Crucially, this climate of easy money lured many people in the developed world to increase their debts. A general, yet erroneous, belief took hold that there would always be more credit available both at the public and private level.

Growth of US Government debts

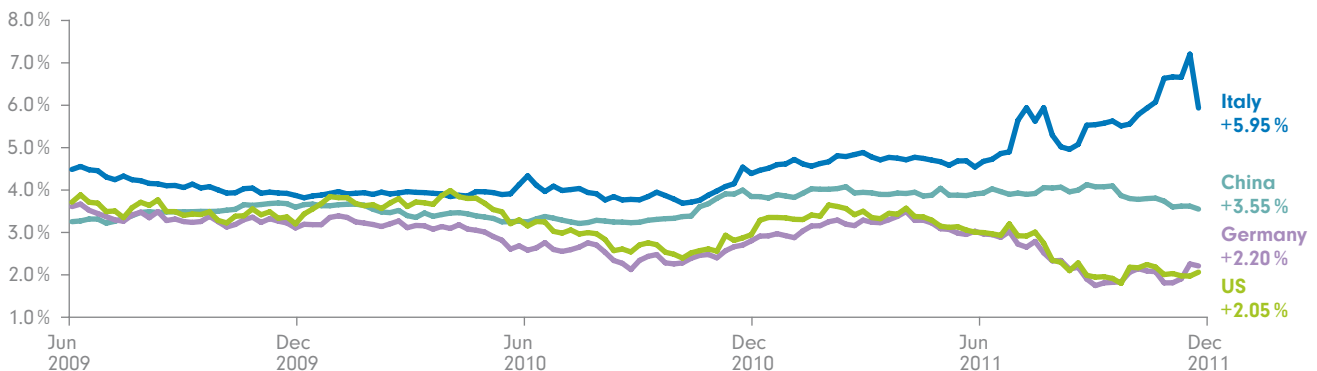


Source: IMF, World Economic Outlook data. October 2011.

Are developed nations serious about getting debt under control?

Some developed countries seem unaware about the risks to growth from their massive debts. This is partly down to the fact that they can still borrow at inexpensive rates for extended periods, with both the German and US governments, for example, being able to borrow at historically low levels.

Ten-year government bond yields for China, Germany, Italy and the US



Source: DataStream, December 2011. Figures all mid-yield apart from China which is bid-yield.

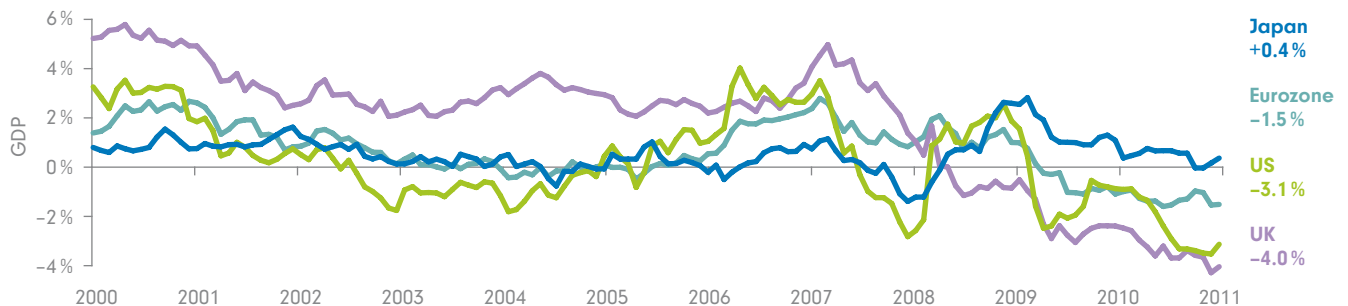
At some stage, and probably sooner rather than later, bond investors will want a greater return for the higher perceived risk of investing in highly indebted developed countries. In many respects, debates in debtor countries about what is the correct debt ceiling are missing the point: it is markets or, more pointedly creditors, who decide when a debtor country has too much debt. When this happens the consequences can be dramatic.

So far this has not happened to Germany or the US. However, over the long term this situation will change, and the US and other developed economies would be well-advised to take heed: the days of easy and cheap borrowing from the developing world are drawing to a close. Furthermore, this shift might not happen at an opportune moment, as the PIIGS countries have recently discovered.

Signs that perceptions are already changing

Tellingly, the yield being offered currently by some developed countries for their bonds is in some cases lower than inflation. This means effectively that there is a negative real interest rate. This has been described as “financial repression”, a method by which governments reduce their overall debt by keeping interest payments as low as possible. The question is, of course, how long countries can continue to do this. Perversely, some developed economies are being loaned money, while also being paid by investors for the honour of holding their investment. This is an indication of the rather unusual times we are living and will certainly not last indefinitely.

Real interest rates of developed economies



Source: DataStream, October 2011.

Tough choices ahead

How can the developed world get these debts under control? There are no easy answers, but the most likely path will be for developed governments to try to cut their debts through a process of general belt-tightening, combined with selling off assets and reducing liabilities, as the alternative of forging ahead due to supercharged economic growth seems unlikely at present. This is without doubt a real problem for developed economies, which have to achieve this against a challenging economic backdrop, but they have few options.

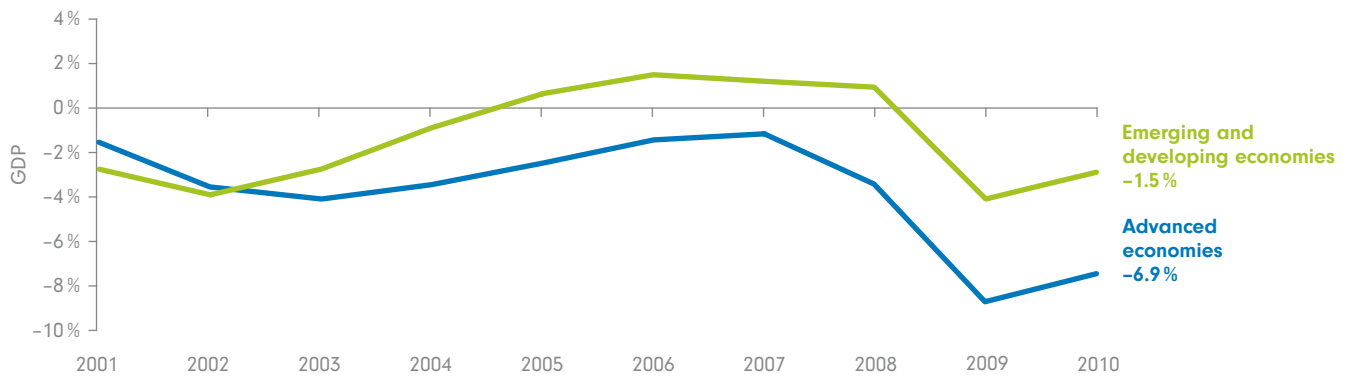
Developed economies will also continue in their attempts to keep their borrowing costs low by directly, or indirectly, creating an environment of negative real interest rates, as described above. However, this will hurt savers (both private and institutional) at the expense of bailing out debtors, most significantly the governments themselves.

For some countries, many commentators have long held the view that an orderly default is the only realistic route out of this crisis, particularly if their response to the crisis appears to be dysfunctional. The prospect of default is not palatable for most developed countries currently. Nevertheless, drastic decisions are looming ahead for some and, if they refuse to make them, markets will force them to, and default will not be considered just as an once-in-a-lifetime tail risk going forward.

Deficits

Not so long ago, many developed economies were running budget surpluses. During the Clinton administration, the US was, at times, enjoying a budget surplus. The picture is now radically different for most developed economies, with the US currently running a huge budget deficit of around 10% annually. But one crucial lesson learnt throughout history is that a country can run a budget deficit for a considerable time until debt levels start becoming too large and, at this point, creditors will become concerned.

Deficits for developed and emerging countries over 10 years



Source: International Monetary Fund, World Economic Outlook Database, September 2011.

There is a symbiotic relationship between debt and deficits. The huge inflows of money coming into the government bond market (made possible by the Asia savings glut) meant that some governments in developed markets were able to run these large budget deficits. The bond markets were effectively handing them a "licence to spend". These times are drawing to a close.

Demographics

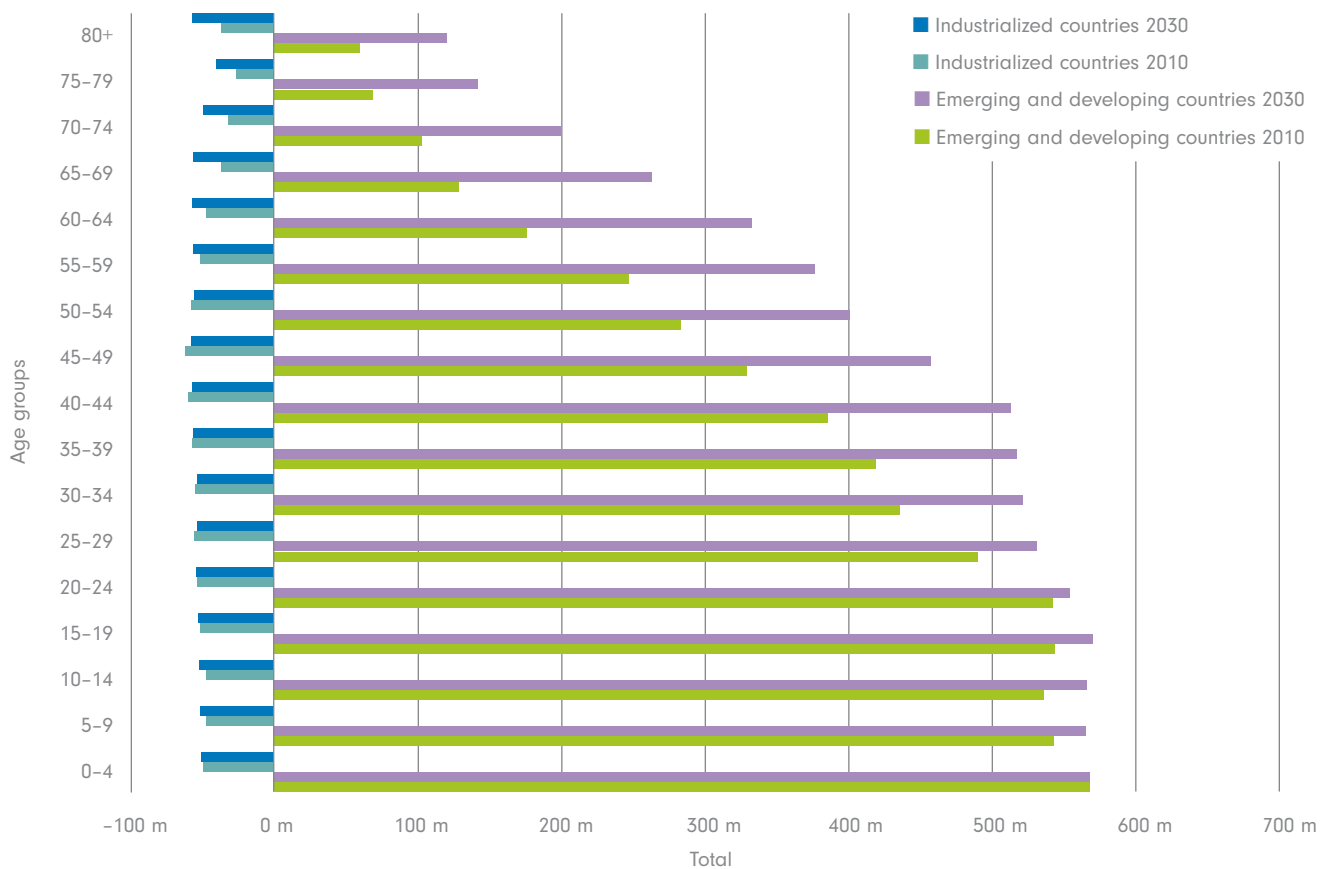
Demography has a large, somewhat abstract influence on investment markets. Interestingly, the period of the past few hundred years has been dominated, economically speaking, by a few under-populated developed countries in the West. There are many reasons for this (industrial revolutions, advanced banking systems, and military might, to name but a few), but some commentators have highlighted this as being rather anomalous in historical terms.

Generally speaking, you would expect large populations to maintain economic dominance over the long term; this seems to be the trend forming right now. As emerging countries have larger population pools to draw from, they should gradually assume dominance through their ability to scale more than developed economies, with a smaller pool of resources at their disposal.

Declining versus growing populations

In developed countries, birth rates are mostly in decline; populations are also becoming older as people are living longer due to medical advances while, by contrast, emerging countries broadly enjoy much more positive demographic profiles.

Population tree showing age distribution of developed & emerging economies in 2010 and 2030



Source: UN Population division, 2011. There are various definitions of developed and emerging markets, for the purposes of this chart we have used the IMF definition. There is also a MSCI definition, which varies regarding the number of countries included. See appendix for further information on definitions. Calculations from both sexes combined, by 5-year age group.

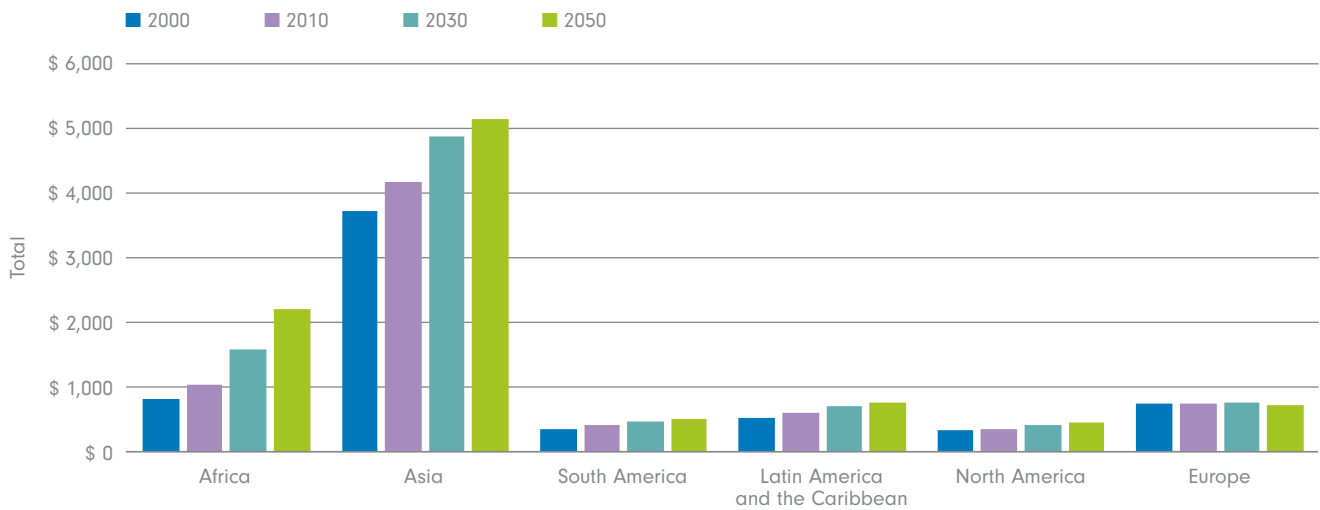
Japan, where the population is believed to have peaked in 2007 at 127 million, is an extreme example; in 40 years it is estimated that it will have fallen below 100 million. By 2055, it is forecast that in Japan there will be 1.3 people in work for each retired person. This will create a significant increase in social costs, but it is harder for governments to raise taxes on pensioners than it is to raise taxes for the working population. Furthermore, older people are by nature more conservative; pensioners are not focused on growth at all costs but, rather, on a comfortable and affordable way of life, and this will also shape voting and consumption behaviour in developed economies.

Some developed economies, such as the US, are still enjoying a growing population. But rather worryingly for the US, the costs of its health and social systems are not forecast to be covered by tax revenues.

As their populations age, developed countries will see their budgets come under enormous strain as their expensive social and medical care systems groan under the weight of so many elderly people. In addition, whatever wealth the declining working population is able to generate will be increasingly focused on the burgeoning, dependent population of retired people.

While the problem for developed markets might be shrinking and ageing populations, the picture is somewhat different in many emerging markets. Here, populations are young and growing fast, with many people in their economic prime.

Population of various regions in millions through to 2050



Source: UN Population Division, September 2011.

China is, in demographic terms, something of a special case, as its one-child policy put a lid on its booming population. This has helped the country control its growth more carefully. Overall, it is a positive picture for developing markets and some estimates put the potential growth rate of the population of the emerging world in the region of 1% per annum, a powerful driver underlying the economic growth they are already enjoying.

There is no easy fix for the structural issues causing weakening demographic profiles in developed countries. As people get richer they tend to have fewer children. Raising taxes is unlikely to cover the shortfall for developed countries. It may also become more difficult to attract economic migrants if growth rates moderate. The impending demographic problems facing developed countries mean that urgent action needs to be taken to resolve debt and deficit issues because demographic trends will only make these issues worse.

Summary

The lack of regard for the risks of burgeoning debts in developed economies helped create the current situation, where growth is likely to be inhibited by the servicing of these debts. Some investors are already asking certain highly indebted developed economies to pay more to service this debt, which is likely to make the situation worse. Despite talk of austerity measures, there is little evidence that all governments in developed countries are really making the tough decisions necessary. However, at some stage, developed economies will have to go down the path of consolidation by cutting jobs and benefits to public sector workers and/or by raising taxes. Neither of these are easy to achieve and have political and social consequences, but markets are beginning to force these choices upon the worse miscreants.

Demographics is a longer term issue with two distinct effects. One, it makes debt reduction for developed countries more urgent, as a declining population puts a natural brake on debt financing. Second, emerging countries will fully benefit from the economies of scale provided by large and growing populations. While developed economies go down the path of consolidation, emerging economies are running budget surpluses and reinvesting the proceeds in their own infrastructure, as well as purchasing assets abroad. These patterns should continue for the foreseeable future, resulting in the divergent growth rates we are now seeing in the Two-Speed World.

Chapter 3: Implications for markets

Introduction

So far we've explained how we've come to face a Two-Speed World. Here we examine the implications for major markets in the developed and emerging world, and argue that Japan offers us a glimpse of what developed world companies might face going forward. We also argue that the emerging world looks set to benefit broadly from the tailwinds of the 3C's: credit, commodities and consumption.

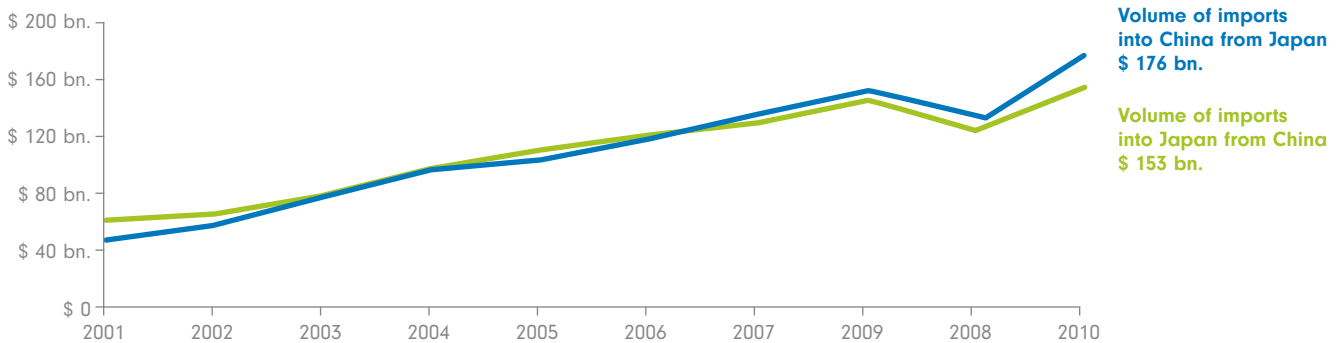
The developed world

Japan is a particularly interesting example within the Two-Speed World framework. When studying Japan, what emerges is a complex picture whereby many companies have somehow managed to remain resilient despite a challenging situation in terms of debts, deficits and demography. However, these headwinds have taken their toll in terms of market performance, which is frequently described by commentators in terms of the lost decade(s).

Many Japanese companies managed to survive against this challenging background because they successfully reinvented themselves: from a primarily domestic focus, they moved to a much more international outlook, responding to stagnation at home. These companies were able to do this due to their valuable intellectual property and expertise – resources that put them at the forefront of many high-end technology industries and at the top of the value chain in many sectors.

In addition, high-end goods and expertise were also in heavy demand in the emerging markets. China is now Japan's biggest trading partner, taking around a fifth of its exports, and Japan is in pole position to benefit from the economic expansion of its giant neighbour. In certain respects, therefore, Japan is somewhat of an exemplar of what life might be like in a low-growth environment, where some businesses might still thrive because of innovation and exposure to emerging market growth, but that structural issues will act as a drag, which can lead to investor apathy and thereby weaker market performance.

China and Japan trade data



Source: IMF, Direction of Trade Statistics (DOTS), October 2011.

American and European companies could learn a lot from studying their Japanese counterparts if they are to cope with life in a Two-Speed World. Despite the challenging headwinds, many Japanese businesses (though by no means all) have survived because of several key factors: excellent intellectual property and expertise; a sound industrial base; strong balance sheets; good business models and exposure to fast-growing emerging markets. European and American firms should mimic these attributes where possible.

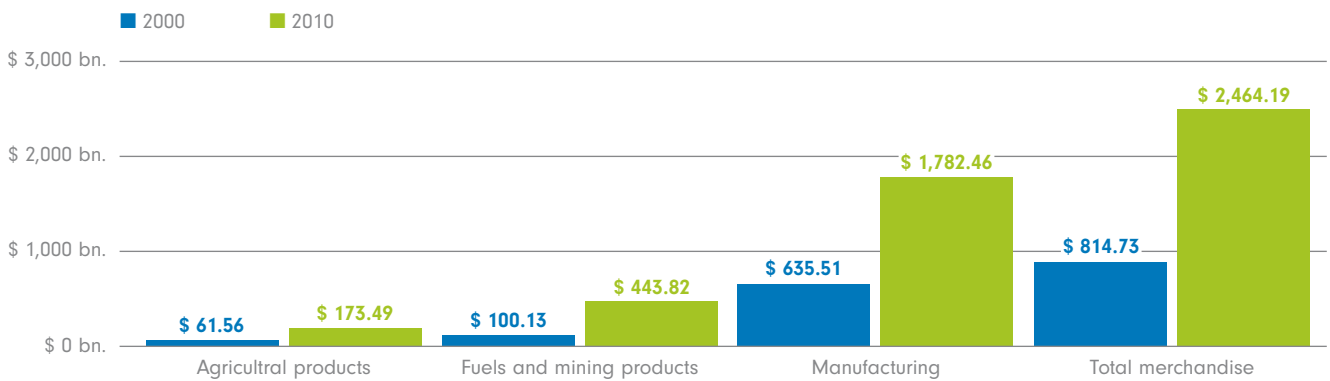
The emerging world

We believe that the implications for the developing world are broadly positive and rather than being negatively impacted by the 3D's it is being buoyed by what could be described as the 3C's: credit, commodities and, most importantly, the expansion of the consumption side of their economies.

The easy part of growth in Asia has already been achieved. Now comes the real test: can Asia cope if the developed economies slow down for a significant amount of time? And will their domestic economies (the credit and consumption parts in particular) grow enough to make up for any shortfall in demand from developed economies.

What is clear is that Asia's trade within the Asia Pacific region is becoming increasingly important: for example, almost a quarter of Korea's exports go to China. This means that Asian countries rely less on exports to developed countries than they have over recent decades.

Intra-regional Asian trade



Source: World Trade Organisation, October 2011.

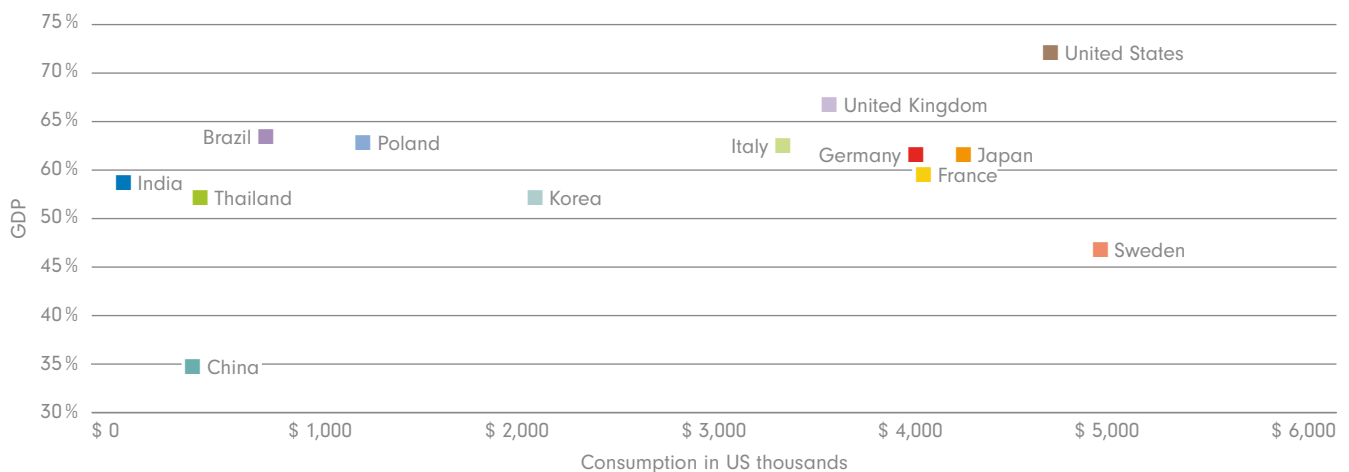
To move on to the next stage, China and other Asian countries need to show that they can successfully develop the domestic side of their economies and, in particular, consumption. The Chinese authorities have already taken notice and this is a stated aim in the latest five-year plan. China is undergoing something of a consumer revolution at the moment, resulting in consistent outperformance of domestic consumer stocks there. Luxury brand names from Europe and elsewhere are also seeing huge profit growth in this market.

“In a Two-Speed World, where developed markets like the US and Europe are faced with sluggish economic growth and heavily indebted consumers and corporates, rapidly growing emerging markets like China will become the bright spots in the financial market. Being a robustly growing consumer market with 1.3 billion consumers, China offers the most promising and enduring investment theme, benefiting from an emerging middle class. I expect China’s consumption to witness an annual growth rate of around 15% for the next five years, underpinned by China’s huge population and vast size. By focusing on China’s consumption story, investors are well placed to benefit from this significant growth potential.”

Raymond Ma, Portfolio Manager, Fidelity Funds - China Consumer Fund

Over the next ten years, it is estimated that the middle-income population in Asia will grow by some 850 million, which could accelerate consumer spending even more. In addition, if the Asian savings glut is also recycled more into the consumer side of the economy, then this could also be a significant boost to domestic and international consumer companies.

Average consumption expenditures for various countries in 2010



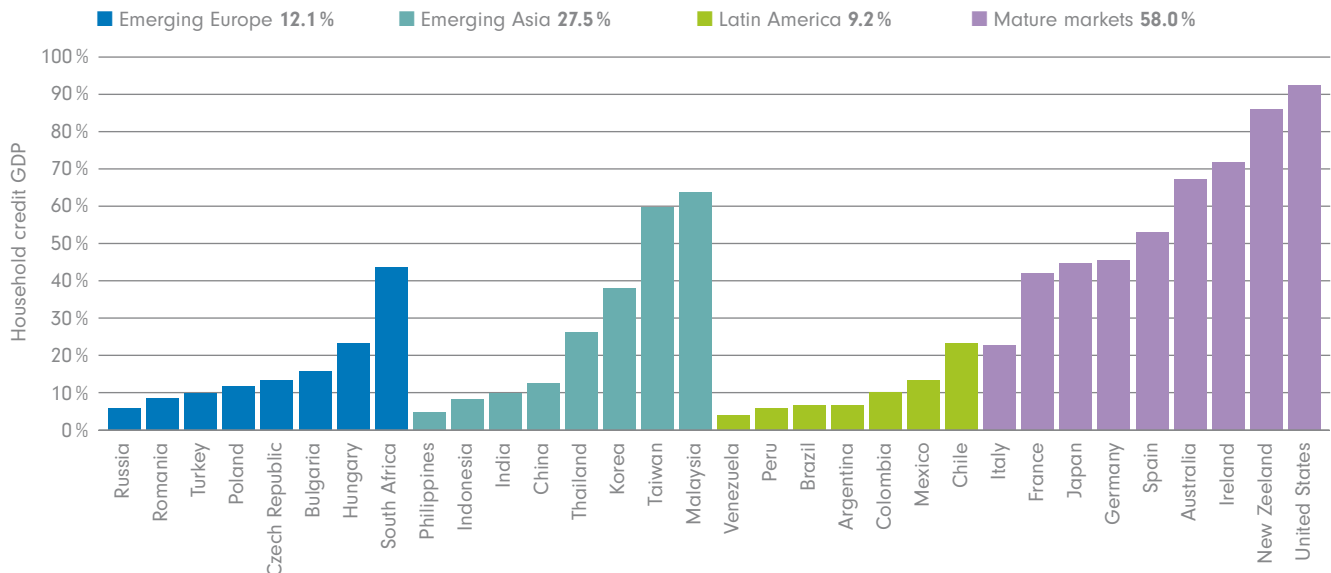
Source: World Bank, 2009, (Gross domestic product, in USD, current prices).

Another indicator is China's adoption of the process that happened (in reverse) almost 30 years ago in the US: "off shoring" of jobs to other less developed economies where the workforce is cheaper, such as Vietnam. As a result, China is starting the move up the value chain.

Without doubt, Asia is set to continue being in the economic fast lane for some time to come, and this should be reflected in market performance and the make-up of global indices. Broadly speaking, Asia is not overly affected by the 3D's but, rather, is benefiting from the development of credit and consumption in its economy.

If we now turn our attention to Latin America, we see that many countries here are also benefiting from the 3C's rather than being hindered by the 3D's. The first 'C' that is broadly assisting Latin America is credit, and this effectively is people's access to credit facilities, which is in many respects the flip-side of the coin of debt. The region used to see regular defaults, and this meant it was dogged by a reputation for a lack of creditworthiness. But the recent development of many Latin American economies means that countries and corporations are increasingly able to issue debt in their own currency, while the banking system is also becoming increasingly more advanced. All these factors indicate real structural changes taking place across Latin America. The first fruits of this are beginning to show: a better capitalised banking system well positioned to play an important role on the global stage going forward. This is why credit rather than debt is starting to work in Latin America's favour.

Regional household credit levels 2005 year end



Source: World Bank, 2009, (Household credit as a percentage of GDP).

Consumption will also be supportive as young populations in the region become increasingly wealthy and develop a taste for consumer products. The better developed banking system mentioned above means that they can borrow to buy these consumer goods, too. Personal debt in the region is low compared to the developed economies, again suggesting huge potential for growth as can be seen in the chart above.

The third C stands for commodities. This has played a huge part in the resurgence of Latin American economies in recent years. There is an abundance of commodities throughout the region, frequently of a type which cannot be found in such large amounts anywhere else. Brazil, for instance, has, over the last decade, increased its exports in this area, so that over half of all its exports consist of commodities and fuel. It is these commodities that are fuelling the expansion we are currently seeing across Asia. The 3C's, combined with freedom from the 3D's, means that Latin America is very much in the fast lane of economic growth.

Chapter 4:

What does this mean for the investor?

Introduction

The Two-Speed World does not automatically mean that there will be fewer attractive investment options available. On the contrary, investors should not fear the Two-Speed World, as it creates opportunities in many areas on a scale that we have never seen before. It does, however, bring with it a more challenging environment in which to make money: there will be different risks to contend with and continued volatility in many major markets. Investors must be careful to position themselves properly. They should also remain mindful of so-called “Black Swan” events, which could become more common.

Safety and risk

There has been a huge shift in the risk landscape as a result of the development of the Two-Speed World, though this has not yet been fully digested by investors. At the moment, developed economies enjoy the vast majority of the weighting in Fixed Income indices. This is because their markets are larger and more liquid (i.e. they are more indebted), and also because, historically speaking, emerging markets defaulted more often due to poor policy making and because frequently their debt was denominated in a foreign currency. This picture has radically changed.

“The development of a Two-Speed World has very significant implications for Fixed Income investors. Those countries that have high growth rates will inevitably improve their balance of payments positions, and fundamental creditworthiness. At the same time, companies within those regions have the opportunity to grow in size and diversity adding strength to their balance sheets. Both of these outcomes offer investors the possibility of capital gains and income from Asian Fixed Income securities, that in the longer term will be lower risk. If the asset manager picks the country and the company well, we can avoid the indebted or low growth areas of the market, and hence the volatility and fear of default that we are seeing stalk the markets in Europe.”

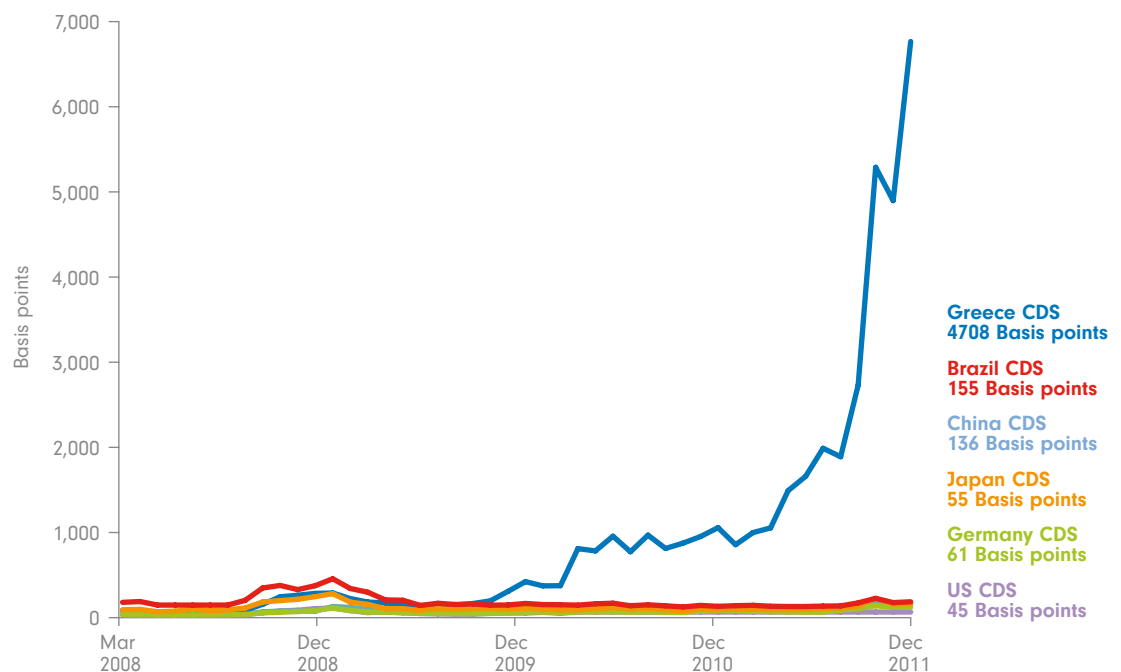
Andrew Wells, Global CIO, Fixed Income

As argued previously, not all countries are willing to walk the path of consolidation. The prospect of default or “haircuts” is becoming very real, as the example of Greece shows. Investors should, therefore change their perception of risk in Fixed Income markets. Today, governments are largely seen as safe (“risk-free”), while corporate debt is considered more risky. We believe that both areas need to be reassessed in the context of the Two-Speed World.

For instance, there are now fewer risks associated with emerging market government debt than some developed market government debt. Moreover, many developed market corporates have much to offer in the current environment as, on the whole, their balance sheets are stronger than their developed market government equivalents.

Credit Default Swaps (CDS) would appear to reflect this shift in risk. In the chart below, showing CDS for various government bonds, we see that the Greek government bond, for example, is seen by investors as being much riskier than either the Chinese or Brazilian ones. This is a relatively new phenomenon.

Credit Default Swaps for various government bonds

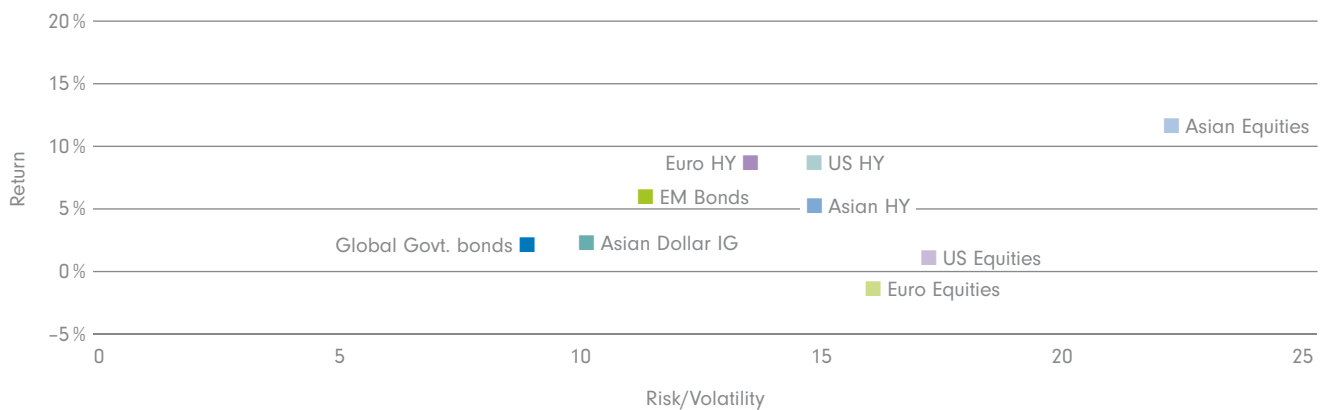


Source: DataStream, December 2011. US CDS data refers to modified restructuring only (5-year).

The chart above is also insightful in what it does not show: the CDS of the US and Japan have not risen despite their exposure to the 3D's. The US and Japan – unlike some peripheral eurozone countries – are therefore enjoying rather low interest rates on their debt repayment as a result. But, as we have asked earlier, how long can this last? At the moment these markets benefit because investors have not yet fully recognised the alternatives.

We believe that emerging market debt offers an attractive alternative in terms of its risk/return profile, and it is also on the way to becoming a more liquid market. Furthermore, this CDS chart reveals the innate risk level of some developed market government bonds. Here we believe that another alternative to be considered are corporate bonds, both investment grade and high yield.

Ten-year risk/return for key asset classes



Source: Morningstar Direct. Ten-year return annualised return and standard deviation (in euro terms) October 2011.

Asset allocation

As we can see from the previous sections, investors' views of risks are changing slowly but, so far, this has not overly affected their asset allocation. Some are, admittedly, marginally increasing their allocation to emerging markets, but they are starting from a very low base in terms of exposure. Indeed, if we actually look at risk through one of the most commonly used measures 'volatility' an interesting picture emerges: volatility in many emerging markets has come down greatly over recent years, and is in some cases comparable with developed markets.

Moreover, the return for emerging markets has been significantly higher over the past decade – on average 16.5% per annum compared with 3.1% per annum for developed markets (figures over 10 years to October 2011). However, even more noteworthy, over that period average volatility for the emerging markets was only slightly higher at 30.4 compared with 24.1 for the developed markets, and this gap is closing.

For some major markets an ever starker picture shines through. Over the last decade, China returned 229.5% with a ten-year volatility level of 27.8, which fell from a volatility level of 36.7 over twenty years. By contrast, Germany returned only 40.1% over ten years, and its volatility has risen from 22.8 over twenty years to 26.5 over ten. (All figures to October 2011).

This highlights that return has been significantly higher in emerging markets over the past decade, with risk falling toward developed market levels while, in some cases, the level of risk has actually increased in developed markets over the past ten years, with significantly weaker returns. Therefore, although returns largely diverged for developed and emerging markets, risk largely converged.

It would appear, however, that many institutional investors are reluctant to take radical steps. The reason for this may be related to outdated modes of thinking. Some investors may be accustomed to thinking of emerging markets as "risky". Others stick to the standard core and satellite approach, where the "core" is the developed world and the "satellite" is the emerging world. However, the realities of the Two-Speed World make a mockery of these biases: it could even be argued that the emerging world should now be considered the "core", as three times as much growth is coming from emerging markets as developed ones.

What will it take to make investors allocate more to fast-growing areas of the world? There are many reasons that make investors unwilling to change, but if a major developed market defaulted it would undoubtedly be a seminal moment. These new event risks should be foremost in investors' minds. It would seem sensible not to wait for such an event to happen, but to move in an early and strategic manner.

“An active investment approach allied to strong on the ground research gives us a firm foundation to generate excess returns, as well as helping us manage risk, which will take on even more importance as a result of the onset of the Two-Speed World.”

Mike Nikou, Managing Director Northern & Southern Europe

Even if investors are not immediately concerned about such an event, they should at least realise the opportunity cost to their portfolio by having only a small allocation in emerging markets. Most developed countries are in the economic slow lane and this will be reflected in returns over the longer term.

Firstly we would advocate: increase weighting to Asian and emerging market equities and be more selective with developed market equities

Our first and primary option for investors to consider is increasing their asset allocation to Asian and emerging markets equities. There are arguments to say using GDP growth rates, for example, is a better guide to assist with portfolio weighting rather than using backward-looking market-cap weighted indices for guidance. Whichever method investors decide to use, these increases should be decisive and considerable, rather than in small increments. We do not believe it is outrageous to consider doubling or tripling your allocation in these areas.

Market capitalization weighted benchmarks reflect the past



Source: MSCI data as of September 2011. Asia includes here only countries that are also reflected in the MSCI AC World Index. IMF, September 2011 (WEO Database).

Our suggestion for a higher and earlier allocation to Asia and the emerging markets is made regardless of whether the investor is risk-averse or adventurous. The old equations of developed = “safe” and emerging = “risky” no longer apply in the Two-Speed World. Obviously, a less risk-averse investor could move more quickly and more decisively into Asia and the emerging markets than an investor who is risk-averse. But even a risk-averse investor should move in increments to these fast-growing regions.

We also believe that, at the same time, investors should contemplate being more selective in their equity investments in the developed world. It will be increasingly vital here to choose the companies with sound business models, strong balance sheets and good cash flows, which are benefiting from exposure to fast-lane, emerging market growth. More frequently than

not such companies offer attractive levels of income, and these factors will enable them to survive and thrive in a more challenging economic environment. Effective stock-picking will play a key role here as the divide between winners and losers will become greater.

“The economic challenges the world is facing will slow global growth for some time, but large emerging economies with strong demographic pressures to increase domestic consumption will persevere relatively better than other economies. As the business environment becomes more challenging, even in countries somewhat insulated from the world debt crisis like China, India and Brazil, quality management will become increasingly important. It will no longer be enough simply to be inside a growing country. We will see greater distinctions between well-run businesses and those that were simply riding the growth wave. Investment opportunities will be there, but it will require experienced judgment to determine which companies will be long-term winners and which will fade as the environment gets tougher.”

Chris McNickle, Global Head of Institutional

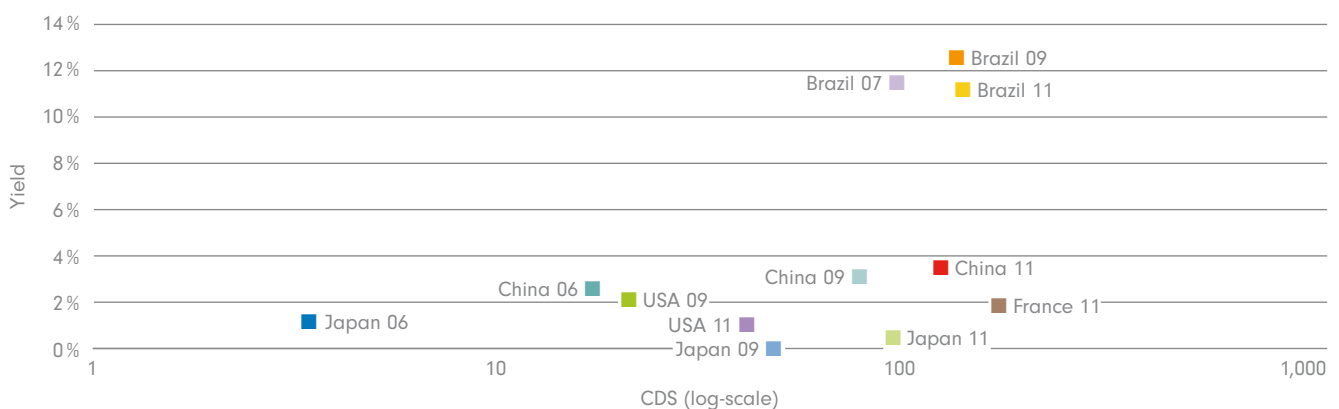
Secondly we would advocate: increase weighting to emerging market debt

The balance of risk has changed in recent times to the extent that most investors would currently consider a default in a developed country more of a risk than in an emerging one. This is very much reflected in the fact that the CDS of many developed countries are now higher than their emerging market counterparts. For example, in the chart below we can see that France's CDS is actually higher than China's, while its yield is lower. Indeed, emerging market debt is broadly offering a more attractive real yield than is available in developed markets that, in some cases, is actually yielding a negative real return. One option, therefore, is an increase to emerging market debt at the expense of developed market debt as the risk/return profile is so much more attractive.

“Ten or fifteen years ago, emerging economies were highly indebted, the way Europe, the US and Japan are today. For the most part, emerging economies have grown out of these problems. There remains growth potential in the emerging markets and I think there is no shortage of opportunities.”

John Carlson, Portfolio Manager, Fidelity Funds - Emerging Market Debt Fund

CDS versus yields of various countries



Source: Bloomberg, October 2011 (5-year); not all data points are available for the USA and France.

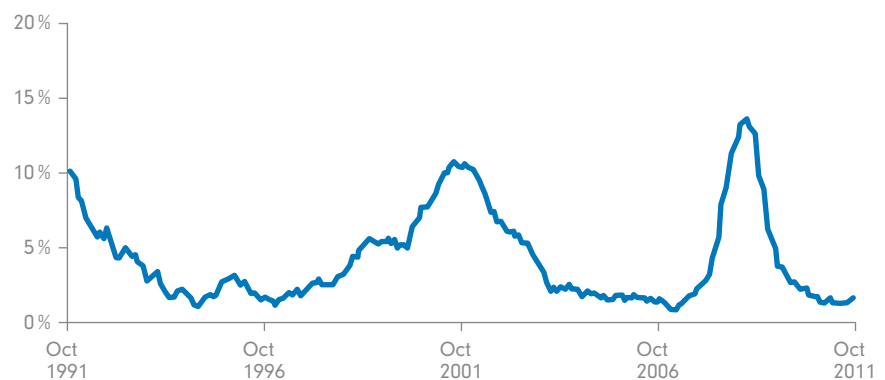
Thirdly we would advocate: increase weighting in developed market corporate debt

Many developed market companies have healthy balance sheets and sound business models, which offer good and predictable income streams. As we have seen from the example of Japan, some companies are able to thrive and build their businesses even against the backdrop of a challenging economic environment. There are many global leading companies in the developed world benefiting from exposure to emerging-market growth, as well as benefiting from technological advantages and strong balance sheets. Moreover, in terms of risk, many developed companies appear to be broadly better placed than their developed government counterparts. Company defaults are currently running at relatively modest levels due to their stronger balance sheets and most forecasts do not predict default levels to reach anywhere near the highs they did in the aftermath of 2007 – 2009. This makes developed market corporate debt much more attractive than developed market government debt both in terms of risk and return. It should also be highlighted here the attractiveness of high yield offerings in some developed markets.

“We are now in a reflationary phase of the economic cycle in developed economies that has, in fact, traditionally been associated with strong bond performance. Economic growth is slowing and inflation is coming down, quite markedly in certain areas. The challenge for investors is to understand that bonds can be a good place to be if your bond manager is exposed to the right risks. A strategic approach is obviously paramount, particularly with regard to sovereign bonds. However, strong cases can be made for high-quality corporate bonds. And while they entail more risk, a good case can also be made for high yield corporate bonds on the grounds that yields have risen to distressed levels that are not borne out by relatively robust corporate fundamentals. In short, many companies are in a better position than their governments now. We are seeing a reassessment of risk in bond markets and, with the exception of financials, corporate bonds can offer an attractive risk/reward payoff.”

Andrew Wells, Global CIO, Fixed Income

Global speculative-grade default rates



Source: Bloomberg, October 2011.

Active management

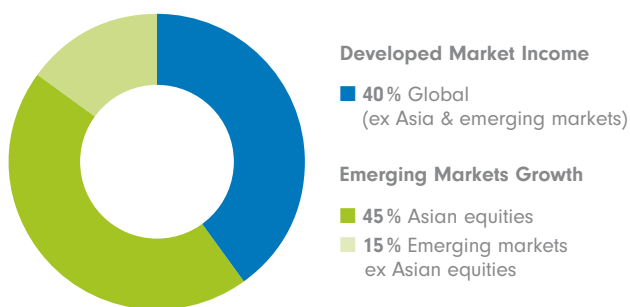
The case for active management in a Two-Speed World is clear. There will be different risks for investors to contend with, and active management is vital for them to avoid the pitfalls. The old model of creditworthiness being positively correlated to the size of the debtor will no longer be a good guide for investors. In addition, picking the global leaders of tomorrow requires in-depth research to find out if a company has the right business model to succeed in this new environment. Active management is often the best way to guide investors under these conditions, increasing their understanding of this new risk environment, as well as illuminating which companies might successfully adapt to a Two-Speed World.

There is no denying that we live in a Two-Speed World where the faster growing economies of the developing countries and their increasing prosperity are driving a major shift in wealth creation and consumption. At the same time, individuals in developed markets are now having to take much greater responsibility for planning their long-term finances, without being able to rely on the safety net of generous state retirement benefits. In today's volatile markets, it is more important than ever to choose an investment manager with the infrastructure and resources on the ground in these growth markets of the future in order to tap into the potential investment returns from the faster track in the Two-Speed World.

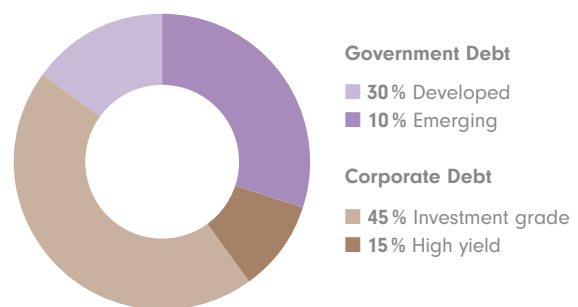
Thomas Balk, President Financial Services

So what are the options open to investors? Below are some merely indicative potential allocation strategies for investors to ponder in terms of just how radically they might alter their portfolios.

Potential equity allocation



Potential fixed income allocation



Conclusion

The Two-Speed World is here to stay, and with it we are seeing huge shifts in the investment landscape. Despite these ongoing changes, there has, so far, been little adjustment in terms of asset allocation and appreciation of risk.

The origins of the Two-Speed World lie in decisions made by policymakers and business leaders in the developed world from the 1980's onwards. These include the running of large budget deficits as well as allowing public debts to balloon (which are two of the so-called 3D's). The "off shoring" of many jobs to emerging markets, as well as setting interest rates too low and trying to recycle the Asia savings glut, only worsened this situation. Combined with a weak demographic profile (the third D), which necessitates quick and firm action on the part of developed market governments, we have now reached an inflection point.

By contrast, emerging economies are continuing to move in the fast lane of the Two-Speed World. This is partly due to the support of the 3C's (credit, commodities and consumption) and a lack of the 3D's. Many countries in the developed world face the prospect of the path of consolidation – either through choice or necessity – and this will happen sooner than many imagine, while the emerging world will become less reliant on the developed world and will increasingly develop the consumption side of its economies.

Despite the divergent outlook for developed and emerging economies, investors have only made incremental changes to their portfolios. Due to the faster growth rates on offer, investors should consider doubling or tripling their allocation in Asia and the emerging markets (both equity and debt), and should do so early, to make the most of a trend that is going to continue for a long time. Many developed market companies still offer strong earnings, as well as good exposure to emerging market growth and solid dividends, but picking the winners here will be key and we believe that investors should contemplate being more selective in their approach here. Another option is for investors to think more in terms of corporate bonds rather than government bonds in developed economies due to their healthier balance sheets. Active management will help in identifying risks and opportunities in this new climate.

The Two-Speed World means that many previously-held assumptions about risk and asset allocation need to be questioned thoroughly and acted upon. Investors who do not adapt to this new environment risk being left behind.

Appendix

Chapter 1

Introduction

1. The divide between developed and emerging world countries used within this White Paper is derived from the World Economic Outlook (IMF). Please refer to the introduction to the WEO's Statistical Appendix. For further details, see www.imf.org/external/pubs/ft/weo. This classification is not based on strict criteria, economic or otherwise, but instead has evolved over time with the objective of facilitating analysis by providing a reasonably meaningful organisation of the data. Data limitations sometimes mean that certain very small and less economically developed countries are not included and remain outside country classification.
2. See various articles by Anthony Bolton on this theme, including "Hold your ground in a Two-Speed World". August 2011, for the Financial Times.

We've been here before,
so why are we here again?

1. See historians Niall Ferguson (The Ascent of Money, Empire: How Britain made the Modern World) and David Hackett Fischer (Price Revolutions) for further detailed and insightful discussion on these subjects.

So where are we today?

1. See journalist Martin Wolf's recent articles in The Financial Times for further discussion.
2. Is China a Threat to the U.S. Economy? January 2007 Congressional Research Service for further information.

Emerging markets
open up Introduction

1. See "Federal Reserve Policy and the Housing Bubble" by Lawrence H. White for further discussion on Greenspan's policy.

The West trails behind

1. See journalist Martin Wolf articles for the Financial Times for further discussion here.
2. See IMF statistics for further detail.

2007 and beyond

1. Fidelity 2011 Research Analyst Survey. Fidelity operates one of the largest investment management research teams in the world, which produces an annual survey sharing their views. This survey highlighted how emerging markets are increasingly viewed as end markets in their own right.

Chapter 2

Debt

1. See www.usdebtclock.org for real time update on US debt.
2. See special supplement in The Economist on debt and deficits 24th - 30th September 2011 for further discussion on this topic.

Demographics

1. See historian Niall Ferguson for discussion on this matter.
2. See UN Population Division statistics for further information on this topic.
3. See Richard Hokenson "The Race to Zero" in the CFA Magazine March - April 2010 for further discussion on demographics.

Chapter 4

Asset allocation

1. See "Is There a Link Between GDP Growth and Equity Returns". May 2010, MSCI Barra Research Bulletin.

This is not meant to be a comprehensive appendix of all documents used but rather refers to key documents cited or used in the text.

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