

Consumer sectors set to drive returns from China

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Raymond joined Fidelity International (Hong Kong) Ltd. in 2006 as an Investment Analyst and has covered China Telecoms, Financials and Consumer stocks.

Raymond was made the Consumer Sector Leader in 2009. He was promoted to Director of Research in 2010 and then Portfolio Manager in 2011.

Raymond has over 10 years of experience in researching companies in the China market. His extensive research experience in the consumer universe gives him an edge in understanding regulations, industry trends and competition within the region.

Raymond graduated from Fudan University, Shanghai, with a Bachelor of Law. He also holds a Master of Law degree from the same university.

Raymond Ma, portfolio manager of Fidelity Funds China Consumer Fund, expects that China's inflation is likely to peak in the second half of this year and a 'hard landing' scenario is unlikely to eventuate. Robust growth in household income should offset the negative impact of monetary tightening and continue to support resilient consumption in China. Raymond views China's 12th Five Year Plan as an important driver of the shift towards a consumption-orientated economy which contributes to a favourable outlook for China's consumer-related sectors. In this piece, Raymond outlines his expectations for the Fund and why he believes the valuation premium present in many China consumer-related stocks is justified.

WHAT FACTORS HAVE CONTRIBUTED TO THE FUND'S RECENT OUTPERFORMANCE?

The Fund has delivered solid returns since its inception on 23 February 2011, outperforming the MSCI China Index over the period. In addition to favourable exposure to the strongly-performing consumer-related sectors, prudent stock selection as well as exposure to a large number of off-benchmark hidden gems such as Trinity Ltd, Shangri-La Asia Ltd and Lifestyle International Holdings Ltd added significant value.

The significant exposure to the consumer staples sector played a significant role in the fund's favourable relative performance. Notably, an off-benchmark holding in President Chain Store, the operator of 7-Eleven convenience stores in Taiwan, contributed to the Fund's performance after investors responded favourably to the firm's expansion plan in China.

Holdings in a number of insurance firms such as an off-benchmark position in AIA Group, as well as the overweight positions in Chinese insurers - Ping An and China Life Insurance, also drove performance. My favourable view of these companies reflects the belief that there is currently an under-penetration of financial products in China. The underweight position in the telecommunications sector and the selection of stocks in the information technology sectors also boosted gains.

Besides those in China, the Fund also holds a number of companies listed in Hong Kong and Taiwan. In particular, the Fund holds companies which are expected to benefit from the influx of mainland Chinese shoppers and their preference for high-end luxury products, particularly those available from Hong Kong. Companies with exposure to Taiwan's travel and tourism sector are also favoured, based on my expectations for an influx of Chinese tourists.

WHAT IS YOUR VIEW ON THE HIGH INFLATION IN CHINA? WILL IT HAMPER CHINA'S CONSUMPTION GROWTH AND THE PERFORMANCE OF CONSUMER-RELATED STOCKS?

Undoubtedly, inflation has become an issue in China. Chinese authorities view combating inflation as their top priority, above promoting output growth and employment.

Indeed, China's inflation growth (in particular, price rises at the producer level) has been gradually slowing down over the past few months as the monetary tightening filters through. While China's inflation may re-accelerate over the next two months as a result of the lower base effect and the catch-up of non-food inflation, I expect China's inflation to peak out in the second half of this year as monetary policy normalisation continues and the growth in money supply decelerates. In addition, food prices are likely to decline further as the supply of food tends to increase during the summer.

I believe that strong growth in household income should offset the negative impact of the monetary tightening and continue to support resilient consumption in China. Consumer-related sectors should enjoy a re-rating in the coming quarters as inflation eases and margin pressures abate.

GIVEN THE AGGRESSIVE MONETARY TIGHTENING POLICY TO COMBAT INFLATION, HOW BIG IS THE RISK OF A HARD LANDING IN CHINA?

Despite the aggressive monetary tightening, I do not see any risk of a hard landing at the current juncture due to the following reasons:

- Economic data releases through to April 2011 shows that China's economic growth momentum remained healthy. Fixed asset investment (FAI) in particular, continued to positively surprise on the back of sizeable investments in social housing projects. Retail sales growth, excluding weak auto and housing-related goods, has remained resilient. Meanwhile, above-trend export growth and the return to a trade surplus suggest external demand will remain robust.
- The combined effect of a reshuffle in local government leadership and commencement of the new Five Year Plan in 2011 creates a strong base for expanding FAI. History tells us that changes in local government leadership often result in new expenditure in areas like housing and infrastructure. This also explains why we have seen strong FAI growth against a backdrop of macro policy tightening actions.
- Although continued hikes in reserve requirement ratios and benchmark interest rates have weighed on market sentiment to some extent, policy makers appear to be intent on striking a balance between controlling inflation pressures and promoting growth. One indication of this is in credit growth which has continued to expand, especially in March and April when new loan creation continued at a higher than expected rate.

WHAT ARE THE ECONOMIC IMPLICATIONS OF CHINA'S AGEING POPULATION? WILL THIS IMPAIR THE CHINESE CONSUMER'S SPENDING POWER?

I am not too concerned about the risks associated with China's ageing population, as I believe this dynamic will create new consumption patterns. For instance, the demand for health care and insurance products is expected to rise as the population gets older.

In addition, strong income growth is driving the creation of an affluent middle class population, which in turn is leading a shift in Chinese consumption patterns. The spending patterns of the new middle-aged generation show a decline in the share of income devoted to living essentials and an increase in spending on discretionary items, particularly in high-end branded goods. Taking Japan's experience as an example, we can expect to see a surge in demand for premium-branded goods as the population gets older. As disposable income grows and people become increasingly aware of quality, under-penetrated sectors like luxury goods, brand names and tourism are likely to benefit over the coming decade, in line with rising living standards.

WHY DO YOU THINK NOW IS A MUCH BETTER TIME TO INVEST IN CHINA'S CONSUMER-RELATED SECTORS THAN 10 YEARS AGO?

Both the breadth and depth of the investment universe of Chinese consumer-related sectors have significantly improved over the past decade. Firstly, over 100 consumer-related initial public offerings (IPOs) are made available every year nowadays, compared with less than 10 on average each year in pre-development years. Secondly, the majority of the Chinese consumer names had a market capitalisation of less than US\$500 million 10 years ago. These days, they range from around US\$2-3 billion. The significant expansion of China's consumer-related sector has increased the opportunities to participate in this generational dynamic.

More importantly, with the start of the 12th Five-Year Plan this year, China's previous emphasis on exports and investment will be shifted towards consumption and from urban and coastal growth towards rural and inland development. As more pro-consumption policies are introduced in the coming years, the consumption intensity of the economy (represented by the consumption/gross domestic product ratio) should rise significantly over the coming years.

This implies a substantial change in the outlook for China's consumer-related sectors. As a proxy of China's economic model, I expect the representation or the weighting of consumer-related sectors in the MSCI China Index to grow materially. Over the next five years, China's consumer-related sectors are likely to outperform the broader market and the sector's market capitalisation is likely to double or triple. Furthermore, as a result of the positive spill-over effect, consumer-related sectors in Hong Kong and Taiwan should also benefit.

CHINA'S CONSUMER-RELATED SECTORS HAVE BEEN TRADING AT HIGHER MULTIPLES THAN THEIR ASIAN COUNTERPARTS AND THE BROAD CHINESE MARKET. DO YOU THINK THAT THEIR VALUATIONS ARE TOO EXPENSIVE?

Most of the consumer discretionary companies are accelerating their 2011-12 expansion plans, which may lead to margin pressure despite robust top-line growth. Some companies are investing into brand-building (i.e. higher advertising and promotion costs), which results in higher selling, general and administrative expenses. These there are investments for the future and I expect margins to recover and earnings growth to accelerate when expansion slows down in 2012-13. In the case of consumer staple names, margins have been lowered this year by higher input costs. The sector's earnings profile will recover once inflation pressures ease later this year or into 2012.

Regarding valuations, China's consumer sectors are now trading at mid-cycle levels. However, consumer stocks provide investors with more sustainable and visible growth versus cyclical sectors, which warrant their valuation premium. Consumer stocks may seem expensive on a relative basis when cyclical sector (e.g. cement manufacturers) earning growth is accelerating. However, consumer stocks are less sensitive to policy risks than cyclical sectors.

I am comfortable with current valuations of China's consumer stocks, in light of their favourable long-term growth prospects. In particular, China's private consumption demand remains resilient on the back of 1) robust income growth; 2) demographics – a plateau in the working-age population provides more bargaining power to labour; and 3) policy actions, evidenced by the government's deliberate attempt to support private consumption.



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