

China in inflationary environment

Martha Wang is the portfolio manager of Fidelity Funds China Focus Fund.

Martha joined Fidelity in mid-2005 and took over management of FF China Focus Fund in May 2006. Martha has nearly 18 years experience researching Chinese companies, having worked with Indosuez WI Carr Securities, First State Investments and HSBC Asset Management.

In this investment perspective, Martha Wang, the portfolio manager of FF China Focus Fund, discusses changes she has made to her portfolio in view of the government's tightening measures and the latest Five-Year Plan. She also talks about social housing, local government debt vehicles and what all of this means for China's future.

WHAT IS YOUR VIEW ON INFLATION IN CHINA?

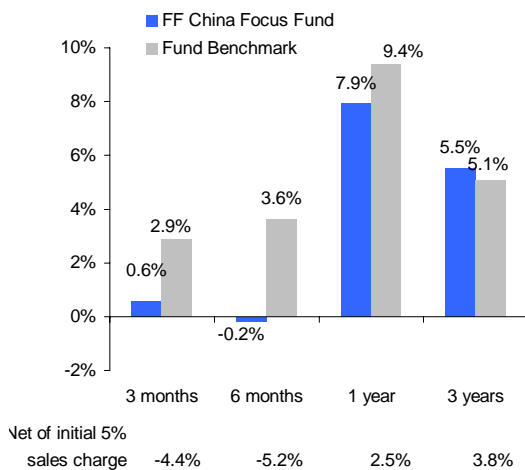
The previous round of inflation expectation was triggered by the system's failure to absorb the vast liquidity from the fiscal stimulus policies implemented since 2009. Previously, inflation was expected to have peaked in Q3 2010, but the QE2 in the US re-ignited inflation concerns.

While heightened inflationary expectations could result in further interest rate and reserve requirement hikes in the short term to help absorb liquidity, I do not expect inflation to be uncontrollable in the short to medium term. For instance, the seasonal factors that affected food prices before Chinese New Year are less likely to have an impact going forward. Indeed, the recent weekly food price data already shows a month-on-month decline in food prices. Unless weather conditions worsen, food inflation should start to peak in the second half of 2011.

However, even after the normalisation of inflation in the second half of 2011 we are likely to see higher base rate of inflation going forward than in the past due to positive structural changes in China coming from domestic factors such as rise in wages, stronger demand for food (and higher quality of food) due to increase in disposable income levels, and rising rents because of higher property prices.

RETURNS (%)

as at 31.03.11



NAV-NAV, gross income reinvested in USD. Returns greater than 1 year are annualised.
Benchmark: MSCI China Index Capped 10%

Please note past performance is not indicative of future performance.

DOES THE FACT THAT INFLATION IS MAINLY DRIVEN BY RISING FOOD AND ENERGY PRICES HAVE AN IMPACT ON STOCK SELECTION IN THESE SECTORS?

Relative to some of the major economies globally, food (25%) and energy (7%) count for a big portion of inflation in China, and it does have an impact on security selection within these sectors.

	Energy Weights as % of total Core CPI	Food Weights as % of total Core CPI
Germany	12.3	Egypt 44.2
Ireland	10.5	China 25.2
Greece	9.2	Malaysia 23.9
S.Korea	9.1	Japan 20.3
UK	8.8	Taiwan 17.2
US	8.6	Greece 16.7
France	8.2	France 16
Philippines	7.4	S.Korea 14
Japan	7.4	Ireland 13
China	7	Germany 12.1
Taiwan	6.9	Australia 10.9
Australia	6.9	UK 10.8
India	6.4	Hong Kong 10.1
Hong Kong	4.3	US 8.9
		Philippines* 46.6
		India* 46.2
		Indonesia* 32.7

For Food table: All do not include restaurant meals. *Include restaurant meals

FOOD

As previously mentioned, I believe the current food price inflation is temporary. Therefore, the current high valuation levels and margin risk rising from agricultural/raw materials pricing mean that the food segment is at high risk at the moment. Instead, I try to stay away from temporary themes and focus on secular stories where a firm enjoys pricing power or has strong growth potential. These bottom-up stock selection adjustments have resulted in my current small overweight exposure to food & beverages segment.

One of the prime examples is China Mengniu Dairy. The current supply demand dynamic in the milk industry is supportive for the company to reduce its cost of purchase going forward. Raw milk cycle in China is different from other major soft commodities due to the melamine incident back in 2009 which means that huge portion of milk producing cattle were destroyed resulting in shortages in milk and high milk prices. However, the supply and demand situation is coming to an inflection point with the milk producing cattle maturing with the typical calf maturity cycle of 1.5 years.

I also continue to like names such as Yantai Changyu Wine which is benefiting from changing consumer tastes and Wuliangye Yinbin, a Chinese liquor (baijiu) producer and distributor that enjoys strong pricing power.

ENERGY

While developed market oil & gas companies benefited from both the rise in prices due to the recent crisis in the Middle East and North Africa (MENA) and rising inflation, Emerging Asia oil and gas companies have not. This is mainly due to price inelasticity of products and services as firms are forced to absorb higher costs and due to the energy intensive nature of growth in countries such as China. For example, a Chinese bus company may not be able to increase bus fares to match the rise in the oil prices. Indeed, many HK/China investors fear the potentially adverse impact that inflation, particularly high oil prices, may have on consumption growth. There is also a concern that high fuel prices will hurt key parts of the Chinese economy such as farming and public transport, further pushing overall CPI higher.

Against this backdrop, I increased my underweight in the energy sector mainly by reducing my coal exposure, due to the increasing likelihood of government intervention in the form of coal price controls. Meanwhile, I maintain a reasonable level of exposure to names such as CNOOC which benefit from increase in price of oil. CNOOC has production facilities both within China and abroad and, with the highest weight in the MSCI China energy sector, represents and determines China's energy sector performance. I do not own oil refiners and producers such as Sinopec, as they import crude at market prices and sell refined fuel at domestically controlled lower prices, with majority of the loss absorbed by the refiner. According to estimates, the company loses around US\$6 per barrel they refine.

HOW IS YOUR PORTFOLIO POSITIONED TO REAP BENEFITS OF CHINA'S 12th Five-Year-Plan?

My portfolio has evolved with the changing pattern in China's economic growth. As my career has spanned over the development of China asset class, I have followed the growth of sectors and companies for a long time. My portfolio reflects the fundamental changes happening in China and is in-line with the long-term objectives of China's 12th Five Year Plan (12th FYP).

The plan focuses on quality of growth instead of quantity, namely the transformation of economic structure towards domestic consumption, development of new strategic industries, social harmony and continued urbanisation/investment growth in the inner land regions.

CONSUMPTION

Consumption continues to be a big part of the 12th FYP. In particular, the focus this time is on boosting the consumption power of the less rich. The government's efforts to narrow the income gap and promote social harmony offer a number of important opportunities in China. For instance, the current tax reform proposed as part of 12th FYP reduces the income tax brackets from nine to five categories, boosting the disposable income for the lower and middle income brackets. Names such as Daphne (lower-middle end shoe company offering cheaper shoes than Belle International) and Little Sheep (a hot pot restaurant chain) are prime examples of companies that should reap the benefit of increased spending power of these income groups.

GO INLAND/URBANISATION (SECOND AND THIRD TIER CITIES)

The central government is reported to have approved plans for a new economic zone in the southwest to boost the economy of the inner western areas and promote balanced regional development. In light of this, I am positive on selected cement companies most likely to benefit from inner-land urbanisation. I have a number of high conviction positions such as China Resources Cement which I like for the strategic positioning of its plants in Southern China. The broad cement industry outlook for existing players is bright due to limited supply (in large part due to government intervention restricting growth of new capacity and eliminating obsolete capacity), strong demand from both property and infrastructure sectors and high regulatory barriers for new market entrants. The cement industry, which used to be very fragmented, has consolidated in recent years. Existing players enjoy price stability and pricing power even during sluggish market conditions, due to their dominant market positions and limited competition.

CREATION OF STRATEGIC INDUSTRIES

The 12th FYP focuses on seven strategic industries which the government wishes to champion for the next phase of development in China. These are new-generation information technology, energy-saving and environment protection, new energy, biotechnology, high-end equipment manufacturing, new materials and new-energy cars. Currently, I am very interested in observing the evolution of the business model of investible energy plays such as Wind power, which has gained even more prominence due to the nuclear disaster in Japan following the recent earthquake.

Within industrials, most of the changes I made to the portfolio reflect the likely increase in construction due to social housing projects as well as creation of new industries. I marginally reduced the overweight in industrials but added to building products, construction & engineering, rail & road and machinery names. I funded these purchases by trimming the stake in holdings which suffer from margin compression due to rising oil prices, such as airlines and shipping companies (Pacific Basin Shipping). I added plastic and metal pipes producer China Liansu Group and substantially increased the exposure to construction tools and machinery leasing and distribution firm Changsha Zoomlion Heavy Industry. I also increased exposure to Guangshen Railway which operates both passenger and cargo transportation routes across Guangdong Province.

SECTOR ALLOCATION (%)

as at 28.02.2011	Fund	Relative
Information Technology	12.8	6.4
Financials	32.4	37.0
Real Estate	0.9	5.3
Banks	16.0	23.2
Diversified Financials	5.5	0.3
Insurance	10.1	8.2
Consumer Staples	6.4	4.7
Materials	6.9	6.1
Industrials	5.2	8.0
Utilities	1.2	1.8
Health Care	1.5	0.8
Telecom Services	6.1	11.4
Consumer Discretionary	12.9	5.4
Energy	12.1	18.4

Source: Fidelity

Benchmark: MSCI China Index Capped 10%

HAS THERE BEEN A CHANGE IN YOUR VIEW ON THE CHINESE BANKING SECTOR?

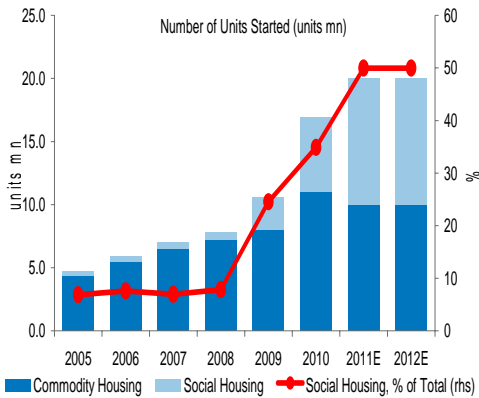
I remain cautious on Chinese banks due to margin compression from increasing reserve requirements, and continue to be underweight due to broad sector headwinds. However, I believe the concern may have been overdone and some of the banks are now trading at extremely attractive valuations. I have used this as an opportunity to add to large commercial banks such as Industrial Commercial Bank of China (ICBC) which has a large depositor base and pays lower rates on deposits compared to smaller peers.

I have also added selected insurance names to take advantage of the rising interest rate cycle. Ping An Insurance remains one of my favorites in the insurance space. China insurance sector is insulated from external factors such as Japanese earthquake. The support for the stock is three fold: its strength in terms of the distribution network, its expansion into banking segment which reduces Bancassurance related risks* other insurers face, and the firm's product portfolio is protective as it allows it to decrease the loss with high guaranteed rate products and retain more incremental returns in the company. These three Ping An specific factors allow the company to grow at a faster pace than the overall life insurance industry which is expected to grow at around 10-22% per annum (assuming 7% GDP growth).

**Bancassurance is the partnership arrangement between a bank and an insurance company where a bank distributes insurance company's products. In China, due to the current banking regulation, banks can only distribute maximum of three insurance companies' products. Bancassurance contribute to more than half of many insurers' topline.

References to specific securities are for illustrative purposes and are subject to change without notice. They should not be construed as a recommendation or an advice to transact in them.

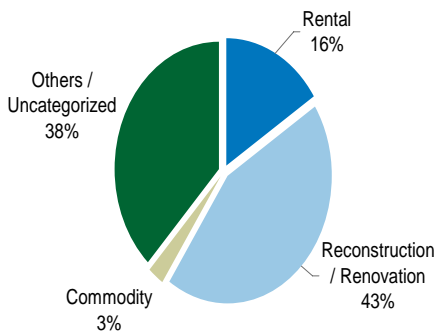
A TWO-TIER PROPERTY MARKET EMERGING



Source: MoHURD, CEIC

CONSTRUCTION TO BE MOSTLY IN THE CENTRAL REGION

Social Housing Mix - Central Region (% of total number of units)



Source: MoHURD, Xinhua

WHAT DOES THE SOCIAL HOUSING PROJECT MEAN FOR CHINA AND ITS PROPERTY SECTOR?

The government's social housing project plans are one of the major parts of the 12th FYP and a very important measure by the government to address the issue of social harmony. It is also one of the most important forces aiding structural rebalancing of the Chinese economy as it will provide sustainable urbanisation, underpin investment in the short run and increase property-related consumption (such as purchase of white goods) as more people move into newly constructed social housing over the next one to two years. It also boosts consumption over medium to long-term as people who could not afford to buy a property, due to rapidly rising commodity property prices, are able to get on the property ladder. This would reduce precautionary savings in the lower income groups and boost consumption. The social housing program will also serve to transfer wealth from public to private sector and to the new owners of social houses.

Moreover, social housing promotes sustainable urbanisation by stabilizing migrant workers in the cities. The lack of residential status and suitable housing have caused frequent job and location changes of many migrant working population which hindered sustainable urbanisation and labour supply in major cities which rely heavily on the contribution of migrant workers. By providing affordable housing at reasonable rents in convenient locations, the social housing program not only improves living conditions and quality of life for migrant workers but also helps them integrate better into the cities, preventing social unrest.

With regard to the commodity property developers, the initial concern was that the large social housing project might over-crowd the market and dry up sales for the commodity property developers since majority of the public rental to be built should be concentrated in large cities in the coastal region, which host the largest migrant population.

However, the details of the social housing projects reveal that the risk of crowding out is low because properties being built are aimed at different segments of the market catering to different end users. Around 43% of the social housing to be built in the central region is expected to be in the form of slum-area reconstruction. The idea is to offer affordable housing to those who could not afford commodity housing.

The current allocation for 2011 social housing is 10 million units. The allocation is explained as below.

- 1.6 million units allocated to low-rent housing - Owned by the government and rented to low-income households. Built on land provided by the local government free of charge and the rental is lower than market rental.
- 2.2 million units for public rental - Targets migrant workers and not necessarily low-income households. Rental is higher than low-rent housing but lower than market rental. This is the kind of social housing the government would like to build more going forward as it would help facilitate sustainable urbanisation.
- 4 million units for slum-area reconstruction – Relocation/resettlement housing.
- 2.2 million units for economic housing - Part of commodity housing market and can be bought/sold in the market and buyers can get a mortgage from banks to finance the purchase. New owners have to fulfil specific eligibility criteria for application. Prices are in general one-third of the market prices of comparable commodity housing.

Therefore, the government's aim is to expand the capacity at the lower end while reducing the supply at the top end. Initially, the sales volume for commodity housing will be negatively impacted due to current purchase restrictions in 35 major cities that prevent residents from buying more than two properties.

However, numbers are expected to recover given the unabating demand for property, both for investment and self-use purposes. Despite tightening measures since last year, property prices in China have been resilient because of ample liquidity and high future value expectations. This is due to limited investment opportunities, which makes property one of the best investment options available.

References to specific securities are for illustrative purposes and are subject to change without notice. They should not be construed as a recommendation or an advice to transact in them.

Until recently due to the size of the ambitious project, land supply and financing was a concern, especially for local governments. However, the recent innovation in financing through REITs and insurance companies viewing social housing as income yielding projects, as well as the traditional bank loans and subsidies from central and local governments should be able to see the plan through. Most importantly, the government's recognition of the paramount importance of the social housing to re-balance the economy from investment-led to consumption-driven economy and the central government's unprecedented political commitment to deliver on the project should ensure that the objective of the government is achieved.

Martha Wang comments that, "In the short term, the implementation of social housing could place added pressure to the property market, or at least cannibalize some of the demand given the size of the supply. However, 10m social housing units equate to 60-70% of annual housing demand (assuming 60-70 sqm per unit vs 1bn sqm commodity housing sold in 2010), meaning that the current commodity housing was inadequately meeting the demand of the lower parts of the society. With the social housing development, a two-tier market (social housing + commodity housing) is likely to eventually develop over time, alleviating pressure over commodity housing."

CAN YOU COMMENT ON THE LOCAL GOVERNMENT DEBT PROBLEM?

Local government debt in China did have the potential to become a major problem had the central government not stepped in 2010 to curtail it.

The government's stimulus package to revive the economy post the global credit crisis had resulted in 2008/09 construction boom as the central government approved many unfeasible projects. This resulted in some unproductive and vacant infrastructures such as empty shopping malls being built in the middle of nowhere.

Recognising the issue, the central government tightened its control to ensure revenue generation for the projects commissioned. This enhanced control is already showing results with the non-performing loan ratio of major commercial banks already falling by the end of 2010 to 1.15% (364.6bn RMB or US\$ 55.5bn). According to a recent report published by Credit Suisse, of the outstanding Local Government Financing Vehicles (LGFV) of RMB 9.1 tn at the end of 2010, RMB 1.8 tn or 3.7% of total loans were high risk. The LGVF problem now appears manageable given China's current growth and inflation outlook (i.e. higher tax revenue generated from inflation in wages and growth therefore enabling the government to service its debts when there is uncertainty over the free cash flow generation ability of the infrastructure in which the debt has financed), coupled with the enhanced risk control at the central government level.

However, the government also recognises that more capital and provisioning are needed by banks such as China Construction Bank (CCB) to be prepared for potential growth in loan defaults by local governments.

The People's Bank of China and the central government have been proactive in preparing the system with more adequate levels of provisioning by raising the RRR for the banks.



This document is prepared by Fidelity International. All views expressed cannot be construed as an offer or recommendation. FIL Investment Management (Singapore) Limited ["FIMSL"] (Co. Reg. No.: 199006300E) is a responsible entity for the fund(s) offered in Singapore. Prospectus for the fund(s) is available from FIMSL or its distributors upon request. Potential investors should read the prospectus before deciding whether to invest in the fund(s). Reference to specific securities or fund(s) is included for illustration only, and should not be construed as a recommendation to buy or sell the same. This document is for information only and does not have regard to the specific investment objectives, financial situation and particular needs of any specific person who may receive it. Potential investors should seek advice from a financial adviser before deciding to invest in the fund(s). If that potential investor chooses not to seek advice from a financial adviser, he should consider whether the fund(s) in question is suitable for him. Past performance of the manager and the fund(s), and any forecasts on the economy, stock or bond market, or economic trends of the markets that are targeted by the fund(s), are not indicative of the future performance. Prices can go up and down. The value of the shares of the fund(s) and the income accruing to the shares, if any, may fall or rise. Investors investing in fund(s) denominated in a non-local currency should be aware of the risk of exchange rate fluctuation that may cause a loss of principal when foreign currency is converted back to the investors' home currency. Exchange controls may be applicable from time to time to certain foreign currencies. Fidelity/ Fidelity International means FIL Limited which is established in Bermuda, and its subsidiary companies. Fidelity, Fidelity International, and the Pyramid Logo are trademarks of FIL Limited. SG11/177