

In Perspective

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October 2011

Investing in a two-speed world

AT A GLANCE

- The balance of economic power in the world is shifting as emerging markets grow strongly, particularly in Asia.
- The effects of this secular shift are being accelerated by the ongoing impact of the financial crisis.
- Huge debt burdens in western economies are constraining their economic growth potential.
- Emerging/Asian markets are in better shape; while they may be buffeted by periods of risk aversion in the west, they increasingly have their own domestic and regional drivers of growth and few debt-related issues.
- China could be the biggest economy in the world as early as 2027.
- Emerging market consumption will be a key driver of future global growth.
- We are now in a two-speed world: The GDP growth differential between developed and emerging markets is already significant and investors must recognise this continuing shift in their asset allocation weightings.

Shifts in the balance of power and macroeconomic headwinds are creating a two-speed world in economic growth terms. The developed world is likely to see slower growth rates due to the austerity measures required to reduce the high debt burdens created by the financial crisis. Meanwhile, the outlook for growth in emerging markets, while revised down, remains far in advance of the developed world and the gap has been exacerbated by the ongoing effects of the financial crisis. Investors must take stock of these shifts and consider whether they have adequate exposure to the fastest-growing parts of the world.

WELCOME TO THE TWO-SPEED WORLD

The investment universe is becoming increasingly polarised between low-growth, mostly developed world economies and higher-growth, mostly emerging economies. This is due to:

- an ongoing structural shift in the global balance of economic power as industrialising emerging markets account for an ever-larger proportion of global growth.
- macroeconomic and financial stress exacerbating the existing growth differential due to the larger incidence of the financial crisis on developed versus emerging economies.

The combination of these factors is creating the conditions for a distinctly two-speed world. Bloated debts, historic fiscal deficits and ineffective politics in western economies have led to a more challenging growth outlook for developed economies and increased the attractions of emerging markets at a time when they can be bought at favourable valuations due to the indiscriminate nature of recent market sell-offs.

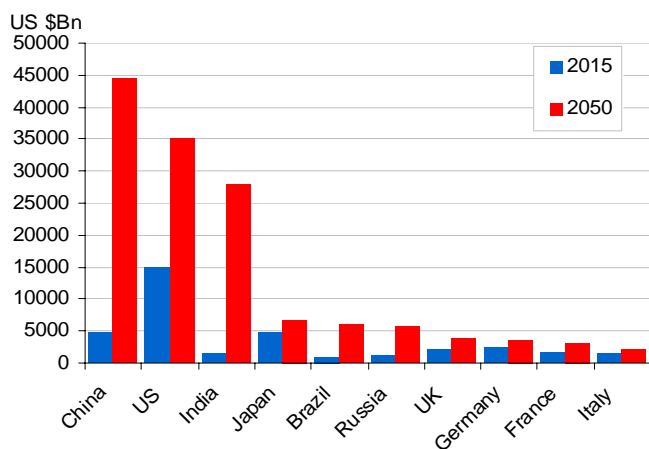
POWER-SHIFT

Before assessing the ongoing impact of the financial crisis on different economies, it is important for investors to take a step back and consider some of the longer-term themes that are steadily changing the shape of the global economy as we know it. The rise of emerging markets, the impact of globalisation and a historic transfer of wealth from western developed nations to developing countries is steadily transforming the economic and investment landscape.

The age of US hegemony is coming to an end. The catalyst is the growth of genuine emerging powers, principally Brazil, Russia, India and China (the BRICs), which together are forcing a re-balancing of global economic activity. It means that, by 2050, we are likely to have a very different-looking 'top 10' economies (see chart). China is almost certain to be the largest economy in the world; figures from Goldman Sachs suggest China may overtake the US as soon as 2027*.

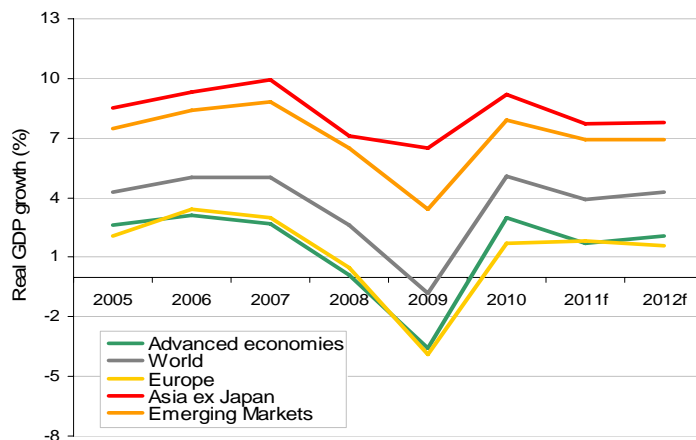
*Source: Goldman Sachs, Paper 192
'The long-term outlook for the BRICs and N-11'
(December 2009)

THE PREDICTED SHIFT IN THE BALANCE OF POWER



Source: Goldman Sachs, December, 2009

ASIAN & EMERGING MARKETS = HIGHER GDP GROWTH



Source: Goldman Sachs, September 2011 actual and forecast figures.

In Perspective

ASIA'S ECONOMIC GROWTH STORY: INDEPENDENTLY STRONG AND RESILIENT

Asia's recent economic performance stands out from all other major regions (see GDP chart on page 1). In 2009, Asia experienced a more modest slowdown when economies in the west went into a credit-inspired recession. Remarkably, GDP growth stayed above 6.0% in Asia. Regional economic growth then picked up strongly in 2010 and, most importantly from an investment perspective, Asia's growth is forecast to stay strong - above 7% in 2011 and 2012, according to Goldman Sachs. This supports a strong outlook for corporate earnings and share prices.

The resilience of Asia during the global financial crisis lends weight to the notion that the region is genuinely decoupling from an over-reliance on western demand. While exports to developed markets still matter a great deal to economies such as China, the key point is that they matter less than they used to. The reason for this is that many Asian economies have reached a stage of economic development where they are seeing a gradual structural rebalancing towards domestic demand. In short, more and more people in these countries are beginning to be able to afford to buy for themselves what they once produced for others in more developed countries.

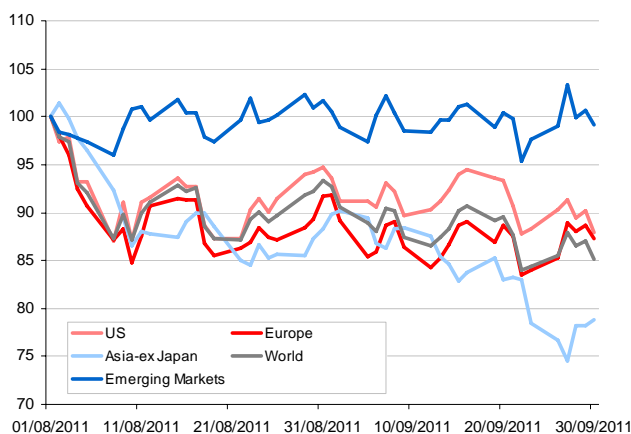
DECOUPLING? IT'S ALL ABOUT TIME HORIZON...

While the evidence of macroeconomic decoupling is becoming very strong indeed, cynics point out that in times of heightened volatility and risk aversion, emerging and particularly Asian stock markets offer little protection from the macro fears surrounding growth in developed markets. The chart (below left) shows stock market performance since the start of August, and demonstrates that for Asia ex. Japan markets this is certainly true, however, the overall emerging market universe has fared relatively better.

One fundamental explanation for the highly correlated recent performance is that Asia ex. Japan is still significantly driven by exports to the developed world and any reassessment of developed world growth has an impact on the region. An equally persuasive explanation is that, for brief periods, the markets are simply not driven by an assessment of the differing fundamentals of the respective areas but instead by emotion. When fear levels surge among investors, they tend to act indiscriminately by selling all risk assets to seek safe havens such as gold and the highest-quality government bonds. This 'risk on/risk off' nature of investor behaviour (which has been pronounced in the last several years) means that emerging and especially Asia ex. Japan markets have not decoupled in the very short-term.

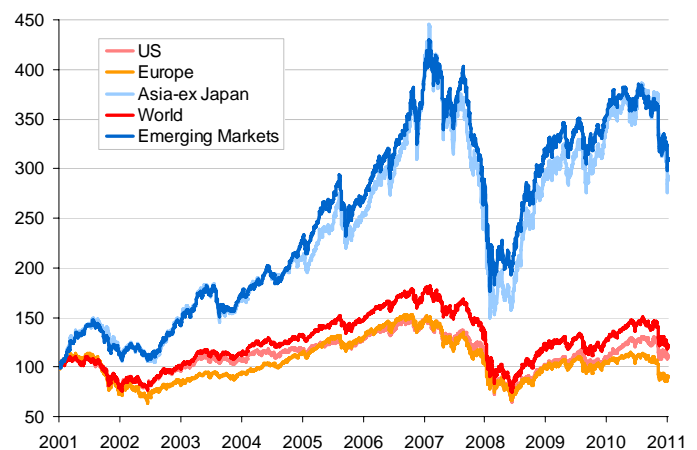
However, despite periods of acute risk aversion where all stock markets are briefly treated in a like-minded manner, the weight of evidence is considerable that emerging economies and stock markets are decoupling over longer periods of time when markets are less influenced by risk sentiment and more by fundamentals. The underlying shift in the balance of power between fast-growth emerging markets and low-growth developed economies has certainly been recognised and rewarded in stock markets over the last five, ten or 15 years (see 10 year chart below right). So, while Asian markets have performed poorly in the context of recent indiscriminate risk aversion, both history and a better economic growth outlook indicate that this is unlikely to last.

FEW PORTS IN A STORM?



Source: Thomson Datastream, as at 03.10.2011

BUT DECOUPLING SEEMS QUITE REAL OVER TIME...



Source: Thomson Datastream, as at 03.10.2011

In Perspective

THE DIVERGENT IMPACT OF THE CONTINUING FINANCIAL CRISIS

The financial crisis had its epicentre firmly in the West, and the shockwaves continue to be felt most profoundly in the economies and financial sectors of Europe and the US. Emerging and Asian economies have by contrast seen limited primary impact. While much of the world grapples with austerity measures aimed at reducing public debt burdens, many emerging market economies, particularly in Asia, are relatively unencumbered by such constraints.

Asia had a crisis of its own in the late 1990s which encouraged economic and financial reforms and a preference for prudence and fiscal restraint. The 1997-98 Asian currency crisis was, in retrospect, an important watershed, as governments vowed to learn from their mistakes.

Many Asian and emerging economies have since built up significant currency reserves; these excess foreign reserves have often been invested in US financial assets such as Treasury Bonds, and led to the establishment of sovereign wealth funds. Indeed, accumulated reserves have allowed China to become the largest creditor nation to the US. Figures from the US Treasury Department show China holds around \$740 billion in treasuries, equal to 60% of US national debt.

"Strong income growth is driving the creation of an affluent middle class population which, in turn, is leading a shift in Chinese consumption patterns. Spending patterns show a decline in the share of income devoted to living essentials and an increase in spending on discretionary items, particularly in branded, higher-value goods. As disposable income grows and people become increasingly aware of quality, under-penetrated sectors like luxury goods, brand names, insurance, education, health care and tourism are likely to benefit over the coming decade in line with rising living standards."

Raymond Ma, Portfolio Manager, China consumer equities

THE LONG-TERM DRIVERS OF ASIAN ECONOMIC GROWTH

The potentially vast domestic demand potential of Asia is arguably the region's single most important thematic driver. China and India are by some distance the world's two most populous countries, effectively ensuring that the wider region is unmatched in this respect by any other.

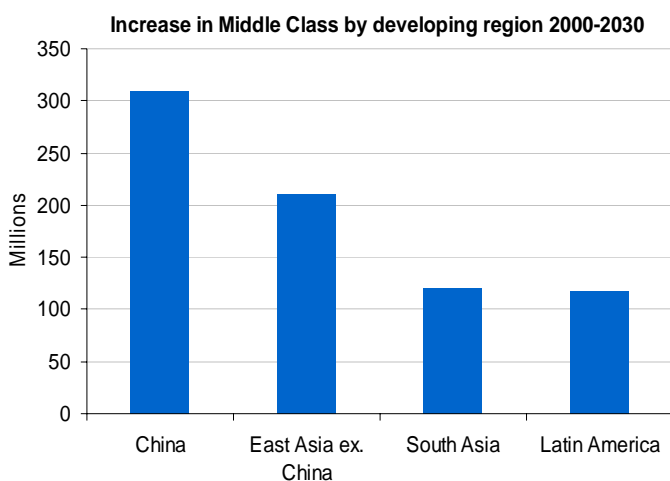
Across Asia, the longer-term trend is towards higher earnings, greater urbanisation and a rapidly expanding middle class. Importantly, these increasingly wealthy population segments also tend to be relatively young and highly aspirational, resulting in both a growing ability and willingness to consume more goods and services. This obviously points to a huge business opportunity for companies, both domestic and foreign. The wider economic significance however is the ongoing re-balancing of demand from external sources to domestic sources.

EXPLODING GLOBAL MIDDLE CLASS POINTS TO MASSIVE CONSUMPTION GROWTH

The rebalancing of global growth from advanced nations to emerging economies is having an unprecedented effect in terms of lifting people out of poverty into the consuming classes. Over the next few decades, the number of people considered to be in the 'global middle class' is projected to more than double, from 430 million in 2000 to 1.2 billion in 2030 (or from 7.6% of the world's population to over 16%).¹

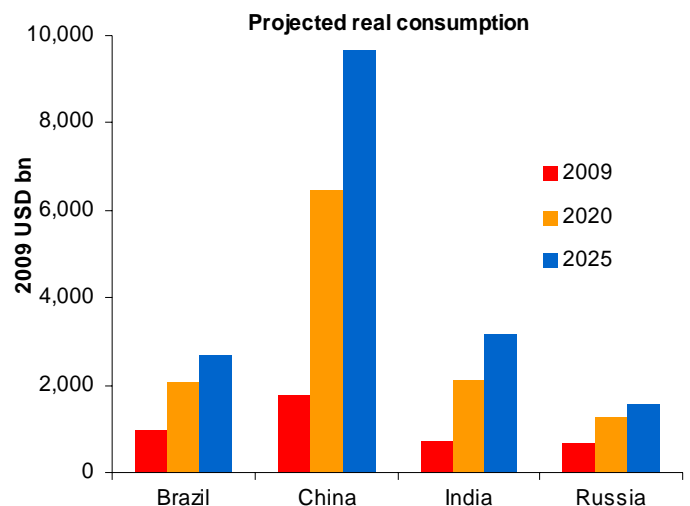
Most of the new entrants will come from just two countries - China and India - where consumption has been growing rapidly in recent years. In fact, to put the source and magnitude of this growth in perspective, the World Bank predicts that by 2030, 93% of the global middle class will be from developing countries.¹

MASSIVE GROWTH IN THE GLOBAL MIDDLE CLASS...



Source: World Bank, Citigroup. 11 March 2011. The World Bank has defined the middle class as individuals earning an income falling between the per capita income of Brazil and Italy.

...AND CHINA IS LEADING THE WAY



Source: Goldman Sachs 'The Rise of the BRICS and N11 Consumer'

In Perspective

"I am optimistic about the prospects for earnings growth in certain Chinese internet businesses that are benefiting from the general growth in internet penetration in China. China's internet population is growing strongly yet is still less than 1/3 of China's population. With more and more people moving online, advertising revenues have substantially increased. Many of these companies, such as Baidu, are increasingly monetising their products and services. Although individual payments are small, the combined sum is substantial given the large number of users."

Allan Liu, Portfolio Manager, Aisan equities

This bare fact alone is the reason why companies from all over the world are at pains to develop a presence in emerging markets. They want to capture rates of consumption growth that are unimaginable in mature western economies. Given the vast size of the consumer market, China is worth highlighting specifically. There will be exceptional investment opportunities going forward and many of the winners of rising domestic consumption will be local companies. These companies have a strong understanding of the local market and are alert to the distinctive needs of Chinese consumers. This is why Chinese brands like Tencent, Baidu, Anta, Li Ning and China Mengniu are all gaining ground rapidly as incomes expand.

Another important consequence of China's burgeoning domestic demand is that it has grown to become a key source of export growth for the region's other economies, reducing their traditional reliance on western demand. This is strongly evidenced by the rising share of China in the export profiles of many countries. For example, China (including Hong Kong) accounted for 41.4% of Taiwanese exports in 2010, up significantly from 24.4% in 2000. In a similar fashion, China's importance as an intra-regional goods supplier has also been increasing, as seen in its rising share in the import profiles of many regional countries.

Chinese outward investment should keep rising strongly in the future which should further boost the trend towards regional integration and economic development. China's non-financial outward investment surged from \$2.7bn in 2002 to \$47.8bn in 2009 (still only less than 1% of GDP).

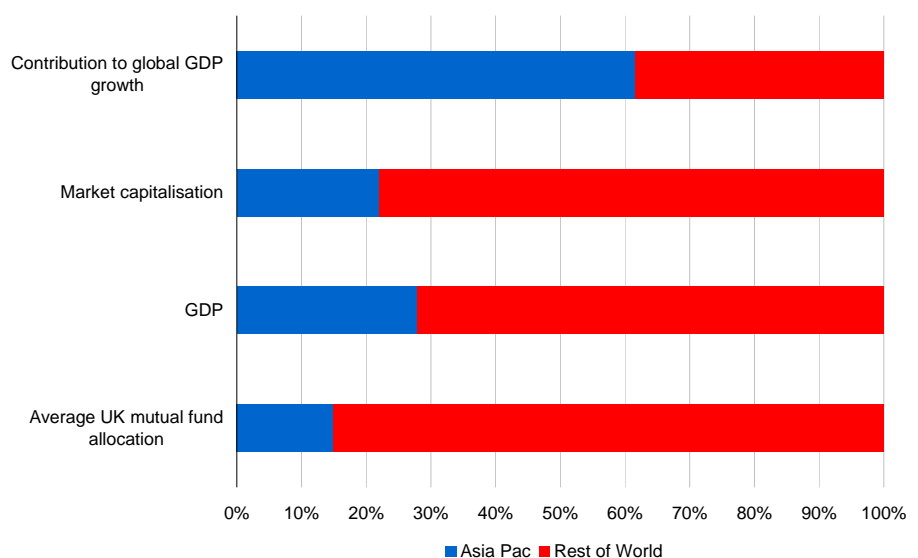
REASSESSING ALLOCATIONS IN A TWO-SPEED WORLD

According to IMF statistics on actual and predicted shares of global GDP, the share of GDP attributable to advanced economies has fallen significantly, from 64% in 1996 to a historic low of 38% in 2011.² This is all the more remarkable when you consider that advanced economies accounted for 64% of world GDP back in 1980 and that figure changed very little over the next 15 years. Emerging markets have gained an increasing share of global GDP; however, the gains in emerging markets have not been evenly distributed. Asia has been the stellar performer and key beneficiary, seeing its share of GDP rise from around 7% in 1990 to 28% in 2010 (increasing to 33% by 2015, based on IMF estimates). Put another way, Asia's share of world growth has risen from under a tenth in the early 1980s to almost one third.

Yet despite this underlying shift in the balance of economic growth, investors have been slow to reallocate away from developed markets. What will it take for investors to recognise the need to allocate more to fast-growth areas of the world? A sovereign debt crisis in Europe, political deadlock in the Euro-zone and the US and a long work-out of the problems created by the financial crisis? There may never be a better time to take advantage of general equity market weakness to strategically allocate more to the fastest-growing parts of the world.

TIME TO MOVE UP A GEAR...

UK INVESTORS HAVE BEEN UNDER-EXPOSED TO FAST-GROWTH ASIA



Source: Average UK mutual fund allocation: Morningstar, July 2011; Market cap: Factset, July 2011; GDP: IMF, April 2011; Contribution to global growth: HSBC, Aug 2011.

In Perspective

TIME FOR AN APPROACH THAT TAKES MORE ACCOUNT OF GROWTH?

The ubiquitous approach to asset allocation in global portfolios is based on relative stock market capitalisations. However, we know that emerging market capitalisations tend to understate the real level of economic activity and the very strong potential for future growth. What if investors were to allocate to emerging markets on a GDP basis rather than a market cap basis, with rebalancing undertaken regularly in a similar fashion to market-cap allocation strategies?

The weights of countries in a GDP-weighted index represent the relative importance of a country's economy as opposed to its equity market. Intuitively, on the basis of the GDP data for the last 20 years, such a strategy would have meant allocating increasingly less of global portfolios to advanced economies and increasingly more to emerging markets, particularly emerging Asia.

Larger overweights in a GDP-weighted strategy would be China and India, whose capitalisation weights are smaller than their economic weights. On the other hand, allocations to the US and UK would be down-scaled in a GDP-weighted portfolio as their market capitalisations are significantly larger than their economic weights.

Studies show that a GDP-weighted asset allocation style more effectively captures the increasing prominence of emerging markets. It could offer an effective means of anticipating the asset allocation decisions of the wider investor community, by increasing weights before the masses buy and reducing before the crowd sells.

CONCLUSION: SHORT-TERM RISKS; LONG TERM REWARDS

Some commentators think that the growth we have seen in emerging markets is unlikely to continue at the same high level. Emerging markets certainly do not exist in a vacuum, and will be impacted by the slowdown in western economies. We are also likely to see bouts of volatility in emerging markets.

However, set against this is the growing ability of emerging markets to create self-sustaining growth based on domestic drivers and strong intra-regional trade. With new sources of growth expected to come from increasing emerging market consumption, investors can be very positive about the medium to long-term outlook. Asian and emerging markets are expected to deliver economic growth numbers that simply overshadow mature, credit-crunched and austerity-constrained western economies.

Investors must reassess whether they have enough portfolio exposure to the fastest-growing parts of an increasingly two-speed world. Identifying the beneficiaries is not about just about selecting the right countries in which to invest, but more acutely, having the fundamental research abilities and presence on the ground to identify the companies which have the scope to succeed in a more globally competitive world.

Notes

1. Source: World Bank, Citigroup. 11 March 2011. The World Bank has defined the middle class as individuals earning an income falling between the per capita income of Brazil and Italy.
2. Source: International Monetary Fund, (www.imf.org) Datamapper.

"I think this is a good time to invest in Asia as valuations are currently attractive compared to historical levels. The Asian corporate sector has ultimately come through tough periods in the past, such as the financial crisis caused by the collapse of Lehman's brothers.

The region's strong fundamentals have always supported corporate earnings and provided resilience to its stock markets on a medium-to-long term view."

Teera Chanpongsang, Portfolio Manager,
Asian equities



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