

China and the commodities cycle



Amit Lodha is a portfolio manager in the Global Equities team. He joined Fidelity as an equity analyst in 2003. Initially covering a number of sectors in the Indian market, Amit became Asian financial sector leader in 2006 before joining the team in London to become global commodities analyst at the start of 2007. He was promoted to the role of portfolio manager in April 2008.

I recently spent a fascinating week in China. I arrived in the country cautious but left with a renewed sense of comfort about the long-term structural growth story. I also gained some interesting insights into China's continuing influence on the global commodity markets.

From a macro perspective, there is no doubt that a combination of monetary tightening, commodity price inflation and electricity supply shortages are driving a significant slowdown in Chinese GDP growth. Credit tightening is also having a serious impact on small and medium-sized companies which will inevitably lead to a growing number of non-performing loans in the banking sector.

Automobile sales are weak on the back of various government measures, housing sales volumes are poor and a weak domestic stock market continues to point towards tightening liquidity. There is also no doubt that the Chinese stimulus programs of 2009/2010 led to some significant misallocation of capital and probably brought forward some commodity demand.

However, to my mind, all this suggests an engineered cyclical slowdown in the pace of growth, designed to control inflationary pressures, rather than signposts on a path to structural decline as some of the China bears would have you believe.

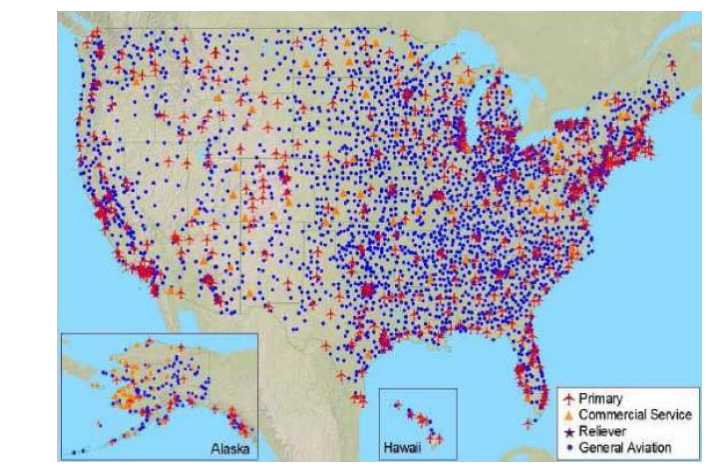
First a few words on growth - China's growth continues to be driven by demographic dividends, urbanization and globalization. Big words, but flipping through an in-flight magazine on my recent trip brought this to life for me. The charts below, courtesy of ResearchWorks (hughpeyman@research-works.com), compare the number of airports in China to those in the US. It is worth remembering that China has a similar land mass but around 3.5 times as many people. Clearly there remains a long "runway" for growth.

CHINA CIVIL AIRPORTS 2010E



Source: CBCC Research, 2011

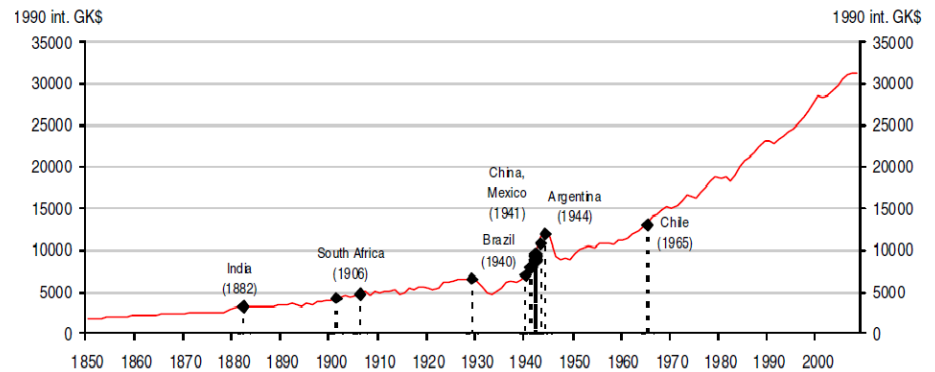
US CIVIL AIRPORTS 2010



Source: US Federal Aviation Administration, 2011

HSBC also recently published an interesting report (The Southern Silk Road – Stephen King Stephen.king@hsbc.com – June 2011) which put the development of various emerging markets into a historical context by placing them on a timeline of US economic development. On this basis, China stands approximately where the US was in 1941 (and die-hard commodity bulls will notice that India is where the US was way back in 1882).

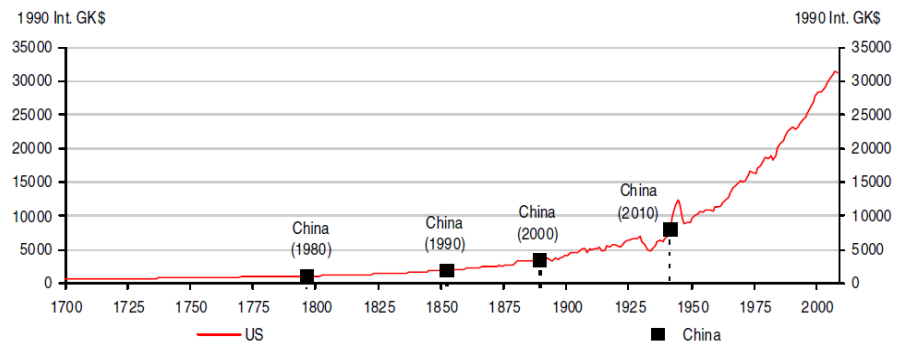
COUNTRIES IN THE EMERGING WORLD BEHIND THE US...



Source: Maddison data, 2011 (Note: GDP per capita is in 1990 International Geary-Khamis dollars)

However, what is even more interesting is that China is achieving in a decade what it took the US 50 years to achieve.

CHINA IS DELIVERING FIFTY YEARS OF US ECONOMIC ADVANCE EVERY DECADE



Source: Maddison data, 2011 (Note: GDP per capita is in 1990 International Geary-Khamis dollars)

This rapid pace of innovation and productivity growth was apparent during my trip. For example, the Chinese have worked hard to increase the domestic supply of some resources and to bring down costs. In commodities like aluminium, bauxite, nickel and stainless steels, Chinese companies continue to innovate and, in my view, are in some cases more competitive than western companies. In manufacturing, the significant size of the domestic market again gives Chinese companies a significant scale advantage, allowing them to invest more in R&D, productivity and innovation.

Much has been written about the supposed property bubble in China. My view is slightly more nuanced than some of the recent commentary. It is true that property prices are towards the top end of their rising trend in real terms and the house price to income ratio is high. The amount of floor space under construction has soared in the past decade and it is argued that prices need to drop to clear supply.

However, the strong counter-argument is that the total housing stock in China is still short of demand (according to some estimates by almost 80m units). Most of the supply has been at the top end which has been absorbed by investors paying cash (given a lack of other domestic investment alternatives in an era of negative real interest rates), leaving a real shortage in the middle and at the bottom end of the market. It is as if there has been massive over-building in Knightsbridge in London but too little construction outside the M25. The government, through its social housing (like the UK's council housing) initiative is trying to set this imbalance right and, over time, this will continue to be supportive of commodity demand.

Domestic consumption also remains a positive driver of demand for some commodities. Copper looks to be a beneficiary, thanks to its importance in, for example, air conditioning and car manufacturing. China remains committed to innovation and renewable technologies. New electric cars, for example, use up to three times as much copper as traditional ones. Cars are largely bought for cash in China and, with fewer than 60 cars per 1000 people (compared with 750 in the

US and an average of 150 in the world), the growth road stretches a long way into the future¹.

So, for me the main insights from my recent trip were:

- China remains on a structural growth path, even as it tries to navigate a near term engineered cyclical slow-down to combat inflation.
- Innovation and productivity continue to remain strong and, while rising labour inflation is a worry, increased GDP per capita will drive the economy more towards consumption-driven growth.
- As China moves towards becoming a consumption-driven economy (as opposed to the investment-driven growth that it has experienced over the last ten years), the outlook for consumption commodities (energy, platinum, potash, oil) will be superior to those driven primarily by investment spending (steel, aluminium, iron ore etc).

These changes will play to the strengths of stock pickers as the 'winners' over the next ten years will be very different from those of the last ten. Backed by our strong on-the-ground research team in China (and indeed around the world), I aim to be well-positioned to take advantage of these changes across the global funds that I manage.



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¹ Source: Macquarie Research, May 2011