

## Positioned for a new innovation cycle



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Amit joined Fidelity as an equity analyst in 2003. Initially covering a number of sectors in the Indian market, Amit took on responsibility for coverage of natural resources stocks and commodities at the start of 2007. He was promoted to the role of portfolio manager in April 2008.

Before joining Fidelity, Amit worked as an equity analyst for Citigroup Smith Barney in India. Amit has both Bachelors and Masters degrees in Commerce and Economics from the University of Mumbai. He is also a qualified chartered accountant and a CFA Charterholder.

### AT A GLANCE

- Scenario probabilities are changing rapidly
- Most likely outcome is inflation spike followed by new cycle of innovation
- Technological leaps often follow periods of disruption
- China to lead next burst of innovation
- Excellent investment opportunities for Global investors
- Pricing power is key

**Investment decisions look neat and tidy in hindsight but in real time there are many considerations to take into account, not least the macroeconomic/geo-political outlook. This is where I find scenario analysis very useful in assessing the likely impact of potential outcomes on the funds I manage and the businesses I invest in. It is important to continually re-evaluate their probabilities and have the flexibility to change that scenario analysis when events demand it. In a changing world, these probabilities are constantly on the move but never more so than today.**

In the past five months, markets have experienced a U turn from worrying about deflation to expecting an inflation problem. Events in the Middle East have triggered an oil price spike, emerging markets have fallen out of favour as investors have retreated back to the familiarity of the developed world and Japan has experienced its worst ever earthquake, tsunami and nuclear crisis.

Against this backdrop, my assessment of the macro-context has evolved and I now assign the following probabilities to various outcomes. I think there is a one in ten chance of significant geo-political upheaval – war, or serious social unrest in China along the lines of what we are witnessing in the Middle East.

I would assign a one in five possibility to a significant policy error leading to central banks tightening too quickly on the back of inflation concerns, leading to a rapid fall back into deflation.

Most likely in the short term, with a probability of 40% or so, is a currency devaluation induced inflationary problem. This could be compounded by a super spike in the oil price as a consequence of trouble in the Middle East escalating in a more significant oil-producing country such as Saudi Arabia or Iran. This would clearly lead into a recession/stagflation scenario for the world economy.

Further out, with in my opinion a probability of 30% or so, is an acceleration in the pace of economic recovery, driven by a stabilisation and then improvement in the US housing market and the emergence of a new wave of innovation in technology/healthcare/alternative energy. Fortunately, this is the most benign outcome and, because it is not widely held, it is not priced into markets today.

These probabilities are not mutually exclusive. Both of these two more likely outcomes are possible sequentially, with the world experiencing an inflation problem first, before we come out on the other side with a positive innovation cycle. Commodity bull markets tend to end with a super spike (which we have not yet experienced in this cycle) and for that reason I am still tactically positive on commodities.

The good news is that inflation will help clear a lot of the debt issues dogging the Western world and go some way to putting its financial house in order (inflation after all, given the difference in consumption baskets and the East's ownership of Western debt, is effectively a wealth transfer from the East to the West). Over the longer term, markets and consumers adjust to the new normal and I expect emerging markets to continue to be global growth drivers and hence the favoured investment destination.

For investors, time horizon is key. Shorter-term investors will be more interested in the commodity boom despite the fact that this multi-year trade (which grew out of the recession of 2003) is running out of steam. The danger in this is that most people lose money at this stage of the commodity cycle because they fail to time their exit appropriately (remember the TMT bubble in 1999-2001).

However, the longer the time horizon the higher the probability of the innovation cycle. History shows that technological leaps often follow periods of geo-political or financial disruption, with the oil price shocks of the 1970s leading on to the personal computer boom and the Asian crisis in the late 1990s preceding the internet and smart-phone developments of the past decade.

In today's context, I believe high commodity prices can be the catalyst for renewed innovation, partly out of necessity, to combat rising costs, and partly as a consequence of new technologies becoming commercially viable for the first time as a result of the new pricing paradigm.

For example, the high cost of energy incentivises innovation in areas such as battery storage and renewables. The latest nuclear crisis in Japan can only accelerate the developments that can make alternative energy sources viable without the requirement of government subsidies.

Innovation will also be driven by the shift in China's economy from an investment-driven to a more consumer/service-led model. China's policy makers remain focused on driving this shift, given the demographic challenges that China faces in the next 15 years as a result of its one child policy. Until now, Japan and the US have been the leading issuers of patents but I expect China to challenge their pre-eminence, especially as its growing affluence and abundance of opportunities encourages ethnic Chinese in, for example, the US to re-locate.

People who have worked at the likes of General Electric and Siemens will bring with them a wholly different mindset to that still prevalent in the large government-owned corporations in China. A more innovative mindset in combination with a highly-educated workforce will prove to be a potent mixture.

Having already largely put in place the physical infrastructure it needs, China will also demand a new generation of software and other technologies. This is the logical progression from the commodity boom that we have experienced. If you look at the quality of infrastructure in China, it is miles better than anything we see in the rest of the emerging world.

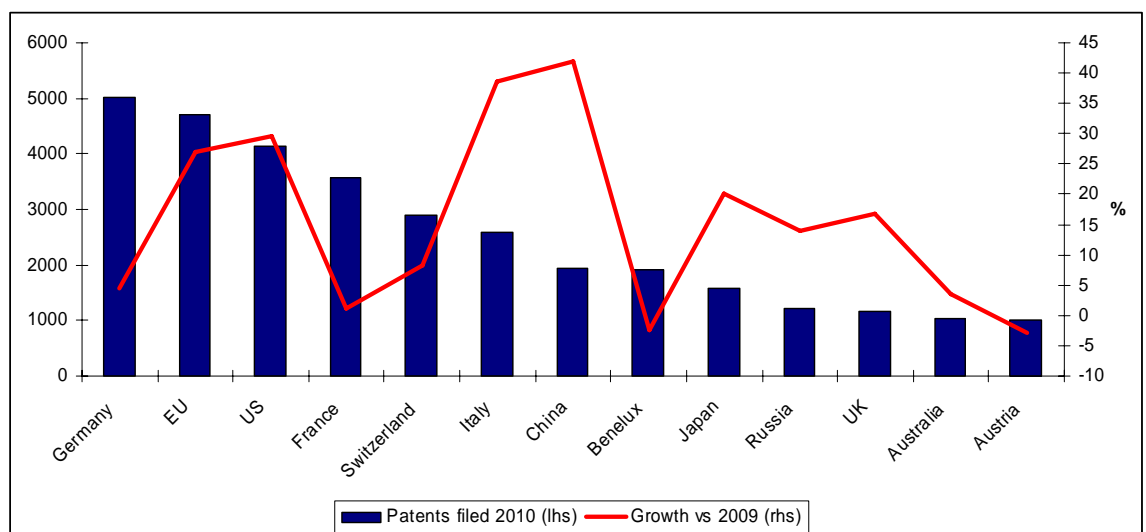
In a globalised economy, an exciting aspect of these new waves of innovation is the fact that some of the beneficiaries will be domestic companies and some will be overseas businesses. Among the latter, beneficiaries of this trend range from multinationals like SAP, Oracle and IBM, which have the technologies, to the luxury consumer goods companies like LVMH, Richemont, PPR, BMW and Daimler which have the brands that the emerging consumers aspire for.

Luckily, from a global investor's point of view the distinction is immaterial. Hence my investment work remains focused on finding the companies operating at the most interesting parts of the value chain, where the pricing power is greatest and most sustainable.

Critically, when evaluating businesses this is about more than just the ability to put up prices. It is also to do with the power of brand and the ability to demonstrate market-leading low-cost manufacturing capability. Pricing power in technology, for example, lies with the companies that can innovate and bring down prices as this increases affordability and expands the addressable market.

At a time of significant concern about the macro-economic and geo-political outlook, this may seem an overly optimistic view of the future but previous periods of innovative progress have also emerged from similarly unpromising backdrops.

## RAPID GROWTH IN PATENT APPLICATIONS HINTS AT INNOVATION TO COME



Source: World Intellectual Property Organization (04/04/11)



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