

The case for Asian equities

AT A GLANCE

- Asian equities have been through a soft patch of late owing largely to concerns about inflation.
- However, concerns about inflation and monetary tightening are overdone.
- The outlook for economic growth is good, which supports corporate earnings.
- The long-term case for investing in Asian equities remains undiminished.
- From the demographic perspective, the region benefits from large, young, increasingly urbanised and wealthy populations.
- Asia's growing consumption potential is enabling a structural shift away from export reliance.
- China is increasingly becoming a key driver of intra-regional trade and growth.
- Investors can gain a measure of assurance from Asia's impressive resilience to the global crisis; a testament to its strong macro-fundamentals.

Having bounced back very strongly since the lows of 2008, Asian equity markets have recently been through a soft patch, underperforming developed markets such as the US and broader global indices. This stemmed mainly from worries about the impact of rising inflation and the monetary tightening needed to counter it. However, such concerns are overdone; they should not obscure the strong long-term case for investing in Asian equities, based on factors such as favourable demographics, strong economic growth, the rising global prominence of China and good macro-fundamentals. Here, we look at the main factors that support the compelling long-term case for investing in Asian equities.

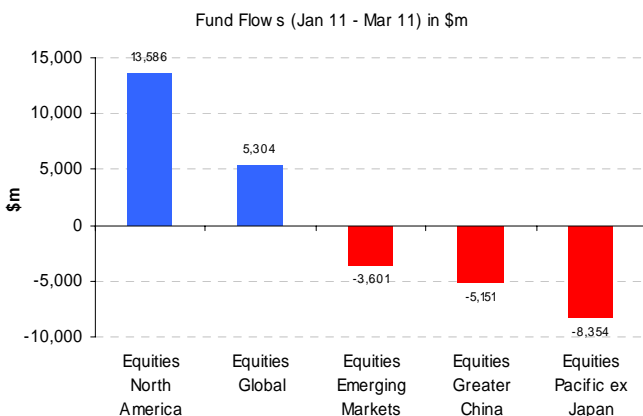
RECENT PERFORMANCE

Investment flows into Asia ex-Japan equities were negative in the first quarter of 2011, with investors tending to favour other markets, notably the US (see chart below left). This is also reflected in the region's relative underperformance against other markets, with the MSCI AC Asia ex Japan index trailing its global counterpart by over 5% in the last six months.

As the chart on the right below shows, inflation in key Asian markets such as China and India has been elevated, causing regional central banks to tighten policy via higher interest rates and higher reserve requirements. Recent Asian equity underperformance has largely reflected concerns about the impact of this tightening on economic growth and, ultimately, corporate earnings.

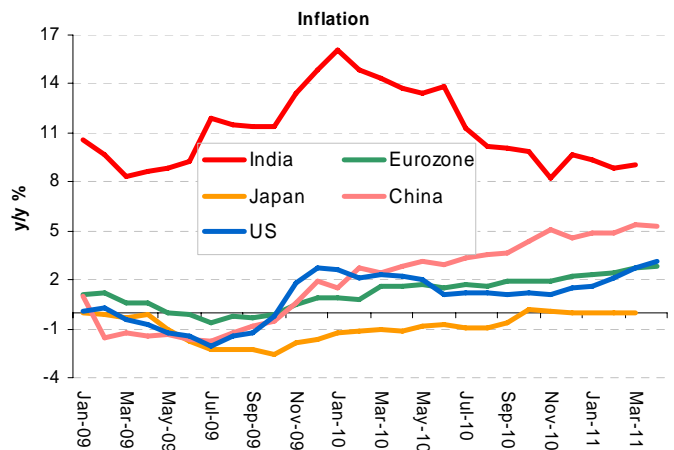
However, a number of factors suggest that investor concerns in this respect may be overdone. Firstly, high regional inflation partly reflects strong economic growth, which remains supportive of corporate earnings. Secondly, it is not a given that policy tightening always leads to market underperformance; for example, between 2003 and 2008 China raised interest rates with no major adverse effects on its growth. Thirdly, while strong demand is a contributory factor, the bigger driver of inflation in recent times has been higher commodity prices, including food prices. The generally accepted view is that these types of price rises tend to be temporary; indeed recent weeks have seen a significant pullback in many commodity prices which, if sustained, should help to cool inflation.

INVESTOR OUTFLOWS...



Source: Lipper FMI, 17.05.11.

...HAVE LARGELY REFLECTED INFLATION WORRIES



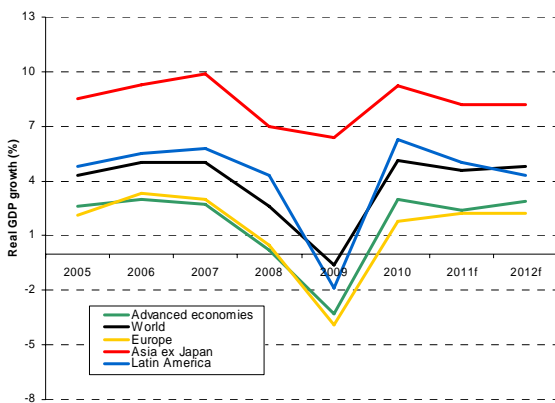
Source: Thomson DataStream, 17.05.11.

THE ECONOMIC GROWTH STORY: STRONG AND RESILIENT

Asia's economic performance stands out from all other major regions (see GDP chart below left). When most of the rest of world experienced a recession in 2009, growth in Asia also took a hit, but only a modest one - remarkably, GDP growth stayed above 6.0%. Moreover, as in the rest of world, regional economic growth picked up strongly in 2010 and, most importantly from an investment perspective, is forecast to stay strong - above 8.0% in 2011-12, according Goldman Sachs. This supports a strong outlook for corporate earnings.

The impressive resilience of Asia during the global financial crisis lends weight to the notion that the region, after some false dawns, may really be beginning to decouple from western demand. Clearly, exports still matter a great deal to manufacturing powerhouses such as China, Korea and Taiwan, but the key point is that they matter less than they used to. One of the reasons 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.

ASIAN GDP GROWTH: CONTINUING TO LEAD THE WAY....



Source: Goldman Sachs, as at 17.05.11

...REFLECTED IN ROBUST EARNINGS OUTLOOKS

	EPS Growth				
	2009	2010E	2011F	2012F	10-12 CAGR *
MSCI AC Asia ex-Japan	21.4%	39.1%	15.5%	13.9%	22.3%
China	16.6%	34.1%	15.5%	15.5%	21.4%
India	16.4%	20.7%	19.2%	18.1%	19.3%
Indonesia	14.1%	22.4%	19.2%	16.1%	19.2%
Korea	57.8%	40.3%	21.8%	12.7%	24.4%
Malaysia	-19.9%	33.3%	13.9%	12.1%	19.4%
Philippines	14.7%	29.4%	8.6%	10.5%	15.8%
Taiwan	52.4%	88.8%	8.7%	19.8%	35.0%
Thailand	35.1%	31.6%	15.8%	15.0%	20.6%

Source: Morgan Stanley, as at 13.05.11; *denotes compound annual growth rate

"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."

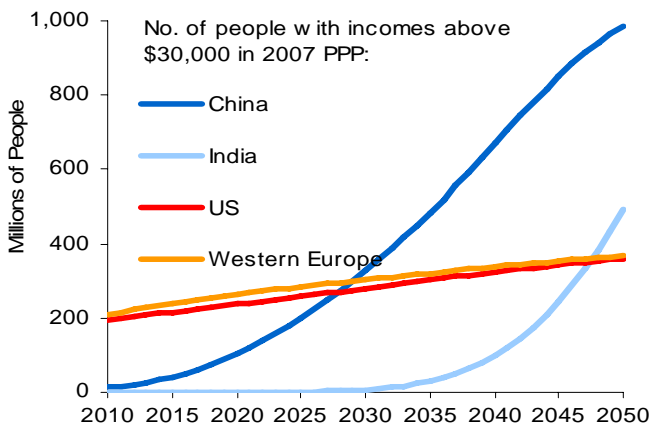
Raymond Ma, Portfolio Manager, China consumer equities

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 all of the region's main countries, moreover, 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, including foreign ones. The wider economic significance however is the ongoing re-balancing of demand from external sources to domestic sources.

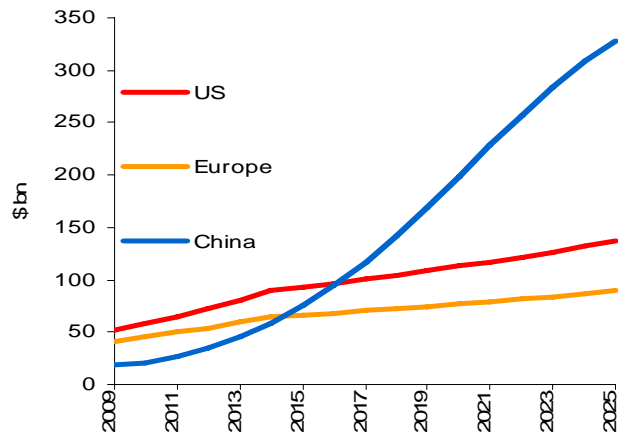
China perhaps represents the most striking regional example of a country which is on the verge of entering a golden age of consumption. To date, the country has been most well known for its manufacturing and exporting prowess and much less for its consumption capabilities. This is unsurprising perhaps when the country's share of private consumption in GDP is only around 36%, roughly half the level in the US, for example.

EXPANSION OF CHINA'S HIGHER INCOME GROUP



Source: Goldman Sachs, 'The rise of the BRICS and N-11 consumer', December 2010

SIZE OF CHINA'S LUXURY GOODS MARKET



Source: Goldman Sachs, 'The rise of the BRICS and N-11 consumer', December 2010

However, owing both to the kind of structural factors mentioned and deliberate government policy, the share of private consumption in China's GDP is very likely, over time, to move closer towards developed-country levels. According to some observers, China today resembles Japan in 1969 and South Korea in 1988: on the cusp of a more mature phase of economic development, where consumption intensity picks up significantly.

CHINA AS A DRIVER OF INTRA-REGIONAL TRADE, INVESTMENT AND GROWTH

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.

As China's economic needs and wealth have increased so has its tendency to invest in other parts of the world - China's non-financial outward investment surged from \$2.7bn in 2002 to \$47.8bn in 2009. However, this investment, which was often initiated by state-owned enterprises and aimed mainly at boosting national resource security, still only amounted to less than 1% of Chinese GDP. According to the World Bank, Chinese outward investment should keep rising strongly in the future, but with a greater expansion into non-resource areas and with more private sector involvement; this should further boost the trend towards regional integration and economic development.

SOLID MACRO-FUNDAMENTALS

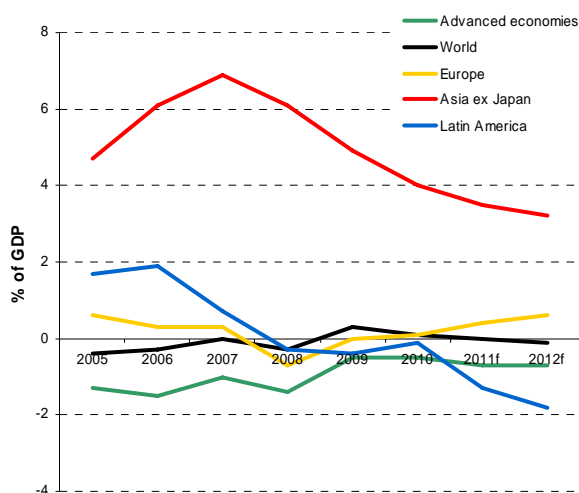
One of the key reasons why Asia did not succumb to the global financial crisis to the same extent as some other regions was the comparative strength of its macroeconomic fundamentals. In the late 1990s, Asia had a crisis of its own which encouraged economic and financial reforms and a general preference for prudence and fiscal restraint. While the West was bingeing on credit, the Asian region was busy consolidating its balance sheets - reducing public and external debt, and building sizeable foreign exchange reserves that stemmed from many years of accumulated current account surpluses. When the rainy times finally arrived in 2008, Asia found itself well equipped to deal with the consequences both by loosening monetary policy and by funding aggressive fiscal stimulus programmes.

Today, while much of the world grapples with austerity measures aimed at reducing public debt burdens, most Asian economies are relatively unencumbered by such constraints. Budget deficits may have risen in many cases but, unlike in less fortunate regions, it will be fast economic growth rather than painful spending cuts that will do most of the work to redress the balance. Likewise, with respect to monetary policy normalisation, the dithering of developed market central banks in the face of persistent concerns about the sustainability of their recoveries has stood in marked contrast to the confident action of Asia's leading central banks.

"Asian countries have strong financial positions with low debt-to-GDP ratios and strong current accounts, especially in comparison to some of the problematic European countries."

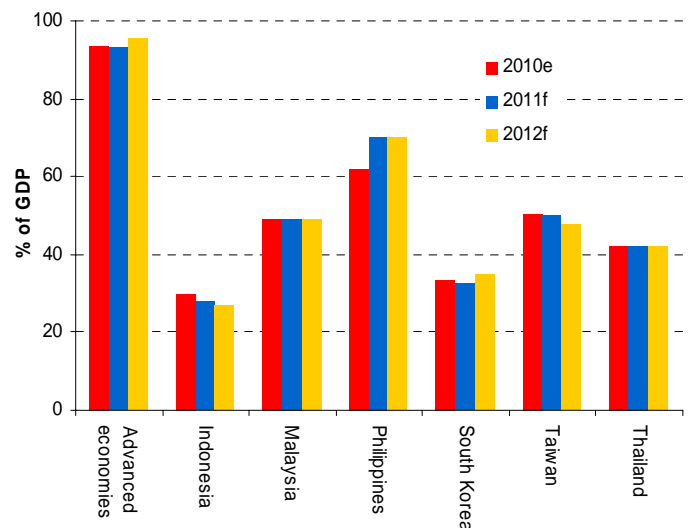
Teera Chanpongsang, Portfolio Manager, Emerging Asian equities

SIZEABLE CURRENT ACCOUNT SURPLUSES...



Source: Goldman Sachs, as at 17.05.11

...AND MODEST PUBLIC DEBT LEVELS



Source: Goldman Sachs, as at 17.05.11

SOME RISK FACTORS

While the attractions of the region are clear to see, investors should always be cognisant of potential risk factors. Although exaggerated in some quarters, there is some substance to the well-reported problem of inflation in Asia. Regional central banks have been raising interest rates to rein back inflation; among the adverse affects of this, however, could be increased hot money inflows which create further upward pressure on regional currencies, along with an increased susceptibility to large capital outflows in the event of bad news. Another area that should not be underestimated in Asia, and in less developed markets more generally, is higher political risk. Some countries in the region such as Thailand and Indonesia have undergone periods of serious tumult in the past which, if repeated, would probably result in investment outflows.

CONCLUSION

Inflation worries and associated monetary tightening have been grabbing the attention of investors of late, helping to explain the recent run of comparatively weaker performance for Asian equities. However, closer inspection suggests that investor concerns in this area could well be overdone - unlike in much of the rest of the world, the willingness of the region's central banks to tighten policy can itself be seen as a good indicator of confidence in the strength of their economies.

The near-term outlook for regional economic growth remains very good and this will be supportive of corporate earnings growth. The longer-term arguments for investing in Asia are also undiminished. From the demographic perspective, the region benefits from large, young, increasingly urbanised and wealthy populations. Asia's growing consumption potential is therefore enabling a structural economic shift way from exports in favour of domestic consumption. This shift of emphasis should also strengthen the increasingly evident trend for China to act as a regional growth driver, lessening the traditional reliance upon western demand. Finally, Asia's comparative resilience to the global financial crisis was a testament to the strength of the region's macro-fundamentals and should continue to act as a source of re-assurance for investors.

"In a low-growth world, uncovering lesser known winners in Asia that are benefiting from rising consumerism or climbing the value chain remains my key alpha generation strategy. Asia Pacific ex Japan remains an under-researched market with favourable demographics and therefore offers excellent stock-picking opportunities for bottom-up-focused managers."

Joseph Tse, Portfolio Manager, Asian equities



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