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OPPORTUNITIES STILL ABOUND IN CHINA – JULY 2011

Evidence of a global deceleration at a time of moderating growth in China has prompted fears of a hard landing for the country by some investors. But as we reveal below, many of the factors worrying investors are more apparent than real. We therefore see recent volatility as an investment opportunity, with the market overlooking a number of favourable developments set to benefit Chinese equities for some time to come.

Recent concerns that the economy might be cooling miss the fact that this is exactly what the authorities have been trying to achieve. We agree that China will see growth slowing down going into the second half of this year, but that surely was the point of policy tightening! We are not concerned about a 'hard landing', past experience (notably the previous two slowdowns) shows China has been successful at achieving 'soft landings'.

With deep cash reserves, the government is willing and able to spend its way out of a potential hard landing. Meanwhile, the country's fiscal debt to GDP remains low at around 3%, giving the government ample financial strength to provide fiscal stimulus should the need arise. First quarter growth came in much stronger than expected, so it is a good sign that second quarter GDP is likely to dip below the high levels that we saw in the first quarter. We still think GDP growth is likely to be at 8% to 9% per year. At these levels, the expansion will continue to support a number of the themes that have made China such a rewarding place in which to invest. We examine some of these themes below.

Inflation remains a key concern for policy makers, but we expect price pressures to moderate as we go into the second half of this year, due in part to the impact of a high base effect for 2011 on annualised numbers. Even stripping this out, a slowdown in the pace of growth should also help to ease inflation pressures. The key risks to inflation remain oil and food prices, but it is worth remembering that China has a reasonably high level of grain stockpiled (40% of annual consumption). If food prices do increase significantly, price controls and other methods of intervention would be introduced, which would create uncertainty for companies and be a negative for equity market performance. After the recent series of tightening measures, we do not expect there to be many more rate hikes in the second half of this year.

A major driver of future economic growth will be the latest five-year plan commencing this year. Among the aims will be to rebalance the economy to make it less reliant on exports and more consumption driven. To that end, another aim is to focus on increased wage growth so that the focus is on GDP per capita instead of simply absolute GDP. A feature of the command economy planning model is that there is a great deal of detail on a bottom-up basis from each province as to what projects will go forward – and this provides a tremendous degree of transparency as to how the growth will be achieved. It is also worth noting that in the past couple of five year plans these spending targets have often been exceeded.

So what opportunities are presented by the developments described above? We list below some themes pointing to promising investment ideas going forward.

Infrastructure

Fixed asset investment growth in 2010 was mainly driven by government-related infrastructure investment. These are for multi-year endeavours – there are over 100,000 projects underway that need to be finished – and so the expectation is that we will continue to see strength in this part of fixed-asset investment spending. Much of the investment is being directed towards the west of the country as part of China's 'Go

West' initiative. This is to address the need for economic development in the region in order to catch up with the east, which is thought to be ten years ahead. There is also a big need for transport infrastructure in Xinjiang province, where 40% of China's coal reserves are thought to be.

Even if in spite of our overall positive outlook fixed asset investment does disappoint, there are niche areas which will remain resilient. One of the brightest is the cement sector, as the investment case is one of supply constraint. Except for western China, no new projects have been approved since September 2009, and with existing capacity utilisation at high levels, cement prices should remain well supported, particularly as incremental supply coming on-stream will be very small. So even with only slight demand growth, prices can rise. When project approvals resume, it will still take one-and-a-half to two years for new capacity to become operational, and the industry supply/demand balance will remain favourable for at least this amount of time. In fact around 10% of China's capacity is out of date and will need to be taken out of the market for environmental reasons. Meanwhile, demand should be well underpinned by continued growth in spending on railways and social housing in particular, which are fairly cement intensive.

Elsewhere we expect that producers of mining machinery will continue to benefit from mechanisation in coal mining. Gas distribution is another one of the more attractive areas for investment. However, we are more cautious about construction firms. These companies have frequently disappointed on margins, and as competition in the sector still appears intense, improvements in margins do not look likely to come through soon.

Consumption

With consumption growth expected to continue, companies with strong brands and pricing power should be underpinned by robust top-line growth – helped by inflation. Earnings numbers continue to be strong, and while stocks are not necessarily cheap they should benefit from continued earnings growth. We particularly like companies with robust high-end brand power, which look set to benefit from buoyant price inflation. After recent sell offs, consumer staples also look better value. Internet businesses remain another favoured area for investment, as they continue to grow rapidly, develop and increase their penetration of China's market, while advertisers stand to benefit from increasing brand competition.

Automation

One of the aims of the latest five-year plan is to focus on increased mechanisation. Although manufacturers are facing wage pressures, productivity gains are still outpacing increases in labour costs. Automation is one of the major reasons why, with businesses spending more on industrial automation to offset increases in labour costs. Among areas we think will do well, China's focus on increased automation will serve to benefit companies that provide associated equipment and know-how in automation processes. A number of stocks in the sector have experienced setbacks due to concerns about delays in nuclear and railway investment. However, the longer-term investment case for these companies remains strong as they are well placed to benefit from the industrial automation theme – and nuclear and railway investments will continue to be strong when they resume.

Conclusions

Above all we continue to believe that the best strategy for investing in China remains a bottom up and nimble one. Whether looking at sectors benefiting from still strong growth or industries less favoured by the five-year plan, the key to maximising performance continues to lie in a stock-by-stock approach to portfolio construction. Investor nervousness illustrated by the recent market volatility provides an ideal environment for stock picking. We see many well managed smaller companies whose intrinsic value is not reflected in their share prices.

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