

China - An Attractive Investment Opportunity

April 2009



Emerging and Far East Equity

Market Review

Like all regions and individual markets, equities in China have fallen heavily over the past year or so. China and emerging markets in general have outperformed developed markets since the start of the millennium. Indeed, after lagging not only emerging but also developed markets from the start of the bull market in March 2003 through 2005, shares in China significantly outperformed in 2006 and 2007 as investors realised the attractions of this huge market opportunity.

Indeed, after peaking in mid-October 2007, Chinese equities significantly underperformed through the first half of 2008. This was a time when most markets were falling and the early stages of the credit crunch were unfolding. With risk aversion building, it was not surprising that highly valued Chinese shares underperformed. Even with China underperforming, emerging markets in general still performed roughly in line during this period.

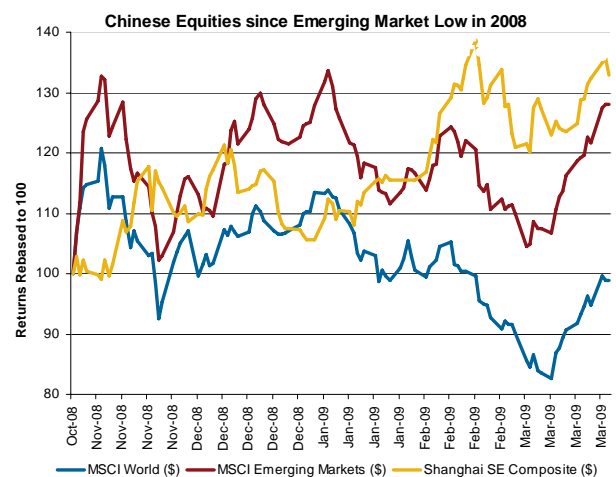


Source: Bloomberg, data from 16 October 2007 - 24 March 2009

However, as negative news-flow increased, emerging equities underperformed significantly in the third quarter, although China held up much better than emerging markets overall.

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As developed markets carried on falling until March this year, emerging markets bottomed out on 27 October, with China slightly later (4 November). Since both of these dates, the trend of emerging markets outperforming has resumed, with China clearly leading the way.



Source: Bloomberg, data from 27 October 2008 - 24 March 2009

Economic Perspective

There is a growing feeling among analysts and economists that 2009 could be the first global growth contraction for 60 years. With this economic decline being global in nature, unlike many previous downturns, which have usually only affected regions, it was inevitable that China would be impacted. Despite growth clearly slowing from the lofty double-digit levels of the last few years, China is likely to grow by at least 6% this year. The Chinese government is still targeting 8%, and Premier Jiabao recently reiterated that this is still achievable.

Clearly, economic data in China have weakened since Q3 2008, but there have been some more encouraging releases recently. PMI jumped for a third consecutive month in Feb to 49, just below neutral level, with new orders showing strong momentum. This indicates that companies are restocking after a weak Q4. Sales of new cars in China jumped by a

quarter in February as government measures to help carmakers countered the global downturn in auto sales. The government has slashed sales tax on smaller cars to boost sales of more fuel-efficient vehicles.

The Chinese government has been proactive in delivering initiatives and fiscal policies to help maintain a strong growth rate. A US\$585bn stimulus package was unveiled last November. One of the weaker areas of the economy has been exports, but the government recently announced that export taxes will be cut to zero.

Premier Jiabao also cheered markets in March: speaking at the annual parliamentary session, he highlighted a willingness to add new economic stimulus measures.

Outlook

The government's commitment to boost economic growth through new initiatives, and further details on the already announced packages, will boost some areas more than others. Sectors expected to benefit from government stimuli are railways, agriculture, power, road and water transport, public housing and healthcare. One area of huge investment will be the railways, with China significantly increasing its capacity to cope with demand. At present, Chinese companies handle around a quarter of global rail traffic with only 6% of track length.

Having fallen approximately 60% from their peak, despite the recent rally, valuations of Chinese equities are now much more reasonable and, when factoring in strong growth prospects, they offer good value in a global context.

There is also a misconception that China is heavily reliant on exports, like many other Asian economies. With exports counting for less than one third of GNP, domestic investment and consumption are the main drivers of economic growth. This should help shield China from the worst of the global problems.

Chinese equities feature in several of our portfolios and there is a strong interest from many fund managers. John Pollen, Head of Emerging Markets Equity, stated that:

“China is one of the fastest growing emerging-market economies, with significantly higher growth rates and growth prospects than developed nations. There is a good mix of companies and we are currently finding opportunities among consumer-related stocks, banks and insurance companies. We prefer companies exposed to the domestic market. Short-term growth prospects in China, like the rest of the world, are hard to predict. Nevertheless, if the economy experiences a further slowdown, the Chinese government has plenty of

firepower to promote growth, which is a luxury many other countries do not have”.

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