

INFLATION

A GLOBAL ISSUE PRESENTING DIFFERENT INVESTMENT OPPORTUNITIES

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With oil having traded at over \$145 a barrel, inflation has become a key concern for markets. The already fragile economic growth of the west is under threat from rising prices whilst the same pressures may also take some of the steam out of the faster Asian and emerging market economies. With so much at stake, some of Fidelity's leading portfolio managers share their views on the subject and explain what inflation means for the way they position their funds.

With the rising oil price central to much of the inflationary pressure being seen around the world, there are obvious reasons for starting with the resource-rich EMEA region.

Nick Price
FF Emerging Europe, Middle East and Africa Fund

"The Middle East economy is booming due to record high energy prices. Because the region's exchange rates are pegged to the dollar, it is seeing interest rates come down and that is fuelling inflationary pressures. However, on the other side, the price inflation in commodities that is hurting elsewhere - driven by the increasing demand for oil from the likes of India and China - has me heavily invested in oil-based stocks, as they are enjoying strong volume growth."

As Nick suggests, the growing demand for oil from rapidly expanding economies like China and India is a major contributor to the rising price of crude. So what does the rising price of crude and the other inflationary pressure mean for the investment theses in these countries?

Wilson Wong
FF Greater China Fund

"Inflation in the Greater China region remains elevated. This prompted China, the world's second-largest oil consumer, to hike energy prices across the board on June 20th. Although the larger and sooner-than-expected oil and electricity price hikes will add to the headline CPI inflation, this is a step in the right direction of normalising the demand and supply distortion."

"In Taiwan, the central bank, at their latest quarterly monetary policy meeting, decided to raise major policy rates by 12.5bp again, in order to manage inflation pressure and to contain general inflation expectations. This comes at a time when real interest rates have been falling into negative territory on the back of rising CPI inflation."

"On the positive side, I continue to see the long term structural trends of industrialisation and urbanisation in China remaining intact. These two trends will continue to support infrastructure spending and domestic consumption growth in China amid an uncertain external environment."

Arun Mehra
FF India Focus Fund

"The Reserve Bank of India has been ahead of the curve in comparison to a lot of countries, by taking active steps to limit any asset mis-pricing. Local prices and inflation should start to come off given a very good harvest and a near-normal monsoon season."

"I'm very positive from a long-term perspective as markets are now showing excellent value for money. This is a good time to buy Indian equities, as a lot of value exists across various sectors."

"I'm currently overweight stocks in the software and services sector, since many of them are trading at relatively reasonable valuations. A global slowdown will also encourage companies to cut expenses by outsourcing to low-cost destinations such as India. I also have a bias towards consumer discretionary stocks, anticipating domestic demand to remain healthy. Conversely, I'm underweight energy and materials sectors, in view of rising input costs."

Away from the regional powerhouses of China and India, the emerging economies of Asia are also facing up to inflationary pressures and investing in the region requires this to be factored into the investment decision.

Teera Chanpongsang
FF Emerging Asia Fund

"New frontier markets like Vietnam and Sri Lanka are facing very high inflation - more than 20%. I therefore spend more time looking at companies on an individual basis to analyse how they are impacted by rising inflation. I like companies that have pricing power and try to avoid downstream companies that have margin pressure due to the inability to pass on incremental costs to end consumers, particularly in markets where there are regulatory price control measures. For example, I prefer oil exploration stocks to oil marketing companies. I am more cautious on banks in some countries within the region since high inflation rates have led to tightening monetary policy by central banks. High interest rates will lead to economic slowdown, low credit growth and potential asset quality deterioration."

While the Middle East is obviously benefiting from high oil prices, many Asian economies are also resource-rich and enjoying the gains from increases in other commodity prices.

Allan Liu
FF South East Asia Fund

"The increase in the Consumer Price Index (CPI) inflation numbers in the region is definitely a concern. However, most of the overall rises are driven by commodity prices and South East Asian countries supply a great deal of commodities. So although commodity price rises are likely to increase inflationary pressures, there is also a growth pay-off for the region. Even for those countries that need to import food items, the amount they need to import is still relatively small compared to their level of overall economic production. Accordingly, South East Asia is likely to be in a better position than regions which do not produce commodity items and therefore feel the full brunt of the increased inflationary pressures with no benefits from the rising prices."

Joseph Tse

FF Asian Special Situations Fund

There is an obvious economic impact from rising prices and that must be considered when constructing portfolios, even in faster-growth regions like Asia.

"Now the question is whether Asia and the world at large is stagflating. In a stagflationary environment, one would want to overweight utilities, staples, cash-generative and lowly-gearred companies. Energy may also perform well if history is anything to go by. Of course, stock selection becomes even more important in the current market condition than it would be in a bull market scenario."

Joseph is not the only one of our managers positioning his fund for a stagflationary environment.

"Our Investment Clock model suggests we are in the 'stagflation' phase of the global economic cycle, where we see both lower growth (stagnation) and higher inflation. Currently, growth indicators are weakening dramatically, while emerging market demand is helping to drive commodity prices and take inflation rates higher.

"Rising food and energy costs have been putting upward pressure on inflation levels. The leading indicators have been pointing upwards for several months already, with the big issue being the rising price of commodities. Not since the 1970s have we seen such pressure come from rising oil, commodity and grain prices. In this environment, stock markets tend to be volatile and so a defensive mix of investments makes sense."

A defensive mix may include a higher weighting towards bonds. Although bond markets suffer at the hands of inflationary pressures too.

"The central banks of the more-developed economies, such as the UK and the US, are treading a tightrope between cutting rates to stimulate their economies whilst keeping their foot on inflationary pressures. Nonetheless, bond markets are not currently pricing in a huge amount of risk for inflation. If inflation continues to track up, which is likely, and the bond market re-focuses on the risks associated with inflation, bond yields will tend to rise to compensate and conversely bond prices will fall, affecting bond funds' returns. Alternatively, if bond prices remain at their current levels and inflation tracks up, running real yields will be affected.

"While we've had a deflationary impact coming out of Brazil, Russia, India and China (BRIC), this is starting to come to an end. In fact, it's starting to tick up. That will slowly start to erode deflationary benefits that have been benefiting the major markets for several years. I therefore think inflation will probably remain at a reasonably high level for some time.

"Rising inflation is a very bad scenario for bondholders and equity holders. Both asset classes hate inflation so it's wise to have a protection against that. For bondholders, inflation linked bonds are an attractive solution."

A last word in relation to equity markets and managing the volatility that accompanies the market's uncertain view of how much the inflationary threat may impact future profits.

"If I look below the skin of markets, I would say there are some stocks which look expensive and there are some stocks which look cheap. The critical thing is to look forensically at individual companies: at their risks and at their opportunities. It is critical to understand what is actually happening in terms of the underlying companies and markets rather than focusing on short-term volatility.

"I'm still focused very heavily on balance sheet analysis - the risk of bankruptcies continuing to escalate and the cost of risk rising again due to poor credit availability. Cash flow is of vital importance at this stage. Companies go bankrupt not for lack of profits but for a lack of cash flow. So stock picking at the moment is very much about evaluating the risks and opportunities of every stock, calculating what that means for the stock's value, and then putting together the jigsaw puzzle. "

Trevor Greetham

FF Multi Asset Strategic Fund

Andy Weir

FF International Bond Fund

Alexander Scurlock

FF European Growth Fund



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