A sleeping dragon

FCSS is well positioned to benefit from a China recovery.

Update
08 July 2025

It's possible that we'll look back on September 2024 as the turning point for the Chinese stock market. That was the month that policymakers pivoted and made it clear that they would put growth back at the top of the agenda and stimulate the economy.

While sentiment remains at a relatively low ebb and there's no one silver bullet that will ultimately improve it, it's encouraging to us that China's central government took the initiative and unveiled a series of measures to stimulate consumer confidence.

The measures launched since September included interest rate cuts and support for the country's beleaguered property market. Incentives to boost consumption, such as offering citizens the option to trade in their old electronic products for newer, subsidised models were also implemented then, and expanded at the start of 2025.

The aim is to boost consumer sentiment, which has been poor thanks to weakness in the property market. When the slump set in in 2021, property accounted for as much as 70% of household wealth, hence, household wealth has been eroded and discretionary spending has been largely put on hold.

As consumer sentiment is critical for growth in China, support is welcome. Coupled with a stabilisation in property values, particularly in top-tier cities, we suspect that confidence should continue to improve.

There have been signs in recent data that this is the case. Retail sales grew 6.4% in May, the fastest pace since December 2023, for instance.

There is plenty more that the central government can do to help this recovery in sentiment and, with the threat of tariffs still hanging over the Chinese economy – even if negotiations with the US remain ongoing – it's needed.

Indeed, our view is that China can no longer rely on big infrastructure spending initiatives and exports to help drive GDP growth. Households are, in the words of Dale Nicholls, manager of **Fidelity China Special Situations (FCSS)**, cashed up. Savings are high as they've underspent in recent years, so further initiatives to unleash consumption should have a powerful effect, in our opinion.

On tariffs, we acknowledge that the path will be tricky as negotiations rumble on, and the end result could be anywhere between 10% to 145% levies. There are, however, a few mitigating factors at play.

Analysts:
David Brenchley
david.b@keplerpartners.com

China's past investment in its manufacturing base means that no country can compete. Companies may be able to slowly move to a China-plus-one supply chain, but they can't simply up and leave the country in favour of any others, be that in Southeast Asia, Latin America or, indeed, the US itself.

In addition, China is much better prepared this time around than the last time tariffs were mooted in 2018. Since then, many Chinese companies have diversified their client base, relocated some of their facilities into neighbouring countries, or even built new factories or plants in the US.

Previous tariff hikes have failed to dent the momentum of those companies with overseas exposure, either. These firms cemented themselves as global leaders and continue to make large market share gains over time.

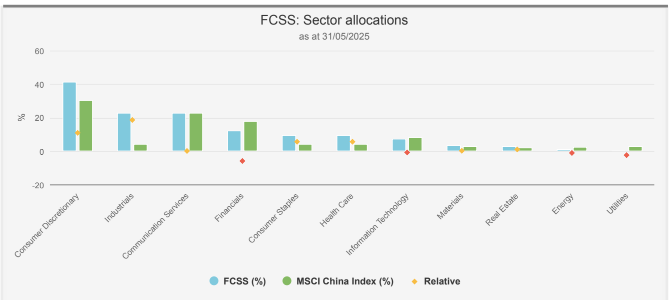
Many industries, from advanced manufacturing to the electric vehicle supply chain, remain deeply anchored in China's irreplicable supply chain ecosystem.

We acknowledge that with this backdrop, sentiment both in China and towards China from the outside understandably remains low. Yet, if we look at a more micro level, there is real innovation going on.

Tariffs are undoubtedly a risk to sentiment, but just 3% of the overall revenue exposure of the companies within the MSCI China index, is directly to the US. Despite a 21% fall in exports to the US year-on-year in April, exports as a whole rose 8.1% year-on-year.

FCSS itself has a clear bias towards domestic spending, which makes up c. 80% of the portfolio. Within the consumer sector, FCSS sees opportunities in selective companies with strong product innovation, digital marketing and brand segmentation, which are likely to drive solid market share gains.

Fig.1: Sector allocations



Source: Fidelity

Dale, who is based in Hong Kong, and his 24-strong on-the-ground team of analysts have recently been evaluating their holdings' price elasticity – that is, how strong their pricing power is.

One key and encouraging finding has been that companies have been able to pass on part of the tariff-related price increases to their overseas customers without seeing demand fall as a result. There are a few reasons for this, notably because buying from Chinese suppliers is still cheap versus buying from suppliers in other countries, even after the tariff increase. Also, as we've demonstrated already, there is no alternative supply chain other than Chinese companies.

Another key development for China was the breakthrough of DeepSeek in February, when it released an artificial intelligence model to rival the likes of OpenAI for a much lower cost. We understand that there are a number of similarly innovative companies in a host of other industries ready to do the same. Generous research and development budgets and a deep pool of talent is enabling this.

Management is keen to focus time and energy on finding such companies and are finding opportunities in autonomous driving, such as Pony AI which recently went public on America's tech-heavy Nasdaq Composite index; and cloud-based enterprise management systems operators, such as Kingdee International.

Pony AI was a company that came into the portfolio when it was privately owned, a key differentiator versus many peers. Bytedance, the $300 billion parent company of TikTok, currently resides in FCSS's top five holdings. In total, c. 11% to 12% of FCSS's portfolio is invested in private companies.

While macro has dominated the headlines for an extended period of time, these factors as well as improving total shareholder returns as companies increase dividends and buybacks are positive for the continued re-rating of Chinese equities, in our view.

As the largest trust focused on China, and with an approach of identifying growth opportunities from a diverse range of sources, from household names to unlisted companies, we believe FCSS is well positioned to capture a potential recovery.

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