

TRANSCRIPT: EPISODE 398

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[INTRODUCTION]

Staci West (SW): Welcome back to the Investing on the go podcast brought to you by FundCalibre. This week we're discussing the evolving landscape of Chinese equities. From shifting sentiment and the impact of global energy prices to AI and property market stabilisation.

Chris Salih (CS): I'm Chris Salih and today we're joined by Dale Nicholls, manager of the Elite Rated Fidelity China Special Situations Trust. Dale, once again, thank you very much for joining us.

Dale Nicholls (DN): Thanks, it's great to be here.

[INTERVIEW]

CS: We had a chat about six months ago about all things China, if you remember. And I guess the feeling I got from you was that, you know, while you expected more sort of volatility in the markets, you kind of thought that the policy changes had worked to a more sort of medium to longer term. There's been times in the past where they've perhaps been short term and not followed through, but I guess you sort of felt that things were turning and that the competitiveness in the market relative to other markets and the number of opportunities in terms of sectors had improved.

But that was six months ago, and there's been a lot that's gone on in the last six months. **[DN: Right.]** Has that changed, with the likes of the oil price with what's going on in Iran? I know you're a stock picker at heart, but you know, the macro, particularly in China, plays a role. How are things at the moment in terms of sentiment?

DN: Yeah. I think, you know, in terms of market sentiment, it's mixed. It's been a very sort of bifurcated market. You know, you mentioned the policy changes. I still have the sense that the policy is still growth focused in terms of that domestic policy. But, you know, there has been some examples of things tightening.

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You've seen sort of increased regulation around capital outflows. You've probably seen sort of the regulation that's happened on some of the brokerage houses that are doing sort of relying on Chinese customers, but operating offshore. So I guess from a domestic regulatory perspective, some tightening. But I do believe you know, there's still very much a focus on growth and improving consumption, and that's still coming through policy-wise around things like you know, around loosening in the property sector and sort of areas like that.

In terms of probably the biggest changes in the market since when we last spoke, obviously, you know, we've got the Iran conflict and increased energy prices. Hopefully we're near a resolution there. But that has led to, I guess more cost pressures domestically. Obviously, from China's perspective, there were concerns at one point about deflation. You've now got PPI that's clearly in positive territory. So you know, maybe for some looking at the market that could actually be viewed more positively. And obviously, China is a better position to deal with higher energy prices than many other countries in Asia. Not the least of which, being that significant investment they've done in sort of building out renewable capacity over the years.

And the other big changes like I guess we see globally is just what's happening with AI. The CapEx there, clearly China has lagged in terms of that CapEx, but there's definitely signs that that's picking up. And at the same time, there's many companies domestically that are benefiting from the global rising CapEx that we're seeing in AI. A lot of companies that benefit in that supply chain, you're seeing obviously strong growth in areas like energy storage. China is a leader within the battery sector. So there's many companies, sort of around that supply chain that are seeing quite a big benefit from that.

But to sum up, it's been a, a pretty bifurcated market. The companies that have benefited from that, and that's come through in earnings growth. And then the other sector, the other big part of the market, more domestic focused areas like consumption where things have continued to remain relatively weak. And those are definitely parts of the market that that have lagged overall.

CS: We talked last time about the shape of the market and how, for example, the S&P obviously has done very well, but it's tied to seven or eight big companies. And I think you said that with China, particularly within the sort of the top end, there had been stronger performance in 2025, but a lot of it had come from those leading sort of tech players. Is that still the case, that the shape of it is that you've got this top layer of strong corners and then there's a host of opportunities underneath even within the larger part of the market?

DN: Yeah, I think less than that type of bifurcation, it's the type of sector bifurcation that's really standing out more now. So again, there are big companies that are benefiting from that sort of CapEx in AI that we talked about and potentially improving things in sort of the EV sector as well, so that, again, I come to, the big battery names and like CETL that are clearly benefiting from that.

But at the same time, if we're talking about big tech we've definitely seen a trend that the companies that are benefiting from the CapEx are clearly outperforming the spenders themselves. So, you know, you're seeing rising rising CapEx from, the big tech names, the big cloud providers, Alibaba, Tencent, et cetera. They're definitely increasing their CapEx. And clearly the market's taken a dim view of that because it does have, I guess, the impact to impact short-term cash flows and earnings. To me in some ways that feels a bit overdone. I think the key question you need to be asking is: will the returns be there on that CapEx and the early signs?

I think that the returns will be there, obviously something we need to watch. So again, I think it's probably better to look at things by sector and sort of where companies are operating as opposed to market cap. I think that probably makes more sense.

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CS: And I guess, I mean, a lot of it does come back to sentiment and I think, the things you highlighted were those tariff concerns and sort of the need for earnings improvements as the two sort of things that needed to lift to improve that sentiment. I'm trying to remember what the latest is on the tariffs across to China. Maybe you could just give us an update on both. I mean, I'm quite interested on the earnings in particular.

DN: Yeah. On the tariff side, obviously you've seen a lot of developments that have played out, and it's still unclear how things will play out from the US side. But what I would say is that I think myself, and probably most market participants, are feeling more comfortable about that.

Not least because it's not just China anymore in terms of who's going to be suffering from tariffs. It's more of a global issue. If anything, in terms of the gap between China and other countries, it looks like that gap is closing. As we've talked about, Chinese companies have a lot of experience dealing with tariffs over the years. They're very flexible. A lot of them have taken steps to move production offshore. So I'd say overall, tariffs are less of an issue.

Your question about earnings is very valid. Again, if I think about China versus the US market, that's an area of weakness because generally we've seen revisions downward in China. I do think the ingredients are there for things to improve. I'm sure we'll talk about things like the property sector, where I think there are clear signs of stabilisation. If we have that, there's still a consumer sitting there very cashed up, having underspent for years.

That, combined with the AI spend we talked about—we see the contribution to overall economic growth that's providing in the US. Obviously that CapEx cycle has been much smaller in China, but again, the signs are that it's accelerating. That, combined with the fact that pretty much all companies are doing more offshore. For companies that do have overseas businesses, in most cases, given the competitiveness of the market domestically, they make better margins offshore. So that's a factor as well that I think can slowly contribute to better margins and hopefully a better earnings outlook.

CS: Okay. I wanted to touch on property. It's a bit of a dirty word whenever someone talks about China, but again, back to that previous conversation we had obviously there were significant clouds. But you felt that while there was a challenge, there were some pricing opportunities at lower levels within that sector. Is that still the case six months on?

DN: Yes, absolutely. I do think there's opportunity there. It's obviously a very out-of-favour sector, and that's what's helped drive multiples to these very low levels. At the same time, as I've said, there are signs of stabilisation, mostly in first-tier cities. In recent months there have definitely been month-on-month increases, though that hasn't translated to a year-on-year increase yet. But I'm hopeful that can play out at some point.

As I've said, the government is doing more to support the market, but more importantly than that, you've seen a significant supply adjustment. Demand has been weak for years, so from a pure supply-demand perspective, there's good potential for pricing to start to stabilise. And you've got very cheap companies in a very out-of-favour sector. In terms of the way the market is looking at these companies, there are quite a few with significant investment businesses. My sense is the market is definitely not valuing those businesses as it would in other markets.

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Clearly, with a lot of these businesses, you've got some very good operators, particularly in areas like shopping malls, that are outperforming the overall consumption environment in China. Yet my sense is the market is valuing them more like the developer part of the business, which is clearly not the same quality. So that's creating, I think, quite a bit of opportunity in the property sector currently.

CS: Okay. And there were two or three areas that you were keen on that I wanted to touch on briefly. They were industrials, healthcare, and, as you touched on earlier, the consumer. Are those still the most promising areas in the market, or has that changed in recent times?

DN: I think definitely those are promising areas, but for quite different reasons. Industrials, for everything we've talked about, you've got many companies benefiting from the CapEx spend we discussed. And as I've mentioned in the past, I still have the sense that the market doesn't fully appreciate the competitiveness of many Chinese companies. Given the scale of their businesses and the investments they've made in R&D over time, there are very few sectors where Chinese companies in these areas are losing market share. They're generally market share gainers. And as we've discussed, as they go offshore, they're getting better margins.

The other sectors you mentioned I'm also quite positive on, but valuation is a much bigger factor there. These are quite out-of-favour sectors. As we've discussed, in consumption sentiment has been weak. There are signs that it's gradually improving. The hope is that with the property market stabilising, you can slowly get a better consumption environment. At the same time, there are still real growth areas within the Chinese consumer. Think back a decade when we were all talking about the Chinese consumer and the potential there—many of those fundamental stories are still very much in play.

Think about areas like services. Areas like travel obviously still have significant growth potential. On the goods side, think about areas like sportswear, where per capita spend is a fraction of what we see in the West. There are still real structural growth stories, combined with the potential for things to slowly improve, alongside very low valuations and weak sentiment. So I think there's potential there.

The healthcare sector is a bit bifurcated. We've seen decent performance in the more innovative drug areas, and I think that's justified. There's obviously a huge amount of innovation happening in that space, and that's been recognised by global pharma. They're beating down the door to China to license many of the novel drugs coming out. There's been weakness elsewhere in the market. The hospital area has suffered. There have clearly been funding issues that have been a headwind there, along with pricing issues. That's driven valuations to very attractive levels. Clearly anti-corruption campaigns and that sort of thing haven't helped. But our sense is that the bad news flow there is probably coming to an end, and with valuations where they are, that part of the market also looks increasingly interesting.

CS: Are you to put, as a simple question, are you finding lots of opportunities within the domestics market in terms of A-Shares and also the unlisted space as well? Maybe just give us an example, particularly on the latter, if possible.

DN: Yeah, clearly the A-share market has definitely outperformed H-shares, and a lot of it is for the reasons we talked about. You've probably got a more export-oriented sector, and there are decent trends there. We talked about the big tech names that have lagged the market as well. So it's that balance again, you've got stronger fundamentals and earnings growth in the A-share market, but valuations are not as attractive. So it's a mix.

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In terms of the portfolio on the private side, there's quite a bit going on. There are things we continue to look at to add to the portfolio, and I'm hopeful we'll see new names come into the portfolio in the next 12 months. Obviously it's an important part of the portfolio. ByteDance is our biggest holding there, and the performance continues to be very strong. That's driven some of the revaluation of those shares. My sense is that there's still quite a way to go there. Despite the very strong earnings, you've still got the overseas business—the TikTok business—which is not really contributing. In fact, it's been a drag on earnings. You can justify the valuation many are using based purely on the domestic business, which means you can take the view that you're effectively getting 2.1 billion users through TikTok at a very low valuation, if not for nothing. So I still think there's very good potential for value to be realised there if they can monetise overseas to any extent close to what they've been able to do domestically.

CS: I appreciate this is a bit of a crystal-ball question, but it's quite interesting with that pivot in September 2024, or whenever it was, with the policy shift. Do you think that, after however long this is—15 years the portfolio has been running now—that those pivots and that pro-growth stance being really cemented leans towards the A-shares and unlisted market in terms of your exposure? Do you think you could see yourself putting more in there because you've got the underpinning of government support now at a more concrete level?

DN: Yeah, I think that policy shift, and when I think about the sectors that are going to benefit most from that, it should be those areas that have struggled: property, consumer, etc. That probably plays more into the H-share part of the market as opposed to A-shares. Consumer and property, at least in terms of my holdings in the portfolio, are probably more concentrated in that H-share part of the market versus private.

CS: Okay. And I guess just one more thing. The trust has grown its dividend every year since launching in 2011. I think it's compounded over 30% now. Do you think that increase in corporate focus from China is just the tip of the iceberg? Do you think that will keep improving in the future?

DN: Yeah, thanks for pointing that out. It's something that, in terms of capital return, isn't talked about enough when we're discussing China. Obviously we've benefited, as you mentioned, in the trust from increased payouts and buybacks from companies. My sense is that the momentum is strong.

In terms of the discussions we're having with companies, the capital return discussion is central to a lot of what we're talking about. Obviously we're happy for companies to invest when they see potential and returns. But otherwise, in terms of running efficient balance sheets, we're happy to see capital come back to us. And yes, I think the momentum there is strong.

I might not be as positive on the outlook for buybacks. We've seen some really significant buybacks over the last few years, particularly when the market was very out of favour. Companies were buying back a lot of stock. I still think buybacks will be significant, but I'm not sure they'll be as significant as we've seen over the past few years. Stock prices are higher from where they were, and for many companies, CapEx needs are rising. Hopefully that leads to better returns and earnings for companies, but maybe less in aggregate buybacks going forward.

CS: And I guess I just wanted to finish with a direct message to investors really. Your trust is known for that smaller mid-cap bias, and clearly it's all about stock selection, right? Do you feel like the way the world and markets are moving is leaning towards your investment style again? Or am I being too optimistic for you?

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DN: Yes and no. China has always been a great stock picking market. It's very volatile and driven by headlines, as you know, and that can create real opportunities. A lot of the market isn't covered, so it's great that we can leverage the team we have on the ground to find those ideas.

At the same time, as I've said, we're in a market that's very driven by some big trends. So I think stock picking has been a really key driver of performance over time, but you can go through periods where thematic exposure is more important than great management teams executing on their strategy.

I think there's an element of the market that is playing the trends, so to speak. Those big trends mean many companies are riding that wave. But over time, management is key. That's a core part of stock selection, and I think it will shine through over time, as it has up to now.

CS: You sort of segued into my last quick question, which was patience. In your tenure on the trust, is this the most patient you've had to be with those stock-specific focuses, with everything swirling around China? Has it been a case of just being patient more than anything else?

DN: Yeah, I think definitely in some sectors. We've talked about holdings in areas like consumer, but that's often the case in markets. It can really take time for the market to recognise the performance of good companies. But again, as long as the earnings are there and the valuation is there, the market will get there as well. So it can take time, but we do benefit from inefficient markets. That's pretty much what the stock selection process is about. So no, I feel like patience has been important really the whole time.

CS: Okay. On that note, they thank you very much for joining us once again and explaining all things to China to us today.

DN: Thanks so much.

SW: This trust invests predominantly in companies listed both domestically in China but can also invest in Chinese companies listed on other exchanges around the world, as well as companies with significant interests and primary revenue exposures in China. To learn more about the Fidelity China Special Situations Trust please visit fundcalibre.com and don't forget to subscribe to the Investing on the go podcast, available wherever you get your podcasts.