

FIXED INCOME

Finding quality beyond government markets

FEBRUARY 2008

Whilst focus has been on equity market volatility in recent weeks, less attention has been paid to fixed income markets. In recent months, government bonds have rallied as the US Federal Reserve cut interest rates and European central banks held off from further tightening. The strong performance of government bonds has also been driven by a "flight to quality" as investors worried about equity markets. Fidelity's fixed income team believes that there is also quality to be found in other segments of the market and, here, explains where and why.

GOVERNMENT BOND MARKETS

Over the next few months, we expect government bonds to continue to do well, as the "flight to quality" is likely to continue and central banks are probably considering further rate cuts. As equity markets fall, demand should increase for bonds, as pension funds think about locking in some of the equity profits they've made in the last few years. We also see the opportunity to enhance overall returns by investing in inflation-linked bonds as the threat of possible inflation in the short term is not fully factored into current prices.

CORPORATE BOND MARKETS

We also see considerable value in corporate bonds, relative to government issues. As investors have sought to reduce their risk, credit spreads have moved out, driving corporate bond prices down. Credit spreads have widened dramatically as the expectation of default has risen, making the potential yields from corporate bonds very attractive. While a softening growth environment can coincide with deteriorating company fundamentals, defaults remain contained. Currently, the US speculative grade default rate is less than 1%. Whilst we expect defaults to rise, spreads are pricing in an extremely negative scenario which seems overdone.

Whilst our portfolios are generally underweight financials, we are mindful of the attractiveness of their current valuations, especially relative to cyclical sectors such as industrials and discretionary consumer. History tells us that a steepening of the yield curve, a positive yield curve slope and a lighter issuance pipeline are pre-requisites to being overweight banks. We are tending to avoid consumer oriented companies as we are cautious about the outlook for consumer spending.

What we are finding attractive are bond issued in the energy sector. We've found some interesting opportunities in bonds linked to the oil rig business. Exposure to less economically sensitive sectors like utilities, telecoms and tobacco companies may also be appropriate for this time.

ASSET-BACKED SECURITIES

One of the most visibly impacted sectors since the sub-prime problems broke last year has been the market for asset backed paper. Concerns regarding the economy, consumer credit and liquidity have caused significant spread widening. We are convinced that the technical and liquidity problems that have affected the ABS markets so badly will disappear. We have yet to see a deterioration of the underlying asset quality of the names held in our portfolios and remain positive on the sector in general. In fact, at these levels, we believe that ABS paper is very cheap indeed and there have already been some very encouraging moves towards restoring liquidity and confidence.

We believe that prime autos issues represent the best value, offering excess returns, but credit cards and student loans are also attractive. Consumer ABS (excluding home equity) could show improvement this year, although this assumes that the market begins to return to normalcy and spreads start to tighten.

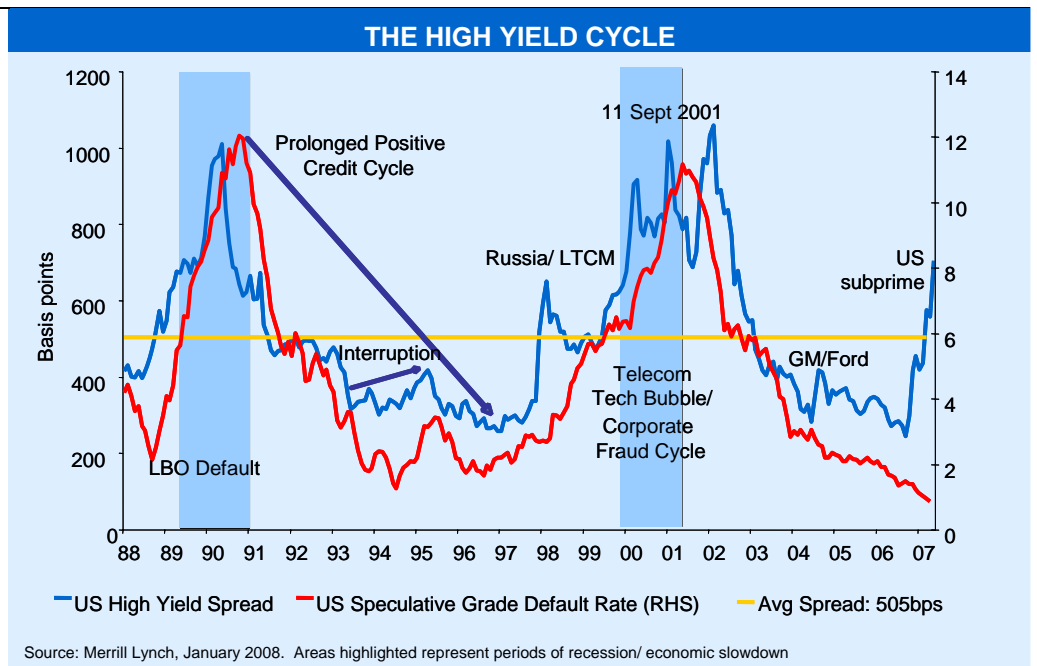
HIGH YIELD BOND MARKETS

Given the subdued outlook for equities, we believe the high-yield asset class also looks particularly attractive. A lot of the recent selling has been technically related, with sentiment or macroeconomic factors being the key driver. This has resulted in some exceptional opportunities to invest at attractive values. For example, there are relatively high quality BB-rated companies in Asia offering yields above 10%. The running yield for the Asian high yield market in general has now moved up to around 9%, from 8% last year and, in Europe, the market now yields over 10%. This is attractive relative to history and provides some cushion against further spread widening and eroding capital values.

As market conditions remain challenging, spreads in high yield markets may drift wider in the near term. However, they are already well above long-term averages in Europe and spreads in the US high yield market are almost 700 basis points (7.00 percentage points) over Treasuries. Such levels are pricing in a lot of bad news. The last time US spreads were this wide was in early 2003, when the default rate stood at over 6% of the market value.

High yield markets are compensating investors for a much riskier economic environment than the one in which we find ourselves. In the near term, with companies well funded and few upcoming financing requirements, we do not expect a material rise in defaults.

Spread widening is helping to restore value to the market and to create interesting investment opportunities. We remain focused on companies with an improving credit profile, an ability to deliver sales growth and a short-to-medium term payment horizon



EMERGING MARKET BOND MARKETS

While EMD volatility has increased from summer lows, it has fared well compared to other fixed income asset classes, notably US high yield. EMD benefits from a strong fundamental and technical back drop as well as having no direct exposure to the US residential housing market. Fundamentals across most emerging market countries remain strong due to persistently high commodity prices driven by economic growth in China and India. Further, many governments capitalised on accommodating capital markets to improve their debt profiles by extending maturities and refinancing into local currency-denominated bonds.

The supply/demand balance is also favorable, with new bond issuance in 2008 anticipated to be less than coupon and amortisation reinvestments. However, broader fixed income market volatility should persist and will likely pressure EMD spreads, particularly lower rated credits. Further, we think the market underestimates the negative impact a global economic slowdown could have on emerging countries, adding an additional risk.

CONCLUSION

We seek to manage risk through our multi-strategy approach to investing. As such, we believe that it is appropriate to maintain a spread of smaller, lowly-correlated positions in a portfolio, reducing the impact of issue-specific risk and volatility. Whilst equity markets remain volatile and the economic picture remains at best uncertain, investors are likely to continue to seek high quality defensive investments like government bonds. However, the indiscriminate selling of credit markets means that we believe value can be found in selective corporate issues. With that in mind, we believe that it is appropriate to steadily increase credit exposure as opportunities arise and believe that there is value to be found by holding selected corporate issues alongside “safe haven” government bonds.

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