



MAY 2008

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Ian Spreadbury joined Fidelity in 1995 as a portfolio manager and has more than 22 years of fixed income fund management experience.

In addition to managing Fidelity Funds European High Yield Fund, he also manages a number of portfolios on behalf of UK retail and institutional clients.

Ian holds BSc and MSc degrees in Applied Mathematics and Mathematical Statistics, respectively, and is a fellow of the Institute of Actuaries.

EUROPEAN HIGH YIELD

The restoration of value

In recent weeks, conditions in the European high yield market have improved: spreads have narrowed, there has been some new issuance in non-euro markets and the loan market has re-opened. However, looking ahead, I expect volatility to stay elevated in the near term and, using history as a guide, I am mindful that spreads could stay wide or widen further. Nevertheless, the spread widening has restored value to European high yield markets and I believe the attractive yields now on offer provide a cushion against the risk of spread widening and an increase in defaults. Overall, and amid the uncertainty, I believe it is an interesting time to consider building an exposure to the asset class.

AN IMPROVING TECHNICAL PICTURE

Through the credit market crisis we witnessed indiscriminate selling across most risk markets. Equities and high yield bonds underperformed the safe haven of government bonds and risk assets were significantly re-priced. Behind the moves were systemic concerns over the financial sector – bank write-downs, worries about monoline insurers, bank and fund collapses, unwinding of structured transactions and de-leveraging by banks and hedge funds were all behind the market weakness.

Since the Federal Reserve and JP Morgan bail-out of Bear Stearns however, high yield markets have seen conditions improve. Spreads have narrowed and new issuance has been brought to the market. We have also witnessed erosion of the supply overhang in loan and high yield bonds. For the time being, the apparent willingness of central banks to ensure financial sector stability have eased systemic risk concerns that had dominated the market previously. Attention is now turning back towards economic indicators and company fundamentals.

ITRAXX CROSSOVER

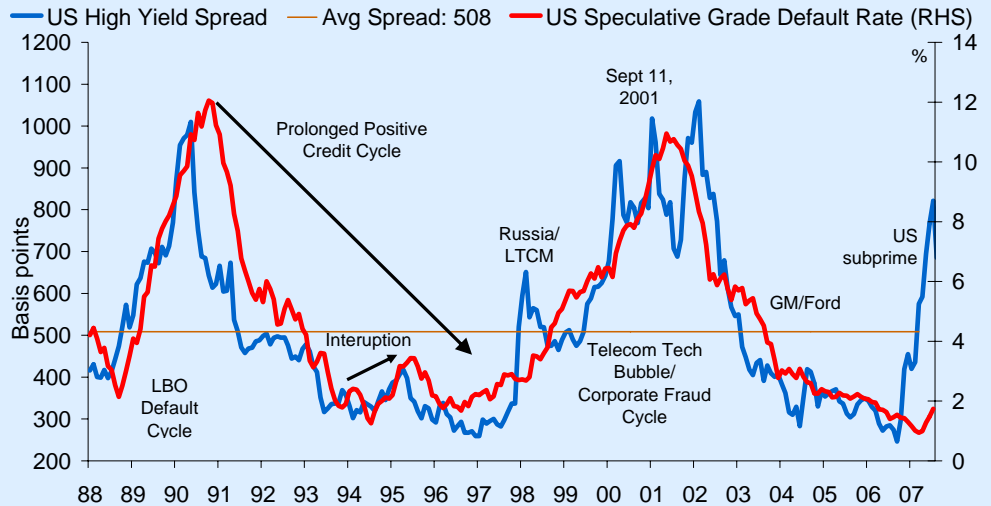
Source: Bloomberg, 24.04.08. ITraxx Crossover reflects a credit default swap basket on crossover companies between investment and sub-investment grade.

FUNDAMENTALS ARE LIKELY TO DETERIORATE

The key risk for the European high yield market is the extent of traction that the credit crisis inflicts on the real economy. Credit creation had been at the epicentre of strong global growth of the past five years and it is now both harder and more expensive to access finance (whether you are a household, a corporate or a bank). US economic indicators are teetering at recession levels while in Europe, the economic picture is deteriorating, albeit much more modestly. While pockets of Europe do face similar housing-related risks witnessed in the US (e.g. Spain, Ireland and the UK), European growth is expected to slow less sharply given its greater reliance on foreign trade (particularly emerging markets) and better equipped household balance sheets.

In this environment of economic weakness, a pick-up in company defaults is likely. Although we do not expect a return to the level of defaults seen in previous cycles and believe high yield markets may be pricing an overly dire economic scenario.

US CREDIT SPREADS vs DEFAULT RATES



Source: Bloomberg, 28.04.08. Shaded areas reflect periods of recession

THE EUROPEAN HIGH YIELD MARKET IS VERY DIFFERENT TODAY

In Europe, there are acute differences between the previous cycle and that of today and we do not expect a return to the level of defaults seen in the past slowdown.

At the broad level, the crash of 2000 to 2002 was associated with an excessively leveraged corporate sector and an overhang of tech-related companies with little free cash flow. In contrast, our analysts believe European high yield companies are currently in good financial health, with many still de-leveraging and earning good profits. Today's corporate sector is quite different to the lending excesses witnessed prior to the leveraged buy out and tech corrections.

Another important distinction is that the structure of the European high yield market is greatly different to what it once was - it is now more diversified by sector, more global and of a better quality. Telecoms accounted for 45% of the European high yield market in 2000 and were the key source of defaults. Today, telecoms account for 7% and the market is more balanced across sectors. The largest sector is now industrials and capital goods, which account for 28% of the market – in 2000 they accounted for only 12%. We don't view this as a risk for the market as many of these companies offer niche products and sell and produce globally across both developed and developing markets. With both a diversified customer and production base, we believe the global nature of industrials should help them better withstand economic weakness.

The final structural difference is that the quality of the market is now better. BB rated companies were only 15% of the market in January 2000 - today they account for 44%.

QUALITY ALLOCATION

%	Cash	BB	B	CCC	CC
Jan 2000	0.1	14.6	69.9	14.8	0.5
Apr 2008	0.4	44.4	46.7	8.4	0.0
Chg	0.3	29.8	-23.2	-6.4	-0.5

SECTOR ALLOCATION

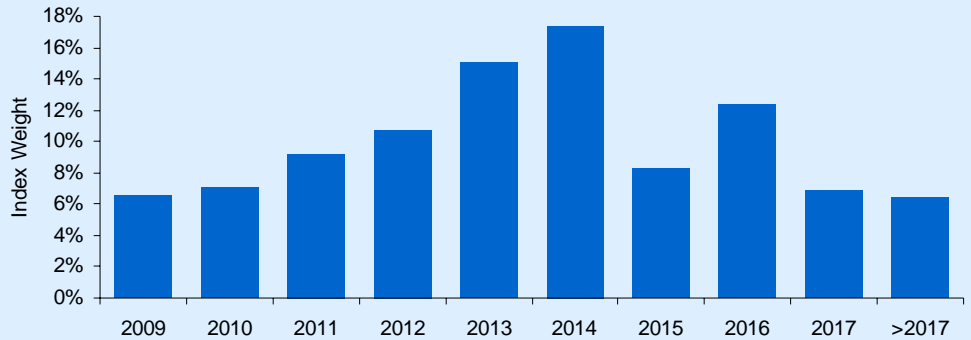
%	Cash	Banking	Basic Industry	Capital Goods	Consumer Cyclical	Consumer Non-Cyclical	Energy	Finance & Investment	Media	Real Estate	Services Cyclical	Services Non-Cyclical	Technology & Electronics	Telecommunications	Utility
Jan 2000	0.1	4.8	0.0	11.6	12.6	5.3	0.0	0.0	11.1	0.0	1.0	1.3	7.5	44.7	0.0
Apr 2008	0.4	7.0	14.9	13.5	14.8	6.5	2.6	1.3	8.6	0.9	16.6	3.1	2.1	7.3	0.3
Chg	0.3	2.3	14.9	1.9	2.2	1.2	2.6	1.3	-2.5	0.9	15.5	1.9	-5.3	-37.4	0.3

Source: Bloomberg, 03.01.00 and 23.04.08: Merrill Lynch Euro High Yield 3% Constrained Index

WELL-FUNDED COMPANIES

A final positive feature of today's European high yield market is the lack of upcoming refinancing requirements – for example, there are very few bonds maturing before 2011. Many companies are well funded with ample cash. This reduces the risk of companies experiencing liquidity-induced defaults, but it does still leave them open to operational risks as the economy slows.

EUROPEAN HIGH YIELD BOND MATURITIES



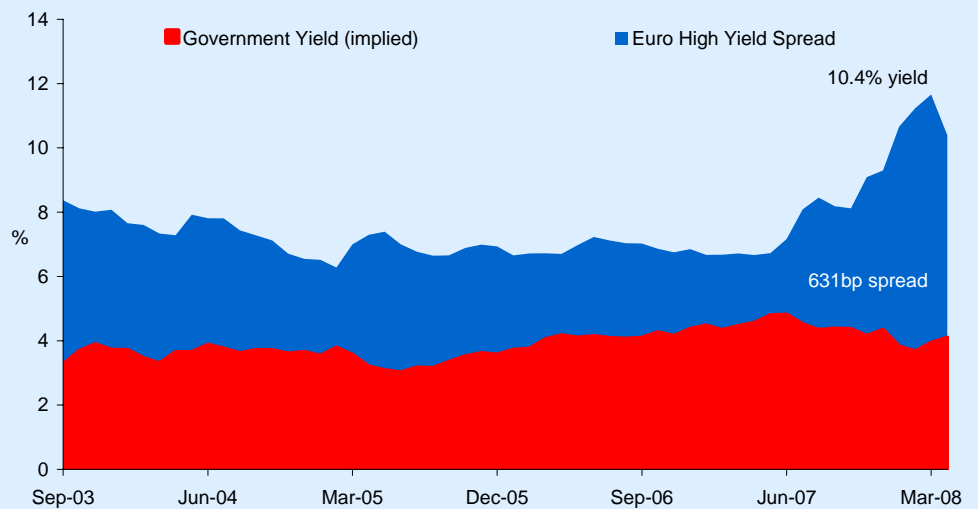
Source: Bloomberg, 01.04.08: Merrill Lynch Euro High Yield 3% Constrained Index

CONCLUSION: VALUE HAS BEEN RESTORED TO THE EUROPEAN HIGH YIELD MARKET

For investors with a medium-to-long term horizon, European high yield bonds are an attractive proposition. Spreads have widened substantially over the past nine months and value has been restored in the market. Most notably, BB and B areas are now offering high yields and attractive spreads – especially relative to the historic average level of defaults. Defaults are likely to rise however and in this environment, individual name selection is likely to be increasingly important for both avoiding those companies defaulting and identifying gems tarnished by broader market weakness.

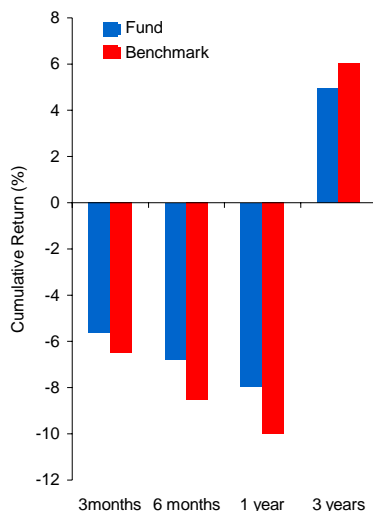
Importantly, markets are already compensating for a dire economic scenario and double digit yields help to cushion against the risk of defaults and further spread widening. Therefore, on a twelve month horizon we expect to see positive total returns from the asset class. In the near term however, volatility is likely to remain elevated as new signs of economic weakness emerge and we believe it is prudent for investors to enter gradually into the asset class.

EUROPEAN HIGH YIELD MARKET



Source: Bloomberg, 28.04.08: Merrill Lynch Euro High Yield 3% Constrained Index, uses option adjusted spread to compute government yield

FIDELITY FUNDS EUROPEAN HIGH YIELD FUND



Source: Morningstar Workstation as at 31.03.08.
NAV-NAV, gross income reinvested excluding initial charge in euros.
Benchmark: Merrill Lynch Euro High Yield 3% Constrained Index

Fidelity Funds European High Yield Fund launched in June 2000. Ian Spreadbury has been manager since July 2002.

FUND PERFORMANCE

Over the quarter to 31 March 2008, the fund outperformed its benchmark and secured a first quartile position (Morningstar Fixed Income Europe High Yield Sector).

Stock selection was the key driver of returns in the period with names including Nordic bus group Concordia, Russian bank VTB and lead recycler Eco Bat, all adding to performance.

At the sector level, an underweight exposure to the consumer and banking sectors boosted relative returns amid declining consumer spending and deepening financial market crisis. A tactical exposure to European government bonds also proved beneficial. In contrast, my selection in the telecoms and utilities sectors namely Greece-based Hellas Telecom and the Hungarian company, Invitel weighed on performance.

Overall, the fund was defensively positioned, favouring bonds that were shorter-dated than the benchmark. For example, the fund was underweight BB-rated bonds, which was an area of the market dominated by longer-dated issues. This strategy proved beneficial as these bonds underperformed through the spread widening.

FUND POSITIONING

The economic environment is deteriorating and volatility in high yield markets is likely to stay elevated in the near term as de-leveraging continues. Looking longer term however, defaults are still low and from a valuations standpoint, spread widening is making European high yield bonds attractive. With this in mind, the manager increased credit risk levels in the quarter, albeit from a defensive base.

The fund selectively added exposure to previously underweight areas in the period, including B and BB-rated issues such as travel and shipping travel services company TUI. The portfolio continues to hold selective names in emerging markets, particularly Eastern Europe, Asia and South Africa. The fund retains exposure to oil rig bonds and is overweight the energy sector. The fund is underweight consumer oriented companies as the manager is cautious about the outlook for consumer spending in Europe and globally.

Overall, the fund is highly diversified across sectors and remains focused on companies with limited re-financing needs, an improving credit profile, an ability to deliver sales growth and a short-to-medium term payment horizon.



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