

FIXED INCOME PERSPECTIVES

December 2007

Our philosophy for successful fixed income management is to identify and capture many lowly-correlated sources of alpha within each portfolio. The driving force for investment ideas is our own credit and quantitative research. This discipline requires a collective approach from our team of specialist analysts and managers, in order that the best ideas are shared and the most valuable strategies are subsequently implemented.

Fidelity International Fixed Income Strategy

The Fidelity Fixed Income team meets regularly to discuss current and future drivers of bond and money markets, and resultant investment strategies for the Fidelity fund range. The PERSPECTIVES report summarises these discussions and outlines Fidelity's view on the global fixed income environment.

HIGHLIGHTS

PAGE

Interest rates and inter-market allocation

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- More US interest rates cuts are expected, although bond yields already discount much of this
- ECB is likely to remain hawkish and keep Euro rates on hold
- Economic data is not supportive of hikes by the BoJ and Japanese yields are likely to trade in a range
- UK rates may fall further in the new year although we do not expect the economic slowdown to be dramatic and inflation remains a concern

Yield curves

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- Favour curve steepening, especially in US and UK

Credit allocation

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- Still cautious on credit exposure short term, but valuations suggest good opportunities longer term
- Structured credit (SIVs, ABS etc) and inter-bank lending market to drive market in the near-term
- Credit fundamentals are deteriorating but spreads have widened to compensate for the higher default environment

Sector allocation

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- Financials are cheap relative to both history and non-financials and the early quarters of 2008 may provide the opportunity to overweight financials. However, off-balance sheet structures are of concern and slowing economic activity threatens future earnings
- The cyclical nature of industrials means that they are not immune to slowing global growth
- Defensive areas such as telecommunications and regulated utilities remain a key focus

High yield and emerging markets

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- Cautious about the outlook for European high yield: credit quality is deteriorating, issuance pipeline is large and market liquidity is low
- We have seen some decoupling of emerging markets but the rising risk of a US recession and extended credit crunch pose significant risks.

Interest rates and inter-market allocation

Slowing economic growth and challenging credit market conditions are likely to keep pressure on central banks globally; the trend of falling interest rates appears likely to continue, particularly in the US and UK. In recent months, we have become more cautious on the outlook for the global economy due to tightening credit conditions and an excessively leveraged household and financial sector.

“...CAUTIOUS ON THE
OUTLOOK FOR THE
GLOBAL ECONOMY”

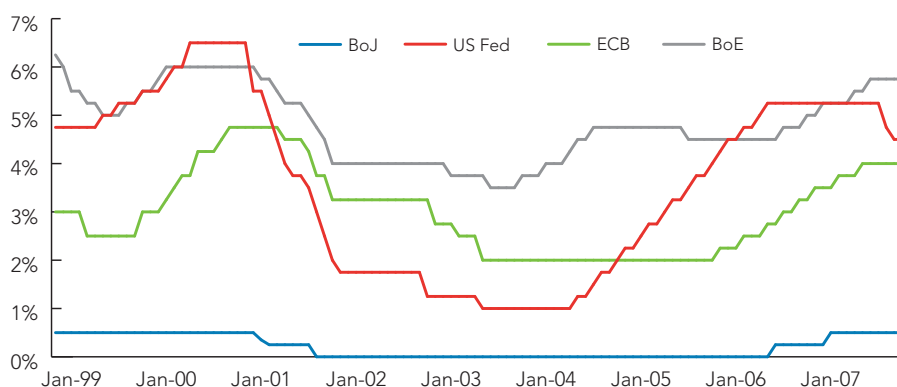
Our base case is for the US economy to experience a mid-cycle slowdown and avoid recession next year. While looser financial conditions (by way of lower interest rates and a depreciating US dollar) can help cushion the economy, we are increasingly mindful that the longer credit markets remain fractured, the greater is the risk of a hard landing scenario. Credit market turbulence is likely to slow the economy as banks tighten lending criteria and the capacity and willingness to lend falls. Market uncertainty is also affecting household and business sentiment and this is likely to dampen the appetite for borrowing, investing and consuming. However, from an investment point of view, we are mindful that bond markets are already discounting much of the potential bad news on the economy (pricing in 75 to 100 basis points of easing by June 2008). Overall, we are broadly neutral duration in the US.

In the UK, the Bank of England's November Inflation Report highlighted downside risks to economic growth but judged inflation risks to be more balanced. We believe the UK economy will slow but not dramatically and we don't anticipate outright declines in house prices. We expect the Bank of England to lower base rates at least a further 25 basis points over the coming twelve months, although the downside risks to economic growth are such that more cuts may be required. Our bias is therefore to be long duration in the UK.

While growth concerns have dominated the economic landscape in the UK and US in recent months, rising inflationary pressures have kept Eurozone short rates higher. Inflationary pressures continue to rise, with CPI up by 3.0% year-on-year in November, reflecting higher energy and food prices. We expect the European Central Bank to continue with a more hawkish tone and to keep rates on hold. Markets are already pricing in static rates. Relative to the UK and US, we attach a smaller probability to a hard landing scenario for the Eurozone but are still mindful that slowing US growth may have a detrimental effect.

The Bank of Japan appears eager to continue normalising interest rates, albeit gradually. Consensus expectations for real GDP growth in 2008 are currently 1.8% , although we believe the deteriorating economic picture globally presents a key downside risk. We expect the BoJ to hold rates steady over coming quarters as the economic data flow remains benign.

CHART 1: Global interest rates



Source: Bloomberg, 30.11.07

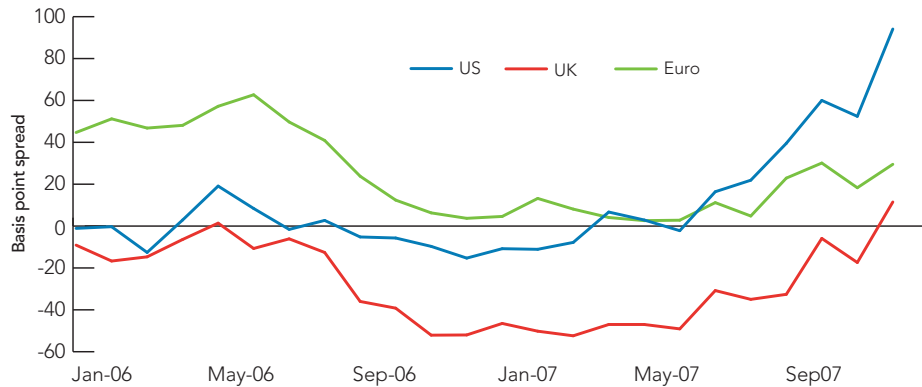
Yield curves

Yield curves have steepened sharply in recent months, reflecting both expectations of central bank easing ahead and investors flocking to safe haven assets. The steepening has been most pronounced in the US and UK where concerns about a housing-driven slowdown have been more salient. Overall, with market sentiment continuing to be driven by developments in the global banking sector and growing inflationary pressures, we expect the steepening trend to continue further.

"...WE EXPECT THE YIELD CURVE STEEPENING TREND TO CONTINUE FURTHER"

In Japan, however, as little is expected to further normalise monetary policy and amid rising inflationary pressures, government bonds are unlikely to break out of their current trading range.

CHART 2: Spreads between 2 year and 10 year government bonds



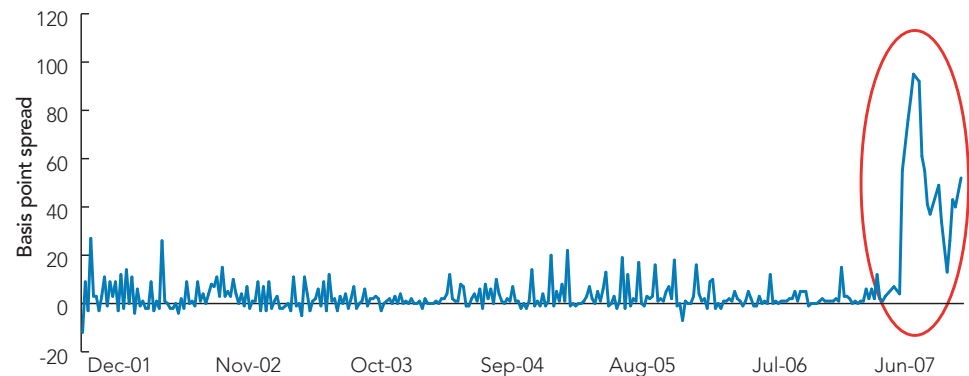
Source: Bloomberg, 30.11.07

Credit allocation

"...MARKET DISLOCATION PRESENTS MANY OPPORTUNITIES"

Our near term credit outlook remains cautious with a focus on developments in the markets for structured products (SIVs, CDOs, ABS etc) and inter-bank market liquidity. Amid this uncertainty, the next few months could see further underperformance by financials and cyclicals.

CHART 3: Spread between Fed Funds Target Rate and 1 day asset-backed commercial paper



Source: Bloomberg, 30.11.07

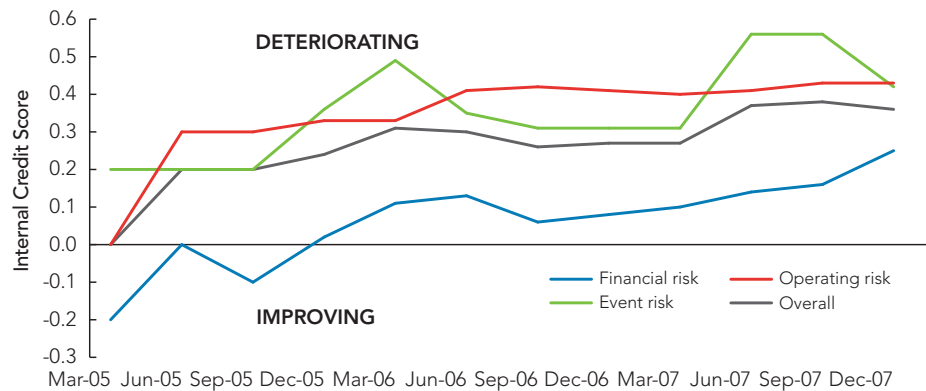
We expect the time to overweight financials and potentially become more positive on credit generally is once new issuance is absorbed and banking sector visibility returns to the market. Meanwhile, spreads have widened to compensate for a higher default environment and the market dislocation presents many opportunities.

From a medium-term perspective, our analysts believe that credit fundamentals are deteriorating, with a notable rise in financial risk in the third quarter of 2007. Positive factors for the market rest on solid company balance sheets with leverage contained, potential central bank easing of monetary policy, confidence returning to the money and asset-backed commercial paper markets and economic growth showing resilience. However, many areas of the market remain dislocated, housing adjustments are ongoing, company earnings trends are deteriorating and issuance is likely to dampen the likelihood of a strong rally.

Positive and negative factors affecting credit markets

Positives	Negatives
Central bank intervention	Money and ABCP markets far from a normal state
Regulatory safety net for financial industry	LIBOR tightening post fed cut stalling
Brokers/banks starting to clear the decks	Shockwaves of possible monoline downgrades
Tentative signs of improvement in money and ABCP markets	Bond supply outstripping demand
Some LIBOR reduction	Leveraged state of the consumer
Re-opening of leveraged loan market	Correction in housing markets accelerating
New buyers of debt emerging	Connection between lending standards and default rates
Fewer forced unwinds	Pure credit quality measures are declining
Resilience of Asia and Emerging Markets	Earnings trends are deteriorating, fears of further negative surprises
	Impact of an equity sell off
	Premiums for cyclical credit at pre-summer lows

CHART 4: Fidelity credit analyst survey of credit fundamentals



Source: Fidelity, 30.11.07

“THE MARKET HAS INDISCRIMINATELY DE-RATED ABS”

Within credit markets, asset-backed securities have experienced some of the greatest corrections as the market has indiscriminately de-rated the asset class. However, the ABS sector is wide and varied and we continue to hold selective exposure to highly rated ABS across many of our portfolios. We have avoided risky areas of the home mortgage market, instead focusing on prime mortgages in the more stable European markets, and a larger focus has been in the estates of tenanted pubs, shopping centres and commercial mortgages. These are assets we feel confident about and where we believe that valuations are attractive. In the short-term, however, a negative tone may continue to dominate the asset class amid a mix of forced sales, large supply and further news of subprime defaults.

Sector allocation

We believe that financials offer the greatest valuation disconnect but deteriorating trends in fundamentals make us cautious about the sector for the time being. Asset quality is softening, capital ratios are under pressure and near term liquidity pressures are high. Meanwhile, the slowing economy is dampening the outlook for earnings.

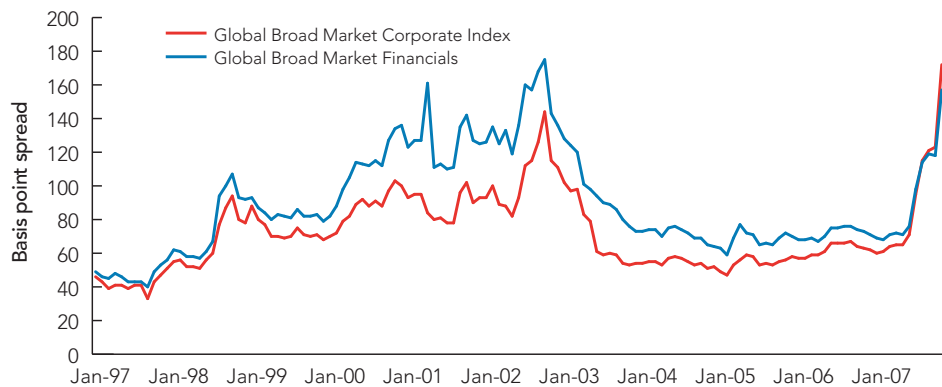
"...OUR PREFERRED STRATEGY IS TO PURSUE POSITIONS HIGH IN THE CAPITAL STRUCTURE"

Looking ahead, we expect increased differentiation across issuers and we are closely monitoring countries such as Spain, Ireland and the UK, that are heavily dependent on housing construction, for signs of weakness. Our preferred strategy is to pursue positions high in the capital structure, as we believe Tier 1 and 2 issues may see wider spreads. However, we do not believe that now is the time to be aggressively overweight banks and we are only gradually increasing exposure to selective names. Looking further forward, we do see some potential for improvement in the early quarters of 2008 as the release of official audited statements should help to clarify the strength of balance sheets.

In industrials, credit fundamentals have been stable in recent quarters but their cyclical nature means they are not immune to slowing global growth.

For non-financials, default risk is still low and balance sheets remain strong. Earnings growth is likely to slow, however, and management initiatives have been increasingly swayed against bond holders. In this environment, utilities, telecommunications and tobacco are safe sectors offering good valuation; we also see opportunities in autos.

CHART 5: Financial sector spreads vs broader market spreads



Source: Bloomberg, 30.11.07

High yield and emerging markets

We are cautious about the outlook for European high yield. While defaults are still low, credit quality is deteriorating, the issuance pipeline is large and low levels of liquidity are keeping spreads wide.

"...SOME DECOUPLING OF EMERGING MARKET BOND ASSETS"

We have seen some decoupling of emerging market bond assets through the recent period of credit market turbulence. Strong commodity prices and better country financial positions have helped instil investor confidence in the asset class but the rising risk of a US recession and extended credit crunch pose significant risks to the decoupling thesis. Emerging market investments are made on a name specific basis; while the asset class carries risks as a whole, specific countries and companies can provide us with interesting, uncorrelated ideas.

AT A GLANCE

	31.07.07	30.11.07
Bond Yields	%	%
5-Year US Govt Bond Yield	4.56	3.39
5-Year Euro Govt Bond Yield	4.32	3.91
5-Year £ Govt Bond Yield	5.37	4.59
5-Year Yen Govt Bond Yield	1.38	1.04
Corporate Bond Spreads	bps	bps
US- AAA	79	116
US- BBB	162	234
Euro- AAA	27	47
Euro- BBB	94	143
UK- AAA	62	94
UK- BBB	135	212
Japan- AAA	14	23
Japan- BBB	40	52
3 Month LIBOR Rates	%	%
US	5.36	5.13
EURO	4.26	4.81
UK	6.04	6.61
JAPAN	0.78	0.99

Source: Bloomberg, 30.11.07



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