

# In Perspective

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## Mixed outlook for global markets



**Andy Weir** is a portfolio manager in the Fixed Income team at Fidelity.

Andy has been with Fidelity for thirteen years; he joined in 1997 as a Quantitative Fixed Income Analyst and was promoted to Director of Quantitative Research in 2002. He became a Portfolio Manager in December 2003. Prior to joining Fidelity, Andy spent five years with JP Morgan Investment Management.

*"Economic growth in developed world economies is still hampered by the debt overhang left in the wake of the financial crisis. Against this backdrop, with unresolved issues in Europe, I expect the global market to remain volatile."*

*The outlook for global corporate bonds is favourable as corporate balance sheets remain relatively robust, monetary policies are accommodative and these bonds offer attractive valuations on selective names.*

*Although inflation is showing signs of cooling down, the tail-risk remains that developed market central banks continue to expand their quantitative easing programmes and reverse this "cooling" period. I would expect index-linked bonds to outperform in this environment going forward."*

Andy Weir, Portfolio Manager

### US

Within the US, I am cautiously optimistic that there will be economic recovery signs going into 2012, notwithstanding external shocks from the Eurozone. Additionally, I continue to believe that US treasuries will remain a sector for investors who are looking for both liquidity and solvency as the US returns to a modest growth level.

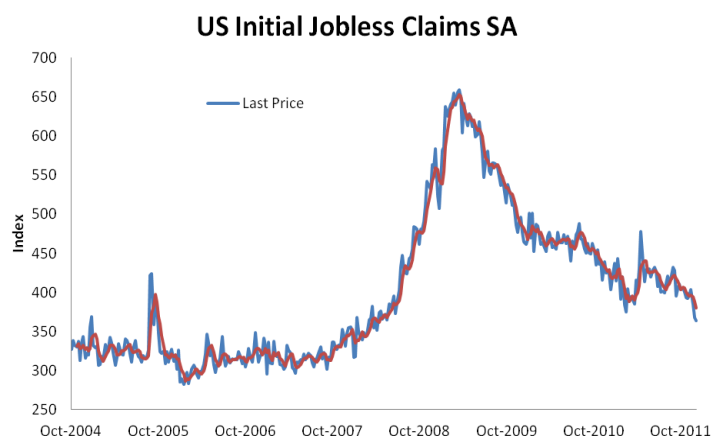
Overall, I expect US treasury debt issuance will remain stable if not to grow during 2012. The U.S. sovereign rating remains stable for the time being. However, this is balanced with the past years negotiations between Democrats and Republicans to secure spending cuts having not achieved much success earlier in 2011. Looking forward this "deadlocked" political process will no doubt result in further wrangling down the line increasing uncertainty in already volatile markets.

On the flip side, whilst the U.S. economy looks to continue to expand in 2012 with these modestly good signs of improvement, it's likely that the recovery going forward will be an uneven one. We have seen recent evidence of the U.S. consumers pouring into the malls during Thanksgiving weekend, accompanied with the Black Friday retail discount window in the U.S, spending a record \$52.4 billion. Going into the Christmas period I will be watching with keen interest to see if this retail purchasing momentum is carried forward into 2012. I believe overall growth to be moderate versus the more broadly stated optimistic consensus views.

On inflation, I believe September saw the peak of domestic inflation in the US CPI numbers at 3.9%, there is likely to be a moderation in domestic inflation. This likely will help create additional headroom for expansion of the QE programmes should the US hit another dis-inflationary bout.

With unemployment rates falling marginally, there is mixed data coming from the US, with modest optimism that the pressure from excess capacity in labour markets is slowly easing. The chart below shows the US department of labour's weekly initial jobless claims, which is constructed to show the actual number of people who have filed for unemployment benefits for the first time. Clearly this is still elevated, however the trend is down and nearing the 2005 levels.

### JOBLESS CLAIMS TRENDING DOWN FROM ELEVATED LEVELS

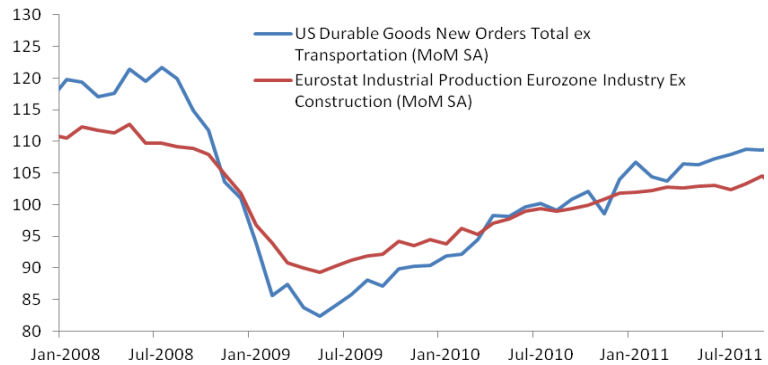


Source: FIL Limited, Moody's, 30/11/2011.

The obvious concern is that any likely that further problems in the confidence of the Euro zone would likely also start to manifest themselves in the US financial sector. I look to monitor this closely. The chart below shows the PMI measures since the global financial crisis, given that the US was the epicentre of the 2008 crisis, there has been some recovery in the realised data during 2011 as the US activity has outpaced Euro PMI, with the Eurozone being weighed down by its political issues. I expect this trend to persist going into 2012.

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## US ACTIVITY WILL CONTINUE TO OUTPACE THE EUROZONE



Source: Bloomberg, using BofA Merrill Lynch Indices, 15/12/2011.

## JAPAN

Barring the earthquake and tsunami, Japan has largely remained out of the headlines. The disinflation dynamic in this region shows no sign of abating as this lack of inflation ultimately continues to benefit the aging population. Over 2012, I see that economic growth remains benign, and does not contribute to overall global growth. I maintain that domestic capital will continue to seek higher yields elsewhere and investors continue to be frustrated with the lack of investment opportunity within Japan itself.

## EUROPE

Eurozone breakup is a nightmare that politicians will try to avoid. I believe that next year's outcome remains opaque and unclear. Accordingly, I look to size my bets accordingly to the volatility and uncertainty around the unresolved political disputes going into 2012. I believe that the markets have seen a brief reprieve from the outward volatility; there have been some changes with the technocratic governments taking charge in Greece and Italy. Given the failure of the various political Eurozone parties to come to agreement in previous meetings, I am not likely to change my stance on a possible "solution" to fix the Euro crisis comprehensively. Whilst I expect that the European project will survive in some shape or another form, I do expect additional debate which will lead to further uncertainty. I remain cautiously sceptical on Europe, with my focus to monitor this closely going forward into the New Year.

Mass fiscal austerity and bank deleveraging will continue to depress growth as all governments in Europe plan to cut their budget deficits further in 2012. Further sovereign rating cuts from debt agencies will not doubt rattle markets – although anticipated, negative rating actions in Europe can only serve to undermine confidence and the capacity of Eurozone support mechanisms such as the EFSF and the ESM, which rely on the ratings of their sponsors. S&P downgrades are imminent given that the stated requirement for confirmation following the recent summit (stronger ECB support) has not materialised. Moody's and Fitch have also signalled that they will revise their Eurozone ratings, most likely already in January 2012.

Governments will continue to stutter towards closer fiscal union but Germany is unlikely to sanction intra-Eurozone fiscal transfers – because fiscal and structural reform cannot happen quickly enough, the only short-term palliative to the Eurozone mess is a pooling of fiscal risk. Either that has to happen through the ECB or through de facto fiscal transfers.

The ECB has the ability but not yet the willingness to produce a big positive surprise – since August, the ECB's interventions in the secondary sovereign bond market have been the major driver of sovereign yields in the Eurozone. However, these interventions are unpredictable. The market has broadly been led to expect that the ECB would reward action by politicians to cut fiscal deficits and implement structural reform. It is difficult to see the ECB giving up on sovereign support (because that would cause defaults) but trying to guess when and in what quantities the ECB will intervene in any given week or ultimately provide the ultimate backstop to sovereigns is left for those that are absolutely clairvoyant.

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Hence, bond yields, especially in the periphery will likely remain very volatile until the ECB comes out with a clearer strategy. Forceful ECB intervention could cause a big reversal of deteriorating bond yields, at least on a temporary basis.

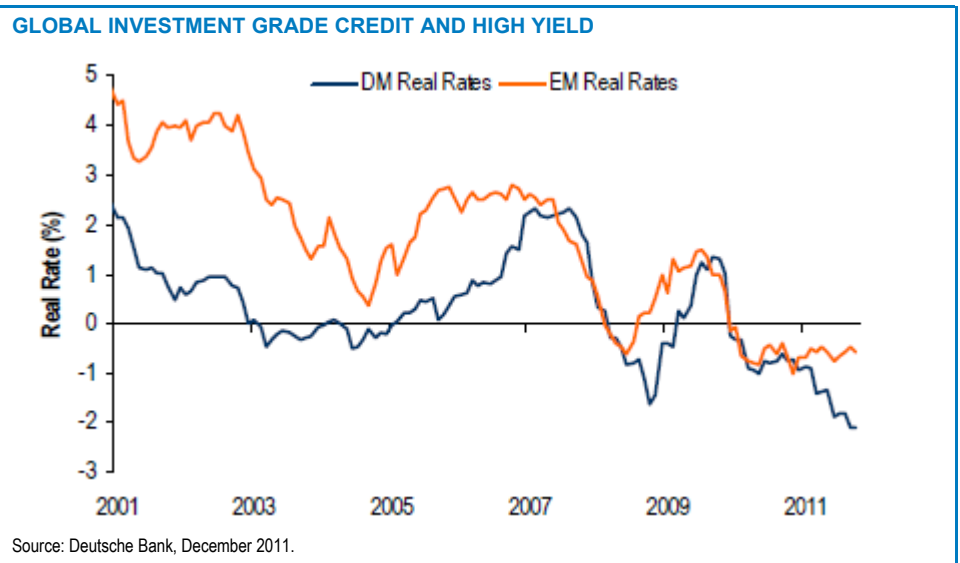
Eurozone breakup is a nightmare that everyone should try to avoid – the costs of a breakup of the Eurozone are difficult to comprehend and would be very substantial both for weaker and for stronger countries. Weaker countries would see a massive devaluation of any new currency, capital flight, a breakdown of their banking system, hyper inflation. Stronger countries would experience a large currency appreciation that would hit exports, damage to balance sheets from the drop in the value of foreign assets, inflows of economic refugees etc. The EU could not survive such an event because it rests on the free movement of capital, labour and trade. All three would be disrupted in the event of countries leaving the euro. Capital controls would have to be introduced to stem capital flight; other countries would erect tariff and immigration barriers in response. Of course, a break-up of the Eurozone could happen by accident or by the sheer force of events but it is not something I believe that policy makers, including the Bundesbank, will willingly allow to happen.

## EMERGING MARKET DEBT (EMD)

I will look to remain cautiously invested in EMD securities. I view it as a common overweight amongst investors and hence very sensitive to global risk aversion levels. My belief is that although emerging markets are set to grow over a super secular basis, I am not convinced that the very strong performance of the past can necessarily be repeated in the short term and hence I am sceptical about future volatility. I maintain a cautious and opportunistic investment with this sector.

## GLOBAL INVESTMENT GRADE CREDIT AND HIGH YIELD

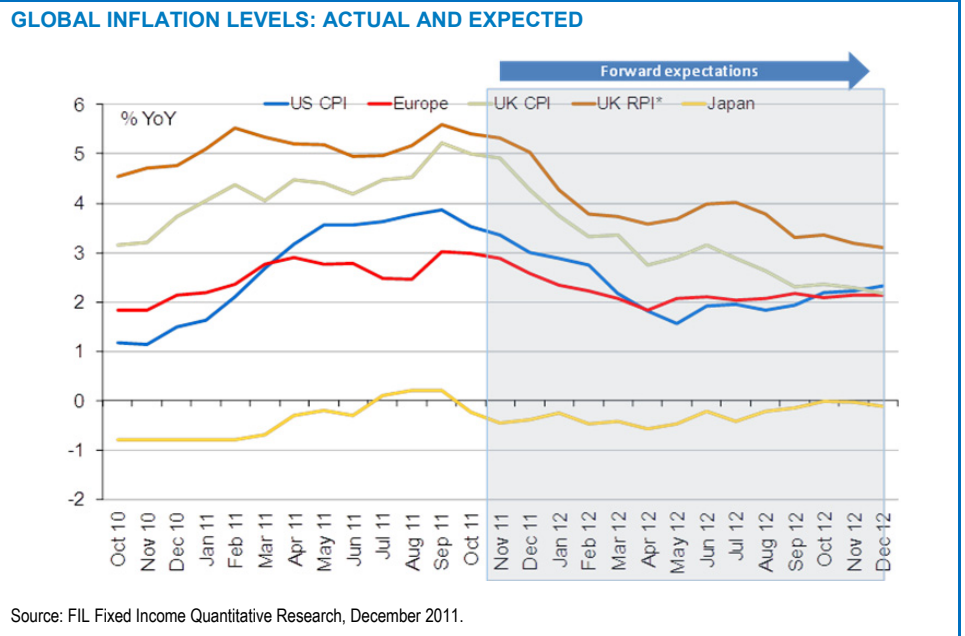
Sovereign risk will remain a large component of the volatility I expect to see in 2012, given all the unresolved issues in Europe. I do believe that corporate fundamentals are still strong, given this; I favour industry and/or company risk of globally diversified organisations. Going into 2012 I will look to maintain a cautious overweight approach to investing ensuring that the potential payoff is fairly rewarding compare to expected / perceived risk exposure to my portfolio. I will maintain high liquidity but also take exposure to high quality corporate names in the IGC and HY space where possible in order to take advantage of the higher yields where there is potential for upside. When selectively chosen, I believe corporate spread investment grade names can provide an attractive relative value proposition to low yielding AAA-AA government bonds. As stated, sector and stock selection is very important going forward. With global government nominal rates being so low, coupled with still elevated, but modestly moderating inflation levels, I expect that this will continue to produce negative real rates globally. Investors will look to reach for yield in the coming yield by adding corporate spread risk to their portfolio.



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## GLOBAL INFLATION-LINKED BONDS

The expectation for global inflation levels is to moderate, however still to remain above central bank target rates for the intermediate future. Of course, inflation is a global economic phenomenon.



Six months ago, I predicted that major developed market headline and core inflation would start to decline towards the end of the year and we still hold that directional view, however it is fair to say that both headline and core inflation surprised on the upside. It is this stickiness of inflation that is the concern that the market should be pricing-in, but are not. Going forward, our models forecast that inflation in the US, the UK and core European economies will remain above central bank targets well into the first quarter of 2012. Although we expect inflation to remain contained, the tail risks are high given the potential for the unprecedented level of monetary stimulus in the global economy.

Of course, higher inflation levels are good for the carry-return aspect of inflation-linked bonds. Additionally, breakevens continue to remain attractive relative to historic standards; this is the difference between nominal and real yields, which indicate the level of annual inflation that markets are pricing-in over a certain time period. From this perspective, inflation-linked bonds look rather attractive in the medium- to long-term, as inflation remains a significant tail risk.

I continue to monitor further rises in commodity prices and the potential overheating of emerging economies. Increasingly, I tend to look for inflation in EM and other developed countries, with better initial conditions, where the output gap is relatively tighter as I believe inflation will likely be seen in these regions first before being exported to the remainder of the developed world where the output gap is wider.

Overall, I still firmly believe that a global approach to investing should be favoured. Global inflation-linked bonds are highly correlated with various domestic inflation measures and an investment in global inflation-linked bonds benefits from greater liquidity than a domestic orientated approach. The possibilities for generating returns are greater, given the wider opportunity set.

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