

It is time to protect your real income



Andy Weir is the portfolio manager of Fidelity Funds - Global Inflation Linked Bond Fund.

Andy joined Fidelity 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 and has managed FF -Global Inflation Linked Bond Fund since its launch in May 2008.

Prior to joining Fidelity, Andy spent five years with JP Morgan Investment Management. He holds a BEng from Nottingham University.

Recent declines in equity markets and developments around sovereign debt risk have raised questions about the sustainability and magnitude of the economic recovery in the developed world. Against this backdrop, increasingly conflicting signals regarding the direction of inflation in the year ahead can be seen. Andy Weir expects the inflation/deflation debate to rage as intensely as ever, as long as the macroeconomic picture remains uncertain.

WHERE DO YOU THINK INFLATION COULD HEAD IN 2010?

Our quantitative research team runs inflation forecast models which currently point towards a positive, but stable, level of inflation this year. Two conflicting views are currently being heard in the markets, keeping expectations in check.

GDP data releases are showing the economy to be in much better shape than a year ago, although the threat of deflation is still present. The main reason for the persistence of the deflationary argument is the amount of excess capacity in the economy, having arisen because of the sharp fall in economic output back at the end of 2008. Large output gaps typically keep the growth in prices, corporate margins and wages contained, if not negative.

However, there are also signs that point to an increase in inflation. Amongst those is the unprecedented monetary stimulus implemented by governments and central banks worldwide in response to the global credit crisis. Quantitative easing amounts to over 10% of GDP in countries such as the US and UK. Although money velocity has remained contained, it could well become an issue in the coming years and result in higher inflation.

In China, inflationary pressures have started to spread across a number of sectors within the economy, with inflation now running at a high single-digit pace. Loose monetary policy and the rapid acceleration in money supply growth have translated into rising commodity prices and an increase in Chinese asset prices such as property. It is this commodity-led pressure that could easily lead to unexpected, high inflation.

Nevertheless, I don't expect inflation to become out-of-control in the short-term as there are too many uncertainties in the economy. Excess liquidity and rising commodity prices will likely drive inflation upwards globally in the long-run but, for 2010, my base case is a low growth environment where inflation remains under control.

AND BEYOND 2010?

I expect inflation to become a greater concern in 2011. The market isn't pricing this in yet. Current ten-year breakevens in the US are at 2.3% (as at 18.02.10). I believe this is attractive relative to history and so now is a good time to start building in some inflation protection.

WHY USE INFLATION LINKED BONDS TO PROTECT AGAINST RISING PRICES RATHER THAN OTHER ALTERNATIVES?

Inflation is typically the key enemy of a fixed income investor, so inflation linked bonds are the natural solution. With coupons and principal indexed to a level of consumer prices, and typically being issued by stable, high quality countries, inflation linked bonds have a demonstrable track record of being an effective, low-volatility hedge against rising prices. They also show a negative correlation to risk assets, which is particularly useful for diversifying a portfolio.

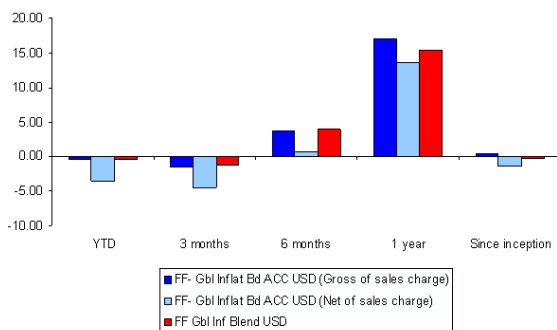
Other investments can insulate a portfolio from inflation risks but they all tend to carry a higher degree of speculative risk. Real estate, for example, is more volatile – and also less liquid. In the same vein, gold has been closely correlated to inflation over the long-term but the increasing role of speculative buyers in setting its market price doesn't make it a risk-free solution either.

Equities are also seen as a good inflation hedge. Stocks in the natural resources, tobacco, food and pharma sectors are popular with investors for this purpose. However, the results can be imprecise over shorter time periods and they too also exhibit higher volatility.

FUND

RETURNS (%)

as at 31.01.10



Source: Fidelity. NAV-NAV in USD, with gross income reinvested

Benchmark: BofA Merrill Lynch Global Inflation-Linked Government Index. (Note that, with effect from 01.02.10, the fund benchmark has changed to Barclays Capital World Government Inflation Linked Bond Index)

Launch date: 29.05.0

Past performance is not indicative of future performance.

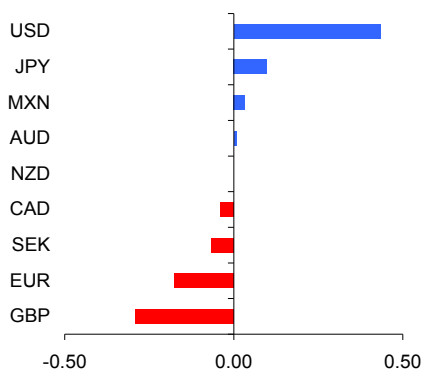
CORRELATION OF INFLATION ACROSS REGIONS

	US	Japan	UK	Global	Europe
US	1.00	0.84	0.94	0.96	0.83
Japan		1.00	0.86	0.91	0.78
UK			1.00	0.97	0.82
Global				1.00	0.92
Europe					1.00

Source: Bloomberg, data from 31.01.79 to 31.12.09.
 *France CPI is used as a proxy for long history Europe inflation. RPI release is used for UK inflation history. Global CPI is approximated using weighted average of regional CPI's.

FUND'S INFLATION POSITIONING RELATIVE TO BENCHMARK

as at 31.01.10



Source: Fidelity
 Positioning is shown in years of real interest duration of the fund relative to its benchmark. Real interest rate duration is a measure of the sensitivity of an asset's price to real interest rate movements. A real interest rate is an interest rate adjusted for inflation. According to the Fisher equation, the real interest rate is defined as the nominal interest rate minus the expected rate of inflation.

WHAT IS THE ADVANTAGE OF GLOBAL INFLATION PROTECTION OVER DOMESTIC PROTECTION ONLY?

Inflation is a global phenomena and the correlation of CPI data over the last 30 years is extremely high. A global approach to investing in inflation linked bonds offers three key advantages:

- The wider opportunity set makes it easier to exploit valuation distortions and to hedge against inflation by using a mix of the cheapest possible markets. For example, the Japanese five-year breakeven is -1.0% (effectively pricing in deflation of 1% in each of the next five years). With equivalent US breakevens at 1.9%, even though current inflation is running at 2.7%, that makes Japan and US look attractive relative to Europe.
- There are obvious diversification benefits to a global approach. I have already mentioned the negative correlation to equities and the low correlation to government bonds. Choosing a global, rather than domestic approach, improves the diversification benefits.
- Looking beyond the domestic market opens up a bigger, and often more liquid, market. As the inflation linked bond market continues to grow, liquidity remains a challenge in some individual markets. A global approach makes it easier to overcome some of these challenges.

WITH ALL THIS IN MIND, HOW IS THE FUND CURRENTLY POSITIONED?

Over the last six months, increasing interest has been seen in the global inflation-linked bond asset class. I have allocated the new funds to be overweight US Treasury Inflation Protected Securities (TIPS) and overweight Japanese linkers where, as I explained previously, breakevens are still attractively priced. Conversely, I am underweight Euro linkers, as I see less scope for a near-term inflation threat. I am also underweight UK index linked gilts as I believe they are currently overpriced.

With regard to "non-core" inflation linked bond markets, I sold exposure to Greek and Mexican bonds ahead of the fund's recent benchmark change (from the BoA Merrill Lynch Global Inflation Linked Government Index to the Barclays Capital World Government Inflation Linked Bond Index, which does not include any countries with less than an A rating).

Lastly, I have used the fund's flexibility to invest in a limited amount of nominal bonds. I have maintained exposure to Euro nominal bonds on the back of my bearish view on the Eurozone's economic outlook. I have also kept less than 6% invested in high-quality nominal corporate bonds. The latter is a tactical beta play rather than a strategic position.

"Uncertainty may dominate the path of inflation in 2010 but, longer term, inflation will be an issue globally. I believe the market has not priced this in completely as breakevens are still historically attractive. It is therefore a good time to build up inflation protection via inflation linked bond instruments, before it gets too costly."

Andy Weir, Portfolio Manager

Disclaimer

This document is prepared by FIL Investment Management (Singapore) Limited ["FILS"] (Co. Reg. No.: 199006300E), a responsible entity for the fund(s) in Singapore. All views expressed cannot be construed as an offer or recommendation. Prospectus for the fund(s) is available from FISL or its distributors upon request. Potential investors should read the prospectus before deciding whether to invest in the fund(s). Reference to specific securities or fund(s) is included for illustration only, and should not be construed as a recommendation to buy or sell the same. This document is for information only and does not have regard to the specific investment objectives, financial situation and particular needs of any specific person who may receive it.

Potential investors should seek advice from a financial adviser before deciding to invest in the fund(s). If that potential investor chooses not to seek advice from a financial adviser, he should consider whether the fund(s) in question is suitable for him.

Past performance of the manager and the fund(s), and any forecasts on the economy, stock or bond market, or economic trends of the markets that are targeted by the fund(s), are not indicative of the future performance. Prices can go up and down. The value of the shares of the fund(s) and the income accruing to the shares, if any, may fall or rise. Investors investing in fund(s) denominated in a non-local currency should be aware of the risk of exchange rate fluctuation that may cause a loss of principal when foreign currency is converted back to the investors' home currency. Exchange controls may be applicable from time to time to certain foreign currencies.

Fidelity, Fidelity International and Fidelity International and Pyramid Logo are trademarks of FIL Limited.SG10/069.