Monthly Newsletter

Fixed Income Insight

May 2012

Is Germany going to save Eurozone?

Angela Merkel faces a dilemma. Does she bow to the inevitable and lead from the front, or does she stick her heels in and risk pushing Europe over the cliff? The problem for Germany is that it can't simply run away. Either it must grit its teeth and plunge further in, underpinning the Eurozone's sagging foundations with its government balance sheet. Or it must contend with a rising torrent of capital inflows and its attendant perils. Either way, it will end up paying a heavy price. On balance, the political and economic incentives still favour its holding the Eurozone together.

Germany's public finances, while strong, are not invulnerable. Although its budgetary discipline is exemplary, it has a sizeable stock of debt. In gross terms, Germany's general government debt is around 80% of GDP, compared with an average for AAA-rated sovereigns of 50%. The US was downgraded last year when its general government debt crossed the 100% threshold, whereas France suffered a similar fate at around 85%. Unlike these two countries, Germany's direct public debt is on a firm downward trajectory and it has sizeable offsetting financial assets. The country is also a net external creditor and has limited private sector debt. Yet these examples show that Germany's public finances are not immune from scrutiny. S&P has Finland's AAA on negative outlook despite the fact that its government balance sheet is far stronger.

This makes the issue of rising contingent liabilities a sensitive one for Germany. It has guaranteed the EFSF to the tune of 8% of GDP. Its capital subscription to the ESM is worth around 7% of GDP. It has shelled out 15 billion euros to Greece in bilateral loans and has pledged to top up the IMF by an estimated 40 billion euros. In the recent update of its stability programme, the German government estimates that its contingent liabilities had climbed to 21% of GDP at end-2011. The cost of propping up the Eurozone is rising quickly. Germany's rebuttal at this week's European Council dinner of pleas from its partners for eurobonds and a common deposit insurance scheme is therefore not surprising.

But Germany is already far onto the Euro hook and its economy is starting to be warped by the fallout from disintegrating confidence in the periphery. This is manifesting itself in a rush of capital to the centre. German three-month sovereign bond yields are negative. On the face of it, this is beneficial. Lower interest rates and rising bank deposits should propel sluggish growth as it spurs the supply of and demand for credit. The government could take advantage of such low rates to borrow and spend more on growth-enhancing capital projects.

Fidelity™
WORLDWIDE INVESTMENT

Yet capital inflows can also bring complications in the form of a misallocation of capital and excessive risk taking. With a fixed exchange rate, inflationary pressures are more likely to mount. So far, inflation has remained subdued. Germany still has one of the lower inflation rates in the Eurozone. House prices are growing, in contrast to the Eurozone average, but moderately. German banks are highly levered so are mainly using the surge in deposits to reduce debt rather than extend loans. For these reasons, an asset bubble is still a potential threat rather than a reality. But a sustained acceleration of capital inflows, sparked by a possible bank run in Spain for example, could quickly bring difficulties. The level of bank deposits in Italy and Spain dwarfs that in Greece, Ireland, and Portugal.

A more extreme scenario of Eurozone break-up would be devastating for Germany's export-driven growth model. German exports have long benefitted from an undervalued exchange rate. Were the Mark to be recreated, it would face massive appreciation as capital fled the periphery. Germany would likely be forced to introduce capital controls and the Bundesbank to intervene to counter appreciation pressure through buying up reserve currencies. This could be politically sensitive. German banks would suffer as their Eurozone assets lost value. Germany as a whole has so far lent around 600 billion to the Eurozone's Target2 payments system, around a quarter of its GDP. Meanwhile, Germany's global political clout would rapidly diminish. Rather than the leader of an economic bloc generating a fifth of global GDP, it would become a middling economic power.

So there is a powerful political and economic incentive for Germany to hold the Eurozone together. Whether Greece stays in or not is open to question (it seems unlikely that they will), but preventing contagion to Spain and Italy through Portugal and Ireland should remain a priority for Germany, if only from the position of self-interest. It will cost them heavily to do this as their contingent liabilities continue to climb but in the end, it is less painful than a Eurozone collapse.

For these reasons, it is likely that Germany's intransigence will eventually be overcome by persistent pressure from its Eurozone partners and their pledges of structural reform. Germany was isolated at the recent G8 summit and is facing a strengthening alliance of pro-bailout advocates. These include France, Spain, Italy, the US, the OECD, and the IMF. It will likely take another crisis or series of crises for Germany to succumb. The severity of these crises will hopefully be smoothed by interventions from the ECB. Greek elections in June will be the next test. The biggest risk is deposit flight in the periphery that becomes impossible to control. However, on balance, we have not yet been persuaded by the Doomsday narrative.

Fixed Income Insight

GOVERNMENT BONDS

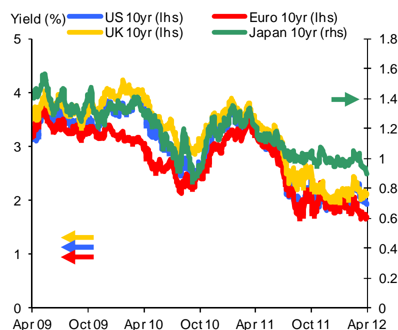
	GLOBAL (USD)	US (USD)	EUROPE (EUR)	UK (GBP)	$ASIA (USD)	JAPAN (JPY)	EM (USD)
1 MONTH PERFORMANCE (%)	1.60	1.53	-0.11	0.54	0.58	0.55	1.47
YEAR-TO-DATE PERFORMANCE (%)	0.95	0.21	3.66	-1.39	3.42	0.84	8.26
YIELD TO MATURITY (%)	1.53	1.06	2.78	2.04	3.49	0.65	7.22

INFLATION-LINKED BONDS

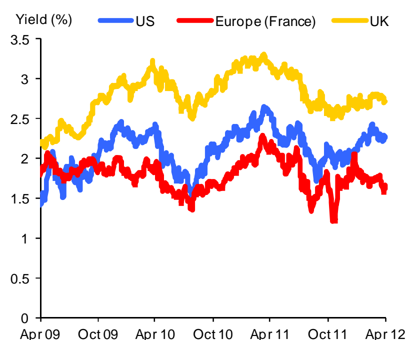
	GLOBAL (USD)	US (USD)	EUROPE (EUR)	UK (GBP)	$ASIA (USD)	JAPAN (JPY)	EM (USD)
1 MONTH PERFORMANCE (%)	1.06	2.17	-0.93	-0.06	n / a	1.24	0.74
YEAR-TO-DATE PERFORMANCE (%)	3.76	2.95	5.17	-2.18	n / a	4.03	9.70
YIELD TO MATURITY (%)	0.02	-0.64	1.31	-0.50	n / a	-0.23	2.68

- Negative news from former Spanish PM that Spain is in a situation of “total emergency and faces its worst crises”, besides all other negative Spanish headlines, have encouraged investors to fly to haven assets. This contributed to German bond yields hitting all time lows, showing investors’ willingness to lend to Berlin for no return. US 10yr yield levels of 1.57% were last seen in 1946.
- Arguably investment grade corporate bonds offer a decent return potential as credit spreads continue to give investors reasonable compensation relative to the risk of deterioration in corporate creditworthiness. Looking ahead, corporate fundamentals have most likely peaked and falling profit margins will cap any further improvement. As a result, careful bond selection will be vital to add value and counter market volatility. Furthermore, the asset class is likely to continue to be supported by investor demand for yield as interest rates remain at low levels.

10 YEAR GOVERNMENT BOND YIELDS



10 YEAR BREAKEVEN INFLATION RATES



CORPORATE BONDS

	GLOBAL (USD)	US (USD)	EUROPE (EUR)	UK (GBP)	$ASIA (USD)	JAPAN (JPY)	EM (USD)
1 MONTH PERFORMANCE (%)	0.92	1.28	0.23	-0.39	1.26	0.33	0.87
YEAR-TO-DATE PERFORMANCE (%)	4.79	3.75	5.57	3.68	5.67	0.95	6.61
YIELD TO MATURITY (%)	3.38	3.39	3.25	5.23	5.12	0.72	5.25

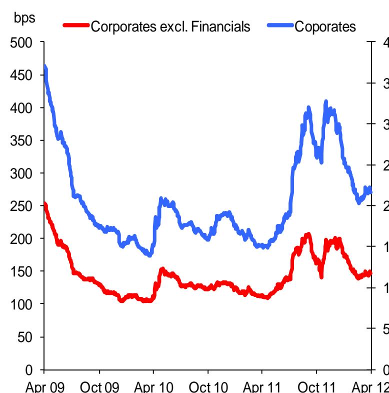
HIGH YIELD

	GLOBAL (USD)	US CASH PAY	EUROPE (EUR)	UK (GBP)	$ASIA (USD)	JAPAN (JPY)	Gl HY & EM (USD)
1 MONTH PERFORMANCE (%)	0.68	1.03	-0.56	0.19	1.30	n / a	0.76
YEAR-TO-DATE PERFORMANCE (%)	8.13	6.13	11.92	12.93	7.45	n / a	8.14
YIELD TO MATURITY (%)	7.99	7.41	9.09	10.06	7.00	n / a	7.94
OPTION ADJUSTED SPREAD (BPS)	656	589	773	854	567	n / a	648

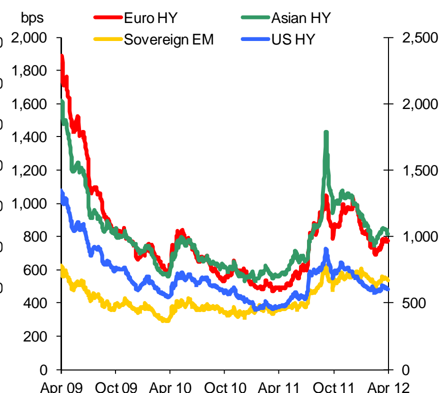
Fixed Income Insight

- High yield total returns are supported by very strong income streams which should dampen volatility. Corporate balance sheets continue to remain in decent shape; however, credit fundamentals have probably peaked and the poor economic backdrop presents a significant risk as it will prevent any further improvement in corporate strength. The ongoing macro weakness is already coming through in the form of softer corporate earnings results.

GLOBAL CREDIT SPREADS



GLOBAL HY & EM CREDIT SPREADS



FIDELITY FUND PERFORMANCE – 30 April 2012

FIDELITY FUND PERFORMANCE BY FRANCHISE - 30-Apr-2012

	YTD			1 Month			3 Months			6 Month			1 Year			3 Years (pa)			5 Years (pa)		
	F (%)	B (%)	R (bp)	F (%)	B (%)	R (bp)	F (%)	B (%)	R (bp)	F (%)	B (%)	R (bp)	F (%)	B (%)	R (bp)	F (%)	B (%)	R (bp)	F (%)	B (%)	R (bp)
Asia																					
Fidelity Funds - Asian Bond Pool	3.93	3.45	46	1.12	0.87	25	2.75	2.34	39	4.33	3.54	76	n / a	n / a	n / a	n / a	n / a	n / a	n / a	n / a	n / a
FF Asian High Yield Pool	9.64	10.29	-58	1.11	1.37	-25	4.64	5.37	-69	7.50	8.42	-85	-0.62	1.09	-168	19.30	19.86	-47	5.50	8.23	-252
European High Yield																					
FF Euro High Yield Pool	9.32	11.38	-185	-0.09	-0.24	14	4.58	4.96	-36	6.71	8.36	-152	2.39	2.15	23	21.69	22.32	-52	6.70	7.24	-51
European Bonds																					
FF - Core Euro Bond	4.09	4.09	-0	0.20	0.08	13	2.28	2.10	17	4.25	4.90	-62	6.60	7.69	-101	5.33	4.96	36	n / a	n / a	n / a
FF Euro Bond Pool	4.56	4.09	45	0.34	0.08	27	2.63	2.10	51	4.93	4.90	3	6.51	7.69	-110	10.29	4.96	508	4.55	4.80	-24
FF European Corporate Bond Pool	5.52	5.58	-5	0.49	0.24	25	2.86	2.89	-3	4.89	5.19	-28	6.35	6.84	-46	13.27	8.25	463	3.51	4.53	-98
UK Retail																					
Extra Income	4.65	6.14	-140	-0.29	-0.24	-5	2.34	2.32	2	4.58	5.22	-61	6.00	3.59	233	15.76	16.99	-105	6.57	6.72	-14
Money Builder Income	1.97	2.27	-29	-0.18	-0.27	9	0.96	0.43	53	3.67	2.75	90	7.37	5.53	175	12.26	10.21	185	6.40	4.30	201
Fidelity Strategic Bond	2.89	-0.46	336	-0.17	0.24	-41	1.37	-1.15	255	4.25	2.52	169	7.39	10.49	-280	12.82	8.19	428	8.32	5.69	249
Global Aggregate																					
FF International Bond Pool	2.96	1.99	95	0.99	1.29	-29	0.91	0.25	66	1.50	0.74	75	2.01	3.10	-105	11.84	7.63	391	6.48	6.39	9
Fid Funds - Global Strategic Bond	2.69	2.06	61	1.13	1.18	-5	0.85	0.38	46	1.81	0.96	84	2.39	3.30	-87	n / a	n / a	n / a	n / a	n / a	n / a
USD Bond																					
FIJ It Us Investment Grade Bond Mother	7.19	5.93	119	-0.32	0.10	-41	7.42	6.74	64	8.71	7.00	160	9.04	7.16	175	4.18	0.82	333	-0.57	-1.63	108
FF Dollar Pool	2.44	1.43	99	1.17	1.33	-16	1.09	0.41	68	3.81	2.47	131	10.60	8.34	208	12.24	7.27	464	7.02	6.33	66
Inflation & Index Linked																					
FF Global Inflation Linked Bond	3.62	4.08	-45	0.51	0.71	-20	1.56	1.84	-27	1.64	1.85	-21	1.64	2.21	-56	9.87	8.79	99	n / a	n / a	n / a
FF Emerging Market Inflation Linked Bond	9.22	10.06	-77	-1.02	1.22	-221	1.81	2.48	-66	0.00	4.06	-390	n / a	n / a	n / a	n / a	n / a	n / a	n / a	n / a	n / a
Money Market																					
Institutional Cash Fund - Sterling	0.24	0.20	4	0.06	0.05	1	0.18	0.15	3	0.38	0.30	7	0.74	0.57	17	0.68	0.49	19	2.41	2.16	24
Institutional Cash Funds: Euros	0.14	0.07	7	0.03	0.01	1	0.09	0.04	5	0.30	0.18	12	0.86	0.69	17	0.70	0.48	22	2.04	1.65	38
UK Institutional																					
Institutional UK Corporate Bond	3.36	2.63	71	-0.22	-0.18	-3	1.07	0.68	39	4.29	3.29	97	8.02	6.66	127	14.89	11.42	311	6.72	5.49	117
Institutional UK Long Corporate Bond	2.36	1.56	79	-0.21	-0.01	-20	0.02	-0.36	38	4.64	3.26	133	10.70	9.34	125	17.68	14.07	316	7.75	5.92	172
Institutional UK Aggregate Bond	1.72	0.56	115	0.05	0.13	-8	0.14	-0.64	79	4.10	2.84	122	11.10	10.10	91	13.51	9.06	408	8.06	6.38	158

This information is for Investment Professionals only and should not be relied upon by private investors. It must not be reproduced or circulated without prior permission. This communication is not directed at, and must not be acted upon by persons inside the United States and is otherwise only directed at persons residing in jurisdictions where the relevant funds are authorised for distribution or where no such authorisation is required. Fidelity/Fidelity Worldwide Investment means FIL Limited and its subsidiary companies. Unless otherwise stated, all views are those of Fidelity. Fidelity only offers information on its own products and services and does not provide investment advice based on individual circumstances. Fidelity, Fidelity Worldwide Investment, the Fidelity Worldwide Investment logo and F symbol are trademarks of FIL Limited. Growth Investments Limited is licensed by the MFSA. Fidelity Funds are promoted in Malta by Growth Investments Ltd in terms of the EU UCITS Directive and Legal Notices 207 and 309 of 2004. The Funds are regulated in Luxembourg by the Commission de Surveillance du Secteur Financier; Our legal representative in Switzerland is BNP Paribas Securities Services, Paris, succursale de Zurich, Selnaustrasse 16, 8002 Zurich. Paying agent for Switzerland is BNP Paribas Securities Services, Paris, succursale de Zurich, Selnaustrasse 16, 8002 Zurich.Issued by FIL Investments International (FSA registered number 122170) a firm authorised and regulated by the Financial Services Authority. FIL Investments International is a member of the Fidelity Worldwide Investment group of companies and is registered in England and Wales under the company number 1448245. The registered office of the company is Oakhill House, 130 Tonbridge Road, Hildenborough, Tonbridge, Kent TN11 9DZ, United Kingdom. Fidelity Worldwide Investment's VAT identification number is 395 3090 35. SSO5041/0213