

OUTLOOK 2010

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After an exciting 2009 which saw most equity markets around the globe recover sharply from their March lows, we move into 2010 with expectations of a steady global economic recovery translating into pick-up in the business and the investment cycles. The key concerns across markets at this point stem from the surge in inflation and the timing of exit of the easy monetary policy by the central banks. This is the time when real assets like commodities should be in focus, says the *Fidelity Global Outlook for 2010*.

In India, while the view is constructive on the equity markets over the medium term, 2010 promises to be an interesting as well as a challenging year for the bond markets, according to the *Fidelity India Outlook for 2010*.

INDIA OUTLOOK FOR 2010

“We are seeing broad based growth signalling a steady recovery. As the business cycle progresses, the investment cycle should pick up as well. In addition, a stable government that is focussed on moving ahead with the divestment process and stepping up infrastructure spending should support the recovery,” says Sandeep Kothari, Fund Manager, Fidelity Equity Fund, Fidelity Tax Advantage Fund, Fidelity International Opportunities Fund and Fidelity India Growth Fund.

“Corporate earnings have been positive and as the economy continues to show improvement, the earnings cycle will become more robust. On that backdrop, current valuations appear to be fair.

“In my view, the key risks to this scenario remain rising inflation and the consequent aggressive tightening of interest rates by the central bank. While current market levels reflect some of this expectation, any surprises could lead to volatility.

“Through 2010, we will have a context where, from an investment standpoint, attractive opportunities will be represented by companies with earnings visibility, quality management and execution capability.

“Overall, we are constructive on the markets in the medium term barring some external shock. While the economic scenario in the Western world is improving, we would need to keep a watch on the risk of sub-par growth given the unemployment levels and de-leveraging consumers.”

About the outlook for the bond markets in India, Shriram Ramanathan, Portfolio Manager – Fixed Income, Fidelity Mutual Fund, says, ““While 2009 saw a secular rise in bond yields for the most part, 2010 promises to be an interesting albeit challenging year for the bond markets on the back of surging supply side inflation and a deteriorating fiscal situation. The two critical factors affecting the bond market in 2010 will be one, the extent to which the supply-side driven inflation will feed through to the rest of the economy; and two, in dealing with it, how far the RBI and the government will go in announcing measures, without risking derailing the growth trajectory.

“The government’s commitment to return to the path of fiscal prudence will be tested as the combination of high deficit and rising bond yields could push up its debt financing costs further. While there could be positives like higher revenues in response to the overall economic growth and pick-up in the disinvestment process, the demand side story for government debt could be trickier as banks’ credit growth picks up in response to the cyclical momentum in the economy.

“Overall, we start the year with a cautious outlook for the sovereign bond market, expecting yields to continue trending higher. However, we may see the markets overdo concerns on the inflation front at some point, leading to attractive - though tactical – opportunities, which in turn, would call for a more nimble approach to bond investing than was required in 2009. As the upturn in the credit cycle gathers pace, we can expect corporate issuance to pick up providing potentially attractive opportunities in the credit space. Diligent credit research and careful bottom-up issuer selection will be crucial in generating outperformance as well as delivering suitable credit focussed products in the market.”

GLOBAL OUTLOOK FOR 2010

In addition to the outlook for India in 2010, Trevor Greetham, Asset Allocation Director at Fidelity International, rounds up 2009 and gives his view on 2010. Here are the highlights:

- Commodities will be the main focus of investor attention next year
- Equity friendly conditions are back but Government bonds are a concern
- Low correlations mean diversification is working better than ever

REVIEW OF 2009

“The past year has been difficult for the pessimistic majority who couldn’t quite believe in the remarkable 2009 market rally.” ‘It’s different this time’ is as dangerous a mantra at the bottom as the top of the stock market cycle and those who refused to see the parallels with 1975’s V-shaped recovery are kicking themselves. I think 2010 could also surprise the sceptics.

“The difference between the multi-year bull market that I believe began in March and previous short-lived bear market rallies was that the turn in stocks was confirmed by business confidence indicators. In 2009, the authorities finally got on top of the financial crisis, loosened policy to an unprecedented extent and, by doing so, restored trust in the system. Stimulus packages were designed to err on the side of doing too much rather than too little. I think there is a real danger that bust could turn to boom.

“Having shut down production, stopped capital expenditure and laid off workers in anticipation of the worst-case scenario that the data was pointing to at the time, companies were wrong-footed by the policy blitzkrieg and the return of animal spirits in the stock market. The recovery seems to be happening in slow motion, but that does not mean it won’t be huge - and the markets have started to sense this much more quickly than most observers.”

OUTLOOK 2010

“Commodities will be the main focus of investor attention next year, with demand from the developed economies the unexpected driver. Commodity analysts are fixated by China with good reason as that’s where we have seen double-digit growth rates in recent years. But developed economies are likely to deliver surprisingly strong growth coming off such a depressed base. Industrial restocking from these sleeping giants should boost commodity prices very significantly.

“I also expect increased investor buying interest, fuelled by fears of inflation and cheap dollar funding.

“The financial panic is now over, as evidenced by narrow inter-bank lending rates. Equity-friendly conditions are back for the first time since 2007, with the emerging markets and Asia best placed to capitalise on the situation. Global growth indicators are strong, policy remains extremely accommodating and inflation is unlikely to become a serious problem in view of the massive spare capacity in the world economy.

“Interestingly, it might not seem this way in the early part of 2010 as dramatically easier year-on-year comparisons in the oil price produce a short-term inflation scare. There's a risk this coincides with renewed growth fears, especially if the momentum of recovery cools somewhat and US unemployment does not come down as quickly as I think it might. A whiff of stagflation could make early 2010 feel a bit like early 2004 when the last equity bull market temporarily ran out of steam. I'd expect a positive trend to reassert itself once markets have adjusted to a good but less break-neck pace of recovery.

“Interest rates could pick up sooner than many think if global growth surprises as positively as I expect. The strength of new orders against a depleted level of inventories in the US and elsewhere points to a repeat of the explosion of world trade we saw in 1975. I expect interest rates to diverge next year with the European Central Bank expressing concern about the headline rate of inflation while the Federal Reserve focuses on core rates excluding energy. Historical differences mean European institutions are usually more anxious about rising prices while America lives under the shadow of deflation.

“My least favourite asset class for 2010 is fixed income. Corporate bond spreads remain attractive, though clearly less so than during the once-in-a-generation buying opportunity at the beginning of the year. My concern is centred on government bonds. No, I don't expect governments to default on their debt. In fact the fiscal position is likely to surprise positively as economic recovery causes tax revenues to flood back in. It is just that yields are already very low and they are likely to rise as central banks move progressively towards removing their ultra-loose policy stance.

“I would expect the recovery in the UK and US housing markets to continue as long as an adverse inflation shock doesn't force interest rates to rise rapidly. Confidence is improving and, together with job creation, this will be a key support for the recovery next year.

“I expect the dollar to remain under downward pressure on two fronts. Emerging market currencies should be expected to be beneficiaries of the global economic upswing. The US currency will probably struggle to make ground against the euro too if the ECB turns more hawkish.

“The uncalibrated and massive nature of the authorities' intervention in 2008/9 is not a recipe for economic stability. Policy-makers panicked after Lehman was allowed to fail and I expect a continuing boom/bust cycle for some time as they try to dampen down some extremely pronounced cycles. This backdrop argues for flexible tactical asset allocation. It also calls for a multi-asset approach to investing. Low correlations mean diversification is working better than ever.”

GLOBAL FIXED INCOME OUTLOOK

Commenting on the outlook for markets in 2010, Andrew Wells, CIO of Fixed Income at Fidelity International, says:

“As investors look towards 2010, three themes are likely to dominate the fixed income investment landscape:

- The hunt for yield continues;
- There is enormous uncertainty about the timing and nature of unwinding policy stimulus such as quantitative easing and low cash rates; and
- The potential for rising inflation to erode fixed income returns.

THE HUNT FOR YIELD CONTINUES

“For investors in search of yield, investment grade corporate bonds are likely to remain the key focus. While yields have fallen from their peaks of March this year, yields remain attractive versus cash and government bond alternatives. Indeed, credit spreads continue to offer ample compensation for default and downgrade risks and are still wide relative to history.

“The attractive value still on offer means that enthusiasm towards corporate bonds is likely to stay in check. Meanwhile, as cash rates stay low and uncertainty about the economy stays elevated, I expect flows into corporate bonds will continue.

“Moving out the risk spectrum and into high yield may also continue attracting investors in search of income. With double digit yields still on offer, there is still value in the high yield asset class but managers will need to rely less on market direction to drive performance. In particular, name selection will be critical as defaults stay elevated. Importantly, mixing investment grade corporate bonds with a portfolio of high yield can offer a very attractive income generator with low volatility as the two asset classes each interact differently against economic and market variables.

PREPARING FOR THE END OF MONETARY EASING

“For investors concerned about the impact of rising cash rates, allowing managers more flexibility to extract value from across fixed income markets may be an important focus for 2010. To this end, strategic bonds funds may be suitable, including those with the ability to hold an efficient mix of government bonds, investment grade credit, high yield, international bonds and inflation linked assets. As interest rates rise, having the right mix of assets may deliver better returns than traditional investment grade credit funds without unduly adding risk in a portfolio.

“Reducing fund duration to better protect an investment portfolio is also likely to be a hotly debated topic next year. However, investors should consider the subtle risks of such an approach. The steep yield curve means it currently pays handsomely to hold longer maturity assets over cash. This means hedging duration can have a sacrifice on yield. Meanwhile, duration offers investors powerful equity diversification benefits as it is the only true source of protection against a sell-off in risky assets and any renewed deflationary concern. Reducing a fund’s duration can therefore leave it highly correlated to equity and vulnerable to an equity market sell-off.

PROTECTING AGAINST INFLATION UNCERTAINTY

“Inflation presents the biggest risk to fixed income markets in 2010 although there are many pockets of the bond universe that can do well if inflation increases. The inflation linked bond market is likely to grow in importance as investors seek protection against policy mistakes.

“However, if inflation pressures re-ignite, it is likely to be a global phenomenon with synchronicity of performance of inflation linked bonds globally. Therefore, to best protect against inflation, investors should look beyond local markets to isolate the cheapest possible protection. For example, countries such as Japan and the US may offer better value than European inflation linked markets, even after currency hedging.

“Another asset class that can also do well in inflationary periods is high yield. For highly leveraged companies the ability to repay debt can improve as prices rise and I’d expect to see further spread narrowing if inflation rises. Therefore inflation linked bonds can be considered as providing a degree of inflation protection for a diversified fixed income portfolio.

DIVERSIFICATION WILL BE KEY

“The above three themes highlight the importance of diversification in 2010 and after a strong credit market recovery in 2009, investors must now think harder about the sources of returns from their fixed income investments.

“After strong performance across our key funds in 2009, our managers are looking far and wide for sources of return. Indeed, directional strategies are likely to be less important next year with renewed focus on cross market interest rate strategies, sector tilts and name selection. Importantly, now is not the time to let top-down strategies dictate an investment portfolio and it is important for managers and investors to diversify not only at the bond level, but also in terms of strategy and asset mix. “

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