

Money Market Commentary: Inflows Soar in Flight to Quality

Money fund assets surge following S&P downgrade of U.S. credit

When the story first broke that Standard & Poor's downgraded the AAA credit rating of U.S. Treasury debt, money market investors braced for another bout of uncertainty and volatility. And with good reason. From the beginning of June through the middle of July, industry assets declined by around \$50 billion following a multitude of disparaging media reports regarding foreign bank holdings in money market funds. But as the long-awaited August 2 debt ceiling deadline approached, focus shifted to the implications of a potential U.S. default. From July 21 through August 1, investors withdrew almost \$135 billion from money market funds, with approximately half of those assets exiting government and Treasury funds. Although Congress came to an eleventh-hour agreement to raise the debt ceiling (which the market generally expected), S&P still downgraded the provider of the world's reserve currency. As a result, a flight to quality ensued and investors poured more than \$90 billion into money market funds in the first two weeks of August, with the inflows relatively split between prime and government funds.

Short-term rates fall to record lows following Fed statement

In its August 9 Open Market Committee meeting, the Federal Reserve redefined its definition of "extended period," stating it "anticipates that economic conditions are likely to warrant exceptionally low levels for the federal funds rate at least through mid-2013." In effect, this proved to be a soft form of easing that reduced expectations for yield across the curve. The central bank remains adamant that it possesses adequate tools to stimulate the economy if needed. So rather than making a knee-jerk commitment to a third round of Quantitative Easing (QE3), the central bank signaled its intention to maintain the fed funds target rate at 0-0.25% for roughly the next two years. Although the amended statement implies that the likelihood of a rate hike is now further into the future, the fed funds futures markets have already priced expectations for a fed hike by the middle of 2013. As of now, one would have to go all the way out to the beginning of 2014 to see a contract yielding 0.50%. Treasury yields recently posted record lows, with the 1-year bill and 2-year note falling as low as 0.09% and 0.16%, respectively. Although government repo rates temporarily eclipsed 30 basis points on an intra-day basis prior to the debt ceiling resolution, they have fallen back to near zero amid the increased market volatility (See Exhibit 1, page 2).

Short-term rates also fell precipitously after the Bank of New York (BNY) announced on August 4 that it will charge institutional customers up to 13 basis points on "extraordinarily high" cash deposits. If other banks follow BNY's lead, investors may prefer Treasury bills at negative yields to avoid being charged for a bank deposit. Not to mention how good a money market fund yield of 10 basis points would look compared to negative 13 basis points in a bank account. Front end rates could fall further if the Fed reduces the interest rate it pays banks on excess reserves or if it enacts QE3. On the other hand, lower money market fund yields could be offset by an increase in LIBOR (see Exhibit 1). From mid-July through mid-August, the 3-month LIBOR rate increased 4 basis points due to credit concerns in the eurozone.

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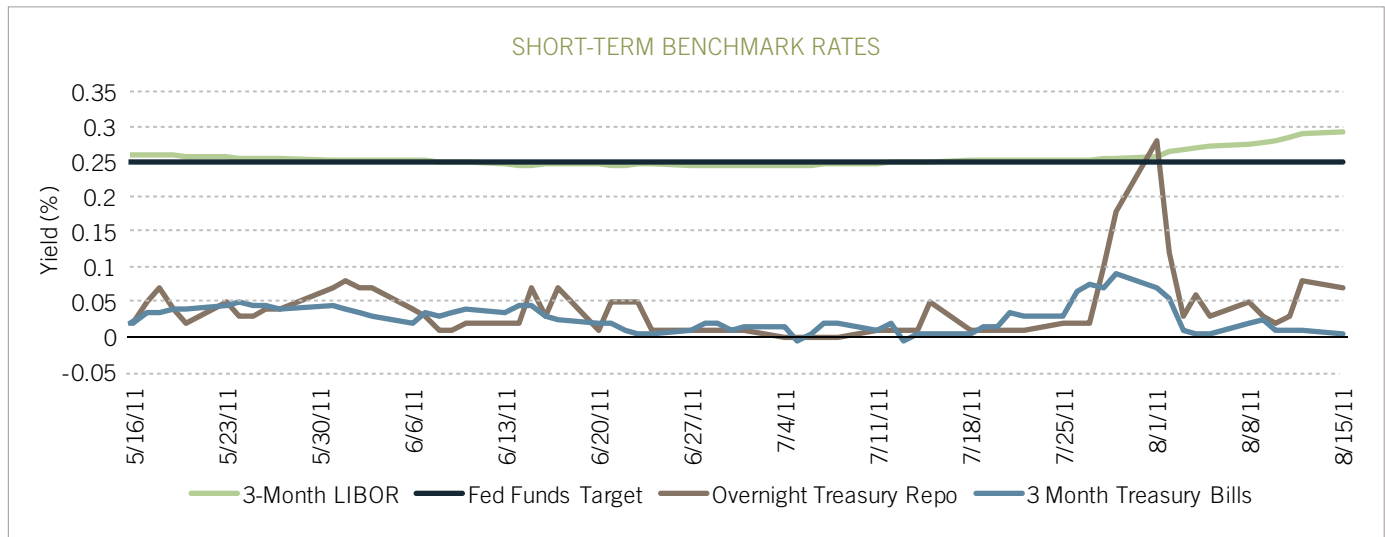
KEY TAKEAWAYS

- Money market fund assets increased following the debt ceiling resolution and S&P downgrade of U.S. credit rating
- Federal Reserve redefined its definition of "extended period"
- European Central Bank takes action to stem fears of contagion through the eurozone



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EXHIBIT 1: Short-term rates have displayed more volatility during the past month.



Source: Bloomberg, as of August 15, 2011.

Credit concerns accelerate in eurozone

Although the global market focus temporarily shifted to the U.S., more-complex fiscal and structural issues remain in the eurozone. While the European markets continue to digest the austerity measures taken by Greece and the 21% haircut to Greek government bonds, fears of contagion caused Spanish and Italian bond spreads to significantly widen versus German Bunds. After long-term borrowing costs for these sovereigns eclipsed 6%, the European Central Bank (ECB) attempted to stem contagion by purchasing Spanish and Italian bonds in the secondary markets. The bond markets reacted favorably to the central bank's support, and spreads narrowed by over 100 basis points in response. The ECB also confirmed that its liquidity-providing operations, which offer member banks below-market-rate financing, would run at least through the end of 2011.

In essence, the ECB is indicating to eurozone politicians that additional fiscal reform is needed to get in front of the crisis.

Fund strategy and outlook

With persistent uncertainty in the eurozone and recent volatility in global markets, Fidelity's general purpose money market funds continue to focus on higher-quality securities located in such havens as Canada, Australia and the Nordic countries. Considering the heightened volatility, our portfolio investment strategy remains focused on maintaining ample liquidity and flexibility. We continue to monitor the heightened risk across the eurozone and remain comfortable with our holdings. As this volatile period evolves, we will continue to prioritize capital preservation and liquidity followed by competitive returns for our shareholders.



An investment in a money market fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although the fund seeks to preserve the value of your investment at \$1.00 per share, it is possible to lose money by investing in the fund. Interest rate increases can cause the price of a money market security to decrease.

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