

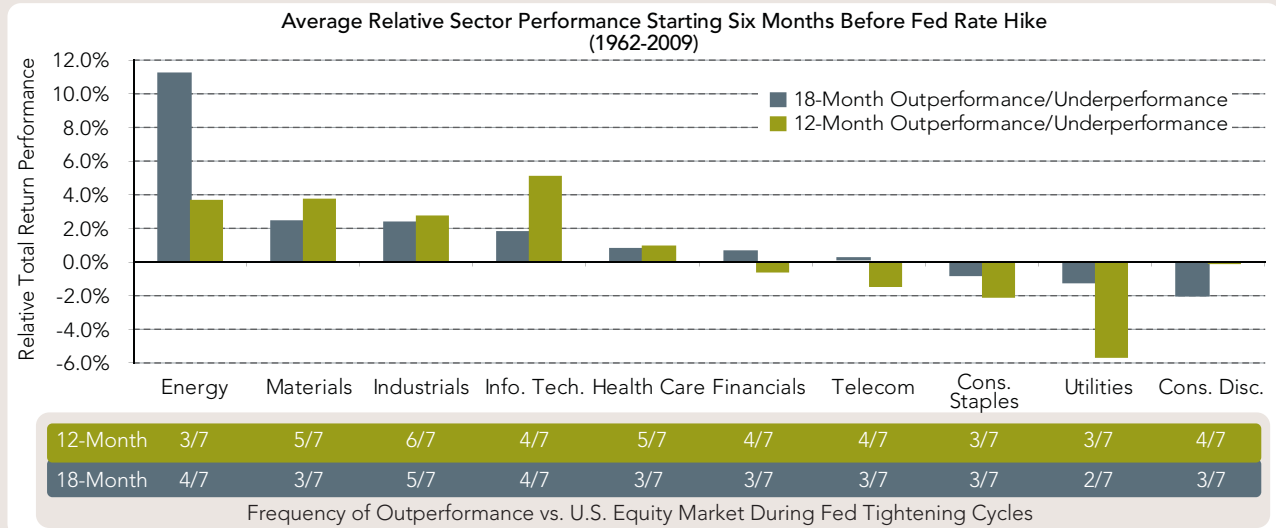
## Equity Sector Leadership and Fed Rate Hikes

With the economy showing signs of improvement, more investors are expecting the Federal Reserve (Fed) to begin raising its ultra-low policy interest rate (currently 0%-0.25%) by the end of 2010.<sup>1</sup> Because upward movement in interest rates increases the cost of borrowing for both corporations and consumers, it historically has coincided with a change in performance leadership among U.S. equity market sectors. MARE examined the impact new Fed rate-hike campaigns have previously had on sector performance.

### Is the early-market-recovery stage over?

So far, the early stage of the current (bull) market cycle has played out as one might expect. Typically, this early-cycle period begins when the economy is in the final stages of recession and the Fed has already lowered interest rates. At some point, the weakened economy begins to stabilize (e.g., spring, summer 2009) and eventually nudge toward recovery (e.g., fall, winter 2009). As all of this developed during the past year, interest-rate-sensitive (financials and consumer discretionary) and early cyclical (information technology) sectors led the broader market's rebound. At the same time, sectors typically perceived as being

EXHIBIT I: Mid-cyclical sectors such as energy, materials and industrials have led the broader market the most during periods when the Fed has started a new rate-hike campaign. Industrials have outperformed most frequently.



Average relative sector performance shown versus average of 3000 largest stocks by market capitalization during 12- and 18-month periods around initial rate hikes during past seven tightening campaigns by Federal Reserve (1963, 1973, 1977, 1980, 1983, 1994, 2004). Sectors defined by Global Industry Classification Standard (GICS)<sup>®</sup>. All returns represented by the top 3000 market-cap-weighted stocks on the New York Stock Exchange (NYSE). Source: Haver Analytics, FMRCo (MARE) as of 2/28/2010.

more defensive, such as telecommunications and utilities, lagged the broader market in this early part of the cycle.

If the economy gains further traction, the market cycle typically moves on to its next phase, characterized by full economic expansion and rising interest rates. The timing of the transition to this next phase is never clear-cut, however, as it varies from cycle to cycle based on a variety of economic and other factors. However, with the current bull market now more than a year old, investors may be looking for clues on sector performance should the transition to this next phase of the cycle unfold in the months ahead. Historically, when the market advances toward this next mid-cycle phase, the Fed makes a shift in its policy toward tightening the money supply (i.e., raising rates).

### Sector performance near Fed cycle turning points

Since 1962, the Fed has initiated seven post-recession rate-hike campaigns. To incorporate both the market's anticipation of the first rate increase in a new series of monetary policy tightening and the impact of this initial shift in policy direction, MARE analyzed sector performance relative to the broader market starting at the six-month point prior to the first rate hike in each of the past seven campaigns.<sup>11</sup> Using that starting point, we examined the average performance of all sectors looking out over 12- and 18-month periods.

#### Mid-market cycle sectors have often led

Which sectors historically have had the biggest returns and have outperformed most frequently at these

### KEY TAKEAWAYS

- With the Federal Reserve expected to start raising short-term interest rates by the end of 2010, investors may want to consider that performance leadership among U.S. equity market sectors often shifts near turning points in Fed interest rate policy.
- Although historical patterns aren't entirely consistent or a guarantee of future results, mid-cyclical sectors, such as industrials and energy, have tended to outperform the broader market during the months prior to and immediately after the first hike in a new Fed tightening campaign.

EXHIBIT 2: The outperformance of industrials and information technology stocks has tended to occur prior to a new Fed rate hike and then waned thereafter. Energy generally outperformed before and after each initial rate hike.

Average Total Return Relative to U.S. Equity Market and Frequency Rate of Outperformance										
Sector	6 Months to Initial Rate Hike		3 Months to Initial Rate Hike		3 Months After Initial Rate Hike		6 Months After Initial Rate Hike		12 Months After Initial Rate Hike	
	Total Return vs. Mkt	Rate: # Out of 7	Total Return vs. Mkt	Rate: # Out of 7	Total Return vs. Mkt	Rate: # Out of 7	Total Return vs. Mkt	Rate: # Out of 7	Total Return vs. Mkt	Rate: # Out of 7
Industrials	1.9%	6	2.0%	5	0.3%	4	0.4%	3	0.3%	2
Energy	2.8%	4	1.9%	5	4.4%	6	1.0%	2	7.5%	4
Info. Tech.	4.5%	4	4.8%	6	0.4%	4	0.2%	3	-1.9%	3
Materials	-0.3%	3	0.1%	4	0.5%	4	3.4%	6	2.9%	3
Cons. Disc.	0.3%	3	0.2%	4	-0.8%	4	-0.8%	4	-2.5%	4
Cons. Stpls	-0.3%	3	-0.7%	2	-3.3%	1	-1.6%	2	-0.9%	3
Financials	0.1%	3	-1.4%	2	-0.9%	3	-0.7%	4	0.0%	4
Health Care	-1.1%	3	0.6%	3	1.3%	5	2.0%	5	1.9%	4
Utilities	-4.4%	3	-4.4%	2	-0.7%	3	-0.7%	4	2.9%	4
Telecom	-2.9%	1	-2.8%	1	0.0%	4	2.35	5	2.9%	3
U.S. Market (Total Return)	11.81%		4.71%		2.07%		4.36%		5.86%	

U.S. Market: Top 3000 market-capitalization-weighted stocks. Source: Haver Analytics, FMRCO (MARE) as of 2/28/2010. Sectors defined by GICS.

Fed Rate Hike

Rate: Represents frequency rate (# out of 7 Fed rate-hike campaigns) a sector outperformed the broader U.S. equity market during period shown.

Past performance is no guarantee of future results

critical turning points in Fed policymaking? Historically, as the economy became more firmly entrenched in expansion, other mid-cycle sectors, such as energy, industrials and materials, gathered steam (see Exhibit 1, previous page). The outperformance of these sectors in this mid-cycle phase is likely driven by the fact that demand for the products and services in these sectors grows as the economic recovery picks up momentum.

More specifically, the energy sector had the highest magnitude of outperformance relative to the broader market on average over the seven campaigns (+11.2 percentage points) on an 18-month basis (i.e., six months prior to initial rate hike and 12 months after). However, energy had a relatively inconclusive frequency rate of outperformance (4 out of 7 campaigns) – see Exhibit 1, page 1. Looking

at performance in smaller, three-month intervals around initial Fed rate hikes, energy sector performance remained fairly strong throughout each of the three-month windows before and after each rate hike, with the biggest quarterly gains seen after the initial increase (see Exhibit 2, above).

The industrials sector had the greatest frequency of outperformance, leading the broader market in 6 out of 7 initial-rate-hike campaigns on a one-year basis, and in 5 out of 7 campaigns over an 18-month period (Exhibit 1). Relative outperformance in the industrials sector was stronger in the months prior to an initial rate hike, and tended to wane during the months beyond the first rate increase (Exhibit 2). For its part, the materials sector outperformed in 5 out of 7 rate-hike campaigns on a one-year basis, and had a solid magnitude of relative outperformance (3.7% pts).

Information technology stocks generated the highest average rate of outperformance on a one-year basis (+5.1% pts), but tapered some further out beyond an initial rate increase (+1.8% pts. outperformance on an 18-month basis). Tech's superior relative returns during the 12-month period were due to the massive gains this sector registered on average during the six months prior to initial rate hikes (Exhibit 2). At the same time, the tech sector's overall frequency of outperformance over both 12- and 18-month periods was less than compelling (4 out of 7 campaigns).

#### Laggards: Rate-sensitive and defensive sectors

Sectors that tend to be heavily influenced by interest-rate movements, such as consumer discretionary and financials, fared relatively poorly around initial-Fed-hike turning points (Exhibit 1). Defensive-oriented sectors, meaning those whose profits tend to be less influenced by swings in the economy, such as consumer staples, utilities and telecommunications, also lagged the broader market around initial rate hikes. However, the more granular three-month view also showed that performance among defensive-oriented sectors—while poor prior to an initial rate hike—gradually improved after the tightening policy had begun (Exhibit 2).

#### No iron-clad performance guarantees

Our analysis showed some interesting sector performance patterns, but investors should take note that the frequency rates for most of these patterns were not particularly compelling overall. Additionally, as our analysis shows, the stated patterns of sector outperformance tend to be more clear prior to an initial Fed rate-hike than afterward. The further out beyond the initial rate increase you go, the trends become less conclusive.

#### Investment implications

With the early stages of the bull-market likely behind us, the market is somewhere in the neighborhood of the pre-rate-hike period when a change in sector leadership often takes place. There are no guarantees that historical patterns of sector performance will be repeated in the current market cycle, but the trends of the past may provide investors with some clues to consider about the future. ■

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**Past performance is no guarantee of future results.**

[i] Fed funds futures contract rates used for investor expectations of the Fed funds target rate. Source: Bloomberg, FMRCo (MARE) as of 3/8/10. Federal Reserve policy rate: federal funds rate, which has been set at 0%-0.25% since December 16, 2008. Source: Federal Reserve Board, [www.federalreserve.gov](http://www.federalreserve.gov).

[ii] Dates when Federal Reserve began its past seven interest-rate hike campaigns: July 1963; January 1973; August 1977, September 1980; March 1983; February 1994; June 2004. Source: Federal Reserve Board, FMRCo (MARE) as of 3/22/2010.

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