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Market Analysis, Research & Education
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Sector Investing: Mid-Cycle Leadership Patterns Emerge

Fed policy a wild card in assessing next inflection point in economic cycle

[The following analysis provides insight on equity market sectors and the current state of the economy, which may help inform active investors looking to pursue a tactical approach. To understand how historical sector leadership patterns have evolved based on inflections points in the economy, please read the **Tactical Handbook of Sector Rotations,** *beginning on page 2.)*

If we map the current economic cycle to the historical roadmap of sector leadership rotations, it generally has been a fairly typical cycle so far. The early-cycle market phase began in the spring of 2009 (roughly three months before the end of the recession) and lasted roughly one year, with the four early-cyclical sectors leading the rally (i.e., consumer discretionary, industrials, financials and information technology all up roughly 60% or more during that 12-month period). The next six months, coincident with the European debt crisis and the downturn in the stock market during the middle of 2010, was a period when some defensive sectors outperformed but no clear leadership pattern emerged. The beginning of the market rebound in the fall of 2010 appears to mark the start of the mid-cycle phase, as mid-cyclical sectors such as energy, materials and industrials spearheaded the market rally through the first quarter of 2011 (see Exhibit 1, page 2).

KEY TAKEAWAYS

- **Performance leadership among U.S. equity sectors often has rotated near inflection points in the economy, and a historical analysis of this relationship can serve as a roadmap for tactical-minded investors.**
- **The business characteristics that heavily identify each sector, such as the interest-rate sensitivity of financials or the relative revenue stability of consumer staples, tend to drive sector leadership patterns.**
- **Mid-cycle equity sectors, such as energy, materials and industrials, have led the market recovery during the past several months, which is consistent with historical patterns showing that mid-cycle leadership typically has preceded and continued beyond monetary tightening by the Federal Reserve.**

Fed policy worth monitoring

The atypical policies employed by the Federal Reserve (Fed) pose a significant challenge in trying to determine an outlook for the current economic cycle based on historical patterns. The Fed is still loosening monetary policy through its quantitative easing program that is scheduled to last through mid-2011, which stands as a historical anomaly for a mid-cycle market phase in which sector leadership usually shifts in anticipation of the first Fed rate hike. If the Fed ends its quantitative easing in June 2011—particularly if it allows its balance sheet to shrink as securities mature—it may be considered the first tightening of this economic cycle. If the traditional measure of an actual increase in the federal funds rate is utilized, current market expectations suggest the first Fed rate hike will occur some time toward the end of 2011 or early 2012.[i]

Typically, the mid-cycle market phase begins roughly three months prior to Fed tightening and lasts for approximately one year. This time, mid-cycle sectors have already outperformed for roughly six months, with the likelihood that we are still at least three months away from any Fed action that could be construed as a tightening. The historical pattern would suggest that mid-cycle sector leadership may continue for several more months, but the end of the mid-cycle depends heavily on one's interpretation of Fed action.

Investment implications

While there are some clear historical patterns of sector leadership shifts amid changes to the busi-

EXHIBIT 1: Given the sector leadership of energy, materials and industrials during the past six months, it appears the market may currently be in the mid-cycle phase, which generally starts prior to and continues beyond initial monetary policy tightening by the Federal Reserve.

Equity Sector Leadership During Recent Bull Market (2009-2011)	Early Phase	No Clear Pattern	Mid-Cycle Phase
	1st Year	Next 6 Months	Past 6 Months
S&P 500 Index	50%	-1%	17%
Consumer Discretionary	**70%**	3%	18%
Consumer Staples	36%	2%	9%
Energy	30%	-1%	**42%**
Financials	**83%**	-10%	15%
Health Care	35%	-4%	9%
Industrials	**73%**	0%	**22%**
Information Technology	**58%**	-2%	13%
Materials	56%	0%	**24%**
Telecommunication Services	12%	16%	13%
Utilities	21%	8%	4%

Early Phase: 4/1/09-3/31/10. No Clear Pattern: 4/1/10-9/30/10. Mid-Cycle Phase: 10/1/10-3/31/11. Source: Factset, FMRCo. (MARE) as of 3/31/2011.

ness cycle, the usefulness of such patterns as tactical roadmaps depends highly on correct prognostications of turning points in the economy. Today, the pattern of mid-cycle sector leadership has asserted itself over the past several months, confirming that the economy moved beyond the early recovery stage and has moved closer to eventual monetary tightening. However, the Fed's unconventional monetary policies make the timing of tightening—the key mid-cycle event—highly uncertain and open to interpretation. For tactical investors, historical patterns suggest mid-cycle sector leadership may continue through the first phase of Fed tightening, but today's unusual monetary cycle makes it difficult to ascertain how long that may be. ■

A Tactical Handbook of Sector Rotations

U.S. equity sector leadership has tended to shift near turning points in the economic cycle

Using the 10 major U.S. equity market sectors is one way opportunistic investors can make tactical adjustments within a portfolio's equity allocation. Because certain equity sectors have tended to assume performance leadership at different inflection points in an economic cycle, an understanding of these historical patterns may help inform active investors who opt to pursue a tactical approach.[ii]

Understanding economic inflection points

Changes in the pace or trajectory of economic growth historically have triggered performance shifts within the equity market. Understanding and recognizing the distinctive turning points within an economic cycle may be useful to developing an effective tactical sector strategy.

Economic cycles do not move in standardized fashion, no two cycles are exactly the same, and unforeseen macro-economic events or shocks can sometimes disrupt a trend. However, a typical cycle unfolds as follows: The economy emerges from recession and the rate of growth accelerates off previously low or negative levels; the rate of growth remains strong, expansion becomes firmly entrenched, and the Federal Reserve (Fed) begins to raise rates to temper growth and prevent an unwanted rise in the rate of inflation; the pace of growth slows and eventually turns negative as the economy contracts and enters recession, leading the Fed to cut interest rates and help move the economy toward recovery (see Exhibit 2, page 3).

While there are many ways to identify turning points in the economy, our research shows the most definitive market changes occurred around three key inflection points[iii]:

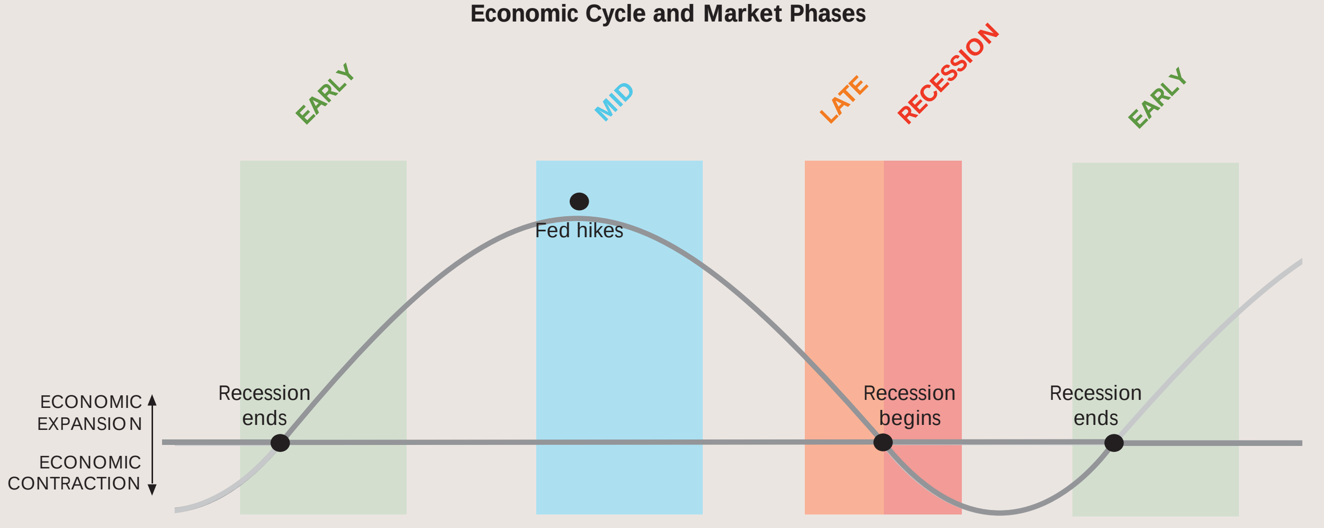
- The end of recession (beginning of expansion)
- The initial (post-recession) interest rate hike by the Fed
- The start of recession (end of expansion)

Identifying equity market phases

The stock market, itself a leading economic indicator, tends to move in advance of actual changes in the economy or the business climate as investors anticipate what is expected to unfold. Our historical research identified four market phases where a shift in market performance and equity sector leadership took place near each of the three inflection points in an economic cycle:

- **Early-cycle phase:** Begins prior to the end of a recession as investors begin to anticipate an

EXHIBIT 2: The four phases that distinguish changes in stock market performance and equity sector leadership have historically tended to take place near key inflection points in the economic cycle.



Source: FMRCo. (MARE).

economic recovery, and extends through the initial economic acceleration. The stock market historically has registered exceptional gains, on average 32% during this period. *[For the purposes of this article, this phase begins three months prior to the end of a recession and extends through the first nine months of recovery.]*

- **Mid-cycle phase:** Begins prior to the Fed's initial rate increase, as the recovery broadens into expansion and the Fed moves to dampen inflation pressure. The market typically performs well during this phase (average return of 11%). *[Begins three months prior to the initial rate hike, and extends nine months beyond.]*
- **Late-cycle phase:** Begins prior to recession as the market anticipates a greater slowdown ahead, and ends as the economy enters recession. Stock market performance has historically been roughly flat (-0.4% average return). *[The six-month period prior to the start of a recession.]*
- **Recession phase:** Begins at the start of recession and lasts for the first part of economic contraction. Stock market returns turned negative (-7% on average). *[First six months of a recession.]*

Since 1963, while the length and magnitude of economic cycles has varied, there have been seven examples of each of the three key economic inflection points, and thus seven examples of each of the four market phases *(The current cycle is not complete so it has been excluded in this historical analysis).*[iv]

Sector leadership rotations near economic inflection points

Sector performance patterns

A historical analysis of the cycles since 1963 shows the relative performance of equity market sectors has tended to rotate near turning points in the economy, with different sectors assuming performance leadership in different market phases. While it was rare that any one sector outperformed 100% of the time during any one particular phase, there are certainly some patterns of leadership consistency within each phase (see Exhibit 3, page 5). For each sector, our analysis examined both the magnitude of performance (average and median) relative to the broader equity market, and the frequency of outperformance (how often each sector performed better than the broader market).

Early-cycle phase

Prior to the end of a recession and during the early months of a recovery, sectors that typically benefit from a backdrop of low interest rates and the first signs of economic improvement tended to lead the market's advance. Interest-rate-sensitive sectors, such as the consumer discretionary and financials sectors, historically have outperformed the market by roughly 13 percentage points and 7 percentage points respectively, on average, and have done so

86% of the time (Exhibit 3). These sectors do well in part due to industries that benefit from increased borrowing, which includes banks (financials) and consumer durables such as autos and housing (consumer discretionary). The information technology sector also has fared well in the early-cycle phase, boosted by industries such as semiconductors and electronic components that are among the most highly leveraged to an economic recovery. Most of tech's early-cycle outperformance has tended to come in concentrated doses early in the period, but has faded after the recession ended. The industrials sector includes some industries, such as air freight, trucking, and rail transportation, where demand escalates rapidly in the very early stages of recovery, with the best performance typically coming during the first three months after the economy emerges from recession.

Mid-cycle phase

As the economy moves beyond its initial stage of growth and the Fed prepares to begin raising interest rates, the leadership of interest-rate sensitive sectors tapers. At this point in the cycle, economically sensitive sectors still lead, but a shift takes place toward some industries that don't tend to see a peak in demand for their products or services until the expansion has become more firmly entrenched. Energy, materials and industrials assume market leadership 71% of the time during this phase (Exhibit 3). For example, demand for certain industrials, such as heavy equipment, and engineering & construction services, tends to pick up during this phase because it takes some time for companies to feel confident and profitable enough to initiate spending on large-scale infrastructure projects. Similarly, such longer-term projects also prompt demand for energy commodities and other raw materials, such as copper, aluminum and steel. Technology also has tended to perform well during this phase, having certain industries, such as software, and computers & peripherals, that typically pick up momentum once companies gain more confidence in the stability of an economic recovery and are more willing to spend capital.

Late-cycle phase

As the economic recovery matures, some economically sensitive sectors, such as materials and energy, continue to do well as the late-cycle economic expansion helps maintain solid demand and prices for commodities and raw materials. Elsewhere, as investors begin to glimpse signs of an economic slowdown, many also rotate to more defensive-oriented sectors, such as consumer staples and health care, where profits are more tied to basic needs and are less sensitive to the economy (Exhibit 3). All of these four aforementioned sectors have outperformed the broader market during this phase by seven percentage points or more on average, and have done so 71% or more of the time.

Recession phase

As economic growth stalls and contracts, sectors that are more economically sensitive fall out of favor and those that are defensive-oriented rotate to the front. These less economically sensitive sectors—including consumer staples, utilities, telecommunication services and health care—are dominated by industries that produce products, such as toothpaste, phone service, electricity and prescription drugs, that consumers are less likely to cut back on during a recession. As a result, investors tend to gravitate to these sectors because their profits are likely to be more stable than those in other sectors during a recession. The consumer staples sector has a perfect track record of outperforming the broader market throughout the entire six-month recession phase. High dividend yields offered by utility and telecom companies have also helped these two sectors hold up relatively well during prior recessions (Exhibit 3). ■

EXHIBIT 3: Since 1963, different sectors have assumed leadership during different market phases, in terms of both frequency and magnitude of outperformance.

U.S. Equity Sector Performance Relative to Broader Equity Market (1963-2007)											
	Relative Sector Performance										Total Return
Early-Cycle Phase	**Financials**	**Cons. Disc.**	**Info. Tech.**	**Industrials**	**Energy**	**Materials**	**Cons. Staples**	**Health Care**	**Utilities**	**Telecom**	**Stock Market**
Median	11.5%	11.5%	6.8%	4.1%	-12.3%	3.9%	4.9%	-1.0%	-17.3%	-20.6%	36.3%
Average	7.4%	13.3%	2.7%	7.3%	-11.1%	1.4%	2.2%	-1.2%	-13.6%	-22.6%	31.8%
Frequency*	86%	86%	57%	86%	14%	71%	71%	43%	14%	0%	
Mid-Cycle Phase	**Financials**	**Cons. Disc.**	**Info. Tech.**	**Industrials**	**Energy**	**Materials**	**Cons. Staples**	**Health Care**	**Utilities**	**Telecom**	**Stock Market**
Median	-2.9%	1.2%	6.9%	2.7%	3.4%	6.5%	-0.2%	4.8%	-6.7%	-2.4%	11.3%
Average	-2.1%	0.2%	4.5%	3.9%	6.6%	4.8%	-0.6%	2.2%	-5.7%	-3.3%	11.4%
Frequency*	43%	57%	57%	71%	71%	71%	43%	57%	14%	29%	
Late-Cycle Phase	**Financials**	**Cons. Disc.**	**Info. Tech.**	**Industrials**	**Energy**	**Materials**	**Cons. Staples**	**Health Care**	**Utilities**	**Telecom**	**Stock Market**
Median	3.8%	-4.9%	-1.4%	1.8%	11.6%	9.9%	8.5%	2.1%	-2.5%	-3.8%	-0.6%
Average	-0.1%	-2.8%	-2.7%	1.7%	7.2%	10.6%	8.1%	6.8%	0.2%	-4.5%	-0.4%
Frequency*	57%	29%	43%	71%	71%	86%	71%	71%	43%	29%	
Recession Phase	**Financials**	**Cons. Disc.**	**Info. Tech.**	**Industrials**	**Energy**	**Materials**	**Cons. Staples**	**Health Care**	**Utilities**	**Telecom**	**Stock Market**
Median	-1.5%	-2.8%	-3.1%	-3.0%	-5.0%	6.5%	5.9%	4.0%	4.5%	5.1%	-8.9%
Average	-2.5%	-1.8%	-3.7%	-3.4%	0.3%	4.2%	5.7%	4.8%	3.1%	4.6%	-7.2%
Frequency*	29%	29%	29%	0%	43%	57%	100%	71%	71%	57%	

*Frequency of the sector outperforming the overall market in each phase. The green shading denotes sectors that outperformed the market. The blue shading denotes a frequency of outperformance greater than 50%. The early-cycle phase is defined as 3 months before to 9 months after the recession ends; Mid-cycle is 3 months before to 9 months after the first rate hike; Late-cycle is 6 months before, up to the start of the recession; Recession phase is from the recession start to 6 months after. Relative sector performance shown versus the performance of the largest 3000 U.S. stocks by market capitalization. Sectors defined by Global Industry Classification Standards (GICS®). All performance data are cumulative total returns over the stated period. Source: FMRCo. (MARE) as of 12/31/07. Past performance is guarantee of future results.

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Investment decisions should be based on an individual's own goals, time horizon, and tolerance for risk.

Past performance is no guarantee of future results.

[i] Source: Fed funds futures, Bloomberg, as of March 31, 2011.
[ii] Sectors defined by Global Industry Classification Standards (GICS®). All performance data are cumulative total returns and are represented by the top 3000 market-cap-weighted U.S. stocks on the New York Stock Exchange (NYSE). Source: Haver Analytics, FMRCo. (MARE) as of 12/31/07.
[iii] MARE also evaluated the acceleration and deceleration in the index of Leading Economic Indicators, the inversion of the yield curve, the first Fed rate cut in an easing cycle, and other factors that are used to gauge shifts in the pace of economic growth. The three inflection points used in this article were the most compelling from the standpoint of demonstrating clear shifts in sector leadership and market performance overall. The three inflection points cited in the article are the recession end dates (Nov 1970, Mar 1975, Jul 1980, Nov 1982, Mar 1991, Nov 2001, Jun 2009); the first rate hikes after the end of a recession (Jul 1963, Jan 1973, Aug 1977, Sep 1980, Mar 1983, Feb 1994, Jun 2004); and the beginning of a recession (Dec 1969, Nov 1973, Jan 1980, Jul 1981, Jul 1990, Mar 2001, Dec 2007). Recessions are defined by the National Bureau of Economic Research (NBER). Source: Federal Reserve Board, National Bureau of Economic Research, FMRCo. (MARE) as of 12/31/07.
[iv] There were periods in between each of the four market phases when the economy was not within the identified range of any particular inflection point. The stock returns cited during the four market phases do not therefore include all stock market performance since 1963 but rather only the periods that fall within one of the four identified market phases. See footnote [iii] above for exact dates.