Market Analysis, Research & Education
A unit of Fidelity Management & Research Company

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.[i]

Understanding economic inflection points

The expansion or contraction of the U.S. economy is often measured by the rate of change in output growth (gross domestic product). 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 1, page 2).

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[ii]:

- 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

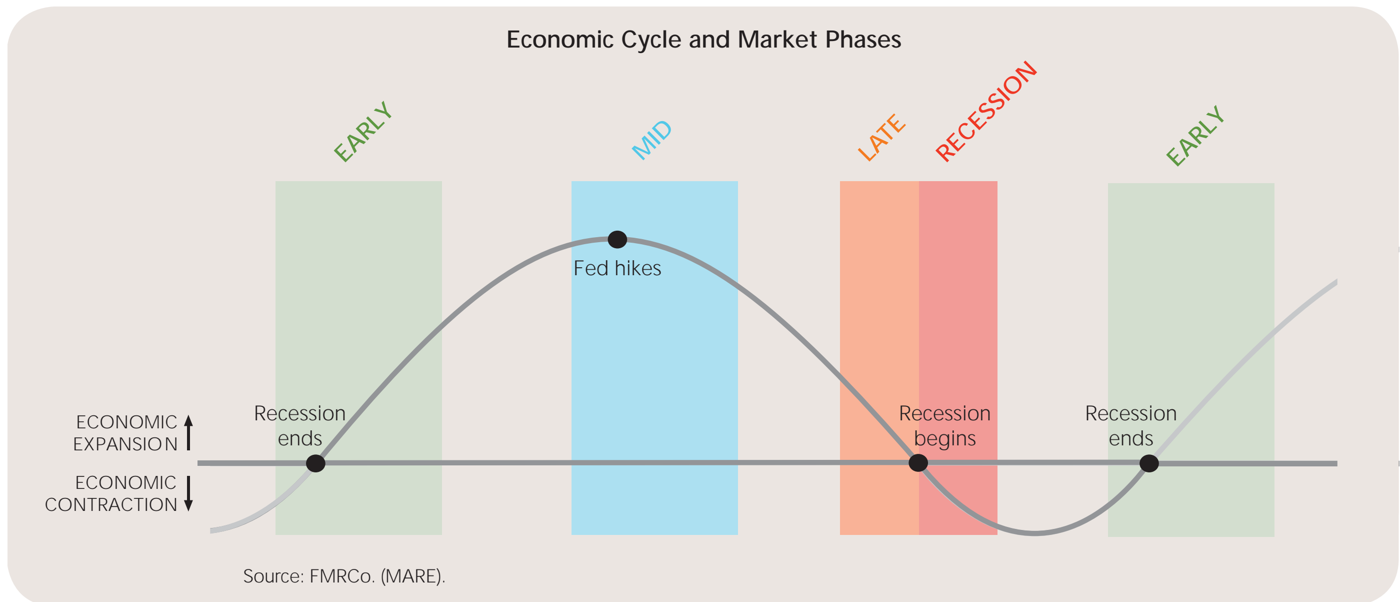
The stock market, itself a leading economic indicator, tends to move in advance of actual changes in the economy or the business climate as investors anticipate what is expected to unfold. Our historical research identified four market phases where a shift in market performance and equity sector leadership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

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.
- The robust stock market rally in 2009 most resembled the early phase of recovery, suggesting the market may be nearer to a mid- or late-cycle phase.

EXHIBIT 1: 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).

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 hence seven examples of each of the four market phases.[iii]

Sector leadership rotations near 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 2, page 3). 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 2). 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

EXHIBIT 2: 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 (1963-2010)

	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 7/31/10. Past performance is guarantee of future results.

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 2). 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 2). 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

EXHIBIT 3: Based on historical performance, sectors may be categorized as better relative peformers during different market phases.

U.S. Equity Sectors — Tactical Snapshot		
Sectors	Best Stages	Highlights of Historical Performance vs. Broader Equity Market Within Each Sector's Best Phase
Financials	Early	Frequency of outperformance higher toward the end of the early phase.
Consumer Discretionary	Early	Frequency and magnitude of outperformance higher toward the beginning of the early phase.
Information Technology	Early	Best performing sector during first three months of early phase.
	Mid	Best performing sector during first three months of mid-phase.
Industrials	Early	Best performing sector during three months after the end of recession.
	Mid	Frequency of outperformance higher toward beginning of the mid-phase.
Energy	Mid	Best performing sector during three months after Fed rate hike.
	Late	Best performing sector during three months before the start of recession.
Materials	Mid	Frequency of outperformance higher toward the end of the mid-phase.
	Late	Frequency and magnitude of outperformance higher toward the beginning of the late phase.
Consumer Staples	Late	Consistent outperformer throughout both late and recession phases.
	Recession	
Health Care	Late	Frequency and magnitude of outperformance higher toward the beginning of the late phase.
	Recession	Frequency and magnitude of outperformance higher toward the end of the recession phase.
Utilities	Recession	Frequency and magnitude of outperformance higher during late part of late phase and early part of recession phase.
Telecommunication Services	Recession	Best performing sector during the three months after the start of a recession.

Source: FMRCo. (MARE) as of 7/31/10. Past performance is no guarantee of future results.

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 2).

Where are we now?

If we map the current market cycle to the historical road map and assume the recession ended in June 2009, it appears the early-cycle market phase ended sometime in the first half of 2010. By our definition of the early cycle phase (beginning three months prior and ending nine months after the end of the recession), the 53% rebound in U.S. stock prices from April 2009 through March 2010 does resemble the typical early-phase pattern. The best performing sectors were typical early-phase leaders such as consumer discretionary (77%), industrials (73%), financials (70%), and technology (61%).

Since the end of the early phase, the market has flattened and the sector pattern has become more muddled. The historical road map suggests the next inflection point will be in anticipation of the first Fed rate hike. However, the current economic cycle – in the aftermath of the worst financial crisis since the 1930s and implementation of extraordinary monetary policies by the Fed – demonstrates the limitations of historical analysis.

Monetary policy is very different today than in the previous cycles over the past four decades, and the Fed appears nowhere close to raising rates today. Some economists are already concerned about the potential for a "double-dip" recession, suggesting a possible scenario where the typical "mid-cycle" inflection point of Fed hiking never occurs. However, leading economic indicators have yet to point to a high probability of a double-dip recession (see MARE's "August Economic Update: Growth Slows, Leading Data Not Showing 'Double-Dip'"), which implies the market is currently somewhere in a mid or late phase but has yet to continue along the classic historical pattern.

Investment implications

There are some clear historical patterns of sector leadership shifts amid changes to the business cycle that serve as a roadmap for tactical investing. Such patterns are by no means 100% accurate, partly because every cycle is different, and their usefulness depends on correct prognostications of turning points in the economy. Today, if one believes the economy is simply in a mid-cycle pause and will remain in recovery mode, mid-phase sectors may move to the forefront (or even some early-phase if the economy re-accelerates). If one believes the economy is headed toward a double-dip recession, late-phase sectors may stand out. At any rate, tactical investors may use the historical patterns as a guide for how to create a sector allocation that is more or less exposed to a variety of different economic scenarios.

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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] 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 7/31/10.
[ii] 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) and MARE estimates the most recent recession ended in June 2009. Source: Federal Reserve Board, National Bureau of Economic Research, FMRCo. (MARE) as of 7/31/10.
[iii] 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 [ii] above for exact dates.

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