

2014 Outlook: Consumer Staples

Robert Lee, Sector Portfolio Manager

Fidelity sector portfolio manager Robert Lee provides his view on the most attractive investment opportunities and the major risks in the consumer staples sector in 2014.

INVESTMENT OPPORTUNITIES IN 2014

Further penetration in emerging markets

One of the most promising investment themes in the consumer staples sector in the coming year will be the revenue and profit growth potential for certain multinational companies due to growing middle-class populations and rising wealth in emerging-market countries. During the past several years, emerging-market economies have modernized and incomes have risen to the point that a growing share of their populations is now able to purchase consumer staples products, such as toothpaste, toilet paper, and shampoo, on a more regular basis.

The behavior of consumers in emerging markets is consistent with what has previously occurred in developed countries. When consumers in emerging markets transition from low-income status to the middle class, consumption increases. Emerging-market populations still consume only a fraction of what populations in wealthier, developed countries consume. For instance, many living in rural China have gone from shampooing their hair once a month to once per week, representing huge incremental growth in product sales. Comparatively, the populations in developed-country markets, such as the U.S., Europe, and Japan, generally consume about as much of these basic staples as they probably will in the future.

The capital costs of launching into a new foreign market can be significant, but during the past several years many large companies have strategically built manufacturing and distribution operations in emerging markets to capitalize on this potential growth opportunity. Companies that have already invested in building the infrastructure required to take advantage of the growth in emerging markets should be well positioned for further incremental growth in 2014 and beyond. Some companies are also attempting to get new emerging-market customers to trade up into higher-priced products. Higher prices boost profit margins, which in turn can improve earnings growth.

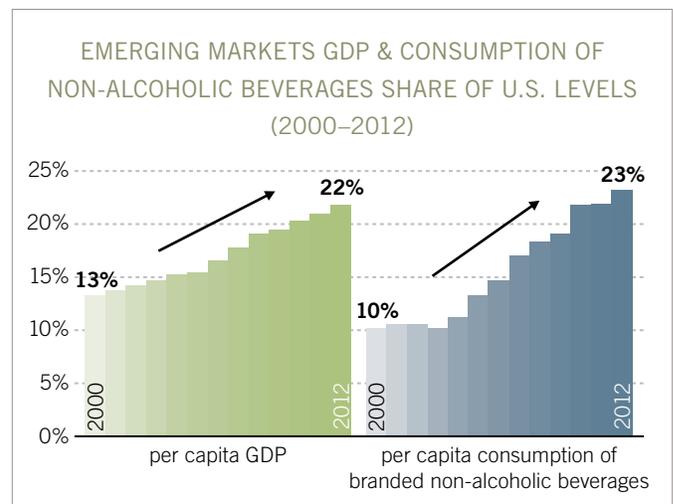
The emerging-markets theme has been in progress for years, but in my view emerging-market consumption of staples products still has a lot more runway over the next decade. During the past

decade, consumption of branded non-alcoholic beverages in these economies has increased from an estimated 10% of U.S. consumption levels in 2000 to an estimated 23% as of 2012 (see Exhibit 1, below). Looking ahead to 2014, I believe major multinational players should continue to be the major beneficiaries of emerging-market consumption growth, barring any unexpected cyclical economic downturn.

Staples companies with pricing power

Another theme that I expect to continue playing out in 2014 is that companies with pricing power—that is, the ability to raise prices without a commensurate decline in demand—should continue to generate attractive earnings and stock price appreciation over time. Pricing power can stem from a variety of sources. For example, certain brand-name products in the alcoholic beverages or tobacco categories may project a social status image that is desirable by consumers who are willing to pay a premium to consume such products. In other instances, some consumers are willing to spend more for a brand because it satisfies an emotional (vs. functional) need. For example, some consumers spend considerably more on baby or pet food items because they intend to provide what they

EXHIBIT 1: Consumption levels in emerging-market countries have risen steadily during the past several years.

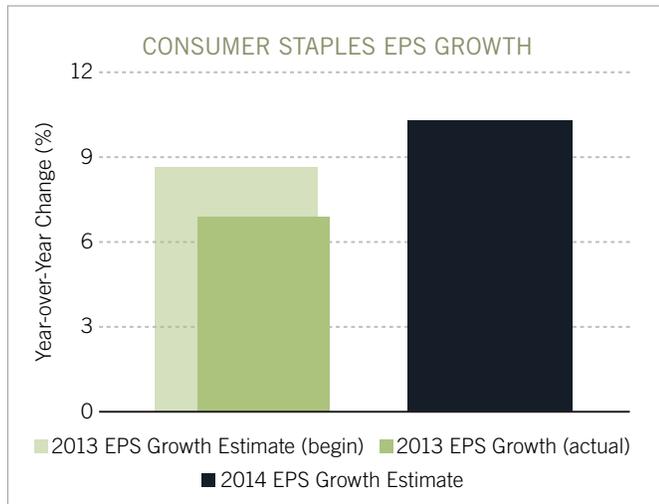


Emerging markets represented by Brazil, Russia, India, and China only. Source: International Monetary Fund, company reports, and Beverage Digest, as of Dec. 31, 2012.

Consumer Staples

December 2013

EXHIBIT 2: Year-to-date earnings growth in the consumer staples sector has been below expectations, but analysts are forecasting faster growth in 2014.



EPS Growth Estimate for 2013 was as of Dec. 31, 2012. Actual 2013 data include estimates for Q4 2013. EPS: earnings per share. Source: FactSet, Fidelity Investments, as of Oct. 31, 2013.

believe is a higher-quality product to their family. In each of these instances, consumers are willing to spend more for higher-priced products, regardless of their income level. Such products often generate higher profit margins for the companies manufacturing them.

Valuation discrepancies

Valuation is a key part of my investment process in trying to identify the most attractive investment opportunities in the consumer staples sector. While there are certain secular themes that I remain mindful of, including companies with emerging-market exposure and pricing power, at any given point the companies that I am most optimistic about can be cheap or expensive. For example, certain companies that I believe have promising footholds in emerging markets were discounted during the past several months because economic growth in these countries declined. In such instances, I see this as an opportunity to own a greater portion of the stock given my view of this company as a beneficiary of a long-term, secular theme. At the same time, some companies that were more domestically focused became more expensive during 2013, given the relatively strong U.S. economic backdrop. Today, the valuations in the sector on average are roughly in line

with historical averages based on traditional price-to-earnings metrics. However, as we move into 2014, investors may want to consider valuation as a tool to build positions in staples stocks that have promising growth potential over the long term.

RISKS: WHAT TO WATCH IN 2014

Further economic weakness in emerging markets

While I expect the sales growth of consumer staples products in emerging markets to be a long-term trend given the burgeoning middle class, the cyclical economic slowdown in these countries during 2013 bears monitoring. Consumer staples spending patterns in emerging markets have been more stable and less sensitive to the macro economy in certain countries during the past several years. However, the macroeconomic backdrop is still a more important driver of sales in emerging markets than it is in developed markets, where fluctuations in sales are less sensitive to swings in the economy.

The primary reason for this greater sensitivity in emerging markets is the relatively lower per-capita income level in the developing world. For typical consumers in the U.S. with annual household incomes of \$50,000 or more, the cost of everyday items such as toothpaste or laundry detergent is low enough to view those items as necessities. But for typical consumers in emerging countries such as China or Brazil with annual household incomes of \$10,000 or less, the cost of those same items represents a much larger portion of their income. Those consumers have been more likely to view such items as discretionary indulgences to purchase when they are feeling optimistic about their financial situation, but tend to cut back on them when they are nervous about the economy.

Going forward, investors should be mindful of the potential greater sensitivity of consumer spending in emerging markets, as further economic weakness could hinder sales and profit growth, as well as stock price appreciation for some multinational companies.

Price wars

Although there is little evidence of extensive price cutting among certain product categories at present, investors should always keep a close eye on pricing trends. Periodically in this sector, a specific company that is struggling and perhaps losing market share in a key product category decides to significantly cut pricing to spark demand. When this occurs, very often other competitors follow suit and match the lower price levels. Such a trend can hinder overall profits in a specific industry, as well as stock prices.

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Robert Lee is a portfolio manager for Fidelity Investments. He currently oversees several consumer staples sector portfolios and subportfolios. He joined Fidelity as a research analyst in 2001.

Fidelity Thought Leadership Vice President and Associate Editor Kevin Lavelle provided editorial direction for this article.



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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.

Neither asset allocation nor diversification ensures a profit or guarantees against a loss.

Because of their narrow focus, investments in one sector tend to be more volatile than investments that diversify across many sectors and companies.

The consumer staples industries can be significantly affected by demographic and product trends, competitive pricing, food fads, marketing campaigns, environmental factors, government regulation, the performance of the overall economy, interest rates, and consumer confidence.

Stock markets, especially foreign markets, are volatile and can decline significantly in response to adverse issuer, political, regulatory, market, or

economic developments. Foreign securities are subject to interest rate, currency exchange rate, economic, and political risks, all of which are magnified in emerging markets.

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