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2014 Outlook: Materials

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Fidelity sector portfolio manager Tobias Welo provides his view on the most attractive investment opportunities and the major risks in the materials sector in 2014.

INVESTMENT OPPORTUNITIES IN 2014

Growing demand for construction materials

As residential construction growth continues and nonresidential construction picks up, producers of construction materials are likely to be first-wave beneficiaries. Construction materials companies serve three end markets: private residential, private nonresidential, and public. All three are improving (see Exhibit 1, below right). Despite a recent slowdown, residential activity continues to increase and supply/demand fundamentals point toward ongoing housing growth. Nonresidential construction tends to lag housing, but has finally begun to show signs of sustained improvement (though at different rates depending on geography and the particular market segment, with energy and commercial construction currently leading the pack).

Public construction is sensitive to government infrastructure funding and has been slow to begin a sustained recovery. However, the 2012 legislation known as MAP-21 included a huge increase in funding for the Transportation Infrastructure Finance and Innovation Act (TIFIA), which encourages public-private partnerships for large-scale surface transportation projects by underwriting low-interest financing.[1] This program alone is expected to support up to $10 billion in loans for transportation infrastructure projects through 2014, greatly stimulating new construction.

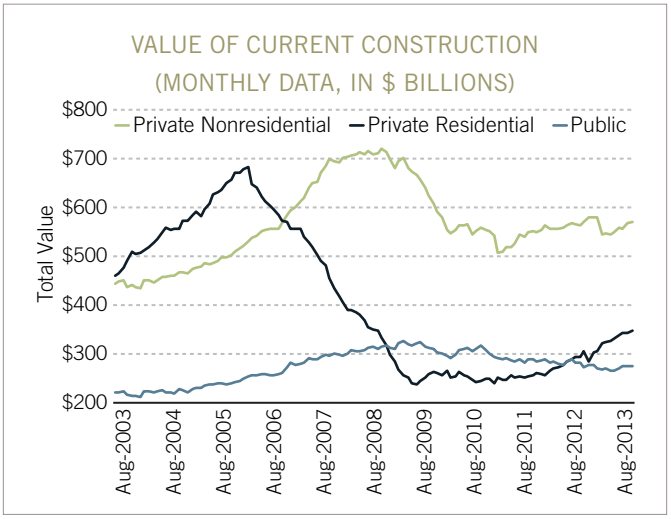
As the construction cycle turns increasingly positive, materials companies have several advantages. In general, they can easily match supply to demand, accelerating or slowing production as the need warrants. Because many construction materials—such as gravel, aggregate, and concrete—are heavy and costly to ship, companies tend to operate within local monopolies or oligopolies. Economies of scale reward companies for owning multiple resources (quarries, manufacturing plants) in a local area, which creates additional barriers to entry for competitors. As a result, increases in demand can very quickly generate increases in earnings. Both volume and pricing in the industry are up by mid-single digits over the past year, and I expect those trends to continue into 2014. The well-managed companies with strong balance sheets and reasonable current valuations are likely to produce the highest risk-adjusted returns over the medium to long term.

Spin-offs instead of M&A

Merger and acquisition (M&A) activity in the sector has been slow, outside of the containerboard sub-industry. The recent deals have been smaller (less than $500 million) and have generally focused on private companies as targets. However, more and more cyclical companies have made efforts to spin off business units into separate entities, attempting to unlock value by refocusing on the right mix of businesses. I expect this trend to continue in the short term, though only a handful of companies in the materials sector remain that have multiple unrelated business lines ripe for potential spins.

In contrast, the containerboard business (a part of the paper and packaging industry) continues to benefit from consolidation and pricing discipline. Inventories have gone down despite slow economic growth, a sign that companies are managing supply and demand well. Even a small increase in demand in 2014 could lead to healthy earnings growth and nice returns for this small group of companies. In the meantime, cash flow has remained very strong, and valuations are still attractive.

EXHIBIT 1: As private residential activity continues to climb, private nonresidential and public construction has begun to recover.



Value of current construction is a measure of the total value of construction under way during the measurement period, as estimated by the U.S. Census Bureau's "Value of Construction Put in Place" survey and seasonally adjusted. Source: U.S. Census Bureau, Haver Analytics, Fidelity Investments as of Nov. 11, 2013.

Fidelity INVESTMENTS

Slowly growing demand for industrial metals

In the highly cyclical materials sector, opportunities and risks sometimes seem to overlap. Companies that can manage well through the down parts of the cycle—and wait out dislocations of supply and demand—often present compelling opportunities, especially over the medium to long term.

The metals and mining industry has been risky recently, but may be starting to offer more opportunities. The industry has been challenged by worldwide declines in demand: For the past year, global industrial economic slowdowns have led to more available supply than needed, contributing to underperformance for mining company stocks. As of late 2013, the overall fundamentals remain negative even as the global economy slowly improves, due to current overcapacity. However, the market seems to have priced certain companies far below long-term values, which could lead to significant upside if demand increases and begins to match supply.

At this point in the cycle, it becomes especially important to look for companies with strong cash flows, a solid balance sheet, and good management. Companies closer to insolvency might offer higher potential stock appreciation if everything goes well, but the risks are too great. Buying cyclical companies near the trough, even solid ones, rarely feels good on a quarter-by-quarter basis, but with market expectations low and the beginnings of sequential improvement evident, long-term investors may find some rewarding opportunities.

Precious metals face a tougher situation. For example, even if the global economy improves, rising interest rates tend to challenge the price of gold, making it difficult for gold and gold mining companies to outperform. Although gold itself is likely to maintain its long-term role as "crisis insurance" within a diversified portfolio, the allure of buying gold or gold miners for short-term tactical gains seems to have diminished for now.

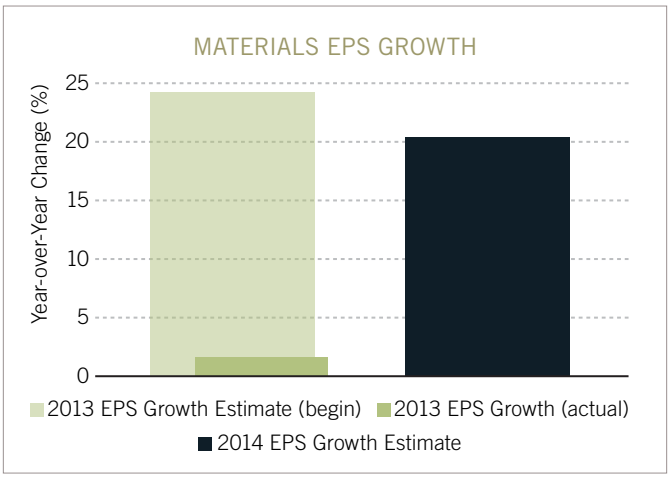
RISKS: WHAT TO WATCH IN 2014

Ag chemicals hit cyclical lows amid long-term growth

Agricultural chemical suppliers produce the materials required for farming, including seeds, fertilizers, and insecticides. Sales are very dependent on global agricultural cycles, which change quickly and can even be disrupted by the weather. After reduced crop yields in 2012 spurred excess production in 2013, grain prices fell and the demand for fertilizers dropped. Going into 2014, inventories are still high, and it may take several quarters or a year for this sub-industry to work its way toward a new equilibrium.

In the medium term, I believe there will be an ongoing need to increase food production per acre of farmland, to support a growing world population and higher standards of living in many developing nations. This need to boost farm production benefits the makers of agricultural chemicals. Cyclical downturns may offer opportunities to buy the stocks of well-managed companies at inexpensive prices, but whether an upward climb in earnings will begin in 2014 or later is difficult to predict.

EXHIBIT 2: With the economy in 2013 slower than anticipated, the expected earnings growth in the materials sector was likely pushed into 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.

Global macro, but company-specific micro

Similarly, commodity chemical sales are very responsive to cyclical patterns, in this case those of the global economy. With slowdowns in China and other emerging nations, companies in this business have been struggling to produce consistent growth through 2013. The stock of well-managed companies with high exposure to emerging markets may be selling at attractive valuations—especially if the global economy picks up in 2014 as anticipated—but it may be too early to invest with high conviction.

The companies in the materials space that produce commodity products are especially sensitive to management decisions about capital allocation. Overbuilt new capacity can depress an industry for several years, which is why a recent wave of activism in the sector has been trying to focus management teams on improving margins and increasing cash returns to shareholders rather than trying to force revenue gains through incremental production. Overcapitalized companies may be risky to own if they are poorly managed and prone to destroying value, but may also offer the opportunity for quick gains in response to shareholder-friendly changes in capital policies.

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Tobias Welo is a portfolio manager and research analyst for Fidelity Investments. Mr. Welo, who joined Fidelity in 2005, is responsible for managing multiple portfolios focused on the industrials and materials sectors.

Fidelity Thought Leadership Vice President and Senior Investment Writer Vic Tulli 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 a single sector tend to be more volatile than investments that diversify across many sectors and companies.

The materials industries can be significantly affected by the level and volatility of commodity prices, the exchange value of the dollar, import controls, worldwide competition, liability for environmental damage, depletion of resources, and mandated expenditures for safety and pollution control.

The gold industry can be significantly affected by international monetary and political developments such as currency devaluations or revaluations, central bank movements, economic and social conditions within a country, trade imbalances, or trade or currency restrictions between countries. Fluctuations in the price of gold and precious metals can dramatically affect the profitability of companies in the gold and precious metals sector and can directly affect the value of the securities issued by such companies.

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.

Endnotes

[1] Source: U.S. Department of Transportation website, "TIFIA Defined." http://www.fhwa.dot.gov/ipd/tifia/defined/index.htm. Accessed Oct. 28, 2013.

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