

STATE OF THE SECTOR

Consumer Staples

Robert Lee, Sector Portfolio Manager

KEY TAKEAWAYS

- Business conditions in the consumer staples sector remain somewhat favorable, with more stability in commodity input pricing and a generally steady global economic backdrop.
- The strengthening U.S. dollar over recent months continued to temper profit growth, though the sector's overall rate of sales and earnings growth remained positive.
- Stock valuations (P/E) remain roughly in line with the sector's historical average, but are slightly cheaper than normal relative to the broader U.S. equity market.
- *Research Spotlight:* Multinational staples companies have seen a deceleration in sales growth so far in 2013, but the pace of growth in emerging markets remains compelling.
- Expectations of single-digit earnings growth and a dividend yield in the range of 2.5% to 3% for consumer staples stocks looks reasonable; these levels have historically been supportive of stock prices.

Update on fundamentals

Business conditions in the consumer staples sector generally have remained fairly stable during the past six months. There have been few instances of extreme pricing competition or price wars. Commodity input costs have been reasonably stable, which is ideal for staples manufacturers because it allows them to better manage their costs and earnings expectations. There has been a modest deceleration in the underlying sales growth experienced by many staples companies so far in 2013 (see Earnings Scorecard, above right), but the growth rates are still within the range of growth seen during the past several years.

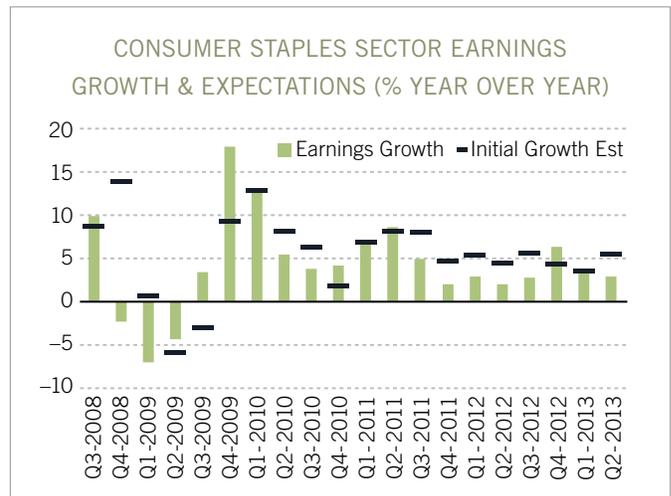
Strengthening dollar continued to be a headwind

Throughout the past couple of years, the strengthening of the U.S. dollar relative to foreign currencies has had a negative impact on the year-over-year earnings growth of U.S.-based consumer staples companies with multinational operations (see Exhibit 2, page 2). The weakening of foreign currencies relative to the U.S. dollar causes the foreign earnings of U.S. companies to decline in U.S. dollar terms, which are how they are reported by the companies. During the first half of 2013, I believe the strengthening of the U.S. dollar contributed to the uninspiring earnings growth in the sector, and it helped

Earnings Scorecard				
Q2 2013	Earnings Growth Actual (%)	Initial Earnings Growth Est. (%) ¹	Revenue Growth Actual (%)	Initial Revenue Growth Est. (%) ¹
MSCI U.S. IMI 2500*	2.8	5.1	2.7	3.5
Consumer Staples	2.9	5.5	0.2	3.4
Beverages	6.4	6.0	0.8	4.5
Food & Staples Retailing	9.6	12.3	0.4	4.3
Food Products	-9.2	-7.7	-1.9	0.0
Household Products	5.1	7.8	3.8	6.3
Personal Products	23.8	16.8	4.5	4.1
Tobacco	-2.9	5.4	-1.1	2.9

*MSCI U.S. Investable Market 2500 Index represents the investable universe of companies in the U.S. equity market. Consumer staples companies of the MSCI U.S. IMI 2500 are classified according to the Global Industry Classification Standard (GICS®). ¹Initial Earnings Growth Estimate and Initial Revenue Growth Estimate reflect a consensus of Wall Street analysts' expectations prior to the start of the quarter. Data reflect reported operating earnings/revenue for 96% of the MSCI U.S. IMI 2500 and 90% of consumer staples companies in the MSCI U.S. IMI 2500 Index, combined with earnings estimates for the remaining firms. Source: Fidelity Investments, FactSet, as of Sep. 30, 2013.

EXHIBIT 1: Consumer staples companies have produced earnings growth in the low single-digit range so far in 2013.



Earnings growth for Q2 2013 based on 90% of consumer staples companies reported, combined with earnings estimates for the remaining firms. Initial Growth Estimate (i.e., "Expectations") reflects a consensus of Wall Street analysts' expectations prior to the start of each quarter. Source: FactSet, as of Sep. 30, 2013.

State of the Sector: Consumer Staples

October 2013

EXHIBIT 2: Since 2011, the U.S. dollar has strengthened relative to foreign currencies.



See page 4 for index definition. Source: Bloomberg, as of Sep. 30, 2013.

cause staples companies in aggregate to miss the market's expectations in the second quarter (see Earnings Scorecard, page 1). The consumer staples sector is one of the sectors, including information technology and health care, that tend to generate a significant percentage of overall profits from their overseas operations. At the same time, investors should keep in mind that while the impact of currency movements can influence the profitability of multinational companies over any short-term period, this impact tends to wash out over an intermediate-term investment horizon because currencies historically have tended to rise and fall in a cyclical fashion.

Looking ahead to the third quarter, Wall Street analysts are currently anticipating a 4.2% rate of quarterly earnings growth, which is down from expectations of 8.3% entering the quarter on July 1, 2013.¹

New product innovation in tobacco industry

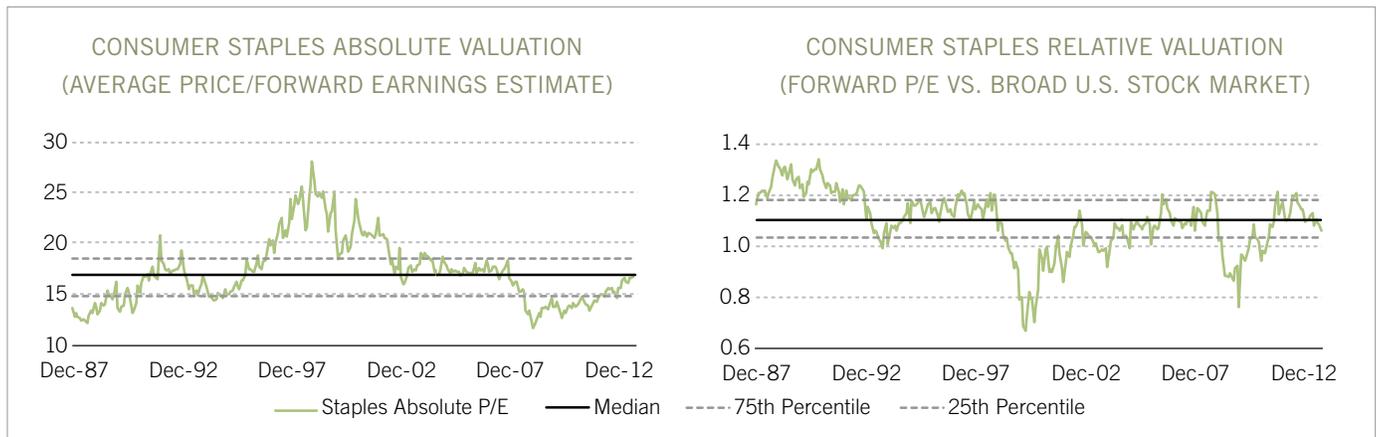
Many investors who are willing to invest in stocks of tobacco companies have become interested in the development of electronic cigarettes. These products, which are promoted as potentially "healthier" alternatives to traditional cigarettes, have gained sales momentum over the past few years and now represent approximately one percent of the industry's sales. At present, the manufacturing and distribution of these new products is fairly fragmented, as several companies are involved, including both the major existing tobacco companies as well as newer, much smaller firms. If these products continue to take market share over time, I would expect at some point to see consolidation among the manufacturers.

Assessing valuation

Stock valuations in the consumer staples sector were reasonable at the end of the third quarter of 2013. The sector's price-to-earnings ratio (forward earnings) stood at 16.8 as of Sep. 30, 2013, roughly in line with its long-term average of 17.0 (see Exhibit 3, below). Comparing this valuation ratio to that of the broader U.S. equity market (15.9 P/E), stocks in the consumer staples sector are about 6% more expensive than the equity market as a whole, but that is modestly below the 10% premium the staples sector has historically averaged.

Investors using valuation as a tool for investment decision making should keep in mind that consumer staples stocks have tended to trade at modest premiums to the stocks in other sectors, due to the historically more attractive balance of earnings growth and consistency that businesses in the staples sector have generated. During periods when investors are unusually fearful and risk averse, they tend to put a higher-than-normal value on the perceived safety of staples-sector stocks, and the relative valuation premium for the sector can be higher than normal. On the other hand, during periods of investor optimism and

EXHIBIT 3: The valuations for consumer staples stocks are below the sector's historical average (left), and are trading at a modest premium to the broader equity market (right).



Forward earnings data as of Jun. 30, 2013. U.S. stock market: Fidelity Top 3000 Stock Index. See page 4 for index definitions. Source: Haver Analytics, as of Sep. 30, 2013.

complacency, they tend to assign less value to the perceived safety of staples sector stocks, and the relative valuation premium for the sector typically can be lower than normal. Today, the

sector's current valuation, which is roughly in line with its historical average versus the broader market, is a sign that investors' current levels of optimism/pessimism are fairly well balanced.

RESEARCH SPOTLIGHT

Sales Growth Slows in Emerging Markets but Still at a Healthy Pace vs. Developed Countries

Many multinational consumer staples companies that produce and sell products such as shampoo, bottled water, and toothpaste in emerging-market countries have seen a deceleration in the rate of year-over-year sales growth so far in 2013. However, this rate of growth in emerging markets still remains strong, particularly relative to levels seen in mature, developed countries.

This deceleration in sales growth of consumer products in emerging markets follows a trend largely in place since 2011, which was the most recent peak in the sales-growth rate for both emerging-market and developed countries since the 2008–09 global financial crisis. More specifically, year-over-year sales growth in emerging-market countries for a basket of multinational consumer staples companies declined to 6.0% at the end of June 2013, from 7.4% at the end of 2012, and down from the peak of 11.8% at the end of the third quarter in 2011. Comparatively, sales growth in developed countries was flat at the end of the second quarter of this year, down from 1.7% at the end of 2012 and from 2.5% at the end of 2011 (see Exhibit 4, below). This deceleration has contributed to the sector's low single-digit rate of earnings

growth during 2013. The primary driver for the slowdown in the pace of sales and earnings growth in emerging-markets during the first half of this year has been economic deceleration, particularly in countries such as China, Brazil, and India.

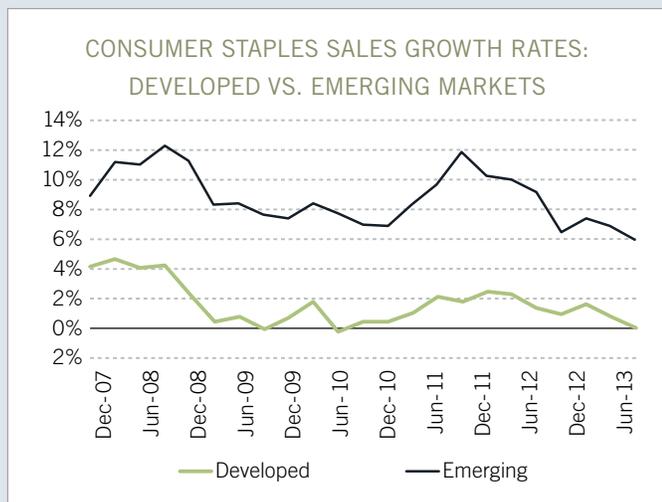
The law of large numbers has also been a factor.² During the past decade, many staples companies have been aggressively expanding their distribution in emerging markets to reach many consumers for the first time. When a product first becomes available in a new city or a new retail channel, the rate of growth in the first few years can be abnormally high because the base level of sales is so small. As the product becomes more established, the base level of sales becomes much larger, so each incremental consumer will have a much smaller impact on the growth rate. This deceleration isn't necessarily a sign that the product is not successful; it is simply a reflection that growth rates naturally diminish as a product's sales base gets larger.

Investment implications

Despite the inevitable deceleration in sales growth for many staples manufacturers, the good news is that the sales growth rates in emerging-market countries remain strong relative to the business conditions in developed countries, and can continue to be a key driver in the sector going forward. Taking a longer-term perspective, the per-capita consumption of consumer staples items in many emerging markets is still substantially lower than it is in the average developed country. This is because consumer incomes and retail distribution are still underdeveloped. As consumers' purchasing power continues to rise in these countries, and as staples companies further increase their manufacturing and distribution capabilities, it would be reasonable to expect that sales growth rates would continue to exceed those in more mature markets, where staples products are widely available and consumed.

Looking at various categories within the sector, some products tend to penetrate emerging markets more quickly than others. For example, food manufacturers can face the challenges of various localized taste preferences in different markets. What is popular to eat for breakfast or as a snack in China may be quite different than what is generally preferred in the U.S. By comparison, consumers tend to have more similar or universal preferences when it comes to such staples items as soft drinks, bottled water, toothpaste, shampoo, and diapers.

EXHIBIT 4: Sales growth levels generally have been higher in emerging markets relative to developed-country markets.



Data from a basket of multinational consumer staples companies that provide quarterly breakdowns of sales in multiple markets. Source: Company reports, Fidelity Investments, as of Sep. 30, 2013.

Outlook for consumer staples stocks

So far, 2013 has turned out to be a fairly typical year for consumer staples. With the exception of the negative influence of currency movements on corporate profits, business conditions generally have remained favorable for U.S.-based consumer staples companies. I continue to expect the sector to average high single-digit earnings growth over time, which together with its current 2.5% to 3% dividend yield would be supportive of shareholder returns if history is a guide. Most companies have

the desire and the ability to raise their dividend payouts each year, and I don't foresee any reason to believe this strategy would change. During the past few months, there have been signs that the global economy will continue its modest growth trends, with some signs of improvement in foreign developed markets and potential stabilization in China. An environment featuring stable global economic growth tends to be favorable for the sales and earnings outlook for consumer staples companies.

Author

Robert Lee

Portfolio Manager

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.

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

Indices are unmanaged. It is not possible to invest directly in an index.

Endnotes

¹ Expected earnings growth rate of 8.3% as of June 30, 2013; expected rate of 4.2% as of Oct. 3, 2013. Source: FactSet as of Oct. 3, 2013.

² Law of large numbers: A theorem in probability theory that suggests that as the number of samples increase, the average of those samples is likely to reach the mean of the whole population. In the context of this article, as a company grows in a certain market, its chances of sustaining the same large percentage of growth diminish.

Index definitions

MSCI U.S. Investable Market 2500 Index represents the investable universe of companies in the U.S. equity market. Consumer staples companies of the MSCI U.S. IMI 2500 are classified in accordance with the Global Industry Classification Standard (GICS®).

Fidelity Top 3000 Stock Index: the 3000 largest stocks based on market capitalization.

The Trade-Weighted U.S. Dollar Index is a measure of the value of the U.S. dollar relative to other world currencies.

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