U.S. Equity Sector 2017 Outlook

The Fruits of Disruption

Fidelity INVESTMENTS

The Fruits of Disruption

When disruptive events occur, it provides our equity sector research teams with opportunity. Opportunity to dig in and determine which companies they believe are going to be the beneficiaries of change, and which may struggle. Novel medical technology, shifts in central bank monetary policy, surprising election outcomes, natural disasters, multi-nation trade agreements, and national accord membership withdrawals are some examples of disruptive change that have influenced the earnings outlooks for companies in various sectors.

We asked our equity sector portfolio managers to focus on elements of disruption that are currently influencing the business outlook for companies in each of the 11 sectors. We then asked them to identify where they see opportunity for investment over the coming year. For example:

- Increasing connectivity among the "Internet of Things" is reshaping business dynamics in multiple sectors. Some have called it the next Industrial Revolution.
- In the health care sector, innovation in the form of new business models is helping consumers make more informed choices and reduce costs, while novel medical devices and potential "game-changing" bio-therapeutics could provide a boost in corporate profits.
- The surprising outcome of the U.S. election has put a spotlight on potential new public policy, such as increased infrastructure and defense spending, and a more benign regulatory environment, which could influence the outlook for businesses in multiple sectors.

These are just some of the key investment themes identified in this publication. We hope these perspectives provide some value to our investors, allowing them to capitalize on opportunities and manage risk.

Sincerely,

Tim Cohen
Head of Global Equity Research
Fidelity Investments

Fidelity sector portfolio managers provide their perspectives on disruptors and subsequent investment opportunities in 2017.

Consumer Discretionary

Brand Allegiance Can Overcome Price Transparency

Peter Dixon | Sector Portfolio Manager

Key Takeaways

- Online and mobile shopping have led to price transparency and profit-margin pressure.
- Strong brands with controlled distribution may be able to ward off product substitution and pricing pressure.

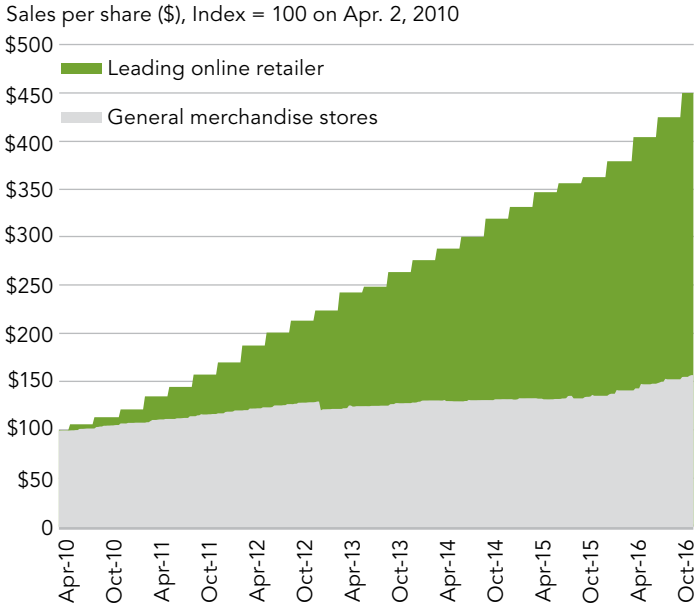
Several disruptive forces have emerged in the consumer discretionary sector. The further proliferation of online and mobile shopping and decreased mall traffic—due in large part to millennials' purchasing habits and tech innovation—have pressured profit margins. Because mobile is the new desktop, consumers are increasingly able to comparison shop, identify, and purchase goods based purely on the lowest prices or additional benefits such as free shipping or corporate rewards incentives.

New competitors with longer investment time horizons have also emerged, including tech start-ups and retailers from outside the U.S., with their sights set on a new market. These companies have been able to disrupt the marketplace by undercutting the competition on price; even operating without profit while they build their businesses to gain market share. Given this disruption, I believe it's important to be selective when investing in consumer discretionary stocks, and to identify companies with strong brands, budding innovation, or other growth drivers that can help them increase their earnings and win over the long term.

With a strong brand and controlled distribution, there are no substitutes

To beat earnings expectations in 2017, consumer discretionary companies (specifically mall retail, mid-tier department stores, and general merchandise) will likely have to overcome the increased price transparency and easy substitution that have resulted from e-commerce and heightened competitive headwinds. As consumers increasingly search online for the lowest prices on a wide range of discretionary goods, and are often incented with free shipping and other rewards (Exhibit 1), the sector

EXHIBIT 1: E-commerce sales are exceeding traditional brick-and-mortar retail sales at a dramatic rate.
Sales Per Share: E-Commerce vs. General Merchandise Stores



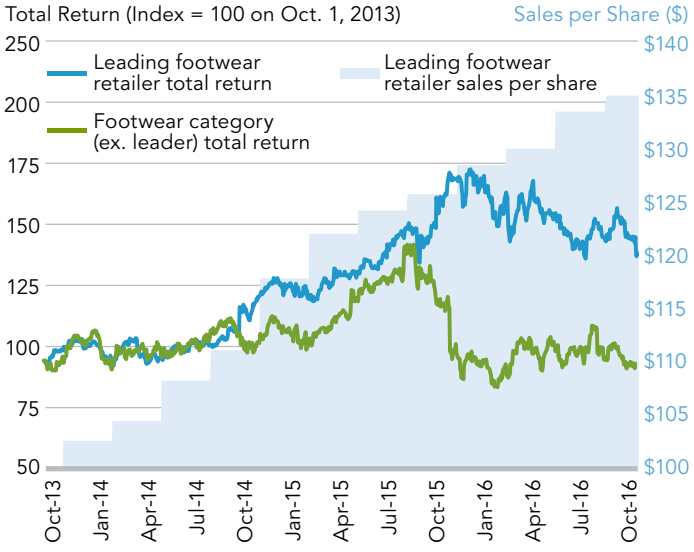
Sales per share (last 12 months) of a leading online retailer versus the general merchandise stores category (S&P Composite 1500/General Merchandise Stores Sub-Index). Source: FactSet, as of Sep. 30, 2016.

faces significant profit-margin pressure. Traditional brick-and-mortar retailers that can set themselves apart from their competition by encouraging consumers to spend more than the market expects look increasingly attractive.

Strong brand allegiance can protect companies against the substitution of their products with cheaper alternatives. Further, companies that can control the distribution and pricing of their goods are better equipped to maintain strong sales margins. For example, certain manufacturers of innovative sneakers (Exhibit 2), women's lingerie, and specialty coffee continue to grow in popularity with consumers. These brands have strong customer connections and tend to distribute their products through their own stores, and thus are able to maintain full pricing. My view is that these types of companies offer the potential for the best sales and earnings growth potential in 2017 and beyond.

EXHIBIT 2: Brand allegiance and pricing power can drive sales, despite competitive headwinds

Total Return and Sales Per Share: Leading Footwear Brand vs. Other Footwear Retailers



Sales per share (last 12 months, index = 100 on Oct. 1, 2013) and total return of a single leading footwear retailer vs. total return of the S&P Composite 1500 Footwear Sub-Index (excluding the industry leader). Source: FactSet, as of Sep. 30, 2016.

Conversely, companies that widely distribute easily substituted, commoditized products through internet retailers and big-box stores are likely to face challenges.

Exclusive content can thwart competition

The pressures of substitution and price transparency aren't limited to the retail industry. In the media category, for example, traditional subscription cable providers are being pressured by a trend known as "cord cutting." The option to avoid or drop cable service has grown in popularity and has been driven largely by millennials. Streaming services have gained traction as a growing proportion of U.S. consumers own a trio of devices: smartphones, laptops, and tablets. A handful of these cable alternatives now produce original content that only their subscribers can access. Companies with such a competitive advantage appear well-positioned heading into 2017.

It's important to note, however, that increased demand for faster broadband/internet speed may help subscription cable providers partially offset some of the lost revenues from cord cutting and slowing advertising proceeds.

Macroeconomic environment a potential headwind

The U.S. economy is viewed by many to be entering the late phase of the business cycle, with the potential for rising interest rates on the horizon. Consumer discretionary stocks tend to outperform the market in the early stages of economic recovery, and the sector's performance during rate-tightening cycles historically has been spotty. Consequently, I seek to own companies and industries with the potential to endure economic headwinds, and to avoid companies that may decline as a result of the macro environment, even if their earnings are strong.

When economic growth slows, consumers tend to spend less on discretionary purchases. Companies with the attributes I discussed earlier, that can encourage consumers to continue to spend on their products, will likely be better insulated in a downturn.

With that said, there continue to be several tailwinds for the U.S. consumer. The housing market is strong, unemployment is low, wage growth has picked up, interest rates are likely to remain low relative to history even if they rise somewhat, and companies are increasingly providing incentives such as free shipping, free returns, and promotional pricing. Therefore, despite disruptive forces and macro headwinds, our research team continues to identify compelling investment opportunities within the consumer discretionary sector.

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Fidelity Thought Leadership Director Christie Myers provided editorial direction.

The consumer discretionary industries can be significantly affected by the performance of the overall economy, interest rates, competition, consumer confidence and spending, and changes in demographics and consumer tastes.

Consumer Staples

Healthy Competition Could Trim Packaged-Brand Earnings Growth

Robert Lee | Sector Portfolio Manager

Key Takeaways

- Consumer staples companies that can effectively respond to changing consumer preferences look appealing heading into 2017.
- Despite global economic headwinds, I still see significant opportunity for large multinationals earning the bulk of their profits outside the U.S.

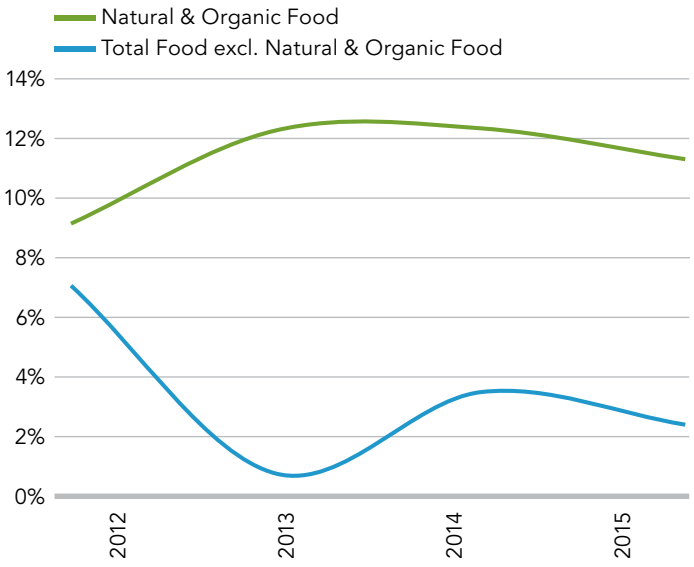
The consumer staples sector is home to many of the products we use every day, such as toothpaste, soft drinks, diapers, and other household items. Because of the consistent demand for the sector's products, any disruption tends to develop over longer time periods, and any impact is often felt only at the margins. Accordingly, the sector has been a consistent performer over time. Nevertheless, there are some disruptive trends that will likely continue in 2017 and beyond, which may influence my investment approach.

For example, there has been a shift in U.S. consumer appetites toward organic, whole foods. This trend could alter the earnings growth prospects for some large packaged-food manufacturers. Companies that can respond effectively to this healthy food movement appear increasingly attractive heading into 2017. In addition, global economic headwinds, such as currency depreciation and slower growth relative to the U.S, have challenged multinational companies that earn a large portion of their profits abroad. However, I continue to see significant growth opportunities for consumer staples companies operating abroad.

Think outside the box: All-natural, organic, and whole foods are in

Driven largely by millennials, U.S. consumers increasingly favor foods that are made locally, or from smaller, artisan producers (Exhibit 1). Further, many Americans now prefer to buy whole, raw ingredients and prepare more of their meals at home. This trend away from processed foods could hamper the earnings of larger packaged-food manufacturers. In response, some companies have successfully changed consumers' perception of their product lines to appear more natural and "smaller." For example, some have acquired smaller companies and

EXHIBIT 1: Sales of natural and organic food have grown much faster than sales of packaged options in recent years.
Year-over-Year Sales Growth

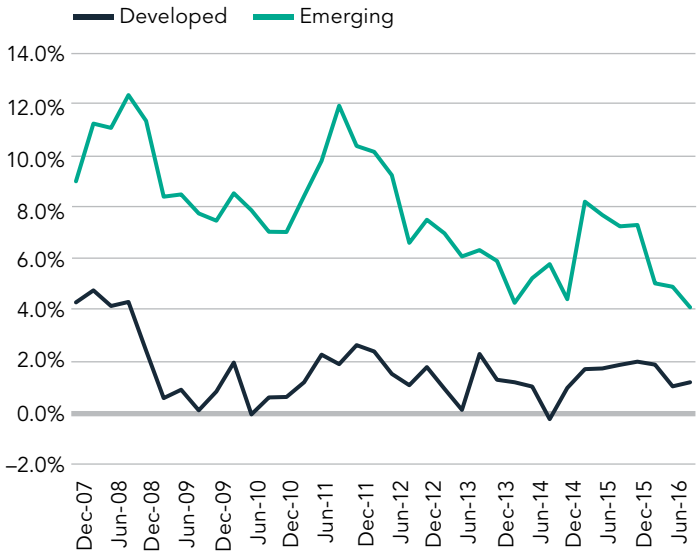


Annual sales data. Source: Natural Foods Merchandiser, Progressive Grocer, as of Dec. 31, 2015.

maintained the original branding that consumers have come to recognize as artisan. Others have changed the formulations of their products to eliminate seemingly harmful ingredients, such as artificial colors or high fructose corn syrup.

Additionally, new companies with unique business models have emerged in the wake of this healthier food trend. For example, a handful of companies will ship all necessary ingredients, detailed recipes, and cooking instructions to consumers looking for a shortcut to prepare healthy meals at home. I continue to seek companies that effectively adjust their product lines to changing consumer preferences, or create innovative new lines of business to capitalize on emerging trends. At the same time, I recognize that as consumers shop for more raw ingredients and prepare more of their meals at home, packaged-food manufacturers may find it difficult to offset that headwind to sales.

EXHIBIT 2: Sales of consumer staples have grown faster in emerging markets than in developed economies.
Organic Sales Growth for Developed vs. Emerging Markets



Three-month sales data of a basket of consumer staples companies. Source: Company filings, as of Sep. 30, 2016.

Recent market preference for U.S.-focused companies over multinationals likely cyclical

Over the past few years, global macroeconomic headwinds have challenged multinational consumer staples companies that earn a large portion of their sales abroad. Declining currencies versus the dollar and a generally slower rate of economic growth have hampered sales outside the U.S. However, I believe this is more of a cyclical trend than a structural shift. Therefore, I seek to own both U.S. and non-U.S. focused companies that sell leading brands, exhibit strong future earnings potential, and are trading at reasonable valuations.

I continue to see a massive opportunity for consumer staples companies abroad—specifically in emerging markets. In the U.S., consumers tend to buy the same amount of toothpaste and laundry detergent every year, so volumes across the sector grow roughly in line with population growth (about 1% annually). However, with incomes on the rise in emerging markets, spending on these items is growing much faster, as consumers transition from low-income status to middle class. Although sales growth has slowed in these regions more recently, it is still much higher than in developed markets (Exhibit 2).

Consumer staples today… and every day

As the U.S. enters a more mature phase of the current economic cycle, increased volatility may be on the horizon. Consumer staples stocks can lend stability to an equity portfolio, due to the relatively consistent nature of consumer demand for their products. The sector may also appeal to income-oriented investors because its dividend yield is currently higher than the yields offered by many bonds. Unlike most bonds where interest payments are fixed, many staples stocks have successfully increased their dividends over time, as

companies have grown their earnings alongside rising inflation—a potentially attractive characteristic should inflation pick up. Looking forward, despite disruptive forces, the consumer staples sector should continue to benefit from its reputation for steady growth, dividend income, and low volatility.

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Fidelity Thought Leadership Director Christie Myers provided editorial direction.

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.

Energy

Land Drilling Technology Extends Renaissance For Oil Producers

John Dowd | Sector Portfolio Manager

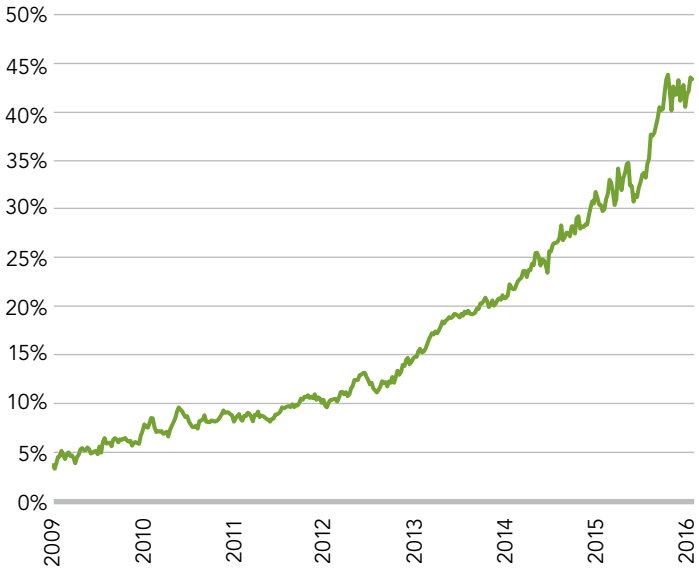
Key Takeaways

- State-of-the-art shale drilling technology continues to allow energy producers operating in fertile U.S. land basins to grow oil production and profits while increasing productivity and lowering costs amid a backdrop of falling commodity prices.
- A more benign regulatory climate under a new Presidential administration and Republican Congress could benefit several industries.

When crude oil prices hit a historical peak of $140 per barrel back in 2008, it prompted a wave of new investment by energy producers for research and development to unearth energy commodities. New technologies enabled exploration and production (E&P) companies to more efficiently extract oil and liquid natural gas from shale land basins. This disruptive technology, known informally as "fracking," has led to a boon in U.S. oil and natural gas production, oversupply, and a steep decline in the prices for both commodities. During the past couple of years, oil prices fell to levels below the costs of production for some producers. Subsequently, about 10% of companies in the oil-related industries went out of business.

Throughout this period of change, a handful of energy producers—those armed with new technology and with drilling rights in the most fertile land basins—had a competitive advantage, and still do. In a challenging environment of low oil prices, these companies have been able to grow production and profits, and they continue to do so at lower costs than other companies without access to the more plentiful shale basins in the United States. I continue to believe that the most effective recipe for investment in energy during the near term is to own energy producers that have access to strategic natural resource locations, are efficiently deploying capital and driving productivity improvements, and are lowering their costs.

EXHIBIT 1: The energy producers operating in the Permian basin (Texas) are operating approximately 43% of the oil drilling rigs in the United States.
Percentage of Horizontal Oil Drilling Rigs in Operation (Permian Basin) vs. Total U.S. Rigs in Operation



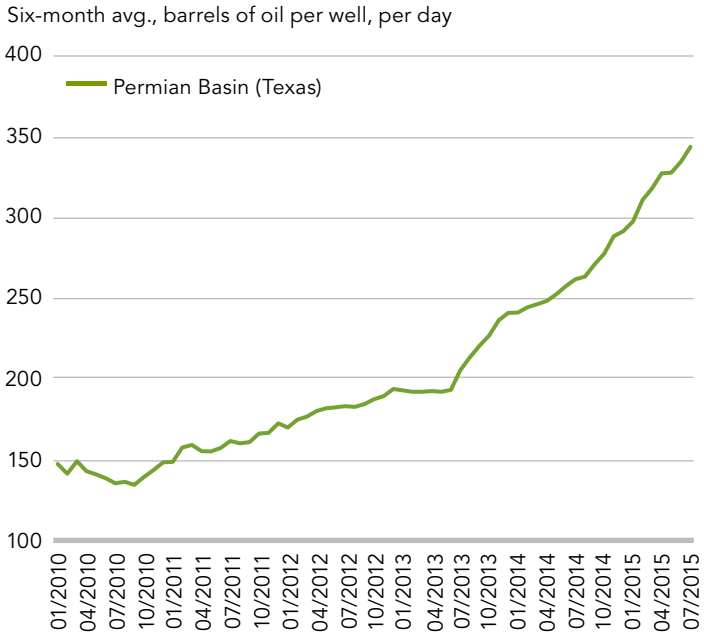
Permian horizontal, active rig count—Platts/RigData weekly data from Oct. 2, 2009 to Nov. 11, 2016. Total U.S. onshore, active oil rig count—Baker Hughes, weekly data from Oct. 2, 2009 to Nov. 11, 2016. Source: Fidelity Investments, as of Nov. 11, 2016.

Certain energy producers are achieving drilling efficiencies and lowering their production costs

Disruptive drilling technologies have enabled some companies to thrive and caused others to suffer. The majority of U.S. energy production growth during the past five years has come from a handful of shale basins: the Bakken in North Dakota (oil), the Eagle Ford and the Permian in Texas (oil), and the Marcellus (natural gas) and Utica (natural gas) in the Appalachian region. Companies with drilling rights in these geological locations have been able to harness new technology to boost production and cash flows.

As these companies continue to drill, they learn more and more about the characteristics of the shale basins, and thus are able to more effectively deploy capital for drilling resources (e.g., rigs and other services) to increase their efficiency in each well. For example, the

EXHIBIT 2: New shale drilling technology has allowed certain energy & production companies to more efficiently tap oil from certain land basins.
Crude Oil Drilling Productivity per Well, Permian Basin (Texas)



Data reflect six-month average of barrels of daily oil, per well. Well results shown reflect most accurate readings through July 1, 2015. Source: IHS Performance Evaluator. © 2016 IHS Markit, www.ihsmarkit.com, Fidelity Investments, as of Oct. 30, 2016.

E&P companies operating in the Permian basin have the highest percentage of oil drilling rigs in operation in the United States; their total rig count is up 256% since the beginning of 2011, while the rig count for the rest of the energy producers in the U.S. is down 65% during the same period (Exhibit 1). These Permian-based companies have increasingly been able to effectively put those rigs to better use. The amount of oil pulled out of the ground by E&P companies operating in the Permian basin for each well has more than doubled over the past five years (Exhibit 2).

As a result of these factors—land location and drilling technology—these companies have been able to increase oil production while lowering their costs, funneling more profit to the bottom line. Moreover, E&P companies operating in these strategic regions have been able to grow cash flow, and their stocks have performed quite well, even in an environment of falling and lower commodity prices during the past five years. At the same time, E&P companies without exposure to those plentiful geological resources have struggled not just to compete but to stay in business.

Development costs and operating expenses vary widely across the sector, and not all companies are able to alter their costs at the same pace. For example, larger, integrated energy companies have international and deepwater drilling operations, which generally incur higher exploration costs, face more variable drilling challenges, and take longer to adjust relative to E&P companies operating in domestic shale regions.

It's important to keep in mind that when disruptive new technologies evolve in an industry or sector, owning the last generation of winners isn't likely to work. The last generation of winners in the energy sector were the large, integrated oil companies—those that engage in exploration, production, refinement, and distribution. In my view, the new winners are going to be companies that figure out how to materially reduce costs and become more efficient than their competitors. So far, a handful of E&P companies operating in domestic shale regions

have achieved those advantages, and their stocks have been performance leaders. I believe this trend will continue in 2017.

Looking across the sector more broadly, I think that it can be rewarding to invest in better-positioned companies at cyclical inflection points, when most sentiment is bearish and the environment is gloomy. This is when you find the best values. In the past several months, lower oil prices have stimulated demand at the same time the industry has been curtailing supply. That's a very powerful combination.

Less regulation may boost several industries

Going forward, a more benign regulatory environment would be healthy for many energy industries, if President-elect Trump maintains this regulatory positioning in his policy agenda. The energy sector has been in the crosshairs of our heightened regulatory environment during the past eight years. Trump has made the case for less regulation going forward, and I believe the absence of a negative is a positive. That alone is a big deal. The market has been concerned with the sustainability of fracking, and particularly to what extent it might have been regulated into obscurity by a different election outcome.

In addition, there is the potential for a rollback of some regulations. For example, I think a more rational implementation of ethanol mandates would be extremely important for certain refiners. The pipeline industry also stands to benefit. There has been a lot of news over the past several years about pipelines to and from Canada to export crude oil. To the extent that those get built, it would reduce price differentials between the U.S. and Canada, and boost the economics of drilling there.

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Fidelity Thought Leadership Vice President Kevin Lavelle provided editorial direction.

The energy industries can be significantly affected by fluctuations in energy prices and supply and demand of energy fuels, energy conservation, the success of exploration projects, and taxes and government regulations.

The commodities industries can be significantly affected by commodity prices, world events, import controls, worldwide competition, government regulations, and economic conditions.

Financials

The Expanding Role of Technology and Regulation as Profit Drivers

Christopher Lee | Sector Portfolio Manager

Key Takeaways

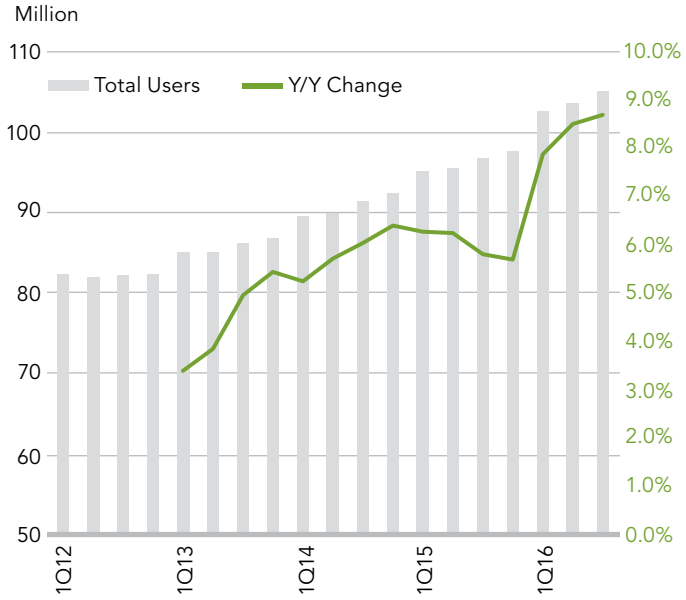
- Emerging financial technology (fin-tech) companies are disrupting the norms of customer interactions.
- Financial companies continue to adapt to expanded regulations; reduced regulation in 2017 under a new Presidential Administration could provide some relief.
- The combination of emerging fin tech and regulations could drive additional mergers and acquisitions.

The staid financial services industry, whose earnings and profits are highly correlated with GDP growth, finds itself adjusting to additional performance drivers—emerging financial technologies and regulation. The sector, which not so long ago required customers to call their bank for account balances and those pursuing a mortgage to visit their local bank branch, is feeling the influence and disruption of innovative technology in the form of fin-tech companies that are redefining customer interactions (Exhibit 1).

In addition, financial companies continue to digest regulatory reforms imposed since the 2008-09 financial crisis—those directed at banks and insurance companies, as well as those intended for asset managers. With a larger regulatory burden and its implicit costs, financial companies find themselves in a conundrum of meeting increased documentation and administration demands while also delivering on customer preferences for simple and fast interactions.

From an investor's perspective, the combination of these factors—emerging fin tech and regulations—against an uncertain growth backdrop could reshape how the sector is valued and lead to further consolidation (Exhibit 2). In fact, these combined influences have already contributed to a few significant mergers in the insurance, asset management, financial exchange, and online brokerage industries. The need for companies to leverage

EXHIBIT 1: The number of customers preferring online banking transactions continues to expand.
Large Bank Online User Transactions



Source: Company filings, Fidelity Investments, as of Oct. 31, 2016.

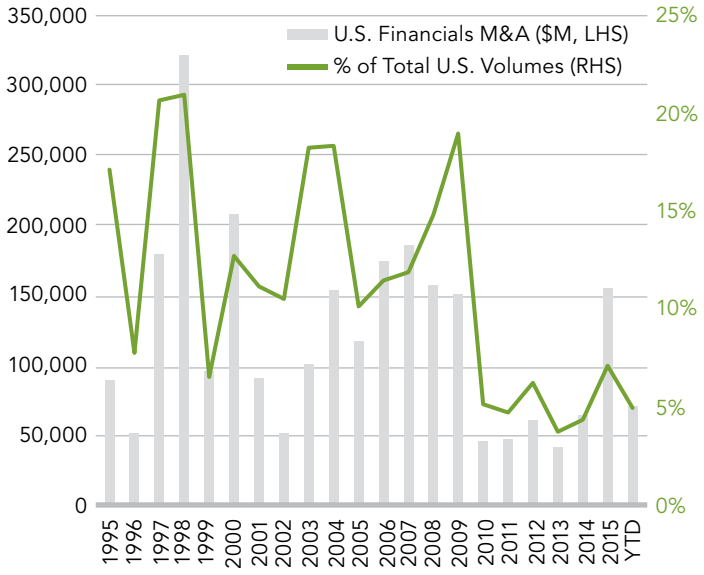
technological innovations to lower their cost structures could also spur further mergers and acquisitions (M&A) as they determine whether to "build" or "buy." With clients increasingly turning to tech-based interactions for many services, companies agile enough to deliver innovative and profitable solutions could see their earnings multiples expand.

The technology reality

The challenge of transforming relationship-based businesses to tech-centric entities

Fin-tech startups see the financial sector as rife with opportunities to disintermediate traditional providers of financial services. These upstarts are premised on making products accessible to all segments of the population (e.g., robo-advisors), reducing human touchpoints during the lending process, and uniquely tailoring customer experiences. However, while these opportunities appear promising, in reality they have been somewhat less compelling. For example, it has been difficult for fin-tech businesses to make inroads with purely transactions-based experiences because large banks have built their businesses through relationships and service.

EXHIBIT 2: The combination of emerging fin tech and regulatory compliance could drive further M&A.
U.S. Financials Sector M&A Trend



Source: Dealogic, as of Oct. 31, 2016.

The long-term outcome will likely involve each faction moving toward the middle, with large banks potentially offering "smarter" interactions with fewer branches, smarter ATMs, etc., and the fin-tech companies looking for opportunities to partner with established brands to bring their innovative advantages to the consumer. Tailoring solutions to customer preferences is an ongoing development, and an example of this can be seen in the ability of payment companies offering multinational processing of payments through applications on mobile devices.

But the evolving disruption of emerging technology does not stop there. Consider insurance companies. Their ability to analyze and manipulate big data has allowed for more informed risk management. This capability has the potential to accelerate decision making and ultimately improve returns. Also, there are large premiums being put on companies that can deliver packaged data solutions (e.g., pricing data for securities). Their ability to deliver highly sought-after data, which oftentimes they own, has given them strong pricing power and stable growth profiles.

Turning point?

The presidential election outcome could translate into reduced regulation and rejuvenated growth prospects for the financials sector, making me more optimistic about the sector than I have been in a while. Potentially, companies could benefit from reduced regulatory-compliance costs, a lifting of restrictions on certain revenue sources, and a loosening of capital allocation constraints—to name a few examples.

However, it is worth keeping in mind that Mr. Trump was elected on a somewhat populist platform, so a tug-of-war between populism and pragmatism may still ensue. It is still in the very early days, and the devil is always

in the details. What hasn't changed for the sector is its sensitivity to the macroeconomy. Any growth pickup is likely to be volatile in nature, which could present investable opportunities. Ultimately, we are still eight or so years into the economic expansion, so the question will persist: whether any of these intermediate-term proposals—if successfully enacted—can truly extend this recovery.

Given this backdrop, the case for stocks in the cyclical segments, such as banks, consumer finance, and capital markets, has improved. That said, there is still a place for high-quality secular growers, such as payment-processing companies, that are benefiting from the shift from cash to electronic payments as well as mobile-payment adoption driven by demographic tailwinds.

Overall, I believe that by focusing on quality financial companies with competitive advantages, above-average returns on capital, and reasonable valuations with the potential for long-term outperformance, we can capitalize on this potential regime shift, and also insulate the portfolios from the ramifications of industry disruption and macroeconomic uncertainty.

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Sector specialist Michael Griffith, CFA, also contributed to this report. Fidelity Thought Leadership Vice President Geri Sheehan, CFA, provided editorial direction.

The financials industries are subject to extensive government regulation, can be subject to relatively rapid change due to increasingly blurred distinctions between service segments, and can be significantly affected by availability and cost of capital funds, changes in interest rates, the rate of corporate and consumer debt defaults, and price competition.

Health Care

As Rising Costs Pain Consumers, New Companies Emerge with Salve

Edward Yoon | Sector Portfolio Manager

Key Takeaways

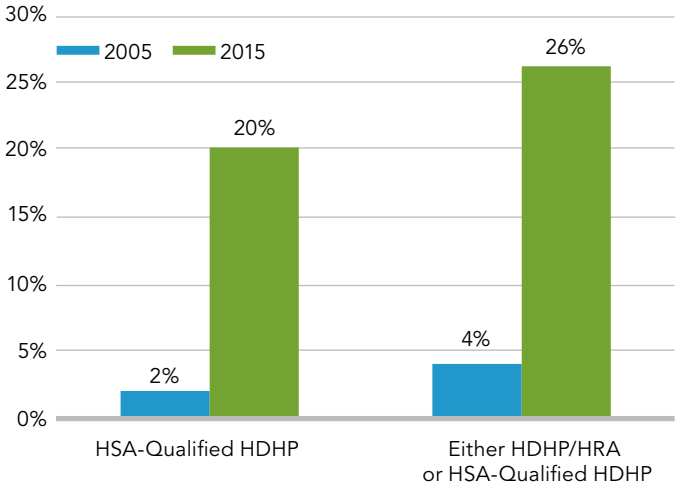
- With the U.S. health care economy putting more of the cost burden on consumers, companies that help consumers make more informed decisions are emerging.
- Some companies offer new technology or services that provide a cheaper alternative to traditional health care, which can help rein in unchecked health care inflation.
- Therapeutics manufacturers have potentially game-changing drugs in clinical trials.

It's no secret that U.S. health care spending has been escalating at an unsustainable pace during the past several years, as rising costs for procedures, pharmaceuticals, and other services continue seemingly unabated. Aging demographics are helping to fuel this secular trend; approximately 15,000 people turn 65 every day in America. From an investment standpoint, there are several new companies using innovative technology or alternative approaches that are driving down costs in the health care system. These efforts are creating disruption—in the form of cheaper alternatives—for traditional health care service providers. In addition, the health care economy remains in the early stages of transition toward becoming more value-based and consumer-driven. As costs rise and more of the burden of paying for health care is shifting toward employees, some companies are providing new services that help consumers make more informed choices.

Transition to a more consumer-driven health care marketplace is under way

I expect the U.S. health care market to be transformed over the coming decades, from one based on expected use to one based on value. In this new environment, consumers will be asked to absorb an increasing share of the total cost of their health care. This transition is under way, and it's been driven by the rising costs of

EXHIBIT 1: High-deductible health care insurance plans are becoming more common.
Percentage of U.S. Companies Offering High-Deductible Health Care Plans



HSA – health savings account; HDHP – high-deductible health plan; HRA – health reimbursement arrangement. Source: Henry J. Kaiser Family Foundation (kff.org), as of Jun. 30, 2016.

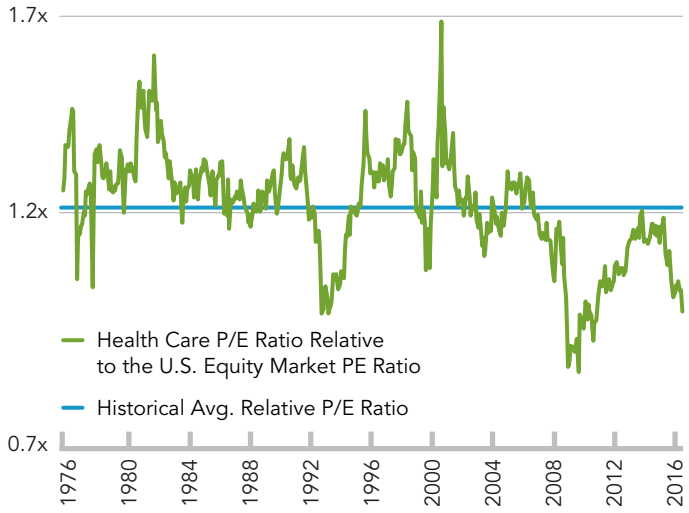
health care drugs and services. Higher costs have been increasingly eating into the profits of corporate America, and more companies have been working with health care providers to offer plans that can shift some of the cost of health care to employees. For example, during the past decade, a larger percentage of companies have been offering high-deductible health plans, which place additional emphasis on the consumer to adopt a healthy lifestyle, make choices about whether to seek care, and inquire and shop for pricing for certain services (Exhibit 1).

New businesses aid consumer decision-making

As the U.S. moves to a payment model that incentivizes consumer value over greater utilization and the consumer becomes a more powerful decision maker, winners and losers should emerge. Some new business models offer consumers greater choices among services. For example, urgent care centers can often serve as a convenient, less expensive alternative to hospital emergency-room visits for consumers paying out of pocket. Some consumers are now choosing to elect surgery and other procedures at ambulatory centers, instead of a more expensive, inpatient hospital setting. Elsewhere, telemedicine business models are on the rise, where consumers can obtain a clinical interaction over the phone, via a video chat, or other web application, instead of at the doctor's office.

Going forward, I expect how consumers interact with the health care system will continue to change, and involve new technology and services. While some of these aforementioned new businesses are publicly traded, others are not because they are still emerging. Still, all of these businesses support the trend of consumers seeking better value, which is here to stay. Shifting to some of these newer services may take time for many consumers, but adoption is already taking place and ultimately puts downward pressure on the sector's overall costs.

EXHIBIT 2: Health care stocks generally remain undervalued relative to the broader U.S. equity market.
Historical P/E Ratio of Health Care Sector vs. U.S. Equity Market



U.S. equity market P/E: Market cap-weighted top 3000 U.S. stocks.
Source: Fidelity Investments, as of Oct. 31, 2016.

New products and medical devices drive down health care costs

Innovative medical devices are entering the marketplace and are making surgeries and diagnostics more efficient, ultimately removing costs from the system. For example, surgeons are now utilizing transcatheter heart valves (THVs) to improve blood flow in some patients with diseased heart valves. These THVs can be put in place less expensively through a less invasive procedure—via an artery in the leg—than open heart surgery, improving patient safety and recovery time. Ultimately, the procedure is more efficient and less costly. It can also be done on older patients who wouldn't qualify for open heart surgery. Other companies have manufactured sensors, placed on the skin, that can be worn by Type-1 diabetics to continuously monitor glucose levels in their blood. This approach improves the blood-glucose awareness for patients, who can receive automatic alerts on their smartphones. Previously, such glucose monitoring was done by pricking a finger—something that could be

more prone to human error, and represented a single point in time. These are just a couple of examples of disruptive medical-device technologies that have the potential to be the big growth engines of the future.

Bio-therapeutic innovation cycle "breakthroughs"

Some remarkable innovation is going on in the area of bio-therapeutics, where several potential game-changing therapies have achieved fast-track status in clinical trials with the Food and Drug Administration (FDA). Among these is a new category of cardiovascular preventive drugs, hope for new treatments for Alzheimer's disease—which, while still years away from the market, would be the first in 15 years (if approved)—and immune-oncology treatments for lung cancer that harness the power of a person's own immune system to ward off the cancer and prolong life. Each of these treatments so far has shown some efficacy in clinical trials. These novel therapies also arrive at a time when the number of drugs and therapeutics approved by the FDA has been rising.

Valuations remain attractive

Health care stocks that have underperformed relative to the broader equity market in 2016 now look particularly interesting on a historical valuation basis (Exhibit 2). Earnings for the sector generally grew nicely during the past year. However, concerns surrounding the future state of health care policy ahead of the U.S. presidential election caused the sector's overall valuation to decline dramatically. With the election now behind us, investors are likely to refocus on the fundamental drivers within the sector, which remain strong and very much intact.

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Fidelity Thought Leadership Vice President Kevin Lavelle provided editorial direction.

The health care industries are subject to government regulation and reimbursement rates, as well as government approval of products and services, which could have a significant effect on price and availability, and can be significantly affected by rapid obsolescence and patent expirations.

Industrials

Infrastructure and Defense May Shift into High Gear

Tobias Welo | Sector Portfolio Manager

Key Takeaways

- Non-residential construction-related industries may benefit as infrastructure spending grows.
- Defense may get a boost as the U.S. budget swells and shifts toward modernization.
- Longer term, look for R&D leaders to disrupt the sector.

After trailing the broader market in 2015, the industrials sector has outperformed in 2016 so far, and seems positioned for a strong 2017. Two big trends will likely matter most in 2017. The first is increased investment in infrastructure, in both the U.S. and China, which may benefit companies exposed to non-residential construction—machinery companies in particular, but also a wide range of other industries. The second is a rising budget for U.S. defense spending, with potential further funding on the horizon. Also, trends in the U.S. economy may support revenues for makers of aftermarket parts and home-building products.

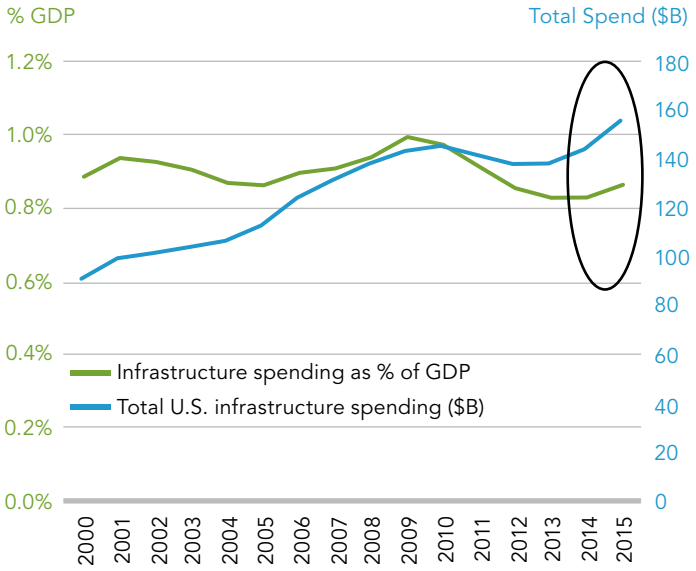
The foundations for longer-term disruption of the sector may lie in multiyear trends toward energy efficiency and the "industrial Internet of Things." Companies making progress within these themes may develop a durable competitive advantage. Over time, emphasis on research and development (R&D) spending may separate the leaders from the followers.

Politics puts a spotlight on infrastructure

The average age of infrastructure is at a record high in the U.S., following several years of below-average investment (Exhibit 1). To address the problem, Congress approved a 2015 five-year highway bill that will increase spending from $52 billion to $61 billion a year, and 28 states have increased infrastructure budgets.

Improving U.S. infrastructure was a common theme in President-elect Trump's campaign, which suggests

EXHIBIT 1: Public infrastructure spending has started to increase, but remains well below the pre-recession average as a fraction of total GDP.
U.S. Total Infrastructure Spending

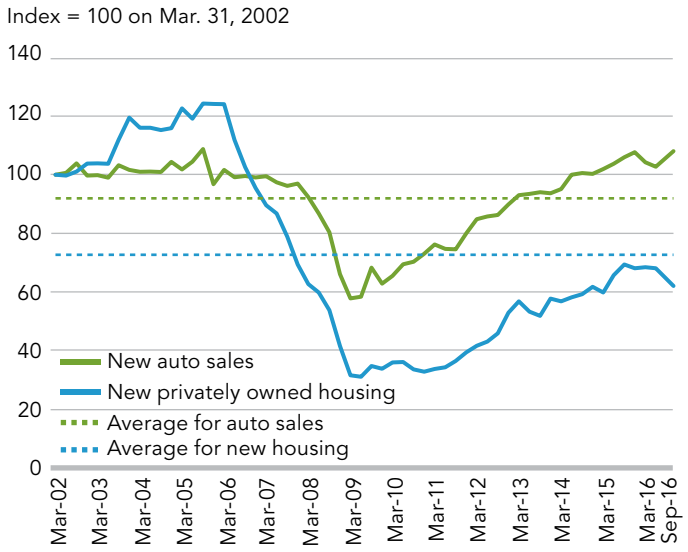


Includes annual federal, state, and local public infrastructure spending as a percentage of nominal gross domestic product (GDP). Source: Bloomberg Finance L.P., U.S. Bureau of Economic Analysis, Fidelity Investments, as of Nov. 1, 2016.

the potential for substantial new funding in the years to come. But even if financing new infrastructure projects becomes difficult, the budgets in place should remain. These are big, long-term projects that tend to be sustained even through an economic slowdown—once you take a bridge out, you have to put it back. A broad range of companies in the sector may see a boost in revenue, with machinery companies at the top of the list. Road and rail, large conglomerates, electrical equipment, and construction and engineering companies may also benefit.

Additionally, the Chinese government may continue to increase stimulus for infrastructure growth as a way to bolster the overall economy. Infrastructure spending in China has been growing steadily over the past few years, and accelerating growth there could benefit companies with global exposure to new construction, such as large machinery makers and international conglomerates.

EXHIBIT 2: In contrast to new auto sales, new housing starts are still below the longer-term average.
Auto Sales and Housing Starts Compared to Averages



New auto sales and new privately owned housing (starts) shown are seasonally adjusted annual rates, indexed for comparison. Averages are for the period shown. Source: Bloomberg Finance L.P., WardsAuto www.wardsauto.com (autos), U.S. Census Bureau (housing). Fidelity Investments, as of Nov. 3, 2016.

Defense budget veers toward modernization

The 2017 defense budget includes an increase from 2016, and may continue to go up as the new administration adopts defense as a high priority. Although the budget boost is small as a percentage of the total budget, the absolute dollars are so large (nearly $530 billion in 2016) that even small increases can make a big difference to the revenue of U.S. defense companies.

President-elect Trump has expressed a desire to work with Congress to permanently eliminate the "sequester," a series of automatic budget cuts that have affected the defense budget in recent years. With a more hawkish administration and a Republican majority in Congress, expectations are that incremental defense spending for key projects may be added to the budget.

How those budget dollars are allocated has an impact as well. Over the past 15 years, the ground war in Afghanistan and then in Iraq required the military to concentrate spending on supporting those efforts. Revenue in the defense industry shifted toward consumables such as ammunition and missiles, at the expense of large multiyear projects to modernize military technology. That trend seems to have changed direction. Several multi-billion-dollar programs to upgrade key platforms have recently been awarded, with more potentially to come. Because these are long-term projects, companies holding contracts can expect stable revenues for many years, and any additional project spending may add to defense contractors' bottom lines.

U.S. consumer end-markets may shift

The U.S. is trending toward the later part of the economic cycle, when the economy still grows but at a slower pace. In the industrials sector, revenues from consumers are driven more by replacement cycles than by consumer spending on new items—which means even if new car sales slow down, sales of aftermarket parts may pick up. However, because the economic recovery has been building slowly, new housing is still below trend and may have room to rise (Exhibit 2). If it does, demand for

building products such as HVAC and electrical systems may continue to grow, elevating the sales revenues of companies making them. More generally, government stimulus and the potential for rising interest rates could drive higher inflation, which is typically positive for industrial manufacturers.

Looming disruptive themes require R&D

Longer term, three disruptive forces loom for the industrials sector: energy efficiency, environmental protection, and the "industrial Internet of Things." Companies that build more efficient or more environmentally friendly products can boost market share quickly, particularly if government regulations force the issue. I look for companies with strong leads on competitors or with patents for superior products.

For most people, the "Internet of Things" calls to mind smart thermostats and self-driving cars. But there are exciting applications within the industrial sector, such as using unified control modules and sensors for greater efficiency and quality assurance in manufacturing, or the increased use of "telematics" (real-time data collection and responsive adjustment) for industrial machinery used in farming, mining, and energy production. Because industrial processes are so specialized, it may be some time before clear winners emerge in these fields. Companies committed to R&D could become early leaders.

Author

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Fidelity Senior Sector Specialist Eadaoin Snee and Associate Analyst Eric Thompson also contributed to this report. Fidelity Thought Leadership Vice President Vic Tulli, CFA, provided editorial direction.

Industrials industries can be significantly affected by general economic trends, changes in consumer sentiment and spending, commodity prices, legislation, government regulation and spending, import controls, and worldwide competition, and can be subject to liability for environmental damage, depletion of resources, and mandated expenditures for safety and pollution control.

Information Technology

Megatrends (Big Data, SaaS) and Emerging Trends (Artificial Intelligence, IoT) Keep Sector at the Nexus of Business Disruption

Charlie Chai, CFA | Sector Portfolio Manager

Key Takeaways

- The megatrends of cloud computing and software as a service remain promising, as they help companies lower capital spending, reduce IT infrastructure support, and improve hardware utilization.
- Foreign-based technology companies have significant growth potential, including those in Internet services, Internet finance, and e-commerce—and especially those at the intersection of the social, mobile, and local themes.
- Artificial intelligence and the Internet of Things are emerging trends that have significant long-term growth potential.

The information technology sector continues to be the nexus of ongoing innovation and disruption that is prominent in industries throughout the global economy. Some of the more famous disruptors, including Amazon, Apple, and Facebook, were built on technologies that enabled them to infiltrate a business segment and redefine it.

When investors and pundits get excited about the "next big thing," it is likely that the technological core of the new ability has been evolving in global laboratories for years. As a research analyst and portfolio manager, I try to identify the risk/reward profiles of technology companies, and determine which types of companies might benefit from their new technologies, and which could be negatively influenced by it.

Cloud computing, Big Data, and artificial intelligence are trends that are here to stay

Much of the innovation I am focused on for 2017 and beyond involves megatrends, such as cloud computing, software as a service (SaaS), and Big Data, that continue to attract a large percentage of corporate technology spending. Specifically, cloud computing enables companies to rely on remote servers instead of maintaining them on site. SaaS centralizes software applications on the Internet (Exhibit 1). Companies increasingly have been adopting these tools as a means of lowering their capital spending, reducing IT infrastructure support, and improving hardware utilization. Big Data reflects the delivery of real-time analytics that help companies better understand their businesses.

Elsewhere, developments in artificial intelligence (AI), a growing industry that involves intelligent behaviors by computers and machines, promises to have a major impact on how people lead their lives and how businesses may be operated and optimized. These AI capabilities are still in the very early innings of adoption, but the pace of change is accelerating and certain companies are going to be key leaders in these technologies.

Looking at the other side of these favorable long-term trends, I remain wary of certain hardware companies whose products are becoming commoditized. For example, in the personal computer market, virtual reality headsets and computers are an opportunity for

growth, but so far, demand has been largely anemic. The smart-device market is increasingly saturated and lacks products capable of driving sunstainable new excitement. On the enterprise hardware front, there continue to be many technology disruptions, which increase the long-term risks for some incumbents. Although valuations are generally low for enterprise hardware companies, I continue to struggle with their challenging long-term outlooks.

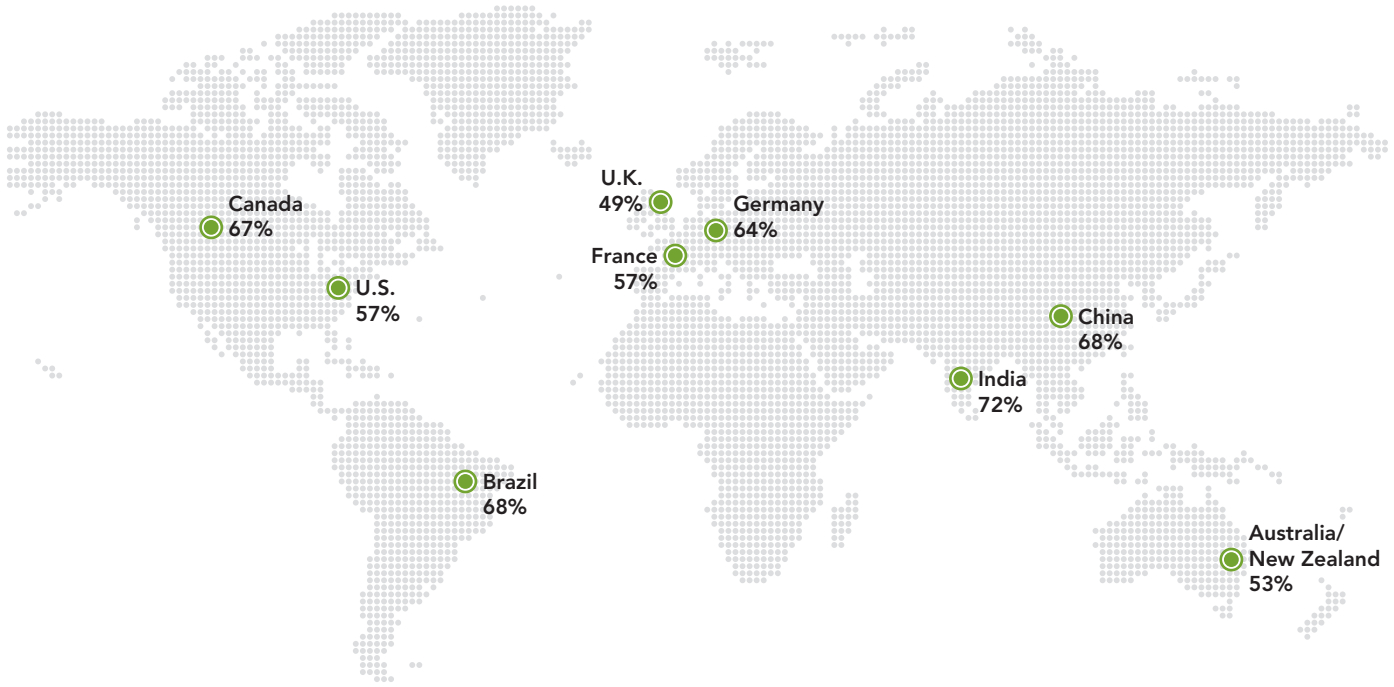
Opportunities abound in international-based tech companies

International-based technology companies tend to be less well known than their U.S. peers, and are a source of some compelling growth opportunities. For example, in the consumer segment, Internet services and e-commerce companies remain attractive growers, especially those that sit in the intersection of the social, mobile, and local themes. Asian markets, such as China, Korea and Japan, have generally seen a pace of innovation as fast as, if not faster than, their Western peers. This pace has been driven by a different regulatory environment and, in general, much-less-mature incumbent companies in certain industries.

Meanwhile, Internet finance is another area of rapid growth. Consumer credit offerings have very low penetration in markets such as China. There has also been a significant amount of new capital poured into tech companies in emerging markets. For example, in Southeast Asia, smartphone adoption has started to resemble growth trends seen in China three years ago. I believe significant long-term value will be created in this region. Further, after a period of significant capital inflows, there has been a recent decline in corporate fundraising activity, which is very positive for existing Internet companies.

EXHIBIT 1: SaaS adoption by country

Percentage of software decision makers who have used SaaS to complement or replace existing applications.



Source: Forrester Research, as of Mar. 30, 2016 (https://www.linkedin.com/pulse/forrester-research-application-adoption-trends-2016-dave-eitler).

Internet of Things: An emerging trend with long-term growth potential

The Internet of Things (IoT) is an emerging trend that seeks to provide intelligence and Internet connectivity to consumer and industrial devices that were previously not connected. Examples include self-driving vehicles, mobile payments, wearable devices, and robotics. I believe many of these product applications are still on the forward slope of a "hype cycle," characterized by overinflated near-term expectations and generous valuations. However, this remains a nascent trend, and there will likely be investment opportunities over the long term. In particular, the IoT could change the structure of the semiconductor industry, in areas such as process technology. It's possible that the growth of the IoT could result in a major shift in demand for semiconductors, much like the growing demand for mobile devices once influenced supply and demand dynamics for the semiconductor industry, which was predominantly PC-driven at the time.

Among other factors to consider in the sector, cash holdings and cash generation by technology companies remain at record levels. Recently, merger and acquisition activity has reaccelerated, particularly in the software and semiconductor industries. Consistent with my longstanding strategy, I continue to look for new ideas in the international markets, where many companies are undiscovered (or underfollowed) by research analysts.

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Fidelity Thought Leadership Vice President Geri Sheehan, CFA, provided editorial direction.

The technology industries can be significantly affected by obsolescence of existing technology, short product cycles, falling prices and profits, competition from new market entrants, and general economic condition.

Materials

The Commodity Cycle Sets the Sector's Pace

Tobias Welo | Sector Portfolio Manager

Key Takeaways

- A turnaround in commodity prices may be a positive disruption for producers.
- Construction materials companies may benefit from infrastructure spending growth.
- Uncertainty from M&A may create investing opportunities in the chemicals industry.

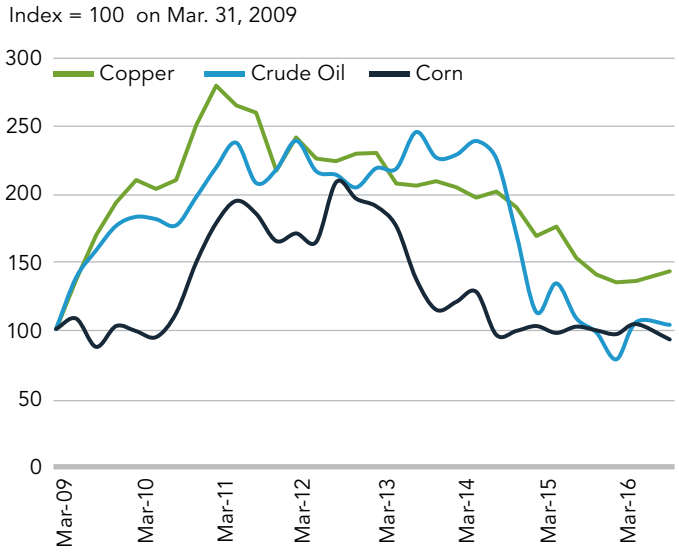
The materials sector has outperformed the S&P 500 in 2016 so far, after lagging in 2015. We appear to be moving off a trough in the commodity cycle, lending support for earnings growth (and upward revisions of earnings estimates) for companies exposed to commodity prices, such as miners. However, the absorption of oversupply can be a gradual process, particularly in the mining and agricultural categories.

Aside from commodity supply and demand, the most disruptive forces in the sector for 2017 are likely to be infrastructure spending growth in China and the U.S., and the potential for widespread mergers and acquisitions (M&A). With the Chinese government trying to stimulate the economy, I expect an ongoing focus on the country's infrastructure to benefit the metals and mining industry. A resurgence in U.S. infrastructure spending may also bolster demand for metals and construction materials. Meanwhile, the chemicals industry is in the midst of several large pending M&A deals that will bear watching into 2017.

The commodity cycle drives earnings for many materials producers

Commodity prices respond to supply and demand. When supply is greater than demand, prices drop, along with commodity producers' revenues and operating margins. In the absence of demand growth, producers can reduce costs and curtail production, but this can take time. However, I believe we may have seen the worst of the recent commodities recession. Exhibit 1 shows the relative futures prices of copper, crude oil, and corn, as general proxies for metals, energy, and agricultural commodities. As supply and demand for copper and oil

EXHIBIT 1: As demand catches up to surplus supply, commodity prices may have passed through their cyclical troughs and could begin a period of price inflation.
Commodity Futures Prices for Copper, Crude Oil, and Corn

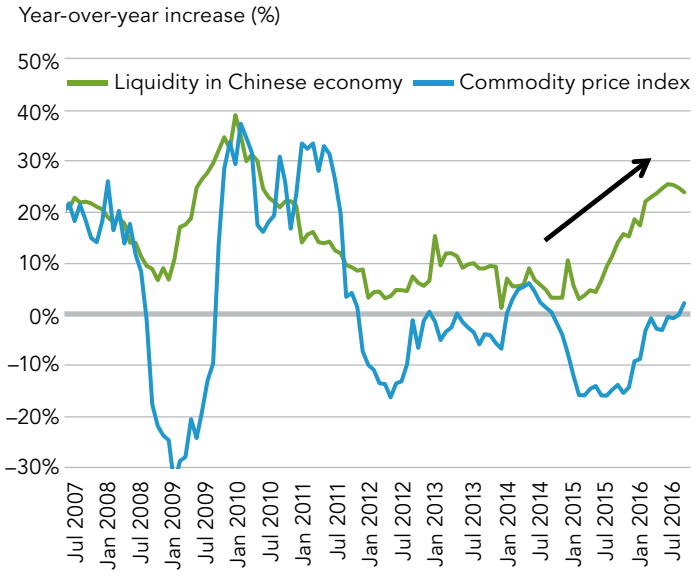


Source: Bloomberg Finance L.P., Comex (copper futures), NYMEX (crude futures), CBOT (corn futures), Fidelity Investments as of Nov. 3, 2016.

came into better balance in 2015, prices have started to rise again. When costs are fixed, rising prices can create higher operating margins for commodity producers. A return to commodity price inflation typically supports higher earnings for producers as well as the industries that support them.

However, different industries have different response times to demand shocks. Mines require long-term planning and high capital investment, so capacity is less likely to fluctuate in the short term. As a result, it can take time for the market to absorb excess supply. (In contrast, energy capacity tends to follow a shorter cycle, leading to faster rebalancing of supply and demand.) Given the global environment of slow economic growth, I favor mining companies with lower production costs, which are well positioned to endure a gradual rebound in price. In addition, if new techniques for producing abundant U.S. natural gas continue to succeed, higher worldwide prices for oil may benefit U.S. chemical companies that use natural gas as a less expensive raw material.

EXHIBIT 2: Chinese economic stimulus tends to increase the demand for commodities, leading to higher prices.
Chinese Liquidity and Commodity Prices



Liquidity: reported China M1. Commodity price index: CRB BLS Spot Market Price Index. Source: Bloomberg Finance L.P., People's Bank of China, Commodity Research Bureau, Fidelity Investments, as of Nov. 1, 2016.

Agricultural commodities have shown a slow recovery (see Exhibit 1 for corn futures prices). Even after excess supply in 2015 led to depressed prices, the 2016 planting cycle did not markedly reduce acreage, and excellent weather led to unexpectedly good harvests. With inventories at 10-year highs, the price recovery from the trough has stalled. A reduced planting cycle for 2017 could lessen supply, but planned acreage has crept up over the past year. Amid a slow recovery for agricultural prices, I expect that producers of agricultural chemicals such as seeds, fertilizers, and insecticides may earn lower revenues through 2017, until supply and demand come into better balance.

China moves the needle on commodities

One of the reasons many commodity and materials prices have been suffering was the reduction of the 2009 government stimulus in China that followed the global financial crisis (Exhibit 2). Six years ago, intensive infrastructure and housing construction followed increased liquidity, boosting the demand for certain mining products, including copper, aluminum, iron ore for steel, and coal. Because China drives a large share of global demand for commodities, this activity in 2009 and 2010 increased prices and encouraged commodity producers to add capacity, which resulted in oversupply and depressed prices when demand slowed in later years. In mid-2015, the Chinese government returned to stimulative policies, injecting liquidity into the economy to encourage investment. Although the long-term sustainability of the current stimulus is uncertain, it should be a tailwind for global metal and coal prices, and for miners' earnings in 2017.

U.S. infrastructure investments set to rise

Infrastructure spending in the U.S. is set to accelerate. President-elect Trump has pledged to make increasing investment in the nation's infrastructure a major priority, and hopes to encourage up to one trillion dollars in new investment, a huge increase. In the meantime, investment growth is already in process. Last year, Congress

approved a new five-year highway bill for $61 billion a year, a meaningful increase from the previous $52 billion. In addition, most states have increased their infrastructure funding during the past two years. These are big, long-cycle projects that tend to continue even if another economic slowdown occurs. Producers of construction materials should see an increase in demand, with the possibility of even more investment and revenue growth on the horizon.

M&A may be disruptive to chemical companies' stock prices

Facing an environment of slower global economic growth, many companies have chosen to pursue M&A as a way to grow earnings. What makes this approach important for the overall sector in 2017 is that a significant proportion of the chemical industry's largest companies has announced potential deals. Government regulators may not let all of them proceed as planned, but some may be approved with conditions, such as spinning off various divisions to avoid creating a monopoly. Although M&A itself should have less of an effect on earnings than the continued price improvement for commodities, deals closing or falling through may create short-term volatility in stock prices—and bargain opportunities for longer-term investors—throughout the year.

Author

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Fidelity Associate Analyst Eric Thompson, Research Analyst Jeriel Rivera, Sector Specialist Sheng Wang, and Senior Sector Specialist Julie Porter also contributed to this report. Fidelity Thought Leadership Vice President Vic Tulli, CFA, provided editorial direction.

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.

Real Estate

E-Commerce Growth Drives Demand for Modern Warehouse Facilities and Data Centers

Steven Buller | Sector Portfolio Manager
Samuel Wald | Sector Portfolio Manager

Key Takeaways

- The continued growth of online sales transactions is fueling demand for warehouse distribution facilities in urban locations.
- E-commerce growth is also forcing the need for state-of-the-art data centers.

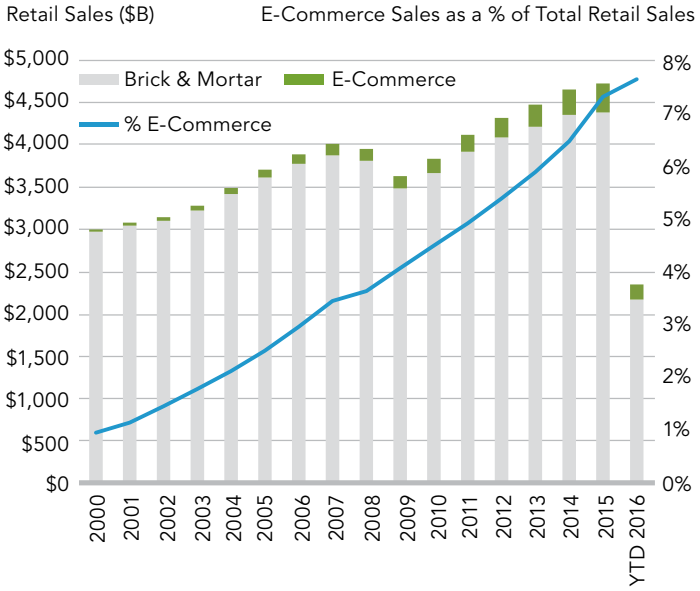
The proliferation of mobile devices and the steep growth of sales transactions over the Internet is fueling demand for modern warehouse distribution centers, particularly in densely populated U.S. regions. During the past decade, U.S. consumers have increasingly turned to the web, once considered a somewhat risky new frontier for buying goods. Improved online security and timely distribution have led to a growing comfort level and discretionary time savings for consumers. We continue to believe that this trend of increasing e-commerce has significant running room. If that is the case, demand for modern warehouse and distribution centers—categorized in the industrial real estate investment trust (REIT) industry—is likely to continue escalating as well.

During the past year, absorption of modern warehouse logistics space exceeded new construction, whether it was built speculatively or to meet the needs of a new or existing tenant (known as "built-to-suit"). At the same time, the growth of online traffic has also boosted demand for data centers—specialized buildings that maintain secure information that sits in the cloud, such as sales transactions, social networking, and other data critical to many newer business models. In our view, REITs that have leadership positions in owning and operating modern warehouses and data centers are poised to continue achieving a compelling rate of growth in 2017 and beyond.

Brisk demand for modern distribution centers in urban markets

The increased volume of online retail sales continues to disrupt the traditional brick-and-mortar sales models

EXHIBIT 1: E-commerce sales continue to represent a bigger piece of the overall U.S. retail sales volume.
U.S. Retail Sales: Traditional Stores and E-Commerce

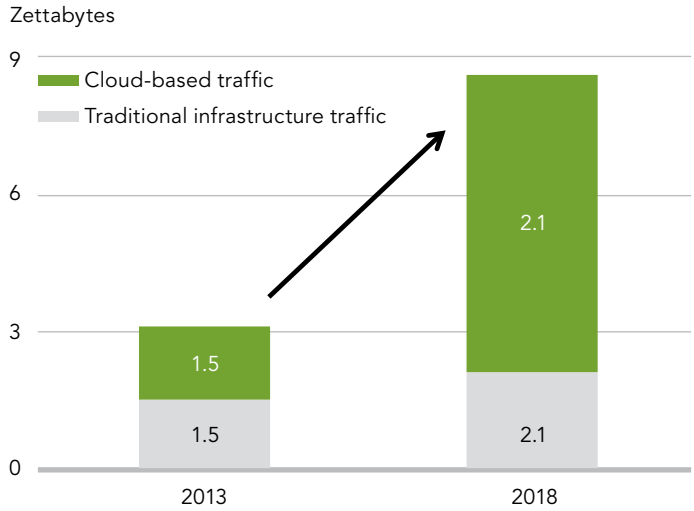


E-commerce sales are sales of goods and services where an order is placed by the buyer or price and terms of sales are negotiated over an Internet, extranet, Electronic Data Interchange (EDI) network, electronic mail, or other online system. Source: U.S. Census Bureau's Retail Indicators Branch, as of Jun. 30, 2016.

of many retailers, pushing up demand for modern distribution centers with the latest logistics technology. During the past 15 years, e-commerce sales have grown to nearly 8% of total retail sales in the United States, up from 1% at the turn of the century (Exhibit 1). The source of demand is coming not only from major online retailers with dominant market share, but also traditional brick-and-mortar retailers looking to grow their own e-commerce capabilities. As a result, a record number of warehouse facilities were under construction in 2016. Still, demand is outstripping supply. As a result, vacancy rates have plummeted and leasing rates have risen in many major markets.

As e-commerce growth continues, competitive dynamics are also driving demand for new warehouse distribution space near more densely populated markets. In the past, much of the industrial warehouse space was built in suburban or rural areas where land was plentiful and cheap, and labor and taxes were low. Many online retailers are trying to differentiate themselves by offering speedy or "last-mile" delivery, and some are charging a premium for it. To be effective, retailers are now looking for warehouse space closer to their customers, many of whom reside in urban markets. This dynamic is pushing up the value of land in and near cities, where it is scarce. Online retailers often find themselves in a bidding war for key space with third-party parcel delivery companies in urban markets.

EXHIBIT 2: The volume of data center traffic has risen significantly during the past five years, with most of the growth coming from cloud-based sources.
Global Data Center Traffic (2013-2018)



Cisco Global Cloud Index, and Ericsson Mobility Report, cisco.com and ericsson.com.

In some domestic markets where land is limited, such as Seattle, developers are constructing the first multi-story warehouses in the country to accommodate demand. Although leasing space in urban markets is more costly, developers believe retailers will be willing to pay more for a prime distribution location. So far, retailers have absorbed premium rent prices, believing they can be offset by lower transportation costs given their closer proximity to customers.

Demand for specialized real estate to accommodate Big Data

The growth of online traffic during the past 15 years has opened up the door to a new type of real estate: data centers. These buildings, many of which are owned by a half-dozen publicly traded REITs, serve as a hub of computer servers that supports and backs up all the data associated with typical business models today. More companies are collecting, analyzing, and storing data, and thus are increasingly relying on data centers to keep their operations up and running. Relatively expensive to build, data centers are state-of-the-art spaces that include the latest technology infrastructure and climate considerations. More specifically, this includes physical and online security, temperature controls, backup power sources, extensive optical fiber, raised floors, and other connectivity measures to ensure that the servers—the lifeblood of e-commerce connectivity—remain functional.

Data center REITs are well positioned to capitalize on many compelling secular growth trends. In particular, they benefit from the proliferation of mobile communications, social networking, streaming video, and the rise of cloud computing. Large e-commerce businesses, including online retailers, social networking firms, financial services

companies, and cloud providers, are among the major tenants for third-party data centers (Exhibit 2). Data centers are also appealing to smaller businesses that can't afford to build their own infrastructure in-house, and thus rent space by the rack or cage within certain "co-location" data centers.

In addition to being the supportive driver of e-commerce growth, data centers have other attractive features. One is their relatively sticky customer base. Given the unique build-out requirements and expense, most tenants are likely to renew their lease agreements with third-party data centers rather than move their servers or develop their own. Data centers also have unique demand drivers compared to other real estate property types. They are less sensitive to the trajectory of the nation's economy and employment level than other properties; if economic growth stalls, scaling back on a data center is typically not one of the first things a business is going to consider. Finally, supply remains in check and demand remains strong. For these reasons, we remain optimistic that the prospects for well managed data center REITs are favorable in 2017.

Authors

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Andrew Rubin, an institutional portfolio manager who is a member of the REIT equity and high income real estate debt teams, also contributed to this article. Fidelity Thought Leadership Vice President Kevin Lavelle provided editorial direction.

A REIT issues securities that trade like stock on the major exchanges, and invests in real estate directly, either through properties or mortgages. A REIT is required to invest at least 75% of total assets in real estate and distribute 90% of its taxable income to investors. Stock markets are volatile and can fluctuate significantly in response to company, industry, political, regulatory, market, or economic developments. Investing in stock involves risks, including the loss of principal. Illiquidity is an inherent risk associated with investing in real estate and REITs. There is no guarantee the issuer of a REIT will maintain the secondary market for its shares, and redemptions may be at a price which is more or less than the original price paid.

Changes in real estate values or economic downturns can have a significant negative effect on issuers in the real estate industry. Because of its narrow focus, sector investing tends to be more volatile than investments that diversify across many sectors and companies. Sector investing is also subject to the additional risks associated with its particular industry.

Telecommunication Services

Growing Demand for Mobile TV/Video Sends a Disruptive Signal

Matthew Drukker | Sector Portfolio Manager

Key Takeaways

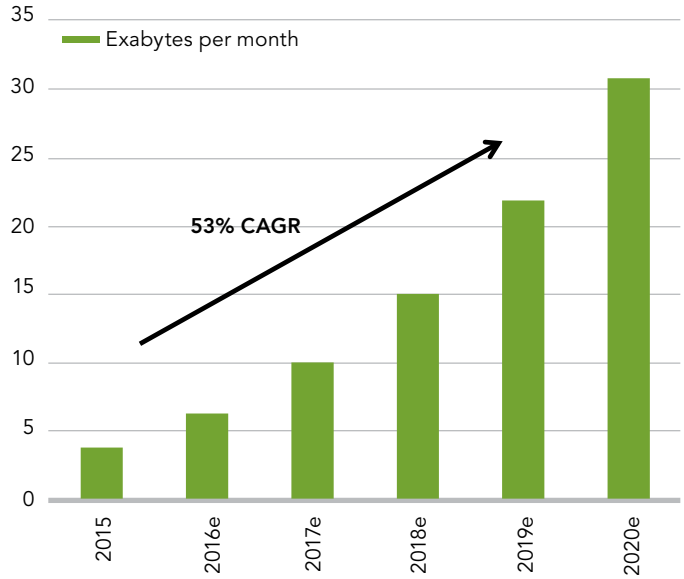
- Consider service providers that are able to generate faster revenue growth, by capitalizing on growing demand for high-speed broadband and mobile video services.
- Companies that own infrastructure for broadband services, including towers and fiber, are strategically positioned to benefit from broadband and mobile data growth.

More consumers are choosing to watch video content over the Internet, a growing preference that is creating opportunities and challenges for many companies in the telecommunication services sector. The proliferation of mobile devices and new technology has led to a surge in broadband traffic. This increased demand is driving the need for higher-speed services and bandwidth. It is also fueling competition, among wireless and wireline (cable) providers that are jockeying for market share, to provide effective broadband capabilities and mobile data services. If demand for data services escalates and continues to drive the sector's growth, as I expect, certain wireless infrastructure providers and wireline companies are well suited to capitalize on this trend.

Video over the Internet is driving usage and demand for faster broadband connections

Growing demand for TV/video consumption over the Internet has been a disruptive force within the sector during the past few years, and it's still a developing trend that I believe will be going more mainstream. New technology in handheld devices, along with increased video content packaging over the Internet, is allowing more consumers, households, and businesses to utilize video on the go (Exhibit 1). The adoption of video over the Internet is driving considerable growth in broadband traffic, which in turn is driving demand for faster connection speeds. Wireline and wireless companies that offer faster broadband services and higher usage allowances stand to win market share. In short, if consumers want to watch more on-demand video when and wherever they want, services providers who deliver that value proposition will benefit.

EXHIBIT 1: The amount of mobile data traffic is expected to grow eightfold in the coming years.
Global Mobile Data Traffic

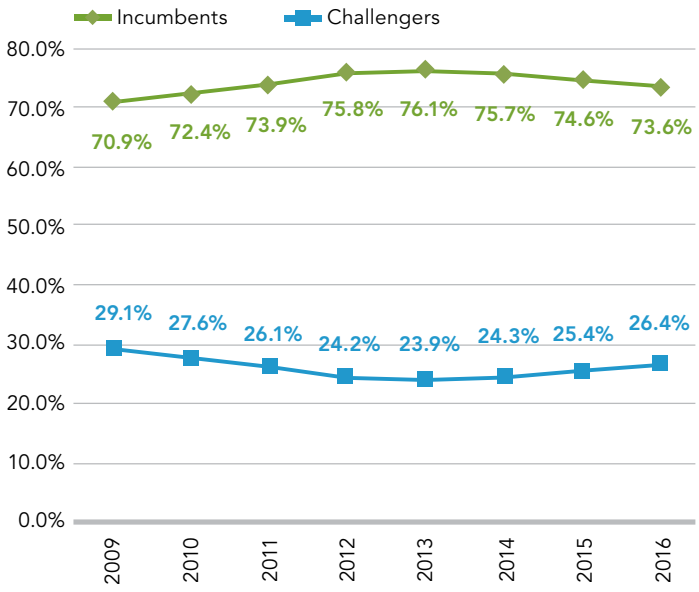


CAGR: Compound annual growth rate. Source: Cisco Visual Networking Index, "Global Mobile Data Traffic Forecast Update," www.cisco.com.

Tower operators could benefit from wireless broadband traffic growth

Among the most attractive beneficiaries of wireless broadband traffic growth are infrastructure providers, such as tower operators. As consumers demand and carriers compete to provide increasing amounts of mobile data, these companies should be in a good position to grow their revenues. For telecom carriers to send out even more video and data over their networks, they need to spend additional capital to build capacity. This involves leasing new space on towers to improve their networks and bandwidth. Often, carriers have limited options in how to densify networks, so the lack of alternatives means tower operators have pricing power.

EXHIBIT 2: Wireless carriers with less market share ("challengers") have picked up ground, in part by offering unlimited data usage.
U.S. Wireless Subscriber Market Share



2016 data includes estimated data for the 2nd half of 2016. Incumbents – Verizon and AT&T; Challengers – T-Mobile and Sprint. Source: company filings, as of Jun. 30, 2016.

Amid intense competition, identify companies that can best monetize broadband growth

Because demand for broadband and higher-speed Internet service continues unabated, I believe companies that can best monetize this trend may be best positioned. Competition to meet demand for mobile TV/video services has intensified among wireless carriers and wireline or cable-based network operators. For wireless carriers, growing market share is a function of offering the value proposition of a high-quality network experience with large data plans. Doing this profitably means balancing the costs of capacity increases, including licenses for wireless spectrum—the set of radio frequencies used for wireless data and voice transmission—to offer next-generation, 4G LTE networks. Going forward, having a high-quality network will be necessary to handle increasing reliance on usage among the "Internet of Things"—network connectivity via everyday physical devices that send and receive data, such as thermostats, automobiles, home appliances, and security systems.

In addition to capital spending, pricing pressures have intensified, and some wireless companies are better positioned than others to benefit from growing demand for video over the Internet. The key trend to watch is whether smaller providers ("challengers") profitably grow their market share at the expense of the two larger wireless providers ("incumbents"), which have the majority of subscribers and the bulk of cash flows (Exhibit 2). Recently, the challengers have picked up some incremental market share through acquisitions and by offering free data packages to subscribers, including unlimited video streaming for a number of popular services, such as Netflix and Hulu.

Wireline broadband providers with high capacity are well positioned to benefit from growth in broadband traffic and video consumption. Cable providers by and

large have attractive infrastructure in place (relative to legacy wireline service providers), allowing them to capture broadband subscriber net growth as the market gravitates to higher-speed services. Cable companies also stand a better chance of capitalizing on the growth in online-video consumption with usage-based pricing. Growing usage of Netflix, YouTube, and Hulu requires a high-speed Internet connection, and cable companies generally face little competition in most of their footprint to provide these video services exclusively. In effect, controlling the broadband relationship to the home is becoming more important and can make certain service providers, by default, the aggregator of video products.

Author

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Fidelity Thought Leadership Vice President Kevin Lavelle provided editorial direction.

The telecommunication services industries are subject to government regulation of rates of return and services that may be offered, and can be significantly affected by intense competition.

Utilities

Shedding Light on Growth in a Historically Slow-Growing Sector

Douglas Simmons | Sector Portfolio Manager

Key Takeaways

- Disruptively low interest rates pushed the valuations of stocks with fast dividend growth and high free cash flow to historically cheap levels.
- New public policy and regulations have created growth potential for utilities focusing on renewable energy and natural gas power plants.
- A surplus of U.S. natural gas is a source of growth for utilities building gas infrastructure.

Three disruptive forces of change—historically low interest rates, public policy mandating the use of cleaner fuel sources, and innovative natural gas drilling technologies—have pushed some utilities into new areas of growth. During the past year, the extended environment of low interest rates and low bond yields boosted demand for utilities stocks from many yield-starved investors. This chase for high dividend yield created an atypical valuation dynamic within the sector. Utilities with the highest (though often slower-growing) dividend yields soared to historical valuation peaks, while utilities with slightly lower (but faster-growing) dividend yields and higher earnings growth fell to attractive valuation levels not seen in years. At the end of 2016, that valuation gap began to close, and the stocks of companies trading at a discount within the sector and producing higher earnings and dividend growth started to outperform. In my view, that trend should continue in the coming year.

Meanwhile, new public policy and regulations have sparked some utilities to embrace renewable energy, seizing the opportunity to grow by modernizing the electric grid to accommodate solar and wind power. New environmental rules also have forced some utilities to retrofit power plants with cleaner, natural-gas-power generation. Elsewhere, a few utility companies are building the infrastructure to transport the increased supply of natural gas to new domestic and international locations. Companies responding to these disruptive changes are likely to achieve a faster rate of sales growth and become tomorrow's winners in the sector.

Historically low interest rates create a valuation anomaly for faster dividend growers

During the past year, with interest rates and bond yields hovering near historically low levels, many investors flocked to the absolute highest-yielding utilities in the sector. Demand surged for these stocks, pushing their valuations to historically high levels. At the same time, the stock performance of better fundamentally positioned utility companies—those exhibiting faster dividend growth (rising payouts) and higher free cash flow yields—lagged, largely because they generally offered moderately lower dividend yields. I think this valuation disparity—the widest in a decade—is likely to reverse course because investors have prioritized dividend yield to the point where it has been inefficiently priced over other stock valuation factors.

Historically, utilities with the highest dividend growth have tended to be the top performers in the sector over an extended period, and across all business cycle phases.

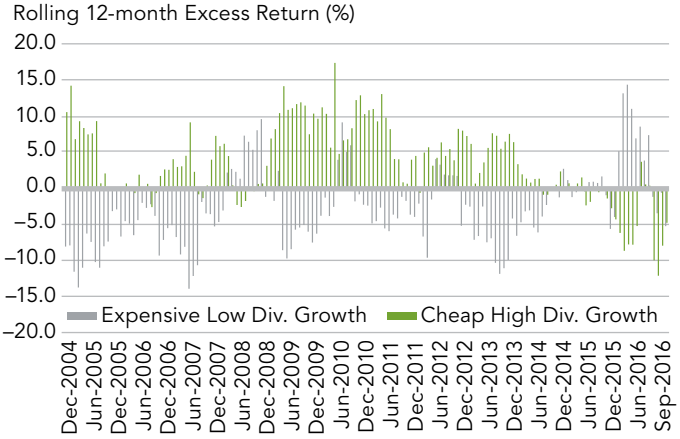
This strategy has historically generated even greater outperformance when these faster-growing companies have traded in line with or at a valuation discount to the overall utility sector, which is where they stood in the fourth quarter of 2016. From December 2004 to June 2016, utilities with lower valuations and faster dividend growth delivered superior excess returns on a rolling one-year basis nearly 70% of the time (Exhibit 1).

Looking forward, I think the broader market's penchant for absolute yield is likely to wane, and utility stocks with the best business fundamentals, lowest valuations, and fastest dividend growth will regain their performance leadership. It's also important to keep in mind that slower-growing utilities that are owned exclusively for yield may have greater downside risk should interest rates rise. Rising rates tend to dampen enthusiasm for high-yielding utilities stocks, as other income-oriented investments, such as bonds, become relatively more attractive. Given the Federal Reserve's recent more "hawkish" stance toward increasing policy rates, the valuations of utilities with high valuations and limited growth prospects may be most at risk.

Early leaders in renewable power generation (wind and solar)

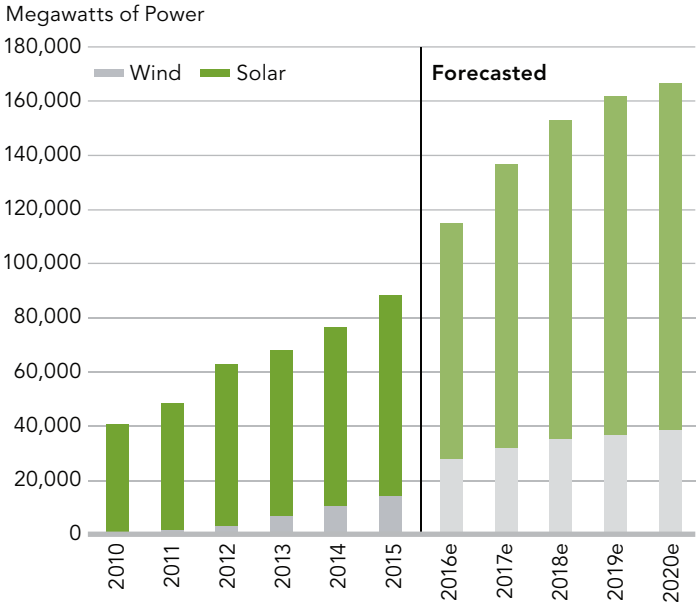
Although power demand across the U.S. typically has fluctuated between 0% and 0.5% growth per year, new areas of growth have opened up. Public policy has been aggressively mandating the transition of the power fleet away from coal-burning power generation into renewables. A handful of utility companies were early movers in building leadership positions in renewable power development. These companies have long-term contracts with regulated utilities, which are required by law to produce a certain percentage of their power production from wind or solar sources. As a result, solar and wind power generation has been growing, and represents about 13% of the nation's power fleet[1] (Exhibit

EXHIBIT 1: Until recently, utilities with lower valuations and higher dividend growth (green bars) have more frequently outperformed more expensive stocks with slower dividend growth (gray bars).
Utilities Sector Performance Based on Valuation and Dividend Growth



Universe of data: utilities stocks in the Russell 1000 Index. Performance for the two cohorts in the chart above was equal-weighted excess returns vs. the equal-weighted return of the utilities in the Russell 1000 Index. Each bar represents a rolling 12-month excess return that was either 1) cheap with above- median dividend growth or 2) expensive with below-median dividend growth. Cheap: defined as above-median Operating Cash Flow Yield (OCF Yield). Expensive: defined as below-median OCF Yield. Source: FactSet, as of Sep. 30, 2016.

EXHIBIT 2: Wind and solar power generation are increasingly becoming a larger percentage of the U.S. power supply.
U.S. Wind and Solar Power Generation



Megawatt (MW): 1 million watts. Source: S&P Global Market Intelligence, as of Dec. 31, 2015.

2). In states such as California, where public policy is mandating the construction of renewable energy, utilities are modernizing the electric grid to accommodate solar and distributed generation so that the grid is actually able to handle the new supply of renewable power. This capital investment is allowing them to grow their earnings and dividends at higher rates than some competitors. Meanwhile, new environmental regulations have forced many utilities to retrofit their power plants with cleaner-burning natural gas, and I believe those that have been leaders in the transition are well positioned.

Growing via development of natural gas infrastructure

Other utilities have begun to capitalize on the increased supply of U.S. natural gas to boost earnings. As energy producers developed innovative land-drilling technology (shale "fracking") during the past few years, a glut of natural gas flooded U.S. markets. Because many of these markets have been ill equipped to manage the surge in supply, a few utilities have successfully integrated into natural gas infrastructure, such as gas pipelines and liquid natural gas (LNG) terminals that provide higher long-term cash flow. Natural-gas-powered utilities that are able to build this infrastructure efficiently in strategic locations—connecting shale gas production to consumers—can achieve a rapid return on their investment, enabling them to put more capital to work and potentially increase dividends and earnings faster than other utilities.

Looking ahead to the coming year, I am optimistic about the stocks of utility companies with leadership positions in renewables, natural gas infrastructure, and grid modernization, given their attractive potential to grow earnings and dividends. Equally compelling: Many stocks with these growth characteristics have been trading at historically low valuations. In the coming year, I anticipate the market will come to more fully appreciate these stocks.

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Fidelity Thought Leadership Vice President Kevin Lavelle provided editorial direction.

The utilities industries can be significantly affected by government regulation, financing difficulties, supply and demand for services or fuel, and natural resource conservation.

Endnotes

[1]About 10% of total U.S. energy consumption was from renewable energy sources in 2015. More than half of U.S. renewable energy is used for producing electricity, and about 13% of U.S. electricity generation was from renewable energy sources in 2015. Source: U.S. Energy Information Administration.

U.S. EQUITY SECTOR PERIODIC TABLE OF ANNUAL TOTAL RETURNS
1992–2016

1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016*	Legend
23%	22%	20%	58%	44%	48%	78%	79%	57%	14%	4%	47%	32%	31%	37%	34%	-15%	62%	28%	20%	29%	43%	29%	10%	17%	Energy
20%	20%	14%	54%	35%	44%	52%	25%	37%	3%	-4%	38%	32%	17%	35%	23%	-23%	49%	28%	14%	24%	41%	28%	6%	16%	Utilities
16%	19%	10%	42%	35%	41%	44%	25%	26%	3%	-5%	37%	24%	12%	24%	19%	-29%	41%	27%	13%	20%	41%	25%	6%	14%	Telecom Services
15%	16%	6%	40%	26%	34%	41%	21%	26%	-6%	-11%	37%	20%	6%	21%	16%	-30%	28%	22%	8%	18%	36%	20%	5%	11%	Info Tech
10%	15%	4%	39%	26%	33%	16%	19%	17%	-6%	-15%	32%	18%	6%	19%	14%	-33%	21%	20%	6%	18%	28%	16%	1%	9%	Industrials
10%	15%	3%	39%	25%	29%	15%	19%	16%	-9%	-19%	31%	13%	4%	19%	12%	-35%	20%	19%	6%	15%	26%	15%	-2%	8%	Materials
7%	14%	-2%	33%	21%	27%	11%	4%	6%	-10%	-24%	26%	13%	4%	19%	12%	-38%	17%	14%	5%	15%	26%	10%	-3%	6%	REITs
5%	13%	-4%	31%	16%	25%	11%	-5%	-16%	-12%	-26%	26%	11%	2%	14%	7%	-40%	15%	12%	2%	15%	25%	10%	-5%	5%	Consumer Staples
3%	11%	-5%	20%	12%	25%	1%	-9%	-20%	-12%	-30%	15%	8%	1%	13%	-13%	-43%	14%	10%	-1%	11%	13%	7%	-7%	3%	Financials
2%	-4%	-8%	20%	6%	20%	-6%	-11%	-39%	-26%	-34%	12%	3%	-6%	8%	-16%	-46%	12%	5%	-10%	5%	11%	3%	-9%	0%	Consumer Discretionary
-16%	-8%	-12%	15%	1%	8%	-18%	-15%	-41%	-30%	-37%	7%	2%	-6%	8%	-19%	-55%	9%	3%	-17%	1%	3%	-8%	-22%	-6%	Health Care

* Indicates YTD performance through October 31, 2016. Sector returns represented by S&P 500® Index sectors, and defined by Global Industry Classification Standard (GICS®), with the exception of real estate, where returns are represented by the FTSE/NAREIT All Equity REITs Index. The S&P 500 Index is a market capitalization-weighted index of 500 common stocks chosen for market size, liquidity, and industry group representation to represent U.S. equity performance. The FTSE National Association of Real Estate Investment Trusts (NAREIT) All Equity REITs Index is a market capitalization-weighted index that is designed to measure the performance of all tax-qualified REITs listed on the NYSE, the American Stock Exchange, or the NASDAQ National Market List. All sector equity returns in the table reflect total returns for the period stated, and include reinvestment of dividends and interest income. Past performance is no guarantee of future results. Source: FactSet, Morningstar Inc., Fidelity Investments, as of October 31, 2016.

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Because of its narrow focus, sector investing tends to be more volatile than investments that diversify across many sectors and companies. Sector investing is also subject to the additional risks associated with its particular industry.

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

Index definitions

The **S&P 500® Index** is a market capitalization-weighted index of 500 common stocks chosen for market size, liquidity, and industry group representation to represent U.S. equity performance. S&P 500 is a registered service mark of The McGraw-Hill Companies, Inc., and has been licensed for use by Fidelity Distributors Corporation and its affiliates. The **S&P 500® Sector Indices** include the standard GICS® sectors that make up the S&P 500® Index. The market capitalization of all 10 S&P 500® Sector Indices together composes the market capitalization of the parent S&P 500® Index; all members of the S&P 500® Index are assigned to one (and only one) sector. The **S&P Composite 1500®** and its sub-indices combine three leading indices, the S&P 500®, the S&P MidCap 400®, and the S&P SmallCap 600® to cover approximately 90% of the U.S. market capitalization. It is designed for investors seeking to replicate the performance of the U.S. equity market or benchmark against a representative universe of tradable stocks. The **Russell 1000®** Index is a market capitalization-weighted index representing the largest 1000 stocks of publicly traded companies in the Russell 3000® Index. **FTSE National Association of Real Estate Investment Trusts (NAREIT) All Equity REITs Index** is a market capitalization-weighted index that is designed to measure the performance of all tax-qualified REITs listed on the NYSE, the American Stock Exchange, or the NASDAQ National Market List. The **Cisco® Global Cloud Index (GCI)** is an ongoing effort to forecast the growth of global data center and cloud-based IP traffic. The forecast includes trends associated with data center virtualization and cloud computing. The **CRB BLS Spot Market Price Index** tracks 22 commodities presumed to be among the first influenced by changes in economic conditions.

Glossary

Price-to-earnings ratio: the market price per share of a stock (or group of stocks) divided by a company's earnings per share.
M1: a measure of the most liquid portions of a country's money supply.
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