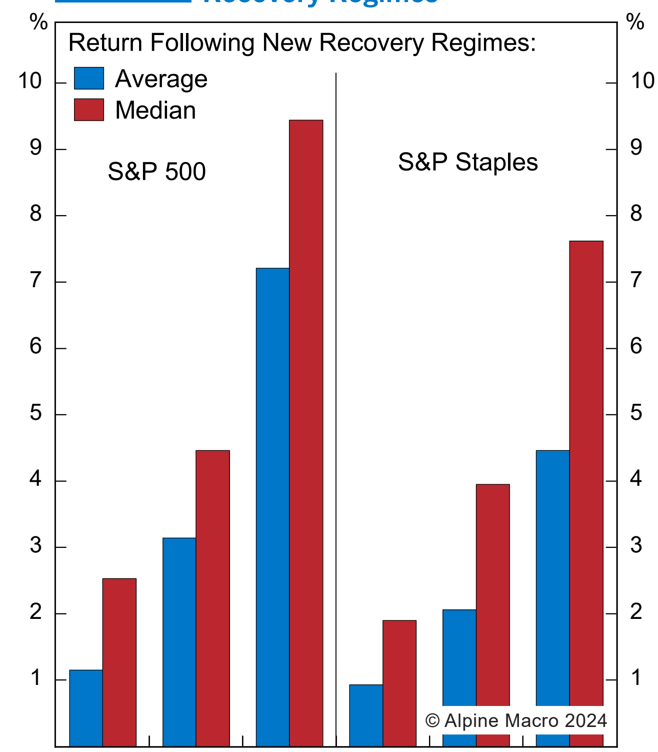
Pushing Down On Staples

Consumer Staples are ill-suited for the current and unique phase of this equities cycle as their defensive characteristics are impaired following years of pantry stocking and pricing increases, while other sectors stand to benefit more from an eventual cyclical upturn. We remain underweight the sector within our tactical framework.

Chart 1 Staples Underperform During Recovery Regimes



Note: Recovery regimes defined as period of profit strengthening and falling yields, data since 1990

Not The Right Regime For Staples

A resilient U.S. growth backdrop corresponding with a Fed rate cutting cycle is anathema to the growth starved environment in which Staples would be expected to outperform. Since 1990, Staples have been the third worst performing sector during recovery phases characterized by overall S&P 500 profit growth and a positive policy impulse. Only Telecom and Utilities fare worse during this regime which is most often marked with strength from more cyclical sectors.

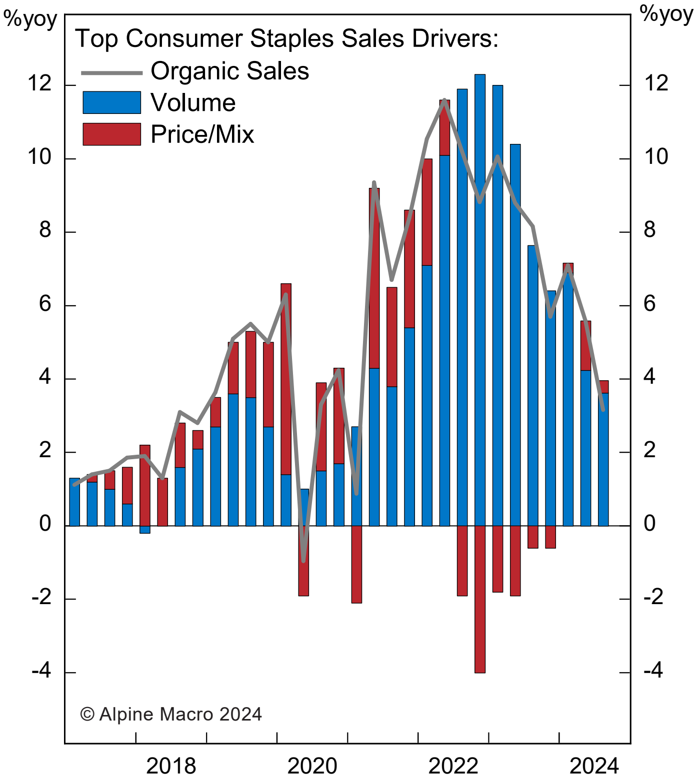
Hahaha we are literally long these 3 sectors

As shown in **Chart 1** the sector underperforms the broader index during recovery periods. We expect more of the same through this episode given a variety of fundamental headwinds, most notably a slowdown in unit demand and pricing power, in addition to a few idiosyncratic elements.

Pandemic-Era Tailwinds Now Headwinds

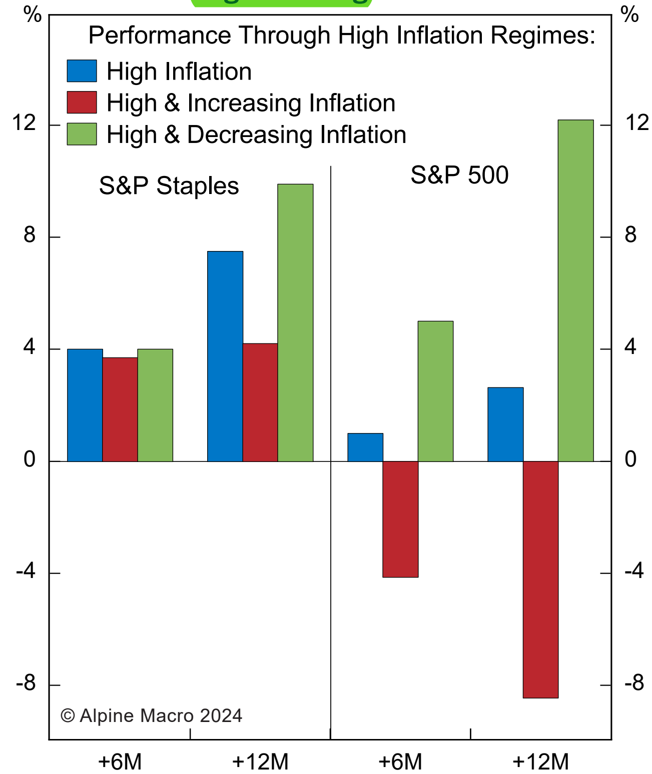
Staples have traditionally been a consummate "defensive" sector given the relative inelasticity in demand for the products its companies provide, including food or personal items and tobacco, which contributes to more stable unit sales and pricing power. This allows for the sector to avoid many of the deeper gyrations other sectors experience across the business cycle.

Chart 2 Lower Volume & Pricing Drive Sales Down



Note: Data reflects averages of PG, CL, KO, KMB & PEP; source: Bloomberg Finance L.P.

Chart 3 Staples Outperform With Inflation High & Rising



Note: High inflation defined as CPI > 3%yoy, data since 1990

However, these countercyclical characteristics often turn from friend to foe following periods of intense turmoil as inventories build in anticipation of continued demand that becomes tapped out as consumers complete their "pantry stocking" process and/or the economy recovers.

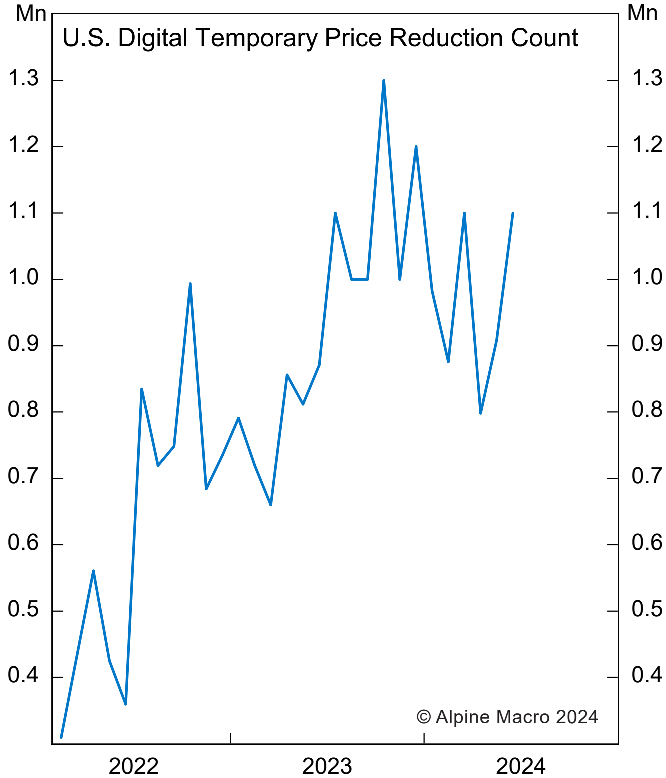
This is precisely the challenge now facing the sector following the post-COVID normalization period, as unit sales stall at near equilibrium levels for many product categories. In Chart 2, we illustrate the drivers of organic sales growth for five of the largest constituents within the Household Products and Beverages industries which highlights the decline in volumes, pricing, and product mix.

Inflation Hangover

Inflation is also moving from a tailwind to a headwind for Staples in an unappreciated twist to the defensiveness of its pricing power. Historically, the segment thrives during inflationary periods and is challenged only by Energy as the sector with the most positive performance corresponding with high and/or rising price levels.

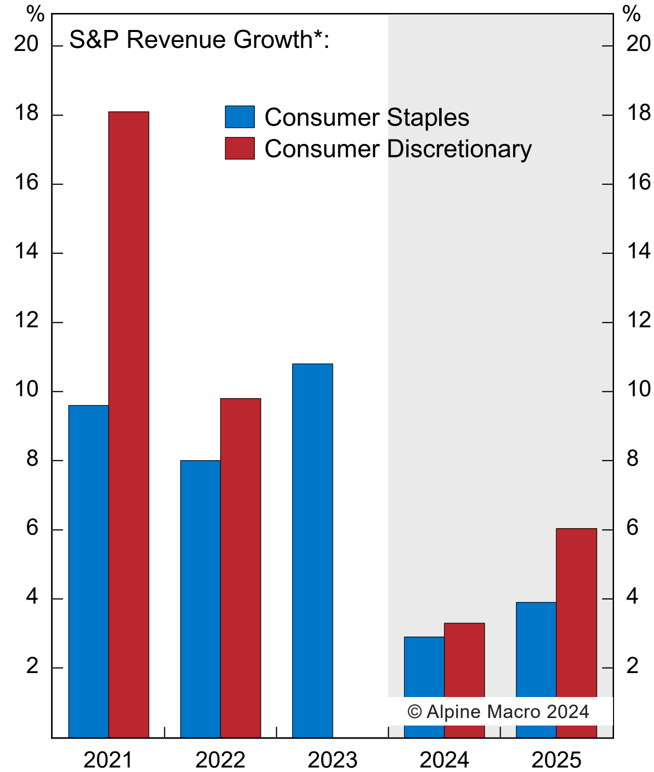
However, that boost often turns into a drag with performance settling into the middle of the pack as inflation drifts down from elevated levels. In the six months following a downward trend in CPI from above 2.5%, Staples has posted the 8th best sectoral performance average since 1990. Chart 3 shows the dispersion in forward returns and sector

Chart 4 Companies Resort To Discounts To Push Sales



Source: Numerator Promotions Intel

Chart 5 Post-COVID Hangover For Staples Growth Trajectory



*Shaded area denotes estimate period; source: Bloomberg Finance L.P.

rank in periods of high relative to moderating inflation.

This dynamic is playing itself out again with corporate management teams increasingly citing the unwillingness of consumers to pay more for product and instead downshifting in the value chain towards cheaper alternatives. This is leading to a raft of discounts and promotional activity to stave off pure declines. Chart 4 shows the number of temporary digital price reductions, or sales.

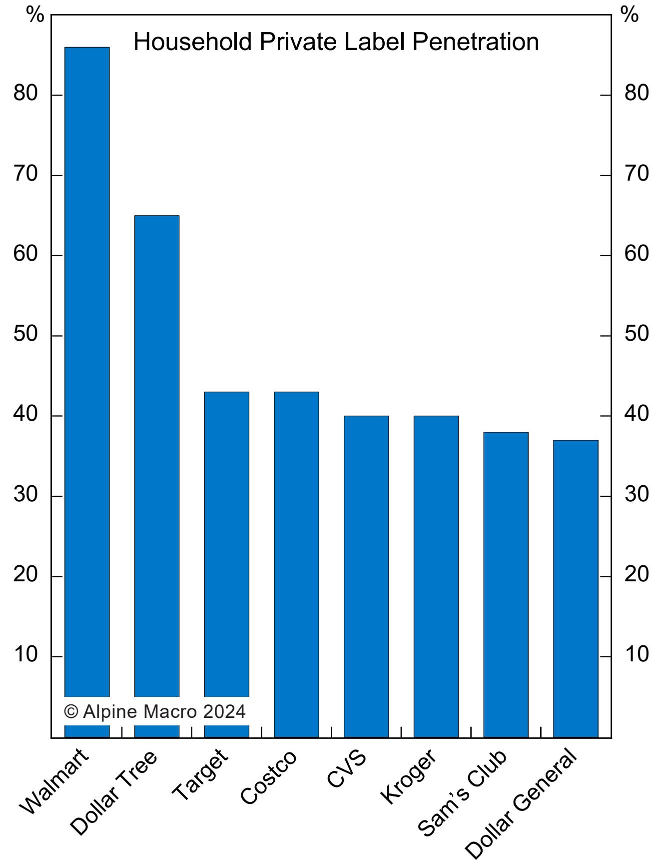
The aggregate effects of weaker product mix, a stall in unit sales growth, and a collapse in pricing power have conspired to push sales growth lower for the sector with no quick fix in sight. From 2021 through last year, the sales per share for the S&P Consumer Staples segment increased by an average annualized rate of 11% but this figure is trending towards just 1.5% through October with low single-digit growth expected in coming periods (Chart 5).

These risks are made even more acute for Staples given the razor thin margins many constituents operate at— the lowest on aggregate of any sector— and consumer spending trends favoring less profitable consumables (ex. groceries) as opposed to more discretionary products.

Multi-Front Challenges For Retail Staples

If the typical cyclical challenges were not enough, the sector is undergoing significant evolution underneath the surface given a few idiosyncratic

Chart 6 Private Labels Are Taking Market Share



Source: Numerator

developments: 1) the competition for market share is fiercer and more innovative than ever, 2) the method or mode where customers transact is shifting, and 3) secular forces including GLP-1 pharmaceuticals threaten to upend consumption patterns.

Private Labels

As noted, an overshadowing narrative in recent quarters has been a prioritization of consumer value to protect against declining sales leading companies to engage in discounts and promotions where possible, however the increasing prevalence and sophistication of "private label" is ratcheting up the stakes. Last year, private label earned 17% U.S. dollar share of consumer goods and is rapidly expanding, according to Nielsen IQ.

Retailers, especially distributors with scale to managing private label brands, are investing more in these proprietary categories and upping the quality of their offerings. This provides them with leverage over suppliers of branded products to force price drops, with little margin split, or face the challenge of competing shelf space. For the distributors it's a win-win of lower prices for customers or earning a greater portion of the total sale while building brand loyalty.

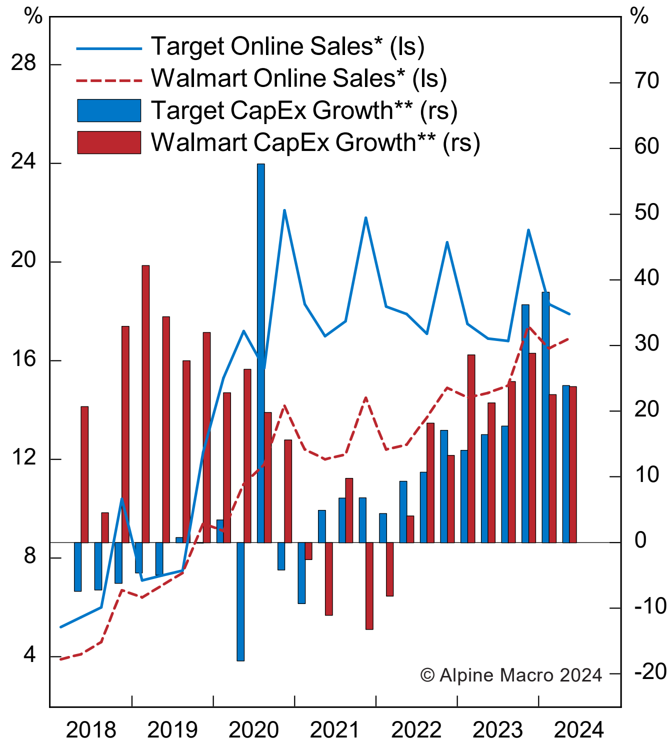
In our view, this trend favors distributors while putting food, beverage, and even household product producers in a vulnerable position. Chart 6 shows the household penetration of the top private label brands within Staples.

Omnichannel

The major trends shaping how and where consumers transact in Staples include: A) a secular decline in store counts for supermarkets and drugstores, B) cyclical shifts across some products in various channels, and C) the costly but surging buildout of online ordering & distribution.

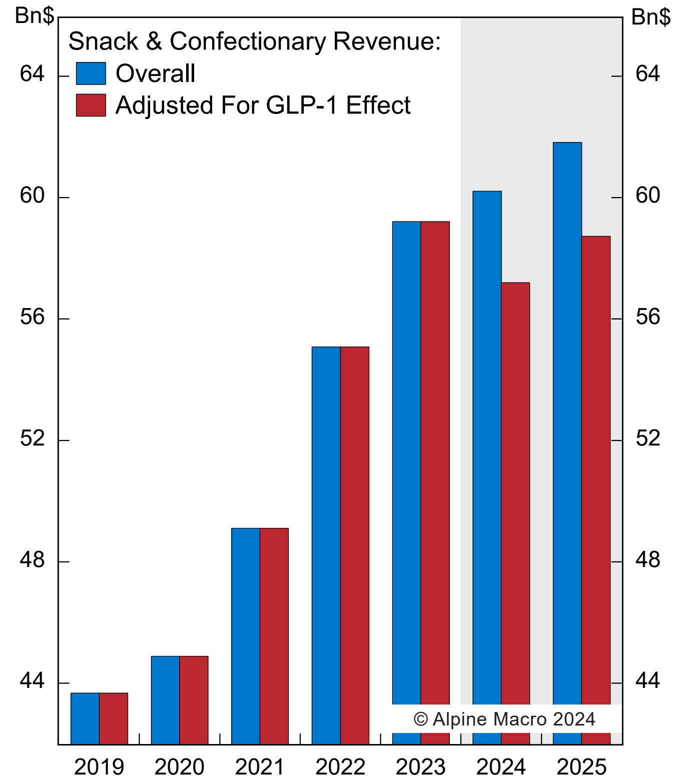
What's become clear is that an omnichannel approach is the preferred method for maximizing the touchpoints between businesses, brands and consumers but some models are better equipped to optimize their digital and physical footprint. Tobacco and snacks, for example, are experiencing demand declines in convenience stores while prepared foods and beverages are picking up growth.

Chart 7 Online Presence Growing Alongside Major CapEx For Distributors



*Shown as % of total sales
**3-year average growth rate
Source: Bloomberg Finance L.P.

Chart 8 GLP-1s Are Eating Snack Revenues



Note: Shaded area denotes estimate period based on GLP-1 usage & effect data. Data includes HSY, MDLZ, NESN, PEP & GIS

Meanwhile, an online presence remains vital in building brand awareness in addition to driving sales across all product segments. Companies are increasingly leveraging their physical locations as distribution centers, innovating through subscription services, and even developing digital advertising platforms.

Businesses with the financial capacity and scale to utilize massive amounts of data (AI) in enhancing the customer experience should own a structural sales and profitability advantage over the rest of the sector. Chart 7 shows the online revenue share for two major distributors increasing ~4x since 2018 while their combined CapEx amounts to 36% of the S&P Staples Index, outpacing their market share of 23%.

GLP-Run?

The rapid rise in popularity of GLP-1 drugs is inching closer to having a material effect on businesses involved in the production and distribution of caloric products. From 2018 through 2022, Medicare spending on the drug increased by an average annual rate of 46%, and some estimate their usage could jump ~15x by 2030. These drugs are clinically proven to reduce the caloric intake of patients while also modifying their consumption preferences.

The potential implications for the Staples sector remain nebulous but likely vast. Most food and beverage producers have so far mentioned that their effects have been minimal, but some distributors have noted increased activity in their health segments at the expense of grocery. Walmart's CFO opined that people might purchase less food but shop for new pants to outfit slimmer waistlines.

In **Chart 8** we extrapolate the effect of the drugs on food, alcohol, snack, and beverage consumption cited in controlled studies to the potential revenue impact on large constituents within S&P Staples Index.

A natural catalyst lurks for the GLP-1 drug category as Ozempic and Wegovy are anticipated to be among the top contenders for inclusion on the February 2025 list of drugs selected for Medicare price negotiation *via* the Inflation Reduction Act. If selected, this would likely put significant downward pressure on the drugs, boosting their usage even further, beginning at implementation in 2027.

What's Ailing Discount Retail?

Investors instinctually flock towards value retail during periods of consumer crunch in the lower and middle-income segments, given the "trade down" phenomenon, but this time is different as their business models are structurally at odds with critical trends.

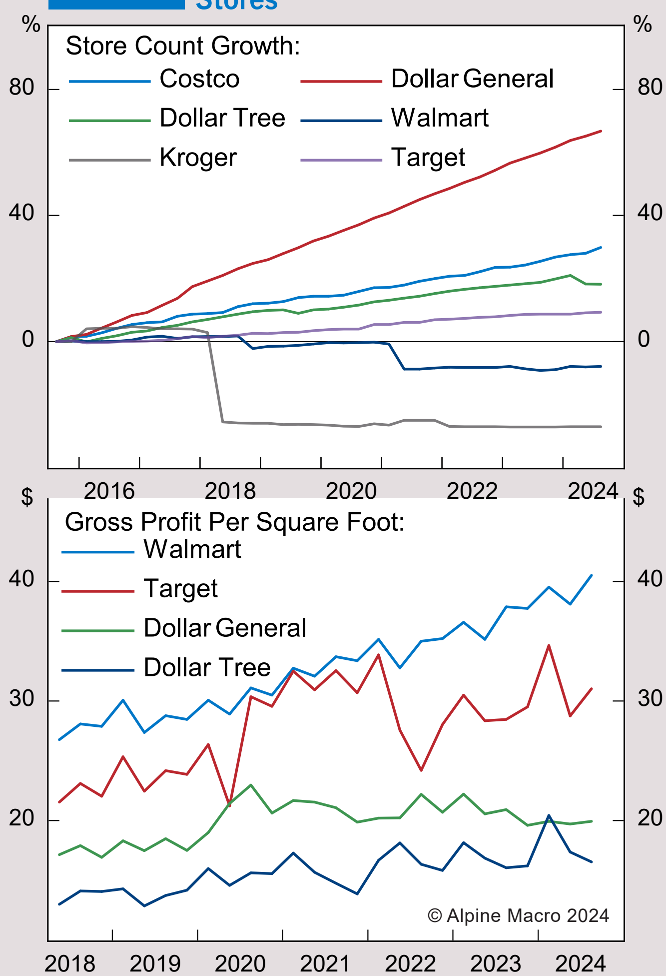
1. Main players struggle to manage expensive and overbuilt brick-and-mortar footprint while other channels consolidate (**Chart 9**)

2. Wage inflation, transportation, and shrink costs have outpaced pricing power

3. The product mix is lower margin and easily replicated/replaceable by online competitors

As a result, discount retailers have suffered since the Spring. Management is intent on reducing inventory and lowering/shifting CapEx to remodels vs. new stores but given our view of a cyclical upturn, we're wary of a major turnaround.

Chart 9 Massive Overexpansion Of Dollar Stores



Source: Bloomberg Finance L.P.

Where's The Hidden Upside?

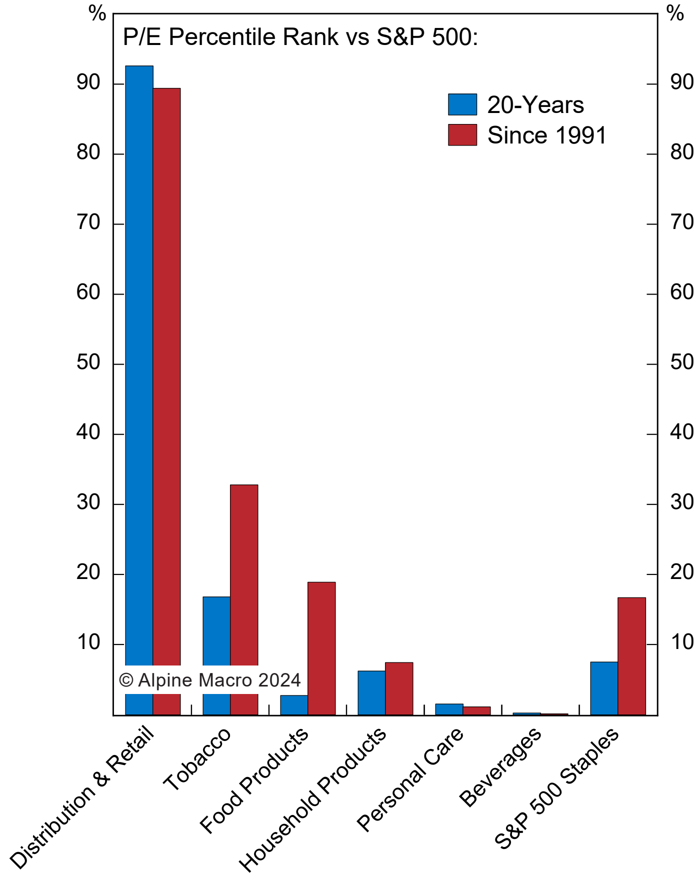
The major risk for maintaining an underweight position in Staples is that it's become a crowded view with attractive relative valuation meaning that there may be a mean-reversion opportunity given a proper catalyst. The sector hasn't completely washed out from a technical perspective but sits just above the laggards of the pack such as Energy, Materials, and parts of Health Care.

From a valuation standpoint, Consumer Staples trades at the 17th percentile relative to the S&P 500 since 1991 on a P/E basis but that figure belies more weakness across the industry level where Food, Household, Personal Care Products, and Beverages trade even lower. The sector's valuation is buttressed by Distribution & Retail which has benefited from a runup since earlier this year (**Chart 10**).

In our view the potential catalysts would likely come in the form of fundamental improvement which would mean that some of the headwinds described abate or reverse, such as a pickup in unit demand or a trade up in the value chain. Continued upside in consumer confidence should be monitored as a potential indicator.

The U.S. election could represent a potential vehicle for signaling improvement if the setup in D.C. favors a stimulative consumer-focused platform, which we expect Candidate Harris to champion. However, that might also accelerate challenges from a GLP-1 perspective and introduce headline risk for others within the grocery and food products space. Finally, the potential for cyclical improvement abroad, where demand has been weak, could also provide a boost, especially as it pertains to currency effects which continue to be a drag on earnings for those companies with larger international presence.

Chart 10 Most Industries Cheap Aside From Distributors



Source: Bloomberg Finance L.P.

Conclusion

We continue to advise investors to underweight Consumer Staples on a strategic basis given what we view to be a weak fundamental setup which promotes an unfavorable risk-reward skew. While valuation for many segments appears washed out, the lack of a high conviction immediate catalyst limits potential upside whereas we'd expect the potential for a cyclical upswing to benefit other sectors to a larger degree.

Within Staples we favor Distributors & Retail companies with an omnichannel presence that have the financial capacity and scale necessary to monetize new product lines or channels through data innovation, including artificial intelligence. These companies are expensive but rightfully so, in our view.

Nick Giorgi
Chief Equity Strategist

Investment Recommendations				
Strategic Recommendations (6 - 12 months)				
Recommendations	**Open Date**	**Performance**		**Active Return**
		Vehicle	**S&P 500**	
Long S&P Industrials	5/29/2024	12.34%	11.05%	1.29%
Long S&P Utilities	6/12/2024	14.29%	7.89%	6.40%
Long S&P 600	6/24/2024	8.92%	7.37%	1.55%
Short S&P Materials	7/24/2024	5.55%	7.77%	2.22%
Long Regional Banks (KRX)	8/21/2024	8.37%	4.05%	4.32%
Long/Short S&P 500 Healthcare Equipment & Supplies/Providers & Services	10/23/2024	-0.79%		-0.79%

A Unique Mind On The Markets