Market overview

[CONSUMER DISCRETIONARY AND STAPLES]

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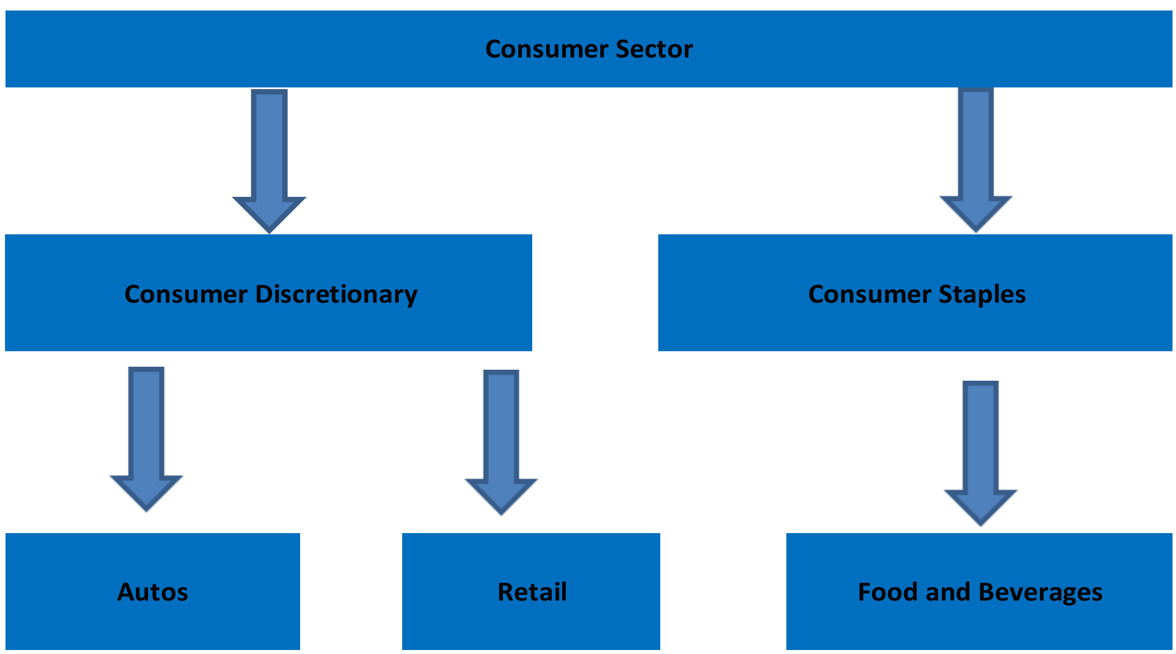
Sector Performance

Sector	Ticker	1M %	3M %	YTD %
STOXX Europe 600 Personal & Household	SXQP	7.23%	-0.11%	-6.78%
STOXX Europe 600 Retail	SXRP	9.39%	2.61%	-6.92%
DAX INDEX	DAX	14.29%	1.44%	-9.21%
STOXX Europe 600 Food & Beverage	SX3P	5.03%	-3.17%	-11.70%
STOXX Europe 600	SXXP	7.29%	-5.55%	-13.44%
EUROSTOXX 50	SX5E	9.84%	-6.32%	-15.66%
STOXX Europe 600 Automobiles & Parts	SXAP	11.27%	-5.34%	-22.55%
STOXX Europe 600 Travel & Leisure	SXTP	9.90%	-15.10%	-31.01%

Overview

The Overview covers both the staples and discretionary segment. On the discretionary side we cover the retail sector and Autos. Whilst on consumer staples we are focused on the food and beverage sector. Our core focus is on the European market using the Stoxx600 as a benchmark, but we will also monitor the main US/Asian peers for **potential read across and trading ideas**. This report will examine the broader consumer sector touching on key drivers, trends and the general market dynamics. In the coming weeks, our analysts will publish a more in-depth dive into their sector focusing on their specific drivers and trends.

Diagram



What is the consumer sector?

The consumer sector can be broken into two sub sections, discretionary and staples. Each section has its own unique characteristics which will be outlined in the report.

Consumer discretionary comprises of businesses that sell non-essential products and services. It is characterized by those firms that tend to be the most sensitive to economic cycles, including hotels, restaurants, and other leisure facilities and consumer retailing. The above characteristics make this one of the **most cyclical sectors** with a large exposure to the COVID-19 shutdown. The below chart shows how Schwab views the sector across multiple metrics'. Despite the historically pro-cyclical nature of the sector, the tailwind by the **internet retailing** sector **has mitigated the negative fallout** from the recession. It is worth bearing in mind, that sharp volatility in the markets, earnings expectations and the economy makes assessing valuations and fundamentals difficult. (Schwab, 2020)

Sector overview: Consumer Discretionary

Sector	Rating	Macroeconomic	Value	Fundamental	Relative Strength
Consumer Discretionary	Marketperform	+	-	-	+

Source: (Schwab, 2020)

Cumulative Index performance- net returns (USD)

Source: www.msci.com

Consumer Staples are the essential products which we need in day to day life. The sector is made up of companies whose businesses are less sensitive to economic cycles, including manufacturers and distributors of food, beverages and tobacco and producers of non-durable household goods and personal products. The Consumer Staples sector **historically has outperformed** during periods of economic slowdown and uncertainty, as investors are attracted by the perceived relative stability of the group. The below chart shows how Schwab views the sector across multiple metrics. Retailers within the sector have aggressively cut costs, leaving them in reasonable condition to deal with limited pricing power and **less–than-exciting top line growth**. COVID-19 related stocking of food and household goods has resulted in few **negative earnings revisions**, supporting the fundamental outlook. (Schwab, 2020)

Sector overview: Consumer Staples

Sector	Rating	Macroeconomic	Value	Fundamental	Relative Strength
Consumer Staples	Marketperform	-	+	+	-

Source: (Schwab, 2020)

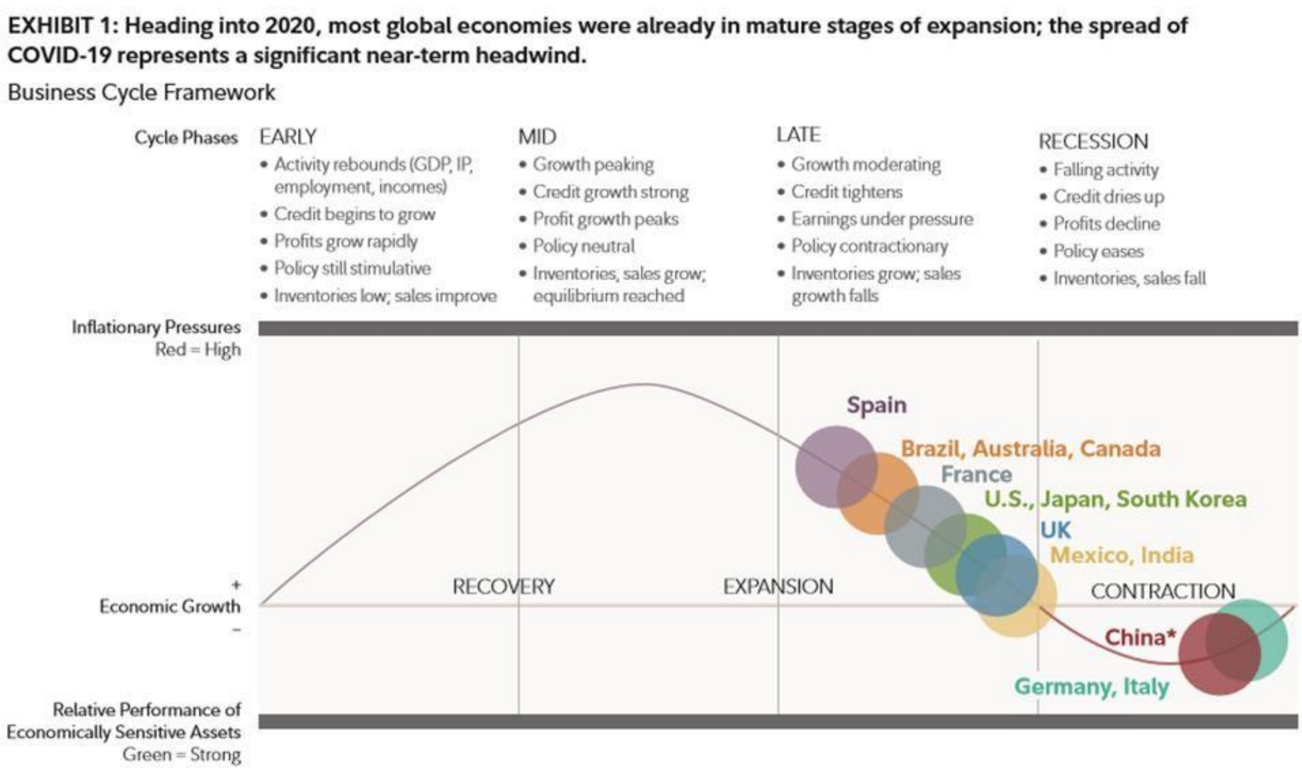
Cumulative Index performance- net returns (USD)

Source: www.msci.com

<u>Where are we in the current economic cycle?</u>

The COVID-19 virus has exacerbated Late-Cycle uncertainty. Dramatic market volatility has been due to a combination of open-ended uncertainty surrounding the spread of the coronavirus and a **vulnerable late-cycle backdrop** (<u>Fidelity,2020</u>). The below chart provides a remarkably interesting insight of where we are in the current economic cycle. Noteworthy, China, Italy and Germany have all dipped into the recession cycle whilst many other countries are **slowly entering into economic contraction**. GDP growth levels are expected at 2.4% from an already weak 2019 but fears remain that if COVID-19 pandemic is extended that **GDP growth could be as low as 1.5%.** We will now explore the late-cycle and Recession phase and it’s impact on the various economic sectors.

<u>The current economic cycle</u>



*Source: www.*Fidelity.com

Late-cycle phase

The average duration of the late cycle phase is roughly 1.5 years whilst the overall stock market performance has averaged 6% on an annualized basis. As the economic recovery matures, the energy and materials sectors, whose fate is closely tied to the prices of raw materials, previously have done well as inflationary pressures build and the late-cycle economic expansion helps maintain solid demand. Elsewhere, as investors begin to glimpse signs of an economic slowdown, defensive-oriented sectors those in which revenues are tied more to basic needs and are less economically sensitive, generally have performed well. These include health care, consumer staples, and utilities. Looking across all three analytical measures, the energy sector has seen the most convincing patterns of outperformance in the late cycle, with high average and median relative performance along with a high cycle hit rate. Information technology and **consumer discretionary stocks have lagged most often**, tending to suffer the most during this phase, as inflationary pressures **crimp profit margins** and investors move away from the most **economically sensitive** areas.(Fidelity,2020).

Recession phase

The recession phase has historically been the shortest, lasting slightly less than a year on average—and the broader market has performed poorly during this phase (–15% average annual return). As economic growth stalls and contracts, sectors that are more economically sensitive fall out of favor, and those that are defensively oriented move to the front of the performance line. These less economically sensitive sectors, including consumer staples, utilities, and health care, are dominated by industries that produce items such as toothpaste, electricity, and prescription drugs, which consumers are less likely to cut back on during a recession. These sectors' profits are likely to be more stable than those in other sectors in a contracting economy. The consumer staples sector has a **perfect track record of outperforming the broader market throughout the entire recession phase**, while utilities and health care are frequent outperformers. High **dividend yields** also have helped these sectors **hold up relatively well** during recessions. (Fidelity,2020)

Sector performance in the Business cycle

Sector	Early	Mid	Late	Recession
Consumer Discretionary	++	–	– –	

++ Consistently Overperform
+ Overperform
– – Consistently Underperform
– Underperform
No Clear Pattern

Sector	Early	Mid	Late	Recession
Consumer Staples			++	++

++ Consistently Overperform
+ Overperform
– – Consistently Underperform
– Underperform
No Clear Pattern

Source: (Fidelity,2020)

Consumer discretionary		
Favour	**Neutral**	**Unfavourable**
Luxury Goods	Hotels, Resorts & Cruise Lines	Distributors
Footwear	Auto Components	Automobile Manufacturers
Restaurants	Casinos & Gaming	Motorcycle Manufacturers
Internet Retail		Diversified Consumer Services
Home Improvement Retail		Leisure Products
Automotive Retail		Department Stores
		Home Furnishing Retail

Source: www.moranwm.com

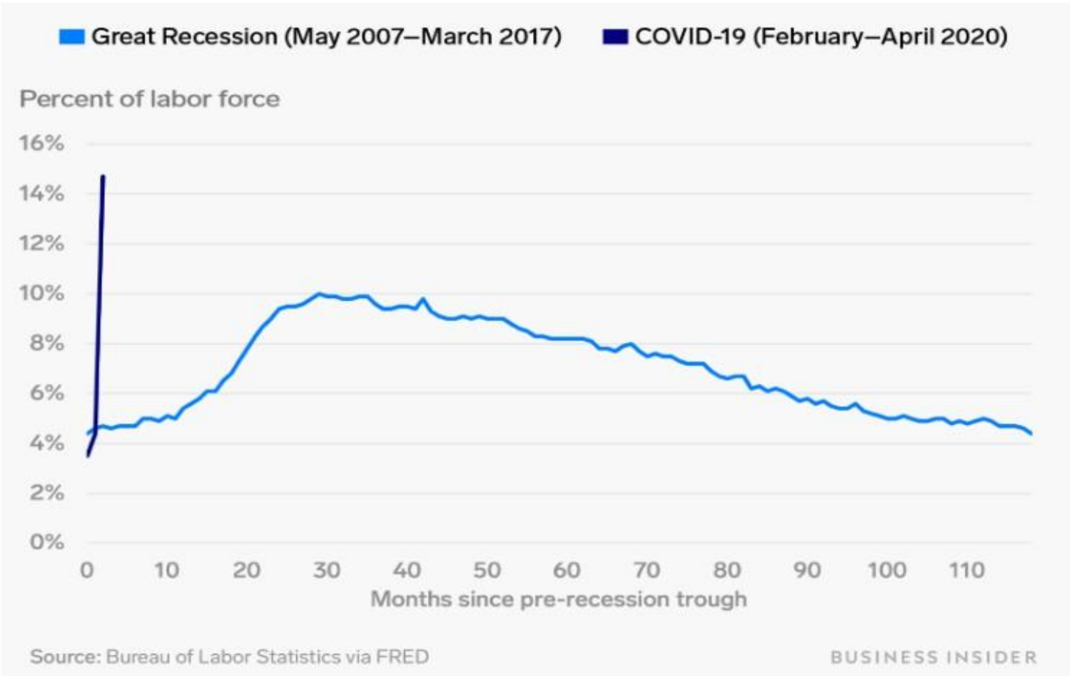
Macro Drivers

How Employment and Wages Affect Consumer Goods Demand

A core factor affecting the demand for consumer goods is the level of employment. As the number of people here are receiving a steady income and expecting to continue receiving one, the more people there are to purchase discretionary goods. Consequently, the **monthly unemployment rate report is one economic leading indicator** that gives clues to demand for consumer goods. Wage levels are also a key driver, if wages are steadily rising, consumers generally have more discretionary income to spend and vice versa. Median income is one of the best indicators of the condition of wages for American workers. (Investopedia,2020)

Global unemployment should start to fall in the coming months as economies start to reopen. We feel that much of the recovery in the economy especially the consumer disc sector will be driven from the consumers themselves. Shopping habits have changed during the lockdown, with **online shopping becoming the main winner**. Stores may reopen but sales and business will not go back to **normal until consumers are ready**. The uncertainty which lies ahead for so many consumers may see staples stocks winning out over disc. The real question remains, how long will It take demand to recover?

Unemployment Rate US



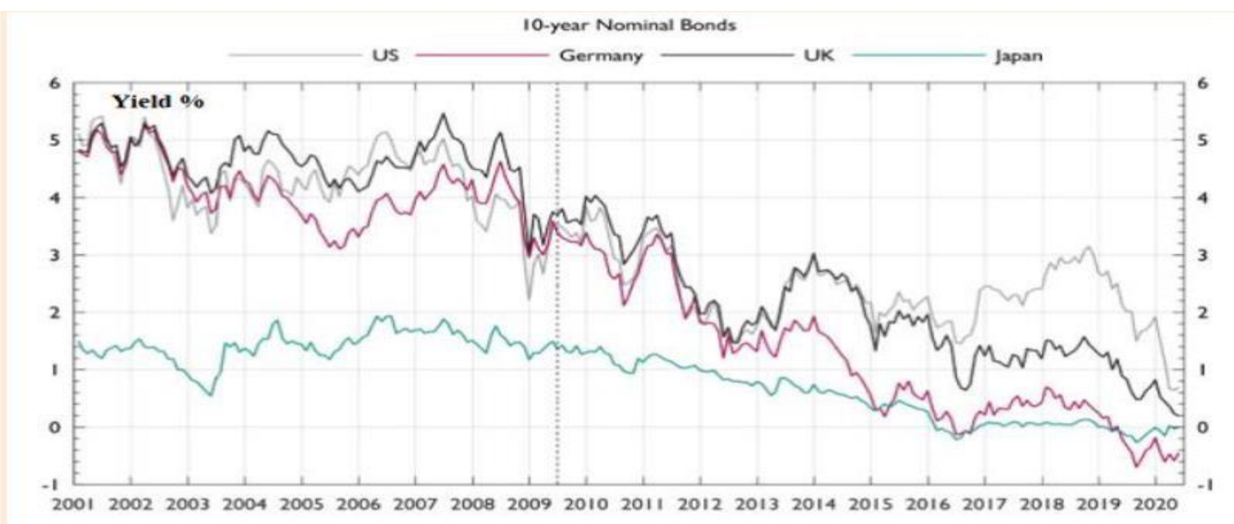
Prices and Interest Rates

Prices affected by the rate of inflation, naturally impact consumer spending on goods significantly. This is one reason the producer price index (PPI) and the consumer price index (CPI) are considered leading economic indicators. **Higher inflation rates erode purchasing power**, making it less likely that consumers have excess income to spend after covering basic expenses such as food and housing. Higher price tagson consumer goods also deters spending. (Investopedia,2020)

Interest rates can also impact the level of spending on consumer goods substantially. Many higher-end consumer goods, such as automobiles or jewelry, are often purchased by consumers on credit. **Higher interest rates** make such purchases substantially **more expensive** and therefore deter these expenditures. Higher interest rates generally mean tighter credit as well, making it more difficult for consumers to obtain the necessary financing for major purchases such as new cars. Consumers **often postpone purchasing** luxury items until more favorable credit terms are available. (Investopedia,2020)

CPI-U declined 0.8% in April on a seasonally adjusted basis, the largest monthly decline since December 2008. The downward pressure on inflation in the short term is largely driven by significant decline in energy prices and growth Currently, **Policy rates** in most of the major economies are either **at or just below zero**, the monetary policy as we know it has become redundant. (FT,2020)

Current Bond Yields



<u>Consumer Confidence</u>

The level of Consumer confidence in the economy plays a pivotal role in affecting demand for consumer goods. Regardless of their current financial situation, consumers are more likely to purchase greater amounts of consumer goods when they feel confident about both the overall condition of the economy and about their personal financial future. High levels of consumer confidence can especially affect consumers' inclination to make major purchases and to use credit to make purchases. **The demand for consumer goods increases when the economic production is growing**. The environment of steady growth is usually accompanied by corresponding growth in the demand for goods and services. (Investopedia,2020)

Consumer Confidence in the European Union increased to -19.50 points in May from -22 points in April of 2020. Consumer Confidence in European Union averaged -9.64 points from 1985 until 2020, reaching a record low of -23 points in March of 2009. (Tradingeconomics,2020)

U.S. **consumer confidence stabilized in May**, indicating Americans are quite hopeful that the economic drubbing from the novel coronavirus outbreak worldwide will be short-lived. According to the Conference Board, the consumer confidence index went up to 86.6 in May from a revised 85.7 in April. This came after **rapid declines in the index in March and April**. (YahooFinance,2020)

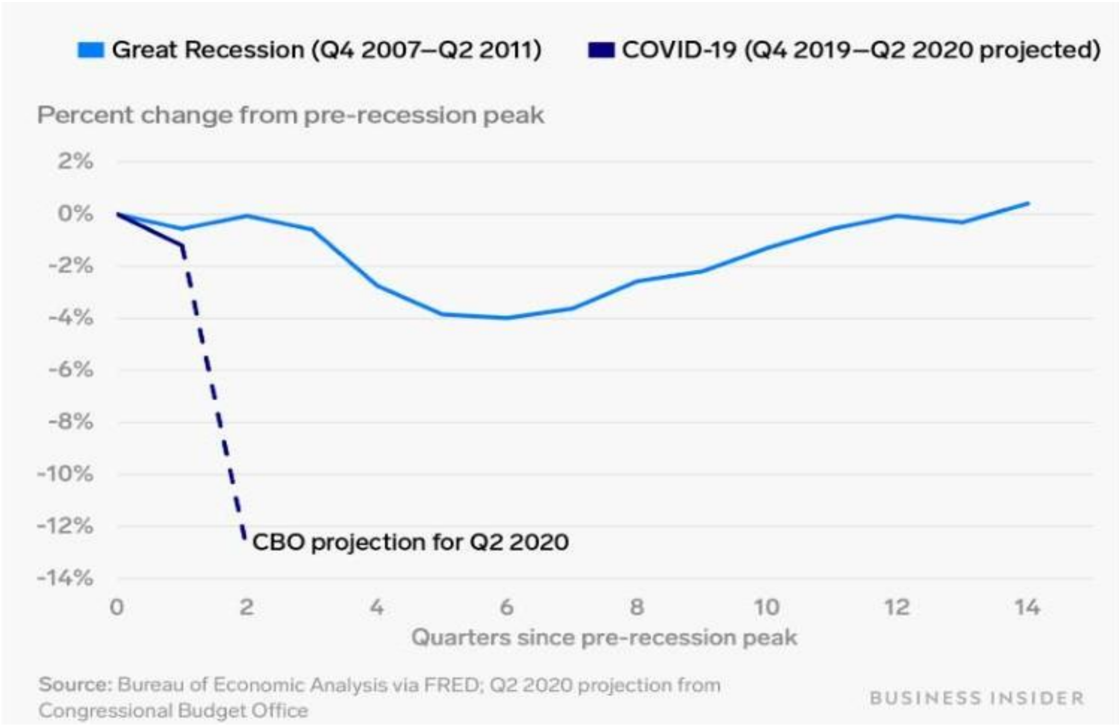
<u>CONSUMER CONFIDENCE INDICATOR FOR EU AND EURO AREA</u>

Economic Growth

When consumer spending is high, the total GDP reflects this consumer confidence through higher GDP figures establishing a direct connection between consumer spending and GDP. Consumer spending is derived by calculating how much individual households spend in the period under consideration. The economy was expected to grow at a similar rate in 2020 as in 2019, considering the impact of COVID-19 annual global GDP growth is now projected to drop to 2.4% in 2020, from an already weak 2.9% in 2019. A prolonged and more severe coronavirus outbreak would weaken prospects considerably. In this event, its estimated that global growth could drop to 1.5% in 2020. In the first quarter of 2020 real GDP fell 4.8% q/q, basically marking the start of a sharp recession as a result of a **halt in economic activity**. Global **PMI's are deteriorating**, across the BRICs, Services PMI fell from 44.9 in Q1 2020 to 30.6 in April.

When GDP is growing at a consistently high rate instead of maintaining a desirable balance, this may indicate that the economy is growing at an unsustainable rate, which will only lead to an **inevitable free fall**. Unmanaged and reckless consumer spending that leads to periods of excessive growth in the GDP overheats the economy to the point that it may eventually implode. (Wisegeek,2020)

US GDP

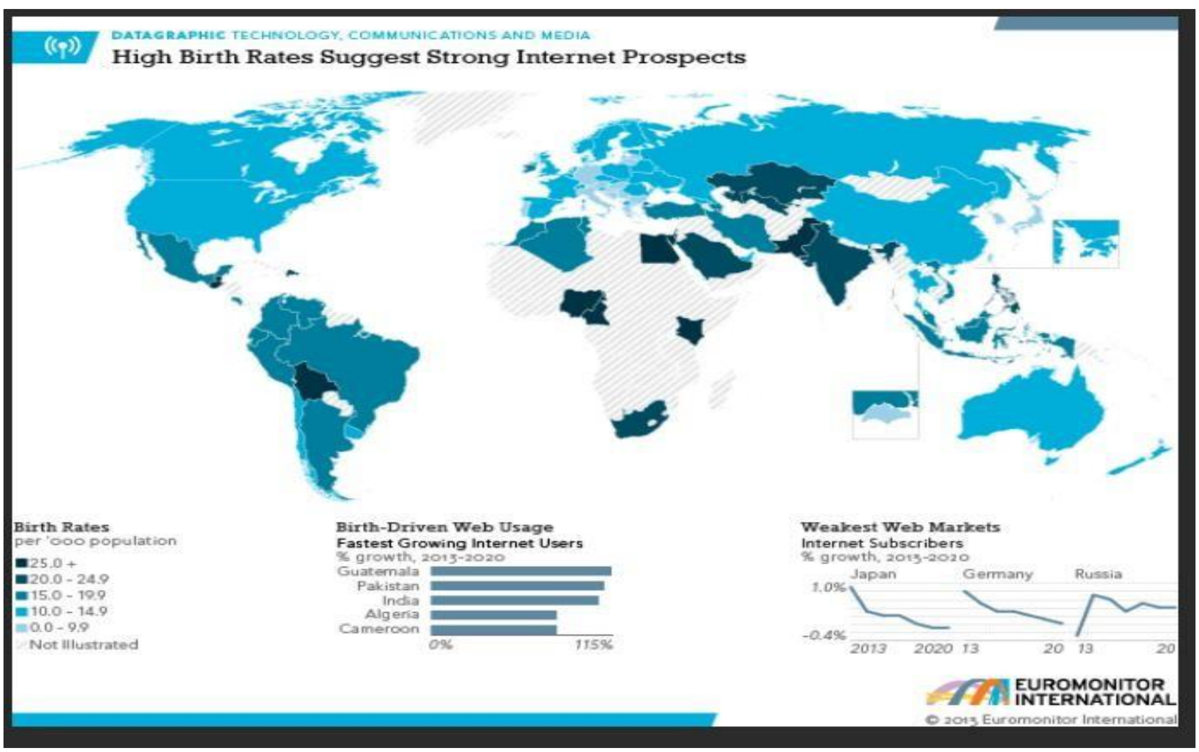


Trends shaping the industry over the next decade

Changing Demographics

The current trends of population growth in the EM makes this decade the tipping point in a fundamental long-term economic rebalancing. While the emerging countries in Asia—most notably China, India, and Indonesia—already had a significant share of global growth (18 percent) throughout the last decade, this growth share is expected to increase to nearly 30 percent in the next decade. As a result, the global middle class will expand dramatically: by **2021, there are expected to be more than 1 billion new consumers spending between $10 and $100 per day**. Nearly everyone agrees on the importance of this trend but understanding these new consumers and meeting their needs will be no simple matter for CPG players. Those who get it right stand to earn tremendous competitive advantage. (MCKINSEY,2020)

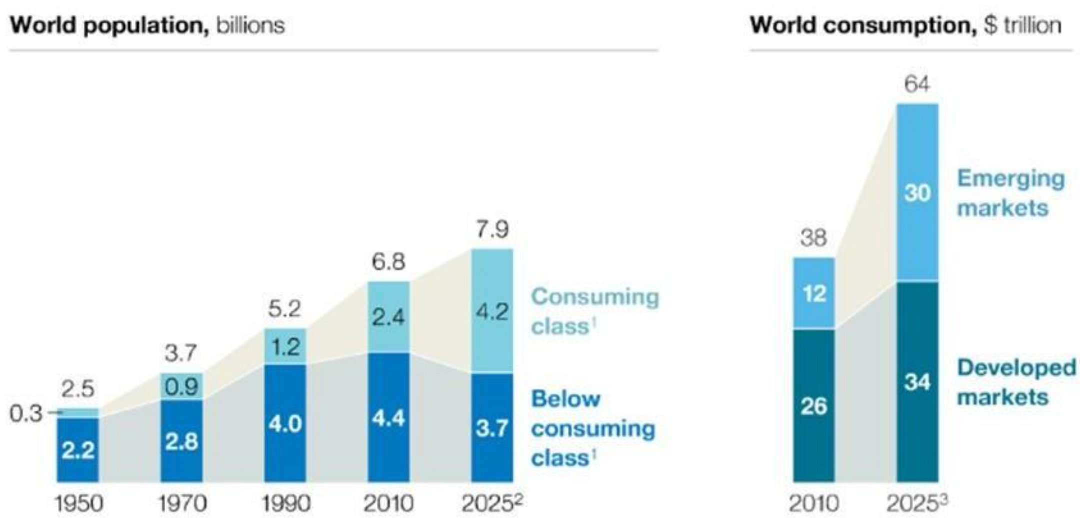
As emerging markets account for an increasing proportion of CPG sales, companies will struggle to maintain their margins. Building scale will be one way of doing so; skillful segmentation of emerging-market consumers will be another. Across emerging markets, thoughtful segmentation will reveal many opportunities to create value and build healthy margins by meeting specific consumer needs. (MCKINSEY,2020)



The world’s population is aging quickly. The United Nations projects that the total population of people older than 65 will double to 1 billion over the next 20 years.11 By 2030, one in four Western Europeans will be elderly, as will one in five North Americans. But the trend will be just as marked in the developing world: **China’s over-65 population will double to 16% of its total population**, while India’s will almost double, reaching 8.5%. (MCKINSEY,2020)

Despite the global aging trend, pockets of younger consumers are growing in key markets. In sub-Saharan Africa, where many observers expect rapid economic growth in the coming decade, the United Nations predicts the under-50 population will grow 23%, reaching about 700 million by 2021. (MCKINSEY,2020)

By 2025, the consuming class will swell to 4.2 billion people. Consumption in emerging markets will account for $30 trillion— nearly half of the global total.



[1]Consuming class: daily disposable income is ≥$10; below consuming class, <$10; incomes adjusted for purchasing-power parity.
[2]Projected.
[3]Estimate based on 2010 private-consumption share of GDP per country and GDP estimates for 2010 and 2025; assumes private consumption’s share of GDP will remain constant.

Source: Angus Maddison, founder of Groningen Growth and Development Centre, University of Groningen; Homi Kharas, senior fellow at Wolfensohn Center for Development at Brookings Institution; McKinsey Global Institute analysis

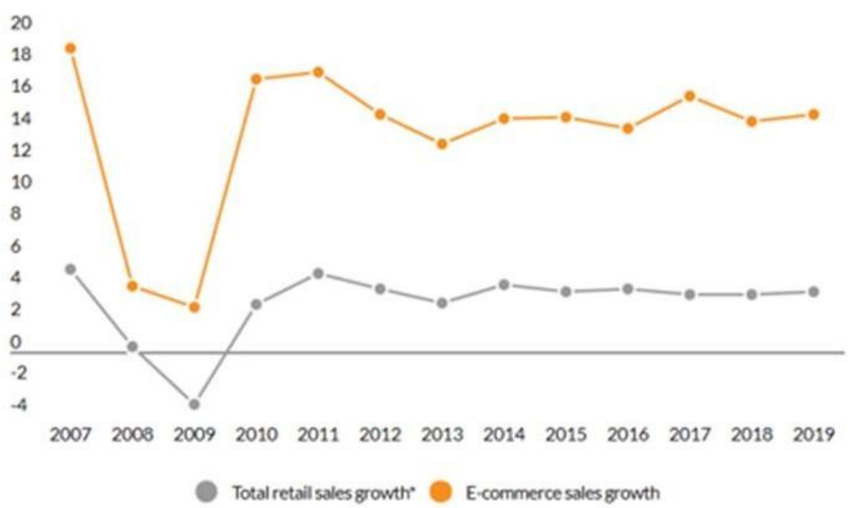
The rise of the digital consumer

Technology will play a key role in the way consumers make purchases. It is expected that global E-commerce sales will double between 2018 and 2023, **surpassing the $6 trillion mark**. Focusing on Europe, combined E-commerce sales in Western Europe (UK, Germany, France, Netherlands, Italy and Spain) were £152.20bn in 2015 and should reach £249bn by the end of 2020.(Statista)

Global **m-commerce is growing at 29%.** This is at a notably higher pace than commerce conducted though other types of devices. 53.9% of all US retail e-commerce will be m-commerce by 2021. (Statista) On Cyber Monday, 54% of visitors came from mobile devices, while around 30% made purchases on their mobile. (Adobe)Examining the long term growth prospects it is estimated that consumers will make **95% of purchases online by 2040** (Nasdaq). Online sales momentum remains strong, generating stable double-digit sales growth yoy.

The proportion of sales via online channels may be reaching a tipping point. However, manufacturers must weigh the trade-offs, and for many the economics of launching a branded e-commerce site will prove unfavorable. For those who decide against launching their own Web stores, online retail platforms such as Amazon.com and Alice.com offer direct access to consumers. Digital technology will have just as great an impact on brand communication. Consumers are more reliant than ever on referrals: **70% look to user reviews to inform their purchase decisions**. (MCKINSEY,2020)

Comparing growth: U.S. retail sales vs. e-commerce



The shift towards value

The current trend of shifting to value will have a huge impact on the sector, eroding the pricing power of the brands. In the value trend, the private labels may become a serious force in the coming decade. In supermarkets these private brands account for more than 40 percent of supermarket sales in the United Kingdom, more than 30% in Germany, and more than 15% in the United States. (MCKINSEY,2020). Other companies are riding the shift to value by running joint promotions with private-label brands in adjacent categories. The shift to value will make scale an even greater competitive advantage than before. The leading CPG companies have already harnessed their global scale to reduce costs, pushing work to low-cost centers and spreading fixed costs over a broader business. The stronger a company's overall market position and the more number-one category positions it holds, the better equipped it will be to win in a value-focused world.

Increasing supply chain volatility

Global supply chains have been adversely affected from COVID-19. Its expected that firms will look to diversify their supply chains to help mitigate risk of disruption in the future. Global decoupling could increase as companies may branch away from their dependence on China. The trend of automation in the labour market is also expected to get a boost. Looking forward firms need to be aware of disruptive trends on the supply side, increasingly volatile input costs, driven by the emergence of bigger, fewer suppliers and natural-resource shortages.

Source: supplychainbeyond.com

WRAP UP

Despite the current state of the economy from COVID-19, its evident that the consumer space remains an interesting sector which offers solid defensive stocks to shelter in during uncertainty. The sectors mega trends should also express optimism about the future growth rates. In terms of where we recommend being positioned, we advise in the consumer disc space to focused on online retailers and from the consumer staples we lean towards the larger more defensive names. We will soon publish our top pick lists from each sub section. In the retail space the two names which we recommend you to look into are **CEWE and Zalando**, more detail cans be found in our retail report " **I**s this the end of traditional brick and mortar stores".

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