Outfitting Your Portfolio for the Changing Consumer

CONSUMER SECTOR REPORT

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ANALYST(S)

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Companies Mentioned in This Report:

Consumer Discretionary
Amazon (AMZN - Buy; $3,441.85)
Booking Holdings (BKNG - Buy; $1,866.97)
Canadian Tire (CTCA.TO - Hold; $138.80)
Dollarama (DOL.TO - Buy; $52.62)
Gildan Activewear (GIL.TO - Buy; $26.55)
Lowe's (LOW - Buy; $170.39)
Magna International (MG.TO - Hold; $66.74)
McDonald's (MCD- Buy; $213.76)
O'Reilly (ORLY - Buy; $462.70)
Ross Stores (ROST - Buy; $89.86)
Starbucks (SBUX- Buy; $82.41)
TJX Companies (TJX - Buy; $53.26)

Consumer Staples
Estee Lauder (EL - Hold; $216.68)
Loblaw (L.TO - Buy; $69.68)
Mondelez (MDLZ - Buy; $58.36)
PepsiCo (PEP - Buy; $138.47)
Philip Morris International (PM - Buy; $79.98)
Procter & Gamble (PG - Buy; $138.39)

Source: Reuters. Prices and opinion ratings as of market close on 8/26/20 and subject to change.

Investment Overview

CURRENT CONSUMER ENVIRONMENT

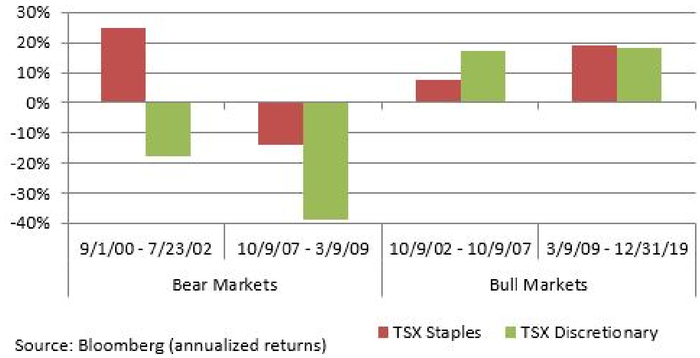
The coronavirus pandemic is negatively impacting the consumer spending environment most directly due to job losses and furloughs, local government stay-at-home and social-distancing orders, and closures or limited hours and services for retailers and restaurants. While we expect e-commerce sales to be robust with more people at home and out shopping less, we don't believe it will be enough to offset the traffic declines at physical retail locations. We expect restaurants will feel the most negative affect due to closures, and nonessential retailers will feel the impact of less traffic and fewer impulse trips as consumers stay at home. We believe investors should focus on companies with strong financial positions, those gaining market share prior to the downturn, and companies rapidly investing in technology to be leading the way in the changing consumer landscape. We would avoid companies with high debt levels, those struggling prior to the consumer slowdown, and companies that have limited ability to invest in and utilize technology.

Playing Offence and Defence

Spending on consumer products and services represents a substantial portion of both the Canadian and U.S. economies. Specifically, consumer spending is about 55% of the Canadian economy and 68% of the U.S. economy. Consumer companies benefit directly from this spending. We recommend consumer companies represent 14% of a well-diversified equity portfolio, with 6% in consumer staples companies (defence) and 8% in consumer discretionary companies (offence). Consumer staples companies make or sell products we need every day, such as household products, packaged foods and beverages. On the other hand, consumer discretionary companies sell products and services we "want" and tend to purchase infrequently after our basic needs are met. In a portfolio, consumer staples companies often provide defence during times of economic slowdowns and falling markets, while consumer discretionary companies often provide offence during times of economic growth and rising markets.

In **Figure 1** on the next page, we compare the performance of the Canadian Consumer Discretionary Index and the Canadian Consumer Staples Index over the past two bear and bull markets. As the chart indicates, Consumer Staples typically outperforms during bear markets and Consumer Discretionary typically outperforms during bull markets.

Figure 1. Canadian Performance in Bear vs. Bull Markets

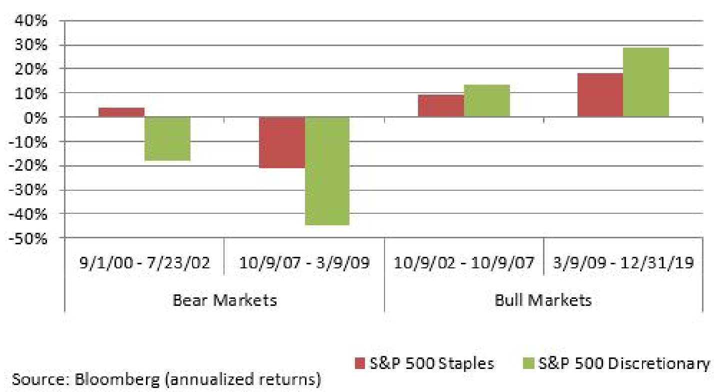


Source: Bloomberg (annualized returns)

Past performance is no guarantee of future results.

As seen in **Figure 2**, this also holds true in the U.S. where the consumer indexes and the broader market are much larger. Since it is difficult to forecast these time periods, we recommend investors own both consumer staples and consumer discretionary stocks. We believe holding a well-diversified portfolio of offensive and defensive names over a full market cycle will improve a portfolio's risk-adjusted returns. Given the limited options for Canadian consumer companies, we recommend diversifying consumer holdings with some U.S. consumer companies. We recommend investors hold up to 50% of their entire equity portfolios in stocks outside of Canada.

Figure 2. U.S. Performance in Bear vs. Bull Markets



Source: Bloomberg (annualized returns)

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What Drives Consumer Stocks?

Consumer companies are dependent on the financial health of the consumer. Wage growth and job growth are key drivers of consumer spending. Consumer debt-levels and interest rates also impact the amount of money consumers have in their pockets. Consumer spending is typically strongest when the economy is growing, unemployment is low, and wages are rising. During this time, consumers often spend more on their "wants". When the economy slows, unemployment rises and debt becomes a larger portion of income, consumers often delay purchasing "wants" and focus on only spending on their "needs". Beyond the financial health of the consumer, we believe there are a number of trends that will drive earnings growth at consumer companies over the long term, including emerging markets, the growing presence of online shopping, and a shift in consumer preference for health and wellness. In addition, consumer stocks often provide rising-income potential.

Emerging and Splurging

While the Canadian and U.S. markets will likely be relatively slow-growing over the next several years, we expect faster growth in the emerging markets of China, India and South America. Many of the consumers in these markets are just beginning to see their incomes rise high enough to allow for spending beyond basic needs. In addition, many of these consumers are moving from rural areas to more developed urban markets, where global consumer brands are expanding. Even though economic growth has been slowing in these regions, we believe a rising middle class will drive consumer spending and fuel economic growth that is faster than the growth seen in Canada and the U.S.

Most Canadian consumer companies tend to be domestically focused. Thus, we recommend looking to global consumer brands in our U.S. coverage list to gain exposure to the faster-growing emerging markets. In **Figure 3**, we highlight some Buy-rated U.S. stocks with emerging-market exposure.

Figure 3: Buy-Rated U.S. Stocks with Emerging Market Exposure

Company	% Sales Outside U.S. & Canada	Emerging Market Presence
Consumer Discretionary		
Amazon (AMZN)	30%	Asia/Pacific countries are the main contributors to Amazon's emerging market presence.
Starbucks (SBUX)	28%	China contributes a small piece of the overall company today, but it is the fastest-growing region for Starbucks.
Consumer Staples		
Mondelez (MDLZ)	73%	Over 40% of sales are from emerging markets in Asia, Latin America and the Middle East
PepsiCo (PEP)	38%	Frito-Lay has a sizeable presence in emerging markets
Philip Morris International (PM)	100%	Emerging markets are over 50% of international cigarette sales creating large growth opportunity

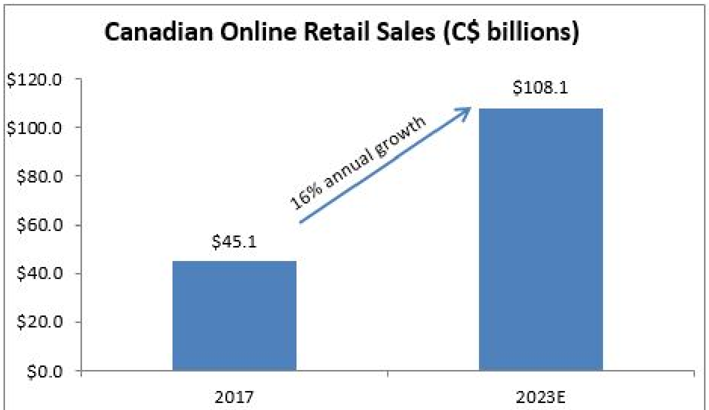
Source: Edward Jones Estimates and Company Reports

The Evolving Retailer

The Internet has been a major disruptive threat to retailers. Online-only retailers, like Amazon, don't have bricks-and-mortar locations, allowing them to offer cheaper prices. Meanwhile, consumers increasingly want to buy products from traditional bricks-and-mortar retailers over the Internet. We believe traditional bricks-and-mortar retailers can stay competitive by developing an omnichannel presence and offering products with limited online purchase demand. Omnichannel retailers have websites consumers can access from cell phones, tablets and desktops. Omnichannel retailers can ship directly to consumers from their stores or distribution centers and to their stores for in-store pickups.

While Canada has been slower to adopt omnichannel retailing than the U.S. (**Figure 4**), online sales in Canada are expected to get closer to U.S. levels, growing an estimated 16% per year over the next few years. As online sales grow, we believe omnichannel retailing will become increasingly important for retailers in both countries to stay competitive.

Figure 4.



Source: eMarketer Research

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In addition, some products are less desirable to buy online. Food, hardware, health and beauty, and auto parts have the lowest levels of online purchases, which we see as a competitive advantage over retailers that sell products such as books, movies, apparel, and toys, which have higher levels of online purchases. We believe investors should own a mix of retailers that invest in an online strategy, have a product offering that provides a competitive advantage, or offer a customer experience that can't be replicated online. **Figure 5** highlights some Buy-rated retailers that we believe are well-positioned to succeed over the long term.

Figure 5: Buy-Rated Retail Investment Ideas	
Technologically Advanced Retailers	
Amazon (AMZN)	• Dominant online presence • Subscription Revenue Model (Prime)
Lowe's (LOW)	• Strong brick-and-mortar locations and an omnichannel presence
Unique Retailers	
Dollarama (DOL.TO)	• Exclusive products
TJX Corporation (TJX)	• Treasure hunt shopping experience that can't be replicated online
Ross Stores (ROST)	• Treasure hunt shopping experience that can't be replicated online
Competitively Advantaged Retailers	
Lowe's (LOW)	• Operate in product categories with low levels of online purchases
O'Reilly Auto (ORLY)	• Physical locations have high level of customer service making the in-store experience more valuable

Source: Edward Jones Estimates and Company Reports

The Conscious Consumer

In an effort to improve their quality of life, consumers are spending more on health-related products. Consumers are increasingly concerned with what they put in their bodies and are paying more attention to product ingredients. This increased awareness has given way to an increase in natural and organic product sales. While most of the natural and organic market is food, consumer products that are made without chemicals are also gaining popularity. Retailers are increasing shelf space for products catering to health-conscious consumers, and many food and consumer-products companies are launching new product lines featuring natural and fewer ingredients. Growth in this market helps offset slowing growth rates in more traditional product lines. We expect consumers to remain mindful in their purchasing decisions over the long term. **Figure 6** lists some Buy-rated stocks that are increasingly catering to a health-conscious consumer.

Figure 6: Buy-Rated Health and Wellness Investment Ideas	
Loblaw (L.TO)	Increased emphasis on produce, meats, cheeses and other fresh, healthy products in-store. President's Choice brand is introducing natural and organic line of products.
Procter & Gamble (PG)	Many brands are innovating to offer chemical-free, natural versions of popular household products.

Source: Edward Jones Estimates and Company Reports

Consumer Companies Provide Rising-Income Potential

Over the long term, as companies mature, they often begin to return more cash to shareholders in the form of dividends and share buybacks. This translates into rising income for shareholders who buy and hold these investments. While our Canadian consumer coverage has companies at various parts of their lifecycles, many are participating in the rising-income trend. Below we highlight our outlook for rising dividends within our Canadian consumer coverage.

Figure 7: Stocks with Rising Dividend Potential

Company	Rating	Sector	Dividend Yield	5 Yr. Estimated Dividend Growth Rate
Dollarama	Buy	Discretionary	0.4%	10%
Loblaw	Buy	Staples	1.8%	6%
Canadian Tire	Hold	Discretionary	3.7%	10%

Source: Edward Jones and Company Reports
Date as of 8/20/20

Past performance is no guarantee of future results. Dividends can be increased, decreased or eliminated any time without notice.

Investing in Consumer Companies

While companies within each of the consumer sectors (staples and discretionary) share similar key drivers, each subsector has unique characteristics. We believe a well-diversified portfolio not only has stocks in both the consumer staples and consumer discretionary sectors, but also includes stocks across multiple subsectors. **Figure 8** and **Figure 9** show our consumer staples and consumer discretionary building blocks, which break out, by subsector, our Buy-rated Canadian stocks, Canadian Equity Buy List stocks, as well as select stocks on the U.S. Stock Focus List and Equity Income Buy List. The coloured levels of the building blocks represent the up and down Price Movement tendencies of each stock relative to the overall market. Stocks with Above Average price movements are at the top, Average in the middle and Below Average at the base. Our advice is to choose stocks where appropriate based on investment category, subsector and price movement diversification needs.

Figure 8:

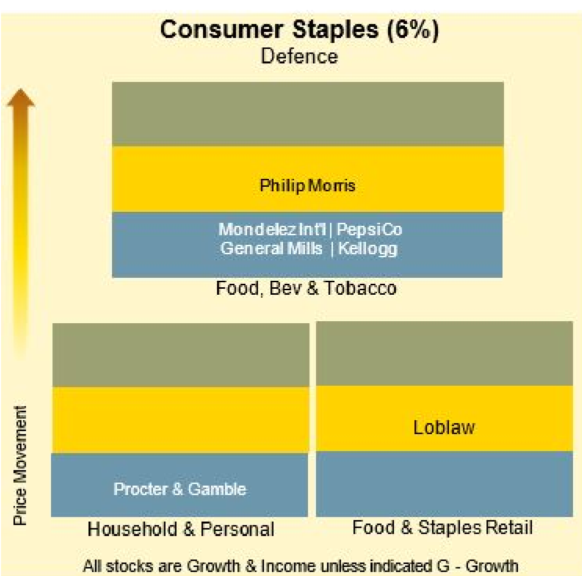
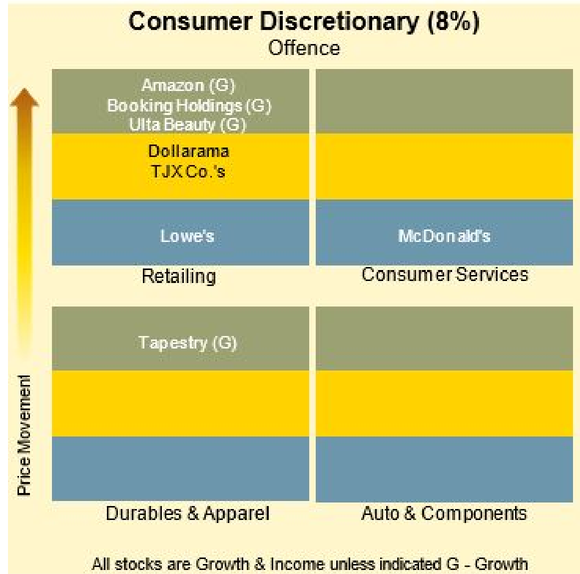


Figure 9:



How We Value and Recommend Stocks

When valuing consumer companies, we use various methods including, but not limited to, comparing price-to-earnings ratios and PEGY ratios (price-to-earnings ratio divided by growth plus dividend yield) with historical and peer averages. We also use discounted cash flow models to incorporate long-term growth expectations.

Investment Risks

Some risks involved with investing in consumer companies include deteriorating economic conditions, a slowdown in consumer spending, rising interest rates, higher commodity prices, and currency fluctuations.

Actions for Investors

We recommend investors play defence by holding 6% of their stock portfolio in consumer staples companies and play offence by holding 8% of their stock portfolio in consumer discretionary companies. Beyond proper portfolio diversification, we believe investors can benefit from owning consumer stocks due to their rising-income and earnings-growth potential. Talk to your Edward Jones financial advisor about opportunities to add consumer stocks to your portfolio.

Please see the full opinions of the individual companies mentioned in this report for additional information, including valuation and risks.

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Brian P Yarbrough, CFA and John Boylan, CFA

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