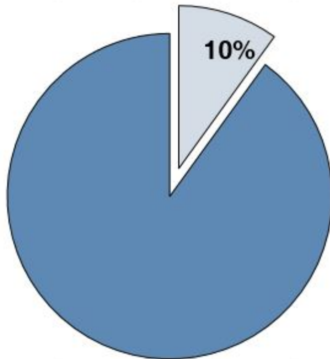
Investing in the Consumer Discretionary Sector

CONSUMER DISCRETIONARY SECTOR REPORT

Rec. Equity Weight for Cons. Discretionary: 10%



Buy-rated companies mentioned in this report:

Retailing:
Amazon (AMZN - $3,279.39)
Booking Holdings (BKNG - $2,410.64)
Lowe's (LOW - $193.67)
O'Reilly Automotive (ORLY - $512.64)
Ross Stores (ROST - $193.67)
TJX Companies (TJX - $67.78)
Ulta Beauty (ULTA - $316.11)

Consumer Services:
McDonald's (MCD - $232.61)
Starbucks (SBUX - $113.19)

Consumer Durables & Apparel:
Gildan Activewear (GIL - $33.06)
Kontoor Brands (KTB - $53.11)
Nike (NKE - $136.54)
Tapestry (TPR - $43.09)
VF Corporation (VFC - $83.98)

Other companies mentioned in this report:

Auto & Components:
Ford (F- $12.73) - HOLD
General Motors (GM - $60.83) - HOLD
Tesla (TSLA - $670.97) - HOLD

Source: Reuters. Prices and opinion ratings as of market close 4/7/21 and subject to change.

For more information:

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Analyst: Jeff Windau, CFA

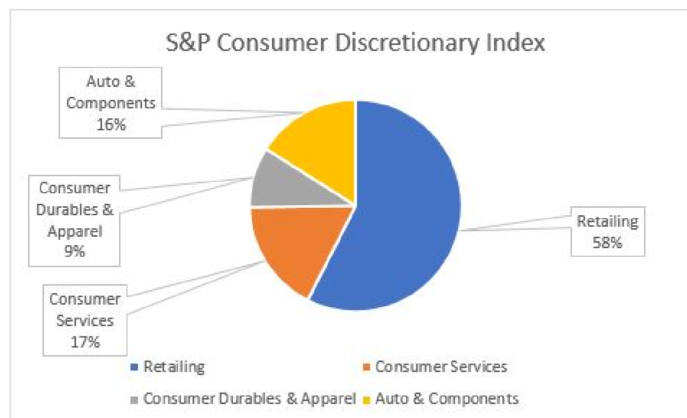
SECTOR INVESTMENT SUMMARY

The coronavirus pandemic has negatively impacted the consumer-spending environment, most directly due to job losses and furloughs, social-distancing orders, and limited hours and services for some 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 most physical retail locations. While the environment has improved from the declines experienced during the lockdown, we believe that consumers remain hesitant to fully return to normal shopping habits until more people are vaccinated. We believe investors should focus on companies that have strong financial positions, were gaining market share prior to the downturn, and that are rapidly investing in technology to be leading the way in the changing consumer landscape. We would avoid companies that have high debt levels, were struggling prior to the consumer slowdown, and that have limited ability to invest in and utilize technology.

RECOMMENDED SECTOR ALLOCATION

We recommend a 10% equity sector allocation in consumer discretionary, and we believe portfolio diversification can be improved by making sure the 10% weighting is further broken down into each of the four subsectors within consumer discretionary: retailing, consumer services, consumer durables and autos & components. Retailing is the largest subsector (**Figure 1**), and we would recommend first establishing a base of holdings within this larger subsector of retailing.

Figure 1.



The S&P 500 Index is based on the average performance of 500 widely held common stocks. The S&P Consumer Discretionary Index consists of 63 consumer discretionary companies within the S&P 500 Index. These are unmanaged indexes and cannot be invested in directly.

HOW TO INVEST IN THE CONSUMER DISCRETIONARY SECTOR

RETAILING

Since retailing accounts for 58% of the consumer discretionary index, we will focus more of the report on this sector. We see three bigger themes continuing to play out for the foreseeable future:

1. Sales Shifting Online

Online sales currently account for roughly 10% of retail sales, but if you exclude gasoline, which cannot be purchased online, and building materials, which aren't purchased online, then online sales are close to 20% of total retail sales. Online has been growing 15%-plus per year over the past decade, but we believe the growth rate will slow over coming years. Online is still taking market share compared with sales in physical retail locations, so we do expect this to continue to be a headwind for brick & mortar stores.

2. Bankruptcies and Store Closings

The retail industry in the U.S. has too many retail stores, and despite the high number of bankruptcies over the past few years, we expect this trend will continue for the foreseeable future for several reasons. First, for many years the retail industry within the U.S. has had too many stores, and the recent shift to more consumers buying products online is lessening the need for so much retailer square footage. Despite the high number of retail bankruptcies over the past few years, the U.S. still has about 40% more retail square footage per person than the next nearest country, and close to 1,200 enclosed malls when most experts agree we only need 500-600. Second, there are still many retailers that are private and have high debt levels, and thus can't afford to make the necessary technology investments to be a strong retailer in today's world. Many banks or private equity players used to be willing to step in and provide financing for struggling retailers, but over the past few years many are unwilling to provide financing due to all the headwinds facing the industry. Third, we expect online sales to continue to outpace sales within physical store locations, which will put pressure on retailers to close additional stores.

3. Increased Investments to Be an Omnichannel Retailer

Many retailers have been shifting their investments from opening new stores to investing in technology to become strong omnichannel retailers. Strong omnichannel retailers offer buy-online-pick-up-in-store, ship-from-store, curb-side pickup, and payment via mobile apps, a seamless transaction whether shopping in store, at your desktop, or from a mobile phone. Customers are changing shopping habits at an increasing rate, and the retailers that aren't investing in technology to be an omnichannel retailer are falling further behind and losing market share. We believe the companies we follow have strong balance sheets, which will afford them the ability to continue investing in technology and take market share.

We recommend the following companies within retailing: **Amazon (AMZN), Booking Holdings (BKNG), Lowe's (LOW), TJX Companies (TJX)** and **Ulta Beauty (ULTA)** are all on the Edward Jones Stock Focus List. **O'Reilly Automotive (ORLY), Ross Stores (ROST)** and **Gildan Activewear (GIL)** are also both Buy-rated names within Consumer Discretionary.

CONSUMER DURABLES & APPAREL

This subsector focuses on items ranging from apparel to homebuilding products as well as appliances. We only follow a few of the apparel and footwear companies within this space. We see several trends emerging within this industry:

1. Companies shifting investments to online

Many brands are shifting investment dollars away from opening stores and distribution centers and more towards branded websites. Since the companies receive the entire retail price and avoid the high cost of operating stores, sales on their own websites carry higher profits. As more consumers shift towards online shopping, we believe companies will continue to benefit from selling on their company-owned websites.

2. Brands lessening exposure to retailers

For many years, most branded consumer companies expanded into too many retail doors, as retail expansion within the U.S. grew rapidly from the late 1990s to 2007. Today, many brands are reducing exposure to retailers in general and pushing more products through select retailers, including online retailers and their own websites. Due to our expectations for the continued closure of retail doors and more sales moving online, we expect companies will continue to pursue this avenue of growth.

We currently recommend **Kontoor Brands (KTB**), **Nike (NKE), Tapestry (TPR)** and **VF Corporation (VFC)** within the consumer durables & apparel subsector. Among these names, **Tapestry (TPR)** is on the Edward Jones Stock Focus List.

CONSUMER SERVICES

This subsector primarily consists of service companies focused on the consumer, such as restaurants, hotels, cruise lines and casinos. We basically only follow restaurants within this subsector, and we see similar themes as retailing. We expect the companies that are rapidly focusing on technology to increase consumer convenience will be the market-share gainers in this competitive industry. We also look favorably on companies that are constantly innovating with exciting new products to drive consumer interests.
We recommend **McDonald's (MCD)** and **Starbucks (SBUX).**

AUTO & COMPONENTS

Until recently, this subsector represented only 3% of the overall consumer discretionary index. However, on December 18, 2020, Tesla (with a massive market capitalization of more than $600 billion) replaced Harley Davidson and boosted the subsector weighting to more than 16% of total sector market capitalization. The companies currently in this subsector are Ford, General Motors, Aptiv PLC, Borg Warner and Tesla. These companies tend to be some of the more cyclical companies within consumer discretionary, which means they should outperform coming out of economic downturns and will likely underperform when the economy is firing on all cylinders, as investors get nervous about the next economic slowdown.

CHALLENGES AND RISKS

1. Potential for Increased Tariffs
While China and the U.S. government came to an agreement on Phase 1 of a new trade deal, the tariffs are still in effect. We don't expect the current tariffs to be removed until the countries come closer to signing Phase 2. We believe there is the possibility for additional tariffs if negotiations break down on Phase 2, which could put pressure on companies to raise prices. We believe the current pricing-power limitations could negatively impact profitability for companies less able to pass through price increases to offset the potential tariffs.
2. Possible Slowdown in Consumer Spending

Due to tax cuts during 2017 and lower unemployment, we experienced strong consumer spending during 2018 and 2019, but we do believe the growth rates could slow. While the near-term effects of COVID-19 on consumer spending clearly overshadowed these factors in 2020, we continue to believe that the potential for a slowdown in spending could increase in 2021 as the impact of tax cuts subsides and because of higher unemployment. Also, due to minimum-wage increases, low-income consumers have seen outsized wage increases over the past few years, which we think will slow.

3. Job Market Peaking

The job market has been particularly strong over the past few years, and unemployment levels recently reached 50-year lows. We believe any type of economic slowdown could lead to layoffs, which would hurt consumer confidence and eventually slow consumer spending. While the unemployment levels can always go lower, we do have concerns about the potential for slower growth to lead to fewer jobs and hurt consumer spending.

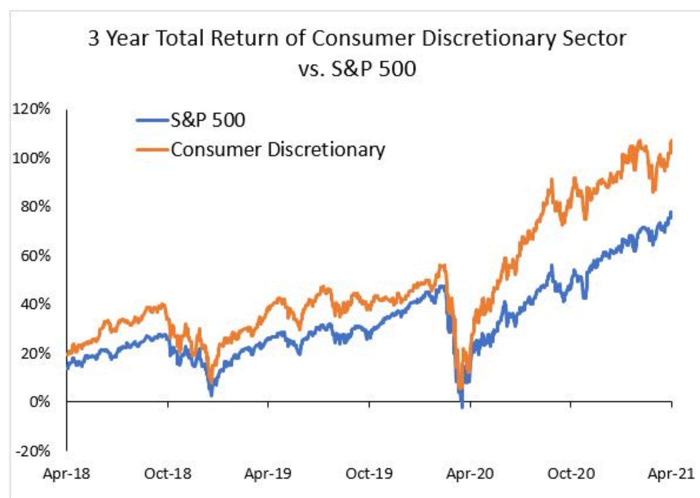
VALUATION

Methods we use to evaluate the attractiveness of consumer discretionary stocks include traditional ratios such as price to earnings (P/E), PEGY ratios (P/E vs. estimated growth and dividend yield), and discounted cash flow (DCF) analysis, as well as other tools. **Please see your financial advisor and read the individual company research reports, which contain additional information on valuation and risks, to see which stocks are appropriate for you and are good values at their current price.**

RECENT SECTOR PERFORMANCE

The S&P Consumer Discretionary Index has outperformed the market over the past three years as a result of strong consumer confidence, consumer spending, tax cuts, wage growth and low unemployment levels.

Figure 2



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Please see the individual research reports for additional information, including disclosures, analyst certifications, valuation and risks specific to each company.

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Brian P Yarbrough, CFA; Jeff Windau, CFA

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