Our Outlook for Consumer Stocks

Can there be green shoots without consumer spending?

By Joel Bloomer, Associate Director of Equity Analysis

Discussions of green shoots and improving second derivatives appear to have stirred consumers from hibernation but haven't quite pulled them out of the cave. Partially driving recent optimism is massive stimulus spending, which has dramatically reduced the extreme downside economic scenario that seemed imminent a few months ago. Now the question is: Where do we go from here?

While the economy is stabilizing, there are still reasons to doubt the green shoots' (economy's) growing power, making a V-shaped recovery only an outlier possibility, in our view. A prevalent headwind that we see for our—primarily consumer-driven—economy is personal income. Here are a couple worrisome stats: A more comprehensive measure of the unemployment rate that includes discouraged and underemployed workers has reached 16.4%, which is substantially higher than, and a record spread to, the 9.4% headline unemployment rate; and the duration of unemployment is nearly 23 weeks, a level never seen in the data series, which started in 1948.

A common rebuttal to these concerns is that employment has traditionally been a lagging economic indicator. While this is historically true on average, we believe that the current situation is likely to disrupt "normal" recessionary patterns, as consumer-credit lines are shrinking, consumer balance sheets are already debt-laden, savings rates are on the rise, and unprecedented wealth destruction has taken place. It's true that inventory destocking and general business investment often lead the economy into and out of recessions with employment in tow. However, at present it's hard to imagine businesses resuming widespread investment with the consumer spending outlook so bleak (flat to lower incomes + deleveraging = weak consumer spending).

Granted, consumer confidence trends may indicate a more optimistic scenario, but with drugs and alcohol being the only two sales categories posting year-over-year growth (tongue-in-cheek), we're skeptical that this confidence will translate into material increases in spending. Seriously though, in the long run, incomes are much more important than confidence: Both components are nice to have but the former is necessary as it represents ability to spend while the latter is simply willingness.

Our bottom-up view of consumer spending supports our top-down outlook. When we separate the strong retailers from the weak, it's clear that trading down is still in effect. Discount retailers (such as Wal-Mart WMT), dollar stores (such as Dollar Tree DLTR), and warehouse clubs (such as Costco COST, BJ's Wholesale Club BJ, and Sam's Club), dominate the consumer spending landscape, as they are known for drawing cost-conscious shoppers—which includes most of us these days. The same is true in apparel, where competitively priced retailers (such as Aeropostale ARO and Ross Stores ROST) are still growing while premium-priced players

(such as Abercrombie & Fitch ANF and Saks SKS) struggle through negative 20%-plus same-store sales. In sum, non-discretionary spending is still absorbing the majority of consumer retail budgets, which we expect to persist for the next few years.

In retail, efforts to reduce overhead expenses are the number-one priority at many companies. According to the Bureau of Labor Statistics, retail employment is down about 4% across the board in recent months, led by a 10% decline at furniture and home furnishing stores, followed by 5% at clothing and clothing accessories stores. While these trends help reduce costs, year-over-year negative operating leverage remains an issue as top lines at some firms are shrinking at a greater rate. Another cost garnering more attention than usual is rent expense. Retail property is grossly oversupplied, so retailers, most notably Starbucks SBUX, are seeking rent concessions. We expect this trend to continue for the next few years, as bargaining power gradually shifts from property owner to retailer.

Interestingly, inventory reductions appear to have run their course: Year-to-date inventories are about flat after widespread discounting and reduced purchasing over the last year. This should help alleviate much of the gross margin pressure in the industry. However, given our outlook for weak consumer spending, we don't expect mass restocking anytime soon, which is likely to weigh on potential growth at apparel manufacturers (such as Gildan Activewear GIL, Guess GES, and Warnaco Group WRC) and the economy as a whole. In addition, many firms in the retail space are rationalizing supply chains, which may further slow restocking trends.

In consumer products, the trade-down effect is also evident as lower-priced private-label goods (sometimes called non-branded, store-branded, or generic) gain market share from branded products. The shift has been magnified as firms have tried to capitalize on their brand equity by raising prices, hoping to offset input cost increases and volume declines. However, price increases in some categories may have gone too far, as Procter & Gamble PG, a behemoth in the consumer products space, is now rolling back some of its recent price increases in order to stem falling unit sales, as consumers have proven more elastic than expected. Even smokers are acknowledging the pinch as many are trading down from their trusted brands to lower-priced packs.

Valuations by Industry

Like most sectors, consumer companies rallied sharply over the last few months. While we still think the consumer space is undervalued, it's not nearly as cheap today as it was a few months ago. However, the range of valuations has widened as investors sort through the wreckage.

At the moment, we believe that two of the more stable industries are the most undervalued according to our star ratings: household & personal products & processed and packaged goods. HPP consists of well-known consumer products firms such as Proctor & Gamble, Colgate-Palmolive CL, Clorox CLX, and others that generally benefit from relatively consistent demand for their brand portfolios. We're especially keen on companies that have the number-one and -two brands in their categories, as tertiary and lower brands appear most susceptible to trading down by consumers. In addition, top brands tend to be positioned well by retailers to drive store traffic.

The PPG industry exhibits very similar characteristics in addition to benefiting from the increasing preference for off-premises (at home) meal consumption—a cheaper alternative to on-premises. A few of our favorite companies in this space are Kraft Foods KFT, Campbell Soup CPB, General Mills GIS, and Kellogg K. The bottom line is that both of these industries are well-positioned for a few years of weak consumer spending because of their economic moats and staple products.

Consumer Industry Valuations

Segment	Average Star Rating	Price/Fair Value*	P/FV Three Months Prior	Change (%)	Uncertainty** (%)
Alcoholic Beverages	3.84	0.75	0.66	14	23
Apparel Manufacturing	3.16	0.84	0.59	42	62
Furniture Manufacturing	3.03	0.95	0.52	83	75
Household & Personal Products	4.47	0.75	0.63	19	2
Non-Alcoholic Beverages	3.79	0.91	0.72	26	5
Processed & Packaged Goods	4.08	0.83	0.66	41	9
Restaurants	3.05	0.78	0.72	8	64
Retail - Apparel	3.01	1	0.64	56	74
Retail - Auto Parts	2.65	1.12	1.05	4	17
Retail - Department Stores	3.13	0.83	0.59	41	78
Retail - Discount Stores	3.75	0.83	0.75	11	7
Retail - Groceries & Pharmacy	3.96	0.78	0.64	22	22
Retail - Online	2.41	0.9	0.51	76	18
Retail - Specialty	3.96	0.78	0.56	39	53
Tobacco Products	3.85	0.79	0.63	25	31
Travel & Leisure - Products	2.76	1.23	0.79	56	26
Travel & Leisure - Services	2.95	1.21	0.81	49	91

Data as of 06-12-09.
*Market-Weighted Harmonic Mean
**Ranks the industry's fair value uncertainty (most uncertain =100) based on the aggregate market-weighted uncertainty ratings of all industries under coverage.

Our Top Consumer Picks

The five stocks in the accompanying table are cheap enough to purchase, in our opinion. Each of them is trading below our consider buying price (and therefore rated 5 stars), has a wide economic moat, and either medium or low uncertainty. As stated earlier, we believe the downside risk to the U.S. economy has been reduced over the last few months, but it still seems prudent for most investors to stick with solid companies trading at reasonable discounts instead of the riskier, less-certain investments that may still be available.

Top Consumer Sector Picks

Company	Star Rating	Fair Value Estimate (USD)	Economic Moat™	Fair Value Uncertainty	Price/ Fair Value
Lowe's	★★★★★	36.00	Wide	Medium	0.53
Procter & Gamble	★★★★★	77.00	Wide	Low	0.65
Altria Group	★★★★★	24.00	Wide	Medium	0.68
Diageo	★★★★★	80.00	Wide	Medium	0.69
Campbell Soup	★★★★★	36.00	Wide	Low	0.79

Data as of 06-17-09.

Lowe's LOW

Although both Lowe's and Home Depot HD look attractive at current levels, we prefer Lowe's because we think it is cheaper, and we expect it to take market share at a faster pace over the next several years. We think Lowe's has been able to compete with (and outperform on many measures) its larger rival by providing superior customer service, a critical point of differentiation, in our opinion. Lowe's also benefits from substantial buying power and efficient store operations, which should help it weather the challenging housing environment. We think its advantages are particularly meaningful over the large number of smaller regional competitors still around. While we don't expect the housing market to rebound anytime soon, most of Lowe's revenue comes from maintenance spending on homes, leaving the top line less susceptible to weak consumer spending and residential real estate construction. We're convinced that Lowe's will emerge from the downturn in a stronger competitive position.

Procter & Gamble PG

Procter & Gamble is a wide-moat goliath with more market-share-leading brands in more categories than any other household products and personal care firm. Over the past decade, the company has focused on building brands in its core businesses in fabric care, home care, baby care, and hair care, giving P&G a broad product platform from which to grow and tiered pricing/brand offerings to better meet consumer needs. It's currently trading at an attractive valuation over concerns that the firm's brands are too premium priced for cash-strapped consumers and that growth in its core categories is slowing. We think these are short-term concerns. P&G has decades of experiencing navigating challenging economic landscapes, the firm's incoming CEO will likely step up efforts to improve productivity and streamline operations, and the company still has an enviable runway in overseas markets for its brands. It throws off a ton of cash, has an impeccable balance sheet and credit rating, and it just raised its dividend by 10%.

Altria Group MO

Although we recognize that the tobacco industry is facing some serious challenges, we think that the market is exaggerating the long-term risks to market leader Altria. We think that Altria has the most to gain from FDA regulation, because tighter marketing controls and restrictions on new products will lock in current market shares. With its dominant 50% market share in the U.S., Altria's position at the top of the industry could become unassailable. It has a strong portfolio of brands, including the iconic, leading premium brand Marlboro and the most popular discount brand, Basic, and we think the strength of its product portfolio should ensure that Altria will continue to generate excess returns on capital for years to come.

Diageo DEO

With eight of the world's top 20 brands and unrivaled global distribution scale, we like Diageo's robust free cash flow generation, which is under-appreciated by the market. As the world's largest spirits maker, Diageo can outsell and outmarket any other spirits company on the planet, and the strength of its portfolio is unmatched. In addition to its dominance of developed markets like Europe and the United States, Diageo is well ahead of its competitors in its brand awareness and distribution development in emerging markets. As such, we expect above-average growth and healthy profit margins from this wide-moat behemoth for years to come.

Campbell Soup **CPB**
We believe Campbell Soup is attractive at its current valuation. The firm controls 80% of the condensed soup market and 70% of the ready-to-go soup category in the U.S.—an attractive position, particularly as consumers eat more meals at home. In our opinion, the unrivaled economies of scale that result from Campbell's dominant and highly profitable U.S. soup business should serve it well, even in the face of the challenging macroeconomic environment.

Joel Bloomer does not own shares in any of the securities mentioned above.