

## The Recovery Gains Steam: Investment Implications for the Consumer Discretionary Sector

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### Key Highlights

- Consumer Discretionary stocks typically lead the market out of a recession, and this was the case in the most recent period
- Both economic data and consumer attitudes are improving at the margin, and we feel confident the Consumer Discretionary sector can continue to outperform in the near term
- Restaurants, apparel manufacturers and travel & leisure are industries we favor as the recovery progresses from its early stages

### Executive Summary

Since the inception of the current recession in December 2007, Consumer Discretionary stocks have been the best performers in the S&P 500. This result is consistent with historical trends. The Consumer Discretionary sector outperformed the S&P 500 in 4 of the last 5

recessions dating back to the 1970's. Keep in mind that stocks are leading indicators of economic activity and Consumer Discretionary companies usually feel the pain of an economic downturn well before a recession is officially underway. Likewise, their stock prices tend to anticipate recovery during the worst of the economic downturn. The current recession is no exception.

Now that the stock market has been in recovery for over a year, we need to consider how long Consumer Discretionary stocks can continue to outperform and what subgroups within it can sustain leadership. Retail stocks have performed the best in this period and are a major reason that the Consumer Discretionary sector has outperformed the S&P 500. We think it is unlikely that retail stocks can repeat this performance. In this edition of Capital Ideas, we examine the evidence for continued outperformance from Consumer Discretionary stocks generally and then examine industries with the best outlook.

### Economic Data Supports an Improving Consumer Outlook

The data in Figure 1 show that Consumer Discretionary stocks have been the best performers in the S&P 500 since the onset of the current recession. While Consumer Discretionary stocks may not continue in the top spot, we feel that the balance of evidence suggest that Consumer Discretionary stocks can continue to outperform the S&P 500. In this section, we outline a number of indicators that coincide with Consumer Discretionary stock behavior. We find evidence for continued improvements in income, employment, and debt reduction, which could translate into further improvements in consumer confidence and spending as people feel better about their financial situation.

### Improving Income, Employment, and Debt

Disposable Personal Income is heading up and the Unemployment Rate appears to be heading down.

A preliminary number for February 2010's Personal Income figure was recently released and it showed continued growth in wages and other sources of income. While the \$12.18 trillion number is slightly below the \$12.20 trillion number seen in 2008, the figures have clearly been heading up incrementally since the summer of 2009, during which time they were in the \$11.90 to \$12.00 trillion range<sup>1</sup>. Transfer payments such as government subsidies, welfare and social security have been a bigger source of growth than wages and salary disbursements, but we are clearly heading in the right direction.

As you can see in Figure 2, initial jobless claims (a good leading indicator of employment) are already much improved, as they have been falling in advance of the unemployment rate drop for the past 6 months. These are key indicators of the health of the consumer, and we believe the consumer stocks can continue to do well as the consumer's status improves.

In conjunction with unemployment rates and income data, consumer confidence is also stabilizing, lending support to the consumer's eventual ability to spend.

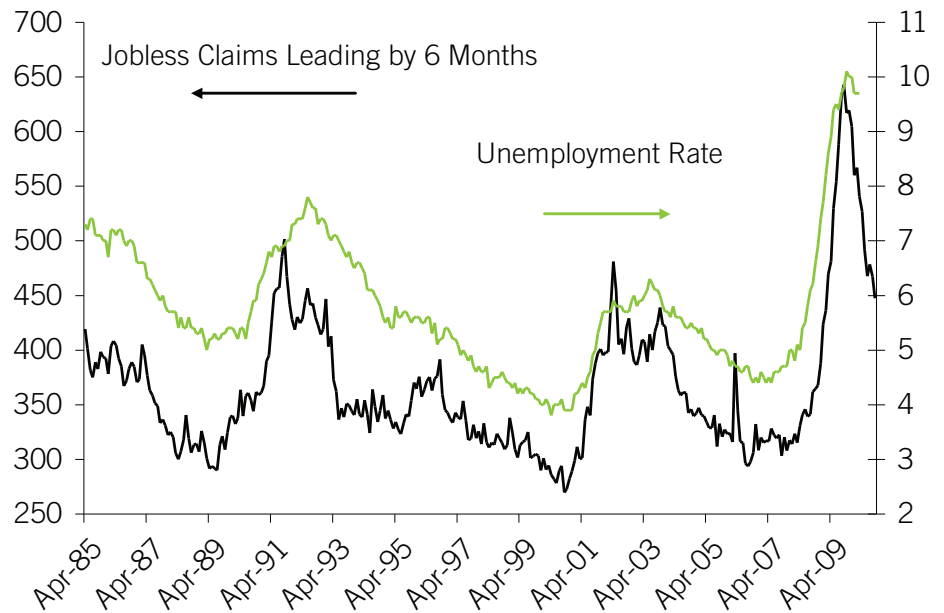
Figure 3 demonstrates the extent to which the household debt service ratio has improved as consumers have put the brakes on spending and worked instead on paying down debt and increasing saving. Household debt service is defined as the ratio of debt pay-

**Figure 1: Total Returns of the S&P 500 Sectors Since the Onset of the Recession (December 31, 2007 to April 12, 2010)**

Company Name	Sector Performance Since Onset of the Recession
Consumer Discretionary	8.76%
Consumer Staples	0.42%
Information Technology	-4.02%
Health Care	-7.66%
S&P 500 Index	-13.79%
Industrials	-16.86%
Materials	-16.93%
Utilities	-21.58%
Energy	-21.78%
Telecommunication Services	-26.13%
Financials	-33.87%

Source: FactSet Research Systems

**Figure 2: Jobless Claims and the Unemployment Rate**



Source: FactSet Research Systems, U.S. Bureau of Labor Statistics

<sup>1</sup> Source: Bureau of Economic Analysis

ments to disposable personal income. Household debt service ratios became unsustainably high before the onset of the recession as consumers believed rising asset prices would allow them to support debt payments in excess of their incomes. Now that home and security prices have fallen, consumers are now adjusting their balance sheets by repaying debt, a necessary step before spending will be able to resume.

Balance sheets still have a long way to go to get back to the levels seen in the early 1990s, but are clearly improving, supporting an improved ability for the consumer to spend once more when the jobs outlook stabilizes.

Willingness will be the other side of the spending coin – a huge blow was dealt to the American consumer’s psyche in the past few years as housing and stock prices plummeted, and savings and caution have ruled. Recently, however, the consumer is showing tentative signs that he is ready to spend once more after several years of saving and paying down debt. The American consumer can only live an austere lifestyle for so long without venturing

<sup>2</sup> “Americans Eager to Enjoy Tax Refunds This Year, According to NRF Survey”, National Retail Federation, March 4, 2010

<sup>3</sup> In the context of the business cycle, a “cyclical” sector or company is one whose performance rises and falls depending on the state of the economy; examples of cyclical sectors would be Consumer Discretionary, Industrials and Materials. In contrast, a “defensive” sector or company is one whose performance is less affected by the state of the economy; examples of defensive sectors would be Consumer Staples, Healthcare and Utilities.

<sup>4</sup> “7 Reasons We Are Early in Cycle for Cyclical...” JP Morgan North American Research, June 25, 2009, Thomas J. Lee, CFA

out into the world again, as can be seen in the results of a recent survey by the National Retail Federation<sup>2</sup>. In this survey, 8,560 consumers were polled in order to gauge their intentions for their tax refunds this year. According to their answers, 12.5% of people expecting a refund plan to treat themselves to a major purchase (up from 11% last year) and 10% plan to spend it on a vacation. 28.8% will use it for everyday expenses, and 40.3% say they will stash it away in savings. Americans indicated that after two years of paying down debt and skipping family vacations, they were now willing to open up their wallets a little bit more.

### More Upside to Consumer Confidence

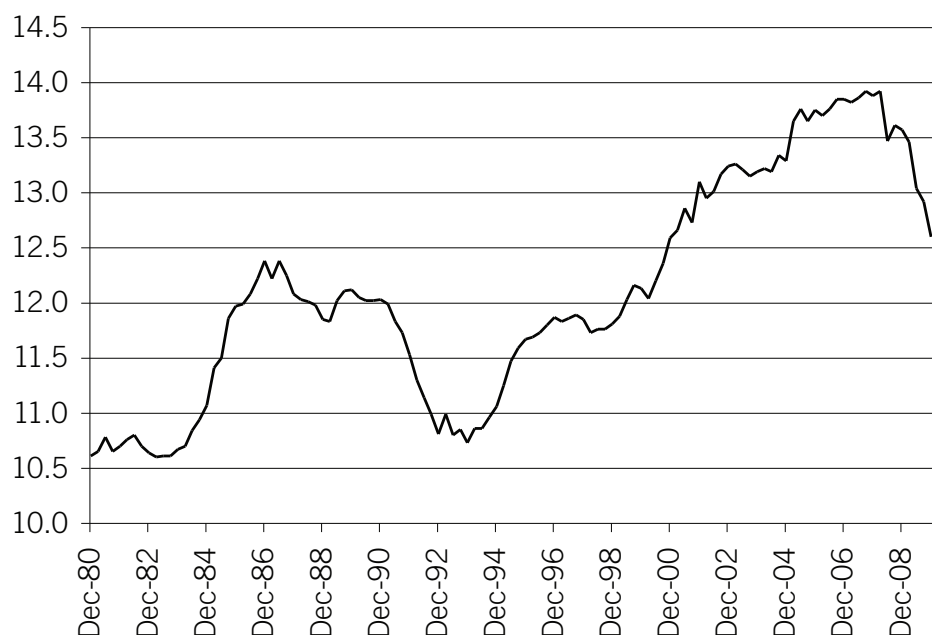
In addition, JP Morgan has published

research demonstrating how the cyclical<sup>3</sup> stocks outperform until Consumer Confidence reaches 100. As you can see in Figure 4, the S&P 500 index has risen dramatically but Consumer Confidence is still pretty low (the most recent report was 46) so it appears as though we still have a long way to go.

### Typical Duration of Cyclical Stock Recovery

We believe that the Consumer Discretionary sector can continue to outperform. According to JP Morgan research<sup>4</sup>, the shortest cycle of cyclical outperformance is 14 months, the longest is 82 months, and the average is 37. The Discretionary sector has outperformed for 24 months.

Figure 3: Household Debt Service Ratio



Source: FactSet Research Systems

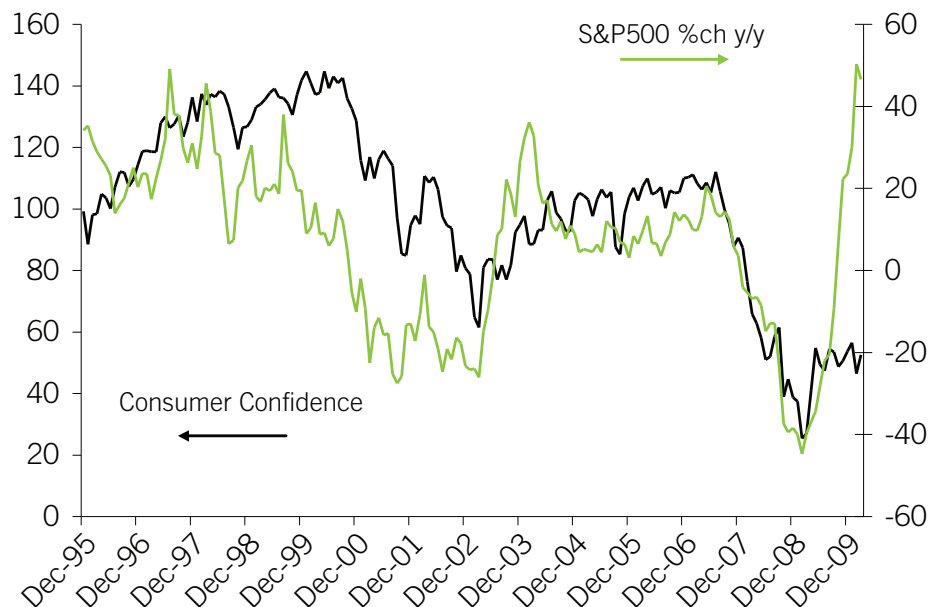
## Areas of Focus

Because the retail stocks have dramatically outperformed, we are beginning to explore the idea that other industries within Consumer Discretionary may take the lead going forward. While Retail is a large component within the sector, other industries within Consumer Discretionary play a large role in the market capitalization of the index. If Retail's dramatic outperformance wanes but the other industries begin to outperform, the handoff in leadership may not affect the overall performance of the sector as a whole. This is why we believe the end of the dramatic outperformance of the retail stocks may not necessarily spell the end of the outperformance of the Consumer Discretionary sector as a whole. There are later cycle industries within Consumer Discretionary, so as the recovery progresses that is where our focus will lie. We think investors may be well-served to take selective profits in Retail stocks and to focus their money instead on the shares of certain Restaurants, Apparel and Durables Manufacturers and Travel companies, and here we explore the reasons why we think these industries may be in favor in the near term

### I. Retail – Early outperformance should fade

Despite the fact that this recession was consumer-led and consumers dramatically curtailed their spending, the Retail stocks outperformed the broader markets and the Consumer Discretionary

Figure 4: Consumer Confidence and the S&P 500 Index



Source: FactSet Research Systems, The Conference Board

ary sector since the recession began on December 31, 2007. Throughout the downturn, many retailers closed underperforming stores and discounted their merchandise in order to maintain operations. Even so, many private retailers were forced to go out of business as capital (and customers) became harder to come by. The larger, stronger (often publicly-traded) retailers actually benefitted from the downturn, in some instances, as their competition fell by the wayside.

Now that the consumer is beginning to regain some confidence and return to the stores, retailers are seeing improved traffic, less discounting and higher margins as a result. Earnings estimates are rising, and confidence regarding the industry outlook is much

better than it has been in many years. Nevertheless, if the recession continues to follow the path history has laid out for it, the early-cycle stocks like those of the retailers will eventually make way for outperformance from later-cycle areas within Consumer Discretionary. Now that the retail stocks have dramatically outperformed, we are beginning to explore the idea that other industries within Consumer Discretionary may take the lead going forward.

### II. Restaurants – Trade-Down transitions to Trade-Up

During the recession, quick service restaurants (fast food) benefitted from a trade-down effect, and these stocks outperformed the shares of other restaurant stocks. Traffic fell, however,

at the casual diners, and the shares of quite a few of the publicly-traded names in this sector appeared to be close to pricing in bankruptcy. Many of these restaurants have since renegotiated the terms of their debt and are no longer at risk of breaking debt covenants or of violating the terms of their borrowing agreements, but their traffic and same-store sales trends are still fairly weak. A recovery will eventually improve their situation, however. As the economy improves, the consumer will begin to increase consumption away from home; the projected growth rate for this trend is 3%. As consumers begin to feel confident enough to go out to eat more frequently, they will likely trade back up to casual and fast casual concepts from fast food, and it is possible the quick service restaurants will be abandoned by middle and upper-class customers. In addition to the eventual revenue recovery, many of the publicly-traded restaurants (both casual and fast-food operators) have a great deal of cash on their balance sheets, so dividend increases and share repurchases could help drive returns in these stocks over the next several years.

### **III. Apparel and Durables Manufacturing – Restocking by retailers will help manufacturers**

For years apparel was a deflationary category and the industry was troubled by consolidating retailers. The recession that began in 2008 made the environment even more difficult for the

manufacturers, as many retailers found themselves in a position in which they were unable to sell items at full price. They were stuck with an abundance of inventory, and their profitability was negatively impacted as they were forced to dramatically discount unsold merchandise. Retailers reacted in 2009 by restricting inventory restocking, and this had a detrimental impact on the earnings of manufacturers of clothing, toys and other discretionary items.

Now that economic data is stabilizing and the consumer is beginning to return to the malls, retailers have started moving merchandise at healthier prices. Their margins are recovering, therefore with traffic and consumer confidence poised to improve, restocking, which will directly benefit the manufacturers, will eventually take place. The apparel and appliance makers should have healthier sales and earnings going forward.

### **IV. Leisure and Travel – Strong wave season already underway**

Throughout the recession, consumers pulled back on many expenditures, and leisure and travel was one of the hardest hit areas. Long vacations became a thing of the past as consumers opted instead to treat themselves to movies and in-home entertainment. Hotels, cruise ship operators, rental car companies and airlines suffered as travel fell. Now, however, we are starting to see tentative signs of recovery, and there is evidence the consumer is

feeling the desire to travel once more. Perhaps the most obvious example of this would be the most recent “wave season” for the cruise ship operators. The “wave season” is the period early in a calendar year when most cruise vacations are booked, and it is widely followed among those in the cruise industry. This year the companies in this industry reported record booking volume, a very encouraging sign for consumers’ confidence regarding their plans to travel this year. In addition to that, a major cruise ship operator reinstated their dividend payment, lending further credence to the rebound theory. Companies with ties to travel should benefit as consumers seek out vacations once more.

## **Conclusion**

The most recent recession was a consumer-led downturn, and unemployment reached double-digits. Nevertheless, the Consumer Discretionary stocks followed their historical playbook and outperformed throughout it, in anticipation of an eventual upturn. Now that the recovery is beginning to take shape, some worry that the stocks in the sector are destined to underperform, but we still believe there is potential in some of the “later cycle” stocks within the sector. In this piece we explored the possibility that dining out, travel and leisure could rebound from depressed levels, and that manufacturers will benefit from retailers’ need to

restock now that traffic and inventory levels are healthier. While the Consumer Discretionary sector may not be able to repeat the outsized gains it had in 2009, we still believe that it is a good sector to own in 2010, with the caveat

that later cycle sectors such as manufacturers and travel providers should outperform the earlier-cycle sector of Retail.

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We look forward to serving you. For more information, please contact us at 1-866-917-8730.

## About the author



**Fran Smitherman, CFA**, serves as an Equity Analyst currently specializing in the Consumer Discretionary sector. She has worked in the investment management profession in a research capacity since 1997. During that time, she has covered many different sectors of the economy in addition to the Consumer Discretionary sector. As a member of the Equity Analyst team, Fran participates in the management of the Total Return Opportunity Portfolio and the Equity Income Portfolio, as well as various institutional accounts. Ms. Smitherman is currently a member of the Investment Strategy Group. She earned a Bachelor of Science in Commerce and Business Administration from the University of Alabama in 1996, and a Master of Arts in Banking and Finance from the same institution in 1997. She has her Chartered Financial Analyst designation and is on the Board of Directors for the Chartered Financial Analyst Society of Alabama.

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