

CONSUMER STAPLES HAVE UNDERPERFORMED: WHEN IS ENOUGH, ENOUGH?



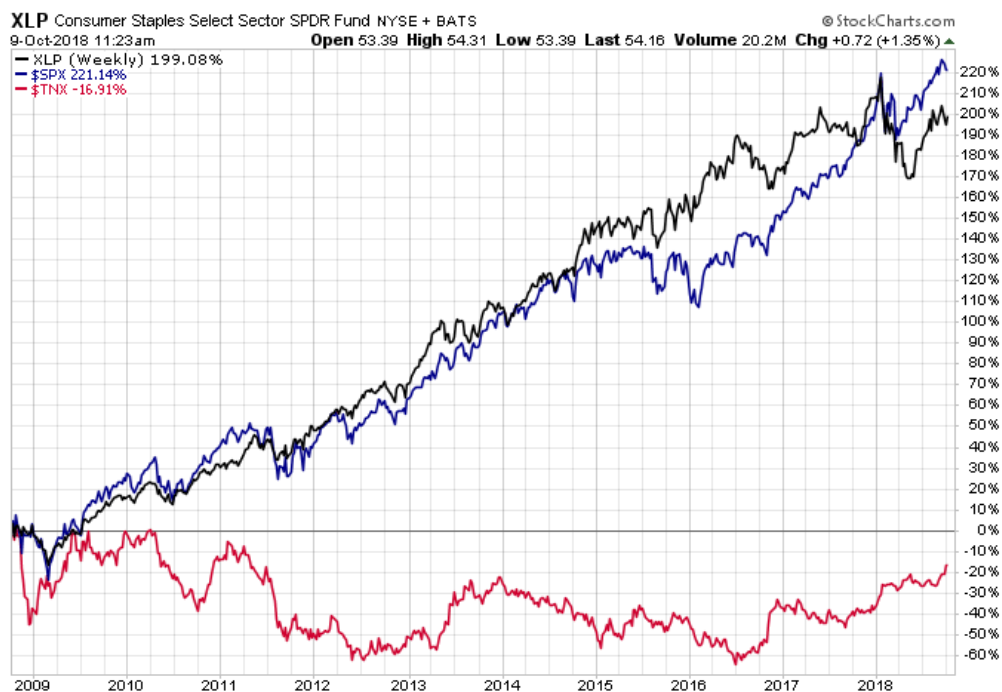
November 2018

After outperforming the broader market from mid-2014 to late 2017, the Consumer Staples sector has underperformed all year. Is this an interest rate story, an industry fundamentals story, or is something else driving this underperformance? In this piece we will show you why we think it is a mixture of issues that is driving this underperformance and what we think we need to see for it to end.

Interest Rates

Sectors such as Consumer Staples and Utilities often act as bond proxies for investors. Over the last 30 years of falling interest rates, these sectors have generally been a good place for investors to find yield, especially in the last decade as treasury yields moved down to a level that directly competed with the yields in these stocks. As treasury yields start to move back above the yields found in the Consumer Staples sector, the money flowing into these stocks is likely starting to reverse. In Figure 1 you can see that Consumer Staples (black line) strongly outperformed the S&P 500 (blue line) from late 2014 into 2017. The S&P started to gain ground in mid-2016 which corresponded with interest rates (red line) hitting a low and turning higher.

Figure 1: Consumer Staples vs. S&P 500 Ten-Year Yields



Source: StockCharts.com

Industry Fundamentals

Consumer Staples has been a hit or miss sector over the last year. Some names are performing very well, and others are underperforming by a large margin. This bifurcation has been driven by several factors in our opinion. Valuations reached a point over the last couple of years where it made more sense to look at investing in large technology companies that were trading at similar multiples while producing much higher earnings growth than the Consumer Staples names. Packaged food and large consumer products companies have struggled while areas like spices, colas, and food distribution have performed very well. Also, the strength of the dollar over the last year has been a headwind for companies with large international exposure.

In 2016, Consumer Staples' NTM P/E ratios approached 21x as a sector, while some of the largest search and technology hardware companies traded at similar or lower valuations. The growth rates of these companies could not allow for this dynamic to stay in place forever. Over the last couple of years we have seen Consumer Staples valuations decline back down to 17-18x, still somewhat elevated compared to historical valuations.

For quite some time Consumer Packaged Goods companies and Packaged Food companies were out of touch with the changing tastes and desires of consumers. As consumers shifted their purchasing to e-commerce and niche brands, the Consumer Packaged Goods companies continued to push traditional brands through traditional retail outlets. Only recently have some of the larger companies shifted their focus toward niche brands by purchasing the companies outright and letting the original management teams continue to run the brands as niche brands. We have seen the rewards in the last couple of quarters in earnings reports, which are starting to show growth again, but the damage to many of these stocks has already been done.

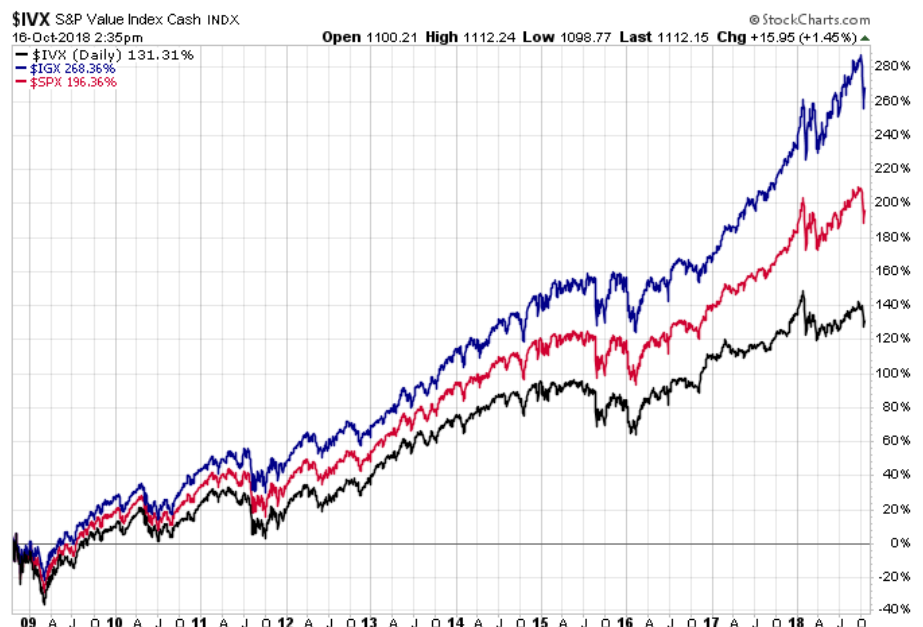
The Packaged Food companies have been hit with multiple shifting trends that they failed to grasp. The two biggest trends have been the shift to organic, fresh foods and the shift to restaurant dining from cook-at-home dining. The big Packaged Food companies that traditionally dominated the center of the grocery store have still not fully grasped the shifts in their business. Money continues to flow away from these businesses, and may not return until we see a major philosophy change on their part, an economic slow down or both. Companies that are positioned in the food industry to benefit from the organic and restaurant trends have continued to perform very well, and have been an area of focus for the Regions Investment Management Equity team.

Lastly, another potential headwind is the strength of the U.S. Dollar over the last year. This is potentially going to cause currency issues for companies with a large portion of their sales overseas. The currency issue has been cited by several companies over the last year as a drag on earnings. If the Dollar continues higher, this drag could increase.

Market Sentiment

Because Consumer Staples is generally viewed as a value sector, the stocks in this sector tend to do well when value is outperforming growth. As you can see in Figure 2, the S&P Value index (black line) has underperformed both the broader S&P 500 index (red line) and the S&P Growth index (blue line) since approximately 2010. That underperformance has increased in severity recently as this bull market has moved through later and later stages. Investors generally move more and more into growth names as bull markets age because they are chasing the winners and trying to keep up with or outperform an index that is getting more and more expensive. As we approach the current bull market turning 10 years old, it is evident that investors have moved into the growth chasing phase. At some point valuations will matter again, and investors will look for more value oriented stocks. For now, long term market sentiment remains in the "dance while the music is playing" phase.

Figure 2: S&P Value Index vs. S&P 500 and S&P Growth Index



Technical

After largely outperforming the S&P 500 from the beginning of 2011 into early 2016, the Consumer Staples sector has significantly underperformed the S&P 500 in recent years. As shown in Figure 3, the ratio of Consumer Staples to the S&P 500 has been in a steep decline until just a few months ago. Since June of 2018, the Consumer Staples sector has broken the downtrend and looks poised to begin a new uptrend against the broader market. We employ technical analysis as an overlay to our fundamental work, and these signs are pointing us in the direction of looking for new ideas in the sector.

Figure 3: Consumer Staples Relative to S&P 500



Source: StockCharts.com

Conclusion

Consumer Staples have underperformed the broader markets for the last couple of years, but that could be about to change. In our opinion there have been several factors driving the underperformance including rising interest rates, overvaluation of the sector, out of touch management teams and a market that was getting frothy and euphoric. The Consumer Staples sector is starting to show signs of life again after being left for dead. If some of these headwinds can abate, such as declining interest rates and market participants seeking safety over growth, we believe that it may be time to start thinking about increasing allocations to the sector.

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