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GLOBAL EQUITY OUTLOOK • SEPTEMBER 2018

Buyer beware: Shop around for consumer stocks

Kate Moore
Chief Equity Strategist,
BlackRock Investment Institute

Economic growth is humming and consumer confidence in the U.S. and Europe is at its highest level since the global financial crisis. Good news for consumer stocks? Not entirely. Large portions of the consumer sectors are at the forefront of major battles gripping markets: disruptive technology, new entrants upending competitive norms, and changing consumer preferences. This challenges long-held conventions and underscores the need to shop around for exposure to consumer stocks.

Highlights

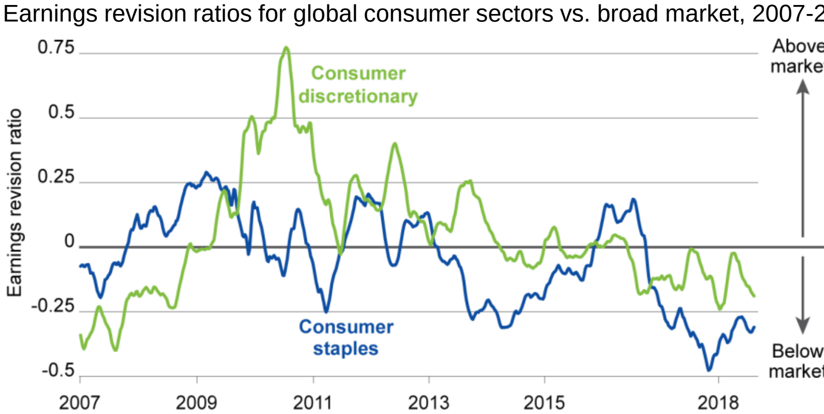
- **Winners and losers.** We see a brighter outlook for consumer discretionary stocks versus staples. The former rank among top-performing sectors globally this year while the latter fall near the bottom even after recent outperformance.
- **A new defense.** Staples broadly are no longer bastions of steady growth, strong cash flow and high dividends. This argues for selectivity and for casting a wider net for defense. We prefer U.S. stocks overall, but see staples opportunities in Europe. For defense today, we like U.S. tech's potential for growth that can outrun inflation.
- **The EM opportunity.** Population and income growth in emerging markets (EMs) has translated to increased demand for developed and EM consumer companies. We remain optimistic on this long-term trend despite recently softer EM data.

A mixed bag

It's been a mixed bag for consumer stocks in 2018: Consumer discretionary has outpaced the MSCI All Country World Index while staples lag year-to-date despite a summer rally. The outlook also is murky: Trade tensions and imposed and threatened tariffs loom as a potential drag on global consumption. U.S. staples sport some of the weakest earnings revision ratios, a measure of analyst upgrades to downgrades, globally. And consumer sectors worldwide pale relative to the broad market on this front, as earnings have faced a disruption-induced deterioration. See the chart below.

Not-so-great expectations

Earnings revision ratios for global consumer sectors vs. broad market, 2007-2018



Sources: BlackRock Investment Institute, with data from Thomson Reuters, August 2018. Notes: The lines represent rolling three-month earnings revision ratios for the MSCI ACWI consumer discretionary and consumer staples sectors less that of the MSCI ACWI Index. Values above zero indicate a higher earnings revision ratio for the sector relative to the broader market, and vice versa. The earnings revision ratio is a three-month moving average of the number of earnings estimates revised up less the number of estimates revised down by analysts.

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Stars aligned for consumer spending

Consumers around the world are feeling increasingly upbeat about the economic outlook. U.S. consumer sentiment, measured by the University of Michigan Surveys of Consumers, has risen to the highest levels since the global financial crisis across all income groups. European consumer confidence has exceeded pre-crisis levels and stands near its highest since 2000, according to data from the European Commission.

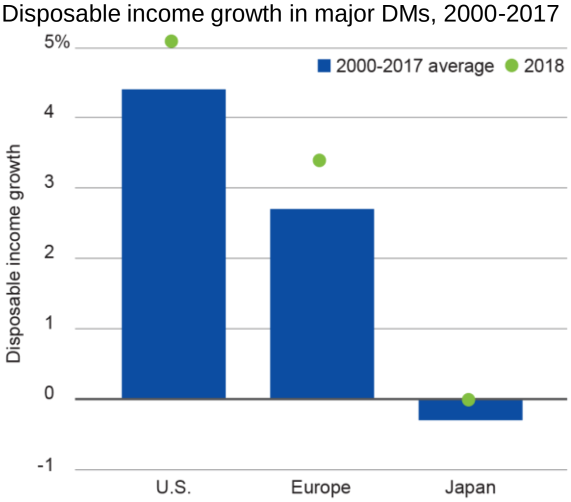
Rising disposable incomes are a key factor. Disposable income growth in the U.S. stands at roughly 5% versus the 4.4% average since 2000. In Europe, disposable incomes above 3% exceed the post-2000 average, as shown in the *Deeper pockets* chart. Japan is an outlier. In China, the National Bureau of Statistics reports household income has been growing at a faster rate than GDP as the country gradually transitions to a consumer-driven economy.

Is growth sustainable? Our BlackRock Growth GPS points to steady, above-trend global growth, even as uncertainty (much of it trade-related) blurs the picture. A recent upward revision to the U.S. saving rate shows consumers are not raiding their nest eggs to shop, while household debt burdens are lower than before the financial crisis, adding another leg of support for consumption as incomes grow.

Bottom line: Rising confidence in the economy, a willingness to spend and growing income provide ample runway for consumption globally. This is particularly true in EMs where a burgeoning middle class is developing the appetite – and means – to spend. Yet the seemingly bright backdrop also features new complexities for consumer companies, and this is changing the opportunity set for investors. The once reliably defensive staples group is showing more dispersion in performance as individual companies weather competitive challenges and changing consumer behaviors with varying success. And consumer discretionary stocks also present more of a mixed bag, as we discuss in the following sections.

Deeper pockets

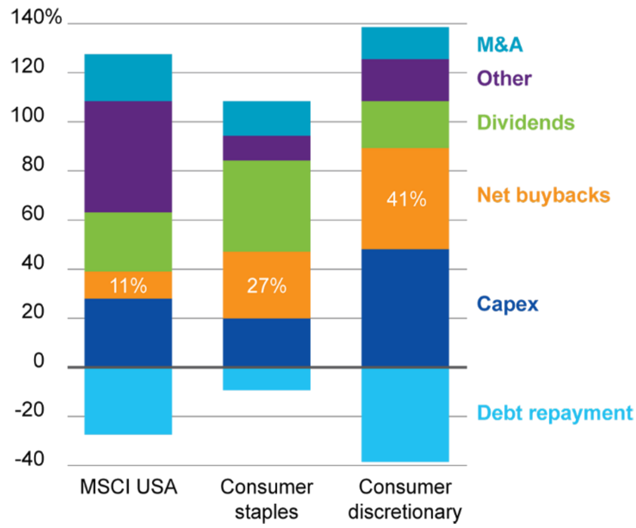
Disposable income growth in major DMs, 2000-2017



Sources: BlackRock Investment Institute, with data from the U.S. Bureau of Economic Analysis, the Statistical Office of the European Communities and the Cabinet Office of Japan, August 2018. Notes: The blue bars represent the average annual growth rate of gross disposable income across major developed markets since 2000. The green dot represents the latest available growth rate.

A knack for buying back

Uses of cash by U.S. firms, 2017



Sources: BlackRock Investment Institute, with data from Thomson Reuters, August 2018. Notes: The bars show the percentage of operating cash flow attributed to each segment among MSCI USA companies and the consumer sectors within the index. “Other” includes everything that does not fall into the listed buckets of the cash flow statement. Negative values for debt repayment imply net issuance.

Staples: Losing their defensive edge?

Consumer stocks fall into two broad buckets – cyclical and non-cyclical. Companies producing and selling staples tend to have a relative edge in slowdowns. Staples are more often necessity items, making them perceived “defensive” plays, particularly in economic downturns. Consumer discretionary companies historically have fared better when incomes are rising and consumers splurge on non-essential products.

Yet we’re seeing some blurring of the common distinctions. Staples are not necessarily the bastions of steady growth, strong cash flow and high dividend payouts they once were. Higher input and tariff-related costs are hard to pass on to more demanding and discerning consumers, whose preferences and shopping habits are increasingly empowered by digitalization. Brand loyalty is fragile. Traditional defensive sectors also have tended to provide minimal protection when yields are rising, our analysis shows. See Building the right defense in equities.

We also find U.S. staples companies have spent less on growth-promoting capex than both their discretionary peers and the broad market. And both staples and discretionary firms have supported their share prices by spending more than other sectors on buybacks, a practice spurred by low interest rates. See the *A knack for buying back* chart. The debt math for buybacks becomes tougher as rates rise, and competition and rising input costs challenge margins.

Geography could be a determining factor in the fate of staples stocks. We observe that staples’ historical resilience in downturns has been stronger in domestically oriented markets (the U.S.), and weaker in export-oriented ones (Japan), where sources of revenue are more globally diversified. Yet our analysis of weekly returns shows intra-sector performance dispersion has increased in developed markets over the past year, indicating investors shopping for staples stocks may need to be more discerning than in prior cycles.

Disruption in consumer discretionary

Selectivity is increasingly important in the consumer discretionary sector as well, but for different reasons. Technological disruption is the big one – and it's hitting retailers particularly hard. The industry was already challenged: Retailers' profit margins have been trending lower in the U.S. and Europe, even as they have been rising in the broader market. See the *Feeling the squeeze* chart.

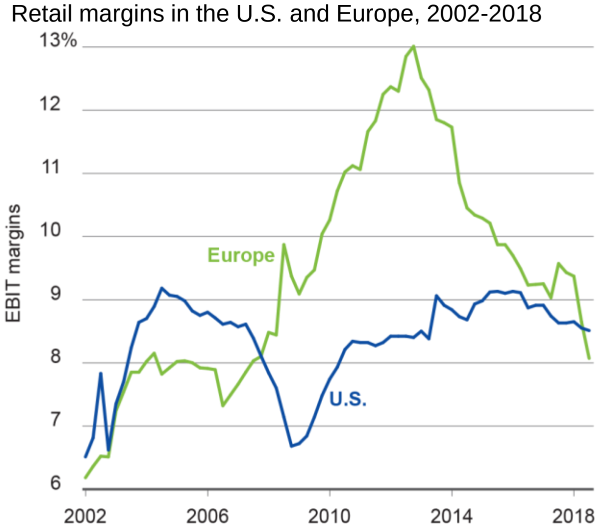
The growth in e-commerce has eroded the market share of traditional retailers, forcing them to adapt to changing consumer preferences and purchasing patterns. The Internet has enabled greater transparency through immediate price comparisons, intensifying price competition and squeezing margins. Sellers without physical footprints have less overhead expense, an advantage amid price convergence. Companies that control distribution, effectively manage inventories, and leverage digital strategies can gain an edge.

Trade friction and tariff threats also loom large – particularly in the auto sector where supply chains are global and highly integrated. Auto demand is still healthy, and global production has grown for nine years running, IHS Markit data show. China – the world's largest car market – has been a chief source of growth. Yet the industry has room to evolve. Traditional auto companies face competition from new entrants moving into electric vehicle production, and tech companies and chip makers are muscling in on auto components makers. Even within EMs – where demand is strong, established automakers face a new environment: New entrants provide the EM consumer with more options than ever.

Consumer health is improving, but retail and autos offer two examples of industries that look meaningfully different from just a few years ago. Many industries are facing new threats – and potential opportunities. We believe in the power of the global consumer, but the expression of that view is often best accomplished through idiosyncratic exposure.

Feeling the squeeze

Retail margins in the U.S. and Europe, 2002-2018



Sources: BlackRock Investment Institute, with data from FactSet, August 2018. Notes: The lines show the trailing 12-month EBIT (earnings before interest and taxes) margins for retail companies in the U.S. and Europe from 2002-2018. EBIT margin is defined as operating income divided by sales.

Where to shop for consumer stocks?

We are watching the extent to which imposed and looming tariffs may dent consumer sentiment. Amid crosscurrents of still steady global growth and meaningful market-related disruptions , our key investment takeaways include:

Seek exposure to EM growth. Growing EM populations and a rising middle class set up a favorable demand scenario for developed market consumer stocks – historically the most liquid way to gain exposure to the burgeoning EM consumer. Yet high-growth consumer industries are attracting new entrants – many from within EM, setting up new competition.

Preferences evolve as consumers move up the income spectrum. Growth in bigger-ticket items like autos and luxury goods has been robust. We see reason to believe sales strength can continue, but acknowledge potential drag from recent EM growth and currency weakness.

We prefer U.S. stocks over other regions overall, but would look to Europe when it comes to staples. We observe structural challenges that are less acute than in the U.S., and find stronger growth characteristics and underlying business models. European staples companies also get 27% of their revenue from EMs, compared to 16% for U.S. staples, FactSet data as of August 2018 show.

Focus on quality in staples. We attribute staples' summer outperformance to investors closing their underweight positions. Earnings revisions appear to have bottomed, which could provide support into year-end. Yet staples are not necessarily "on sale." U.S. valuations are only slightly below their five-year average and at a modest premium to the broader market. We find most of the "cheap" stocks are cheap for a reason – namely, limited clarity on growth prospects and a lack of financial flexibility. We prefer a focus on quality and momentum versus fishing for value in challenged companies.

Don't completely break from "tradition." Traditional retail is not dead. A PwC survey shows an *increase* in weekly visits to brick-and-mortar stores by consumers over the past three years. Same-store sales growth has been trending above historical levels in major developed markets, and sales per square foot stand at record highs in the U.S., FactSet data show. This points to opportunities in more traditional retail companies that have been beaten down as markets underappreciated the coming of age (and spending) among millennials and the overall health of the U.S. consumer.

Expand your definition of defense. Consumer staples companies historically have shown little dispersion across individual names, our analysis of MSCI returns from 2002-2018 shows. They share certain characteristics, such as high dividend yields, and have tended to move together. Lately, the gap between winners and losers in the sector has moved higher across the U.S., Europe and Japan. This tells us staples broadly cannot be relied upon as a defensive play, and that investors should be selective. We believe a good defense today is in quality companies demonstrating high profitability, sound balance sheets and strong brands. The key is targeting growth potential that can outrun inflation. That leads us to favor a position in U.S. technology stocks.

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