

Fast-moving consumer stocks

Weekly Digest

21 May 2018

– Andrew Hardy, CFA

As the oil price soared higher last week, with Brent crude briefly breaking through \$80 per barrel, I spotted a Bloomberg headline which read “What happens if oil hits \$100?”. Remarkable when you consider it was just over two years ago that oil troughed at around \$30 with commentators predicting a further one third decline! The pendulum has swung a long way; investor sentiment was very weak two years ago but is much more bullish now. A recent casualty of this change in sentiment has been the consumer staples sector, which has severely lagged the equity market rebound. To some extent this is understandable given its lower economic sensitivity, but relative valuations have now contracted significantly. Markets may be overreacting somewhat.

Since the low in markets in February 2016, the consumer staples sector has returned just 14% in US Dollar terms (including dividends), while the IT, financials and energy sectors have delivered four to seven times that gain! The price to forward earnings valuation multiple of the sector is now at just a 12% premium to the rest of the market, compared to 37% back then, while the 3% dividend yield is a quarter higher than the broader market for the first time since 2011. Many companies in the sector have incredible track records of delivering high and stable returns on capital by virtue of their world-renowned brands and the resulting pricing power, which has justified a substantial valuation premium in the past.

Some would point to the concurrent rise in bond yields to explain the sector's recent weakness. That may be partially true but it is a lazy argument predicated on viewing these stocks as ‘bond proxies’. Clearly the high quality, stable

and cash generative nature of businesses in this sector made them relatively more attractive when bond yields were lower, but the comparisons end there and investors should not treat these stocks like bonds.

A combination of relatively disappointing earnings results of late and fears of disruption to their business models seem to be the more important factors. Multinational makers of everything from soap to soup are struggling to adapt to new consumer preferences and private label products. The dominant incumbents in the tobacco industry are investing heavily to develop new products while facing pressure from new players. The channels these companies sell through are battling to keep prices down while adapting to combat Amazon or discounters. Such shifts in industry dynamics are leading investors to worry about future pricing power and the ability to maintain margins.

The jury is still out on how successful businesses in this sector will be at adapting, however many have track records of doing so for several decades (if not centuries) so probably deserve the benefit of doubt. Admittedly the pace of change and level of disruption feels higher now than ever before but the recent underperformance leaves the relative valuation for the consumer staples sector offering a better margin of safety than it has for several years. The market is probably overreacting again which is creating a good opportunity for our active managers to buy into these high quality businesses at much more reasonable valuations than a couple of years ago. As easy and tempting as it is to extrapolate a trend, it often leads to the wrong conclusion...

The Marketplace

- Gold fell 2.2% an ounce to 1,293
- U.S.-China trade war averted for now...
- Brent Crude oil rose 1.8% to \$78.7 a barrel
- US treasury yield breaches 3.1%

Market Focus

US

- US retail sales rose 0.3% during April
- Industrial production rose 0.7% and Factory output rose 0.5% in April. Both are in line with expectations
- Inflation gathers apace with government 'prices received' reports at their highest in 29 years
- Slight increase in jobless claims of 11K to 222K, but level remains at a near 50-year low
- The Dow Jones fell 0.5% to 24,715
- The Nasdaq fell 0.5% to 6866

UK

- Productivity decreased by 0.5% in Q1. Wages by contrast rose faster than inflation for the first time in over 12 months

- Marks and Spencer plan to add another 40 stores to the 60 already earmarked for closure. This follows announcements from other fashion retailers such as House of Fraser and New Look to shut stores
- Unemployment decreased by 46,000 to 1.42M in Q1
- The FTSE 100 rose 0.7% to 7779

Europe

- Some slowdown in European growth momentum during Q1 at 0.4%. Germany, Dutch and Portuguese GDP all fell short of forecasts
- 5 Star and League parties form a government in Italy - Plans of flat rates of 15% flat for individual tax, and 20% corporation tax are one of their more eye-catching policy proposals
- The Eurostoxx 50 index rose 0.2% to 3573.8

Asia

- North Korea abruptly cancelled peace talks with the South
- China announced it would end its anti-dumping investigation into US imports of sorghum and is rumoured to have offered to reduce its trade surplus with the US by \$200 billion through increased imports
- The Hang Seng index fell 0.2% to 31,047.9

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Asset Class/Region	Currency	Currency returns			
		Week ending 18 May 2018	Month to date	YTD 2018	12 months
Developed Market Equities					
United States	USD	-0.5%	2.6%	2.0%	16.3%
United Kingdom	GBP	0.7%	3.9%	2.9%	8.2%
Continental Europe	EUR	0.4%	2.4%	2.5%	3.5%
Japan	JPY	1.1%	2.1%	0.8%	19.2%
Asia Pacific (ex Japan)	USD	-0.9%	-0.1%	0.3%	18.5%
Australia	AUD	0.1%	2.3%	2.2%	10.7%
Global	USD	-0.4%	1.9%	1.7%	14.9%
Emerging markets equities					
Emerging Europe	USD	-3.8%	-3.2%	-5.9%	8.5%
Emerging Asia	USD	-1.2%	-0.6%	0.3%	20.7%
Emerging Latin America	USD	-5.9%	-9.4%	-3.4%	12.6%
BRICs	USD	-1.6%	-0.4%	1.3%	26.6%
MENA countries	USD	0.7%	-2.5%	6.9%	8.9%
South Africa	USD	-6.4%	-4.5%	-9.6%	10.1%
India	USD	-2.9%	-3.3%	-5.1%	8.8%
Global emerging markets	USD	-2.3%	-2.2%	-1.2%	17.7%
Bonds					
US Treasuries	USD	-0.4%	-0.6%	-2.6%	-2.0%
US Treasuries (inflation protected)	USD	-0.7%	-0.9%	-1.8%	0.0%
US Corporate (investment grade)	USD	-0.6%	-0.7%	-3.9%	-0.8%
US High Yield	USD	-0.2%	0.0%	-0.2%	3.0%
UK Gilts	GBP	-0.4%	-0.8%	-1.6%	-1.8%
UK Corporate (investment grade)	GBP	-0.3%	-0.8%	-2.3%	-0.7%
Euro Government Bonds	EUR	-0.8%	-1.0%	0.0%	0.9%
Euro Corporate (investment grade)	EUR	-0.3%	-0.3%	-0.7%	0.9%
Euro High Yield	EUR	-0.3%	-0.4%	-0.3%	3.2%
Japanese Government	JPY	-0.2%	-0.1%	0.3%	0.7%
Australian Government	AUD	-0.6%	-0.5%	-0.1%	0.8%
Global Government Bonds	USD	-1.2%	-1.8%	-1.5%	1.5%
Global Bonds	USD	-1.1%	-1.7%	-2.0%	1.6%
Global Convertible Bonds	USD	-0.7%	0.0%	1.2%	4.5%
Emerging Market Bonds	USD	-1.6%	-2.5%	-5.9%	-3.5%

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Property					
US Property Securities	USD	-3.4%	-0.6%	-7.7%	-3.8%
Australian Property Securities	AUD	-1.0%	0.3%	-2.8%	-0.4%
Asia Property Securities	USD	-0.4%	0.2%	2.9%	16.0%
Global Property Securities	USD	-2.0%	-0.7%	-2.7%	7.4%
Currencies					
Euro	USD	-1.5%	-2.6%	-2.0%	5.9%
UK Pound Sterling	USD	-0.5%	-2.1%	-0.3%	3.8%
Japanese Yen	USD	-1.3%	-1.4%	1.8%	0.3%
Australian Dollar	USD	-0.5%	-0.5%	-3.8%	1.1%
South African Rand	USD	-3.5%	-2.0%	-2.5%	5.7%
Swiss Franc	USD	0.3%	-0.7%	-2.3%	-1.9%
Chinese Yuan	USD	-1.8%	-1.6%	1.0%	6.6%
Commodities & Alternatives					
Commodities	USD	0.7%	2.0%	7.7%	18.0%
Agricultural Commodities	USD	0.8%	0.3%	5.1%	1.7%
Oil	USD	1.8%	4.4%	17.4%	49.5%
Gold	USD	-2.2%	-1.9%	-1.0%	3.0%
Hedge funds	USD	0.4%	1.0%	0.1%	4.1%

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