Our take on the global consumer -

And what it means for Australian investors

John Guadagnuolo 24 June 2023

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Earlier this month we attended the world's premier annual consumer conference, the Deutsche Bank Global Consumer Conference. We heard from over 20 companies in 2½ days, ranging from manufacturers of fast moving consumer goods (FMCG), to supermarket operators, apparel retailers and luxury goods providers. Companies present at the conference included Proctor and Gamble (P&G), Unilever, Walmart, Sketchers, Campari, Remy-Cointreau, Shiseido, L'Oréal, Zegna and LVMH, to name but a few.

A number of consistent themes emerged, both from the presenting companies and from the attending investors. We have summarised these themes and explained how these could be relevant for an investor in the Australian equities market and why we are cautious about Australian consumer focused stocks.

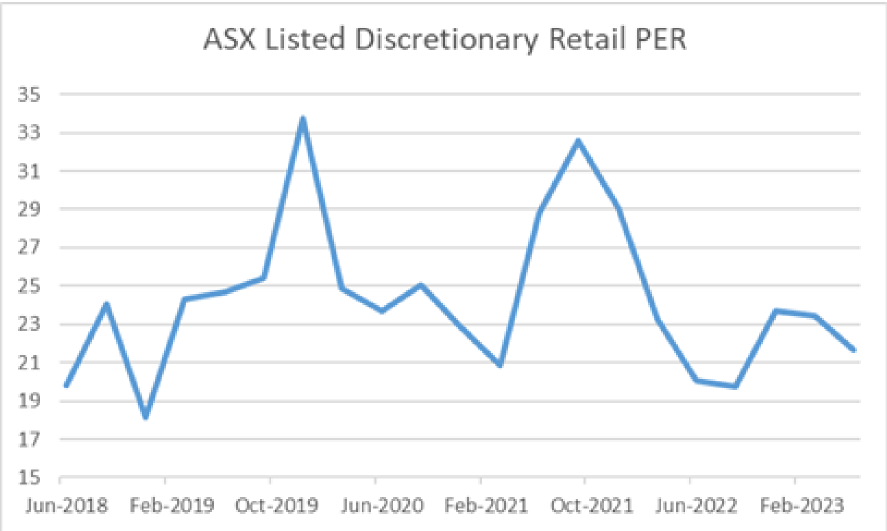
Global Consumers are not (yet) impaired

This was the area where there was greatest divergence between the tone of questions from investors and the answers provided by companies. Most investors were looking for signs of weakness, from volumes declining to any evidence that the price rises taken to offset inflation were beginning to unwind. With very rare exceptions, all companies we encountered said the same things:

- volumes were generally steady now, no longer declining. The big declines had been 1st Quarter 2022 with the declines moderating since as consumers adjusted;
- there was little "downshifting" from premium to generic brands other than in the most basic of categories post that initial shock of the war in Ukraine;
- indeed some FMCG companies, such as Clorox and P&G spoke of their scale as an advantage against private label, which struggled to stay price competitive; and
- prices were not under pressure in manufactured goods, although FMCG companies did speak of the need to return value to the consumer via promotions and other means.

Australian take:
We see a similar thematic here as investors have heavily discounted the prospects of consumer companies, especially those linked to perceived discretionary spending (See Chart 1).

Chart 1: Australian discretionary retailers* aggregate PER (x)



Source: Bloomberg and Antares Equities; June 2023. Note: *Component companies are: JB Hi Fi, Harvey Norman, Premier Investments, Super Retail, Lovisa, Accent Group, Nick Scali, Temple & Webster, Kogan and Adairs.

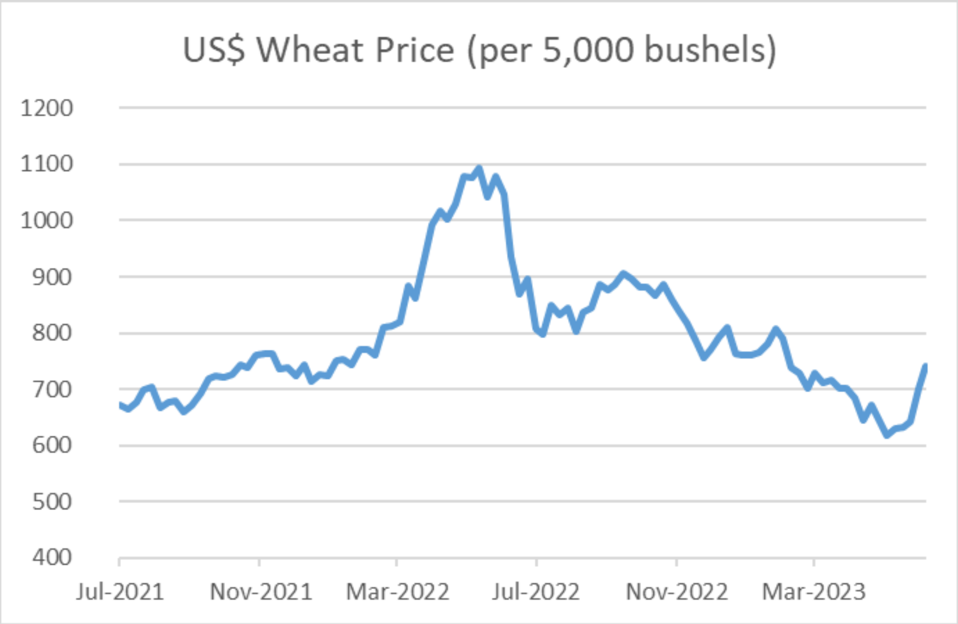
On the flipside, investors have crowded into perceived "quality defensive" stocks such as Coles (COL) and Woolworths (WOW). As investors, we struggle to see the rewards from such positioning. Indeed, despite both recording better than expected March quarter sales, neither stock appreciated, suggesting buying sentiment has topped out – at least for now.

Inflation in consumer goods has peaked globally

While there are still pockets of inflationary pressure, namely wages and energy, the majority of inflationary pressures have eased:

- supply chains have normalised, as evidenced by container freight rates falling to pre- pandemic levels; and
- many soft commodity prices have fallen back below levels last seen in Q4 of 2021, indeed some UK supermarket operators were materially lowering prices of items such as pasta, olive oil and dairy as the underlying commodity prices had normalised.

Chart 2: Wheat futures pricing



Source: Bloomberg; June 2023

Australian take:
If Australian companies follow the UK lead and pass on the falls in commodities prices back to consumers, we will see some of the cost of living pressures abate, at least in food. This would help sentiment generally, and perhaps assist the discretionary sector a little more. This is interesting in the context of the crowded trades in defensives.

China isn't broken

Global retail travel was a key feature of discussions. It has been strong in Europe and North America, but lagging in North Asia, although Hong Kong and Singapore have seen strong rebounds. Some reasons why there is potential upside for Chinese travel include:

- international air capacity in China is only back to 30% of pre COVID activity;
- there are significant delays in renewing Chinese passports and visas from a processing perspective;
- a second COVID wave swept through China in May, depressing sentiment; and
- there are early signs Chinese travelers are returning to Europe – France and Italy are the first to see it.

Chart 3: Chinese international air travel

Source: Bloomberg; June 2023

Australian take:
Chinese tourism is an important potential stimulus to the Australian economy. In 2019, nearly 1.4m Chinese visited Australia, spending approximately A$19bn in total whilst here. This was both the highest number of visitors from any country and the biggest spend. Were this to return it would provide a substantial stimulus, which perversely might keep monetary conditions tighter for longer as such stimulus can be inflationary in an economy already close to full capacity. On the flipside, we see it driving greater demand for labour (with SEEK a potential beneficiary) and possibly apartments (with Mirvac a potential winner), as historically, mainland Chinese have sought to accumulate real estate in countries like Australia.

Premiumisation is accelerating
While many people might scratch their heads at the seemingly never-ending demand for luxury goods, many companies cited the continued growth of their premium products. Some notable examples include:

- Demand for luxury spirits has accelerated with China's reopening
  - Remy-Cointreau and LVMH noted a sharp increase in demand for higher quality Cognac;
- The trend towards high end skin care has strengthened as people are more interested in their health and well-being post the impact of the pandemic
  - L'Oréal and Koti both noted demand for products associated with personal health remained on a strong growth trajectory as other beauty demands normalised post the COVID re-opening;
- Sustainability also plays a part here with people preferring items that last longer given the environmental impact of fast fashion.

Australian take:
There is little exposure to the premiumisation trend in the Australian market, with the exception of Treasury Wine Estates (TWE). TWE is pursuing precisely this strategy across all of its markets as it seeks to move away from the high volume, low value commercial wine sector. We also note that Qantas (QAN) is pursuing a premiumisation of its cabin strategy. (We will examine QAN in depth in a subsequent note.)

Sustainability – it's a real thing in consumer land

There is a clear divide in approaches to sustainability in consumer products:

- European companies embraced sustainability and believed that premium pricing was available from presenting sustainable choices.
  - For instance, Coty was decarbonising the ethanol used in its perfumes and able to charge a premium accordingly.
- US companies, on the other hand, were clear that the consumer was interested but not willing to pay a premium.
  - P&G pointed to the need for a mutual benefit e.g. Tide detergent needing a lower effective temperature per wash, saving both energy and prolonging garment life.
  - Clorox pointed to its research that while consumers were interested, few were willing to pay the premium required.

- Packaging looked to be under considerable pressure, especially flexible plastic packaging (flexibles), as companies moved away from its use, so as not to appear as poor corporate citizens given its proclivity to end up in waterways and the like.

Australian take:
While we note the progress towards the recyclability of flexibles in particular, we remain nervous of the packaging sector of the market. We see increasing capital demands to ensure less and less material is lost to waste (as requirements for labeling etc. steps up) and given the competitive landscape, we see challenges posed by the increasing sustainability demands of major consumer companies.

Our conclusion from an Ex 20 strategy Australian market lens

Despite all the bearish sentiment, both here and abroad from investors, the global consumer remains resilient, at least for now.

Interestingly, there were clear signs of disinflation emerging in European and US products. Could this suggest that perhaps central banks may be more likely to achieve a so-called soft landing whereby inflation is contained without breaking economies?

It is a seemingly different story to Australia where inflation seems to be embedded at this stage and there are signs that consumers are starting to flag. (Interestingly, this is the first time in the 10 years we have been attending this event that Australia was not mentioned in any of the interactions we had with the companies.)

This is not to say Australia will have a recession and other countries will not. It may be that because Australia was late to the inflationary story it will emerge from it later. But, on balance, we are cautious for pure Australian retail. Australian consumers carry far more debt and are more sensitive to floating interest rates than other major markets.

Productivity remains a major headwind in the fight to grow real wages and contain inflation. Our takeaway is that we need to be defensively positioned on consumer related sectors and look for growth opportunities that are largely uncorrelated to the local economic environment.

For example, we have recently invested into waste disposal via Cleanaway (CWY) and energy generation via AGL. Our thesis in both cases was that both businesses would benefit from new management teams that were aiming at improving the efficiency of the underlying operations, which had been mismanaged recently. Hence each was underearning according to the potential of their privileged asset base (it is hard to enter either market due to regulation). Further, demand for the products was not particularly economically sensitive, hence the turnarounds were unlikely to be impacted by the prevailing economic conditions.

We also note the stocks already mentioned as potential beneficiaries of global consumer trends - Seek, Mirvac, Treasury Wine Estates and Qantas.

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