Postcard from The South:

The US consumer is starting to slow

Winston Chong 3 April 2023

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Last month we attended the Citi Global Consumer Conference and visited retail stores across a number of southern states in the US. As has been the case in Australia, the US consumer seems to have held up better for longer than anticipated. Sentiment amongst US investors on consumer spending seems to be mixed. Management teams seem fatigued from questions around an impending recession, which has persistently been six months away, for the last two years. However, we came away with the view that US consumer spending is starting to show some clear signs of softening, and we think this has implications for us given the time lag between Australia and the US on inflation and interest rate hikes.

Figure 1: Companies at the Citi Global Consumer Conference (March 2023)

Source: Citi, company websites; March 2023

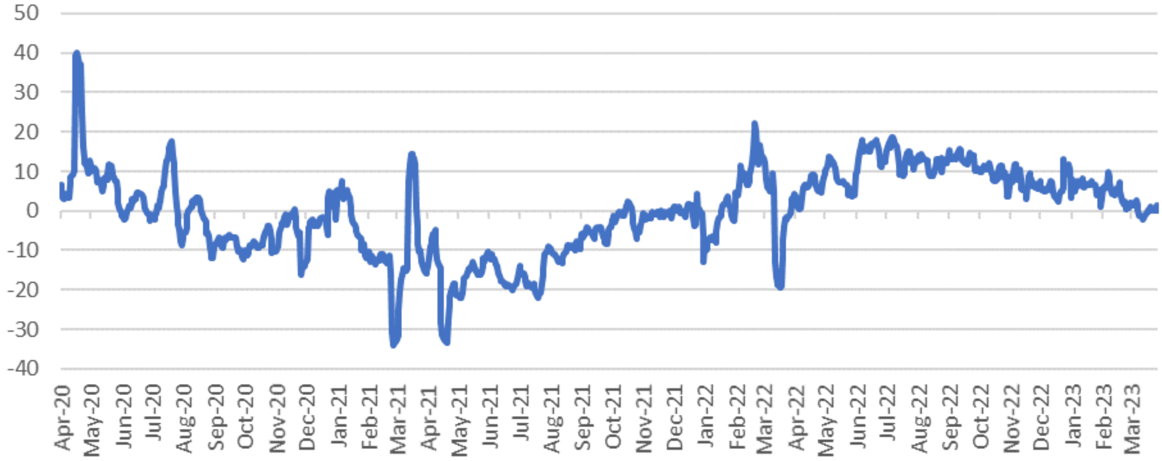
The consumption environment appears to be softening

Whether justified or not, low to middle income consumers in the US are beginning to feel some anxiety and concern around their ability to spend and are becoming increasingly discerning with their consumption choices. In our meetings with supermarkets, consumer staples companies and discretionary retailers some of the common trends we noticed included:

- an increase in downtrading and private label penetration;
- a shift in spending from discretionary items to staples as prices rise;
- pockets of excess inventory in apparel and fashion accessories;
- deflation in discretionary categories in electronics, soft lines and apparel;
- a heightening use of credit in the purchases of groceries;
- greater customer sensitivity to deals and promotions; and
- a strong reluctance to increase prices in all categories outside of consumer staples.

This feedback is consistent with high frequency data that suggests spending has continued to slow over March.

Figure 2: US low to middle income consumer spending (yoy % growth) - slowing



Source: Facteus, Bloomberg, March 2023

Some bright spots remain

- **Luxury** companies across apparel, fashion accessories, fragrances and wine reported consistently strong demand from their consumers. While these companies are cognisant of the external environment, the view appears to be that the luxury consumer is relatively unaffected by macroeconomic conditions and continues to spend.
- **Restaurants and fast food** appear to be holding up relatively well too – whilst the cost of labour and inputs have been substantial headwinds over the past 12 months, the price rises to offset these have not impacted customer count materially. The return of promotions, which some still argue are below pre COVID levels, is also helping. There is also a view that better data and digital engagement with consumers will provide additional resilience in the case of a slowdown. Most chains also appear intent on continuing and accelerating store rollouts.

China reopening yet to show meaningfully

- US investors seem to be disappointed at the pace of China's reopening to date, however companies (particularly in the luxury space) are quite bullish on the outlook.
- There appear to be some question marks over whether recovery has been tempered by health concerns. That said, evidence of "revenge spending" seen in other markets is only likely to be become most apparent in 2Q/3Q calendar year (CY) 23 as the major Shanghai lockdown only began at the start of March 2022.
- Lastly, most US luxury brands are not worried about US-China relations impacting sales as they see their positions as more nuanced than being "made in the USA".

Price inflation has peaked

- None of the discretionary consumer companies we spoke to expect to raise prices this year following some very substantial price increases over the past few years.
- On the consumer staples side, price rises are expected to be more moderate but still above trend with price rises from 2HCY22 flowing through to 1HCY23 followed by further moderate prices on top of that from the lagged effect of input/labour costs.
- Value retailers are focussed on bringing prices back down to demonstrate their value proposition as input costs normalise and even noted deflation in several discretionary categories.

Promotions still below pre COVID levels

- There is a hope amongst both the discretionary consumer companies as well as staples that COVID is a reset to the degree of promotions.
- One example of this was Coca Cola Europacific Partners which has lowered promotions in the heavily promotional market of Australia to 40% off vs 50% historically. They are also looking to bring down frequency (noting that they are on special 50 weeks of the year in Australia vs 20 in Europe)
- However, a few companies in the discretionary space have not been able to avoid this given they were caught out with too much inventory as the market has softened.

Wages have been adjusted, labour improving but tight

- A few retailers we met with have seen significant step changes to their wages over the past few years (as large as 30-65%), which is a symptom of labour market tightness as well as a concession that pay had previously been at unsustainably low levels. Whilst we were in the US, Home Depot announced an increase in starting wages to $15/hr.

- Whilst others had seen more moderate increases in wages, the increases have been above trend and some companies had paid staff inflation bonuses to limit staff turnover.
- In areas like fast food, companies report that labour availability is slowly improving but there is a need to pay up for staff. Several fast food chains we walked by have their rates posted at the front of their stores.

Figure 3: Wage advertisements at Chipotle and In & Out

Source: Antares Equities, March 2023

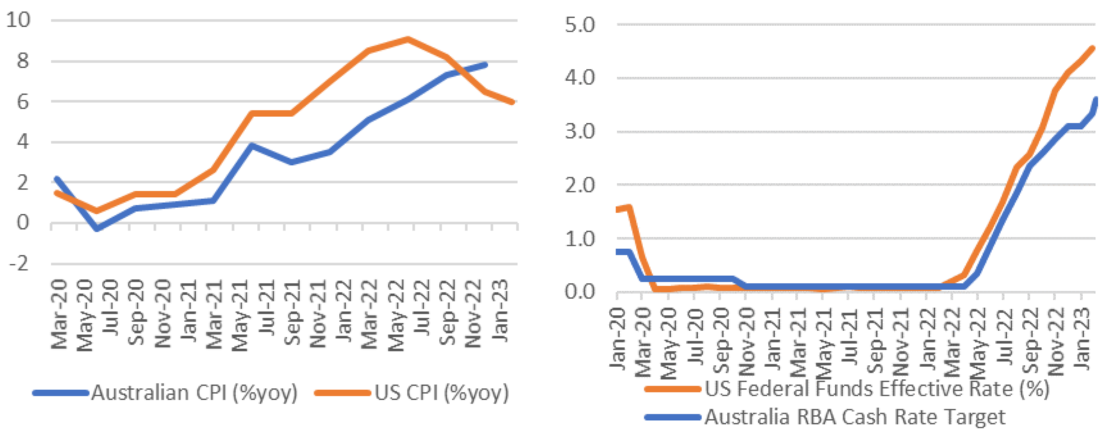
Focus on productivity and costs

- Pretty much every company we spoke to is currently laser focussed on driving sales productivity and cost efficiency through their business following the supply chain disruptions of 2020-22.
- For some this seems to be a symptom of sales rising significantly over the past few years with not much falling through to the bottom line. Areas of focus are around automation, smart scheduling of labour and incentives.
- Margin improvement is very topical in this softening environment – one area that is helping is high freight costs coming off the boil.
- On the rent side of the equation, good luxury space is still high in demand. Most specialty retailers expect rents to revert to fixed annual escalation post the COVID incentives.

Implications for Australia – is it just a matter of time?

On the balance of probabilities, our view is that there are more similarities between the Australian and US consumer than differences. Australia's inflation and rate hiking cycle has lagged the US and so the US consumer softening may be a sign of things to come in Australia.

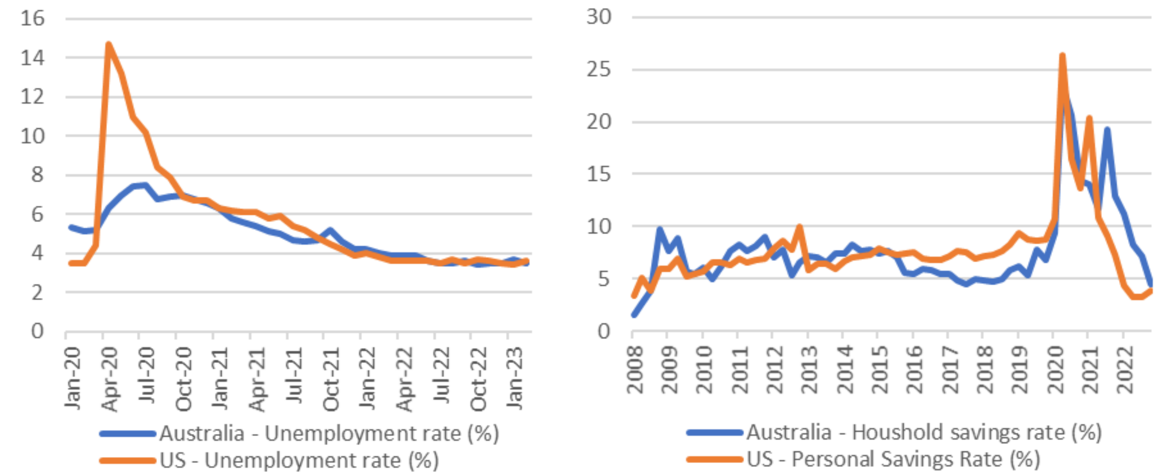
Figure 4: Australia vs US- CPI and central bank interest rates



Source: Bloomberg, March 2023

At present, both the US and Australia have similar, low unemployment rates. One difference is that while personal/household savings for both the US and Australia have declined, the savings rate in the US is half that of Australia's. Interestingly for both Australia and the US the savings rates are at levels broadly in line with the GFC.

Figure 5: Australia vs US – Unemployment and savings rates



Source: Bloomberg, March 2023

Given these trends, coupled with feedback from our trip, we understand the caution many Australian retailers have had in giving outlook statements. While consumer discretionary stocks are screening "cheap", we are reminded that they run high fixed cost businesses. The strong operating leverage they enjoyed while sales were robust (the EBIT margin for the ASX200 Consumer Discretionary Sector increased from 6% to 10% in from 2020 to 2022) works both ways. Our experience suggests that the market persistently underestimates company operating leverage and given the outlook for the consumer we remain cautious for now.

And lastly - there's no substitute for on the ground research

After years of travel restrictions, over the last year our team has been out and about again travelling to gain insights. Our US trip has reminded us that there's no substitute for on the ground research to fact check what our companies are telling us.

We leave you with a few other miscellaneous company insights (and photos on the following page) we picked up along the way:

- Store manager insights: We visited some new stores of an Australian small cap retailer in the US. What stood out to us is that staffing levels were incredibly low (1 person working in a 150sqm store). We asked the store manager what she does if she needs to get lunch or a bathroom break and her reply is that the store simply closes. Similar stores in Australia are staffed with 2-4 staff. Whilst this is probably in part a symptom of the tight labour market, we note that the CEO of this company has a very aggressive incentive target to increase earnings as quickly as possible – the easiest way to do this is to open as many stores as possible and worry about service levels and productivity later.

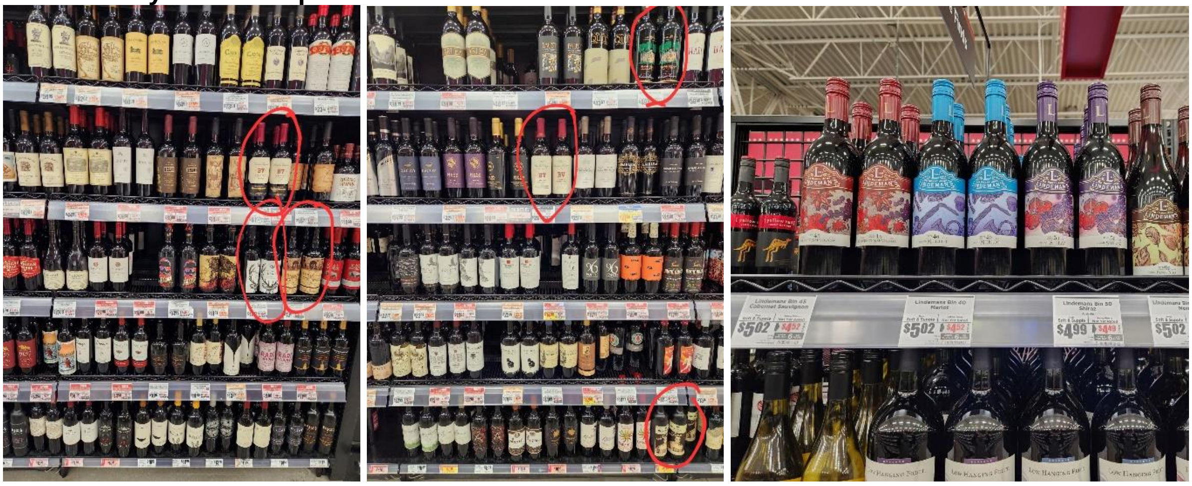
- Testing knowledge of sales representatives: We visited several retail points of distribution of an ASX100 consumer discretionary company which is selling products in the US. The retailers also sell other brands, including their own house brand. Speaking to various sales staff we found there was very little (if any knowledge) of the Australian owned product and a preference to push competing house brands due to staff incentive structures.

- Visits to supermarkets highlighted the sheer number of wine brands available to the consumer and hence the need for differentiation. One thing we learnt on the trip was that there were some successful launches of Australian wines in the US with Lindemans in the 1980's and Yellowtail in the 2000s. Unfortunately, the US consumer never graduated from this $5 price point and Australian wine as a result remains very underrepresented on the shelf.

- Retail experiences: We visited a number of retailers (whilst also doing our part to stimulate the US economy) who were putting forward exciting and engaging retailing concepts with great in-store theatre and experiences. We think Australian retailers can learn from some of these.

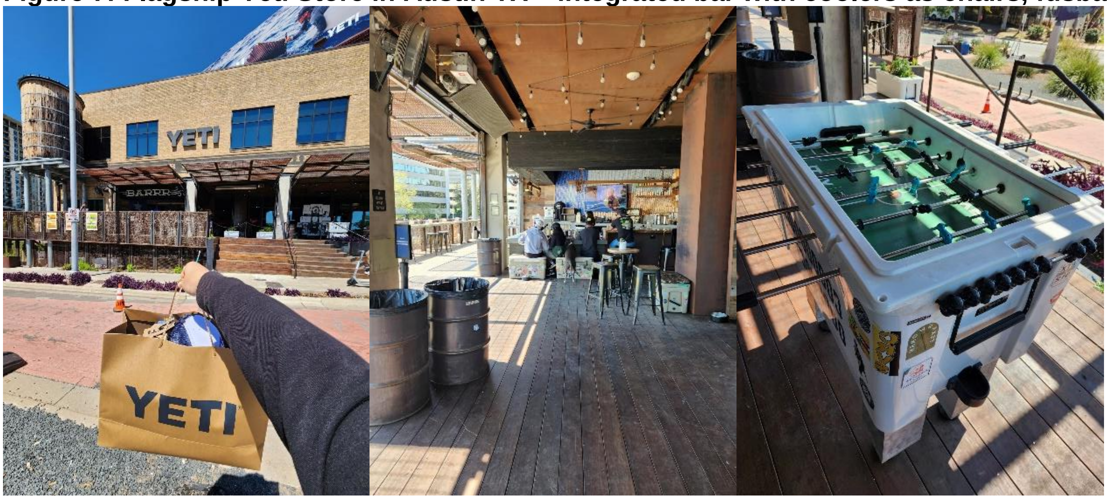
- Bigger than it looks: We had the opportunity to spend the day at the Austal shipyard in Mobile, Alabama, and drive around the Tesla Gigafactory in Austin, Texas both of which gave us an appreciation of the sheer scale of production. They are certainly some very big buildings!

Figure 6: Grocery shopping at Walmart – Two US premium/luxury wine bays within two entire aisles – spot the Treasury Americas product.



Source: Antares Equities; March 2023

Figure 7: Flagship Yeti Store in Austin TX – integrated bar with coolers as chairs, fusbal tables, artwork



Source: Antares Equities; March 2023

Figure 8: Cabelas/Bass Pro in Austin TX – great in store theatre with aquarium, shooting range and taxidermy

Source: Antares Equities; March 2023

Figure 9: Tesla Giga factory in Austin TX – the pictures don't do justice to the scale of the operation

Source: Antares Equities; March 2023

Figure 10: Austal Shipbuilding yard in Mobile, Alabama –the scale and design intricacy was impressive

Source: Antares Equities; March 2023

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