Insights Series | Consumers

Podcast Transcript

Chris Villalba Investor Relations:	Welcome to Boston Partners Insights, going beyond the headlines with our investment team to provide a deeper perspective on the capital markets. I'm Chris Villalba from Boston Partners Investor Relations Team. On this episode, we focus an investment lens on everyday spending, a conversation that is about consumers, companies that produce consumer goods and the state of the consumer sector at a complex time for the economy. [cash register sounds] That's the familiar sound of buying and selling. The sound of consumers going about their business. It's the heartbeat of the everyday economy. With the disruption of the pandemic two years ago, that sound could have turned into something much more ominous. But a spending flatline amid a COVID driven downturn never really came. Instead, kept afloat by economic stimulus and relief packages, 2020 and 2021 actually turned out to be good years for consumer spending. And the capital markets remain strong despite some major speed bumps. Global supply chain challenges, for example, being perhaps the most visible. Consumer confidence remains strong as well, at least for a while, that is. This year in the U.S. and around the world, it's been one aftershock after another. Inflation, which was already on the rise, was further exacerbated by Russia's invasion of Ukraine and its impact on the energy and agriculture sectors, as well as ongoing supply chain interruptions and more. In short, it's been a rough year so far for the consumer at the checkout line. To deepen our understanding of why and inform our thinking about investing amid all these events, we are joined by Boston Partners equity analyst Volkan Gulen. Volkan has covered the consumer sector for more than 16 years. He specializes in a range of consumer product equities as well as agriculture, business services, media and more. Volkan and I sit down at our headquarters in Boston to take an overall snapshot of the economy and delve into the ways consumers are looking at that picture today and for the future. Volkan, welcome..
Volkan Gulen Equity Analyst:	Hey, Chris, how are you?
Chris Villalba:	Doing well, thanks. Now we're sitting here in Boston recording this on June 22nd as the summer travel season is about to begin. And consumers have a lot on their minds, especially what they're paying at the pump. To get started, Volkan, I think it's worth defining some terms and context for our audience. First, what exactly are we talking about when we say the consumer sector?

Volkan Gulen:	Overall, my focus is on consumer communication services and business services, as you highlighted. It's a pretty broad set of sectors, but that also gives me a unique perspective on different parts of the economy. As it relates to consumer, I tend to focus on the staples side, which tends to be companies like beverages, food, household products, with some focus on consumer discretionary companies, which is generally more out of home services. Most of the staple companies, they manufacture, market, distribute products to companies like Walmart, Target, grocers, and convenience stores. So, it gives us a broad view of the consumer.
Chris Villalba:	Now, the hot button, perhaps the backdrop for this whole discussion: are we in a recession or not? And how bad is it going to be?
Volkan Gulen:	Technically, we're not in a recession, but if we just kind of observe the present state of the economy and position ourselves accordingly without trying to make projections, we can make a couple of simple observations. You know, government stimulus is winding down, as you highlighted, material and supply shortages around the world are driving prices higher. And consumer sentiment, in response, is hitting all-time lows. So, we're getting lots of mixed signals. Our challenge is to reconcile the bottom up company specific data points that we get from management teams and bring that together with the macro data to get a clear picture. Overall, lots of mixed signals, but it appears the momentum is definitely negative. As it relates to some of the empirical data, mixed signals would relate to consumer balance sheets, and employment data is strong, but the spending and sentiment trends have lost momentum. So, looking at some pretty simple indicators, like the yield curve and consumer sentiment measures, those suggest we're entering or close to entering a recession. And historically, these have been pretty reliable indicators. On the employment and wages side, there's a lot more positives. The consumer, overall, is in a good position as it relates to their savings and there is ample cushion to navigate the current environment. But as we get into the second half of the year and 3Q earnings season, in particular, we are at a crossroads, so to speak, and it will be important to monitor how the consumer is holding up as prices continue to rise across the board. In order to check some of this data, we speak to the companies on a regular basis. Anecdotally, we're starting to see some weakness at the low-end consumer, but this has not filtered through to the broader consumer just yet. And generally, the weaknesses is in certain discretionary categories.
Chris Villalba:	Now, I hate to say the R-word in any discussion on the economy, but if the U.S. economy slips into a recession, are there some companies that are positioned to withstand a downturn better than others? Because we should probably talk about some of those.

Volkan Gulen:	Yeah. So generally, consumer staples is a good place to hide in a recession. They have characteristics, on average, like pricing power, limited capital needs, and the discretionary sector can generally be a little bit tougher as consumers tend to cut back on spending. And that's where we're starting to see some of the negative momentum. Overall, staple companies sell products that consumers need, generally, with low price elasticity. These businesses tend to exhibit stable and consistent organic growth, high margins, limited capital intensity. And the pricing power then serves to really generate a resilient free cash flow stream in order to offset some of the cost increases. So, bringing it back to the bottom up, fundamental analysis from a Boston Partners three circles perspective, we have strong fundamentals and strong momentum in these staples businesses, and that's balanced by premium valuations since they have higher quality. So, on average, investors have to pay a slight premium for a higher certainty of profitability in the future in the current uncertain environment.
Chris Villalba:	How about we take a look at one or two of those companies as case studies, make the case for why they might be set up to fare well in an economic slowdown or even a recession.
Volkan Gulen:	Yeah, one of the most obvious examples I think, would be Proctor & Gamble. This is an example of a business that is currently generating pricing gains that are tracking CPI. So that's high single digit pricing gains and that's what mitigates some of the cost pressures of the business. The business is still facing pressure, but the high single digit pricing increases goes a long way for them to offset that. Food, beverage, tobacco companies generally share similar traits to Procter, but not all staples have real pricing power. Another simple example would be Hershey. Hershey is another business that is effectively a rational duopoly. They have one private competitor in Mars.Both those companies are passing high single digit pricing increases, and generally chocolate bars is a pocket of the consumer spending where generally private label doesn't really come into factor where brands really matter, and that's where consumers are willing to pay a little bit more.
Chris Villalba:	So discretionary purchases were up during the pandemic; is that what you're saying?
Volkan Gulen:	Yeah. So, it's a little counterintuitive, but basically unprecedented stimulus combined with the lockdowns really fueled unconventional spending patterns, which are now normalizing. So overall, the consumer basically took their out of home entertainment budget during the pandemic, reallocated that to big ticket household items and durables, and that's now starting to roll over. The consumer's now switching back to out of home services, and that's being confirmed by the data based on personal consumption expenditures. Spending on consumer services remains below pandemic levels, so still recovering, while spending on goods remains above. And they're both in the early stages of mean reverting as consumers generally pulled forward a lot of their goods purchases. So, the data really confirms what Target said recently in their earnings call and their negative earnings announcement shortly thereafter. The consumer's reallocating dollars away from durables to pay for price increases on the grocery side of the store. And retailers are in the early stages of adjusting their inventories to keep pace with these volatile consumer trends, which have been difficult for them to predict and has then caused some issues for profit margins.

Chris Villalba:	So to sum that up, now, people are buying food and basics instead of durables and goods, and services is coming up on the horizon?
Volkan Gulen:	Yes.
Chris Villalba:	What's your process? How do you analyze these companies? Can you walk us through that?
Volkan Gulen:	Yeah. So, like I mentioned earlier, we always want to observe the macro situation, but we're not trying to project GDP or interest rates. And what we're really focused on is bottom-up, fundamental analysis. So, we're currently in a challenging environment and we really try to build in checks and balances into our process so we can preserve capital. From a behavioral standpoint, the three circle process is our guideposts. So, when we start to see yellow flags and red flags emerge, we're very focused on the momentum characteristics of our holdings and limit exposure to negative earnings revisions. in this environment. We take in as much empirical data as we can from the consumer and from our companies. We talk to our management teams of our companies, their competitors, their customers, their suppliers, and we try to confirm some of the empirical data that comes out with real anecdotal data points at the company level. That ends up being easier said than done. Just in the past week, I've talked to ten different companies spanning different sectors of the economy, and their commentary does not always align with the data. In many cases, today, stocks are starting to price in a recession where no weakness has been seen in the business yet. So, people are already anticipating things to roll over, and in many cases, the management teams haven't seen that weakness flow into their business. Within consumer, we're working hard to preserve capital by focusing on the companies with pricing power, the limited capital requirements, and that's really what drives attractive free cash flow yield valuations.
Chris Villalba:	Let's go back to prices and focus on inflation. It's definitely going to peak at some point. We all know that the Fed target is around 2%. But on the news, some economists are saying we're probably going to be around 4% for a while. What are your thoughts on this?
Volkan Gulen:	Inflation is not something we try to project. And I think case and point for that would be, you know, all the Fed economists were the experts, got it dead wrong. We have the benefit of hindsight, but ultimately predicting macro variables is very difficult. But we can look at it from a bottom-up standpoint., and if we just think of some of the biggest components--housing, energy, food-- you know, I guess we can set housing aside. Obviously, with mortgage rates going up, pressure will be to the downside balanced by limited inventory and the fact that no one wants to trade a 3% mortgage for a 6% mortgage. But that's unique to housing dynamics.
Chris Villalba:	Let's drill down on the impact of the energy situation on inflation. As I noted when we first sat down, we're heading into summer as gas prices are surging. I look at current events and geopolitics shows few signs that things will change. And it's pretty much conventional wisdom that 2% may not be achievable until the energy situation gets sorted out. What are your thoughts on this, Volkan?

Volkan Gulen:	Yeah, so I spent several years as the energy analyst here at Boston Partners through the last downturn in 2015, which was an energy specific downturn. And so, you know, we've got to talk about energy, I spent a lot of time in that sector. First off, on the supply side, we simply do not have enough barrels of oil in the world to meet current demand. We can't just turn on production with the flick of a switch. Bringing on new supply takes time, it takes capital, and it takes the willingness of companies to invest, which is low right now. So, the most likely path to bring oil prices lower is demand destruction, and unfortunately, that's a painful process. And always in collaboration with our current energy analysts and our materials analysts to get a high-level view of our sectors, looking back to 08/09, which is another energy downturn, higher gas prices will impact consumer spending behavior. We're in the early stages of watching this play out. The longer gas prices stay elevated, the more pronounced impact it will have on the consumer. Based on some of the survey data, a majority of low-income consumers are already cutting back on spending due to high gas prices. This will take time to flow through, and 2008 was a good analog for this type of behavior, solely on the gas prices impact on consumer spending.
Chris Villalba:	Let's talk about food for a second. You know, with everything that's going on with Russia and Ukraine, it's no surprise that there are food shortages coming down the pike. How will the U.S. consumers be impacted by all this moving forward.
Volkan Gulen:	On the food side, obviously, it's tough to see demand destruction in food, given the nature of the product. But the supply situation is not much better. Feedstocks for proteins, which includes soybeans and corn, remain structurally tight supply. Fertilizers, much of which comes from Russia, also remains limited, thereby keeping prices elevated for produce. So, food companies are already announcing second and third phases of pricing increases. The offsetting dynamic to that is going to be Wal-Mart had recently mentioned implicitly that there are a limit to some of the pricing increases. So, to the extent that the situation persists, the consumer will have no choice but to continue cutting back on discretionary purchases in order to save their dollars for more essential purposes like gas and food.
Chris Villalba:	During COVID, the consumer strengthened their balance sheet with the stimulus, but that is all gone away. Now prices are up, so they're going to start drawing down on their balance sheets and start eroding their savings. To what extent is that a concern?
Volkan Gulen:	One of the more concerning charts that I've come across is during periods of weak consumer sentiment, which we currently have, if consumer revolving spending growth accelerates, that's usually not a good combination. What that means is the consumer's not feeling good about their prospects, sentiment is low, and they're increasingly relying on their credit cards to drive their spending, which is generally not a sustainable activity. There's still some savings left, on average, which is still above pre-COVID levels. But another one of the things that's a little misleading is we have to look at real spending, not nominal spending. So, the nominal spending figures are growing. But when you look at real spending, adjusted for inflation and pricing increases, it's basically flattish. So, the consumer is relying more on their credit cards, and they don't feel good about their situation and their dollars are buying less goods.

Chris Villalba:	Sounds like you're seeing a lot of negativity out there. Is there more negative from this point going forward or what might change this?
Volkan Gulen:	In the spirit of connecting the data to what's happening on the ground, if you speak to some of the consumer credit bureaus who formulate the consumer credit scores, which we all use to take out loans, they acknowledge weakness in the housing market. So, we're seeing 30% declines in mortgage applications in response to higher rates. But in terms of personal loans, credit cards, auto loans, which are less sensitive to rates, those areas of the business remain healthy. So, the optimists would say that the excess savings and consumer debt to income levels will help the consumer navigate the current environment. But ultimately, the pessimists would highlight that weakness is already flowing through certain pockets and simply has yet to flow through some of these other categories within consumer lending. Overall, the balance sheets are much better positioned compared to 08/09. It's the consumer income statement, the P&L [profit and loss] that's getting squeezed because costs are growing faster than wages.
Chris Villalba:	Let's look at this through the Boston Partners three circle lens. You know, we focus on valuation, fundamentals, and momentum. Clearly, it looks like the momentum is negative based on your comments. What makes that shift and change?
Volkan Gulen:	From the Boston Partners perspective, three circles, the momentum is clearly negative. The catalyst to change the negative momentum is prices need to stabilize. That's why the recent CPI print was so problematic. We got worse inflation and we got very concerning consumer sentiment readings. It's really tough to spin those data points into a positive. From a bottom-up standpoint, these macro data points hit simultaneously when Walmart and Target reported earnings and highlighted a slowdown in spending and discretion items. So overall, we're seeing weakness in certain pockets of the low-end consumer, and the question now is will this spread to the overall consumer and other pockets of the economy. As we just highlighted, the balance sheets, wages, employment are all in pretty healthy areas to counteract some of these price increases. But ultimately, discretionary spending patterns likely will be pressured moving forward, which is the current trend. Unfortunately, employment is a lagging indicator and we have started to get some hiring freeze announcements from companies in the tech sector. So that will be an important area to monitor. More recently, we've started to get some layoff announcements within financials in the mortgage sector. So that will be another area to watch closely. Obviously, if jobs start moving in the wrong direction, that will also impact spending.
Chris Villalba:	So let's sum it up. Final answer, what's the insider takeaway for investors right now?

Volkan Gulen:	Overall, we're getting mixed signals on the state of the consumer, but the momentum is negative. Out-of-home services remain well positioned, but consumer discretionary goods are starting to roll over. The overall health of the consumer remains strong relative to history, but if inflation stays persistent, that will continue to negatively impact the low-end consumer, spread to the overall consumer, and the sentiment readings are starting to reflect this. The best consumer staple companies have pricing power and low capital requirements. Therefore, they mitigate the inflationary pressures. Some consumer discretionary management teams have confirmed weakness, but overall, many businesses still see few signs of recession. So, there are a lot of red flags out there. The consumer's hanging in there, and pretty resilient so far, but the sustainability of that resiliency is up for question.
Chris Villalba:	Volkan, thanks for your insights. Great having you on the show.
Volkan Gulen:	Thanks for having me.
Chris Villalba:	That was Boston Partners' equity analyst, Volkan Gulen, who covers the consumer sector. Once again, we thank him for the insights and also thank all of you, the consumers in our audience, for joining us. We look forward to having you back on future episodes of the show. For more investment related content from Boston Partners, check out our Entry Points video series, which can be found on our website, boston-partners.com, as well as on our LinkedIn page. I'm Chris Villalba. We'll see you next time with more Boston Partners Insights.

Christopher Villalba
Investor Relations

Mr. Villalba is a member of the Investor Relations team at Boston Partners and joined the firm in 2010. In this capacity, his responsibilities include sales and relationship management of Boston Partners products within financial intermediary channels. Prior to joining the firm, Mr. Villalba was a regional private banker with Wells Fargo Bank, N.A. Before that, Mr. Villalba held the role of investment associate at Morgan Stanley in the firm's Global Wealth Management division. He holds a B.B.A. degree in finance from Pace University and FINRA licenses series 7, 66, and 3. Mr. Villalba has fourteen years of industry-related experience.

Volkan Gulen
Equity Analyst

Mr. Gulen is an equity analyst with Boston Partners specializing in the consumer products, tobacco, agriculture, business services, media and advertising sectors of the equity market. He joined the firm from Fidelity Investments where he was a research analyst with coverage of the consumer sector with roles spanning equity and high yield securities. Mr. Gulen holds a B.B.A. degree in finance from the University of Massachusetts, Amherst. He holds the Chartered Financial Analyst® designation and has sixteen years of investment experience.

Terms and Definitions

Yield Curve: A yield curve is a line that plots yields (interest rates) of bonds having equal credit quality but differing maturity dates. The slope of the yield curve gives an idea of future interest rate changes and economic activity.

CPI (Consumer Price Index): The CPI is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services. Indexes are available for the U.S. and various geographic areas. Average price data for select utility, automotive fuel, and food items are also available.

Free Cash Flow Yield: A financial solvency ratio that compares the free cash flow per share a company is expected to earn against its market value per share. The ratio is calculated by taking the free cash flow per share divided by the current share price.

Disclosure

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