

A consumption bubble

The Consumer Discretionary sector **comprises the media, automobile, retail and luxury, consumer durables and, apparel, and hotel & leisure company segments. The common denominator, and, in this case, the common problem, is obviously the consumer.** Over the last couple of years, the global consumer (and more specifically, the Anglo-Saxon consumer) has been on fire because of **low real-interest rates and ever-rising house prices.** Coupled with a culture of debt and leverage and a financial system all too eager to provide this debt, this unsurprisingly resulted in a consumption bubble.

The flipside of a rising debt burden is obviously a **heightened sensitivity** (even on a national scale) **to rising interest rates;** this was the **first inkling of discomfort.** When rising food and commodity prices forced the Federal Reserve to finally abandon its low interest-rate policy, **the escalating house prices started to stabilise.** At the same time, **consumer purchasing power was severely clipped** by those same high energy prices. All this would, in itself, have been enough to herald a mild contraction in consumption patterns but then **Murphy's Law** reared its ugly head and the problems were hugely aggravated by the **crisis in the financial system.** The second side effect of a **debt mountain** is stress in the financial system. In this case, the stress was substantial, **leading to a credit crunch. We are clearly heading into a global recession that will put paid to any consumption growth aspirations.**

A different impact depending of the subsector or the company

The impact on the sector obviously varies a lot depending on the subsector and the specific company. Consumers first cut back on their travel and car expenses, for instance. As, coincidentally, **car manufacturing** is a very capital-intensive business with high fixed costs, the sector has been under pressure on the stock market. Many consumer-orientated companies' operational leverage is rather high. **Retail and cruise liners** are seeing a 5% bottom-line decline for every percentage-point top-line decline. As expected, retail sales suffered most in countries which witnessed a housing bubble and subsequent debt hangover. **Clothing retailers** like Next, Marks & Spencer and Inditex bore the brunt of the suffering, surpassed only by the woes of **white and brown goods retailers** like Dixons and Kesa. The **travel** business is obviously not immune to the trend and, while package holiday companies like Tui Travel and Thomas Cook have some cost flexibility – which cruise companies like Carnival lack – the stocks nevertheless went down in line with the sector.

Once the macroeconomic environment entered the picture, it was not only the frugal consumer that weighed on the sector: advertising is very important for media companies and many are planning drastic cuts over the coming quarters. This has hit not only **newspapers** (very dependent on housing and job ads) and **free-to-air TV stations,** but also magazine companies like Lagardère. **Advertising agencies** (WPP, Havas, Publicis) cannot escape the trend and are sharing their clients' pain. Business and leisure travel is being curtailed and **hotel chains** are seeing their revenue per available room (revpar) fall. Even the more defensive apparel companies like Adidas and Puma are being brought down by the negative sentiment.

Our investment decisions

Clearly, **Consumer Discretionary was not the best sector for investment. In our investment decisions, we first of all steered clear of companies with bad balance sheets and refinancing needs.** Some free-to-air TV stations and broadband companies (like Virgin Media), even the otherwise defensive satellite companies, are burdened by heavy debt loads. The same goes for retailers like DSGI and the Spanish hotel chains Sol Melia and NHH Hotels. Worst hit are the UK pub companies, whose massive debts make it impossible to reach a rock-bottom valuation and whose share prices have become almost worthless.

As the crisis deepened, we concentrated on the more defensive names: businesses with greater resilience and healthier balance sheets. In this respect, Vivendi stood out: almost half of its income is provided by telecom, the rest from more cyclical but very high-quality operations. Activision, for its part, is world leader in online games and their latest releases have been a resounding success. We also liked (and still do) Pearson, strong in education (school books, IQ testing, etc.) which, despite school funding worries, is still a stable business. Their subsidiary, Penguin, is world leader in the editing and publishing of pocket books which, again, is very much recession-proof. Emerging markets are a source of growth: India has more English-speaking inhabitants than the US and its balance sheet is among the best in the sector. At the other extreme, among the bigger cap companies, we find PPR Group, despite that company having some very strong brands such as FNAC, Gucci and La Redoute under its umbrella. PPR's balance sheet is extremely stretched and the only pillar of growth – the luxury activities segment, spearheaded by Gucci – is slowing down fast. Even at current depressed levels, we are giving PPR a wide berth for the moment.

Perspectives?

This begs the question, what's next? **Consumer deleveraging will take time and we don't foresee any near-term bottoming of the stock market.** Still, **some of the more exposed companies are nearing valuations that at least warrant closer investigation.** Some companies will certainly survive and do offer **excellent long-term potential.**

First to mind come the **better positioned luxury companies** like LVMH, Richemont and Swatch. We also see good long-term value in **some of the leisure companies**: Carnival Cruise is the bigger of the two cruise lines that dominate the industry. The same goes for the **better hotel chains** like Whitbread and Accor. **Travel agencies** like Thomas Cook and Tui Travel are also discounting fairly horrific outlooks. In **retail**, strong names like Inditex, H&M, Marks & Spencer and Kingfisher are here to stay. And finally, the better **advertising agencies** like Aegis and WPP offer deep value. Within the **car** sector, companies like Daimler and Volkswagen (we only recommend exposure to the preferred shares) will rebound strongly as they have product, brand name, distribution and balance sheet strength.

There is no shortage of excellent companies within the sector but, even at their low valuations, we prefer to wait for more tangible positives before committing ourselves further. It is better to leave the first 10% rally to the punters, as the upside in those quality companies will be long-lasting and substantial, but only when the macro environment stabilises. **Timing is everything and patience a virtue.**

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