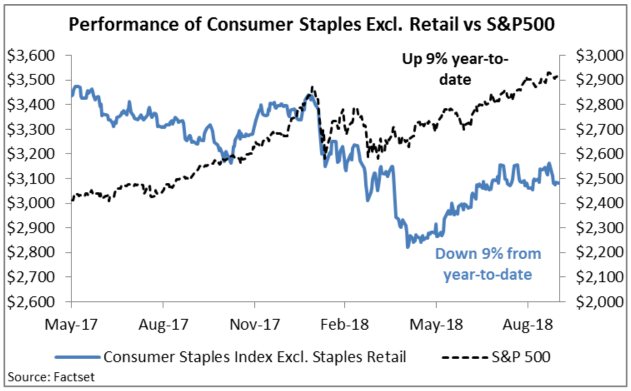
October 3, 2018

Consumer Staples Under Pressure

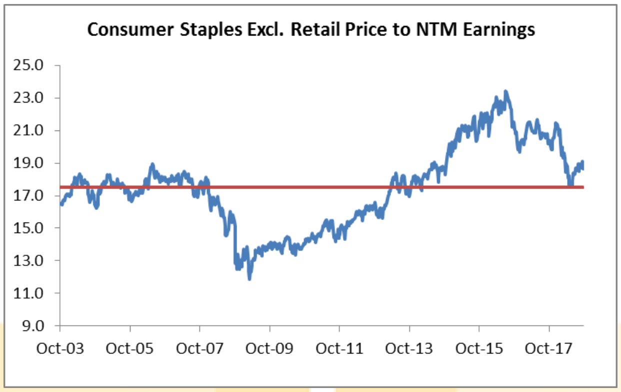


Shares of consumer staples companies are down 9% from the beginning of the year and have underperformed the broader market. The main reasons for the declines include investors favoring stocks in higher-growth sectors, sluggish sales growth, and more recently, higher expenses.

Investors Favor Growth in a Growing Economy - From 2008 to 2016, investors favored consumer staples companies because their dividend yields were attractive relative to yields on government bonds like the 10-year Treasury. This led to high valuations for consumer staples companies. When the Federal Reserve began raising interest rates and the economy started picking up steam, investors began selling consumer staples stocks and began buying stocks in faster-growing sectors like technology. Consumer staples companies traditionally underperform immediately following higher interest rates, but often outperform over the couple of years following higher interest rates as the economy heats up and investors become concerned the economy will slow. While it is difficult to predict when, we do believe consumer staples stocks will once again be viewed positively by investors.

Sales Challenges - Over the past couple years, many consumer staples companies have struggled to grow sales. These struggles worsened as companies focused too much on cutting costs and lowering advertising spending, and didn't spend enough on product innovation and merchandising. At the same time, consumers have gotten increasingly fickle in their purchasing decisions, and there is increased competition from store-branded products and smaller new entrants. Many companies have gone back to basics and are now focused on reviving sales growth. While we're starting to see signs of improvement in trends, progress is slow.

Cost Pressures - Consumer staples companies are facing increased headwinds from higher costs. Most recently, the higher costs are due to spikes in transportation and logistics costs, as well as higher input and packaging costs. These higher expenses come at a time when retailers are fighting hard against the threats of Amazon and as a result are placing increased demands on deliveries from consumer staples manufacturers. This adds to companies' cost pressures. Companies are working hard to offset these higher costs through efficiency initiatives, but we expect they will still pressure profit margins and earnings growth in the near term.



What Should Investors Do? - The combination of higher interest rates and slowing earnings growth has left consumer staples stocks out of favor with many investors. We believe valuations are reasonable, trading near long-term historical averages, and with many of our consumer staples stocks trading at the lowest levels in the last five years. While consumer staples companies face many headwinds in the near term, we believe the companies can return to growth longer-term. We would use pullbacks in our Buy-rated companies to add to positions where appropriate.

Brittany Weissman, CFA