Investing in the Consumer Discretionary Sector

CONSUMER DISCRETIONARY SECTOR REPORT

Companies mentioned in this report:

Retailing:

- Amazon (AMZN - Buy; $180.60)
- Home Depot (HD - Buy; $356.42)
- Lowe's (LOW - Buy; $217.76)
- Ross Stores (ROST - Buy; $138.22)
- TJX Companies (TJX - Buy; $125.50)
- Ulta Beauty (ULTA - Buy; $377.74)

Consumer Services:

- Starbucks (SBUX - Buy; $82.81)

Consumer Durables & Apparel:

- Nike (NKE - Buy; $57.39)
- VF Corp. (VFC - Buy; $11.11)

Other companies mentioned in this report:

Auto & Components:

- Ford (F- Hold; $9.78)
- General Motors (GM - Hold; $45.84)
- Tesla (TSLA - Hold; $250.74)

Source: Reuters. Prices and opinion ratings as of market close 4/23/25 and subject to change.

For more information:

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Sector Investment Summary

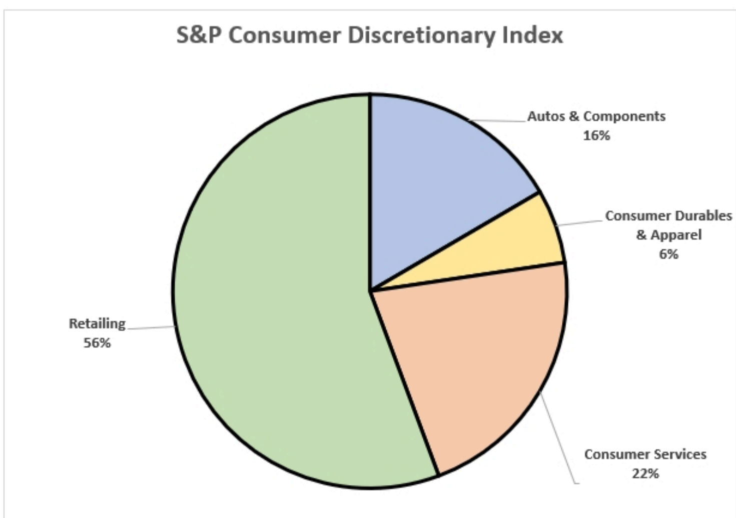
Consumers have returned to more normal shopping habits as the economy has moved past the pandemic, which caused significant growth in e-commerce sales and durable goods orders. While demand for goods should remain positive, we don't expect growth to be as strong as it was during the pandemic given the availability of services and the lack of massive government assistance. Consumers, broadly speaking, have remained in a healthy financial position. But savings rates are being pressured by high rates and the lingering effects of inflation. The pressure is causing some shift in spending toward more staple items and away from discretionary items.

We believe investors should focus on companies that have strong financial positions, that were gaining market share prior to the downturn, and that are rapidly investing in technology; to be leading the way in the changing consumer landscape. We would avoid companies that have high debt, that were struggling prior to the consumer slowdown, or ones that have limited ability to invest in and use technology.

How to Invest in the Consumer Discretionary Sector

Retailing is the largest subsector (**Figure 1**), and we would recommend first establishing a base of holdings within this larger subsector of retailing. Portfolio diversification can be improved by adding stocks in the Consumer Services (i.e., restaurants and leisure) and Durables & Apparel (i.e., homebuilding, apparel manufacturing) subsectors.

Figure 1.



The S&P 500 Index is based on the average performance of 500 widely held common stocks. The S&P Consumer Discretionary Index consists of 53 consumer discretionary companies within the S&P 500 Index. These are unmanaged indexes and cannot be invested in directly.

How to Invest in the Consumer Discretionary Sector

Retailing -- Since retailing accounts for 56% of the Consumer Discretionary Index, we will focus more of the report on this sector. We see three bigger themes continuing to play out for the foreseeable future:

1. Sales Shifting Online
Online sales currently account for over 10% of retail sales. Online has been growing at a fast pace annually over the past decade, but we believe the growth rate will slow over coming years. Online is still taking market share compared with sales in physical retail locations, so we expect this to continue to be a headwind for brick & mortar stores. We believe online sales growth rates will slow down over time, and we forecast that online sales will probably peak around 35%-40% of overall retail sales, partly limited by some categories that don't tend to be purchased online (building materials, gasoline, etc.).

The internet has been one of the most disruptive threats to retailers in many years. Since most internet-only retailers, like **Amazon,** don’t have brick-and-mortar locations with rent, mortgages or utility costs, they can offer cheaper prices and can compete at lower profitability levels. While we understand these threats, we believe most brick-and-mortar stores can stay competitive by developing an omnichannel presence.

2. Bankruptcies and Store Closings
The retail industry in the U.S. has too many retail stores, and despite the high number of bankruptcies over the past few years, we expect this trend will continue for the foreseeable future for several reasons.

First, for many years the retail industry within the U.S. has had too many stores, and the recent shift to more consumers buying products online is lessening the need for so much retailer square footage. Despite the high number of retail bankruptcies over the past few years, the U.S. still has more retail square footage per person than the next nearest country.

Second, there are still many retailers that are private and have high debt, and thus can't afford to make the necessary technology investments to be a strong retailer in today's world. Many banks or private-equity players used to be willing to step in and provide financing for struggling retailers, but over the past few years many are unwilling to provide financing due to all the headwinds facing the industry.

Third, we expect online sales to continue to outpace sales within physical store locations, which will put pressure on retailers to close additional stores. The impact is likely to have an acute impact on enclosed malls. We expect a continuation of mall closures as more sales shift online.

We believe the companies we follow all have solid financial and marketing positions and have fewer concerns around bankruptcy. While we haven't seen the companies we currently cover announcing mass store closings, we believe some of the more mature mass merchandisers, such as Walmart and Target, could close stores over the coming years, as online continues to gain as a percent of overall retail sales. With that being said, the companies we cover are all well-capitalized and have lower debt, so we don't expect any bankruptcy filings in the foreseeable future.

3. Increased Investments to Be an Omnichannel Retailer
Omnichannel retailers have websites that consumers can use from all types of devices, from cell phones to tablets and desktops. True omnichannel retailers have the ability to ship from one store or distribution center to another store for easy pickup.

Many retailers have been shifting their investments from opening new stores to investing in technology to become strong omnichannel retailers. Strong omnichannel retailers offer buy-online-pick-up-in-store, ship-from-store, curb-side pickup, and payment via mobile apps, offering a seamless transaction whether shopping in store, at your desktop, or from a mobile phone.

We believe retailers that have a wide variety of products online, seamless checkout, favorable product reviews, strong customer service in stores, and differentiated products will be successful over the longer term. It is our belief that the companies we follow have strong financial positions, which will afford them the ability to continue investing in technology and take market share.

We recommend the following companies within retailing: **Amazon (AMZN), Lowe's (LOW),** and **Ulta Beauty (ULTA)** are all on the Edward Jones Stock Focus List. **Home Depot (HD), Ross Stores (ROST),** and **TJX Companies (TJX)** are also both Buy-rated names within Consumer Discretionary.

Consumer Durables & Apparel

This subsector focuses on items ranging from apparel to homebuilding products as well as appliances. We only follow a few of the apparel and footwear companies within this space. We see several trends emerging within this industry:

1. Companies shifting investments to online

Many brands are shifting investment dollars away from opening stores and distribution centers and more towards branded websites. Since the companies receive the entire retail price and avoid the high cost of operating stores, sales on their own websites carry higher profits. As more consumers shift towards online shopping, we believe companies will continue to benefit from selling on their company-owned websites.

2. Brands lessening exposure to retailers

For many years, most branded consumer companies expanded into too many retail doors, as retail expansion within the U.S. grew rapidly from the late 1990s to 2007. Today, many brands are reducing exposure to retailers in general and pushing more products through select retailers, including online retailers and their own websites. Due to our expectations for the continued closure of retail doors and more sales moving online, we expect companies will continue to pursue this avenue of growth. We currently recommend **VF Corp. (VFC)** and **Nike (NKE)** within the consumer durables & apparel subsector.

Consumer Services

This subsector primarily consists of service companies focused on the consumer, such as restaurants, hotels, cruise lines and casinos. We only follow restaurants within this subsector, and we see similar themes as retailing. We expect the companies that are rapidly focusing on technology to increase consumer convenience will be the market-share gainers in this competitive industry. We also look favorably on companies that are constantly innovating with exciting new products to drive consumer interests. We recommend **Starbucks (SBUX)** within the consumer services subsector

Auto & Components

Until recently, this subsector represented only 3% of the overall consumer discretionary index. However, on December 18, 2020, Tesla (with a massive market capitalization of more than $800 billion) replaced Harley Davidson and boosted the subsector weighting to 14% of total sector market capitalization. The companies currently in this subsector are **Ford (F), General Motors (GM)**, Aptiv PLC, Borg Warner and **Tesla (TSLA)**. These companies tend to be some of the more cyclical companies within consumer discretionary, which means they should outperform coming out of economic downturns and will likely underperform when the economy is firing on all cylinders, as investors get nervous about the next economic slowdown.

Environmental, Social and Governance (ESG) Considerations

ESG concerns often revolve around two issues. One issue is the labor-intensive nature of retail. With the mass closure of retail doors over the past few years and the increases in the minimum wage, there have been more labor issues surrounding the retail industry. Another issue is privacy and data security. As more sales shift online, the risk surrounding the potential for privacy or data-security breaches only increases. We see most of our Buy-rated companies taking positive steps to address these concerns by raising wages and continuing to invest in technology to lessen potential threats around privacy and data security.

Challenges and Risks

1. Labor Market Issues

The labor market has been extremely challenging, as many people have left the labor force during the past few years due to COVID-19 and some have chosen to retire. The consumer discretionary industry is facing some of the largest challenges with hiring, and companies are seeing pressure on wage rates to attract candidates. We expect wage-rate pressure to remain for the foreseeable future.

2. Shifting Consumer Spending

Consumer spending during 2020-2021 shifted away from service to goods because of government stimulus, child tax-care credits, and COVID-19 lockdowns. Spending has since shifted back towards travel, leisure and entertainment over the past year or two, which negatively impacts demand for some goods. Elevated consumer spending could come under pressure given the higher-interest-rate environment and its effects on employment.

3. Higher Costs to Operate

Most companies are experiencing higher costs to operate their businesses across the board. While we expect that cost pressures experienced during 2021 will continue to ease as inflation cools, some cost pressures will remain, and it will depend on the companies' ability to offset the cost increases through higher prices or improved productivity.

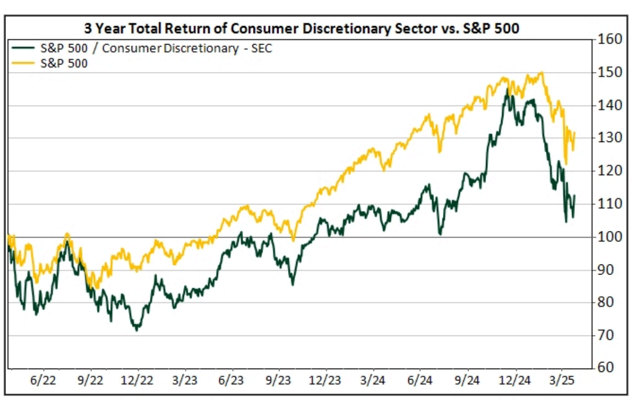
Valuation

Methods we use to evaluate the attractiveness of consumer discretionary stocks include traditional ratios such as price to earnings (P/E), PEGY ratios (P/E vs. estimated growth and dividend yield), and discounted cash flow (DCF) analysis, as well as other tools. **Please see your financial advisor and read the individual company research reports, which contain additional information on valuation and risks, to see which stocks are appropriate for you and are good values at their current price.**

Recent Sector Performance

The S&P Consumer Discretionary Index has underperformed the market over the past three years as a result of tariff policy uncertainty and concerns around pressures facing the consumer, especially at the low end of the income spectrum, over the next six to 12 months.

Figure 2



Source: FactSet. The S&P 500 Index is based on the average performance of 500 widely held stocks. The S&P Consumer Discretionary Index consists of 53 consumer discretionary companies within the S&P 500 Index. These are unmanaged indexes and cannot be invested in directly. Past performance is no guarantee of future results.

Please see the individual research reports for additional information, including disclosures, analyst certifications, valuation and risks specific to each company.

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