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Sector Views – Assessing the Resilience of the U.S. Consumer

The U.S. economy is primarily driven by consumers, who contribute to roughly 70% of its economic activity.[1] The combination of fiscal stimulus and robust wage growth resulted in a remarkable surge in consumer spending. With the easing of these two factors and high inflation rates, the once robust U.S. consumer is showing signs of strain.

The state of the U.S. consumer most directly impacts the Consumer Discretionary and Consumer Staples sectors. In this piece, we analyzed the health of the U.S. consumer and how to position U.S. sector portfolios within this economic backdrop.

Key Takeaways:

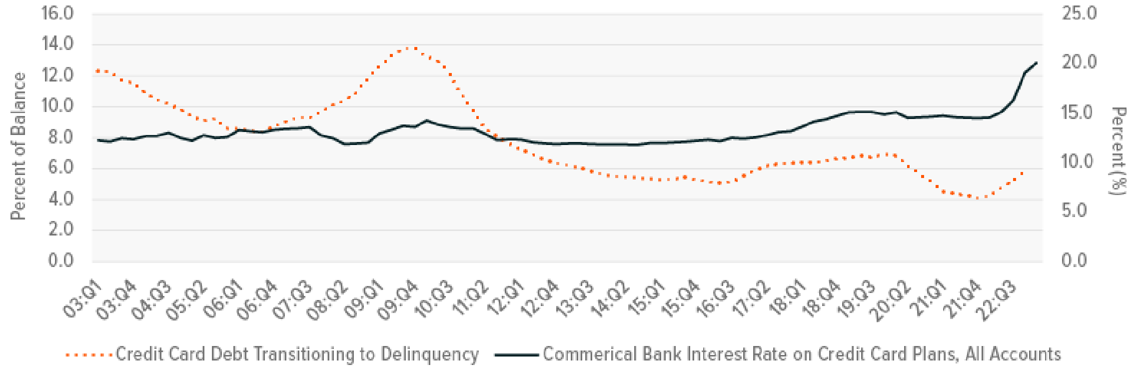
- The state of the U.S. consumer is deteriorating as personal debt levels rise, interest rates remain high, and inflation is elevated.
- In 2023, growthier areas of the market have shined, leading to outperformance in the Consumer Discretionary sector.
- We favor the defensive nature of the Consumer Staples sector as we transition from a late-stage market to an anticipated recession.

Health of the U.S. Consumer

U.S. consumer health has steadily declined over the last few quarters as elevated inflation and high interest rates weighed on savings. Over this period, savings rates deteriorated from over 30% at the peak of the pandemic, to 4.6%, significantly below pre-pandemic levels.[2] Spending increased and has remains slightly elevated.[3] Household debt has continued to rise, reaching $16.9 trillion at the end of 2022 with non-housing balances hitting a record $4.64 trillion.[4]

Credit card balances have surpassed the pre-pandemic high and stand at $986 billion, after declining to $770 billion in March of 2021.[5] At the same time, credit card interest rates have risen to 20.09%, its highest historical level.[6] This has led to a pickup in the credit card loan delinquencies, as seen below. If treasury rates remain higher for longer, we expect credit card rates to remain elevated, potentially increasing delinquencies as payments become larger and tougher to make.

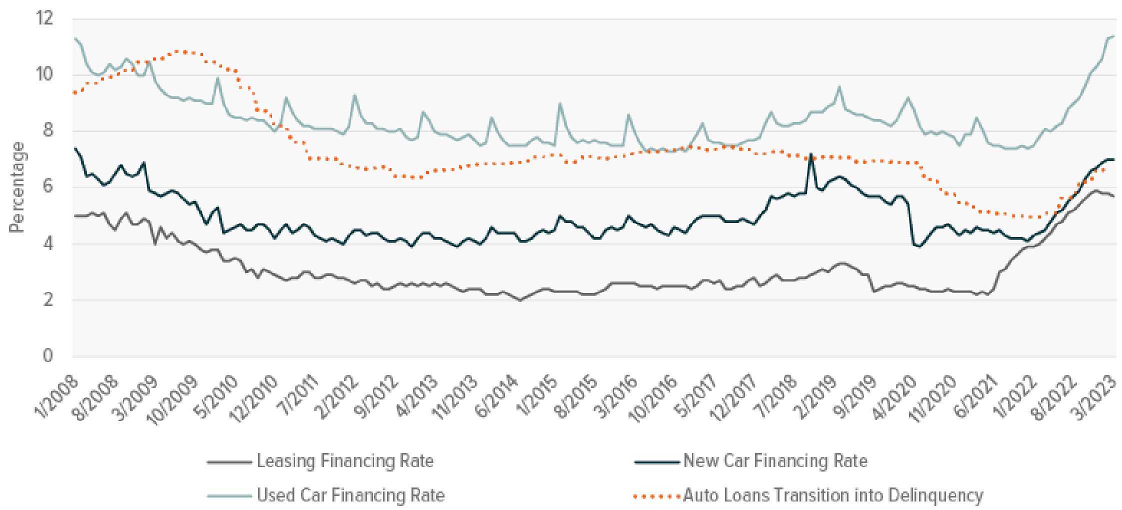
CREDIT CARD LOANS TRANSITIONING TO DELINQUENCY (30+ DAYS)
Source: NY Fed and St. Louis Fed data as of February 28, 2023



Total outstanding auto loans have also seen a surge, increasing nearly 15% over the past 2 years.[7] Interest rates on auto loans, regardless of the type, have grown to levels not seen since 2008. As of recently, similar to credit card loans, there has been a tick up in the percentage of auto loans entering delinquency, as seen below. While this increase in loans is something to be mindful of, most auto loans have fixed rates as opposed to credit card variable rates, therefore the increase in interest rates affects current auto loans more than it would for legacy loans locked in at lower rates. Furthermore, auto demand has weakened, indicating that consumers may have already begun to shift purchasing patterns.

AUTO LOAN FINANCING AND LOAN DELINQUENCIES (30+ DAYS)

Source: NY Fed and Edmunds.com data as of March 1, 2023



The rising delinquencies indicate that there are cracks forming. Consumers are facing increasing pressures. We expect delinquencies to rise as the ability to pay these large sums of debt becomes more difficult due to slowing wage growth, limited savings, and still high inflation.

Consumer Sectors – Tale of Two Stories

The impact of higher interest rates has begun to have an effect – starting with the collapse of Silicon Valley Bank and Signature Bank. Despite this, markets have rallied, with the S&P 500 up 7.5%.[8] As with many of the previous late-stage cycles, growthier market segments have outperformed. This year's rally has been driven by the hopes that the Fed rate hiking cycle is nearing an end.

The Consumer Discretionary sector benefitted from the rally within growth stocks, outperforming the S&P 500 by about 6.5%.[9] The sector's auto exposure has rebounded significantly this year after tumbling in 2022. On the other side, the Consumer Staples sector has underperformed the S&P 500 by about 5.8%.[10] The sector tilts toward value, which has been out of favor.

Positioning in the Current Environment

Markets have shifted the prioritization between interest rate sensitivity and economic growth sensitivity. As we shift from late cycle to recession, we favor the defensive nature of Consumer Staples over the cyclicality of Consumer Discretionary. Historically, in recessionary periods, the stability and defensive nature of the Consumer Staples sector outperformed. This was the case in both 2008 and Q4 2018.[11]

The tightness of the labor market remains at the crux of the consumer's strength. With renewed focus on corporate efficiency and the rise in corporate bankruptcies, layoffs are on the rise.[12] Continuing jobless claims remain low but are on an increasing trend.[13] If unemployment continues to increase, this can create a more challenging environment for an already stretched consumer. Couple this with the likely resurgence of student loan payments later this year, the consumer would be forced to redistribute its spending. Spending would likely be limited to essentials, favoring Consumer Staples.

Despite the decline in consumer health, recent signs could point toward peak pessimism. Inflation has been steadily declining, as evidenced by the March CPI and PPI releases.[14] The labor market remains tight, with more job openings than workers.[15] If consumers are able to weather the tide, they could be better positioned than current expectations.

As illustrated in the chart below, certain sectors have historically been more sensitive to slower economic growth during the four U.S. recessions since 1990. Our sector views table below provides more detail on sector positioning.

AVERAGE RETURN ON KEY S&P 500 SECTORS IN EXCESS OF THE RETURN ON THE S&P 500

Recessionary periods since 1990

Source: Bloomberg data as of April 27, 2023

CURRENT VIEWS ON U.S. SECTORS

	Positive Factors	Negative Factors	Overall View
Communication Services	Reasonably positive trends in subscription services, including streaming, benefit the sector. The development of augmented reality and the Metaverse may provide positive benefits in the long run.	The privacy overhang from major hardware providers could impact revenues for interactive media companies. Slower advertising spending remains a drag on social media earnings.	**Underweight**
Consumer Discretionary	Ecommerce remains resilient despite declining consumer spending.	Highly cyclical. Typically lags the broader market during the recessionary phase.	**Underweight**

		Wage pressure combined with higher input costs in materials are a risk to margins, especially if companies are unable to increase sales prices.	
Consumer Staples	Demand for consumer staples could remain steady, especially in the event of a deeper economic contraction. Could benefit from consumers trading down.	Performs well during the recession but is likely to lag in the recovery phase.	**Overweight**
Energy	Escalated tensions with Russia and greater natural gas demand from Europe could keep energy prices elevated globally. OPEC+ production cuts and a delayed supply response in terms of drilling could keep energy markets tight and prices high. Large, diversified oil and gas companies ramped up buybacks along with record profits and healthy balance sheets.	A global economic contraction could weigh on demand.	**Market Weight**
Financials	Attractive valuations. Large financial institutions may benefit from the challenges that are currently facing regional banks.	A deeper economic contraction could slow lending growth and increase credit risk. A flattening or inversion of the yield curve will likely hurt margins. Pressure within the commercial real estate market could have negative spillover effects within the banking system.	**Market Weight**
Health Care	Aging demographics around the world combined with the growing middle class in emerging markets benefit health care demand.	Drug pricing pressure remains a risk factor. Senate proposals to grant Medicare powers to negotiate prices on certain	**Overweight**

	Health Care is a defensive sector that typically outperforms during severe economic downturns.	drugs could limit price increases on medicines.[16]	
Industrials	Reshoring and a shift toward automation infrastructure spending will likely be a long-term benefit for Robotics & AI. An increase in U.S. public construction spending from fiscal packages could boost demand for tools and machinery for the foreseeable future.	Elevated leverage, increasingly expensive valuations, and rising earnings volatility may detract from performance. High labor costs could pressure margins, particularly in the transport industry.	**Market Weight**
Information Technology	The sector displays quality factors and positive free cash flow growth. The increased adoption of cloud computing, cybersecurity, and cleantech are likely to remain in a post-COVID-19 world as societies adapt to these key disruptive technologies. Beneficiary of secular themes related to onshoring, automation & CapEx.	Increased regulatory scrutiny is a risk, and there is bipartisan support for increased regulation in this space.	**Market Weight**
Materials	Could benefit from China's economic reopening as well as infrastructure and CapEx spending. Increased focus on electric vehicle adoption, alternative energy sources, and energy storage may benefit disruptive materials such as lithium, copper, and battery producers.	A deeper economic contraction could be a big headwind. Increased regulations, especially those focused on preventing climate change, is a potential negative.	**Market Weight**
Real Estate	The sector can offer inflation-protected yield.	Typically underperforms during recessions. Adversely impacted by rising real interest rates.	**Market Weight**

Utilities	A preferred defensive sector in recessionary environments due to the inelasticity of goods and services. Adoption of renewables could help transform the sector over the long run.	The potential for increased climate-related regulations over time may detract from this sector's appeal. Companies may not be able to pass through higher inflation-related costs due to government regulations.	**Market Weight**

Footnotes

[1] St Louis FED, Share of gross domestic product: Personal consumption expenditures, Q1 2023.
[2] St Louis FED, Personal Savings Rate, March 2023.
[3] Trading Economics, United States Consumer Spending, April 2023.
[4] Federal Reserve Bank of NY, Household Debt and Credit Report, Q4 2022.
[5] Federal Reserve Bank of NY, Household Debt and Credit Report, Q4 2022.
[6] St. Louis FED, Commercial Bank Interest Rate on Credit Card Plans, Feb 2023.
[7] Federal Reserve Bank of NY, Household Debt and Credit Report, Q4 2022.
[8] Fidelity data as of 4/20/2023.
[9] Fidelity data as of 4/20/2023.
[10] Fidelity data as of 4/20/2023.
[11] Morningstar, XLP and XLY, representing the Consumer Staples and Consumer Discretionary sectors, respectively.
[12] Bloomberg, A Corporate Credit Crunch is Just Getting Started, April 21, 2023.
[13] St Louis FED, Continued Claims (Insured Unemployment), April 15, 2023.
[14] Trading Economics, United States Consumer Price Index (CPI), April 12, 2023.
[15] Number Nomics, Job Openings, March 8, 2023.
[16] CNBC, 'Once-in-a-generation' Prescription Drug Pricing Reform Could be Coming, July 29, 2022.

Definitions

Capital Expenditures (CapEx): Funds used by a company to acquire, update, and maintain physical assets such as buildings, technology, and equipment; often used to undertake new investments/projects.

Consumer price inflation (CPI): CPI measures the average change in prices that consumers pay for a defined basket of goods and services.

Producer Price Index (PPI): The index measures the change in the price of goods as they leave their place of production.

S&P 500 Total Return Index: The index includes 500 leading U.S. companies and captures approximately 80% coverage of available market capitalization.