DECEMBER 2022— Karin Braack Cannon, CFA, CIPM, Junior Product Specialist and Junior Research Analyst

The Light at the End of the Tunnel

As we highlighted in our equity quarterly, much of the negative performance realized in equity markets during the first half of the year was due to multiple compression. However, we see the risk narrative shifting to earnings over the next several quarters as more persistent inflation, higher-for-longer rates, currency-related headwinds, and smoldering geopolitical risks have significantly raised the risk of recession globally.

Against the weakening macro backdrop, investors have sought out “safe harbor” areas of the market to weather the storm. Since August, however, we have seen broad-based downgrades across sectors, save Energy and Utilities, suggesting even traditionally defensive plays are not immune to the one-two punch of inflation and higher rates. There is a growing list of high profile names that have come under pressure following disappointing earnings, or perhaps more importantly guidance cuts, including Heineken (softening demand in Europe), Reckitt Benckiser (weakness in more discretionary categories), and L’Oreal (China impact).

In this environment, it is crucial to understand exactly what risks you are taking within your portfolio; when you run towards the light at the end the tunnel, you want to make sure it’s not the headlight of an oncoming train. A more granular assessment of category, geographic, and company-specific risks may be required to identify categories or names with the lowest risk of earnings downgrades and/or negative earnings surprise.

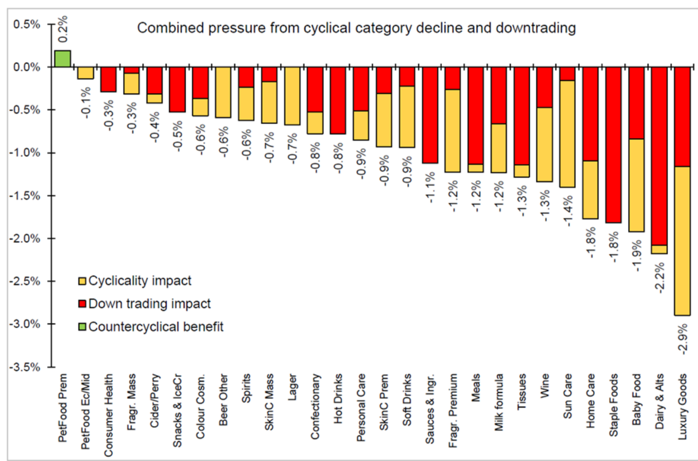
Even within Consumer Staples, traditionally one of the most defensive areas in the market, not all categories are created equal. Cyclicality can vary greatly within the sector, as can the risk of downtrading[1]. Geographic exposure can further complicate the picture, with some categories more or less resilient in developed versus emerging economies.

Figure 1 details the theoretical combined impact from cyclicality and down trading by category at the global aggregate level (combining developed and emerging markets). What is perhaps most interesting is very few categories offer dual protection. In fact, there tends to be an inverse relationship between cyclicality and downtrading. Staple Foods, for example, tend to be very recession proof, but consumers frequently switch to cheaper brands or private label as they look to cut costs. Conversely, sun care products tend to be very cyclical but few consumers are willing to switch brands.

Geographic exposure matters as well. Surprisingly, infant milk formula has a fairly high level of cyclicality, but the cyclicality is due almost entirely to emerging markets whereas demand in developed markets is very stable. Even within developed markets, down trade risk across many categories is higher in Europe than the US as private label penetration is much higher (particularly in Germany and the UK where discount food retailers have higher market share).

The takeaway from this research is that, while it is impossible to avoid all negative surprises, better fundamental insights in category and geographic exposures and sensible end market diversification constitute an important risk management tool in this kind of macro environment.

Figure 1:



Source: Bernstein “Global Consumer Goods: Recession and Down Trading. Who Is Most at Risk? A Global Framework” August 2022

[1] The practice of a consumer switching from expensive brands to cheaper alternatives.

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