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# TRIVARIATE RESEARCH

## INVESTING IN THE US CONSUMER

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## SUMMARY AND CONCLUSIONS

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Our consumer activity gauge leads us to believe the US consumer remains in solid shape. However, investors have been concerned about a modest softening in retail sales from May's peak and now likely will question a softer-than-expected August jobs report. With August consumer earnings showing more large beats than misses, but also some stock volatility following the earnings reports, many investors have been asking about the consumer playbook from back-to-school through year-end

- **Consumer activity is positive:** We have a proprietary consumer activity gauge that contains several metrics, such as retail sales, consumer confidence, jobs, wages, etc. The gauge continues to show positive and increasing consumer activity
- **Increase gross and net exposure to discretionary:** Our discretionary quantitative model generates materially stronger performance when consumer activity is positive and increasing, leading us to advise higher gross exposure today. Moreover, all industries within consumer discretionary outperform during periods where consumer activity is increasing (except autos), leading us to recommend a high net exposure as well. Only 16% of discretionary stocks have seen relative multiple expansion this year, despite the consumer strength, and relatively few of the big consumer drawdowns occurred during a regime of increasing consumer activity, bolstering our confidence to increase exposure
- **Staples are more idiosyncratic than discretionary:** Despite conventional wisdom, staples have beaten discretionary on a beta-adjusted basis over the long-term and the median stock has more idiosyncratic risk. With a far greater percentage lagging the market by 20% or more than leading, we think staples is a rich area to look for short ideas

## TWO INVESTMENT STRATEGIES FOR CONSUMER STOCKS

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1. **Investment Strategy #1:** Long quality reopening, short junk work from home. Since the beginning of the pandemic:

- Quality reopening stocks have barely outperformed junk reopening stocks
- Junk work from home stocks have still strongly outperformed quality reopening stocks

As the recovery continues, we see a high probability that quality outperforms junk, and reopening outperforms work from home. Hence, our recommendation is to:

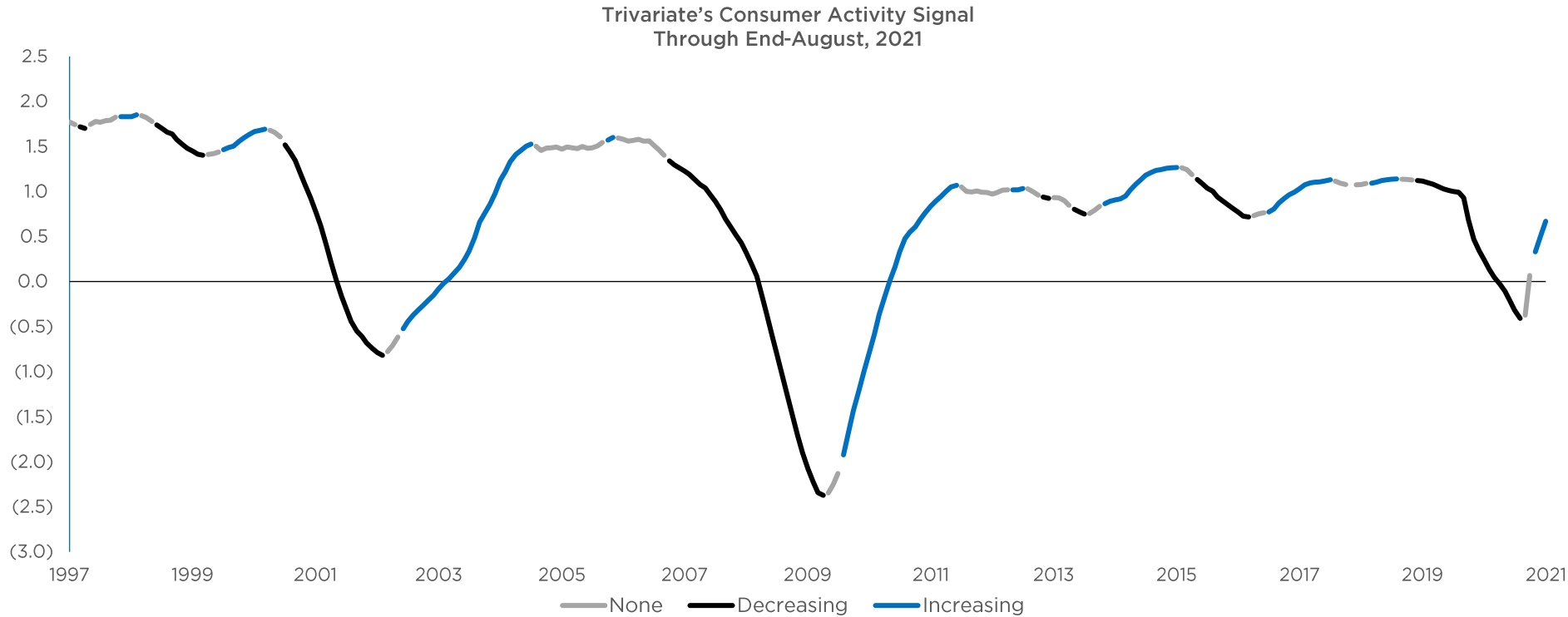
- **Long:** Quality stocks with high correlation to our “reopening” basket (stocks on page 15)
- **Short:** “Junk” stocks with high correlation to our “work from home” basket

2. **Investment strategy #2:** We like a consumer barbell:

- **Long:** Consumer services with suppressed profitability that likely recover as reopening continues and demand for services grow. Since services now trade like junk stocks, multiple expansion is likely as balance sheets improve over the coming cycle
- **Long:** Select retailers given we want to run with higher-than-normal net exposure
- **Short:** Highly idiosyncratic staples, given company-specific risk is higher for staples than discretionary and there are many names lagging the market by 20% or more. We can see the logic of being long a staples ETF (to capture long-term above average performance) and short some high company-specific risk staples names given the fact pattern
- **Short:** Durables that appear to trade like growth stocks with record momentum, and are likely over-earning (stocks on page 16)

# OUR CONSUMER ACTIVITY GAUGE IS POSITIVE AND INCREASING

Our consumer activity gauge contains metrics like 90-day credit card delinquencies, retail sales, consumer confidence, wage growth, unemployment data, and several other metrics. While consumer activity was decreasing for much of 2020, it has rebounded sharply off the bottom. Today, our signals show a positive and increasing consumer overall



## THE US CONSUMER IS STRONG BUT THERE IS FEAR OF A SOFTENING

On the positive side, labor trends have generally been positive despite today's softer-than-expected report, credit card delinquencies are at all-time low, and consumer confidence and retail sales are at the 99<sup>th</sup> percentile levels vs. history. On the flip side, the year-over-year growth in retail sales did peak in May, and while hourly earnings are relatively strong, the Atlanta Wage growth tracker is only slightly above longer-term averages. Personal income growth has also been weak

### Consumer Activity Signals As of End-August, 2021

Consumer Activity Component	August 2021 Value	Percentile vs. Long-Term History
ADP Payrolls (YoY%)	4.6%	99%
US Hourly Earnings Growth (6-Month MA)	4.0%	93%
US Consumer Confidence (YoY%)	40.8%	96%
US Credit Cards 90+ Days Delinquency Rate	0.38	0%
Non-Farm Payrolls (YoY%)	5.2%	99%
US Personal Income (YoY% Change)	2.7%	13%
US Retail Sales	15.8%	99%
Atlanta Fed Wage Growth Tracker	3.7	56%

## RECENT EARNINGS HAVE SHOWN UPSIDE, BUT WITH SOME BLOWUPS

69 out of 88 consumer stocks reporting in August beat earnings expectations, with notable strength in the lower-end consumer stocks like WMT, TJX, and ROST, among others. There were some double-digit earnings misses however (DASH, PTON, BKNG), and others where the beats disappointed investors as expectations were for stronger performance and guidance (i.e. JWN)

August Earnings  
Mega and Large Cap. Consumer Stocks  
As of August 30, 2021

Ticker	Company Name	Industry Group	Market Cap. (\$ US Bil.)	Estimate	Actual	Surprise	Forward 3d Return (Relative to SPX)
WMT	Walmart Inc.	Food & Staples Retailing	422.42	1.57	1.78	13.7%	1.2%
HD	The Home Depot, Inc.	Retailing	356.24	4.42	4.53	2.4%	(2.0%)
LOW	Lowe's Companies, Inc.	Retailing	128.31	4.01	4.25	5.9%	14.4%
TGT	Target Corporation	Retailing	125.98	3.48	3.64	4.7%	(0.4%)
EL	The Estée Lauder Companies Inc.	Household & Personal Products	115.67	0.51	0.78	54.2%	3.6%
ABNB	Airbnb, Inc.	Consumer Services	91.95	(0.36)	(0.11)	69.3%	(4.5%)
BKNG	Booking Holdings Inc.	Consumer Services	85.64	(2.10)	(2.55)	(21.4%)	2.8%
GM	General Motors Company	Automobiles & Components	83.96	2.08	1.97	(5.2%)	(5.2%)
TJX	The TJX Companies, Inc.	Retailing	83.43	0.57	0.80	39.7%	7.2%
DASH	DoorDash, Inc.	Retailing	61.33	0.09	(0.22)	(349.7%)	(1.0%)
DG	Dollar General Corporation	Retailing	55.45	2.61	2.69	3.2%	(4.7%)
MNST	Monster Beverage Corporation	Food, Beverage & Tobacco	48.63	0.68	0.75	10.8%	7.2%
KHC	The Kraft Heinz Company	Food, Beverage & Tobacco	47.63	0.72	0.78	7.9%	(4.8%)
MAR	Marriott International, Inc.	Consumer Services	47.18	0.47	0.79	69.2%	(3.1%)
EBAY	eBay Inc.	Retailing	46.34	0.95	0.99	4.8%	9.9%
ROST	Ross Stores, Inc.	Retailing	45.20	0.95	1.39	45.7%	(4.0%)
SYT	Sysco Corporation	Food & Staples Retailing	37.58	0.60	0.71	17.5%	6.6%
PTON	Peloton Interactive, Inc.	Consumer Durables & Apparel	34.24	(0.39)	(0.92)	(139.8%)	(13.4%)
JWN	Nordstrom, Inc.	Retailing	6.01	0.27	0.49	84.9%	(23.2%)
M	Macy's, Inc.	Retailing	5.64	0.20	1.29	558.2%	22.6%

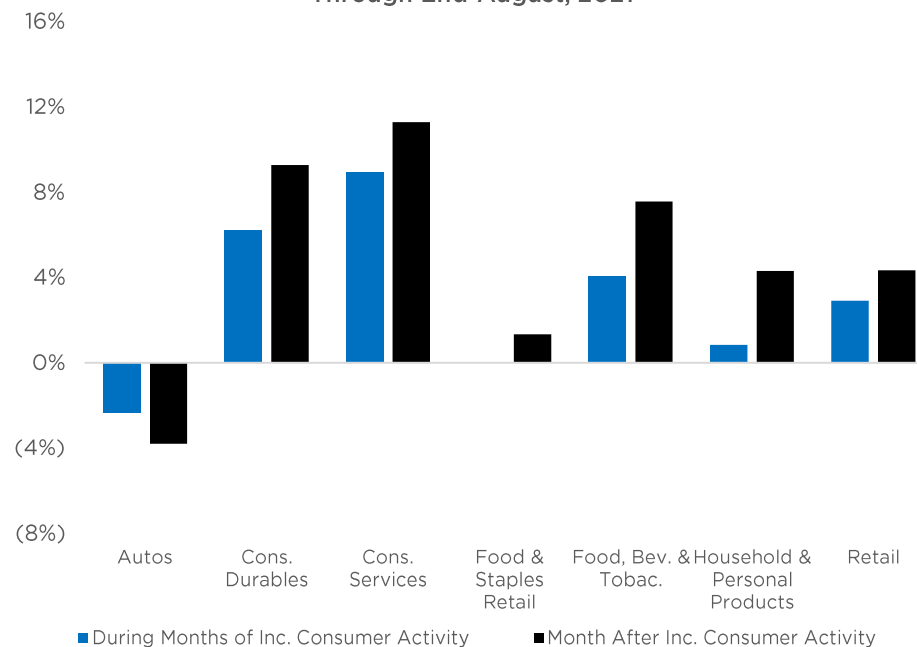
## GROSSING AND NETTING UP DISCRETIONARY IS PRUDENT

Our quantitative model that forecasts returns for discretionary stocks performs better when our consumer activity gauge is increasing, with a higher top vs. bottom quintile spread and hit rate (left chart) that when consumer activity is not increasing. Grossing up exposure to discretionary stocks is therefore prudent. We also analyzed the performance of each of the consumer discretionary industries when our consumer activity gauge is increasing and found that relative performance is strong for all industries except autos (right chart). We saw little reversal in the subsequent month, bolstering our confidence to make a higher net exposure recommendation as well

Performance of Consumer Discretionary Model  
When Consumer Activity Is Positive and Increasing  
Through End-August, 2021

Stat	Consumer Activity Positive and Increasing	Consumer Activity Not Positive and Increasing	Difference
Hit Rate	75.5%	56.4%	19.1%
Weighted IR	1.82	0.80	1.01
Weighted Mean	19.0%	9.3%	9.7%
Weighted Median	21.8%	13.3%	8.5%

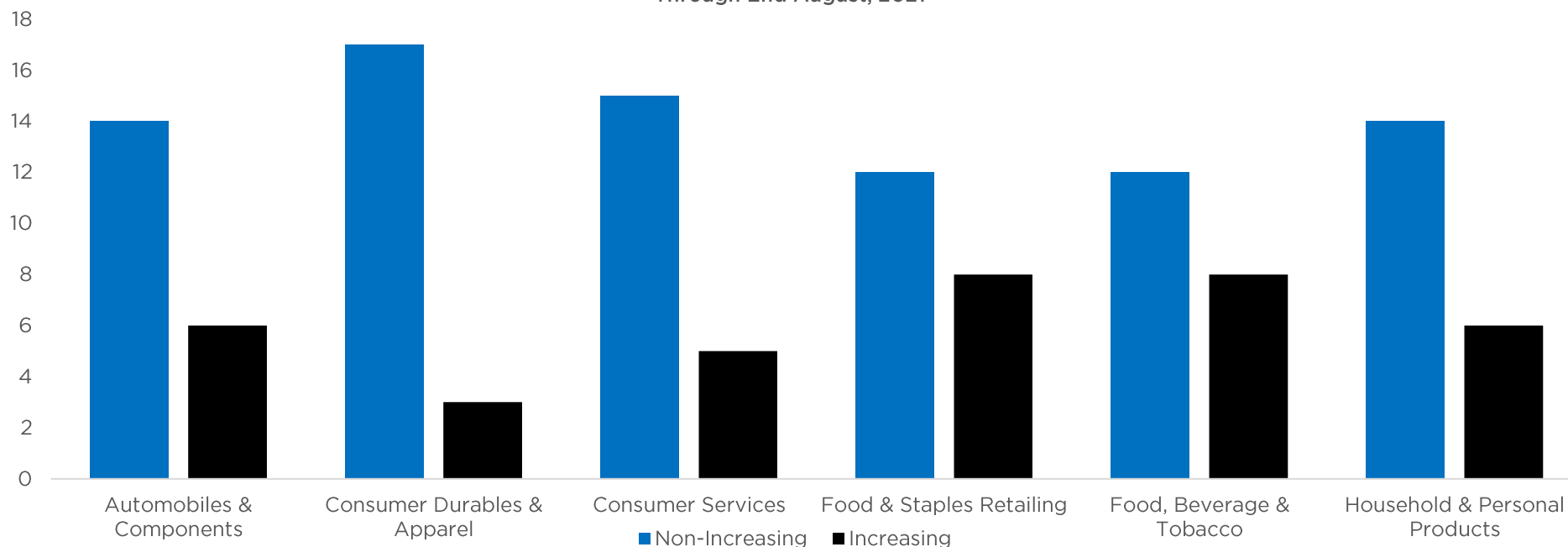
CAGR of Index-Relative Monthly Returns  
Increasing Consumer Activity  
Through End-August, 2021



## WHAT IF WE ARE WE LATE?

We evaluated the worst 20 months of consumer industry performance in the last 12 years to see if these drawdowns more frequently occurred during or right after periods of increasing consumer activity. Given that we may not know when the consumer has peaked until a couple of months after, we do not want to “ride it over the edge” and recommend a high net and gross just as things soften. We are heartened by the fact that consumer industries typically have their worst relative performance when consumer activity is not increasing

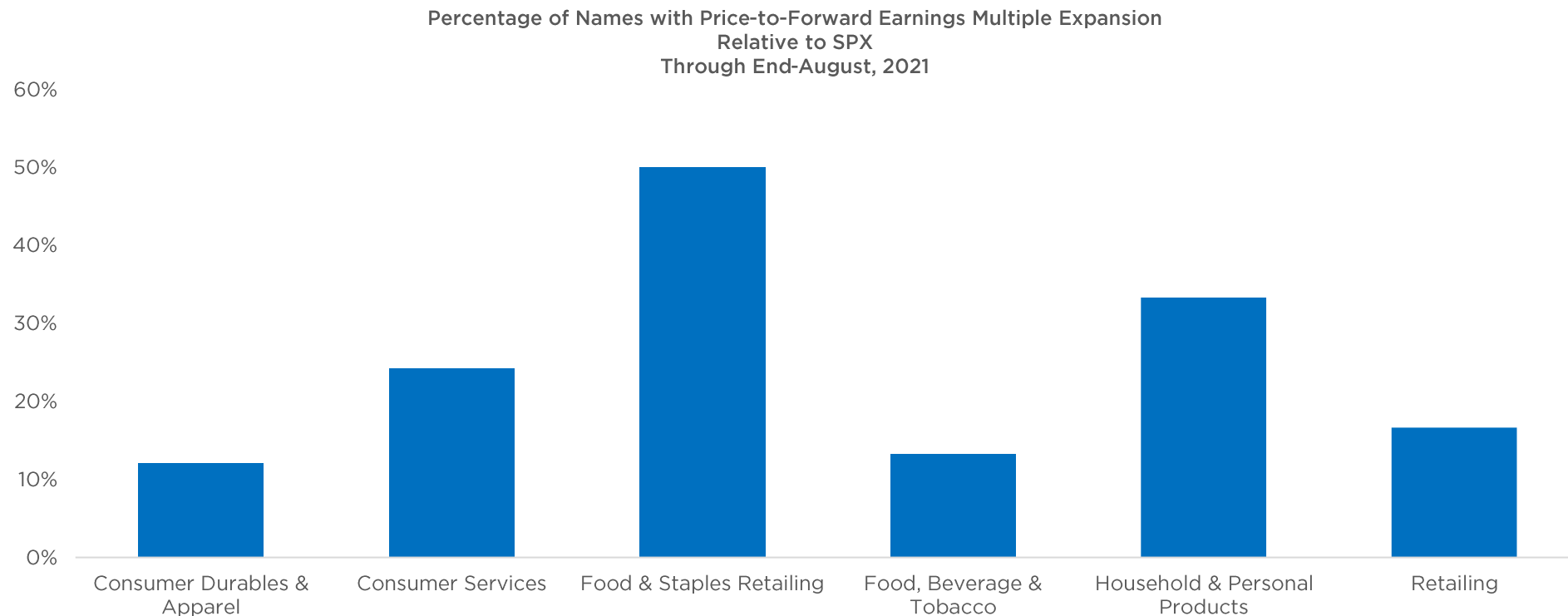
Count of Worst 20 Months by Index-Relative Return  
When Consumer Activity Increasing vs. Not Increasing  
Through End-August, 2021





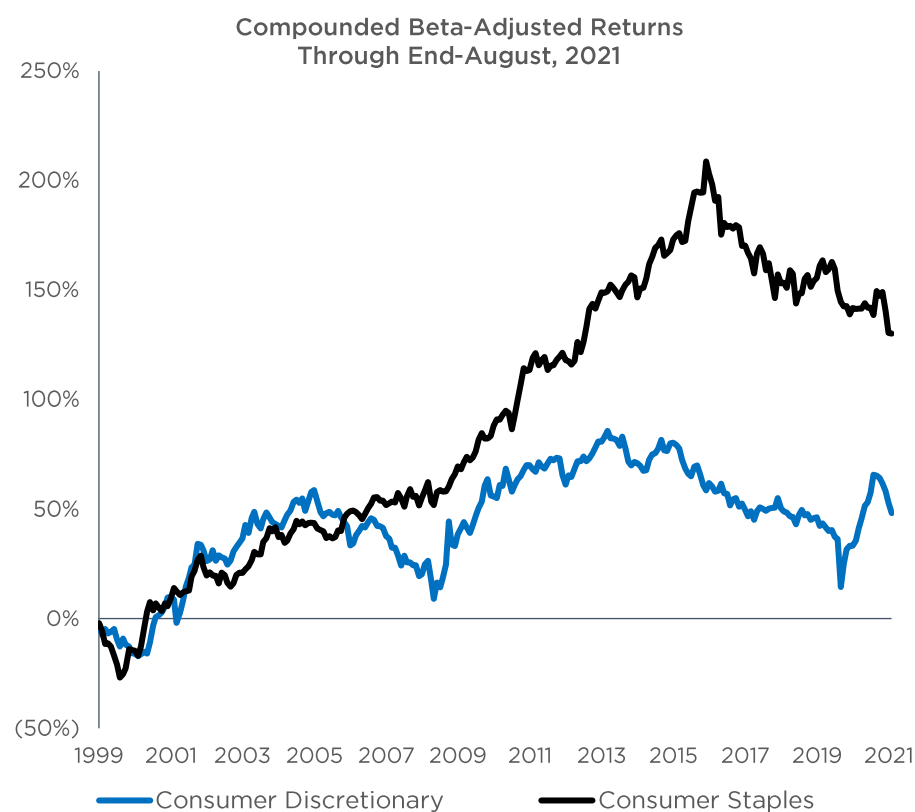
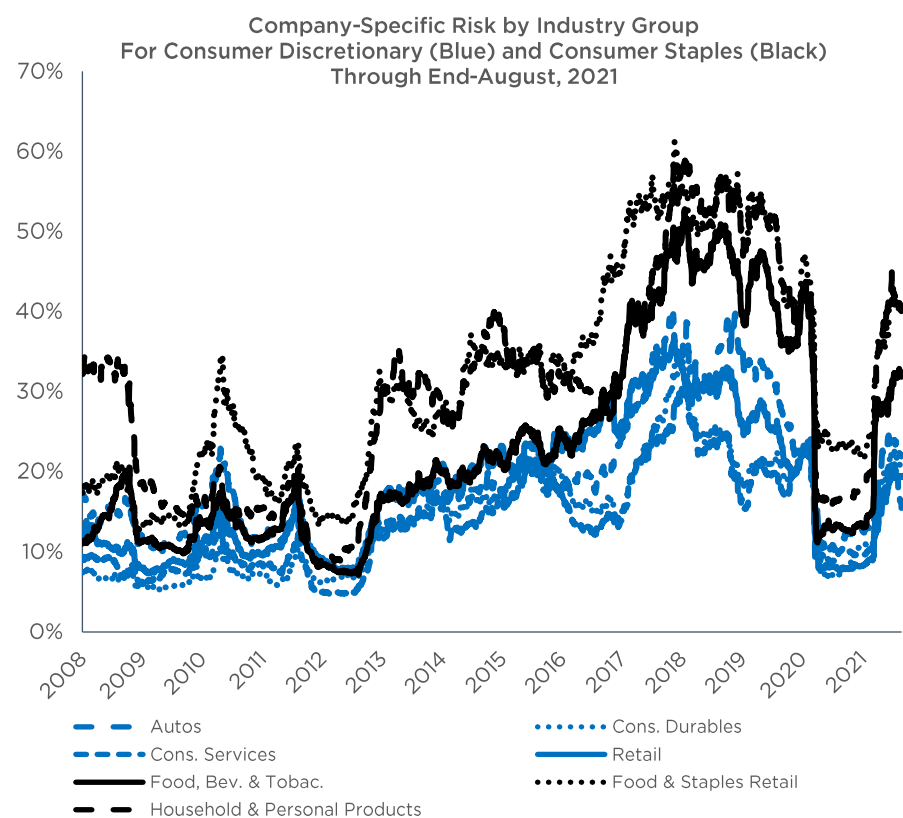
## WE HAVE SEEN LITTLE RELATIVE MULTIPLE EXPANSION SO FAR

An additional reason to be bullish on consumer stocks is relative valuation. Way less than half the consumer stocks have seen relative-to-SP500 price-to-forward earnings multiple expansion this year, despite the obvious consumer strength. About half of the food and staples retailers have seen relative multiple expansion, but relatively few consumer services, retail, food, beverages & tobacco, or durables have, meaning in general investors have not bid up consumer stocks despite their fundamental strength



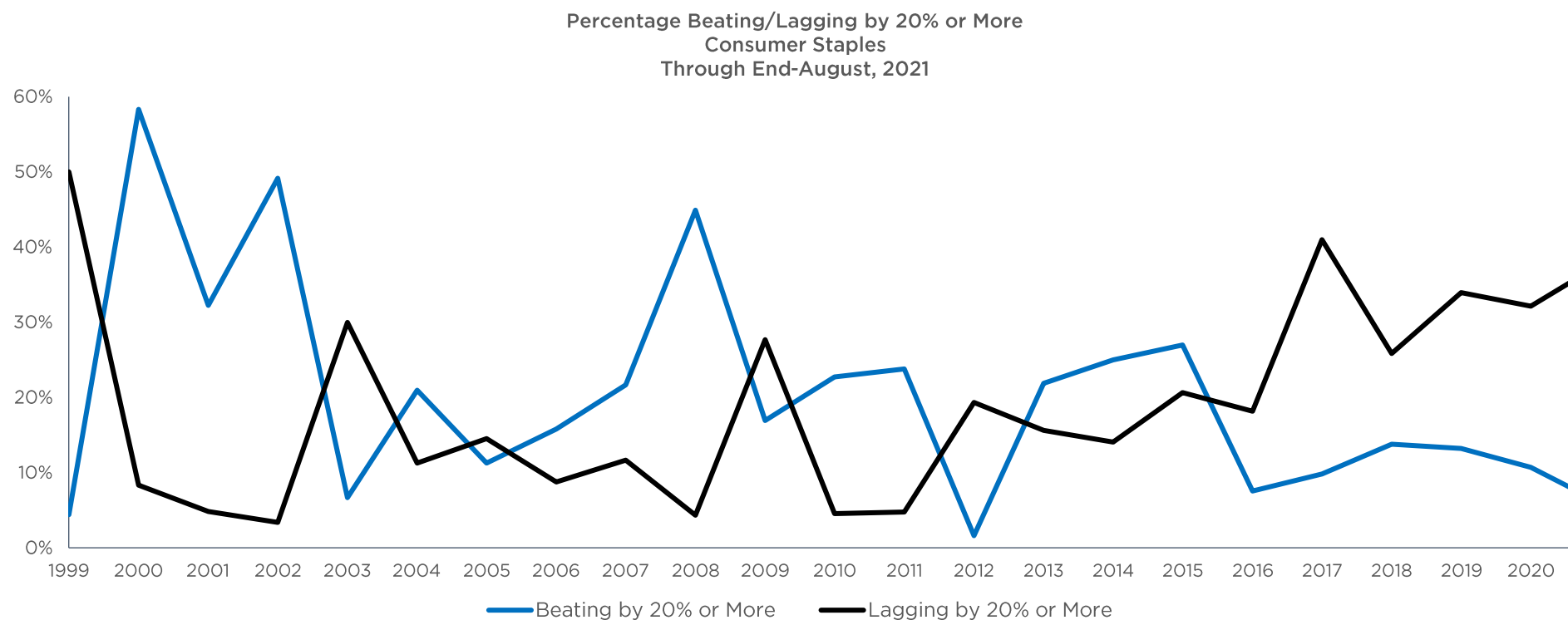
# STAPLES ARE MORE IDIOSYNCRATIC AND HAVE HAD HIGHER ALPHA...

Conventional wisdom is that staples are more macro and discretionary stocks are more idiosyncratic among consumer analysts. However, (left chart) food, beverage & tobacco, and household and personal products tend to have more company-specific risk than retail, durables and consumer services. Since the TMT bubble, staples have also strongly beaten discretionary on a beta-adjusted basis (right chart)



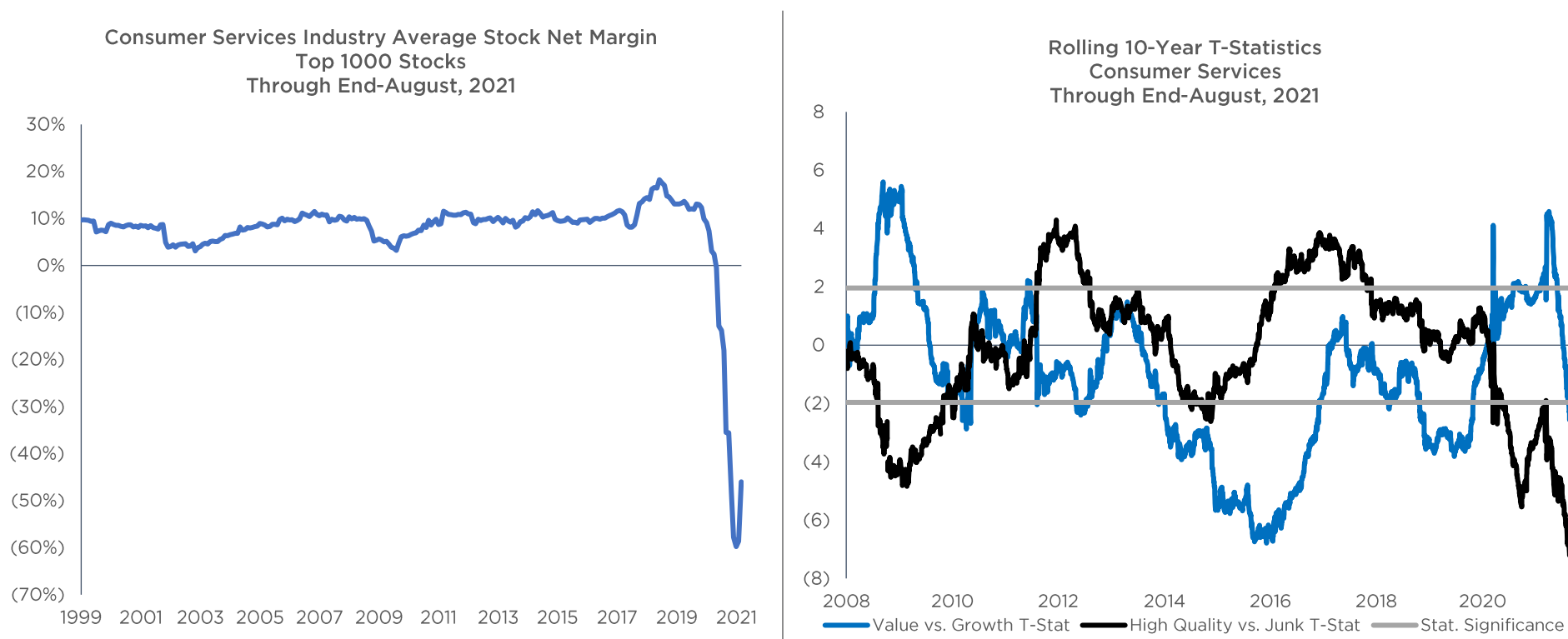
## ...BUT THERE ARE MORE LARGE LAGGARDS IN STAPLES

Identifying strong long ideas in staples is particularly challenging today. The fewest number of staples in nine years are beating the market by 20% or more but the largest number of staples stocks in 12 years are lagging the market by 20% or more. Given there is higher company-specific risk in staples than many might surmise, hunting for idiosyncratic shorts in staples is prudent. We could also see the logic to stay long a staples ETF and short some high company-specific risk staples to lower the net exposure



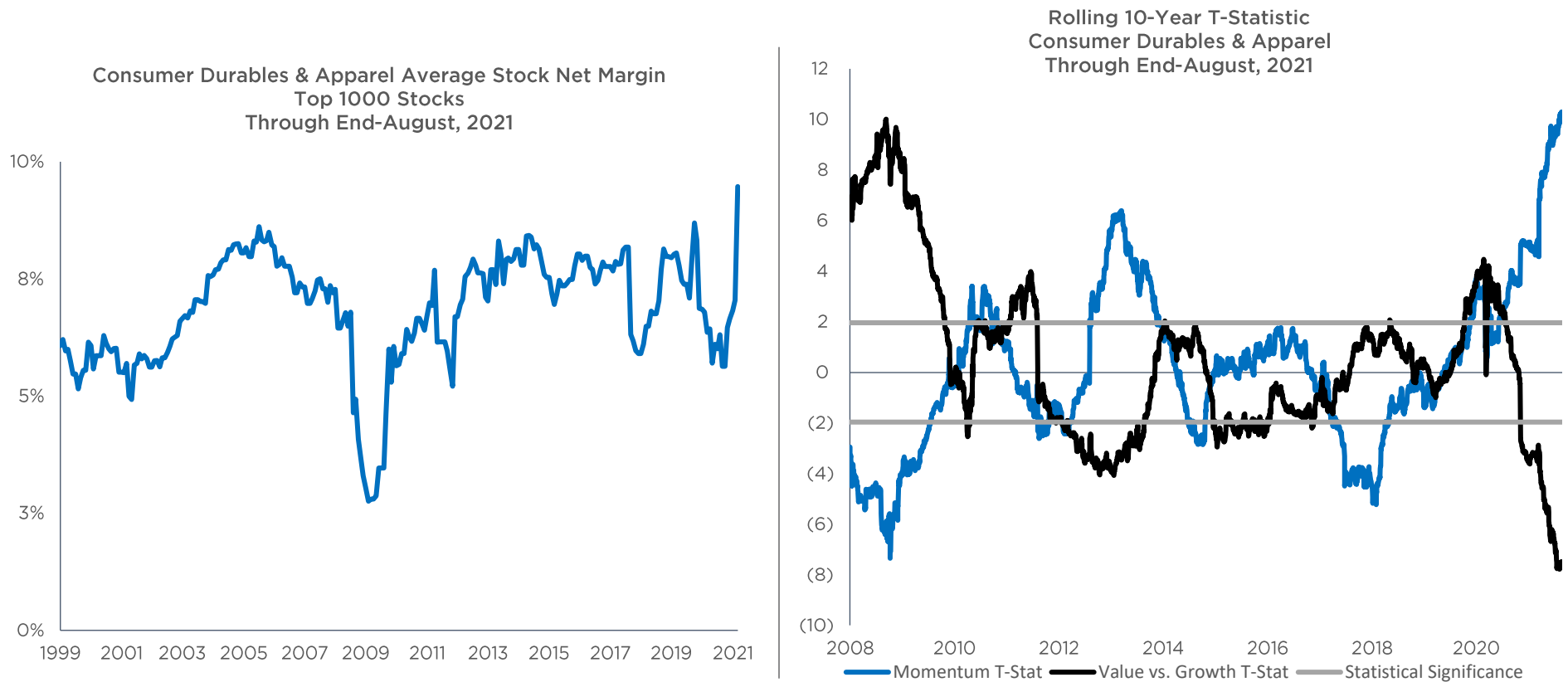
# THE CONSUMER SERVICES INDUSTRY IS UNDER-EARNING THE MOST

The consumer service industry has been rocked by COVID-19, with the average companies' net margin bouncing just above record lows right now (left chart). As the economy and demand for services grow, it stands to reason that the services industry will regain profitability back toward the lower volatility high single-digit band it was in for the previous two decades. The result of the sustained losses in consumer services is the industry now has the strongest statistically significant relationship to junk and value this cycle (right chart)



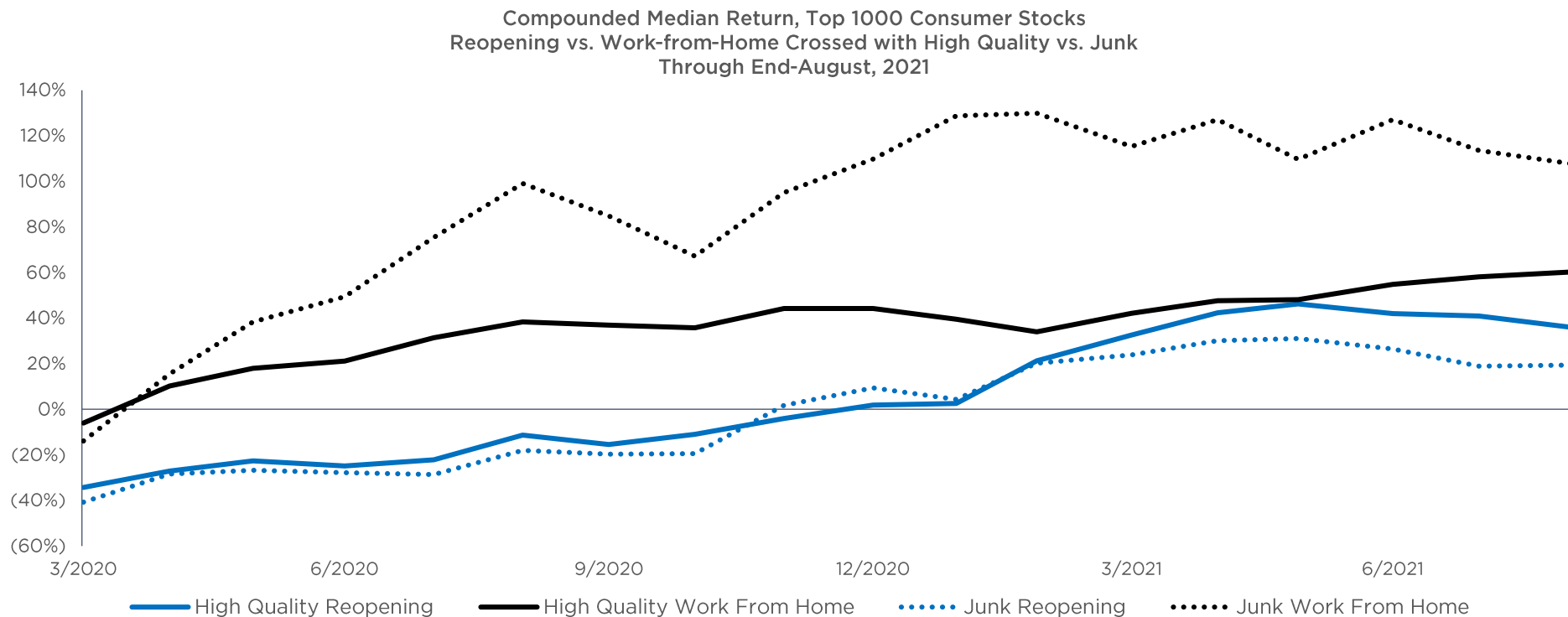
# WHEREAS DURABLES SEEM TO BE OVER-EARNING THE MOST

Durables appear to be over-earning the most, with record profitability due in large part to housing demand and the homebuilders (left chart), a trend that is likely to rollover in the coming quarters. The result of strong profitability is the industry now trades the most like the growth universe ever, with the highest momentum ever (right chart). While durables can have prolonged cycles, we doubt there will be a structural shift to growth and momentum for the industry, viewing this as a place to sell winners over the coming months



# JUNK WORK FROM HOME WILL EVENTUALLY LAG QUALITY REOPENING

We analyzed the returns of quality vs. junk within “work from home” and “reopening” consumer stocks, given the on-again-off-again nature of consumer demand and experience in a Delta-variant world. We have two observations. Firstly, we think quality reopening will ultimately outperforming junk reopening by a more substantial margin over the coming quarters. Secondly, we think quality reopening will perform better than junk work from home as the world continues to adapt and adjust. Our advice is to look for quality reopening long ideas, and junk work from home short ideas



# STRATEGY 1: QUALITY CROSSED WITH WORK FROM HOME / REOPENING

Consistent with this theme, we offer long and short consumer ideas in the quality reopening and junk work from home buckets, respectively

## Long Quality Reopening, Short Junk Work From Home, As of August 31, 2021

Longs				Shorts			
Ticker	Company Name	Industry Group	Market Cap (\$ US. Bil)	Ticker	Company Name	Industry Group	Market Cap (\$ US. Bil)
ROST	Ross Stores, Inc.	Retailing	43.82	PTON	Peloton Interactive, Inc.	Consumer Durables & Apparel	35.21
HLT	Hilton Worldwide Holdings Inc.	Consumer Services	36.63	CVNA	Carvana Co.	Retailing	27.33
EXPE	Expedia Group, Inc.	Consumer Services	23.64	DKNG	DraftKings Inc.	Consumer Services	19.48
ULTA	Ulta Beauty, Inc.	Retailing	18.39	FTCH	Farfetch Limited	Retailing	17.75
GPC	Genuine Parts Company	Retailing	18.18	SAM	The Boston Beer Company, Inc.	Food, Beverage & Tobacco	8.66
LKQ	LKQ Corporation	Retailing	15.04	LAZR	Luminar Technologies, Inc.	Automobiles & Components	6.25
LEVI	Levi Strauss & Co.	Consumer Durables & Apparel	11.06				
GPS	The Gap, Inc.	Retailing	11.01				
RL	Ralph Lauren Corporation	Consumer Durables & Apparel	8.34				
SKX	Skechers U.S.A., Inc.	Consumer Durables & Apparel	8.33				
USFD	US Foods Holding Corp.	Food & Staples Retailing	7.62				
CHH	Choice Hotels International, Inc.	Consumer Services	6.63				

## STRATEGY 2: A BARBELL

Another consumer theme we like is a barbell approach - long retail as discretionary tends to work when consumer activity is strong and services on a rebound of suppressed profitability - short idiosyncratic staples and durables which are potentially over-earning

### Long Retailers and Services that Favored by Our Model, Short Highly Idiosyncratic Staples and Durables Our Model Disfavors, As of August 31, 2021

Longs				Shorts			
Ticker	Company Name	Industry Group	Market Cap (\$ US. Bil)	Ticker	Company Name	Industry Group	Market Cap (\$ US. Bil)
HD	The Home Depot, Inc.	Retailing	344.24	KHC	The Kraft Heinz Company	Food, Beverage & Tobacco	44.03
LOW	Lowe's Companies, Inc.	Retailing	141.18	STZ	Constellation Brands, Inc.	Food, Beverage & Tobacco	40.58
TGT	Target Corporation	Retailing	120.54	KR	The Kroger Co.	Food & Staples Retailing	34.43
ROST	Ross Stores, Inc.	Retailing	42.28	PTON	Peloton Interactive, Inc.	Consumer Durables & Apparel	30.11
ORLY	O'Reilly Automotive, Inc.	Retailing	40.96	CLX	The Clorox Company	Household & Personal Products	20.64
BBY	Best Buy Co., Inc.	Retailing	28.66	HAS	Hasbro, Inc.	Consumer Durables & Apparel	13.54
TSCO	Tractor Supply Company	Retailing	22.21	CPB	Campbell Soup Company	Food, Beverage & Tobacco	12.65
CZR	Caesars Entertainment, Inc.	Consumer Services	21.69	DAR	Darling Ingredients Inc.	Food, Beverage & Tobacco	12.07
DRI	Darden Restaurants, Inc.	Consumer Services	19.63	TAP	Molson Coors Beverage Company	Food, Beverage & Tobacco	10.35
RH	RH	Retailing	14.74	CASY	Casey's General Stores, Inc.	Food & Staples Retailing	7.59
GPS	The Gap, Inc.	Retailing	10.05	COTY	Coty Inc.	Household & Personal Products	7.48
SGMS	Scientific Games Corporation	Consumer Services	6.97	POST	Post Holdings, Inc.	Food, Beverage & Tobacco	7.13
WEN	The Wendy's Company	Consumer Services	5.13				



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