Evenlode Global Income Investment View

October 2024 – The consumer economy

EVENLODE
GLOBAL INCOME FUND

Market data is from Bloomberg, FE Analytics and S&P Capital IQ.

As we edge through the year and inch toward the US presidential election that will mark the crescendo of a bumper year for votes in democratic nations, the equity market is in excitable mood. With the dominant US market hitting new all-time highs in late October there is no doubt that growth is in the ascendancy when it comes to investor sentiment. There is clearly a very specific boom going on in spending on artificial intelligence capabilities, and cyclical sectors such as capital goods are in a market upswing, but on the ground in the economy the picture is pretty mixed. As companies comment on their third quarter results, we're seeing reports of relatively strong spending with healthcare names and business service companies enjoying solid growth, but consumer and some business-to-business franchises experiencing variant performances depending on their product categories and geographic presence.

Below we will take a close look at the luxury goods sector, an area of consumer spending that is currently much-discussed as even the better off in society appear to be feeling the pinch. Without giving away the punchline, luxury performance does depend on the particular brand in question. Looking more broadly at consumer spending, geographically the Chinese consumer is subdued. From drinks by Pernod Ricard, to P&G's upmarket SKII beauty brand, to LVMH's Dior fashion house, Chinese consumers are spending less. Reduced confidence, reflected in a languishing stock market, has resulted in coordinated stimulatory packages being announced from the Chinese authorities. Not all areas of consumer spending are in a downturn in the country; bicycle components maker Shimano reported that China was a bright spot for bike demand compared to a post-covid retreat elsewhere, although things do seem to be stabilising. At the moment this strength in China is the exception rather than the rule, but in any case, the performance demonstrates that multinational consumer goods firms can benefit from sources of revenue that are regionally diversified.

In something of a turnaround, Europe has proven resilient for the likes of L'Oréal in cosmetics and LVMH in luxury goods whilst other territories see softening demand. The US is a real mixed bag for corporate performance with the business services of testing, inspection and certification companies SGS and Bureau Veritas remaining in demand in the country, luxury spending holding up, but some consumer categories like alcoholic beverages seeing inventories being sold down and thus beverage makers are experiencing declining revenues. Tool-maker Snap-on experienced moderately declining sales; how much of the negative elements of US spending is to do with economic effects and how much to do with consumers and companies awaiting the outcome of the election with bated breath is difficult to unpick. We don't have long to wait for the electoral outcome at least.

If all that sounds a little bit gloomy, whilst there's been a clear deceleration in consumer spending globally this year the revenues from consumer firms in the Evenlode Global Income portfolio continue to rise. The average revenue increase across all portfolio firms that have reported third quarter results so far has been +5%, and for consumer franchises growth has been +1%[i]. So, growth in consumer spending for portfolio companies has slowed and is below the business-to-business sector for the portfolio, but not falling off a cliff. The market response to this softening however has been to mark down the share prices of some consumer goods firms quite significantly, to a point where attractive

valuations are on offer for very solid long-term compounders. We have responded by growing these positions over time; we have increased L'Oréal from 2.7% of the portfolio at the start of the year to 3.8% at the time of writing, and LVMH from 2.8% to 3.3%[ii]. As their stock prices are down by -20% and -13% respectively in sterling terms over the year so far, valuations look good in an absolute and a relative sense compared to other businesses in our investable universe.

What's equally encouraging about the current opportunity set available in globally listed businesses is that it is quite broad, meaning that we can have exposure to great franchises at attractive valuations whilst diversifying the portfolio. We could have a much greater position in L'Oréal for example, but at present we have a great deal of value in consumer goods and so we can comfortably spread out the positions accordingly. The same is true across different sectors, and an indicator of this at the whole portfolio level is that the proportion held in the top ten positions is currently 37%, down from 47% in early 2022[iii]. This helps to disperse the risks associated with any one geography or business model, whilst enjoying undemanding valuations and the yields that come with them at the current time. With dividend growth coming through backed by fundamental cash generation, the portfolio is well set and whilst we will continue to evolve the portfolio as with L'Oréal and LVMH, we expect the pace to be slower than it has been in recent years.

For those businesses where valuations look more attractive, when share prices decline it's important within our process to understand what the real-world dynamics are that are driving stock market sentiment. When prices are moving there is usually a story behind it and Ben Armitage and Phoebe Greenwold have been examining the narrative for the luxury goods market.

Handbags and glad rags - A life of Luxury

In a well-known song from the 1960s, Rod Stewart laments the value of 'handbags and glad rags' whose affordability to the putative wearer is made possible by the toil of a grandparent. Whilst the brand of garments grandad was sweating for in the song is never made clear, the fact that famous fashion houses from the time persist and thrive well over half a century later is testament to their value to a sub-set of consumers. Their products are generally perceived to be higher quality, more durable and inherently more valuable than their non-luxury counterparts (although Rod may have disagreed on the latter point). The combination of those factors means that they tend to have solid pricing power, durable competitive advantages buoyed by intangible brand strength, and resilience in the event of an economic downturn, although as we will see this does not mean complete invulnerability to all economic situations.

These qualities make luxury goods companies potentially appealing when viewed through the lens of the Evenlode investment philosophy. For the Evenlode Global Income fund, we have held LVMH for some time, and Richemont has also recently been under our microscope although has not yet made it into our investable universe. Both companies are 'houses of brands', in other words a collection of well diversified luxury businesses serving multiple end markets. For example, half of LVMH's income derives from fashion and leather, with the other half coming from a mix of perfumes, watches and alcoholic beverages among others. Richemont on the other hand, focus more on the so called 'hard

luxury' of jewellery (they own Cartier) and watches, with a smaller segment dedicated to soft luxury clothing and apparel. These differences provide an opportunity to diversify exposure to risk from various sub-sectors within luxury, although some market factors influence both stocks in similar ways.

For most luxury companies, and certainly LVMH and Richemont, geographical sales are dominated by a combination of the US and China to varying degrees. Consequently, macroeconomic developments in either of these territories can affect sentiment toward the stock price. Since Covid, both countries have had numerous events which have caused some level of economic volatility, impacting the spending power of consumers both positively and negatively. On a 5-year backwards view, up until the start of 2024 and despite volatility, luxury share prices have tended to trend upwards at a healthy rate driven by consistent sales growth in both the US and China. However, during the current year the economy has slowed and share price growth has stalled. The US has been relatively stable and healthier than many feared after employment levels remained strong, and a recessionary environment failed to materialise, despite the looming election causing some concern amongst consumers. China, however, has fared less well. In a country where much wealth is tied to a faltering real estate market, consumer sentiment is weak, and not expected to recover in the short term. That weakness culminated in announcements of a stimulatory package by the People's Bank of China (PBOC) at the end of last month.

Having been a contributor to growth over the last decade, it was hoped amongst both the Chinese government and investors with exposure to Chinese revenue streams that the stimulatory package would titillate the consumer into the first knockings of an economic recovery. However, the potential impact of the stimulus is uncertain and will only unfold over time. During their recent Q3 earnings call, LVMH's CFO Jean-Jacques Guiony described consumer confidence in Mainland China as "back in line with the all-time low reached during Covid". On a more positive note, many are expecting growth within the luxury sector to pick up in the US, and for this to be the main contributor to growth in luxury in 2025. Interestingly, political machinations in the US may account for some of that resilience. Richemont recently called out that central US states including Texas and North Carolina are starting to perform in-line with their historically wealthier cousins in the coastal states, as fiscal policy on a state-by-state basis drives mobility in business operations and employment opportunities.

The period since Covid has been an interesting and volatile time for the luxury sector generally. As people emerged from the pandemic, they engaged in "revenge spending" with stockpiles of savings built during lockdowns spending on goods, some of them in the 'luxury' bracket, they had dreamed about whilst they didn't have much else to do. Social media exposure, combined with increased savings, created the perfect conditions for a post-Covid spending spree. As a result of growing demand, many manufacturers continued to raise their prices, leading to significant growth in gross margins for many luxury brands. In fact, between the end of March 2020 and the end of November 2021, the S&P Global Luxury Index rose by 135%, according to the Financial Times.

However, what becomes of aspirational spenders when that spending power wanes? Apparently, if numbers provided in 2024 are indicative, they stop buying quite so many handbags and glad rags. Consumers, particularly those in the "aspirational middle class" category, have become more

discerning in their spending. Privately-owned Chanel's medium classic flap bag is a good example of what consumers face; having increased their prices bi-annually, it has now doubled in price since 2016. Sales at LVMH's Louis Vuitton and Dior fashion and leather businesses declined in the third quarter of 2024 compared to the prior year, primarily due to Chinese consumers; other geographies showed more resilience. Ultra-high-end Hermes (owned in the Evenlode Global Equity portfolio) continued to grow, although also noted a softening demand picture in China.

Richemont operate somewhere between LVMH and Hermes in terms of the tier of luxury goods that they sell. Their jewellery brands and some of their luxury watch portfolio is undoubtedly in the very top tier of luxury goods, by both price and reputation. Their soft luxury brands, on the other hand, may not be quite as high tier when compared with their rivals in the space, and they are getting out of the online market business by selling Yoox Net-a-Porter (YNAP), an acquisition that never really got going. Cutting losses at this stage is viewed by many as a positive step for the company, and we will monitor progress of the disposal with interest. Additionally, the jewellery segment of luxury remains quite fragmented, providing opportunities for further consolidation where, YNAP aside, they have historically proven to be shrewd operators in M&A.

Overall, we think the luxury segment has attractive investment characteristics despite near-term challenges, partly thanks to its geographic diversification. If we may return to Rod Stewart, at Evenlode we never miss school when it comes to monitoring our investment opportunities, and on balance it seems unlikely that high-net-worth and aspirational wealthy consumers will eschew handbags and glad rags away any time soon. Exactly where around the world the growth is driven from may change though, making a multinational approach appealing. While consumer spending could remain soft in the short term, the valuations at which some luxury companies are trading relative to history provides a risk offset to these challenges. We will continue to monitor progress and the evolving consumer situation closely all the same.

Ben P, Chris E, Rob, Ben A, Phoebe and the Evenlode team

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Evenlode has developed a glossary to assist investors to better understand commonly used terms – please see https://evenlodeinvestment.com/funds/evenlode-global-income-fund#Documents

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the ongoing charges and portfolio transaction costs unless otherwise stated. The figures do not reflect any entry charge paid by individual investors. Current forecasts provided for transparency purposes, are subject to change and are not guaranteed. Source: Evenlode Investment Management Limited authorised and regulated by the Financial Conduct Authority, No. 767844.

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[i] *Source: Corporate reports. 49% of the portfolio had reported revenue figures for Q3 2024 at the time of writing.*
[ii] *Source: Evenlode, IFSL.*
[iii] *Source: Evenlode, Waystone, IFSL.*