CONSUMER DISCRETIONARY SECTOR (XLY)

Sector Overview

February 25, 2013

Analysts:
Erik Fritz
Todd Mehrkens
Will Zajac
**Description of Sector:** There are 82 companies in this sector for the S&P 500. The estimate weight of XLY components in the S&P 500 as of 2/14/2014 is 12.36%.\(^1\) It also has a market cap of $4.21 Trillion.\(^2\) Companies in this sector include retailers, media companies, consumer services companies, consumer durables and apparel companies, and automobiles and components companies.\(^3\)

**Sector Breakdown (Sub-Sectors, Industries, and Sub-Industries):**

**Automobiles & Components Sub-Sector**

1. **Auto components:**
   a. **Auto Parts & Equipment:** Manufacturers of parts and accessories for automobiles and motorcycles. Excludes companies classified in the Tires & Rubber Sub-Industry.
      - **Delphi Automotive (DLPH):** Makes automotive parts.

2. **Tire & Rubber:**
   a. **Automobiles:** The Automobiles Industry in the Consumer Discretionary Sector includes companies that produce passenger automobiles, light trucks, motorcycles, scooters, or three-wheelers.
   b. **Automobile Manufacturers:** Companies that produce mainly passenger automobiles and light trucks. Excludes companies producing mainly motorcycles and three-wheelers classified in the Motorcycle Manufacturers Sub-Industry and heavy duty trucks classified in the Construction & Farm Machinery & Heavy Trucks Sub-Industry.
      - **Ford Motor (F):** Produce and sell cars.
   c. **Motorcycle Manufacturers:** Companies that produce motorcycles, scooters or three-wheelers. Excludes bicycles classified in the Leisure Products Sub-Industry.

**Consumer Durables & Apparel Sub-Sector**

1. **Household Durables:**
   a. **Consumer Electronics:** Manufacturers of consumer electronics products including TVs, VCRs, hi-fi equipment, game consoles and related products.
   b. **Home Furnishing:** Manufacturers of soft home furnishings or furniture, including upholstery, carpets and wall-coverings.
   c. **Homebuilding:** Residential construction companies. Includes manufacturers of prefabricated houses and semi-fixed manufactured homes.
      - **Lennar Corp (LEN):** Builds homes.
   d. **Household Appliances:** Manufacturers of electric household appliances and related products. Includes manufacturers of power and hand tools, including garden improvement tools.
   e. **Housewares & Specialties:** Manufacturers of durable household products, including cutlery, cookware, glassware, crystal, silverware, utensils, and kitchenware and consumer specialties not classified elsewhere.

2. **Leisure Equipment & Products:**
   a. **Leisure Products:** Manufacturers of leisure products and equipment including sports equipment, bicycles and toys.
      - **Hasbro Inc. (HAS):** Producer and seller of children toys.
   b. **Photographic Products:** Manufacturers of photographic equipment and products.

---

\(^1\) [http://www.sectorspdr.com/sectorspdr/sector/xly](http://www.sectorspdr.com/sectorspdr/sector/xly)
3. Textiles, Apparel & Luxury Goods:
   b. Footwear: Manufacturers of footwear. Includes sport and leather shoes.
   c. Textiles: Manufacturers of textile and related products not classified in the Apparel, Accessories & Luxury Goods, Footwear or Home Furnishings Sub-Industries.

Consumer Services Sub-Sector
1. Hotels, Restaurants & Leisure:
   a. Casinos & Gaming: Owners and operators of casinos and gaming facilities. Includes companies providing lottery and betting services.
   b. Hotels, Resorts & Cruise Lines: Owners and operators of hotels, resorts and cruise-ships. Includes travel agencies, tour operators and related services not classified elsewhere.
   c. Leisure Facilities: Owners and operators of leisure facilities, including sport and fitness centers, stadiums, golf courses and amusement parks not classified in the Movies & Entertainment Sub-Industry.
   d. Restaurants: Owners and operators of restaurants, bars, pubs, fast-food or take-out facilities. Includes companies that provide food catering services.

2. Diversified consumer services:
   a. Education Services: Companies providing educational services, either on-line or through conventional teaching methods. Includes, private universities, correspondence teaching, providers of educational seminars, educational materials and technical education.
   b. Specialized Consumer Services: Companies providing consumer services not classified elsewhere. Includes residential services, home security, legal services, personal services, renovation & interior design services, consumer auctions and wedding & funeral services.

Media Sub-Sector
1. Media:
   a. Advertising: Companies providing advertising, marketing or public relations services.
   b. Broadcasting: Owners and operators of television or radio broadcasting systems, including programming.
   c. Cable & Satellite: Providers of cable or satellite television services. Includes cable networks and program distribution.
   d. Movies & Entertainment: Companies that engage in producing and selling entertainment products and services.
   e. Publishing: Publishers of newspapers, magazines and books, and providers of information in print or electronic formats.

Retailing Sub-Sector
1. Distributions:
   a. Distributors: Distributors and wholesalers of general merchandise not classified elsewhere. Includes vehicle distributors.
2. Internet & Catalog Retail:
   a. Catalog Retail: Mail order and TV home shopping retailers.
   b. Internet Retail: Companies providing retail services primarily on the internet.
      - Amazon.com Inc. (AMZ): Internet retailer for a wide variety of goods.

3. Multiline Retail:
   a. Department Stores: Owners and operators of department stores.
      - Nordstrom (JWN): Provides high-end retail to customers.
   b. General Merchandise Stores: Stores offering diversified general merchandise.

4. Specialty Retail:
   a. Apparel Retail: Retailers specialized mainly in apparel and accessories.
      - TJX Companies Inc. (TJX): Chains of off-price apparel.
   b. Computer & Electronics Retail: Owners and operators of consumer electronics, computers, video and related products retail stores.
   c. Home Improvement Retail: Owners and operators of home and garden improvement retail stores. Includes stores offering building materials and supplies.
   d. Specialty Stores: Owners and operators of specialty retail stores not classified elsewhere.
   e. Automotive Retail: Owners and operators of stores specializing in automotive retail.
   f. Homefurnishing Retail: Owners and operators of furniture and home furnishings retail stores.

**Sensitivity of Sector and Sector Expenditures:** The business cycle for the consumer discretionary sector is cyclical. It is very sensitive to the business cycle because this sector has a positive correlation to people’s disposable income. Higher sensitivity to the business cycle make the volatility of their earnings high. Sensitivity varies across the different industries in this sector. Industries that are focused around consumer discretionary purchases that are large, such as buying a car or building a home, will be more sensitive to the business cycle of the global economy than smaller purchases. This sector is known for having large capital expenditure mostly based around inventory. Having these expenditures weighted mostly in capital creates some volatility, but not as much as having these expenses focused in legal or research & development.

**Macro-economic Environment**

**Quantitative Easing:** The macro-economic environmental indicators for the consumer discretionary sector of the S&P 500 is showing bearish signs. Quantitative Easing has boosted consumer demand throughout the Great Recession and for the following years. This has enabled the sector to vastly outperform the S&P 500 since this sector depends on high consumer demand for success. With Ben Bernanke stepping down as the Fed chairman and Janet Yellen taking his place, we expect that tapering will continue throughout the coming year. QE has decreased from 80 billion dollars of bought assets per month to 65 billion. Without the support of the Fed CND will struggle to maintain its current growth.

**Emerging Markets:** The recent volatility of the emerging markets has also put a damper of the growth of this sector. Most of the firms in this sector such as Ford, Coach, and the Home Depot all depend on emerging markets for new growth opportunities. Since the United States has been going through a recession there have been fewer purchases than there would have been otherwise. As a result, these firms sought out the growing middle classes of the emerging markets in Asia and the BRIC countries. Unfortunately, the stock market lost faith in the ability of these new markets to grow. Every nation in the large pool of countries called the “emerging markets” had different reasons for slowing down growth. Some had simply been growing too fast for too long and needed a contraction, while others had currency...
troubles, and still others experienced political upheavals. For US investors who had become accustomed to treating the emerging market as a homogeneous system, this came as a bit of a shock and many pulled their funds out. As a result, US firms with a stake in those nations suffered.

**US Labor Market:** One of the main reasons that the CND sector has been struggling domestically is a poor US labor market. Without a strong economy that produces jobs that yield high incomes these firms are going to struggle in the United States. Since the recession, the US job market has been bleak. The unemployment rate has been slowly improving in the years since the recession, however, there is still much debate about the quality of the jobs being produced. Its no secret that most of the profits and gains in the past few years have gone to the wealthy, while most new job growth has been in the fast food industry in the form of minimum wage jobs. This creates a systematic problem for firms depending on large discretionary spending. With the decrease in discretionary income amongst American consumers we expect that the sector will experience a contraction in the coming months.

**Inflation and the Balance of Trade:** Two indicators that are neutral on their outlook for the consumer discretionary sector are inflation and the balance of trade. Inflation has been very constant throughout the recession, staying between 1 and 2% since 2008. This has been against the predictions of many economists and market watchers who believed that QE would flood the market with liquidity which would result in an inflated currency. Fortunately this rampant inflation has not materialized and the USD has remained one of the most stable currencies in the world. The next neutral indicator has been the balance of trade decrease in the United States. The United States has been a nation of consumers for decades and seeing imports increase and exports decrease is nothing new. If anything, it is good for most of the CND sector since those imported products are being sold through retail chains in the CND.

**Industry Life Cycle Stage & Competitive Outlook**

The consumer discretionary sector can be split into five major groups; automobiles and their components, consumer durables and apparel, consumer services, media, and retail. This creates a very diverse sector with industries that are at very different parts of the life cycle and very different competitive outlooks.

The automobiles and components industry is experiencing a surprising growth with ever more companies entering the market. Even though the market in the US is growing very slowly, the emerging market nations are on fire in terms of auto growth. Emerging middle classes are buying cars. This has resulted in a mad dash for market share in these new markets from old companies like Ford and GM but also new companies that are local to those markets. With this fierce competition among many new companies and old ones, the outlook for growth for this industry is very high.

The consumer durables and apparel industry is beginning to slow down. Firms in the sector include Coach, Nike, the Gap, and many others. This industry has clearly reached the maturity stage. While it seems that consumers will always be on the market for clothing and fashionable wear, the industry has been slowing down in recent years. Earnings reported by these firms was less than expected, in addition to the fact that there are fewer and fewer firms entering the space.

Consumer services is an interesting industry within the CND. It possesses far more niche firms that have little relation to one another. Examples of this would be security firms, tutoring, and legal services. Most of this industry group are experiencing growth at modest rates and have reasonable competitive outlooks. The industries are not growing fast enough to warrant a substantial number of new firms but new competition is always a threat. This industry is certainly in the later stages of growth.
Media firms are some of the most established and well entrenched firms in existence. They control massive markets and are constantly trying to take market share from their competitors. When they are not attempting to grow the old fashioned way, they are acquiring their competitors for lofty prices. Competition is fierce in this sector with little room for real growth. The media sector is mature on its path through the life cycle.

The retail industry is also a mature industry. The competition between retailers is high with new boutique market entrants entering all the time. For firms like Target and Bed Bath and Beyond, it is becoming harder to compete with such stores on quality and still maintain low prices.

**Valuation Matrices:** The consumer discretionary sector can be complicated when you attempt use ratios to compare a company’s performance because of the wide variety of industries that comprise the sector. Comparing automobile producers, hotel/cruise services, broadcasting companies, and retailers is difficult because the companies have vastly different business operations. We attempted to look for some trends in the valuation matrices and noticed a few things. First, the stocks generally have higher P/E ratios. This can mean that an investor is paying more for each dollar of earnings. This sector also has fairly low P/B ratios across different industries; this means that the companies are typically fairly priced based on the book value of their equity. Finally, the consistently low P/S ratio in the sector can mean that many of these companies are growing, as the price of their shares is low compared to the sales the companies generate. Although using valuation matrices can be helpful when making investment decisions, investors still need to be careful when ratios between companies as they may not correctly represent the business environment in the specific industry. (Refer to Exhibit 1.0)

**Price Charts:**

**3-Month Price Chart:** The 3-month price chart the sector follows the S&P 500 fairly closely. However since the beginning of the 2014 the sector has underperformed the average for the S&P 500. The consumer discretionary sectors underperformance in the market can partially be attributed to the very slow holiday retail season in late 2013. This poor holiday season is now being shown as earnings are being reported and most companies are reporting disappointing numbers. In addition to the retail market, the implementation of the Affordable Care Act has decreased the amount of discretionary income that the average consumer has. Healthcare expenses became more of a priority in many households starting in January leading to less spending on nonessential products that characterize this sector. (Refer to Exhibit 2.0)

**6-Month, 1-Year, 5-Year Price Chart:** The consumer discretionary sector has outperformed the S&P 500 over all three-time periods. The 6-month price chart demonstrates how sensitive this sector is to the overall market conditions. When you begin to look at the one and five year price charts, you see that the consumer discretionary has really started to take off in recent years. For example, in the last five years, the sector ETF doubled the performance of the index. This rapid growth in the consumer discretionary sector can be explained the United States governments attempt to keep interest rates low to help stimulate the economy following the recession in 2008. During the financial crisis, unemployment skyrocketed and consumers drastically cut back spending. This caused consumers to postpone expensive, big-ticket items such as cars and housing accessories. As unemployment and overall economic conditions began to improve, consumer began to regain confidence in the economy leading to increased spending. Recently, many consumers have had the financial capability to make these big-ticket purchases they had previously put off. (Refer to Exhibit 3.0, 4.0, and 5.0)
**Recent News:**

**Comcast & Time Warner Cable Merger:** In recent weeks there has been a proposed merger between Comcast and Time Warner Cable that has the chance to reshape the broadcasting industry. Comcast Corp. (CMCST) is the largest company in the Consumer Discretionary sector (largest broadcasting company in industry) while Time Warner Cable (TWX) is the ninth largest company (second largest company in industry). The proposed deal to unite the two companies will cost Comcast $45.2 billion dollars. This merger has received criticism from antitrust representatives who are concerned with larger corporation gaining unfair position where they could influence the deal. This deal also drastically cuts out the competition that Comcast faces in the broadcasting industry, as one company now will dominate the market and be the primary provider of cable services in the United States.

**Volkswagen & United Auto Workers:** The United Auto Workers (UAW) is a labor union that has traditionally represented automobile manufactures in labor disputes in the United States. However, a Volkswagen factory in Chattanooga, Tennessee recently decided to use the UAW as their union representative. Instead, they will implement a techniques used by Volkswagen in almost all nations (except the United States) called a ‘work council’ that is used to manage inter company problems and improves discussions with management.

**Target Credit Card Fraud:** In late 2013, Target was hit with a cyber theft attack that compromised the credit/debit card numbers of over 40 million customers as well as partial personal information of over 70 million customers. As a result, Target is currently experiencing very high legal expenses as they are being forced to reimburse credit card companies for some of the fraudulent charges. In addition to legal expenses, Target has the massive expense of replace all the cards that were compromised. This incident has spurred on a lot of talk in the government to enhance the security of systems to prevent cybercrime like this from happening.

**Affordable Care Act:** With the new healthcare law, small businesses are struggling to handle the increased cost of providing healthcare options for their employees. As a result, some of these companies are being driven out of business because they cannot afford to operate at a loss. The decline of small businesses decreases the competition that consumer have to choose from creating a higher demand for the products of larger corporations.

---


## APPENDIX

### Exhibit 1.0

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Starwood Hotels &amp; Resorts</td>
<td>Hotels, Motels &amp; Cruise Lines</td>
<td>HOT</td>
<td>26.93</td>
<td>2.46</td>
<td>4.49</td>
<td>11.34</td>
<td>18.10</td>
<td>*</td>
</tr>
<tr>
<td>Mohawk Industries</td>
<td>Home Furnishings</td>
<td>MHK</td>
<td>32.70</td>
<td>1.56</td>
<td>2.47</td>
<td>5.94</td>
<td>17.27</td>
<td>37.20</td>
</tr>
<tr>
<td>Newell Rubbermaid Inc.</td>
<td>Houseware &amp; Specialties</td>
<td>NWL</td>
<td>21.54</td>
<td>1.58</td>
<td>4.35</td>
<td>*</td>
<td>15.56</td>
<td>30.75</td>
</tr>
<tr>
<td>Comcast Corporation</td>
<td>Broadcasting</td>
<td>CMCSA</td>
<td>20.98</td>
<td>2.16</td>
<td>2.76</td>
<td>*</td>
<td>6.45</td>
<td>30.39</td>
</tr>
</tbody>
</table>

### Exhibit 2.0:

3-Month