Investment Newsletter – March 2024

Investing in consumer brands – Beware of the middle wasteland

Welcome to the March 2024 letter.

Having covered the consumer sector both in Australia and globally for over 15 years, we have seen fair few trends play out over several economic cycles. We are potentially in an extended period of elevated inflation, subpar economic growth (impeded by high debt levels) and pressure on family budgets. In this environment, we believe consumer brands caught in the "middle wasteland" – that is, they are neither value nor ultra-luxury brands – are likely to materially underperform.

Affordable luxury – potentially doomed for wasteland. What we have seen is an increasing number of consumer brands caught in the middle-tier, defined as affordable luxury brands. These consumer brands target the aspirational consumer and offer luxury for less, likely at the expense of exclusivity and scarcity. Either side of the affordable luxury segment are:

(1) value or everyday low price (EDLP) category – which refers to brands with consistently low prices which don't require discount or promotional periods.

(2) ultra-luxury brands – which refers to highly exclusive brands with an element of scarcity.

In our view, consumer brands experimenting with affordable luxury to increase their target market size and hope to gain market share may be doomed for middle wasteland. That is because, in our view, the aspirational consumer is more likely to quickly downgrade to the value / EDLP category in times of family budget hardship or economic uncertainty than the ultra-wealthy whose spending habits are unlikely to be altered by economic conditions.

Remember department stores Myer & David Jones. The most prominent Australian examples of "middle wasteland" would be department stores Myer and David Jones. In our view, both department stores offered affordable luxury brands to the aspirational consumer. But over time their target market gravitated towards value, in our view, and shifted towards online shopping. Since listing, Myer's share price has gone from around $4.00 to current price of $0.86. Interestingly, in the end when David Jones was acquired & delisted from the Australian Stock Exchange, it was likely purchased for its underlying property portfolio (very attractive city locations) rather than the brands. We also strongly believe many of the value/EDLP players we follow have materially improved their value and quality proposition over the recent years whilst still offering everyday low prices. In our view, investors should "pick a side" of either value/EDLP or ultra-luxury when considering an investment in the consumer brands space.

Ultra-luxury brands don't compete on price. If you go into a Ferrari shop and ask about the price as your starting point, then it's probably out of your budget. Price is not a consideration for the consumer that ultra-luxury brands target, given these brands offer exclusivity, scarcity, and personalised services. The waiting list for a new Ferrari can be up to 2-3 years. Hermes, one of the most luxurious & exclusive brands in the world and producer of the iconic Birkin bag, sells its products ranging from $10,000 to $100,000. It is reported most of the new Hermes product releases are only offered to their exclusive existing clients who have previously purchased a Hermes product.

Ultra-luxury brands enjoy higher margins. Ultra-luxury brands also appear to enjoy materially better operating margins than affordable luxury brands. The operating earnings margin (EBITDA) for Ferrari (38.1%) and Hermes (47.8%) is materially higher than Mercedes-Benz (15.9%) and Ralph Lauren (19.8%). In our view, higher operating margins are a clear sign of a business model that enjoys high moat – companies with a sustainable competitive advantage.

Numbers don't lie – Ultra-luxury has significantly outperformed. Several market analysts have suggested that ultra-luxury brands have been picking up market share from brands catering to the mid-tier luxury aspirational consumer. Our own analysis provides irrefutable evidence. Our analysis looks at the revenue growth over the past 6 years (2017 to 2023) of publicly listed:

- **ultra-luxury brands** - Ferrari, Hermes, LVMH
- **affordable luxury brands** - Mercedes-Benz, Burberry, Ralph Lauren, Myer and
- **value / EDLP brands -** Kmart, Bunnings.

For the period six years to 2023, on a compound annual growth rate basis, our ultra-luxury brands bucket grew revenue on average by +14.3% p.a., our affordable luxury bucket grew revenue on average by just +0.2% p.a. and our value/EDLP bucket grew revenue on average by +6.0% p.a. The outperformance of revenue of ultra-luxury and value/EDLP brands was reflected in their respective share prices, which is what we as investors are ultimately interested in – shareholder returns (share price appreciation and/or dividend return). In this regard, from Jan-17 to 22 Mar-24, our ultra-luxury brands' bucket share price has delivered

+29.3% p.a. on average, the affordable luxury bucket's share price is up +4.5% p.a. on average and our value/EDLP bucket's share price is up+19.8% p.a. on average. We are cognizant that our sample size is small and that there will be winners & losers in each category. However, we believe the broader trend still holds true.

Figure 1: Revenue and share price performance of our selected brands.

	6-Yr (2017-23) Revenue CAGR (%)	Share Price Performance (p.a.)
Ultra-Luxury		
Ferrrai	9.8%	32.96%
Hermes	15.9%	29.54%
LVMH - Fashion & Leather Goods	18.2%	25.29%
Middle Market / Affordable Luxury		
Mercedes-Benz	-1.1%	8.30%
Burberry	1.9%	-1.09%
Ralph Lauren	-0.5%	12.94%
Myer Holdings	0.7%	-2.30%
Value / EDLP		
Wesfarmers - Kmart	3.7%	19.83%
Wesfarmers - Bunnings	8.3%	19.83%

Source: Banyantree, Bloomberg, share price performance Jan-17 to 22 Mar-24,
For Kmart/Bunnings we have used Wesfarmers (WES) share price

GLOBAL MARKETS OVERVIEW

		Month End	Price Performance (% Chg)			
	Units	Value	1-day	1-mth	6-mths	1-year
Developed Markets Equities						
ASX 200	AUD	7,699	0.50%	0.23%	5.39%	6.07%
ASX 200 Futures	AUD	7,660	0.41%	0.22%	5.16%	8.27%
Dow Jones	USD	38,996	0.12%	2.22%	12.31%	19.41%
S&P 500	USD	5,096	0.52%	5.17%	13.06%	28.36%
Stoxx Europe 600	EUR	495	0.00%	1.84%	7.95%	7.27%
FTSE 100 (UK)	GBP	7,630	0.07%	-0.01%	2.57%	-3.13%
DAX (Germany)	EUR	17,678	0.44%	4.58%	10.86%	15.05%
CAC (France)	EUR	7,927	-0.34%	3.54%	8.35%	9.07%
Nikkei 225	JPY	39,166	-0.11%	7.94%	20.07%	42.71%
Emerging Markets Equities						
MSCI Emerging Markets	USD	1,021	0.22%	4.63%	4.14%	5.91%
Shanghai Composite	CNY	3,015	1.94%	8.13%	-3.36%	-8.06%
South Korea	KRW	2,642	-0.37%	5.82%	3.37%	9.51%
Taiw an	TWD	18,967	0.60%	6.02%	14.02%	22.34%
Brazil	BRL	129,020	-0.87%	0.99%	11.47%	22.96%
South Africa	ZAR	66,350	0.81%	-2.48%	-4.23%	-7.45%
Foreign Exchange						
AUDUSD	Currency	0.6497	0.02%	-1.08%	0.20%	-3.45%
AUDGBP	Currency	0.5147	0.33%	-0.57%	0.60%	-8.05%
AUDEUR	Currency	0.6013	0.33%	-0.96%	0.55%	-5.50%
AUDCNY	Currency	4.67	-0.06%	-1.21%	-0.59%	-0.09%
Commodities						
LME ALUMINUM 3MO ($)	USD/mt	2,228	1.71%	-2.28%	0.91%	-6.11%
LME COPPER 3MO ($)	USD/mt	8,494	0.53%	-1.34%	0.84%	-5.22%
LME NICKEL 3MO ($)	USD/mt	17,896	1.68%	10.00%	-11.79%	-27.82%
SILVER FUTURE May24	USD/oz	22.89	1.10%	-2.17%	-10.01%	3.03%
ICE New c Coal Fut Apr24	USD/mt	132.25	1.15%	12.46%	-19.60%	-31.64%
62% Import Fine Ore in USD	USD/t	115.16	-0.56%	-9.36%	1.48%	-1.46%
Gold Spot $/Oz	USD/oz	2,044	0.48%	0.23%	5.37%	11.90%
WTI Oil	USD/bbl	78.26	-0.36%	3.37%	-1.94%	7.47%
Henry Hub	USD/mmBtu	1.67	3.73%	-23.74%	-35.02%	-33.20%
Corn	USD/Bu	415.75	0.60%	-7.25%	-9.82%	-33.96%
Wheat	USD/Bu	577.50	1.14%	-2.98%	0.79%	-16.49%
Fixed Interest						
10-Yr Bond Yield						
Australia	AUD	4.14%	-0.03%	+0.12%	+0.11%	+0.28%
US	USD	4.25%	-0.01%	+0.34%	+0.14%	+0.33%
Germany	EUR	2.41%	-0.05%	+0.25%	-0.06%	-0.24%
Japan	JPY	0.71%	+0.01%	-0.02%	+0.06%	+0.20%
Italy	EUR	3.84%	-0.04%	+0.12%	-0.28%	-0.63%
Australian Rates						
Cash Rate	AUD	4.35%	+0.00%	+0.00%	+0.25%	+1.00%
90-Day BBSW	AUD	4.34%	+0.00%	+0.01%	+0.20%	+0.74%
180-Day BBSW	AUD	4.49%	+0.00%	+0.10%	+0.12%	+0.54%
CBOE Options						
CBOE VIX (Volatility Index)	Index	13.40	-3.18%	-6.62%	-1.25%	-35.27%

Data as of 29 February 2024

ECONOMIC NEWS

• **In Australia** – RBA left interest rates at a 12-year high of 4.35% and signalled further tightening remains possible, leading to swaps now pricing in the chance of a June rate cut at 42% from about 50% beforehand, despite RBA Governor Michele Bullock telling a parliamentary panel, Australian inflation doesn't need to be inside the Reserve Bank's 2-3% target band for policy easing to begin while warning Australia's inflation challenge is not over.

• **In US** - U.S. Economy expanded at a slightly slower rate in 4Q23 with GDP revised down -10bps to +3.2% annualized pace, as a downward revision to inventories masked stronger household spending and investment, equating to expansion of +2.5% for 2023, marking an acceleration from 2022 and far outperforming the broader eurozone and Japan. Consumer confidence fell in February for the first time in four months as a measure of expectations dropped to a 3-month low, while the gauge of current conditions also slipped, however, the average inflation rate expected by consumers over the next 12-months continued to ease and remained at the lowest since 2020 at 3% with expectations of costs rising 2.9% over the next 5-to-10 years. Factory activity shrank at a faster pace in February as orders, production and employment contracted, all of which dropped to the lowest levels since July 2023.

• **In China -** Factory activity shrank for the fifth straight month in February with official manufacturing PMI declining MoM, however, a gauge of non-manufacturing activity rose MoM, remaining in expansion, helped by a pickup in travel and tourism during a recent long holiday. Home sales slump dragged on in February with the value of new home sales from the 100 biggest real estate companies sliding -60% y/y (-20.9% MoM) to 185.9bn yuan. Foreign businesses' direct investment into China in 2023 increased by the lowest amount since the early 1990s, declining -82% y/y and being at the lowest since 1993.

• **In Europe -** Euro-area narrowly avoided a recession in 4Q23 following its slight contraction in 3Q23 with GDP flat q/q (up +0.1% y/y). Inflation eased in February with CPI up +2.6% y/y (core CPI up +3.1% y/y), with declines in Germany, France and Spain, while Italy announcing inflation was unchanged at +0.9%. Private-sector activity hit an eight-month high in February, with services stopping to shrink after 6-months of contraction while manufacturing seeing a surprise deepening of the slowdown. Economic confidence unexpectedly deteriorated in February, falling to lowest in 3-months.

• **In UK -** U.K. Economy slipped into a mild recession in 2H23 with GDP falling -0.3% q/q (-0.2% y/y) in 4Q23, equating to the economy growing +0.1% y/y in 2023, the slowest annual expansion the country had seen since 2009, excluding the first year of the pandemic. Wage growth slowed less than expected in 4Q23 with wages excluding bonuses rising +6.2% y/y. Inflation in stores slowed to the lowest level since March 2022 in February with overall shop prices rising +2.5% y/y, marking a ninth consecutive monthly decline, driven by easing supply-chain pressures, falling input costs for energy and fertilizers, and fierce competition between retailers. Consumer confidence slipped back in February with a gauge of willingness to make major purchases slumping, however, households remaining relatively upbeat about their finances in the year ahead.

• **In India.** RBI kept the benchmark repurchase rate at 6.5% while sticking to its hawkish policy stance, as the bank projected inflation to average 4.5% and the economy to grow +7% in 2024. Economic growth accelerated in 4Q23 with GDP expanding +8.4% y/y and government revising up figures for the previous two quarters to above 8% as well, buoyed by strong private-sector investment and a pick-up in services spending, leading to the government upgrading GDP outlook for the fiscal year through March by +30bps to +7.6%.

• **In Japan.** The economy unexpectedly contracted for a second quarter 4Q23, with GDP shrinking at an annualized pace of -0.4%, leading to country's economy slipping to fourth largest in the world in dollar terms in 2023. Businesses ramped up investment in 4Q23 with capital expenditures on goods excluding software rising +8% q/q (+11.7% y/y).

• **In Germany.** Inflation slowed in February with CPI rising +2.5% y/y (+2.7% EU harmonized). Investor outlook improved for a seventh month and by more than anticipated in February despite a measure of current conditions decreasing to its lowest since mid-2020, with Wolfgang Schmidt, a close aide to Chancellor Olaf Scholz, announcing the first signs are emerging of a consumer-led rebound, with further tailwinds to come from initiatives on the national and regional level to slash red tape.

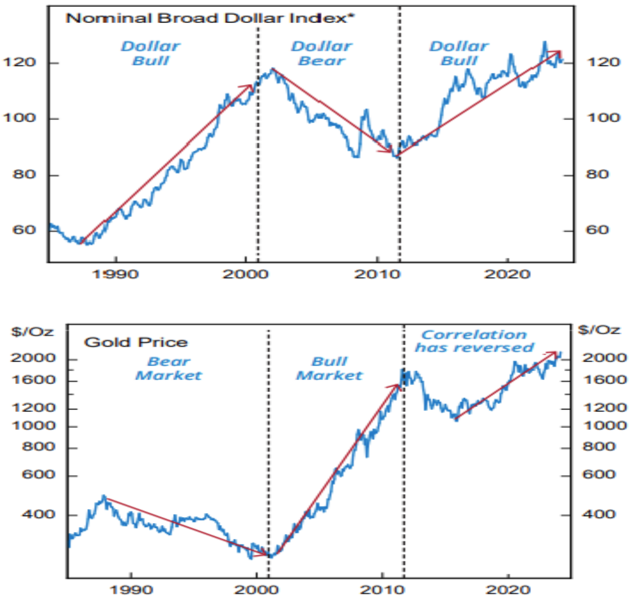
THE LONG READ

Gold – Something has changed…

A key investment theme for CY24 will again revolve around gold which has now delivered two solid years' worth of returns – the Global X Physical Gold ETF (our proxy for gold price and most commonly used ETF by Australian investors) delivered +12.9% in CY23 (vs S&P 500 TR Index AUD +26.1% & S&P/ASX 200 TR Index +12.8%) and +6.3% in CY22 (vs S&P 500 TR Index AUD -12.6% & S&P/ASX 200 TR Index -1.1%).

Has gold's negative correlation to the U.S. dollar changed? Historically there has been a strong negative correlation between the gold spot price and the U.S. dollar – i.e., bull market in the U.S. dollar normally spells trouble for the precious commodity. However, more recently the spot price of gold has continued its upward climb despite a stronger U.S. dollar. We believe central bank purchases have contributed to the historical negative correlation fading to a degree.

Figure 1: Gold price versus U.S. dollar.



Source: Alpine

What environment does gold thrive in?

• **Low or negative real interest rates.** When real interest rates (interest rates adjusted for inflation) are low or negative, the opportunity cost of holding gold, which does not yield any interest, declines, making gold more attractive compared to interest-bearing assets.

•**Economic uncertainty/instability.** In times of economic uncertainty, such as recessions, market downturns, or high volatility, investors often turn to gold as a safe-haven asset.

• **High inflation/hyperinflation.** Gold is traditionally seen as a hedge against inflation. When inflation is elevated, the purchasing power of fiat currency declines, but gold often maintains its value or even appreciates, attracting investors.

• **Currency devaluation.** When there is a devaluation of major currencies (like the U.S. dollar or the Euro), gold often becomes more attractive. Since gold is priced in U.S. dollars, a weaker dollar can make gold cheaper for investors holding other currencies, increasing demand.

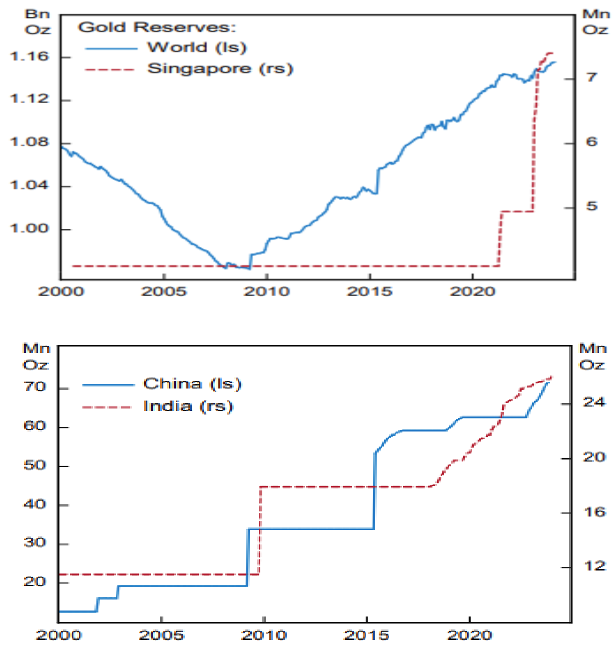
• **Geopolitical tensions.** During times of geopolitical uncertainty or conflicts, gold is often sought after as a safe-haven asset. With heightened tension in the Middle East (risks of the Hamas/Israel conflict spreading throughout the region) and constant news headlines of "China will invade Taiwan", safe-haven assets are likely to remain in demand.

• **Diversification needs.** Investors looking to diversify their portfolios often turn to gold. Gold's price movements are generally not correlated with traditional financial assets like stocks and bonds, making it a good diversification tool.

• **Central bank policies.** Actions by central banks, such as quantitative easing (increasing the money supply) or rate cuts, can also create favourable conditions for gold. Such policies can lead to lower bond yields and potential currency devaluation, both of which can boost gold's appeal.

• **Central bank buying.** It's not just investors who have turned to gold in recent years, increasing global geopolitical tensions, deglobalization and ex-U.S. central banks' desire to reduce exposure to U.S. dollar investments (e.g. U.S. Treasuries), global central banks have been on gold buying spree in recent years.

Figure 2: Central banks' purchases of gold have materially picked up over the past decade.



Source: Alpine

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