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Under the hood of the consumer economy

Magellan has long invested in the consumer sector, the largest part of the economy, with a focus on luxury companies, consumer discretionary and consumer staples. Portfolio Manager and Analyst Hannah Dickinson discusses the current consumer sentiment, which is showing signs of stabilisation despite a dip in discretionary spending during the 2024 election period. She also examines the impact of Trump's policies on consumer companies and identifies opportunities in the sector, highlighting the importance of companies with strong pricing power to navigate these complexities.

How has consumer sentiment evolved over the last 12 to 24 months, and what are your perspectives on its impact on investing in the consumer sector?

The story of consumer health over the past 12 to 24 months is one of stabilisation, with distinct trends across different income cohorts. Lower-income consumers have faced significant cost-of-living pressures due to rising prices of essentials like petrol, groceries and rent, but there are signs of improvement as inflation moderates. Middle- and upper-income consumers have been more resilient, supported by a strong job market and share market. Although there was a dip in discretionary spending in the third quarter of 2024, likely due to election uncertainty, spending rebounded in the fourth quarter, leading to a strong holiday period for retailers. Overall, while consumers are still under pressure and seeking value and convenience, the outlook is more positive than it has been.

How are President Trump's policies and initiatives affecting consumer companies?

Consumer companies are facing another four years of operating uncertainty and headline noise due to fluctuating policies and directions under President Trump. One of the primary concerns we are focused on is tariffs, which can pose significant risks for multinational companies with complex global supply chains. These tariffs could lead to increased prices and potentially accelerate inflation, complicating the operating environment further. Given this, what we look for are companies with strong pricing power or a compelling value proposition like Chipotle, which are better positioned to navigate these challenges. Additionally, companies with more localised manufacturing, such as L'Oréal, are likely to be more resilient compared to those like Elf Beauty, which is heavily reliant on imports. Overall, the focus is on identifying companies that can manage these risks effectively and maintain their competitive edge.

Given some uncertainty in the consumer sector, it's not surprising that consumer staples and consumer discretionary have lagged behind the market. However, household goods have been performing better than food within the consumer staples sector. Can you explain this dynamic and share your thoughts on whether it will continue?

The consumer staples sector has shown a clear bifurcation, with household and personal goods companies outperforming packaged food companies. Packaged food has struggled due to a combination of cyclical factors, such as inflation and price increases in agricultural commodities, which have had negative impacts on volume growth and sentiment. Additionally, structural factors, including the rise of anti-obesity medications, are affecting household spending on packaged food. These dynamics make it challenging to predict future earnings for packaged food companies.

Amidst these challenges, our focus has shifted to companies with strong pricing power and a compelling value proposition. We believe household and personal goods companies like Colgate, L'Oréal and Procter & Gamble are positioned well to offer downside protection and more stable, risk-adjusted earnings. This strategic shift aims to navigate the complex operating environment and capitalise on more resilient segments within the consumer staples sector.

Can you explain why L'Oréal remains an attractive investment in our Magellan Global Fund after several years?

L'Oréal stands out in the consumer sector due to its strong structural growth profile in the beauty category, which has grown consistently at 4-5% per annum for decades. Despite its scale as the largest player in the beauty sector, L'Oréal has shown remarkable organisational agility, innovation, and investment in research and development, allowing it to adapt to a fast-changing consumer environment. Currently, the beauty sector is facing cyclical headwinds related to macroeconomic factors in China and the US, which have weakened market sentiment. However, these challenges are seen as short-term noise rather than structural issues, making L'Oréal an attractive investment at a compelling value.

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Article Adapted from Magellan Minutes Series 10

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