



MORNING BRIEFING

June 8, 2017

Beware of Fighting Elephants

See the [collection](#) of the individual charts linked below.

(1) Proverbial elephants. (2) Clash of the titans: Amazon vs Walmart. (3) Food at home is over \$900 billion industry. (4) Prime service for less-than-prime customers. (5) Food stamps for online groceries. (6) Playing ball with a big elephant. (7) Amazon banning CR*P products. (8) Consumer Staples: Paying up for safety. (9) Beer, cigarettes, and drugs.

Consumer Staples: Getting Trampled. Proverbs are great at conveying big ideas simply but colorfully. Consider this African proverb: “When elephants fight, it is the grass that suffers.” Simple, yet colorful.

Fighting elephants came to mind when Amazon announced this week its plans to offer folks on government assistance a reduced rate to become Prime members. It’s the latest salvo in the battle between Amazon and Walmart to dominate Internet shopping. While the two have been tussling for years, the fight has intensified in recent months, and their suppliers and competitors alike are likely to get trampled in the grass beneath them.

You’d never know the elephants are fighting by looking at the industries in the S&P 500 Consumer Staples sector, where many of the suppliers and competitors are housed. Many of them have outperformed in recent weeks and trade at lofty multiples relative to low-single-digit earnings growth expectations. Investors may be turning to the sector because it has historically been a safe haven during times of turbulence, and offers dividends that look attractive in today’s low-interest-rate environment. Could this be the quiet before many of the Consumer Staples industries get trampled? Let’s look:

(1) *The grocery showdown.* There’s no mistaking it: Amazon and Walmart are making a big push to dominate Internet grocery shopping. They’ve both introduced a laundry list of new programs in an effort to woo customers. Personal outlays on food consumed at home totaled \$939 billion (saar) during April ([Fig. 1](#)). Retail sales of food and beverage stores totaled \$713 billion (saar) the same month. The difference between the two series is likely to be mostly the grocery sales of the warehouse clubs and super stores ([Fig. 2](#)). In other words, it’s a huge and natural arena for fighting elephants.

Amazon earlier this week offered a reduced rate for Prime membership—\$5.99 a month instead of \$10.99 a month—to customers on government assistance. The move comes as Amazon, Walmart, and seven additional retailers are participating in a pilot program that will allow food stamps to be used to purchase groceries online beginning next year, according to the [US Department of Agriculture](#).

In addition, Amazon opened two grocery pickup locations in Seattle recently, and it lowered its free shipping threshold to \$25—after Walmart lowered its threshold to \$35, [Recode reported](#) on 6/6. Meanwhile, Walmart bought Internet retailer Jet.com for \$3.3 billion last year, and it added discounts for anyone picking up packages in the store. Walmart is also testing a program where its workers are paid if they drop off packages ordered online on their way home from work.

The rapid succession of new initiatives gives the impression that both companies are throwing food at the wall to see what sticks. In the meantime, other retailers—whether they be grocery stores like Kroger, larger-format stores like Target and Costco, or dollar stores—have to be wondering what the grass will look like after the elephants finish fighting.

(2) *Price slashing.* Margins are already notoriously thin in the grocery business. But as Walmart and Amazon get even more competitive, they reportedly are asking suppliers to cut prices. According to a 3/30 Recode [article](#), Walmart told some of its largest suppliers that it wants to have the lowest price on 80% of its sales.

“To accomplish that, the brands that sell their goods through Walmart would have to cut their wholesale prices or make other cost adjustments to shave at least 15 percent off. In some cases, vendors say they would lose money on each sale if they met Walmart’s demands,” the Recode article stated. “Brands that agree to play ball with Walmart could expect better distribution and more strategic help from the giant retailer. And to those that didn’t? Walmart said it would limit their distribution and create its own branded products to directly challenge its own suppliers.”

Amazon is also twisting arms. The Recode 3/30 article reports that Amazon has software that finds the lowest price online for an item and then matches it on Amazon, even if it means the sale is unprofitable. “Unprofitable items are known inside Amazon as [CR*P] products—the acronym stands for ‘Can’t Realize a Profit.’ ... When Amazon warns suppliers that a product is pre-[CR*P], meaning it’s in jeopardy of being kicked off the site for profitability issues, it makes demands. Oftentimes, to lower wholesale prices. But that doesn’t always work, especially if a brand has the leverage of also selling into Walmart, which is still the biggest retail customer for many manufacturers.” So Amazon may move the product to a different part of its site that charges an additional shipping fee or prevent advertisement of the product on its website.

(3) *Safety sells.* Despite the upheaval in the retail space, the S&P 500 Consumer Staples index has turned in a strong performance over the past four weeks along with Utilities as defensive sectors have outperformed and Treasury yields have dropped. Here’s the performance derby of the S&P 500 sectors for the four weeks through Tuesday’s close: Utilities (4.7%), Consumer Staples (3.9), Tech (3.4), Materials (1.8), Health Care (1.7), Real Estate (1.6), S&P 500 (1.4), Telecom Services (0.9), Industrials (0.5), Consumer Discretionary (0.2), Financials (-1.6), and Energy (-2.3) ([Table](#)).

During the past four weeks, numerous industries in the Staples sector have outperformed the broader market, including: Tobacco (7.6%), Soft Drinks (5.0), Distillers & Vintners (4.8), Personal Products (4.5), Packaged Foods & Meats (4.1), Hypermarkets & Super Centers (3.8), Household Products (3.7), and Brewers (3.5). Meanwhile, the S&P 500 has returned 1.4% over the same four-week period from May 9 through Tuesday.

Before jumping into Consumer Staples, remember that the elephants are fighting and the sector’s forward P/E, at 20.5, is almost three times the 7.2% earnings growth analysts are expecting over the next 12 months ([Fig. 3](#) and [Fig. 4](#)). That’s pricier than the multiple of earnings that investors are paying for stocks broadly: The S&P 500 sports a lower forward P/E of 17.6 yet higher forward earnings growth of 11.3%.

(4) *Food retailers.* Given the battle between Walmart and Amazon, it’s ironic that one of the Consumer Staples’ industries with the most stretched valuation is S&P 500 Food Retail (KR, WFM). It has forward earnings growth of only 3.4%, yet the shares trade with a forward multiple of 15.4 ([Fig. 5](#) and [Fig. 6](#)). Its earnings growth rate has come down from north of 10%, where it routinely stood from 2012 to 2014. The last time earnings growth was this low was in 2009, when the P/E was much lower at 8.7.

In addition to the Amazon/Walmart battle, there's a new company entering the fray. German grocer Lidl is [opening](#) its first 10 stores in the US this month. Over the next year, the company plans to open a total of 100 stores, and its ultimate goal is to have 600 stores in the US to complement the 10,000 stores it has in 27 European countries, according to a 5/17 Business Insider [article](#). Food retailers have been slashing prices in response to increased competition. Declining prices led Kroger to report its first earnings decline in 13 years for Q4-2016, the 3/2 *WSJ* [reported](#).

Hypermarkets & Super Centers (COST, WMT), which is expected to grow earnings by 5.0% over the next 12 months, sports a forward P/E of 20.8 ([Fig. 7](#) and [Fig. 8](#)). Dollar stores and Target are in the Consumer Discretionary sector, but we thought we'd mention them anyway. They're in the S&P 500 General Merchandise Stores industry (DG, DLTR, and TGT), which has already fallen 12.4% ytd. Analysts are calling for forward earnings in the industry to fall 1.4%, and the industry's P/E has dropped to 14.6 from a recent high of 19.6 in 2015 ([Fig. 9](#) and [Fig. 10](#)).

(5) *Pricing pressures?* As Walmart and Amazon race to offer Internet shoppers products with the lowest prices, their suppliers' profits are at risk of being squeezed. Yet investors in the S&P 500 Consumer Staples Household Products index (CHD, CL, CLX, KMB, PG) don't appear concerned. The industry has a forward P/E of 22.1, even though it's expected to grow earnings by only 6.6% over the next year ([Fig. 11](#) and [Fig. 12](#)).

Along the same lines, the S&P 500 Soft Drinks industry (DPS, KO, MNST, PEP) is projected to boost earnings by 4.8% over the next year, but it has a forward P/E of 22.8 ([Fig. 13](#) and [Fig. 14](#)).

(6) *Better prospects.* There are some Consumer Staples industries that offer faster growth and lower multiples than the ones mentioned above. Not surprisingly, many of them don't sell their products through Walmart or Amazon. Agricultural Products (ADM), for example, has a forward P/E below its earnings growth rate. The industry is expected to grow earnings by 16.6% over the next year and has a forward P/E of 14.6 ([Fig. 15](#) and [Fig. 16](#)).

Similarly, the S&P 500 Brewers (TAP) is expected to grow earnings by 23.8% over the next 12 months because Molson Coors Brewing acquired SABMiller's 58% stake in MillerCoors. The industry has a forward P/E of 14.2 ([Fig. 17](#) and [Fig. 18](#)). As the deal is anniversaried, the industry's earnings growth rate is expected to decelerate to 6.5% in 2018.

Two other industries with lower valuations are Drug Retail and Tobacco. The S&P 500 Drug Retail index (CVX, WBA) peaked in 2015 and has fallen 25.0% since then ([Fig. 19](#)). When the shares were at their peak, the industry's forward P/E was roughly 21. Today, its forward P/E has fallen to 13.6, and earnings growth has tumbled to 6.8%, down from double digits in years past ([Fig. 20](#) and [Fig. 21](#)).

The best-performing Consumer Staples industry is Tobacco, up 22.5% ytd, followed by Distillers & Vintners (20.1%) and Personal Products (18.5) ([Fig. 22](#)). Tobacco companies have had strong results in the US because they've increased prices to more than offset declining volumes of cigarettes sold. "The number of cigarettes sold in the U.S. fell by 37% from 2001 to 2016, according to Euromonitor. Over the same period, though, companies raised prices, boosting cigarette revenue by 32%, to an estimated \$93.4 billion last year. An average pack in the U.S. cost an estimated \$6.42 in 2016, up from \$3.73 in 2001, according to TMA, an industry trade group," the 4/23 *WSJ* [reported](#).

In addition, Tobacco stocks have been helped by M&A activity. There is speculation that Philip Morris International will buy Altria, and Reynolds American is in the midst of being acquired by British American Tobacco. Companies are also developing products that heat tobacco and release nicotine in

a vapor. “Philip Morris says its internal studies have shown that by avoiding combustion, the product prevents or reduces the release of many harmful compounds. The company has asked the FDA for authorization to market IQOS as less harmful than cigarettes through a partnership here with Altria,” the *WSJ* article stated. Even though vaping products are not marketed to kids, kids are vaping, presumably drawn to the practice by fruity flavors and the desire to be like their friends. Hopefully, history isn’t about to repeat.

The S&P 500 Tobacco industry (MO, PM, RAI) is expected to boost earnings 9.4% over the next year, and its forward P/E has climbed to 23.0, the highest it has been over the past 22 years ([Fig. 23](#) and [Fig. 24](#)).

CALENDARS

US. Thurs: Jobless Claims 241k, Weekly Consumer Comfort Index, EIA Natural Gas Report. **Fri:** Wholesale Inventories -0.3%, Baker-Hughes Rig Count. (Bloomberg estimates)

Global. Thurs: Eurozone GDP 0.5%q/q/1.7%y/y, Germany Industrial Production 0.5%m/m/2.1%y/y, China Trade Balance \$48.2b, ECB Rate Decision 0.00%, ECB Marginal Lending Facility & Deposit Facility Rates 0.25%/-0.40%, ECB Asset Purchase Target (euros) 60b, Draghi, UK Parliamentary Elections. **Fri:** Germany Trade Balance (euros) 23.0b, UK Headline & Core CPI -0.3%/0.7% y/y, Canada Employment Change & Unemployment Rate 15k/6.6%, China CPI & PPI 1.5%/5.6% y/y. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators ([link](#)): The Investors Intelligence Bull/Bear Ratio (BBR) rebounded back above 3.00 this week, to 3.05, after sinking the prior two weeks from 3.40 to 2.60—which was the lowest reading since the last week of November. Bullish sentiment jumped 5.8ppts to 55.8% following a two-week drop of 8.1ppts to 50.0%, which was near its low for the year of 49.5%. Most of the jump in bullish sentiment this week came from those expecting a near-term correction, which fell 4.9ppts to 25.9%; bearish sentiment slipped 0.9ppt from 19.2% to 18.3%. The AAll Bull Ratio dropped to 46.0% last week after climbing from 41.0% to 52.3% the prior week. Bullish sentiment fell from 32.9% to 26.9% last week, while bearish sentiment rose from 30.0% to 31.5%.

S&P 500 Earnings, Revenues & Valuation ([link](#)): S&P 500 consensus forward revenues rose to a second straight weekly record high, and forward earnings was at a record high for a ninth straight week. The forward profit margin forecast rose w/w to a record high of 11.0% from 10.9%. The profit margin’s record high is its first since September 2015 and up from a 24-month low of 10.4% in March 2016. Forward revenue growth for the S&P 500 was steady w/w at 5.4%, but that’s down from 5.8% in late January, which was the highest since May 2012 and compares to a cyclical low of 2.7% in February 2016. Forward earnings growth improved to an 18-week high of 11.3% from 11.2%, which is down from 11.7% in January; that was the highest since October 2011 and compares to a cyclical low of 4.8% in February 2016. S&P 500 forward revenues and forward earnings growth are enjoying a tailwind now due to easy y/y comparisons for Energy and improving prospects for Financials, but currency translation is likely to be a slight drag. However, Energy’s contribution to forward growth peaked at the start of 2017. Looking at last week’s results for the S&P 500 ex-Energy, the forward growth rates for revenues (4.6%) and earnings (9.0) are lower, but improving. The ex-Energy forward profit margin improved w/w to 11.6% from 11.5%, making a record high for the first time since August 2007. Valuation edged down w/w to 17.6 from a four-week high of 17.7, which compares to a 13-year high of 18.0 in early March and a 15-month low of 14.9 in January 2016. However, ex-Energy valuation remained steady at 17.3, which is down from a 13-year high of 17.6 in early March.

S&P 500 Sectors Earnings, Revenues & Valuation ([link](#)): Consensus forward revenue and earnings forecasts rose last week for 10/11 sectors. Telecom had both measures decline w/w. Forward revenues and earnings are at or around record highs for 5/11 sectors: Consumer Discretionary, Consumer Staples, Health Care, Industrials, and Tech. Energy's forward revenues has stalled recently around its 15-month high in March, but forward earnings is moving higher again and at a 21-month high. Forward P/E ratios rose w/w for 4/11 sectors, and the forward P/S ratio was up for 7/11 sectors. These four sectors had both measures rise w/w: Consumer Discretionary, Consumer Staples, Telecom, and Utilities. Financials' P/E is up from 12.0 before the election to 13.1, but that's down from a post-election high of 14.6 in early March. Health Care's P/E of 15.7 and P/S of 1.66 are down from early March's 19-month highs of 16.1 and 1.70, respectively, and remain well below their early 2015 highs of 17.9 and 1.88, respectively. With Energy's forward revenues and earnings improving, its valuation is beginning to come back to Earth; its P/S ratio of 1.27 compares to a record high of 1.56 in May 2016, and its P/E of 24.3 is down from a record high of 57.5 then. Higher y/y margins occurred for only 7/11 sectors in 2016, and margins are expected to improve in 2017 for all but Real Estate and Utilities. However, Real Estate's forecasted margin should improve as the year progresses when gains on property sales are included in the forecasts. Here's how the 11 sectors rank based on their current 2017 forecasts: Information Technology (to 19.8% in 2017 from 19.2% in 2016), Real Estate (17.1, 25.2), Financials (15.7, 14.4), Telecom (11.3, 11.2), Utilities (10.9, 11.4), S&P 500 (10.6, 10.1), Health Care (10.4, 10.3), Materials (10.0, 9.4), Industrials (9.1, 8.8), Consumer Discretionary (7.3, 7.2), Consumer Staples (6.7, 6.5), and Energy (4.4, 1.1).

US ECONOMIC INDICATORS

Consumer Credit ([link](#)): Consumer credit slowed markedly in April, rising at its slowest pace since August 2011. Credit climbed only \$8.2 billion, less than half March's \$19.5 billion advance and considerably below Q1's average monthly gain of \$15.8 billion. Nonrevolving credit increased at a 10-month low of \$6.7 billion, half the Q1 monthly average. Revolving credit advanced \$1.5 billion in April following a two-month gain of \$9.8 billion; it had recorded its first monthly loss since November 2013 at the start of this year.

GLOBAL ECONOMIC INDICATORS

Germany Manufacturing Orders ([link](#)): German factory orders continued their up-and-down pattern in April, though the economics ministry predicted a "continuation of the gradual upswing" in the sector. April orders slumped 2.1% after a 4.7% jump the prior two months. April's decline was virtually entirely driven by a drop in foreign orders (-3.4%); domestic billings (-0.2) barely budged. The decline in foreign orders was widespread, with orders from both outside (-4.8) and inside (-1.4) the Eurozone contracting. The drop in the former was driven by a 7.7% plunge in capital goods orders—which followed a two-month jump of 7.1%; consumer (1.6) and intermediate (1.5) goods orders rose in April. The decline in orders from within the Eurozone was widespread, with consumer (-3.3), capital (-1.7), and intermediate (-0.2) goods orders all in the red, though the setback in consumer goods billings followed a 24.9% surge during the first three months of the year to a new record high. As for domestic orders, there was little change in capital (0.1), intermediate (-0.4) or consumer (-0.5) goods orders during the month.

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