November 2020

Consumer Cyclical Industry – Outlook

The consumer discretionary sector represents 3.6% and 11.6% of the TSX Composite and S&P 500 indices respectively as of the end of October. Taking my 55% US 45% Canadian equity benchmark weight, this works out to an 8% exposure to the North American markets.

This sector is divided up into different industries such as Auto Manufacturers and Auto Parts, Bricks and Mortar and E- Commerce Retailers, Airlines, Cruise Ships, Movie Theatres, Hotels and Restaurants. This is a fairly diverse group with some pockets such as E-Commerce Retailers doing extremely well under the Covid lockdowns while others that have seen devastation in their revenues and profitability. The Airlines are technically in the Industrials sector, but they perform like consumer discretionary stocks as their business ebbs and falls with consumer spending patterns.

After today's announcement on Monday, November 9th, of some significant initial success with Pfizer's vaccine, the most downtrodden stocks in this sector have sharply rebounded from oversold levels. While this news is certainly encouraging, it is still a little premature to be staging a massive equity rotation into the airlines, cruise ships, movie theatres and restaurants.

However, there are areas in this group that continue to benefit whether a vaccine is immediately on the horizon and available to everyone or not. These include certain bricks and mortar retailers in addition to the E-Commerce ones and the Auto companies. Given the future expected changes in the automobile manufacturing area, I prefer the Auto Parts companies that will supply both hydrocarbon and battery propelled vehicles now and into the future.

Currently the daily stats from the Covid-19 pandemic are not looking very good. Even if a vaccine is approved for distribution in the very near future, it will not be readily available in the quantities needed for a minimum two dosage amount until the middle of next year at the earliest. Consequently, I continue to recommend an overweight but still cautious approach to this sector.

Recently I added Martinrea, the Canadian auto parts manufacturer that specializes in lighter vehicles made with aluminium to both portfolios. I also like Magna which registered a very strong third quarter earnings report last Friday. The reason I only included Martinrea on my list of recommended stocks is that it is trading at a much cheaper valuation than Magna.

In the midst of this pandemic, both new and used auto sales have staged a very dramatic recovery and this is expected to continue into next year. The public is likely to remain very reluctant to take public transportation until they are convinced that a vaccine will be available to everyone and is proved effective in controlling the spread of this virus.

The market is viewing the traditional US bricks and mortar retailers like Wal-Mart, Costco, Target, Dollar General, Home Depot and Lowe's and the E-Commerce ones like Amazon, as Covid-19 beneficiaries. The positive vaccine announcement today by Pfizer has caused the above retailers to decline in price with the market rotating into the more undervalued areas such as airlines, cruise ships, restaurants and movie theatres that stand to benefit proportionately more from the end of the pandemic. As I have already indicated, this new market rotation may be short lived until more evidence of the vaccine becomes available.

Recommendation

I remain cautious of the retailers that have been decimated. I do not recommend bottom fishing the airlines, cruise ships, restaurants and movie theatres at this time. Upon any market weakness, I would add to my positions in the Covid-19 beneficiary retailers like Home Depot and Lowe's that I have mentioned above in addition to Amazon. I also like Dollarama, our domestic discount retailer. Lastly, I would focus any immediate new purchases on the auto parts companies and in particular, Martinrea.