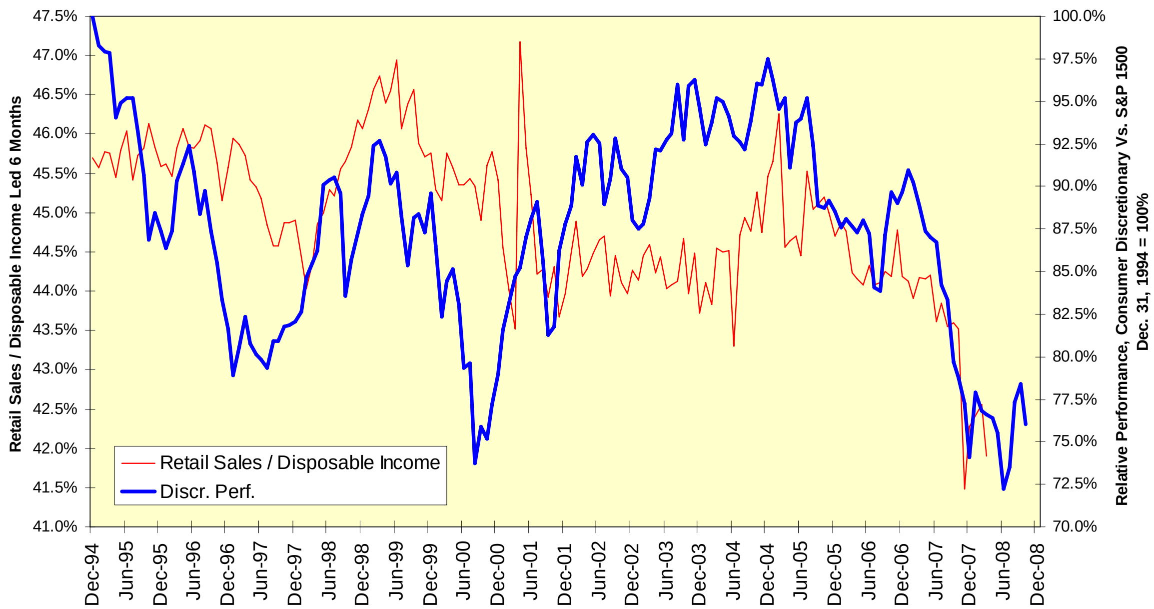
No Valor In Consumer Discretion

Much of the dreadful economic news in recent weeks has centered on consumer spending. Last Friday's 2.8% decline in retail sales, the largest since the series began in 1992, simply confirmed what has been obvious all around us and that is a precipitous decline in all economic activity since the mid-September bankruptcy of Lehman Brothers.

The stock market has been getting this one right. The relative performance of the S&P 1500 (SPR) consumer discretionary sector to the SPR itself leads the ratio of retail sales to personal disposable income by six months on average. If this relationship holds, then we should be in for at least two more months of dreadful retail sales before stabilizing in early 2009. It is too bad from an investment point of view the relationship does not work the other way around, but retail sales do not lead the relative performance of the consumer discretionary sector.

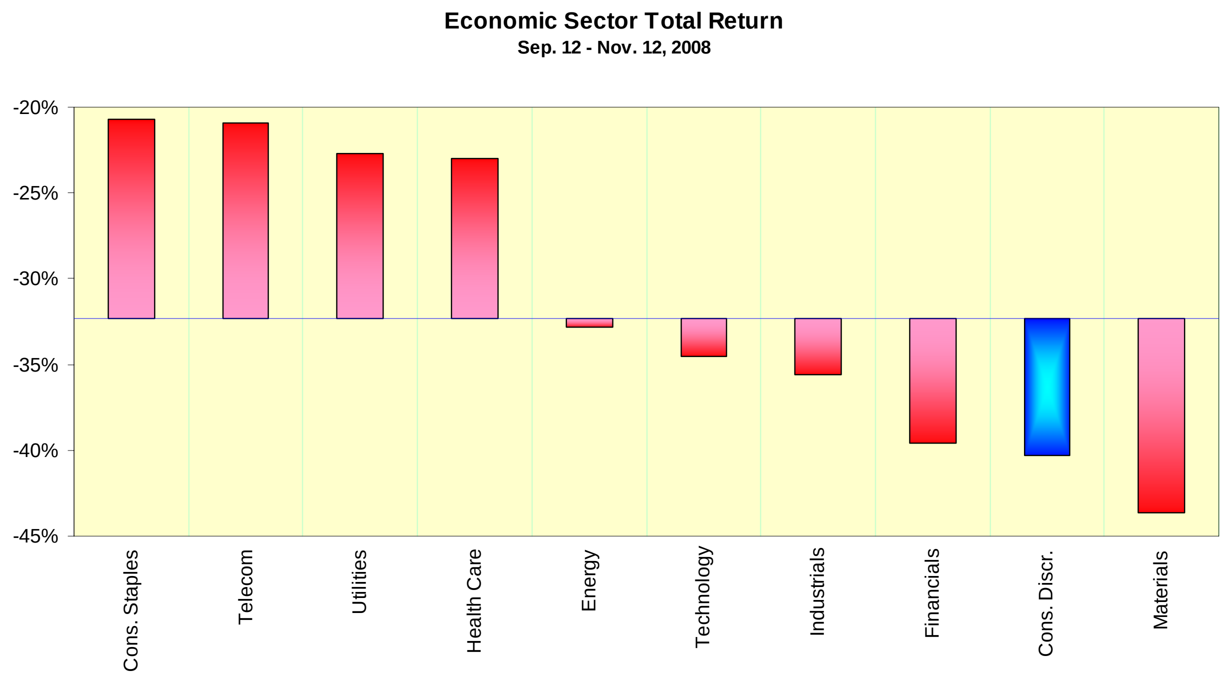
Consumer Discretionary Stocks Lead Spending



Also apparent in this short history is consumer discretionary issues outperform the broad market only during bullish phases. That, as we shall see below, is precisely the opposite of the current situation and suggests this sector should be avoided until we some evidence of an economic and market turnaround.

Sector Performance

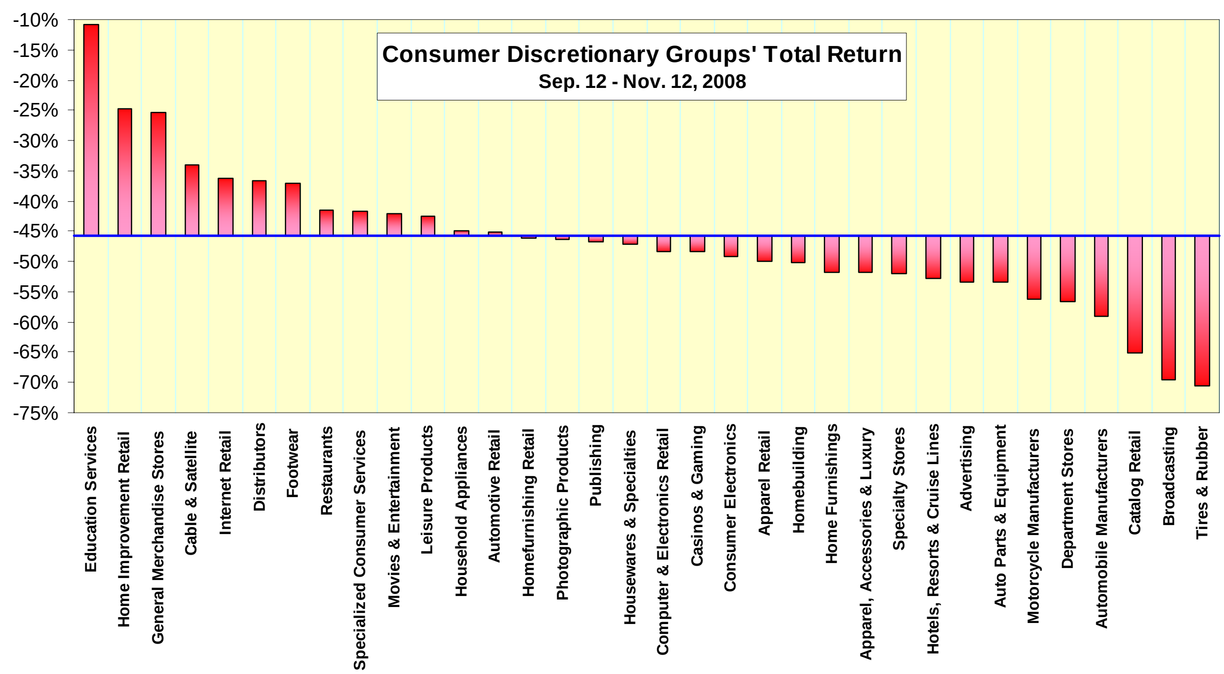
If we use September 12, 2008, the Friday before the Lehman Brothers bankruptcy as a starting point and go through Wednesday of last week, we can see how only the basic materials sector, last discussed here in the context of global mining stocks, has performed the worst. That cannot be surprising in a deflationary environment. The consumer discretionary sector, highlighted in blue, comes next. The total return for the sectors is centered on the -32.3% total return for the SPR itself over this period; please note that even the "best performing" sector, consumer staples, had a -20.7% total return over this period.



Industry Groups

All categorizations in the stock market are arbitrary and therefore are open to quibbling. Take the worst-performing industry group within the consumer discretionary sector, tires & rubber, which is simply Goodyear Tire. A reasonable person might wonder why this is not in the industrial sector or even whether new tires should be considered a discretionary purchase at all.

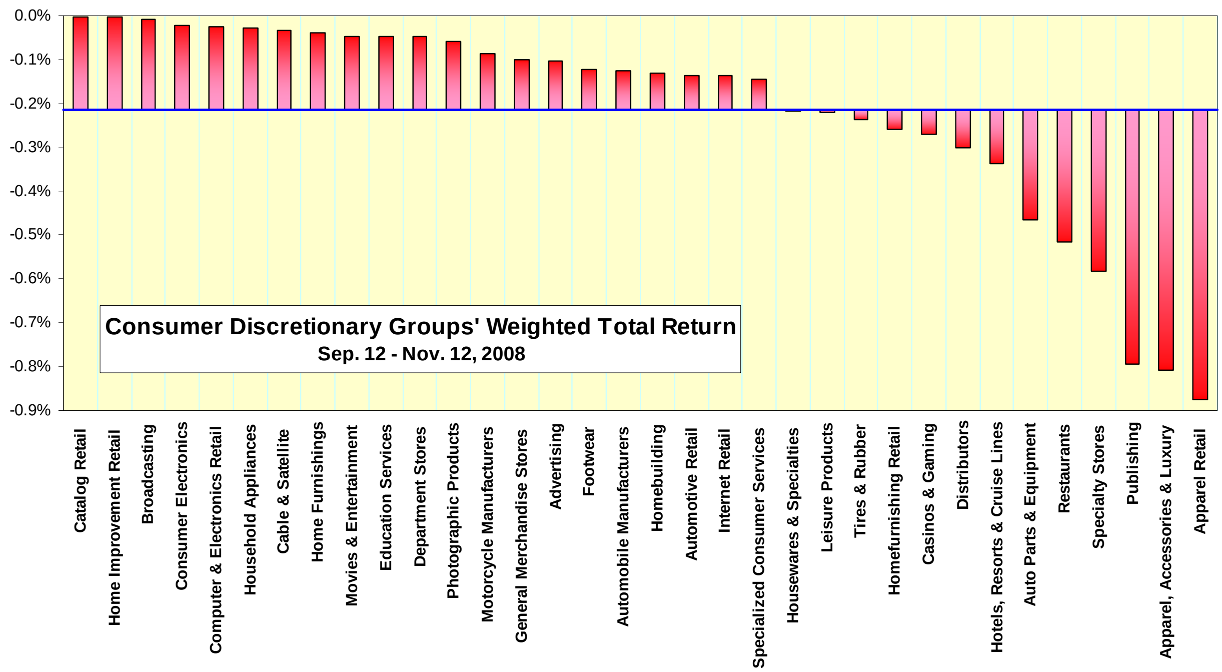
Let's take a look at industry group performance within the sector on two bases, the first unweighted average total returns and the second total returns weighted by capitalization within the SPR. The unweighted group returns, displayed against the average return of -45.77% over the two-month period. Thirteen of the thirty-four groups had total returns of -50% or worse in just a two-month period.



Who were the best performers on a relative basis? Education services and home improvement retail, both of which have an investment component of sorts, in yourself and in the house you might be stuck with for a long time, respectively.

The worst performers on an unweighted basis include tires & rubber, the automobile-related groups and anything related to advertising, including advertising itself, broadcasting, catalog retail and department stores.

Now let's switch over to the weighted total return map measured against the -.216% weighted total return for all groups in the sector. Here's where the story gets bad for the shop-till-you-droppers in our society. The worst-performing groups include apparel retailers, apparel, accessories & luxury and specialty stores. Other poor performers include restaurants and travel-related groups such as hotels, resorts & cruise lines and casinos & gaming.



The weighted return map tells us quite clearly American consumers, a category that includes all of us, are cutting back and cutting back severely on their truly discretionary purchases. Yes, there are legends about how lipstick and other cheap "reward thyself" purchases rise in a recession, but the data here tell us we are cutting back on life's little joys. Like clothes.

Save Till You Rave

I noted back in March how risk-averse investors would respond to losses by spending less and saving more; I did not, in all honesty, anticipate the severity and magnitude of the present dual wealth shock in real estate and financial assets.

Americans were able for years to delegate their future income-generation liabilities to rising asset prices. Either your investments were rising in price or your house could be turned into an ATM machine. More important, we had created institutions designed to shovel credit out the door irrespective of the borrower's creditworthiness. What could go wrong there?

We are now in a perfect storm of a credit crunch, declining asset prices and rising unemployment. The logical response for households is to rebuild their balance sheets by saving more and spending less. That decline in aggregate demand, as Keynes noted during the Great Depression, needs to be offset by government spending.

What is our government doing? Are they borrowing our collective savings to engage in worthwhile investment projects such as the Hoover Dam or in needed infrastructure development and improvement? No, they are coming up with a plan-of-the-day to bail out previous bad investment decisions and inept corporate managers. I cannot speak for the deceased Lord Keynes, but I suspect he would be puzzled by Hank Paulson's frantic and cockamamie actions of throwing money around, confusing various markets and holding out the promise of government assistance to anyone and everyone with the temerity to ask for it.

The net result of a scared consumer who is not spending and is turning over household savings to a government congenitally unable to spend it productively was tried both in the U.S. in the 1930s and in Japan in the 1990s. As I noted in this context last month, past performance does not predict future results, but what else can you use?

If discretion is the better part of valor, consumer discretionary stocks are the better part of forbearance.