

Sector Overview

Consumer Discretionary A is comprised of automobiles and components, consumer durables and apparel, and consumer services. Specifically, consumer discretionary refers to any consumer spending that is not a necessity. Based on the second quarter of 2018, the chart below shows consumer discretionary makes up 12.86% of the S&P 500's total weight. The top five holdings within the consumer discretionary sector are: Amazon (AMZN), Apple (AAPL), Microsoft (MSFT), Facebook (FB) and At&T (T).

Business Analysis

Compared to the S&P 500, the consumer discretionary market has been performing very well over the past year. The chart below shows that the consumer discretionary sector has outperformed the S&P 500 by a little over 13 percent. It is also the largest growth sector over the past year at 29.83%. Further into this report, we are going to look at what specific factors are driving this sector and why it is the number one performing sector over the past year.



SWOT Analysis

Strengths: <ul style="list-style-type: none"> • Current economic status • Considerably low interest rates • Wage growth 	Opportunities: <ul style="list-style-type: none"> • Technology growth • Newer, more innovative products
Weaknesses: <ul style="list-style-type: none"> • Non-essential goods and services • Dominant corporations control the majority of market share 	Threats: <ul style="list-style-type: none"> • Economic uncertainty • Current political conditions (Trade Wars)

Personal Consumption Expenditure (PCE) Changes

Over the past decade, Consumer spending has started to shift. Research shows that there is less and less spending on durable goods, such as household equipment, home furnishings, automobiles, and auto parts. This slack has been picked up in increasing purchases of accommodations, recreation, and other experience-related products and service. The market has seen a sharp increase in households planning vacations over the past year, while at the same time, recreational vehicles, cruise lines, and other recreation/leisure services and products are seeing increasing consumer-confidence scores.

The reason for this shift is related directly to social media use, especially among millennials. Social media users are just one click away from seeing a picture or video of their friends and family sailing across the Mediterranean Sea, hiking across the Andes, attending a music festival and so on. As the number of people who view these things online grows, so does the desire and envy to share their own travel experiences.

Sub-Sector Overview

Automobiles and Components: The automobile and components industry group include companies that make cars and motorcycles as well as companies that make auto parts and tires. Making up .52% of the S&P is the Automobile and Components subsector. The top five companies (Market Cap) within this category include: General Motors (GM), Ford (F), Aptiv PLC (APTV) BorgWarner Inc, and Harley Davidson (HOG).

Consumer Durables and Apparel: Consumer durables and apparel refers to products that are not purchased on a frequent basis. Examples include, sofas, TVs, microwaves and even homebuilding are considered durable products. This sub-sector of consumer discretionary makes up 1.18% of the S&P 500. The top companies (Market Cap) within this sub-sector include: Nike, Inc (Nke), Vf Corporation, (VFC), D.R. Horton (DHI), Lennar (LEN) and Tapestry (TPR).

Consumer Services: The last section of consumer discretionary A is consumer services. This sub section is broken down into two main industries which include hotels, restaurants and leisure and “diversified consumer services.” Diversified consumer services include every other business from educational services to legal services. Within the hotels, restaurants, and leisure industry there are casinos, travel agencies, cruise lines, fitness centers, stadiums, golf courses and theme parks. Making up 1.70% of the S&P 500 is the Consumer Services Subsector. The top five companies (Market Cap) within this sector include: McDonalds (MCD), Starbucks (SBUX), Carnival Corp. (CCL), Marriott INTL, and Yum Brands (YUM).

Porter’s Five Forces: Porter’s five forces helps us analyze the overall sector of consumer discretionary to give us a better understanding.

1. **New Entrants** – The consumer discretionary sector is very hard to enter due to the dominance of well-known companies and corporations that control a massive amount of the market space. This space also requires a large amount of capital making it tough for new entrants. Thus, it is very tough for new entrants making this force extremely high within the Consumer Discretionary sector.
2. **Supplier Power** – Since this sector relies heavily on demand of the consumer, the consumer has a great amount of power. Discretionary items are only bought when consumers have a spare discretionary income, thus placing the power in their hands. This sector can also be price sensitive as the consumers control most of the power. Therefore, supplier power is low within this sector.
3. **Threats of Substitutes** – This sector is comprised of many competing brands and products consumers can choose between. A perfect example of this is displayed within the automobile space, when looking for a truck the consumer has a choice between many different brands.

Therefore, this makes competition tough as corporations are fighting continuously for market share, which making this a high force within the sector.

4. **Buyer Power** – Since products in the consumer discretionary sector are non-essential, the buyer has the ultimate power over whether they will purchase. The discretionary sector has many alternative products giving buyers even more control as they are often not brand loyal and will switch between brands. This makes the issue force of buyer power especially high within this space.
5. **Degree of Rivalry** – Competition is extremely intense within this sector making this force also high. An example of this can be seen within the fast food industry as there are many different competitors battling for market share. Since rivalry is strong, corporations have to focus heavily on marketing efforts to position their brands within the consumers mind.

Economic Analysis

Key Drivers:

- Inflation
- Overall Economy
- Interest Rates
- Political Atmosphere
- Unemployment Rate
- Commodity Price Volatility
- Consumer Confidence
- Consumer Discretionary Income (Prices/interest rates, Availability of financing, Savings rate, Real income)

Inflation: Inflation greatly affects the consumer discretionary market as well as the entire economy. If inflation is controlled to a reasonable rate, employment will increase, causing consumers to have more money to spend on discretionary goods. When inflation is greater than nominal wage growth, consumer's disposable income will fall, therefore, reducing discretionary spending. Inflation erodes away at purchasing power, causing consumers to have less disposable income after covering for necessities. On top of that, higher price tags on discretionary goods and services deters spending.

- **Our Prediction:** The current inflation level this year has average out to be 2.55%. Over the past three years, this number has been steadily increasing. We believe that the current inflation rate in the United States will stay around 2.0% -2.5% through the year 2023. This is because gas prices are modestly increasing, and the cost of household utilities is dropping. Furthermore, the CPI has been rising slightly over the past couple of years, (2.3% increase this calendar year) causing inflation to rise from the previous years which will eventually stabilize this year at 2.0% - 2.5%.

Overall economy: The single most key driver we feel is the economy. Since consumer discretionary goods and services aren't a normal everyday purchase for our society, the economy greatly impacts this

sector. With the economy being a key influencer of the market, we feel the discretionary sector is especially influenced as discretionary spending only occurs when the market is thriving, as it currently is.

- **Our Prediction:** Looking into the future, we feel the market will continue to grow and thus this sector will continue to thrive. We believe we are in the stabilized stage of the economic growth cycle as consumer discretionary is outperform the S&P 500 by over 13%.

Interest Rates: Interest rates are another major driver of this industry, as they are a key influencer of major discretionary purchases bought with credit. As interest rates rise, we see a decline in consumer willingness to spend and this remains true in the consumer discretionary space. Forecasts show interest rates steadily rising which we see as a positive for this sector. Since certain aspects of the consumer discretionary sector are heavily dominant on credit, this potentially causes trouble if rates were to jump as it would surely halt revenue.

- **Our Predictions:** We believe the Federal Reserve is going to slightly increase interest rates through 2018. Just announced on 9/26/2018, policymakers under Chairman Jerome Powell agreed to raise the federal funds rate a quarter percentage point, to a range of 2% to 2.25%. The policymakers also stated, we should expect one more raise hike by the end of 2018. Even if the Fed were to raise the benchmark interest rate to 3% next year, we do not think this will slow the economy down. This should not cause mortgage rates to raise substantially and we do not see this as that big of threat to credit line borrowing.

Political Atmosphere: The political atmosphere both domestically and globally drives the consumer discretionary market. One key example of this are the current trade disputes such as NAFTA that are a current hot button issue. Since the discretionary products made overseas require a complex and tedious supply chain this is a great threat. US manufacturers rely heavily on imports from overseas which may soon be seeing increased tariffs. As tariffs increase, so will prices down the line which will affect the industry.

- **Our predictions:** We believe that increased trade wars will impact the economy. Since we are in an era that involves a complex global supply chain, trade wars will play a part. Basic economics say that if goods are more expensive early in the supply chain, it will cause a lasting effect further and further down.

Unemployment Rate: The current unemployment rate has a huge impact on the overall economy especially the consumer discretionary sector. When there is a high unemployment rate, this slows down the flow of money by lack of inflow, as well as outflow. Less money will get pumped into the economy, causing growth to become sluggish. This will shift consumer expenditures to increasingly lower levels because the unemployed are trying to stretch their financial assets for longer durations due to uncertainty of the end of unemployment. Because of financial limitations of the unemployed, their discretionary income and expenditures will go down. With less sales, consumer discretionary companies must reduce their outputs, subsequently decreasing profits. This causes companies to reduce their budgets, often by laying off employees. It is clear to see that as unemployment goes up, the consumer discretionary sector takes a big hit.

- **Our Predictions:** The current unemployment rate has reached an all-time low since 2000, at 3.8%. We believe that this number will go down slightly as the number of jobs created this year alone is well over one million.

Commodity Price Volatility: Commodity price volatility such as gas prices, plays a crucial role in discretionary spending. Research shows that consumer discretionary spending closely mirrors oil prices and that individuals spent nearly 80 percent of their savings from lower gas prices at the pump. Meaning for every dollar less spent paying for gas, consumers spent 73 cents on other things like discretionary goods. Most of these savings are spent on restaurants, department stores, entertainment, electronics, and appliances.

- **Our Predictions:** We believe that the price of crude oil is going to rise through 2018 and a little into 2019. Oil prices have just hit a 4-year high of \$82 a barrel and driving this is the Iranian Sanctions. Because of these sanctions, supply will be lower and there are end of year predictions of \$90 per barrel. This will continue into the first half of 2019 where prices could reach \$100 per barrel.

Consumer confidence: Another large driver of the consumer discretionary sector is consumer confidence. Consumer confidence measure consumers' feelings about the current and future state of the economy. Consumer confidence has been on a steady incline since 2008 and in 2018 alone, the consumer confidence index has reach all-time highs since 2004. Based on the current 10-year trends of consumer discretionary spending, we can establish that when consumer confidence goes up, so does discretionary spending. This occurs, because when consumers believe the economy is heading in the right direction, they change from saving money to spending money and this helps boost the consumer discretionary sector.

- **Our Predictions:** Consumer confidence is at its highest level in nearly 18 years (138.4) and closing in on the all-time high (144.7), which we see as a positive driving force for the consumer discretionary sector. When consumers are highly confident they are much more likely to spend, especially in the discretionary space. Thus, we feel this is a very positive predictor for the trend of the discretionary sector.

Consumer Discretionary Income: When evaluating these key drivers of the consumer discretionary A, it boils down to the consumer being the main driver of this industry. Based on a Porter's Five Force's analysis of this sector, the buyer power is extremely high, while the supplier power is low. The main reason for this is because the products in this sector are non-essential items. Buyers can choose if they want these products or not because they can live without them. One needs to look at what controls consumer's discretionary income to fully understand this sector.

Consumption in the United States is primarily financed out of our income. This means that real income greatly controls consumer discretionary spending, however, other drivers such as prices and interest rates, availability of financing, and savings rate also play a roll. Real income is affected by wage growth and inflation. If inflation continues to rise, while wage growth stays the same, consumers have less discretionary income because they will have less money after paying for higher priced necessities. Another impact of consumer discretionary income is current prices of certain goods. As the prices of necessities such as food, housing, clothing, etc. go up or down, it directly impacts available funds for

discretionary products. Interest rates also play a key role in consumer discretionary income because as interest rates drop, more people are willing to spend more money on larger purchases. Furthermore, by paying less in interest payments, consumers have more income that can go towards other goods and services across the broader economy. When interest rates increase, it makes certain purchases on credit substantially more expensive, therefore deterring expenditure. Higher interest rates also cause stiffer financing, which again, make it more difficult for customers to obtain necessary loans on major purchases. Research shows that consumer often delay purchasing luxury items until more favorable financing terms are available.

- **Our Predictions:** We believe that job growth, tax cuts, CPI trends, and inflation are all going in favor of consumers increasing their discretionary income over the next 3 years. On the other hand, factors such as oil price increases and interest rate increases are going to hinder discretionary income. In total, the pros outweigh the cons and discretionary income should increase slightly over the next coming years

Recommendations

Current Portfolio Consumer Discretionary A:

Security Name	Ticker	SHARES	PRICE	Value (\$)	WEIGHT	INDUSTRY
Ulta Beauty Inc	ULTA	13	\$ 282.87	\$ 3,677.31	2.1%	Consumer Discretionary A
MGM Resorts International	MGM	110	\$ 27.59	\$ 3,034.90	1.7%	Consumer Discretionary A

When analyzing our current portfolio consumer discretionary A companies, we decided to focus on revenue, net income, and same store sales growth. We chose these metrics because this industry relies on sales and without them, these companies will not grow.

APTIV PLC: SELL

Year	Jan '18	Jan '17	Jan '16	Jan '15	Jan '14	Jan '13	Jan '12	Jan '11	Jan '10
Sales	\$ 12,884.00	\$ 16,661.00	\$ 15,165.00	\$ 17,023.00	\$ 16,463.00	\$ 15,519.00	\$ 16,041.00	\$ 13,817.00	\$ 11,755.00
YoY Sales Growth (%)	-29.3%	9.0%	-12.3%	3.3%	5.7%	-3.4%	13.9%	14.9%	
Net Income	\$ 1,021.00	\$ 1,152.00	\$ 1,188.00	\$ 1,351.00	\$ 1,212.00	\$ 1,077.00	\$ 1,145.00	\$ 631.00	
YoY NI Growth (%)	-12.8%	-3.1%	-13.7%	10.3%	11.1%	-6.3%	44.9%	100.0%	

We recommend a sell on APTIV PLC. Net income has shown negative growth over the past three years over a time where vehicle production has displayed steady growth. With trade wars and tariffs looming, we feel APTIV will be among the companies impacted. The complex global supply chain the auto industry utilizes will be strongly affected by increased tariffs and trade regulations, thus impacting APTIV PLC first hand. We are also recommending a sell based on the opinion that APTIV will not be perform

positively in years to come. Therefore, unfavorable forecasts and the threat of increasing costs due to trade regulations make us believe APTIV PLC deserves a sell recommendation.

MGM Resorts: HOLD

Year	Jan '18	Jan '17	Jan '16	Jan '15	Jan '14	Jan '13	Jan '12	Jan '11	Jan '10
Sales	\$ 10,774.00	\$ 9,455.00	\$ 9,190.00	\$ 10,082.00	\$ 9,810.00	\$ 9,161.00	\$ 7,849.00	\$ 6,019.00	\$ 5,979.00
YoY Sales Growth (%)	12.2%	2.8%	-9.7%	2.7%	6.6%	14.3%	23.3%	0.7%	-----
Net Income	\$ 1,942.00	\$ 1,101.00	\$ (448.00)	\$ (150.00)	\$ (157.00)	\$ (1,768.00)	\$ 3,115.00	\$ (1,437.00)	\$ (1,292.00)
YoY NI Growth (%)	43.3%	-----	-198.7%	4.3%	91.1%	-156.8%	-----	-11.3%	-51.0%

We recommend a hold for MGM Resorts. MGM has shown an overall increase in NI and sales throughout the past two years, with another positive year forecasted. This makes sense considering the many positive factors that are driving this company. To begin, consumer confidence is at 18-year high meaning consumers are more likely to take that vacation or trip they have been holding out on. Consumer discretionary companies depend highly on the economy which certainly is stable meaning, discretionary spending is up, making MGM attractive. Another positive factor for MGM is the newly founded sports franchises making the trek to the strip. With recent success of Vegas' expansion franchise, the Golden Knights and the Raiders set to move in within the near future, Vegas is a booming town. Thus, we feel MGM will continue to thrive off these outside forces and should be held.