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New Year New Rules: The Shifting Landscape of Retail

2020 was a market-shaping year with effects that will be felt well into the future. While the pandemic reshaped most facets of everyday life, there is no doubt that the retail industry experienced a shift that will be felt long after the pandemic subsides. Today, as we navigate new virus strains and vaccine rollouts, it is important to understand how consumer behavior changed in 2020 and what that may mean for 2021.

Sector Views

The retail market is a really a conglomeration of overlapping and integrated business sectors: Consumer Discretionary and Consumer Staples.

The Consumer Discretionary sector, as the name implies, includes companies that produce or sell non-essential products that consumers often do without when they are under financial stress or worried about job security. These industries within the sector tend to do best when the economy is growing and consumers feel confident about spending money. Low interest rates also tend to be a positive, as this encourages people to borrow and spend.

The sector has a number of industries with a high degree of exposure to COVID-19 business shutdowns and shelter-in-place orders, particularly the hotels & leisure and apparel industries. Many of the travel-related hotel and cruise liner stocks remain well below year-ago levels, but other COVID-sensitive retailers have fully recovered amid stimulus to households and businesses, despite still-high unemployment. However, those industries are often overshadowed by bigger companies in the sector, many of which were boosted by COVID-19-related restrictions, such as home improvement stocks and the internet retail equities: Amazon in particular, which constitutes about 33% of the sector's market cap. And the addition of Tesla late in 2020 further concentrated the sector, with these two stocks constituting nearly half of the market capitalization. The ongoing trend away from brick-and-mortar retail business and toward electric vehicles is likely to continue, but investor enthusiasm may have pushed valuations too high, despite the strong fundamentals in the sector heavyweights.

Positives for the sector:

- Online and home-improvement retailers benefit from social distancing;
- The shift away from brick-and-mortar is likely to continue to support online retailers;
- Economic recovery is positive for many of the more traditional discretionary industries.

Negatives for the sector:

- COVID-19 uncertainty likely to continue to weigh on travel and leisure activities;
- The sector is overly concentrated in internet retail and automobiles;
- Valuations and investor enthusiasm appear stretched.

Risks for the sector:

- Antitrust action is possible for the largest online retailer;
- Renewed weakness in the economy and/or stay-in-place orders likely would hurt traditional retailers.

Consumer Discretionary Conclusion: Market Performance

The ongoing recovery in the economy and shift toward cyclical sectors has resulted in underperformance of the Consumer Staples sector since the market low in March 2020—as would be expected for a defensive sector whose constituents are less affected by changes in the business cycle. However, there have been winners and losers within the sector as ongoing—albeit more modest—social-distancing behaviors continue to bolster grocery and big-box discount retailers, while some food wholesalers that service restaurants face continued headwinds. In general, retailers within the sector have aggressively cut costs, leaving them in reasonable financial condition. But limited pricing power in a low-interest-rate environment gives them less–than-exciting top-line growth potential.

With additional fiscal stimulus, rollout of the vaccines, and accommodative monetary policies, we think the economic recovery has a better chance of maintaining traction—though some choppiness is expected early in the year. At this stage of the business cycle, the consumer staples sector typically underperforms the overall market. We think growing confidence in the economy will continue to weigh on relative performance going forward.

Positives for the sector:

- It typically has a stable earnings profile;
- Companies have engaged in aggressive cost-cutting.

Negatives for the sector:

- An improving economy and strong stock market historically typically make this defensive sector relatively less attractive to investors;
- Companies tend to have limited pricing power in a low-inflation environment.

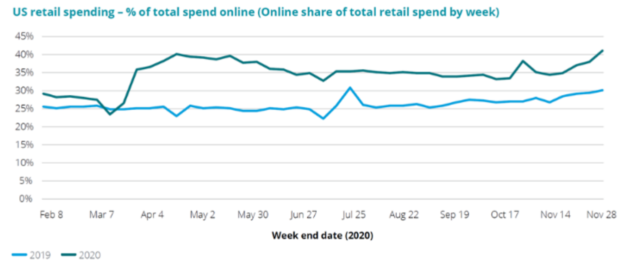
Risks for the sector:

- Additional government fiscal stimulus and the future availability of a COVID-19 vaccine could further support the economy and reduce stay-at-home food and staples demand.

Consumer Staples Conclusion: Underperformance

While many retail executives agree that prepandemic trajectory levels will take time, 2020 provided many organizations the opportunity to re-evaluate their business models in light of this disruptive environment and pivot towards a more sustainable approach more rapidly.

The retail business landscape no longer looks like a small brick and mortar storefront with the occasional online presence and email newsletter. In Deloitte's 2020 holiday retail survey, half of consumers said their most preferred starting point for their holiday shopping journey was online search engines or online-only retailers.



For the long game, the new rule of retail is about looking for new revenue models, like subscriptions or memberships, and forming new partnerships and alliances to create a profitable and digital omnichannel experience. For example, some traditional brick-and-mortar companies are teaming up with digitally native retailers to gain efficiencies. These partnerships may open up cross-channel opportunities for both while also expanding their customer bases.

At MFA Wealth, our view is to maintain a broadly diversified portfolio in spite of these sector forecasts. The retail sector of today will not be the retail sector of tomorrow. Despite the push towards online shopping en masse, there will be still be a need for local retail stores for shoppers who prefer convenience and have "try before you buy" attitudes. Our portfolios will maintain prudent exposures to both types of retail businesses as they evolve over time.

References:

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