

Consumers are game changers in 2011

Strong retail sales, personal income and consumption data bode well for the equity market

INVESTMENT STRATEGIES

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We are in the midst of a broadening global synchronized expansion with the ascendant consumer as a game changer.

A year's worth of consumer-spending growth in the United States was punctuated by a populist uprising in November's midterm elections that resulted in a redirection of fiscal policy. Hugely populous "emerged" markets in Brazil, India and China have developed a consumer class, as have newly emerging markets in South Africa, Turkey and Vietnam.

As an unexpected bonus, certain parts of the Middle East are beginning to move toward democratic systems of government more likely to allow them to participate in and contribute to world prosperity.

The consumer is back.

Despite nearly 10% unemployment in the U.S., 2010 retail sales delivered 12 months of year-over-year increases and reached their highest monthly level ever in December, at \$380.9 billion. Both personal income and personal consumption reached all-time highs by year-end.

Those fearful that profligate consumer spending has returned will be reassured to hear that the savings rate remains above 5%, illustrating a smarter, more confident consumer.

Although largely overlooked, clear evidence of this consumer renaissance could be found in the equity market. Amid pervasive fear and a tepid economic recovery, consumer discretionary stocks dominated the S&P 500 last year, returning a splashy 27.66%.

Consumer discretionary also was the top-performing sector among small- and mid-cap names.

The consumer accounts for 70% of U.S. gross domestic product. We forecast that the U.S. will add 2 million jobs this year, further fueling the consumer growth engine.

Although employment growth out of the recession has been sluggish, initial jobless claims recently dropped below the 400,000 mark to reach their lowest level in two and a half years, a very positive signal

for the job market. The resurgent employment picture suggests that investors should be fully exposed to the equity market, with particular attention to those sectors likely to benefit from increased momentum in consumer spending.

To identify potential beneficiaries, look at top-line growth, or sales.

Although earnings growth has been solid for some time now, it has been driven mostly by the cost cutting that took place when the recession hit. Top-line growth, however, especially in consumer-oriented sectors, only recently has begun to pick up — foretelling future investment opportunity.

Within the consumer discretionary sector, the number of companies beating consensus estimates for top-line growth has been high across capitalizations; 70% of large-caps, 71% of mid-caps and 66% of small-caps posted higher-than-expected sales results last year.

We especially favor small- and mid-cap stocks, which often are overlooked and underanalyzed but have outperformed large-caps in every market cycle. Mid-caps offer the most favorable risk/reward trade-off.

However, those investors who are more comfortable with large-caps still can find much to like. Of the 11 large-cap consumer services companies that have reported fourth-quarter results, 100% had increased earnings and 82% revenue. In particular, household names within the consumer discretionary sector beat expectations by reporting fourth-quarter-sales growth in excess of 20%.

Keep in mind that a client can participate in the virtuous consumerism sweeping the globe simply by investing in the United States, the largest and most consumer-driven economy in the world. Already, almost 50% of sales generated by S&P 500 companies originate abroad, and U.S. companies are by far the world's most sought-after, experienced consumer companies.

Rest assured, though strong results already have been generated, it isn't too late to ride this wave. Consumer sentiment is just hitting its stride, reaching an eight-month high in February.

When it comes to the markets, the consumer is a game changer, and the game has only just begun.

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