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Consumption recovery through 2024 provides opportunities

Key messages

- Despite the weaker economic environment, consumption in the U.S. and Europe is holding up relatively well. The main reasons for this are savings, a continued high level of employment, a slow recovery in real incomes, declining inflation and the prospect of falling interest rates in 2024.
- Estimates of remaining savings from the pandemic years vary widely and should be treated with caution. Consumption has returned to trend in the U.S., but not in Europe. Real wage increases and better growth prospects should also drive the European recovery.
- European and U.S. consumer discretionary stocks outperformed the overall market in 2023 as economies remained resilient but a recession was priced into the sectors. The further development of the sector depends largely on the future situation of private households in Europe and the U.S., as well as the growth in Asia.

01 Weak growth, but...

Growth prospects in Europe and the U.S. for 2024 are subdued. However, the Eurozone is likely to see moderate growth of 0.7% over the course of the year as inflation eases. For the U.S., we expect a slight recovery towards the end of the year after an equally weak performance in the first half.

This weak economy is a result of monetary policy aimed at further reducing inflation. In this respect, the resulting decline in price pressure is an important determinant of the further development of private consumption. This is because the decline in inflation brings interest rate cuts by central banks within reach.

Although the slowdown in the economy is likely to cause some fallout for the labour market, it seems unlikely that there will be any major job cuts. Rather, many companies are likely to have learnt from the pandemic years and will avoid making large-scale job cuts so that they have the necessary skilled workers available when the economy recovers. In the aftermath of the pandemic it became clear that employees who had been dismissed could not be easily rehired when the economy picked up again. These fairly favourable employment prospects should buoy consumer sentiment for the rest of the year. The positive mood among consumers is likely to be reinforced by a further recovery in real incomes due to wage increases and falling inflation.

In this environment, we recommend a differentiated investment approach. We see opportunities in the area of cyclical consumer stocks, although we see some regional variations. By contrast, we see less potential for returns from consumer staples stocks in the current market environment.

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02 Situation of consumers

Private consumption in the U.S. has proven to be very robust despite high inflation in recent years. Observers attribute this phenomenon in particular to households having been able to fall back on savings that they had built up during the coronavirus pandemic.

On one hand, these savings were accumulated because households received extensive government support, including comparatively high one-off payments and a moratorium on student loan repayments. In addition, the financial situation of households improved as interest rates fell and loans could be rescheduled at favorable terms.

At the same time, consumption was only possible to a limited extent during the pandemic. As a result, the household savings rate increased significantly during the pandemic. At its peak, U.S. households set aside more than 30% of their after-tax income, more than three times as much as in the years before the pandemic. Economists refer to the difference between the actual savings during the pandemic and the savings that would theoretically have occurred if the savings rate had continued along its long-term trend as "excess savings".

The fact that households reduced their savings again after the pandemic led to a rapid economic recovery, which first fed through to the consumer goods market and then to the previously particularly hard-hit service sector and is still evident today. At the same time, however, this has also contributed to a rise in inflation, which in turn is now weighing on households.

In order to forecast how long the one-off effects on consumption that have resulted from the excess savings can continue, economists are trying to deduce how much of these savings households still have left. Unfortunately, their estimates vary widely. This is because the estimates are based on assumptions about the historical savings trend. The lower the assumed trend savings rate, the higher the resulting excess savings, and vice versa (see Figures 2 and 11). Some analysts therefore argue that the excess savings in the U.S. have already been used up, while others estimate that U.S. households are still hoarding more than USD1tn in their accounts.

We believe it is reasonable to assume that the tailwind from excess savings for consumption in the U.S. is likely to weaken going forward. Other important factors such as the development of the labour market and interest rates should therefore become more significant.

The change in interest rates is relevant because those households whose savings have been exhausted may tap other sources of finance such as loans (including credit cards) to finance their consumption. Following the Fed's tightening of monetary policy, these households are facing significantly higher interest rates and much stricter lending conditions. Both factors suggest that consumption by these households is likely to decline in the medium term, especially as student loan repayments have to be made again in the meantime.

Overall, however, the household sector in the U.S. is still in a strong position and shows little sign of imminent weakness. The number of borrowers who are in arrears with their repayments remains very low and is still below pre-pandemic levels. This applies to mortgages in particular. However, there has recently been at least a slight increase in late payments for credit cards and car loans.

One important reason for this is that real household incomes are recovering. In November, they were already 4% higher than in the same month last year. This was also reflected in the latest data:

According to the latest figures from the University of Michigan, consumer confidence rose from 69.7 index points in December to 78.8 index points in January due to falling inflation, reaching its highest level since July 2021. In November, real consumer spending (i.e. adjusted for price effects) also increased by almost 3%. Nominal data from December, which is already available, shows no signs of a slowdown. The fact that real estate values in many regions of the U.S. have now bottomed out or are even trending upwards and that the stock market has climbed to new highs is certainly also responsible for the robust state of the economy. Both factors have ensured that average household wealth has resumed its long-term upward trend.

In the final quarter of 2023, the U.S. economy grew at a strong annualised rate of 3.3%. One of the main reasons for this was the sharp rise in household consumer spending, which grew at an annualised rate of 2.8%. Analysts expect the positive trend in real incomes to continue in 2024. They are forecasting a further increase of around 3%. In our opinion, the chances of this are good. Finally, we expect that the tightening of monetary policy will lead to a further normalisation of the labour market, but that there will be no sharp rise in the unemployment rate.

The effect of interest rate hikes on the labour market to date, which have had a negative impact on companies' demand for employees, is reflected in the ratio between the number of job vacancies and the number of job seekers. While there were still two unfilled vacancies for every jobseeker in summer 2022, there are now only 1.4 and therefore only slightly more than before the pandemic, when the figure was 1.2 vacancies (see Figure 7).

This normalisation is likely to continue over the course of the year. In our opinion, there may well be a slight increase in the unemployment rate, as companies could start to both stop advertising new jobs and lay off employees. The unemployment rate could therefore rise slightly from its current record low of 3.7%.

Nevertheless, structural factors such as the shortage of skilled workers, caused among other things by the retirement of baby boomers from the labour market, should ensure that wage growth remains robust despite the rise in the unemployment rate. As inflation is also expected to fall according to our forecasts, real wage growth should still be positive.

Overall, the factors described above result in a mixed outlook for U.S. consumption. Declining savings and high interest rates are negative factors – especially for the lower income groups. At the same time, the structural situation on the labor market for employees should have an overall positive effect on the economy and allow real wages to grow moderately. Due to the absence of the usual weakness on the labor market in the traditional economic cycle, we therefore see more light than shadow and expect U.S. consumption to remain robust and support the economy.

This also applies to the Eurozone, where the labour market has also defied all the odds so far.

Due to the also increasing impact of structural factors, the unemployment rate fell to a new historic low of 6.4% in November despite stagnating growth overall (Figure 1). Another reason for this development is, among others, that weak Eurozone growth stems primarily from the manufacturing sector. However, as the more labour-intensive service sector has held up better so far, the overall impact on employment has so far remained manageable.

Although the proportion of unfilled vacancies has fallen slightly recently, it is still at a historically high 2.9%. We therefore expect wage growth in the Eurozone to outpace inflation in 2024 for the first time since the end of the pandemic. There are already signs of this: real wage growth has already turned positive in Germany and Spain, among other countries.

This should support consumption, which still has potential to catch up anyway. Real retail sales are still below their 2019 level in many EU countries. Falling inflation has already led to a positive trend in consumer confidence. However, the current mood is still being weighed down by the weak macroeconomic outlook and stricter bank lending standards and should brighten over the course of the year. However, the favourable state of the labour market is also evident here: household members consider the risk of losing their job in the near future to be rather moderate. These expectation components usually play a certain role, particularly when deciding on major consumer purchases.

We expect the unemployment rate to rise only slightly to 6.5% in 2024. The further development of wages is an important determinant of the ECB's monetary policy. In the eyes of the ECB, excessively high wage settlements could trigger unwelcome second-round effects and cause inflation to rise again. In this case, the expected interest rate cuts by the ECB could be postponed further.

The recovery in consumption could therefore initially remain weak and only gain momentum in the course of 2024 when inflation has fallen further, recovering real wages are slowly reflected in spending, the ECB begins to cut interest rates and the positive growth outlook becomes clearer. Our forecast points precisely in this direction.

A major part of our economic growth forecast comes from Asia. After a strong upswing in the first half of 2023, China recorded GDP growth of 5.2% in the last quarter of 2023. The slower growth in the final quarter is largely due to the current weakness of the residential real estate market. The residential real estate market will remain the biggest brake on growth and sentiment in the medium term. Many Chinese invest their savings in real estate, which is why price declines weaken the asset position of many households.

Unsurprisingly, Chinese consumers are holding back on consumption. Inflation rates confirm this picture, with consumer price inflation decline in December at -0.3%.

However, the government responded to the economic situation with further support measures. In addition to the central bank's reduction in minimum reserve rates, targeted measures are being taken to improve the situation on the residential real estate market.

If the real estate market develops more favourably again, consumer confidence should also return. The improvement in consumer spending that we expect in the U.S. and Europe should also help to support the economy in China. Electronic consumer goods and semiconductor manufacturers in particular are likely to benefit from rising demand from abroad, thereby stimulating domestic consumption.

Asia remains at the centre of global economic growth, even if China's economy is currently still facing a number of challenges. In addition to China, India is expected to grow by more than 6% annually over the coming years according to our forecasts. However, we also expect Indonesia to grow by around 5% annually over the next few years. Household prosperity is increasing and should lead to higher demand for consumer goods in the coming years.

03 Consumer staples stocks unconvincing

For the consumer staples sector 2023 was a difficult year. The sector only just managed to break above the 0% line in the S&P 500 thanks to dividends. In U.S. dollar terms, the sector's share price index fell by -2%; including dividends, it managed a meagre gain of +0.5%. The European sector in the STOXX 600 performed even worse, falling by -4.5% in euro terms and by -1.5% (in euro terms) when dividends are taken into account.

The consumer staples sector underperformed, although the sector lived up to its reputation as a defensive sector and increased its profits despite a slowdown in global growth. In the U.S., the sector may have achieved above-average annual earnings per share (EPS) growth of 2%, while analysts expect minimal growth of less than 1% in Europe compared to 2022.

In our view, several factors are responsible for the sector's underperformance. However, the biggest impact has undoubtedly been the rise in capital market interest rates, which has made bonds an interesting alternative to equities again. Many investors, who had turned to consumer staples in the years of zero interest rates due to a lack of attractive fixed-income investments – as these usually pay steady dividends and have comparatively low price fluctuations – have used the turnaround in interest rates as an opportunity to switch back into bonds. In recent years, this has been reflected in particular in the close synchronisation of sector performance with the prices of government bonds (see Figure 8).

Although it is not unlikely that some investors will invest in the sector if the economy cools further in the first half of the year, we believe that capital market interest rates are unlikely to provide a significant tailwind. This is mainly because we forecast that bond yields will remain high throughout the year and therefore continue to represent an alternative for dividend investors.

Another factor that could dampen share price performance in the sector is the ongoing debate about the potential impact of new anti-obesity drugs on the demand for various consumer staples. Indeed, some experts are predicting significant long-term consequences. Although we believe that the impact of these drugs is likely to be limited, at least in the short term, given the still limited uptake, market participants may already start to demand a higher risk premium for food and beverage stocks, which make up a large part of the consumer staples sector. Our analysts have conducted initial research into the impact of these drugs on consumer behaviour and based on a survey of U.S. consumers, have already been able to identify initial indications of which specific food products could be subject to potential shifts (see Figure 5).

However, the decline in inflation that we expect, which should have a positive impact on overall economic consumption, should not only trigger positive effects in the consumer staples sector. It is likely to become increasingly difficult for companies to pass on their costs to customers compared to previous years when prices rose almost everywhere, and consumers were therefore less price-sensitive overall. This can be seen with food, for example. The inflation rate here is already falling rapidly and is already negative in some countries, i.e. prices are falling.

On balance, consumer staples companies in the U.S. and Europe may achieve EPS growth of 5-6%, according to analysts' consensus. While this is a solid rate, we do not believe it should trigger a run-on consumer staples stocks. Rather, investors are likely to prefer shares in companies that have proven that they can make large profit gains even in a low-growth macroeconomic environment. These can be found, for example, among consumer discretionary stocks, which we will examine more closely in the next chapter.

Overall, we therefore see only limited upside potential for consumer staples stocks, despite valuations that are below historical averages in Europe and the U.S. Based on expected earnings over the next twelve months, European consumer staples producers are trading at a price-to-earnings (P/E) ratio of 16.3x, which is 14% below the average of the last 10 years, while their U.S. counterparts are valued at 19.0x, only 3% cheaper than the average of the last 10 years. The food and grocery retail sub-sector, currently trading at an expected P/E ratio of 23.1x (a good 20% above the 10-year median), is largely responsible for the high average P/E ratio in the U.S. (see Figure 9).

04 Cyclical consumer stocks – good prospects

Compared to consumer staples stocks, consumer discretionary stocks performed significantly better in 2023. The corresponding stocks in the European STOXX 600 and the S&P 500 in the U.S. achieved returns of 22% and 38% respectively in 2023, outperforming the broader market by 5 and 4 percentage points. We see further scope for the sector to continue this trend in 2024. Firstly, this is supported by the factors listed above: falling inflation, robust labour markets and positive real wage increases.

Secondly, the sector is less affected by the rise in capital market interest rates. On the one hand, this is due to the fact that the stocks do not belong to the category of traditional defensive dividend stocks and therefore experienced fewer outflows in favour of bonds during the low interest rate phase. On the other hand, many of the companies in the sector are highly profitable and have sufficient liquidity, meaning that rising interest rates have comparatively little impact on them.

Compared to historical valuations, both the STOXX 600 and the S&P 500 for consumer discretionary are trading broadly in line with their 10-year medians with expected P/E ratios of 13x and 25x respectively. While the latter may seem a little expensive, U.S. consumer discretionary companies are heavily weighted towards technology and artificial intelligence, which should lead to robust earnings growth over the long term.

In contrast, the European sector provides the opportunity for a more balanced exposure to growth and substance. Growing and high-margin luxury brands dominate the sector and account for around 50% of total market capitalisation. They have a significant exposure to the Chinese market which has grown strongly over the last decade but was ailing lately. However, recent data from China showed that demand for luxury items is recovering nicely. Sales of luxury goods in mainland China climbed by around 12% to over EUR50bn in 2023. Although this is around 15% less than in 2021, growth is likely to continue in the coming years. By 2030, China's share of the global market for luxury goods is expected to rise from around 16% at present to over 20%. This should support shares of European luxury goods manufacturers going forward.

The remainder of the sector is made up the automotive industry (20%), but retail, media and the travel and leisure sector also play an important role. European and U.S. consumer discretionary stocks are forecast to grow earnings by 3% and 12% respectively this year and 10% and 17% next year. If the global economy and consumers prove resilient again this year, the figures could even be revised upwards.

For investors who want to benefit from the prospects in the consumer sector, we therefore recommend favouring the cyclical consumer sector over the consumer staples sector. The relatively good outlook for this consumer sector is in line with our macroeconomic forecasts, which expect economic momentum to accelerate in Europe and the U.S., particularly in the second half of the year.

05 Conclusion

GDP growth rates in the U.S. and Europe are likely to weaken further in the coming months as a result of the current restrictive monetary policy of the central banks in the fight against inflation. Nevertheless, it is worth taking a look at the consumer sector from an investor's perspective. In contrast to a normal economic cycle, there is currently a lot to be said in favour of an imminent recovery on the part of private households. Due to the increasing impact of demographic factors, the labour market is likely to deteriorate less than in a normal economic cycle. Companies must fear that employees made redundant today will be harder to find again in the future and are therefore refraining from major job cuts.

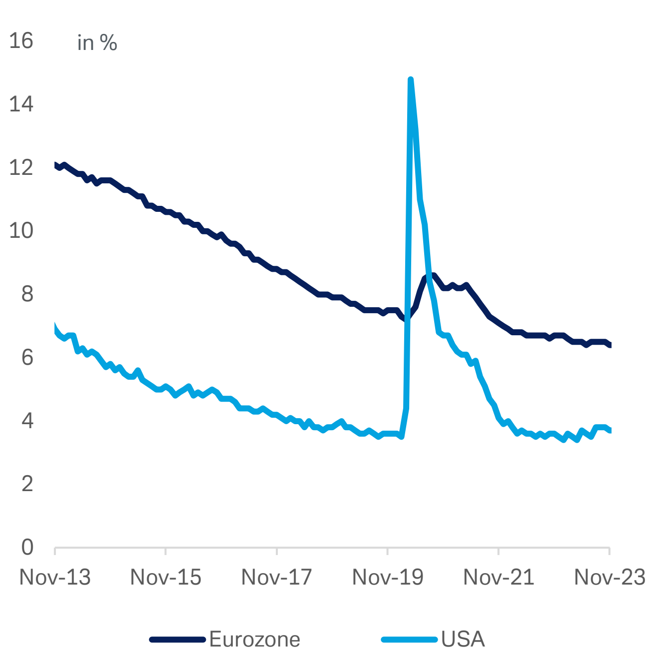
In addition, some households still have considerable savings, particularly from the pandemic. These savings were and still are one of the reasons why growth rates have recently been so high, particularly in the U.S.

In Europe, where the real income of private households initially suffered from higher energy price increases in the wake of the Russian invasion of Ukraine, a slow recovery is now also evident. Due to the comparatively high level of collective bargaining agreements, wages in Europe are generally rising with a slight time lag compared to the U.S. As the demographic situation on the labour market in Europe is similarly favourable to that in the U.S., real incomes in Europe, and thus household consumption, should also recover over the course of the year.

In addition, the comparatively strong growth in Asia and the associated increase in household prosperity there should also have a positive impact on the sector. Luxury goods already enjoy a high status in parts of Asia and, with increasing prosperity, the tourism sector should also be able to benefit from a growing middle class in Asia.

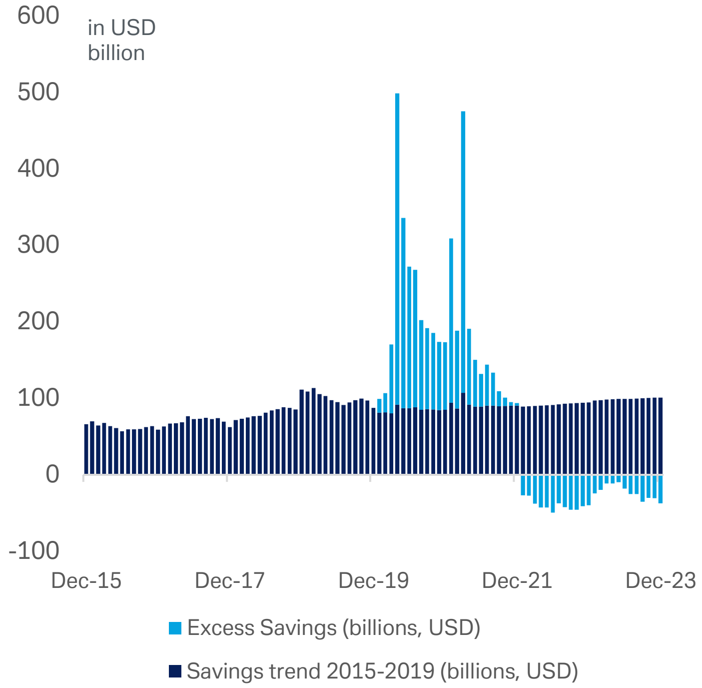
We therefore see interesting investment opportunities on the equity market, particularly in the area of discretionary consumption. On the one hand, the valuation based on the 12-month expected earnings of the sector in Europe and the U.S. as a whole corresponds to the historical average and therefore does not appear overpriced. On the other hand, the sector offers a diverse and broad positioning: while U.S. stocks have a strong focus on interesting long-term themes such as AI and technology, European stocks offer opportunities particularly in the high-margin luxury goods segment as well as in the automotive and tourism sectors. With the central banks expected to cut interest rates for the first time in mid-2024 due to inflation having fallen sufficiently by then and the associated economic stimulus in the U.S. and Europe, household income and consumer spending are also likely to recover. Shares in the consumer discretionary sector should benefit from this development.

Figure 1: Unemployment rate U.S. and Europe



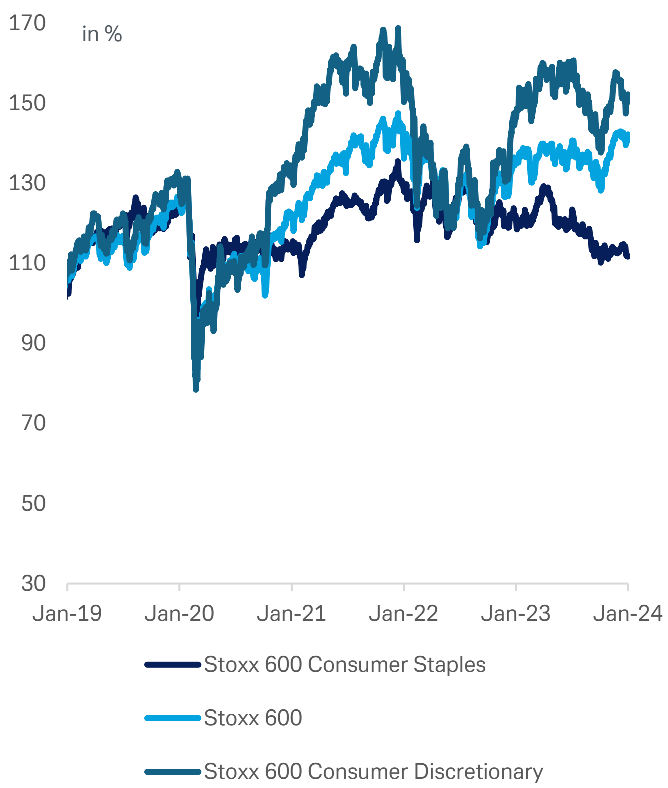
Source: Bloomberg Finance L.P., Deutsche Bank AG. Date of January 24, 2024.

Figure 2: Surplus savings in the U.S. over time



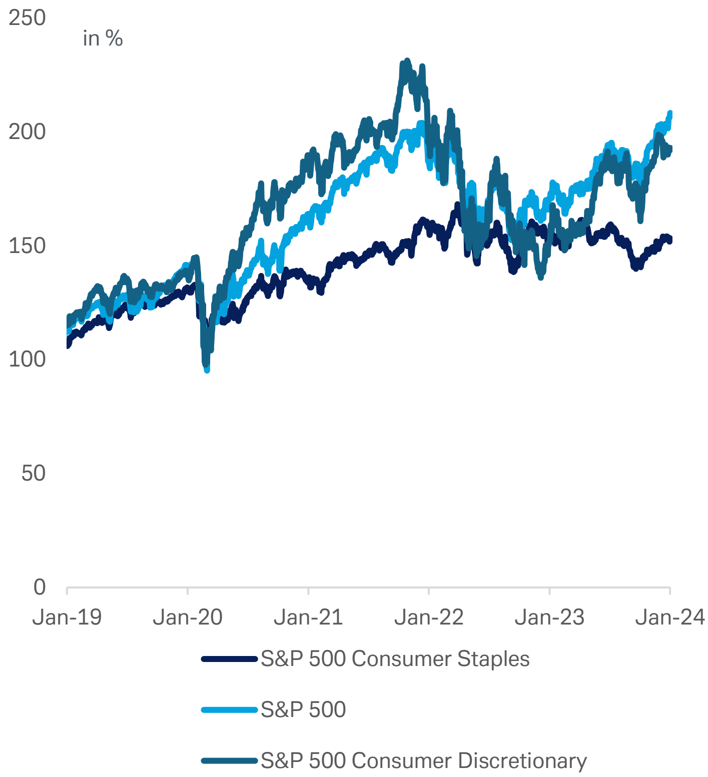
Source: Bloomberg Finance L.P., Deutsche Bank AG. Date of January 24, 2024.

Figure 3: EUR-Performance of Stoxx 600 and consumer sectors (indexed to 24.01.19)



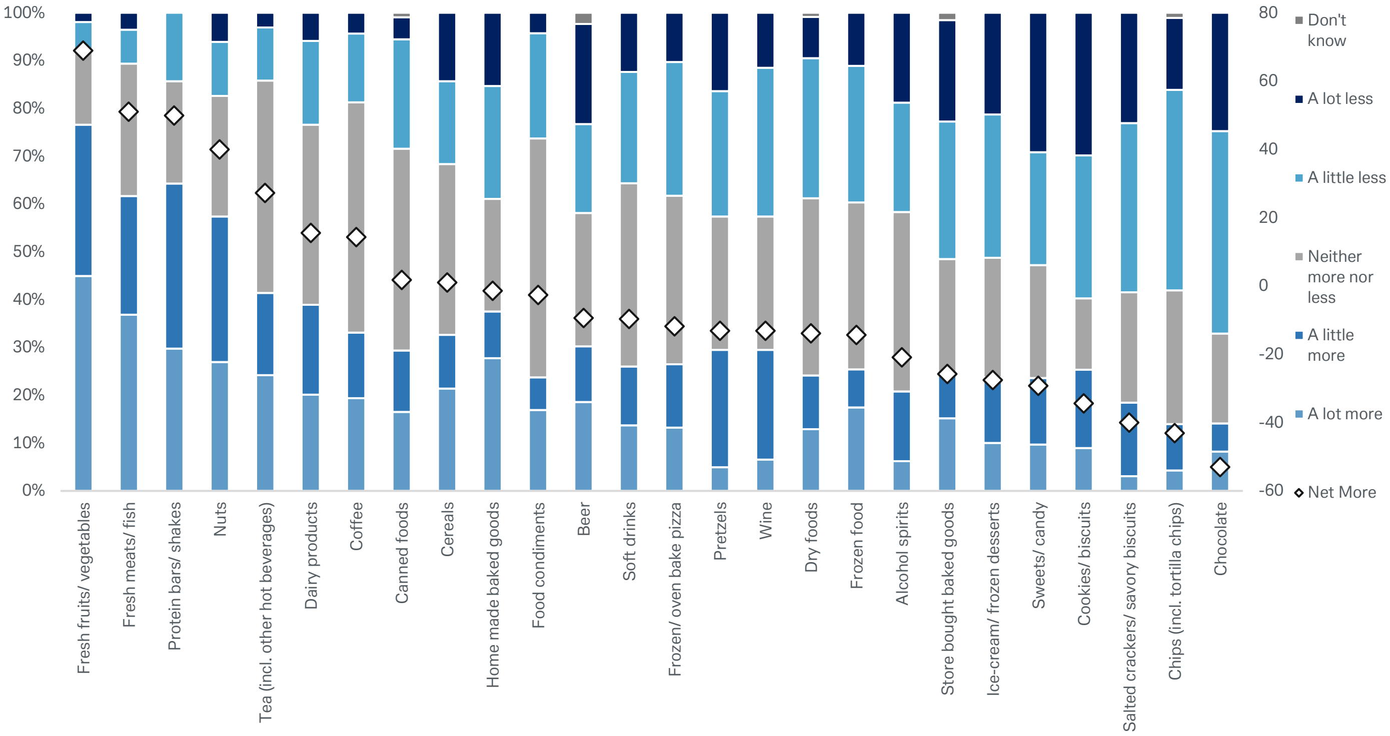
Source: Bloomberg Finance L.P., Deutsche Bank AG. Date of January 24, 2024.

Figure 4: USD-Performance of S&P 500 and consumer sectors (indexed to 24.01.19)



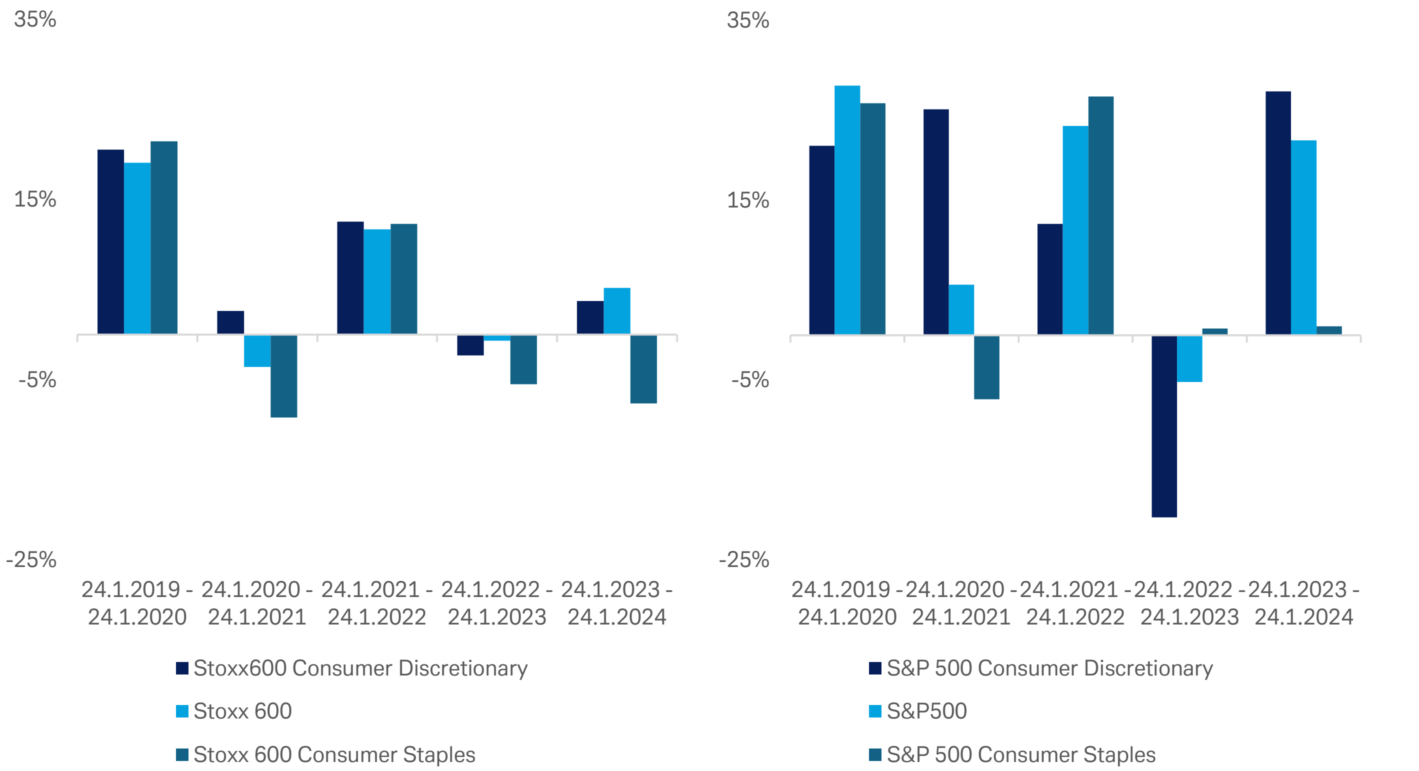
Source: Bloomberg Finance L.P., Deutsche Bank AG. Date of January 24, 2024.

Figure 5: Survey result: Comparison before taking weight loss medication to while taking weight loss medication



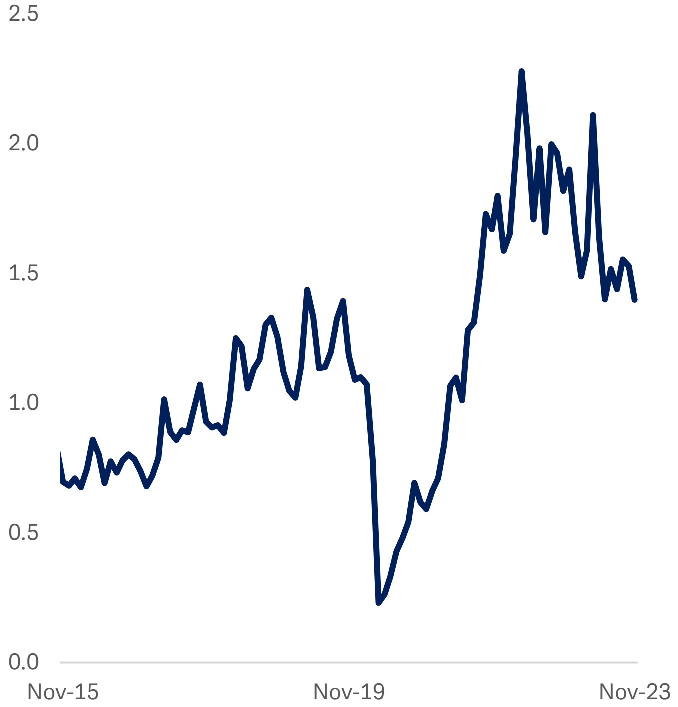
Source: Deutsche Bank AG. Data as of January 2024.

Figure 6: 12-month performance of the Stoxx 600 and S&P 500 and sub-indices over the last five years



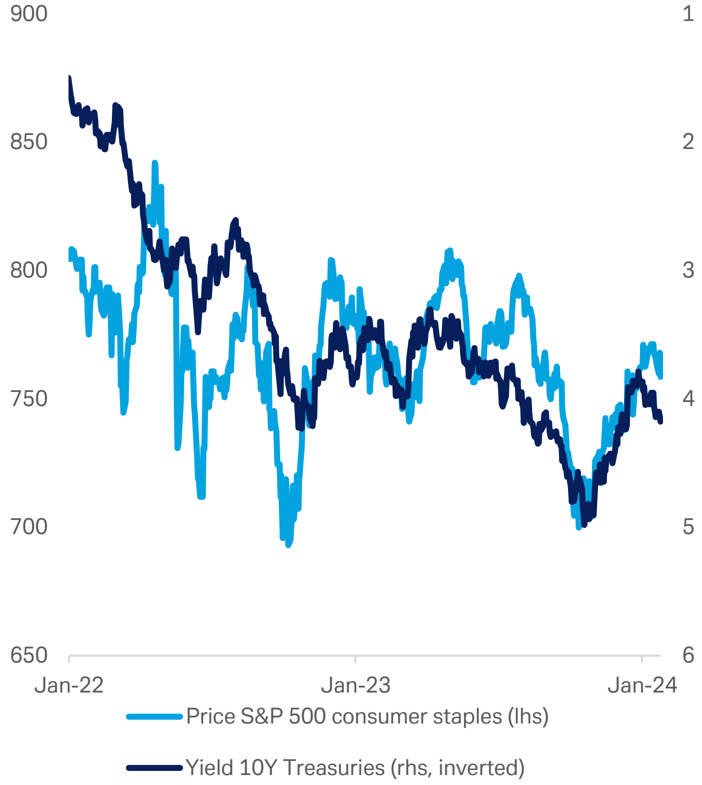
Source: Bloomberg Finance L.P., Deutsche Bank AG. Date of January 24, 2024.

Figure 7: Number of unemployed per vacancy, seasonally adjusted



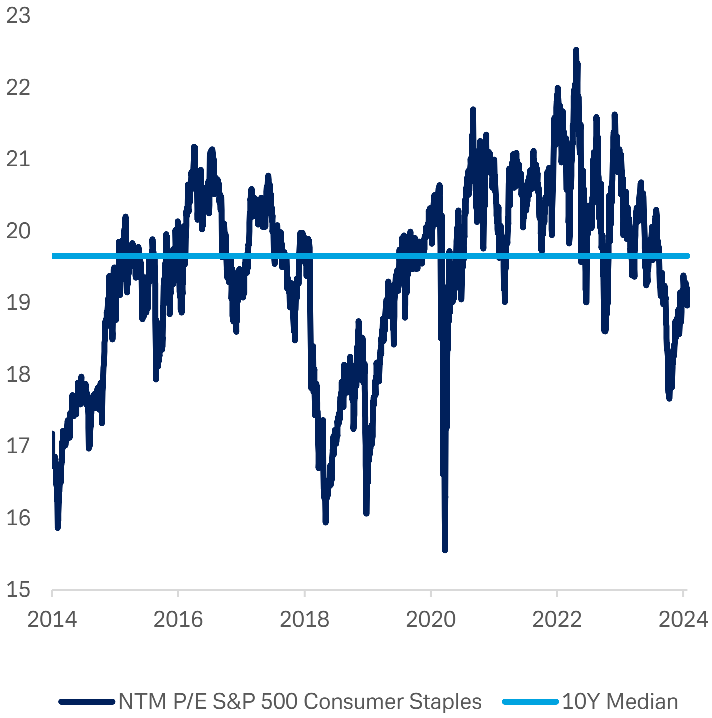
Source: U.S. Bureau of Labor Statistics, Deutsche Bank AG. Data as of 2023.

Figure 8: Performance comparison between government bonds and consumer staples stocks



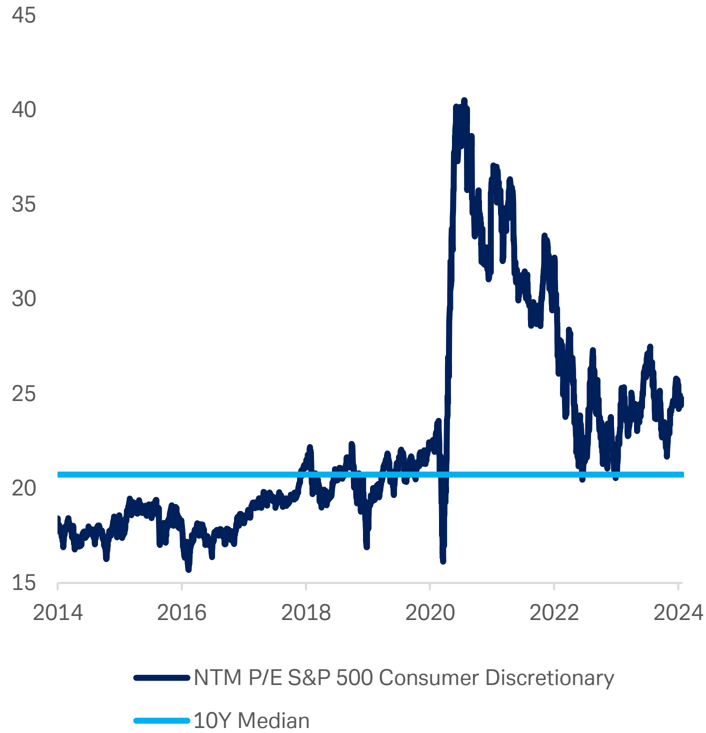
Source: LSEG Datastream, Deutsche Bank AG. Date of January 24, 2024.

Figure 9: Valuation of S&P 500 Consumer Staples in historical comparison



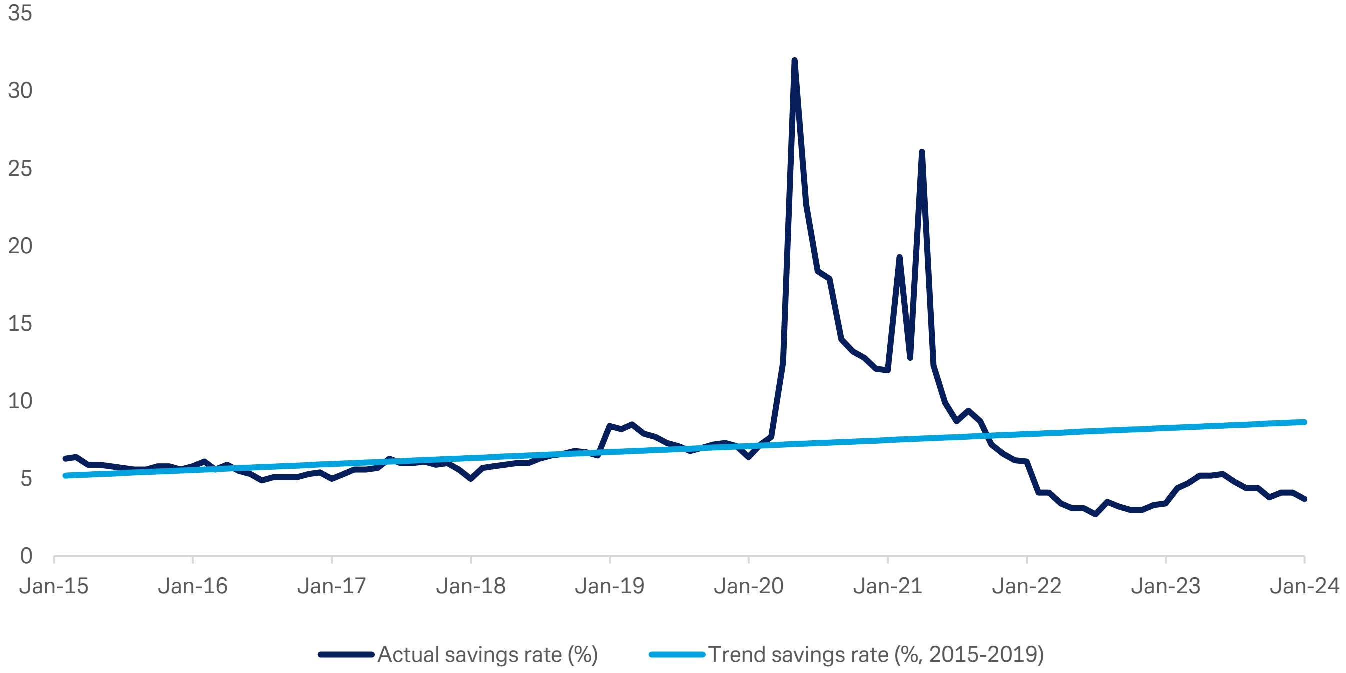
Source: LSEG Datastream, Deutsche Bank AG. Date of January 24, 2024.

Figure 10: Valuation S&P 500 Consumer Discretionary in historical comparison



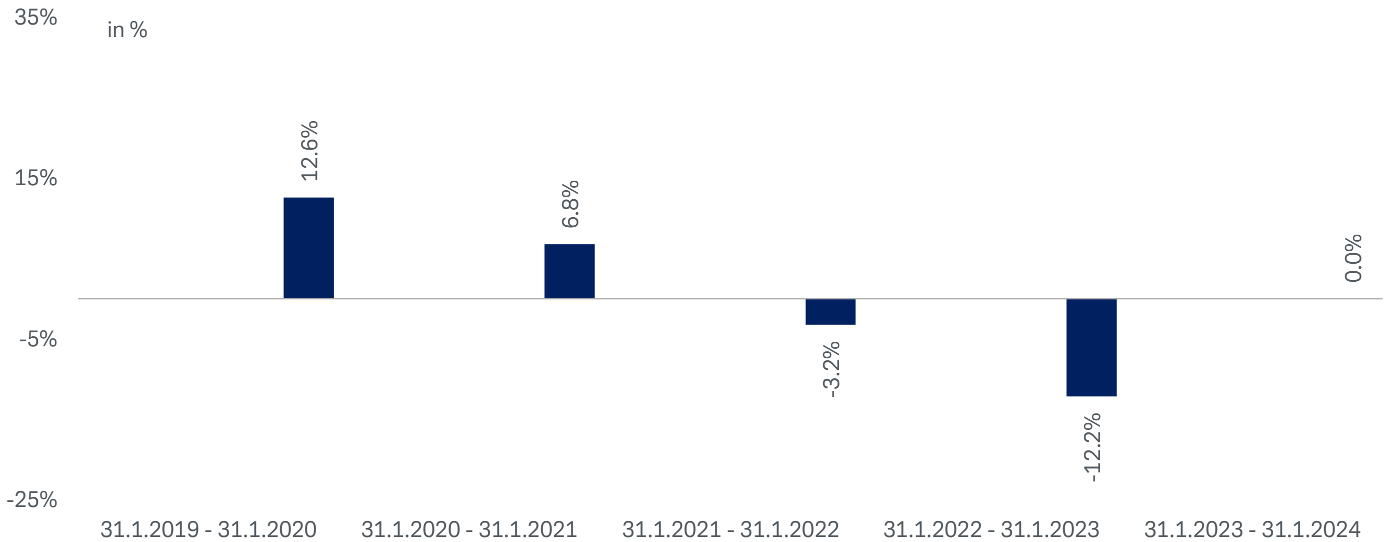
Source: LSEG Datastream, Deutsche Bank AG. Date of January 24, 2024.

Figure 11: U.S. savings rate over time, in % of disposable income



Source: Federal Reserve. Data as of 2023.

Figure 12: 12-month performance of 10-year U.S.-Treasury Bonds over the last five years



Source: LSEG Datastream, Deutsche Bank AG. Date of January 31, 2024.

Glossary

The Consumer Price Index (CPI) measures the price of a basket of products and services based on the consumption of a typical private household.

Defensive stocks offer more consistent dividends and stable returns, regardless of the performance of the stock market as a whole.

The European Central Bank (ECB) is the central bank of the eurozone.

The Euro (EUR) is the only legal tender in the EU member states that have adopted it.

The Eurozone is made up of 20 member states of the European Union that have adopted the euro as their common currency and sole legal tender.

Earnings per share (EPS) is calculated as a company's net profit less the dividend for preference shares, divided by the total number of shares in circulation.

The Federal Reserve (Fed) is the central bank of the United States of America. The Federal Open Market Committee (FOMC) determines the Fed's monetary policy.

Growth stocks are companies that are likely to achieve above-average profit or sales growth.

The price/earnings ratio (P/E ratio) measures the current share price of a company in relation to its earnings per share.

Next twelve months (NTM) refers to any financial ratio forecast for the immediate next twelve months from the current date.

The Stoxx Europe 600 is an equity index that tracks the performance of the securities of a total of 600 of the largest companies from 17 countries in the European Union.

The S&P 500 is a share index (price index) in the U.S.. It includes shares of the 500 largest and highest-turnover companies in the country.

U.S. is the designation for the United States.

USD is the currency code for the U.S. dollar.

The volatility of a financial asset is the degree of variation of its trading price series over time. It is usually measured by the standard deviation of logarithmic returns from the asset's average value.

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