



Market Commentary

Weekly perspective on current market sentiment

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Last week's S&P 500 Index: +1.2%

Inventories

Key takeaways

- In the post-COVID economy, companies are trying to get back to basic decisions about how to run their businesses.
- One of these basic decisions involves inventory. What will consumer spending look like in coming quarters?

We all know that inventories of consumer goods were out of whack during the pandemic as global supply chains crashed and everything from parts to fix your garage door to semiconductor chips used in products from autos to toasters were extremely hard to get. As demand from homebound consumers surged, inventories just couldn't keep up. Now, in the post-COVID economy where the supply chain is largely back to normal for the bulk of goods, companies are trying to get back to basic decisions about how to run their businesses.

One of these basic decisions involves inventory. In this week's commentary, we are not talking about inventory for service businesses like restaurants that must decide how many filets they need to order to meet next week's anticipated demand. What we are discussing are consumer goods (like apparel) inventories and how businesses might think about those as they look ahead and anticipate demand in coming quarters. How much inventory will a company keep on hand?

The key is what consumer spending will look like in coming quarters. Many consumer companies have been cautious on the economy since last year as reflected by the continued low readings on the National Federation of Independent Business's (NFIB) Small Business Optimism Index. Given that data, it makes sense that inventories relative to sales have slightly lagged. Companies do not want to get caught holding too many apparel items, for instance, if they think the economy might significantly slow or slip into recession resulting in higher unemployment and less consumer spending. Our retail analysts suggest that the bulk of the companies they follow will be focused on holding profit margins at current levels in the year ahead. Avoiding discounting to move excess inventory will be a major factor in maintaining those margins.

Saying all that, keep in mind that core retail sales in December were up a strong 0.8%. Core retail sales exclude autos, gasoline, and building materials. As we like to say, Americans with jobs and money in their pockets are going to spend. However, as the economy slows as we move through the middle portion of this year and the labor market softens, we continue to believe the holiday spending that occurred last year was a bit of a last hurrah for the consumer. We do not believe that good holiday sales mean the spending strength will continue into and through the middle of this year. We remain unfavorable on the Consumer Discretionary sector and favor those portfolios carrying overweight positions trimming back and looking to move those funds to the Energy, Industrials, Materials, and Health Care sectors where we believe opportunities over the next 6 to 18 months are more attractive.

We look for the economy to slow noticeably as we move through the middle of this year and believe that consumer-product companies will continue to be cautious and not boost inventories to any meaningful extent. That is an added headwind for economic growth.

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Definitions

NFIB Small Business Optimism Index is the small business optimism index is compiled from a survey that is conducted each month by the National Federation of Independent Business (NFIB) of its members. The index is a composite of ten seasonally adjusted components based on questions on the following: plans to increase employment, plans to make capital outlays, plans to increase inventories, expect economy to improve, expect real sales higher, current inventory, current job opening, expected credit conditions, now a good time to expand, and earnings trend.

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