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## Commentary

# Global 2024 Consumer Discretionary Outlook: Pressures on Consumer Purchasing Power Continue to Weigh on Earnings

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### DBRS Morningstar

January 8, 2024

#### Key Highlights

- Our negative outlook acknowledges the challenging global operating environment that we expect will change consumer spending habits and affect demand for consumer discretionary products.
- We expect credit ratings to be pressured in the near term.
- Our outlook is largely consistent across all geographies.

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### 2024 Outlook: Negative

While the global macroeconomic environment remains uncertain, our outlook for companies in the consumer discretionary sector is negative for 2024. This reflects our expectation that pressures on consumer purchasing power because of significant interest rate hikes—whose effects have not yet been fully felt—coupled with the compounded effects of easing inflation will constrain consumer spending. Discretionary spending in 2023 was supported to some extent by resilient unemployment rates as well as accumulated household savings, which contributed to generally stronger household balance sheets. However, we anticipate that depleted excess savings and rising household debt burdens will likely pose material challenges for this sector over the near term. As such, we generally expect the credit risk profiles of issuers in the consumer discretionary sector to be pressured in 2024.

While not the primary focus of this commentary, the behaviour of very-high-income and affluent consumers is less likely to be affected by economic turbulence. As such, luxury consumer discretionary companies, including those that produce haute couture clothing, high-end jewelry and watches, and premium spirits and vintage wines, may be more insulated from the uncertain macroeconomic environment than mass-market discretionary companies. Similarly, we believe that companies with more value-product offerings will exhibit more resilient earnings performance. Lastly, we expect consumer staples companies to better manage the challenging operating environment, as outlined in our commentary *Global 2024 Outlook for Consumer Staples Companies: Staying the Course* published on January 8, 2024.

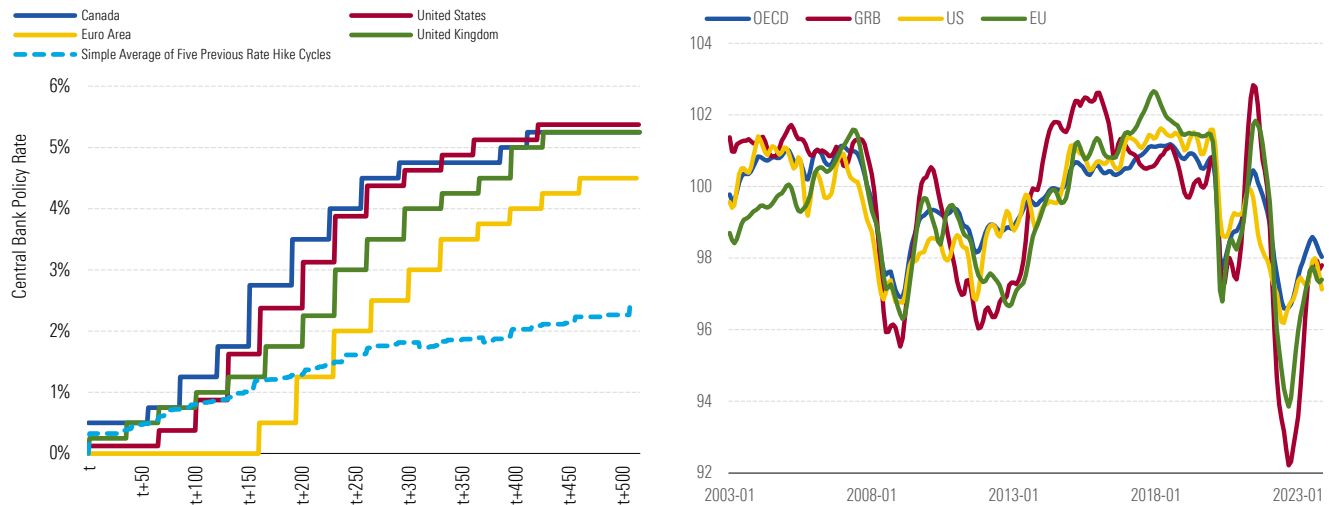
### Near-Term Ratings Pressure in 2024

We believe the challenges to consumer spending are likely to broadly pressure the credit risk profiles of consumer discretionary companies in 2024. While we expect the higher interest rate environment to weigh on consumer spending, it should not have a considerable effect on the weighted-average interest expenses and coverage levels of most investment-grade issuers, because largely fixed-rate debt maturity profiles are relatively well spread out, even if near-term maturities are fully refinanced. Furthermore, while we believe that the broader sector trends could result in negative rating actions for some consumer discretionary companies, the primary drivers of negative rating actions will likely continue to be related to company-specific factors. These credit rating triggers could include weakened operating performances and/or more aggressive financial management policies. Furthermore, we anticipate that the larger investment-grade issuers in the consumer discretionary space will likely be better equipped to navigate a challenging 2024, while smaller non-investment-grade issuers with large variable rate debt stacks and already stressed credit metrics are likely to be more severely affected.

### Consumer Discretionary Wallet Size Shrinking and Confidence Dwindling

Largely in line with our expectations (see our commentary *Global 2023 Outlook for Consumer Discretionary Companies: Troubled Times Ahead*), stubbornly high inflation and rapidly increasing interest rates have worn down consumers' disposable incomes and purchasing power. As a result, while consumer confidence has rebounded from pandemic-related lows, it remains subdued across geographies (see Exhibit 1). This has generally resulted in a shift in consumer behaviour as customers cut back spending on more discretionary items, shifted to lower priced product offerings, and were more diligent in looking for sales and promotions (see our commentary *Global 2023 Holiday Retail Outlook: No Festive Cheer For Some Retailers*).

**Exhibit 1** Consumer Confidence Index and Central Bank Policy Rates



Source: OECD (2023), Consumer confidence index (CCI) (indicator). doi: 10.1787/46434d78-en (Accessed on 20 December 2023)

Source: Bank of Canada, Federal Reserve Bank of New York, Bank for International Settlements, Bundesbank, OECD, DBRS Morningstar.

Note: For current cycle, t = December 15, 2021 (first Bank of England rate hike). Date count ends at t+516 and excludes weekends. Previous rate hike cycles for Bank of Canada: 1999, 2002, 2004, 2010, 2017; Federal Reserve: 1988, 1994, 1999, 2004, 2015; Bundesbank/ECB: 1979, 1988, 1999, 2005, 2011; Bank of England: 1994, 1996, 1999, 2003, 2006. Data as of December 7, 2023, for Canada; December 6, 2023, for U.S.; December 4, 2023, for Euro Area; and December 1, 2023, for the UK.

Looking ahead, in light of the soft economic outlook (see our commentary *2024 Sovereign Outlook: Higher Rates and Slowing Economies, but Stable Credit Ratings and Baseline Macroeconomic Scenarios for Rated Sovereigns: December 2023 Update*), and considering the impacts of aggressive interest rate increases — which have not yet been fully felt — and the compounded effects of gradually easing inflation, we expect many of the trends related to strained consumer purchasing power observed in 2023 to persist well into 2024. We therefore expect consumers will be increasingly reluctant to spend on discretionary products in 2024, with big ticket/higher-priced products likely to be especially affected. Furthermore, we believe that consumers will be increasingly diligent in shopping for sales and promotions as well as looking to trade down to lower-priced brands or value-based substitute products (see our commentary *UK Discount Grocers Taking a Bigger Slice of the Pie as Food Inflation Remains Stubbornly High*). As such, we expect volume contractions across the spectrum of discretionary products, albeit to different extents, in 2024.

**Margins Expected to Remain Squeezed**

We forecast the profitability of consumer discretionary companies to generally remain pressured as these firms continue to experience some—albeit easing—cost inflation, particularly in wages. This is likely to be heightened by weaker operating leverage given lower volumes, especially given the intensely competitive operating environment that is likely to result in considerable promotional activity. We do, however, anticipate that margins will experience some relief as inflation continues to gradually subside, coupled with the benefits from pricing actions taken over the last 12 to 24 months. That being said, consumer discretionary companies in the current operating environment have limited ability to pass on any operating cost increases to consumers without experiencing material volume declines.

Furthermore, we expect consumer discretionary companies to react to earnings pressure by practicing conservative cost management and/or intensifying their cost-saving and efficiency-improving initiatives to defend their EBITDA margins. That being said, we project these companies will generally be challenged to maintain EBITDA margins and dollars in 2024.

**Measured Capital Allocation As a Result of Cash Flow Pressures**

Given the challenging earnings outlook coupled with high interest rates, we project cash flows, especially of smaller, non-investment-grade companies with material variable-rate debt burdens, will remain pressured. Consequently, we expect these companies to prioritize debt repayment over capital projects and/or returns to shareholders. On the other hand, while we expect that larger investment-grade companies with stronger balance sheets and liquidity positions are likely to exercise more conservative financial management practices, including scaling back debt-funded acquisitions and taking a more measured approach to distributions to shareholders. We also anticipate these companies will continue to invest in streamlining operations through automation and technological innovation—including Artificial Intelligence—to be in a position to maintain or grow their market share when economic conditions ultimately improve.

**Consistent Global Outlook**

Our negative 2024 outlook for consumer discretionary companies is largely consistent across geographies. We note that, given the challenging macroeconomic economic outlook and highly competitive nature of the industry, the headwinds on the operating performance of consumer discretionary issuers could be magnified by a heightening of competition, in any given market. Nevertheless, we expect to see the effects of some differences among these markets. Upcoming mortgage renewals in Canada because of relatively shorter terms are likely to force Canadian households to allocate a higher proportion of their disposable income toward mortgage payments, while some countries in Europe could see a slower easing of inflation, both of which would reduce consumers discretionary spending. That being said, we believe larger, more geographically diversified companies with wider product offerings, especially those with lower-priced products, economies of scale, efficient pricing/promotional strategies, and strong brands, will be more successful in mitigating the impact of regionally weaker consumer sentiment. Conversely, we expect smaller-scale, less diversified issuers with weaker brands that offer larger ticket/higher-priced products to experience more meaningful and severe impacts.

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