INTUITION
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A Consumer-led recovery in the Year of the Rabbit

The Year of the Rabbit is off to a flying start. Hundreds of millions of Chinese tourists took to the roads, railways and air to celebrate the Lunar New Year. Many analysts are expecting the high levels of Chinese household savings ($1.3 trillion), built up during the Pandemic, to translate into a consumer-led recovery, supported by business-friendly policy reforms. This positive sentiment has seen luxury goods companies leading the charge in anticipation that Chinese consumers will take the baton from their US and European counterparts. In July 2022, we wrote about why we felt CF Richemont was looking attractive from a valuation perspective, despite the short-term economic uncertainty in its biggest market. This article will look at the latest economic news out of China, trends positively impacting consumer spending and the feed-through to the luxury goods sector, in particular CF Richemont which has already rallied extremely hard. Set against a tough global environment where the US, Europe & UK are flirting with recessions and geo-political tensions remain heightened, can China provide an underpin?

Nick Rogers

China's sudden and unexpected re-opening has prompted the International Monetary Fund (IMF) to increase its forecast for 2022 global growth to 3.4% (from 3.2%) but to slow to 2.9% for 2023. Furthermore, the IMF expects growth in 9 out of 10 advanced economies to decelerate, with the largest economy, the US, slowing to 1.4% as high interest rates work their way through the economy. In stark contrast, China's GDP growth is set to rebound from 3% in 2022 to 5.2% in 2023. The IMF states, "Together, China and India will account for half of global growth in 2023." How is this possible so soon after China's growth in 2022 slumped to the second slowest pace since the 1970s? Policymakers in President Xi's new government have made it clear that they will prioritise economic growth, by focusing on the consumer over the next decade.

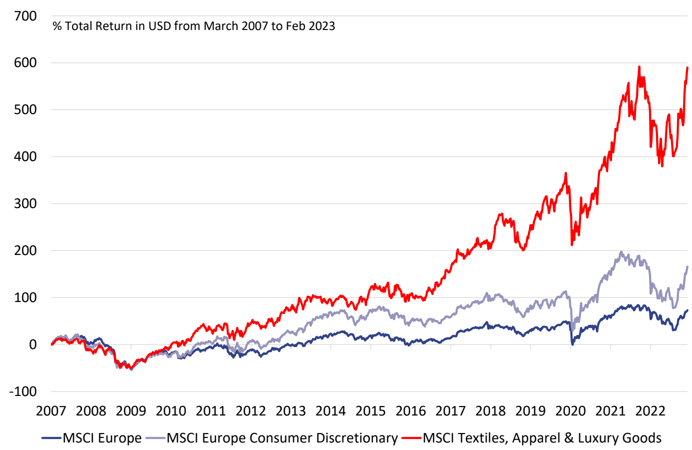
One of the quickest ways to boost consumer spending is via the banks. For instance, China Merchants Bank, the nation's leading retail bank, offered a 34% discount on consumer loans in January and 30% in February. Consequently, bank lending is expected to reach $593 billion, a monthly record. Just when the US and Europe are being forced to tighten credit, China's multiplier effect of more cash in the system is what is hoped will 'grease' the wheels of economic growth and help mitigate the slowdown elsewhere.

SPEED READ

- **By 2019, the Chinese were the largest luxury goods consumers, accounting for c30% of global high-end purchases.**
- **In 2023, it is predicted that China and India will account for 50% of global GDP growth (IMF).**
- **Chinese households have an estimated $1.3 trillion in savings – good news for global luxury goods companies like CF Richemont.**
- **CF Richemont (at 18.5%) has overtaken Anglo American (12%) as the company with the largest weighting in the JSE Top 40 Index. Positive sentiment from China's re-opening has helped the share rise by 57% since Oct '22, which has helped propel the JSE to record highs.**
- **At 23x 12-month forward earnings, the European luxury sector is currently trading at a premium of 82% to its historic mean, almost twice the 20-year average.**

Prior to Covid, China was the world's most important source of international tourism. 155 million tourists spent more than a quarter of a trillion US dollars beyond its borders in 2019. Last month, the Chinese New Year celebrations, which last 15 days, saw locals (laden with luxury gifts) make over 308 million domestic trips or roughly 89% of pre-pandemic travel levels. On the international front, popular destinations were Thailand and the Maldives, with bookings up 1800% and 1500% respectively. Duty-free sales are a big underpin for luxury companies as savvy consumers seek out the best deals abroad.

THE OUTPERFORMANCE OF LUXURY

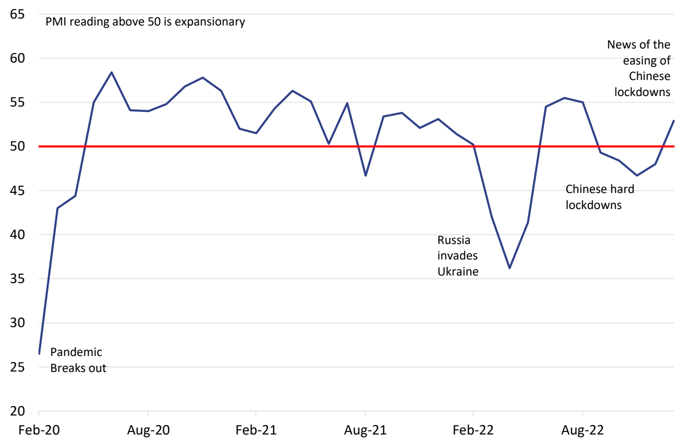


The MSCI World Textiles, Apparel & Luxury Goods Index, dominated by luxury companies like LVMH, CF Richemont, Hermes and Kering, have outperformed other European indexes handsomely since 2008 as the global middle-class grew, especially in Asia.

Rising employment is core to achieving economic growth since one cannot rely on savings alone. The Caixin China Services PMI index tracks variables such as sales, employment, and inventories across the services sector. A reading above 50 indicates that the services sector is expanding; below 50 indicates that it is contracting. The index rose to 52.9 in January from 48.0 in December, the first positive reading since last August. Although it is still early days, during the first week after the Lunar New Year holiday, job openings in the hotel and catering sectors surged by 40% (year-on-year), transport and logistics by 85% and tourism services by 59%. As jobs increase, those salaries provide an additional boost to spending on goods and services.

For years, China has been considered the "factory of the world". In 2019, it contributed 28.4% of total global manufacturing output adding nearly $4 trillion to the world economy (according to the US Statistics Division). Jobs in the manufacturing sector rose by 42% as the Caixin Manufacturing PMI edged closer to the neutral 50 level. We acknowledge that the employment numbers are all off a low base but combined, they bode well for the much-anticipated consumer recovery as the Chinese cogs begin to turn.

CHINA'S SERVICES PMI



The Caixin China Services PMI index has moved back into positive territory as Covid restrictions were eased in late 2022.

Let us now turn our attention to the luxury sector and Richemont's opportunities and risks.

1. **Exposure to the re-opening trade in China counts.** Luxury goods companies' share prices fell sharply in early 2022, mostly due to China-related concerns. Lockdowns curbed sales in the first half of the year by about 30% on the mainland and more than 10% globally. Although Richemont missed consensus earnings for the 3rd quarter (to 31st December 22) due to a 24% drop in Chinese sales, the share price was reflecting none of the bad news. This is due to the re-opening sentiment in China where the company has the highest exposure amongst its peers. Standard Bank estimates that the re-opening trade could add 15% (c€3 billion) to Richemont's FY23 sales. This is important as sales will be up against a high base from FY22 where sales increased 46% to a record €19.2 billion.

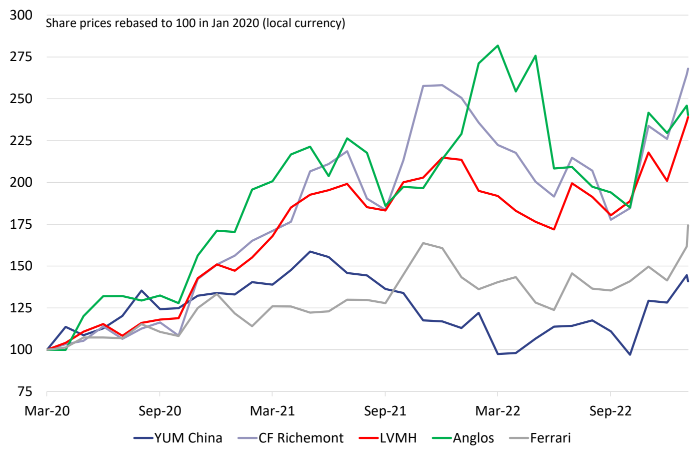
2. **Lofty valuations.** In July, the luxury sector was trading at a 15% discount to its historical average. Currently, the European luxury sector, in which Richemont sits, is trading at a 23x 12-month forward P/E, a premium of 82% to the 20-year average (according to Refinitiv). Richemont's forward P/E is currently at 22.7x, well off its low of c.15x last year but also well above the long-term average of 18.5x. High-quality companies can trade at high valuations for an extended period but over time valuations tend to trend towards their historical averages.

3. **Momentum is key.** The US Federal Reserve, the Bank of England and the European Central Bank are all hinting strongly at higher-for-longer interest rates which will increase pressure on consumer discretionary spend.

This is in contrast to China's deflationary environment, which is allowing the Peoples Bank of China (PBOC) to pump liquidity into the market, spurring consumer spending. On the positive side, the PBOC is hell-bent on supporting the middle class via policy reforms until at least 2030, adding millions of potential high-net-worth individuals to the luxury market.

4. **The defensive nature of the luxury sector remains intact**. Price inelasticity - the ability to increase the price of products without losing customers - has and will remain a key competitive advantage of Europe's luxury brands. For example, the average price of a Richemont-owned Cartier product is $10,000. Whether it increases to $11,000 is neither here nor there for most of its clientele. Price hikes of 10% were common over 2022 and prices are expected to rise further this year, albeit at a slower pace.

PRICE PERFORMANCE: CHINESE-CENTRIC EQUITIES



Whilst headline inflation in the US has fallen from 9.1% to 6.5%, wage and core inflation has proved far stickier. There needs to be a meaningful reduction in these metrics before the US Federal Reserve will believe that inflation is back under control.

5. **US and European sales are moderating.** Whilst sales in the US are slowing from high single-digit to more normal levels, demand remains solid. It is worth noting that the US share of Richemont's sales has surpassed that of Europe and is now at par with Mainland China. A struggling European economy has been supported by wealthy American and Middle East tourists. In China, one would expect to see domestic demand for luxury goods recover first, followed by regional tourism in SE Asia like Thailand, Japan and Macau before wealthy Chinese tourists provide additional support across Europe.

6. **Structural shift to online to provide a tailwind.** Richemont has upped its digital offering and is engaging heavily on social media to target both Millennials (anyone born between 1981-96) and GenZ (1997 onward). The latter currently accounts for 35% of the market. Why is this important? This demographic is dominated by Asians, especially the Chinese, who are expected to account for 50% of global luxury spending by 2025. Richemont's joint venture with online giant Alibaba is well-placed to capitalise on this shift.

7. **Structural shift to domestic shopping.** In the past, affluent Chinese consumers took advantage of currency and tax benefits whilst shopping abroad. However, structural changes are afoot. The Pandemic has taught the Chinese that they can get their fix locally as international brands increase their overseas ranges. "In the long run, domestic luxury consumption will account for 70% of the Chinese luxury consumers' spending, and a mere 30% from abroad" (Daxue consulting), the exact opposite of pre-2018 data. Luxury companies are very aware of the need to build more physical stores in Asia where face-to-face interaction leads to enhanced brand loyalty and education.

8. **Russian Exposure.** Exposure to Russia from the luxury majors is minimal, comprising 1-3% of revenue for most in 2021. LVMH (14%) and Kering (8%) hold the largest share of the Russian luxury market, whilst Richemont (1% exposure) is below the market average.

In conclusion, one must remain cognisant that risks of higher Covid infections post the Lunar New Year or a sharper-than-expected slowdown in Chinese property remain a threat to the recovery. Furthermore, any escalation of the war in Ukraine could fuel global inflation and hurt sentiment, and US/China tensions seem to be escalating, not moderating. Yet looking ahead, the high rate of Chinese savings will remain an underpin to the luxury sector but it may take six months before we start to see the Chinese becoming more confident. Richemont has confirmed that growth in China turned positive in the 4th quarter, before the Lunar New Year, and remains upbeat about the Group's long-term prospects. The company remains the global leader in branded jewellery and one of the leaders in high-end watches. In the near-term the valuation is full, so we don't expect much further share price appreciation. Nonetheless, we are comfortable to hold those shares we do own and will use any market weakness to keep accumulating. Luxury has proved its defensiveness over many economic cycles. This time should be no different.

Topic: TBC

The details of our next Insight seminar will be published shortly.

Natal Midlands	
Date:	16 March 2023
Venue:	Oasis Conference Centre, 72 Main Road, Howick
Morning Time:	10am for 10.30am
Evening Time:	5.30pm for 6pm

Johannesburg	
Date:	14 March 2023
Venue:	Rosebank Union Church, Cnr William Nichol and St Andrews Road, Hurlingham
Time:	7am for 7.30am

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