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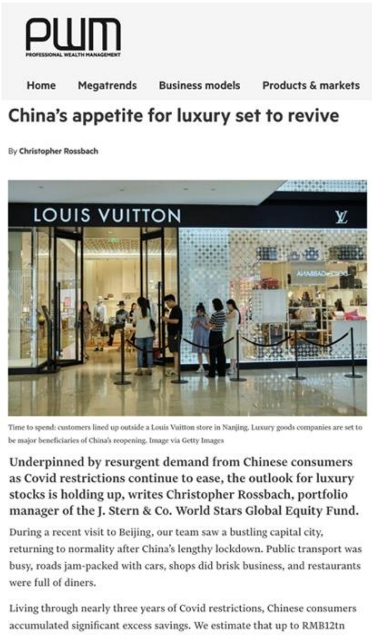
Investment Insight

LUXURY STOCKS NAVIGATING TROUBLED WATERS WITH WIND IN THEIR SAILS

Underpinned by the resurgent demand from Chinese consumers as the prolonged COVID restrictions continue to ease, the outlook for the sector remains strong. In an article first published in the Financial Times publication, Professional Wealth Management, we explore the outlook for the luxury sector, with a specific focus on our holdings in the J. Stern & Co. World Stars Global Equity Fund.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China's appetite for luxury set to revive

By Christopher Rossbach

Time to spend: customers lined up outside a Louis Vuitton store in Nanjing. Luxury goods companies are set to be major beneficiaries of China's reopening. Image via Getty Images

Underpinned by resurgent demand from Chinese consumers as Covid restrictions continue to ease, the outlook for luxury stocks is holding up, writes Christopher Rossbach, portfolio manager of the J. Stern & Co. World Stars Global Equity Fund.

During a recent visit to Beijing, our team saw a bustling capital city, returning to normality after China's lengthy lockdown. Public transport was busy, roads jam-packed with cars, shops did brisk business, and restaurants were full of diners.

Living through nearly three years of Covid restrictions, Chinese consumers accumulated significant excess savings. We estimate that up to RMB12tn

One of our team members was in Beijing earlier in the year. It was their first visit since the pandemic was declared three years earlier and they couldn't but notice how the city was bustling. All the signs were that China was returning to normality after its lengthy lockdown. Public transport was busy, roads were jam-packed with cars, shops were open as normal, and restaurants were full of diners.

During nearly three years of COVID restrictions, Chinese consumers accumulated significant excess savings. Some analysts have estimated that up to 12 trillion RMB (equivalent to 10 per cent of GDP) has been saved by consumers during the pandemic. With the re-opening, these excess savings are being unleashed, as experienced in the US and Europe when restrictions were lifted. The re-opening is fuelling spending on discretionary goods and services, travel and cross-border duty-free shopping. Luxury goods companies like *LVMH* and *Hermès* are major beneficiaries of these excess savings.

LVMH has long been a major holding in our flagship World Stars Global Equity Fund, and it will continue to be despite its share price drifting lower in recent weeks. There are widespread concerns that the post-pandemic economic recovery in China is faltering. There are numerous challenges and recovery is never a straight line. Everybody likes to call a bottom but in our view, these concerns will prove short-lived and the market is underestimating the breadth of levers at the Government's disposal to support the economy through stimuli programmes.

The challenges to companies doing business in China include geopolitical instability, with Taiwan and Russia of particular concern, and tensions with the US and Europe. Much has also been said about China's high youth unemployment, but we believe this is cyclical rather than structural.

China is emerging from three years of lockdown and the economic recovery post re-opening has been uneven and below expectations. It is not a surprise that employment growth is slow, with a wave of new graduates leaving university this summer compounding the problem. However, following a flurry of government measures to re-ignite economic growth,

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in late August, we believe the trend will correct itself with better GDP growth in the coming quarters.

The government's measures to stimulate the economy include targeting the property sector. Specific measures have been introduced including the reduction of mortgage down payments and mortgage rates, as well as the relaxation of property purchases criteria in all tier-one cities. Together with lower interest rates and stamp duty cuts on stock purchase, and raising the personal income tax allowance, consumer confidence and spending are set to receive a boost.

In the long term, China wants to double the size of middle-income earners to 800 million by 2035, adding a pool of consumers the size of the US or Europe. It may take some time for all these measures to take full effect, but we are seeing green shoots emerging from the month-on-month stabilisation in property sales and better-than-expected August and September manufacturing PMI.

One of the positive drivers for the luxury sector has been travel retail, especially in Asia. It has been recovering strongly, led by Chinese tourists to neighbouring countries. The price differential of luxury goods between mainland China and elsewhere can be as high as 30-40 per cent. We think the luxury sector is poised for further inflection following the lifting of the suspension of tour groups to more than 70 countries, including the US and the UK. Attracted by more competitive prices at duty-free, Chinese consumers are some of the top spenders when they travel, and luxury goods companies are primed to capitalise.

LVMH is better positioned than many to weather the near-term global macro headwinds, and its share price fall since June is, in our view, an overreaction. Its third-quarter earnings announced this month were below expectations driven by slower demand in the US and Europe, and destocking. We expect the company's growth to normalise from the above trend strong double-digit seen in recent years to more sustainable high single-digit. However, fundamentally the long-term investment case remains intact. The continued desire of aspirational consumers to own these products and the growth in the middle class in emerging markets like China underpin the demand potential for LVMH. Its valuation continues to be supportive, suggesting to us that the wall of worries has been priced in.

Hermès, which is held in our European Stars portfolio, has also delivered strong results over many years and is trading at a high price to earnings multiple reflecting the unique nature of its business model and brand positioning, helped by the capacity constraint and a waiting list for its iconic handbags. In an uncertain environment, the French design house is one of the most resilient companies in the luxury sector and deserves to be trading at a premium to the sector.

The long-term narrative on the luxury sector remains unchanged. Growth in the sector continues to be powered by structural demand; pinned on the aspiration of consumers to own luxury brands, by the rise of the middle class in emerging markets, and by strong brand equity and pricing power.

The re-opening of China will be a catalyst for the sector. Chinese consumers have been the engine of growth pre-pandemic, accounting for almost a third of all luxury demand. The recovery of Chinese consumer spending is still at an early stage, but we see an acceleration of growth in the sector led by Chinese consumers in the coming year despite the likely normalisation of demand from US and European consumers. They say a rising tide lifts all boats. When the race for luxury gets going LVMH and Hermès will have the wind in their sails.

Equity Investment Team
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