

PALOS

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Weekly Commentary

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The Retailers Report and the Winners Are....

As we reported in our November 13 letter, last week saw a slew of earning reports from several major retailers. Investors and analysts closely followed results with the aim of getting a pulse on the health (or lack thereof) of the American consumer.

Leading the charge was **Home Depot (HD:NYSE)** releasing its third quarter earnings report before the opening bell on Tuesday. Earnings per share (EPS) came in at \$3.81 per share versus \$4.24 in Q3/2022, and sales of \$37.7 billion were down 3% from last year. The “pro customer” outperformed the do-it-yourself (DIY) customer as small projects trumped sales of big-ticket discretionary items like flooring, countertops and cabinets. Although results were comparatively weaker, investors reacted positively to the “mostly in line” results with HD shares closing up by 5.4% on the day. By Friday’s close, HD shares were higher by 5.4% for the week.

Target (TGT:NYSE) reported Wednesday morning with results blowing away analysts’ expectations. The news sparked an 18% move higher on the day resulting in TGT’s best single-day gain in over four years. On the earnings call CEO Brian Cornell provided encouraging remarks and said the company has seen a “meaningful improvement” in profitability. EPS of \$2.10 per share were well above expectations for Q3 and, for the first three quarters of 2023, EPS was 40% higher compared to the same period last year. Despite telegraphing challenges tied to higher interest rates, higher credit card balance, theft, and lower discretionary spending, the expectations for a poor quarter did not materialize. TGT shares rocketed higher by 17.8% on earnings day and were higher by 19.9% for the week with speculation that bargain hunters saw a turning point. Shares were down 25.6% for 2023 heading into earnings.

Discount retailer **TJ Maxx (TJX:NYSE)** also reported Wednesday morning. Quarter-over-quarter EPS (\$1.03 per share versus \$0.91%) and net sales (+\$13.3 billion versus \$13.1 billion) were above expectations and guidance for Q4 remained positive. Lower freight costs led to a significant gain in Gross margins, which were up 200% compared to last year. Management believes TJX is “strongly positioned” leading into the holiday season as the company capitalizes on “one of the most flexible business models” in retail that enhances changes in store assortment according to prevailing trends. Despite the beats, TJX shares traded lower by 3.3% on the day but are higher by 11.6% in 2023.

Wal-Mart (WMT:NYSE) followed with results released Thursday before the opening bell. Despite beating estimates on both the top and bottom line (i.e., revenues and net income), the world’s largest retailer saw its shares fall by 8.1% during Thursday’s session. The company cited a “sharper fall off” in sales during the last two weeks which led to a more cautious tone looking forward. CEO Doug McMillon speculated that rising interest rates, a resumption of student loan

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repayments, and “anomalous weather” may have hampered October shopping although in-store traffic continues to grow; e-commerce sales grew by 26% in Q3. WMT shares were trading at all-time highs prior to the earnings announcement and in our view the pullback was due to elevated expectations and profit-taking.

On Thursday, **Ross Stores (ROSS:NYSE)** reported Q3/2024 EPS of \$1.33 and Net income of \$447 million versus \$1.00 and \$342 million last year. Comparable store sales grew by 5% in the quarter and Operating margin climbed 135 basis points to 11.2% as management cited lower freight costs as the “main driver” behind Merchandise margin improvement. CFO Adam Orvos reiterated prior guidance while mentioning that “macroeconomic volatility, persistent inflation and geopolitical uncertainty” warranted a “cautious approach”. ROST shares reacted positively and climbed 7.2% on the day (+11.0% this year). The stock price is approaching its all-time establish in May/2021.

Several less influential retailers also reported last week. **Macy’s (M:NYSE)** skyrocketed by 31.6% on the week closing at \$14.44; however, the stock remains well below its most recent closing high of \$37.37 established in November 2021. **The Gap (GPS:NYSE)** recorded its best one-day gain ever as shares jumped a whopping 30.6% on Friday alone. GPS shares are higher by 58.2% y-t-d and are back to levels last seen in January 2022 although well off the most recent high of \$36.33 set in May 2021.

The **SPDR S&P Retail Exchange Traded Fund (XRT:NYSE)** is designed to provide investors with exposure to a basket of 78 companies operating in the apparel, automotive, consumer electronics, pharmacy, food, and specialty retail segments. Since bottoming in March 2020 at the outset of Covid, the XRT “tripled” by November 2021 as many stuck-at-home shoppers spent their newfound stimulus cash on shopping. Presently, the XRT is roughly 40% off those highs. We should also note that retail stalwarts like Walmart, Amazon, Target, and Costco collectively carry less than a 6% weighting in the fund, hardly a material reflection given their giant-sized presence among America’s retailers.

So, to answer the question “who the winners are?”, it seems to us that signs clearly point to retailers that appeal to price conscious consumers, have the scale to manage rising costs in an inflationary environment, use technology (artificial intelligence?) to manage costs effectively, and hence, optimize inventory, shipping costs and margins. In our view, the clear winners should come as no surprise: Walmart, Amazon, and Costco remain best-in-class in the big box category while off-price discounters like TJ Maxx and Ross Stores should continue to attract the price conscious cohort.

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Chart 1: Palos Domestic Funds versus Benchmarks (Total Returns) ¹	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL100	\$7.94	3.48%
Palos Equity Income Fund - RRSP	PAL101	\$6.58	2.17%
Palos WP Growth Fund - RRSP	PAL213	\$9.52	-23.51%
Palos-Mitchell Alpha Fund ³	PAL300	\$10.04	27.59%
S&P TSX Composite (Total Return with dividends reinvested)			7.13%
S&P 500 (Total Return with dividends reinvested)			19.28%
S&P TSX Venture (Total Return with dividends reinvested)			-6.77%
Chart 2: Market Data ¹			Value
US Government 10-Year			4.44%
Canadian Government 10-Year			3.68%
Crude Oil Spot			US \$75.89
Gold Spot			US \$1,987.30
US Gov't10-Year/Moody BAA Corp. Spread			182 bps
USD/CAD Exchange Rate Spot			US \$0.7287

¹ Period ending November 17th, 2023. Data extracted from Bloomberg

² Fund is priced annually

³ Fund is priced weekly on Tuesdays

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