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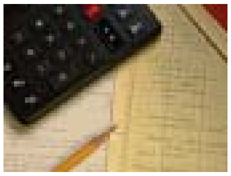

# Economics & Financial Markets

## United States Equity Markets

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# Polo Ralph Lauren Corp (RL) added to Recommended List

## I. Introduction

Closing Price: $36.97
52 Week Range: $31.22 to $82.02
Market Cap: $3.61 B
Div Yield: 0.50%
PE: ttm 8.20

Earning Q3 2009

Ralph Lauren on February 4, 2008 announced their Q3 2009 earnings and despite troubled times their Q3 y/y net revenues were down only 1.4%, and net income down 6.6%, with EPS diluted down only 2.8% from a year ago. This compares to Abercrombie (ANF), for example whose sales plunged 19% and profits 68%. Their forward guidance was lowered slightly from $4.00 to $410 for the full year 2009 which ends on March 20, 2009 to 3.85 to $4.00, with net revenues flat to down single digits.

RL Stated Outlook

RL stated that: "the continued rapid deterioration in the global economic environment which intensified in our third quarter beyond our expectations, and is having a negative impact on our business trends in the fourth quarter to data… Our outlook assumes the continuation of the negative same store sales trends that we experienced in the third quarter into the fourth quarter, as well as our most recent sales experience in the fourth." They continue that: ' I know we have historically given guidance for our next fiscal year on this February call, at this point there is a tremendous amount of uncertainty regarding how long the current retrenchment in consumer spending will last or how much additional deterioration in personal consumption may occur."

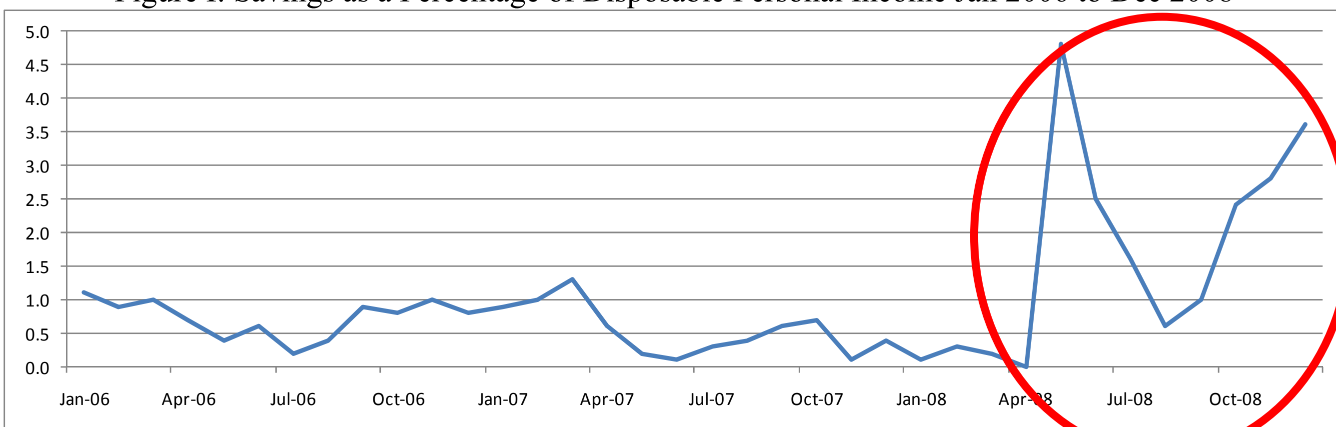
# II. Reasons for Placing RL on Recommendation List

## A. Traditional Theory

Traditional business cycle theory indicates that one of the early sectors of the economy that will tend to outperform is that of the retail sector, as disposable income begins to improve. This is exactly the argument that we have been making for the past several months.

As soon as gasoline price came down discretionary disposable income increased, however, given the serenity of the recession and fear, instead of spending, the consumer has increased their savings rate from a prior 0.6% rate of savings to a 3.8% rate of savings. Our argument, however, has been that as soon as consumer confidence returns this savings rate will decline significantly, and return back to or near the rate of the past few years.

Figure I: Savings as a Percentage of Disposable Personal Income Jan 2006 to Dec 2008




Source: BEA, SISR

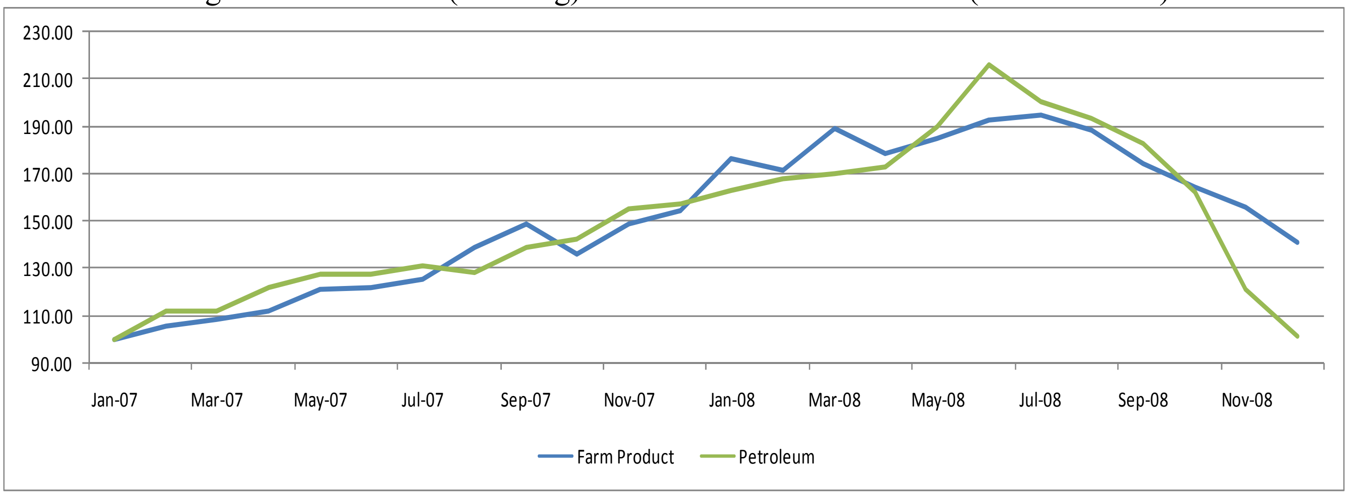
Unfortunately, despite the TARP program, the expansion of TALF, the Stimulus Bill, a new administration, the retirement of the lame duck administration, high approval ratings for this new administration in contrast to the low approval ratings for the prior administration, we have found that consumer confidence in the intermediate term has not only not improved but has actually gone down. Part of the reason for the slowness of confidence from returning has been the lame duck period of the prior administration, and the recent divisions by the current Congress, which has caused confusion within the populous.

## B. Positive Recent Economic Trends

### 1. Wholesale Sales

The SISR retail thesis begins with the belief that as gasoline prices were coming down that individuals would have more discretionary income and they would spend this additional income on small ticket items like retail apparel, and restaurants. As gasoline prices came down apparel and restaurants have outperformed other sectors of the retail space, particularly the more durable items. The declining price of gasoline has been helping the nondurable sector, as has the decline in the price of farm products, providing the consumer with greater discretionary income. Sales of petroleum (wholesale shipments of refiners to gasoline stations), and farm wholesale products (going to food manufactures), have shown significant declines, since the summer of 2008 (Figure II).

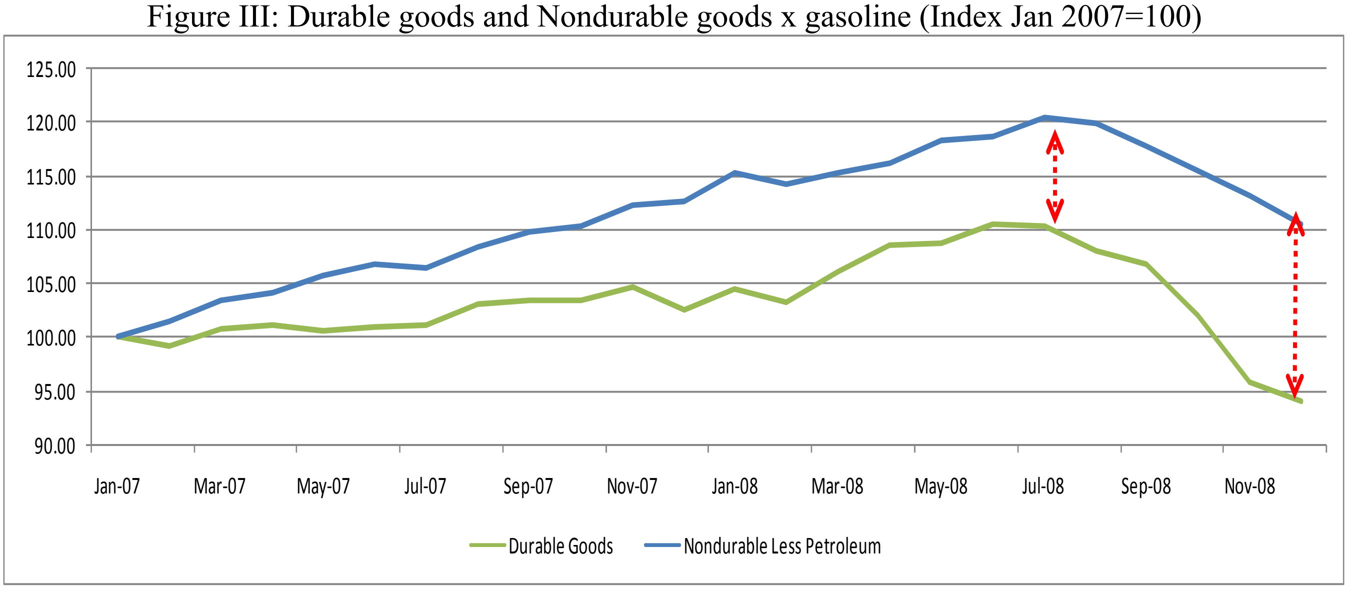
Figure II: Petroleum (Refining) and Farm Products - Indexed (Jan 2007=100)




Source: Department of Commerce: SISR

This has been our thesis for the past several months that as gasoline prices have come down despite the recession worsening, individuals will purchase smaller ticket items as opposed to larger priced items with their additional disposable income. The arrows show the extent of the drop in Durables as contrasted to Nondurables x gasoline.

Figure III: Durable goods and Nondurable goods x gasoline (Index Jan 2007=100)



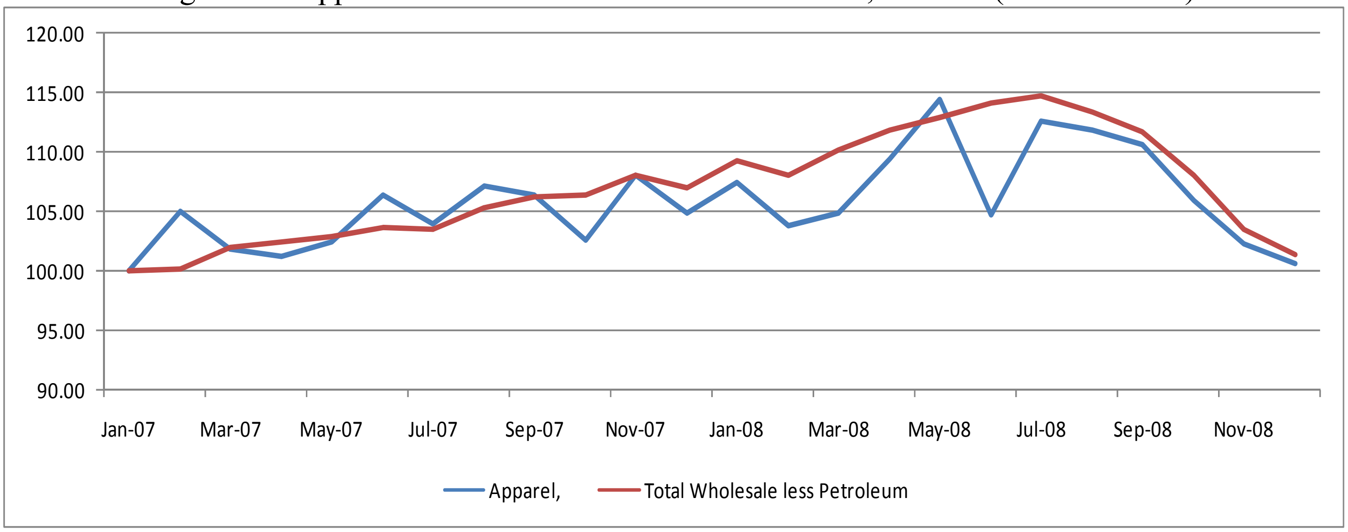

Source: Department of Commerce: SISR

Apparel as a low ticket item has outperformed the durables in recent months as it has this month being down 1.7% with durables being down 2%. Nondurables x Petroleum was down 1.5% this month with apparel down 1.7%. What is interesting is that apparel almost functions like bell weather for this report.

Plotting apparel with total wholesale less petroleum we find that apparel is almost a perfect trend line for the index less petroleum. The two variables are indexed base 100 for Jan 2007.

Figure IV: Apparel and Total Wholesale less Petroleum, Indexed (Jan 2007=100)

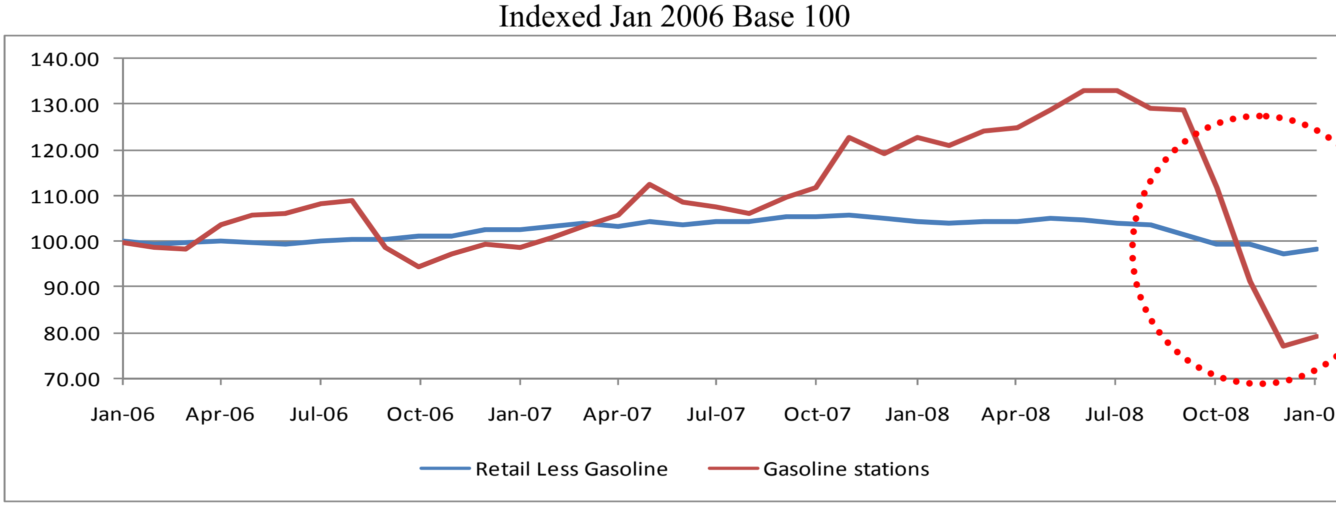



Source: Department of Commerce: SISR

## 2. Retail Sales

January retail sales were up 1% m/m the first increase since April, and the April increase was assisted by the Stimulus package of 2008. Clothing stores and food and drinking places were up 1.3% and 0.8% m/m respectively. General merchandise stores were up 1.1% with department stores down 0.3%. Even Autos were up 1.6% and gasoline stations were up 2.6%. Often the gasoline stations have distorted the top line data; however this was not the case this month. Electronic store which includes computers were up 2.6%, an area that has some strength of late.

M/M Change in Total Retail Sales less Gasoline, and Gasoline Stations from Jan 2006 to Jan 2009
Indexed Jan 2006 Base 100

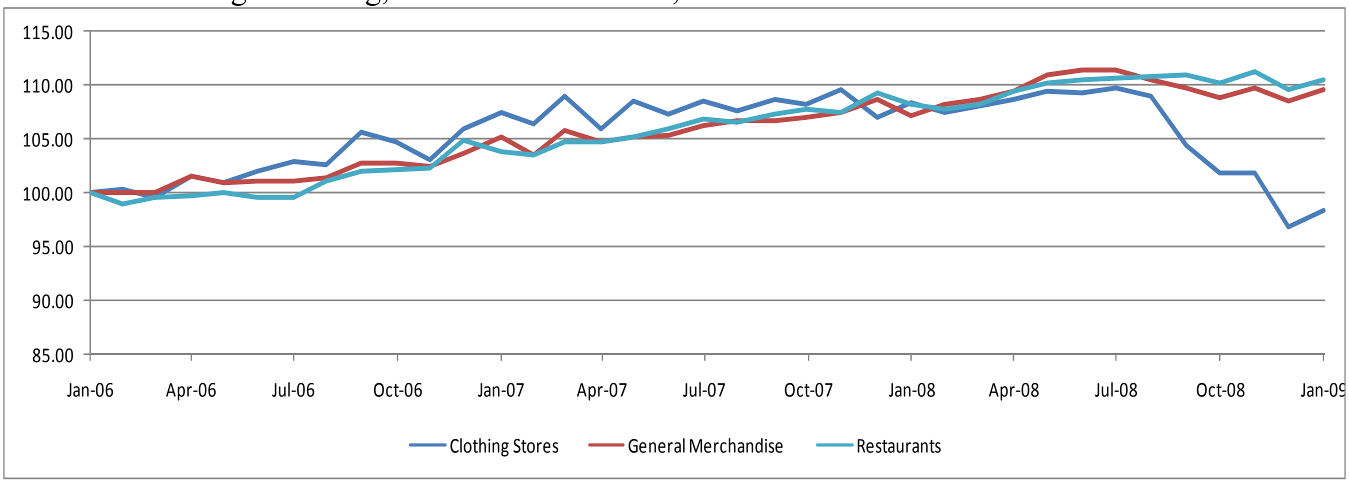



Source: Department of Commerce, SISR

For the past four months we have argued that as gasoline has come down the low priced retail items will begin to do better, because household disposable income will increase. We have seen various signs of this pattern over the past few months, but in this retail report was the first time that this retail thesis appears to be playing out more fully. Clothing stores were up 1.6% this past month, with restaurants and General Merchandise stores having stabilized over the past couple of months. They were both also up this past month up 08% for restaurants and 1.1% for general merchandise stores.

M/M Change Clothing, General Merchandise, and Restaurants: Indexed Jan 2006 Base 100




Source: Department of Commerce, SISR

## 3. Other Current Economic Events

a. On February 12, Retail sales were much better than expected coming in at 1.0% in contrast to the expectation of being down 0.7%.
b. On February 11, the trade balance came in considerably better than expected with international trade while declining, the import/export ratio improved despite the fact that the dollar had become much stronger in recent months.
c. On February 10, wholesale sales were much better with a clear dichotomy between the high cost durable items like autos and furniture and the lower cost retail items like restaurants and apparel, with the low cost items doing considerably better than the more durable retail items.
d. On February 3, Pending home sales were much more positive than expected which is a leading indicator for existing home sales which the week prior on January 26, the NAR announced that existing home sales rose by 6.52%.
e. On February 2, it was reported that construction spending for total construction was continuing to hold up, with non residential construction actually up over 8% y/y. With the stimulus program helping non residential construction should certainly stabilize and with existing home inventories declining, as they have been, and with no residential construction, we would expect that residential construction will pick up sooner rather than later.
f. January 26, 2009 NAR announced that existing home sales rose by 6.52%.
g. More importantly NAR announced that single home inventories had fallen to 8.7 months from a high of 11.6%. This was the lowest inventory rate since June of 2007.
h. On January 30 it was reported that while GDP was down 3.8%, but real disposable income increased by 3.3% in December.

i. Leading indicators were positive for the first time in 5 months as reported on January 26, 2009 by the Conference Board. More importantly money growth and the yield curve the two leading indicators of the leading indicator index, have been positive for the past four months.
j. The FFBond spread (10 year note less fed funds) is one of the strongest indicators of the health of the financial institutions, and the spread is currently at a multi year high of 2.5%. This enables banks to begin lending.
k. Building permits were reported on January 22, 2009 to be the lowest ever recorded for the second month in a row. December's 2008 permits broke the record from November 2008. This series began in 1960 when the population in the country was approximately one half what it is today. This data is seasonally adjusted but not population adjusted. The October 2008 reading was the 6th worst of all time. Implication there is very little downside here, and with existing home inventories declining and lowered interest rates residential building has likely reached its low point.
l. On January 5, 2008 the Commerce Department reported that residential construction was at historic lows, but nonresidential construction was up 1% again, and up 9.2% y/y, and has been rising continuously since 2003. (We expect this to slow, but we have been expecting non residential construction to slow for the past year also). Also the levels are at historic highs.
m. In late November, President elect Obama announced a major initiative to invest in infrastructure within the U.S. This week the stimulus bill was signed into law.

## 4. The Stimulus Package ,TARP, and TALF

The markets have been very weak since the Geithner non announcement. While that was not good the economic data is looking better, the stimulus package was signed into law, the Treasury is making progress on figuring out how to help the mortgage holder with a new announcements today on the program, and the TALF program has been expanded, and is likely to be the mechanism by which these toxic assets will eventually be traded.

The TARP is currently functioning in the manner that it was intended to particularly in the way that it helped Bank of America, CITI bank and the auto industry. No major bank has been in dire straits in recent weeks, Morgan Stanley and Goldman are likely to give back the money soon, and lending is picking up slowly. The TARP additionally will begin to focus on the home owner and the mortgage crisis, with TALP being the life line for the banks. This breakdown of the Treasury to the populous and the Federal Reserve working with the Banks appears from this sitting, a more appropriate structure.

## 5. When Market Recover from Recessions

The markets always rebound prior to the end of the recession, and rebound when there is some expectation that the cause of the recession has been sufficiently addressed. We argued that there were three tests that the conditions were in place for the recession to end:

- Citigroup and Bank of America – When they encountered trouble TARP immediately assisted.
- Auto Industry- TARP more protractedly assisted when needed

- Retail while weakened – there have been store closings, but most of the retail sector is hanging on. Non Durable retail has been benefited more than durable retail from the lower gasoline prices.

When the systems are in place for systemic fallout the market historically have rebounded long before the end of the recession. The three passed tests indicate that those systems are in place. What is different this time is that confidence has not return because of the divided elite problem. Once the economic data become resoundingly better we can expect to see confidence improve and all the elites get on board with the improving economy.

## III. Justification for Recommending Polo Ralph Lauren (RL)

Several weeks ago when we recommended Caterpillar (CAT) we concluded with the following: "When conditions look the worst often times the price of stocks mimic those sentiments, especially when the company issues dismal outlook for next year. Historically, these are often the best buying opportunities, because all the bad news is generally out there, and new news releases will either reiterate the bad news or be better news than the already really bad news."

The irony today is that there is progressively better economic data than there has been in months; there are all the programs in place that need to be in place for the conditions that caused the recession to be resolved, however, the economy and confidence is not returning. We attribute this largely to the divided elite problem. As soon as there is the perception that conditions are improving we are expecting a major reversal in confidence which will lead to an increase in discretionary spending.

Polo Ralph Lauren (RL) has been one of the strongest non discounter of all the retail companies throughout this recessionary period. Their Q309 revenues were only slightly lower than their Q3 08 revenues. If we experience the kind of economic recovery that SISR is anticipating with real signs of recovery by midsummer than the retail space will as it traditional has done, will be one of the market leaders, with RL being one of the strongest companies in that space.

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**Price Chart:**

A price chart, with changes of ratings and price targets in prior periods, is included above, for all securities covered in this report.

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