

THE TRADER

As World Soars, U.S. Stocks Tread Water

It was a quiet week, but once investors grasp what's ahead for first-quarter earnings, the ride could get bumpier.

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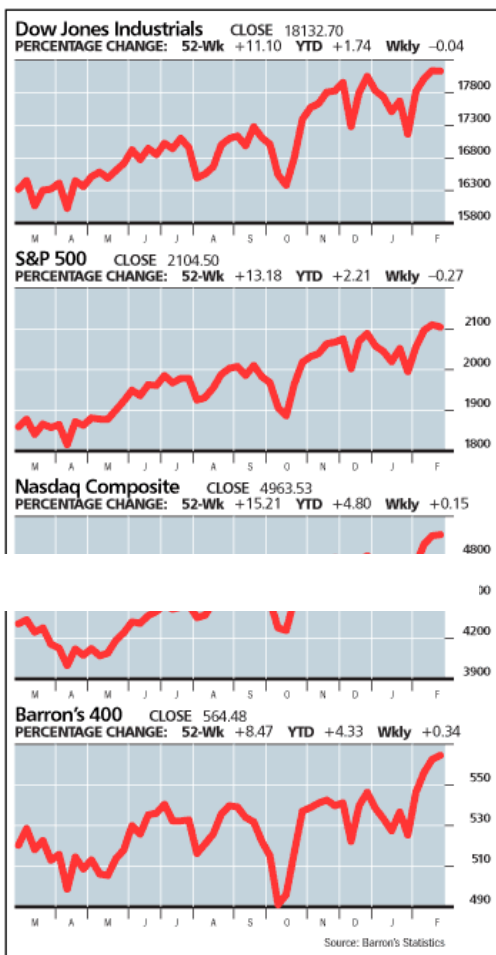
By VITO J. RACANELLI
Feb. 27, 2015 11:27 p.m. ET

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Vital Signs

U.S. stocks treaded water last week in quiet trading, sans the volatility that has characterized 2015 so far. The rest of the world's equities, however, rocked ahead.

Though U.S. major indexes finished little changed, there was enough action to make yet another new high in the Standard & Poor's 500 index Tuesday. Prices eventually fell back and trading was light.



Friday saw a revision of the U.S. fourth quarter gross domestic product growth rate down to 2.2% from 2.6%. Other economic reports released during the week were similarly mixed, notes Chris Gaffney, president of EverBank World Markets. The data wasn't enough to push the indexes out of their recent range, he adds.

Last week, the Dow Jones Industrial Average lost seven points to 18,132.70, while the S&P 500 index fell six, or 0.3%, to 2104.50, after hitting a high of 2115.40 Tuesday. Both rose over 5% last month. The Nasdaq Composite gained eight points, or 0.2%, to 4963.53, and was up 7% in February.

As March begins, investors will have lots of data to parse, especially the February unemployment report Friday, adds Gaffney. After Federal Reserve chair Janet Yellen spoke to Congress last week, the market appears to be moving its expectation of the

first rate hike to later in the summer from the beginning.

Stock markets outside the U.S. were ebullient, and "pretty much every other market is beating the U.S.," notes Michael Shaoul, chairman of Marketfield Asset Management. The MSCI World Index excluding the U.S. rose almost 1% last week. Year to date that index has doubled the S&P 500's 2.5% rise, even in dollar terms.




That's a bit of a surprise, Shaoul adds, considering the consensus coming into 2015 saw U.S. equities as the place to be. But while the U.S. is roughly meeting economic expectations, the bar is lower in the rest of the world—whether Japan, Europe, or emerging markets. That allows expectations to be beat, even though risks are higher.

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overseas.

Shaoul's favored investment area is Japan. Though Japanese economic data are mediocre, its companies are in good shape, he says. While rates will be going up stateside, they are going down elsewhere.

With fourth-quarter earnings season over, the focus will turn back to macroeconomic data and a number of non-U.S. central bank meetings this week, says John Canally, an investment strategist at LPL Financial. European Central Bank policy makers assemble March 5.

Further ahead, Canally says that although market professionals recognize that the S&P 500's first quarter earnings will be negative, thanks to deep declines in energy, "it's still not widely known among average investors."

Soon it will be. That could be the occasion for renewed volatility next month.

Cold Soup?

[Campbell Soup](#) (ticker: CPB) is known for steady if slow growth in a reliable sector. Folks have to eat, and it sports some well-known brands besides the soup made famous by Andy Warhol, such as Pepperidge Farms and V8 juice, among others.

At \$46.59, the stock, like the market, is near all-time highs. Campbell trades at a 15% valuation premium to the S&P 500 index, though results have been flattish for years. For example, annual revenue has revolved around \$8 billion since 2008, while earnings before interest, taxes, depreciation, and amortization (Ebitda) have been stuck around \$1.5 billion since 2007. Annual earnings per share (EPS) growth since 2008 has averaged 4%, a good chunk derived from a 12% drop in shares outstanding.



With growth looking bland and with the S&P 500 obtaining a price/earnings ratio of 17 times, does Campbell's stock deserve a rich P/E of about 20 times consensus analyst EPS estimates of \$2.35 for the fiscal year ending July 2015?

Perhaps not. Campbell's EPS this year will be down from 2014's \$2.53, and the P/E is significantly above its historical median of 16.4 times. Given the headwinds the company revealed last week, the shares look like dead money for this year and might even backtrack 5% to 10%, short of signs it's

getting itself in gear or a bear market.

Last Wednesday, the company reported weak earnings for the fiscal second quarter ended Feb. 1, and lowered annual EPS guidance 3% to 5%, to \$2.32 to \$2.38. The Camden, N.J.-based firm's quarterly sales fell 2% to \$2.2 billion, while earnings from continuing operations slipped to \$207 million or 66 cents from \$228 million or 75 cents. Ebitda fell 17% to \$312 million.

While organic sales gains were seen in four of its five main businesses, this was offset by a relatively large gross-margin decline of 3.1 percentage points to 32.6% in the quarter. The size of the drop was a surprise for investors, which the company blamed on cost inflation in meat and produce, as well as higher logistics costs and promotional spending, and currency issues.

Campbell has been fighting a serial drop in gross margin since fiscal 2010, when it was 41%.

In response to a request for comment, a Campbell spokesperson referred *Barron's* to the recent conference call, in which the company said it expects second half performance to improve as inflation and supply-chain effects moderate. For 2015, the gross margin decline will be about 1 percentage point. Campbell is looking at ways to improve that metric.

The supply-chain issues that hurt the second quarter resulted from a decision to incur additional expenses to improve customer service, the company said.

What would boost the stock price is better and steadier growth in its soup business, Campbell's biggest product. The U.S. simple meals division, which includes domestic soups, saw organic growth of 2% in the first six months of fiscal 2015, but we wonder if Campbell's soup resonates with millennials. Campbell called premium soup one of its

faster-growing areas and said it's expanding its Slow Kettle and organic-soup products.

In the stock's favor is a 2.7% yield. And Campbell has announced a plan for \$200 million in annual cost savings to be addressed in fiscal 2016. Still, low earnings growth, mainly from cost cuts and share buybacks, doesn't seem to justify such a high P/E.

Wall Street analysts have talked about the possibility of Campbell being bought, and that's supporting the price for now. It's small enough at a market cap of \$14.6 billion, has desirable brands, and those gross margin problems would seem ripe for an outsider to solve. But there's also a large concentrated family holding that is seen as a potential barrier to a buyer.

Some Campbell issues seem resolvable with time, except for the important one about challenged growth.

The Emperor's New Clothes?

Shares of [Men's Wearhouse](#) (MW) are up over 20% in the past two months, to \$50.19, sharply outperforming the broad market, on rekindled ardor for the acquisition by the discount men's clothing retailer of its low-end rival, Jos. A. Bank, last June.

The \$1.8 billion deal doubled the company's size and eliminated a big rival, but the soaring stock price seems to overlook the higher risks that have come with the merger. After paying a high premium for Bank, Men's Wearhouse saw its debt jump to \$1.7 billion from \$90 million. Throw in another \$700 million or so in off-balance-sheet operating leases, notes David Trainer, president of New Constructs, an independent research outfit, and debt is roughly equal to Men's Warehouse's total market capitalization of \$2.4 billion.

In the fiscal third quarter ended Nov. 1, 2014, interest expense of \$25 million consumed more than half the \$45 million operating income. In the year-earlier period, without Bank, interest expense was just \$1.2 million, against \$60 million in operating income. The organic sales-growth synergies, even with the U.S. economy expanding and a better retail picture, is unimpressive so far. While total third-quarter sales went up 37% to \$890 million, that was due to the addition of Bank. The Men's Wearhouse division, half of total sales, rose a so-so 2%, or \$8.5 million, to \$436 million.

The drop in quarterly operating income came from sharply deteriorating results at the Bank division, where third-quarter same-store sales fell 8%. The picture isn't getting better. In its third-quarter conference call the company said it expects Bank sales to continue to fall by "high single-digit to low single-digit levels."

Men's Wearhouse faces a tough task trying to stem the outgoing tide at Bank. Costs have gone up dramatically. Trainer notes that the total cost of sales jumped 47% to \$521 million; selling, general, and administrative expense, 34% to \$282 million; occupancy, 56% to \$114 million; and advertising, 86% to \$42 million. Granted, it's just one quarter, but this doesn't bode well for the company's promise to wring \$100 million to \$150 million from annual corporate costs.

So far, the combination hasn't added value, argues Ivan Feinseth, an analyst with Tigress Financial Partners, who Friday dropped his Men's Wearhouse rating to Sell from Neutral.

The merger created a company harder to manage and overleveraged in a business where the competition has intensified, he says. Department stores—and [Macy's](#) (M) in particular, he says—have done a "phenomenal job of eating into Men's Wearhouse," through improved merchandising, discounting, and offerings in the men's area, he says.

Macy's, a more diversified retailer, adds Trainer, has net operating profit after tax margins (Nopat) of 7%, almost twice the 4% Nopat margins at Men's Warehouse. (Nopat essentially strips out nonoperating gains and losses from results.) Yet Men's Wearhouse sports a P/E ratio of 15 times consensus analyst EPS expectations of \$3.40 for the 2016 fiscal year ending in January, significantly higher than Macy's 13 P/E. On price-to-Nopat, Men's Wearhouse is double Macy's valuation.

That \$3.40—already down from \$3.80 a few months ago—is much higher than the \$2.52 EPS seen for the recently ended fiscal 2015. That incorporates a lot of hoped-for improvements yet to be seen.

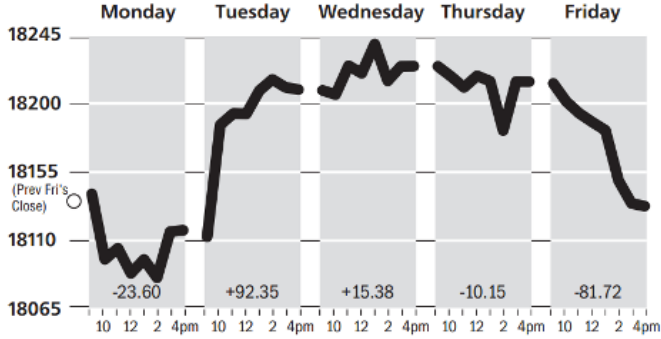
These high expectations, says Feinseth, would be justified by trend growth of over 20% in sales, but that hardly seems achievable. Both Tigress and New Constructs value Men's Wearhouse stock in the "mid-\$20s," sharply below the current price.

Men's Wearhouse declined to comment.

The current multiple seems ill-suited to the stock, since Men's Wearhouse needs to get its costs down fast and revive sales at Bank. The company reports fourth-quarter results March 12. It won't take much in the way of bad news to pressure this stock.

FIVE-DAY DOW COMPOSITE

Bull Caged: The Dow finished the week mostly unchanged, bucking a world stock market trend higher. Mickey D's jumped 5% and Coke 3%, but Boeing fell almost 5%.



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