

From the Fourth Quarter 2008 Edition of Platt Retail Institute's *Quarterly Retail Analytics*:

Summary of our Retail Business Outlook.

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IS A CONSUMER-LED DEPRESSION NEXT?

Strength in exports masked from the macroeconomic landscape weakness in the consumer sector through the second quarter of 2008. Unfortunately, since late 2007, when a consumer-led recession began, things have gone from bad to much, much worse. And the outlook for the economy and consumer spending is looking extremely volatile for much of 2009 and beyond.

In what Federal Reserve Chairman Ben Bernanke has described as the worst financial crisis "endured since the Great Depression," the US, as well as other countries around the world, has embarked on various plans intent on buttressing the financial system and reestablishing credit availability. Early indications are that these steps are having a positive influence. On this point, former Federal Reserve governor Laurence Meyer's recent comment is instructive: "the most extreme downside risks have been diminished, but the damage has been done, and this isn't going to prevent the economy from being in a recession and remaining weak for a while."

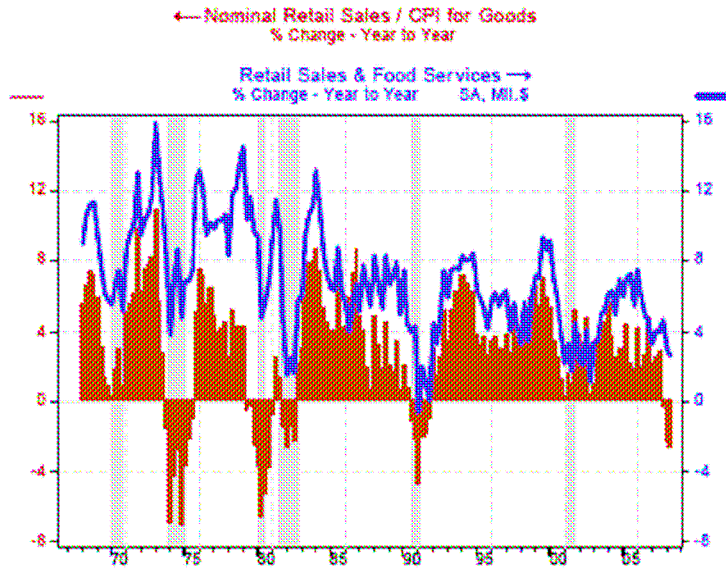
Assuming that the US (and indeed the global) economy works through the current credit crisis, as we do, many questions remain. Those considered here are retail sales and consumer spending, the economic outlook, and a structural shift in consumer spending.

Retail Sales and Consumer Spending

Sales for retailers with over \$50 million in assets increased in the second quarter by 4.6% versus the first quarter, and by 4.9% compared to the second quarter of 2007. However, after adjusting for the Consumer Price Index (net of inflation), the Northern Trust Bank found that "retail sales on a year-over-year basis have been declining for three quarters running, contracting by -2.6% in the second quarter of this year (see Chart 1). More telling, for the second quarter, after-tax profits for these retailers increased by 8.3% versus the first quarter, but were down -30.2% compared to the second quarter of 2007.

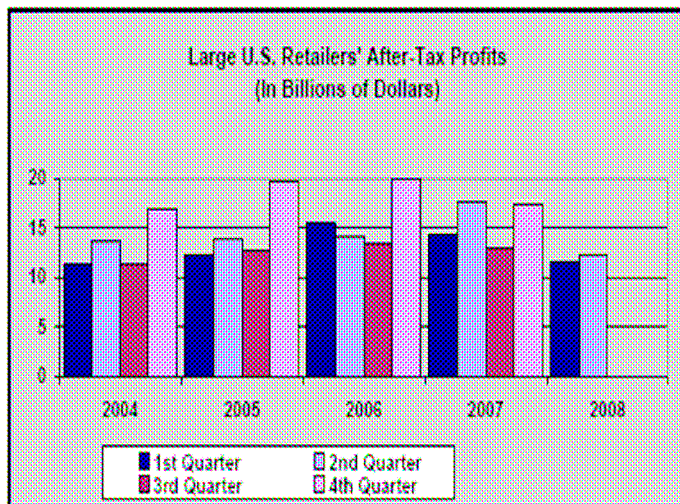
Second quarter profits for these retailers were the lowest of any second quarter dating back to 2004 (see Chart 2).

Chart 1.



Source: Northern Trust Bank

Chart 2.



Source: US Census Bureau

During the third quarter consumer spending fell -3.1%, versus an increase of 1.2% in the second (see Chart 3). October retail sales, released on 14 November, again indicate weakness in consumer spending. Retail sales declined by -2.8% in October. This is the fourth consecutive drop and the largest drop since 1992, when this series began (see Chart 4). Excluding autos and gasoline, retail sales fell -0.5% in October. Most major categories of retail sales posted declines, for example, furniture was -2.5%, apparel -1.4%, building materials -0.4%, electronics -2.3%, and general merchandise -0.4%. Only restaurants and health and personal care showed increases.

Chart 3.

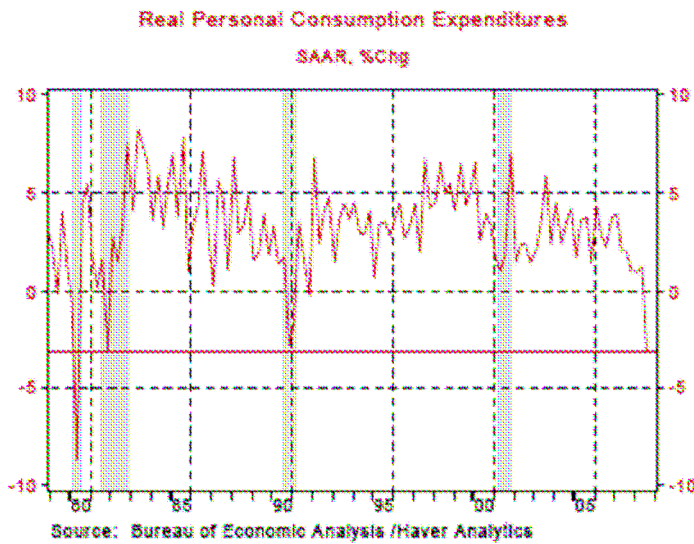
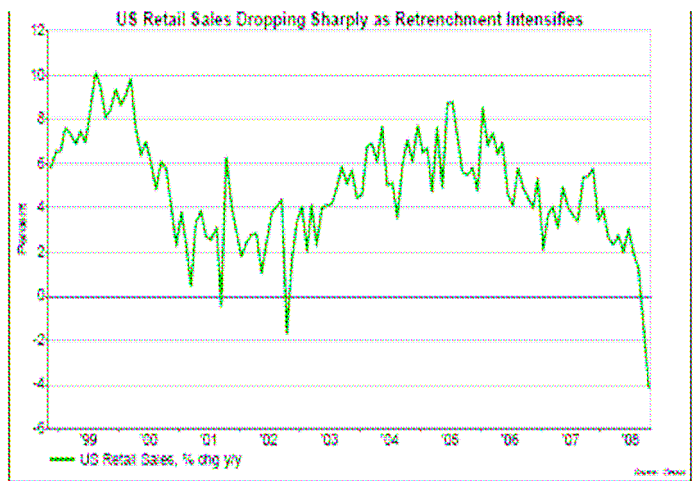


Chart 4.



Source: State Street Global Advisors

Economic Outlook

Estimates are for negative GDP growth for the next three quarters. Global Insight Chief Economist Nariman Behravest is projecting fourth quarter GDP falling by -3.3%, first quarter 2009 GDP off by -2.1%, and second quarter 2009 GDP decreasing by -0.5%, with a very mild recovery during the second half of 2009 (both Global Insight and BMO Capital Markets Economics project 2009 GDP to fall by -1.0%, Oxford Economics looks for 2009 GDP to be 0.41%, and the IMF predicts growth of 0.1%).

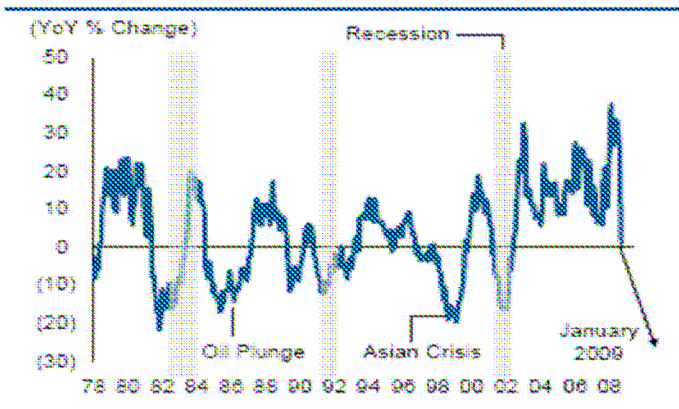
Entering the fourth quarter the employment picture has deteriorated substantially, real estate prices continue to fall, the stock market can best be described as dazed and confused, and funds being injected into credit markets that were frozen are still thawing, as such capital is slow in reaching its intended recipients. The industrial sector is now following the consumer sector into the abyss, as exports will no longer aid economic activity. The result will be a long and deep recession, accompanied by a major retrenchment in consumer spending.

Economic indicators support the conclusion that the economy is entering into a prolonged recession. These include falling commodity prices, and declines in both the Federal Reserve Bank of Chicago's National Activity Index, among others.

Falling commodity prices are an indicator of an economic slowdown, as user demand falls. Over the past few months, commodity prices have fallen off dramatically (see Chart 5).

Chart 5.

Display: Commodity Prices in Free Fall
Reuters-CRB Commodity Price Index

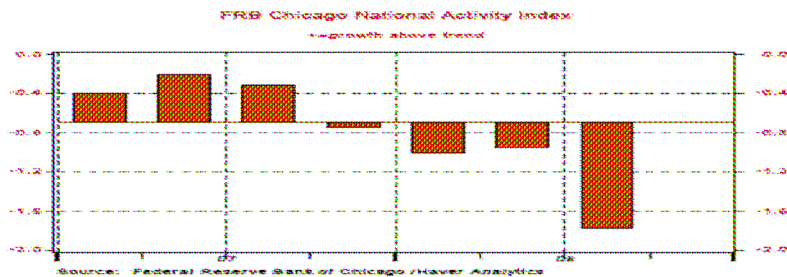


Source: Haver Analytics and Thomson Reuters

The Federal Reserve Bank of Chicago's National Activity Index is a strong indicator of an economic slowdown. It has been advanced that "when the quarterly average drops below minus 0.70, a recession has occurred." Chart 6 shows that the quarterly average of the

Index fell below minus 0.70 in the fourth quarter of 2007, and has now fallen for four quarters, with a steep drop in the first quarter of 2008.

Chart 6.



Source: Northern Trust Bank

The Index of Leading Economic Indicators also supports the conclusion that the economy is entering into a prolonged recession. The Index began contracting in the first quarter of 2007. With the exception of the third quarter of 2007, the Index has continued to contract (see Chart 7).

Chart 7.



Source: Wachovia Economics Group

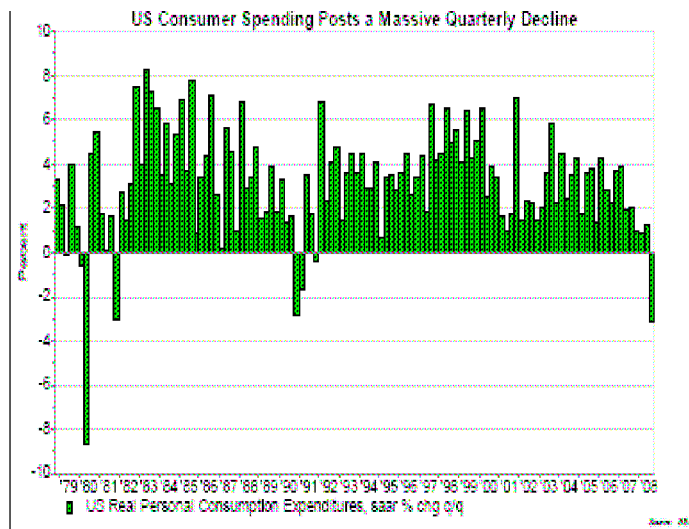
Finally, recent comments made by the Federal Open Market Committee are useful to consider: “The pace of economic activity appears to have slowed markedly, owing importantly to a decline in consumer expenditures. Business equipment spending and industrial production have weakened in recent months, and slowing economic activity in many foreign economies are damping the prospects for US exports. Moreover, the intensification of financial market turmoil is likely to exert additional restraint on spending, partly by reducing the ability of households and businesses to obtain credit. [Moreover] downside risks to growth remain.”

Much as we are trying to find good news about consumer spending, this is becoming an impossible task. In conclusion, we anticipate an economic train-wreck. Holiday sales could fall by as much as -2 to -3%, and consumer spending and retail sales will be extremely weak until at least the summer of 2009. Beyond 2009, a significant structural shift in consumer spending will take place that will impact retailers for a long time.

Long-Term Consumer Spending Outlook

The -0.3% read for third quarter GDP confirms that a long-term recession has begun. Most troubling is the -3.1% decline in consumption (see Chart 8), which is the biggest decline since the 1980 recession.

Chart 8.



Source: State Street Global Research

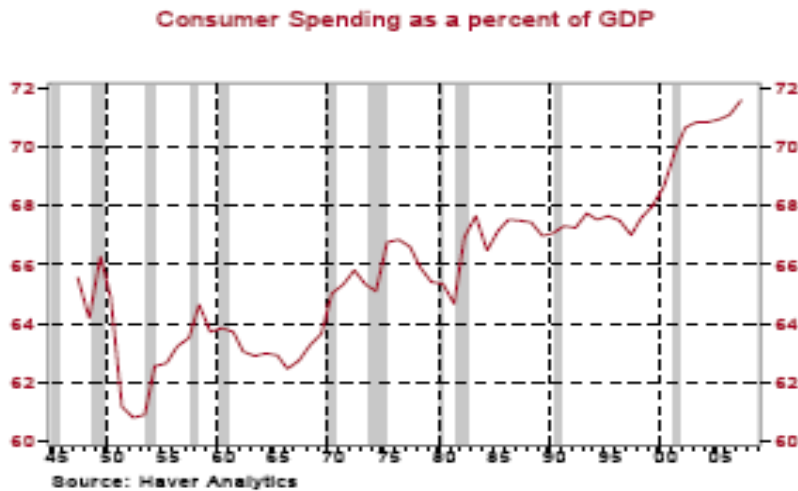
We now believe that we are entering into a prolonged period of reduced consumer spending. Which raises the question of will this decline lead us into a depression? We do not anticipate this occurring, but do forecast a decline in holiday 2008 sales of -2 to -3% due to current economic conditions. Following the recovery from the current recession, in 18-24 months, we look for a structural change in consumer spending. Longer-term, we anticipate a reduction in consumer spending as a percent of GDP by -4% +/-, to more historic levels.

Our outlook of a long-term contraction in consumer spending is contrary to most, and represents the minority view. Indeed, the US consumer has been styled a “spending machine.” In fact, in perhaps only 8 of 115 or so quarters has consumer spending declined. Many factors have contributed to the free spending of the US consumer in the past. Chief among them has been access to more and more credit and an increase in wealth accumulation. Both credit availability and household wealth are declining, which will result in a return to historic levels of consumer spending. Additional noteworthy

factors impacting our view, but not addressed here, include slowing population growth, an aging population, and modest long-term wage growth.

For the past 27 years, consumer spending as a percent of GDP has been creeping up. For example, at the end of the 1981 recession, personal spending accounted for perhaps 67% of GDP. Today, it approaches 71% (see Chart 9).

Chart 9.



Assuming that US GDP is around \$14.3 billion, 71% would mean that around \$10 billion of GDP is related to personal consumption. Therefore, this -4% decrease (on a non-adjusted annual basis) could equate to perhaps \$400 billion (this amount exceeds the annual domestic sales of Walmart or the combined sales of the top seven US retailers excluding Walmart). This falloff would have a major impact upon US retailers.

Conclusion

In the third-quarter edition of the PRI Retail Analytics, we advanced that a structural shift in consumer spending was a likely outcome from the consumer-led economic downturn. This was prior to the credit crisis that has since unfolded and, in our view, changed the landscape of the US economy forever. Going forward, consumers face many challenges. Rising unemployment and stagnant wages. Falling home values and investments. Credit is extremely limited. Real consumer spending fell at an annualized rate of -3.1% during the third quarter, and all signs point to a disappointing holiday shopping season. We also anticipate a major reduction in consumer spending longer-term.

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