Improved Consumer Confidence Bodes Well for Strong Holiday Retail Sales

A brief snowfall on Halloween in Chicago quickly reminded us that the holidays are fast approaching. Pumpkin candy buckets and "Frozen" costumes have been replaced with Christmas trees and colorful lights. According to the National Retail Federation (NRF), about 40% of shoppers begin their holiday shopping before Halloween. The holiday season is a critical time of year for retailers as up to 40% of annual revenues are realized. Various analysts and trade organizations predict that holiday sales will be up anywhere from 1% to 5%. We believe that sales for this year will come in at the high end of that range. This paper explores some of the more important drivers of our analysis.

Statistical Analysis – Purely Quantitative but Supports Stronger Sales

Looking back on data over the last twenty years reveals a significant correlation (85%) between back-to school retail sales (August and September) and holiday sales (November and December). To complete this analysis, we used the U.S. Census Bureau's monthly retail trade data, which includes a variety of retail businesses. A regression model predicts holiday sales of 2.7% when using 2.6% for the back-to-school sales observed in 2014. This would be slightly above the ten year average of 1.9%.

Most Trade Group Surveys Are Positive for 2014 Holiday Sales

According to a recent survey by the National Retail Federation, consumers are expected to spend 4.1% more this holiday season vs. the average increase over the past ten years of 2.9%. About 80% of shoppers are forecast to spend more or the same this year compared to 79% in 2013 and 77% in 2012. The survey also indicted that the top three purchase drivers to shop at a particular retailer are: special sale prices, quality of merchandise, and selection of merchandise.

The International Council of Shopping Centers (ICSC) expects holiday sales will be up 4% this year. Deloitte's retail practice predicts sales from November 2014 through January 2015 will grow 4.0% to 4.5%. A more pessimistic view comes from PricewaterhouseCoopers (PwC) which predicts average holiday spending per household will fall 7% from $735 in 2013 to $684 this year. According to PwC, 84% of consumers plan to spend the same or less than last year.

The Consumer Is Strengthening

We believe the most important driver of retail sales is the strength of the consumer. The table in Exhibit 1 summarizes our analysis of nine different economic factors, which contribute to a consumer's ability and willingness to spend. We will also opine on individual factors in terms of how they may impact spending going forward.

Exhibit 1

Factor	View	Comments
Employment	Positive	Unemployment <6%. Payrolls averaged +200,000 YTD. Job openings and quit and hiring rates are increasing. Participation still low.
Consumer Confidence	Positive	Michigan has been above 80 for 10 months in a row. Conference Board climbing above 90.
Income	Neutral	Personal income inching up. Growth averaged +3% YTD. Adjusted growth of 2.5%.
Savings Rate	Neutral	Rate is slowly increasing. At the 5 year average of 5.8%.
Debt Position	Neutral	Credit card debt outstanding is climbing. Debt service ratio stabilized.
Household Wealth	Neutral	Net worth improved through second quarter of 2014. Big component is equities, which are up this year.
Housing	Neutral	Affordability is down. Year-Over-Year sales growth and prices have slowed.
Gas Prices	Positive	Prices have been falling since the end of June. At 2014 lows.
Inflation	Neutral	CPI Index is slowly climbing. Year-Over-Year growth has been between 1% and 2%.

Source: AAM

Overall, these factors have improved from last year. Positive developments include falling gas prices, an improving job market, and higher consumer confidence. Stagnant income growth, a low labor participation rate, and unpredictable headlines (i.e., Ebola) could impact spending. In addition, GDP in the U.S. has been volatile throughout the year and is not expected to be significantly better in 2015.

Seasonal Hiring Better than Last Year

The National Retail Federation predicts that between 725,000 and 800,000 seasonal workers will be hired this year[1]. Supporting the higher end of the range, ICSC is forecasting 794,258[2]. These forecasts compare to 768,000 hired last year and are above pre-recession levels. Companies continue to shift from hiring in stores to adding staff in call centers and/or distribution warehouses. E-commerce giant, Amazon, plans to hire 80,000 seasonal employees, up from 70,000 last year. Most traditional retailers have stated their seasonal employment is either flat or up from last year, including Walmart which expects to hire almost 10% more seasonal employees this year. In addition, shipping giants FedEx and UPS are predicting stronger holiday demand,

[1] *Kimberly C. Greenberg, Simeon Gutman, CFA, Ellen Zentner, Vincent J. Sinisi, Jay Sole, and Lauren Cassel, "Nice Inventory, but Sales Could be Naughty: Cautious on Holday 2014," Morgan Stanley Retail Research, (October 27, 2014), 6.*

[2] *Greenberg et al., "Nice Inventory," 6.*

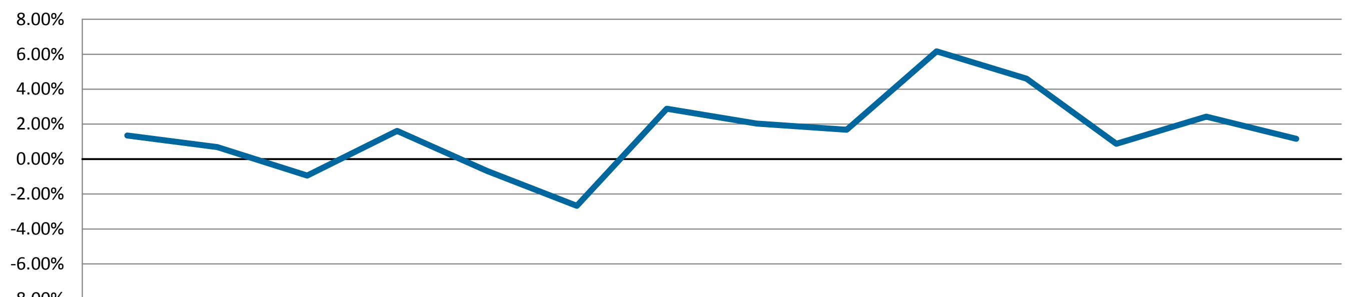
resulting in a higher level of hiring. UPS expects to ship more than 585 million packages in December, which is an 11% increase over last year. UPS expects to hire between 90,000 to 95,000 seasonal workers and FedEx may hire 50,000.

Improved Inventory Could Help Retail Pricing and Margin

Consumer shopping patterns are not expected to be much different this year. Consumers are better equipped to shop smarter and more efficiently. Shoppers will continue to hunt for deals, forcing retailers to remain price competitive and promote earlier. We believe that retailers are in a better inventory position this year. The table in Exhibit 2 graphs the difference (spread) between inventory growth and expected sales growth on a quarterly basis for some of the largest retailers in the U.S. Inventory is a balance sheet item which is based on the company's expectation of future sales. We look for a close match in inventory growth in the third quarter when compared to expected revenue growth for the fourth quarter. The spread for the last three quarters seems to put retailers in a better position versus last year.

Exhibit 2

Inventory (Growth) - Sales (Forward Growth)



	CQ2 2011	CQ3 2011	CQ4 2011	CQ1 2012	CQ2 2012	CQ3 2012	CQ4 2012	CQ1 2013	CQ2 2013	CQ3 2013	CQ4 2013	CQ1 2014	CQ2 2014	CQ3 2014
TGT	-2.55%	0.53%	-1.61%	-3.66%	-5.65%	-10.36%	0.77%	3.58%	7.21%	14.17%	8.86%	2.65%	2.90%	3.94%
WMT	2.97%	2.14%	3.26%	2.74%	1.69%	3.24%	6.66%	2.27%	3.85%	3.21%	1.63%	2.23%	3.35%	1.33%
M	2.71%	4.11%	3.23%	2.92%	-2.01%	-6.48%	-0.24%	3.89%	3.07%	8.63%	6.38%	1.41%	2.39%	-1.23%
KSS	1.89%	2.81%	3.98%	8.25%	10.29%	11.27%	17.58%	13.69%	11.39%	6.76%	6.43%	1.60%	2.69%	-1.39%
LOW	-0.30%	-5.73%	-7.54%	3.32%	-3.29%	5.07%	3.43%	-5.27%	-2.64%	1.09%	3.72%	-3.31%	-3.29%	-3.08%
HD	-4.41%	-8.38%	-8.68%	-2.63%	-3.21%	-11.67%	-3.66%	-7.39%	-5.78%	6.55%	0.30%	-1.34%	-0.15%	0.23%
JWN	-4.37%	3.30%	4.50%	12.43%	7.69%	-3.74%	13.74%	1.92%	2.31%	8.44%	5.95%	8.21%	14.42%	16.31%
TJX	11.92%	7.26%	-4.38%	-12.21%	-21.36%	-26.15%	-4.59%	-2.11%	-2.90%	10.00%	-6.46%	-3.59%	0.76%	1.20%
JCP	7.20%	7.43%	10.82%	13.12%	10.36%	5.23%	-3.32%	2.61%	10.47%	14.08%	19.07%	-3.78%	-9.19%	-11.84%
BBBY	4.53%	4.43%	-0.54%	0.10%	-6.30%	-0.48%	-7.24%	1.28%	6.44%	0.56%	10.08%	2.87%	1.96%	2.86%
SPLS	7.62%	4.53%	5.47%	4.04%	-0.05%	-7.38%	-1.34%	-2.39%	-0.53%	10.76%	3.37%	-0.39%	3.47%	-0.62%
CVS	-15.17%	-17.11%	-25.93%	-11.41%	-10.18%	-9.84%	9.97%	-2.53%	-4.20%	-1.34%	-6.18%	-5.11%	-2.28%	-2.43%
FDO	5.97%	4.74%	5.69%	5.82%	11.53%	10.79%	4.61%	16.32%	0.43%	-0.36%	9.50%	4.95%	3.48%	6.85%
AZO	0.85%	-0.40%	-1.43%	-0.18%	0.93%	3.10%	3.92%	2.56%	-5.66%	3.72%	1.79%	5.84%	13.51%	4.19%
AVG	1.35%	0.69%	-0.94%	1.62%	-0.68%	-2.67%	2.88%	2.03%	1.68%	6.16%	4.60%	0.87%	2.43%	1.17%

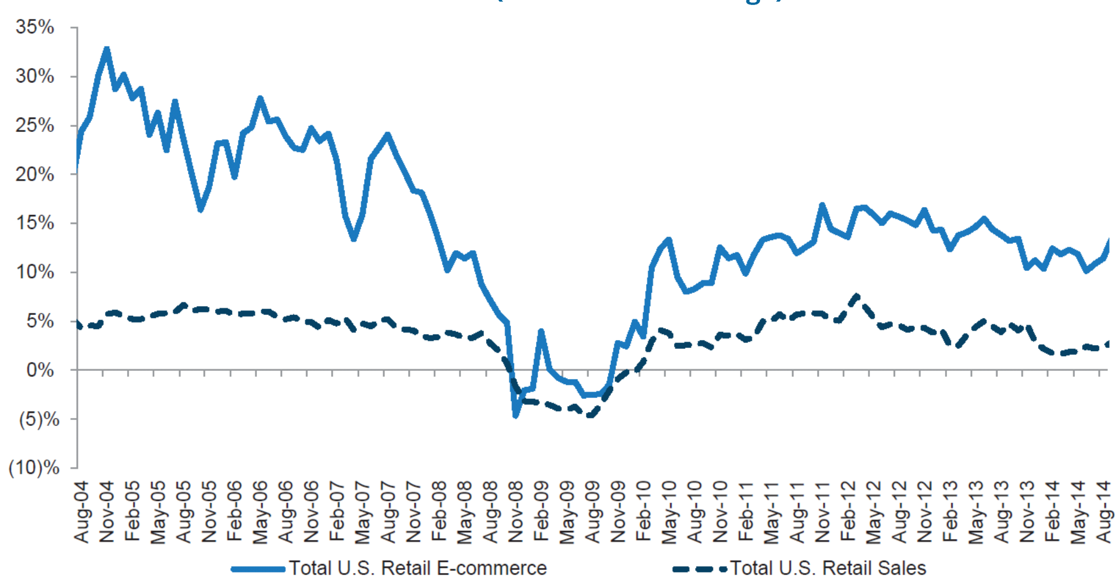
Source: Bloomberg

We believe the lower trending spread should reduce markdowns and help protect from shrinking margins. Also, for the group of retailers listed in the table, it's important to note that the average expected revenue growth for the fourth quarter is 3.9% compared to 0.0% for last year.

Online Shopping Continues to Gain Importance

E-commerce continues to be a very important area of growth for the retail industry. Most retailers have had to adapt quickly to remain relevant among consumers. Omni-channel retailing has merged the inventory and distribution of physical stores with the online business. As shown in Exhibit 3, e-commerce has grown much more quickly than the traditional retail business. E-commerce penetration also continues to grow. In the last ten years, the penetration has grown from less than 4% to around 10%. We expect that number to continue to grow as traditional retailers and new, online only retailers accommodate the growing popularity of electronic shopping. Even with lower margins, traditional retailers recognize that their best customer is one who shops in multiple channels and is most familiar with their brand. Their challenge is to incentivize their customers to both visit the store and shop online. According to Shop.org, holiday sales are expected to be up 8%-11% this year to as much as $105 billion[3]. Mobile devices are getting easier to use and are playing a bigger role in shopping for consumers. An estimated 27% of purchases this year will be done on a mobile device with 48% of those made on a tablet[4]. A lot more is done with the help of mobile devices, including researching products, comparison shopping on prices, and utilizing e-coupons.

Exhibit 3: Year-Over-Year Growth of Total Ecommerce Sales versus Total U.S. Retail Sales (Three Month Average)



Note: E-commerce excludes travel and event tickets.
U.S. Retail includes furniture and home furnishings stores, clothing and accessories stores, sporting goods, hobby and book stores, general merchandise stores, and office supply, stationery, gift stores, grocery stores, e-commerce.
Source: William Blair Company, Census.gov, comScore

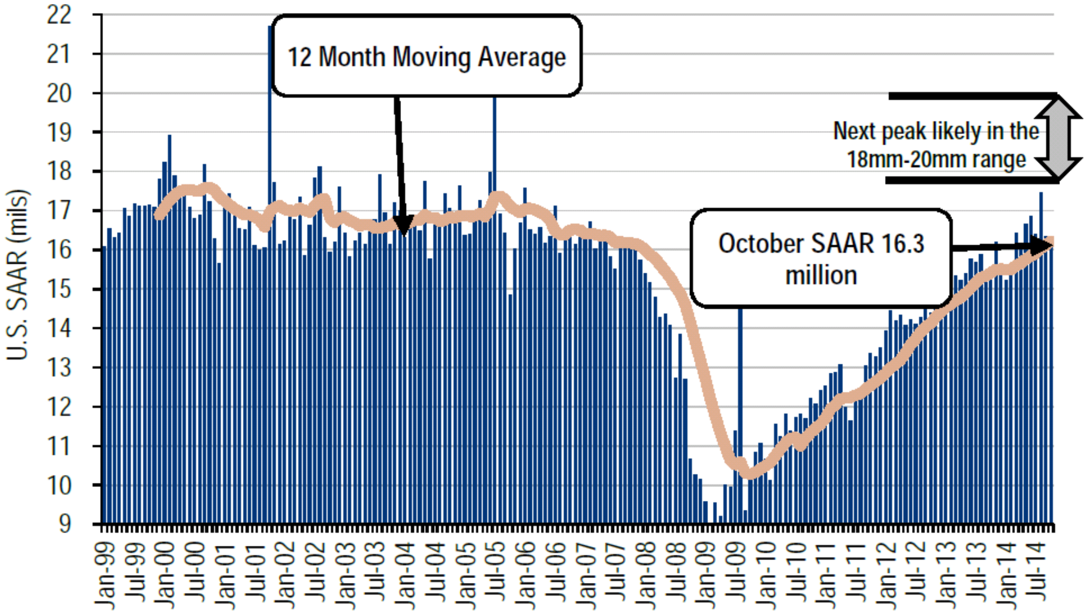
---

[3] Kate McShane, CFA, Corinna Van der Ghinst, Nancy Hilliker, Goeffrey Small, Christopher Weng, "Ho Ho Hoping for a Happy Hardlines Holiday," Citi Research: Equities – Apparel/Footwear/Textiles, North America (October 30, 2014): 13.
[4] "'Tis the Season to be Mobile: Criteo Unveils US Holiday Online Shopping Behavior Insights," http://finance.yahoo.com/news/tis-season-mobile-criteo-unveils-135000710.html, accessed, November 18, 2014.

Big Ticket Items May Result in a Shorter Shopping List

Similar to 2013, a significant amount of consumer spending this year has been on big ticket items, including new cars and housing related items. This trend could result in lower spending on discretionary items during the holiday season. Auto sales have been stronger than expected because of very attractive financing and secular trends, including the increasing age of used cars and number of cars owned per household. Exhibit 4 shows auto sales over the past fifteen years. A return to a historical sales level implies continued growth in the near to intermediate term.

Exhibit 4: U.S. Seasonally Adjusted Annual Rate (SAAR)

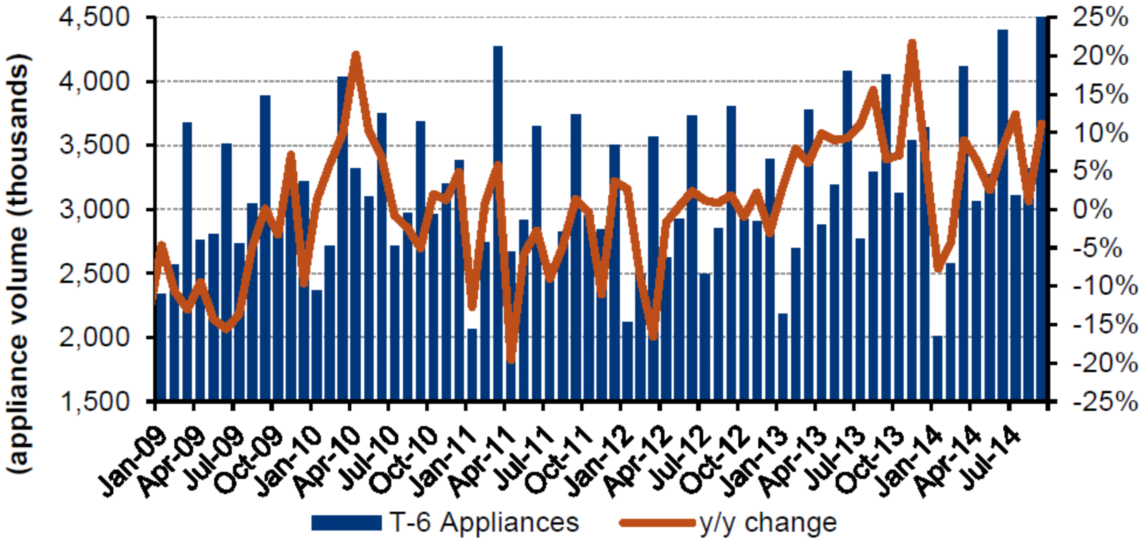


Source: Ward's AutoInfoBank, BofA Merrill Lynch Global Research

Years of pent up demand from curtailed spending, high average appliance age (approximately 10 years), improved housing prices, and a better job environment are giving consumers greater confidence to spend on their homes (Exhibit 5). There is the risk that a greater piece of the spending pie will be used to buy these types of big ticket items, leaving a smaller portion for typical Christmas items such as apparel and electronics. That said, this year there are a number of new/innovative electronic devices that we expect will be on many Christmas lists. These include new Apple products (iPhone 6, iPad3), 4K TV's, and newer gaming consoles complete with a better catalog of games. The Consumer Electronics Association expects tech spending this holiday to be up 2.5% compared to up 0.9% last year[5]. Headphones and earbuds are likely to be the most popular tech gift this year[6].

[5] "Holiday Season Tech Spending to Reach Record Levels, According to CEA's 21st Annual Holiday Forecast," Consumer Electronics Association, accessed November 18, 2014, http://www.ce.org/News/News-Releases/Press-Releases/2014/Holiday-Season-Tech-Spending-to-Reach-Record-Level.aspx.
[6] "Holiday Season Tech Spending."

Exhibit 5: September Appliance Volumes Accelerate Up 11% vs. 6.5% Last Year



Source: BofAMerrillLynch, AHAM

Weather and Calendar Unlikely to Provide Support

Weather and the calendar are always important factors for holiday spending. Last year was the coldest and wettest winter in decades. According to Weather Trends International (WTI), temperatures are expected to be below normal but better than last year[7]. WTI also predicts a snowy winter albeit less severe than last year. Positively, in this new era of technology, consumers can shop online if weather is an issue. We do not expect weather to be a headwind for consumers this year relative to 2014.

The days between Thanksgiving and Christmas are key shopping days. This year, those days total 27 (26 is the min, 32 is the max) versus 26 last year. In addition, there are eight total weekend days to shop, the same as last year. The shortened holiday shopping season could lead to an earlier start to promotions, but overall, we do not expect the calendar to negatively impact holiday sales.

Conclusion

We believe 2014 will be a strong year for holiday spending. The most important factor is the improved domestic economy, which will positively impact consumers' willingness and ability to spend. Retailers seem well positioned this year with improved inventory levels, exciting and innovative products, and more access and control of consumers' shopping patterns via technology. The adjustments made by retailers in the face of changing consumer buying habits and technology over the past several years should allow companies to

[7] *Greenberg et al., "Nice Inventory,"33.*

compete on areas other than price, providing revenue and margin support. Their optimism is reflected in robust seasonal hiring. A potential headwind to spending is the preference for big ticket items, which may limit spending on higher margin, nondiscretionary items. We do not expect the calendar or weather to be a drag vs. 2013.

Written by:

Mike Ashley
Principal and Senior Analyst, Corporate Credit

AAM THOUGHT LEADERSHIP

Improved Consumer Confidence Bodes Well for Strong Holiday Retail Sales

For more information, contact:

Colin T. Dowdall, CFA
Director of Marketing and Business Development
colin.dowdall@aamcompany.com

John Olvany
Vice President of Business Development
john.olvany@aamcompany.com

Neelm Pradhan
Vice President of Business Development
neelm.pradhan@aamcompany.com

30 West Monroe Street
3rd Floor
Chicago, IL 60603-2405
312.263.2900
www.aamcompany.com