The "Retail Recession" Label Does Not Fit

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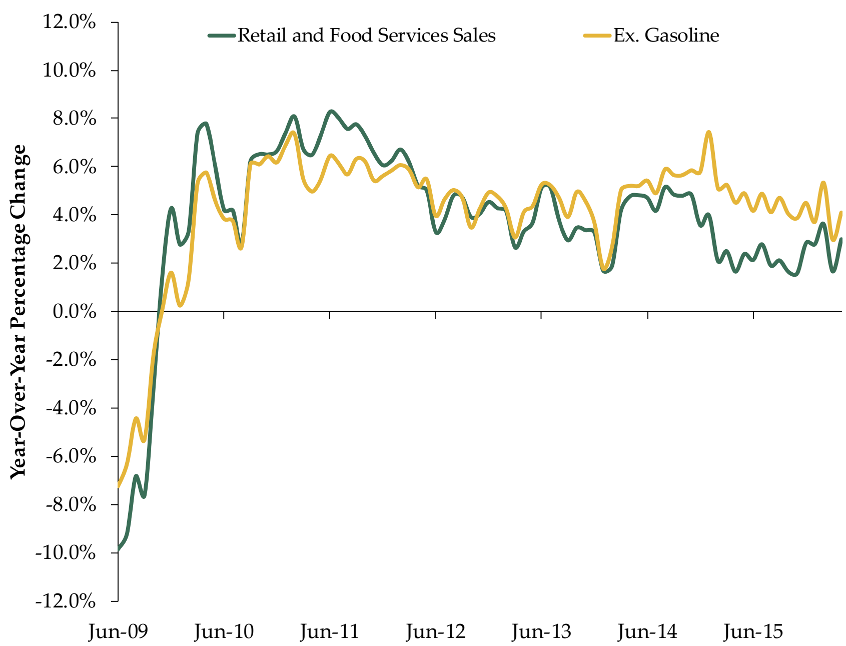
In the Q1 2016 earnings season, some department stores reported weaker-than-expected results with news of declining sales and profits. Media was quick to dramatize the reports with cries of a US "retail recession" and assertions that the consumer is tapped out —all bad signs for US growth looking forward. However, we would humbly suggest that is incorrect. A recession is a broad-based decline in economic output. The narrative painted by the media is more akin to narrow, virtually anecdotal data points and a shift in shopping habits—away from department stores and towards online and specialty retailers. Despite some retailers' recent difficulties, there is ample evidence that US consumers are in solid shape, and that the economy is not headed for recession anytime in the foreseeable future.

On May 11th, Macy's reported Q1 sales fell over -7% y/y while earnings tumbled -29% y/y. The following day, Kohl's said Q1 year-over-year revenues fell more than expected and earnings slid -50%. The negativity continued after market close on Thursday when Nordstrom reported Q1 earnings contracted -61% y/y, badly missing estimates (though sales grew about 1%). All lowered their guidance for full 2016 results. Friday of that week, JC Penney joined the retail decline, also posting poor results.

In the perspective of the media, this is an indication of consumers materially tightening their belts. And, with consumer spending accounting for roughly 70% of US GDP, the media suggest it signals a weak economy—and maybe an approaching recession. That narrative, however, is only based on a select sample size of companies, and seems quite unfitting when put into perspective against broader, more-indicative economic data like US retail sales. April's data beat estimates with 1.3% m/m growth (3.0% y/y). As Exhibit 1 shows, this is not a new trend—retail sales are growing at a fine clip, which is especially clear when you remove the negative influence of falling gas prices by excluding gas station sales. (Which reversed in March and April.)

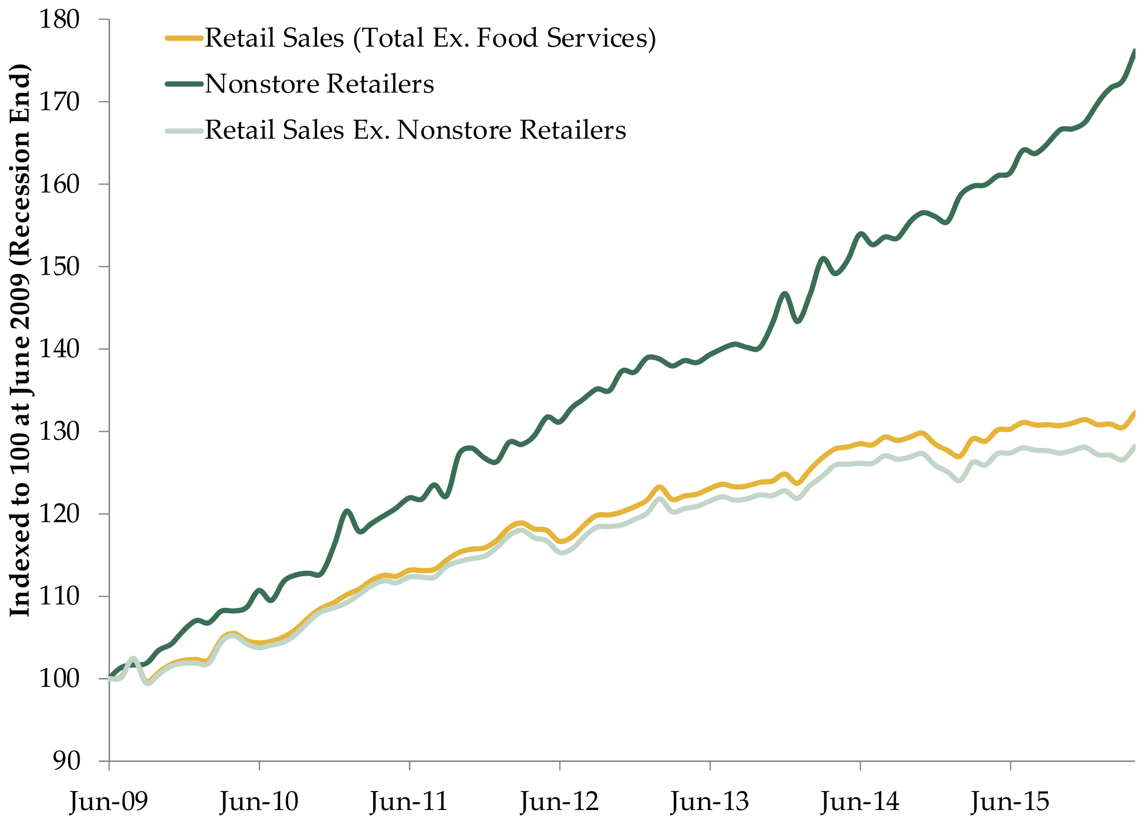
Exhibit 1: Retail and Food Services Sales and Sales Ex. Gas Stations



Source: Federal Reserve Bank of St. Louis, as of 5/13/2016. Seasonally adjusted retail and food service sales and sales excluding gasoline, June 2009 – April 2016.

Within the retail data are clues to identifying the root of these big retailers' earnings issues—and it is not due to overstretched consumers at all. It is in part just competition from newer, specialty retailers. However, more significantly, nonstore retailing—a technical term covering internet and catalog retailers—has vastly outgrown brick-and-mortar sales throughout this expansion. Exhibit 2 shows the growth in retail sales in goods (which excludes food services sales), nonstore sales and goods sales ex. nonstore sales since the 2007-2009 recession ended.

Exhibit 2: Online Shopping is Growing By Leaps and Bounds



Source: Federal Reserve Bank of Saint Louis, as of 5/12/2016. Total retail sales excluding food service, nonstore retail sales and total retail sales minus nonstore sales, 6/1/2009 – 3/1/2016.

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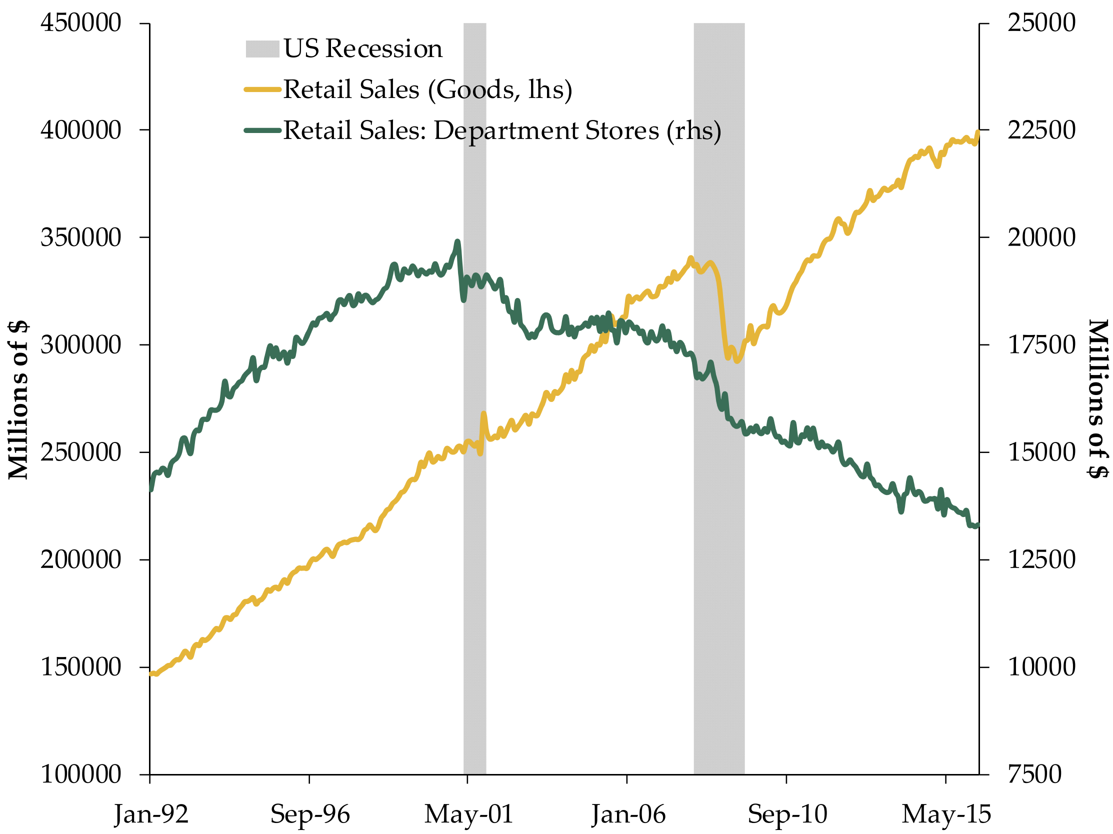
As you might expect after viewing Exhibit 2, S&P 500 internet and catalog retailers' profit growth has been quick. In the last three quarters, earnings have grown 143.0% y/y, 30.2% and 58.0%. A trend that has been occurring for years, mainly due to the convenience of shopping online as opposed to trekking out to a physical brick-and-mortar location. When consumers do venture out to physical locations, long-term trends show they are increasingly less inclined to shop at big department stores. (Exhibit 3)

Exhibit 3: Declining Department Store Sales Is a Long-Term Trend

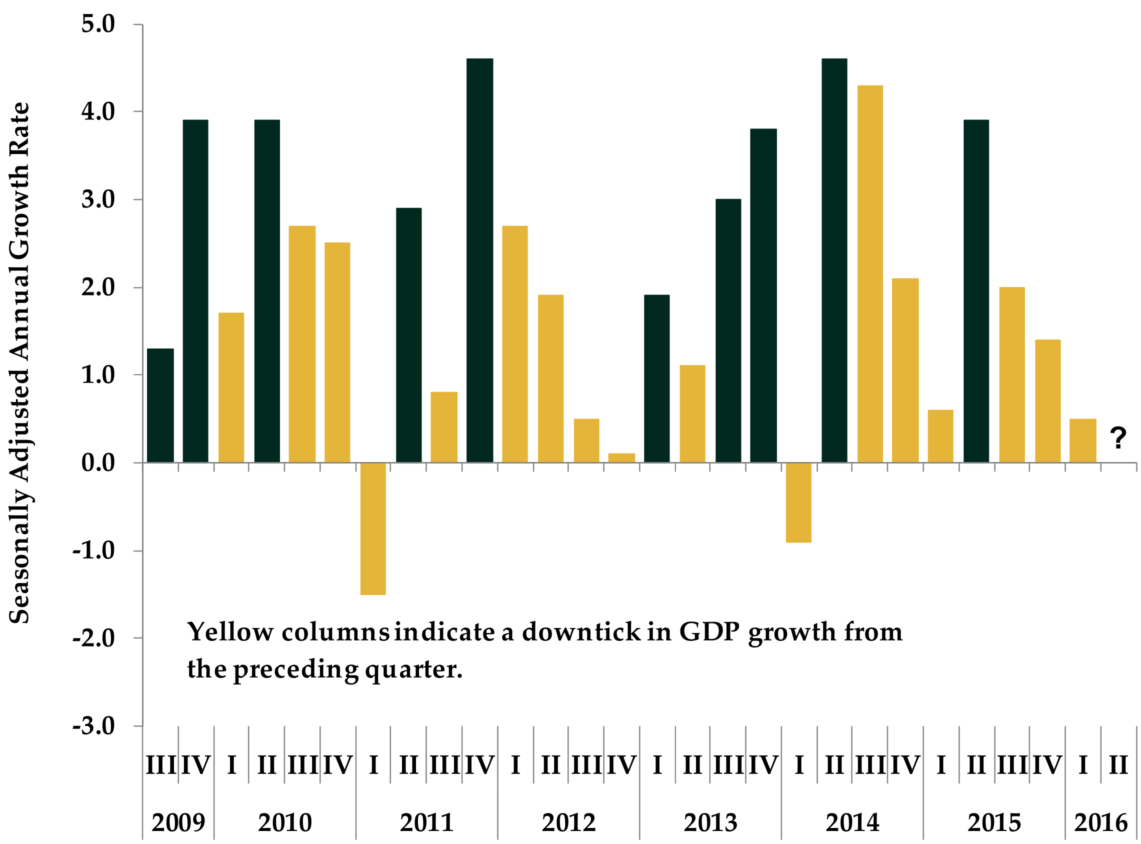


Source: Federal Reserve Bank of Saint Louis, as of 5/12/2016. Total retail sales (goods only) and retail sales at department stores, January 1992 – April 2016.

So why are so many fretting faltering brick-and-mortar store sales now? It's likely a manifestation of recent widespread recession fears.

Yet these fears are unfounded. It is true US GDP growth slowed to 0.5% annualized in Q1, stoking weak economy fears. People erroneously equate these fears to the US nearing recession as they extrapolate the slowdown into the future, but that is not how economies work. Growth rates typically fluctuate throughout expansions, and there is little evidence Q1's slow growth is an indication of worse to come. In this very expansion, growth has slowed or briefly contracted a handful of times, yet these periods did not foreshadow a recession. (Exhibit 4)

Exhibit 4: Slowing GDP Doesn't Necessarily Mean Recession Ahead

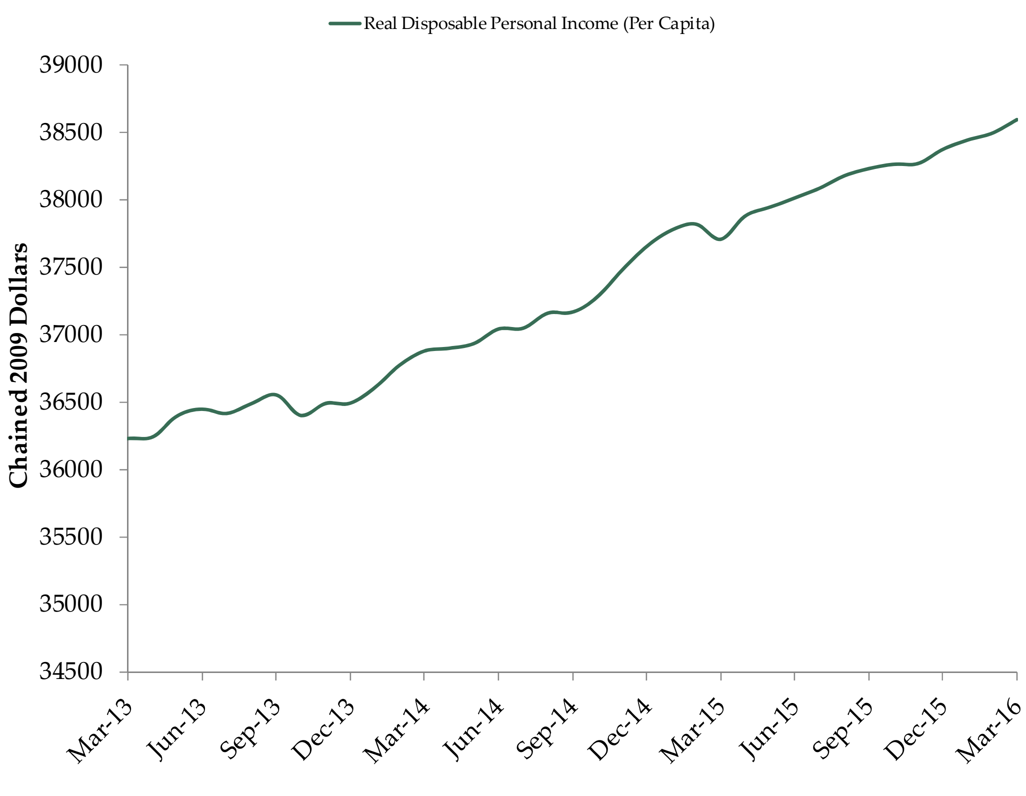


Source: Bureau of Economic Analysis. US GDP, seasonally adjusted annual rate, Q3 2009 – Q1 2016.

Forward-looking economic data does not suggest weakness looms. Loan availability is a key driver of economic growth—hence why tight credit conditions often precede recessions. Yet today, lending is growing nicely and the yield curve spread—long term rates minus short-term—is positive. Banks typically borrow short term (deposit accounts, overnight funding, etc.) and lend long term, so long rates exceeding short indicates profitable lending. Profitable lending stimulates loan growth, providing capital businesses need to grow. This is one reason why The Conference Board's Leading Economic Index remains high and rising, and in its nearly 60-year history a recession has never occurred while this has been the case.

Moreover, falling consumer spending tends to *result* from economic downturns, not spur them. Most spending is for housing, food, utilities, transportation, and basic household goods—forms of necessities people have little flexibility to cut spending on. Of course, when the economy turns down consumers tend to spend less on luxuries such as vacations and other non-necessities, but that is not the case in the current environment. The S&P 500's Hotels, Restaurants & Leisure industry's earnings grew over 13% y/y in Q1—despite a -122% drop at one trendy Mexican food restaurant that had some widely known issues with food poisoning. This highlights another reason investors should not fret this week's weak retailer results: Spending on goods is just one component of overall spending. Services accounts for the majority of the total. In any case, the biggest driver of consumption growth is real disposable income, which is growing quite nicely these days (Exhibit 5).

Exhibit 5: Disposable Income is Rising



Source: Federal Reserve Bank of Saint Louis, as of 5/12/2016. Seasonally adjusted real disposable personal income in chained 2009 dollars, 1/1/2013 – 3/1/2016.

So by factoring in the broader economic data, it is clear to see that there is no sign US consumer spending is on shaky foundations. Despite the media's take on a handful of brick-and-mortar retailers posting bad earnings, the reality is far from the false label "retail recession". As average consumers shift towards online and specialty retailers, investors must practice prudence and contrast the anecdotal data points against the broader economic data – a matter of viewing the whole picture, not just the frame.

Source: Federal Reserve Bank of St. Louis, Bureau of Economic Analysis, Fisher Investments