



## **Consumer Spending has Flat-Lined; When will it Recover?**

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We interviewed Johnson on November 7, 2008.

**The media is presenting a scenario where consumer spending has ground to a halt. How does this compare to the data you are seeing?**

We take a longer view of it, rather than looking at the news and the headlines. You have to be realistic but optimistic about the consumer, who is much more resilient than the pundits predict.

Based on our numbers, consumer spending hit a wall around the second half of September, specifically around September 18-20. [This was just after the AIG bailout on September 16.] We have talked to retailers and confirmed this. Spending has not recovered through October and early November.

That is the bad news — clearly growth has flat-lined. But we think this will not be permanent, because of two factors. First, the rising energy prices during the first 8-9 months of this year took a huge bite out of consumer spending. Moreover, most of this money went overseas. Energy prices have dropped sharply in the past two months, putting consumers in a better frame of mind to spend money. Second, the whole credit crisis has been amplified on TV with a steady drumbeat of bad news. So it has created a psychological barrier, and consumers are keeping their powder dry.

The personal consumption expenditure (PCE) numbers are down 0.8% sequentially on a real basis from the second to the third quarter, although nominally there has been some growth. The nominal numbers are aided by inflation early this year, which has now subsided.

So, the seeds of positive news are there. But it will not save an otherwise sorry retail season. It will make for a merely mediocre holiday season,



instead of a total disaster. Nonetheless, this holiday season will be the worst since 1980.

**One of the bellwether variables you look at is Wal-Mart's total sales, which you have found to be a reliable proxy for the rest of the economy. How has Wal-Mart been doing?**

There are two issues to consider when you look at Wal-Mart. First, regarding their role as a proxy for the economy, they account for 10% or more of retail sales nationwide. Wal-Mart has been doing very well, and this should be a good sign.

But the second issue concerns Wal-Mart-specific factors, which mitigate Wal-Mart's value as a proxy. Wal-Mart has achieved a huge turnaround in the last 12-18 months. This will be a Wal-Mart Christmas. Times like this are what Wal-Mart was created for.

To be fair, Wal-Mart is clearly outperforming most of the rest of the retail sector. As a result, Wal-Mart's role as a proxy may be overstated. In short, the rest of the retail economy is lagging behind discounters, including Costco, BJ's and the dollar stores, not just Wal-Mart.

Wal-Mart's year-over-year growth in the US (excluding non-US revenue and the effect of currency movements) was 5.1% in October, which is very decent growth, and clearly faster than the rest of the economy. In the second quarter, Wal-Mart grew 8%, followed by 7% growth in the third quarter. So certainly there has been a deceleration in growth, even at Wal-Mart. These are strong numbers for Wal-Mart, and they will do very well in terms of profitability.

**Most of the recent reports of headcount reduction are coming from the housing, financial services, and technology sectors. Do you expect downsizing in the retail sector? Do you expect industry consolidation or failures?**

There has already been consolidation in the retail industry. Look at Linens 'N' Things, Mervyn's, and Sharper Image, all of which entered bankruptcy or liquidation. Circuit City (the number two consumer electronics retailer behind Best Buy) is shutting 20% of its store base and laying off 7,000 people. Tweeter, a smaller electronics retailer, just reentered Chapter 11.

Clearly there has been consolidation along with some Chapter 11 failures and some outright liquidation. There have also been product line consolidations. Saks has closed Libby Liu (a "tween" store) and Talbot's



is unloading J. Jill. We anticipate there will be more of this activity, as this is a very challenging time.

Retailers are still hiring for the holiday season. A recent survey showed that 81% of retailers will hire the same or more people for the holidays, and only 13% plan to hire fewer people. But, there are also lots of other retailers, including DSW shoes and the Piggly Wiggly grocery chain, that are reducing their headcount.

**Consumer spending has been fueled by home equity withdrawals (HEW), which peaked in Q3 of 2005 (at \$714.5b) and are now down to 1990s levels (Q1 of 08 was \$24b). What does the lack of HEW going forward bode for consumer spending?**

We have looked at this closely and have a slightly different opinion. There is a lot of glib talk about consumers using their homes as ATMs. Data from the Fed have shown that, over the period following 9/11 — roughly from 2002 to 2007 — about \$150 to \$200 billion of HEW went to PCE annually. Most of the HEW went to repay debt or toward down payments on second homes. Only a relatively minor amount went to consumer spending — about 1.5% of PCE. By contrast, the great driver of PCE has been the rise in personal income, which now exceeds \$12 Trillion annually.

The bad news is that personal income growth tracks job growth, and with today's announcement of 240,000 joining the ranks of the unemployed, the long-term rise in personal income growth is slowing down. As a result, PCE growth will slow down.

A second and related factor — one which is a double-edged sword — is that the personal savings rate has been rising very rapidly and, for the last six months, it has been 2% or better. Consumers are keeping their powder dry and not spending. We are seeing healthier consumer balance sheets than we have in a long time, but this comes at the expense of reduced PCE.

The Fed data shows the household debt service ratio peaked in the fourth quarter of 2006 (at 14.85%) and has been declining ever since. It is now 13.6% and heading in the right direction, which is down.

Overall, households are healthier from a balance sheet perspective, but they are spending less money.



**Pressure is mounting for another stimulus package. How successful was the last one (the \$600 tax rebate) relative to consumer spending? Are there fiscal policy actions that you believe could stimulate consumer spending?**

We measured the effect of the last package earlier this year. Approximately \$100 billion went out and only about 50% of that money was spent by consumers. The rest went to savings or debt repayment.

We are not convinced that a stimulus package for infrastructure is the best way to address consumer spending. Infrastructure is necessary, but these projects — highways and water works, for instance — tend to require long design and approval cycles. We should be working on infrastructure, but it is not the best way to get things moving in the short term.

The best way to get consumer spending going is by keeping money in the hands of consumers and businesses to allow them to spend and invest. This means lowering the tax rate, which was a major issue in the just-concluded presidential campaign.

If people think taxes — including dividends and capital gains taxes — will go up, it will crimp their spending.

**You have cited a strong inverse relationship between the price of gasoline and consumer spending. With the recent drop-off in gas prices, have consumers responded?**

Energy prices have created a huge overhang holding down consumer spending. In the third quarter, energy was 7% of household spending, the highest level since 1980 (when it reached a peak of 9.4% during the Iraq-Iran war). Since the summer, energy prices have declined at the steepest pace in history, faster than in the 1980s. High energy prices take a huge bite out of the consumer dollar.

We have tracked the role of energy prices in consumer spending for decades. When energy gets over 6% of the consumer dollar, it affects spending patterns — retail spending specifically and economic activity more broadly.

Energy prices peaked in Q3 and have perhaps hit bottom now. As a result, we have seen a decline of roughly \$1.80 in the price of a gallon of gasoline since their peak earlier this year (which is more than they fell following the spike in the post-Katrina period). Natural gas prices have gone down as well. And gasoline prices are now \$.75/gallon below where they were a year ago.



We think the decline in energy is so significant that it will put about \$30 billion in hands of consumers just for the holiday season. Consumers will bank half of that money, but that still leaves \$15 billion in consumers' pockets. This adds another 2% to holiday spending versus what it would have otherwise been.

**Do you expect consumer spending patterns to change in any lasting way as a result of the recession? Are there companies or industries that will achieve a lasting advantage as a result of this downturn?**

We have talked with Wal-Mart about this issue, as well as about the "trade down" shift of shopping at stores like Wal-Mart, Costco, and BJ's. The question is whether this a permanent shift or just increased activity from "Wal-Mart Moms." Have upper- or middle-income segments shifted their shopping patterns to the big discounters? If so, and you are Wal-Mart or BJ's, how do you keep these customers coming back?

In Wal-Mart's case, the answers to these questions are all good news. They have dramatically improved customer service, store ambiance, and selection. This is not your mother's Wal-Mart any more, and they will attract shoppers who may be setting foot there for the first time in five years. They will see the selection of consumer electronics, pharmacy items, home furnishings, and even apparel is better than ever before. There will be some stickiness of these new shoppers.

The old adage is that smart companies use downturns to expand market share. Even in the current environment, companies like Lowe's, Best Buy, and CVS are investing in their core business. They may not be opening as many stores as last year, but they are still expanding, advertising, and taking other actions to improve market share. This will be a permanent change and will give them a sustained advantage over time.

**What is your forecast for the severity and duration of the recession?**

We are clearly in a recession, which we believe will last a minimum of another six months but, more realistically, a full year or possibly longer.

The key issues are the housing market and energy prices. We see some rays of optimism in the housing market. Sales of existing homes are starting to tick up. If that is a true point of inflection, it bodes well. The other factor is energy, but that is cyclical. Any spike back up in energy prices will prolong the recession.



This will be the most challenging holiday period in over a quarter-century. Good retailers with careful inventory management will still make money this year, and discounters and a few upscale retailers will do okay, but it will be a difficult period for many of the rest. The good news, however, is that the 2009 holiday season we could be on the rebound.

My overall message is that the American consumer is much more resilient than many of the experts say, but it's still going to take her a while to bounce fully back.

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