

Retail Forecast: Holiday 2009



Summary: Despite pronouncements that the recession ended in the third quarter of 2009, the prospects for the holiday retail season remain bleak. This report describes the factors that will continue to suppress retail sales for the holiday season and beyond and forecasts how different retail categories will fare this holiday season.

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Retail Sales Forecast

Gross Domestic Product (GDP) rose 3.5 percent in the third quarter marking the beginning of the end of the recession according to many economists. By definition GDP is the primary factor used to declare whether the United States is in a recession or not, however it is not useful in predicting consumer behavior or reflecting “real recovery” in the short run. Much of the growth in GDP in the third quarter was fueled by government spending whether directly, as with stimulus money, or indirectly through programs like Cash for Clunkers which artificially propped up consumer spending.

Real recovery requires the so called “lagging indicators” such as employment, wealth and income to all see improvement. Without growth in these areas not only will households face the real threat of not being able to afford their basic consumer needs, but those that still have employment will respond to the uncertainty by saving more money and consuming less. This is the Paradox of Thrift, where consumers acting rationally to economic incentives reduce consumption and increase their savings rates, deepening the recession. This paradox becomes more pronounced as uncertainty increases, a situation that currently is paralyzing businesses and consumers. The average consumer cannot feel GDP growth in the short run and therefore will not be incentivized to spend more this holiday season based on the news. Consumers spend based on their own incomes, wealth, and their subjective opinion as to how secure they are in this economy.

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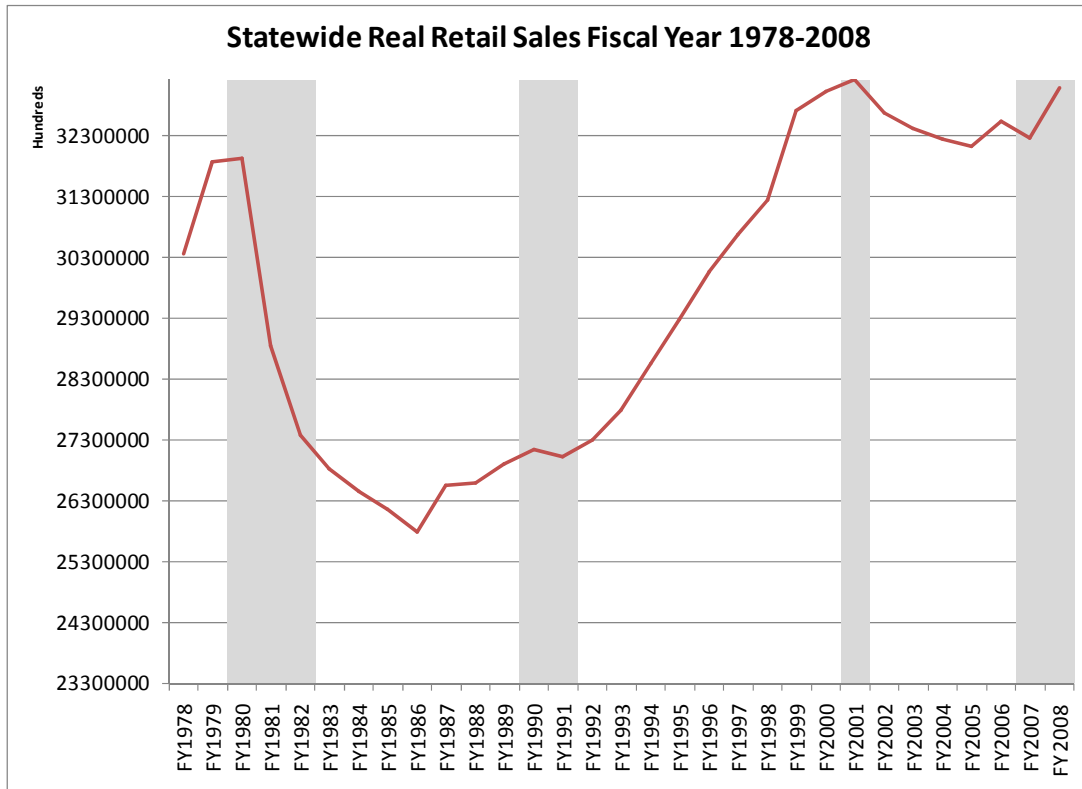
The National Retail Federation is projecting a 1 percent decline in holiday sales from last year. This projection seems to be optimistic given the economic climate and consumer confidence levels. It is more likely that holiday sales excluding gasoline and automobiles, will experience a 3 to 3.5 percent decline from last year. With lack of credit access, unemployment rising, consumer confidence shaken, and incomes falling sales will fall. The question remains whether economic news in November and early December could significantly alter consumer’s plans. With the majority of Americans declaring that they will spend considerably less this year, it is unlikely people will adjust their planned spending upwards in December. Although Iowa and the U.S. as a whole will not have the same decline in retail sales, it is to be expected that Iowa’s decline will not differ substantially from the national average.

It is important to note that while holiday sales nationally fell 3.4% from 2007 to 2008, in Iowa the change was slightly less pronounced. According to Iowa Department of Revenue data, retail sales in the 4th quarter fell 2.4 percent when adjusted for inflation from 2007 to 2008 and were unchanged in nominal terms. One year ago Iowans had more confidence that the recession would not have as severe of an impact locally due to the lag between the start of the national recession and its worst impacts in Iowa. This perception seems to have changed substantially given the job loss impacts across most industries, conditions in the housing market, and Iowa’s current budget situation.

Retail Sales in Iowa fell from the 4th quarter of 2007 to the 4th quarter of 2008 by 2.4% when adjusted for inflation.

The current recession has most closely resembled the recession in the early 1980's for Iowa, particularly in the loss of manufacturing jobs and overall declines in employment. It is to be expected that retail sales during this recession should mimic those in the early 1980's recession given the structural similarities between the two. Figure 1 illustrates how retail sales, when adjusted for inflation, have varied over the last 30 fiscal years. The shaded grey bars on the graph illustrate fiscal years in which the economy was in recession.

Figure 1. Real (\$2008 dollars) taxable retail sales 1978-2008, ISU Extension Retail Trade Reports.



It is important to note that the fiscal year ends on March 31st, so the 2008 data only includes the 1st quarter of that year. In the last three quarters of 2008 (FY 2009) real sales increased over the prior year 1.1 percent in the 2nd quarter and 5.39 percent in the 3rd quarter. The 4th quarter however experienced a decline from the prior year of 2.4% in taxable retail sales.¹

¹ Iowa Department of Revenue data has not been formally released yet for the last quarter of FY 2009 ending on March 31, 2009 or sales subsequently. It is presumed that due to layoffs and the economic situation there may be declines over the previous year. It is also important to note that direct stimulus payments were made to consumers during mid 2008 that could have made sales appear more robust than they otherwise would have been.

Key Economic Factors

Unemployment

Employment is a fundamental indicator of whether consumers will spend at prior rates or reduce consumption.

Iowa's unemployment rate in September was 6.7 percent while the U.S. rate was 9.8 percent. Although Iowa's rate held steady from August to September, the employment situation is likely to look worse the remainder of the year and well into next year. In the last two weeks more manufacturing layoffs have been announced and the severity of Iowa's budget situation indicates state employees may find their jobs vulnerable as well.

As uncertainty about the economy continues, layoffs will not come to a halt particularly since there are lag and ripple effects as budgets are constrained and impacted by other firm's decisions. While the private sector has been rapidly disinvesting, corporate profits are rising once again. This will not result in rehiring in the short run for the vast majority of businesses due to economic uncertainty and businesses ability to adjust to lower employment by increasing productivity.

Household Wealth

Over time, we see that household wealth and consumption fluctuate together. Household wealth represents the difference for households between their assets and liabilities and its level dictates how much households can spend and consume. The tremendous growth in housing prices led to greater levels of household wealth despite greater levels of mortgage debt but proved unsustainable as homes were leveraged beyond their sustainable values. Further compounding the problem is the erosion of wages, or the fact that incomes were growing more slowly than the prices of basic goods and services. As we have witnessed, this led to a rapid destabilization in both household well being and the economy as a whole.

The ratio of household debt in relation to GDP reached an all time peak in 2006 while household wealth and correspondingly, spending reached its peak between 2004 and 2005. The consumer spending between 2004 and 2006 then marked the beginning of the downfall for the economy as households borrowed from future consumption by spending borrowed funds in disproportionate amounts to their actual wealth. The implications are staggering when viewed in historical perspective. The previous record for a decline in inflation adjusted wealth was a 12% decline March 1973 and September 1974, during the oil crisis. Between June 2007 and December 2008, inflation adjusted wealth fell a record 22.8% with impacts felt around the world.

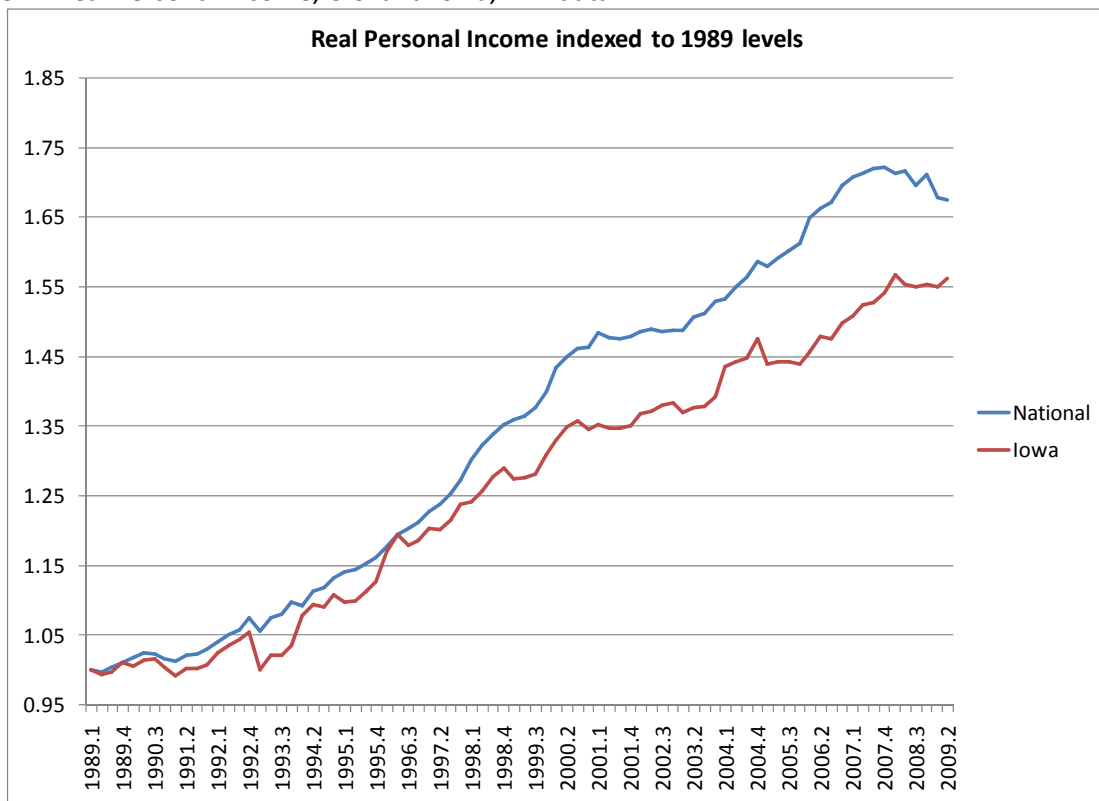
Although individuals are increasing their savings rates, household wealth will need time to recover particularly given that housing prices are not yet stabilized. Less wealthy consumers spend less money, and consumers who don't feel secure or wealthy tend to dramatically cut spending.

Personal Incomes

Much like wealth, personal income correlates with consumer spending over time. Typically if one is in decline so is the other.

Nationally, real personal income fell 2.4 percent from the 2nd quarter of 2008 to the second quarter of 2009. In Iowa, real personal income held steady between the 2nd quarter of 2008 and 2009, posting a modest .5 percent gain. Typically Iowa follows the national trend in personal income, despite some timing differences and occasional variations due to farm income. With national income in decline, it would appear that Iowa should expect personal incomes to fall throughout 2009 and possibly into 2010. Forced furloughs of employees, reduction in paid time off, and other budgetary adaptations all reduce personal income. Figure 2 depicts real quarterly personal income for the U.S. and Iowa indexed to their 1989 level. It is evident that Iowa began to deviate from national income growth in 1996 with the gap becoming wider over time.

Figure 2. Real Personal Income, U.S. and Iowa, BEA data.



Consumer Confidence

Consumer confidence serves as a proxy for how individuals feel about employment, wealth, and income all of which determine consumption. Consumer confidence slid significantly in October due to concerns about the employment situation. The Present Situation Index, which weighs more heavily on consumer's present day concern rather than their expectations, was at its lowest level since 1983. Until labor market concerns are less prevalent among consumers, it will remain a tough road for retailers.

Category Performance

Major retail categories that could see retail sales growth in the holiday season and into next year are general merchandise discounters (generally big box retailers) and grocery stores. Since the beginning of the recession consumers have demonstrated their ability to substitute down, shifting their shopping habits away from more expensive department stores and specialty retailers to stores like Wal-Mart, Costco, and Super Target. This trend will continue for quite some time and will not reverse to household wealth approaches pre recession levels.

Grocery and food stores will also perform well as people do more entertaining in their homes rather than dining out during the holiday season. In addition grocery stores will benefit from the opportunity for people to purchase food gifts as well as more practical gifts as budgets are constrained. There is the potential for grocery gift cards to boost this category as well as people change their shopping habits towards fundamental needs.

Pharmacies and convenience stores also have the potential for growth, the former as people avoid department stores and malls for gifts and the latter due to people traveling more by car during the Holidays and less by air. There is also the potential for convenience stores to capture some gift food sales as well as gift card sales.

The categories that will likely suffer the most are apparel, home furnishings, specialty retail, and restaurants.

Because dining out is a luxury, consumers spend more in grocery stores, substituting away from the more expensive option of restaurants. Apparel stores face a tough holiday season due to the volume of competition within the industry, whether within a single shopping mall or more dramatically, when competing with the discount retailers for substitutable items.

Home furnishings has already been in decline due to the shocks in the housing market, it is expected that this will continue and again will be exacerbated by the fact that discount retailers are increasing the presence of furniture and home related goods in response to the market changes.

Finally, specialty retailers often get squeezed out during recessions unless they serve a well defined niche market. As an example, specialty food stores (non-grocery) will find themselves in competition with both discounters and grocery stores for their traditional holiday sales.

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