Thackray Report

Retail Rollover

Is it the canary in the coal mine?

May 24, 2022

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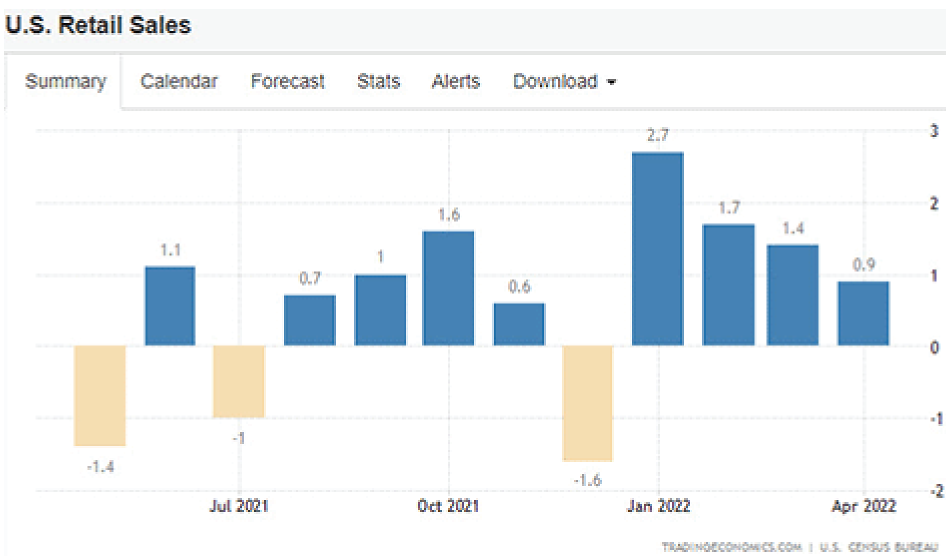
Retail stocks got rolled over last week, what does it mean for the economy and stock market? Not good!

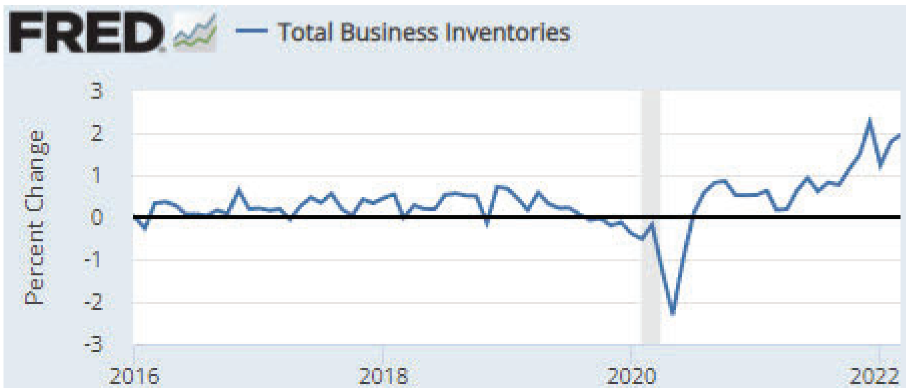
Government stimulus and central bank easy monetary policy has caused runaway inflation. Government stimulus is largely gone and the Federal Reserve is starting to tighten its monetary policy. During the pandemic, consumers have been living the high life as incomes were artificially pushed higher than pre-pandemic levels by government stimulus. Times have changed and consumers have been trying to keep their spending habits going. In the pandemic, consumers switched to online buying. As COVID dissipated, consumers switched their buying patterns to more in person buying and services. With the lack of government cash, consumers have been racking up huge debts on their credit cards. It takes a while for buying patterns to change. As interest rates have moved higher, consumers have been forced to adjust and have started to reduce their spending.



Retail spending growth rates have been declining since January 2022. The US Retail Sales report was released on Tuesday May 17, 2022, showing a growth rate of 0.9% on a month-over-month basis, as expected. Although this looks like a strong number, it must be remembered that the Retail Sales report is not adjusted for the CPI inflation rate of 8.3%. Other non-official inflation reports show inflation at much higher levels. The trend of declining growth is important. The last three months have been showing a declining trend. Given some of the recent earnings reports from companies in the retail sector, it is possible that we could see the trend continue lower.

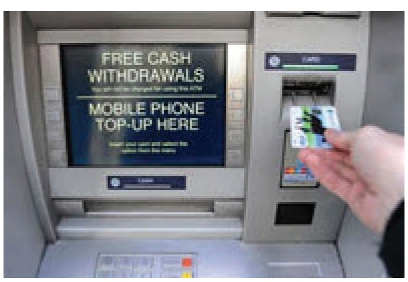
On Tuesday May 17, Walmart announced earnings that fell short of expectations and substantially reduced their forward guidance. Walmart ended up being 11.4% lower on the day. On Wednesday May 18, Target announced earnings that fell short of expectations and also lowered their guidance. Target ended down 25% on the day. It was interesting to note Target's CEO commented that Target had noticed a shift in buying patterns two months ago as consumers were buying less and shifting down market. Last week, other retail companies, including Kohl's reported earnings that were worse than expected. Consumers are starting to struggle.

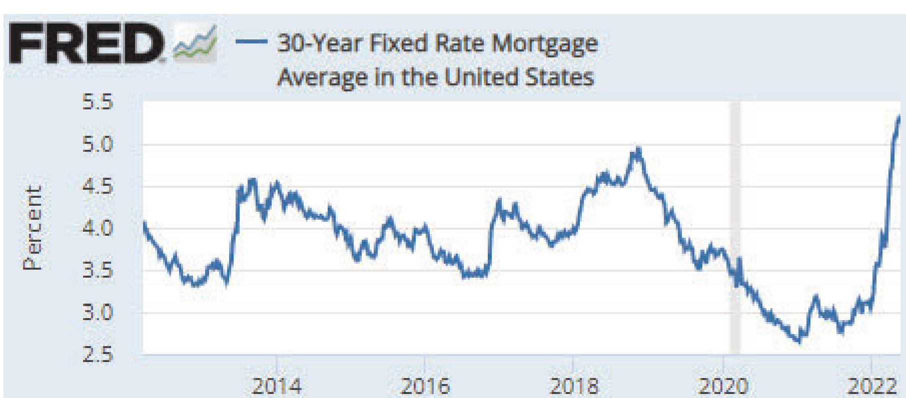
There are shortages in certain products, but overall inventories are increasing (see graph below). Rising inventories are partly from companies ordering a lot of product during the supply chain crisis. Retail operations wanted to make sure that they had enough product when delivery times increased by weeks and sometimes months. Retail operations are also suffering from consumers not being able to buy as much product due to higher prices. Consumers have only so much to spend and as prices rise, they have to reduce how much they can buy. The combination of overstocking and consumers reducing the amount of items that they are purchasing has driven inventories higher. As some point, companies are going to have to put their inventories on sale and lower their prices. This will not be good for corporate profit margins.



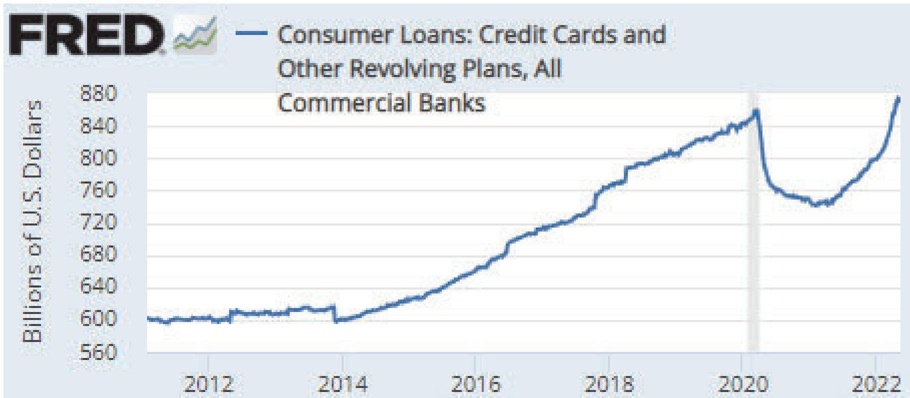
The consumer cash machine is broken

In the US, as interest rates fall and housing prices increase, consumers can rewrite their thirty year mortgages, essentially using their houses as a cash machine. The world has changed. Now interest rates are rising and house prices are falling. This has huge implications for the economy. Consumers are going to have less money to spend. The 30-year mortgage rates have recently skyrocketed and are now getting close to 5.5%, more than doubling in a few months (see graph below). Homeowners do not refinance when rates are moving higher. The cash machine for free money is broken. Without excess cash, consumers are going to be spending less, not just on homes and furnishings, but every day items.





Without money from government handouts and from refinancing homes, consumers are turning to their credit cards, racking up more and more debt (see graph below). They are doing this as interest rates are rising (including credit card interest rates). So, credit card debt is rising and is becoming more expensive to maintain. As interest rates rise, consumers are going to have a harder time paying down their credit card balances.



Consumers with low credit scores are falling behind on car loan payments and personal loans. Subprime credit cards and personal loans over sixty days late are increasing (Equifax). It is the eighth month in a row of rising delinquencies.

Implications for the stock market

Declining retail spending is the canary in the coal mine. Companies producing goods and services are experiencing higher costs and are having difficulty passing on the costs to consumers. Consumers are struggling with falling real wages and rising inflation. Consumers are starting to have to make some choices: do I buy food for my family (at more expensive prices) or do I buy a new outfit? For more and more people, there is no longer a choice, they have to buy food. The consumer discretionary sector has been underperforming the S&P 500 since November 2021. Fundamentally, this sector is in trouble as consumers are reducing their discretionary purchases. The potential damage goes far beyond the retail sector. Consumer spending makes up approximately two-thirds of economic activity. As the consumer is reducing spending with higher interest rates starting to bite, economic growth is going to be difficult and hence there is going to put downward pressure on company earnings and ultimately stock prices.

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