Dear Chicken Little, About that sky...

ITR sees positive signals for retail industry

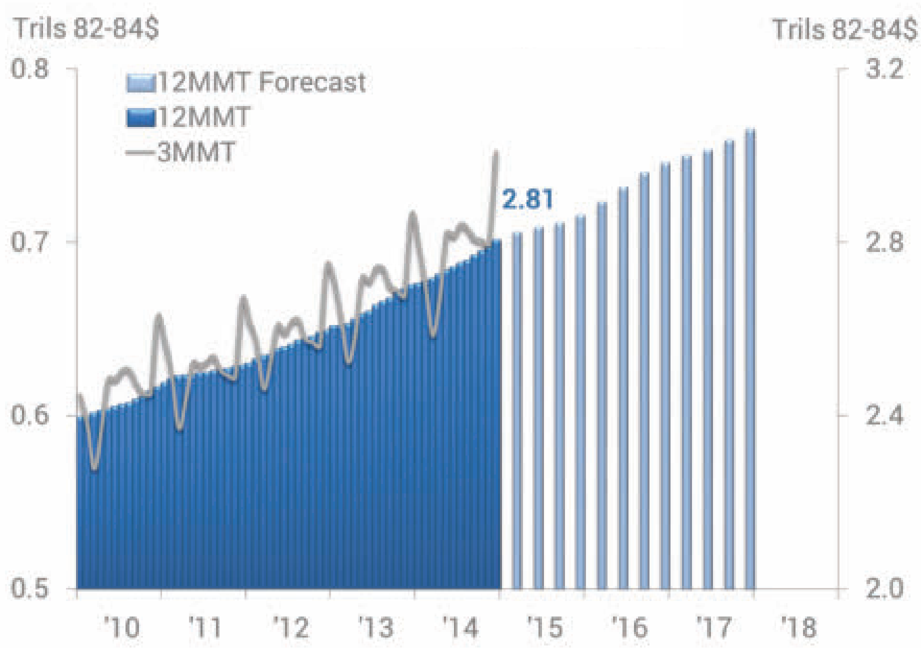
By Danielle Marceau

With recent headlines such as *The New York Post's* "Holiday Retail Sales Anything but Jolly," *USA Today's* "Retail Sales Drop a Disappointing 0.9% in December," and *Fortune's* "If Gas Is So Cheap, Why Do Retail Sales Stink?," you may be fearful that the bottom is falling out of the consumer market, and understandably so.

At ITR Economics, we examine the numbers with an unbiased, apolitical, and accurate methodology. This analysis is telling us that the U.S. consumer and retail sales are getting stronger.

The numbers in the pessimistic articles have been adjusted for seasonal patterns, rather than simply being compared to the same time period the prior year. We take the latter approach at ITR Economics with our rate-of-change methodology. The late-in-the-year surge in retail sales that is typical around the holiday season makes the seasonal adjustment for the month exceptionally difficult, and the mathematical manipulation to the numbers can be extreme. December's "adjustment" was the harshest one in three years. If we examine the numbers prior to any manipulation, we see a much rosier picture.

Total Retail Sales (deflated)



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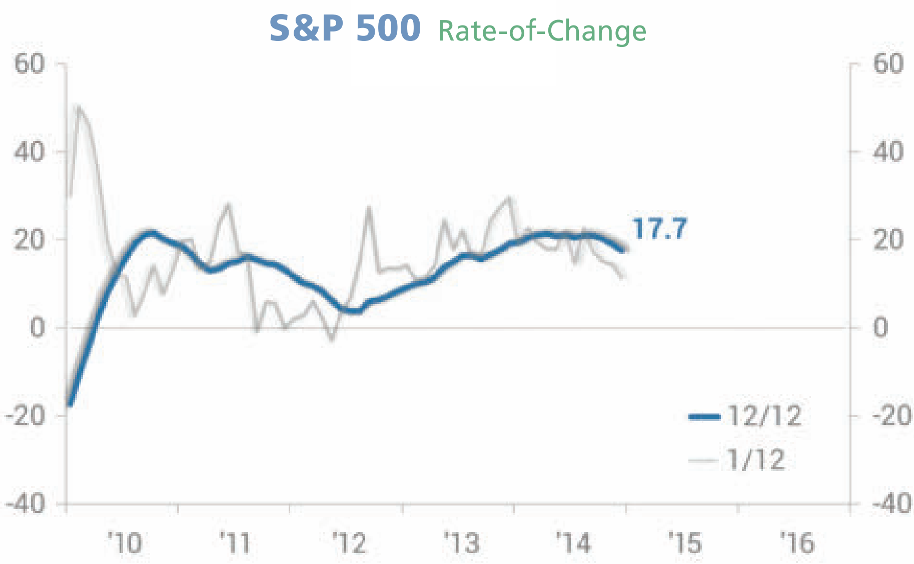
Record-high retail sales

Total Retail Sales reached a record-high $0.51 trillion in December after increasing 14.2% from November to December. This was a stronger November-to-December increase than both of the previous two years. Retail sales during the final month of the year marked a 4.6% improvement over the December 2013 number. If we adjust the trend for inflation, there is an even stronger impression of the U.S. consumer. **Total Deflated Retail Sales** in December came in 6.7% ahead of December 2013 and annual growth accelerated to 3.9% for the year as a whole. These numbers tell us that the U.S. consumer did not pull back in late 2014, but rather surged ahead.

The positivity in the retail sector of the economy can be attributed to benign inflationary trends, the unanticipated plunge in oil prices, and rising wages. These three factors are contributing to rising real disposable incomes. Not surprisingly, the sharp drop in oil prices translated to lower prices at the pump. **Retail On-Highway Gas Prices** averaged $2.63 in December, down from $3.77 just six months ago in June. Consumers in the northern hemisphere also face lower costs to heat their homes as we head into peak heating season, resulting in excess cash in their pockets.

In addition, middle-class wages, as measured by **Average Hourly Wage of Private Production & Nonsupervisory Employees** are also on the rise. In December, wages increased 1.6% compared to December 2013. This was nearly double the rate of rise in consumer prices, meaning that the actual spending power is increasing and consumers have fatter wallets. **Disposable Personal Income** (chained, 2009 dollars) reached $12.1 trillion in November. This marked a 2.9% rise over November 2013, the largest such rise in nearly two years.

We are also seeing tame inflationary pressures. The **Consumer Price Index (all items)** in December was a mere 0.8% ahead of December 2013 marking the slowest rate of inflation since 2009. This can be attributed to not only low oil prices, but also lackluster global demand for many other commodities, leading to lower prices and stable inflation. With oil prices



The most important observation about the S&P 500, which was 0.4% lower in December, is that the rates-of-change are declining, indicating that growth is slowing.

A.R.E. forecasts growth of 10% in 2015

The Association for Retail Environments predicts a 10% increase in spending on North American retail store construction and renovations in 2015. The forecast, based on a survey of A.R.E.'s nearly 750 member companies and input from the industry association's economic advisors, represents the sixth consecutive year of industry growth. Retail design firms, store fixture providers, visual merchandising, and other retail environments companies reported 2014 growth of 7.2% over 2013.

expected to remain subdued throughout the year, consumers will be able to enjoy these savings in the coming months. These trends will continue to support gains in retail sales as we head through the first half of 2015.

Solid gains in production

U.S. Total Industrial Production (our gauge of the U.S. economy) itself is not showing any sign of breaking down either after posting solid gains in December. Manufacturing and Mining both contributed to the rise in Total Industrial Production. The Capacity Utilization Rate for manufacturing moved higher to 79.3%, up significantly from 77.1% in December 2013 and the highest utilization rate for manufacturing since April 2007. The leading indicators are pointing toward widespread deceleration in U.S. economic growth, but as of yet, none are indicative of the more ominous scenario of recession. A notable exception is the possibility of a decline in Oil and Gas Extraction Production (approximately 10% of Industrial Production) due to lower prices eating away at margins.

The good news is that we have yet to see either a contract of the volume being produced or major layoffs in the industry. We are, however, seeing some layoffs in the steel industry tied to weakness in oil prices, and financial distress is becoming more apparent within the industry. Despite this, the positives that are emanating from lower oil prices will outweigh the negatives.

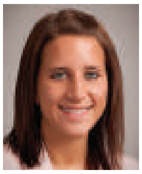
The S&P 500 edged 0.4% lower in December. The decline is easily within the parameters of month-to-month noise although some intra-month decline seemed to result from uncertainty stemming from falling oil prices. The most important observation about the S&P 500 trend is that the rates-of-change are declining indicating that growth is slowing. The weakness in the actual S&P 500 Index would not be surprising.

Do not become overly concerned should this quasi-leading indicator post some stagnant or downward movement. The fundamental health of the U.S. economy is good, and additional macroeconomic rise is probable. The S&P 500 leads the economy through highs and lows only 50% of the time, so a hard landing in share prices with the economy being sound cannot be ruled out. However, we think the current trend status for the S&P 500 is indicative of a slowing in the economy's rate of growth in 2015 (no contraction expected in macroeconomic data like U.S. Total Industrial Production, GDP, or Retail Sales).

The overall retail sales trend is not reflecting any signs of concern regarding weakness in share prices. It could be that consumers simply have enough "extra" money from low energy prices or that they have faith that stock prices will not fall enough to hurt them. The rate-of-change signals for the S&P 500 are not encouraging for the near term, which doesn't mean some months won't be "up," but rather that there remains a greater risk of "down" months ahead.

Gains in consumer spending

Overall, we see no end to the ongoing gains in consumer spending over the next three years. As we head through the second half of 2015, we may begin to see the rate of rise slow, but this is not to be alarming. It is something that ITR has been calling for and will not derail spending, nor the U.S. economy. A solid rising trend in consumer activity concurrent with a softening in the industrial side of the economy is consistent with the economic rotation ITR Economics presenters have been discussing on the road and with our overall forecasts. Expect the service side of the economy in general to outperform the industrial side in 2015. More robust activity is projected to develop in 2016 as both the U.S. economy and the global economy begin to run on all cylinders once again.



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