After more than two years of mostly uninspired sales growth and mediocre operating results, 2015 was supposed to be the year it finally all came together for the U.S. retail sector. This wasn’t just wishful thinking; there was good reason to be optimistic going into the year. The 2014 holiday season surpassed modest expectations, and retail sales had some momentum as we entered 2015. Moreover, energy prices had plummeted, job creation was decidedly on the upswing and the housing market continued its recovery — all factors that should spur more robust consumer spending. (The financial windfall from lower energy prices alone should save consumers nearly $100 billion in 2015, much of which assumedly would be spent.) But it hasn’t turned out that way so far. Today’s retail spending environment still lacks vigor. More puzzling, many of these broad economic trends have continued along their favorable trajectories as expected but stronger consumer spending has not followed with the exception of autos. Why is this, and what does it signify for the retail sector?

At this juncture, we must consider the possibility that the long-standing characterization of American consumers as indulgent spenders remains profoundly altered by the experience of the Great Recession and its aftermath. We are not the same shoppers we were less than a decade ago. Consumers have changed their shopping habits, baskets and priorities in ways that are not as predictable or tethered to conventional economic variables as they used to be. “Shop till you drop” — the shopping mantra of the previous two decades — is about as relevant today as a Myspace account. Consumers look back on the pre-crisis period, and many now recognize how financially overextended they were — a predicament they are determined not to repeat. Total credit card debt outstanding is 12 percent lower today than it was just prior to the recession. Americans are saving more of their income than they did 10 years ago. For better or worse, depending on your perspective, it doesn’t appear we are going back to those spendthrift days anytime soon. We’re still spenders at heart, but it seems the gusto is gone.

This is not to suggest that the current state of retailing is lousy — lackluster or disappointing would be more apt descriptions. Retail sales, especially discretionary spending, should be stronger today considering where we are in this recovery cycle. More than five years into an economic recovery, consumer spending should be humming along based on historical...
precedents. But it’s not. We can demonstrate that at a similar point in the previous two expansion cycles, from 1995-1999 and then from 2004-2007, retail sales growth was much more robust than it is currently.

More precisely, Exhibit 1 indicates that discretionary retail sales growth (nominal and real) since 2012 is more than two percentage points below peak cycle growth rates of the previous two expansions. It’s hard to appreciate the magnitude of this difference. (We define discretionary spending as sales generated by General Merchandise, Apparel and Accessories, Furniture and Other Sales category stores plus online retail sales — an aggregate that totaled nearly $2.0 trillion in 2014.) Today’s subpar growth translates into approximately $50 billion of lost sales annually of discretionary goods that would be accruing to retailers had this recovery been more similar to the previous two. To put that in perspective, that’s roughly the equivalent of Amazon’s domestic sales disappearing from the U.S. retailing landscape. That represents a huge loss, and it behooves us to understand why this is happening.

What Is Different Today?

As one might expect, there is not one overriding reason or cause behind today’s sluggish retail sales environment. It is the result of several factors, some obvious and some subtle, that have conspired to dampen consumer demand for many discretionary goods. Let’s consider some of the primary culprits.

Stronger Economic Readings Are Concealing Underlying Consumer Weakness: By now it is widely understood that headline economic readings are not telling the whole story as it relates to the consumer economy. This has always been true to some extent but seemingly more so today. The official unemployment rate of 5 percent implies that our economy is near a full employment level. Does this feel like an economy nearing full employment? Hardly, but the Federal Reserve is likely to consider an interest rate hike on the basis of hitting this target, among others. But a well-known shortcoming of the unemployment rate is that it doesn’t count jobless folks who have given up seeking employment as unemployed. Another statistic, the labor force participation rate, does capture the impact of this discouraged cohort by measuring the percentage of working age people with jobs or seeking jobs—and it is near a forty-year low of 62.4% compared to 66.0% prior to the recession. This represents more than 5 million working age Americans who have exited the workforce since the recession, mainly because they have given up looking. Moreover, millions of others who have found jobs since the recession ended are underemployed, having taken jobs at lower skill and wage levels than their previous employment. These realities are reflected in wage growth statistics, which remain weak compared to prior recoveries.

The consumer price index of consumer inflation is another indicator that seems out of touch with facts on the ground. It is telling us that the consumer level inflation rate currently is running at 1.5 percent. How many Americans would claim that their cost of living is rising at such a low rate? We dare say not many. Other widely cited economic metrics in the business media like gross domestic product, weekly claims for unemployment and monthly job creation are important indicators that are trending favorably but provide limited insight into the financial condition of average Americans, which is recognized by most economists to be slowly recovering.
The surprising popularity of presidential candidates Donald Trump and Sen. Bernie Sanders arguably reflects a deep frustration with slow economic progress and a perceived lack of financial opportunities among many Americans at both ends of the political spectrum and their rejection of conventional policy solutions for intractable problems. Both men have tapped into the anxieties of a large percentage of Americans that ultimately are rooted in financial insecurities and underscore the inadequate breadth of this recovery.

Consumers Are Spending Even More on Services, Less on Goods: Americans spend far more of their income on services than on goods. It always has been that way. More than 60 percent of our total annual spending — defined as personal consumption expenditures ("PCE") — has been on services such as housing, healthcare and recreation over the last 30 years, and that percentage has gradually been climbing for decades, reaching nearly two-thirds of PCE in the years preceding the 2008 recession. Curiously, this percentage has moved higher since the end of the recession, rising to 67.5 percent in 2015 from just under 66 percent in 2007. Again, it is hard to convey the magnitude of such an increase. It, too, is huge representing close to $200 billion of consumer spending being redirected from goods to services.

Much of this shift has to do with inflation disparities in recent years. Inflation rates in the service categories have been running considerably higher than inflation for many consumer goods — which has been negligible since 2011. Consequently, services are getting more of our hard-earned dollars in absolute and relative terms [Exhibit 2]. Whether it’s household operating costs, healthcare expenses or education costs, inflation is not so benign in most service categories.

As for healthcare, the impact of providing coverage to millions of Americans under the Affordable Care Act also may be responsible for some of the spike in service outlays. The Department of Health and Human Services estimates that 14 million adults who had no health insurance prior to the act’s 2013 implementation today have coverage. (This figure excludes 2.3 million young adults under age 26 who now can remain on their parents’ policies.) Even assuming greatly subsidized insurance premiums, total consumer outlays for their share of premiums and related expenses are not insignificant — around $20 billion annually. For Americans who struggle to pay $100-$150 monthly for premiums, deductibles and co-pays, that money will come from foregone spending elsewhere. That’s not about to change. Many marginally middle class Americans who previously lacked access to healthcare coverage now have it and are willing to defer some consumption to keep it.

Demographic Changes Are Dampening Consumption: Population growth and new household formation tailed off during the recession, as they typically do, but are nowhere near pre-recession growth rates today, nearly six years into an economic expansion. Net population growth (which reflects births, deaths and net immigration) averaged about 1.0 percent per annum in the 30 years that preceded the 2008 recession. Today, that growth rate is 0.75 percent, where it has been stuck since 2010 — the longest skein of low growth since the 1930s. It may not seem like a lot, but this is a big deal, especially if it persists. (Just look at the anemic economic growth of any of the sclerotic nations of Western Europe, all of which exhibit very low population growth.) Our nation’s population would be 6 million greater than it is today if population growth had returned to its long-term average following the recession. There is an economic cost associated with such
low population growth — mainly the lost consumption of these millions of people who would inhabit our country had that long-standing trend resumed.

Depressed household formation is another wet rag on economic growth. When your 22-year-old son leaves your house and takes an apartment with his college buddy, that’s good for the economy (and good for you!). Unfortunately, like population growth, this is not happening at the rate it did in the past. In fact, new household growth from 2007 through 2014 grew at just one-half the rate (0.6 percent) it did in the 30 years prior to the recession (1.25 percent). Much of this slump is attributable to the cautious behavior of millennials, a 63 million person cohort consisting of 18-34 year olds. A recent study from Pew Research indicates that fewer millennials today live independently (67 percent vs. 71 percent) despite the fact that unemployment rates among this cohort have eased considerably in recent years. This general trend holds true irrespective of education levels. Some 20 million millennials today live with their parents or other relatives. Millennials are marrying later and starting families later than similarly aged folks of decades past. Their decisions to put off these milestone events of adult life are not beneficial to economic growth.

New household formation has picked up pace so far in 2015, an encouraging development but needs to accelerate if this metric is to make up the ground it has lost since the recession.

Homeownership Rates Are Still Declining: Despite a housing recovery that continues to grind along, the American dream of homeownership is increasingly out of reach for many aspiring home buyers, with the homeownership rate at 63.5 percent (a 25-year low) compared with an all-time high of 69 percent prior to the recession. This represents some 5 million heads of households who no longer are homeowners compared with a decade ago. Most have become renters, either by choice or circumstance. Rental vacancy rates are near record lows in many major metro markets. This development no doubt has dampened spending on home improvement, a $300 billion category, which is only now approaching nominal sales levels of 2006.

**Consumer Debt Is at Record Levels:** This is the big elephant in the room that too few are talking about. Consumers may have cut way back on credit card debt, but many are up to their eyeballs in other non-mortgage debt, mainly auto and/or student loans. Non-revolving consumer debt has grown at an 8 percent annual rate since 2011, an alarming growth rate, and is at record levels in absolute terms and relative to personal income — having blown past pre-recession levels [Exhibit 3]. This debt represents an average of $22,000 per household. Such financial obligations undoubtedly tame discretionary spending for those so burdened.

**Strong Auto Sales Are Discouraging Other Discretionary Spending:** You’d never know this was a modest economic recovery judging by automobile sales. It is the one area of the consumer economy that looks perfectly normal compared with prior recoveries, with sales of new light vehicles tracking at 17 million units this year. These are healthy numbers — just ask the auto industry. After several years of postponing the purchase of replacement vehicles in the years around the recession, Americans have been buying new cars at a robust clip since 2012. The problem is that auto-related consumer debt has swelled, and servicing this debt is diverting consumer income away from other spending. Nearly $1 trillion of the $3.4 trillion of non-revolving consumer debt we discussed above is auto related compared with $750 billion of such debt at the end of 2011 — a compound annual growth rate of 8.5 percent.

**Online Shopping Discourages Impulse Buying:** We’ve said many times before that the online shopping
channel is merely a means by which retail sales are redistributed among competitors. As we like to say, it is not a pie grower in the aggregate though it certainly is changing the size of the slices. But there is a downside to online shopping for the retail sector that gets less mention than it merits — it discourages spontaneous spending by making us narrowly focused, purpose-driven shoppers. We almost always go online to shop with a specific purpose or product in mind, either to research or purchase. We rarely browse a site the way we walk a store aisle or would have casually flipped through a catalog 20 years ago, discovering things we didn’t realize we needed.

So as shoppers migrate more of their spending to the online channel from stores, the opportunity to generate those impulse purchases is greatly diminished. What are we talking about here? These are the random items you toss in your shopping basket that you had no intention of buying when you entered the store: those marked-down candles, earrings, movie DVDs or headphones that tempt you as you snake around the checkout line. These items are there by design, and they are an effective way to generate incremental sales — unless you are buying online. Online sites have become much better at making suggestions based on previous purchases or searches, but that is no match for the serendipitous possibilities of an in-store visit. We’re not claiming that this is a game changer, but if customers buy 10 percent more items than they intended on a typical in-store shopping trip, this would amount to more than $25 billion of potentially lost sales based on current online sales totals. Retailers of soft goods and other non-durables would feel this sting more than others.

More broadly speaking, the efficient, highly targeted approach to shopping that the online channel has engendered likely is changing our larger views and attitudes toward shopping in general. For many of us, shopping has become a utilitarian experience driven by price consciousness. The fun of casually browsing a store and the pleasure of shopping as a leisure activity has lost its excitement for many Americans. As ShopperTrak data remind us monthly, we are making fewer trips to the mall — a shopping experience that doesn’t excite us as it did a decade or two ago. Our shopping DNA is changing, shaped by the online revolution and its ability to meet shoppers’ highest priorities these days price discovery and convenience. But the thrill of the experience itself is fading — getting a great deal is all that seems to matter today.

What Does It All Mean?

The inability of retail sales growth to accelerate as the broader economy strengthens is an ongoing concern for retailers, who must be more competitive than ever to get those marginal sales dollars. There’s an argument to be made that we are having a Waiting for Godot moment: waiting in vain for a consumer recovery that never arrives as we expect. Several of the trends we have noted are embedded in the economic landscape and cannot be reversed quickly.

Furthermore, it’s plausible that we have the recovery we deserve and that the previous two consumer recoveries were the anomalies — one that was built upon a housing bubble and the other built on a stock market bubble. Perhaps. But the most disturbing thought of all for retailers should be this: If this is as good as it gets, more or less, for consumer spending, then what awaits us when the next recession rolls around?

The Energy Wildcard

Energy-related spending by consumers in 2015 is down more than 20 percent from a year earlier and is on track to save Americans nearly $100 billion this year. But low energy prices that have prevailed since late 2014 have yet to stimulate consumer spending to any perceptible degree despite the financial windfall (approximately $1,000 per household annually) it has provided to so many Americans to date. Why is this so, and what could change that?

We analyzed the history of energy spending by households since 1970, and it reveals some telling insights, mainly that relative energy spending by consumers has had little impact on retail sales most of the time. In fact, the correlation between relative energy spending (which we define as energy-related outlays by consumers relative to their total spending (PCE)) and discretionary consumer spending is not compelling and is statistically weak. This is attributable to the fact that relative energy spending by consumers has vacillated within a fairly narrow range for much of the last 45 years [Exhibit 4] and is not usually a large item in our spending baskets. But those periods in which relative energy spending broke out of this
range — either above or below it — are associated with notable changes in discretionary spending.

The two standout periods for energy were the late 1970s through the early 1980s and the late 1990s. The former period encompassed the Arab oil embargo of 1973-1974 and the 1979 oil shock precipitated by the Iranian revolution. It was a dismal period for the U.S. economy generally and consumer spending, both of which were afflicted by other buffets as well; namely, high inflation. But the period during the late 1990s was quite the opposite, characterized by $1 per gallon gasoline prices, the comeback of large cars and the advent of SUVs, and strong consumer spending across the board. Again, this noteworthy period for the U.S. economy was the result of several key variables, including strong jobs growth and productivity gains in addition to the influence of low energy prices.

Our economy now is approaching the relative energy lows of the late 1990s. So where is the spending boost? We surmise that because energy prices have fallen so sharply and so quickly this time around, many middle class Americans have been reluctant to embed this windfall in their spending, not knowing how long this good fortune might last. (The energy bust of late 2008 lasted less than one year.) As more Americans come to believe that low energy prices will persist, stronger spending may yet follow.

As we enter the 2015 holiday season, it is increasingly apparent that low energy prices will endure at least through year-end and most likely through the winter heating season. (Most experts believe low energy prices will continue through 2016 or longer.) Consumers know this, and they may very well begin spending more of their windfall this upcoming holiday season. We’re not banking on it, but what better time for shoppers to loosen up the purse strings a bit.

**The 2015 Holiday Forecast**

**More Ho-Hum than Ho Ho Ho This Holiday Season**

By now, the shortcomings of this recovery are readily apparent to folks from all walks of life — and to retailers as well, who seem to be planning with a mindset of modest expectations.

It’s remarkable how little enthusiasm we hear coming from retail executives these days. But however imperfect this recovery is, it is less imperfect than it was a year or two ago — that is to say, our economy is improving ... gradually. Consumer spending restraint on discretionary goods continued in the first half of 2015, much as it has for the last couple of years. Contributing to the restraint this year is slower spending growth by more affluent shoppers and the impact of the stronger dollar and global financial markets turbulence on U.S. tourism and spending.

Without question, specialty apparel chains have been the most challenged segment of U.S. retailing for the last couple of years. Nothing has changed very much on that front since we wrote about it in last year’s report. Prominent retail bankruptcy filings in 2015 have featured a fair share of apparel chains, including Quiksilver, Caché, American Apparel and Wet Seal, and we anticipate that several more are on the way. Many of those not on such ill-fated trajectories are nonetheless underperforming. (See Appendix for more details.) Apparel chains are uniquely challenged among retailers. Foremost, there’s the element of fashion risk, which is ever present. Beyond that, consumers likely have more shopping options for apparel than any other product category. They can buy apparel basics anywhere: Specialty chains, department stores, general
merchandisers, off-price stores, outlet centers and online sites all compete for this business. Specialty apparel retailers, especially small and midsized chains, are not naturally positioned to excel amid such intense competition in a highly price-sensitive environment. Last, it seems that apparel has generally become less of a spending priority for young adults and millennials. Higher priced apparel chains, such as Abercrombie & Fitch and True Religion, that were thriving only a few short years ago, are struggling to find their lost mojo. Specialty apparel chains have been among the deepest discounters in retail these last two years, and we would expect that behavior to continue throughout this holiday season. One could make the argument that there’s no going back now. The lack of distinct fashion trends other than athleisure isn’t helping.

Shopping online is as popular as ever (we’ll probably be saying that every year) and will figure prominently in the upcoming holiday season. For all the traditional imagery of festive shoppers strolling the mall with bags in hand at Christmastime, Americans have been doing more shopping online during the holiday season than they do the rest of the year. That is, the proportion of relevant monthly retail sales purchased online is highest during the months of November, December and January. Translation: More shoppers are tiring of the hassles of store visits at peak holiday season and are opting for the convenience of shopping from home or work. A shopping excursion during the holiday season still is a tradition beloved by millions, but the average American is choosing to make fewer such trips during the holidays. Generally speaking, online sales growth has decelerated slightly in 2015, to a low-teens rate from a mid-teens rate (YOY) previously. This slowing is quite normal, as its growth rate must inevitably slow as online sales become larger and larger. Large omni-channel retailers continue to make sizable investments in their online businesses and integrate them into the overall enterprise. Such efforts are generating significant sales and market share for them from the online channel, but much of the growth has come at the expense of store-based sales.

Early reads on the 2015 holiday season are neither encouraging nor discouraging. Back-to-school (“BTS”) season sales, considered a harbinger of holiday spending, were okay — not terrible, not terrific. But comparisons with 2014 are not so straightforward, as a fair portion of BTS sales this year was reflected in September sales data (rather than August for BTS in 2014) due to the late Labor Day. Additionally, seasonal hiring plans for Holiday 2015 announced by large chains to date, including Macy’s, Kohl’s and Toys”R”Us, are mostly in line with last season’s hiring. So there aren’t many meaningful takeaways from these data points.

Shoppers pleasantly surprised retailers last year with a holiday season that exceeded mostly modest expectations. Holiday sales in 2014 (GAFO categories plus online/mail order sales in November through January) increased by 5.2 percent — an above-average season for sales by historical standards — or a 4.8 percent increase, excluding January. (The difference between the two being an exceptionally weak sales month in January 2013 that boosted this year’s comparable month.) The uptick in 2014 holiday sales is at least partially attributable to the exceptionally poor showing in 2013, which was the worst holiday season in 22 years, excluding the 2008-2009 recession years. Early reads on the 2015 holiday season are neither encouraging nor discouraging. Back-to-school (“BTS”) season sales, considered a harbinger of holiday spending, were okay — not terrible, not terrific. But comparisons with 2014 are not so straightforward, as a fair portion of BTS sales this year was reflected in September sales data (rather than August for BTS in 2014) due to the late Labor Day. Additionally, seasonal hiring plans for Holiday 2015 announced by large chains to date, including Macy’s, Kohl’s and Toys”R”Us, are mostly in line with last season’s hiring. So there aren’t many meaningful takeaways from these data points.

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Our forecast model projects a 3.9 percent increase in retail sales for the 2015 holiday season — slightly stronger than our 2014 forecast of 3.5 percent but weaker than last year’s
5.2 percent gain. In the larger context of time, this would be considered a below-average season but not terribly so. Our forecast model variables are marginally more favorable than last year’s figures. Consumer confidence remains fairly high (considering the frustration felt by many Americans with the pace of this recovery) but has backed off its post-recession peaks of midyear when most confidence polls were at eight-year highs. Surveys by nearly all credible pollsters of consumer confidence indicate that most Americans are increasingly hopeful on the economy and their financial prospects — not exuberant by any stretch but far from dour. Wage gains remain the weak link in this recovery (and in our forecast model) — again, having improved from puny post-recession levels but not nearly large enough to encourage robust spending. For all the energy and brainpower devoted to handicapping the holiday season, a fundamental truism continues to apply: Real income gains are the single most important determinant of our discretionary spending, and we still have a way to go on the front. But the direction of that trend is mildly encouraging.

Here’s hoping that more Americans feel confident enough this holiday season to cast off some of their spending caution. But even if they do, you can be assured that retailers still will have to battle like street fighters to get that business. Shoppers have gotten too smart to be snookered.
Appendix: Total Sales Growth

(Year Over Year Percentage Change in Nominal Sales)

APPENDIX EXHIBIT 1
LTM Sales Growth (YOY)

Source: S&P Capital IQ

APPENDIX EXHIBIT 2
LTM Sales Growth (YOY)

Source: S&P Capital IQ

Note: Analysis based on financial statement data obtained from U.S. Securities and Exchange Commission filings for more than 100 U.S. retailers with annual sales exceeding $100 million.
Appendix: EBITDA Margin

APPENDIX EXHIBIT 3
LTM EBITDA Margin

Source: S&P Capital IQ

APPENDIX EXHIBIT 4
LTM EBITDA Margin

Source: S&P Capital IQ

Note: Analysis based on financial statement data obtained from U.S. Securities and Exchange Commission filings for more than 100 U.S. retailers with annual sales exceeding $100 million.
Appendix: Return on Invested Capital

(Pre-tax LTM EBIT / Average Invested Capital)

APPENDIX EXHIBIT 5
Return on Invested Capital (Pre-Tax LTM EBIT / Avg. Invested Capital)

Source: S&P Capital IQ

Note: Analysis based on financial statement data obtained from U.S. Securities and Exchange Commission filings for more than 100 U.S. retailers with annual sales exceeding $100 million.
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