Michael Dang
Research Analyst

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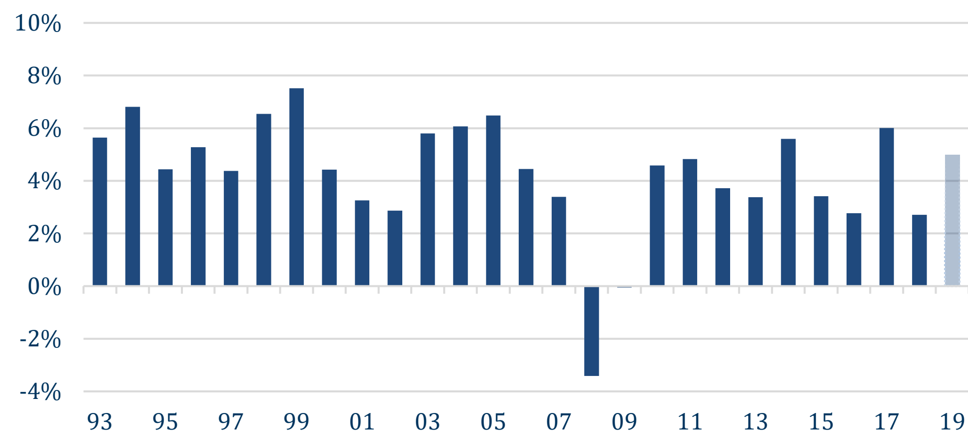
2019 Holiday Sales Outlook

Following a disappointing 2018 holiday sales season, driven in part by equity market volatility, uncertain trade policy and the government shutdown, retail sales in the United States quickly recovered in early 2019. With the holiday season upon us again, we look at how the retail sector has performed year-to-date, market expectations for the holidays, and recent factors impacting earnings.

Disappointing 2018 holiday season

2018 holiday sales were largely disappointing. The results were likely triggered by worries over the ongoing U.S.-China trade dispute, an 11% drop in the S&P 500 between Thanksgiving and Christmas Eve 2018, and the government shutdown. According to retail sales numbers released by the U.S. Department of Commerce (Exhibit 1), retail sales growth (excluding auto and gas) decelerated from +2.1% in November 2017 to +1.3% in November 2018. December retail sales growth rate declined from +5.6% in 2017 to +3.5% in December 2018, the sharpest decrease observed since 2009. As a result, 2018 holiday sales growth came in at 2.9%, falling short of the National Retail Federation's forecasted holiday sales increase of 4.3% to 4.8%.

Exhibit 1: US Holiday Sales from 1993 to 2019



Source: US Department of Commerce

Retail so far in 2019 and holiday forecasts

Economic trends have stayed resilient over the course of 2019, and a healthy consumer environment has continued. U.S. retail sales rebounded sharply in the first half of 2019, and have remained robust year-to-date, with the latest data showing continued strength of +0.3% month-over-month growth in October. The outlook for holiday sales is supported by solid consumer confidence and spending being driven by low unemployment, and wage growth tracking at nearly a 3% yearly increase. Also, the S&P 500 and Dow Jones Industrial Average continue to climb into all-time highs, while interest rates remain quite low.

Industry followers, including the National Retail Federation, Alix Partners, and Deloitte have forecasted 2019 holiday sales to grow between 3-5% over 2018 numbers, driven by the macroeconomic strength in the overall U.S. economy, continued rise of e-commerce spending and an easier comparison from last year's disappointing performance. E-commerce shopping overall is expected to increase by more than 10% as mobile apps and digital order fulfillment become more popular.

Winners and losers

While consumer trends have been tailwinds for the sector in 2019, not all retailers have benefitted equally. Many retailers have struggled with some combination of excessive debt, too many locations, exposure to disrupted product categories, and private equity ownership difficulties. But the more impactful competitive threat traditional retailers continue to face comes from the

For more information, please contact:

Kevin Seabury,
Director of Business Development
508-855-3112
kseabury@opusinvestment.com

continued growth of e-commerce, as customers eschew visiting physical locations for the convenience, lower prices, and greater product availability offered by online shopping.

Smaller retailers like department stores have fared especially poorly in recent years. After investing heavily to improve inventory management and omnichannel capabilities in recent years, department stores are still experiencing lower foot traffic and earnings pressure. Between 2014 and 2018, operating income for Macy's, Dillard's, Kohl's, and JC Penney has decreased nearly 50% on average, while Sears filed Chapter 11 bankruptcy in 2018. In the meantime, e-commerce as a percentage of total retail industry sales has continued to gain market share. According to the US Department of Commerce, non-store retail sales (viewed as a proxy for online sales) is the best performing retail segment, up 12% year-over-year. Large discount retailers like Wal-Mart and Target, who have the financial resources and the size and scale to compete against pure e-commerce retailers like Amazon, have invested heavily into developing viable e-commerce platforms, which has helped them compete more successfully against Amazon and continue to outperform versus more traditional department stores.

Beyond changing consumer shopping preferences and increased competition from e-commerce, retail earnings have also been pressured by rising input costs. Rising wages and low unemployment have been a boon to the consumer but continue to be a source of margin pressure for retailers. Additionally, retailers are being impacted by the continued trade dispute between the U.S. and China. Retailers and consumer products manufacturers have already been hit by higher costs of goods sold after several rounds of previously imposed tariffs levied on a wide range of Chinese made goods (from footwear to flat panel televisions) and are bracing for an additional round of new tariffs scheduled for December 15th. In response, retailers and manufacturers continue to slowly diversify supply chains away from China. While trade policy tensions have abated, the situation remains in flux and something we continue to monitor closely. In terms of any impact on 2019 holiday performance, retailers placed advance inventory orders during the summer and early fall, so the full brunt of tariffs will be more apparent for future results in 2020.

Given the constantly evolving landscape in retail, we have stayed away from investing in retail subsectors and individual companies most susceptible to disruption, like traditional department stores. We also look to position in more defensive retail channels including mass market, drug, and home improvement. These channels possess structural defenses that are more difficult to replicate through e-commerce and can adapt to secular industry changes. Drug stores sell perishables, household staples less prone to changing consumer buying preferences, and OTC and prescription drugs, which require the consultative services of an in-store pharmacist. Home improvement retailers sell large bulk items, power tools, and home repair/remodel products, which often require the technical guidance of an informed sales associate. Mass market retailers leverage high quality balance sheets and strong free cash flow to compete on price, invest in distribution, and achieve scale efficiencies.

Even amid a healthy consumer backdrop, performance between retailers can vary greatly depending on product category and distribution channel. Between exposure to deteriorating product categories, disruption from e-commerce, and eroding margins from tariffs and rising input costs, retailers are being pressured on many fronts. We favor companies and retail subsectors that are more defensive against online disruption or equipped with greater financial flexibility to invest and preserve margins.