ECONOMIC CURRENTS

NOVEMBER 13, 2018

The Grinch Fails Again

Annual Holiday Sales Outlook

Diane C. Swonk, Chief Economist

One of my fondest childhood memories was waiting for the classic holiday program, *How the Grinch Stole Christmas!* based on the Dr. Seuss book. My father would tease me weeks in advance, saying the Grinch would succeed this year; he even bet me on the outcome. Some might think that idle play, but I took it seriously. My father worked on the cutting edge of technology and was known to leverage his programming skills to play practical jokes. When I was six years old, he programmed a computer to "talk" with me during an office party. I was floored that the computer knew everything about me, including the names of my pets. (I had a cat, white mice and tropical fish, which in retrospect was not an ideal combination.)

When my favorite holiday classic finally aired, my father would pop popcorn, drizzle it with butter and chuckle as he plotted the Grinch's victory. I played along. The fear that my father might use his technical powers to alter the ending faded over time but did not diminish the pleasure of watching it with him. Rooting for Max (the Grinch's dog) and Little Cindy Loo Who became a holiday tradition.

Table. Holiday Spending Outlook
Y/Y Percent Change, November and December

	2017	2018
Total Retail	4.6%	4.5%
Gen. Merchandise, Apparel, Online	5.8%	5.0%
Online Only	12.3%	10.2%
Restaurants and Bars	3.4%	7.8%

Source: Commerce Dept., Haver Analytics, Grant Thornton

Growth Moderates

Real GDP rose at 3.5% in the third quarter after topping 4.2% in the previous period. That is the strongest back-to-back growth since mid-2014. Federal government and consumer spending fueled those gains. Inventories also picked up as manufacturers scrambled to order ahead of more tariffs. Business investment paused, while the housing sector contracted for the third quarter in a row. The trade deficit deteriorated further.

Prospects for the fourth quarter are not as promising. We expect to see consumer spending moderate slightly, while the inventories used to hedge against tariffs are drained. Home buying and building are expected to rebound a bit with repairs and rebuilding in the wake of another round of hurricanes. Remodeling activity is expected to remain strong, as older homeowners opt to make repairs and improvements instead of trading up. Business investment will bounce back, but the oil sector will lose ground. The trade deficit will continue to deteriorate. Additional tariffs on China are expected to be levied in December.

Federal Reserve Doubles Short-term Rates

A rate hike by the Fed in December is all but a done deal. That will bring the pace of rate hikes up to four in 2018, which represents a doubling of short-term rates from the start of the year. We expect the Fed to continue to pace us with rate hikes as the marathon expansion continues into 2019. Real (inflation-adjusted) interest rates will finally reach positive territory early next year. Even then, monetary policy will still be considered easy.

“Discretionary travel is expected to pick up, which will siphon some spending away from traditional holiday purchases.”

It is not a fairy tale that consumers will spend a little more generously this holiday season. Spending by low-income households has picked up, suggesting that the expansion is finally reaching those hit hardest by the financial crisis; it has been a long nine years.

This special edition of **Economic Currents** takes a closer look at the holiday outlook and the implications for retailers. Solid spending gains will not be enough to stave off more store closings in 2019. Foot traffic at malls continues to fall as consumers shift from shopping in stores to online purchasing. Discretionary travel is expected to pick up, which will siphon some spending away from traditional holiday purchases.

The table details our outlook for holiday sales. We expect to see spending at general merchandise, apparel and online retailers increase 5% from a year ago in November and December. That would be a slight slowdown from 2017 when replacement demand created by back-to-back hurricanes buoyed spending during the holiday season.

Spending online will likely rise at a double-digit rate and remain a driver of overall gains. The biggest upside surprise has been a rebound in spending on clothing, which has been weak for years. Increased job creation has triggered a pickup in both men and women’s apparel store sales. Clothing sales for men, at least according to the Commerce Department numbers, now exceed the growth for women.

Consumers are dining out and traveling more. Full-service restaurants and bars are doing better than fast-food restaurants although spending at both is picking up. We expect total spending at restaurants and bars to jump nearly 8% from a year ago during the holiday season, more than double the increase last year. A recent drop in prices at the gas pump could free up even more discretionary dollars in the weeks to come.

Improving Fundamentals

Labor Markets Tighten

Labor market conditions continue to improve on the eve of the holiday season:

- The unemployment rate remained at a 48-year low in October.
- Wages rose at the fastest pace since before the crisis.
- Employers are casting wider nets to find new hires.
- Labor force participation picked up, with a particularly strong rebound by women in recent months.

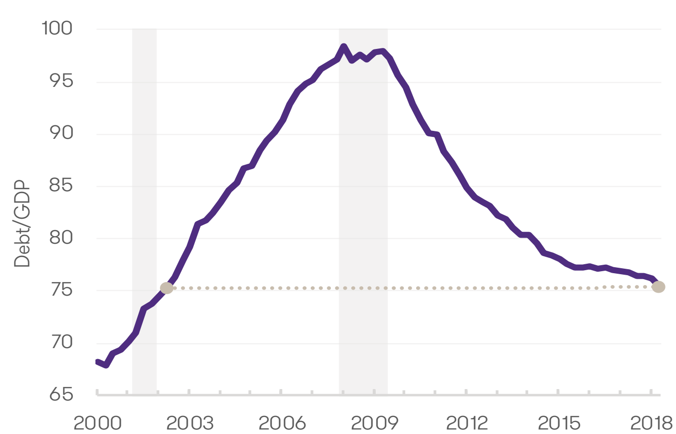
In response, consumer sentiment held at pre-crisis highs in early November despite another ugly election cycle. I finally unplugged the televisions in my home to block the flow of vitriol on the airwaves during this year’s midterms.

Debt Burdens Fall

Household debt as a share of GDP fell to 2002 levels in the third quarter. (See Chart 1.) That suggests consumers could take on more debt to subsidize their holiday spending, but we don’t think they are likely to do so. One **legacy** of the crisis is greater aversion to debt than in the past. Consumers who experienced and/or witnessed the pain triggered by the surge in mortgage foreclosures and the elimination of credit lines are more reluctant to take on debt to subsidize their spending. This could limit spending gains during the holiday season, but for the right reasons.

Student debt is a different animal. Young people felt compelled to take on debt to get college degrees and improve their earning potential. Escalating tuition costs, fueled by debt, and cuts to entry-level wages undermined their efforts.

Chart 1. Debt Drops to 2002 Levels
Household Debt as a Share of GDP



Source: Federal Reserve, Haver Analytics

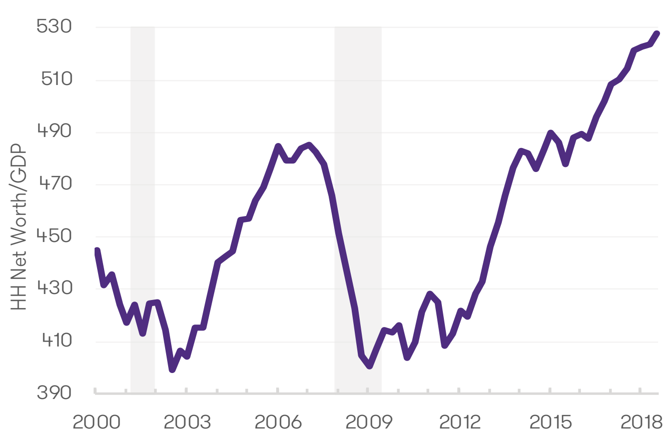
> "It is not a fairy tale that consumers will spend a little more generously this holiday season. Spending by low-income households has picked up."

Many college graduates are pressed to service their interest payments, let alone the principal on their student loans. That suggest that defaults on student debt will eventually rise more rapidly than we have aleady seen. An overhang of student debt has already limited home-buying by younger households. The threat to larger spending patterns is more medium-term than immediate. Home-buying is typically one of the largest triggers to additional spending. Spending on everything from home furnishings to lawn mowers and cleaning supplies surge once people buy their first home. Homes are money pits, especially if you start with a really old home. (I know from experience.)

Household Wealth Surges

Household net worth conservatively jumped by our estimate to $108 trillion during the third quarter. That is more than five times the size of the overall economy. (See Chart 2.) Those gains provided a cushion for investors in October when the stock market corrected. That said, wealth effects do not play the role they once did when it comes to overall consumer spending. The levels of stock and home ownership are still well below the peaks achieved during the housing market bubble.

Chart 2. Household Net Worth: Still high
Household Net Worth as a Share of GDP



Source: Federal Reserve, Haver Analytics, Grant Thornton

This is at the same time that gains in home prices—the primary source of wealth for most households—remain uneven across regions. Home values in the hottest, urban markets on the East and West coasts have far exceeded peaks of the housing market bubble, while second-tier markets, most notably in Nevada and Florida, are still playing catch-up.

In response, changes in asset prices play a smaller role in both fueling and slowing spending during the holiday season. The most conservative estimates suggest asset prices (wealth effects) will have almost no impact on spending decisions this year, except for a few retailers in San Francisco and New York.

Implications for Retailers

Big-box discounters, niche clothing stores and online retailers are expected to do the best this holiday season. The return of low-income households will be particularly good for discounters who have been left out in the cold.

More traditional department store sales will lag. Mall traffic continues to fall despite efforts by retailers to lure shoppers into malls with experiences and dining. Millennials do not like the old-line department stores. Discount department stores will be hardest hit. Sears was a primary example of that on the clothing side.

Profit margins will be crimped by escalating shipping costs and rising wages. Retail wages rose faster than overall wages in October as retailers scrambled to hire up for the holiday season. We expect to see prices pick up a bit, but not enough to fully offset the squeeze in margins. Higher shipping costs will be especially hard to pass on to consumers, given the announcements by Target and Amazon that they will waive shipping fees.

Smaller retailers have the hardest time absorbing higher shipping costs. FedEx has announced plans to raise costs by almost 5% in January. Major shipping companies have also refused to guarantee last-minute shipments. The shipping company I used recently to deliver my presentation for a meeting in Washington D.C. claimed it had delivered my package twice before it actually arrived. Once it arrived, the company said the receptionist had signed off on receiving it when, instead, it had just been left next to the door. Lovely.

Those shifts, coupled with the end of the profit increases fueled by tax cuts in early 2018, suggest high-profile store closings will remain a feature of the economy in 2019. An escalation of the trade war with China is another major concern. Threats of an across-the-board 25% tariff on all goods coming in from China have already prompted retailers to look into ways to shift production from China to less expensive, neighboring countries but it will take at least three years to move plants. No one wants to make the shift until they know the tariffs will be implemented.

Wall Street has been lobbying the White House against levying more tariffs on China, given the threat to profits. There were signs of progress prior to the election when the president softened his tone on China. One of the president's closest advisors on trade, Peter Navarro, called those lobbying the president "unregistered foreign agents" for their efforts to stem protectionism. He is not alone. China bashing is a bipartisan sport. No one likes China's theft of intellectual property. The question is whether the current path leads us where we want to be.

China is the second-largest economy in the world and already slowing in response to massive debt problems. No one is quite sure how a dramatic slowdown in China would affect the global economy, except that it would be consequential. What happens abroad does not stay abroad. Disruptions to the supply chain at home have been significant and will compound over time.

Why can't we just produce more at home? Retailers are worried that the costs of bringing production back to the U.S. will be so prohibitive that they will literally make their products too expensive for most households to afford. Electronics face even higher hurdles.

Bottom Line

Holiday spending will remain solid this year as consumers shift away from traditional purchases to spending more on experiences. That includes spending on travel, restaurants and bars. I will join that party, packing up my family to travel at least for a few days prior to Christmas.

My father passed this year. My family decided to honor his memory by visiting a place he took me as a child. We will buy some extra sweaters to keep us warm on our journey. Upon our return on Christmas Eve, I plan to make some popcorn, drizzle it with butter and toast the man who taught me the real magic of the holiday season: being with those I care about most. Cheers, Dad.

Economic forecast — November 2018

	2017(A)	2018	2019	2017:4(A)	2018:1(A)	2018:2(A)	2018:3	2018:4	2019:1	2019:2	2019:3	2019:4
National Outlook												
Chain-Weight GDP[1]	2.2	2.9	2.6	2.3	2.2	4.2	3.5	2.6	2.3	2.3	2.1	1.8
Personal Consumption	2.5	2.7	2.7	3.9	0.5	3.8	4.0	2.7	2.5	2.5	2.4	2.1
Business Fixed Investment	5.3	6.8	4.3	4.9	11.5	8.7	0.8	6.6	4.4	4.0	3.3	3.0
Residential Investment	3.3	-0.3	-1.3	11.1	-3.4	-1.3	-4.0	-4.1	-0.5	-0.4	1.4	1.5
Inventory Investment	19.1	30.6	61.4	13.7	25.8	-31.3	64.9	62.8	62.2	60.6	65.1	57.6
Net Exports	-713.7	-760.7	-858.4	-748.6	-751.0	-696.0	-782.7	-813.1	-835.4	-853.6	-869.6	-875.0
Exports	3.0	4.3	3.8	6.6	3.6	9.3	-3.5	4.2	4.8	4.7	4.3	4.6
Imports	4.6	4.9	6.1	11.8	3.0	-0.6	9.1	7.2	6.5	5.8	5.2	4.1
Government Expenditures	-0.1	1.8	2.7	2.4	1.5	2.5	3.3	3.9	2.9	2.7	1.0	0.7
Federal	0.7	3.0	4.9	4.1	2.6	3.7	3.3	8.1	6.4	5.4	1.1	-0.1
State and Local	-0.5	1.1	1.4	1.4	0.9	1.8	3.2	1.5	0.8	1.0	1.0	1.3
Final Sales	2.2	2.8	2.4	3.2	2.0	5.4	1.4	2.6	2.3	2.4	2.0	2.0
Inflation												
GDP Deflator	1.9	2.2	2.4	2.5	2.0	3.1	1.7	2.3	2.7	2.2	2.4	2.4
CPI	2.1	2.5	2.5	3.3	3.5	1.7	2.0	2.9	2.9	2.6	2.3	1.9
Core CPI	1.8	2.1	2.3	2.2	3.0	1.8	2.0	1.9	2.6	2.4	2.4	2.4
Special Indicators												
Corporate Profits[2]	3.3	8.0	3.2	3.3	5.9	7.3	8.8	8.0	8.8	6.2	4.7	3.2
Disposable Personal Income	2.6	2.8	2.1	2.3	4.5	2.5	2.5	1.1	1.7	2.7	2.7	2.5
Housing Starts (mil.)	1.2	1.3	1.3	1.3	1.3	1.3	1.2	1.3	1.3	1.3	1.3	1.3
Civilian Unemployment Rate	4.4	3.9	3.5	4.1	4.1	3.9	3.8	3.7	3.5	3.5	3.5	3.5
Total Nonfarm Payrolls (thous.)[3]	2176.7	2507.9	1811.9	556.3	632.3	634.3	623.0	618.2	555.1	488.7	421.0	347.1
Vehicle Sales												
Automobile Sales (mil.)	6.3	5.5	5.0	6.2	5.7	5.5	5.4	5.5	5.3	5.1	4.8	4.7
Domestic	4.6	4.0	3.7	4.5	4.1	3.9	3.9	4.0	3.9	3.8	3.6	3.5
Imports	1.7	1.5	1.3	1.7	1.6	1.5	1.5	1.5	1.4	1.3	1.2	1.2
Lt. Trucks (mil.)	10.9	11.7	11.3	11.5	11.5	11.8	11.7	11.7	11.5	11.3	11.1	11.1
Domestic	9.0	9.4	9.2	9.4	9.3	9.5	9.4	9.4	9.3	9.2	9.1	9.1
Imports	1.9	2.3	2.1	2.1	2.2	2.3	2.3	2.3	2.2	2.1	2.0	2.0
Combined Auto/Lt.Truck	17.2	17.2	16.2	17.7	17.2	17.3	17.0	17.2	16.8	16.4	15.9	15.8
Heavy Truck Sales	0.4	0.5	0.5	0.4	0.5	0.5	0.5	0.6	0.6	0.5	0.5	0.4
Total Vehicles (mil.)	17.6	17.7	16.7	18.1	17.6	17.8	17.6	17.8	17.4	16.9	16.4	16.2
Interest Rate/Yields												
Federal Funds	1.0	1.8	2.8	1.2	1.5	1.7	1.9	2.2	2.4	2.7	2.9	3.2
10-Year Treasury Note	2.3	2.9	3.4	2.4	2.8	2.9	2.9	3.2	3.3	3.4	3.5	3.6
Corporate Bond BAA	4.4	4.8	5.5	4.3	4.5	4.8	4.8	5.1	5.2	5.3	5.6	5.8
Exchange Rates												
Euro/Dollar	1.1	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2
Dollar/Yen	112.1	110.3	109.8	112.9	108.3	109.1	111.5	112.3	111.2	110.0	109.4	108.6

1. In 2016, GDP was $16716.164 billion in chain-weighted 2009 dollars.
2. Corporate profits before tax with inventory valuation and capital consumption adjustments, quarterly data represents four-quarter percent change.
3. Total nonfarm payrolls, quarterly data represents the difference in the average from the previous period. Annual data represents 4Q to 4Q change.

Quarterly data are seasonally adjusted at an annual rate. Unless otherwise specified, $ figures reflect adjustment for inflation. Total may not add up due to rounding.