Federated

Orlando's Outlook: Will stock market Grinch steal holiday spending?

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Bottom line *Buoyed by a healthy labor market, elevated confidence and a sharp decline in gas prices, consumers have largely shrugged off double-digit stock market declines over the past three months, generating a solid start to the holiday shopping season. The Commerce Department reported this morning that nominal retail sales in November rose a slightly higher-than-expected 0.2% on a month-over-month (m/m) basis, led by November's powerful 2.3% m/m surge in internet sales, the most in a year. It also reported a sizable upward revision in October from a preliminary 0.8% gain to a strong 1.1% increase. The big story, in our view, is that so-called control results leapt a much stronger-than-expected 0.9% in November (consensus estimate at 0.4%), with October revised significantly higher from a preliminary 0.3% m/m gain to a strong 0.7% increase. Because consumer spending accounts for 70% of GDP, this gives us greater confidence in our above-consensus forecast for fourth-quarter GDP growth of 2.8%.*

Strong labor market is contributing to robust holiday spending:

- Unemployment rate (U-3) was unchanged at 3.7% in November, a 49-year low.
- Wage growth was unchanged on a year-over-year (y/y) basis in November at 3.1%, matching its strongest gain since a 3.4% increase in April 2009.
- Initial weekly unemployment claims (a leading economic and employment indicator) for the week ended Dec. 8 fell to 206,000, just off September's 49-year low of 202,000.

Consumer confidence remains strong:

- Leading Economic Indicator (LEI) has now risen for 26 consecutive months, up a modest 0.1% in October 2018 on a m/m basis to 112.1, a new 58-year cycle high.
- Conference Board's Consumer Confidence Index surged to a new 18-year high of 137.9 in October 2018, up from 100.8 in October 2016, although it slipped to 135.7 last month.
- Michigan Consumer Sentiment Index rose to a 13-year high of 101.4 in March 2018, up from 87.2 in October 2016, although it has since declined to 97.5 last month.

Gas prices have fallen sharply by 18% over the past three months Thanks to a 34% collapse in crude oil (WTI) prices over the same period, from $76 per barrel to a recent low of $50, prices have declined from a peak of $2.92 per gallon in early October to $2.39 today. The rule of thumb is that every 1 cent decline at the pumps adds $1.2 billion in consumer discretionary spending, which could translate into 30 basis points of stronger GDP growth annually.

Back-to-School (BTS) sales are usually a good touchstone for holiday spending Christmas historically tends to be 80-90% positively correlated with BTS results, excluding any weather-related issues. In 2018, BTS spending rose 5.7% in July, August and September on a y/y basis, the strongest results since 2011's robust gain of 7.8%. For this Christmas, the National Retail Federation (NRF) is forecasting a 4.3-4.8% y/y gain for November and December, and our friends at the Telsey Advisory Group are forecasting 5.2%. At Federated, we've been thinking that holiday retail sales growth will approximate 5%. So far, fourth-quarter retail sales for October and November combined have risen by 4.5% y/y, which is spot-on with the average gain since 2010. By comparison, last year's retail sales during October and November rose a stronger 5.7%, a 6-year high (since 2011's 6.7% gain.)

Importantly, we typically include January in our analysis of Christmas sales, because of post-holiday gift-card redemptions. Gift cards only count as a retail sale when they're redeemed, not when they're purchased. About 15% of gift cards are typically redeemed the week after Christmas, and 60-65% are usually redeemed during the first half of January. So January gift-card redemptions will help determine the overall strength or weakness of the holiday season.

Will ongoing stock market volatility harm the balance of holiday sales? Over the past three months, the S&P 500 has fallen 12%, the technology-laden NASDAQ Composite has dropped by 16%, and the small-cap Russell 2000 Index has plunged 18%, with so-called technical "death crosses" forming in each over the past month. The top socio-economic half of America owns stocks in their retirement and college-savings plans. Moreover, the top two-thirds of Americans own their own homes, and real estate has been under pressure for most of this year.

Over the past 20 years, our research friends at Evercore ISI note that there has been an 86% correlation between the fourth-quarter performance of the S&P and holiday sales. So with the S&P down about 10% so far in the fourth quarter, that suggests that retail sales could be negative. While we don’t believe there’s any chance of that happening, we will concede that holiday spending in December and January may be less robust than expected, in part due to pressure from extreme equity market volatility and a negative wealth effect.

What do weak Christmas tree sales mean? Since 2002, ISI has also gathered data from 24 regional Christmas tree associations, farmers and retailers in the U.S. and Canada during each of the four (or five) weeks in between Thanksgiving and Christmas, to gauge the relative strength or weakness of the sale of Christmas trees, wreaths and garlands. They believe if consumer confidence is high and the economy is strong, people likely will spend more money on holiday decorations in addition to gifts, food and beverages and travel. With three weeks now complete, ISI’s annual Christmas tree unit sales survey has posted a weaker-than-expected average y/y sales gain of 4% in 2018, versus 7% in 2017 and 10% in 2016’s first three weeks, which were the strongest results in the history of their survey. The average annual sales gain over the 16-year life of the survey approximates 6%.

True, we have a five-week gap between Thanksgiving and Christmas this year, versus only four weeks in each of the past two years, and there have been some weather issues both out west and in the southeast this year. In addition, there is still a shortage of mature Christmas trees available to be harvested this year (due to planting issues a decade ago during the Great Recession), so prices are higher. That may be driving some buyers to purchase artificial trees instead, which ISI’s survey does not capture. But softer Christmas tree sales so far this season may be a proverbial canary in the coal mine, suggesting that extreme equity market volatility and declining stock prices may be weighing on investor sentiment and holiday cheer.

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Editor's note: This will be the last regular weekly installment from Phil this year. Happy holidays!

Views are as of the date above and are subject to change based on market conditions and other factors. These views should not be construed as a recommendation for any specific security or sector.

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The Conference Board's Composite Index of Leading Economic Indicators is used to predict the direction of the economy's movements in the months to come.

The Conference Board's Consumer Confidence Index measures how optimistic or pessimistic consumers are about the economy.

Gross Domestic Product (GDP) is a broad measure of the economy that measures the retail value of goods and services produced in a country.

Nasdaq Composite Index: An unmanaged index that measures all Nasdaq domestic and non-U.S.-based common stocks listed on the Nasdaq Stock Market. Indexes are unmanaged and investments cannot be made in an index.

Russell 2000® Index: Measures the performance of the 2,000 smallest companies in the Russell 3000 Index, which represents approximately 8% of the total market capitalization of the Russell 3000 Index. Investments cannot be made directly in an index.

S&P 500 Index: An unmanaged capitalization-weighted index of 500 stocks designated to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. Indexes are unmanaged and investments cannot be made in an index.

The University of Michigan Consumer Sentiment Index is a measure of consumer confidence based on a monthly telephone survey by the University of Michigan that gathers information on consumer expectations regarding the overall economy.

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