CONSUMER SPENDING SHIFT

REGIONS
ASSET MANAGEMENT

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Key Highlights

- Consumers are changing how they spend their discretionary income. Categories such as cruises, home improvement and online spending are poised to be the beneficiaries of this shift.
- Thanks in large part to Baby Boomers retiring in substantial numbers and the newly found freedoms retirement can offer, travelling and cruise ship spending have increased to levels we have not witnessed in decades.
- While many have been looking for and proclaiming the death of traditional retail for years, it seems that 1Q17 has certainly seen an inflection point. Home improvement and online spending are likely to be the winners in the years ahead.

Executive Summary

The consumer is shifting their spending habits in a big way. We are currently in the midst of a major shift in the ways that consumers allocate their discretionary resources, and this has had and will continue to have consequences for stock market investors. Retailers have seen declining same store sales, and store closures are accelerating to combat declining traffic. Online spending is the obvious culprit, but additional forces such as the retirement of Baby Boomers and family formation by Millennials are also worth exploring. We will go through each one of these factors below and discuss the areas that should benefit over the next few years.

Wallet Shift Trends

The last few years have seen dramatic shifts in the way that consumers are spending their money, and this shift seems to have rapidly accelerated in the beginning of 2017. Figures 1 and 2 below show the sales growth by major retail sector for the months of February and March. A few things stick out in the tables below including increased spending on cruises and home Improvement and the extreme fall off in department store spending.

Figure 1: Sales by major sector February '17

	3mo % mom	% yoy	Prior 5 yr % yoy avg
Gasoline Stations	1.70%	22.60%	-6.80%
Cruise	1.50%	14.80%	3.10%
Home improvement	1.20%	6.40%	4.00%
Food Services & Drinking Places	0.20%	3.70%	6.50%
Lodging	0.20%	4.60%	3.60%
Dollar stores	0.00%	-1.00%	5.40%
Home goods	0.00%	-1.20%	5.10%
Discount apparel	-0.10%	-2.80%	4.80%
Furniture	-0.40%	1.30%	2.40%
Food & Beverage	-0.50%	0.20%	3.80%
Airlines	-0.90%	2.80%	1.90%
Luxury	-1.00%	-1.30%	12.90%
Sporting goods	-2.50%	-4.40%	2.60%
Department stores	-5.30%	-16.80%	-2.80%

Source: BAC internal data[1]

Note: Shaded categories represent declines in year-over-year rate.

Figure 2: Sales by major sector March '17

	3mo % mom	% yoy	Prior 5 yr % yoy avg
Home goods	1.80%	-0.20%	5.20%
Luxury	1.40%	3.60%	11.70%
Furniture	1.30%	3.90%	2.30%
Food Services & Drinking Places	1.10%	3.20%	6.60%
Home improvement	1.10%	5.40%	4.20%
Cruise	0.90%	10.90%	4.30%
Dollar stores	0.50%	0.50%	5.20%
Lodging	0.40%	7.20%	3.30%
Sporting goods	0.10%	-6.10%	3.00%
Gasoline Stations	0.00%	17.50%	-7.20%
Food & Beverage	0.00%	0.00%	3.90%
Discount apparel	-0.50%	-0.40%	4.90%
Airlines	-0.90%	7.50%	1.40%
Department stores	-2.20%	-13.20%	-2.40%

Source: BAC internal data[1]

Note: Shaded categories represent declines in year-over-year rate.

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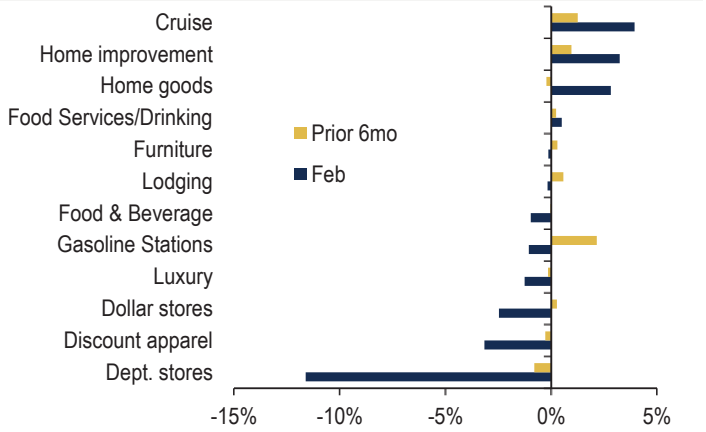
Cruise ship spending is accelerating at rates we have not seen in decades. This is being driven by Baby Boomers retiring in massive numbers and spending their newly found freedom travelling. Cruise spending was up 14.8% year over year (YOY) in February and up 10.9% YOY in March. You can see in figure 3 that cruise spending led all categories in spending growth in February followed closely by home improvement and home goods.

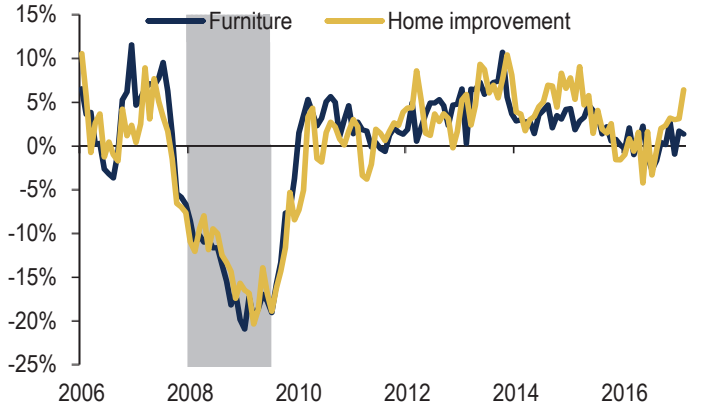
Figure 3: Sales by growth by sector February '17



Source: BAC internal data[1]

The second major theme that is evident in the charts is the increased spending at home improvement stores. This spending is being driven by the upturn in the housing cycle which is likely just getting started as Millennials enter family formation ages. Home improvement spending was up 6.4% YOY in February and 5.4% YOY in March. Both of these numbers are above the 5-year Average of 4%.

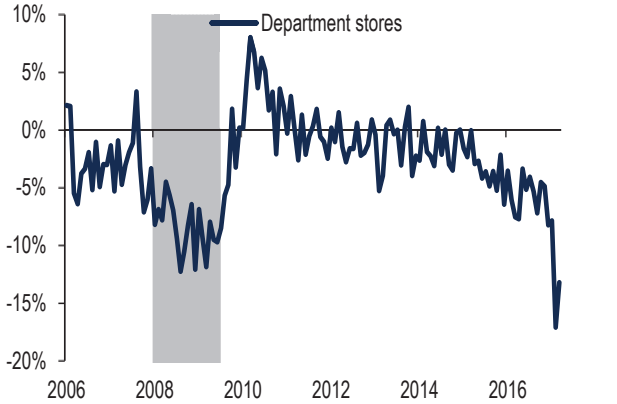
Figure 4: Home improvement sales growth February '17



Source: BAC internal data[1]

Lastly and maybe most dramatically is the massive fall off in department store spending. Department stores are the biggest losers in the shift to online retail. Department store spending was down 16.8% YOY in February and despite rebounding modestly in March, was still down 13.2% YOY. The department stores seemed to be gaining their footing in late 2016 after suffering a decline earlier in the year. As you can see from the huge drop in figure 5, the inflection point that everyone has been waiting on as spending continues to shift online finally came in the beginning of 2017.

Figure 5: Department stores sales growth February '17

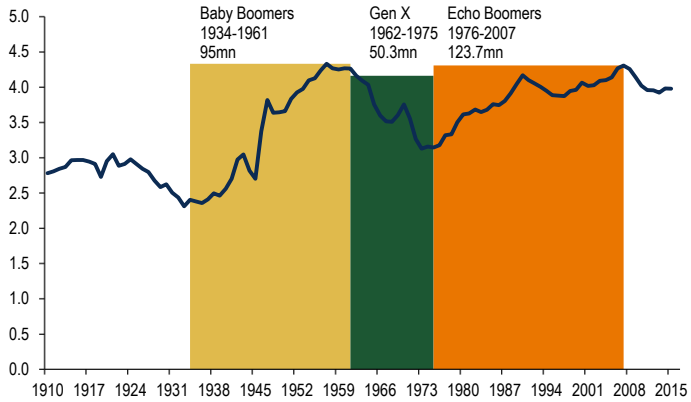


Source: BAC internal data[1]

Boomers Retiring in Large Numbers

Demographics is the quiet force driving purchasing decisions behind the scene. It moves so slowly and subtly that most of us fail to recognize its impact. Figure 6 is the birth rate chart in the United States for the last 105 years. It is broken into generational categories, known to most of us as Boomers, Gen X and Millennials (Echo Boomers). There was a massive wave of Boomers born between 1945 and 1960 with the peak year seeing just over 4 million children born around 1958.

Figure 6: Generational Birth Chart



Source: Census Bureau, BofAML[1]

If we fast forward to 2017, we can see that these Boomers are starting to hit retirement age and will continue to do so until about 2027. In 1952, there were 3.93 million Boomers born. This is the group that will hit retirement age this year. The number of Boomers retiring each year will continue to climb for the next 6 years before plateauing into 2027.

This chart is important to understand because research has shown that spending habits peak for each consumer category at different ages. As we grow up, start a family, send the kids off to college and retire, we have different needs and spending goals. Figure 7 shows the lifetime spending cycle.

Figure 7: Lifetime spending cycle

Age	Peak Spending Category
26	Apartments
31	Starter Homes
41	Trade-Up Homes
46	Furniture
51	College Tuition for Kids
53	Autos
60	Hospitals
65	Vacation/Retirement Homes
70	Cruises
77	Prescription Drugs
84	Nursing Homes

Source: Census Bureau, Dent Research

With the majority of Boomers starting to hit retirement age (65 years old), we can see from the spending cycle that vacation/retirement homes and cruises should see increased spending. This is exactly what the spending growth charts showed at the beginning. The good news is that these trends are just beginning, and we should have another 10 years or so before they wind down. If we position ourselves correctly, we should benefit from these massive spending cycles.

Millennials Starting Families

The next major wave of births picked up again in 1976 as the Millennial generation began. The number of births bottomed at just over 3 million in 1976 and climbed steadily until reaching a peak of 4.3 million in 2008. This is the second wave that will cause major spending shifts as we move forward through time. This generation will cause major shifts not only as they move through the spending life cycle, but also as they continue to move to online shopping. As Boomers shop less as they age, the Millennials will be picking up the slack and causing the continual march toward online shopping.

The Millennial generation is starting to hit the family formation stage which begins around age 30. This is typically when people decide to buy the starter home and settle down. This phase is just beginning for the Millennial generation as the uptick in births really started to ramp higher in 1987. This will provide a strong tailwind for home improvement and home goods stores for the next several years. It should also provide an opportunity for home builders if they can recognize that they need to shift from luxury homes that Boomers have been buying for the last decade to starter homes as the demand shifts from aging Boomers to young millennial families.

Continued Shift to Online Shopping

According to the U.S. Census Bureau, the nonstore retail category (online sales) grew 11.6% in 2016 vs. 2015. This was followed by health & personal care stores which saw 7.2% growth and home improvement which saw 5.9% growth in 2016 vs. 2015. This compares to overall retail sales growth of 3.0% in 2016. This double digit growth in nonstore retailers came largely at the expense of general merchandise and electronics & appliances stores which each saw growth decline during the year.

While many have been looking for and proclaiming the death of traditional retail for years, it seems that 1Q17 has certainly seen an inflection point. The abysmal drop in department store sales after more than two years of mid-single digit contraction should be a signal that something has changed in the retail landscape. Combine this with the announcement of 11 retail bankruptcies and over 3,000 store closures so far in 2017, and the secular trend for traditional retailers looks scary. Retail has traditionally experienced cycles of overbuilding followed by right-sizing of the industry, but this time feels different.

The reasons for the continued shift to online sales are many and have been discussed for years. Some of these reasons include: ease of shopping and home delivery, increased comfort with conducting financial transactions online, avoiding crowds and wait times at brick and mortar retailers, increased selections online and easily comparable prices online. All of these reasons are true and contribute to the continued shift from brick and mortar to online sales, but the biggest driver may be the demographics issues we discussed above.

Investment Conclusion

As Americans continue to progress through the life spending cycle, Boomers will need to purchase fewer and fewer goods while Millennials will be the ones driving the spending. Millennials are well known to spend large quantities of time online and more so on their phones. So this does not bode well for brick and mortar retail in general. As online purchasing becomes easier on phones and Millennials account for more of the purchasing power, we should see nonstore retail continue to grow and take more share from the traditional retailers. This has investment implications for traditional retailers and will bear watching.

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