ECONOMIC OUTLOOK

REGIONS

November 2017

Holiday Sales Outlook: How Much, And How, Will Consumers Spend?

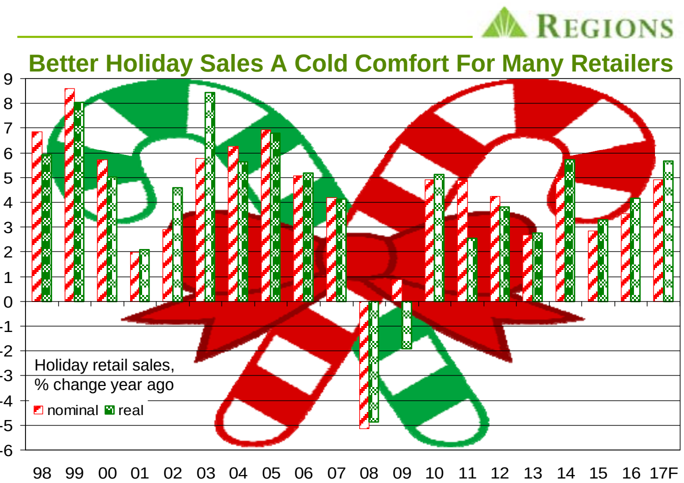
It's the most wonderful time of the year. Unless of course it's not. Either way, it's time for the November *Monthly Economic Outlook*, which means it's also that time of the year when we take the pulse of the U.S. consumer, apply the collective force of our years of professional experience, conduct extensive research, perform highly sophisticated statistical analysis, and then basically guess how much consumers will spend over the holiday sales season.

Okay, fine, it is still early and you may not quite feel that holiday spirit just yet. And we get that, because in many ways the holiday season has been ruined by the holiday shopping season, at least for us. But, just you wait, when the first large-scale in-store brawl breaks out over which holiday-inspired shopper will get the last *Cuddly Calico* ceramic cat collection on the shelf, which subsequently gets replayed endlessly on the national news, the holiday spirit will hit you. Like a sack of bricks. Bah.

In any event, in what follows, we'll discuss how we see the holiday shopping season shaping up for consumers and for retailers. Before proceeding, it's worth noting that the definition of "holiday sales" tends to vary considerably – for a quick empirical test of this just count how many estimates you see each year of sales on "Black Friday" or "Cyber Monday." As has always been our practice, our measure of holiday sales consists of combined November and December retail sales excluding motor vehicle, gasoline, building materials, restaurant, grocery store, and drug store sales – things not typically given as holiday gifts.

Again, it's early still, but this is shaping up to be a bit of an odd holiday season. Like many other analysts, we are expecting to see a bigger increase in holiday sales than has been the case in the past couple of years, yet there is not really any single item out there creating that "must have" buzz. After all, cuddly or not, ceramic cat collections don't do it for everybody, though we suspect they do it for more people than will admit to it. And, sure, there's the latest, greatest mobile phone ever, which at some point will actually be available but which costs roughly as much as the entire GDP of many developing nations. Still, despite the lack of a clear driver of sales, this is shaping up to be a strong holiday sales season, though far more so for buyers than for sellers.

We look for a 4.9 percent increase in holiday sales, as defined above, which would easily top the gains seen in 2015 and 2016, as seen in the following chart. That 4.9 percent increase, however, will feel better for consumers than it will for retailers, as persistent goods price deflation weighs on margins for those who sell goods. The following chart also shows holiday sales in real terms, i.e., adjusted for price changes, and our forecast anticipates 5.7 percent growth in in real holiday sales this year. This would make 2017 the fifth consecutive year in which growth in real holiday sales tops growth in nominal holiday sales. In other words, we look for further declines in prices for core consumer goods (consumer goods excluding food and energy) this holiday season which, to our earlier comment, will feel much better for those buying goods than it will for those selling goods.



Source: U.S. Census Bureau; Bureau of Labor Statistics; Regions Economics Division

Though it has persisted for the past several years, many observers continue to overlook the impact of goods price deflation and instead offer assessments of the state of the consumer based on spending data reported in nominal terms. As regular readers of our analysis of the top-tier economic data know, this is something that shoots our blood pressure higher each month when the monthly retail sales reports are released. As we routinely point out, one simply cannot make a credible assessment of the state of the consumer without accounting for falling goods prices.

In the interest of full disclosure, last year's holiday sales forecast fell short of the mark. Our forecast was for nominal holiday sales to increase by just 2.9 percent in nominal terms, which combined with our forecast for lower core goods prices yielded a 3.5 percent increase in real holiday sales. Actual holiday sales rose by 3.6 percent on a nominal basis and 4.1 percent in real terms. While we were on the mark in our forecast for core goods prices, nominal spending was stronger than we had anticipated. That we expect such a sharp increase in nominal holiday spending this year reflects what we believe to be solid consumer fundamentals coupled with consumer confidence at a level last seen in late-2000.

Over the past few months we've discussed, in some detail, various elements of household financial conditions, including household net worth, the personal saving rate, household debt, and the implications of inflation and interest rates having been notably low for what has been an extended period. As such, we won't go into a lot of detail on those elements here. We will, however, reiterate

Regions Financial Corporation, 1900 5th Avenue North, 17th Floor, Birmingham, Alabama 35203
Richard F. Moody, Chief Economist • 205.264.7545 • richard.moody@regions.com

a point we consistently make – in terms of their wherewithal and willingness to spend, U.S. consumers are on solid footing.

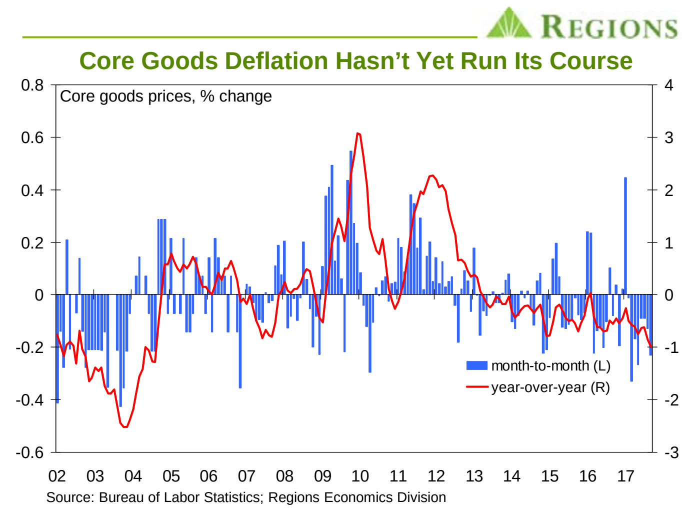
This is not to say there are no causes for concern. For instance, in our discussions of household debt we've noted that low interest rates have to some extent masked what remains an elevated level of household debt, in that low interest rates have held monthly debt service obligations near historical lows. This would change, perhaps quickly, should interest rates rise by any meaningful degree. And, even to the extent fixed rate debt is more prominent than floating rate debt, the elevated level of debt would act as a binding constraint on households taking on additional debt.

Also, some point to recent patterns in the personal saving rate as a warning sign for growth in consumer spending over coming quarters. At 3.1 percent in September (the latest data point available), the saving rate is at its lowest since the start of the 2007-09 recession. While the decline in the saving rate in September is a bit overstated due to measurement issues, the broader point is the saving rate has fallen sharply over the past year. At some point, it seems likely consumers will want to increase savings, particularly those households who have not seen their net worth rise due to higher stock or house prices. To the extent this is the case, for a given level of disposable income, more saving means less spending. As a side note, if Congress enacts tax legislation that would lower tax burdens on lower-to-middle income households, in turn raising their disposable income, an increased preference for saving would mean less of an impact on consumer spending and GDP growth from any such tax cut than many analysts are now incorporating into their forecasts.

So, while we do see some potential clouds on the horizon for consumer spending, keep in mind our focus here is on holiday spending, and neither high levels of debt nor low levels of saving are likely to infringe on consumer spending during this holiday season. To be sure, the post-holiday bills rolling in could be a trigger for consumers to address both debt and saving, but this would pose downside risk to our outlook for growth in consumer spending in 2018 as opposed to the 2017 holiday sales season.

As such, we feel confident in our holiday sales forecast, at least directionally, i.e., that this year will see a larger increase in holiday sales than that seen in 2016. Still, keep in mind that spending on consumer goods accounts for only about one-third of all consumer spending as measured in the GDP data. As such, any measure of holiday sales that does not incorporate consumer spending on services, such as recreation, travel, dining out, and entertainment, will not fully capture the extent of spending during the holiday season. This measurement issue is of course present each year and becomes meaningful only to the extent the shares of holiday spending accounted for by goods and services shift sharply from one year to the next.

That caveat aside, even if our forecast of a 4.8 percent increase in holiday sales this year proves to be on the mark, it may not bring much joy to retailers. As noted above, persistently declining consumer goods prices mean that sellers of consumer goods have for some time now had little or no pricing power. While goods price deflation is not as pronounced as was the case in 2003, as seen in the following chart, it has been more persistent, with core goods prices down year-on-year in 53 of the past 54 months as measured in the Consumer Price Index (and for 58 consecutive months as measured in the PCE deflator). This makes for a challenging environment for retailers, and for many will mean a joyless holiday sales season as profit margins remain under pressure.

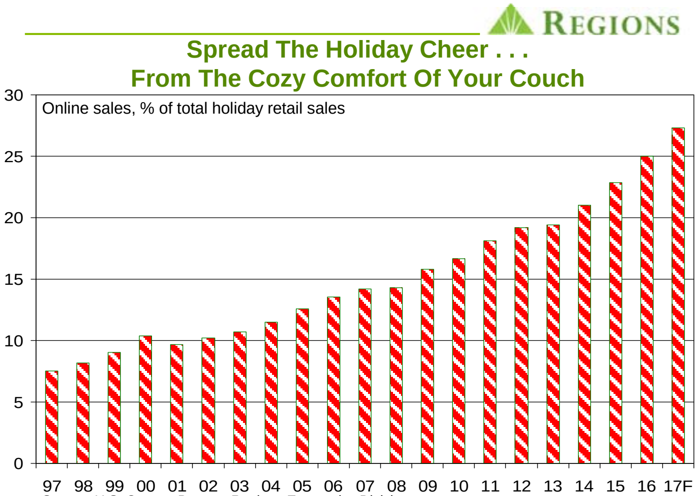


Compounding the misery for many retailers is that U.S. consumers have become accustomed to holiday discounting by retailers hoping to clear inventories, which comes on top of the falling prices that are captured in the inflation data. Do not, well, discount the significance of this effect during this holiday sales season, as elevated inventory-to-sales ratios across the retail landscape will likely test the resolve of merchants needing to clear out stocks, particularly if the holiday sales season gets off to a slow start.

While these price effects can be accounted for so that we can paint a more accurate picture of the strength of consumer spending, the pressure being exerted on retailers' profit margins from a lack of pricing power can't be brushed aside. Moreover, rising labor costs are further intensifying the squeeze on profit margins. Though it may seem logical to attribute rising wages to tighter labor market conditions, we think the bigger factors, at least in retail, are higher minimum wages in many parts of the U.S. and many large national retailers having voluntarily raised entry level wages, increases which tend to ripple up through the ranks. Indeed, data from the Employment Cost Index, our preferred measure of changes in labor compensation costs, show that since Q1 2015 retail trade has seen faster wage growth than any other industry group, though the level of hourly wages remains well below average.

So, if your friendly local retailer isn't all that friendly when ringing up your purchases this holiday season, you can understand why. Well, assuming you actually see a retailer, friendly or otherwise, this holiday season. After all, as if shrinking profit margins and labor costs rising at a faster rate aren't making things tough enough for brick and mortar retailers, they are also having to contend with the steadily increasing share of consumer spending accounted for by online sales. As we've said before, the issue for many retailers isn't how much consumers are spending, but instead how consumers are spending.

Our holiday sales forecast incorporates a 14.7 percent increase in online sales this holiday season, compared to the 13.3 percent increase seen during the 2016 holiday season. Our forecast would put online sales at 27.3 percent of total holiday sales, easily the highest in the life of the data. As seen in the chart below, not only are online sales accounting for an increasingly larger share of holiday sales (and, to be sure, of control retail sales as reported in the monthly retail sales data), but the rate of increase has steadily accelerated over recent years.



Source: U.S. Census Bureau; Regions Economics Division

One mistake to avoid, however, is assuming online sales spell the death knell for physical retail stores – for some strange reason people tend to extrapolate the trend in the above chart out to the point where online sales account for 100 percent of all retail sales, holiday or otherwise. The reality is that for those brick and mortar retailers able to successfully integrate the two, online sales have been a powerful boost to sales without totally cannibalizing in-store sales. Those unable to get the online platform right have suffered in both cyberspace and physical space, and they are rapidly running out of time to figure it out.

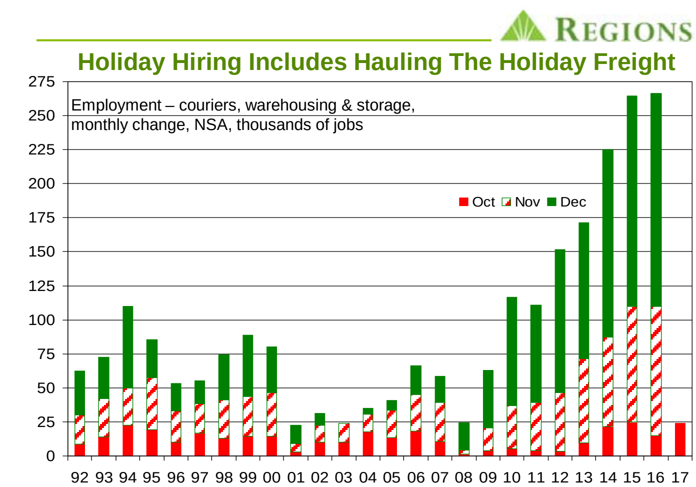
That said, online sales have contributed mightily to the lack of pricing power across much of the retail landscape, and we expect this holiday sales season to further illustrate that point. Additionally, while free shipping may be a boon for consumers, the reality is that free shipping isn't really free – someone has to pay for it, and doing so only adds to retailers' costs of selling goods. Don't expect consumers to shed many, if any, tears over this, however, and we expect rapid growth in online sales this holiday season to be a key contributor to growth in overall sales.

At this point it may seem that the best strategy for retailers to follow this holiday season would be to simply fire all their workers and bar their doors. Instead, many are stubbornly clinging to the old-fashioned way of doing things, i.e., hiring more workers and trying to find ways to lure people into their stores. To be sure, many retailers are less enthusiastic about this approach than has been the case in past years, which is perfectly understandable. The holiday hiring season for retailers typically begins in October, with larger increases in November, while hiring tapers off in December. The following chart shows seasonal holiday hiring (October through December) in retail trade, but for consistency we've excluded hiring in those retail categories excluded from our measure of holiday sales. Additionally, the data shown in the chart are not seasonally adjusted, which is the proper basis on which to compare data for the same months across different years.

Source: Bureau of Labor Statistics; Regions Economics Division

As seen in the chart, holiday hiring in retail hit a post-recession peak of roughly 747,000 workers in 2013 but has tailed off in each year since; in 2016, retailers hired roughly 623,000 workers over the three-month holiday hiring period. This year, however, saw the smallest October increase in adjusted retail payrolls since 2009, and when all is said and done we look for 2017 to see the smallest increase in total holiday hiring in retail since 2009, when the U.S. economy was still very much in the grips of the 2007-09 recession, even if the recession was officially over.

It should be noted that the tailing off in holiday hiring in retail trade over the past few years has coincided with the acceleration in the growth of online sales as a share of total holiday sales. So, just as shopping patterns have changed, so too have holiday hiring patterns. In other words, once the goods have been ordered, they have to be packaged then transported and delivered to consumers, and to get a measure of the full extent of holiday hiring we must also account for activities such as warehousing, distribution, and delivery, which we do in the following chart.



Source: Bureau of Labor Statistics; Regions Economics Division

The above chart makes a useful point that holds all year round, not just during the holiday season. While the ongoing shift in shopping patterns is acting as a persistent drain on employment in retail trade – payrolls have fallen by over 65,000 jobs over the past 12 months – those shifting shopping patterns are also supporting hiring in transportation, warehousing, and distribution. In terms of holiday hiring, last year saw holiday hiring of roughly 267,000 persons (again, using the not seasonally adjusted data), the highest number on record. To be clear, we narrow the transportation sector down to the "couriers and messengers" industry group as this is the category into which home delivery services fall. It can also be seen from the above chart that the vast majority of hiring in this cluster of industries takes place in November and December, though the 24,000 such jobs added this October is the second highest gain for October since 1992.

One point to keep in mind, however, is that given the increased emphasis on online shopping, holiday hiring in transportation, warehousing, and distribution may not be as pronounced going forward as has been the case in the past. In other words, with it being more important to be fully staffed up year round, there may be less need for seasonal warehouse and delivery workers. To be sure, holiday hiring won't be dispensed with entirely, but at some point, even if not this year, it won't play as prominent a role.

On the whole, we look for a fairly strong holiday sales season, though one that will likely bring more cheer to consumers than to retailers. As has been the case in recent years, price effects will again mean that growth in real holiday sales will be stronger than growth in nominal sales. Although, in what has become not just a holiday tradition but a year-round tradition, many analysts will fail to account for these price effects and crank out the usual "what's wrong with U.S. consumers?" narratives.

At least in terms of this holiday shopping season, we find the question of how much will consumers spend to be of less interest than the question of how consumers will spend. It will likely be a tough holiday season for brick and mortar retailers, at least those without a viable online presence. Limited pricing power, higher labor costs, and further growth in online sales won't do much for already thin profit margins, and to the extent retailers will have to resort to discounting in order to help clear inventories, which we think are still too high, the pressure on margins will only intensify.

The question of how much consumers will spend will become more interesting after the holiday season has passed. There are any number of moving parts that go into answering this question. Will consumers feel inclined to build up savings, will higher interest rates make servicing debt more problematic, will disposable income get a boost from a tax cut, will wage growth kick into a higher gear, will there be some sort of a correction in asset prices that would take a bite out of household net worth – these are some, but by no means all, of the factors that will determine how consumer spending will hold up in the coming year. For now, though, holiday shoppers, take your mark . . .

Economy On A Solid Growth Path

As we did last month, we'll finish with a brief recap of the economic data, taking care to separate the noise stemming from Hurricanes Harvey and Irma from the underlying trends. As with the data for the month of September, the effects of the hurricanes are visible in the data for the month of October, though we've seen nothing to make us question the underlying health of the U.S. economy.

The BEA's initial estimate shows annualized real GDP growth of 3.0 percent in Q3. The effects of the hurricanes are apparent in the Q3 GDP data, in some cases (motor vehicle sales) adding to growth and in some cases (construction) taking from growth. The hurricanes likely played some part in what was a notably faster rate of inventory accumulation in the nonfarm business sector. To the extent consumer and business spending was put off due to the storms, that would have led to higher inventory levels. Inventory accumulation added seven-tenths of a point to top-line real GDP growth in Q3 but will likely be a drag on Q4 growth.

As in September, post-hurricane replacement demand supported motor vehicle sales in October, with unit sales coming in at an annual rate of 18.0 million. This means spending on consumer durable goods will make another hefty contribution to top-line real GDP growth in Q4, but as replacement demand fades, unit sales will drift down to a more sustainable pace of just over 16 million units. As such, spending on consumer durables will likely be a drag on real GDP growth in Q1 2018.

The October labor market data were clearly impacted by the hurricanes. Total nonfarm employment rose by 261,000 jobs as many workers temporarily kept from work in September returned in October. Also, the original estimate of a 33,000 job decline in nonfarm employment in September was revised to show an 18,000 job increase, meaning the U.S. economy's streak of monthly job gains remains intact, standing at a record 85 consecutive months.

As was the case in September, the mix of workers across industry groups impacted by the hurricanes skewed the data on average hourly earnings in October. September's work disruptions were heavily concentrated in leisure & hospitality services, for which hourly earnings are less than 60 percent of the overall average. Those workers not being counted as employed in the September data biased measured average hourly earnings higher, hence the reported 0.5 percent increase. Those workers returning to work in October had the opposite effect, which resulted in a one-cent decline in measured average hourly earnings. Neither month's data reflect underlying labor market trends, though it was both amusing and annoying to listen to some of the same analysts who saw the September wage data as a harbinger of runaway inflation do a complete U-turn when the October data hit the wire.

Having jumped by better than 10 percent in September after Hurricane Harvey took out more than 20 percent of the nation's refining capacity, retail gasoline prices gave back about half of that gain in October. One implication is the October data should show only a modest increase in the headline CPI after the 0.5 percent increase posted in September. Of course, for the FOMC the issue will be that core inflation, as measured by the PCE deflator, will remain stubbornly below the 2.0 percent target rate. Also, the drop-off in retail gasoline prices could push total retail sales lower for October (again with those pesky price effects).

We closed out last month's edition by stating that the momentum seen prior to the hurricanes would remain in place even though that might be hard to see in the post-hurricane data. We've yet to see anything to cause us to alter that view. Beginning with the November data, the economic data should be fairly "clean" (save for the residential construction data), which should make it easier to see the U.S. economy remains firmly on a path of solid growth.

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Q2 '17 (a)	Q3 '17 (p)	Q4 '17 (f)	Q1 '18 (f)	Q2 '18 (f)	Q3 '18 (f)	Q4 '18 (f)	Q1 '19 (f)		2016 (a)	2017 (f)	2018 (f)	2019 (f)
3.1	3.0	3.0	1.7	2.1	2.4	2.2	2.0	Real GDP[1]	1.5	2.3	2.4	2.0
3.3	2.4	3.2	1.8	2.2	2.2	2.0	1.7	Real Personal Consumption[1]	2.7	2.7	2.3	1.8
								Business Fixed Investment:				
6.7	6.8	4.7	3.6	3.1	2.8	2.3	2.2	Equipment, Software, & IP[1]	0.3	4.1	4.1	2.5
7.0	-5.2	0.9	4.4	3.1	3.4	3.8	2.9	Structures[1]	-4.1	5.5	2.3	2.8
-7.3	-6.0	4.1	6.1	8.2	12.7	12.6	10.2	Residential Fixed Investment[1]	5.5	1.1	4.9	9.8
-0.2	-0.1	0.5	0.6	0.7	0.9	1.0	0.9	Government Expenditures[1]	0.8	-0.1	0.5	0.9
-613.6	-595.5	-598.2	-611.8	-615.8	-619.4	-623.8	-627.4	Net Exports[2]	-586.3	-607.4	-617.7	-631.1
1.167	1.165	1.196	1.225	1.270	1.325	1.374	1.402	Housing Starts, millions of units[3]	1.177	1.191	1.298	1.442
16.8	17.1	17.4	16.7	16.4	16.3	16.3	16.1	Vehicle Sales, millions of units[3]	17.5	17.1	16.4	16.1
4.4	4.3	4.2	4.1	4.1	4.0	4.0	3.9	Unemployment Rate, %[4]	4.9	4.4	4.0	3.9
1.6	1.4	1.4	1.3	1.3	1.2	1.2	1.1	Non-Farm Employment[5]	1.8	1.5	1.2	1.1
1.6	1.8	1.7	1.6	1.9	1.8	1.8	1.9	GDP Price Index[5]	1.3	1.8	1.8	1.9
1.6	1.5	1.5	1.4	1.8	2.0	2.0	2.0	PCE Deflator[5]	1.2	1.6	1.8	2.0
1.9	2.0	1.7	1.4	2.1	2.1	2.2	2.2	Consumer Price Index[5]	1.3	2.0	2.0	2.1
1.5	1.3	1.5	1.4	1.7	1.9	1.9	2.0	Core PCE Deflator[5]	1.8	1.5	1.7	2.1
1.8	1.7	1.7	1.5	1.9	2.1	2.2	2.3	Core Consumer Price Index[5]	2.2	1.8	1.9	2.3
0.92	1.13	1.18	1.41	1.63	1.64	1.88	1.88	Fed Funds Target Rate, %[4]	0.39	0.97	1.64	2.02
2.26	2.24	2.36	2.50	2.60	2.70	2.80	2.90	10-Year Treasury Note Yield, %[4]	1.84	2.33	2.65	2.98
3.98	3.88	3.92	4.14	4.23	4.36	4.48	4.60	30-Year Fixed Mortgage, %[4]	3.65	3.99	4.30	4.68
-2.6	-2.6	-2.7	-2.6	-2.7	-2.8	-2.8		Current Account, % of GDP	-2.4	-2.6	-2.7	-2.9

a = actual; f = forecast; p = preliminary

Notes:
1 - annualized percentage change
2 - chained 2009 $ billions
3 - annualized rate
4 - quarterly average
5 - year-over-year percentage change

Regions Financial Corporation, 1900 5th Avenue North, 17th Floor, Birmingham, Alabama 35203

Richard F. Moody
Chief Economist

Greg McAtee
Senior Economist