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Intelligent Investing Panel

Don't Bet On A Retail Recovery

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Consumers are spending more, but mostly it's a dead cat bounce.

Though some numbers show that consumer spending has gone up recently, financial advisors do not anticipate a booming retail recovery. If you insist on playing the retail sector, however, you should look at value-oriented firms, rather than luxury brands.

First, some figures. Total January retail sales went up 0.5% seasonally adjusted over December and 3.2% unadjusted year-over-year, according to the National Retail Federation. Disposable personal income went up $45.9 billion (0.4%) in December from November.

Also, people not only have more cash but the jobs scene is also improving. Unemployment is currently at 9.7%; down from 10% in December, according to the Bureau of Labor Statistics. All this means that as the labor market gradually heals, consumers will eventually follow, right? Not so fast.

"Consumer spending is rising," says RiverSource Investments Chief Market Strategist David Joy, adding, "however, it is rising from very depressed levels and is not likely to become robust." In other words, retail might just be in the midst of a dead cat bounce.

Increased sales might not translate into increased profits for discounters, says Ron Roge, chief executive of R.W. Roge & Co. "I am cautious about the very aggressive discounting that may have been the driver behind those numbers," he says.

It's not hard to find examples of discounters that have seen their fortunes differ during the holiday season. For example Target is currently enjoying a bit of a renaissance, with its fourth-quarter sales up 3.7% year-over-year, to $19.7 billion from $19 billion. J. C. Penney, however, is on the other path, having seen its fourth-quarter sales slide $5.55 billion from $5.76 billion the year prior, a retracement of 3.6%.

Thesis Fund Management portfolio manager Stephen Roseman agrees with Roge's idea that deep discounting could hurt some retailers. "Although retail sales have increased, my concern is that it is coming at the expense of profit margins in the form of discounting to generate sales," he says.

The projections that last holiday season's retail sales would exceed expectations created growth in some retail stocks, says LPL Financial Chief Investment Officer Burt White. Urban Outfitters, for example, saw its stock price go from $32.63 on Nov. 25 to a peak of $35.64 on Dec. 29, and it is currently trading at just under $32. So since these rosy expectations are already baked into some of the stocks, the retail sector could disappoint investors, White adds.

For investors who find the retail sector's recent growth story more compelling, look for companies that are offering value. Granted, value is subjective, but Financo President William Susman says even luxury retailers can be considered value. Some of these companies are being redefined as high-end merchandise producers rather than just brand names, he says. That means consumers will spend when it comes to items such as Louis Vuitton handbags if they are perceived as a value and seem like a classic that can last for several years.

Telsey Advisory Group CEO Dana Telsey also stresses value as the trend for this 2010. She adds that companies such as Urban Outfitters and Saks Fifth Avenue will prosper because they have room to open stores and offer unique products.

Another trend this year is that stores that better tailor their merchandising to their consumers will thrive. Karabus Management CEO Antony Karabus notes that retailers need to work on their store productivity and focus on what consumers consider value to see improved sales. Retailers such as Macy's Inc. have honed in their store productivity through a program called My Macy's, which was designed to heighten sales growth by paying closer attention to merchandising. For example, stores in areas that see more traffic from teenagers would carry more junior-size clothing. Karabus described this program as a "fabulous strategy to become more relevant to local consumers."

Macy's fourth-quarter earnings beat expectations, though the company's sales were down 1.1% from last year at $7.85 billion. Even so, My Macy's helped to increase the retailer's online sales by 26.6% in the fourth quarter according to its latest earnings report.

For investors like White, who do not anticipate retail sales driving this recovery, look to business spending instead. He notes that in the fourth quarter gross domestic product business spending beat personal consumption by a rate of 7 to 1. "It is business spending that we have to watch for because that is what will drive the next phase of this recovery as stimulus-led growth passes the baton for growth to business," he says.

Run From Retail

Forbes: Some data is showing a modest turnaround in retail sales. If this is true, where would you invest or advise others to invest based on this info? What are some retailers that you like and what are some other companies that will benefit from a more robust retail environment?

David Joy: The retail sales data was encouraging. Consumer activity is rising, and that is good news. Since gross domestic product is measured relative to the prior quarter, consumer spending is, and will continue to make, a positive contribution. However it is rising from very depressed levels and is not likely to become robust. High unemployment, de-leveraging and the negative wealth effect from depressed home and portfolio values will conspire to keep consumer activity modest. Consequently, consumer discretionary stocks do not interest us very much. We prefer instead more global business-oriented sectors such as tech, industrials and materials.

Stephen Roseman: I have to agree with David on all accounts. I would like to add that although retail sales have increased my concern is that it is coming at the expense of profit margins in the form of discounting to generate sales. In addition, if we do not see continued improvement on the jobs data, any improvement in retail sales data may be short lived. That being said I think we are moving in the right direction.

Ron Roge: It's good to see that consumers are remaining active participants in our economic recovery. The consumer is an important part of GDP. The increase in the retail numbers looks relatively good because they are coming off the lows of last year and the very aggressive discounting by retailers. So an increase in retail sales may not translate into profits for the retailers. I am cautious about the very aggressive discounting that may have been the driver behind those numbers.

Burt White: I agree with all the comments already made. One other element is expectations. They have really gotten much more in-line with actual results, so we have no more surprises. In fact, the crowded trade in November and December was that retail for the holidays was going to be above expectations. That propelled growth in retail stocks. But now, expectations are quite high and I think the sector could match or disappoint.

In addition, we have to be very careful about viewing past recessions and recoveries to draw assumptions about this one. Over the last seven recessions before the latest one, reduced consumer consumption accounted for only 7.3% of the contribution to the negative GDP result. In other words, consumers spent right through the recessions. This time was different, as reduced consumer spending was 32% contribution of GDP's negative result. More importantly, in the last seven recoveries, increased consumer spending accounted for 56% of the increases in GDP. That is supportive of the study shown in the email you sent which says that consumers drive recoveries.

But I do not think that will happen this time around. Why? Consumers are in far worse shape. So it will likely be business spending that drives this recovery, not the consumer. In the fourth quarter 2009 GDP, business spending trumped personal consumption by almost seven to one.

Thus retail sales have increased. But that does not mean that they will predict a recovery or be good investments. Retail has improved, but that is because consumers stopped spending. Now they are spending some, but not enough to drive this recovery. It is business spending that we have to watch for because that is what will drive the next phase of this recovery as stimulus-led growth passes the baton for growth to businesses. While 2009 was all about companies "protecting profits" through spending cuts, I expect 2010 to be a transition year from simply surviving to the pursuit of growth. This transition from protecting the bottom-line in 2009 to growing the top-line in 2010 will be a key mile-marker in the economy's continued road to recovery. Consumers will just hang in there. Retail sales will not be the marker to watch. Rather, things like increases to cap-ex, re-hiring, number of new patent applications, dollars allocated to research and development and a number of new exploration projects will be more reflective of the strength of this recovery as opposed to retail sales.