

Economic Forecast for Retail for 2009 to 2010

'Hard pounding, Gentlemen'

An Economic Analysis and Forecast for the Retail Sector
from the Centre for Retail Research

The Main Questions

Most UK comment in any information medium about our economic prospects seems to boil down to, **'You're all doomed, doomed I tell ye'**.

As economic analysis this lacks analytical rigour, but perhaps shows why the index of consumer confidence fell from 93 points (June 2007) to 61 in June 2008.



Are things bad? **Yes**. Are things going to get worse? **Yes**.

What people really want to know is:

'How bad will things get?' and

'When will things start improving?'

'What will this mean for the retail sector?'

What happens if the politicians get it wrong?

That is what this paper is about. We avoid much economic jargon and graphs.

Centre for Retail Research

Since the centre returned to economic forecasting in 2003, we have had a successful few years. We correctly forecast the retail downturn in 2005-6, when others were blithely optimistic. We were correct about Christmas 2005 and 2006 (optimistic when others were blithely pessimistic 'the worst Xmas for 20 years' etc). We did not spot the crisis arriving last year and we did not believe that the chaos of September-October 2008 was theoretically possible.



Index of UK Manufacturing

We were correct in our belief that the Bank of England's fears about inflation would inhibit significant reductions in the bank rate, but not that they would spin on a sixpence in November 2008 and cut the rate to 3%. We did suggest that failing banks would be stuffed with liquidity and partially nationalised, which has occurred.

What is the Nature of the Current Economic Crisis?

There has been such an extensive account of the causes of our current problems elsewhere, that we'll keep this short.

To quote my first lecture on the banking system in October 1969, "All banking is based on a confidence trick. It only works if people believe it. If you or I did what banks do, we would be arrested for fraud. It's all about confidence." I said the same every year for 20 years, so it is not difficult to remember.

In those days, *confidence* was based on (a) reputations built up over centuries, (b) central bank control over the *quantity, quality* and *proportions* of assets banks held and their ability to lend, and (c) parsimonious lending by banks about how much they lent and to whom they lent. Rather like turn-ups on gentlemen's trousers these have all had their day.

Shortages of liquidity, the failure of inter-bank lending, and foolish lending to people who cannot repay are the immediate causes of the crisis. The collapse of asset values, particularly houses, has savaged the balance sheets of banks and other companies. They cannot borrow against depreciated assets; they cannot sell them; and the fall in asset values makes it imperative for banks and businesses to raise more cash and investment capital to bring their balance sheets into balance.

Financial panic that started with American mortgages and affected banks over much of the world has cut liquidity and the money supply, cut the sale of houses, and hit the domestic and commercial property markets. Consumer confidence and spending is cut to ribbons. Their wealth has fallen with the fall in shares, pension entitlement and house prices.

The three industries mainly affected are: banking/finance, housebuilding/ construction, and retailing. How important is this? Financial services and retailing together account for around 30% of the UK gross domestic product (GDP) - so pretty important. After a slow start, the problem of falling demand is now spreading quickly through the economy, *consumer led* in services, finance and building and *export led (downwards)* as foreign orders dry up as a result of the financial problems in other countries and business contractions because they are not selling so much abroad.

This was accentuated by a separate phenomenon - the increase in oil, food, and commodity prices, which produce a shift in assets in favour of producers of oil, farm goods, and raw materials. Recently, commodity prices have fallen back (see chart), which should reduce inflation. We don't see much prospect for further price advances over the next 18 months.



Whilst the impacts of the financial crisis and the commodity-price crisis are extremely serious, we feel that much of the comment from media and politicians is actually frightening people. We were talking ourselves into a depression and have now done so. The headline of the London Evening Standard, when the Bank cut interest rates by 1.5% following pleas from business, politicians, commentators, and the media was '**PANIC**'. Commentary seems to be directed to showing that actually things are *very much worse* than they seem to be.

Retail Forecast

This is about shops rather than international economics, but these are so tightly bound together that they can only be understood together.

The questions for retailers are:

- When will people start spending again?
- When will the economy turn upwards so that confidence returns?

The answer to both questions may be the same date, but probably won't be. Retailing is a 'leading indicator' that signals when things are turning nasty, but is one of the first to improve when things are starting to go right. Indications are varied, but retailing has been in trouble for a year.

We think there is a chance that people may start spending again late next year, but, unlike our previous forecasts, April/May 2010 has the best chance of marking a retail revival. Here are the prospects:

| | |
|------------------------------------|-----|
| Spending improves May/June 2009 | 5% |
| Spending improves October/Nov 2009 | 25% |
| Spending improves April/May 2010 | 50% |
| Spending improves 2011 | 20% |

You will note that we think there is a good chance that recovery will be delayed until 2011.

We may not know until April 2009 exactly how things stand for the next couple of years.

We expect this recession to last two years. However, unlike our January forecast, we feel its impact will be more severe and that there is little chance of a sizeable upturn in the latter part of 2009. We are optimistic about 2010.

Over the next 12 months, in volume terms - ie allowing for inflation - we expect

| | |
|---------------------------|-------------------|
| Retail sales | Fall by 0.8%-1.4% |
| Food & drink | Increase by 0.4% |
| Clothing and Footwear | Fall by 2.8% |
| Household, consumer goods | Fall by 4.7% |
| DIY/hardware/ | Fall by 6.0% |
| Entertainment | Fall by 1.9% |
| Books & stationery | Fall by 1.9% |
| Other | Fall by 1.0% |
| Internet sales* | Increase 55% |

(* includes retail merchandise only, not tickets or travel)

The performance of individual businesses may be very much better or very much worse than the above forecast.

We suggest a flat, although reasonable Christmas 2008, good New Year's sales, a flat February and March, good Easter, and variable sales in the rest of the year. We expect sales to be flat towards the latter part of the year (rather than declining), probably a good Christmas 2009 and things getting better thereafter.

Official Retail Expenditure data. This is so poor now that we suggest that ONS estimates of changes in monthly retail spending *should be completely ignored*. More comment on this later.

Rationale for the Forecast

Rather like the big dipper, you need to go down before you can go up.

- Economic news is dire and there is plenty of evidence that businesses and consumers have adjusted their spending patterns downwards. Retail sales are down, unemployment is rising, projects are being postponed and costs and capital investment cut.
- If this were simply a trade cycle involving weak demand it would be possible to forecast its track more precisely. Added to the trade cycle is: the failure of bank liquidity; weak bank balance sheets; collapse of the housing market; consumer fear and panic; and the destruction of created wealth by falling asset prices. It will be five years before consumers get their mojo back and they may never return to their old spending habits (but people do forget).
- However, there is evidence that people are reducing their reliance on credit; spending less; and that much consumer discretionary spending (eg holidays and consumer goods) has been cut back.
- Although people feel worse off, living standards for those still in a job should rise over the next 6 months compared to the last 6 months - fuel will be cheaper, mortgage payments lower, food prices falling. Not good, precisely, but **less bad**.
- A fiscal stimulus is likely in the UK and we can assume that the new US Government will do the same.
- In a few months' time therefore many people should have some cash available and may be prepared to increase the *proportion* of their spending that goes through the retail sector.

When will the economy stop falling?

There are 2 requirements:

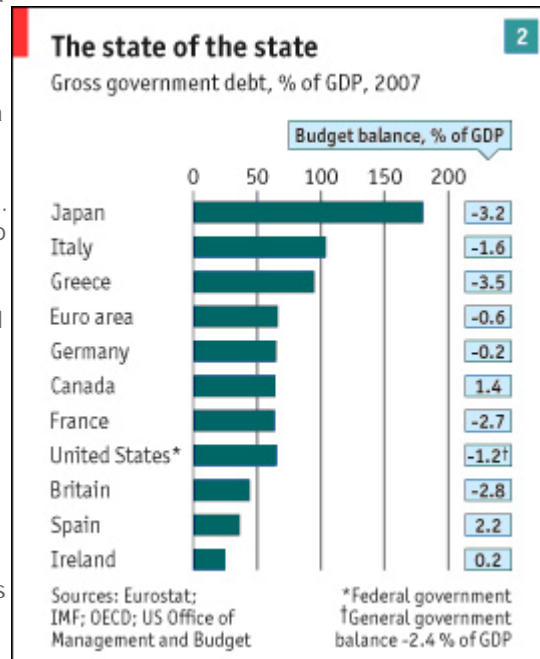
- **Banks:** When there are signs that (a) everything horrid in bank balance sheets is known and allowed for, and (b) bank liquidity in the UK and the US is sorted out. This is looking pretty good in the UK and by Christmas or January 2009, these problems may be screwed down pretty tight. The US looks pretty flakey, its system of government may inhibit anything radical, nobody knows whether Obama actually has an economics policy, etc etc so we will see.
- **Housing:** UK house prices stop falling, perhaps in April to June 2009. This will be the signal for all the people who have not been able to move house to get on with it, a resumption of borrowing, money starts to circulate etc.

By the middle of next year therefore, banking may be sorted, many people will have a bit more cash and savings (and have stayed away from shops for many months), and the housing market starts going again. Whilst it could be hectic enough for a reliable trend to start in September/October, we think the process will be very slow at first. **Less bad, therefore, rather than GOOD.**

A lot depends, therefore, on the prospects for jobs. The fall in exchange rates may assist job creation in manufacturing and financial services by April 2009. Unless we all get some more terrible shocks in 2009, things should turn up late in 2009. And a good Christmas 2009!

What Else Needs to Go Right?

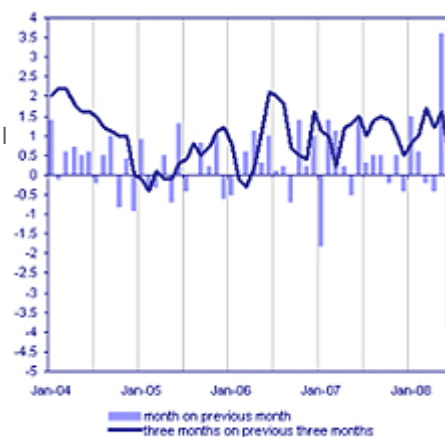
- Oil and commodity prices stay low or fall further- the Budget based its predictions on oil at \$83 a barrel, it rose to \$148 a barrel in July, falling to \$61 in November.
- When it becomes clear that inflationary pressures will not create a wage-price spiral in the UK.
- When bank liquidity improves so that they lend more readily to one another. This requires the Central Bank to keep pushing liquidity into the system. When banks get in difficulties, they need to be rapidly sold or nationalised so that the financial system does not break.
- Confidence in Banks improves
- The Sterling exchange rate stays midway between the US\$ and the Euro, supporting exporters.
- No more terrible shocks to the economy, and problems are cleared away quickly, including financial crises in Central and Southern Europe and the Far East. The table on state spending shows that some countries may have problems in debt servicing over the next 3-4 years.



We feel that the single most important issue is bank liquidity, and the second most important is house prices.

Statistical problems

We have felt for the last two years that the data published by the ONS (Office of National Statistics) do not report retail sales accurately. We first reported our fears in 2006, but were particularly concerned about the January 2007 results (see Retail Sales graph) which showed sales see-sawing between December 2006 to to March 2007. This is happening again - not the massive rise in the barchart in May 2008 and then the massive fall in June. This, we think, is the result of the ONS being too wedded to the old structure of retailing, insufficient measurement of aggressive discount stores, and weak data on Internet sales.



Retail Sales 2004-08

Increasingly, retailers are reducing prices across the range or concentrated on a small number of items and bringing in many new products for a short period only. This makes it exceptionally difficult to calculate changes in volume, particularly on a monthly basis.

Therefore the best (or *least bad*) measure of retail output for the next few years is likely to be retail sales value rather than volume measures. Although one will have to take price inflation into account, the problem is that ONS volume data on a current basis is likely to be incorrect.

General Outlook for Retail Sales

As explained in January 2008, we feel that unless there is a sudden deterioration this recession will last two years. However, *unlike* our January forecast, we feel its impact will be more severe and that there is little chance of a sizeable upturn in the latter part of 2009. We are very optimistic about 2010.

Over the next 12 months, in volume terms - ie allowing for inflation - we expect

| | |
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(* includes retail merchandise only, not tickets or travel)

This relates to major sectors only.

The performance of individual businesses may be very much better or very much worse than the above forecast.

Two Hard Years to Come: Who Benefits and Loses?

Although the financial services sector expects to lose 100,000 jobs, the areas that are least affected by the downturn will be prosperous ones, either attractive in themselves or recently modernised, with a good range of shops, surrounded by middle-class dormitory areas, particularly those with a high proportion of older 45-60 year people (low mortgages, high salary, high net worth).

Internet sales will continue to boom, increasing by a cumulative 55% per year.

Middle-of-the-road stores and franchisees will have a problem - too expensive and uninteresting for the poor and the strugglers, their clientele will become increasingly elderly. More prosperous consumers will also avoid them in favour of a combination of more aggressive discounters and quality middle-class shopping.

Successful business areas will include mothers and babies (at last, a baby boom), food supermarkets, electronic games, recreational wear and cycling. Good quality environmental/ethical retailers should do reasonably well if what they do is related to what people prize, they tell a good story, and they are located in a reasonable shopping area.

This could be the time, when multiple retailers with hundreds of stores decide to close 20% to 30% of their retail branches to concentrate on the Internet and their remaining more successful outlets.

The Crisis: 2008-2010 Retailing's Best of It and Worst of It

The Worst of It

Second- and third-tier shopping centres

Out-of-town retail parks, particularly remote and/or nondescript ones

The Best of It

London retail

Internet retailing

| | |
|--|--|
| Nondescript second and third rank towns such as Northampton, Coventry, Bradford, Banbury, Huddersfield | Centres of high-quality revamped major cities like Birmingham, Leeds, Glasgow, Cardiff |
| Landlords and property developers | Food and drink retailers |
| Middle-of-the-road retailers selling to lower income consumers | Smartish areas of towns with a good range of traffic-builder stores and nice independent stores |
| Low-income areas, former industrial areas of England and Wales | Market towns with significant middle-class enclaves, e.g. Newark, Chipping Norton, Harrogate, Malton etc |
| Badly-thought through, costly takeovers | Large aggressive retailers with low cost base that gobble up competitors without overpaying |
| DIY/hardware, furniture, carpets | Discounters |
| Electrical retailing through stores | Garden products |
| Clothing and footwear retailers, particularly middle-of-the-road | Holiday towns with a good reputation |
| Tired-out City centres | Farmers |
| Butchers | Electronic games |
| Premium products/retail formats not meeting valued customer requirements. | Green retailing formats that are more than middle-class twaddle |
| Newsagents, toys, | Mother and baby stores |
| Coffee shops | Bicycles, leisure outerwear, pet shops |

How Do We Stand Compared to Others? European Retailing Prospects 2009

Britain is not the only country affected by these worldwide problems. Here are our predictions for a range of other European countries in 2009. The classification relates to retailing only.

The main retail issues with these countries concern: housing crisis (Spain); banks (Switzerland and Germany); export problems (Germany and France); overvalued currency (Portugal, Spain, Italy, Greece); blowout (Ireland); serious banking issues/central banking (Hungary, Czech, Romania, Bulgaria, and Greece).

Retail Prospects in 19 European Countries 2008-10

| Weak (small fall -0.2%- 1.2%) | Not Good (Some fall -½% - 2%) | Poor (retail fall 2½%+) |
|--|--|--|
| Poland | UK | Italy |
| Finland | Denmark | Greece |
| Switzerland | France | Spain |
| Sweden | Netherlands | Ireland |
| Germany | Belgium | Portugal |
| Czech Republic | Hungary | Romania |
| Russia | | Bulgaria |
| Norway | | Greece |

'Hard pounding, Gentlemen' as the Duke of Wellington announced to his officers during the Battle of Waterloo as cannon fire was blowing off their arms and legs.

For 2008-2010 this could be the watchword of every retailer in the land.