
# Deep Dive: Retail X Factor— The US Economy

1) This is the first report in our *X Factor* series in which we identify themes that we believe will be critical for the US retail landscape throughout 2017 and beyond. In this report, we look at the macroeconomic backdrop in the first quarter of 2017, and analyze the economic outlook and how this could impact retail for the rest of the year.
2) In 1Q17, the US economy saw its weakest real GDP growth of 0.7% since 2014, mainly due to a warm winter which inhibited the consumption of goods and services. One beneficiary of this warmer winter was the US housing market, which saw 8.1% more housing starts and 15.6% more new home sales than last year.
3) Another sign of the strength of the overall economy is the unemployment rate, which is at a historical low of 4.4%.
4) Retail sales experienced year-over-year growth of 5.7%, 5.9% and 5.4%, respectively, in the first three months of the year, driven by increasing inflation and gains in income.
5) We expect favorable policies, including tax cuts, and strong fundamental macro data to support growth for the remainder of 2017.

Deborah Weinswig
Managing Director,
Fung Global Retail & Technology
deborahweinswig@fung1937.com
US: 917.655.6790
HK: 852.6119.1779
CN: 86.186.1420.3016

## Table of Contents

## Executive Summary

This is the first report in our *X Factor* series in which we identify themes that we believe will impact the US retail industry. In this report, we review the macro picture for the first three months of the year, and analyze the macroeconomic factors that could impact retail the rest of the year.

**The Macro Economy as an X Factor for Retail**

Despite the ongoing retail revolution in the US, retail sales in 1Q17 grew at their highest rate since 1Q12. Consumers demonstrated strong confidence in the economy, as evidenced by buoyant consumer sentiment, and the rising inflation rate was generally favorable for retailers.

A strong US economy is a tailwind for US consumers and, in turn, for retailers. However, not all retailers are created equal—the ongoing shift to online shopping and the change in consumers' preferences for experiences over products means that the retail landscape will continue to evolve. That being said, those retailers struggling at the bottom will not be able to shift the blame for their predicament on economic factors, as the US economy looks set to remain on a steady course for the remainder of 2017.

**1Q17 Review**

*The US economy decelerated in 1Q17, negatively affected by unconventionally warm weather and delays in tax refunds.*

The US economy decelerated in 1Q17, negatively affected by unconventionally warm weather and delays in tax refunds. At the same time, the housing market continued to grow, contributing 0.5% of the 0.7% GDP growth. The US unemployment rate also hit a 10-year low in April, at 4.4%, pointing to a resilient job market. Overall, we believe the slowdown in the first quarter will not extend into the rest of the year, as strong fundamentals and a strong housing market look set to support economic growth.

**Figure 1. Summary Table of Macro Factors**

| Macro Factor | FGRT's Interpretation* | Description |
|---|---|---|
| **Gas Price** | – | Gas prices are likely to rise in future, due to production cuts in crude oil. |
| **Job Market** | + | A recent job report indicates full employment is approaching, as the unemployment rate continues to edge lower and increases in nonfarm payrolls show a strong trend. |
| **Consumer Spending & Income** | = | We expect consumer spending and disposable income to be boosted by strong fundamentals in the economy, but negatively affected by increasing gas prices. |
| **Housing Market** | + | Increasing home prices are generating a wealth effect which encourages consumption and borrowing. Interest rates may increase moderately, but we expect the housing market to remain solid. |
| **Retail Sales** | + | We expect strong retail sales growth to continue throughout the year, driven by positive consumer sentiment. |

** Fung Global Retail & Technology's evaluation of the macro factor's impact on consumption: + indicates a positive effect on consumption; – indicates a negative effect; and = indicates a negligible or mixed effect.*
*Source: Fung Global Retail & Technology*

Deborah Weinswig, Managing Director, Fung Global Retail & Technology
deborahweinswig@fung1937.com US: 917.655.6790 HK: 852.6119.1779 CN: 86.186.1420.3016

## Macro Environment

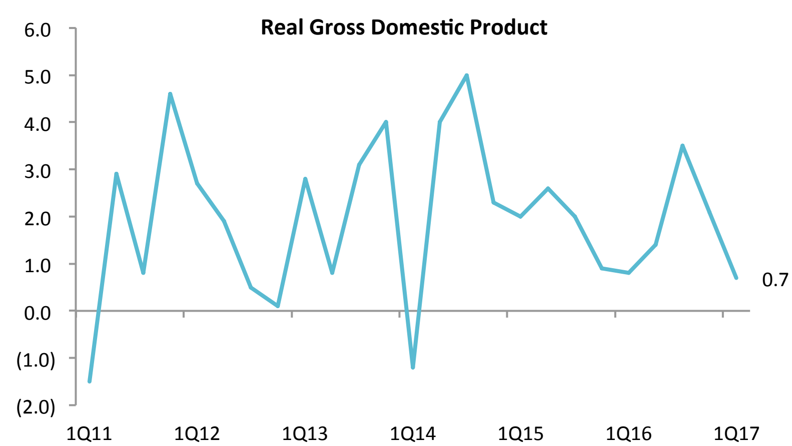
**Real GDP (-)**
GDP growth in 1Q17 slowed to its lowest level since 2Q14, at 0.7%, from 2.1% in 4Q16 and 1.1% in 1Q16, missing the consensus estimate of 1.2%. The weakness can be attributed to following factors:

*We expect the weak performance of 1Q17 to be a one-off, and do not expect it to persist into the rest of the year.*

- **An unusually warm winter:** The warm winter inhibited consumer demand for seasonal products, such as heating appliances and cold-weather apparel.
- **Delayed tax refunds from the IRS:** The PATH Act enacted earlier this year to combat tax fraud delayed tax refunds.
- **Increasing savings rate:** The increasing savings rate, possibly driven by political uncertainty, has led to decelerated consumption.
- **Inflation:** The core personal consumption expenditures index rose to its highest since 2011, which offset some benefits from wage gains.
- **Investment:** Businesses invested less in inventories, which dragged down overall GDP by almost a full percentage point.

We expect the weak performance of 1Q17 to be a one-off, and do not expect it to persist into the rest of the year for two reasons: 1) the warming climate trend will turn into a positive for the coming summer; and 2) the strength of the housing market and the low unemployment rate are evidence the economy is fundamentally resilient.

**Figure 2. Real GDP**




*Source: US Bureau of Economic Analysis*

**Employment (+)**
The US job market had its strongest quarter in 1Q17 when compared with the past 10 years. The unemployment rate hit its lowest level since May 2007, dropping to 4.4% in April.

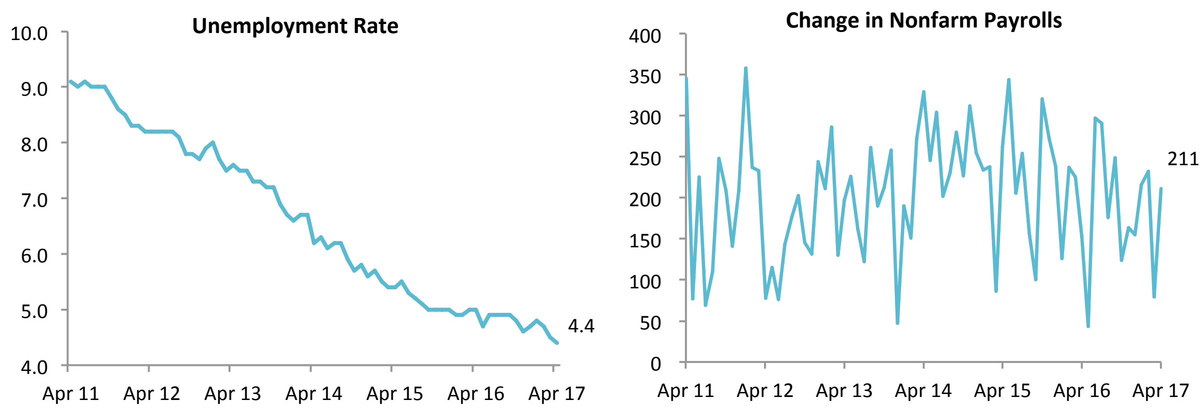
Nonfarm payroll was 211 in April, rising from 79 the previous month and higher than 153 in April 2016.

Deborah Weinswig, Managing Director, Fung Global Retail & Technology
deborahweinswig@fung1937.com US: 917.655.6790 HK: 852.6119.1779 CN: 86.186.1420.3016

*The decline in unemployment was partly driven by growth in new jobs.*

The decline in unemployment was partly driven by growth in new jobs, with the US economy adding 211,000 jobs in April, beating the 190,000 consensus estimate.

**Figure 3. Unemployment Rate (%); Change in Nonfarm Payrolls ('000)**



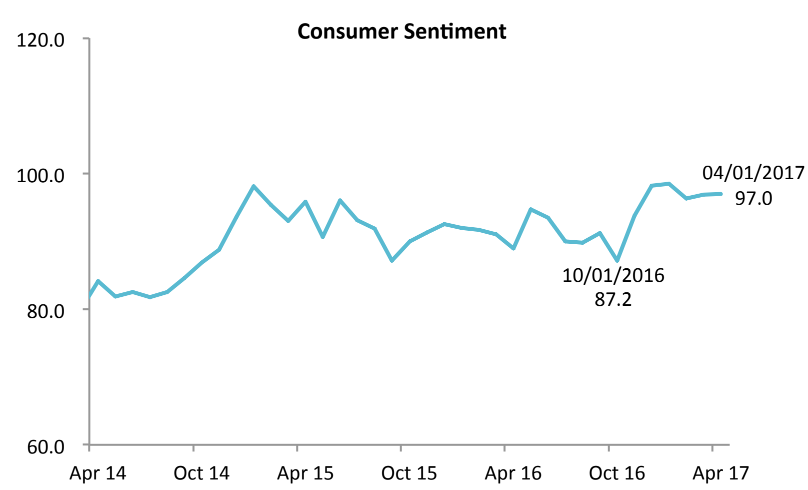

*Source: US Bureau of Economic Analysis*

## Consumption

**Consumer Sentiment (+)**

US consumer sentiment increased to 97.0 in April 2017, from 96.9 the previous month and 89.0 in the year-ago period. The higher figure is the result of the strong US job market and reflects consumers' firm confidence in the economy.

**Figure 4. Consumer Sentiment**




*Source: University of Michigan*

*We expect strong consumer spending numbers over 2H17, with low unemployment and improving real disposable income.*

**Consumer Spending and Income (+)**

Personal consumption expenditure (PCE) was 0.3 in March 2017, up from (0.1) in February.

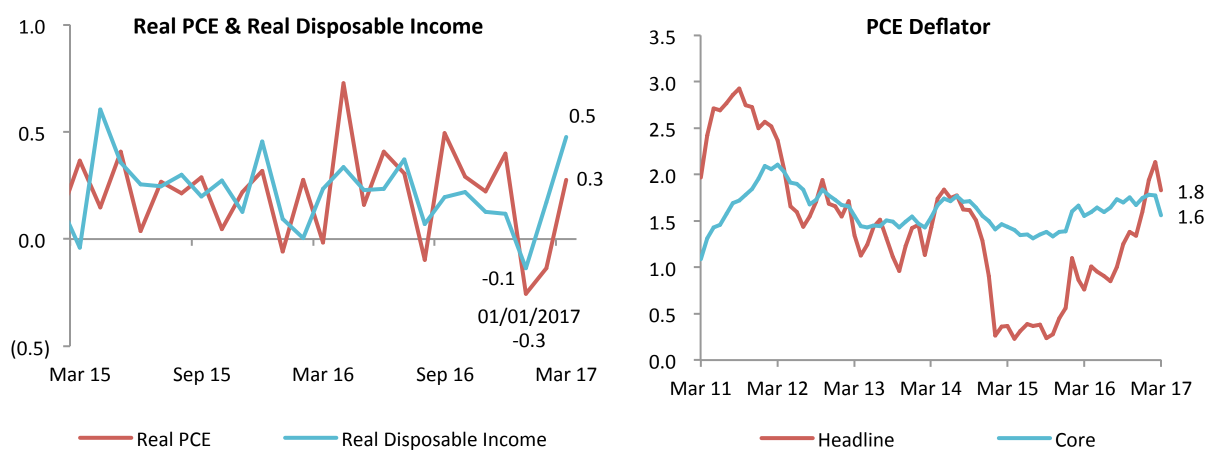
Real disposable income increased steadily by 0.5% month over month in March.

The headline PCE deflator reached 2.1 in February, a 5-year peak, then adjusted to 1.8 in March.

The savings rate reached 5.9% in March 2017, steadily rising since December 2016. Although consumers appear to be more cautious amidst the backdrop of political uncertainty, we do not believe this will affect aggregate consumer spending in a significant way for the remainder of year.

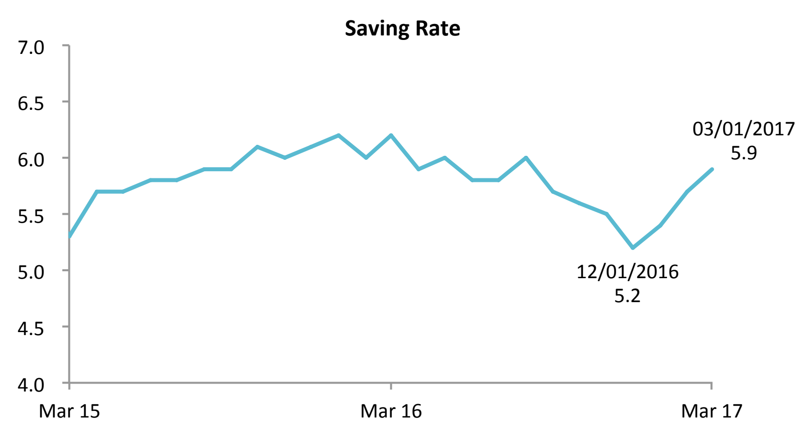
We expect strong consumer spending numbers over 2H17, with low unemployment and improving real disposable income.

**Figure 5. Real PCE & Real Disposable Income (MoM % Change); PCE Deflator (YoY % Change)**




*Source: US Bureau of Economic Analysis*

**Figure 6. Savings Rate (%)**



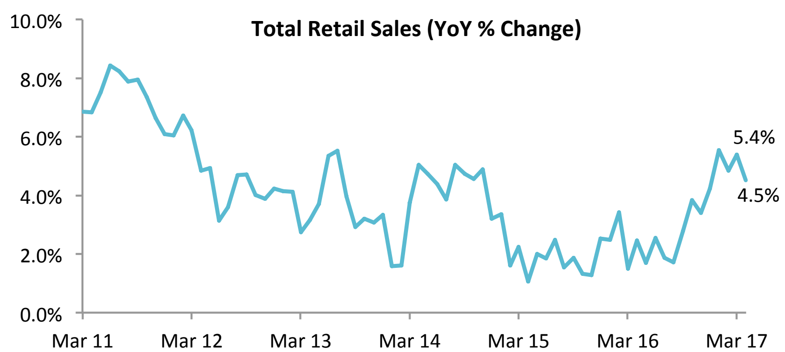

*Source: US Bureau of Economic Analysis*

*Higher consumer spending and confidence will help lift retail after the weak performance during the winter.*

**Retail Sales (+)**

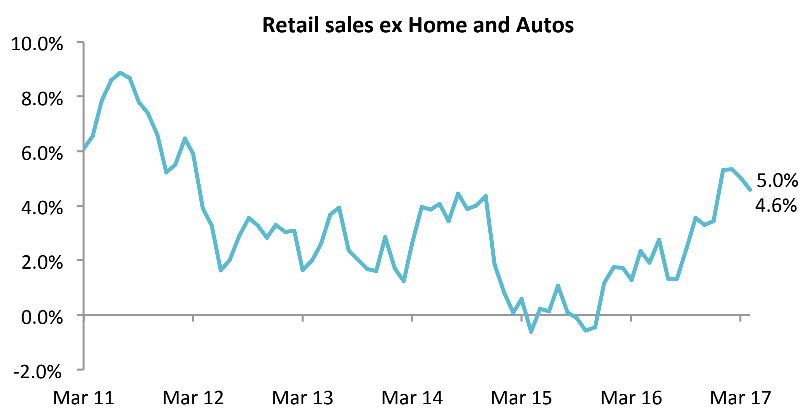
Total US retail sales in March decreased by 0.2% month over month to $470.8 billion. However, on a year-over-year basis, retail sales rose by a solid 5.4% in March and 4.5% in April. Higher consumer spending and confidence will help lift retail after the weak performance during the winter. An improving inventories-to-sales ratio also indicates an acceleration of retail sales in 1Q17.

**Figure 7. Total Retail Sales (YoY % Change)**



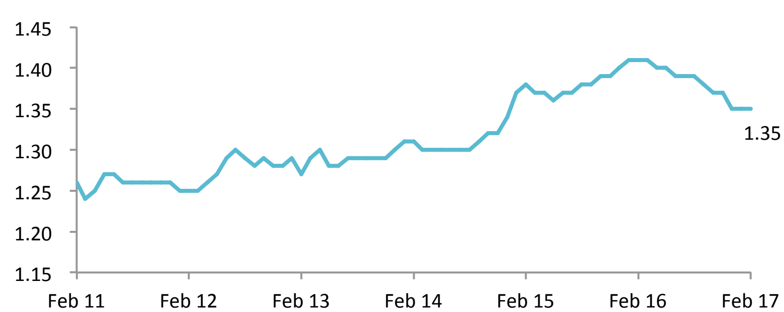

*Source: US Bureau of the Census*

**Figure 8. Retail sales ex Home and Autos**




*Source: US Bureau of the Census*

**Figure 9. Inventories-to-Sales Ratio**




*Source: US Bureau of the Census*

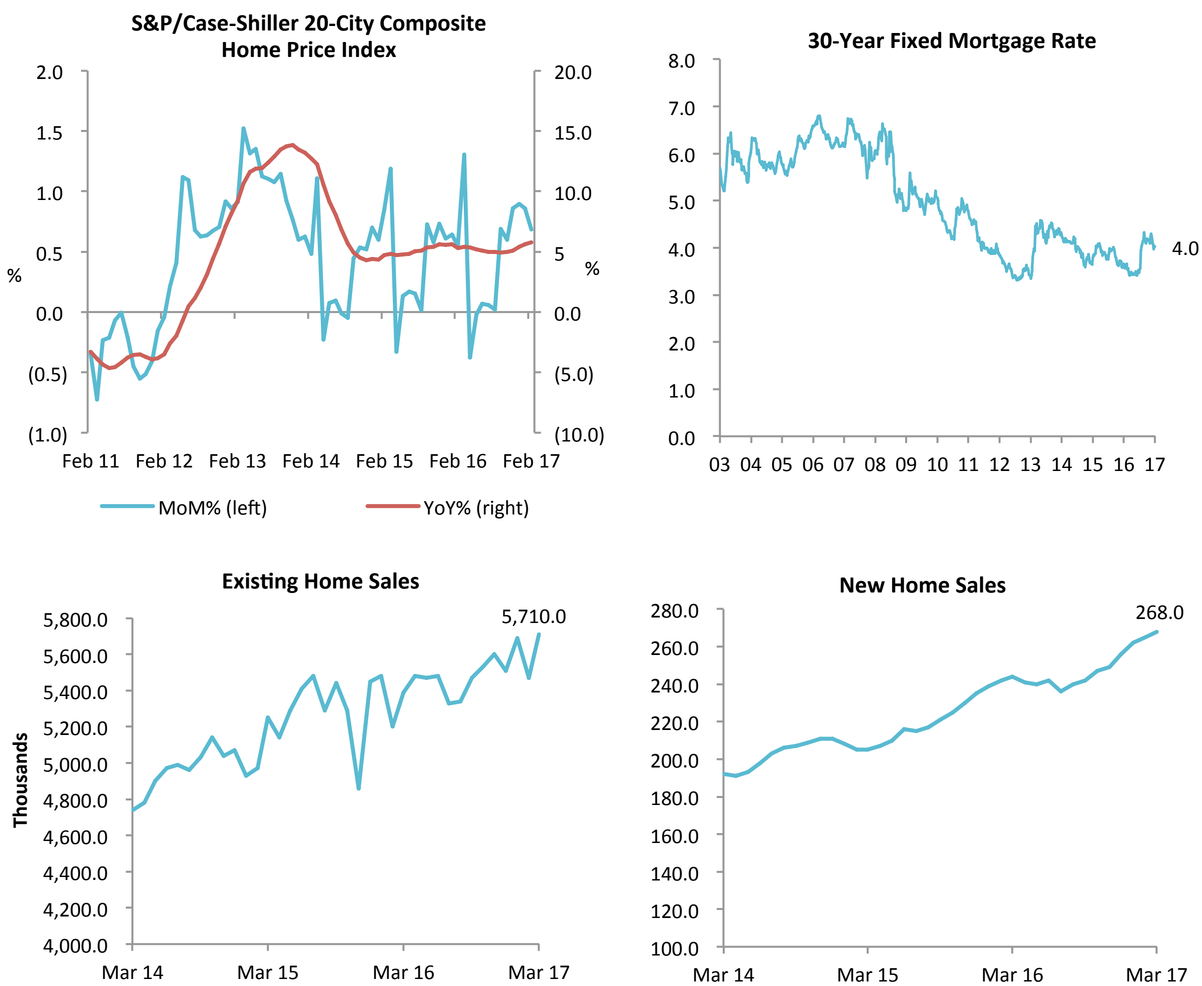
*The housing market was strong in 1Q17, as home prices continued to increase.*

**The Housing Market (+)**

The housing market was strong in 1Q17, as home prices continued to increase. The S&P/Case-Shiller 20-City Composite Home Price Index increased by 0.9% and 0.7% month over month, respectively, in January and February. The warm weather accelerated construction activity, boosting housing starts in 1Q17 by 8.1% year over year.

Low interest rates continue to be favorable for the housing market. The 30-year fixed mortgage rate was 4.0% in April, lower than the 4.1% in March, but higher than its historical low of 3.6% last April.

**Figure 10. S&P/Case-Shiller 20-City Composite Home Price Index; 30-Year Fixed Mortgage Rate (%); Home Sales ('000)**




*Source: S&P/Case-Shiller/Freddie Mac*

New home sales jumped for the third consecutive month in March, increasing by 15.6% year over year, the fastest pace of growth since July 2016.

Existing home sales increased by 4.4% year over year in March, driven by significant supply shortages in recent months.

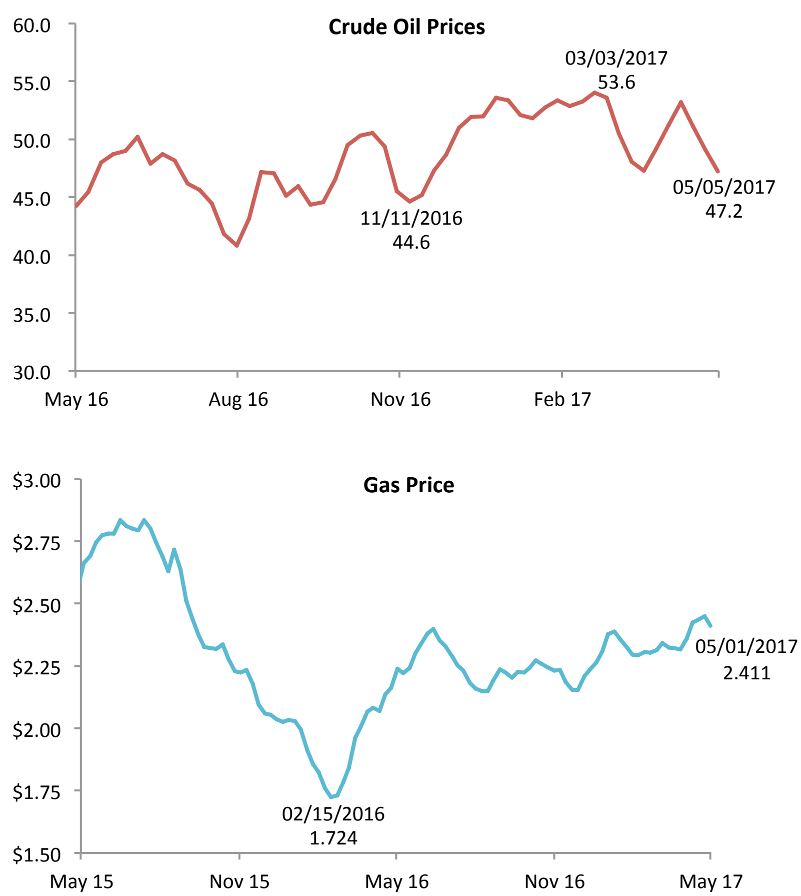
*Savings created by the low price of gas have boosted spending on food services and experiences.*

**Commodities: Crude Oil (=) and Gas Price (–)**

The crude oil price has been hovering at a relatively stable range between $45 and $54 for the past six months. The crude oil price declined to US$47.2/barrel on May 5, 2017, below the 1Q17 average of US$51.7/barrel and higher than the 2016 average of US$43.2/bbl. The production cuts agreement among OPEC and concerns over lingering oversupply keep the crude price fluctuating.

The gas price in the US was $2.4 per gallon in May, up 9% from $2.2 per gallon in the year-ago period, hitting a 12-month high. Savings created by the low price of gas have boosted spending on food services and experiences. A rebound in gas prices could reduce such spending.

**Figure 11. Crude Oil Prices ($/Barrel); Gas Price ($/Gallon)**




*Source: US Energy Information Administration*

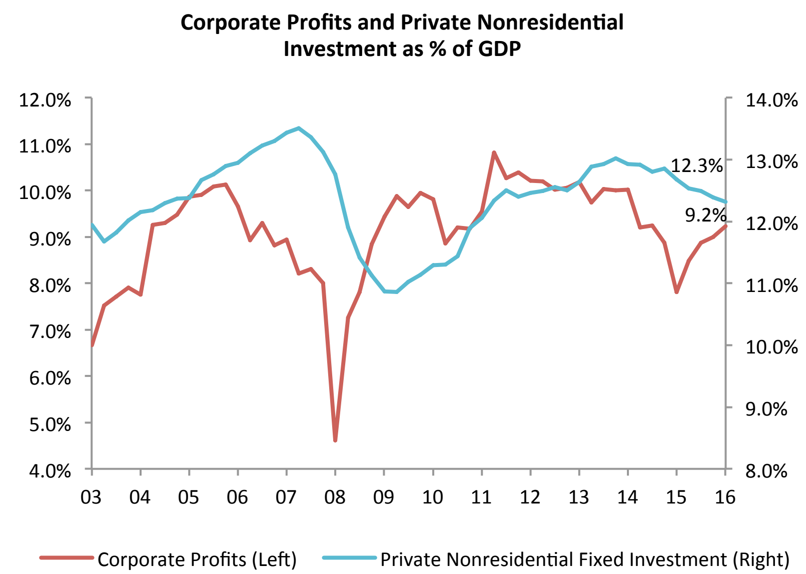
## Corporate Profits and Private Nonresidential Investment

As a percentage of GDP, the corporate profits rate increased to 9.2% in October 2016, from 7.8% in October 2015.

*We expect business investment to pick up again as corporates get more clarity on taxes and policy in the second half of 2017.*

Nonresidential investment dropped to 12.3% in 4Q16, as US businesses are investing less in their inventories, likely due to policy uncertainty. The recent 1Q17 data show a slight improvement in nonresidential investment to 12.5% of total GDP. We expect business investment to pick up again as corporates get more clarity on taxes and policy in the second half of 2017.

**Figure 12. Consumer Profits and Private Nonresidential Investment**




*Source: Bureau of Economic Analysis*

## Outlook

We expect the economy to continue to grow at a healthy pace, benefitting from the new administration's proposals.

*We expect the economy to continue to grow at a healthy pace, benefitting from the new administration's proposals.*

- **Firm GDP growth:** The Federal Reserve Bank of Atlanta forecasts GDP growth of 3.6% in the second quarter.
- **Reduction in taxes:** A massive reduction in taxes for residents should boost consumer spending. We expect consumer discretionary or luxury retailers to benefit.

Deborah Weinswig, Managing Director, Fung Global Retail & Technology
deborahweinswig@fung1937.com US: 917.655.6790 HK: 852.6119.1779 CN: 86.186.1420.3016

**Deborah Weinswig, CPA**
Managing Director
Fung Global Retail & Technology
New York: 917.655.6790
Hong Kong: 852.6119.1779
China: 86.186.1420.3016
deborahweinswig@fung1937.com

**Kiril Popov**
Senior Analyst

**Charlie Poon**
Research Assistant

**Zane Yang**
Research Assistant

**Hong Kong:**
8th Floor, LiFung Tower
888 Cheung Sha Wan Road, Kowloon
Hong Kong
Tel: 852 2300 4406

**London:**
242-246 Marylebone Road
London, NW1 6JQ
United Kingdom
Tel: 44 (0)20 7616 8988

**New York:**
1359 Broadway, 18th Floor
New York, NY 10018
Tel: 646 839 7017

**FungGlobalRetailTech.com**