Retailing: Survival of the Fittest

See the collection of the individual charts linked below.

(1) For the birds. (2) Doves, hawks, and cranes at the Fed. (3) Two FOMC voters see gradual rate hikes. (4) Two FOMC nonvoters see less and more gradual paths. (5) Last department stores standing do so by selling space. (6) Strategic partners are a survival strategy for retailers. (7) Toys were Us. (8) Blockchain could solve Trump’s trade problem. (9) Maersk keeping track of shipping containers with blockchain. (10) US trade deficit problem worsening, especially with China, as US economy expands.

The Fed: Bird Watching. Melissa and I don’t know much about ornithology. But from what we gather, several members of the Fed are aligning much more with whooping cranes than hawks or doves at the moment. Whooping cranes’ calls can carry far and express warnings to their partners about potential danger ahead. But the birds aren’t particularly predatory themselves. They are more like doves than hawks.

As we discussed earlier this week in the 3/14 Morning Briefing, the calls of two of the three Fed governors, namely Lael Brainard and Fed Chair Jerome Powell, currently are bullish on the US economy yet cautious. Both are permanent FOMC voters and continue to think that a “gradual” pace for monetary policy normalization is appropriate even as economic “headwinds” shift to “tailwinds.” Two regional Fed bank presidents chimed in following Powell’s and Brainard’s recent speeches with similar bullish talk couched in caution, but neither of them gets a vote in the FOMC rotation this year.

The Fed is on course for three rate hikes this year. That is what we expect, unless the whooping turns into a clearly hawkish screech. For now, we are not seeing an obvious shift in the Fed’s flight pattern. Consider the following:

(1) A bit faster (maybe). In a speech last Friday, Boston Fed President Eric Rosengren repeated the magic word: “gradual.” He said: “To keep the economy on a sustainable path, I expect that it will be appropriate to remove monetary policy accommodation at a regular but gradual pace.” Even so, Rosengren warned that too much stimulus could promote a “boom and bust” cycle that policymakers will want to avoid. In his mind, a “regular but gradual pace” for 2018 could be “a bit faster than the three, one-quarter point increases envisioned for this year” in the Fed’s December projections. He chalks up the softness in inflation of late to transitory factors.

Rosengren hedged his bets, though, saying: “Of course, following through on this expectation is conditional on the economy unfolding about as expected, and that unexpected events such as a trade war or a substantial change in the geopolitical situation do not surprise on the downside.”

(2) Wait & see. In an interview with CNBC on the same day, Chicago Fed President Charles Evans said that he’d prefer to “wait a little longer” beyond the next FOMC meeting before raising interest rates. Evans would prefer to see the “transitory” factors weighing on inflation “fall out” before moving ahead. Nevertheless, his tone was basically bullish, except on wage growth, which he’d like to see stronger. Evans concluded that the trajectory of rates is much more important than whether there are “three, two, four rate increases” this year.
(3) **Breadcrumb trail.** The FOMC has seven more meetings this year. No change was made to rates at the first meeting of the year in January, which had been former Fed Chair Yellen's last one. The new Fed chair is likely to lead the March meeting with a 25bps increase, as widely expected. After that, three more FOMC meetings this year will have an associated updated Summary of Economic Projections released and a press conference held by Powell—during June, September, and December. We see a “gradual” 25bps (give or take) rate rise at two of those three meetings, not much to whoop about. We will be on the lookout for more obvious warning signs after the March FOMC meeting, particularly in the March Summary of Economic Projections.

**Retailers: Selling Space.** The 2017 end-of-the-year rally that propelled investors to snap up retail shares has lost a little steam this year. However, you’d never know it by looking at the performance of the S&P 500 Consumer Discretionary stock price index, which is up 7.1% ytd, beating all of the S&P 500 sectors save Technology.

Here’s the performance derby for the 11 S&P 500 sectors ytd through Tuesday’s close: Technology (10.2%), Consumer Discretionary (7.1), Financials (4.5), Health Care (4.2), S&P 500 (3.4), Industrials (1.3), Materials (0.4), Consumer Staples (-4.8), Telecom Services (-5.4), Real Estate (-5.6), Utilities (-6.3), and Energy (-6.6) (Fig. 1).

The Consumer Discretionary sector is being weighed down by Specialty Stores (-8.7% ytd), Home Furnishings (-7.1), Home Improvement Retail (-6.3), Apparel Retail (-2.5), and General Merchandise Stores (-0.9). The slide in these industries was corroborated by the 0.1% m/m drop in February retail sales. It was the third month in a row the indicator has fallen—the first time that has happened since 2012, Debbie reports. That said, retail sales are still up 4.0% y/y.

The negative momentum in the above retail industries has been more than offset by the gains in the Internet & Direct Marketing Retail industry, home to Amazon and Netflix, which is up 37.0% ytd. The S&P 500 Department Stores index is also solidly in the black, up 15.3% ytd. Exclude the Internet & Direct Marketing industry, and the Consumer Discretionary sector is down 2.1% ytd. Back out the Department Stores industry as well, and the Consumer Discretionary sector is down 2.3% ytd, according to Joe’s calculations.

The S&P 500 Department Store index’s three members—Kohls, Macy’s, and Nordstrom—all have outperformed this year. But not all department stores are faring well. Shares of Sears Holdings are down 28.8% ytd, and regional department store Bon-Ton Stores filed for Chapter 11 bankruptcy protection in February.

Within the trio of department store outperformers, Kohl’s stands out for both the strongest stock performance and for reimagining ways to better use its bricks-and-mortar stores. The retailer’s stock is up 18.2% ytd and 61.0% over the past year. Let’s take a look at what this department store has done to shake off the industry’s blues:

(1) **Smaller is smarter.** Kohl’s has been opening smaller new stores and shrinking existing ones. Smaller stores are roughly 35,000-55,000 square feet instead of the traditional 80,000 square feet. The smaller size allows the company to enter smaller markets and carry less inventory without losing sales.

At the end of Q4, 300 of the company’s stores were in the small-to-standard size category, and Kohl’s anticipates continuing the rollout of the program to another 200 stores this year.

Sometimes, Kohl’s will sublet its extra space to other retailers. In Framingham, Massachusetts, Kohl’s...
cut 20,000 square feet, and the landlord leased the excess space to a Pier One. Another Kohl’s, in Medford, Massachusetts, cut 30,000 square feet that was then leased to Wegmans, according to a 2/23/17 article in the Milwaukee Journal Sentinel.

The company believes grocery stores and gyms are ideal new neighbors because both draw traffic to the stores. And since most Kohl’s are in strip malls instead of traditional malls, their locations are in demand. Kohl’s latest announcement: It will lease space in five to 10 of its stores to Aldi, the German grocer expanding aggressively in the US.

Kohl’s hasn’t been aggressively closing stores as have some of its competitors. It ended 2017 with 1,158 stores and selling footage of 82.8 million square feet, down only slightly from 2015 levels of 1,164 stores and 83.8 million square feet.

(2) New partners. Investors are excited about the deals Kohl’s struck with Amazon and Under Armour. Starting in October, Kohl’s began providing free returns for Amazon customers in 82 Kohl's stores across Los Angeles and Chicago. The deal offers Amazon customers added convenience and gives Kohl’s a new way to drive traffic to its stores.

Kohl’s also benefitted from the addition of Under Armour products to its active wear collection. The two companies struck a distribution deal in 2016, and sales began last spring. Kohl’s footwear and apparel same-store sales grew 25% in Q4, thanks to high-single-digit increases in Nike sales, double-digit increases in Adidas sales, and the introduction of Under Armour product, the company revealed in its Q4 conference call.

(3) Opportunistically pouncing. Those retailers that are still standing look to benefit from the massive store closures done by the industry’s weakest. Kohl’s results were “further aided by our successful efforts to capitalize on competitive store closures in our markets,” said CEO Kevin Mansell, in the Q4 conference call.

The pace of store closures is slowing a bit, but remains elevated. This year to date, there have been 2,160 store closure announcements and 1,588 opening announcements, for a 1.36-to-1 closure-to-opening ratio, according to CoreSight Research. That’s a slight improvement over the 2.2-to-1 ratio for 2017. Closures ytd were announced by Sears and Kmart (103), Bon-Ton (47), Macy’s (11), and JC Penney (8).

Toys “R” Us announced 182 store closures ytd, but the company may be about to liquidate its entire business instead of restructuring it in bankruptcy protection, said the sources for a 3/13 CNBC report. If liquidation is in the company’s future, all of its 800 stores, including roughly 200 Babies R Us stores, could be closing. Amazon, Target, Walmart, and Bed Bath & Beyond (which owns buybuy BABY) would stand to benefit.

(4) The numbers. The S&P 500 Consumer Discretionary sector has strong revenue and earnings growth to back up its healthy stock performance over the past year. Analysts forecast the sector’s revenues will grow 6.9% this year and 5.7% in 2019, while its earnings grow 16.9% this year and 12.2% in 2019 (Fig. 2 and Fig. 3). After suffering through negative net earnings revisions over the last three-plus years, the sector benefited from net positive revisions in January and February (Fig. 4). This positive news is reflected in its reflating forward P/E, which stands at 20.0. But the P/E shrinks to a much more reasonable 15.1 after Joe backs out the Internet & Direct Marketing Retail industry.

The statistics for the Department Stores industry aren’t as comforting. The industry’s revenue is expected to increase by only 0.1% this year and 0.5% in 2019. And analysts are forecasting 9.2%
earnings growth this year and a 3.1% decline in earnings in 2019. While this industry also has pleasantly surprised analysts over the last two months, investors certainly should shop carefully despite its below-market forward P/E of 10.9 (Fig. 5 and Fig. 6).

Blockchain: The Tariff Alternative. You might not like tariffs, but you’ve got to tip your hat to President Trump for addressing the US trade deficit, the elephant that most politicians ignore. With his plan to slap 25% tariffs on steel and 10% tariffs on aluminum imports—for good or ill—he has brought the issue of the US trade deficit front and center.

That said, might we suggest that President Trump consider using blockchain technology to solve trade imbalances, instead of the blunt instrument of tariffs? By using blockchain, the US could gather better data on who is dumping steel, at what price, and pinpoint where it was produced. Blockchain might also be used as part of a system that could proactively prevent dumping. Let’s take a look at how this 21st century technology might be used to solve a problem as old as time:

(1) Blockchain basics. We’ve long been fans of blockchain, the technology behind bitcoin and other cryptocurrencies. It’s a distributed ledger, or database, where data of all sorts is housed in multiple locations, so that, in theory, it cannot be hacked. To change the data, it must be changed in all of the locations, and all of the holders of the data must agree to the change.

(2) Spreading fast. The implementation of blockchain is gaining momentum. A 3/11 WSJ article gave some examples: “Already, 1.1 million items sold or on sale at Walmart are on a blockchain—including chicken and almond milk—helping the company trace their journey from manufacturer to store shelf. Global shipping giant Maersk uses the same technology from IBM to track shipping containers, making it faster and easier to transfer them and get them through customs. … Everledger, a company started in April 2014 with the intention of creating a blockchain-based registry of every certified diamond in the world, already has 2.2 million diamonds in its registry. It’s adding about 100,000 diamonds a month, says Leanne Kemp, chief executive and founder.”

Other potential uses for blockchain include tracking property titles, loans, deposits, derivative contracts, stocks, and bonds. It could be used by retailers to ensure their goods are indeed organic or being produced using fair-trade or sustainable practices.

Chinese companies have also adopted blockchain. JD.Com is working with a state-backed research institution to track bird nest imports using blockchain to block counterfeits, a 3/1 article from Yicai Global stated. “JD.Com will attach unique identifying codes to all bird nests it imports, so consumers can see online who made and sold the product, where it was stored and where it is in the delivery process. Buyers can also scan QR codes on delivered goods to check the product details,” the article explained. The company is also using blockchain to track beef imports from Australia.

(3) Ballooning deficit. This brings us back to trade and tariffs. The real merchandise trade deficit widened to $69.7 billion in January, which is a bit of good news and a bit of bad news. It’s good news because the US typically sees a surge of imported goods when demand is high and the US economy is growing. The last time the trade deficit was this large was in 2006 (Fig. 7). It’s bad news because those goods aren’t being produced in the US.

President Trump’s complaints about trade should zero in on China, the country with which the US has the largest deficit by far. Compare the US deficit with China, at $379.9 billion over the past 12 months, to the US deficits with the Eurozone ($135.2 billion), Mexico ($71.2 billion), and Japan ($69.0 billion) (Fig. 8).
(4) **The blockchain solution.** If the US required the registration of imported steel on a blockchain system, it could easily determine where the steel was being produced and what price was being asked for it. The government could more precisely track whether Chinese steel was being dumped in Canada and then sold into the US at below-market prices. And it could set limits on how much steel could be sold at below-market prices—thereby targeting the below-priced steel shipment instead of any specific country.

“The use of the ‘smart contracts’ created by blockchain technology allows for the irrefutable, certainty of the origin of any product produced or [traded] around the world. By tagging the origin of products, it’s no longer ‘trust and verify’, it becomes proof or no trade! The supply chain will never be the same,” noted a 3/13 CNBC commentary by Jack Bouroudjian, chief economist and co-founder of UCX, a secondary marketplace for cloud computing resources. He continued: “One thing we should all agree on is that you can’t fight a digital economic war with analog ideology. As the creators and proliferators of American free market style capitalism around the world, it becomes the job of the U.S. to lead. Smart contracts and blockchain technology will be much more effective than any tariff ever established.”

Information, harnessed by technology, is power.

**CALENDARS**

**US. Thurs:** Jobless Claims 229k, Empire State Manufacturing Index 15.0, Philadelphia Fed Manufacturing Index 23.0, Import & Export Prices 0.3%/0.3%, Housing Market Index 72, Weekly Consumer Comfort Index, EIA Natural Gas Report, Treasury International Capital. **Fri:** Headline & Manufacturing Industrial Production 0.4%/0.4%, Capacity Utilization 77.7%, Job Openings 5.80m, Consumer Sentiment Index 98.8, Housing Starts & Building Permits 1.285mu/1.322mu, Baker-Hughes Rig Count. *(Wall Street Journal estimates)*

**Global. Thurs:** European Car Sales. **Fri:** Eurozone Headline & Core CPI 1.2%/1.0% y/y, Japan Industrial Production. *(DailyFX estimates)*

**STRATEGY INDICATORS**

**Stock Market Sentiment Indicators** *(link)*: Our Bull/Bear Ratio (BBR) climbed to 3.50 this week after falling to 3.14 last week—which was the lowest reading since last September. Eight weeks ago, the BBR was at 5.25, which was the highest since early April 1986. Bullish sentiment (to 54.9% from 48.6%) rebounded back above 50.0% this week, after three weeks below. Last week, it was little changed at 48.6%, after plummeting the prior four weeks from 66.0% (most bulls since April 1986) to 48.1%—with most of the bulls moving to the correction camp, which rose from 21.4% to 37.5% (the highest since May 2016) over the four-week span. Over the past two weeks, the correction count has dropped 8.1ppts to 29.4%, with 6.8ppts moving to the bullish camp and 1.3ppt to the bearish camp—with its percentage climbing from 14.4% to 15.7%. The AAII Ratio fell for the third week last week, from 69.4% to 48.2% over the period, with bullish sentiment falling from 48.5% to 26.4% and bearish sentiment rising from 21.4% to 28.4% over the time span.

**S&P 500 TCJA Earnings Leaders & Laggards** *(link)*: The 2018 earnings forecast for the S&P 500 has surged 8.0% in the 12 weeks since the TCJA was signed into law on December 22. This outstanding performance has no comparison over the years since consensus earnings forecasts were first derived in 1978. However, that gain is up only 0.1ppt in each of the past weeks. With the Q4 earnings season complete, companies have finished providing post-TCJA guidance, and revisions are now likely to revert back to their usual historical pattern of declines throughout the rest of the year. Indeed, five of the 11 sectors had their 2018 consensus earnings estimate remain steady or decline w/w. The top sector
gainers since the TCJA was passed: Energy (24.1%), Telecom (16.8), Financials (11.5), Industrials (9.5), and Consumer Discretionary (8.2). Real Estate is the sole decliner, with a drop of 3.4%; also underperforming the S&P 500 are Utilities (1.1), Consumer Staples (4.1), Tech (5.1), Health Care (5.5), and Materials (6.6). Higher oil prices, a.k.a. “animal spirits,” have contributed heavily to the improvement in Energy’s earnings.

S&P 500 Earnings, Revenues & Valuation (link): Last week saw S&P 500 consensus forward revenues fall for the first time in 10 weeks from a record high, but forward earnings rose to a new record. While the 2018 profit margin forecast was steady for a fifth straight week at 11.8%, the 2019 forecasts rose 0.1ppt to 12.5%, and the forward profit margin remained steady at a record high of 12.0%. With the Q4 earnings season essentially complete, we believe the positive impact of the TCJA on margins has been fully recognized. Prior to the passage of the TCJA, the forward profit margin had been steady at 11.1% since October, which was the highest since September 2015 and up from a 24-month low of 10.4% in March 2016. The easy growth comparisons are waning too: Forward revenue growth for the S&P 500 dropped 0.1ppt w/w to 6.0%, and is down from an 80-month high of 6.3% at the end of February. That reading compares to a cyclical low of 2.7% in February 2016. However, forward earnings growth remained steady at 16.2%, but that’s down from 16.9% in late February, which had been the highest since October 2010. Still, that’s up 5.1ppt from 11.1% prior to the passage of the TCJA, and 11.4ppt from the cyclical low of 4.8% in February 2016. Among the 11 sectors, seven had their forward earnings growth forecast improve w/w. However, Real Estate was the biggest decliner w/w, dropping 0.6ppt to -9.6%. Energy’s contribution to forward growth peaked at the start of 2017. Looking at last week’s results, the S&P 500 ex-Energy’s forward growth was up 0.1ppt each to 5.5% for revenues and to 14.9% for earnings. However, the S&P 500 ex-Energy forward profit margin remained steady at a record high of 12.6%, which is up from 11.7% before the TCJA. The S&P 500’s forward P/E edged up to 17.1 from 17.0, which compares to a 16-year high of 18.6 at the market’s peak in late January and a 15-month low of 14.9 in January 2016. The S&P 500 price-to-sales ratio rose to 2.05 from 2.03, which compares to late January’s record high of 2.16.

S&P 500 Sectors Earnings, Revenues & Valuation (link): Consensus forward revenues forecasts rose last week for 6/11 sectors, and forward earnings rose for 8/11. Consumer Staples and Tech had both measures decline, and these five had both rise: Consumer Discretionary, Financials, Health Care, Industrials, and Materials. Forward revenues and earnings are at or around record highs for 5/11 sectors: Consumer Discretionary, Consumer Staples, Health Care, Industrials, and Tech. Energy’s forward revenues and earnings appear to be back on uptrends after stalling during 2016-2017, and earnings have nearly tripled from their 18-year low in April 2016. Forward P/S and P/E ratios are down from their highs for all sectors. Energy’s valuations remain elevated relative to historical levels, but are normalizing now after soaring in 2016 when revenues and earnings collapsed. Energy’s P/S ratio of 1.18 compares to a record high of 1.56 in May 2016, and its P/E of 18.7 is down from a record high of 57.5 then. Due to the TCJA, higher margins are expected y/y in 2018 for all but Real Estate, but the sector’s earnings includes gains from property sales and typically improves as the year progresses. The post-TCJA improvements in forward profit margins are waning now, as just three sectors improved marginally w/w and one fell. Utilities improved 0.2ppt w/w to move back above the S&P 500. Here’s how the sectors rank based on their current forward profit margin forecasts: Information Technology (22.3%), Financials (18.5), Real Estate (16.4), Telecom (13.3), Utilities (12.1), S&P 500 (12.0), Materials (11.3), Health Care (11.2), Industrials (10.1), Consumer Discretionary (8.1), Consumer Staples (7.1), and Energy (6.3).

US ECONOMIC INDICATORS

Retail Sales (link): Consumers have been taking a break from shopping, suggesting that consumer spending may be weaker than expected this quarter. Retail sales in February fell for the third straight
month—the first time since April 2012 that sales have declined for three straight months. However, the declines were negligible, only 0.1% in each of the three months; sales are still up a robust 4.0% y/y. Core retail sales ticked up 0.1% after no change in January and a 0.3% decline in December. (The BEA uses this core retail sales measure to estimate personal consumption expenditures each month.) We estimate real retail sales were flat in February after declines of 1.1% and 0.1% the previous two months. These sales fell 1.6% (saar) during the three months through February, based on the three-month average—the first decline since July 2011; sales had accelerated 6.3% (saar) during Q4. Real core retail sales rose for the first time in three months, climbing 0.2% after a two-month slide of 1.4%. These sales fell 1.0% (saar) over the comparable three-month period—the first decline in a year—weakening steadily from the 3.8% increase at the end of 2017. Seven of the 13 major nominal retail sales categories fell in February, while six rose. Sizable gains were recorded by sporting goods (2.2%), building materials (1.9), and nonstore retailers (1.0), with sales of clothing (0.4), restaurants (0.2), and miscellaneous store (0.1) establishments fractionally higher. The biggest declines were recorded by gasoline (-1.2), auto (-0.9), and furniture (0.8) retailers, with declines among the remaining components ranging from -0.1% to -0.4%.

Business Sales & Inventories (link): Nominal business sales in January were stalled around record highs, while real sales in December once again reached a new record high. The details: Nominal manufacturing & trade sales (MTS) edged down 0.2%, only the second decline in the past 18 months, rising 10.1% over the period. Inflation-adjusted MTS rebounded 4.0% in the eight months through December after slumping 1.0% the first four months of 2017. Real sales of both retailers and wholesalers were at record highs in December, while manufacturers’ sales accelerated to a new cyclical high. December’s real inventories-to-sales ratio held at 1.40—the lowest since mid-2013; January’s nominal inventories-to-sales ratio ticked up to 1.34 from a three-year low of 1.33 the prior two months.

GLOBAL ECONOMIC INDICATORS

Eurozone Industrial Production (link): Output in January fell after reaching a new cyclical high in December. Industrial production (excluding construction) contracted 1.0% in January after expanding five of the last six months of 2017 by 2.4%. The decline in January output was led by losses in energy (-6.6%), consumer durable goods (-1.9), and intermediate goods (-1.0), while capital goods production rose for the second time in three months, by 1.2% m/m and 3.5% over the period, to a new record high; production of consumer nondurable goods was flat around recent highs the past three months. The data available for three of the top four Eurozone economies show that only Germany (0.3%) recorded an increase in production; Spain (-2.5) and France (-2.0) posted sizable declines. Aside from Spain and France, the biggest decline was recorded by the Netherlands (-5.7). The largest gains were recorded by Portugal (2.5) and Estonia (1.9). Production for the Eurozone remains bright: February’s M-PMI (58.6) slowed but remained close to December’s record high of 60.6. The Netherlands’ M-PMI (63.4) topped the leader board—at a new record high—while Germany’s (60.6) remained above 60.0, with Austria’s (59.2) not far behind. M-PMIs for Italy (56.8), Ireland (56.2), Spain (56.0), and France (55.9) showed manufacturing growth slowed, though remained robust. Meanwhile, Greece’s M-PMI (56.1) climbed to more than a 17-year high, after contracting during the first half of last year.