2017 REPORT: HOLIDAY RETAIL

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I just realized this will be the first year in the Ashley house when none of my kids believe in Santa. While slightly depressing, it's still a fun time of year to shop and share time with the family. And, based on the data below it looks like this holiday shopping season will still have some magic!

The Christmas season continues to be a critical time of year for retailers as they earn up to 40% of their annual revenues during this time period. Based on adjusted figures from the U.S. Census Bureau, retail sales (excluding auto and gas) for holiday 2016 were up 3.0% (unadjusted were up 3.6%). We believe that sales for this year will be stronger, up as much as 4.0% on an adjusted basis with risks skewed to the upside.

THE CONSUMER IS SOLID

The most important driver of retail sales is the level of consumer confidence. The following table summarizes our analysis of nine factors that contribute to that level of confidence measured year over year.

Factors Affecting Consumer Confidence

	Last Year	
Employment	Neutral	Pushing towards 4%. Payrolls trending down. October rebound from hurricane impact
Consumer Confidence	Positive	Michigan and Conf. board look healthy. Conf. Pushing 120. Mich 1st time above 100 in 10+ yrs
Income	Neutral	Adjusted income continues to grow. Adjusted Growth looks to have stabilized at 1.3%
Savings Rate	Neutral/ Positive	Savings rate trend slowly moving down. Below 4.0% for the last 7 months
Debt Position	Neutral/ Negative	Credit card debt is climbing. Debt service ratio increasing
Household Wealth	Positive	Net worth improved 1H'17.Main drivers were real estate and equity prices
Housing	Neutral	Affordability is trending down. Price Y/Y growth is stable. Volumes seem to be loosing steam
Gas Prices	Neutral	Marginally above last year
Inflation	Neutral/ Negative	CPI index is slowly climbing. Y/Y growth increasing, stabilizing around 2%.

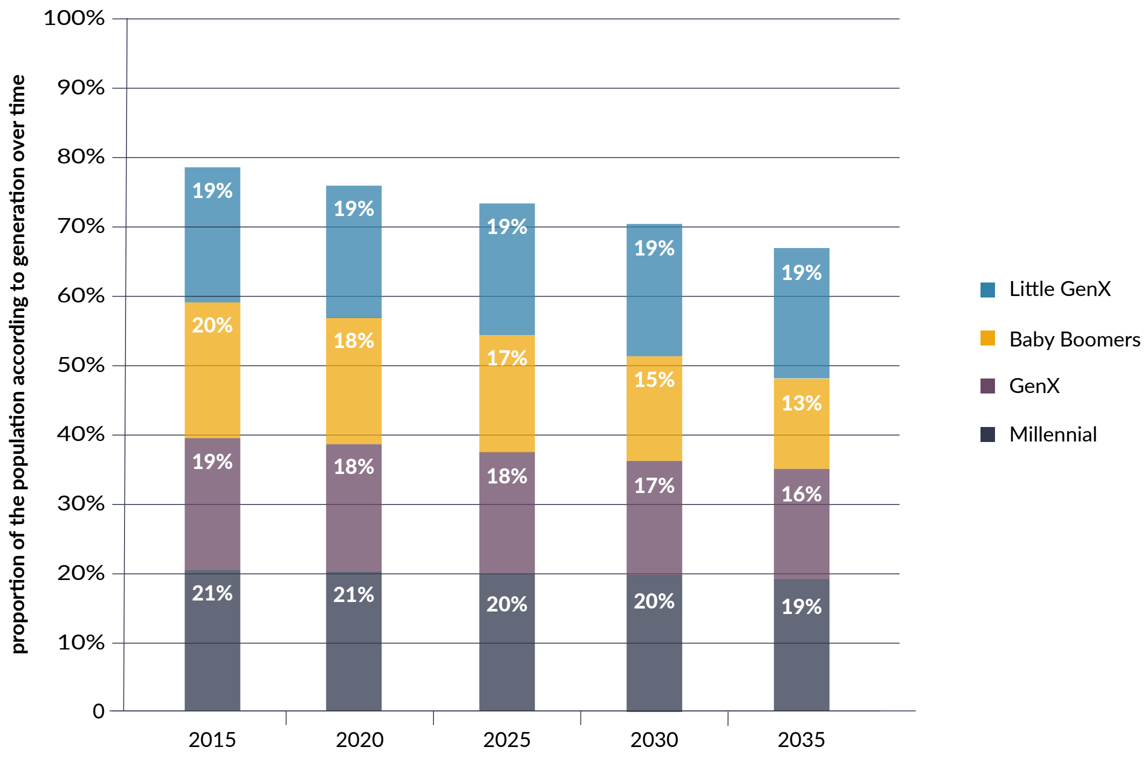
Overall, consumer confidence is strong. In October, the Conference Board Consumer Confidence index rose to 125.9, the highest it has reached in almost 17 years. Strong equity markets, better economic growth, and expectation of some level of tax reform have played into current confidence levels. We also continue to see net worth statistics improve given solid real estate values in addition to strong equities, and consumers are becoming more comfortable with the job market.

We continue to watch consumer debt climb with growing credit card debt as an important indicator. This trend, along with a lower savings rate, may be the result of inflation outstripping wage growth. This could be especially concerning if the economy hits a slowdown. For the near term, a lower savings rate signals more spending.

DEMOGRAPHICS AS A LONGER TERM CONSIDERATION

With all the talk about Millennials, this holiday season we thought it would be interesting to take a look at some demographics. While this is more of a longer term consideration, it helps to set the stage for future forecasts and helps to explain why certain segments of retail are doing better than others. In particular, we analyzed expected population growth available from the United States Census Bureau. We broke down growth by age groups from 2015 through 2035. The available data by age group is done in increments of five years, which is not necessarily ideal for matching generational groups. For comparison purposes, we are assuming Millennials are 20-34 years of age (as of 2015), Gen Xers are 35-49, and Baby Boomers are 50-64. If you track population growth for the next 20 years or so, it is clear that the Millennial generation will dominate. Out of my own self interest (I have three of my own kids in this category) we looked at another age group of 5-19 years of age as of 2015. Lets call this group the "Little Gen Xers". It turns out that by 2035, this group will be slightly larger than Millennials, however, what we know about this group is fairly limited. We do know that Little Gen Xers shop the most online relative to the other groups. They are also not as interested in shopping at mass merchants as they are in fast fashion stores. They are very cost conscious and expect quick turnaround on purchases. *The graph below shows the proportion of the population according to generation over time.*

Proportion of Population by Generation



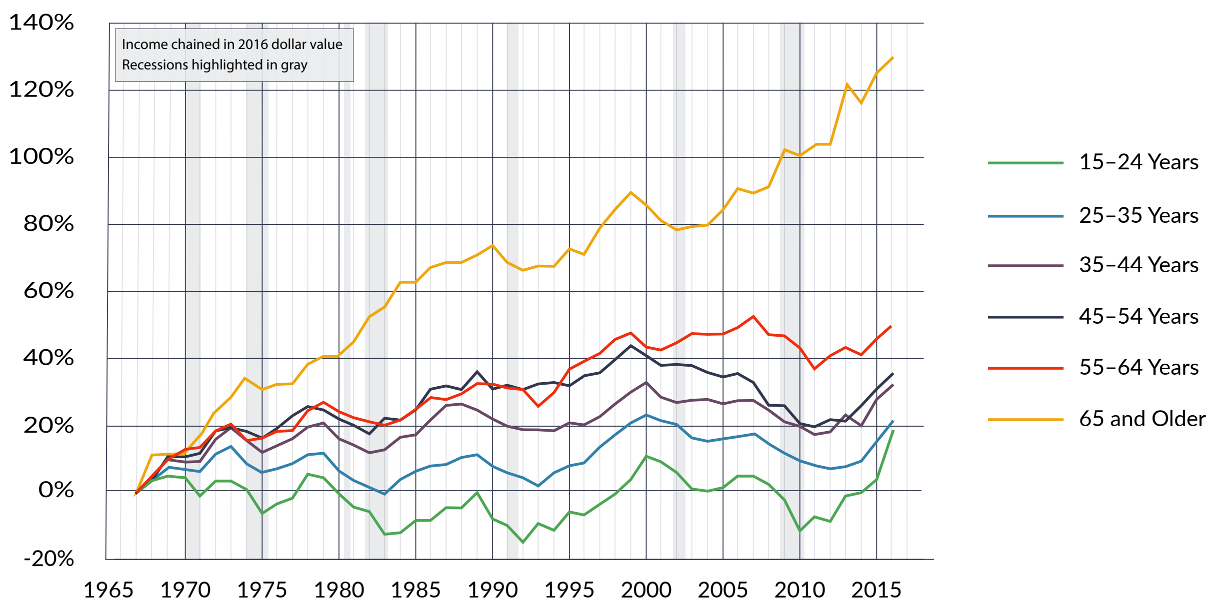
In terms of spending power, our thesis is that spending is more a function of personal income creation than generational habits. While generations seem to enact secular change in how and where their money is spent, the actual amount is more a function of the economy and wages. With that said, over a long period of time, the 45-54 year olds have consistently been the highest income earning wage group (Advisors Perspective web site, Jill Mislinski, 9/22/17). The chart below shows the percentage of the total population by age group. In addition, we added the real median household 2016 income by age group.

Real Income and Percentage of Population by Age

Real Income	Age	2015	2020	2025	2030	2035
$ 41,655	15-24	13.6%	12.9%	12.5%	12.1%	11.9%
$ 60,932	25-34	13.7%	14.0%	13.7%	13.1%	12.8%
$ 74,481	35-44	12.6%	12.7%	13.2%	13.6%	13.4%
$ 77,213	45-54	13.4%	12.2%	11.7%	11.9%	12.5%
$ 65,239	55-64	12.7%	12.9%	12.0%	11.0%	10.7%
$ 39,823	65+	14.9%	16.9%	19.0%	20.6%	21.4%

The great recession stalled household income growth for the 45-54 group. It has only just started to recover, and we expect this will be supportive for future spending growth. The change in the 65+ age group is notable, as it has had the largest real income growth while also maintaining overall low income levels and a lack of spending motivation due to retirement. As such, we do not expect this group to be a meaningful contributor to retail growth.

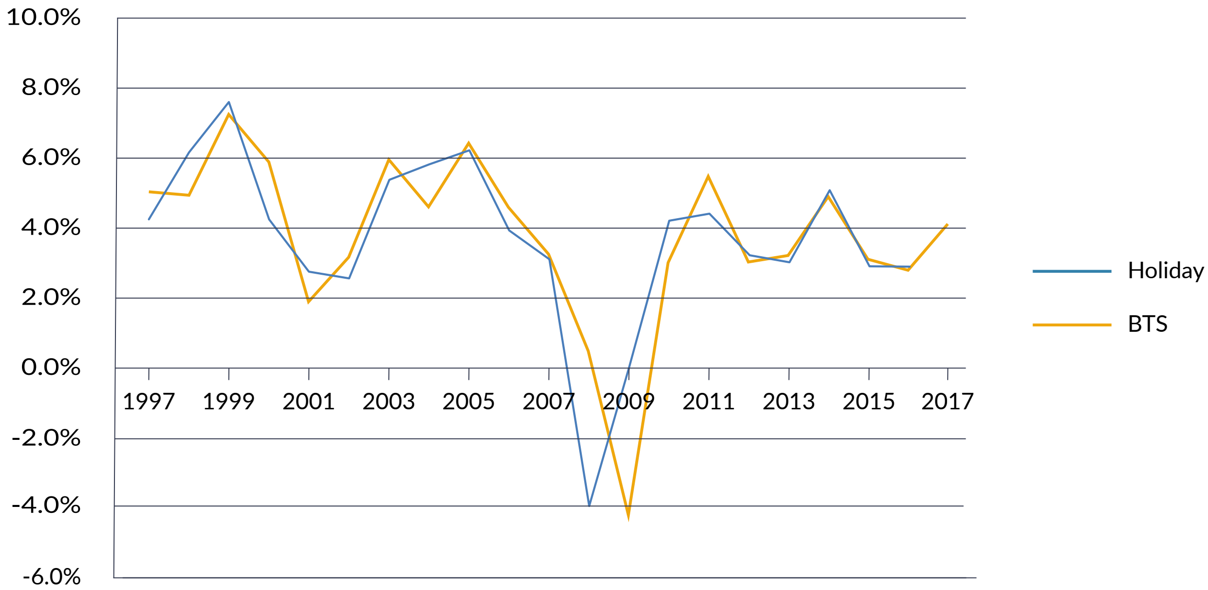
Median Real Household Income Growth by Age Bracket



STATISTICAL SALES ANALYSIS

A review of data from the last twenty plus years (graphed below) reveals a significant correlation (79%) between “Back to School” retail sales as measured in August and September and holiday sales, as measured in November and December. To model the 2017 trend, we used the U.S. Census Bureau’s adjusted monthly retail trade data which includes a variety of retail businesses (excluding motor vehicle and parts dealers and gasoline stations; sales in those segments have been more heavily impacted by factors outside the control of consumers).

Back to School Versus Holiday Sales (1997 – 2017)



Our regression model predicts adjusted holiday sales of 4.2% when using the 4.3% actual for “Back to School” sales in 2016. Comparatively, 2016 “Back to School” sales of 2.9% led to actual holiday sales of 3.00%. If the model is correct, holiday sales of 4.2% in 2017 would exceed the 20 year average of 3.9%. Adding to momentum recently, the “Back to School” sales figures were revised up to 4.3% from 4.0%

SEASONAL HIRING LOOKS COMPARABLE TO LAST YEAR

Overall, holiday related hiring at **retailers** is projected to be about flat versus last year. Some struggling department store operators are hiring slightly less largely attributable to store closings. E-commerce leader Amazon is hiring 120,000 seasonal employees, which is also flat from last year. However, Amazon has been hiring steadily throughout the year and expects to move thousands of temporary employees to full time status. Shipping giants FedEx and UPS are optimistic about this year. Between Thanksgiving and New Year’s, UPS expects to complete 750 million deliveries worldwide, about 40 million more than last year (3Q Earnings Transcript). Based on this data, we believe retailers are expecting a similar holiday season as compared to last year. The exhibit below was compiled by Standard and Poor’s.

Selected Holiday 2017 Hiring Announcements

Company	2017 Planned Hiring (Thou.)	Year-Over-Year Change (%)
UPS	~95	0
USPS	No total disclosed. 2016 was 37.5	N/A
Amazon	>120	0
GameStop	No total disclosed. 2016 was 28.	N/A
Kohl's	No total disclosed. 2016 was >69.	N/A
FedEx	>50	0
JCPenny	~40	0
Macy's	~80	(4)
Toys "R" Us	>12	Total for 2016 was not disclosed.
Target	~100	30
L Brands	~4	0
Nordstrom	~13.7	20

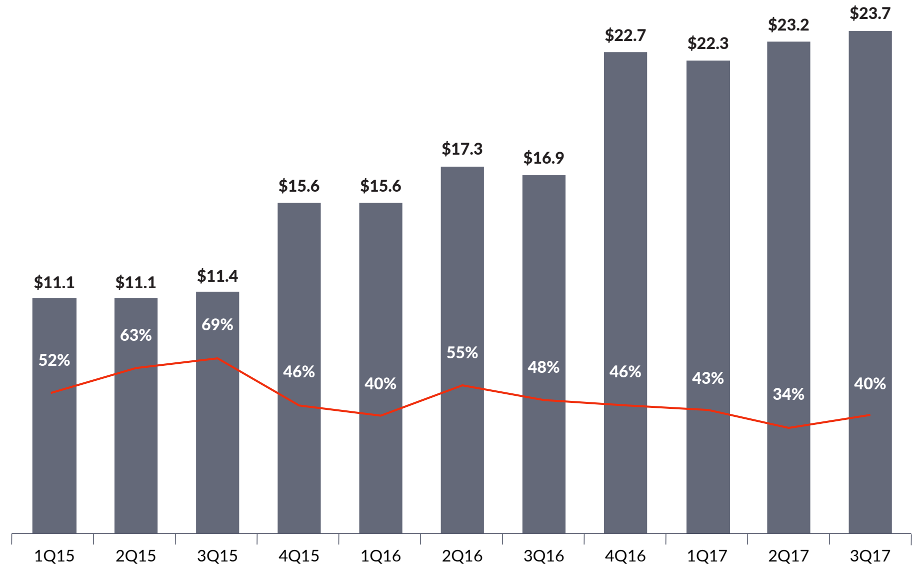
E-COMMERCE REMAINS STRONG – MOBILE EVEN STRONGER

Online retail sales continue to gather momentum. Most analysts are expecting mid-to-high teen increases this year from e-commerce sales. While we expect the trend to continue, we don't believe brick and mortar stores are going away completely. For those retailers focused on apparel, some items simply need to be touched or tried-on before being purchased. Of course, it is becoming more convenient to return those purchased items that do not live up to their online photos or fit a little more snug than expected. In addition, holiday shopping can be a very sentimental experience, something that the internet can't mimic with the click of a button, as compared to physical stores.

According to the U.S. Census Bureau, e-commerce now accounts for 10.8% of total retail sales year-to-date. We believe that figure is closer to 18% if you take out segments that are not currently at risk of an internet presence such as auto sales, restaurant/bar sales, and gas station sales. YTD growth for the online category was 10.1%. According to the National Retail Federation (NRF), the average shopper said that 59% of his/her shopping will be completed online, up from under 56% last year.

Mobile (versus desktop and tablet) shopping continues to be the largest driver of e-commerce, which now comprises about 23% of total digital spending (Jefferies 11/16/17). We have seen consistent growth in mobile, as highlighted in the graph below. This is a look at domestic mobile retail sales in billions and the growth on a quarterly basis.

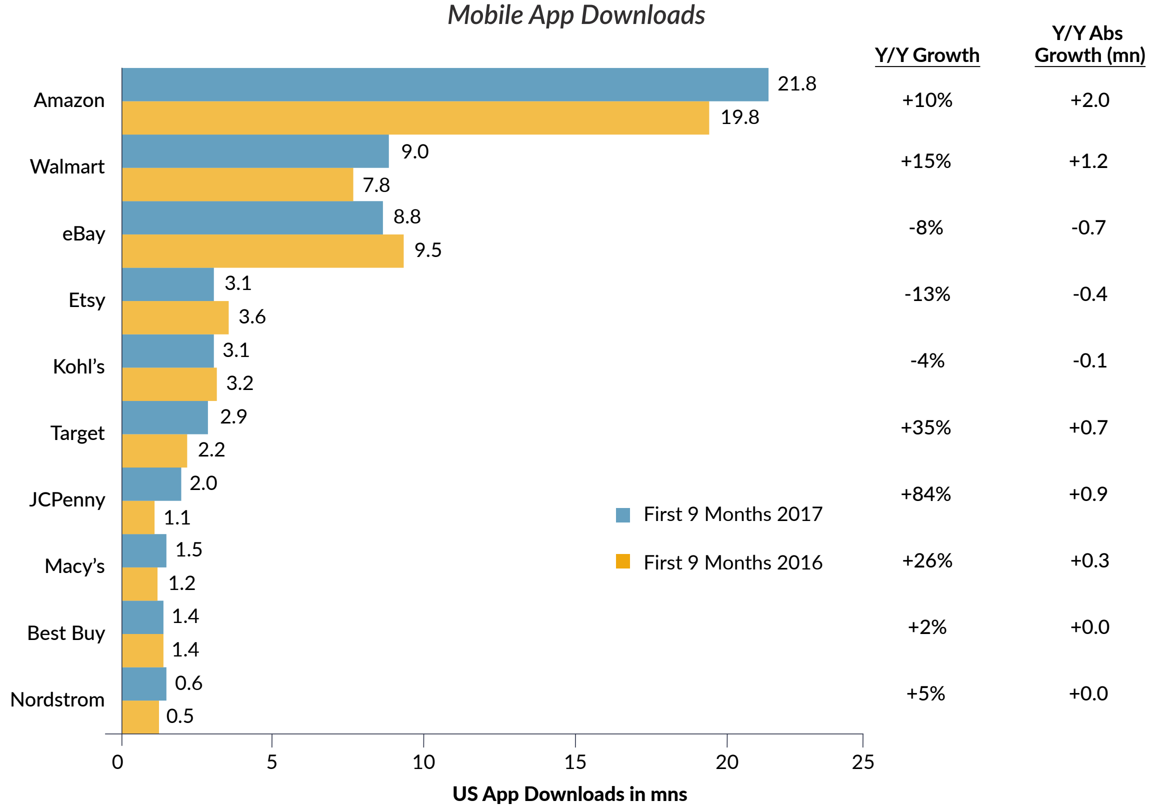
Mobile Retail Sales



Source: *comScore, Jefferies*

Most of the traditional retailers are spending significant amounts of capital building out their e-commerce strategy. So, while Amazon continues to dominate and gain share in this area (42 cents of every dollar spent online went to Amazon (WSJ Stevens 11/21/17)), others are becoming more competitive and are helping to grow the overall pie. One retailer to watch in the e-commerce space is Walmart. One way to monitor growth and market share is to track changes in mobile traffic. The following exhibit shows growth in mobile app downloads for a variety of retailers. Aside from Amazon, Walmart and eBay are strong in terms of mobile utilization. When looking at the top five players, Walmart has easily had the best execution based on year over year growth of 15%.

Mobile App Downloads



Source: *Sensor Tower, Morgan Stanley Research*

TRADE GROUPS MORE OPTIMISTIC THAN LAST YEAR

We have included a summary of three trade groups that publish their views on upcoming holiday sales. While each of them uses a different data set to support their expectations, it is still important to note the growth year over year. In addition, we thought it would be interesting to look at how accurate each group has been over the past three years. Based on this data, we would not favor any one of these trade group's prediction over the other. This year, all three look more optimistic versus 2016's expectations.

Trade Group Forecasted Versus Actual Holiday Sales

	Forecast 2017	Actual 2016	Forecast 2016	Actual 2015	Forcast 2015	Actual 2014	Forecast 2014
Deloitte	4.0 - 4.5	3.6	3.6 - 4.0	3.6	3.75	5.2	4.25
National Retail Federation	3.6 - 4.0	3.6	3.6	3.2	3.7	4.1	4.1
Intl. Council of Shopping Center	3.8	3.6	3.3	2.2	3.3	3.6	4.0

According to National Retail Federation (NRF), shoppers will spend an average of $967.13 per consumer in 2017 for a total of approximately $679 billion. The average growth over the last 5 years was 3.5%. About 63% of the total will go towards gifts with the balance to be spent on holiday related items including food and decorations. Shoppers plan to spend most of their time online, in department stores, and in discount stores. The most popular present is expected to be gift cards followed by clothing. Holiday shoppers rank price discounts as the most important factor while shopping at a particular retailer, which is a trend that has continued.

WEATHER & CALENDAR ARE IDEAL

Weather and the shifting calendar are always important factors for holiday spending. According to Weather Trends International (WTI), this holiday season is expected to be cooler while precipitation in December is predicted to be somewhat lower than last year. The ideal weather for department stores is cold and dry. Retailers want shoppers to buy winter products but not be turned away by heavy snow.

The days between Thanksgiving and Christmas are key shopping days. This year, those days total 31 (26 is the minimum, 32 is the maximum) versus 30 last year. In addition, there are ten total weekend days to shop (maximum), one more than last year. This year, Christmas falls on a Monday which gives consumers another full day to shop and spend on those all important impulse items.full day to shop and spend on those all important impulse items.

CONCLUSION

We are optimistic about 2017 holiday spending because just about every variable is lining up for a better year than 2016.

- The consumer continues to be in good shape as unemployment inches lower and wages grow.
- Online purchases, especially mobile shopping continue to trend higher providing a headwind for overall sales.
- Seasonal hiring patterns appear neutral while weather/calendar may create a slight edge to final results.
- In addition, trade groups are all in agreement predicting better growth from a year ago.
- Finally, statistically speaking, back to school sales are forecasting a stronger holiday season.

Maybe there really is a Santa Claus!

Michael J. Ashley *is a Principal and the Senior Analyst of Corporate Credit at AAM with 19 years of investment experience. Prior to joining AAM, Mike worked at Northern Trust Global Investments with responsibility for following investment grade industrials including credits in the basics, energy, consumer products, media, and retail sectors. Mike earned a BA from the University of Iowa in Management Information Systems and an MBA from DePaul University in Finance.*