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Light at the end of the tunnel for Australian retail sales

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Key points

> Retail sales growth has been poor for four years now reflecting a combination of consumer caution, falling wealth, "excessive" interest rates, the strongly rising $A, surging electricity prices, slowing income growth and job insecurity.

> With some of these factors now fading or set to fade, retail sales growth is likely to pick-up a notch next year. This should see growth pick up to around 4 to 5% pa from 2-3% over the past four years.

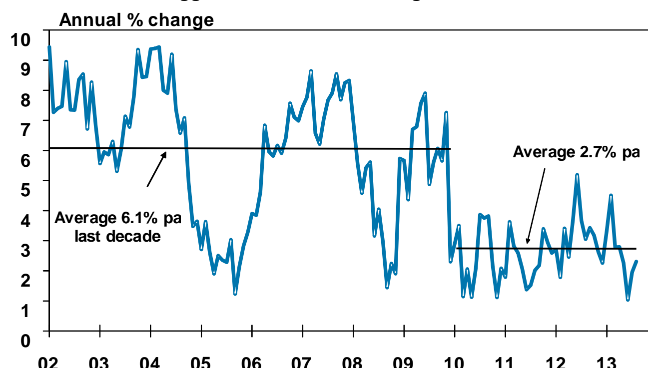
> This would be good news for the Australian economy as it would signal a broadening in the recovery in non-mining sector growth from just the housing sector.

> While it would add to confidence that we have seen the low for interest rates, for investors it will help underpin the share market via higher profits and support other growth oriented investments.

Four years of poor retail sales

When looking for growth in non-mining investments to fill the gap left by the mining investment boom, retail sales are critically important accounting for nearly 20% of economic activity in Australia. As is well known Australian retailers have had it tough for nearly four years now. Nominal retail sales growth has averaged 2 to 3% since 2010, which is less than half the 6% annual pace seen last decade.

Sluggish nominal retail sales growth



Source: ABS, AMP Capital

Initially this was not a disaster for the overall economy as mining investment was booming which soft retail sales helped make way for, and demand for consumer services was holding up well such that overall consumer spending was okay. Recently it's been more of a problem for the broader economy as mining investment has started to soften and so too has overall consumption growth. However, there are signs of light at the end of the tunnel for retailers and hence for the broader economy.

Drivers of the slump

The retail slump of the past four years has been driven by a range of factors including:

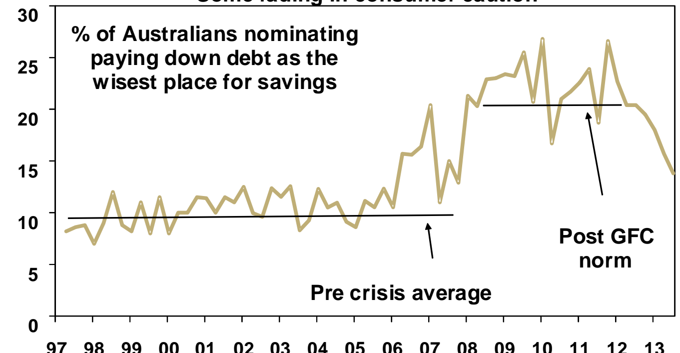
- cautious consumer attitudes towards debt and savings post the GFC;
- weakness in household wealth on the back of both falling house prices and share markets;
- "excessively" high interest rates relative to debt levels and wealth expectations;
- the impact of the strongly rising $A leading to more spending on overseas holidays and accelerating on-line penetration;
- a surge in the cost of necessities such as electricity (of around 10 to 15% pa) and health which ate into household budgets. This has been particularly painful for low income households – the bottom 20% of households (in terms of income) spend around 9% of their disposable income on electricity;
- a slowdown in household income growth recently; and
- job insecurity associated with more cost conscious corporates, particularly since 2010.

Outlook

In the short term the rising trend in unemployment will act as a drag. However, a range of factors suggest that retail sales growth will pick up pace a next year.

First, while consumer caution clearly remains it appears to be fading a bit. The household savings rate is no longer rising, having stabilised at around 10 to 11%, but more interestingly the proportion of Australian's nominating paying down debt as the "wisest place for savings" has fallen to its lowest since 2007.

Some fading in consumer caution

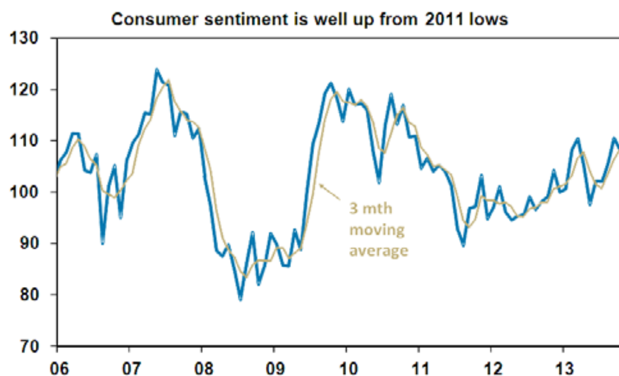


Source: Westpac/Melbourne Institute, AMP Capital

Second, the combination of now very low interest rates and strongly rising household wealth on the back of rising share markets and rising home prices is very positive for household finances and is likely a big factor behind fading consumer caution. Australian share prices are up 24% over the past year and average home prices are up 5.5% (or 8% in Sydney).

Third, the housing recovery is likely to see a solid pickup in housing construction over the year ahead which will help drive a pick-up in demand for household items.

Fourth, reflecting some of these factors along with the change of Government consumer confidence is well up from its lows. All the new Government needs to do is stay out of trouble for the next six months at least!



Source: Westpac/Melbourne Institute, AMP Capital

Fifth, the fall in the $A from its highs (with further to go hopefully) will over time help slow the momentum towards offshore holidays and online purchases from foreign sites. At the same time, the downtrend in the $A along with improving global growth should lead to an improvement in offshore visitor arrivals. All of which should help local retail sales.

The $A has had a strong bounce from its August low of $US0.89 as a result of the Fed deciding to delay tapering its monetary stimulus program and signs Australian interest rates are near the bottom. In the short term the $A could rise further as "short" positions remain extreme. However, it is likely to resume its downtrend next year as Fed tapering eventually gets underway, emerging country growth remains constrained by the standards of the last decade and the supply of commodities increases.

Sixth, the surge in the price of electricity looks to be slowing after 5 or so years of 10 to 15% gains. Over the year to the September quarter it had slowed to a 6.1% gain and it could even go backwards by 5% or so in 2014-15 if the carbon tax/ETS is abolished. This could provide a huge psychological boost to perceptions of household finances.

Finally, the rise in unemployment over the next six months may not be as much of a drag as feared as falling workforce participation of older workers (on the back of the aging population along with the rebound in wealth which has made retirement feasible again) takes the edge off the rise in the headline unemployment rate. It could end up peaking around 6% rather than the 6.25% the Treasury has forecast. This could mean that job insecurity may not be quite as bad as feared.

With some constraints remaining, eg household income growth is likely to only pick up slowly, a return to last decade's pace of retail sales growth looks unlikely. But some improvement next year is looking likely which is expected to see nominal retail sales growth pick up to around 4-5%. No boom, but at least a let up in the gloom.

Good news for the rest of the economy

An improvement in the pace of retail sales would be good news for the rest of the economy. Interest rates typically work through the economy with a lag: by first boosting housing, then consumer spending and eventually business investment. To date we have seen a clear pick up in housing related indicators both prices and to a lesser degree housing construction indicators. Signs that it is flowing through to forward indicators of retail sales suggest the recovery may be starting to broaden and add to confidence that the softness in mining investment will be at least partly offset through next year leading to a pick up in overall economic growth from the recent 2.5%pa pace. There is still a way to go yet but the signs are positive.

One outworking of this is that official interest rates have likely seen their bottom, or if not are pretty close to it.

Implications for investors

There are a number of implications for investors.

First, the prospective recovery in retail sales growth combined with the housing recovery already underway is a positive sign for profit growth in the year ahead and this is in turn supportive of the outlook for shares.

Second, the likelihood of stronger profit growth and hence a further rise in the local share market highlights that cash rates and bank term deposit rates of now 4% or less are unattractive for investors looking to grow their long term wealth.

Finally, while consumer discretionary shares have run hard – up 40% over the last 12 months – they should be reasonably supported if retail sales start to pick up as expected.

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