

## **MVI Article --**

# **The Challenges of Retail in a Slow Growth Inflationary World**

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The USA has been on an unprecedented run of economic growth and stable prices over the last 25 years, but a couple of basic macroeconomic factors are conspiring to make 2008 a fairly rocky year:

1. **The declining US dollar.** WPP Chairman Martin Sorrell describes a country's currency as "something akin to its share price," and the US is trading below its historical averages today. High levels of international debt, very low interest rates, and a sense that the US market is higher risk than it used to be all conspire to bring the dollar's value down.
2. **Investment liquidity dramatically reduced.** Investor appetite for risk had gone up exponentially in recent years, primarily driven by the securitization of different types of financial risk (e.g., subprime mortgages) and the extensive use of hedges and derivatives to offset inherently risky propositions. Without delving into arcane financial theory, investors were very willing to take on high levels of risk for decreasingly low levels of incremental returns because they believed they could bundle the risk into large scale packages and sell most of those packages onto someone else.

The challenge here arose when the bundles become so complicated that no one really knew exactly what they were buying. This is the core of the panic that the subprime mortgage crisis has caused; no one knows exactly how much risk they have, and when they find out (as Merrill Lynch did last month) it can be an enormous amount.

### **The Declining US Dollar**

A declining currency is not necessarily all bad for a country—it increases the attractiveness of the country's exports (as they become cheaper) and can encourage foreign investment (which can create economic growth and jobs). One pillar of China's economic growth in the last decade was a currency that most experts would agree was theoretically undervalued.

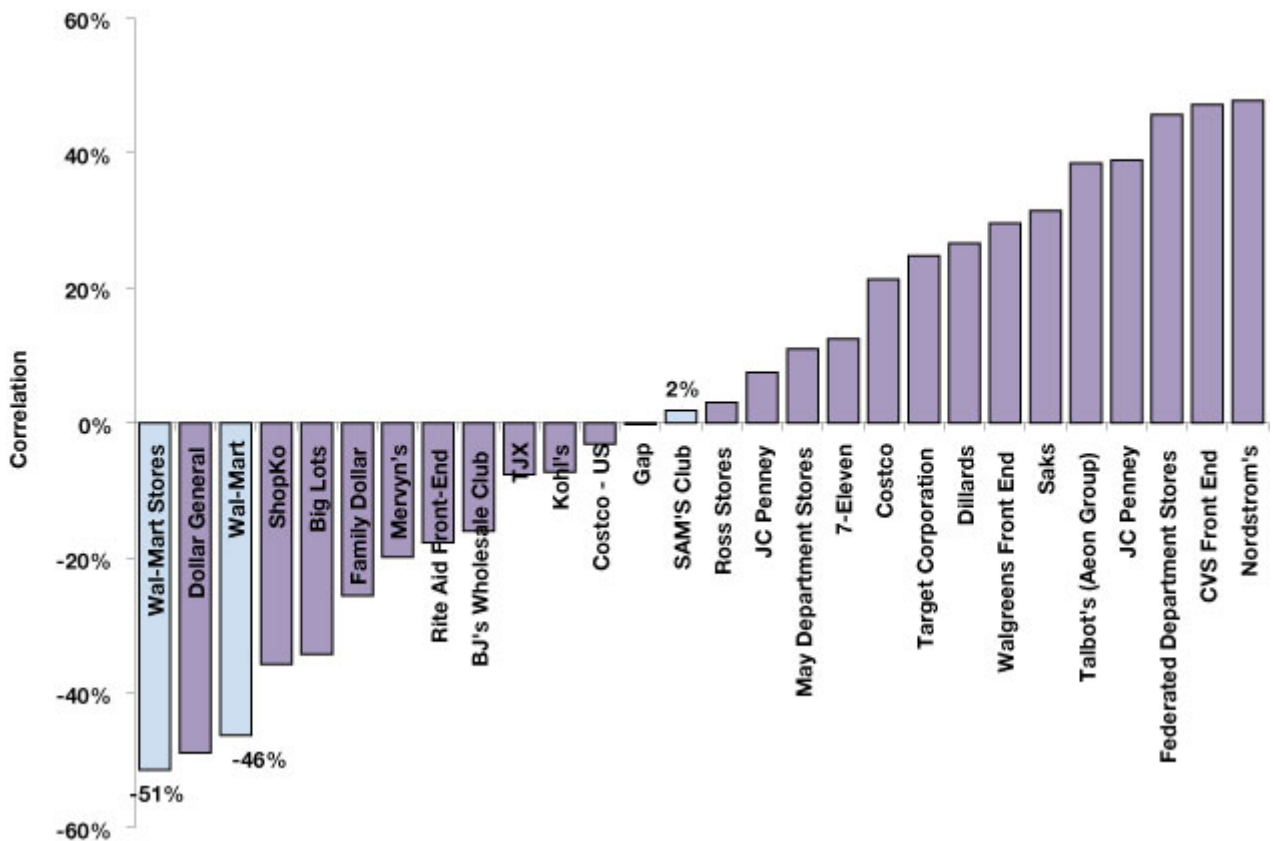
The challenge a declining dollar presents for US CPG companies are fourfold, and in some cases obvious.

1. **Price inflation in the marketplace** – As imported product becomes more expensive, inflation gets baked back into retail pricing across the board.
2. **Commodity pricing pressure** – Because most commodities are priced in dollars but produced and traded globally, a declining dollar drives up commodity prices (even if that commodity happens to be produced in the USA). Most suppliers have seen this manifest itself

in plastics or raw food components, which puts intense pressure on margins, and has driven marked price increases in the marketplace from many CPG companies.

3. **Oil prices** – In addition to impacting CPG margins, oil prices in particular impact disposable income (particularly for low income Americans). With oil trading at USD90+ per barrel, this will put intense pressure on the core consumers for retailers such as Wal-Mart, Dollar General, and Family Dollar. Figure 1 shows the correlation between comparable store sales and gas prices for the last six years.
4. **Canada** – For those in Canada, or managing customers that operate in both the US and Canada, the rise in the Canadian dollar’s value versus the US dollar creates havoc for cross-border pricing strategies.

**Figure 1: Comparable Store Sales & Gas Prices (January 2001 – April 2007)**



Source: Company reports, Energy Information Administration

### Investment Liquidity

Some readers might be thinking, “I’m not sure why I need to care when someone who made a USD6 million bonus at Merrill Lynch last year lost their job last month.” Fair enough. However, the real challenge with investment liquidity is twofold:

1. **Real estate** – Much of US consumer spending growth was fueled to some degree by home valuations. Either people were reinvesting in their homes to raise their value (and you have the exponential growth of Home Depot and Lowe's to prove it) or their changing house value raised their perception of wealth, which allowed them to splurge on luxury goods (the rise of Best Buy and the continued success of Costco are testament to that).
2. **Corporate investment** – Economics 101 tells us that if consumer spending is slowing down, business or government spending must rise or overall expenditure will drop.

Government spending in the USA is unlikely to increase in total (though it continues to increase exponentially in certain sectors such as healthcare, which goes some way toward explaining the rocketship growth of Walgreens and CVS). Therefore, business investment becomes critical to economic growth—and business spend is, to a large degree, capital market liquidity dependent.

### **So What?**

The real challenge this presents, is that the fundamental drivers “government” (read: both the elected government and the Federal Reserve) has to drive the economy are fairly limited and fraught with difficulty. Most of the steps available would have an adverse effect on the dollar:

- **Lower interest rates** – As the Federal Reserve did on October 30, 2007, they can continue to reduce interest rates, which can fuel economic growth and drives a short-term bump in the stock market. However, a declining interest rate impacts a country's currency fairly dramatically, and the Federal Reserve cannot lower interest rates too much without exacerbating pressure on the dollar and causing the four factors outlined above to intensify.
- **Reduce taxes** – Without a reduction in government spending, a tax reduction would fuel consumption but drive the dollar down as the US government would be forced to borrow more. If these “lenders” are non-US entities, this reduces demand for the dollar and lowers its price.
- **Spend more** – The current US budget deficit causes the same problem as #2 above. A tax increase would obviously fund this spending, but at that point it cuts into domestic expenditure and does not have a net positive effect on the economy.

Said another way, most of the things that can be done to drive expenditure will drive down the dollar. On the flip side, most of the steps that can be taken to reinforce the dollar's strength (e.g., rising interest rates and reducing the US budget deficit) would reduce expenditure. Therefore, it is unlikely that US-based economic growth or the dollar will post an extreme recovery in 2008. It is more likely that an outgoing administration/Congress will work to try and cut a middling course—avoiding an extreme position either way.

The key conclusion to draw is this: *both increased inflation and reduced liquidity will conspire to reduce demand at retail*. Interestingly, each will conspire to reduce demand for different types or retailers. And there is no clear prescription to fix this that does not intensify one of these two issues.

## MVI Interpretation

### *Now What?*

From a retail perspective this would appear to have seven key areas of impact (many of which will be explored at MVI's 2007 **Year End Forum** in Atlanta):

1. **The US will be less important to a global company's topline growth.** As the dollar declines, growth becomes easier to achieve in other markets (particularly the developing BRIC markets where inherent market growth is also extremely dramatic). The key implication is that suppliers working for global CPG companies will find their boards asking the US to become a profit generator as much, or more, than a growth driver. This makes resources significantly harder to come by.
2. **There are very few people in the US landscape today that know how to manage inflation.** It impacts everything from interpreting results and building business plans to retail price and margin management. For those under the age of 35 reading this, go find someone in your company over 50 and debrief on how working in an inflationary environment will change your company!
3. **Be cautious of sales growth and GDP growth numbers.** You may see some of your customers posting robust growth, but if much of that is due to inflation, that does not help you (particularly if your bonus is tied to cases, not dollars). Watch unit sales as carefully as dollar sales in this environment—unit growth may point out potential weakness in a customer before their public numbers show challenges.
4. **Lower income consumers look unlikely to recover purchasing power in the short-term.** Oil prices are the primary squeeze, but the declining dollar also raises the price of imports from low cost markets (i.e., China). The margins of retailers that rely heavily on global sourcing (i.e., Dollar Tree) should also come under significant pressure in this environment. This suggests that Wal-Mart will continue to fight to create demand, even with its new marketing strategy—and the longer Wal-Mart's new strategies take to gain traction, the more potential for confusion exists inside its organization.
5. **Retailers exposed to highly volatile real estate markets will struggle to get "want" spend from their shoppers.** This is one of the key reasons MVI revised our 2008 growth projections down somewhat for Costco. The interesting retailer here will be Target, especially in California, which is its highest exposure marketplace.
6. **Inflation has historically been good for EDLP.** Wal-Mart's rise to retail prominence came in inflationary times. Historically, Wal-Mart has been very good at holding retail prices as manufacturers passed through cost increases and working creatively with manufacturers to rebuild its gross profit dollars off the lower maintained margin rate. At this time, however, Wal-Mart seems to be moving away from some of the core EDLP disciplines that it built its business on to seek higher returns.
7. **It is not all doom and gloom.** We would expect certain types of retailers to grow faster than the market in this type of environment. Those would include:

- **Retailers who can execute.** This is obvious, but pressure on disposable income means you have to capture the spend when the shopper is there and ready. There are too many pressures on their disposable income and if you lose them once for a purchase, they are unlikely to come back for that purchase.
- **Retailers who can sell across taste levels well.** In MVI terminology this is a retailer with a “tiered” merchandise ladder—any retailer that allows a shopper to find exactly the level they want to spend in a category will be valued by the shopper. This will put more pressure on “horizontal” assortment (e.g., flavors and varieties) as retailers seek to spread the taste level at shelf more decidedly.
- **Retailers who sell exactly what someone wants.** Online retail, in particular, should benefit here as retailers that do not carry large physical inventories benefit from more selective shoppers.
- **Retailers with a well developed private label program.** This allows consumers a choice to trade down where they want to.
- **Retailers whose proposition successfully imitates something more familiar but at a lower price.** TJX and Ross selling brands for less is a start. But other examples may include:
  - **Tesco’s** more price competitive healthy eating in its new Fresh & Easy stores;
  - **Safeway’s** “O” organic private label that looks remarkably like Whole Foods’ 365; or
  - **JC Penney’s** improved merchandising standards that replicate a higher end department store.

For more information on how these trends will impact the retail landscape, come to MVI’s 2007 **Year End Forum** in Atlanta, December 11 to 13!