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The Tide Shifts: Low-End Retail Begins Outperforming Luxury

Pattern Likely to Continue in Second-Half 2015

*Based on a July 14, 2015
client bulletin.

During most of the U.S. recovery to date, sales and earnings of luxury retailers outperformed much of the rest of the retail sector, but luxury underperformed in the first quarter and may continue to do so during the rest of 2015. Lower-income households are experiencing some of the best boosts to their purchasing power of the recovery, and their discretionary spending appears to be accelerating. High-income households, on the other hand, have already registered slightly slower spending growth this year and also are likely to retrench more quickly in response to any financial and economic problems that emanate from abroad. Thus, high-income households may temper their spending before the next U.S. recession, whereas lower-income households are likely to continue spending up until global recessionary forces lead to rising domestic unemployment.

Lower-income households have three strong tailwinds at present:

- **Rising pay raises.** Wage inflation, while still muted, has edged up to its fastest pace of the recovery (chart 1). Although we do not expect significant acceleration from here, wage rates will continue to rise as long as employment gains continue.

- **Lower gasoline prices.** Given both the lagged effects on spending of accumulated fuel savings in bank accounts and our forecast for oil prices to fall further in the second half of the year, fuel savings will tend to continue to free up purchasing power for discretionary spending.
- **Lower prices of non-energy goods.** The stronger dollar is helping reduce prices of a range of imported consumer goods, and we expect dollar strength to persist on a secular basis.

These tailwinds disproportionately benefit lower-income households. Both energy spending and wage income are larger relative to purchasing power for lower-income households. Meanwhile, price-conscious spenders are more likely to increase their spending as prices decline. Indeed, spending on a number of categories of discretionary goods and services—for example, eating out—showed signs of picking up in recent months as gasoline prices fell (chart 2).

Outperformance of lower-income household discretionary spending relative to luxury spending is increasingly beginning to show up in company reports as well. Luxury hotel revenue per

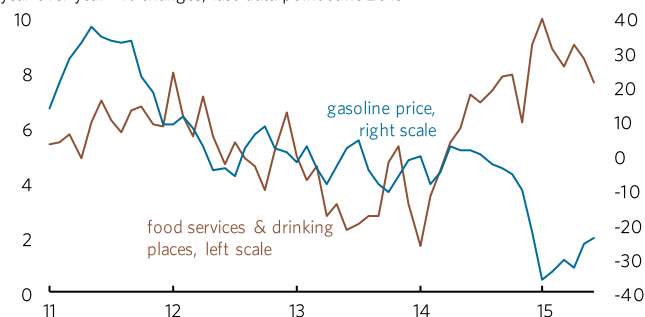
Wage Growth Has Been Accelerating CHART 1

BLS: Employment Cost Index: Wages & Salaries: Private Industry Workers
year-over-year % change, last data point Q1 2015



Lower Gas Prices Have Boosted Eating Out CHART 2

BEA: Retail Sales: Food Services & Drinking Places, \$ billions, seas. adj.
Dept. of Energy: Retail Gasoline Price, Regular Grade, cents/gallon
year-over-year % changes, last data point June 2015



available room has slowed below overall U.S. hotel performance (chart 3). More broadly, in the first quarter of this year, earnings at various types of U.S. retailers catering to lower-income households strongly outperformed their high-end counterparts (table 1).

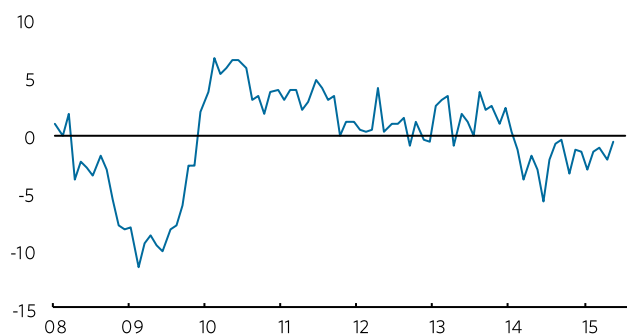
Such outperformance is likely to continue as low-end retailers are more insulated—at least initially—from financial and economic problems emanating from abroad than luxury retailers. First, the stronger dollar could hit luxury retailers hard by reducing foreign tourist traffic. Second, higher-income U.S. households are likely to more quickly pull back on spending in the event of declines in financial asset markets that shift wealth effects into reverse. Lower-income households will pull back as

well in the event of an outright U.S. recession, but probably not before labor markets weaken. Since labor markets often lag the rest of the economy, lower-income households may be slower to reduce their spending in a downturn.

Equity prices have already priced in some luxury underperformance, and we expect that they will face further disappointments in the next six months. After years of close alignment, equities of luxury retailers began underperforming the broader consumer discretionary market last summer (chart 4). We expect the outperformance of lower-income consumer discretionary spending to become more pronounced in business sales and earnings reports over a summer already marked by abundant global financial market disruptions.

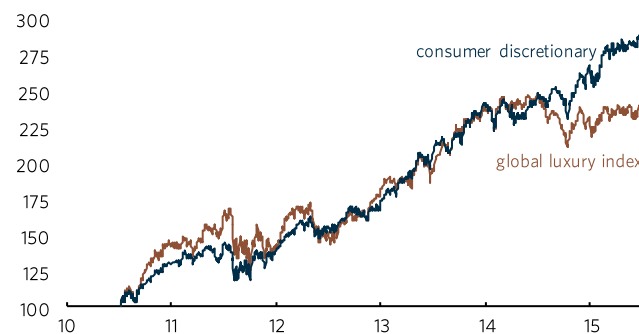
Luxury Hotel Revenue Underperforming Total CHART 3

Smith Travel Research: Growth in Hotel Revenue per Available Room difference in year-over-year % changes, luxury less total, last data point May 2015



Luxury Retail Equities Underperforming CHART 4

S&P Global Luxury Index, Consumer Discretionary SPDR Select ETF index, July 6, 2010 = 100, last data point July 6, 2015



Lower-End Consumer Discretionary Earnings Outperformed in Q1 TABLE 1

First-Quarter Net Income Growth for Selected Consumer Discretionary Companies year-over-year % change

Higher-End	Growth		Lower-End	Growth
Cheesecake Factory	26	} Dining	Darden Restaurants*	22
Ruth's Hospitality Group	17		Denny's	33
			Cracker Barrel**	23
Starwood	-28	} Lodging	Choice Hotels	-7
Hyatt	-61			
Tiffany's	-16	} Jewelry	Signet Jewelers	17
Winnebago Industries*	-16	} Motor Homes	Thor Industries	14

* Indicates results are for December 2014 - February 2015 period
 ** Indicates results are for February - April 2015 Period



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