25 August 2023

# ECONOMIC UPDATE

## Retail spending and the consumer

BOQ GROUP

# Key Points

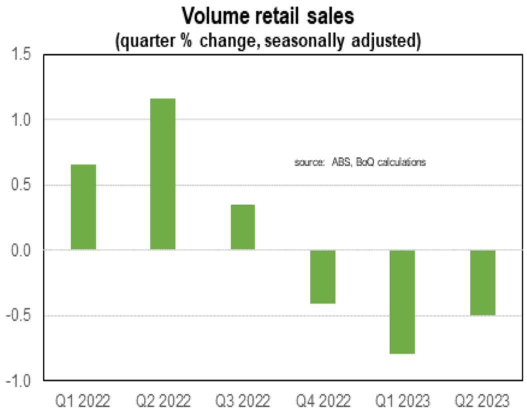
- **Analysts' point to the fall in retail sales volumes as a sign of weak consumer spending;**
- **Certainly, declining real income growth has made households more cautious with their spending;**
- **The increase in relative prices had also weighed upon retail spending;**
- **As has the catch-up spending on services.**

## The weakness of retail volumes

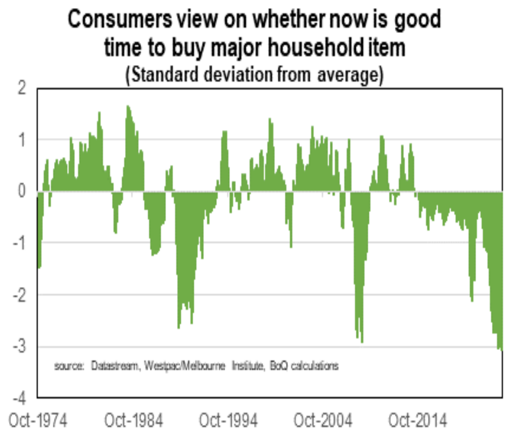
The volume of retail sales fell in Q2 2023. That was the third successive quarterly decline, only the second time that has happened in the past forty years. The only other time was in 2008. Maybe the GFC played a role then although I suspect rising interest rates was the bigger culprit.

Analysts have pointed to the decline of retail volumes as the clearest sign of weakness in consumer spending. Certainly, there is no lack of supporting evidence for that view, whether that be survey's about consumer spending intentions on households goods, their declining sentiment about the jobs market or their views about the current state of their household budgets.

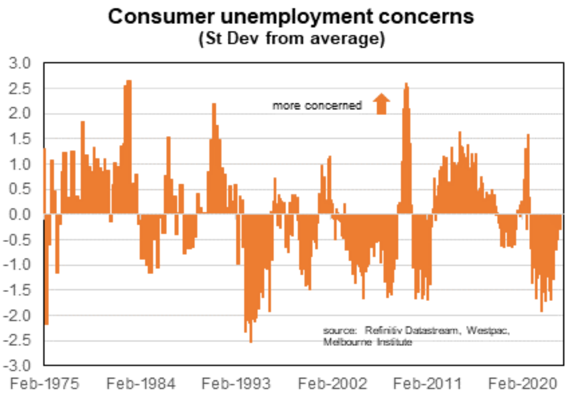
The volume of retail sales fell in Q2 for the third successive quarter.



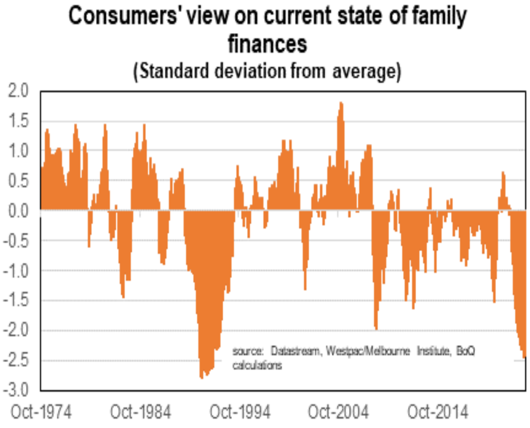

This is consistent with consumers sentiment about buying household items.




Reduced confidence about the jobs market might be playing a role.

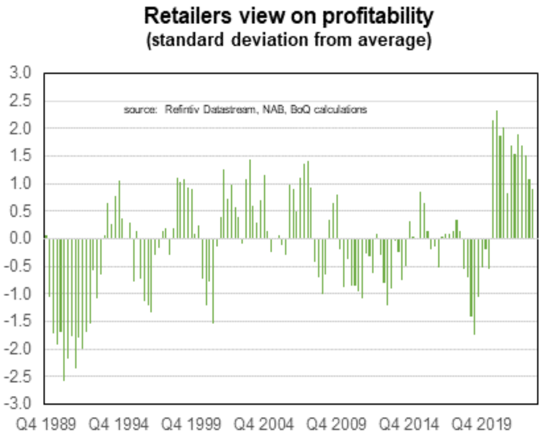



The bigger issue is the state of family finances.

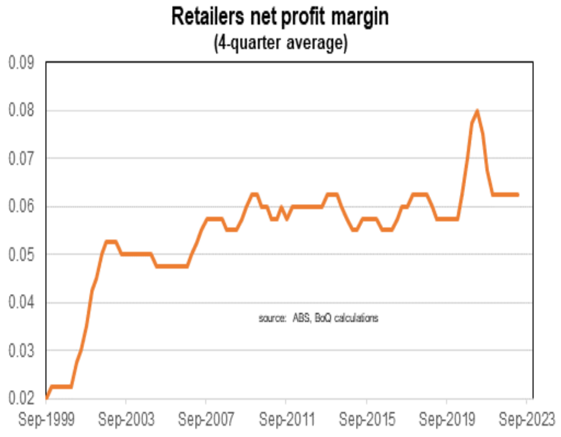


The negative sentiment about consumer spending on retail goods sits a little at odds with the view from retailers. Retailers view about their profitability in H1 2023 was above its long-run average, albeit down from their peak optimism hit during the pandemic. A key factor was that many retailers have been able to keep their profit margins at above pre-pandemic levels despite rising costs and slowing demand (including increased inventory and higher labour costs). The combination of increasing supply of goods at a time of falling demand will increasingly weigh on retailers over the next year. The decline in confidence suggests that may already be taking place amongst small retailers.

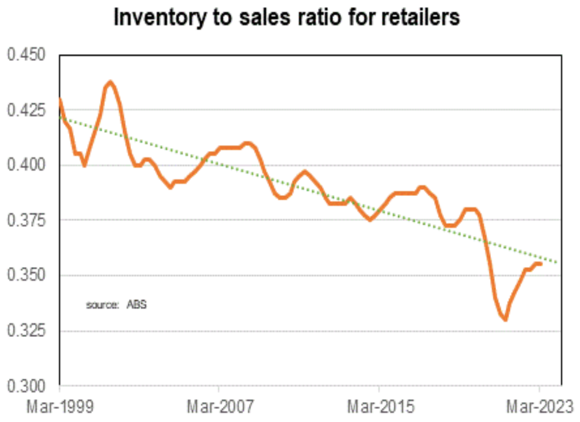
Retailers have had a positive view on profitability, albeit not quite as rosy as during peak pandemic.




A key reason is that they managed to keep profit margins above pre-pandemic levels.




This was despite having to rebuild inventory due to strong demand.



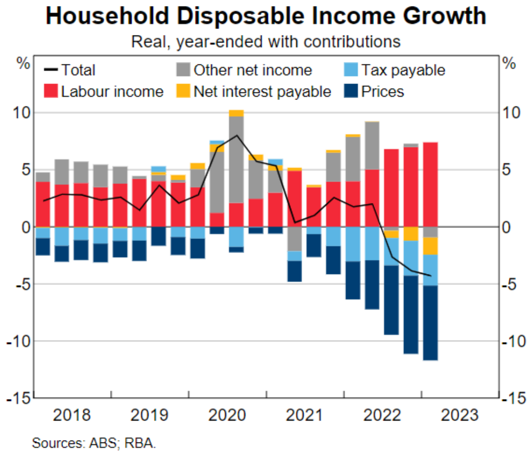

Confidence though has been weaker amongst smaller retailers.


Despite the decent vibe from retailers, there can be no doubt that consumer spending took a step down in H1. The weakness of ‘real’ household disposable income growth (disposable income growth after allowing for the impact of inflation) was the main driver. It is unusual that the weakness of disposable incomes has occurred at a time of rising labour income (a result of strong jobs growth and increasing wages). According to RBA analysis, inflation and rising mortgage payments have played a significant role driving the weakness in real disposable incomes, as has the decline in ‘other net payments’.

A focus just on the retail sector over-states the weakness of the consumer. Up to Q2 prices for retail goods had risen more strongly than prices for consumer services. Particularly at a time of declining real disposable incomes that relative price shift would cause some consumers to shift a portion of their spending towards services and away from retail goods.

The improvement in many global supply chains has seen a slowing in goods inflation in the first half of this year. With the likelihood of further slowing in goods prices in coming quarters (and a rise in the price of services), relative prices are shifting again to make the retail sector more attractive. That may lead to some consumers to switch some of their spending back towards retailers (such as hosting more dinner parties versus eating out).

The decline in real household disposable income growth has played a key role in slowing spending.



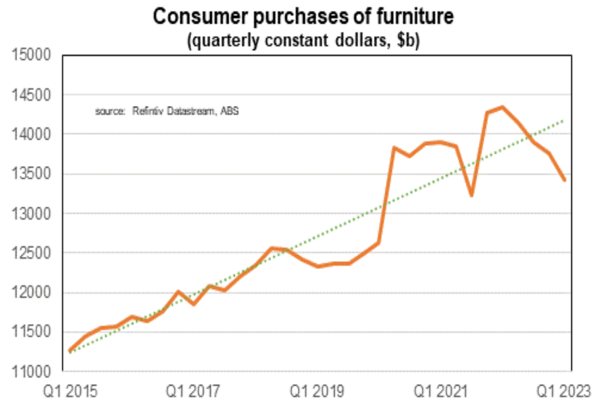

Changes in relative prices is beginning to favour spending on goods over services.


An even bigger influence on the patterns of consumer spending has been the pandemic. Being stuck at home and not being able to go out to a restaurant or a museum meant that many households took the opportunity to upgrade their furniture (or purchase another bottle of wine) which they could buy on-line. Spending on those categories jumped well in excess of their pre-pandemic trend and was therefore vulnerable to a pullback once the furniture had been upgraded and restaurants opened their doors.

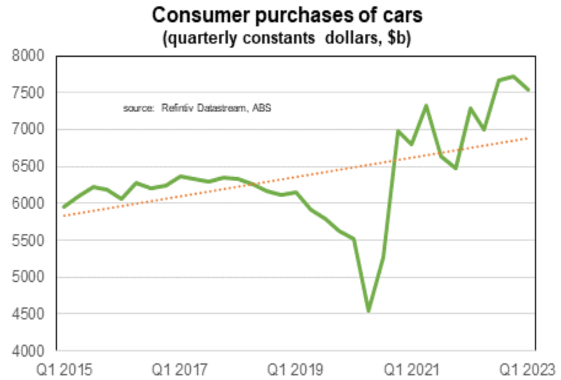
Consumers were not able to maintain their usual rate of spending on some goods categories (such as on cars and clothes) through the pandemic, and they have benefitted from catch-up spending over the past 12-18 months. But with spending on those categories moving above its pre-pandemic trend they became vulnerable to a pullback, which appears to be taking place. This catch-up spending was even more evident for many services (such as recreation), with that spending also now beginning to slow.

One category of consumer spending that remains below its pre-pandemic trend is transport. Partly that reflects the reduced use of mass transport as working from home becomes an established part of the work culture. It also reflects that spending on holiday travel has not yet returned to its pre-pandemic level. That suggests that further catch-up spending on transport is still to come.

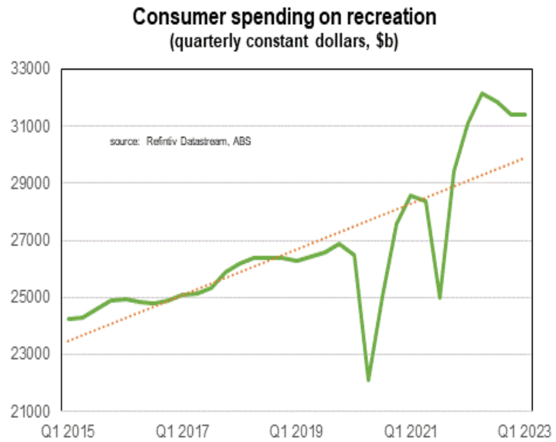
There has been payback from the above-trend spending on some categories of goods.



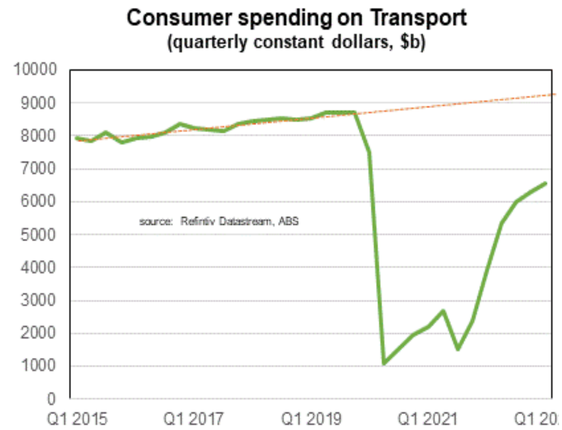

There has been catch-up spending on some other goods categories, such as cars.




As there has been more generally for services.




There is still some distance to go before transport spending hits its pre-pandemic trend.




Consumer spending growth is slowing, reflecting the decline in real disposable income growth. But a focus just on retail spending overstates the weakness of consumer spending. Real disposable income growth is likely to improve in coming quarters. How much of this extra income consumers decide to spend or save will play an important role in the outlook for the economy over the next 1-2 years, particularly in the retail sector.

We really do live in interesting times.

Regards

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