Themes on the Economy®

Mesirow Financial™

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Nowhere to Hide

Special Holiday Edition

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A Real Time Recession

Now that the elections have passed and the dust from the credit crisis has settled, we can take a moment and see where we are at—and the picture is not pretty. The credit freeze, triggered by the failure of Lehman Brothers, acted as an accelerant to an economy that was already stumbling:

- Layoffs came almost instantaneously, as big firms failed and smaller firms were absorbed into their larger and better-capitalized brethren.
- Home prices continued to drop, as mortgage rates soared and mortgages became scarce.
- Fortunes and 401(k) accounts shrunk, as stock prices plummeted.
- Short-term financing disappeared, forcing even the best of companies to cut costs and hoard cash.
- Retailers, scrambling to stock up on inventories ahead of the holiday shopping season, couldn't get financing, and shut stores or declared bankruptcy.

Table
The Holiday Outlook[1/]

	'06	'07	'08(f)
Total Retail Sales	4.7	4.6	-2.1
Adj. for inflation	2.4	0.3	-3.7
GMA[2/]	5.0	3.6	0
Adj. for inflation	2.6	-0.7	-1.7

[1/] November-December data, year-over-year percent change.
[2/] General merchandise and apparel store sales.

"The contraction in consumer spending will be painful this holiday season, especially for those at the lowest end of the income strata, as they never got to participate in the extraordinary rise in wealth."

- Consumers, who were shell-shocked by the events unfolding on Wall Street, cut back spending. In October, vehicle sales plummeted to their lowest levels since 1983, while spending at department stores plunged more than 6% from a year ago. And, Halloween, which is now the second-largest spending holiday next to Christmas for many retailers, was probably one of the worst in the last thirty years.

This marks a sharp contrast to the situation in 2001, when credit acted as a stabilizer and allowed consumers to bridge the turbulence created by the burst of the tech bubble, helping them keep their heads above water even as unemployment picked up and the economy contracted. Indeed, some are still trying to determine whether or not the contraction we experienced in 2001 actually qualifies as a recession, given the extraordinary role that credit played in dampening the pain for consumers.

This special report takes a closer look at the forecast for holiday sales. Special attention will be paid to the underlying fundamentals of consumer balance sheets, and the role that the credit crisis continues to play in curtailing spending. Banks remain particularly reluctant to lend into the headwind of a recession, despite the recent infusions of capital.

The report will conclude by identifying the winners and losers of the holiday season. There are few places for retailers to hide this holiday season, with the recession hitting virtually all regions and all income groups. Even high-end retailers are getting hit, with credit card companies reporting double-digit declines in purchases over $1,000 during the month of October.

The Holiday Outlook

It's Ugly

The *Holiday Outlook Table* provides the outlook for retail sales in November and December. Total retail sales are expected to contract 2.1%, driven largely by a sharp decline in vehicle sales. General merchandise and apparel store sales (GMA), which more closely track seasonal spending patterns, are expected to remain almost unchanged from a year ago. The only upside is falling energy prices, which are keeping the inflation-adjusted data from looking as bad as it did during previous contractions.

It is hard to find a winning spending category. Computers may get a slight lift at year-end,

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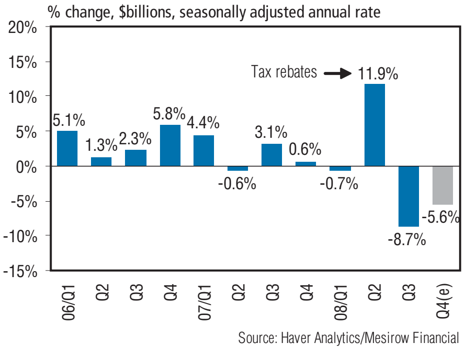
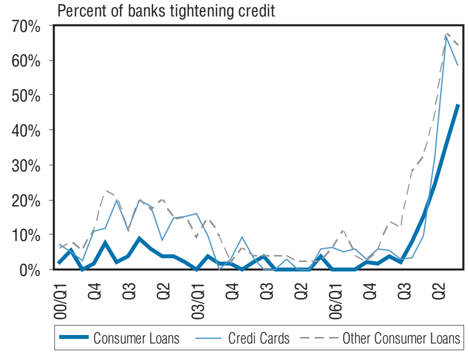
For all charts/graphs:
■ = Actual ■ = Estimate (e) □ = Forecast

CHART 1
Real Disposable Income Contracts



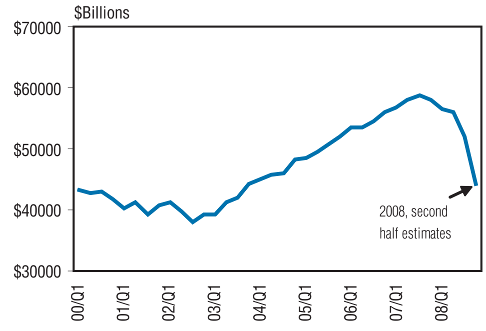
Source: Haver Analytics/Mesirow Financial

CHART 2
Credit Conditions Remain Tight



Source: Haver Analytics

CHART 3
Household Net Worth Declines



Source: Haver Analytics

as small businesses take advantage of the earlier stimulus package, which allowed for an accelerated depreciation rate on capital equipment. In general, however, consumer electronics are expected to do significantly worse than they have in recent years. A lack of new product offerings, especially in electronic gaming, is one reason, and a lack of financing is another. Large-screen television sales are particularly weak, despite the shift to high-definition broadcasting slated to occur in February, 2009.

Separately, purchases of gift cards and on-line spending are expected to abate, as consumers trade the convenience of gift shopping from their homes, for the values that they will find at brick and mortar stores offering discounts and "going-out-of business" sales.

Underlying Fundamentals

Charts 1 through 5 depict the underlying fundamentals of the holiday outlook:

- Real disposable income growth—the single largest determinant of consumer spending—contracted sharply, once the tax refunds were spent in the third quarter, and is expected to continue to contract in the fourth quarter. A further deterioration in employment is the primary reason for the decline. A shortfall in overtime hours, commissions, and bonuses (especially in the financial sector), however, will also put downward pressure on incomes. This marks a sharp contrast from the previous recessions, when wages continued to rise, at least before adjusting for inflation, even as employment plummeted. Indeed, one company in Chicago recently "promoted" a large number of its hourly workers, to eliminate the costs associated with overtime pay. It didn't, however, lower the number of hours that their employees are working, which means that the company is now getting more work out of them for less pay.
- Credit conditions remain extremely tight, despite some healing in corporate credit markets, and are expected to continue to put a damper on big ticket purchases. Auto loans, home equity lines of credit, and credit cards are all harder to get than they were even a few months ago, and are expected to remain constrained during the balance of the quarter. Indeed, some banks have actually rolled back or eliminated current lines of credit for homeowners in recent weeks. This is to say nothing of the crunch in credit that retailers experienced in recent months, which is sure to limit the zero and deferred financing deals that helped spur retail spending in previous years.
- Recent losses in the stock market have only worked to exacerbate the loss in wealth felt by the middle class due to the housing market bust. (Most households in the U.S. still consider their home their largest asset.) This, coupled with the recent surge of layoffs in the finance industry, have begun to erode spending even at the very top of the income distribution. Boutiques on Oak Street in Chicago have been complaining about the slowdown, and are now beginning to offer deals to recapture business lost since Lehman went down in mid-September.
- In October, consumer attitudes hit their lowest levels since the inception of the surveys. It is worth noting, however, that the surveys were taken at the height of the crisis on Wall Street, which, no doubt, reflected the sense of panic on Main Street.
- The dollar has strengthened *significantly*, which, along with a slowdown abroad, is expected to limit the number of foreign tourists spending in the U.S. during the holiday shopping season.
- The only bright spot is oil prices, which have plummeted in response to threats of a global recession. This is the closest thing to a tax cut one could hope for, and will help to keep food on the table during the holiday season, but will not put many additional presents under the tree. It is worth noting, however, that the effects of lower energy prices tend to be cumulative, which means we could see more of the positive effects associated with lower energy prices (providing that they stay low) in 2009.

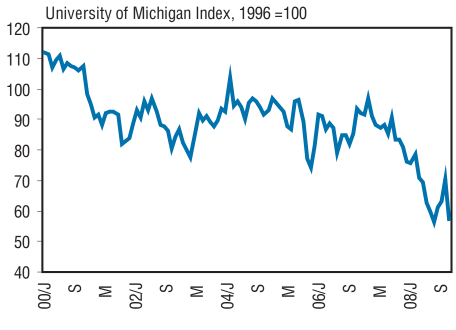
On net, consumer spending will continue to contract in the fourth quarter, as the economy slips further into recession. The search for value, in particular, will intensify. The good news is that retailers have already responded, with some offering their traditional Thanksgiving-week discounts a full month in advance of Thanksgiving. Others offered discounts tied to the election on November 4th, to stimulate lackluster demand.

A Second Stimulus Plan

The only major wild card is a second stimulus plan, which could be passed by a lame duck Congress before Thanksgiving. The focus of a second stimulus plan, however, will be to keep homeowners from defaulting on their mortgages, and to

CHART 4

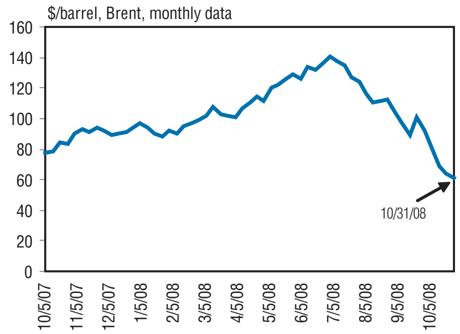
Consumer Sentiment Collapses



Source: Haver Analytics

CHART 5

Oil Prices Recede



Source: Haver Analytics

increase infrastructure spending, which would do more to stimulate the economy in 2009 than in 2008.

The hope is that an increase in infrastructure spending, in particular, might help to blunt the impending blow to construction activity from a correction in commercial real estate in 2009. (Very few new real estate deals have been financed since the credit crisis got underway in August, 2007, and much of the construction that was in the pipeline is now being completed.)

This is to say nothing of the offset an increase in infrastructure spending would bring for state and local governments, who have had to shelve many of their infrastructure plans as the tax revenues from residential real estate plummeted. Governors are lobbying hard for Washington to target those projects, to get the federal spending into the system faster.

Survival of the Fittest

- Department stores are expected to continue to lose market share relative to discounters. Sears has already announced several store closings, as their clients struggle to make ends meet. Luxury department stores are also feeling the pinch, with Barney's, Saks, and Neiman Marcus already offering discounts to keep their once well-heeled clientele from moving down the retail food chain to cheaper alternatives. High-end New York retailers are expected to be particularly hard hit, as many flagship stores in Manhattan bragged that they saw more foreign than out-of-state shoppers visit their stores during the Christmas holiday in recent years.
- Discounters are expected to continue to gain market share from more traditional department stores, as all households seek value. Indeed, Wal-Mart recently reported an increase in the median income of families that shop the discounter, as middle-income households expand their search for value. (I recently saw Wal-Mart advertise on CNBC, which touts some of the wealthiest viewers and retirees in the country.)
- Men's and children's apparel stores are expected to fare better than women's apparel stores. This is mostly because of overbuilding in the market for women's apparel and, at least in my own case, the fact that apparel purchases for women tend to be more discretionary than they are for children and most men I know.
- Electronic and appliance stores are expected to ration, as the competition from discounters entering the consumer electronic market intensifies, and consumers cut further back on big-ticket purchases. Circuit City has already upped its initial estimate of store closures during the season.
- Resorts are expected to continue to get squeezed, despite the decline in oil prices, which is one of the factors that forced consumers to curtail the length and number of their vacations in the first place. Tourism in Las Vegas is already down relative to a year ago. Air fares, in particular, have yet to fall much in response to receding energy prices. Even luxury resorts, which cater to the wealthiest of households and foreigners, have seen cancellations surge.
- Lower energy prices might free up some discretionary spending for restaurants and entertainment. The movie industry has always prided itself on being recession-proof. I have my serious doubts, however, given the proliferation of on-demand programming and ease with which movies can be rented, via Internet, video store, or vending machine. This is to say nothing of the shift toward prepared food and limited-service restaurants for families who are strapped for time and still struggling to make ends meet in a deteriorating economy.
- The only true winners appear to be bars and liquors stores, which saw extremely strong gains this summer (spending at bars surged at a double-digit pace from a year ago), as people decided to numb the pain associated with a contracting economy. Even there, however, people are expected to make trade-offs, picking cheaper wine and lower cost beer and liquors as they try to stretch their discretionary budgets.

The Bottom Line

We will all be moderating and curtailing our spending this holiday season. We will also be moving down the retail food chain, trading conspicuous consumption and luxury travel for more practical purchases. The days of designer bags, shoes, and luxury cars have temporarily passed, unless you buy them at outlet or discount stores. It will be a potluck, BYOB, and Secret Santa Christmas, instead of an over-the-top Trump affair.

The contraction in consumer spending will be painful this holiday season, especially for those at the lowest end of the income strata, as they never got to participate in the extraordinary rise in wealth. This is something that we should pay particular attention to as we set our own holiday budgets. We need to set a aside a little for those who need it most, which is not only an American tradition, but a good lesson for our children.

I have given more to educational scholarships in the last two months than I generally commit, because I believe most in investing in human capital. This is despite substantial paper losses in my investments and a freeze in my pay. Where will you give this holiday season?

Mesirow Financial Economic Forecast (Numbers as of November 10, 2008)

	2007(A)	2008	2009	2008:2(A)	2008:3(A)	2008:4	2009:1	2009:2	2009:3	2009:4
National Outlook										
Chain-Weighted GDP	2.0	1.3	-0.3	2.8	-0.3	-3.9	-1.3	1.0	2.0	2.4
Personal Consumption	2.8	0.3	-0.2	1.2	-3.1	-4.2	1.6	0.9	2.1	2.2
Business Fixed Investment	4.9	2.8	-5.5	2.5	-1.0	-7.5	-8.4	-7.1	-4.8	-1.5
Residential Investment	-17.9	-21.0	-9.4	-13.3	-19.1	-20.4	-18.9	-3.9	19.6	32.8
Inventory Investment (billions)	-2.5	-31.4	-34.0	-50.6	-38.5	-26.2	-62.8	-37.7	-22.4	-12.9
Net Exports (billions)	-546.5	-386.7	-364.6	-381.3	-350.0	-353.5	-351.2	-358.7	-369.1	-379.4
Exports	7.5	8.3	-0.7	16.3	7.5	-9.7	-4.1	0.4	1.5	3.0
Imports	1.7	-3.0	-1.1	-7.1	-2.8	-5.2	-3.5	2.6	5.3	7.8
Government Expenditures	2.1	2.9	2.6	3.9	5.8	1.2	2.6	2.9	1.8	0.6
Federal	1.6	5.7	4.3	6.6	13.8	2.0	3.5	3.0	2.5	2.1
State and Local	2.3	1.3	1.7	2.5	1.4	0.7	2.1	2.8	1.4	-0.3
Final Sales	2.4	1.6	-0.3	4.4	-0.8	-4.3	0.1	0	1.5	2.0
Inflation										
GDP Deflator	2.7	2.4	2.4	1.1	4.2	2.9	3.0	1.3	1.4	1.2
CPI	2.9	4.2	1.1	5.0	6.7	-3.7	0.6	1.3	1.7	1.8
Special Indicators										
Corporate Profits*	-2.0	-6.5	4.9	-8.3	-8.5	-6.5	-5.9	-1.2	1.4	4.9
Disposable Personal Income	2.8	1.5	3.5	11.9	-8.7	4.6	16.5	-5.2	1.1	2.0
Housing Starts (millions)	1.34	0.94	0.87	1.03	0.88	0.79	0.73	0.80	0.91	1.03
Civilian Unemployment Rate	4.6	5.7	7.7	5.3	6.0	6.7	7.3	7.6	7.8	8.0
Employment	0.8	-0.8	-1.9	-0.6	-1.1	-3.0	-2.9	-1.8	-0.7	-0.2
Vehicle Sales										
Automobile Sales (millions)	8.0	6.9	6.8	7.7	6.8	5.8	6.2	6.6	7.0	7.5
Domestic	5.5	4.6	4.4	5.0	4.4	3.8	4.0	4.2	4.5	5.0
Imports	2.5	2.4	2.4	2.7	2.4	2.0	2.2	2.4	2.5	2.5
Lt. Trucks (millions)	8.6	6.3	5.3	6.6	5.5	5.1	5.2	5.3	5.3	5.4
Domestic	7.1	5.1	4.2	5.3	4.4	4.1	4.2	4.2	4.2	4.2
Imports	1.5	1.2	1.1	1.2	1.1	1.0	1.0	1.1	1.1	1.2
Combined Auto/Lt. Truck	16.6	13.2	12.1	14.3	12.3	10.9	11.4	11.9	12.3	12.9
Heavy Truck Sales	0.4	0.3	0.3	0.3	0.3	0.3	0.2	0.3	0.3	0.4
Total Vehicles (millions)	16.9	13.5	12.4	14.6	12.6	11.1	11.6	12.2	12.6	13.3
Interest Rates/Yields										
Federal Funds	5	2	$\frac{1}{2}$	$2\frac{1}{8}$	$1\frac{7}{8}$	1	$\frac{1}{2}$	$\frac{1}{2}$	$\frac{1}{2}$	$\frac{1}{2}$
10-Year Treasury Note	$4\frac{5}{8}$	$3\frac{3}{4}$	$3\frac{1}{2}$	$3\frac{7}{8}$	$3\frac{7}{8}$	$3\frac{3}{4}$	$3\frac{5}{8}$	$3\frac{3}{8}$	$3\frac{3}{8}$	$3\frac{3}{8}$
Prime Rate	8	5	$3\frac{1}{2}$	$5\frac{1}{8}$	$4\frac{7}{8}$	4	$3\frac{1}{2}$	$3\frac{1}{2}$	$3\frac{1}{2}$	$3\frac{1}{2}$
Corporate Bond AAA	$5\frac{5}{8}$	$5\frac{3}{4}$	$5\frac{3}{4}$	$5\frac{5}{8}$	$5\frac{5}{8}$	$6\frac{1}{8}$	6	$5\frac{3}{4}$	$5\frac{5}{8}$	$5\frac{1}{2}$
Exchange Rates										
Yen/Dollar	118	104	105	105	108	98	95	100	110	115
Dollar/Euro	1.37	1.46	1.23	1.56	1.50	1.29	1.25	1.20	1.20	1.25

A= Actual

Quarterly data are seasonally adjusted at an annual rate. Unless otherwise specified, $ figures reflect adjustment for inflation.

*Corporate profits before tax with inventory valuation and capital consumption adjustments, quarterly data represents four-quarter percent change. Totals may not add up due to rounding. In 2005, GDP was $10,989.5 billion in chain-weighted dollars.

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