Mesirow Financial

THEMES on the Economy

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A Holiday for the Rich

Special Holiday Edition

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Perhaps you are taking mass transit instead of driving to work. Maybe you are renting DVDs instead of going to the movie theater. Or, you plan to turn the thermostat down a notch or two this winter. The point is that you are reacting to higher energy prices, and it is those reactions that will determine not only what, but how and where, you'll spend this holiday season.

This report takes a closer look at the outlook for the holiday shopping season. Special attention will be paid to the constraints created by both record-high debt burdens and persistently high energy prices on consumer spending decisions. Also, distortions to spending created by this year's trio of hurricanes will be discussed.

Middle- and low-income households will become more price sensitive as they seek to limit the impact that rising debt burdens and higher energy costs have on their holiday budgets. High-income households, however, are expected to largely ignore prices at the pump and higher heating bills, as they continue to spend with abandon. The result is a doughnut-shaped economy, with spending concentrated at discounters and luxury retailers, and hollowed out of traditional department stores.

Table
The Holiday Outlook[1/]

	'03	'04	'05(f)
Total Retail Sales	**4.9**	**7.7**	5.7
Adj. for inflation	**3.3**	**4.6**	1.9
GMA[2/]	**6.0**	**6.1**	6.0
Adj. for inflation	**5.0**	**4.1**	4.1

[1/] *November-December data, year-over-year percent change.*
[2/] *General Merchandise and Apparel store sales.*

"Middle- and low-income households will be struggling to both heat their homes and put gifts under the tree, while high-income households continue to live it up."

The Holiday Outlook

The *Holiday Outlook Table* outlines the forecast for spending during November and December. Total retail sales are expected to rise 5.7% from a year ago, a fairly substantial slowdown from the pace of spending in 2004, especially after adjusting for inflation. A sharp drop in vehicle sales is the primary reason for the weakness, as owners of gas-guzzling SUVs have seen not only incentives disappear, but trade-in values collapse. Earlier incentives also borrowed a bit from sales today.

General Merchandise and Apparel (GMA) store sales, which more closely track gift-buying decisions, are expected to hold up slightly better and rise 6.0% from a year ago. All boats, however, will not rise with the tide and many traditional department stores are going to find themselves awash in inventories once the holiday season comes to an end in early January.

NOTE: The proliferation of gift cards, which allow consumers to choose their own gifts and better time their purchases to coincide with store sales, is expected to further extend the holiday season. The best selling weeks of the year now include both the week before and after

Weathering the Storm

Real GDP growth rose 3.8% in the third quarter, shrugging off the drag created by hurricane disruptions. The scramble to deal with damages and survivors provided some stimulus to the economy. Government spending surged as FEMA moved to provide food and shelter to survivors, while investment in new equipment was buoyed by purchases of construction equipment and recreational vehicles (temporary housing). Consumer spending also held up extremely well, as consumers in the path of hurricanes boarded windows and stockpiled merchandise ahead of the storms. Inventories, however, were liquidated.

Prospects for the fourth quarter are somewhat better than previously expected, with growth now forecast to rise about 3½%. Persistently strong equipment investment, and a rebuilding of inventories should keep our factories humming, despite some slackening in consumer demand. Imports are also expected to pick up now that key ports in the Gulf Coast have re-opened. Those gains, however, will widen the trade deficit and put a damper on overall growth.

Transitioning to a Bernanke Fed. As expected, the Fed continued to normalize rates with a quarter-point hike in November. Core inflation remains contained, but is becoming more of a concern for policymakers than it was earlier this year. It will likely remain a concern when Ben Bernanke takes over as Chairman on February 1. (He could take over even sooner if his nomination process is expedited.) The forecast now shows the fed funds rate reaching 4¾% in 2006.

Chart 1
Oil Prices Remain High

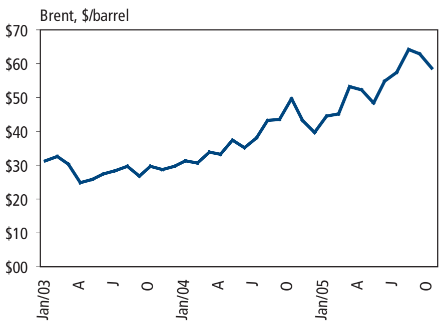


Chart 2
Unleaded Gas Prices Still High

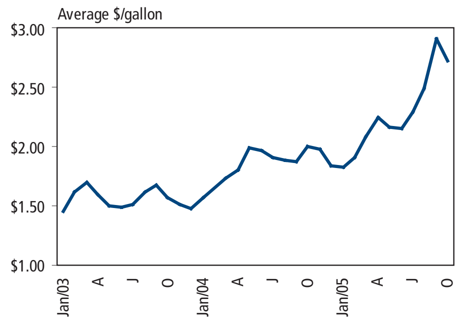
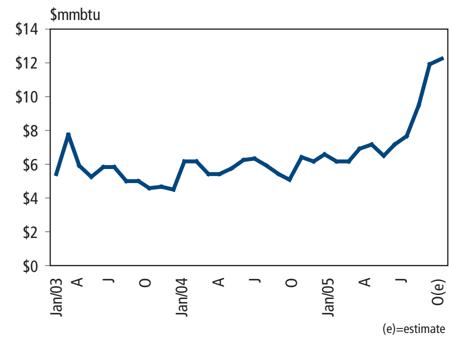


Chart 3
Natural Gas Prices Skyrocket



Christmas, with some spillover into January, when discounts are greatest.

Balance Sheet Problems

Until recently, rising employment and increased credit card usage helped consumers circumvent the pinch of higher prices at the pump. However, consumers can't spend beyond their means indefinitely. Eventually, their bills will come due. In July and August, credit card delinquencies hit record highs as debt burdens became overwhelming.

Simultaneously, mortgage refinancing dried up, while rates on home equity loans rose. This erased a substantial source of funding for consumer spending.

Persistently higher gasoline prices became harder to ignore and trade-offs were made:

- DVDs were substituted for trips to the movie theater.
- Time-strapped parents bought prepared foods at the grocery store instead of more expensive takeout.
- Adults consumed more alcohol at home than in bars.

(One can almost see a family of four, eating their roasted chicken meal from their local grocery store, the adults sipping a glass of pinot and watching a recently released DVD on a Friday night. The difference between the cost of that scenario and going to dinner and a movie for a family of four would easily cover the extra expense associated with filling at least one gas tank, maybe two, in a week.)

On August 29, Katrina wreaked havoc on the Gulf Coast and, along with her wicked sister Rita, further exacerbated the run-up in energy prices. The need to reallocate consumer budgets intensified, and consumers responded. Gasoline usage actually declined during the Labor Day holiday as travelers cancelled vacations planned for early September.

Add to that, the burden of higher interest rates and an increase in the minimum monthly payments that banks charge on credit card balances, and consumers are sure to be even more squeezed this holiday season.

NOTE: In an effort to discourage consumers from carrying high credit card balances, regulators are requiring banks to shorten the period over which they amortize those balances. This change will double the monthly minimum payment for some card holders before the end of the year.

Energy Burdens

Charts 1 through 3 show the behavior of energy prices. Prices remain relatively high, despite warmer weather and signs of softening in recent weeks:

- Oil prices remain in the $60-per-barrel range, more than 30% above a year ago, despite a retreat from record highs in the wake of Katrina. Moreover, the market remains extremely volatile and vulnerable to supply shocks.
- Prices at the pump have returned to pre-Katrina levels, but are still more than fifty cents per gallon ahead of a year ago.
- Natural gas prices remain stubbornly high, almost doubling from a year ago during the first week of November.

The result has been a fairly substantial run-up in the energy share of consumer spending (*see chart 4)* and a subsequent crimp on non-energy purchases. Moreover, the situation could get worse before it gets better:

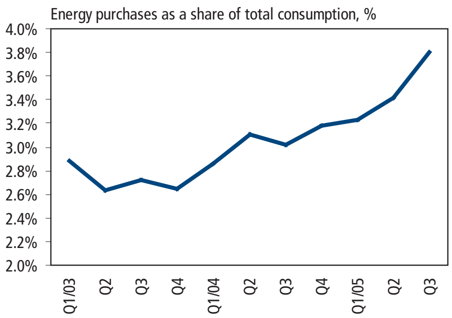
- Consumers paid roughly $9.2 billion more for gasoline in September than they did a year ago, despite a 3% decline in gasoline consumption.
- Natural gas bills are slated to rise almost 50% from a year ago, shaving another $3.1 billion from consumer budgets over the winter.
- At least a portion of those increased costs are expected to spill into other transportation costs. Everything from bus fares, air fares, parking fees and tolls have soared in recent weeks.

Risks? Warm winter weather could bring energy prices down even further than we have seen in recent weeks, and alleviate the squeeze of higher energy bills this holiday season. Many retailers, however, rely on a cold snap to clear their shelves of winter wear.

Trade-Offs for the Masses

Tax return data for 2003 (the most recent available) show that more than 91% of taxpayers earn less than $100,000 per year. A good portion of those consumers will be forced to continue making trade-offs in order to make ends meet this holiday season:

Chart 4
Energy Slice of Pie Widens



- Buying at discount and warehouse clubs instead of traditional department stores.
- Purchasing gift cards instead of actual gifts, which allow recipients more choice and an edge at getting goods on sale after the holidays. Gift cards from major credit card companies and discounters are expected to be particularly popular, as these offer the greatest amount of flexibility for recipients.
- Entertaining at home instead of going out will mean more spending at grocery and liquor stores than at mid-level restaurants and bars.
- Spending on consumer electronics and games instead of movie tickets and sporting events, as home bound consumers try to enhance home entertainment systems. This includes spending on computers (games) and Internet access, which have both fallen in price over the last year.
- Making fewer car trips to conserve fuel means fewer chances for retailers to lure shoppers to stores.
- Taking fewer and cheaper vacations to less expensive destinations with smaller and lower-priced hotels.

The Exceptions

Not all consumers, however, will behave the same. The wealthy and moderately wealthy, which have benefited the most from the rise in profits (via large bonuses) and rebound in employment over the last year, are still spending aggressively:

- Paying $15,000 for two tickets to watch the Chicago White Sox at the first home game of the World Series. (Although given the outcome, it may have been worth it.)
- Buying $350 Prada t-shirts.
- Spending more than $200 for a pair of ripped jeans.
- Booking $500-a-night hotel rooms. (Pricing and occupancy rates at high-end hotels have already exceeded the highs hit during the peak of the Internet bubble in early 2000.)

It is a fairly good bet that the wealthy will continue to ignore high energy prices, and provide a major impetus to spending this holiday season. They will keep full service/high-end eateries in business. They will order $100 bottles of wine, eat the most expensive meals and hire caterers to serve their friends. They will shop at luxury retailers, buy expensive jewelry and book vacations in some of the most expensive resorts in the world.

Moreover, their impact will be substantial, despite their small ranks. Some estimate that the top income brackets account for up to 40% of discretionary spending in the U.S. That number, however, is probably conservative. The nearly 9% of taxpayers who reported earning more than $100,000 a year in 2003 accounted for almost *half* of all income generated in the U.S.

Hurricane Distortions

Rebuilding and replacement demand associated with hurricanes Katrina, Rita, and Wilma will provide an extra boost to spending at building supply stores this holiday season. To some extent, they already have, as home owners rushed to hurricane-proof their homes and businesses ahead of the storms.

Spending at furniture and appliance retailers should also get a small lift from storm repairs. The push to replace damaged property by firms and homeowners in Florida will be particularly strong.

Retail Winners and Losers

Luxury retailers, niche-designer stores and high-end jewelers will remain at the top of the heap. Pricing power is especially good at the high end of the market. A good example is Coach, which was able to achieve a 9% year-over-year increase in purse prices in the third quarter.

Discounters and warehouse clubs are next in line. An increase in market share over traditional department stores is expected to provide some offset to the squeeze on spending created by rising debt loads and persistently high energy prices. Competition is expected to remain intense, however, as their clients become more price sensitive.

Traditional department stores are at the bottom of the food chain, losing market share to both luxury and discount retailers. Sales promotions will be aggressive, but not enough to stave off further consolidation. We will continue to see mergers and acquisitions and department store closures for some time to come.

The Bottom Line

The result is a sort of bifurcated holiday season: Middle- and low-income households will be struggling to both heat their homes and put gifts under the tree, while high-income households continue to live it up.

Remember that if you are in the minority of taxpayers who earn more (and most of you are), Spread your holiday cheer, be a little more generous to those less fortunate, and be thankful that it is still better here than almost anywhere else.

Mesirow Financial Economic Forecast (Numbers as of November 7, 2005)

	2004	2005	2006	2005:1(A)	2005:2(A)	2005:3	2005:4	2006:1	2006:2	2006:3
National Outlook										
Chain-Weighted GDP	4.2	3.6	3.5	3.8	3.3	3.8	3.6	3.6	3.7	2.9
Personal Consumption	3.9	3.6	2.8	3.5	3.4	3.9	2.0	2.9	2.9	2.5
Business Fixed Investment	9.4	8.6	8.5	5.7	8.8	6.2	8.0	9.4	8.4	8.9
Residential Investment	10.3	7.0	7.9	9.5	10.8	4.8	6.0	9.0	10.0	8.0
Inventory Investment (billion $)	52	20	36	60	-1	-16	36	34	38	35
Net Exports (billion $)	-601.3	-632.0	-699.0	-645.4	-614.2	-611.8	-656.5	-672.5	-688.8	-709.2
Exports	8.4	6.5	5.4	7.5	10.7	0.7	2.6	6.7	6.9	6.4
Imports	10.7	6.0	7.2	7.4	-0.2	0	12.1	7.9	8.0	8.5
Government Expenditures	2.2	2.1	3.3	1.9	2.5	3.2	4.1	3.7	3.3	2.6
Federal	5.2	2.8	3.8	2.3	2.4	7.7	4.1	3.3	3.0	2.6
State and Local	0.4	1.8	3.1	1.6	2.6	0.6	4.0	4.0	3.5	2.5
Final Sales	3.9	3.9	3.4	3.5	5.6	4.4	1.8	3.7	3.6	3.0
Inflation										
GDP Deflator	2.6	2.7	2.5	3.0	2.6	3.1	2.4	2.6	2.5	2.2
CPI	2.7	3.3	2.9	2.4	4.2	5.1	2.5	2.4	2.4	2.3
Special Indicators										
Corporate Profits*	11.7	18.6	13.9	19.1	21.9	16.5	16.9	15.9	8.5	16.4
Disposable Personal Income	3.4	2.0	3.2	-3.4	1.5	2.7	3.3	3.8	3.4	2.9
Housing Starts (millions of units)	1.95	2.04	1.94	2.08	2.04	2.07	1.98	2.0	1.95	1.91
Civilian Unemployment Rate	5.5	5.1	5.0	5.3	5.1	5.0	5.1	5.0	5.0	5.0
Employment	1.1	1.7	1.4	1.6	1.9	1.7	1.0	1.6	1.5	1.0
Vehicle Sales (millions of units)										
Automobile Sales	7.5	7.7	7.4	7.5	7.7	7.9	7.6	7.6	7.4	7.3
Domestic	5.3	5.4	5.3	5.4	5.4	5.6	5.3	5.4	5.3	5.2
Imports	2.2	2.2	2.1	2.1	2.2	2.3	2.2	2.2	2.1	2.1
Lt. Trucks	9.3	9.2	8.6	9.0	9.6	10.1	8.0	8.5	8.6	8.5
Domestic	8.1	7.9	7.4	7.7	8.3	8.9	6.9	7.3	7.4	7.4
Imports	1.2	1.2	1.2	1.2	1.2	1.3	1.2	1.2	1.2	1.1
Combined Auto/Lt. Truck	16.8	16.8	15.9	16.4	17.2	18.1	15.6	16.1	16.0	15.8
Heavy Truck Sales	0.4	0.5	0.4	0.5	0.5	0.5	0.5	0.5	0.4	0.4
Total Vehicles	17.2	17.3	16.4	16.9	17.7	18.5	16.1	16.6	16.4	16.2
Interest Rates/Yields										
Federal Funds	$1\frac{1}{4}$	$3\frac{1}{8}$	$4\frac{5}{8}$	$2\frac{3}{8}$	$2\frac{7}{8}$	$3\frac{1}{2}$	4	$4\frac{3}{8}$	$4\frac{5}{8}$	$4\frac{7}{8}$
10-Year Treasury Note	4.3	4.3	4.7	4.3	4.2	4.2	4.4	4.5	4.7	4.8
Prime Rate	$4\frac{1}{4}$	$6\frac{1}{8}$	$7\frac{5}{8}$	$5\frac{3}{8}$	$5\frac{7}{8}$	$6\frac{1}{2}$	7	$7\frac{3}{8}$	$7\frac{5}{8}$	$7\frac{7}{8}$
Corporate Bond AAA	$5\frac{5}{8}$	$5\frac{1}{4}$	$5\frac{3}{4}$	$5\frac{1}{4}$	$5\frac{1}{8}$	$5\frac{1}{8}$	$5\frac{3}{8}$	$5\frac{1}{2}$	$5\frac{5}{8}$	$5\frac{7}{8}$
Exchange Rates										
Yen/Dollar	108	109	112	104	107	111	113	112	111	113
Dollar/Euro	1.24	1.25	1.25	1.31	1.26	1.22	1.22	1.24	1.24	1.25

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, four-quarter percent change. Totals may not add up due to rounding. In 2003, GDP was $10,381 billion in chain-weighted dollars.*

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