Forbes

Randy Warren Contributor

Opinions expressed by Forbes Contributors are their own.

INVESTING 8/31/2017 @ 12:52PM | 93 views

Are ULTA and Home Depot the Next Victims of Amazon?

POST WRITTEN BY
Troy Logan, Chief Economist, Warren Financial

One of our most favored stocks, ULTA has recently been laid low leading into and following earnings.   ULTA recently reported excellent same store sales comps of 12+% and Home Depot was at 6%. Unfortunately, ULTA is part of a long list of companies in the retail sector that have been taken to the woodshed by investors this year.

(Photo by Frazer Harrison/Getty Images)

Home Depot (HD) was *__not__* rewarded for reaching their high water mark of 6% comps. What gives? Why is retail so hated? We have all heard the anecdotes of Amazon (AMZN) being the retail killer.   And true enough there is a secular change in shopping behavior where more of us are buying online and most people have a Prime membership and take full advantage of the convenience. Also, we hear the constant refrain: “going to the mall is dead”. In fact, it’s easy to see that the youth no longer gather in packs to meet at the mall. All of this interaction is now “curated” by Facebook, Snapchat, multi-player gaming and the like. Clearly binge watching on Netflix (NFLX) and Amazon (AMZN) Prime accounts takes away from the marginal trip to the mall. However, as compelling as these explanations sound, we took a journey into the Federal Reserve data and found two other factors that have clearly walloped retail: healthcare costs and student loan costs.

<u>In spite of ecommerce trends, ALL Retail Spending is down so it cannot be Amazon alone…</u>

Table 1

Column 1	Column 2	Column 3	Column 4	Column 5	Column 6	Column 7	Column 8	Column 9
Date	Real Disp Income $B	Total Spend $B	Health Spend $B	Retail Sales $B	Ecommerce $B	Student Loans $B	Est. Loan Debt Service $B	Total Debt Service $B
2007 12 mo	$10,821	$10,042	$1,563	$1,372	$140	$582	($79)	($1,412)
16/17 12 mo	$12,674	$11,729	$1,980	$1,479	$375	$1,275	($173)	($1,269)
Pct Change	17.1%	16.8%	26.7%	7.8%	168.3%	119.0%	119.0%	-10.1%
Fred Series->	DPIC96	PCECC96	DHLCRX1Q020SBEA	RSXFS	ECOMSA	SLOAS	Calculated	TDSP * DPIC96

Note: values are inflation adjusted

Table 1

The secular change in shopping is clearly revealed in Table 1. Ecommerce Retail Sales have grown +168% since The Great Recession (“TGR”). In 2007, Ecommerce represented 10% of the overall Retail Sales $1,372 billion (Column 6/Column 5). Recently, this share grew to $375 billion in the 4 most recent quarters available or 25% (Column 6/Column 5) of the overall share. Has ecommerce growth been spectacular? Absolutely. Has Amazon been a clear beneficiary? Clearly! But there is more to the story.

There has also been real growth in overall personal income and personal expenditures over the same time period. Each increasing 17.1% and 16.8%, respectively since 2007. If overall income and spending is growing at a 16-17% rate over the period, how are Retail Sales faring?

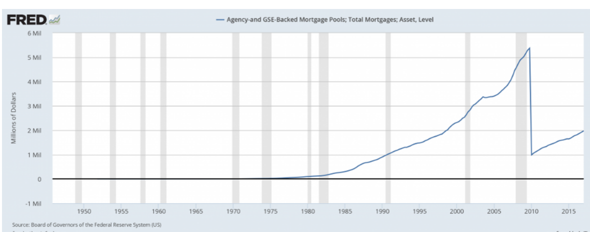
Retail Sales have grown +7.8% over the same period per column (5). So, on a relative basis Retail Sales are clearly lagging. What else could be vying for the consumers’ share of wallet and spend?

<u>Personal Expenditures on Healthcare have been through the roof…</u>

Health spending has grown at a much faster rate than income and overall spending. Total spending in 2007 was $1,563 billion or 14% of Disposable Income. This grew to $1,980 billion in the most recent 4 quarters or +26.7% since TGR and representing 16% of Disposable Income. The surge of increasing healthcare costs have flooded consumer budgets and contributed to the lagging Retail Sales growth. But this is only one factor hurting retail spending. The other factor is the Student Debt debacle, but first we must explain the 10% drop in overall debt service.

<u>A decline in debt service that is misleading...</u>

From Federal Reserve data summarized in table 1 column 9 we can see that overall debt service has dropped 10% since the TGR. This should be beneficial. Less money on debt should mean more to spend shopping. However this is not a beneficial decline in debt service. To be beneficial consumers would have to have built up equity as a result of paying down a liability. Instead, this decline in household debt service is largely an artefact of the massive mortgage write-offs occurring during TGR. As the FRED fed Graph 1 below shows loan balances dropped from over $5 trillion prior to TGR to around $1 trillion following TGR.



Total Mortgages; Asset, Level

This substantial decline in debt led to a lower debt service. However, unlike paying down debt this reduction was accomplished through write-offs. Instead of increasing household equity this reduced household equity. This reduction is a negative toward Retail Sales. And monthly housing expense didn't just go away, it was simply swapped from debt service to monthly rent. At best this has no impact on Retail Sales. Unfortunately, lower overall debt service is not helping Retail Sales.

<u>We can all agree that University and College Tuitions are out of control, but the consequences are just now blowing in</u>

Student loan balances have ballooned since TGR. Column 7 of Table 1 shows them growing +119% to approximately $1.3 Trillion today. In order to calculate their impact on spending we assume a 6% loan rate and a 10 year amortization in Column 8. There has been approximately a $100 billion increase in student loan debt service since TGR.

The consumer spending shift has an impact across the entire US age demographic as illustrated by a cross-sectional credit bureau chart constructed by the NY Fed presented in Figure 2.

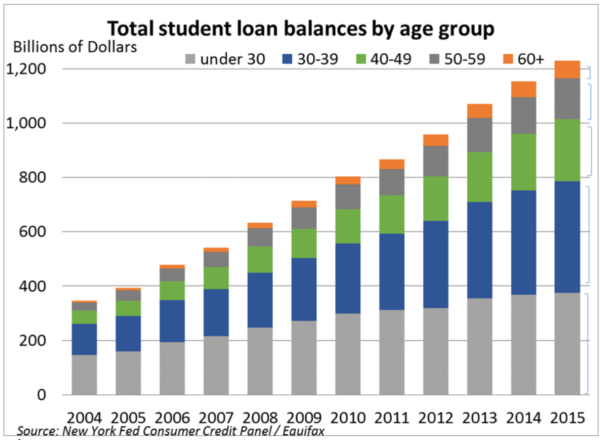


Figure 2

It is surprising to see the increase among the older demographic, but we speculate that this is explained through co-signing college loans due to underwriting requirements or pricing advantage and/or due to re-education. But, in either case, it is certainly not helping Retail sales to have $100 billion (and growing) going to service school loans.

A look at the data reveals something other than Amazon has been slamming Retail stocks. Healthcare costs and student loans will most likely continue to limit the growth of the US economy for the time being. To avoid getting slammed we have directed our investments into other names and sectors such as Information Technology, US Defense and Medical Devices.

Disclosures*: Warren Financial has long positions in some of the stocks mentioned in this article (Amazon, Ulta, Netflix, Home Depot, Facebook, etc) both for our clients and our own portfolios. We may be starting new long positions in some of these companies in the future. The fact that a company is mentioned is not a recommendation or offer to buy or sell that stock or bond. Investors should always seek advice from an advisor that knows their particular financial situation and not assume that general information such as the* *information in this article will apply directly to their portfolio. Investing includes the risk of loss.*

Warren Financial is an independent RIA firm under SEC regulation. Why do we do what we do? We believe that individuals make an impact. We help our clients achieve their "Greater Purpose".

Randy Warren is CIO of Warren Financial. For information on how to protect your investments from volatility visit WarrenFinancial.com and make sure to investigate our Safer-Equity strategies.