Maple-Brown Abbott
Flash Note

Australian Small Companies
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Why retailers are in for a tough 12 months

By William Hanna

Viewpoint

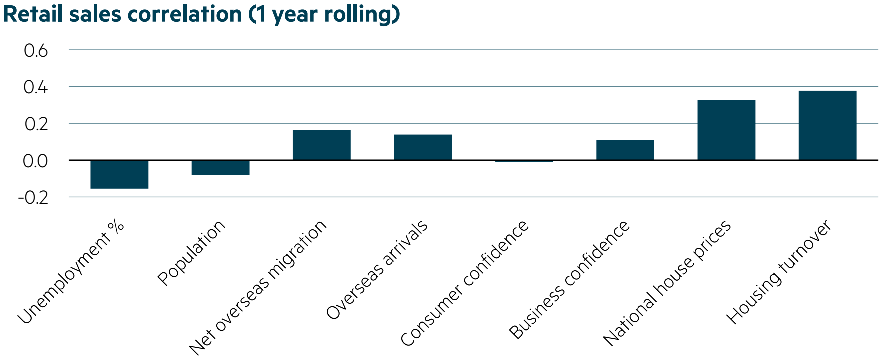
- Analysis of lead indicators for consumer spending patterns
- Can the buoyant retail environment continue?
- Where do we see opportunities in the retail sector

For any student of economic history, it's self-evident that economies and markets move in cycles. While this reality appears obvious, the elongated cycle that endured over the past decade may have caught investors in an illusion that this decade may revert back to the 'good times' – that market price weakness is short, temporary and likely to see another elongated bull market ensue. The retail sector is a good example, with consistently elevated sales levels in the period post-COVID, however we believe this will begin to unwind over the remainder of 2023.

Coming out of the February 2023 reporting season, it's clear that both consumers and businesses are preparing for the economic uncertainty ahead, given the steep interest rate hike cycle by the RBA (10 hikes since May 2022). Data analysis supports the view that retailers will face a more challenging 12 months ahead as consumers adjust their financial decision-making to account for the new economic regime.

Correlation analysis going back to the early 1980s in the chart below highlights that Australian house prices, housing turnover and the unemployment rate are key determinants of future expectations of consumer spending and retail sales growth.

Retail sales correlation (1 year rolling)



Source: MBA, Australian Bureau of Statistics, September 1982 to December 2022.

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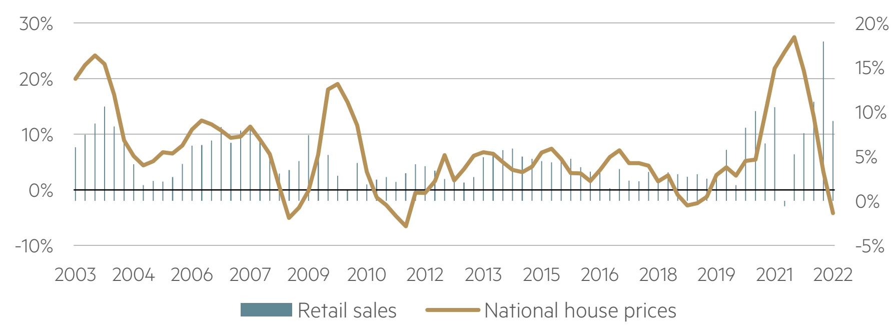
When considering the confluence of leading economic indicators – the normalisation of savings rates, low unemployment rate, high household debt, slowing house prices/turnover, fixed mortgage interest rates rolling into variable rates and, to a lesser extent, general confidence in the global banking system – it creates a toxic mix for businesses reliant on the financial health and confidence of the consumer.

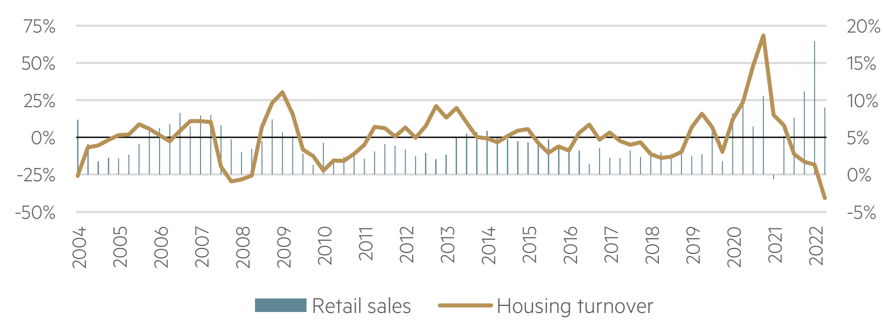
While this hasn't fully materialised yet, the data so far suggests that house prices and turnover are the biggest factors in driving retail sales, and with national house prices falling around 10% in the past year, and housing turnover declining rapidly towards the end of 2022 by over 20% (see charts below), the stage has been set for weaker retail sales in 2023. This has already started to come through for housing related retailers, with weak 2023 calendar year trading updates for Nick Scali (-12.1% written sales order growth),[1] Temple & Webster (-7% sales growth)[2] and Harvey Norman (-10.2% Australian sales growth)[3].

Retail sales vs National House Price changes (%)



Source: MBA, Australian Bureau of Statistics, June 2003 to December 2022.

Retail sales vs National Housing Turnover (%)



Source: MBA, Australian Bureau of Statistics, September 2004 to December 2022.

1 Nick Scali, FY23 Half Year Results Presentation, 6 February 2023.
2 Temple & Webster, H1 FY23 Investor Presentation, 14 February 2023.
3 Harvey Norman, Half Year Results Presentation, 28 February 2023.

It's unsurprising that consumer spending should slow provided that approximately two-thirds of Australian households own their own home, half of which carries a mortgage.[4] In addition, almost 20% of Australians own an investment property.[5] This presents significant balance sheet risks for households as house prices fall, leading to constrained budgets, income shocks and ultimately an unfavourable wealth effect for broader economic activity.

Net overseas migration and overseas arrivals have the potential to be a positive offset (to some extent), and the key factor to watch is the unemployment rate, given that continues at ultralow levels and can have a material impact on retail sales if it starts rising. Surprisingly, the data shows that consumer confidence has historically been a poor predictor of retail sales growth – so ignore the headlines!

Parting thought

We remain cautious on retailers but nonetheless find opportunities in select consumer names with a favourable customer base that is, for the most part, insulated from the effect of interest rate increases. Youth focused retailers such as Lovisa Holdings have, in our view, defied the broader trend of weakness with consistently good top line growth, a large global store roll-out program, and strong return metrics. The company is leveraged to younger female consumers who are less affected by interest rate rises and mortgage repayments, and an average price point of around $20 presents the offering as an affordable option in the jewellery and accessories category.

4 www.aihw.gov.au/reports/australias-welfare/home-ownership-and-housing-tenure.
5 Australian Taxation Office (2019–20).

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