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Broadlines & Food Retailing

History Repeats (So Far), Unemployment and Retail, Where We Go From Here

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Provided a significant ~71% correlation between real consumer spending and employment growth, we've kept a close eye on trends in unemployment as a barometer of traffic and spending patterns at stores. Moreover, as we noted in our November 2008 study (see 11/11/08 FC note entitled ***Broadlines Retail: Unemployment Rising, Retail Close To A Bottom?***), in looking at the past five recessionary periods, we found that the unemployment rate increased 250 bps, on average, and determined that retail stocks bottomed about half-way up the curve in each occasion. Based on this analysis, we're taking another look at how retail stocks have performed through the '08/'09 recession and our thoughts on where we are along the yield curve today.

To this end, if we assume unemployment peaks at ~10%, the "halfway point" may already be in the rearview mirror and likely took place in 1Q with retail staging an impressive rally since early March. Looking ahead, once again using history as a benchmark, retail tends to enjoy another leg up even as unemployment plateaus with a 9.4% average 6-month return in the retail index following the peak of unemployment (SPX up 3.0%) and a 16.6% 12-month gain (SPX +6.0%).

- **Step #1: A look back – 250 bps average increase in unemployment in each of the last 5 recessions.** A look back reveals that the past 5 recessionary periods were characterized by an average 250 basis point increase in unemployment. During these five periods, the average return of the general retail stock index was roughly 15.1% (vs. SPX at +2.4%) – see Table 1 herein. Retail stocks historically offer two distinct trades through the unemployment cycle – initially, retailers come under deep pressure for the first half of a rising unemployment cycle (-20.7% on average) before catching a bid and rallying through the peak of unemployment into a recovery (+45.6% on average).

- **Step #2: Where we are today – unemployment up 460 bps and climbing.** In the current downturn, unemployment has increased 460 bps in 16 months, from 4.8% in February 2008 (the most recent *sustained* trough) to 9.4% in May 2009. Moreover, J.P. Morgan's Economists expect that the unemployment rate will continue to climb from here – eventually peaking at ~10.0% in 4Q09/1Q10. If our academic analysis holds true and the 10.0% peak-unemployment forecast is accurate, it implies retail stocks should have bottomed in 1Q09 with unemployment in the mid-7.0% range. As a result, it's very possible that we've seen the bottom for retail stocks in this unemployment cycle, with the retail index off considerably from February 2008 to February 2009, but bouncing off lows and rallying since early March.

See page 5 for analyst certification and important disclosures.

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- **Step #3: A look ahead – stocks hold the rally as unemployment plateaus.** In looking at average returns post-unemployment stabilization (i.e., near-peak levels), we found that unemployment historically begins a modest rebound (improvement) gradually over the ensuing 12-months. Specifically, unemployment rates declined an average of 30 bps, 40 bps, and 80 bps in the 3 months, 6 months, and 12 months post-stabilization, respectively – see Table 2. In terms of stocks, we found that the retail index more/less held its second-half cycle gains in the 3-month period following unemployment stabilization, before rallying again – with a 9.4% average 6-month return in the retail index following the peak of unemployment (SPX up 3.0%) and a 16.6% 12-month gain (SPX +6.0%).

- **Summary – Staying barbelled on the long side.** Given that there are many moving parts to the macro dynamic with the unemployment peak still an unknown, our conviction in remaining barbelled on the long-side is as strong as ever, with exposure to both defensive plays and early-cycle recovery stories. Said differently, we recommend staying long retailers with formats that "work" in a recessionary environment, but balancing that exposure with best-in-class and/or early cycle movers as well. Therefore, we point to Wal-Mart, Dollar Tree, and BJ's as retail formats which have improved through the recessionary environment, and Kohl's, Target, and Saks as companies with solid fundamentals, but more opaque outlooks.

I. A Look Back at The Past 5 Recessionary Periods

We tracked the performance of a wide range of retailers though the past five economic downturns in the last 35 years that were characterized by a large increase in unemployment. Our analysis compares and contrasts the return and the correlation of our retail index with the increase in the unemployment rate.

Table 1: RLX and SPX Returns vs. Unemployment During Recessionary Periods

	# of	Unemployment Rate			Retail Index	SPX	Trough	Start - Low	Low - End
Period	Months	Start	End	Rise	Return	Return	Reached	Return	Return
5/74-5/75	13	5.1%	9.0%	390 bps	-12.1%	1.1%	More than 3/5	-42.8%	53.6%
12/79-8/80	9	5.9%	7.8%	190 bps	7.3%	14.6%	Near Middle	-10.4%	19.7%
7/81-11/82	17	7.2%	10.8%	360 bps	65.3%	5.2%	One-third	-8.7%	81.1%
6/90-3/91	10	5.2%	6.8%	140 bps	4.5%	2.9%	Middle	-28.4%	46.0%
5/01-4/02	12	4.3%	5.9%	160 bps	10.7%	-11.8%	More than 2/5	-13.1%	27.4%
Average	12			250 bps	15.1%	2.4%		-20.7%	45.6%
Today's Cycle									
2/08-5/09		4.8%	9.4%	460 bps	-16.3%	-29.0%	TBD	-24.5%	TBD

Source: National Bureau of Economic Research, Datastream, and J.P. Morgan. * Index appreciation calculated from trough to next peak period. General Retail Stock Index includes ANF, AAP, AMZN, AEO, APOL, AN, AZO, BBBY, BBY, BJ, CECO, KMX, CPRT, COST, DV, DKS, EBAY, FDO, GME, GPS, GES, HRB, HD, IACI, ESI, JCG, KSS, LTD, LOW, M, MELI, JWN, ORLY, ODP, JCP, PETM, RL, RSH, ROST, SKS, SHLD, SCI, BID, SPLS, STRA, TGT, TIF, TJX, URBN, WOOF, WMT, and WSM.

- **Takeaway #1: Steady unemployment rate increases typically last 12 months.** As seen in Table 1, steady unemployment rate increases have lasted for as few as nine months and as many as 17 months, but an average of 12. We are currently in the 16th month of a rising unemployment cycle.

- **Takeaway #2: Trough of retail stock index typically occurs at midway point.** We found that retail stocks are initially unfavorably impacted as unemployment rises before hitting a trough near the mid-point of the rate increase cycle. From the time of the start of unemployment rate increases to that trough, the stocks declined an average of 20.7%.

- **Takeaway #3: Substantial stock returns from trough to period of rate stabilization.** Over the course of the remaining half of employment rate increases to stabilization, retail stocks rose materially, making up for the ~21% average loss during the first half of the period and more. On average, over the second half of jobless rate increases, our retail index increased 45.6%.

II. A Quick Glimpse At What May Be Ahead

Equally as important as it may be to understand the signs of a rising unemployment cycle, we also believe it important to detail the ensuing events post unemployment stabilization. As such, in the table below, we examine trends following the end of a rising unemployment rate environment (i.e., what happens in the months following a continuous rise in unemployment – generally peak unemployment levels) in terms of both unemployment rates and stock returns.

Table 2: Life After Stabilization

post unemployment stabilization, changes in unemployment rate, retail index returns, and SPX returns

	Unemployment Rate				Retail Index Return Post Stabilization			SPX Return Post Stabilization		
Period	Stabilization	+3 months	+6 months	+12 months	+3 months	+6 months	+12 months	+3 months	+6 months	+12 months
5/74-5/75	9.0%	(0.6%)	(0.7%)	(1.6%)	(13.6%)	4.2%	3.8%	(5.5%)	(0.5%)	10.9%
12/79-8/80	7.8%	(0.3%)	(0.3%)	(0.6%)	3.3%	1.8%	25.1%	12.1%	12.5%	9.2%
7/81-11/82	10.8%	(0.4%)	(0.7%)	(2.3%)	8.5%	35.8%	35.8%	8.2%	20.3%	20.7%
6/90-3/91	6.8%	0.1%	0.1%	0.6%	16.5%	22.6%	34.6%	2.3%	2.7%	8.6%
5/01-4/02	5.9%	(0.1%)	(0.2%)	0.1%	(15.4%)	(17.4%)	(16.5%)	(16.7%)	(20.1%)	(19.2%)
Average		(0.3%)	(0.4%)	(0.8%)	(0.1%)	9.4%	16.6%	0.1%	3.0%	6.0%

Source: National Bureau of Economic Research, Datastream, and J.P. Morgan. General Retail Stock Index includes ANF, AAP, AMZN, AEO, APOL, AN, AZO, BBBY, BBY, BJ, CECO, KMX, CPRT, COST, DV, DKS, EBAY, FDO, GME, GPS, GES, HRB, HD, IACI, ESI, JCG, KSS, LTD, LOW, M, MELI, JWN, ORLY, ODP, JCP, PETM, RL, RSH, ROST, SKS, SHLD, SCI, BID, SPLS, STRA, TGT, TIF, TJX, URBN, WOOF, WMT, and WSM.

- **Takeaway #1: Peak unemployment typically lasts for 1-2 months.** Unemployment typically remains at peak levels for 1-2 months before declining 10 basis points. By three months post stabilization, unemployment is down ~30 bps from the peak, on average.

- **Takeaway #2: It's not uncommon to retest peak unemployment levels.** Although on average, unemployment rates improve in the 12-months following a stabilized jobs environment, it isn't too uncommon to see the unemployment rate retest peak levels, evidenced by reversion in the 1990 and 2001 periods. Specifically, unemployment peaked at 6.8% in March 1991 after rising for 10 consecutive months – after initially improving in April, unemployment quickly returned to peak-ish levels in May and held steady for six months before breaking to a new high 100 bps above the prior peak (to 7.8%) in June 1992. Similarly, unemployment peaked at 5.9% in April 2002, followed by six months of declining rates – however, unemployment spiked again beginning in November and ran to 6.3% by July 2003 (14 months post the initial stabilization).

- **Takeaway #3: Retail stocks respond favorably to improving employment.** On average, the retail index increased 9.4% and 16.6%, respectively, in the 6-months and 12-months following the end of a rising unemployment cycle – more than doubling gains of 3.0% and 6.0% in the SPX over the same period.

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