



# The Consumer Spending Spree Is Ending. That's a Good Thing.

Business media reaction to July's advance retail sales report from the U.S. Census Bureau was decidedly positive, with most coverage praising the resilience of consumer spending in the face of above-average inflation and high interest rates. There's truth in this sentiment; consumer spending has held up surprisingly well in the year since Fed tightening began in earnest in mid-2022, as a still buoyant labor market and remaining household savings from the COVID-19 period have mostly offset economic headwinds. However, it is also clear from the trending data that the unprecedented spending surge that began in late 2020 is ending (Figure 1). It's about time.

The strongest period of sustained sales growth for U.S. retail goods in our lifetimes occurred from late 2020 through mid-2023, with nominal retail sales growing by nearly 40% cumulatively or 8.5% annually (CAGR) since 2019. This was approximately double the long-term annual growth rate in this unprecedented period of big spending. It's a familiar story by now: A faster than expected labor market and economic rebound following early COVID-related shutdowns and stay-at-home conditions coupled with an excessive federal financial relief response to the COVID-19 pandemic and significant personal savings generated by work-from-home policies to create a huge financial windfall for tens of millions of households, many of whom have been spending it freely. Americans haven't restricted their free spending ways to retail goods, though that has been the primary beneficiary of stepped-up consumption. While the early strength in retail sales was attributable to stay-at-

home living conditions during COVID, Americans have been out and about and spending on travel and other excursions for more than a year without meaningfully denting sales of retail goods. The personal consumption expenditures ("PCE") metric, which measures the totality of personal spending (not just retail sales), also has shown exceptional nominal growth since 2020 that far exceeds historical norms.

But there has been a downside to this stellar spending story, mainly in the form of high inflation. Quite simply, this consumer spending spree has contributed indirectly to the inflation scourge that has afflicted our economy for the last two years — though admittedly, high inflation has been a global phenomenon since COVID arrived. The U.S. Consumer Price Index ("CPI") has increased by 18% cumulatively since the end of 2019, more than double the pre-COVID average of 2.2% annually since 2000.

Many factors initially contributed to accelerating consumer-level inflation on the supply side, including supply chain bottlenecks, labor shortages and rising product costs. But persistently strong consumer demand and shoppers' willingness to absorb hefty price hikes throughout the COVID and post-COVID periods have encouraged producers, sellers and service providers to continue playing that card after years of fearing consumer backlash to any sizeable price increases. Implemented out of necessity during COVID era shortages and disruptions, aggressive price hikes for many consumer goods and services have continued even as many of these disruptions have been mitigated, as some sellers try to see how far they can push shoppers on price. The pushback hasn't been too hard to date. In economic parlance, price elasticity remains favorable for many sellers of goods and services, meaning that the percentage decline in unit volume demand is less than the percentage increase in prices charged. Sky-high airfares, hotel room rates and concert ticket prices this summer, which mostly were booked or purchased months in advance, attest to this reality. So far, most consumers have yet to cry "uncle," but nominal spending growth has slowed notably since April.

Our nation's struggle with high inflation since mid-2021 has made it difficult to discern the underlying nature of consumer spending growth and judge whether retailers and other sellers are benefitting from price hikes or merely offsetting their own inflationary woes. For more than a decade prior to COVID, it was more easily discernible, as the overall inflation rate experienced by consumers for most retail goods consistently stayed close to 2.0%-2.5% annually, with real (i.e., inflation-adjusted) sales growth for retailers (in the aggregate) also in the same range. Clearly that template no longer prevails since COVID-19 reached our shores. Has consumer spending since 2021 been mostly inflation-driven, that is, are shoppers buying more goods and services or simply paying more for the same consumption baskets? Are retailers and other sellers more profitable as a result of price hikes or just treading water? High inflation makes it harder to answer these questions. Furthermore, with consumer-level inflation moderating in recent months, it's certainly possible that the slowdown in nominal retail sales growth since 1Q23 is mostly disinflation-driven (as opposed to smaller purchase baskets by shoppers), which would be a favorable development. Which is it?

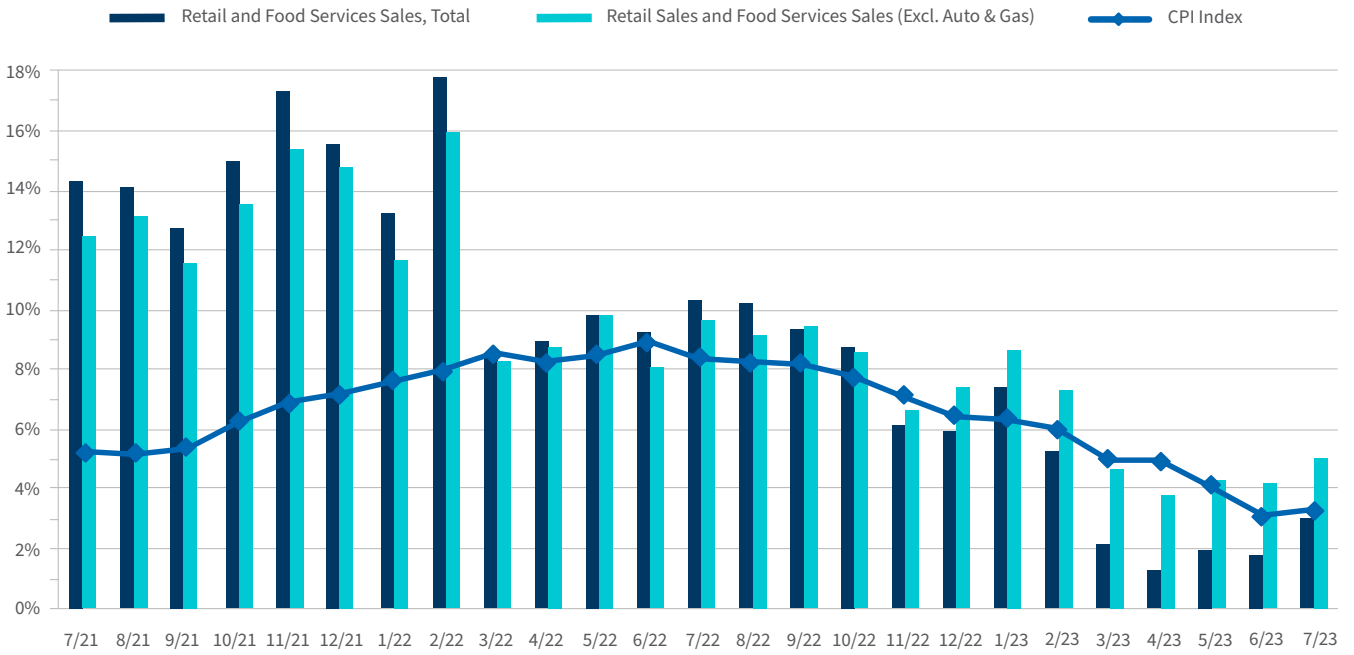
When we adjust nominal retail sales growth by changes in the CPI (admittedly an imperfect approach because CPI measures price changes for all consumer purchases of goods and services, but is still directionally accurate for this purpose), it indicates that nominal sales growth since mid-2022 was mostly inflation-driven, with high-single-digit growth (YoY) in nominal retail sales reduced to 2.0% or less on an inflation-adjusted basis (Figure 2). Moreover, real growth in retail sales turned negative for several months earlier this year before returning to positive territory since June as spending rebounded a bit. If this favorable trajectory persists, it suggests mid-single-digit nominal sales growth and low-single-digit real growth in the months ahead.

For retailers and other consumer-facing companies, this spending slowdown isn't necessarily bad news, especially if it is mostly tied to slowing inflation. They too have been plagued by high inflation for product and fulfillment costs since the onset of the COVID pandemic, and recent inflation relief for consumers almost certainly reflects relief for them as well. Indeed, the Producer Price Index ("PPI") for retailers (Figure 3) shows that inflation was crushing for retailers in much of 2021-2022 — more so than for consumers — but those price pressures have eased considerably in the past year, with slight YoY price declines (i.e., deflation) indicated for the last five months. It's hard to generalize here, but retailers could see gross profit and margins hold even as nominal sales growth slows, provided their product costs continue to ease and they effectively manage other operating costs within their control. However, the bottom-line performance of some retail chains will be hurt by slower consumer spending, as we already have caught a glimpse of in some 2Q23 earnings releases.

The retail sector has enjoyed a two-year windfall since COVID-19 struck to due highly anomalous factors, and it has been a much needed reprieve from its struggles to achieve more than modest sales and earnings growth prior to the pandemic. Those who thought stellar sales growth was sustainable indefinitely and built their business plans around that assumption are likely to be disappointed. The retail sector should gird for slower sales growth as the heady spending period since COVID seems poised to enter a new phase.

**Figure 1 - Nominal Monthly Retail Sales Growth**

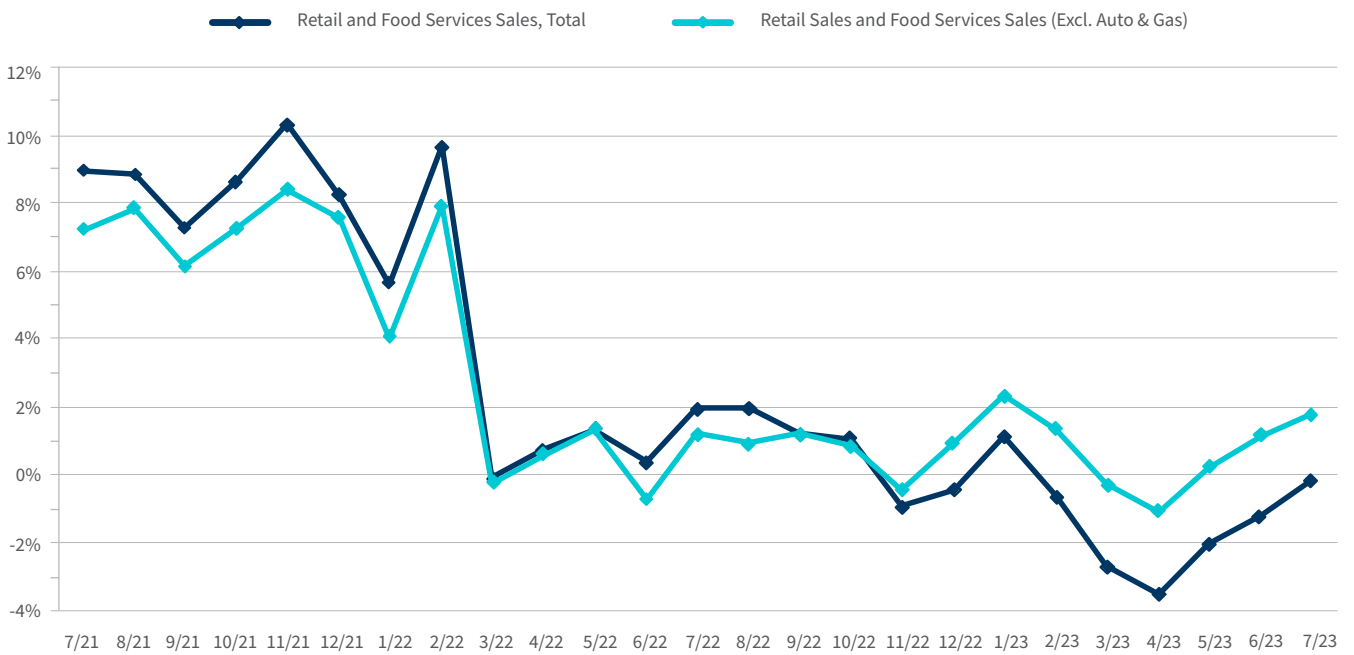
(YoY % Change)



Source: The U.S. Census Bureau, FTI Consulting Analysis

**Figure 2 - Real Monthly Retail Sales Growth**

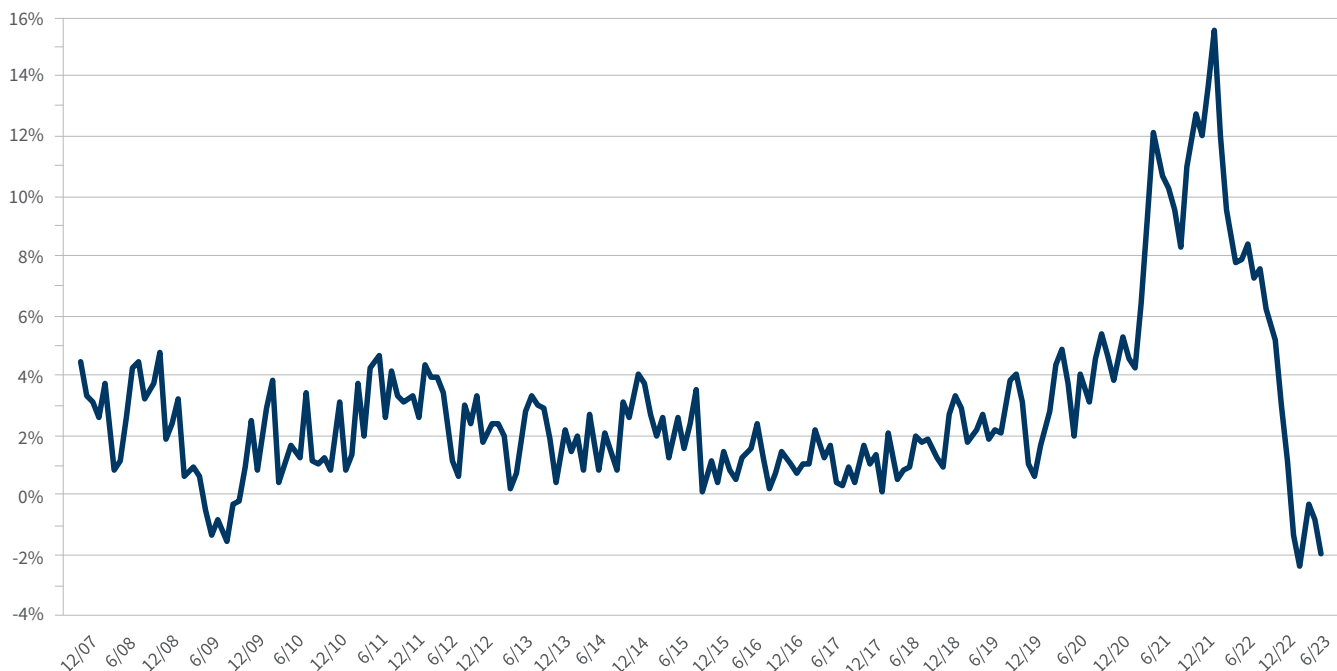
(YoY % Change)



Source: The U.S. Census Bureau, FTI Consulting Analysis

**Figure 3 - Producer Price Index: Retail Trade Industries**

(YoY % Change)



Source: FRED (Federal Reserve Bank of St. Louis)

The Fed must be pleased with the scenario that is playing out, as its tightening policies to date have slowed inflation considerably without inflicting undue harm on the consumer economy. Retail sales growth and PCE are now on a glidepath toward historical norms as inflation moderates; this is encouraging, provided that consumer spending doesn't stray too far on either side of the tracks. Headline retail sales this upcoming holiday season almost certainly will show the slowest growth since the onset of COVID, and that would be welcome news for those hoping for a return to pre-COVID economic normalcy and predictability.

Ironically, most interest rates have firmed or risen this summer even as inflation has eased (the 10-year Treasury note recently closed at a 16-year high of 4.3% while

3-month SOFR approaches 5.4%), as the Fed vocally advocates that its inflation vigilance will continue and has given no indication that the start of monetary easing is coming soon. It is uncertain whether the Fed is done with rate hikes, and a September pause is the best that markets can expect currently. More broadly, there is a growing belief that the Fed will not prematurely declare victory in its inflation fight and that interest rates will remain elevated despite progress made on the inflation front. "Higher for longer" increasingly is the refrain heard in the business community, and the draining impact of high interest rates on the cash flows of highly leveraged or poorly managed companies will keep restructuring activity grinding higher in the months ahead.

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