

## ECONOMIC INSIGHT – AUSTRALIA

21 MARCH 2017

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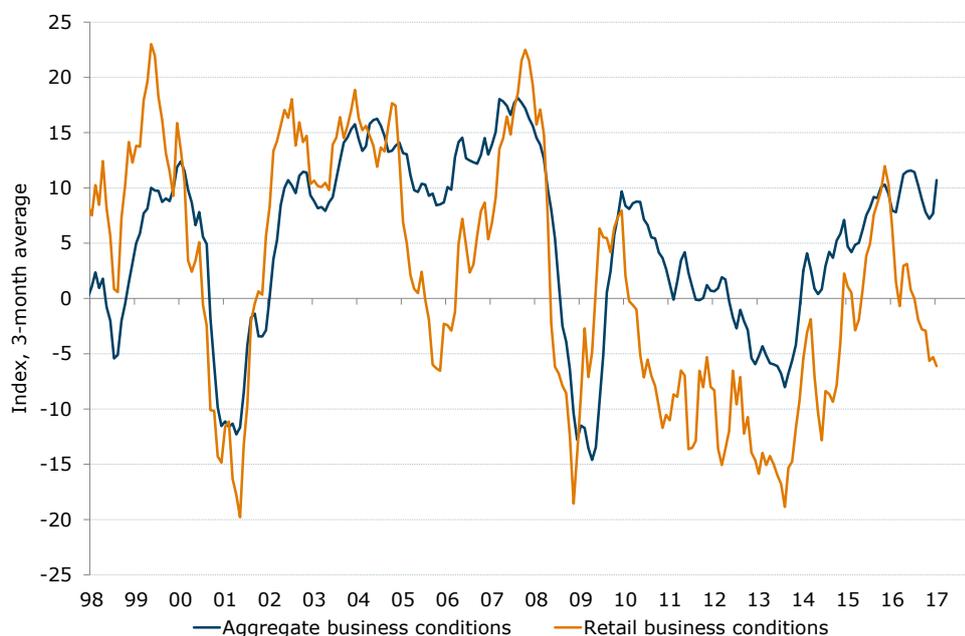
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## AUSTRALIA'S RETAIL LANDSCAPE: IT'S TOUGH OUT THERE

- Trading conditions in Australia's retail sector are difficult and likely to remain so given intense competitive pressure around pricing and slowing growth in retail sales per capita.
- The surge in foreign retailers opening brick and mortar stores continues to disrupt the retail landscape. With only 16% of the world's top 250 retailers currently with a physical presence in Australia, and the rumoured opening of Amazon this year, we expect pricing pressure to remain intense for at least the next year or two.
- Consumers will benefit from lower prices but ongoing weak retail price inflation will weigh on the broader inflation profile, leaving an up-lift in wage growth as critical to underpinning a rise in core inflation.

FIGURE 1. RETAIL CONDITIONS ARE TOUGH



Source: NAB, ANZ Research

## CONDITIONS IN AUSTRALIA'S SECTOR ARE TOUGH

The NAB survey of business conditions highlights how difficult conditions are in the retail sector compared with the overall economy. Indeed, business conditions in the retail sector have been in negative territory since July 2016 (indicating that the majority of firms surveyed expect conditions to worsen), while conditions in the overall economy have trended higher (see Figure 1).

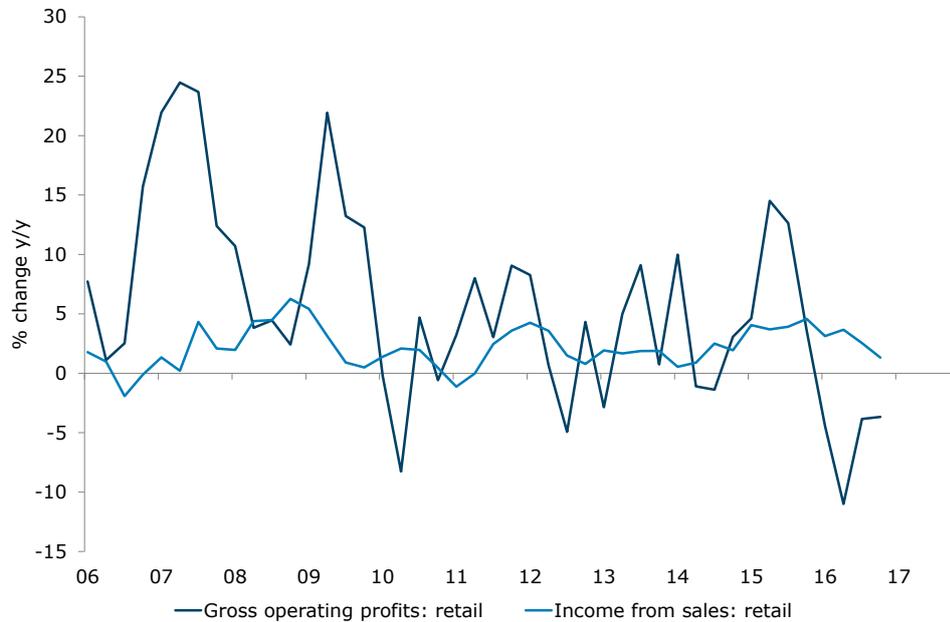
Just how difficult conditions are is also highlighted by the fact that four major Australian retailers have gone into voluntary administration in the first two months of this year (Marcs, David Lawrence, Herringbone and Rhodes & Beckett) following Pumpkin Patch and Payless Shoes in late 2016.

Moreover, gross operating profits are falling, growth in income from sales has slowed and pricing power is under pressure from international competition.

In annual terms, gross operating profits have been falling for a year and income from sales were up just 1.3% y/y in December, the weakest reading since mid-2014 and well below the decade average of 2.2% (see Figure 2).

Perhaps not surprisingly, the retail sector has been shedding jobs - with more jobs lost in the year to November 2016 than any other industry (see Figure 3).

**FIGURE 2. INCOME AND OPERATING PROFITS ARE UNDER PRESSURE ...**



Source: ABS, ANZ Research

**FIGURE 3. ... AND THE SECTOR IS SHEDDING JOBS**



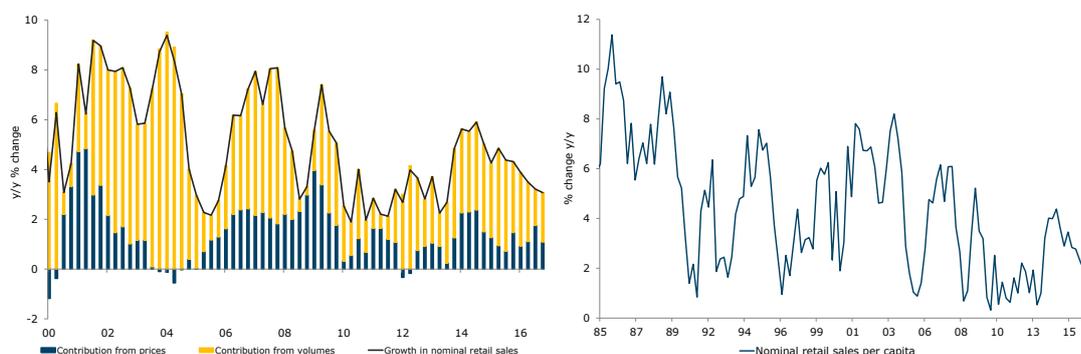
Source: ABS, ANZ Research

## SOFTER DEMAND IS PART OF THE EXPLANATION

Annual growth in both retail sales and retail spending per capita has been slowing (see Figure 4). Retail sales volumes were up just 2% in the year to December 2016, well below the long run average of 3.6%.

In part this reflects shifting consumption patterns away from traditional retail goods in favour of services. In contrast to relatively weak retail sales, overall private consumption has been rising steadily, by around 2.5% annually, for several years now (see Figure 8).

**FIGURE 4. RETAIL SALES ARE DECELERATING ...**

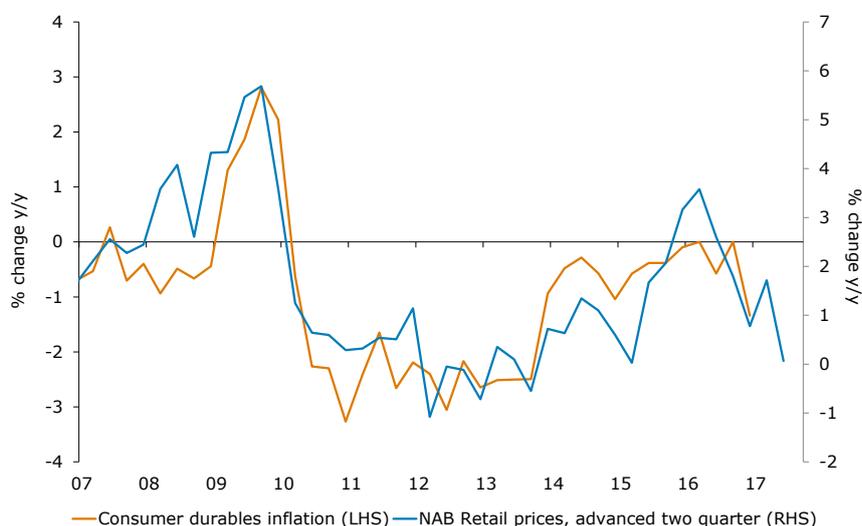


Source: ABS, ANZ Research

## BUT COMPETITION AND A LOSS OF PRICING POWER IS HAVING A MAJOR IMPACT

While lacklustre demand is part of the story, weak conditions are also reflective of low retail price inflation. This is evident in the retail trade data (see Figure 3), the NAB survey and the retail items in the CPI (see Figure 4). Retail prices excluding volatile items (fruit, vegetables, alcohol and tobacco) fell 2.5% in the year to Q4 2016, weaker again than the 1.1% decline in the year to Q4 2015.

**FIGURE 5. RETAIL PRICES ARE UNDER PRESSURE**



Source: NAB, ANZ Research

Retailers' pricing power is being constrained by both the rise of online shopping (although online still represents less than 10% of sales in Australia), and the trend by major global retailers to enter the Australian market with brick and mortar stores. The expansion of the online market place is driving a convergence of retail prices across countries and is impacting retail inflation across the globe. However, the brick and mortar aspect is relatively unique to Australia. We first wrote about this in a November 2015 Economic Insight, [Australian inflation in a globalised world](#).

Competitive pressure is evident across a range of retail areas, including supermarkets, clothing, footwear and accessories, and increasingly furnishing and homewares.

The [Global Powers of Retailing 2017](#) report by Deloitte found that just 16% of the top 250 global retailers are currently operating in Australia, with the largest category being apparel and footwear (at 36% of the total), followed by supermarkets (at 20%).

Interestingly, in the survey, 41% of Australian retailers cited foreign-owned brick and mortar stores as their greatest competition and 12% reported that pricing is a key focus this year, up from just 2% in 2015.

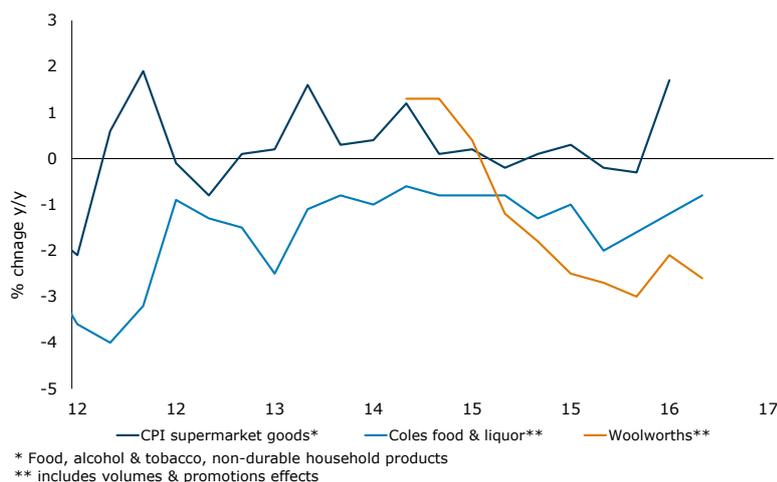
Foreign retailers are attracted by relatively high margins in Australia and will continue to enter the market as long as that additional margin is on offer. While it's difficult to put timing around this, it would appear to have further to run across all industries. Indeed, in its most recent Statement of Monetary Policy (SoMP), the RBA noted "the disinflationary effects on final retail prices from heightened retail competition and low wage pressures are expected to dissipate slowly, although there is uncertainty about the size and timing of these effects".

The price pressure in supermarkets has been intense and shows no sign of fading. To date, the bulk of the margin compression in the supermarket space has occurred at the wholesale level leaving retail margins above global norms.

Coles and Woolworths are already feeling the impact of Costco and Aldi (see Figure 6). Woolworths has invested AUD1bn in cutting prices while Coles has extended its 'every day pricing' promise to over 4,000 products. Coles' average prices have recorded 23 consecutive quarters of deflation.

Speculation about German retailer Lidl and UK's Marks & Spencers entering the Australian market at some point continues (although there are no confirmed plans at present), which would add to pricing pressure already in play.

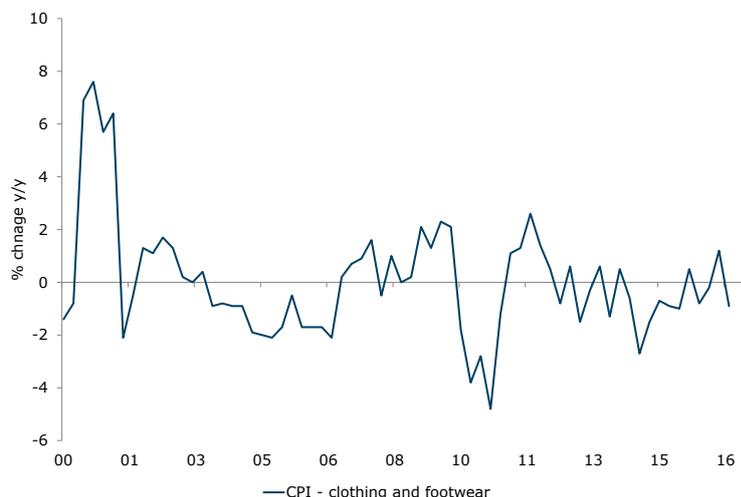
**FIGURE 6. SUPERMARKET PRICES ARE STILL IN OUT RIGHT DEFLATION**



Source: ABS, ANZ Research

While not as intense as the pressure in supermarket space, price inflation in clothing has been lacklustre. Indeed, prices for clothing and footwear have fallen in y/y terms for 16 of the past 20 quarters, with the +30% depreciation in the currency from its 2011 peak seemingly having limited impact (the so-called 'missing pass through').

**FIGURE 7. WEAK INFLATION ACROSS CLOTHING**



Source: ABS, ANZ Research

We expect foreign entrants to continue to inhibit retailers' pricing power in consumer goods. In the past year, TJX – the 9<sup>th</sup> largest global retailer – entered the Australian market through the acquisition of Trade Secret. British department stores John Lewis and Debenhams have joined forces with established retailers to provide an offering to the Australian market. We expect to see more global retailers establish a physical presence in Australia this year across clothing, footwear, accessories, make-up and homewares.

Indeed, J.Crew and Banana Republic are reportedly looking for retail space and Germany's Kaufland (groceries and general merchandise) is expected to open in Australia this year. Sporting and outdoor retailers are expected to be the next wave, including France's Decathlon and UK's JD stores.

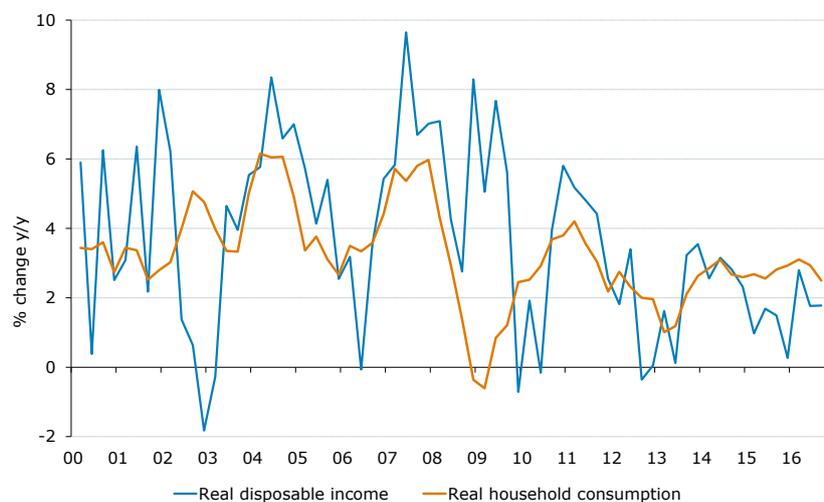
The 'x' factor this year is the rumoured opening of Amazon in Australia. Details are sparse but Amazon has reportedly lodged over 250 trademarks and advertised for over 100 roles in IT, marketing, sales and human resources. Amazon's expansion in to Australia is rumoured to include Amazon Fresh (the online grocery delivery business) and as the Deloitte report concludes "What we do know is that where Amazon has entered new markets the impact on local retailers has been seismic and has impacted almost all categories and channels".

### MORE OF THE SAME TO COME

Both demand and pricing power are likely to see retail conditions remain difficult this year and next.

To date, rising house prices, strong employment growth, and a fall in the household savings rate have helped to offset weak household income growth and support consumption at around trend growth rates. Looking forward, however, we expect wage growth to remain weak, the decline in the unemployment rate to continue but at a more gradual pace, and house price growth to moderate. In this environment, and given already elevated levels of household debt, we doubt households would be willing to rundown savings much further.

**FIGURE 8. HOUSEHOLD INCOME VERSUS CONSUMPTION**



Source: ABS, ANZ Research

More importantly, though, we expect pricing power to continue to be dampened by competitive pressures. These pressures may not intensify but are equally unlikely to dissipate any time soon (particularly given the expected arrival of Amazon to Australian shores).

While consumers will benefit from lower prices (so retail volumes may look solid, even though nominal sales remain quite weak), ongoing weakness in retail inflation is a key factor weighing on the broader inflation outlook. Food, clothing and consumer durables account for nearly 30% of the CPI basket.

This, combined with weak rental inflation, leaves the onus for lifting inflation squarely on wage growth (or more specifically, unit labour costs which feed through to domestic services inflation), which is yet to show any sign of a sustained acceleration.

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