The Retail Store Industry has been a bit of a mixed bag since our last review in October. The average consumer is feeling better about their finances and is spending more in general. That said, mall visits remain sluggish and growth has largely been limited to e-commerce and off-price outlets. Although recent price declines may tempt bargain hunters, we suggest investors proceed with caution here.

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The Current Climate

The cost of doing business in the retail industry is on the rise. Freight and distribution expenses have gone up meaningfully in the past 18 months due to strong demand and tight capacity. The Cass Truckload Linehaul Index, which tracks per-mile full-truckload pricing and does not factor in fuel costs, rose 7.2% in December. There were also double-digit increases in July and August, the highest growth rates since 2005.

U.S. employers added 2.64 million jobs to their payrolls in 2018, the best year since 2015. The unemployment rate clocked in at 3.9% in December, below the Fed's long-term target of 4.4%. Many economists think this metric will fall even further in the coming quarters. Encouragingly, wages rose 3.2% in December, the strongest yearend result in over a decade. Wage growth in the retail sector was even better in 2018, growing 4.6% versus a 1.6% rise in 2017.

The Trump Administration recently reversed a policy to enable the Internal Revenue Service to pay tax refunds despite the government shutdown. That said, last year's tax reform limits many deductions and eliminated some personal exemptions. Thus, refunds for low- and middle-income taxpayers may be lower than last year. This could potentially hinder retail sales in February and March.

The Commerce Department was scheduled to publish retail sales data before this report went to press, but the government shutdown prevented that from happening. Other independent organizations have weighed in though. IHS Markit said retail sales grew 5.0% year over year (excludes autos, gas, and food) in the November-December period. Too, according to Mastercard SpendingPulse, holiday sales rose 5.1%, the strongest growth rate in six years.

The three-month moving average of the Michigan Consumer Sentiment Index is above nearly all scores for the past 18 years. However, this metric may dip over the near term owing to the government shutdown, a volatile stock market, and trade disputes.

Obviously tariffs are a current/potential headwind for many companies in this industry. Still, there are ways for retailers to combat these taxes, like alternate country sourcing, negotiating with vendors on price, and reengineering products, but U.S. consumers will most likely bear the brunt of these levies in the form of higher prices.

Retailers

Quintessential department store chain *Macy's* stock recently experienced its largest one-day price drop on record at 18%. The company's holiday season started off strong, but then hit a lull in the middle before strengthening in the days leading up to Christmas. Fiscal 2018 same-store sales were originally expected to grow 2.3%-2.5%, but that forecast was cut to 2.0%. We think investment in the mobile app and improvements to the store experience should help boost traffic. The dividend yield is attractive, and we recommend the shares to those with a long-term investment horizon.

Macy's higher-end rival *Nordstrom* has also experienced a steep price decline since our October report. The company reported a disappointing 30-basis-point rise in same-store sales at its full-priced locations. A 3.9% comp rise for its off-price concept *Nordstrom Rack* did little to quell investors' fears. The company will be forced to discount to clear unsold full-price inventory. Further, investments in digital initiatives and technological updates will likely hurt earnings ahead. Even with the recent price decline, the shares still have below-average long-term price appreciation.

The world's largest physical retailer, *Walmart*, has been one of the best-performing stocks in the Dow Jones Industrial Average of late. Although it has yet to release holiday results, same-store sales growth has been consistently strong for some time, and we doubt this changed. Further, its e-commerce division has been growing on par with Amazon recently thanks to a steady pace of innovation in its omnichannel experience. The recently-acquired Indian e-commerce platform Flipkart faces some new government regulations aimed at supporting smaller domestic online outfits. Nonetheless, we think the stock is suitable for conservative investors.

Elsewhere in the big box space, *Costco Wholesale* continues to record impressive same-store sales. This metric clocked in at 7.5% over the holidays. The company remains committed to expanding its physical footprint at a healthy pace, a rarity in the retail world. Although the shares are richly-valued at present, we think they are a safe bet overall.

Conclusion

In the age of Amazon, it has become vital for retailers to develop an effective omnichannel experience. Robust traditional and mobile e-commerce platforms with distribution capabilities like buy online, pick-up in-store, reserve in-store, and ship from store are now must haves. Retailers that continue to churn out innovative functionality and targeted email marketing that improves the customer experience and builds loyalty will likely be rewarded long term.

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