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Retail.... The Cost of Sales

This retail reporting season will be an important window into the real state of the consumer and those companies that serve them. We have long speculated that the relative robustness of retail sales volumes reported in the monthly same store sales data figures may be deceiving. Retailers have historically fallen into the trap of prioritizing sales growth/market share over profitability. Thus, while sales may remain relatively resilient, the costs of achieving those sales have been rising. Larger discounts, greater incentives, and more generous financing terms keep the registers ringing in the short-term but may come with longer-term consequences like consumer conditioning and brand deterioration. Since the mid-January '08 lows, an equally-weighted composite of the retail stocks in the S&P 500 have outperformed the broader market by nearly 15% (chart 1). We were not surprised by the bounce given the extra-ordinary sell-off the group experienced in the latter half of 2007, but we are not yet convinced that the conditions exist for a full recovery in the near-term.

Bottom Line: Many of the recent retail bulls have touted the resiliency of the consumer and the pending tax rebates as the rationale for returning to sector. While recognizing that retail stocks have already discounted a large amount of bad news, we still believe it is too early to overweight the group. \$4.00+ gasoline, housing values that continue to fall and a darkening employment environment will, in our opinion, take a lasting toll on consumer spending. The American consumer will eventually make it through this crisis, however, we believe it is likely to get worse before it gets better.

Chart 1: Relative Performance of S&P 500 Retail vs. the Market



Chart Courtesy StockVal

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