Retail Health Index September 2023

KPMG Australia

Contents

Introduction

Welcome to KPMG Australia's Retail Health Index © (RHI). The KPMG RHI provides *data driven* insights on the future health of Australia's retail sector from the perspective of businesses operating in the sector.

The KPMG RHI is more than a measure of expected sales, or just the cost base retail and consumer businesses face in Australia. Rather, the KPMG RHI incorporates the revenue *and* cost drivers of a retail and consumer focused business operating in the Australian economy, *plus* allows for future expectations through incorporating a measure of consumer confidence.

This report is the first edition of the KPMG RHI, and future editions will be issued each quarter following the release of the latest data point that makes up the quarterly calculation, which is typically the ABS Wage Price Index.

So, what do we see?

After almost three years of booming consumer spending, largely off the back of record levels of fiscal and monetary stimulus, we now see rapidly declining consumer confidence and a change in spending patterns (both quantity and type) that suggest the immediate outlook for the retail sector may be significantly less rosy than how it has performed over the past few years.

The KPMG RHI suggests that *we may not see a retail spending recovery until well into 2025*. We believe this means many retailers should *batten down the hatches* and focus on margin and inventory management while they ride out the storm.

Traditionally spending slowdowns have also seen businesses adopt greater restraint in capex spend, and technology and transformation investments to conserve cash and protect balance sheets. While this conservative approach is necessary for those businesses that have pushed their businesses to the limit – in terms of costs, debts, or both – those within the sector that have sound balance sheet fundamentals should look at this impending slowdown as an opportune time to enact change and investment in readiness for the next upswing.

The discretionary retail sector appears particularly vulnerable with up to 55 percent of people believing now is a bad time to buy major household goods according to the ANZ–Roy Morgan Consumer Confidence survey. Even food retailing has seen a pull back in the volume of consumption activity, with the household trolley containing fewer items and lower cost brands as belts tighten in response to higher interest rates.

So, what are the levers we think retail leaders will pull to manage their business in the immediate future?

– Core vs non-core will be squarely in focus. This means investments which are cash-consuming but unlikely to produce their projected benefits in the near term, will likely be slowed down or temporarily shelved.

– Inventory and margin management will have no room for error. Consumer austerity will drive a hunt for value, and we are likely to see a shift back to *just in time* inventory management as retailers seek to optimise working capital.

– Online will remain an important channel to market and customer experience will define those retailers who are more trusted than others when the times are tough for consumers.

– Labour costs and capacity remains a challenge that, for many retailers, is simply the new reality. As retail volumes slow, gross margin dollars will inevitably be impacted with further growth in retail prices likely to become more difficult.

– The 'cost of doing business' remains the ongoing subject of transformation discussions in retail boardrooms across the country. Our best retailers are laser focused on creating operational efficiency across the front, middle and back office, with a focus on driving productivity. Those retailers with the strongest balance sheets will keep their *foot to the floor* to drive a long-term competitive advantage.

We hope you enjoy reading our first KPMG RHI report and continue finding value in future reports as they are rolled out each quarter.

Importantly, if KPMG can help your business in any way navigate the current retail environment and plan for any future developments that are facing the industry, then please contact us.

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Retail Health Index

KPMG's Retail Health Index© (RHI) is projected to remain negative for the near term with a protracted recovery period extending into 2025. We expect retailers to batten down the hatches and stay focused on margin and inventory management while consumer spending remains constrained.

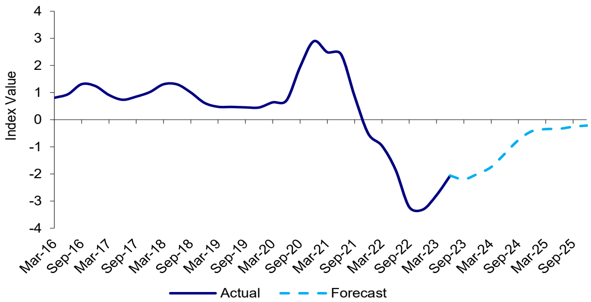
Better times are coming, but just not yet …

The KPMG RHI assesses the current and expected future health of the Australian retail sector by analysing four key variables that represent revenue and expenditure pressures influencing the overall performance of the sector.

The variables are differently weighted and are applied as year-on-year growth values, with forecasts based on projections developed by KPMG and as presented in our latest KPMG Quarterly Economic Outlook.

FIGURE 1

KPMG Retail Health Index, Actual & Forecast



Source: BoE, ECB, FRB, RBA, Haver, KPMG

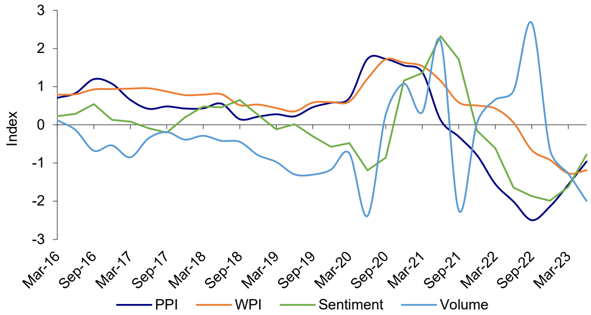
The variables included in the KPMG RHI are:

- retail sales volumes[1]
- the producer price index (PPI)[2]
- the retail sector wage price index (WPI)[3]
- the Westpac–Melbourne Institute's consumer sentiment index[4].

The movement in the variables since the start of 2015 that make up the KPMG RHI are shown in Figure 2, noting the annual growth rates of PPI and WPI are presented as inverse values (i.e. a negative growth rate for PPI and/or WPI represents positive growth in those variables, while conversely a positive growth rate for PPI and/or WPI represents negative growth in those variables.)

FIGURE 2

KPMG RHI by Component Factors



Key findings

The KPMG RHI peaked in December 2020 despite Australia experiencing a raft of negative social and economic effects associated with Covid. In the December quarter of 2020 all elements of the RHI were positively contributing to the index value – retail sales were increasing following the lifting of lockdowns across the country, costs and wages were well contained and consumer sentiment was rising on the belief that the pandemic was seemingly getting under control.

Since then, the KPMG RHI has declined rapidly from positive to negative territory, albeit that different variables were driving the decline at different points in time. Currently the weakness in the RHI is being driven by the sharp fall in retail sales volumes, as the reality of higher interest rates and rents start to kick in and influence not only spending patterns but total spending as well. The most recent ABS Retail Trade data shows volumes have stayed flat in trend terms into September 2023 which reinforces KPMG's view that sales are expected to remain weak into the near term.

Notably, all four variables of the RHI are operating on a negative contribution basis, albeit that inflation and consumer sentiment have come back from their lows. We expect the recovery of the RHI to take a small hit in the September quarter of 2023, before resuming its slow recovery path. *We do not expect the RHI to return to its long-term trajectory before September 2025*, meaning many retailers will potentially be operating in challenging conditions for the next couple of years.

Spending indicators

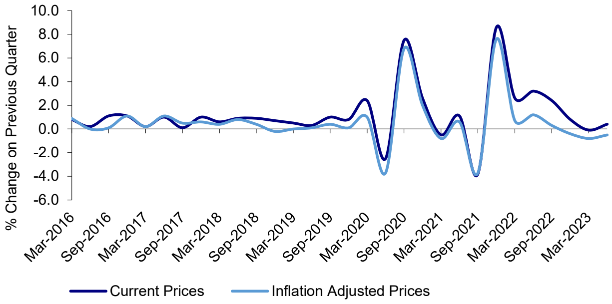
The retail sector is likely to take a hit as consumers and households reduce discretionary spending due to lower purchasing power, increased employment risk and significantly higher mortgage interest payments.

Retail sales

Retail turnover at current prices was increased by 0.4 percent during the June quarter of 2023, a +0.5 percent turnaround on the March quarter's result. However, once price inflation had been adjusted, retail sales volumes fell 0.5 percent during the quarter – the third straight quarter of falling activity levels. Even within the context of declining turnover, consumers are spending proportionally less on food and groceries, suggesting the 'nice to haves' are now being left out of the household shop.

FIGURE 3

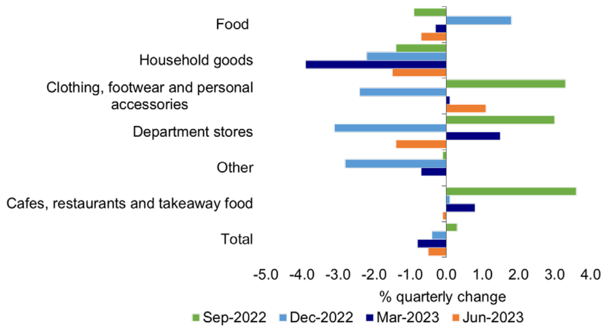
Change in Retail Turnover, Australia, Current and Inflation Adjusted, Quarterly



Household goods (-1.5 percent q/q) and Department stores (-1.4 percent q/q) experienced the largest declines in spending activity during the quarter, and surprisingly, followed by Food retailing (-0.7 percent). Spending activity by Australian households looks not only to be changing by composition of spend but also by source of income, with much lower savings activity taking place in the June quarter of 2023 compared to more recently (even during the Covid period).

FIGURE 4

Change in Quarterly Inflation Adjusted Sales by Category, Australia



Consumer sentiment

Consumer sentiment, an important leading indicator for retail, lifted in July 2023, albeit it still remains at levels worse than that seen during the Covid lockdown period and Global Financial Crisis.

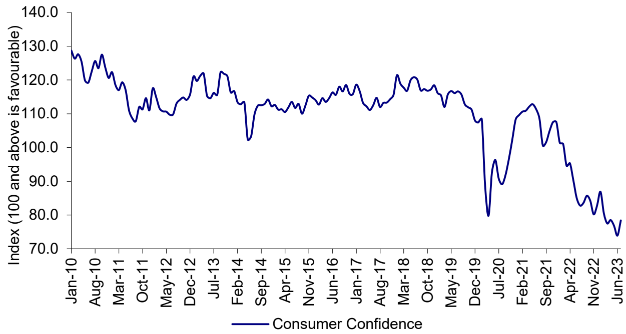
Consumer confidence indicators unanimously paint a pessimistic consumer outlook. The ANZ–Roy Morgan Consumer Confidence Index prevailed at levels last seen prior to the 1990s. Concurrently, despite the uptick in its latest reading, the Westpac–Melbourne Consumer Sentiment Index has continued to remain below the neutral 100 mark for 17 consecutive months now.

Negative consumer perspectives are at odds with the strong labour market spanning the unemployment rate which hovers near historical lows matched by positive wage growth. However, turning to the sub-components of the consumer confidence indicators sheds some light. Households continue to assess their current financial conditions as unfavourable due to high mortgage payments as well as an enduring cost of living crisis.

Future expectations about the strength of the economy and their own personal household finances remain weak, albeit that they have improved slightly over the past month. Importantly, one of the leading indicators of retail, which is about the timing to buy major household items, suggest that the majority of households do not feel comfortable about big expenditure items at the moment.

FIGURE 5

ANZ–Roy Morgan Consumer Confidence



Cost indicators

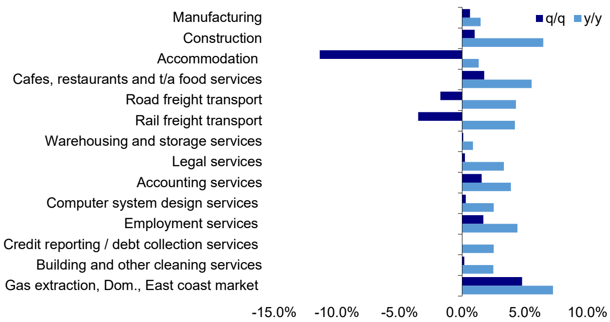
Producer Price Index

The producer price index (PPI) increased by 0.5 percent q/q in the second quarter of 2023; the lowest rate of increase since the March quarter of 2021. Annualised PPI is now running at 3.9 percent, which while still high, is showing a clear downwards trajectory. Growth in production costs were largely driven by passing through costs associated with labour costs, energy intensive inputs in the construction industry, and increased electricity and freight costs for the engineering construction sector.

Two-thirds of the 60 categories that contribute to the PPI recorded either zero price increases or disinflation in the June quarter of 2023. Of the remaining 20 categories still seeing price increases, the majority are associated with value-added processing which require electricity or other forms of energy as intermediate inputs. The likelihood is energy costs are only going to continue to rise as the transition from carbon-intensive to renewable energy picks up pace in the coming years.

FIGURE 6

Producer Price Index, Output Price Growth by Selected Industry Sectors, June Quarter 2023

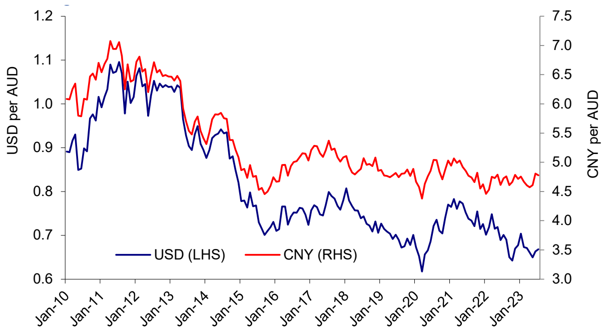


Foreign exchange

The Australian Dollar remains under pressure in foreign exchange markets, falling from USD 0.683 at the start of January 2023 to be trading at around USD 0.648 at the time of writing the report (30 August 2023), a 5.1 percent depreciation. However, on a Trade Weighted Index Basis the depreciation of the AUD has been much less pronounced, falling only 1.8 percent. This is because the AUD has appreciated against the Japanese Yen (6.7 percent) and has stayed relatively flat against the Chinese Yuan – Australia's two largest trading partners.

FIGURE 7

Exchange Rate, AUD v. USD v. CNY



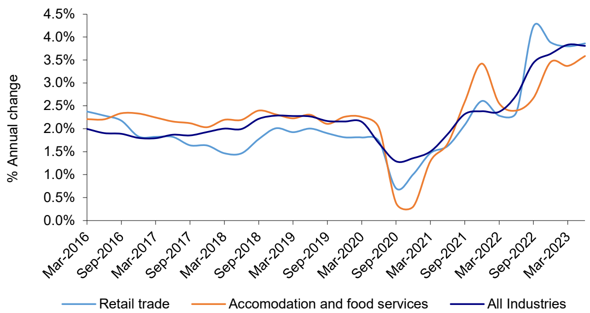
Wages

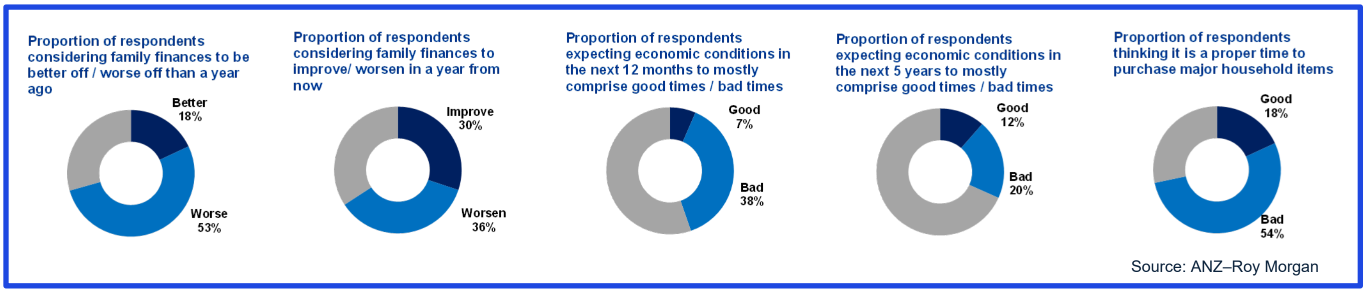
Wages growth in the retail and hospitality sectors is weakening as discretionary spending pares back and labour demand softens. However, this weakening in wages growth comes after a recent period of higher-than-average labour costs increases for the sectors because of the labour market dynamics associated with the Covid pandemic.

For the retail sector, demand for goods and services peaked during the second half of 2022 as lockdowns ceased and residents switched from online purchasing to instore experiences. Labour demand also peaked during this period in order to meet consumer demand, and with Australia's labour market still being disrupted with the limited availability of foreign workers, the retail sector needed to lift wages to compete to secure staff from the wider workforce. However, as consumer demand got satisfied, and in fact weakened due to higher accommodation costs (mortgages and rents), overall retail sector labour demand is falling resulting in softer wages growth as a consequence.

FIGURE 8

Annual Growth in Wage Price Index by Selected Industry





Household spending

Household spending has fallen sharply from the December 2022 peak, with the exception of spending by households on overseas holidays.

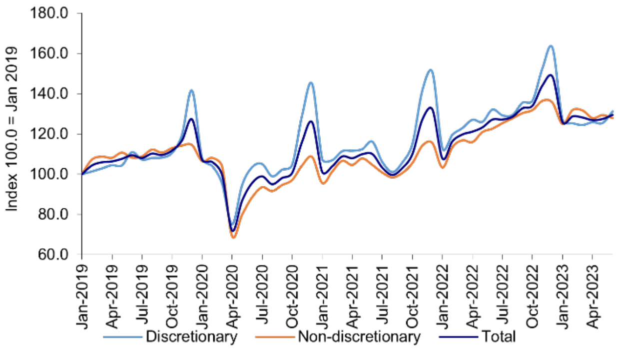
Household spending growth has been anaemic during the first half of 2023, with spending in June 2023 just slightly above the average monthly spending achieved in 2022, which was still a lockdown year.

Weak consumer confidence, declining employment certainty and higher accommodation costs are causing households to cut back on their spending in an attempt to balance their family budgets. Consumer sentiment is negative and *55 percent of consumers think it's a bad time to purchase major household items*. Even though inflation now appears to be in a steady decline, falling from 7 percent in the March quarter of 2023 to 6 percent in the June quarter of 2023, it is significantly above the historical average, and remains well above the RBA target band of 2 percent to 3 percent. This suggests that while the cash rate is at or near its peak, it is likely to remain elevated for some time until inflation returns to the target band.

The consequence of higher interest rates on household spending can be readily seen in the latest National Accounts (March quarter of 2023), which shows property interest costs are ratcheting up as a proportion of household income. Further, with the expected roll-off of low-cost fixed rate to higher variable rate mortgages accelerating from the middle of this year, this reallocation of household spending away from goods and services towards mortgage interest payments is also likely to step up over the near term.

FIGURE 9

Monthly Household Spending by Type, Australia



Net overseas migration

With the full opening of borders, *Australia's growth is now being driven by net overseas migration* rather than natural increases.

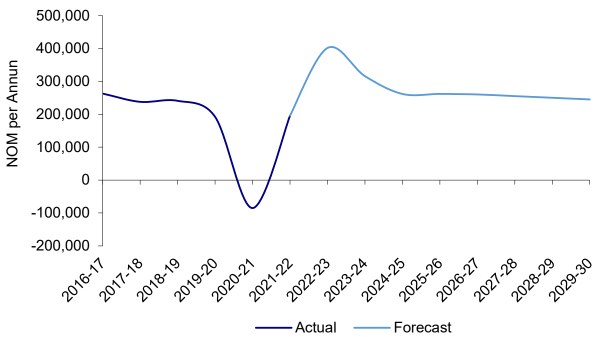
In the 12 months to December 2022, nearly 620,000 people migrated to Australia while around 233,000 Australians emigrated. During this period, New South Wales and Victoria were the primary destinations for overseas migrants settling in Australia, with around two-thirds of all net overseas migration landing in those jurisdictions even though they represent only around 57 percent of Australia's population.

While Queensland received around 15 percent of all net overseas migrants coming to Australia during 2022, this was still below its share of Australia's population. However, Queensland is the destination of choice for interstate migration, with nearly 35,000 domestic residents relocating there in the 12 months to December 2022 – with most interstate migration being sourced from New South Wales (31,000).

Importantly, net overseas migration tends to help slow down the (average) ageing of Australia's population. During the Covid pandemic when Australia's border was closed the average age of Australia's population grew by around 0.3 years for each of 2021 and 2022 – the fastest rate of ageing over the period being analysed (i.e. from June 1971). An ageing population has the equivalent effect of reducing a country's marginal propensity to consume; in essence because older residents tend to spend less as they have already established their own homes. Conversely, a youthful population tends to spend more as they move out of their parental homes and set up their own independent residence for themselves (and possibly their partner and future family).

FIGURE 10

Net Overseas Migration, Actual and Forecast, Financial Year



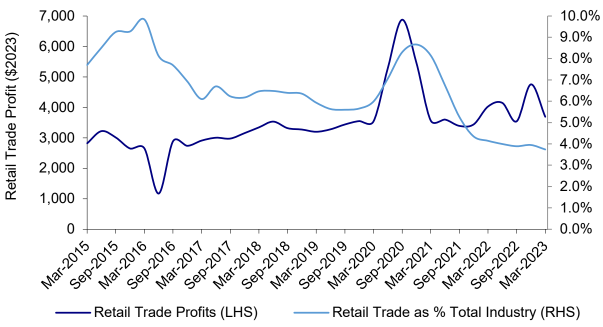
Performance indicators

Profitability

Profitability with the retail sector has been sliding from the middle of 2021, despite the December quarter of 2022 recording a strong result for the industry. Interestingly, while profits within the sector have been squeezed over the past 18 months, it seems the squeeze has been larger than what many other sectors have experienced as shown by the fact that the retail sector currently only accounts for less than 4 percent of total industry profit (before tax) in Australia compared to its long run average of 6.4 percent.

FIGURE 11

Retail Sector Profit before Income Tax

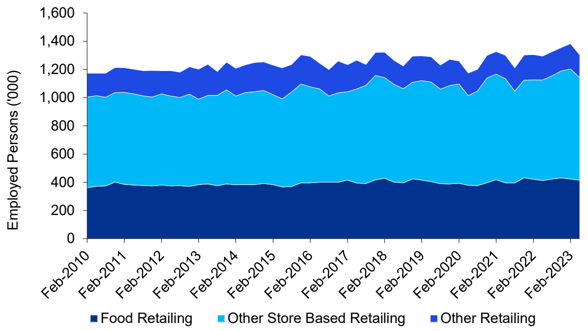


Employment

The retail sector employed just over 1.3 million people in Australia at the end of June quarter of 2023. Food retailing employed around 415,000 workers, other store-based retailing around 728,000 workers, with the remaining 160,000 workers employed in other forms of retailing activities.

FIGURE 12

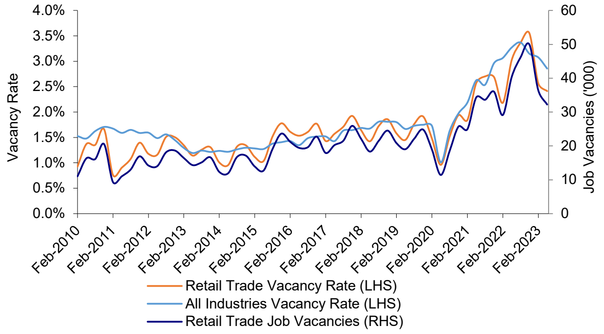
Retail Sector Employment, Australia ('000)



There has been a sharp reduction in the number of job vacancies within the retail industry in Australia, falling from nearly 50,000 unfilled jobs available within the sector at the end of 2022 to around 32,000 unfilled jobs by the middle of 2023. This decline in job vacancies also coincided with a fall in the number of people employed in the sector, meaning the fall in vacancies is indicating a fall in labour demand rather than previous job vacancies being filled.

FIGURE 13

Job Vacancies

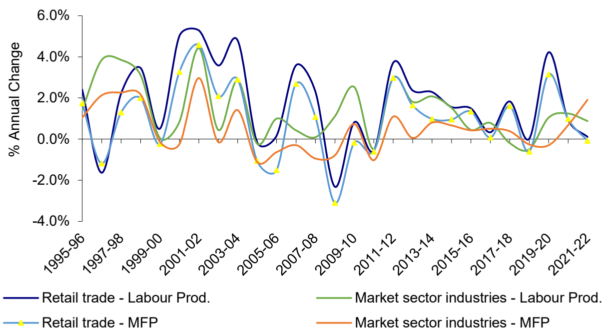


Productivity

The most recent productivity measures for the retail sector show a relatively poor outcome for FY22 compared to both the historical performance of the sector and against other market sectors in Australia. There could be several reasons for this given that it is unlikely the sector became less productive during that year. More likely measurement issues, including the timing of additional capital investment and new hirings, had the effect of showing a productivity holiday for the sector.

FIGURE 14

Productivity Estimates



Technical appendix

The KPMG Retail Health Index (RHI) provides an assessment of the health of the Australian retail sector based on households and producers' data available at a quarterly frequency. It represents the common component of series covering consumer behaviour and retailer's production.

A leading framework for the construction of an economic index from multiple time series is the so-called factor model. The factor model suggests the existence of a small number of unobserved series, called factors, which drive the co-movements of the observed economic time series. Leading applications of the framework includes the New York's FED Weekly Economic Activity Index.

In our application, we assume that there is a single factor, RHI_t, that drives co-movements of the retail variables, X_t

$$X_t = \Lambda RHI_t + \epsilon_t,$$

where Λ captures the factor loadings and ϵ_t refers to the idiosyncratic dynamics.

And the common method for estimating the unobserved factors is by principal components. In other words, principal component analysis is a dimensionality reduction method that is often used to reduce the dimensionality of large data sets, by transforming a large set of variables into a smaller one that still contains most of the information in the large set of variables. That is, principal components are constructed components from linear combinations of variables which best explain the variance in the data.

The RHI is computed as the first principal component of four quarterly variables: retail volume, the producer price index (PPI), the retail sector wage price index (WPI), and the Westpac–Melbourne Institute's consumer sentiment index. These data are then transformed to year-on-year growth terms. All transformed series are then standardised to have a mean of zero and a standard deviation of one. Furthermore, the growth rates of wages and prices are reversed for the purpose of interpretation, i.e. higher wages and costs mean the retail sector is not doing so well.

Table T.1 below shows the respective weights of each variable on the RHI, and the total variance explained by the RHI.

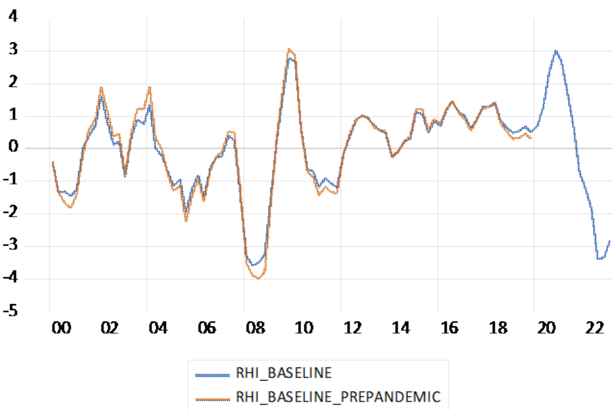
Table T.1 – RHI Weights

Variables	Weights	
	Baseline	Baseline Pre-pandemic
Producer Price Index	0.63	0.64
Wage Price Index	0.51	0.47
Consumer Sentiment	0.57	0.57
Retail Sales Volumes	0.14	0.22
Total Variance Explained	0.51	0.48

Source: KPMG

The first column provides the weights using the full sample between the March quarter 1999 to the March quarter 2023. The second column shows the weights using the pre-pandemic sample for the baseline, which are little changed from the full sample weights. The pre-pandemic RHI, as a result, remains quite similar to the full sample one (Chart T.1).

Chart T.1 – RHI Baseline & Pre-pandemic Baseline



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