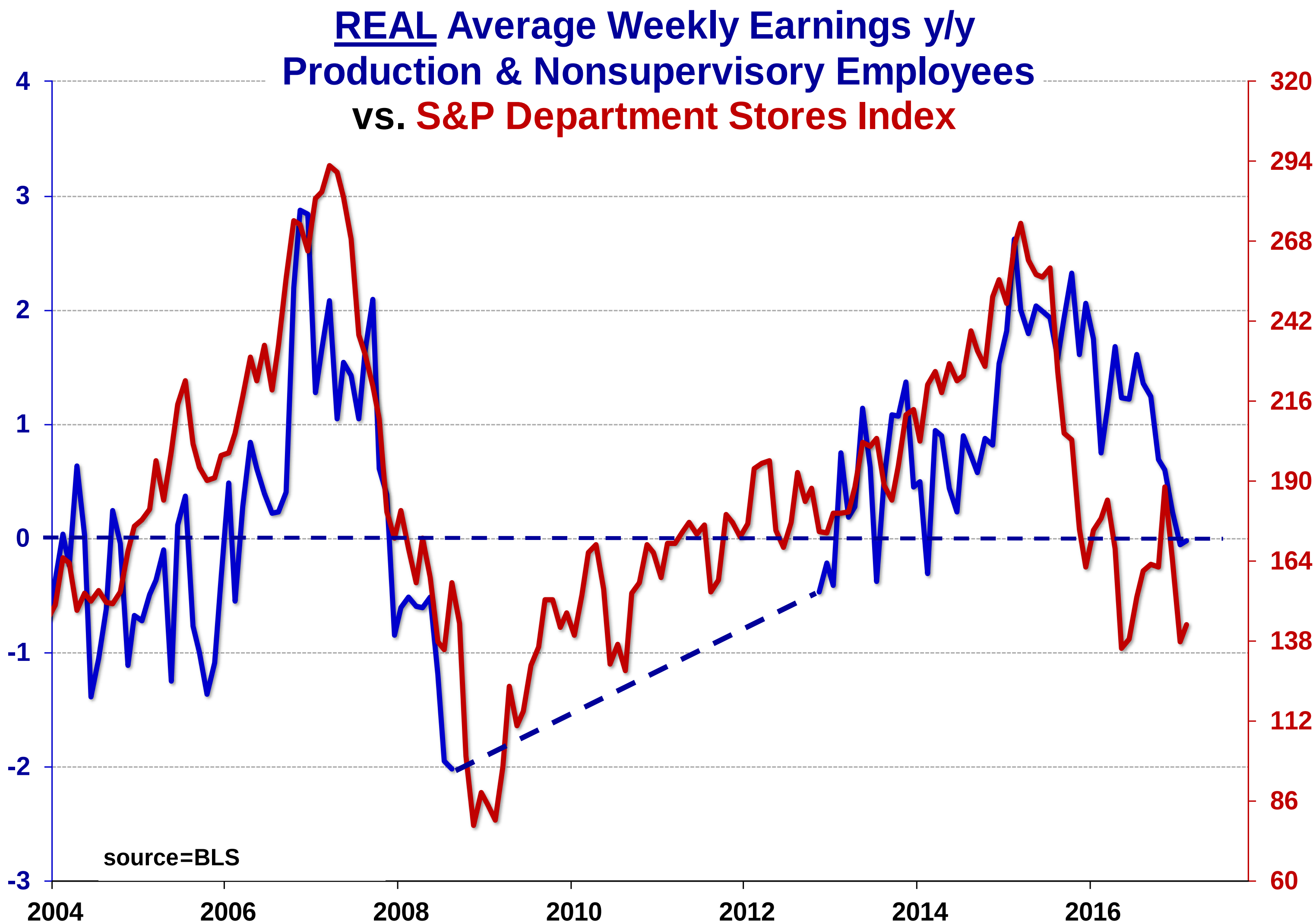
Rest easy, folks…the consumer is strong, wages are jumping, and Retail sector carnage is merely a shift in consumer spending habits from traditional brick-and-mortar to online. Or so we are led to believe. Let's see if we have this straight: the narrative is that consumers, flush with cash amid rising wages, have decided to forego the in-store experience of seeing, touching, and trying-on merchandise (along with ease of returns/exchanges) in favor of shopping from their laptop at home. Apparently, they're ***SO*** excited to splurge with their extra disposable income they've decided not to leave the house! Of course, this narrative is full of holes and bordering on preposterous. One need look no further than the fact real wages are sinking fast, but why let that get in the way of pushing a bullish outlook!? We've yet to hear a single mainstream economic pundit even hint at the idea the consumer may not be as healthy as everyone seems to be indicating. For if they did, they know they'd be stripped of their credentials and immediately shown the door. It seems that, in addition to fire sales at major retailers, there's also a big sale going on in False Narratives. Buyer beware.

The question isn't really **whether** people are shopping online more (they are), rather ***WHY*** are they shopping online more. We would conclude they're shopping online not because they enjoy it more, or its easier, or more convenient, but because their wages are declining while primary outlays of Health Care and Housing are soaring…and ***online shopping is the cheapest option for their retail needs***.

The point here is simple: this deterioration in brick-and-mortar sales is not some sudden shift to the 'easier, more efficient' online sales platform for consumers. It is a sign of distress on their part, plain and simple. And, as the consumer represents ~70% of the economy, this deterioration in traditional store sales should not be dismissed as just a shift in 'spending location' habits. To the contrary, we would submit it is a flashing red warning sign that consumer distress is well underway. ***Are we really to believe that if the economy were running on all cylinders, high-paying full time jobs were plentiful and real wages were rising at +3-4% y/y or better, we would be witnessing major retailers under such duress? Highly improbable.***

So, let's look at our first chart which fires a shot across the bow of the 'strong consumer' theory….

Department Stores tumbling in lock-step with real earnings. This supports our contention that consumers are flocking to the internet due to tighter budgets. Yes, internet sales have increased partly due to convenience etc…however, the more probable reason for increased sales is the consumer <u>seeking cheaper deals</u>, and they're finding them online. (note: post-recession earnings 'noise' data removed).



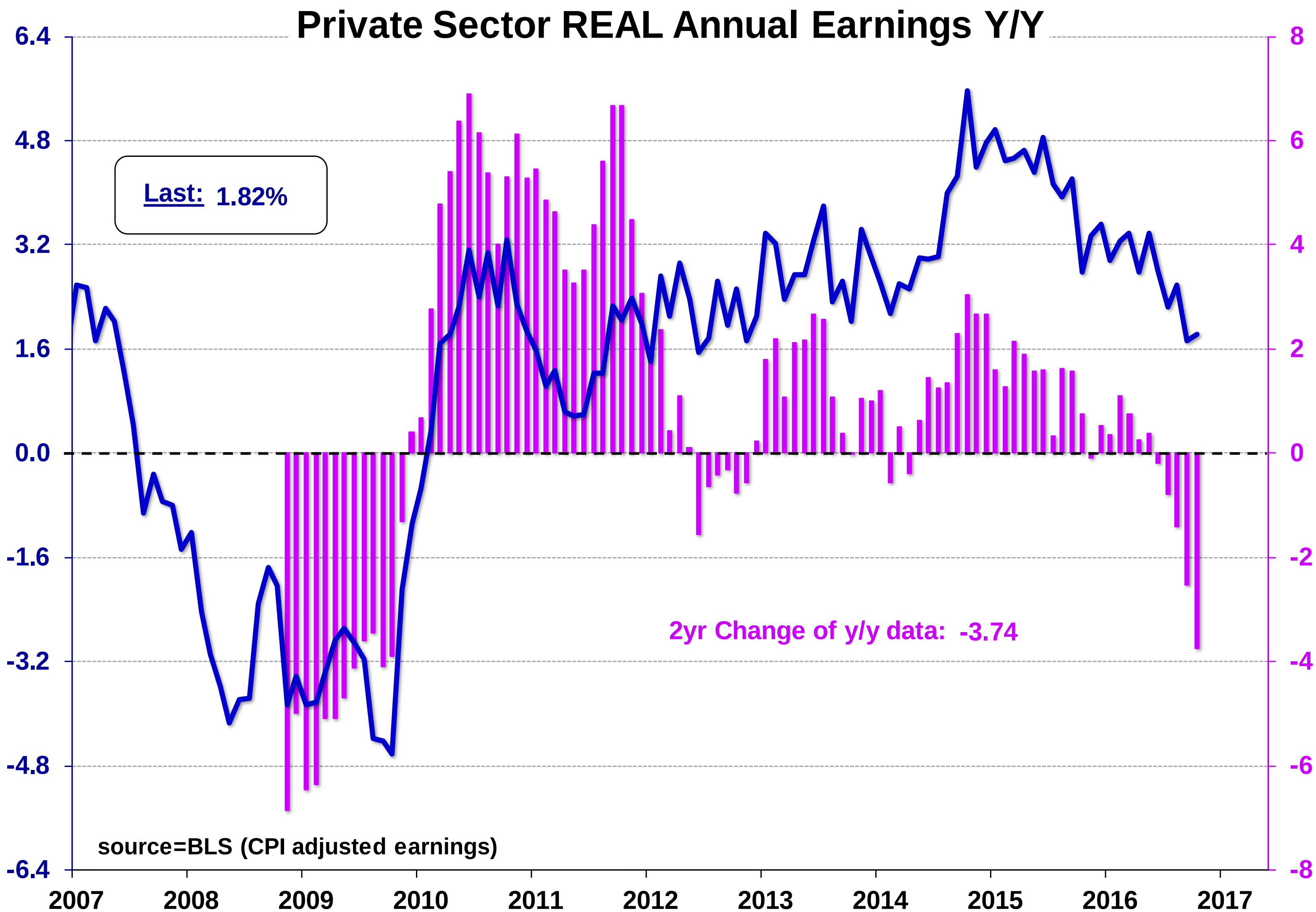
How bad are things in retail? So far in 2017, there have been a staggering number of announced store closings from major retailers: The Limited (250 stores); Abercrombie & Fitch (60); JC Penney (140); Sears (150): Macy's (68); HHGregg (88); Wet Seal (170); CVS (70); Crocs (160); Family Christian (240); BCBG Max Azria (120 stores, filed for Chapter 11); American Apparel (110 stores, filed for Chapter 11). And let's not forget a few of the store closings announced last year for 2017-2018: Aeropostale (154 stores); American Eagle Outfitters (150); Chico's (120); Children's Place (200), WalMart (154), etc.

So if you're in the market for 50% off clothing….or perhaps a mannequin …your ship has come in! As many retailers stated in Q4 earnings reports, they continued to cut prices throughout the holiday season (citing slow consumer traffic and people waiting until very late in the season to shop) and it looks as if the deals are still ongoing. It seems clear that the weak ***consumer is not 'rising' to prices; retailers coming 'down' to consumers***.

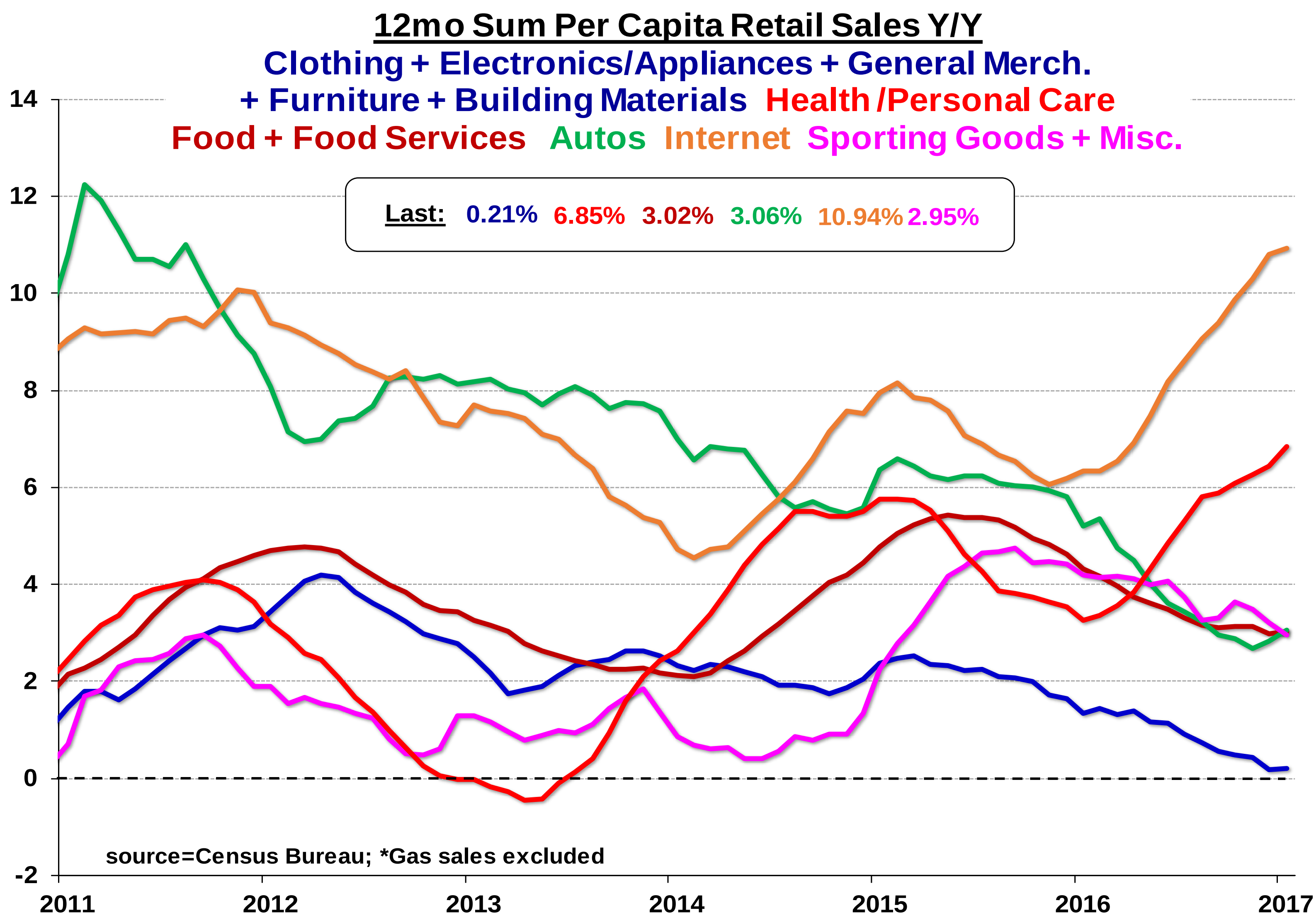
(photo: fire sale at BCBG Max Azria)

The Face of Retail

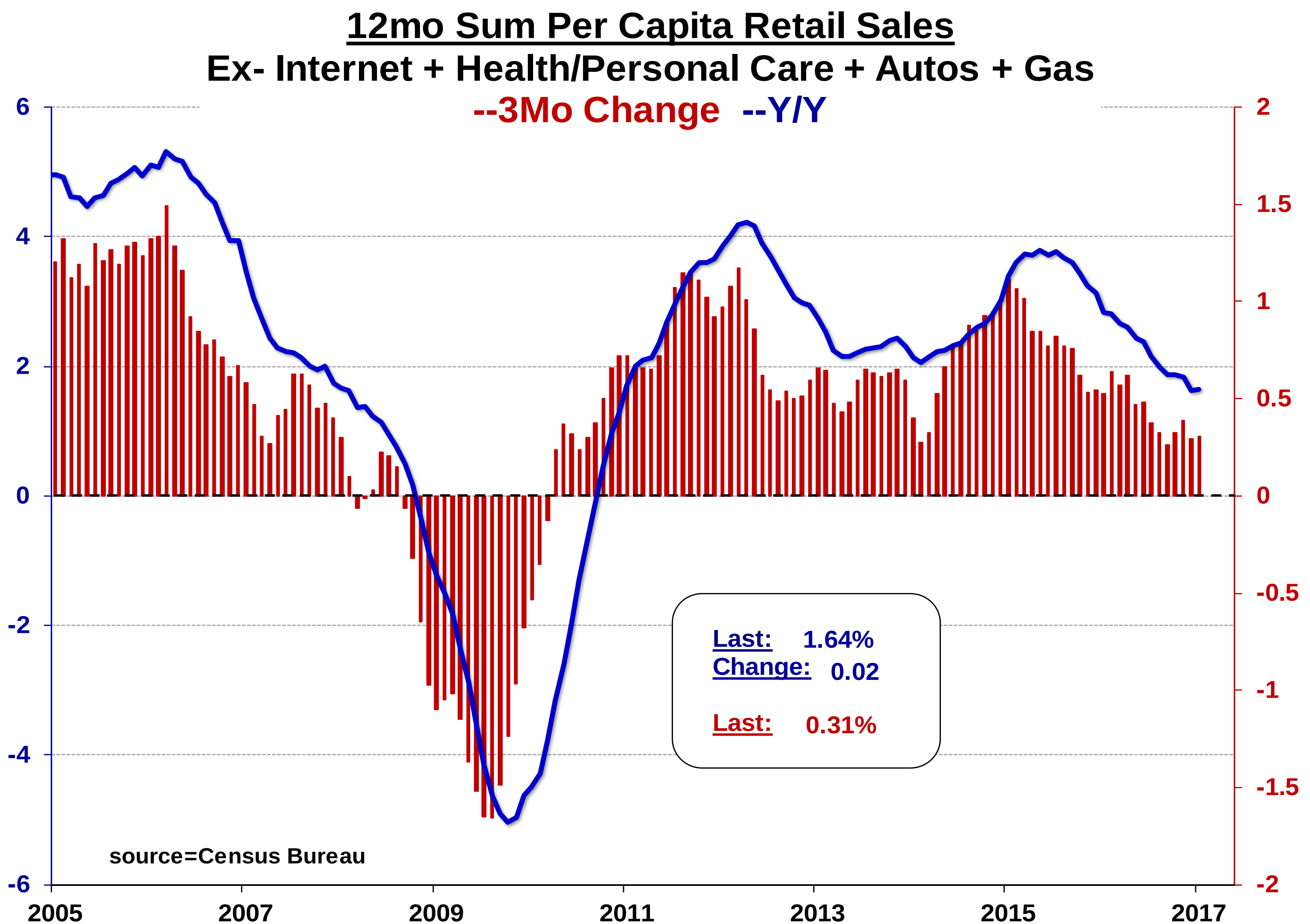
As for the rate of change in earnings, we find Real Annual Earnings deteriorating at fastest (2yr) clip since the recession.



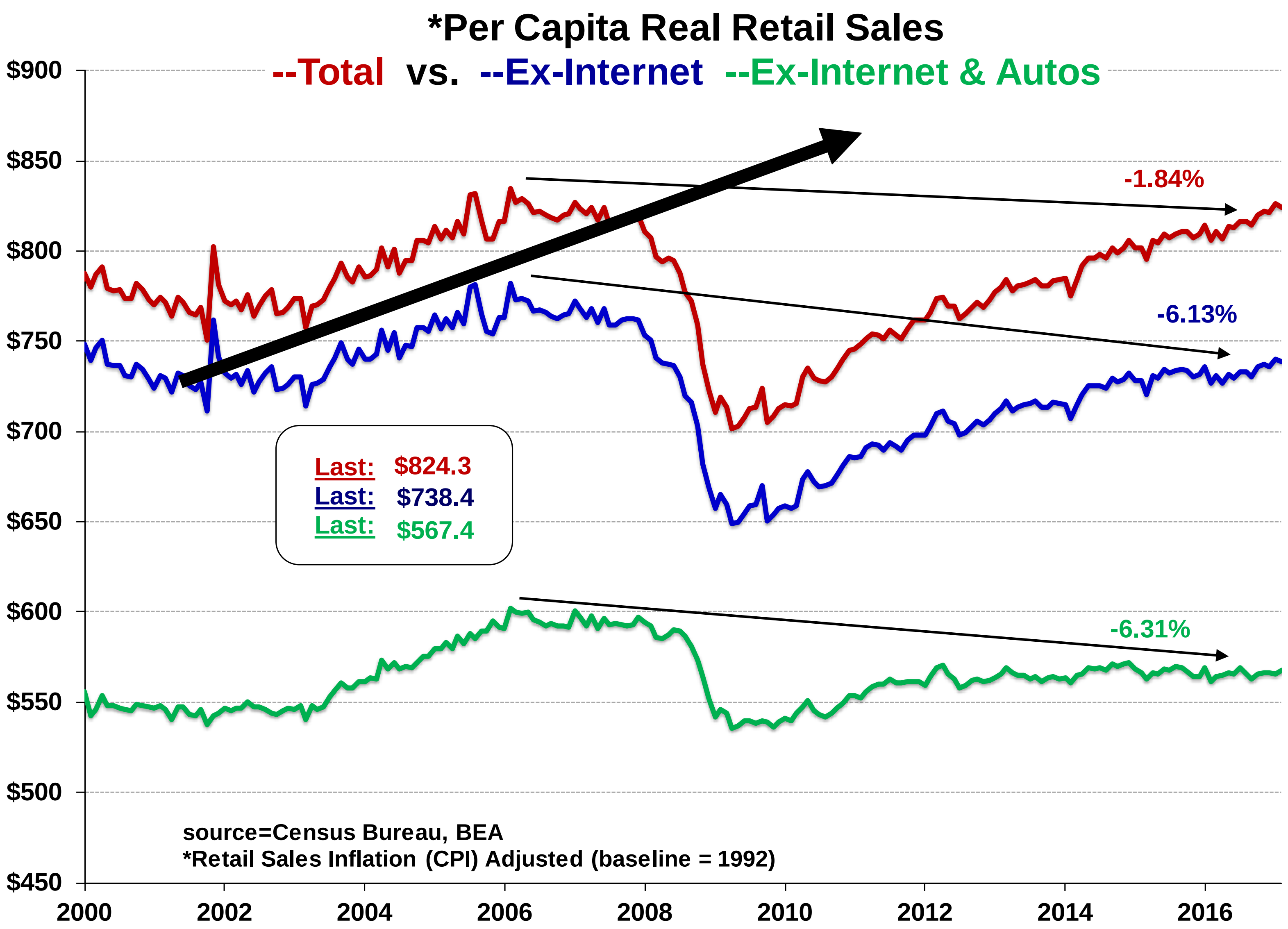
Internet and Health/Personal Care sales (which account for just over 16% of total retail sales) are trending higher while all other sales (excluding Gas which is also trending higher, not shown) are deteriorating. And then there's the question which nobody seems to be asking: what happens if (or when) internet sales either flat-line or deteriorate?



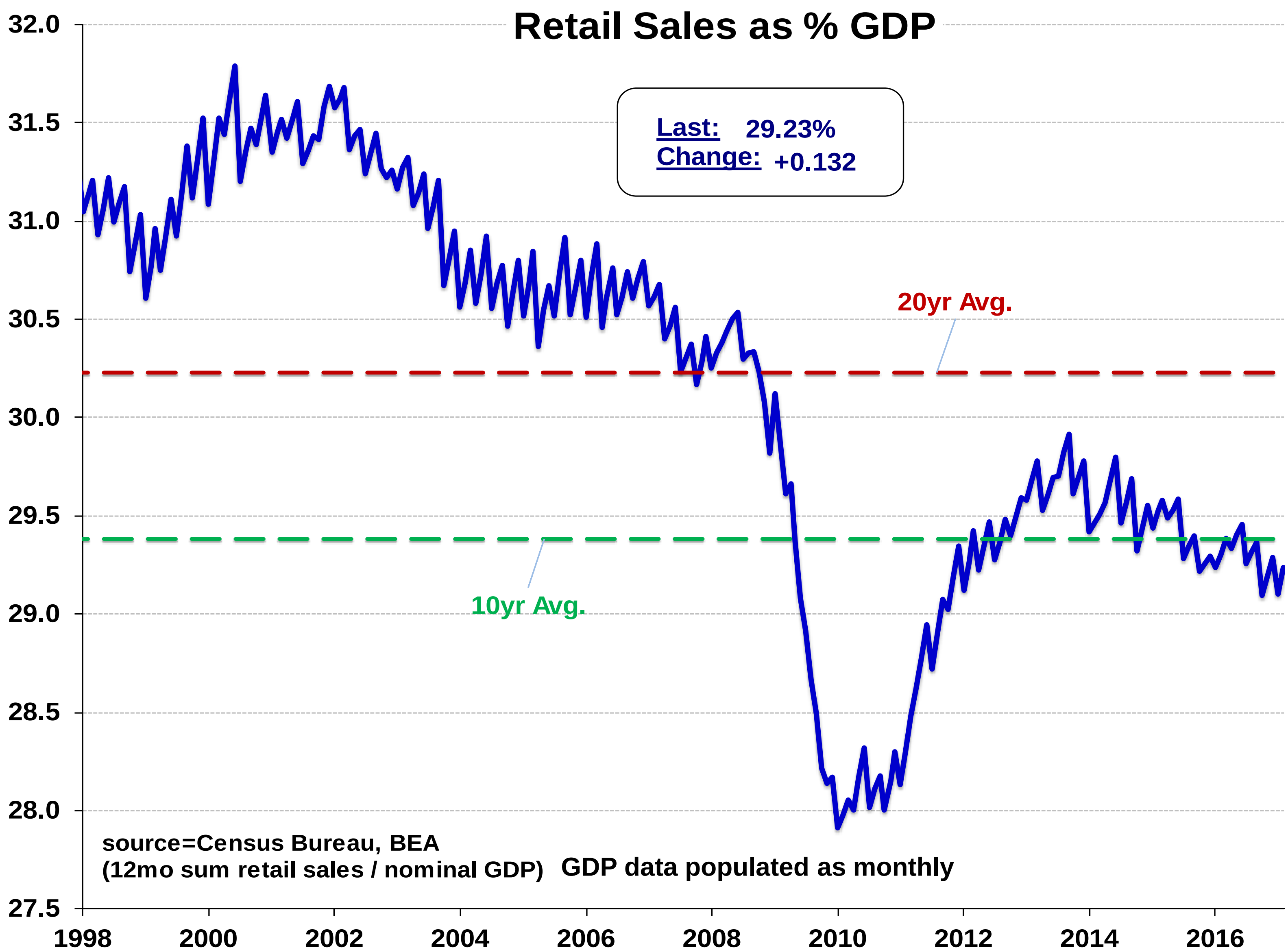
Retail sales **excluding** Internet, Autos & Gas, and Health & Personal care (which have been soaring as health/medical commodity prices have skyrocketed in last few years), are at recession levels. **This chart represents 55% of total retail sales**



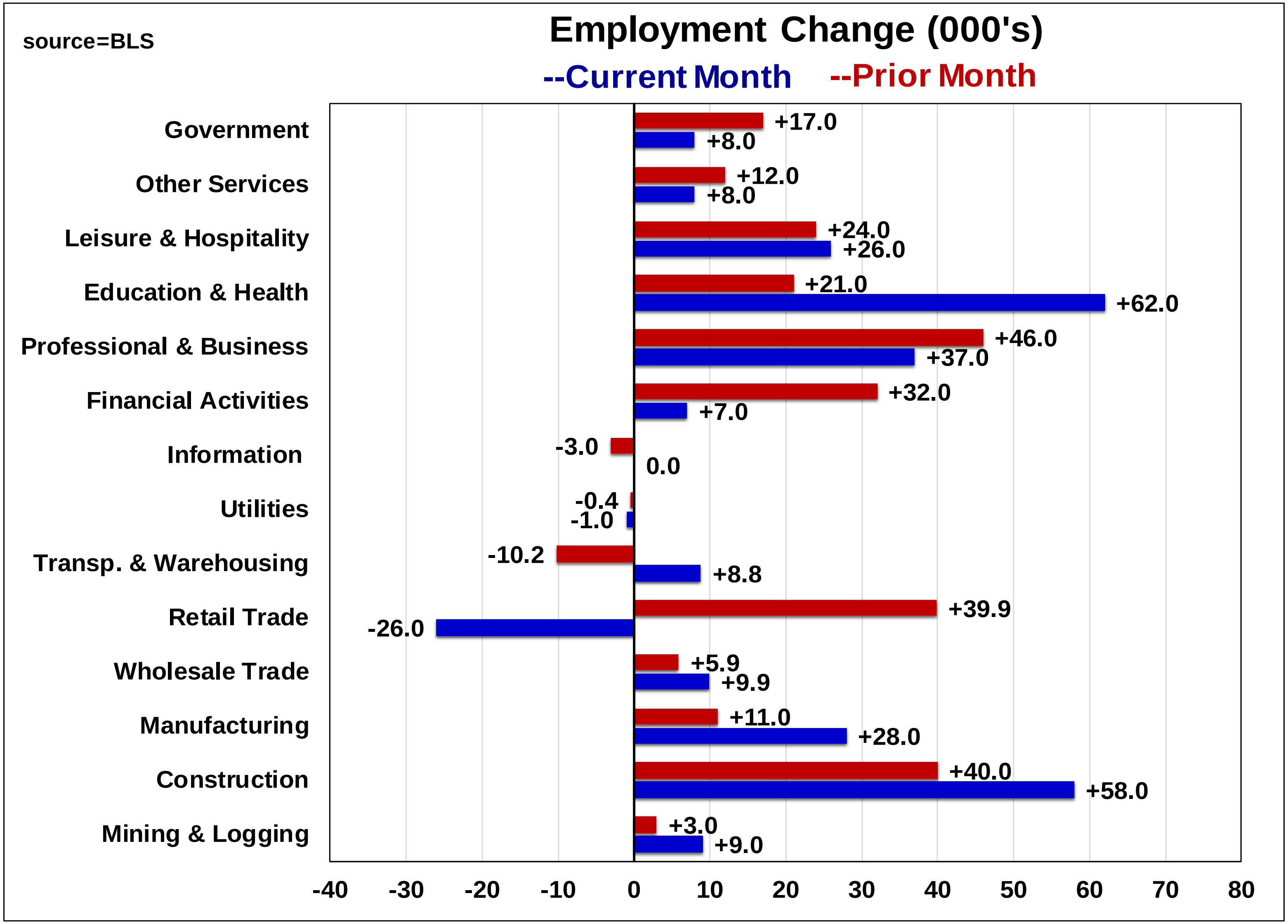
Real (inflation adjusted) sales remain quite weak considering we're a decade past pre-recession highs. Also important to note that the current $ trend level of sales is considerably below prior trend.



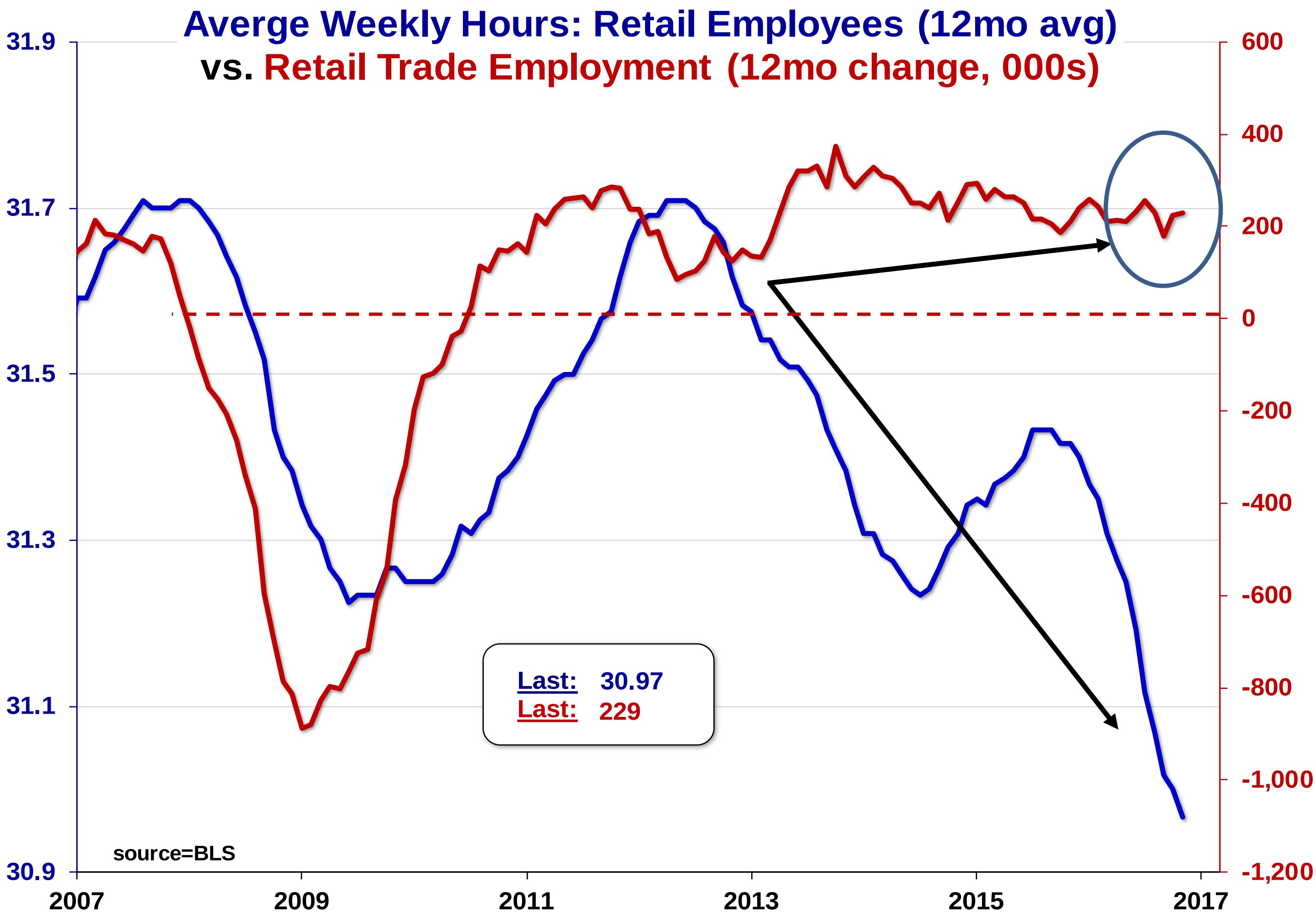
…to the point that Retail Sales as % GDP have resumed their downtrend, below 10yr average.



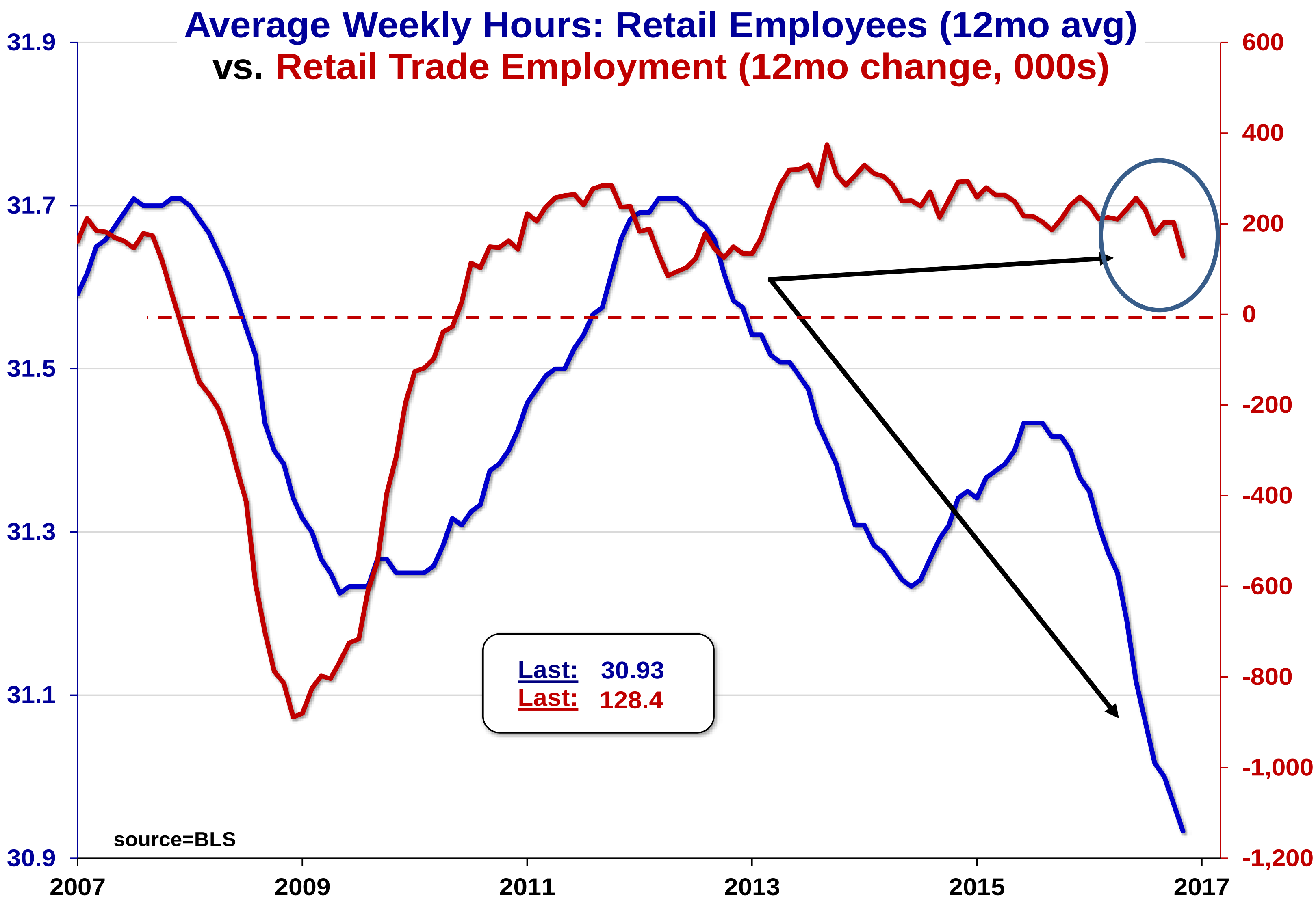
February Payroll report: **Retail sector sheds -26k jobs**. If looking at pre-revision data, January data was revised down from a gain of +46k to a gain of just +20k. Yet, including revisions we find January remained at a gain of +40k (shown below) as December data was revised much lower. **As such, we need to take a look at the reported historical revisions to get a better sense of how Retail sector is faring…**



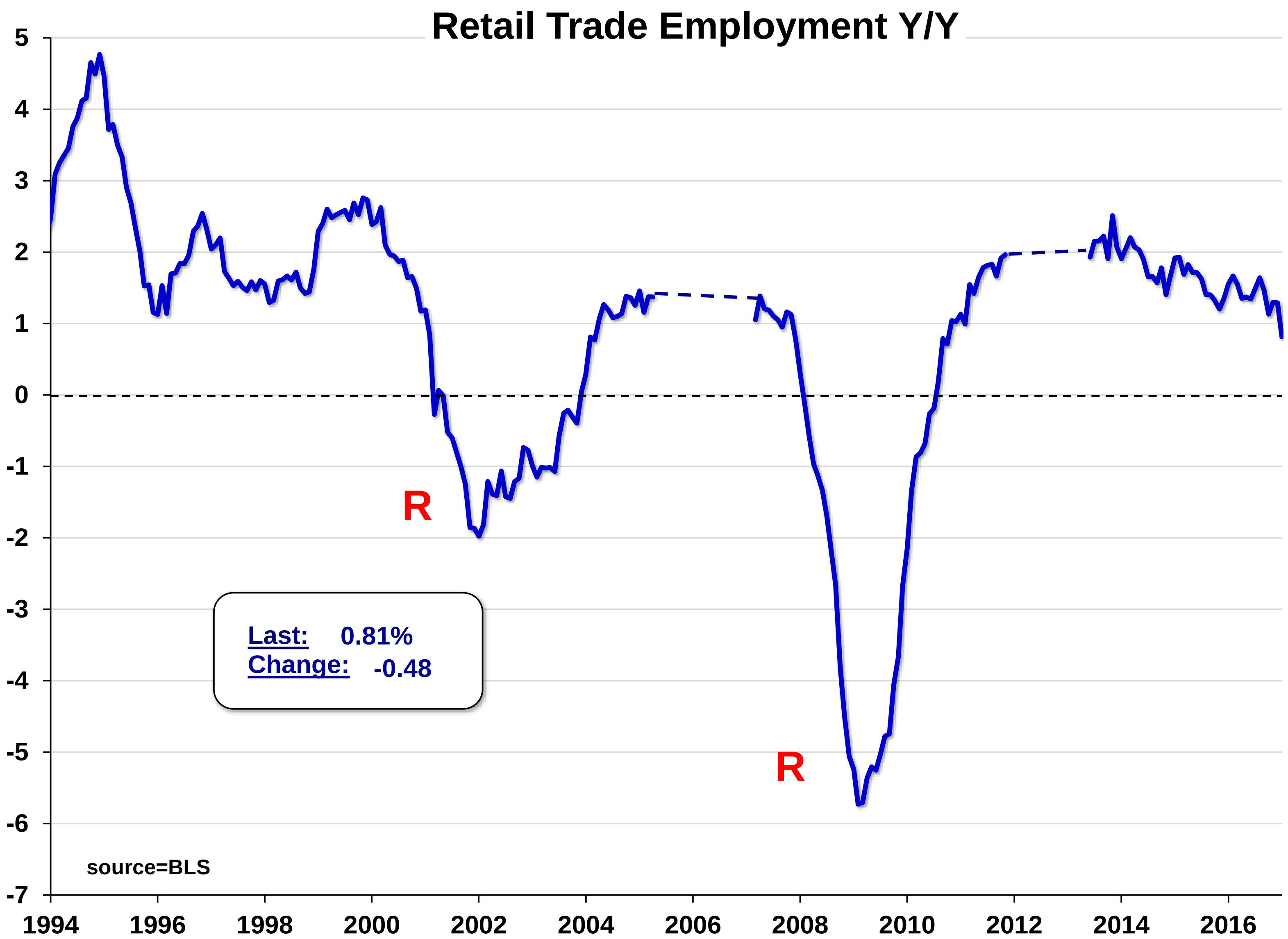
Before we get to the revised data, a look at Retail Employment data reported for **January** (report date: Feb. 3rd). As you can see, the 12mo change in Retail Employment was **229k** and was hovering (on average) around that level for over a year. Also, for further back reference, the December payroll report showed an initial 12mo Retail employment change of **256.7k**…



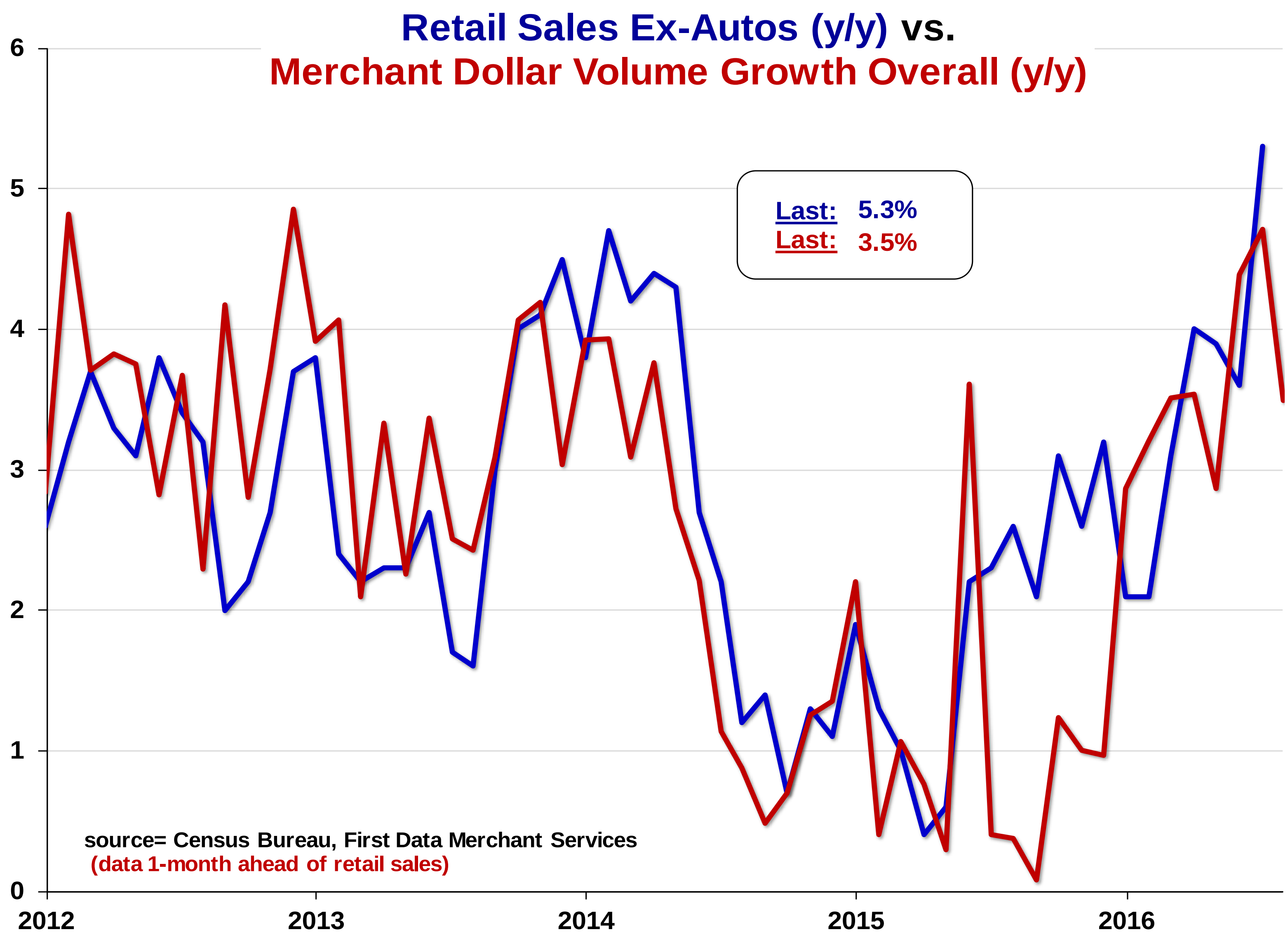
Now let's go to the latest (February) payroll update which includes revisions. *Whoa Nelly*! Revisions show 12-month change is **100k** lower than prior reading (128k vs. 229k), **half** of the initial December reading of 256.7k, and suddenly looking quite weak. It looks as if the decline in hours which we've been saying for some time would eventually result in shedding of retail jobs, may now be coming to pass. The revisions no doubt make more sense given the trouble in retail sector.



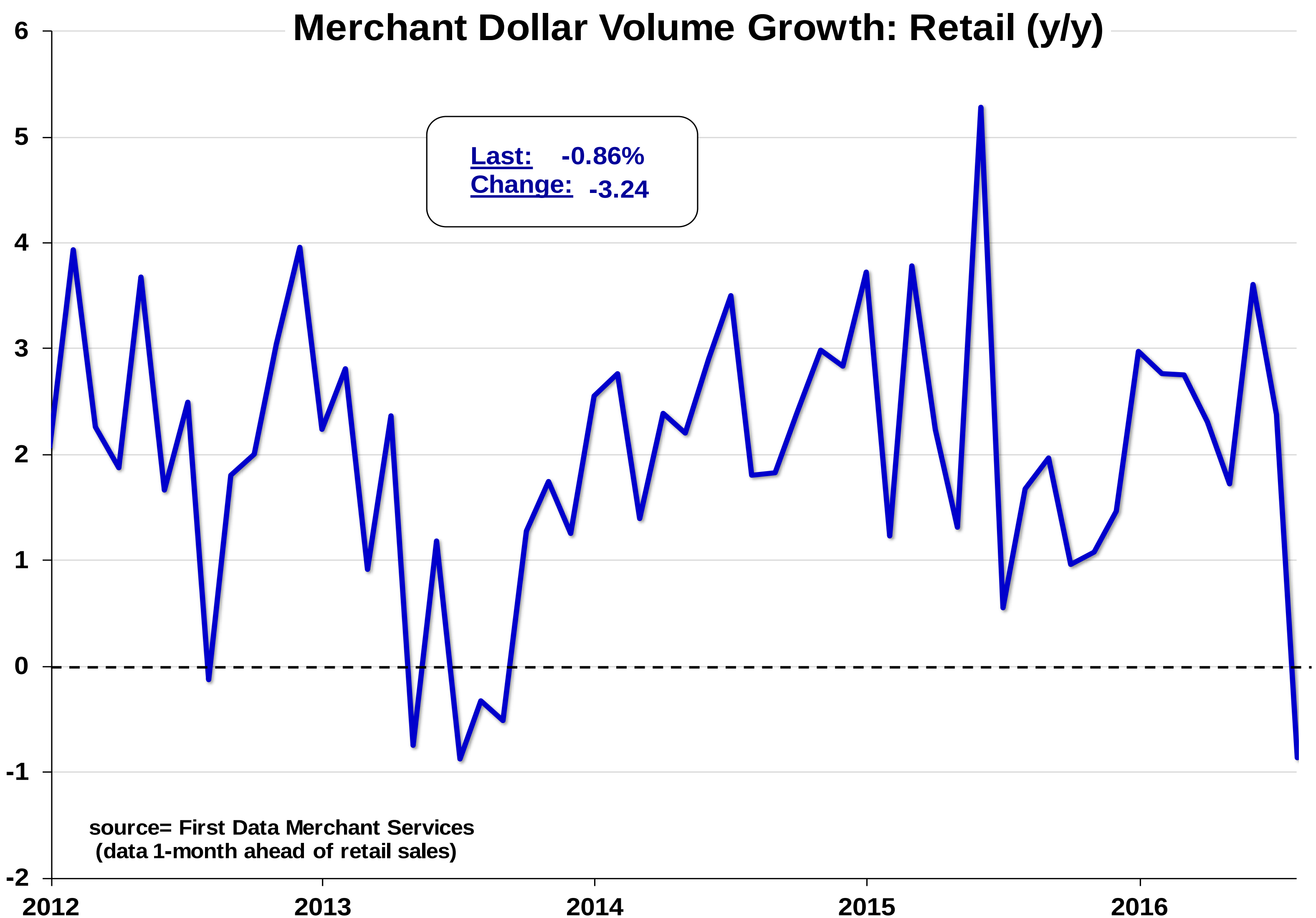
On a y/y basis, Retail Employment has taken a sudden turn for the worse, dropping at fastest pace since the recession. Amazon may have to step up its announced 100k job creation in 2017 by a huge margin to keep this from heading further south! (Note: post-recession 'noise' data removed to smooth out the chart…see dotted lines)



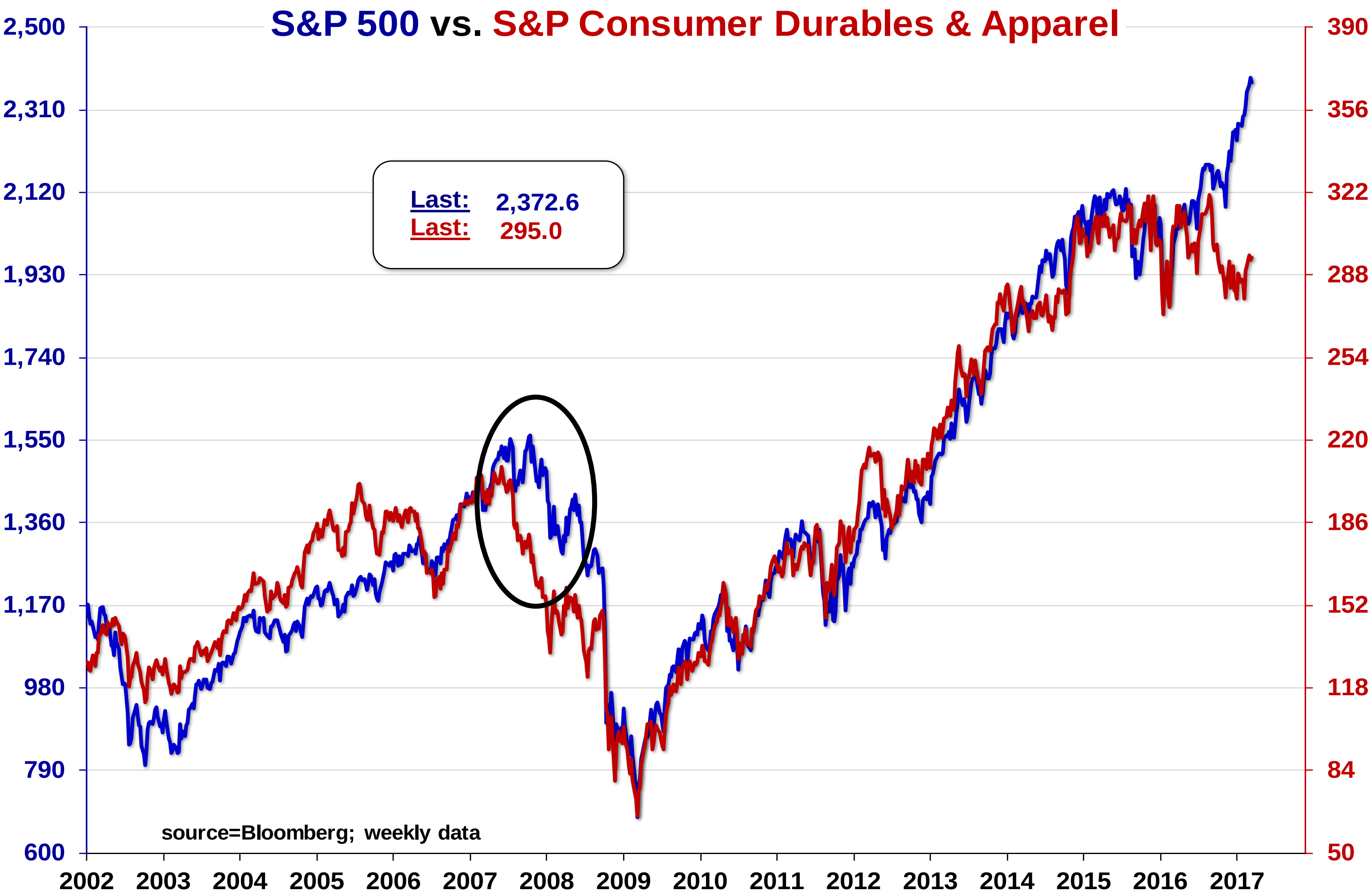
According to First Data Merchant Service's consumer spending metrics (which report ahead of Census Bureau Retail Sales data release), **February retail sales are likely to disappoint**. Chart: Dollar Volume Growth drops -1.2pts to 3.5% in Feb.



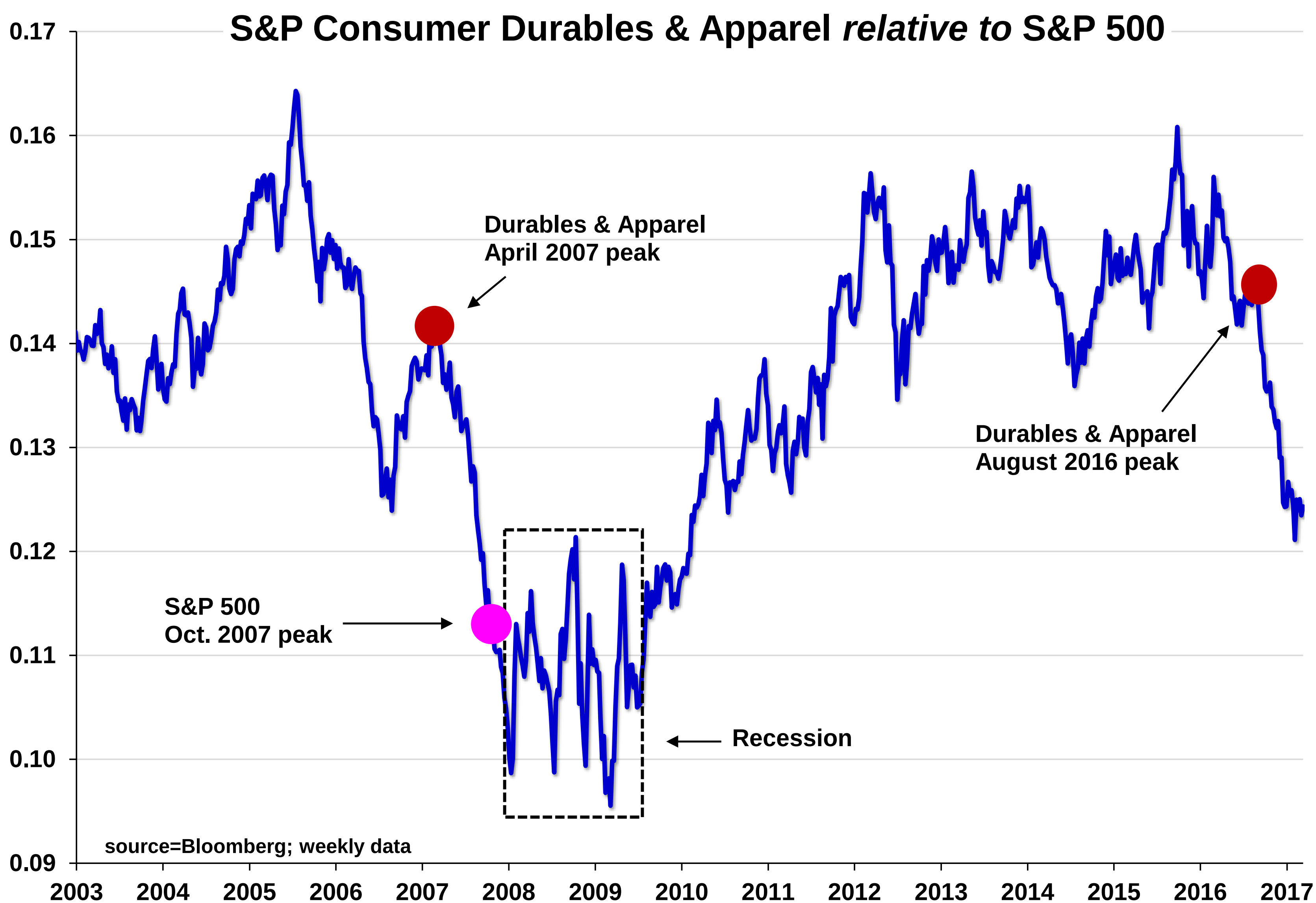
When looking at just the Retail component of the data (which we believe is focused on Department Stores), February looks to be a very disappointing month. Chart: Dollar Volume Growth reading for February tumbles; 2nd lowest print on record (data only available back to 2012). This certainly lines up with some of the Comp Sales disappointments being reported for February: ***Buckle comp sales -23.2%; Cato -25%, L- Brands -13%, etc.***



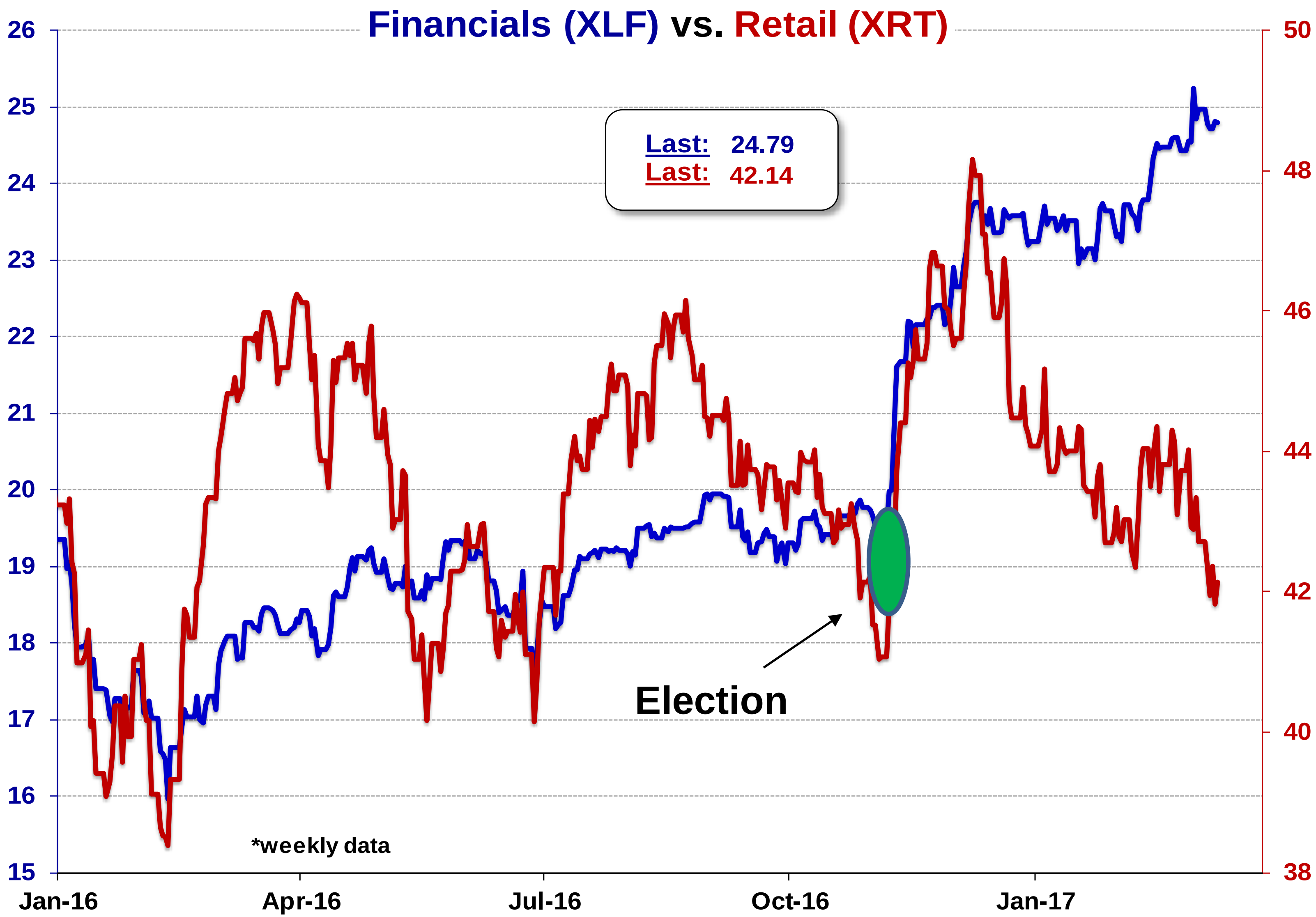
The Durables & Apparel Index provides a good representation of the consumer: 19 stocks in the index, ranging from Nike, Ralph Lauren, Coach, Hanesbrands…to Pulte Group, Whirlpool and Lennar. Historically, the Durables & Apparel Index and S&P have enjoyed a tight correlation, yet a clear divergence has developed. As you can see, a similar divergence appeared in 2007 just before S&P peaked…



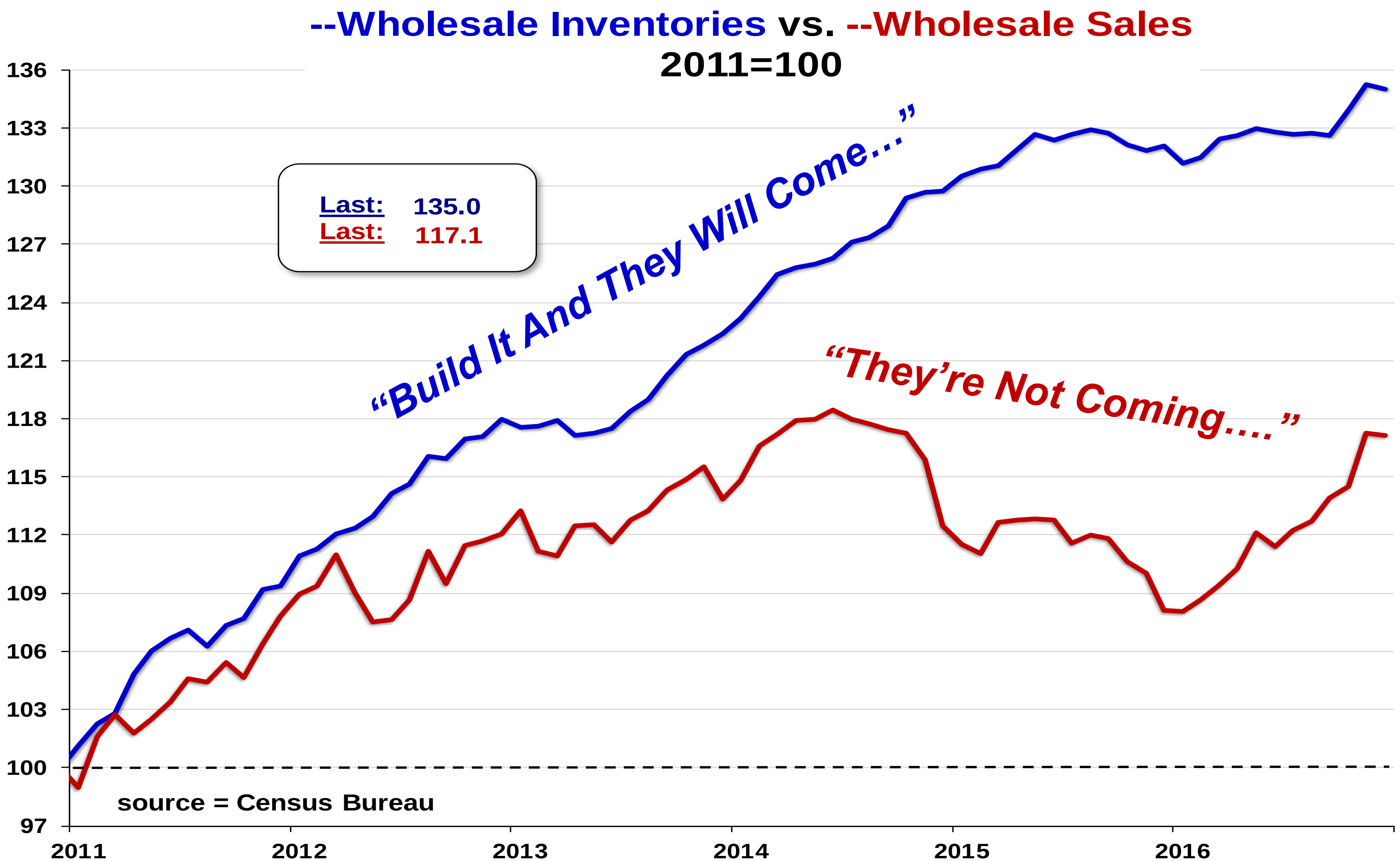
Recent decline in Durables & Apparel / S&P ratio may be cause for concern.. ***As ever, the economy all comes down to the consumer***…and the still unfolding retail sector troubles are almost certain to push the ratio further into the danger zone.



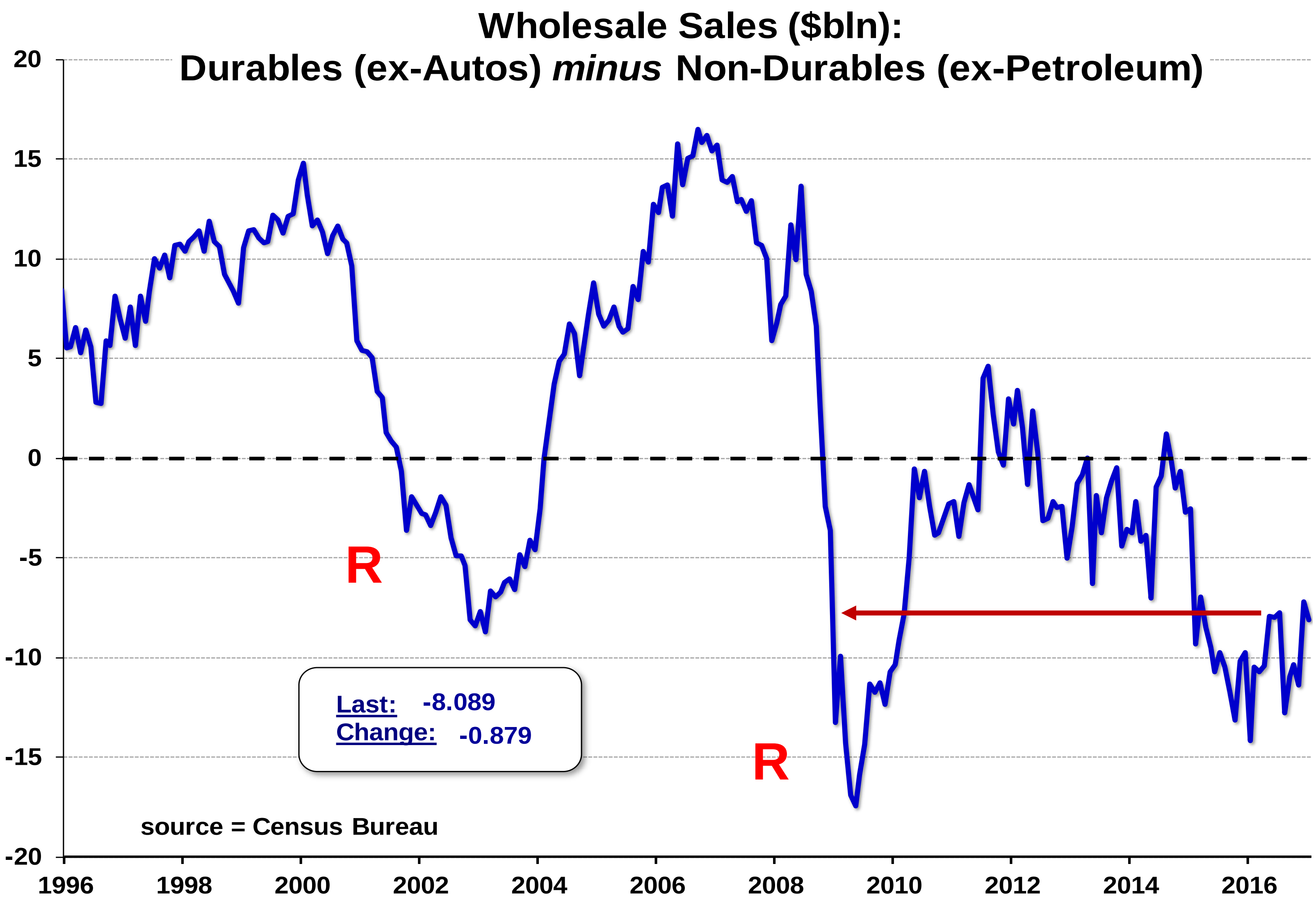
The Disconnect. Retail (XRT) has just nearly given up all post-election gains while Financials are at highest levels since December 2007. The very backbone of the post-election rally in financials…the belief in a strong economy, thus expectation of rising yields…is belied by carnage in the retail space. And let's not forget, over 12% of XRT is comprised of internet retail, thus an ex-internet version of this ETF would be more troublesome indeed.



In late 2011/early 2012, Wholesale Sales began to lag behind rise in Inventories, leading to a record $159bln gap in Jan. 2016 which has fallen now to $136bln…still a very high level. Since end of the recession, it has been a '***build it and they will come***' inventory rise, yet they still have not come. This resolves itself in 1 of 2 ways: earnings rise considerably in the near future sparking a surge in sales, or prices are slashed, production slowed and inventories unwound. Given the recent reports coming from Retail sector (and the fact that consumer 'real' wages are negative y/y), it seems the latter scenario is set to unfold as prices are being slashed to entice consumers…which would indicate a recession may be near.



When assessing the health of the economy and consumer, the strength in **durable goods sales** is a solid metric (see: furniture, appliances, building materials, machinery, etc.). Looking at the 'core' Wholesale Sales data (ex autos and petroleum), we find a not-so-rosy picture. Sales of Durable Goods (ex-autos) minus sales of Non-Durable Goods (ex-petroleum), while turning modestly higher in past year, remain at recession levels.



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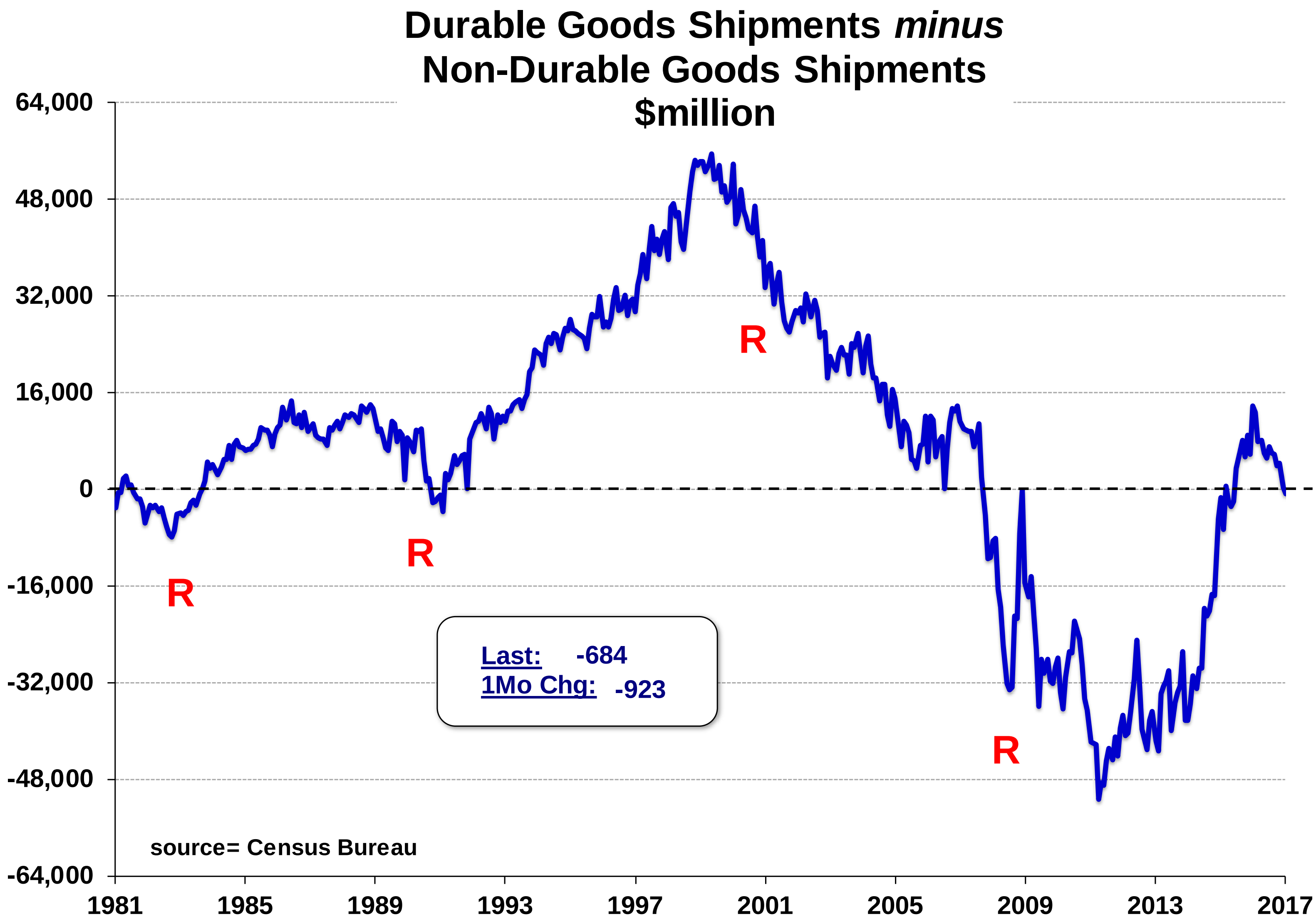
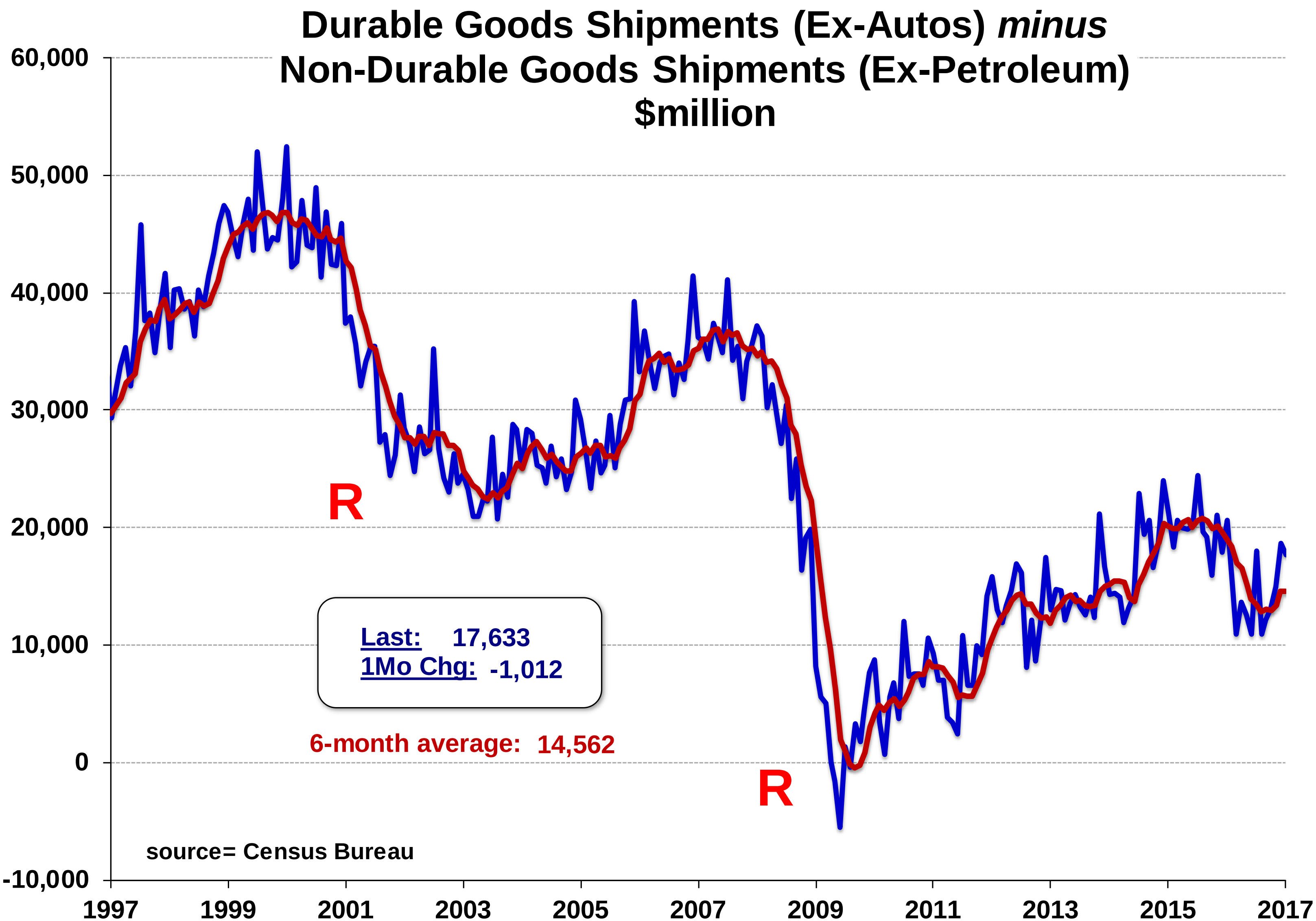
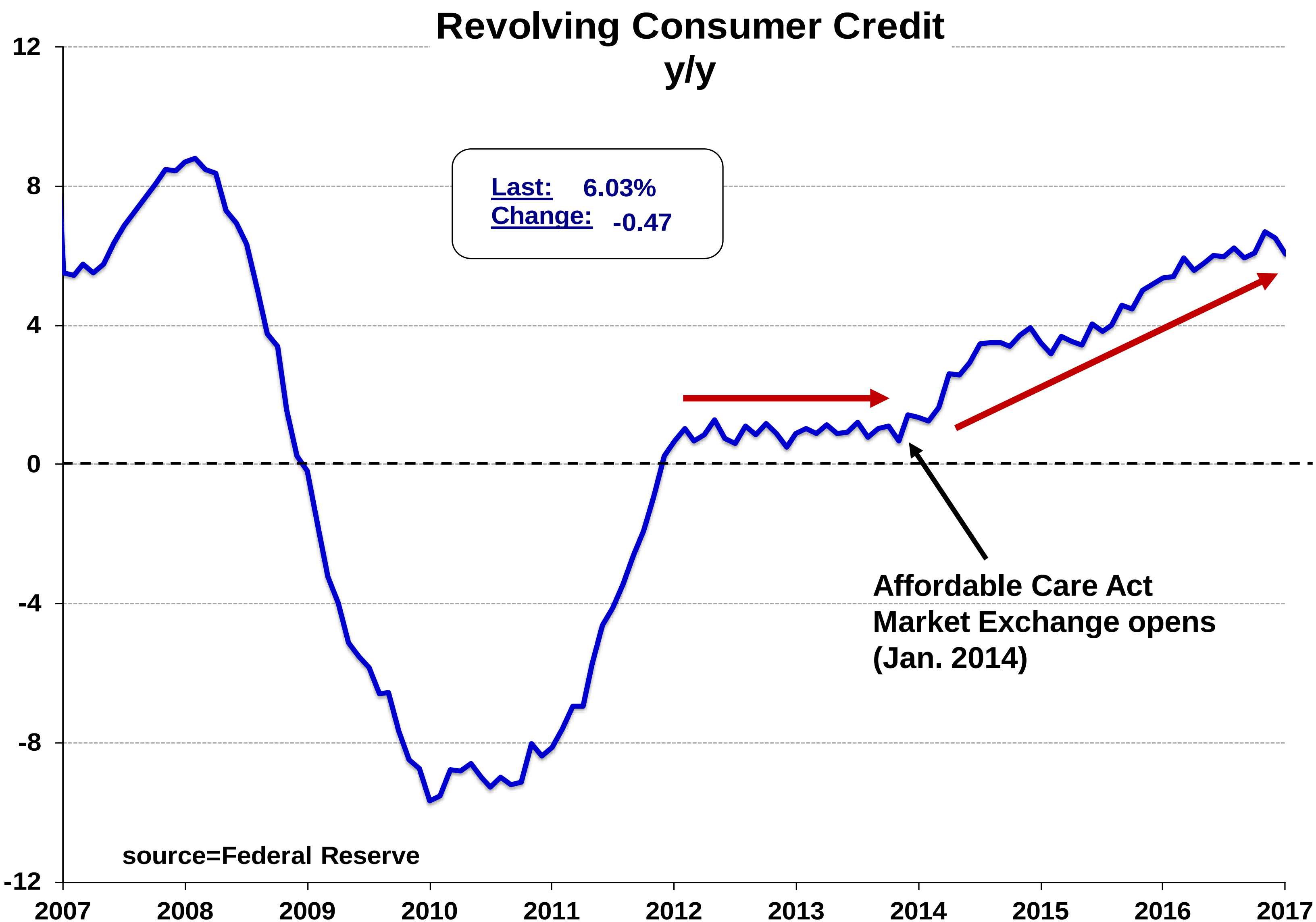
Again here, we find a troubling scenario: Durable minus Non-Durable Shipments have turned negative for first time since the recession. But let's clean this up a bit with the 'core' look at it…



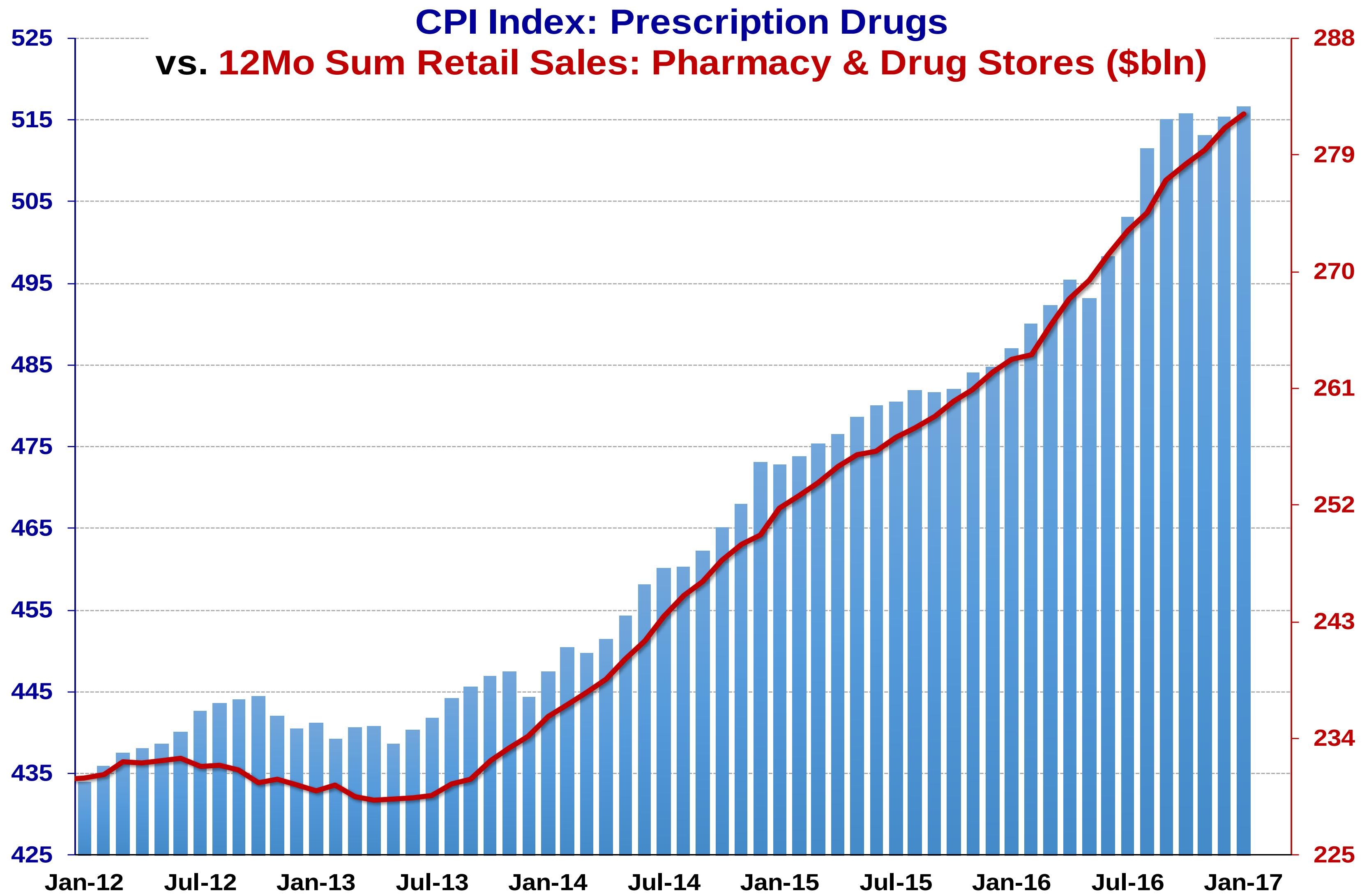
As with Wholesale Sales data, 'core' Durable minus Non-Durable shipments have slipped back into recession territory over the past couple of years, breaking below the favorable trend which was developing.



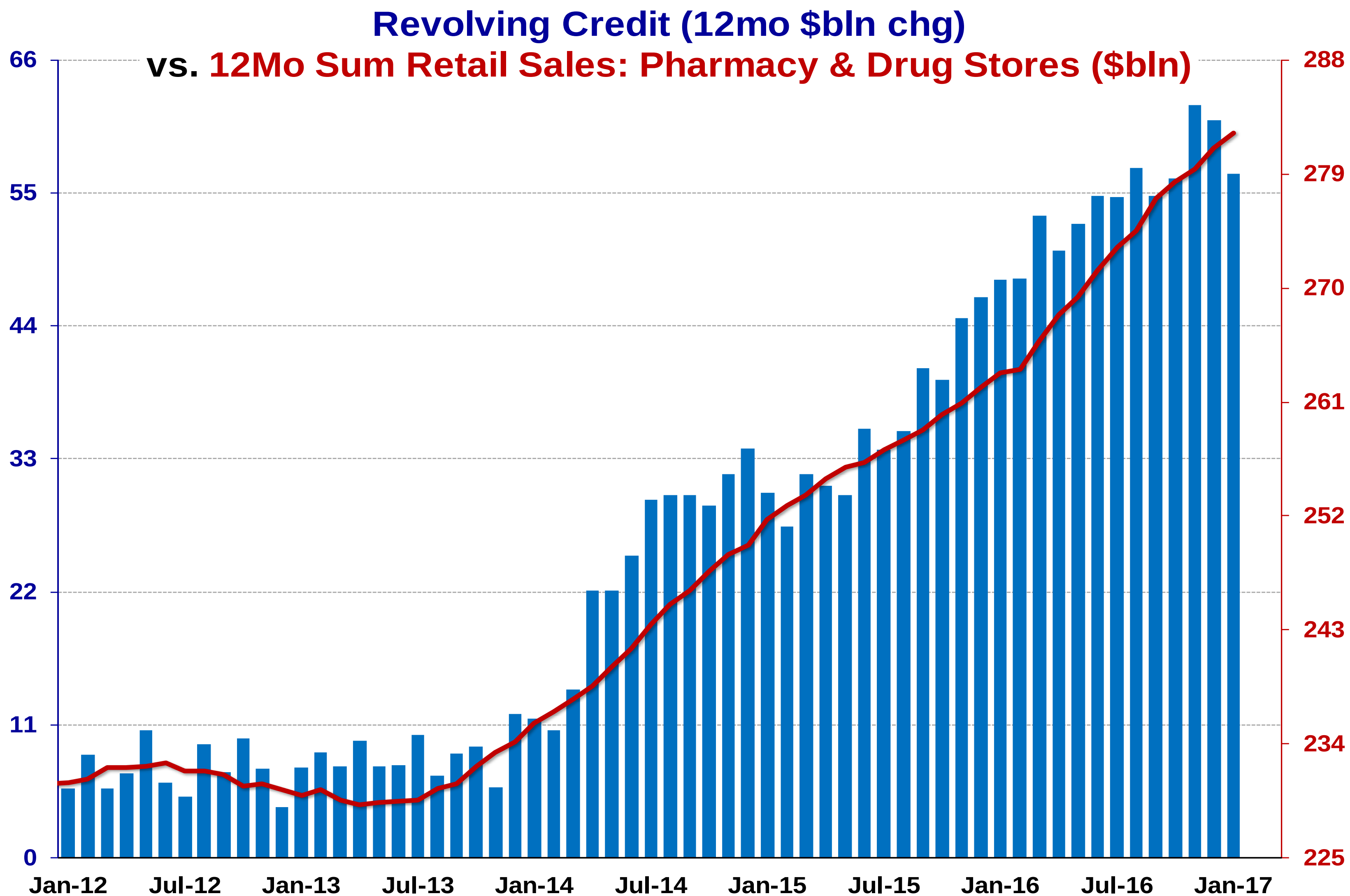
Consumer Credit: latest report shows revolving credit continuing to rise. Note that credit growth was subdued right up until the full implementation of the Affordable Care Act in Jan. 2014…after which the steady rise began.



While the ACA came with a heap of reforms for the health care system, Big Pharma escaped any such federal oversight. As such, drug (and overall medical commodity) costs began to surge as pharmaceutical pricing remained unchecked and unregulated. The 3yr percent change in Prescription Drug CPI is now highest since 2002… leading to a sharp (and non-consumer-friendly) surge in Pharmacy & Drug retail store sales.



While we don't attribute the rise in revolving credit entirely to surge in prescription drug and other medical commodity costs, it seems clear these costs (coupled with declining real wages and part time jobs) are affecting consumer pocketbooks thus pushing them to credit card usage. In short, the rise in Revolving Credit should be viewed as a clear sign of distress…not a consumer feeling confident of future earnings and job security to the extent they're willing to accumulate debt.



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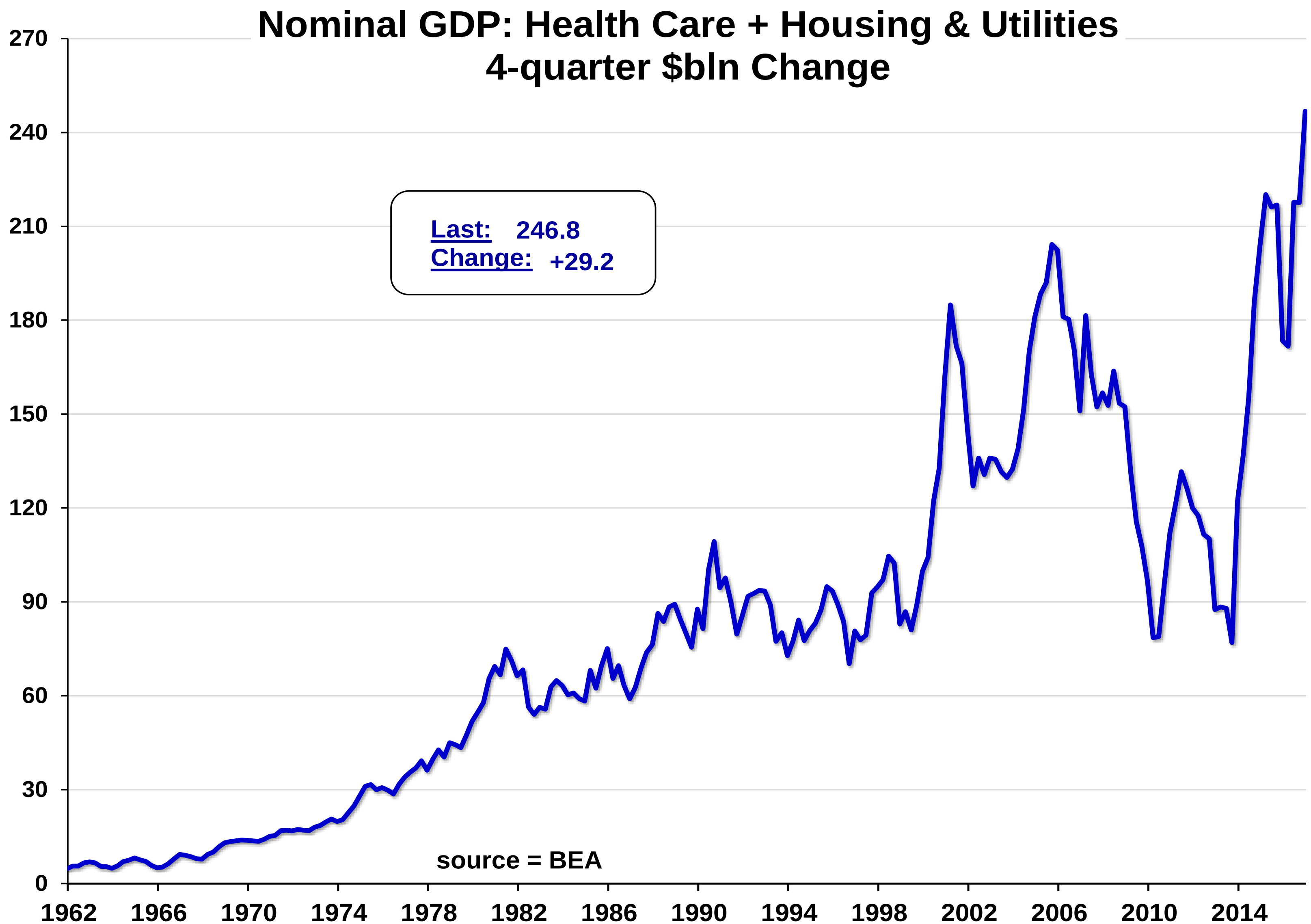
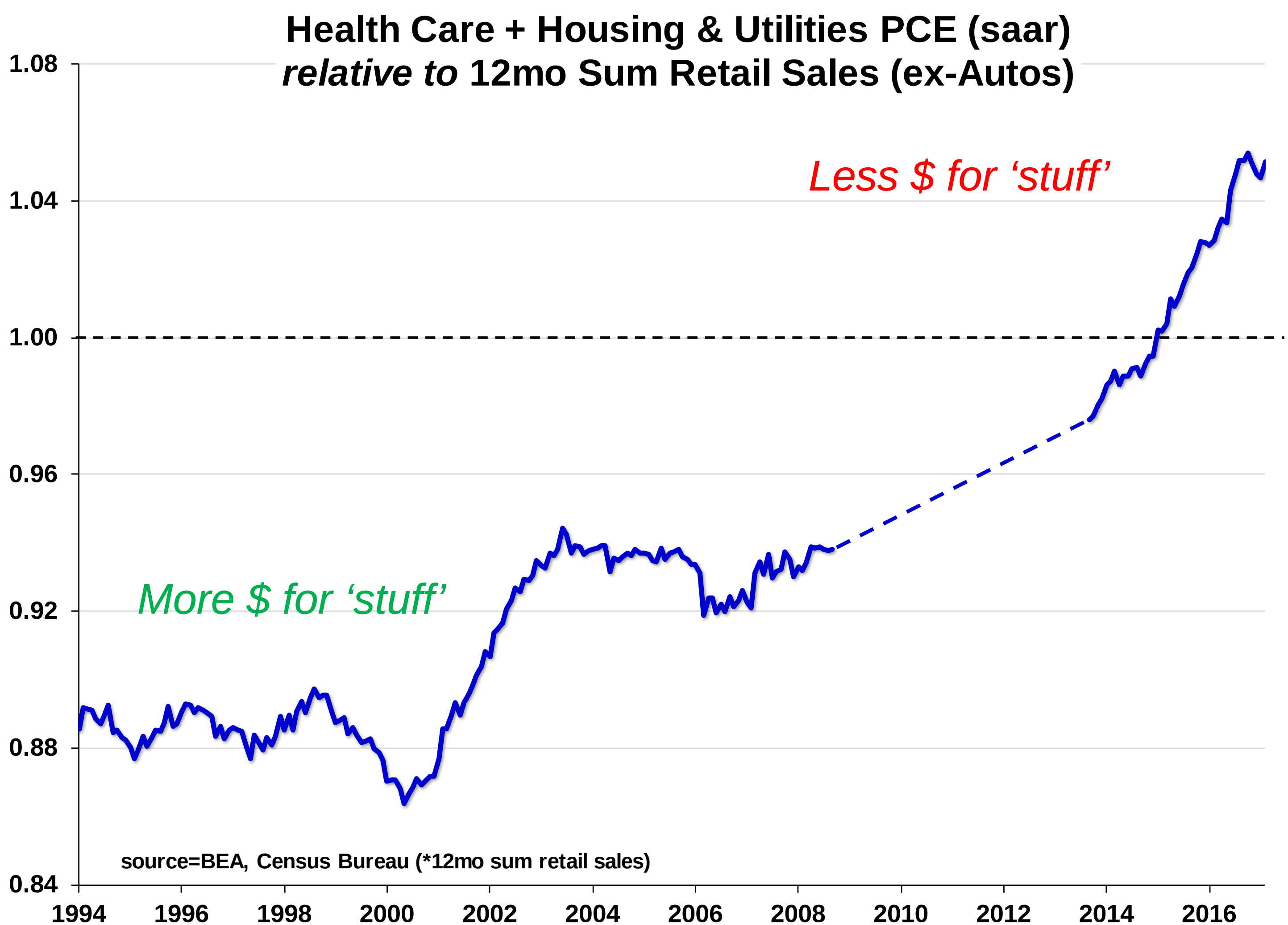
If you were wondering where the bulk of consumer headwinds (and inflation) are coming from, look no further than this chart. 4-quarter change of Health Care + Housing & Utilities just hit highest reading on record.

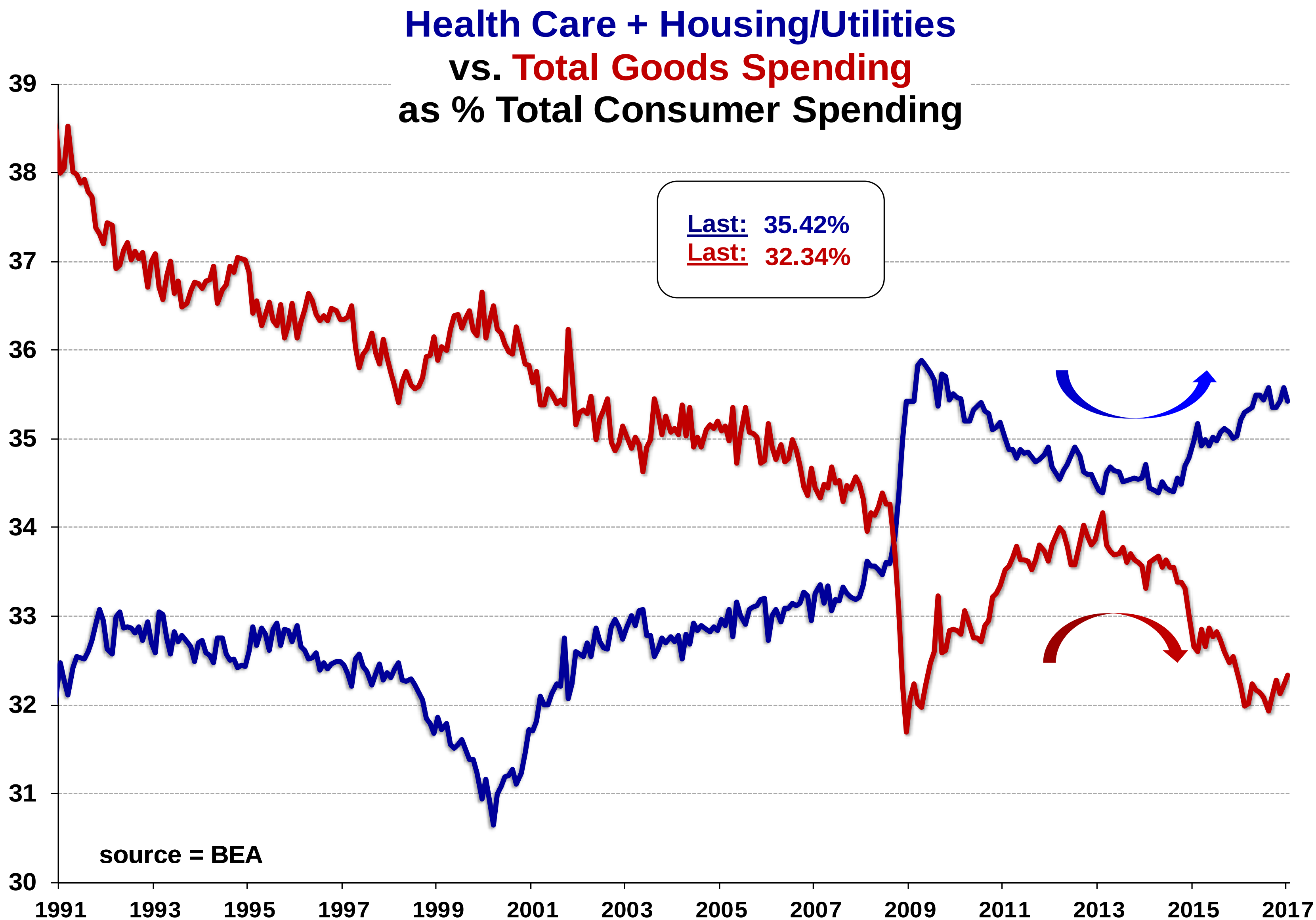


In 2015, Health Care and Housing outlays exceeded Retail Sales (ex-Autos) for **first time on record**. (note: recession/post-recession 'noise' data removed to smooth the chart). As we stated in a report earlier in the year, either earnings must rise sharply in the near-term (clearly not happening) or the consumer needs quick relief from soaring Health Care costs…or a combination of the two. Given the sharp rise in health insurance costs since the ACA went into effect, we suggested prices would have to be slashed 40% or more from current levels to give the consumer any chance at spurring economic activity via such 'tax' relief, and that such relief would have to happen in very short order. Yesterday, the bad news came: the CBO published it's scoring of the newly proposed Health Care law…and it clearly offers **no relief** in the immediate term. As we understand the CBO results, insurance costs are **set to rise 15-20% thru 2020 and eventually drop by 10% by 2026**. This is simply too long a time frame for relief which means consumers will remain under stress for some time to come. A negative for the consumer and negative for growth.

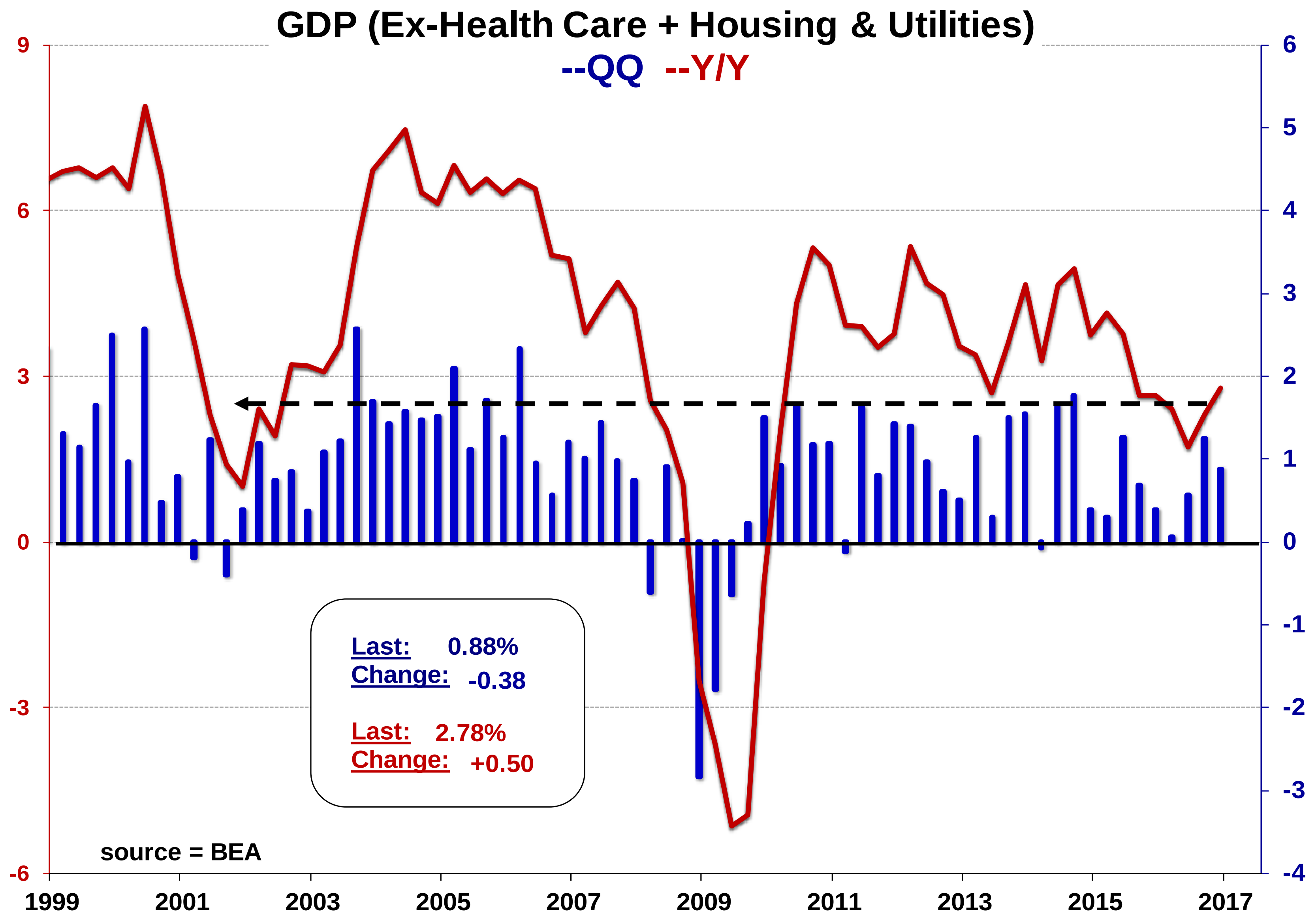


Their only recourse is to drop coverage altogether to keep additional money in their pocket, which will likely be the option for many as the penalty for not purchasing health insurance will be removed

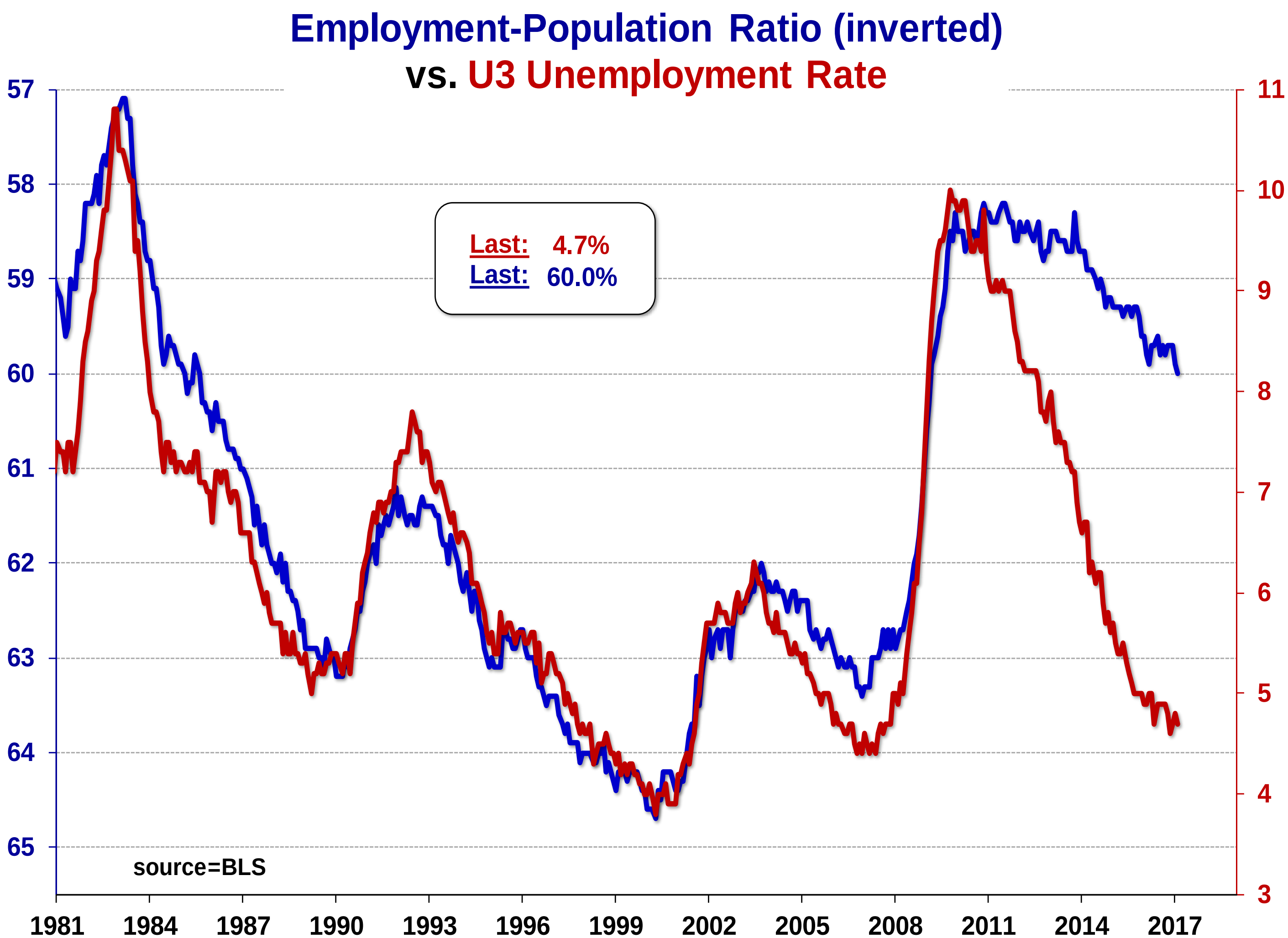
As spending on services (primarily Health Care, Housing & Utilities) assume a larger portion of outlays, consumer spending on 'stuff' increasingly taking a back seat…



Growth…or lack thereof: GDP excluding Health Care, Housing & Utilities remains very weak. These two components represent the largest contributors to CPI rise, and largest mandatory outlays (effective 'taxes') for the consumer.

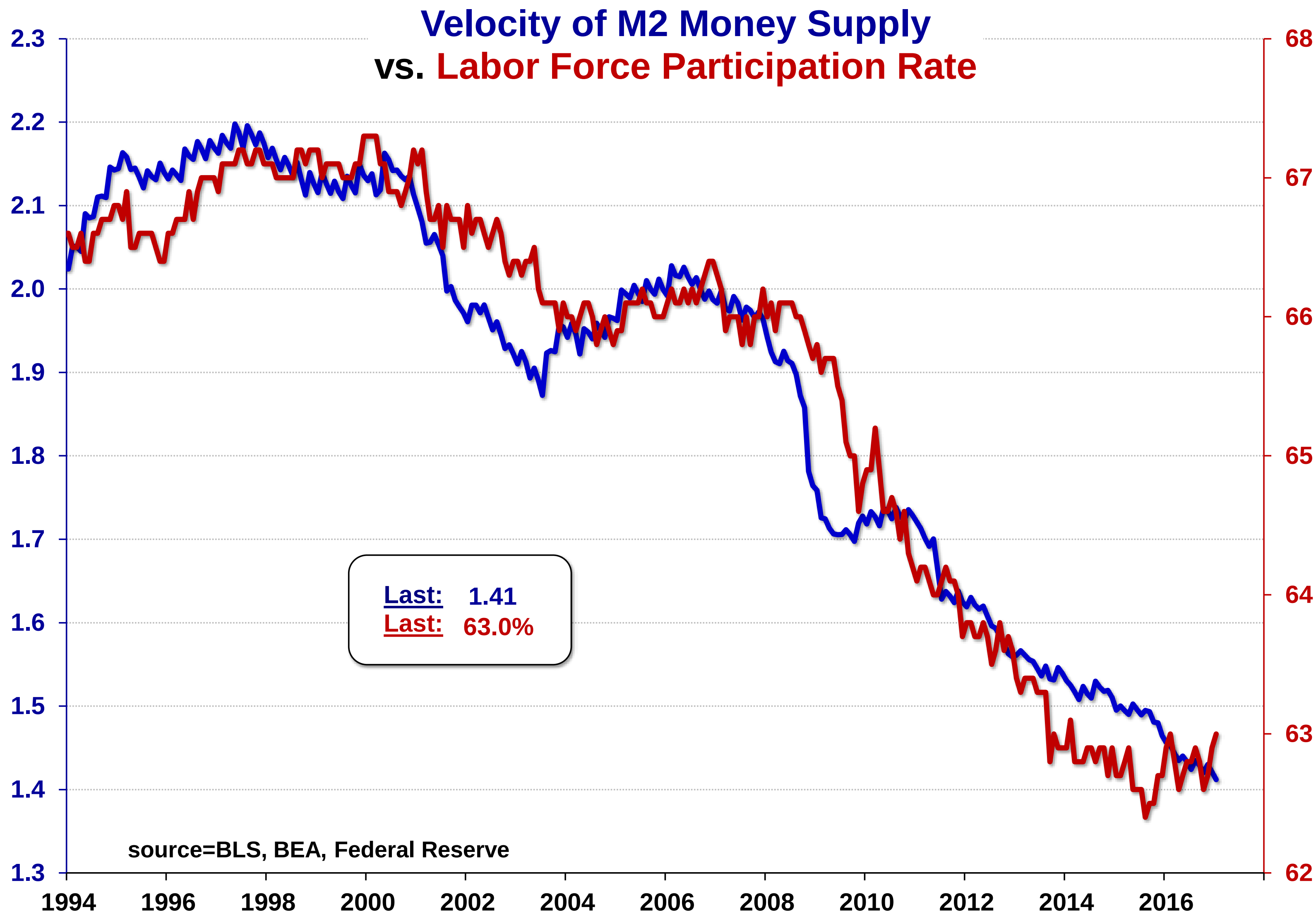


Glaring divergence between Labor Market indicators. In short: the modest gains in Employment-Population Ratio since the recession brings into question whether the headline (U3) rate has even the slightest correlation to reality of Labor Market conditions. As we put forth in a previous report in our 'back of the envelope' calculations, neither the U3 or wider U6 measures truly capture those who have dropped out of the labor force altogether (excluding retirees, disability recipients, students without work, etc), leading us to conclude the **real** unemployment rate is likely well north of the widest (U6) measure which currently stands at 9.2%. The Employment-Population Ratio (which has now clawed its way back to Feb. 2009 level) clearly has a distance to go to validate the U3 measure , indicating there is **far greater** labor slack than the U3 is signaling. Which, of course, leads to quite a bit of head-scratching when Fed members continue to say we are at/near full employment. But lo!...a rare moment clarity from one of our intrepid Fed members: ***Kaplan: Feb. 27 – "We Might Have More Labor Slack Than 4.8% Unemployment Rate Suggests".***

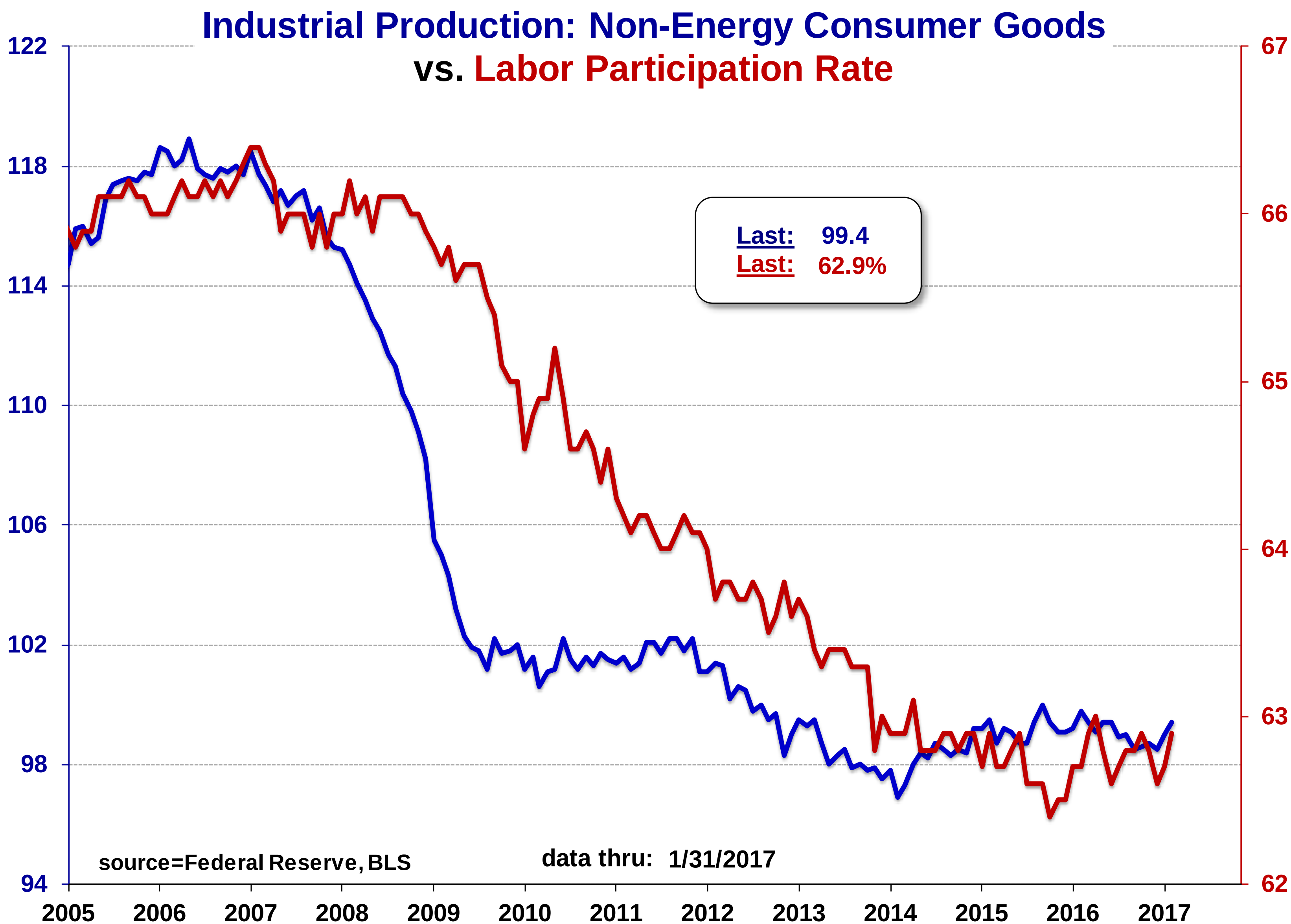


Yes. A lot more.

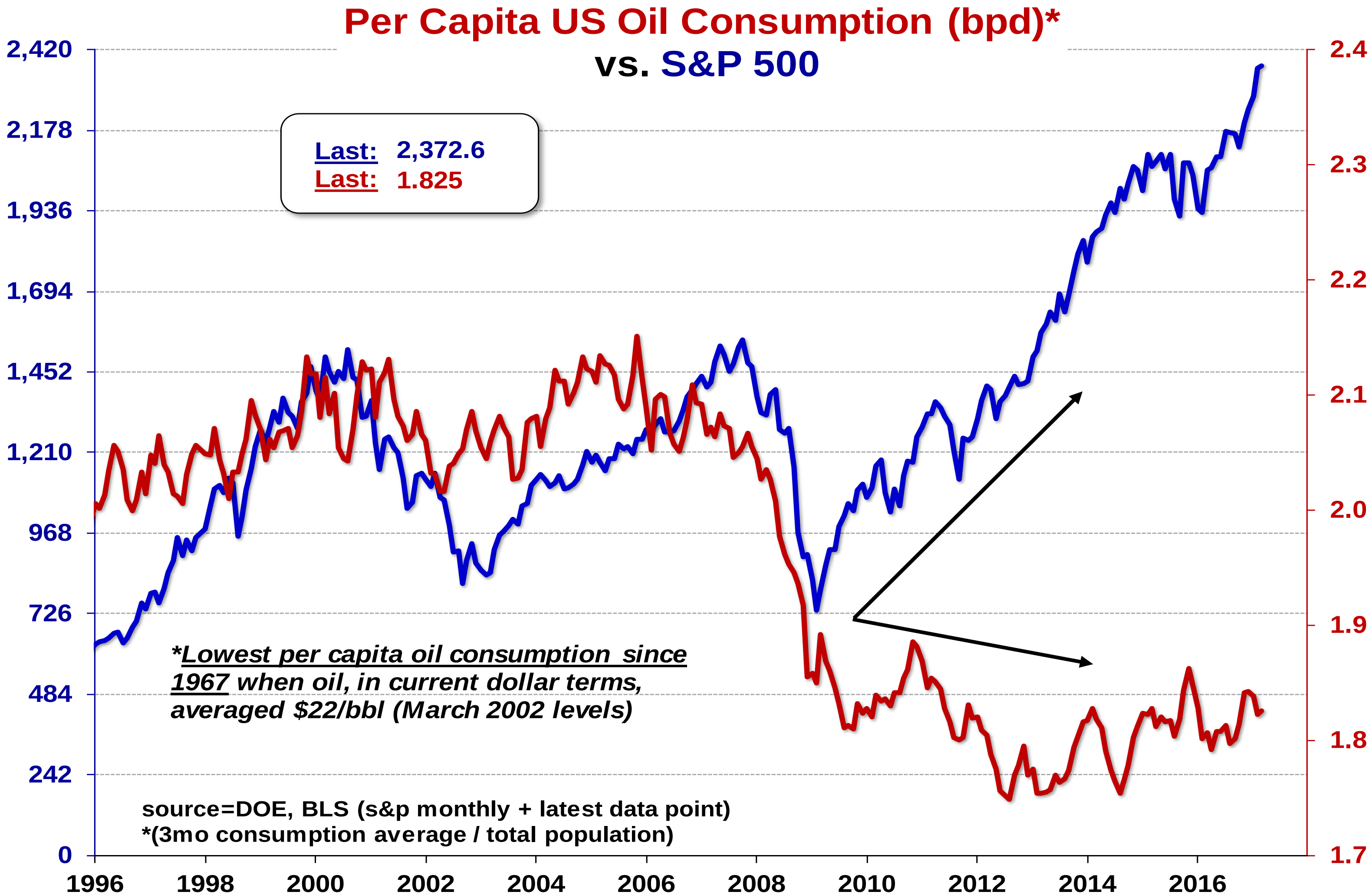
Should anyone suggest Velocity of Money doesn't matter, show them this chart. It matters…a lot. As one might expect with Labor Participation near record lows, the flow of money through the economy is equally dismal. But have no fear! The economy is apparently running hot and rate hike cycle is set to get underway.



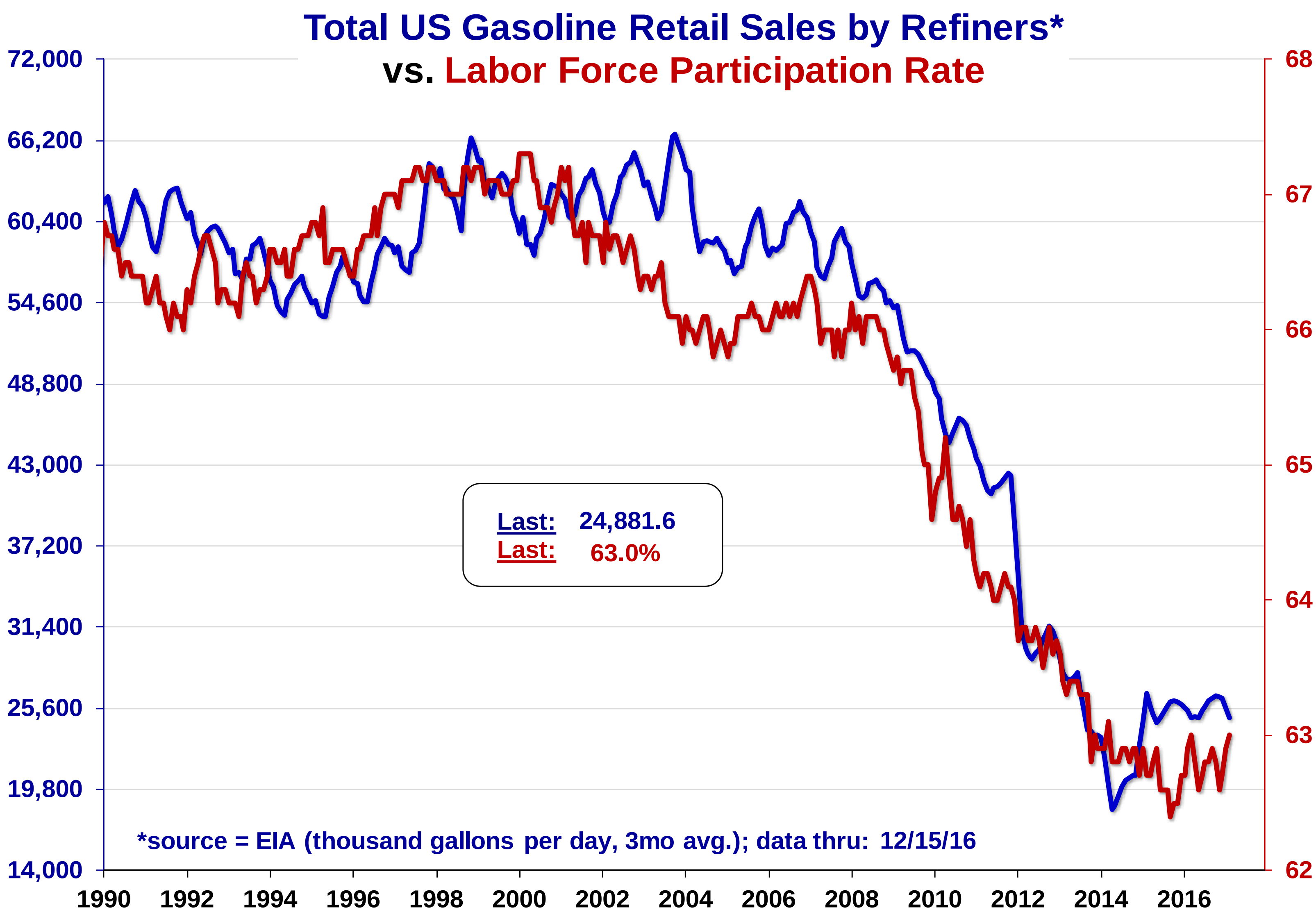
Non-Energy Consumer Goods index going hand-in hand with weak labor market conditions



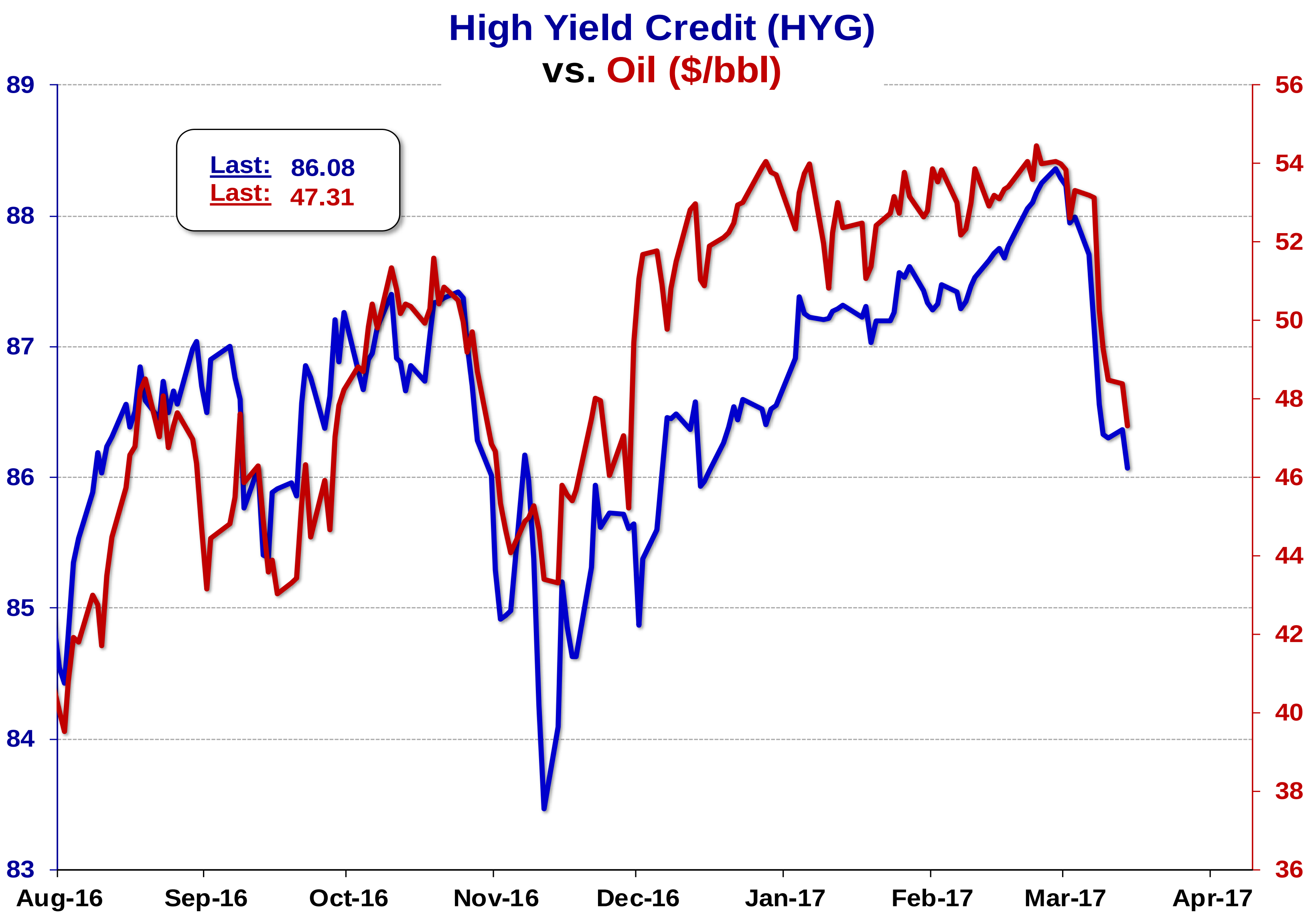
We've made the point that oil's rise the past year (aided in no small part by months of OPEC jawboning, followed by an OPEC output cut 'deal' which has run its course) has temporarily presented the '***illusion of growth***', yet the demand side has remained decidedly weak. And, of course, now we have inventories at record highs which are not helping matters. For OPEC, attempting to fight a supply issue is one thing. Attempting to fight both a supply AND weak demand issue is quite another. As we've been saying for many months, oil was likely to roll over which now seems to be happening. As such, there exists the distinct possibility that oil retests 2016 lows ($26/bbl).



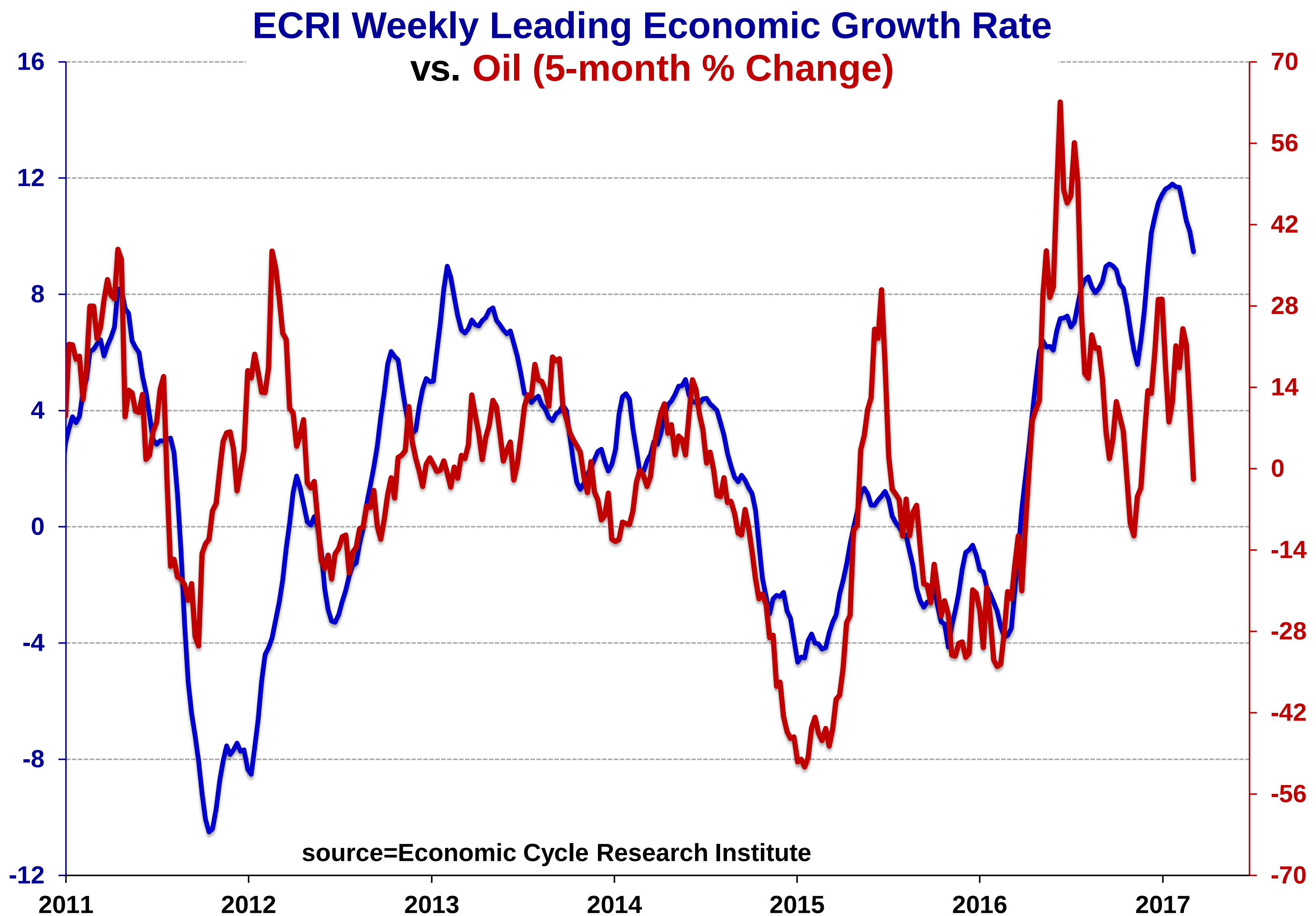
Weak demand on display: Gas sales by refiners matching Labor Participation rate which is at lowest level since April 1978.



As we alluded to in a January report, a decline in oil would be a game changer for a wide swath of credit and growth metrics….

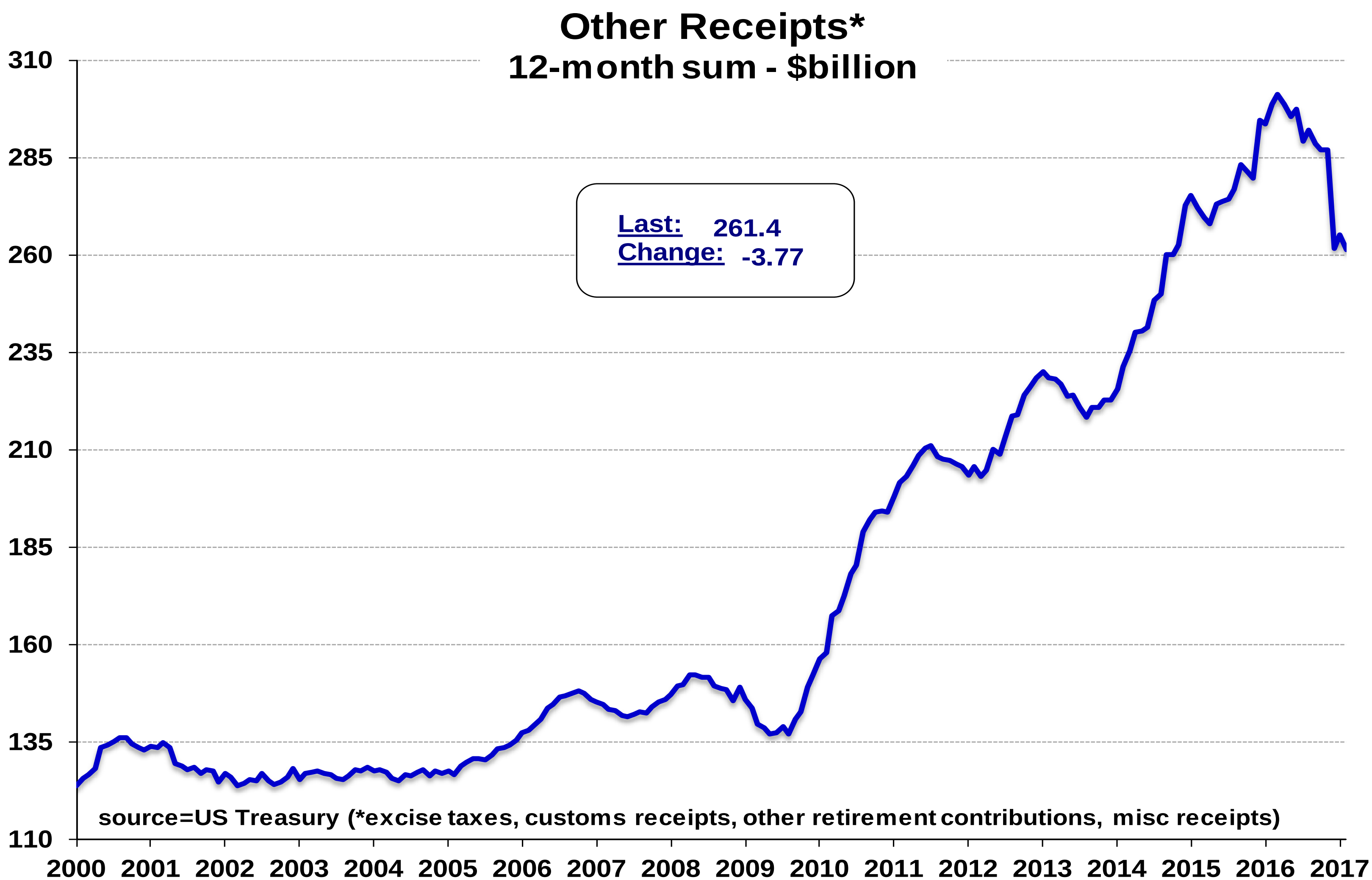


An example of Oil's effect on growth metrics: ECRI Growth Rate Index…which enjoyed a considerable surge in 2016…is now tracking Oil lower. Much of gains in various growth indicators this past year we would argue are a result of higher energy prices as they've provided **the 'illusion' of growth**. (chart data thru last Friday)

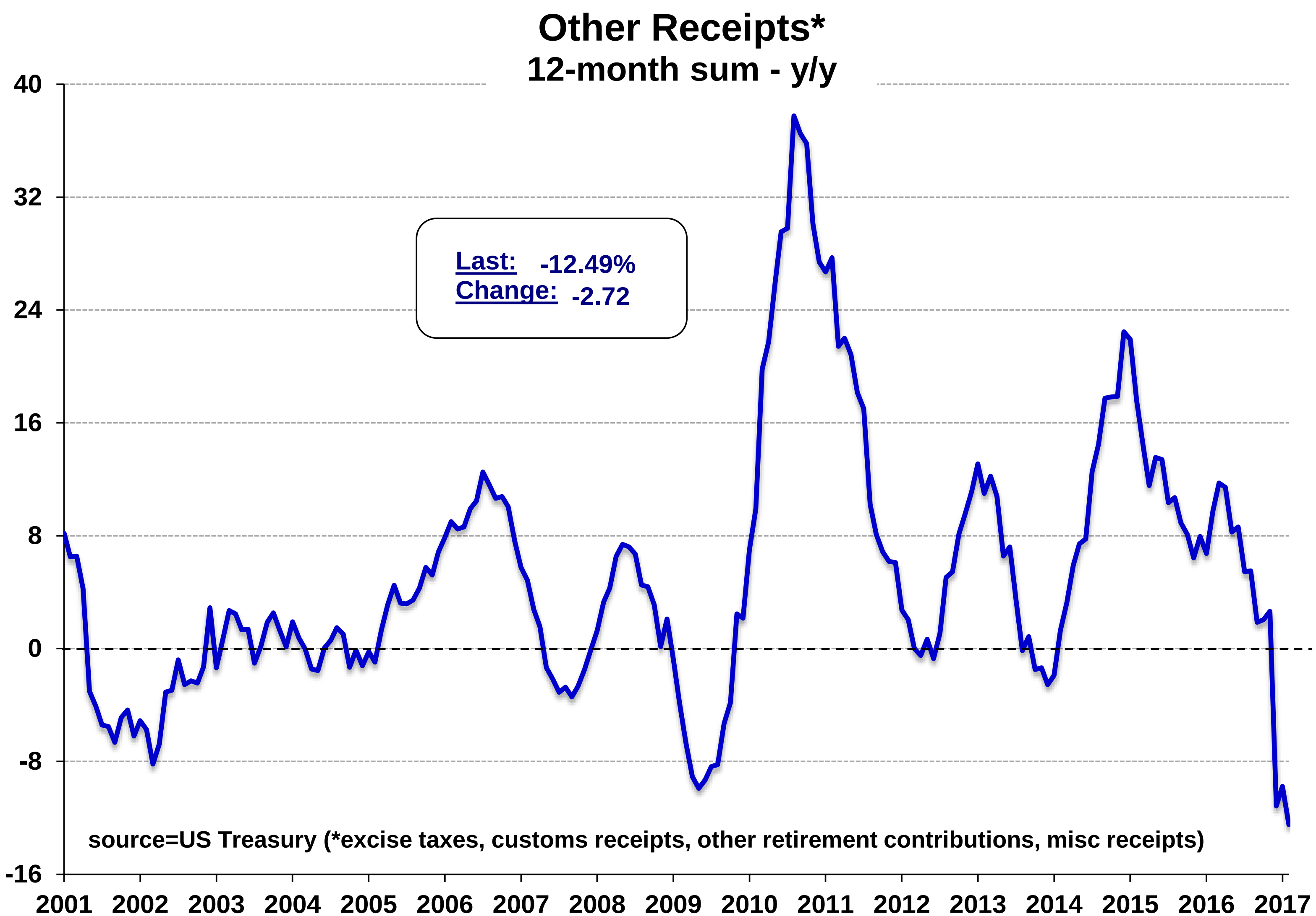


A few final charts to consider as we wrap things up….

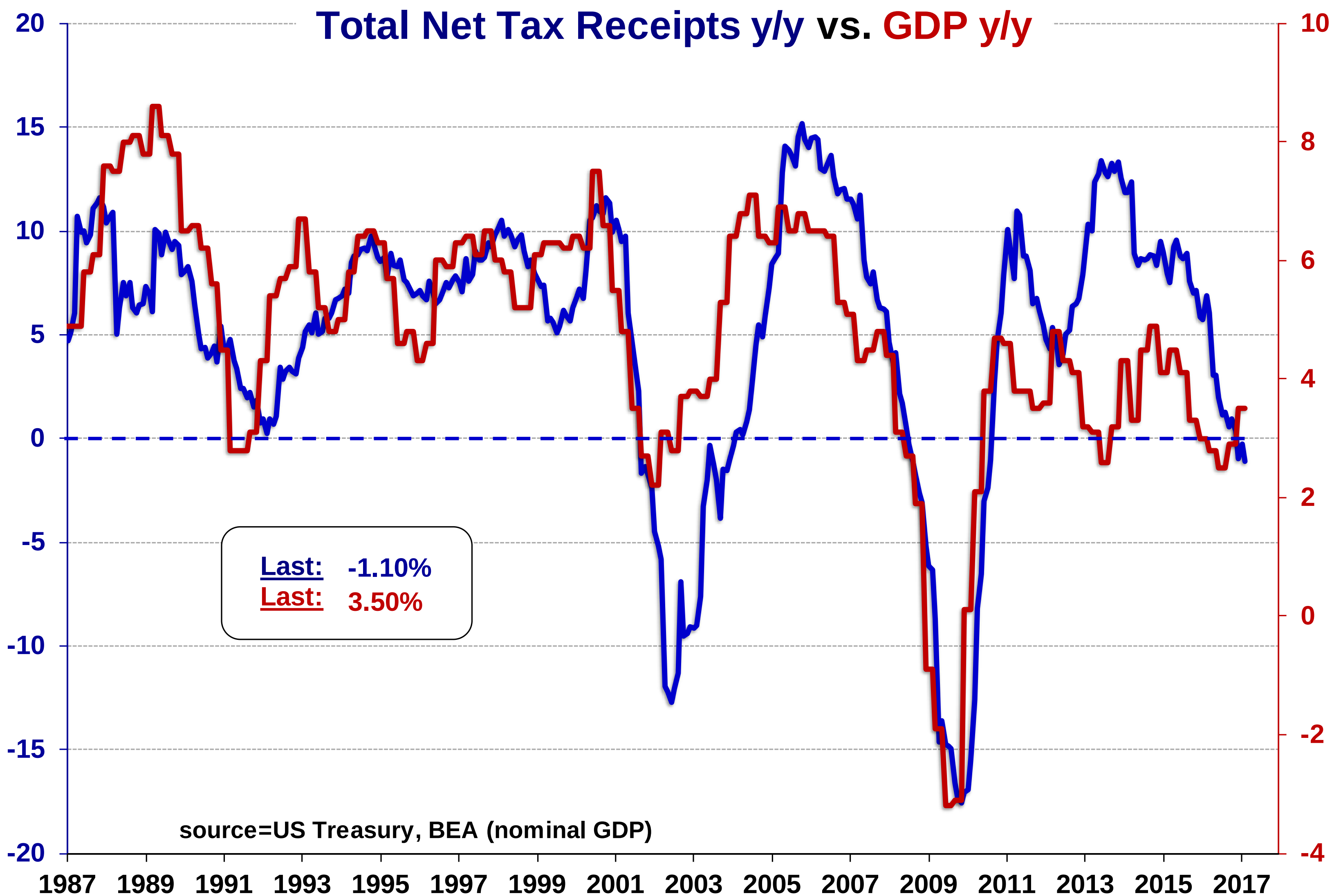
First, from the US Treasury Monthly Budget Report: 12mo sum of 'Other' Receipts (excise taxes, customs receipts, other retirement receipts, miscellaneous receipts), drop -$3.77 billion in February. To put this 'other' category in perspective, 12mo sum Corporate Tax receipts are not much above this, at $298bln, so this is not an insignificant portion of receipts…and it's falling off a cliff. Let's proceed to chart on next page…



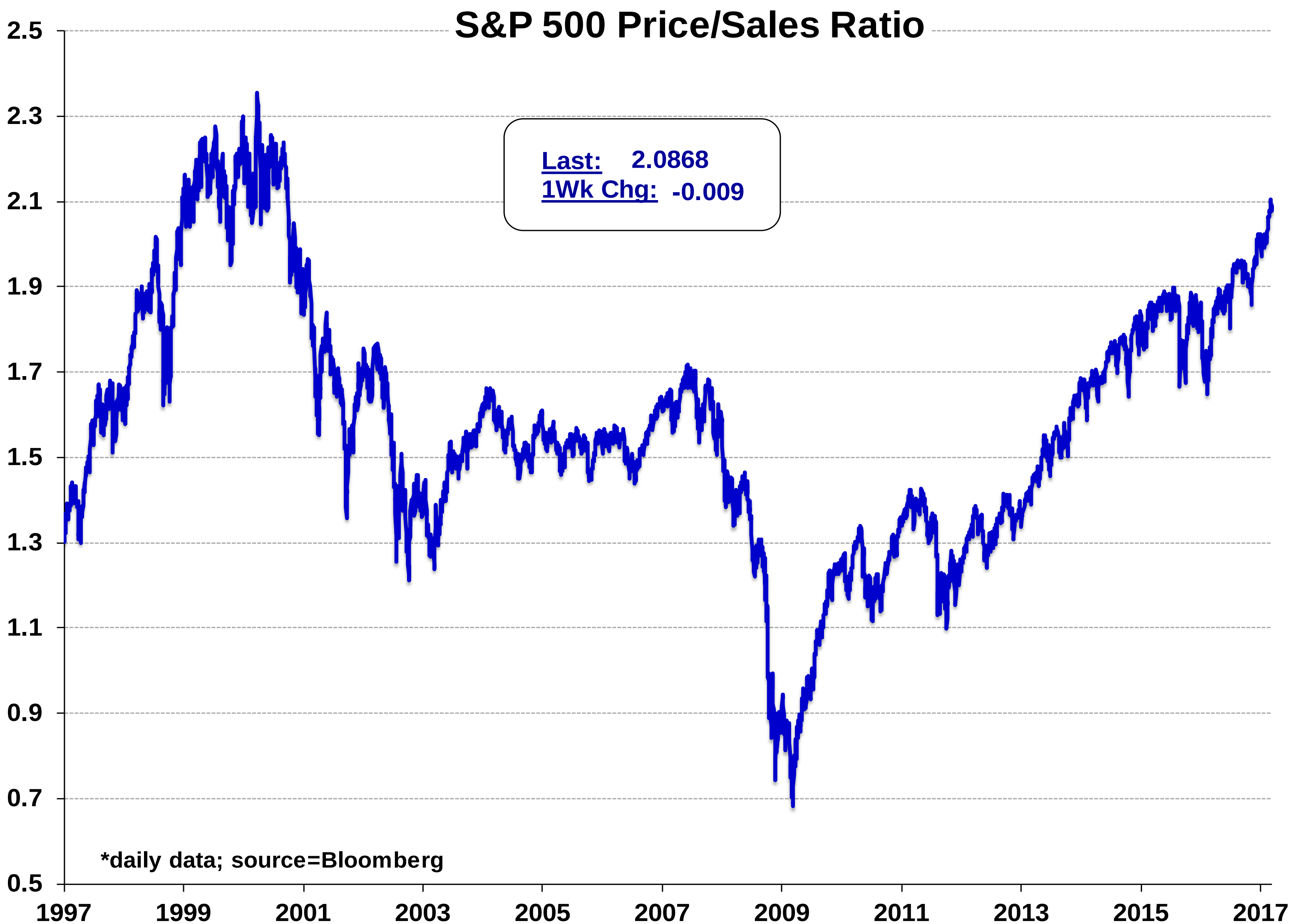
The ***'other receipts***' category just posted it's **biggest y/y decline on record at -12.5%.** Lastly, the 12mo interest expense on debt (excluding intra-governmental debt) hit $253 billion in February…which is the **highest on record**. And that's with interest rates hovering just barely above record lows. And the Fed is (apparently) setting off on a rate hike cycle. We'll just let that settle in for a moment.



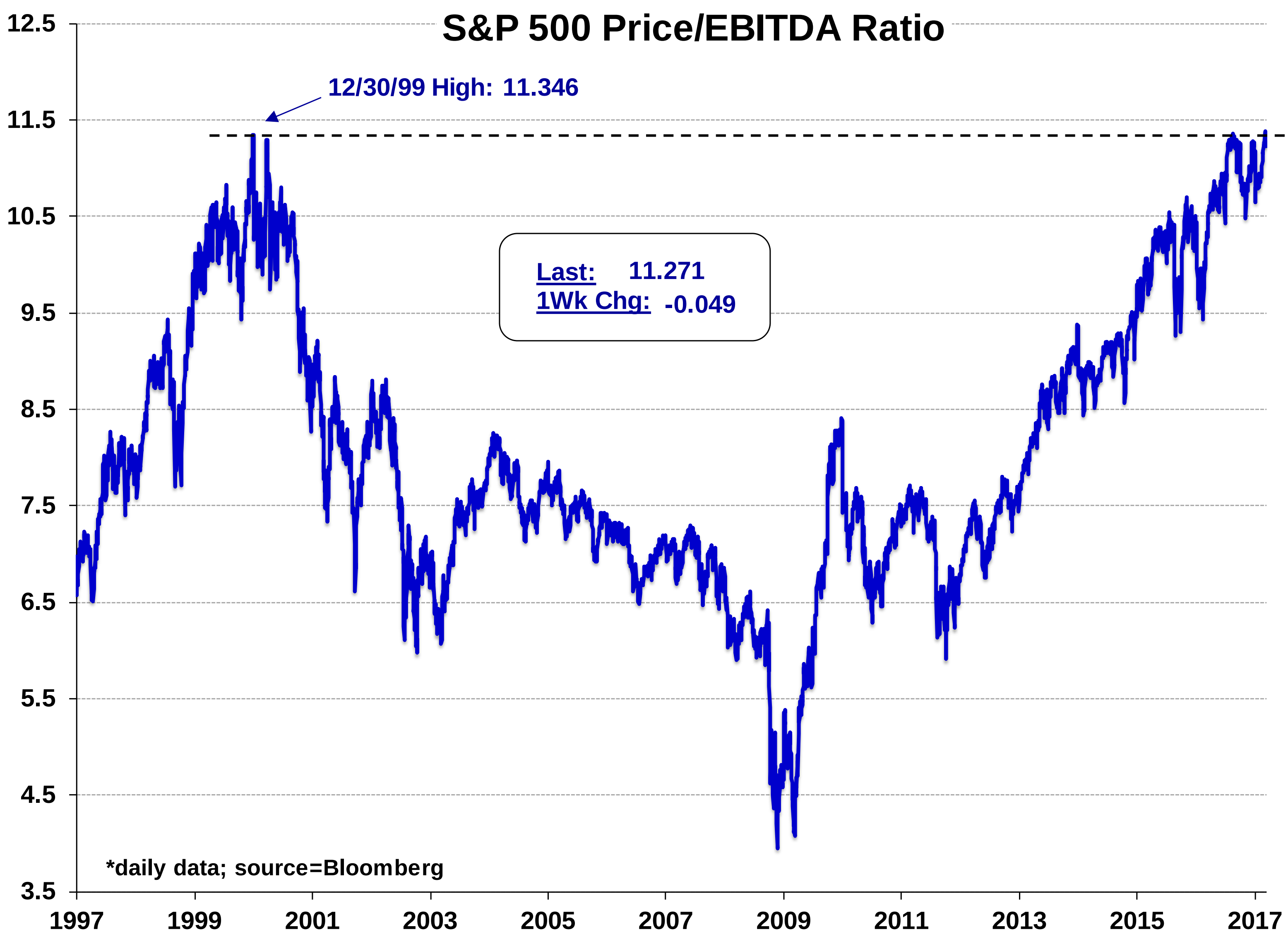
US Treasury Federal Budget Report: Total Net Tax Receipts drop -0.82pts to -1.1% y/y…**lowest since the recession**. Data would infer a Nominal GDP reading between 2-2.5% (currently at 3.5%)



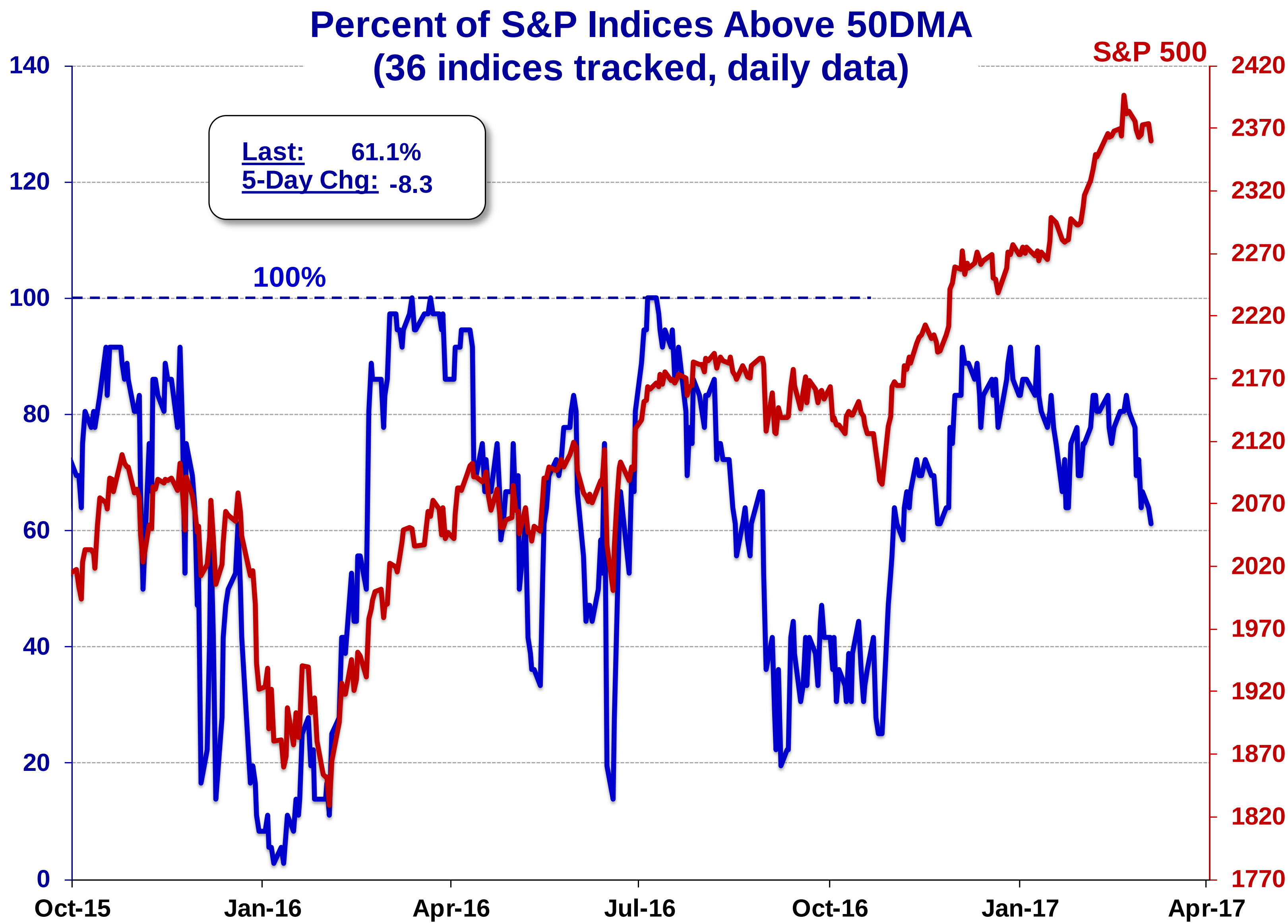
Price/Sales ratio heading up toward record highs



S&P Price-to-EBITDA Ratio just a hair below record highs



S&P just shy of record high while percent of indices above 50DMA have given up post-election gains; support pillars weakening.



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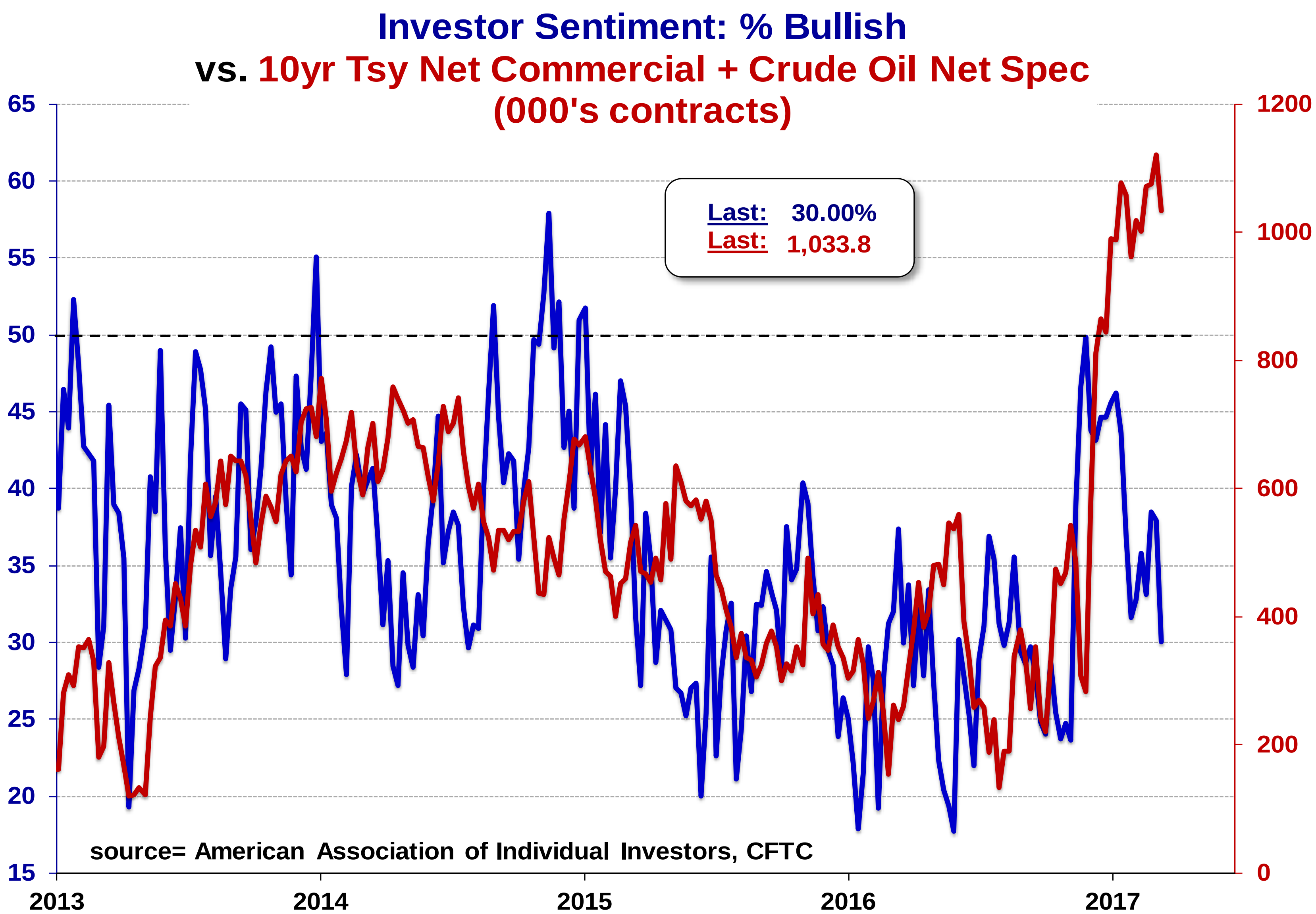
Commercials (10yr Treasury) and Specs (Oil) face off at opposite sides of the bullish market narrative. Investor Sentiment (and oil's recent turmoil) signaling the Commercials may have the winning argument.



Stock/Bond Ratio at record high…