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Special Foodservice Economic Viewpoint

“The fact that wealthier households are on more solid footing is good news for foodservice since the top 20 percent of households account for over 40 percent of foodservice spending.”

Signs of Improvement?

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After three years of unprecedented uncertainty, the overall economic outlook has improved significantly across a number of key sectors. Services, manufacturing, and export output have all risen sharply leading to three consecutive quarters of GDP growth and upgraded GDP growth forecasts—from 2.6 percent to 3.2 percent—for 2010.

Although the economy is at its healthiest point in several years, success will be slow, uneven, and dependent on the hope that continued government stimulus and corporate sector inventory stocking today will promote enough job growth to revive consumer spending in the years ahead. In this update, we assess this possibility, particularly in light of recent economic setbacks in the gulf and the Eurozone economies.

I. CONSUMER UPDATE

Employment and consumer sentiment in recent months has risen from 2007–2009 lows. This is the direct result of government interventions in the financial sector that have calmed credit markets and enabled asset price growth. However, the improvement has been uneven, with wealthier households returning to pre-recession levels of prosperity while the remaining 60 percent of the population continues to struggle. The fact that wealthier households are on more solid footing is good news for foodservice since the top 20 percent of households account for over 40 percent of foodservice spending.

Employment Market. Past recovery cycles suggest that significant productivity increases like those observed at the beginning of 2010 are followed by robust job growth. Unfortunately, many managers continue to maintain a conservative hiring posture as they wait to see whether spending on inventory replenishment in the corporate sector translates into sustained consumer spending in 2011. This dynamic translates into a labor market where employed workers experience higher job stability at the expense of longer hours worked for similar pay. It also suggests continuing difficulties for the nearly 17 percent of the workforce who define themselves as either “unemployed” or “underemployed.” The depressed labor market is a major headwind for foodservice.

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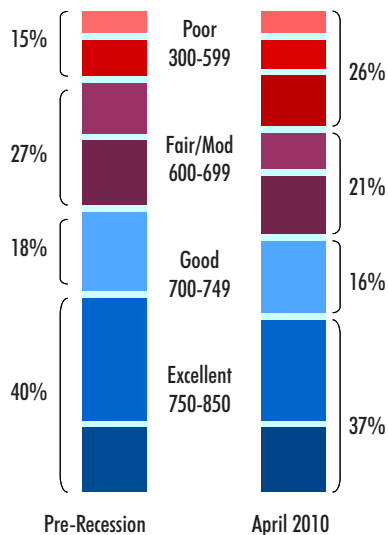
Perceptions of Wealth and Spending Habits. More assured of their long-term solvency, relatively affluent and older professionals who account for a large proportion of foodservice spending appear to be saving less and reverting to pre-recession spending norms. In contrast, middle class and poorer Americans continue to struggle. They are more exposed to employment shocks, benefit less from recent stock market gains, and importantly, are very likely to be among the two-thirds of Americans who count their home as their primary asset.

Nearly 25 percent of American households are worth less than the mortgage value. As massive government interventions in the housing market expire, we anticipate a further 5 to 10 percent drop in home prices. The home equity cash outs that drove the majority of American consumer spending from 2001 to 2007 have hit a record low of \$8.8 billion dollars in the first quarter of 2010, a mere one tenth of peak levels during the boom. If countries with similar housing busts are any indication, declining home values will significantly dampen consumer spending and job mobility for the next decade without a major innovation in economic growth. Foodservice will certainly continue to feel the effects of the weak housing market.

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Consumer Debt and Spending Habits. A recent study by FICO, Inc. finds that American consumers with credit scores below the acceptable “600” threshold have ballooned from 15 to 25.5 percent from 2007 to 2010. Further, the relative robustness of those with higher credit scores illustrates the economic strength of the wealthy relative to the middle class as we exit the recession. Middle class consumers are in the midst of a massive deleveraging process since the collapse of the housing market. Fortunately, the average financial obligations have reverted from 19 percent of disposable income in 2007 to 17.5 percent at the end of 2009. Barring no major changes in government policy or economic conditions, debt-to-income ratios should trend toward “pre-bubble” norms by mid- to late-2011.

Consumer Creditworthiness (FICO Score)



Source: Myfico.com

As income converts from debt to disposable income, households will either resume consumption or build precautionary savings to account for other sources of income (i.e., credit). Surveys conducted during the peak of the recession suggest a chastened, increasingly price conscious consumer. Many of these patterns persist today, as consumers engage in couponing, shopping around, and switching to private label brands (Booz Allen).



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June 2010 Federal Reserve data suggests, however, that many consumers are already re-engaging in one-off purchases of services and non-durable goods relative to recession-era lows. This includes spending on food away from home, alcoholic beverages, and other relatively small indulgences. Consumption of durables is also on the rise, though will likely be postponed through the end of deleveraging into late 2011. These are all positive signs of stability relative to the significant uncertainties of past recessions.

II. RISKS TO RECOVERY

Government backing of the financial system improved stock market wealth and increased job security. However, as government stimulus programs expire in 2011, private sector demand will have to pick up in the form of corporate sector spending, domestic consumer spending, and export markets.

Weak domestic demand leaves American economic prospects more dependent on export markets than ever before. U.S. producers have benefitted in recent months from robust corporate demand, particularly in Europe and Asia. A stunning lapse of corporate governance in Southern Europe has produced banking and sovereign debt crises that threaten this progress. The magnitude of the \$1 trillion Southern European bailout relative to the size of Eurozone economies is a shock to credibility that will adversely affect Europeans' ability to borrow and service debt at low interest rates.

In the short term, investors will flee from the euro to the relative safety of the U.S. dollar and keep American interest rates low. The cost of low domestic interest rates is significantly reduced demand from European trading partners that account for one fourth of the U.S. exports. The European crisis effectively shifts the burden of the global recovery squarely on the backs of the U.S. government and American consumers at a time when they are both extremely vulnerable.

Measures of bank stress and volatility are already reflecting this risk, pushing the S&P 500 down as much as 10 percent off its April highs. If investors are less bullish on the outlook for corporate profits, the immediate implication is that upper income consumers may feel less comfortable with their 401ks than they were a few short months ago. Consumer demand may not be able to pick up the slack for reduced government spending by the middle of next year; we can expect slower growth (though likely not a double-dip recession) in 2011.

Looking to the long term, we should note that the current flight to the "safety" of the U.S. dollar is largely a leap of faith for many global investors. The U.S. economy is merely the best investment at a time when the supply of alternative investments (i.e., gold) cannot absorb global demand. To maintain this investment, the U.S. must immediately develop a strategy that blends fiscal austerity in areas with low economic return (e.g., military conflict, ineffective subsidies) with significant public and private investment in areas with comparatively high economic return (perhaps education, entrepreneurship, and a globally-oriented competitiveness infrastructure). Though it requires a monumental amount of coordination, political will, and sacrifice, it is the viable path to long-term growth. In the meantime, foodservice performance will be largely a reflection of a very slowly and unevenly recovering economy.