Is the Canadian Consumer Running Out of Steam?

Description

In the second quarter, Canadian debt levels increased 6.1% from the year-ago quarter. This is good news for the economy in the short term — it drives economic growth — but given that Canadians are already heavily indebted, it poses some longer-term problems.

Also, after a robust month of May for retail sales, the June numbers from Statistics Canada show a slowing in retail spending. Core retail sales, which exclude autos, decreased 0.8% versus the expected 0.1% decline. Total retail sales declined 0.6%.

Is this just the beginning of weak consumer spending, or is it just a blip?

Breaking down the numbers
The uptick in debt was largely driven by an 8.6% increase in auto loan balances and a 7.4% increase in outstanding mortgage credit. This comes as no surprise. We have seen that the housing market has had resilience, as buyers rushed to take advantage of low rates while they were still being offered. Since then, **Bank of Montreal**, **TD**, and **Royal Bank** have all increased the rates on their five-year mortgages to 3.89%.

And we've also seen **Magna's** results this year come in better than expected. Second-quarter profit increased 19%, as European and North American sales were stronger than expected. But this has come at a cost, as household debt continues to rise, and debt-to-income currently stands at 160%, according TD.

Let's look deeper at the retail sales number. While total retail sales declined 0.6%, core retail sales fell by a seasonally adjusted 0.8% in June, versus expectations of a 0.1% increase. Food and beverage stores sales were down 1.2%, building and material outlets sales were down 1.9%, and clothing stores sales were down 1.8%.

Stats Canada cited the flood in southern Alberta and the construction strike in Quebec for the weakness, but this does not appear to be the full story: Ontario sales declined 1.4% without any one-time negative events.

Year over year, retail sales increased 1.8%, which is a good showing, but the question I'm asking myself is whether this sequential decline in retail sales is the start of continued weakness in consumer spending.

Record debt levels
Let's get back to those record debt levels. If Canadians are overextended, it poses a big risk to our financial health in the event that rates go up or the economy stumbles. We may be hoping that things can continue as they are, but we are leaving ourselves in a vulnerable position. The cost of debt is rising and that is concerning. It is no wonder that consumers seem to be pulling in the reins.

Retailers that are struggling
Against this backdrop, many retailers are struggling to find sales growth and profitability. And it seems like consumers may be redirecting their spending on what would be more "essential" expenditures. Let's look at a few of the retailers being caught in the current:

- **Sears Canada** (TSX: SCC) continues to struggle, and announced that it is cutting 245 jobs in order to streamline and cut costs. Same-store sales at Sears decreased 2.5% in the latest quarter.
- **Rona** (TSX: RON) also continues to struggle, with declining same-store sales and continued losses in market share. As we have seen in the retail sales numbers, shoppers are not spending as much at home improvement retailers such as Rona.
- At **Reitmans** (TSX: RET), same-store sales declined 3.5% in the latest quarter. Reitmans is a very well-run company that is facing headwinds from the macro environment. The stock currently has an 8% dividend yield.

Which retailers are doing better than the rest?
Not all retailers are struggling in this environment. Here are three that are bucking the trend:

- **Costco's** (NASDAQ: COST) same-store sales growth for the five weeks ended July 7, 2013 increased 6% in the U.S. and 8% in the International division (of which Canada is almost half). It will be interesting to see if Costco can maintain this momentum.
- **Canadian Tire** (TSX: CTC) has also seen increases in sales. In the latest quarter, sales increased 2.1%, while same-store sales increased across all banners. Canadian Tire's same-store sales increased 2%; same-store sales at its subsidiaries FGL Sports and Mark's Work Warehouse increased 7.2% and 6.4%, respectively.
- While **Dollarama** (TSX: DOL) is still seeing same-store sales increases, results have been below expectations. In the latest quarter, traffic declined 0.9% and same-store sales rose 3.7%.

Final thoughts
Given record debt levels and rising interest rates, it comes as no surprise that retail sales are showing weakness. The risk that the consumer is running out of steam is very real — and it's a good idea to base your investment decisions with that risk in mind.

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Karen Thomas does not own shares of any companies mentioned. The Motley Fool owns shares of Costco Wholesale.

CATEGORY

1. Investing

TICKERS GLOBAL

1. NASDAQ:COST (Costco Wholesale Corporation)
2. TSX:CTC.A (Canadian Tire Corporation, Limited)
3. TSX:DOL (Dollarama Inc.)

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