

## Trading Down: Cheap Is the New Chic

July 6, 2009

“Home sizes have been trending down recently. The era of the McMansion could well be over.”

– Kermit Baker, Chief Economist, American Institute of Architects

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Upscale retailer Crabtree & Evelyn Ltd. filed for Chapter 11 protection last Wednesday. The preceding week, health and hygiene products maker Kimberly-Clark said it would trim 1,600 jobs in order to cut costs. While both companies blamed the recession for declining sales, the broader story is that sweeping changes in consumer behavior are underway and are likely to continue.

Unlike cars, boats and other big-ticket items, demand for personal products tends to be recession resistant. In the case of Crabtree & Evelyn, people generally do not stop using soaps and lotions whenever the economy turns bad. Likewise, the Kimberly-Clark lineup consists mainly of bathroom tissue, paper towels, diapers and other products whose sales are not dependent upon economic prosperity. Instead, revenues for both companies are falling largely because customers are trading down to less-expensive brands.

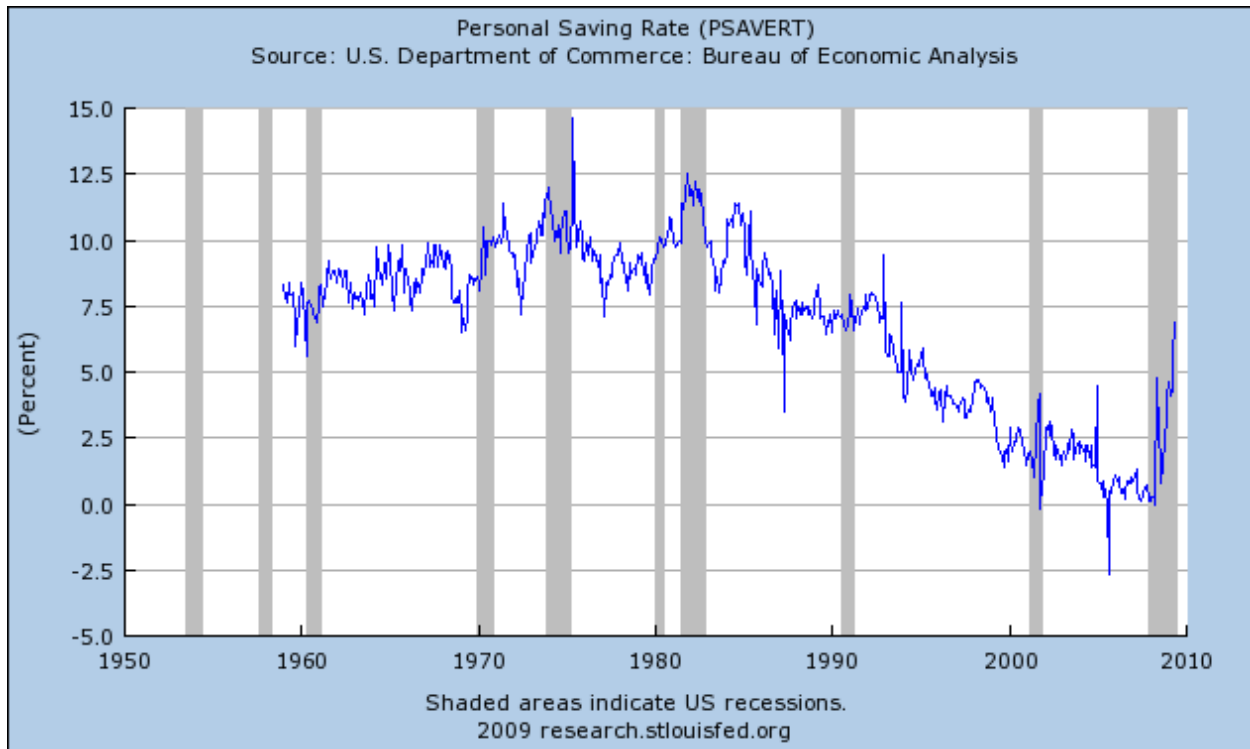
Trading down also is occurring at the store level as shopping habits trend toward less-upscale outlets. Obvious beneficiaries include retailers such as Wal-Mart, Family Dollar Stores, Dollar Tree, Dollar General and Aldi. These chains are particularly well situated because they typically offer brand-name products at discount prices, as well as discount brands and quality store brands. That wide array of options provides customers with the most ways to trade down in price with little noticeable decrease in quality.

Perhaps nowhere is the trading-down phenomenon more apparent than in housing. According to U.S. Census data, the median new-home size fell to 2,200 square feet in 2008 and has fallen further in 2009. Last year's drop was the first such annual decline in 13 years. It reverses a 60-year trend toward larger homes that began when the median size of a new home was less than 1,000 square feet. The shift reflects the economic reality that smaller homes are cheaper to build, heat and furnish. Previously popular but costly amenities such as cathedral ceilings and granite countertops are being eliminated. Additionally, tightened lending standards have encouraged the move toward smaller, cheaper homes in the post-housing-bubble economy.

This propensity on the part of Americans to trade down even within such product categories as personal care and housing is unusual. While past recessions have seen temporary, less-profound changes in purchasing behavior, these new trends imply a permanent drop in expectations for the future. In addition to millions of jobs, this recession has destroyed trillions of dollars in stock-market and housing wealth. Households are feeling the pinch and have begun cutting back for the long term. The upshot is that U.S. living standards appear to be in secular decline.

## Savings Rate Jumps, but Debt Remains

Increased saving is the other side of the trading-down coin. As households spend less, they are saving more and paying down debt. The chart below, courtesy of the St. Louis Fed, shows the personal-saving rate climbing from near zero at the beginning of this recession to 6.9% in May. The May reading was the highest since 1993.



Despite the spike in saving, household debt remains high by historical standards. Measured by the ratio of debt to personal disposable income, household leverage fell to around 124% in the second quarter. This is down only moderately from an all-time high of 133% when the recession began, and virtually unchanged from 126% during the third quarter of 2005 when the saving rate was negative. Moreover, household leverage remains approximately double the levels of 55% to 65% that prevailed during the 25-year period starting in 1960. Clearly, high debt burdens will continue to weigh on the consumer and make trading down an important investment theme for the foreseeable future.

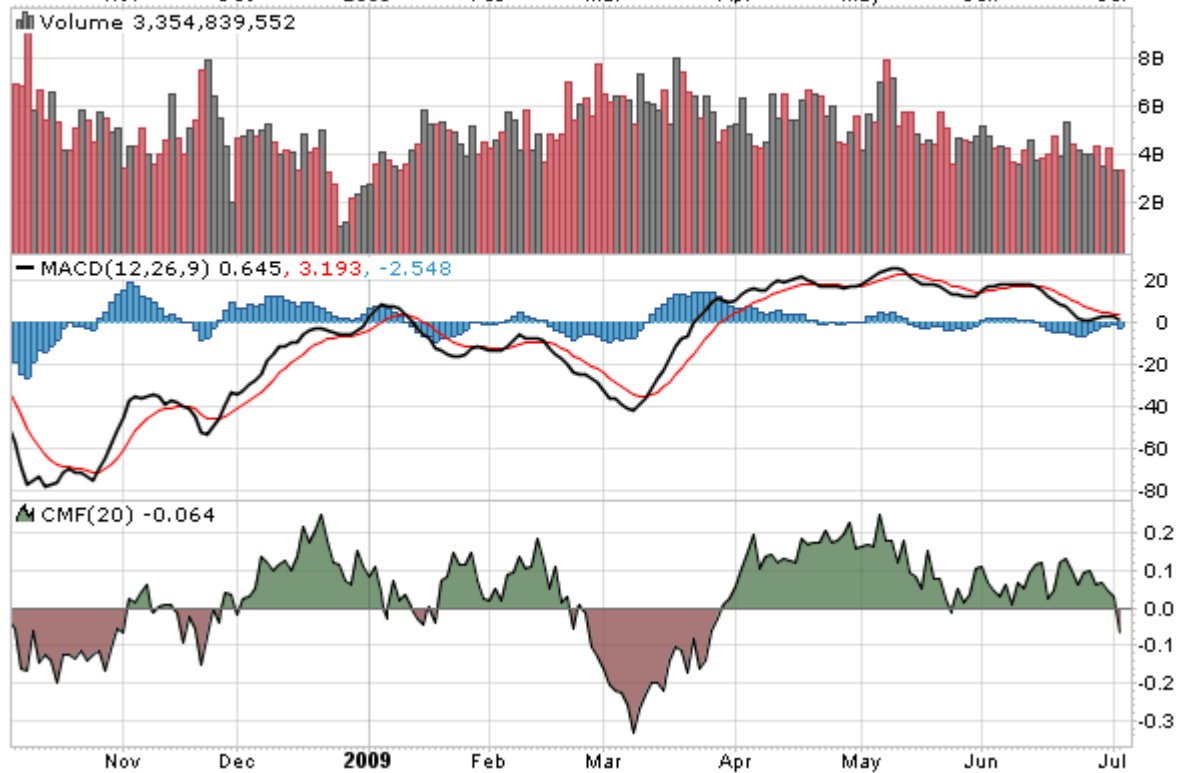
## The Picture

In recent commentaries, we have been looking at the S&P 500 Index and examining the significance of the exhaustion move into its May 8th momentum high of 930. That exhaustion now appears to have marked the end of the “easy money” phase of the rally from the March lows. As shown in the chart below, the index has dropped below its 20-day simple moving average, which now is providing resistance. A seven-day rally failed at the moving average last Wednesday, as did a two-day run that failed on June 19th. Both of these were struggling-type moves with countertrend characteristics. While we continue to give the four-month-long rally the benefit of the doubt, the evidence now indicates a pause may be in order.

**\$SPX** (S&P 500 Large Cap Index) INDX

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2-Jul-2009 **Open** 921.24 **High** 921.24 **Low** 896.42 **Close** 896.42 **Volume** 3.4B **Chg** -26.91 (-2.91%) ▼



Momentum has weakened considerably, with RSI breaking below the 50 level and MACD registering negative bars on its histogram. Although MACD itself remains barely positive at .645, a break below zero would produce the first negative readings in that indicator since March. Chaiken Money Flow, shown in the bottom panel of the chart, has traced out a decline indicative of unhealthy price-volume behavior since its May 8th peak.

Despite the near-term negatives, any further weakness in the index should meet support in the 875 to 880 area. Additional support should materialize around 850. There is resistance at the 20-day simple moving average, as well as in the areas of 925 to 930 and 944 to 950. Major resistance is at 1,008. From current levels, the index could undergo further distribution in the weeks and months ahead. Another probability is a correction or consolidation to clear the way for another leg up.

For those that follow classical chart formations, there is a potential small head-and-shoulders top formation developing in the major market indexes. If the S&P 500 Index breaks through 875 on relatively high volume, we could see a further quick decline.

With debt-strapped households pulling back and the government becoming more and more involved in the economy, the secular bear market that began in 2000 could prove to be a long, drawn-out affair. Meanwhile, the cyclical bull move that has provided a welcome respite since March appears to be weakening at least for now. To the extent that unrealistic expectations already have been priced in, any additional legs up should be viewed with skepticism and caution rather than complacency and acceptance.

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