RETAIL BULLS GET SLAUGHTERED

The bulls in the retail sector over the past year got another disappointment with weak sales during the holiday season. As we recently pointed out to our Dohmen Capital clients, Wall Street analysts were bullish on retail late last year, predicting that Christmas sales would be strong. The election results produced further optimism, saying that the prospects of the new President will encourage consumers to spend more.

If the world were only that simple! To spend more, people need more income, which has been declining for several decades. They need jobs, which right now is not happening except in the phony statistics out of Washington. And then they need motivation to buy. Prices of clothing are still declining, the closets of consumers are full, and the prospects of even lower prices don't put any urgency into buying more.

Kohl's cut its full year forecast for 2017 to $3.60-$3.65 per share, down from $3.80-$4.00 less than two months ago. Furthermore, comparable store sales are down by 2.1% year-over-year between November and December. Kohl's stock plunged over 19% after the close of trading on January 5th.

Macy's report after the close of trading January 4th was even worse. It reported a drop in same store sales, cut forecasts, and said it would close 100 stores and lay off over 10,000 workers. About 3,900 of these layoffs were announced this summer. Obviously, management isn't counting on a rebound.

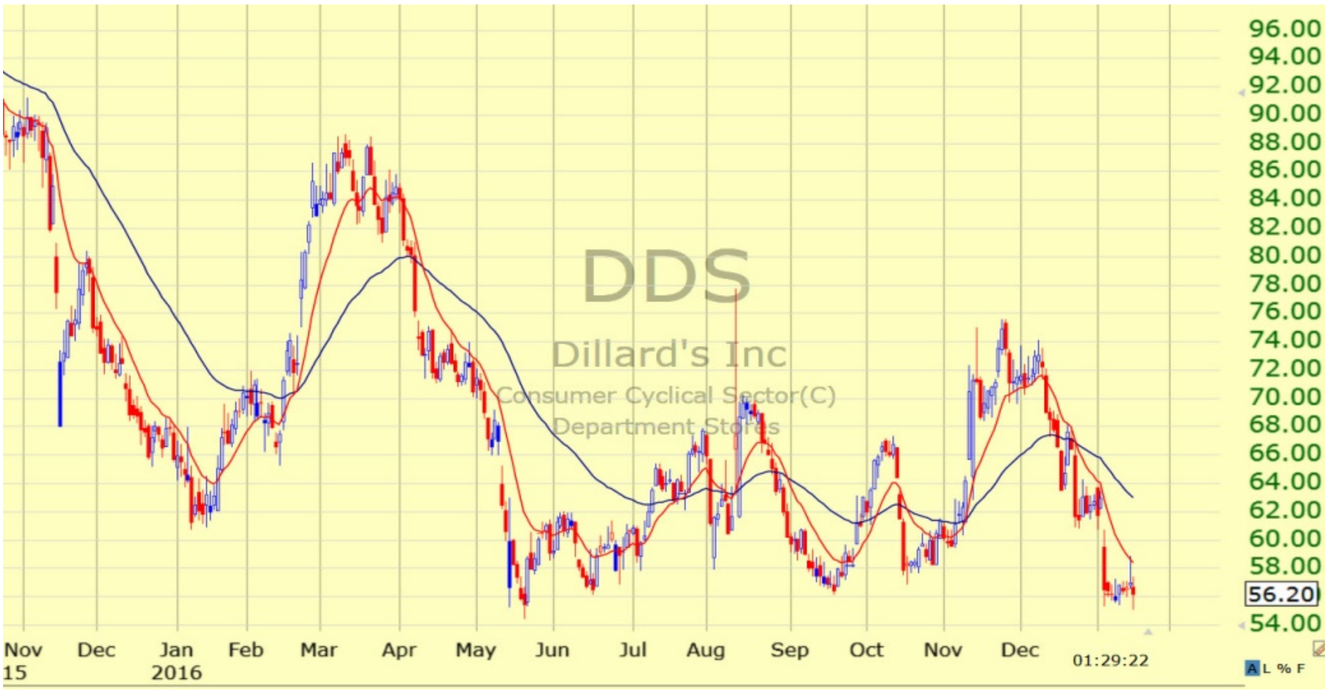
Full year guidance for earnings per share was cut to $2.95-$3.10 from $3.15-$3.40. Sales for 2017 are expected to be cut by approximately $575 million.

The stock of Macy's (M) is down 37% the past two months. That's a crash! It will be closing many stores in a hurry when the current CEO Lundgren leaves this year. He said he is not willing to sell Bloomingdale's. We have considered that part of Macy's a dinosaur, a left-over from the age of opulence, when everyone bought apparel and paid excessive prices just to display the logo. Those days are gone.

If you walk into a Bloomingdale's now, you can shoot off a canon and not hit anyone. How many people will really pay $550 for a pair of jeans with holes? Or $150 for khaki shorts? Bloomingdale's is only 10% of sales of Macy's. It has 38 stores. And we would bet that each one loses a boat load of money. We believe that a new CEO will have that at the top of the list of assets to shed or close.

There are so many less expensive alternatives everywhere. Why pay $30 for a T-shirt when you get can it for $9 at the well-known discounters.

Dillard's department stores, Abercrombie & Fitch, and many others are in big bear markets. Look at these charts.



The Limited Stores chain filed for Chapter 11 bankruptcy on January 17, 2017 after it recently announced that it would close all of its 250 stores immediately. At one time, these stores were considered very well-managed.

A Private Equity (PE) firm, Sun Capital, bought a majority interest in the boom of 2007. PE firms often then load up the firm the bought with high debt, pay themselves big fees, with the idea of unloading the debt ridden carcass some time later in an IPO, with the help of Wall Street firms, who have big lists of suckers who will go for their story.

But the crash and recession of 2008-2009 interfered with that. So, Sun Capital bought the rest of the

Limited in 2010. Many PE firms are not good at managing operations. They are financial engineers. So, things got worse.

Two weeks ago, Sun Capital said that Limited Stores is looking into alternatives for its remaining e-commerce business and intellectual property.

American Apparel is laying off 2,400 workers in California. It had filed for Chapter 11 bankruptcy last November. It first went into bankruptcy in October 2015. That's the end of American Apparel manufacturing in the US. It couldn't sell its 110 retail stores.

Now we will see other retailers caught in the wake of declining sales. We wrote in late 2015 that shopping centers would go the "way of the Dodo bird." That means extinction. Just look at some of the major shopping centers and all the vacant stores. The centers often try to disguise this by calling it 'remodeling' and use the emptiness to actually remodel and do some construction. What else can they do with empty stores?

The large shopping mall companies are now financially supporting some of their big chain store tenants. Aéropostale is one that might no longer exist if it weren't for such help.

The company sold its assets in September to a group led by Simon Property Group and General Growth Properties. The mall operators paid $243 million for the assets in order to keep it alive, according to Bloomberg.com. (9/12/2016)

They plan to keep at least 229 stores open. But that doesn't increase sales, which are required to keep the chain going. This sounds much like "vendor financing," where the manufacturers keep their customers alive in order not to have cancelled sales.

We ask, will shoppers ever come back after the remodeling is done? We doubt it, unless they have attractions. Some enlightened shopping center developers like Rick Caruso in Los Angeles started that at least 15 years ago. He always said, shopping centers must entertain. Perhaps some of the big shopping center owners will catch on before they go out of business as well.

The big retail boom from the 1990's to perhaps 18 months ago was caused by one thing: prices came down significantly because import quotas into the US on apparel came down continuously. A person may have bought ten T-shirts in a year instead of just two.

Now that trade barriers are being discussed as a negotiating tool by the incoming administration, there is a possibility that import prices will rise in a meaningful fashion. If these are passed along to the consumer, it leads to higher prices, and thus lower demand. If the importers or wholesalers absorb the increase, it leads to lower profits.

And that is why watching the policies unfold is so important now.

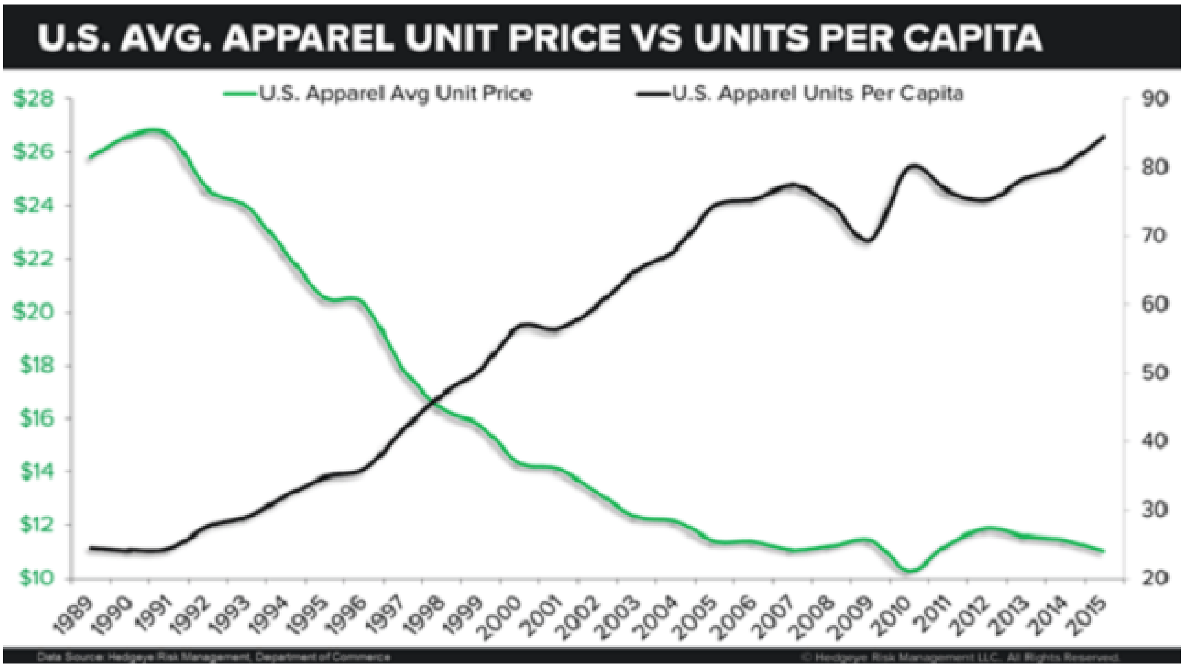
Here is a great article from Hedgeye with a chart that shows clearly how sales soared when prices came down.

> "Starting in the late 1990s, we started to see apparel import quotas phased out. It took the

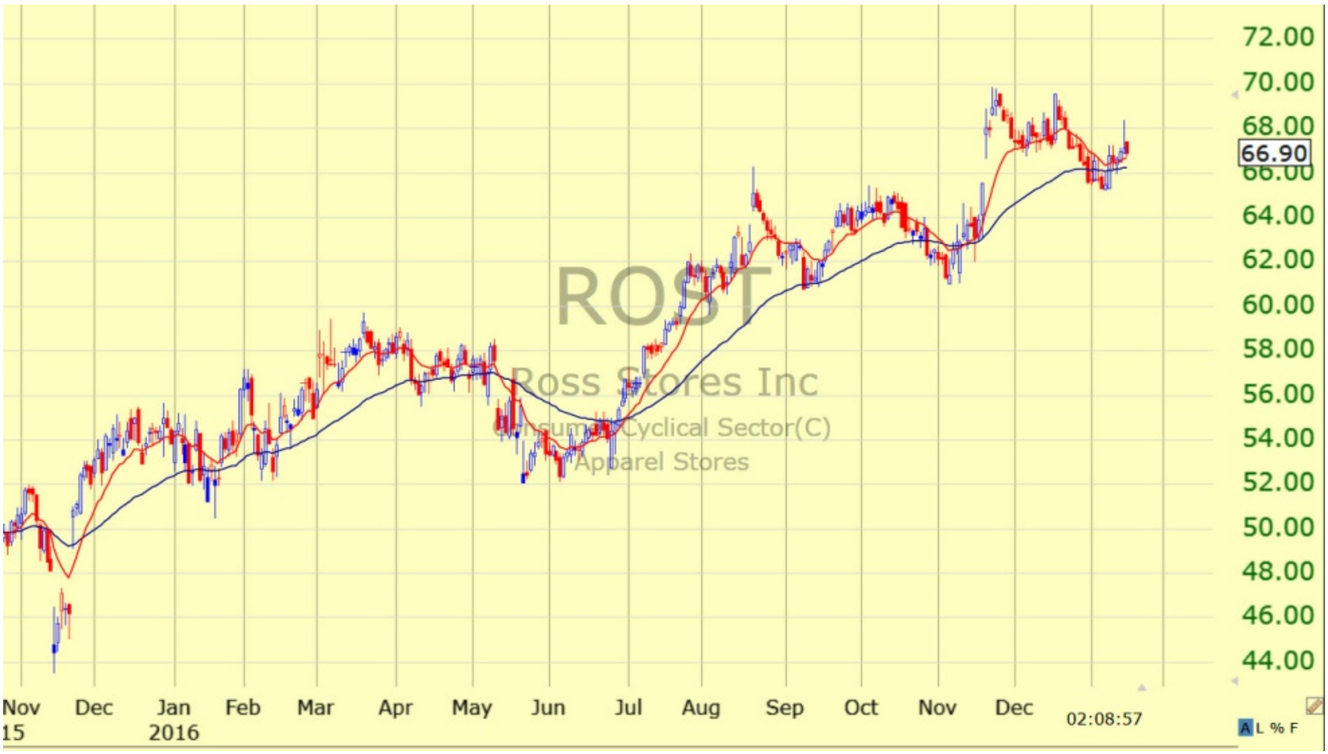
better part of 7 years – though the factories started jockeying in price wars to secure a customer base in a post-quota environment. **That, my macro-loving friends, was the beginning of a tsunami of apparel deflation that lasts through today. Consider the numbers…**

1. From the 1990s, we saw the cost of apparel come down by 5-10% per year – every year for two decades.
2. Yet the CPI for apparel only came down by only 2-4% annually. So that means that the brands, retailers and virtually everyone in the supply chain had a multi-billion dollar kitty to boost margins every year (by about 700-1,000 bps in total).
3. That allowed the industry at large to both boost margins AND pass lower costs through to consumers in order to boost per capita unit consumption.
4. That is anomalous in every way. Most of the time, when this happens we see either consumption OR margins take off. Not both. But in this instance, we saw both.
5. The punchline is that this trend boosted per capita unit consumption to 84 units!
6. I'll say that again, the average number of unit purchases by US consumers on **a per capita basis more than doubled over 25 years.**
7. This is a paradigm change. People bought lower quality stuff at far lower prices, and simply cycled those every 3-4 years instead of every seven years (remember the 7-year fashion cycle? That was effect, not cause).

This ultimately took the barriers to entry down to the point where lousy brands (by our standards) could fill the shelves at the Kohl's and JC Pennys of the world, and actually allow the bottom-of-the-barrel retailers to earn money, while also allowing short-sighted investors to say 'but they're so cheap on cash flow'."



One sector in brick & mortar retail that is doing OK is the discount retailers of mostly surplus merchandise, Ross Stores (ROST) and TJ Max (TJX).



Yes, people love bargains. But even that sector will not be problem free.

CONCLUSION: In addition to the above negative trends, there is the fear that threats of big tariffs by the new Administration in Washington will produce soaring import prices and thus produce another plunge in consumption.

However, we believe that trade tariff talk, or duties, by the new administration are a negotiating tool.

The new people coming in are smart and don't want to produce big sales and profit declines, nor do anything that would jeopardize stronger economic growth. But a smart negotiator never starts in the middle. They ask for everything and then settle for the middle. It's the opposite of the past administration.

However, the Chinese are smart negotiators as well. Sometimes a game of chicken becomes deadly. Let's hope that they can compromise. More trade supports more trade, while a cut in trade unleashes a contraction.

And so it goes for apparel and retail. The remaining companies also face big headwinds if they are too slow to adapt. The bright spot for retail is online sales. Amazon has shown the way. It's amazing how slow brick & mortar retailers have been to recognize the huge trend change of American shoppers.

There are huge changes coming in the economy, all caused by technology. The motto is, as it was for the dinosaurs, "Adapt or Die."

Wishing you successful investing,

Bert Dohmen,

Founder Dohmen Capital Research, Inc.
Celebrating its 40th year of excellence in un-biased Research