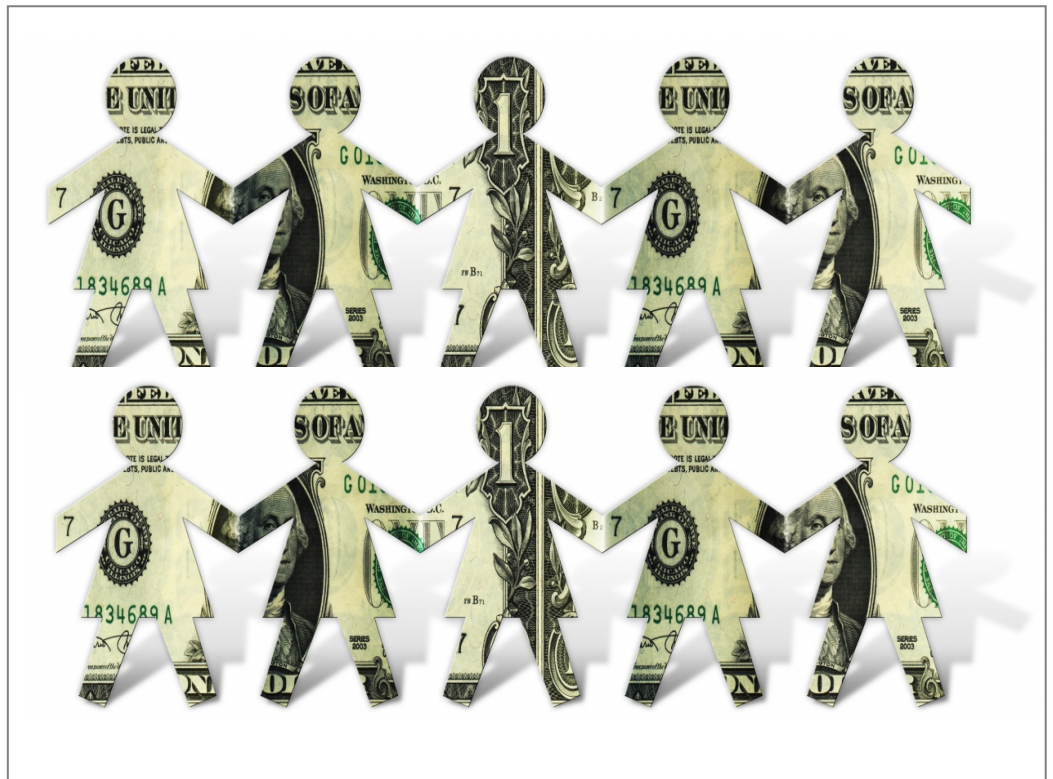


# TIMES & TRENDS

A SNAPSHOT OF TRENDS SHAPING THE CPG INDUSTRY

## MACROECONOMIC TRENDS

### UNDERSTANDING AND PREDICTING CONSUMER SPENDING PATTERNS



December 2005

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## EXECUTIVE SUMMARY

- ▶ Consumer spending on CPG/healthcare products tracks closely with macroeconomic trends
- ▶ Non-food products are more sensitive to economic changes than food, but food product sales require more time to rebound
- ▶ Reduced spending on food away-from-home during soft economic periods buffers at-home food sales declines and opens new growth opportunities for food manufacturers and retailers
- ▶ Private label benefits from economic downturns, while brand manufacturers have a window of opportunity to capture share immediately following economic peaks
- ▶ The CPG industry has sustained the growth accrued when gas prices exceeded \$2.00 per gallon, but at a slower pace
- ▶ GDP forecasters predict solid economic growth into 2006, but a negative trend in real average hourly earnings may signal a downturn

## INTRODUCTION

### **U.S. economic health is a critical consideration in understanding and predicting CPG/healthcare consumer spending.**

In the quest to understand and predict consumer spending patterns, many CPG marketers may be missing a powerful influencing factor – the economy.

Consumer purchase decisions are clearly impacted by a broad range of factors – many within marketers' control, but the economy provides an underlying current that wields strong directional influence.

The ability to account for the influence of macroeconomic trends will enable manufacturers and retailers to more accurately assess the success of a specific marketing or promotional initiative, identify the optimal timing of a new product introduction or advertising campaign and enhance the accuracy of sales forecasts. The effects are far-reaching.

As some consumers are more heavily influenced by economic conditions than others (largely driven by income), and some products are more discretionary in nature than others, the degree of economic influence will vary by category, brand and store. Identifying the specific relationship between macroeconomic conditions and sales trends within your products/stores is well worth the effort.

This report is intended to help CPG/healthcare manufacturers and retailers do the following:

- ▶ See the high-level relationship between macroeconomic trends and consumer spending, as well as critical forecasting and early warning economic indicators
- ▶ Act on these insights by incorporating macroeconomic trends into sales performance analysis, sales forecasts and marketing and strategic plans
- ▶ *Win* at the shelf by timing marketing and merchandising initiatives to secure position in advance of economic changes

## IMPACT OF MACROECONOMIC TRENDS TOTAL CPG/HEALTHCARE

**Consumer spending on total CPG/healthcare tracks closely with macroeconomic trends.**

U.S. economic health has a powerful influence on consumer spending across CPG and healthcare products.

As evident in the chart below, CPG/healthcare spending tracks closely with the Gross Domestic Product (GDP) – the total value of goods and services produced within the U.S. and a widely-accepted indicator of economic growth.

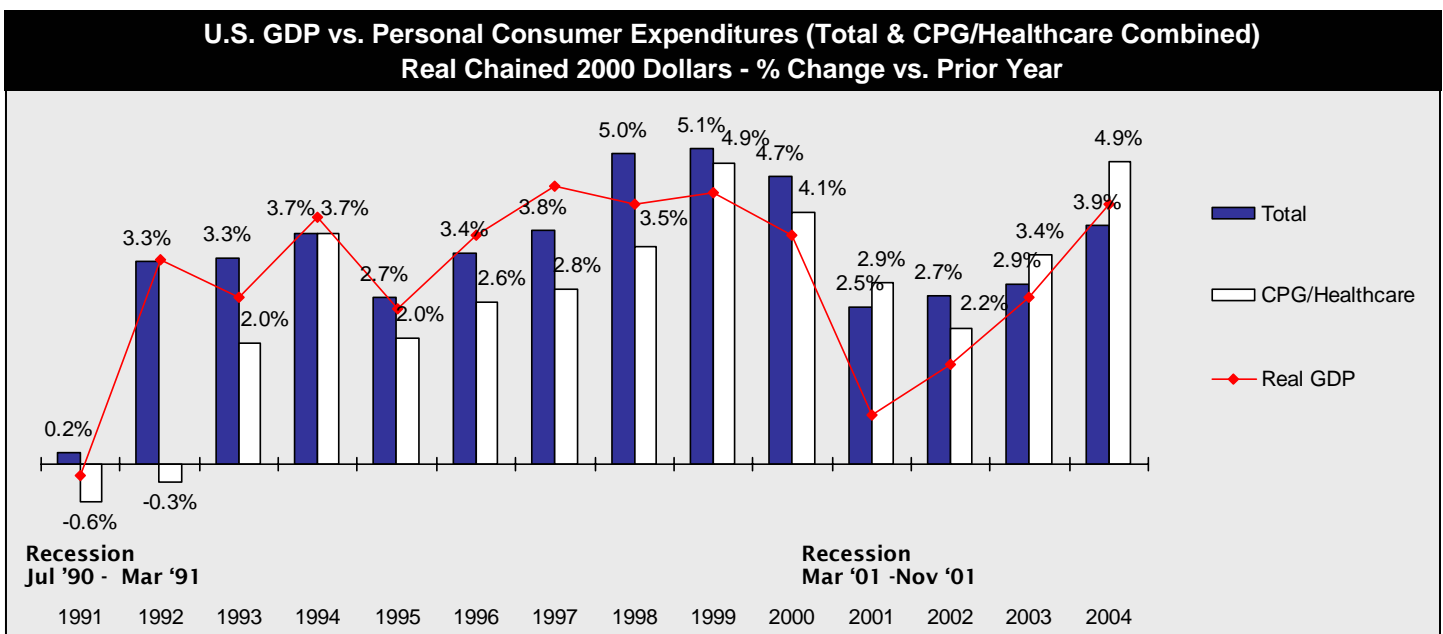
The CPG/healthcare industry’s actual growth rates do deviate from the total economy growth rates--reflecting the impact of industry-specific events and trends; however, the directional trends are closely aligned.

Sensitivity to macroeconomic conditions is most pronounced during major economic events, such as the two recessions that have occurred over the

past fifteen years (July 1990 – March 1991 and March 2001 – November 2001.)

During the 1990/1991 recession, CPG/healthcare spending was hit harder than total consumer expenditures and took longer to rebound. While growth slowed significantly during the more mild 2001 recession, the industry fared better and recovered more quickly.

Both events illustrate the fact that spending on CPG/healthcare is not insulated from economic downturns and recessions and highlight the critical importance of incorporating total economy trends and forecasts into planning and forecasting for categories, brands and stores.



Sources: U.S. Department of Commerce, Bureau of Economic Analysis (2004 most recent data available for personal consumption expenditures)

## IMPACT OF MACROECONOMIC TRENDS FOOD VS. NON-FOOD

**Consumer spending is more sensitive to economic changes for non-food vs. food purchases.**

Consumer spending on food clearly responds to big swings in the GDP but is less reactive to minor swings. Spending on non-food CPG products (excluding healthcare), however, has been more sensitive to relatively minor GDP adjustments over the past ten years.

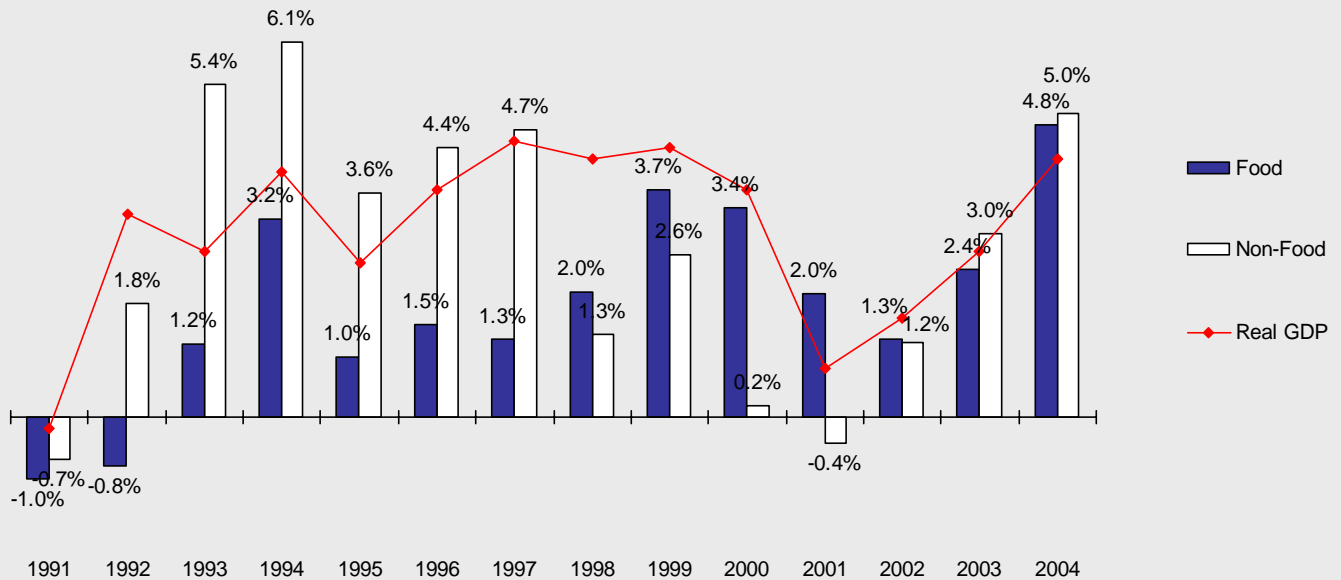
During the 2000-2001 recession, the slowdown in non-food spending was more dramatic than food and began sooner. Across non-food categories as a whole, impact was felt a full year before the recession even hit.

Manufacturers and retailers need to identify the relationship between general economic trends and spending within their categories, brands and stores -- including the timing of impact.

There will be variance from the total industry trends depending upon income mix of the consumer base, promotional sensitivity, price elasticity and brand equity.

Once the relationship is known, timing of product development, marketing and merchandising initiatives can be planned more effectively, and sales forecast accuracy will be enhanced.

**U.S. Personal Consumer Expenditures, Food vs. Non-Food (Excluding Healthcare) and GDP  
Real Chained 2000 Dollars - % Change vs. Prior Year**



Sources: U.S. Department of Commerce, Bureau of Economic Analysis (2004 most recent data available on personal consumption expenditures)

Note – Food spending trends from the Dept. of Commerce differ from the USDA-based food-at-home trends on page 7 due to definitional differences.

## IMPACT OF MACROECONOMIC TRENDS HEALTHCARE

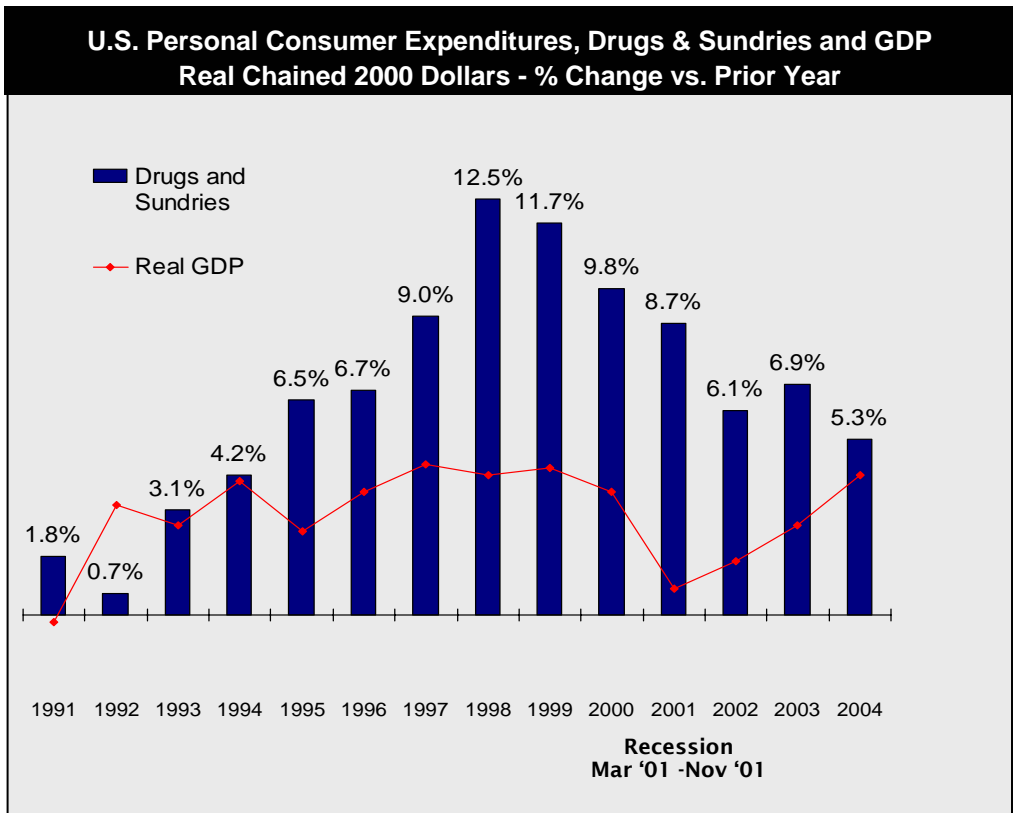
**Healthcare spending is impacted during major economic downturns but to a much smaller degree than total CPG spending.**

Spending on healthcare products is less tied to general economic trends than spending on total CPG products. As the majority of healthcare purchases are “must haves” vs. “wants”, it is not surprising that consumers are less likely to decrease purchases during tough economic times.

As with food categories, growth rate deceleration was more aggressive one year after each of

the past two recessions-- highlighting a lingering effect.

For prescriptions and over-the-counter drugs and other healthcare remedies, while economic growth is an important consideration in strategic and marketing plans, major industry events, such as OTC switches, regulation and the implementation of Medicare Plan D will likely have more influence.



Sources: U.S. Department of Commerce, Bureau of Economic Analysis (2004 most recent data available on personal consumption expenditures)

## IMPACT OF MACROECONOMIC TRENDS FOOD AT-HOME VS. FOOD AWAY-FROM-HOME

**Soft spending on away-from-home-food benefits at-home food expenditures.**

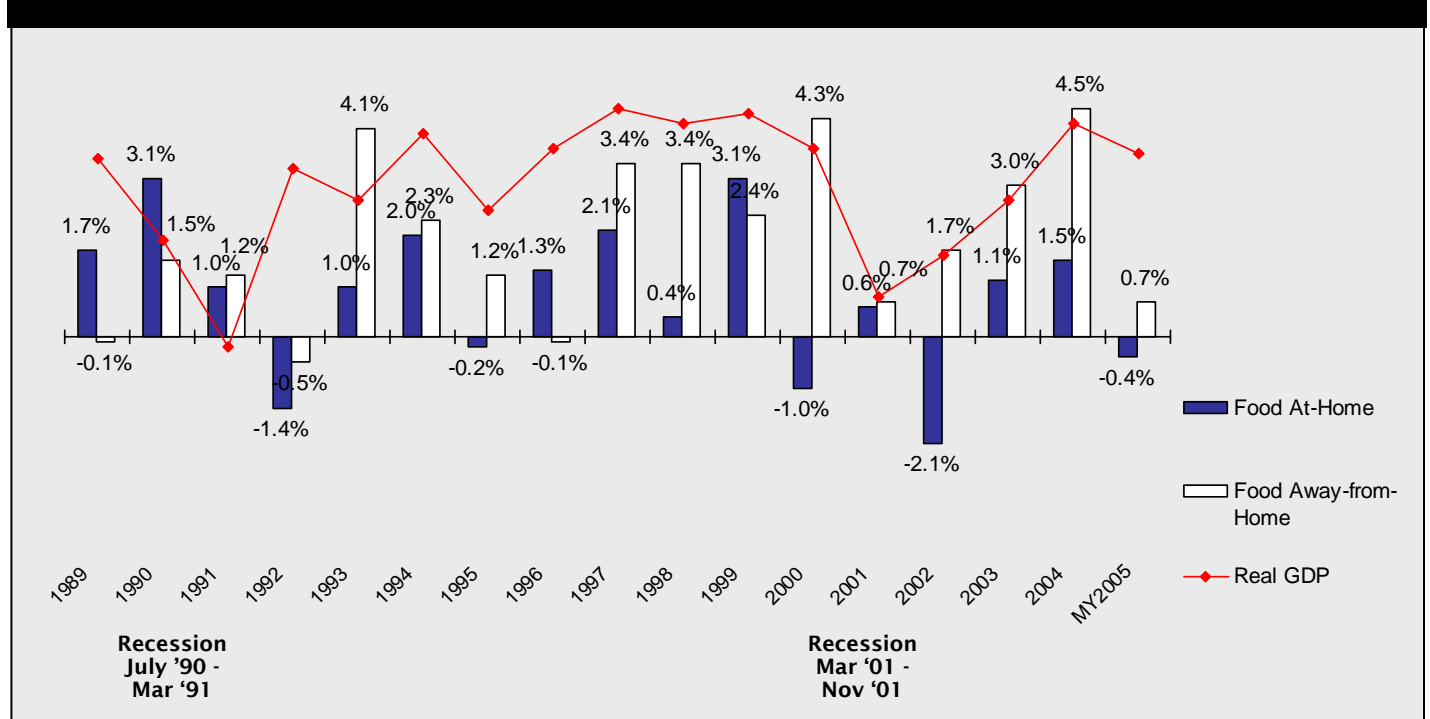
While consumer spending on food both at-home and away-from-home is impacted by macroeconomic trends, spending shifts do differ. In general, at-home spending shows impact of economic downturns sooner but with less dramatic swings than away-from-home spending.

One possible explanation for this difference is that higher income consumers fuel total dollar away-from-home expenditures (if not frequency) and feel the pinch of an economic downturn later and for a shorter period of time than lower income consumers.

When away-from-home growth does in fact slow, there is a benefit to at-home spending. During the 2001 recession, for instance, a decline in at-home spending that began in 2000 was buffered as away-from-home spending slowed (but declined again as away-from-home rebounded).

It is critical that food manufacturers and retailers understand the relationship between their consumers' spending on their brands/stores and away-from-home expenditures. (Income mix of consumers will likely be a key determinant). They can then plan for the window of opportunity in at-home spending that will occur when away-from-home spending softens.

**Consumer Expenditures on Food At-Home vs. Away-from-Home and GDP**  
Real 2000 Dollars - % Change vs. Prior Year



Sources: USDA; U.S. Department of Commerce, Bureau of Economic Analysis

Note – Food spending trends from the Dept. of Commerce differ from the USDA-based food at home trends on page 5 due to definitional differences.

## IMPACT OF MACROECONOMIC TRENDS PRIVATE LABEL

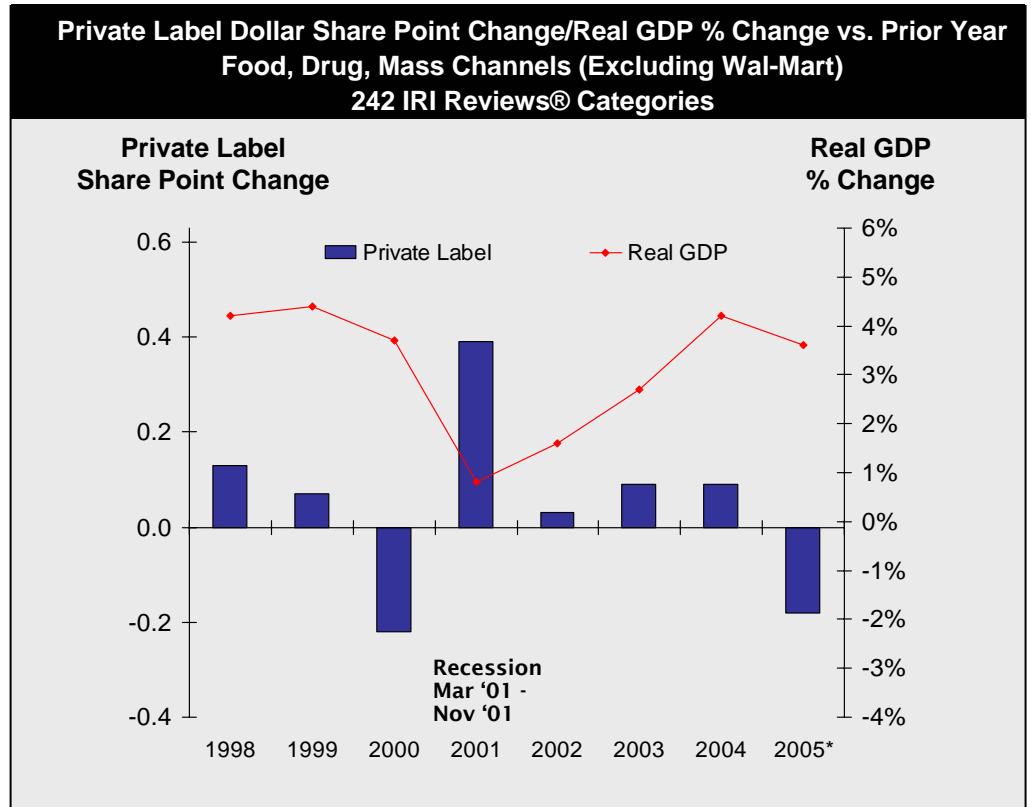
**Private label share declines just after economic peaks but rebounds during recessionary periods.**

Private label share trends show an interesting pattern with respect to economic growth. Private label share across food, drug, mass channels excluding Wal-Mart (FDMx) declined just after the past two economic peaks. It appears as though consumers became comfortable with economic conditions and perhaps eased up a bit on budget watching.

When the economy fell into recession in 2001, private label experienced a relatively sharp (but still less than ½ a percentage point) share increase.

Private label share change among FDMx channels in 2006 will be driven in part by GDP growth. As noted in the forecasting section, current forecasts place GDP growth at roughly 3.5% -- in alignment with 2005 growth. If forecasts hold true, private label share is likely to maintain current levels. If GDP growth is significantly less, we can expect private label share gains.

(Note: As highlighted in the November 2005 *Times & Trends*, all outlet private label share increased 0.3 points this year versus last year, driven to a large extent by share increases among supercenters and club stores.)



Sources: IRI InfoScan® Reviews; Bureau of Labor Statistics  
\* 2005 data represent 52 weeks ending 10/2/2005

## IMPACT OF MACROECONOMIC TRENDS CATEGORY

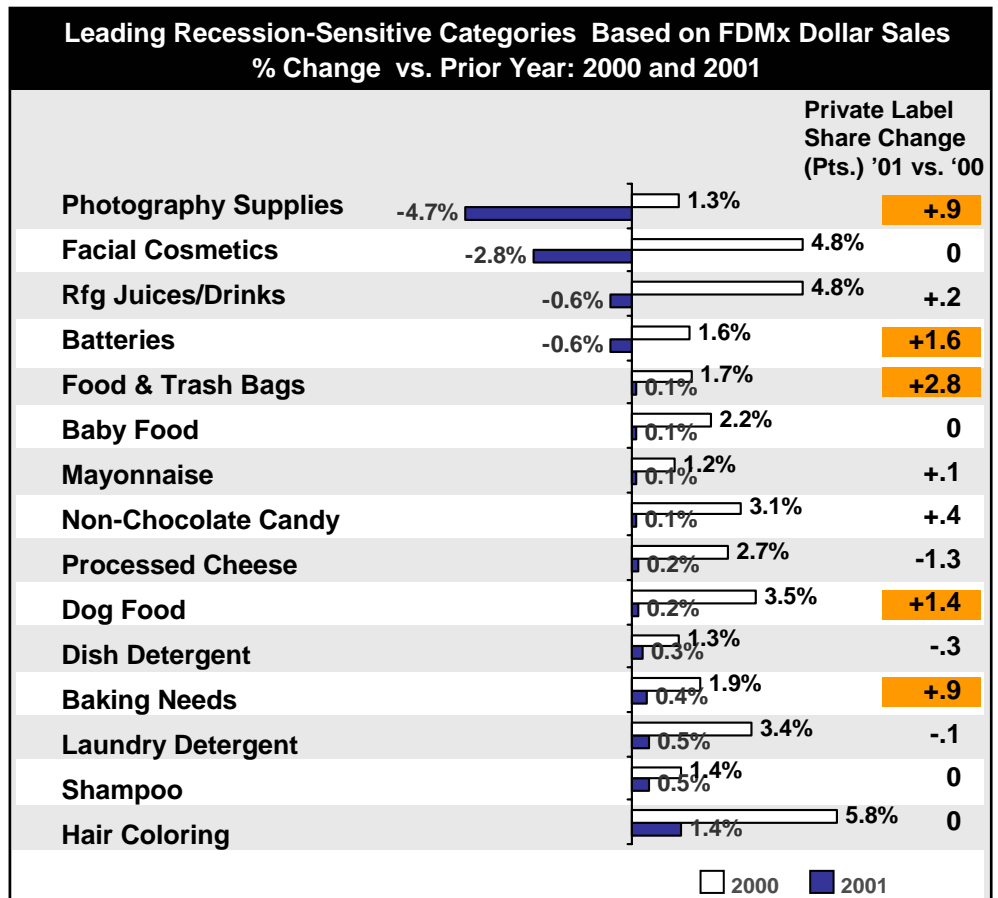
**“Non-essential” foods and several non-food categories are particularly sensitive to recessionary conditions.**

As the impact of the general economic environment is most evident during major economic events, this section explores category sales growth during the last recession.

The chart below highlights 15 top 100 categories that were growing in 2000 but faced sharp deceleration or declining dollar sales in 2001 across food, drug, mass channels, excluding Wal-Mart.

Consumers not only decreased the amount of product they purchased in these categories (all fifteen saw unit sales declines), but they also shifted brands in many cases. Among one-third of these categories, private label made substantial share gains.

“Non-essential” foods (such as candy and baking needs) and non-foods appear to be most sensitive to recessionary conditions.



Source: IRI InfoScan® Reviews; among top 100 categories

## CURRENT ECONOMIC CONDITIONS

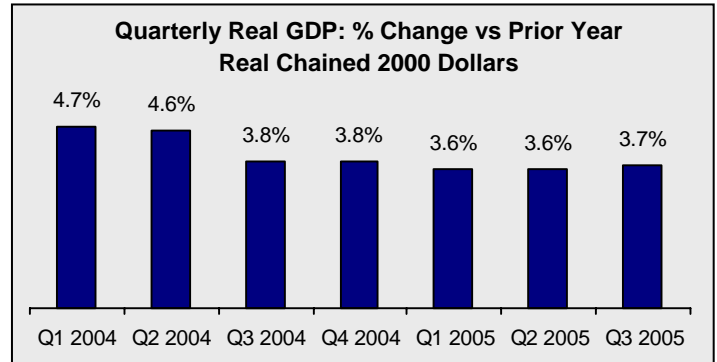
**Major economic indicators highlight a stable economy -- reflected in stable CPG industry sales.**

Despite major concerns regarding rising fuel costs, the economy has actually been relatively healthy over the past year. Real Gross Domestic Product (ie inflation-adjusted) has held steady at 3.6%-3.8% - stable growth albeit one point below first half 2004 levels.

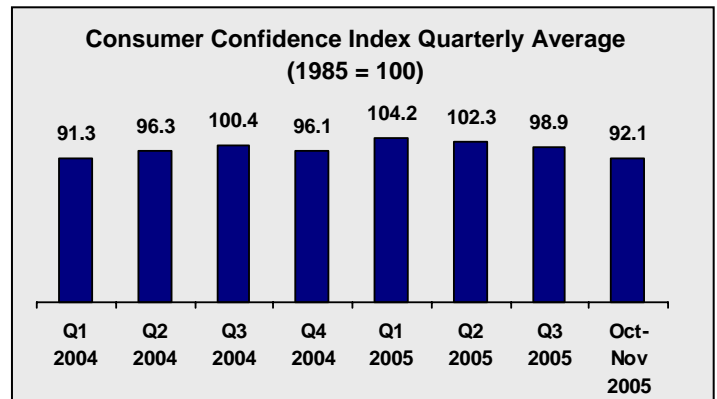
Although declining slightly in the fourth quarter, consumer confidence has also held its ground.

There was good news on the unemployment front, as well -- unemployment rates have steadily dropped throughout the year.

The relatively stable economy is reflected in stable CPG industry sales. Quarterly sales growth appears sporadic due to seasonal shifts; however, sales for full year/year-to-date periods show steady, very modest growth.



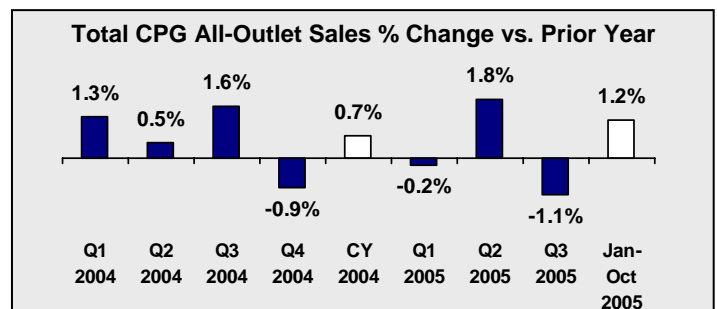
Source: U.S. Dept. of Commerce, Bureau of Economic Analysis



Source: Conference Board



Source: Bureau of Labor Statistics



Source: IRI Consumer Network®

## GAS PRICE IMPACT

**High gas prices contributed to increased CPG sales, which continued despite gas reaching the dreaded \$3.00 per gallon threshold.**

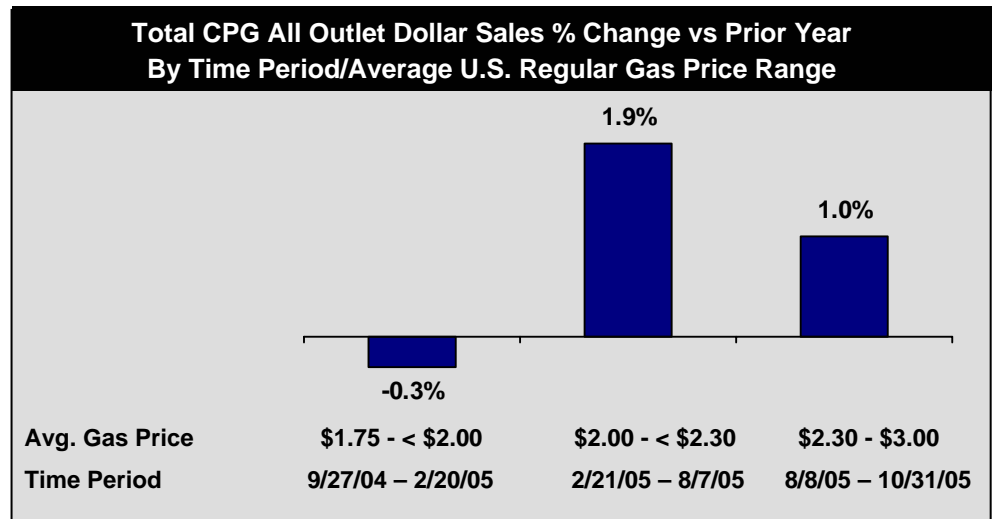
Soaring gas prices over the past year have raised concerns regarding the CPG industry's ability to sustain sales as consumer budgets tighten. While gas prices have come down from a record average high of \$3.04 in September to roughly \$2.12 per gallon, current price levels remain 13% above prior year.

IRI's September *Times & Trends Special Report: Impact of Rising Gas Prices* found that rising prices actually seemed to benefit CPG spending. As prices hit the \$2.00 per gallon mark, CPG growth rates accelerated. Presumably, consumers shifted some spending on restaurants, entertainment and services to CPG.

The impact diminished as consumers adjusted to the new higher prices, and growth trends leveled off at 1%.

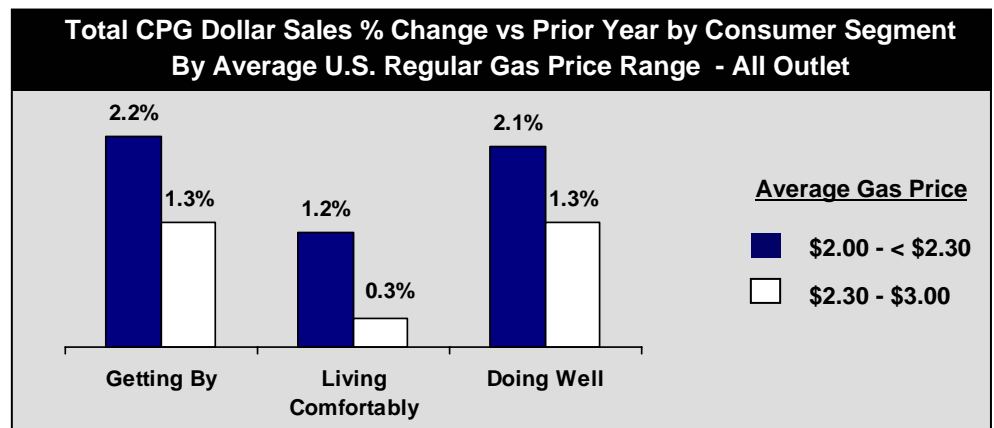
The latest sales trend data confirm that the CPG industry has sustained the 1% growth level, despite gas prices exceeding \$3.00 -- which many feared would be the threshold that would spur industry sales declines.

Further, the pattern of increased sales followed by a plateau was consistent across income groups. Interestingly, the middle income group changed CPG spending levels the least during the gas price crisis.



Sources: IRI Consumer Network®; U.S. Department of Energy

**Sales trends vis-à-vis gas prices are consistent across income groups.**



Sources: IRI Consumer Network®; U.S. Department of Energy

## FORECASTING GROSS DOMESTIC PRODUCT

**Most major economic forecasters predict steady growth into 2006.**

Given the powerful link between economic health and CPG industry sales, GDP forecasts are a critical input into CPG planning and forecasting models.

There are numerous sources for GDP forecasts. As noted in the chart below, while most of these estimates are very consistent, there are outliers that are worth exploring. Further, it is imperative to continually track forecast updates to be forewarned of potential turns in the economy as early as possible.

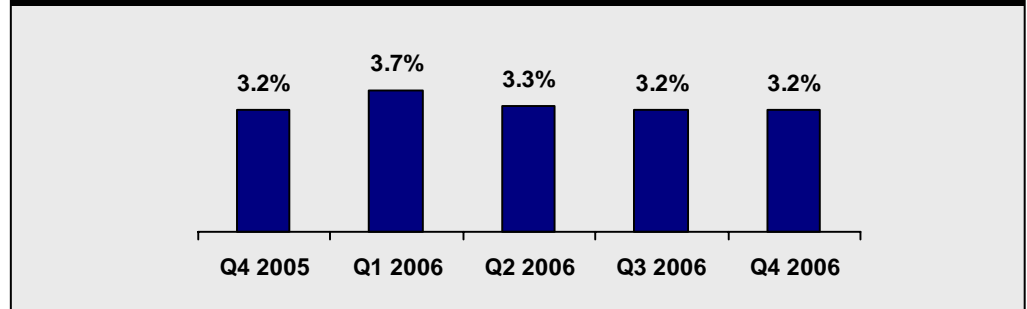
*The Economist's* Poll of Forecasters is updated monthly, reflects the input of numerous leading analysts and provides a range that identifies outliers.

Most major analysts expect continued solid growth in 2006.

### Projected U.S. Real GDP Growth vs Prior Year

<u>Source</u>	<u>2005</u>	<u>2006</u>
U.S. Office of Management and Budget	3.5%	3.4%
OECD Economic Outlook	3.6%	3.5%
National Association for Business Economics	3.6%	3.3%
Federal Reserve Bank of Philadelphia: Survey of Professional Forecasters	3.6%	3.4%
<i>The Economist</i> Poll of Forecasters	3.4% - 3.7%	2.6% - 4.0%

### Projected U.S. Real GDP Growth vs Prior Year by Quarter



**“The forecasters see little chance of a downturn in real GDP over the next five quarters.”**

– Federal Reserve Bank of Philadelphia, Survey of Professional Forecasters; November 2005

Source: Federal Reserve Bank of Philadelphia; Survey of 51 Professional Forecasters

## FORECASTING ADVANCED WARNING INDICATORS

**Many heavily watched economic indicators accurately reflect current conditions but have limited predictive power.**

As noted previously, GDP forecasts provide an immensely valuable tool to CPG planners; however, forecasts have room for error and may not identify impending downturns soon enough.

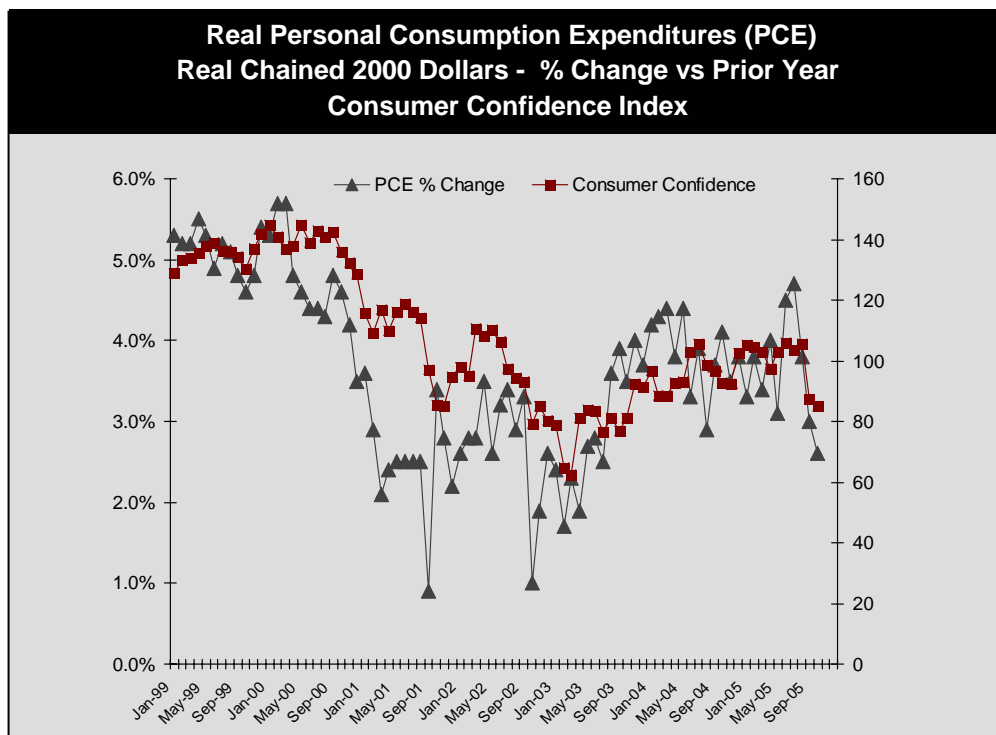
It is imperative that marketers also track leading indicators to identify early warning signs that signal the need for caution.

In *Ahead of the Curve*, Joseph Ellis, who was ranked as Institutional Investor's #1 Wall Street retail analyst for 18 years, provides a comprehensive

exploration of the relationship between key economic indicators and consumer spending.<sup>1</sup>

Ellis concludes that many of the most closely watched indicators are not effective in forecasting consumer spending. For instance, as highlighted in the chart below, consumer confidence typically coincides with, rather than precedes changes in inflation-adjusted consumer expenditures. The Consumer Confidence Index is a strong measure of current conditions but may not provide sufficient warning of economic softening.

**“The process of asking consumers to look forward to predict their financial circumstances and spending plans appears on the surface to have forecasting value. However, answers to questions asked today will reflect the respondents’ attitudes today.”**  
– Joseph Ellis  
*Ahead of the Curve*



Sources: U.S. Department of Commerce, Bureau of Economic Analysis; Conference Board

<sup>1</sup> Ellis, Joseph. *Ahead of the Curve*, Harvard Business School Press, 2005.

## FORECASTING ADVANCED WARNING INDICATORS (CONT'D)

**Real average hourly earnings has proven value in predicting changes in consumer expenditures.**

Ellis' analysis reveals that a more obscure measure, *real average hourly earnings*, is the "single most reliable leading indicator of consumer spending."

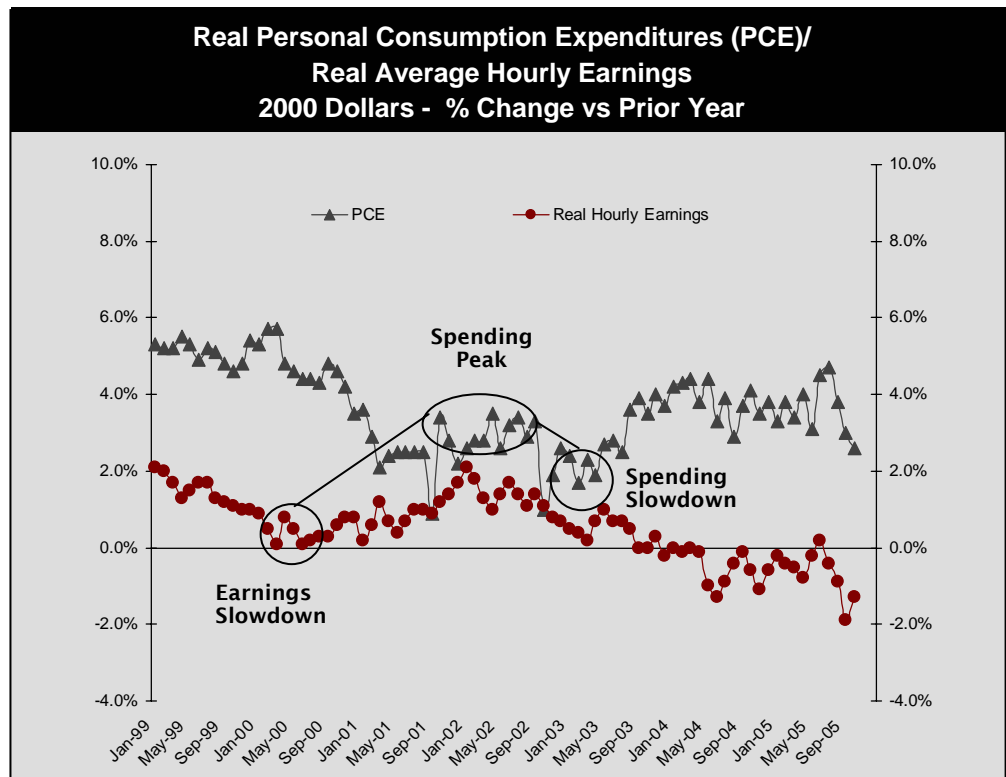
The chart below illustrates this relationship. Ellis found that growth in real hourly wages versus prior year begins to wane six to twelve months before the peak in consumer expenditures, after which spending declines.

A six-to-twelve month warning provides CPG marketers ample time to implement measures to protect and grow share throughout an economic downturn.

Despite favorable 2006 forecasts by most analysts, a review of current trends in real average hourly earnings suggests the potential for spending deceleration. Assuming a continuation of this cycle, the 2% decline in real earnings in September 2005 may signal a spring 2006 slowdown.

As cycles can and do alter over time. Marketers should watch real earnings for warning signals and make contingency plans accordingly but continue to closely follow other indicators, such as monthly real GDP forecasts, for confirmation.

**Declines in real average hourly earnings suggest a downturn is possible – despite GDP forecasts of solid growth.**



Sources: U.S. Department of Commerce, Bureau of Economic Analysis; Bureau of Labor Statistics

## CONCLUSIONS

- ▶ CPG/healthcare retailers and manufacturers should invest in identifying the specific relationship between macroeconomic trends (as measured by real GDP) and sales for their categories, brands and stores
- ▶ Assessments of current sales performance, sales forecasts, category management initiatives and marketing and strategic plans should incorporate the impact of current and forecasted economic trends
- ▶ Identifying periods of likely economy-driven sales increases and declines among competitive products/channels (such as away-from-home food or private label for food manufacturers) will highlight critical windows of opportunity and risk
- ▶ Staying ahead of macroeconomic trends will require monthly monitoring of GDP forecasts and the establishment of contingency plans
- ▶ Real average hourly earnings is a promising advanced warning indicator that may provide up to twelve month's advanced notice of major economic changes

## RESOURCES

To gain insight into the relationship between general economic growth and sales across your categories, brand or stores, contact your IRI client service representative regarding custom analyses leveraging the following resources:

### **IRI MarketInsight™**

Proprietary model-based sales tracking service providing superior coverage of channels, including Wal-Mart, for which point-of-sale data are not available. Reflects sales across IRI InfoScan® Reviews CPG categories. Wal-Mart data include traditional outlets and supercenters.

### **IRI Consumer Network®**

Nationally representative panel of households tracking purchases with hand-held barcode scanners; extensive demographic profiles enable in-depth analysis of purchase behavior across standard or custom-defined consumer segments across channels.

### **IRI AttitudeLink**

IRI's custom survey capability that can be executed via mail, telephone or Internet; the ability to link attitudes with actual purchase behavior enables clients to track sales across custom attitudinal segments.

## MORE INFORMATION >

Please contact Sheila McCusker at [sheila.mccusker@infores.com](mailto:sheila.mccusker@infores.com) with questions or comments about this report.

### ABOUT IRI

Information Resources, Inc. (IRI) is the world's leading provider of enterprise market information solutions and services, empowering its clients to grow their business profitably in a complex marketplace. Driving the transformation of the consumer packaged goods (CPG), retail and healthcare industries, only IRI provides a unique combination of real-time market content, advanced analytics, enterprise performance management software and professional services. The company's portfolio of services, solutions and technology enable leading retailers and their suppliers around the globe to see what they are missing, act faster and with greater confidence and win at the shelf. Ninety-five percent of the FORTUNE Global 500 in CPG and retail leverage IRI to power their business. For more information, visit [www.infores.com](http://www.infores.com).

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