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The impact of consumers shifting spending from goods to services

Article

The trend: While inflation hasn't stopped most consumers from spending, what they're spending on has abruptly shifted.

- **US consumers spent 18% more in March 2022 than they did two years earlier**, and 12% more than they were forecast to spend based on the pre-COVID-19 trajectory, per McKinsey & Co.

- But after roughly two years in which consumers bought up TVs, furniture, and other goods, consumers are returning to their pre-pandemic spending habits by **shifting spending to services**, per data from Flexport reported on by the Washington Post.
- The change came about suddenly, which left a number of retailers with excess inventory in Q1, including mass merchants **Walmart** and **Target**, big-box electronics seller **Best Buy**, furniture chain **Kirkland's**, apparel retailers **The Gap** and **Urban Outfitters**, and discount merchants **Big Lots** and **Burlington**.

A shift away from discretionary purchases: Inflation has driven people in every age cohort and income group to spend more of their money.

- The year-over-year (YoY) spending growth was highest among millennials (17%) and high-income consumers (16%), per McKinsey.
- But there are growing signs that **inflation is straining lower-income families**, many of which have been hit hard by rising prices and used up much of their pandemic-era savings.
- Some of those families are beginning to pull back on discretionary purchases, which accounts for some retailers' excess inventory.

First, the bad news: **Retailers with excess inventory will mark down those items** to move them off their store and fulfillment center shelves.

- That's a stark difference from last year when retailers pulled back on promotions due to limited inventory resulting from production bottlenecks and strong demand.
- "We have begun experimenting with our promotional levers to stimulate customer demand and turn through excess inventory," said Kirkland's COO, **Nicole Strain,** during the retailer's recent earnings call.
- While discounts have boosted the retailer's sales, Kirkland's revenues are still down by a double-digit percentage, she said. The retailer expects to be more promotional in the near term, which will impact its margins.

Now, the good news (for some): The challenges by other retailers is welcome news for off-price retailers that have been struggling to maintain their inventory levels.

- "Long story short, the current environment is conducive to off-price buying," said **Tuesday Morning** CEO **Fred Hand**, during the retailer's earning call.

- He noted that in the previous 30 days, the retailer has “seen an incredible amount of availability,” he said. “And the product we've been offered is priced as aggressively as we have seen in the last two years.”

The big takeaway: The sudden change in spending patterns caught many retailers off guard.

- However, the silver lining is that it may serve as a catalyst for many retailers to begin leveraging AI-powered predictive analytics to better match sales to forecasts.
- Those tools leverage machine learning as they marry first-party data with third-party signals of consumer intent.
- That may ultimately drive lasting change by minimizing their excess inventory in the future.

Cost Decreases Attributable to AI Use According to IT Professionals Worldwide, by Business Function, June 2021

% of respondents

	Decreased by less than 10%	Decreased by 10%-19%	Decreased more than or equal to 20%
Manufacturing	23%	27%	37%
Product and/or service development	22%	24%	23%
Marketing and sales	21%	35%	27%
Human resources	20%	26%	40%
Risk	17%	20%	41%
Service operations	12%	24%	51%
Supply chain management	15%	27%	36%
Strategy and corporate finance	10%	28%	30%
Average	**18%**	**28%**	**33%**

Note: among respondents whose organizations have adopted AI; cost decreases for fiscal year 2020
Source: McKinsey & Company, "The State of AI in 2021," Dec 8, 2021

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