IDEX ONLINE RESEARCH

Christmas 2005 Forecast

Ho-Hum Holiday Sales Expected For Jewelers

By Ken Gassman, Analyst | October 16 2005

U.S. jewelry sales are projected to rise by a moderate 3-4% in the all-important 2005 holiday selling season of November and December. This year, IDEX Research is projecting that U.S. holiday jewelry sales will be in the range of $15.6 billion, up more than $400 million from last year. That represents an increase in sales of about $16,000 per specialty jewelry store in the U.S., or the equivalent of selling just over six additional diamond engagement rings at the industry-average price of $2,500.

The holiday season is a make-or-break period for U.S. jewelers. Retail jewelers in America typically generate about 1/3 of their annual sales and up to 100% of their yearly profits in this two-month period which includes Christmas, Hanukkah, and Kwanzaa.

Thus, this very moderate projected increase in sales will make it tough for jewelers to post any notable increase in profits this year versus the same period in 2004.

IDEX Research's jewelry sales predictions for the U.S. market are as follows:

- U.S. jewelry sales will be up in the range of 3-4% for the November-December 2005 holiday selling season.
- Consensus forecasts for total U.S. holiday retail sales call for gains in the 5-7% range. Thus, jewelers are expected to lose share-of-wallet this year.

+3 to 4%

Projected U.S. jewelry sales gain in the 2005 November-December holiday selling season

There are several positive and negative factors that will affect jewelry demand in the U.S. market.

- Key positives
  - Prime economic indicators – employment and wage trends – are steady.
  - Consumer wealth is climbing.
  - The post-Christmas week could be the biggest shopping period of the season.
- Key negatives
  - Soaring energy costs will take a greater share of wallet.
  - A record-high consumer debt burden will dampen shoppers' spending.
  - Retail competition is expected to be especially stiff this year.

- The possibility of new “system shocks” could disrupt holiday spending.

Jewelers’ profit forecasts also indicate a challenging year:

- Profits will be under pressure due to lack of sales leverage of operating costs.
- Early, intense discounting will dampen profits.
- Higher commodity costs will also pressure profits.

Other trends that will affect jewelers’ holiday sales include the following:

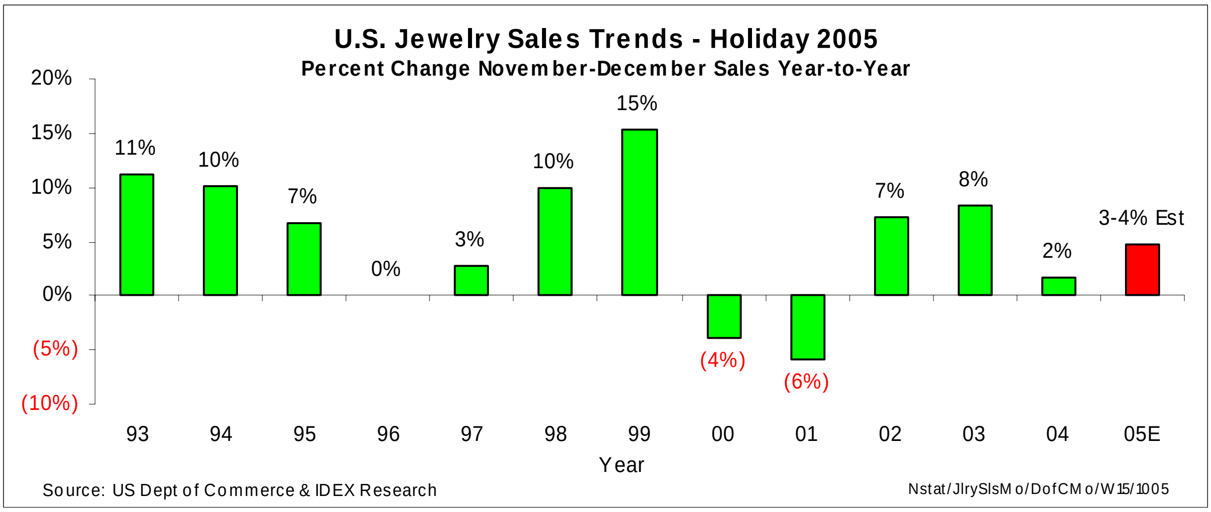
- Online sales will soar.
- Mall sales will be under pressure.
- High-end retailers will post stronger sales than jewelers offering popular-priced merchandise.

Hot products for the jewelry industry include the following:

- Diamonds and diamond jewelry demand will be strong. It will be a white Christmas for many lucky spouses and fiancés this year.
- Gold jewelry demand will be about in line with the industry average, while virtually all other mainline jewelry categories are expected to post sub-standard gains.

Jewelry Sales Forecast: +3-4% for Holiday 2005

Jewelry demand during the all-important 2005 holiday selling season isn’t expected to be robust, but the season won’t be a total bust either. IDEX Research is expecting 2005 holiday sales of jewelry in the U.S., which consumes about 50% of the world’s jewelry, to be up by about 3-4% over the November-December 2004 period. That’s better than last year’s weak 2% increase, but well below solid gains posted in the 2002 and 2003 selling season, as the graph below illustrates.



2005 Holiday Season Jewelry Demand

Modest Jewelry Sales Gain Projected

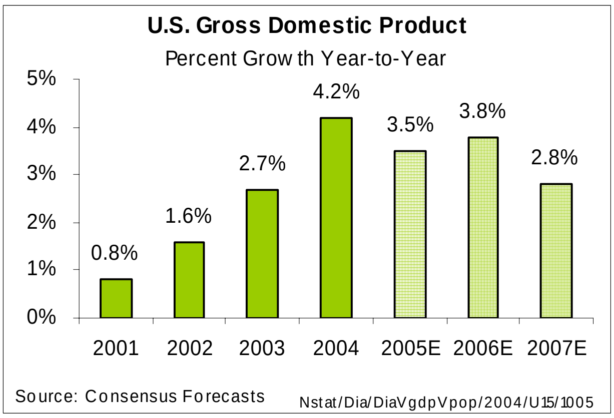
Challenging. Difficult. Bah-humbug. Adverse. Heavy discounts. Scrooge-like. Cut-throat competition. Online threats. All of these descriptions and more have been used by forecasters to characterize the upcoming 2005 holiday selling season in the U.S.

There is no question that this year's holiday season – including Christmas, Hanukkah, and Kwanzaa – will be one of the most challenging in several years. But to paraphrase Winston Churchill, the pessimists will see the difficulties while the optimists will see the opportunities.

As with any forecast, there are positives and negatives. The problem this year is that the positives aren't very strong and the negatives are significant.

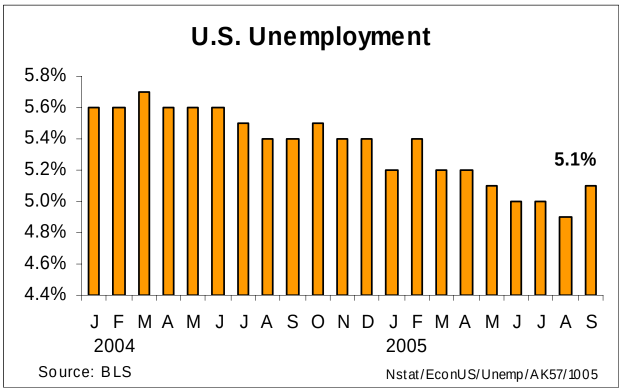
Positives – A Short List

- **Key economic factors are generally positive** – The U.S. economy continues to post solid quarterly gains. While there could be some short term negative impact from Hurricanes Katrina and Rita in the third quarter numbers, the next three quarters (4Q 2005, 1Q-2Q 2006 and perhaps beyond) will be stronger than we originally expected due to the impact of Gulf Coast rebuilding programs, many covered by insurance, which

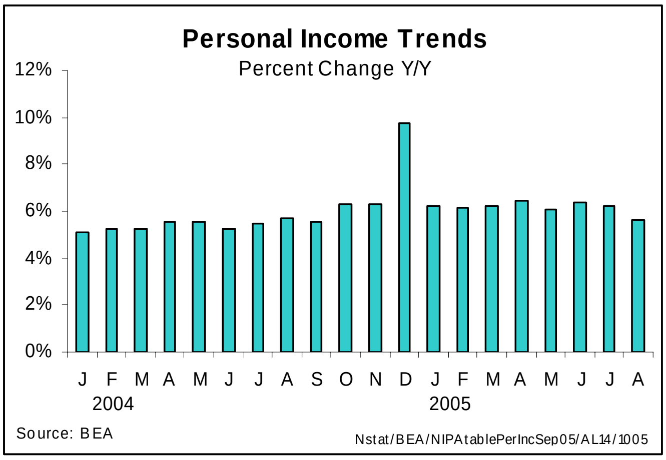


will inject billions of dollars into the economy via new jobs, increased manufacturing capacity, and service sector growth. There are two key economic indicators that particularly affect demand for jewelry: employment and personal income trends.

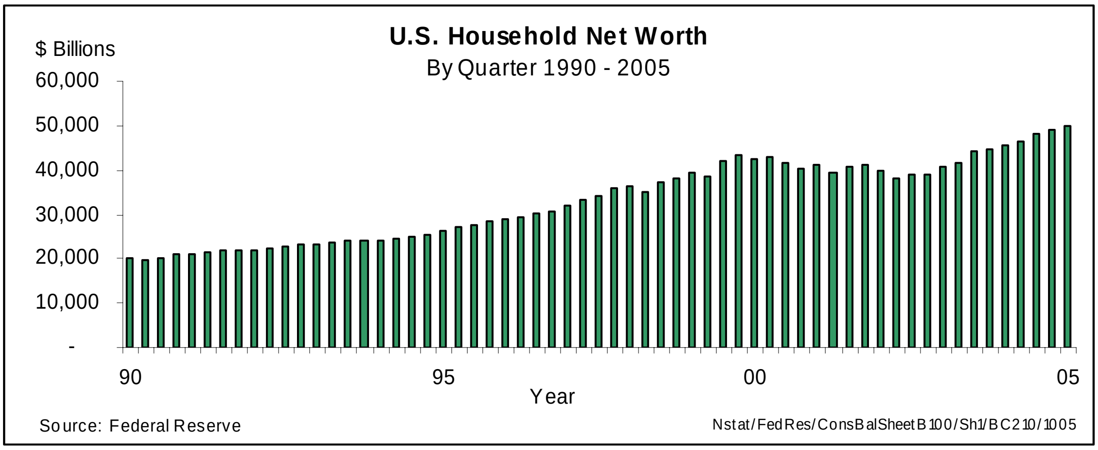
- **Employment trends are solid** – The U.S. unemployment rate has held relatively steady at a 5.2% average for the past 12 months. For the past three months, it has averaged 5.0%. Net new jobs created have also held steady at around 175,000 – 200,000 per month for the past year. Job layoffs have also remained relatively steady. When consumers perceive that their job is secure, they typically spend more freely.



- **Personal income gains have been steady** – Wages and salaries have posted consistent, though moderate gains, during 2005. Personal income for the year has risen slightly more rapidly than inflation. However, climbing energy prices this Fall are expected to send the inflation rate much higher. Personal income trends are a major determinant of consumer spending.



- **Consumer wealth factor is positive** – When consumers feel wealthy, they tend to loosen their purse strings. Between home price appreciation and stock market performance, consumers' personal wealth levels are at record heights. Home prices have risen at an average rate of 7% annually for the past several years. Further, many U.S. metros have reported home prices have risen by as much as 20% year-over-year. Consumers' homes are the highest-value asset on their personal balance sheets; thus, as home prices appreciate, personal net worth rises sharply. While the U.S. stock market has not broken through its previous high, aggregate gains from price appreciation and income (primarily dividends) have added measurably to consumers' personal net worth.



- **Jewelry is a balm** – There is an old saying among American shoppers, "When the going gets tough, the tough go shopping." What to they shop for? Something that makes them feel good. Luxury goods such as jewelry are often the beneficiary of shopping flings. Jewelry is a balm for stressed consumers.

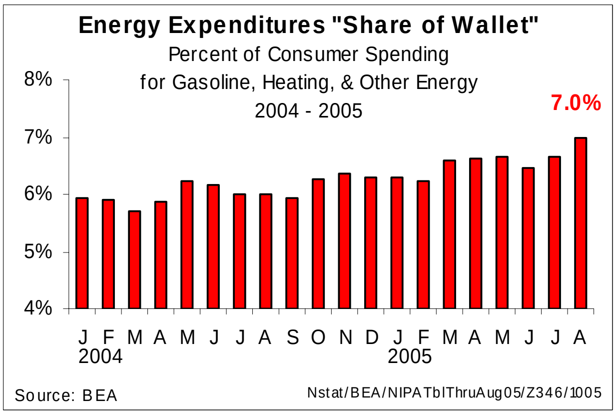
- **One extra day in the holiday season** – Most forecasters measure the U.S. holiday selling season as the number of days between Thanksgiving (last Thursday in November) and Christmas (invariably December 25). This year, there will be one more day in that period versus last year. Depending on your source, a longer holiday selling season will either have no impact, will cause shoppers to procrastinate, or will cause consumers to spend more. It can't hurt, and it will most likely have some positive impact, in our opinion. Further, because Christmas occurs on a Sunday this year, shoppers have until Saturday evening to complete their shopping. Saturday is traditionally an important shopping day.

- **Post-Christmas week could be a pleasant surprise** – Most employers will observe the Christmas holiday on Monday December 26. Shoppers are expected to be out in full force in the stores that day. As a result, aggregate consumer spending during the final week of December could make it the most important shopping period of the 2005 holiday selling season.

Negative Factors Are Significant

There are some negative factors which will affect consumer spending during this year's holiday selling season.

- **Gas pain** – Energy prices – gasoline, natural gas, heating oil – are soaring. Clearly, this will put a crimp in consumers' spending during the 2005 holiday selling season.

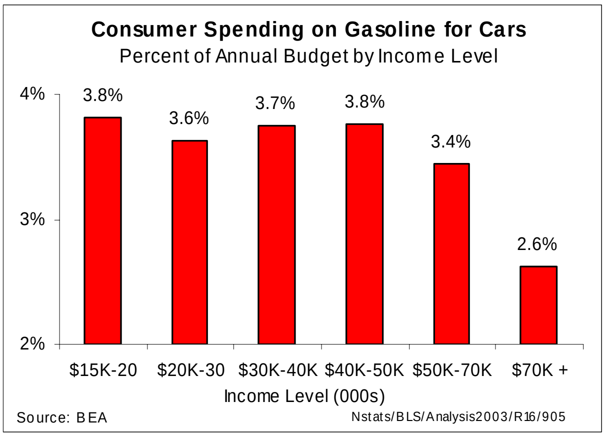


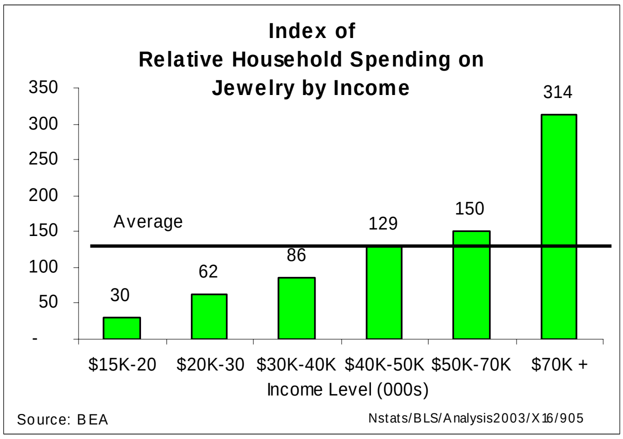
o **Energy's "share of wallet" will increase** – As a percentage of the typical consumer's household budget, energy expenditures have historically represented 5-6% of total spending. The latest figures suggest that energy spending has risen to 7%, with further increases expected later this year, to perhaps as much as 9%.

As a result of higher gasoline costs, Americans have cut back on their purchase of "daily consumables" such as beer, cigarettes, gasoline, and restaurant visits. So far, discretionary spending for luxury goods has not been measurably affected.

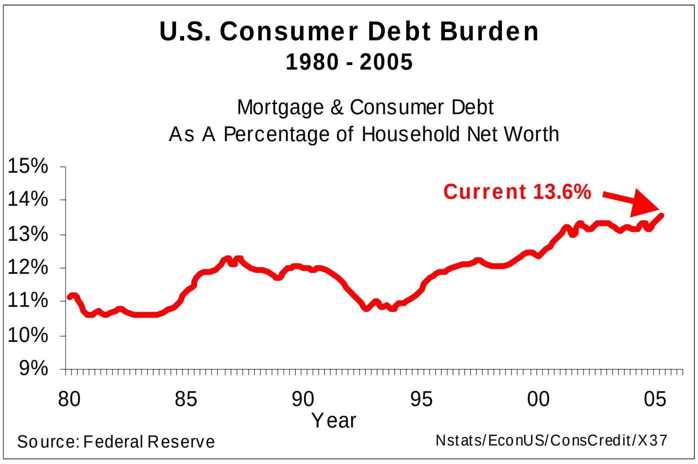
o **High income consumers will be less affected** – High-income American consumers – generally defined as households with annual income of $50,000 and above – have more flexible budgets than lower-income households. For example, higher income households spend proportionally less on gasoline. These high-income households, with represent 32% of all U.S. families, account for just over 60% of total jewelry spending. In short, about 1/3 of American households are responsible for almost 2/3 of all jewelry sales.

High-Income Consumers Spend Less on Gasoline . . . And More on Jewelry



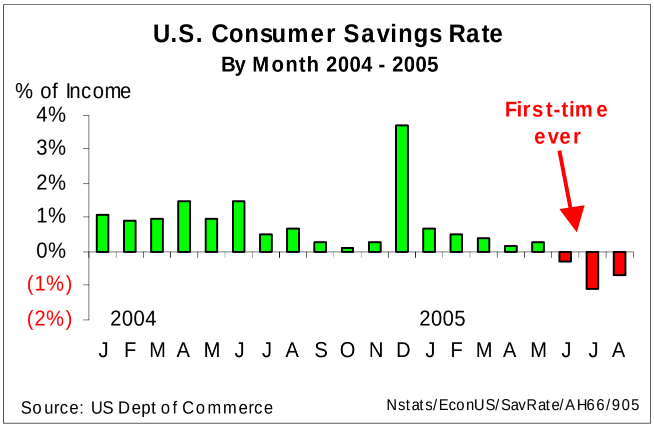


- **Consumer debt burden is high** – The consumer debt burden – defined as monthly payments for mortgages, credit cards, revolving credit, and other debt-related instruments – has reached record levels this year. Jewelers depend on some form of revolving credit (usually a monthly payment plan) for up to 45% of their sales. While some economists argue that the consumer has the ability to adequately service this debt, it is



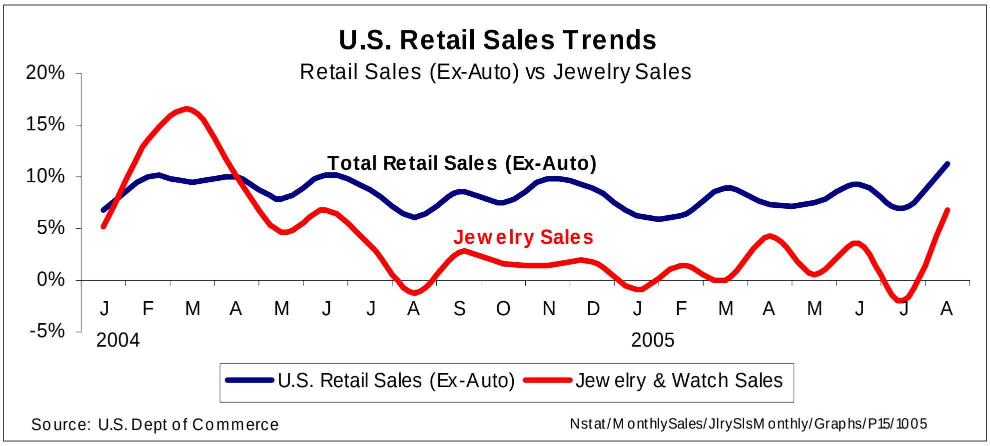
worrisome. At some point, consumers may say, “Enough is enough.”

- **Savings rate is low** – In June, the U.S. personal savings rate went negative for the first time in recorded history. In short, consumers tapped their savings account to fund day-to-day spending. This won’t last long. If consumers try to “repay” their savings accounts, it will take dollars that would have otherwise been spent during the 2005 holiday selling season.



- **Credit card balances are soaring** – The most recent figures show that the typical American consumer who carries a monthly credit card balance has accumulated a debt of about $9,300 per credit card. Roughly 55% of all American credit card holders do not pay their credit card bills in full every month.
- **New minimum monthly credit card payments will hurt** – Under new laws, credit card holders’ minimum monthly payments will jump by as much as 50%. While this could be only a few hundred dollars in the worst case, it is money that would otherwise be spent on holiday goods.
- **Higher interest rates will hurt** – The Fed has ratcheted up interest rates, and says it intends to continue to raise them, in the face of potential inflationary pressures. While this does not affect most credit card holders (unless they make a late payment or run their balance up abnormally high, in which case most banks substantially inflate the card’s interest rate), it does affect millions of Americans who have variable rate home mortgages. As their monthly mortgage payments rise, day-to-day spending for goods will slow.

- **Stiff competition** – So far this year, U.S. jewelry industry sales have significantly lagged total U.S. retail sales gains, as the graph below illustrates.



While many factors may have an impact on jewelry demand, it is clear that many other retail segments are doing well versus jewelry because of two key factors:

- **Other retailers are out-promoting jewelers** – Face it: jewelers' 50%-off promotions are simply not credible any more. Other retailers have come up with innovative promotions. For example, the auto industry's "employee discount" pricing created very strong demand for new cars in an otherwise lackluster period.
- **Nothing new and compelling** – Other than a few new diamond brands, which may have boosted the egos of the diamond suppliers, there isn't anything new in jewelry to capture shoppers' attention. Tennis bracelets are passé, the right-hand ring may finally be catching on but it will not represent a major diamond sales segment, and other categories such as gold, pearls, silver, and platinum have ho-hum product offerings. What is new? Moissanite, while less than one percent of total jewelry sales, is creating strong demand for Finlay and others who are brave enough to sell it. Synthetic diamonds could be the next major category, but diamantaires are doing everything in their power to kill the category.

- **Possibility of more system shocks** – Most Americans can take "shocks to the system" from time to time. They have weathered the terrorist events of September 11, 2001, federal building and embassy bombings, earthquakes, hurricanes, and other disasters. These events, while horrific, had only a transitory impact on consumer spending. While spending dips in the face of a system shock, it typically recovers within six months or less.

  But, if shocks to the system come too frequently or if "aftershocks" continue, then consumer demand could be impaired. This is the case with gasoline. Despite dire predictions, gasoline prices have retreated modestly. Forecasters suggest they will never be back down to 2003 and 2004 levels, but they may hold in the current range, giving consumers time to adjust their spending patterns. But a huge shock to the system would be blocks-long gas lines at petrol stations. This would have a dramatic impact on consumer mindsets; according to forecasters, it would take the wind out of consumer spending trends.

Jewelers' Profits Will Be Under Pressure

Jewelers' costs will rise this year, and their profits will likely be flat or lower than in prior years for several reasons.

- **Earlier, more intense discounting** – Christmas displays went up in some merchants' stores in late August. This was an effort to capture market share from those one-in-five shoppers who typically buy seasonal gifts prior to September. Most merchants indicate that they expect this holiday season to be especially promotional, as retailers vie to capture market share. Unfortunately, most retailers fall back on competition's lowest common denominator – a discounted price.
- **Lack of sales leverage** – With only a modest sales gain predicted, jewelers won't be able to leverage rising costs.
- **Higher commodity prices** – While most jewelers claim that they have raised their retail prices over the past year in response to higher diamond, gold, platinum, and silver costs, we sense that many jewelers have not fully recovered these costs. Our crystal ball suggests that commodity prices aren't going down near term.

Other Trends Affecting Jewelers' Sales

- **Online sales will soar** – Most prognosticators are predicting that holiday online sales will rise 20-25% this year. Four factors will drive online sales during the 2005 holiday selling season:
    - **High gasoline prices will reduce driving** – Consumers will make fewer trips to the mall, opting instead to buy more goods online as a result of high gasoline prices.
    - **Better selection** – Online commerce has finally begun to mature. As a result, virtually anything consumers want can be found online. Most merchants are offering their full product line via their online store.
    - **Low prices** – Most online merchants operate with lower cost structures, and are therefore able to offer merchandise at very low retail prices. In the jewelry industry, online merchants' gross margins are about half the level of store-based jewelers.
    - **Convenience & fewer hassles** – Traffic and parking is a "no hassle" situation with online shopping. For the price of shipping, merchandise is delivered right to the door of time-pressed consumers.

- **Mall sales will be under pressure** – Consumers perceive that the best values are found at off-mall retailers such as Wal-Mart, Target, and other big-box retailers. Thus, mall traffic continues to decline. As a result, off-mall jewelers are likely to post larger sales gains this year.

- **Higher-end retailers will outperform lower-end retailers** – Beyond the obvious – gasoline costs have put a crimp in lower-income consumers' pocketbooks – other costs have also been rising this year. Further, a bulk of the wage gains have occurred among higher-income consumers. Thus, low-end shoppers are expected to spend proportionally less. However, there is one unknown. The new bankruptcy laws, which make it more difficult for consumers to escape their debts, could help boost jewelers' sales. If third-party credit providers loosen credit standards as expected, low-end consumers who typically opt for monthly payment plans may find they have higher credit limits.

- **The average ticket will be down** – We sense that jewelers will be promoting the $99 price point more heavily than in past years. While this is a popular price point for Valentine's and Mother's Day, holiday opening price points are generally in the $199-299 range. If jewelers choose to feature more $99 goods, their average ticket will be down, further depressing sales.

- **Weather forecasts are favorable** – Early indicators suggest that this will be one of the coldest seasons in recent memory. This is good: cold weather gets consumers into the spirit of the season (think "Jingle Bells," "I'm Dreaming of a White Christmas" and other music).

Consumer Indicators Not Meaningful To Retailers

- **Consumer confidence** – Recently, consumer confidence dropped dramatically, and some forecasters have suggested that this is a harbinger of bad news for holiday sales. Studies continue to show that there is no significant correlation between consumer confidence and retail demand. In fact, the contrary may be true. Consumers often indulge in "recreational shopping" as a way to fight the blues.

- **Consumer bankruptcies** – Consumer bankruptcies have soared this year. This is almost totally related to tougher bankruptcy laws which went into effect this month. We expect a decline in bankruptcies near term. Thus, the current aberration in bankruptcy statistics is not projectable.

Hot products – It Will Be A White (and Yellow) Holiday

- **Diamonds will be hot** – Diamond jewelry sales are expected to be up one or two points higher than the average for all jewelry. Our forecast calls for diamond jewelry sales to be up 5-6% or so.

- **Gold sales will be in line with the average** – The World Gold Council (WGC) has done a good job of putting together effective promotional programs for retailers. Kay Jewelers, for example, continues to note the success it has had with WGC jewelry promotional programs.

- **All other categories will be flat to down** – Virtually all other mainline jewelry categories are expected to post sales either in line with the jewelry industry average or below.

Jewelers' holiday promotional plans

For competitive reasons, publicly held chain jewelers have not revealed their holiday promotional plans. However, our intelligence-gathering network has pieced together the following fragments:

- **Chain jewelers believe engagements will help fuel Christmas sales** – Zale generates over 35% of its total sales from bridal related merchandise; Kay generates about 40% of its sales from bridal goods. Demographics are the only determinant of engagements and weddings; these events are not affected by transitory disruptions.
- **Signet's advertising budget will grow** – Signet's marketing spend-to-sales ratio will be broadly similar to last year, but total ad spending will be up by at least 10% because of strong sales growth this year. All of the Jared stores will be covered by local television advertising.
- **Television advertising will be the major driver of sales for Zale** – The company recently changed advertising agencies; this should result in a new fresh approach. Management also mentioned that it plans to promote the $99 price point more heavily via silver and gold jewelry on the front of its catalogs. However, it is unclear if this will begin in the 2005 holiday selling season.
- **Finlay says that the extra day will help boost its department store sales** – Further, management said that its new line of moissanite fashion jewelry could provide a significant boost to sales.
- **Blue Nile says it may raise its ad-to-sales ratio** – Currently, online diamond retailer Blue Nile spends about 4.0% of sales on advertising; this may rise to 4.5% later this year.
- **The DTC has its usual marketing plans in place, but its sales goal will be a stretch** – Earlier this year, the DTC – the diamond marketing arm of De Beers – said that global diamond sales were up 5% in local currency in the first six months of 2005. Further, it said that it was projecting that full year diamond jewelry sales would be up 6% in local currency. If so, second-half diamond sales gains will need to be near 8% to achieve this goal. Based on current sales trends, it appears that it will be difficult to post an 8% increase in second-half diamond sales.

Retail Jewelers: What Can You Do?

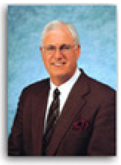
As a jeweler, how can you compete in the current challenging environment? As most jewelers know, the 20/80 rule applies to your best customers. This rule says that 20% of your customers generate 80% of your sales. While the percentages may vary, the concept is sound: you have a few customers that you can count on. So...

- Court your loyal customers
- Whatever you do, do better
- Have ample inventory to meet your customers' needs

- Have more sales people in your store. Don't keep any customer waiting for service

About IDEX ONLINE RESEARCH

IDEX ONLINE RESEARCH is a division of IDEX ONLINE (www.idexonline.com) which produces real-time transparent, unbiased pricing information for the global diamond and jewelry industry. IDEX ONLINE RESEARCH provides exclusive, in-depth analysis of the global diamond and jewelry trade, industry research, retail and consumer analysis, as well as trend forecasts and financial breakdowns.



IDEX ONLINE RESEARCH is headed by leading industry analyst Ken Gassman. For over 20 years, Ken has been a leading retail and consumer analyst on Wall Street, covering the global diamond and jewelry trade, working with major national U.S. retailers including Wal-Mart and Home Depot as well as jewelers such as Zale Corporation, Signet Group, Movado, and others.