First Trust
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Keynesian Model Blew It Again

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If there's one economic conclusion we can make from recent data, it's that the Keynesian model has failed - again.

Remember that "fiscal cliff clock" on cable TV? Well, the year-end deal included an end to the payroll tax cut and then two months later, on March 1, the dreaded federal spending sequester went into effect. In other words, the Keynesian clock struck midnight, the economy was supposed to slow sharply, and a recession was possible.

The theory was – still *is* in some quarters – that higher payroll taxes and less federal spending would reduce spendable incomes (especially for government workers and contractors) and hit consumer spending. This drop in spending would set off a multiplier effect that would drag down economic growth.

One widely-followed Keynesian forecasting unit predicted an uptick in the unemployment rate in the second quarter and a decline in nonfarm payroll growth to 100,000 per month. And when March payrolls rose a tepid 88,000, Keynesians blamed it on the fiscal cliff and said "here we go, it's started."

But the unemployment rate is lower in Q2 than in Q1 and nonfarm payrolls have risen an average of 155,000 since the sequester went into effect. Payroll growth during the same three months in 2012 was 147,000. Even the tepid March number was revised from 88,000 to 142,000.

The Keynesians, expecting doom and gloom anytime the government cuts spending, have pounced on any signal of soft economic growth. They jumped on the initial report of weakness in retail sales in March and blamed it on the sequester, even though the last three times Easter had been in March, like this year, sales have been unusually weak compared to other indicators (2002, 2005 and 2008).

But we found out this past week that core retail sales – which take out the monthly volatility caused by autos, gas, and building materials – have been up eleven months in a row and didn't miss a beat after the sequester went into effect. Assuming consumer prices rose 0.1% in May (see our forecast table, below), "real" (inflation-adjusted) retail sales are up about 3% from a year ago. Total consumption, adjusted for inflation, is up 2.1% during the year-ended April 2013 versus the 1.8% growth during the year-ended April 2012

Meanwhile, equity investments, held by US households, are up about $800 billion in value since March 1. Taken at face value, it seems like the effect of the sequester has been positive, not negative.

Keynesians haven't even been right about the stock market. We're not going to call anyone out by name, but we're thinking of a famous Keynesian economist who is widely known for having made a prescient call about 2008-09, whose name starts with an "R" and sounds a lot like Houdini.

It's true that he called the collapse in 2008-09, but he originally went bearish in 2005, especially after Hurricane Katrina. Reports say that he recently turned bullish. So what if you sold in mid-2005 and waited until now to buy back in? Since mid-2005, the annualized total return on the S&P 500, including reinvested dividends, has been 6.2%. That's nothing compared to the late 1990s – but, hey, it ain't shabby either. In other words, completely ignoring the dire Keynesian advice, even when it was right, would have been profitable.

In mid-2005, you could have bought a 10-year Treasury Note that yielded 4%. Less drama for sure, but no clear advantage. Gold, on the other hand, was trading at about $430/oz. back in mid-2005, so that would have been a great buy, but not an option normal Keynesians would have recommended.

The bottom line is that all this focus on government actions through the lens of a Keynesian model has been basically worthless. Investors are better served when they follow free-market economic theories that focus on production, not demand-side models that focus on spending and debt. And this appears true in both the long, and the short, run.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
6-17 / 7:30 am	Empire State Mfg Survey – Jun	0.0	**-1.4**	+7.8	-1.4
6-18 / 7:30 am	CPI – May	+0.2%	**+0.1%**		-0.4%
7:30 am	"Core" CPI – May	+0.2%	**+0.2%**		+0.2%
7:30 am	Housing Starts – May	0.950 Mil	**0.939 Mil**		0.853 Mil
6-20 / 7:30 am	Initial Claims – June 15	340K	**342K**		334K
9:00 am	Existing Home Sales – May	5.000 Mil	**5.000 Mil**		4.970 Mil
9:00 am	Leading Indicators – May	+0.2%	**+0.2%**		+0.6%
9:00 am	Philly Fed Survey – Jun	-2.0	**-3.5**		-5.2

Consensus forecasts come from Bloomberg. This report was prepared by First Trust Advisors L. P., and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.