First Trust
Monday Morning OUTLOOK

630-517-7756 • www.ftportfolios.com May 18th, 2015

Taxes Culprit Behind Slow Sales

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Last week's report on retail sales in April came in weaker than most economists expected, with no change from the pace of sales in March. As a result, the chorus calling for the Federal Reserve to postpone the start of rate hikes beyond June, already loud, grew even louder.

The fretting was a little misplaced. "Core" sales, which strip out the most volatile items like autos, building materials, and gas, rose a respectable 0.2% - the 13th gain in the last 15 months - in an environment with low inflation. Meanwhile, sales in March were revised up to a gain of 1.1%, the largest increase in a year. In other words, the news wasn't all bad.

But, with gas prices down, the weaker than expected top-line reading was a little bit of a surprise. So, what happened? We think we know, and it makes us even more confident that sales will accelerate in the months ahead.

The afternoon before the announcement on retail sales the US Treasury Department reported an all-time monthly record for individual income tax payments, which hit $288 billion in April, $50 billion, or 21% higher than just one year ago!

Most of the increase compared to last year came in the form of "non-withheld" income tax payments, which rose $40 billion from a year ago. We can surmise that most of this was because taxpayers didn't withhold enough from their paychecks in the previous year and had to make additional payments on April 15th. This can happen for lots of reasons, capital gains, over-estimating deductions, or just underpaying as incomes, bonuses or other income rise during better economic times.

Compared to a GDP of about $17.7 trillion, an increase in tax payments of $50 billion may not sound like much, but it could certainly make a big difference in a monthly report like retail sales. Here's how:

Let's say that workers had already anticipated about half of the $40 billion increase in final tax payments. So $20 billion came as an unpleasant surprise. And let's also assume taxpayers decided they'd make up for this shortfall by cutting spending over a full year. This means, assuming these taxpayers or their accountants did the calculations at the start of the month, that they'd want to reduce their spending by about $1.7 billion per month.

In turn, $1.7 billion is 0.4% of monthly retail sales, more than enough to turn a report that could have been better than the consensus expected to one that was worse. We'd also anticipate that having to pay the IRS more than expected would put a bigger dent in big-ticket purchases. This could be why April saw a drop in the sales of cars and light trucks.

The good news is that once taxpayers decide to cut spending by a certain amount per month, the growth rate of sales is only affected in the first month. After that, sales growth should revert back to normal, but from a smaller base. In other words, after the April lull, retail sales are probably already growing again in May. In addition, our supposition that taxpayers spread the extra taxes over a full year of spending is probably underestimating the impact on April sales.

What this all means is that when the May retail sales report comes out, in mid-June, it will be just a few days before the Fed meets to discuss changing short-term interest rates. If we are right, and a bigger than expected number is released, a rate hike in June is still a distinct possibility.

In terms of the overall fiscal picture, the budget deficit looks like it'll come in at about $440 billion in the fiscal year that ends in September, or about 2.5% of GDP, the smallest relative to GDP since 2007.

But we're much more focused on long-term government spending projections than what the federal deficit is in any particular year and the long-term outlook remains bleak, with entitlement spending – Medicare, Medicaid, Social Security, and Obamacare – set to push federal spending up substantially over the next generation if left unreformed.

But that's why they have elections. And we have faith that sooner or later the American voter, in contrast to the Greek voter, will choose dynamism and freedom over stasis and dependence. When it does, we need politicians willing to tackle the big budget issues, cut tax rates, and rollback the welfare state rather than accept the status quo.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
5-19 / 7:30 am	Housing Starts – Apr	1.018 Mil	**1.040 Mil**		0.926 Mil
5-21 / 7:30 am	Initial Claims May 16	270K	**268K**		264K
9:00 am	Existing Home Sales – Apr	5.230 Mil	**5.210 Mil**		5.190 Mil
9:00 am	Leading Indicators – Apr	+0.3%	**+0.4%**		+0.2%
9:00 am	Philly Fed Survey – May	8.0	**8.5**		7.5
5-22 / 7:30 am	CPI – Apr	+0.1%	**+0.1%**		+0.2%
7:30 am	"Core" CPI – Apr	+0.2%	**+0.1%**		+0.2%