THE ECONOMIC OUTLOOK GROUP

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ECONOMIC TALKING POINTS

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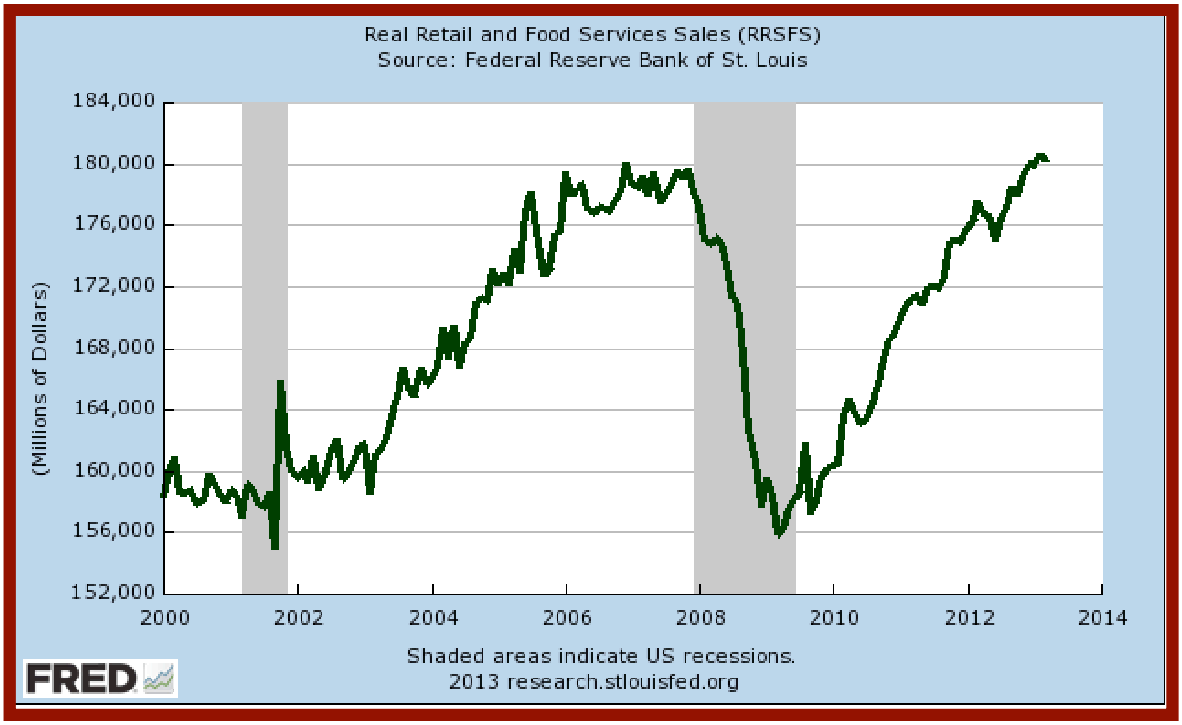
Fresh Data Suggests The Economy Is On The Precipice of Faster Growth

We have said numerous times in recent weeks that anyone who writes off the consumer because of the hike in payroll taxes would be making a mistake. There is just no evidence that households are materially cutting back expenditures simply because take home pay is fractionally lower. There are too many other positive economic factors that have effectively emboldened consumers to ramp up spending. We'll get to those factors in a moment.

First, let's review the actual data on retail sales.

While most analysts had forecast a decline in April retail sales, consumers chose to accelerate spending. (It's another cautionary tale that forecasting consumer behavior is usually a trap for mathematical economists.) Retail sales rose 0.1% in April, defying the consensus prediction of a 0.3% decline. Moreover, virtually all categories that can be characterized as discretionary spending increased (with auto sales up 1%; building material and garden supplies surged 1.5%; electronics and appliance stores rose 0.8%; clothing jumped 1.2%; sporting goods and hobbies up 0.5%).



One should also take note that retail sales in April was 3.7% above the level a year ago in nominal dollars. With annual inflation (PCE price index) creeping along at a 1% rate, last month's increase represents a promising start to real GDP growth in the second quarter.

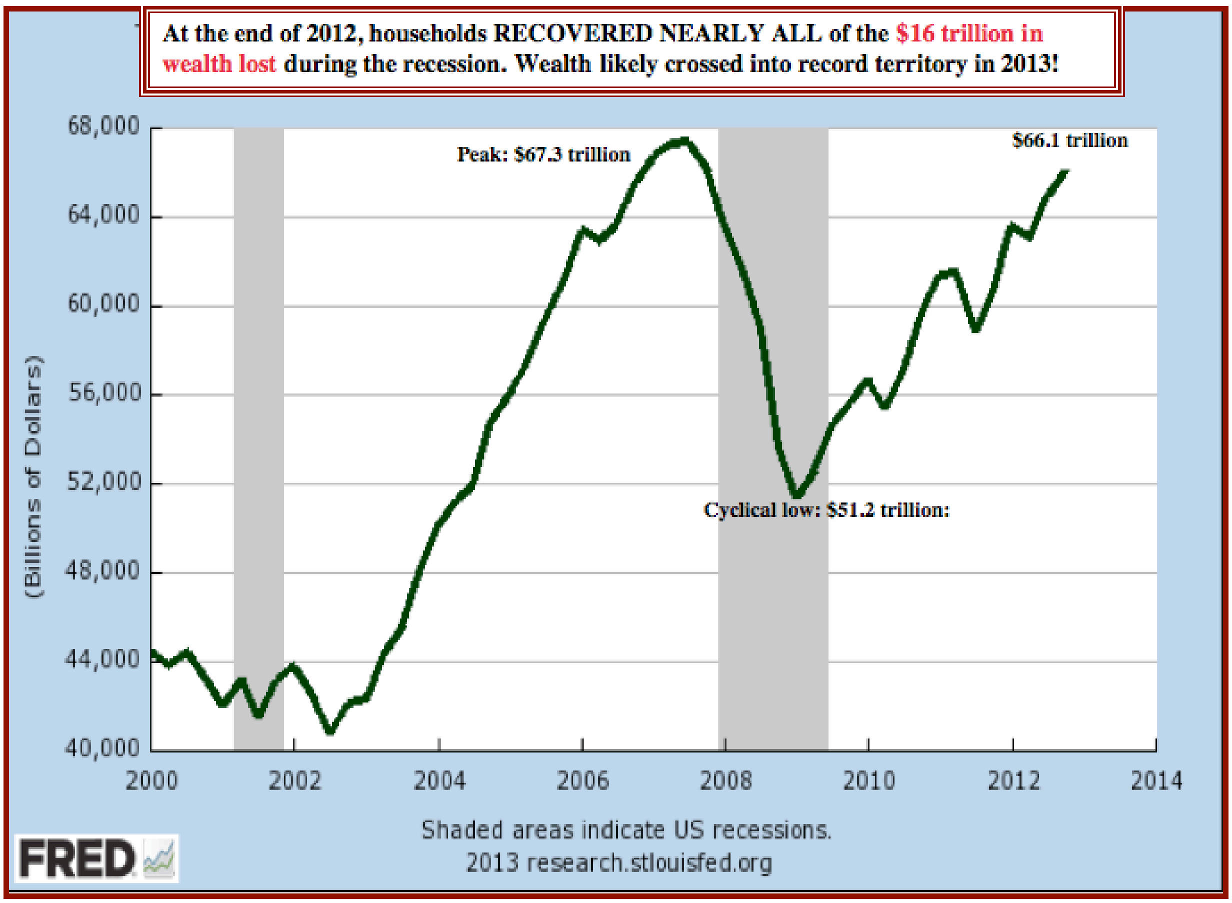
Why is it Americans hardly reacted to the increase in the payroll tax? The broad answer to that question is that by focusing excessively on this one impediment to spending, one ignores numerous other factors that have more than offset the impact from a decline in after-tax income.

One is the extraordinary fall in gasoline prices. The average national price in April dropped to $3.55 a gallon, the lowest for that month since 2010. Gas prices plummeted by about 13 cents, or 3.5% in April, which turned out to be the biggest percentage decline for the month in ten years! That 13-cent decline if sustained translates into $13 billion in consumer pockets that can be spent elsewhere.

Here' s more good news. History has shown that the two most important drivers of consumer spending are job security and changes in household wealth. Both are now setting the stage for more consumption.

Labor market conditions continue to improve on several levels. We saw a strong pick up in business payrolls in April, while applications for unemployment insurance continues to decline on a four-week moving average. The last jobs report also revealed that average weekly earnings in real terms during March (the latest available) was the highest since October 2010! Given these trends, it should not come as a surprise that consumer confidence in April also jumped. The Conference Board reported sentiment last month was the most optimistic since November 2012, and the more current Bloomberg Consumer Comfort series, which is surveyed weekly, has hovered near a five-year high. All are important prerequisites for a further increase in consumer outlays.

The second major factor that fuelled personal spending is the extraordinary rebound in household wealth. With both the Dow and S&P 500 reaching record high levels --- AND with Case-Shiller reporting the fastest yearly rise in home prices in nearly seven years (up 9.3% in February, YOY), household net worth has now likely returned to record territory. (We'll get the official numbers from the Federal Reserve on June 6th.) It is well documented that the propensity for consumers to spend increases with the improvement in household wealth, and we believe April's retail sales underscores this trend.



One thing is clear. Retailers were caught off guard by the strength in consumer outlays. Perhaps fearful that households might retrench as a result of the payroll tax increase, executives chose to be hyper cautious about ordering new inventory. They didn't want to get stuck with goods that would end up languishing in stockrooms. But what retailers experienced instead was the opposite. The resilience in household spending ended up eroding inventory levels. The government reported today that retail inventories shrank 0.5% in March, the most in two years. This drop will likely lead more inventory investment in the coming months by retailers, wholesalers and manufacturers.

Bottom line:
With consumer spending snapping back, business inventory investments about to accelerate, and the Federal Reserve still committed to a highly accommodative monetary policy, the economy may be on the precipice of faster economic growth.

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