



MORNING BRIEFING

April 17, 2019

Many Unhappy Returns?

See the [collection](#) of the individual charts linked below.

(1) “Tax Return” is a non sequitur for more Americans this year. (2) Failure to increase withholding rate boosted take-home pay for many last year, reducing refunds this year. (3) Pleasant surprise for high-income earners. (4) Rising personal saving offsetting the stimulus from tax cuts. (5) Corporate tax rate falls to 13.2% on “kitchen-sink” transactions. (6) S&P 500 capital spending during 2018 back at 2014 record high. (7) Buybacks widely misunderstood, though tech companies did boost EPS last year with buybacks.

Taxation I: Lumps of Coal for Individuals? Monday, 4/15 was T-Day, the deadline for filing personal income tax returns for 2018. The Trump administration continues to have high hopes that the individual and corporate tax cuts enacted at the end of last year will boost economic growth. However, the President continues to harangue the Fed to lower interest rates, suggesting some concerns that the positive supply-side effects of the tax cuts may not be fully realized without some monetary stimulus to boost the demand side of the economy.

The personal tax cuts should be lifting demand, but there are mounting concerns that most Americans aren’t even convinced that their taxes have been cut at all. Even worse is that many middle-income Americans perceive that their tax bills have gone up, while most upper-income taxpayers are pleasantly surprised that they are no worse off, contrary to their expectations. Consider the following:

(1) *Warning from the IRS.* Also on tax day, UPI [reported](#): “A NerdWallet survey found 20 percent of Americans who’d filed their 2018 federal tax return earlier ended up owing money. Of those taxpayers, 32 percent received a refund last year. That amounts to 7.9 million new Americans owing money this year, the survey said.”

Many Americans have been shocked that Trump’s tax cuts have had this unexpected perverse impact on their taxes. However, most of them didn’t realize that the increase in their after-tax take-home pay last year would cancel out the refund they were accustomed to receiving. Undoubtedly, their accountants will explain what happened, perhaps mitigating taxpayers’ disappointment at the news of owing a tax bill on 4/15 instead of being owed a refund.

The IRS warned taxpayers to review their tax withholding to reflect the lower tax rates and increased standard deductions. The NerdWallet survey found that just 17% of taxpayers did so after the new law went into effect. Furthermore, while the standard deduction was raised, the new tax code eliminated personal exemptions and slashed the deductions for mortgage interest and SALT (i.e., state and local taxes).

(2) *Disappointing refunds.* A 4/12 *New York Magazine* [article](#) titled “Tax Refunds Are Down. That’s a Threat to Trump—and the Economy” reported: “Now, many are suffering an unwelcome surprise: As of

March 29, total tax refunds were about \$6 billion lower than over the same period in 2018. In an economy as large as the United States', that isn't an enormous figure—this year's average tax refund is only about \$20 less than it was last year. But that modest reduction is not evenly spread across the population. Many Americans are seeing slightly higher tax refunds than in the past. But 1.6 million other Americans—who received tax rebates in 2018—are discovering that they actually owe the government money this time around." These numbers hardly justify the sensationalist title of the article sounding the alarm about a "threat" to Trump and the economy.

Nevertheless, such headlines may be depressing favorable opinions about the tax cuts. The article observes: "This reality is reflected in opinion polling—a new CBS survey finds that nearly three out of four Americans believe the Trump tax cuts either raised their taxes or left them unchanged." Putting a political spin on the situation, the article states: "One of the primary reasons so many people lost their tax refunds this year is that the Trump tax cuts phased out many deductions that disproportionately benefit residents of blue states (such as the state and local tax deduction, which is more valuable in areas that have high state and local taxes). Thus, Republican strongholds have largely escaped 'refund shock,' which has been concentrated in high-tax, Democratic areas. But 'red' and 'blue' America share one macroeconomy. And if consumer spending in blue areas drops off enough, it could take red America's economic growth down with it."

(3) *Relief for upper-income taxpayers.* Ironically, upper-income taxpayers with high SALTs and mortgage interest outlays were probably pleasantly surprised that the bottom lines of their 2018 returns weren't much different than their 2017 returns. That's because most of them were subject to the alternative minimum tax (AMT). Under the new tax law, many fewer people are paying the AMT, and getting a small benefit from deducting \$10,000 of their SALT expenses.

(4) *Taxes have consequences.* It's actually hard to see the impact of the tax cuts on consumers in the monthly personal income data, which is seasonally adjusted and annualized. On this basis, there was a slight dip in income taxes early last year before this series resumed rising to a record \$2.1 trillion during February ([Fig. 1](#)). Adjusted for inflation, the dip has been followed by a flat trend in income taxes.

Current personal taxes paid in personal income as a percentage of personal income is down from 12.1% at the end of 2017 to 11.6% during February of this year ([Fig. 2](#)).

Notwithstanding solid employment gains, inflation-adjusted retail sales growth actually declined 0.4% (saar) during the three months through February, based on the three-month average ([Fig. 3](#)). That weakness might be mostly attributable to terrible winter weather and the partial shutdown of the federal government during that period.

Then again, uncertainty about upcoming tax returns might also have put a lid on consumer spending. Indeed, there is evidence that some of the windfall Americans received from the tax cuts went into saving. The 12-month sum of personal saving rose from \$957 billion during November 2016 (when Trump was elected) to \$987 billion during December 2017 (when the tax cut was enacted) to \$1.06 trillion during January ([Fig. 4](#)).

Needless to say, many factors drive consumer and business confidence. Tax changes can certainly have a big impact. After Trump won the election, the Consumer Confidence Index (CCI) soared from 100.8 during October 2016 to 123.1 during December 2017, on expectations of tax cuts ([Fig. 5](#)). After taxes were actually cut, the CCI rose to a cyclical high of 137.9 during October. It has edged down since then to 124.1 during March.

When Trump was elected, 40.5% of small business owners said that taxes and government regulation

were their top problems, based on the six-month average. During March, only 29.2% said so ([Fig. 6](#)).

Taxation II: Gift Basket for Corporations? Trump's tax reform slashed the corporate statutory tax rate to 21% from 35%. The effective tax rate was lower than the official rate before the tax cut and even less than 21% last year. It was down to only 13.2% during Q4-2018, from 18.4% during the previous quarter, according to data from S&P Global ([Fig. 7](#)). That's even though the effective tax rate includes taxes imposed by state and local governments in the US as well as by foreign governments.

Joe reports that year-end funky accounting issues probably distorted the tax rate. The taxes paid are not based on "operating" activities. Occasionally, companies will record large one-time reorganization expenses and write-offs. Among Q4-2018's notable cases which resulted in tax credits, PepsiCo reorganized their international operations and Berkshire Hathaway wrote down the value of their investment in Kraft Heinz. Companies typically conduct "kitchen-sink" activity during the final quarter of the year. Indeed, a lower tax rate was also recorded during Q4-2017, when it fell to 20% from 25%, and during Q4-2016 when it dropped to 24% from 27%.

US Treasury data show that over the 12 months through March, corporate tax receipts totaled \$194 billion, down from \$286 billion over the 12-month period through December 2017, before the tax cut ([Fig. 8](#)).

As forecast by the Trump administration, some of the tax cut probably boosted capital spending. In 2018, companies in the S&P 500 index increased their spending on plants, equipment and other investments by 14% to \$638 billion ([Fig. 9](#)). Joe reports that matches the 2014 record high.

However, a 4/15 NYT [article](#) correctly observed that "companies spent significantly more last year buying back their own stock, and that amount, \$806 billion, was 55 percent higher than in 2017" ([Fig. 10](#)). Unfortunately, that incorrectly implies that the S&P 500 companies could have used all that money for better purposes, including more capital spending and paying their workers more.

As we discussed most recently in the 4/2 [Morning Briefing](#), our work shows that, since 2011, roughly two-thirds of S&P 500 buybacks might have been associated with employee stock compensation plans. Rather than aiming to artificially increase earnings per share, the goal is to offset dilution resulting from issuing more stock to pay employees.

Taxation III: Tech Companies Buying Back Shares. Our analysis of the role of share repurchases in the corporate financial activities of the S&P 500 suggests that progressives are misguided in their obsession with limiting or even banning buybacks. That's not as clear cut when the spotlight is on the S&P 500 Information Technology sector.

This was the focus of a 4/14 Bloomberg [article](#) titled "Big Tech's Big Tax Ruse: Industry Splurges on Buybacks." The two authors berate the Tech giants for pushing for Trump's tax cuts with promises to expand their capacity and payrolls.

The authors find little evidence that Big Tech kept its end of the bargain in 2018. Instead, they see that these companies spent most of their tax windfalls on buybacks:

"The top 10 U.S. tech companies spent more than \$169 billion purchasing their shares in 2018, a 55 percent jump from the year before the tax changes, according to data compiled by Bloomberg. The industry as a whole authorized the greatest number of share buybacks ever recorded, totaling \$387 billion, according to TrimTabs Investment Research. That's more than triple the amount in 2017."

I asked Joe to run our analysis of S&P 500 buybacks just for the S&P 500 Information Technology sector. Here are his major findings:

(1) *Share count*. From Q4-2010 through Q4-2018, the share count for the current tech companies in the S&P 500 has dropped 17.5%, or 2.2% per year on average, according to Joe's calculations ([Fig. 11](#)). (The sector's S&P divisor plunged during Q3-2018 as a result of the shifting of companies to Communication Services and Consumer Discretionary.)

Our data show that 2018 was an outlier: The share-count declines during previous years didn't add much to earnings per share. Last year, the decline boosted the sector's earnings per share by 14 percentage points ([Fig. 12](#)).

(2) *Net buybacks*. The "wrinkle" in our analysis of buybacks is that we can derive the average price per share of the stocks in the S&P 500 Tech sector by dividing the sector's market capitalization by Joe's share-count series for the sector ([Fig. 13](#)). That allows us to convert the sector's buybacks in dollars to the actual number of shares that have been repurchased ([Fig. 14](#)).

The question is what percentage of these gross buybacks are actually used to reduce the share count as opposed to offsetting the impact of employee stock compensation plans and M&A activity? The answer is that it has been a volatile series around 50% since 2011, which is above the roughly 33% figure we previously derived for the overall S&P 500 ([Fig. 15](#) and [Fig. 16](#)).

CALENDARS

US. Wed: Advance Merchandise Trade Balance -\$53.6b, Wholesale Inventories 0.4%, MBA Mortgage Applications, DOE Crude Oil Inventories, Beige Book, Bullard, Harker. **Thurs:** Retail Sales Total, Ex Autos, Ex Autos & Gas, and Control Group 0.8%/0.7%/0.5%/0.5%, Business Inventories 0.3%, Leading Indicators 0.4%, Jobless Claims, Philadelphia Fed Manufacturing Index 11, M-PMI & NM-PMI Flash Estimates 53.0/55.0, EIA Natural Gas Report. (DailyFX estimates)

Global. Wed: European Car Registrations, Eurozone Headline & Core CPI 1.4%/0.8% y/y, Eurozone Trade Balance, UK Headline & Core CPI 2.0%/1.9% y/y, Canada CPI, Japan Industrial Production, China GDP 1.4%q/q/6.3%y/y, China Retail Sales 8.4% y/y, China Industrial Production 6.0% y/y, Carney, Villeroy. **Thurs:** Eurozone C-PMI, M-PMI, and NM-PMI Flash Estimates, UK Retail Sales Including & Excluding Auto Fuel 4.6%/4.0% y/y, Canada Retail Sales, Australia Employment Change & Unemployment Rate 15k/5.0%, Australia Business Confidence, BOE Credit Conditions & Bank Liabilities Surveys. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500 Q1 Earnings Season Monitor ([link](#)): With just over 8% of S&P 500 companies finished reporting revenues and earnings for Q1-2019, the y/y growth rates in revenues and earnings have slowed substantially from Q4. The revenue surprise metrics have weakened substantially, but earnings continue to beat forecasts. Of the 42 companies in the S&P 500 that have reported through mid-day Tuesday, 81% exceeded industry analysts' earnings estimates. Collectively, the reporters have averaged a y/y earnings gain of 4.3%, and exceeded forecasts by an average of 5.5%. On the revenue side, just 45% of companies beat their Q1 sales estimates so far, with results coming in 0.5% above forecast and 4.0% higher than a year earlier. Q1 earnings growth results are positive y/y for 69% of companies, vs a higher 94% at the same point in Q4, and Q1 revenues have risen y/y for 76% vs a higher 86% during Q4. These figures will change markedly as more Q1-2019 results are reported in the coming weeks. Looking at earnings during the same point in the Q4-2018 reporting period, a higher

percentage of companies (83%) in the S&P 500 had beaten consensus earnings estimates by a lower 2.0%, and earnings were up a higher 21.5% y/y. With respect to revenues at this point in the Q4 season, a higher 61% had exceeded revenue forecasts by a lower 0.2%, and sales rose a greater 7.8% y/y. The early results for Q1 indicate a slowdown in revenue and earnings growth from Q4, but that comes as no surprise to investors. Q4-2018 had marked the tenth straight quarter of positive y/y earnings growth and the 11th for revenue growth. Looking at the Q1 results ex-Financials and Real Estate, the earnings surprise drops to 4.9% from 5.5% and growth falls to 0.7% from 4.3%. The ex-Financials and Real Estate revenue surprise would be 0.1% instead of 0.5%, with revenue growth improving to 5.8% from 4.0%.

US ECONOMIC INDICATORS

Industrial Production ([link](#)): Industrial production is stalled just below November's record high, depressed by weak factory output. Headline production ticked down 0.1% last month—after ticking up 0.1% in February and contracting 0.3% in January—as factory output was unchanged in March after declines of 0.3% and 0.5% the prior two months. Manufacturing production contracted 1.1% (saar) last quarter, the first quarterly decline since Q3-2017, driven by a 12.8% drop in auto output—which was the steepest in almost eight years. By market grouping, business equipment production expanded for the ninth time in 10 months, by 4.9%, as output of information processing equipment soared; production of both transit and industrial equipment remained stalled around recent highs. Consumer durable goods production has slumped 4.0% since reaching a new cyclical high in December, while consumer nondurable goods production has remained in a volatile flat trend around recent highs. Meanwhile, mining output, which increased 14.4% y/y in December, hasn't posted a gain yet this year; utilities usage, on the other hand, jumped 4.5% over the first three months of this year.

Capacity Utilization ([link](#)): The headline capacity utilization rate fell in March, for the fourth month, to 78.8%, after rising to 79.6% in November—which was the highest since May 2008. It was 1.0ppt below its long-run (1972-2018) average. Meanwhile, the manufacturing capacity utilization rate slipped for the third month to a 10-month low of 76.4%, from 77.3% at the end of last year; it was about 2.0ppts below its long-run average. The utilization rate for mining sank to 90.9% last month, though remained well above its long-run average of 87.1%; the rate for utilities was unchanged at 79.9%—5.5ppts below its long-run average.

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