Valuation: Beauty & the Beast

See the collection of the individual charts linked below.

(1) More on earnings-led vs P/E-led meltups. (2) The former is more sustainable than the latter. (3) Is the “Great Rotation” finally starting? (4) Buffett Ratio is going higher, according to S&P 500 price-to-sales ratio. (5) Forward earnings soaring while forward revenues are flying. (6) REY and MAPE models show fairly valued market. (7) More on impact of TCJA on earnings. (8) DTA vs DTL.

Valuation: Extremely Fair. Despite the extraordinary ascent in their prices, stocks aren’t extremely overvalued. Of course, by some measures, they are as overvalued as they were at the tail end of the tech bubble during 1999 and early 2000. As Joe and I noted yesterday, the meltup in stock prices over the past year has been an earnings-led meltup rather than a P/E-led meltup. The latter kind usually ends badly with a meltdown. However, the current meltup has been led by strong earnings rather than levitating valuation multiples. So it is likely to be more sustainable than a P/E-led rally.

The most obvious risk is that the fundamentals driving earnings higher will also drive bond yields higher. However, stock prices might actually get a boost from rising bond yields (up to a point) if investors are rotating out of bonds and into stocks. If that happens, then the long-anticipated “Great Rotation” might finally be under way. In any event, let’s review the latest valuation metrics, recognizing that valuation, like beauty, is in the eye of the beholder:

(1) Beastly valuation measures. Let’s start with the ugliest measures, suggesting that stocks are grossly (and grotesquely) overvalued. The Buffett Ratio is equal to the US equity market’s capitalization (excluding foreign issues) divided by nominal GNP (Fig. 1). It is available quarterly and isn’t very timely. In fact, it currently is only available through Q3-2017 when it was 1.78. However, even back then it nearly matched the previous record high of 1.80 during Q1-2000.

A more timely version of this ratio is the ratio of the S&P 500 stock price index to forward revenues (i.e., sales) per share, which is available weekly. This forward price-to-sales ratio (P/S) is only available since January 2004, but it has tracked the Buffett Ratio closely since then. During the first week of January, it rose to a record high of 2.08.

(2) P/S vs P/E. The S&P 500 P/S ratio is highly correlated with the index’s forward P/E, which is about as high as it was in 2004 (Fig. 2). The P/E tends to be about 10 times greater than the P/S (Fig. 3). The same can be said for actual revenues relative to actual earnings (Fig. 4).

That’s not surprising since the E/S ratio is the profit margin of the S&P 500 (Fig. 5). The weekly forward P/S is at a record high while the forward P/E is not because earnings are rising faster than revenues. That’s been mostly attributable to faster global economic growth over the past year, and now going forward will also be attributable to the cut in the corporate tax rate at the end of last year.

As Joe and I noted yesterday, forward P/E’s are certainly elevated, with Friday’s readings at 18.5/18.4/20.0 for the S&P 500/400/600 (Fig. 6). However, they are now discounting the improvement in the outlook for forward earnings following the passage of the Tax Cut and Jobs Act (TCJA) late last
(3) **Inflation-adjusted valuation measures.** Of course, P/E and P/S models are essentially reversion-to-the-mean models. They don’t account for inflation and interest rates, which remain historically low. Not only does this boost the discounted value of earnings but it also increases the odds of a longer economic expansion. The longer investors perceive that the expansion can last, the higher the P/Es they’ll be willing to pay.

One model that reflects the impact of inflation is the S&P 500 real yield (Fig. 7). It’s only available through mid-2017, but the market was close to fairly valued back then, and is moving toward overvalued.

Our misery-adjusted P/E model (MAPE) also reflects inflation (Fig. 8). It is simply the S&P 500 forward P/E plus the misery index, which is the sum of the unemployment rate and inflation. MAPE was fairly valued at the end of last year.

**US Tax Reform: Rubik’s Cube.** The big tax changes in the TCJA are turning Q4 and FY 2017 earnings numbers into an accounting Rubik’s Cube. Under the TCJA, the federal effective statutory corporate tax rate drops to 21% from 35%. The obvious implication is that effective tax rates (ETRs) should decline for most companies. In addition, the tax rate cut will force lots of companies to take one-time earnings hits resulting from non-cash balance-sheet changes. Furthermore, lots of US multinationals will take one-time hits resulting from the newly implemented mandatory transition tax on earnings held overseas.

Analysts have their work cut out untangling the TCJA effects on the financials for the companies that they follow. It helps that public companies are required to footnote the effects of the TCJA, if material, in the notes to the 2017 financial statements. Some companies that have not reported yet are warning investors to expect big forthcoming charges. Here are some examples:

(1) **A big hit to DTA.** Deferred tax assets (DTA) are balance-sheet accounts where companies may park future expected tax deductions or credits. Net operating losses, for example, are a type of DTA. When a company incurs a net operating loss, tax rules permit corporations to carryforward any “unused” portion of the loss as an offset to future profits. On the balance sheet, the DTA reflects the amount of the “unused” loss multiplied by the tax rate expected to apply to the DTA when it is reversed, or “used up” against future profits.

This is relevant for tax accounting under the TCJA because corporations will need to revalue their DTAs at the new 21% statutory federal corporate tax rate rather than the old 35% rate. “The cumulative adjustment will be recognized in income tax expense from continuing operations as a discrete item in the period that includes the enactment date. Consequently, a calendar year-end company will need to adjust its deferred taxes” in the December 31, 2017 financial statements, according to the accountants at BDO.

During a 12/6 conference, Citigroup’s CFO John Gerspach said that Citigroup “built the DTA at a 35% tax rate.” He stated that at the new tax rate “those losses are going to be worth less than they were when we put them on the balance sheet.” In its earnings report yesterday, Citigroup reported a $22 billion charge from the TCJA. Indeed, the majority of the charge was due to writing down the company’s massive DTAs, mostly composed of net operating loss carryforwards from the financial crisis, reported the WSJ. On 12/22, Goldman Sachs announced in an SEC filing that it would take a $5 billion charge at the end of 2017 for items including “the remeasurement of U.S. deferred tax assets at lower enacted corporate tax rates.”
Not all deferred taxes are on the asset side of the ledger. Deferred tax liabilities (DTL) are the opposite of DTAs. They reflect future expected tax liabilities resulting from current transactions. JPMorgan’s Q4 earnings, reported on Friday, included a $2.1 billion gain for the revaluation of its net DTL.

Corporate financial ratios will also get all twisted up by the revaluation of deferred taxes. For example, Citigroup’s return on equity will get a boost as the company’s DTA is written down. Gerspach explained that the combination of the lower tax rate that’s going to drive higher income and the impact from writing off the DTA is “going to give us a much lower [tangible common equity] going forward, which means that we should get a nice lift in the [return on tangible common equity] going out in 2019 and 2020 … by a couple hundred basis points.”

(2) **Territorial tax system.** Before the TCJA, “companies owed income tax of up to 35 percent (with a credit for foreign income taxes paid) on profits they repatriated in the form of dividend payments from their foreign affiliates to the US parent company.” Previous accounting rules allowed companies to report net profits to their shareholders that ignored the taxes that they would owe if they were to bring foreign profits back home, observed a Tax Policy Center note. US companies’ overseas earnings could be treated as permanently invested overseas, encouraging firms to accumulate foreign assets.

With the TCJA, overseas earnings are now “deemed” as repatriated as the US transitions to a territorial tax system. EY summarized the change in a 12/16 press release: “US 10%-shareholder’s pro rata share of the foreign corporation’s post-1986 tax-deferred earnings” are to be taxed at a mandatory one-time two-tiered “toll” rate of 15.5% for liquid assets and 8% for non-liquid assets. The tax applies regardless of whether overseas earnings are physically brought back to the US or not and may be paid over a period of 8 years.

In its latest TCJA revenue estimates, the Joint Committee on Taxation (JCT) footnotes that the tax is “effective for the last taxable year beginning before January 1, 2018,” so that would be for the annual period ending December 31, 2017 for calendar-year corporations. Importantly, taxpayers can use net operating loss and foreign tax credit (FTC) carryforwards to offset the transition tax liability, according to BDO.

On JPMorgan’s Friday morning earnings conference call, CEO Jamie Dimon stated that the “impact of tax reform was largely driven by a deemed repatriation of our unremitted overseas earnings.” According to the shareholder presentation, the impact of the tax was $3.7 billion. Dimon explained that “the operative word” is “deemed.” In other words, the overseas earnings will stay overseas “in order to meet local jurisdictional capital and liquidity requirements. Separately, Citigroup anticipated the deemed repatriation would cost $3 billion to $4 billion, a non-cash one-time hit to the P&L to be covered by FTCs. Yesterday, Citigroup reported the actual hit to be about $3 billion. Approximately two-thirds of Goldman Sach’s $5 billion hit to 2017 earnings from the TCJA is due to the repatriation tax.

By the way, the repatriation tax is just a part of international income tax reform under the TCJA. Melissa and I are not international tax experts, but like other curious market analysts, we’ve studied the JCT’s estimates for the TCJA as best we can. It shows that the “deduction for dividends received by domestic corporatons from certain foreign corporations” will “save” multinationals $223.6 billion. That’s a big offset to the repatriation tax that will “cost” multinationals $338.8 billion. (For a hint at just how complicated it is to account for income taxes, have a skim of Deloitte’s 800+ page guide that was written before the TJCA was passed.)

The Tax Policy Center explained: “The rationale for imposing the one-time tax as part of a transition to a new system is that firms would have paid tax on those profits when repatriated under the previous
law. Therefore, the reforms should only fully exempt repatriations of future profits.” Reuters observed on 12/19 that the new tax law “exempts U.S. corporations from U.S. taxes on most future foreign profits, ending the present worldwide system of taxing profits of all U.S.-based corporations, no matter where they are earned. This would align the U.S. tax code with most other industrialized nations, undercut many offshore tax-dodging strategies and deliver to multinationals a goal they have pursued for years.”

(3) **Brand new bag.** The revaluation of deferred taxes and repatriation tax are really just one-hit wonders and are just the beginning of the tax reform effects. Starting in the 2018 tax year, the drop in the federal statutory corporate tax rate is a big one from 35% to 21%. Even so, ETRs probably won’t drop as much as that for most companies, as we’ve previously explained. JPMorgan’s 2016 effective tax rate was 28.4%, according to an earnings release supplement. It jumped to 31.9% for 2017 including estimated tax expense from the TCJA. For 2018, JPMorgan expects about a 19% rate. and 20% through 2020.

Dimon pointed out that’s about a 10ppt decrease (from 2016 to 2020), which is less than the 14ppt decrease in the federal statutory rate because of the “geographic mix” of JPMorgan’s taxable income among “smaller benefits associated with tax-exempt income and other deductions as a result of the lower absolute rate.” Melissa and I discussed other tax adjustments that will offset the federal statutory corporate rate reduction in our 1/9 Morning Briefing.

**CALENDARS**

**US. Wed:** Headline & Manufacturing Industrial Production 0.4%/0.3%, Capacity Utilization 77.3%, Housing Market Index 73, Treasury International Capital, Beige Book, Mester. **Thurs:** Housing Starts & Building Permits 1.280mu/1.300mu, Jobless Claims 250k, Philadelphia Fed Manufacturing Index 25.0, Weekly Consumer Comfort Index, EIA Natural Gas Report, EIA Petroleum Status Report. (Wall Street Journal estimates)

**Global. Wed:** Eurozone Headline & Core CPI 1.4%/0.9% y/y, BOC Rate Decision 1.25%. **Thurs:** China GDP 1.7%/q/6.7%y/y, China Retail Sales 10.2% y/y, China Industrial Production 6.1% y/y, Australia Employment Change & Unemployment Rate 15k/5.4%. (DailyFX estimates)

**STRATEGY INDICATORS**

S&P 500 Q4 Earnings Season Monitor ([link](#)): With 6% of S&P 500 companies finished reporting earnings and revenues for Q4-2017, their earnings surprise and y/y growth results are mixed compared to the same point during the Q3 earnings season, but all their revenue metrics have improved. Of the 30 companies in the S&P 500 that have reported, 77% exceeded industry analysts’ earnings estimates by an average of 2.9%; they have averaged a y/y earnings gain of 18.4%. At the same point during the Q3-2017 reporting period, a higher percentage of companies (83%) in the S&P 500 had beaten consensus earnings estimates by a higher 5.4%, but earnings were up a lower 14.5% y/y. Q4’s earnings surprise is typically smaller relative to Q3, so we’re not concerned. On the revenue side, 87% beat sales estimates so far, with results coming in 1.3% above forecast and 8.8% higher than a year earlier. At this point in the Q3 season, a lower 73% had exceeded revenue forecasts by a slightly lower 1.2%, and sales rose a lower 6.9% y/y. Q4 earnings results are higher y/y for 80% of companies vs a lower 85% at the same point in Q3, but revenues are higher y/y for 93% during Q4 vs 85% a quarter ago. These figures will change markedly as more Q4-2017 results are reported in the coming weeks. The earnings surprise is typically smaller during Q4 relative to Q3 because the Financials typically clear their books during Q4, so we’re not concerned. The early results on revenues are very encouraging, particularly with the percentage of companies growing y/y. Q4-2017 should mark the sixth straight
quarter of positive y/y earnings growth despite the potential negative impact of writeoffs related to the TCJA.