MORNING BRIEFING
February 8, 2018

More Tax Windfalls

See the collection of the individual charts linked below.

(1) The 1970s are back for US oil output. (2) US oil trade deficit is tiny. (3) US frackers may be about to put a lid on oil prices. (4) Energy earnings have been energized. (5) Exxon planning on spending more to make America even greater in oil production. (6) Exxon has been paying its taxes on foreign earnings. (7) Valero planning to buy back shares with extra cash. (8) Mickey’s effective tax rate will fall from 35% to 21%. (9) MaBell used cash windfall to pay bonuses and for medical plan, and will spend more on capital equipment.

Energy: Stayin’ Alive. It might be hard to take the pop music created during the 1970s seriously, but it sure was fun and memorable. Who could forget Debby Boone, the Bee Gees, or Donna Summer? Five of Billboard’s top 11 songs in the decade were sung by the Bee Gees or the group’s most famous brother, Andy Gibb. No artist has the same dominance so far in the current decade, but there’s still a little time.

The 1970s are back for the US oil industry. In December, US oil production hit record levels that exceeded anything the industry has enjoyed even during the heydays of the 1970s (Fig. 1). Production continued to rise into the new year, with weekly production hitting 10.251 million barrels a day (mbd) last week (Fig. 2).

The renaissance in US production owes everything to fracking technology that has turned the industry’s world order on its head. The US petroleum trade deficit was 2.5 mbd at year-end 2017, down from the peak deficit of 12.5 mbd in 2007 (Fig. 3). The market seemed to be absorbing the additional supply with little concern, until this week. The price of Brent crude oil hit a recent high of $70.53 on January 24 and fell back slightly to $66.86 as of Tuesday’s close (Fig. 4). The recent price represents a sharp recovery from Brent’s low of $27.88 during January 2016, but it remains far below the $100 price fetched early in the decade.

The major jump in the price of oil over the past year will help the Energy sector’s Q4 earnings. The S&P 500 Energy sector is expected to have 140.3% y/y earnings growth in Q4 and 51.0% consensus expected forward earnings growth, making it the fastest-growing sector in the S&P 500. Here’s how the other sectors’ forward earnings stack up through the week of February 1: Energy (51.0%), Financials (24.8), Materials (19.0), S&P 500 (16.1), Industrials (15.4), Consumer Discretionary (14.5), Tech (13.3), Health Care (12.1), Telecom (11.8), Consumer Staples (10.1), Utilities (5.2), and Real Estate (-10.2) (Table 1).

Not surprisingly, some of the industries with the fastest consensus expected forward earnings growth reside in the S&P 500 Energy sector: Oil & Gas Exploration & Production’s is at 208.3%, while Oil & Gas Equipment & Services’ is at 60.4% and the Oil & Gas Refining & Marketing industry’s is at 41.8%. Exxon Mobil and Valero Energy reported Q4 earnings last week. I asked Jackie to take a look at what they had to say about future growth prospects and the impact of the Tax Cuts and Jobs Act (TCJA):

(1) Exxon: Betting on the USA. Exxon Mobil’s (XOM) earnings didn’t hit expectations, but the company is going to spend lots of money in an effort to ensure that such a miss doesn’t happen again. Exxon
reported Q4 operating earnings of 88 cents a share, below the $1.04 analysts expected, as production fell 3% and the amount of volume processed at the company’s refineries dropped 4%.

Exxon anticipates spending $50 billion in the US over the next five years—about two-thirds on oil & gas exploration & development, “a lot” of which will be spent on hydraulic fracturing wells—though that’s not set in stone, explained Vice President of Investor Relations Jeff Woodbury on the company’s Q4 earnings conference call: “The $50 billion that we’ve talked about is a projection. We haven’t made a decision to move forward with those investments at this point, but certainly the US tax reform is going to strengthen and build that investment confidence.”

The company has current production of roughly 200,000 oil equivalent barrels per day in the Bakken and Permian regions, but that’s expected to surge to 700,000-800,000 by 2025. By year-end, Exxon plans to increase the number of rigs in the region from 26 to 36. The company also aims to boost productivity by drilling horizontally for longer distances. The longer wells may allow the company to increase its expected recovery from the wells by 15%-20%, Woodbury explained.

Exxon has been knitting together acreage in the US since 2009, when it agreed to buy XTO Energy for $41 billion. Last year, the company spent another $6.6 billion to buy 250,000 acres in the Permian from the Bass family. And in September, Exxon announced it had acquired 22,000 Permian acres since May but didn’t disclose the price, according to a 9/27 article in Oil and Gas Investor.

Exxon’s 2017 tax rate was 35% excluding the impacts of tax reform and asset impairments. This year, the company estimates its effective tax rate will be between 25% and 35%. The new tax plan meant Exxon enjoyed a non-cash earnings gain in Q4 of $5.9 billion related to the company’s large deferred income tax liability. Because of the tax plan, those liabilities were revalued at the lower tax rate, which resulted in the gain. Despite its massive operations abroad, Exxon won’t be paying a repatriation tax because it has been paying taxes on its non-US earnings at rates above 35% on average.

Exxon is a member of the S&P 500 Integrated Oil and Gas stock price index, which has fallen 1.8% y/y (Fig. 5). The industry’s consensus expected forward revenue growth is 13.4%, and expected forward earnings growth is 31.6% (Fig. 6). The industry’s forward P/E appears elevated at 19.6, but it reflects far lower earnings than earlier this decade when oil prices were elevated (Fig. 7).

(2) Valero: Refined results. As a refiner, Valero’s (VLO) fate is determined by the volume of oil it processes and the spread between the price of crude oil and the price of the product once refined. In Q4, Valero reported operating profit of $509 million, or $1.16 a share, which beat analysts’ estimates by eight cents a share. The adjusted results exclude a $1.9 billion income tax benefit from the TCJA. Valero expects the TCJA to lower its tax rate from 30% in Q4, excluding the income tax benefit, to 22% this year, boosting both earnings and cash flow.

“[W]e pro-forma’ed our 2017 results, and we had $3.2 billion of pretax income. We wanted to determine the change in our tax provision as well as the cash taxes, so we assumed that all available capital in 2017 was available for full expensing,” explained CEO Joe Gorder on the company’s Q4 conference call. “So, in regard to our income statement, the tax provision would be lower by approximately $230 million, or $0.50 per share. On the cash side, … our US cash taxes would decrease by approximately $400 million based on those assumptions. And then when you include the repatriation tax to transition to the Territorial system, the savings would be $350 million.”

In January, Valero’s board approved a 14% increase in its quarterly dividend to 80 cents a share. It also upped the $1.2 billion available on the company’s share buyback plan by an additional $2.5 billion.
“To the extent that we continue to throw off significant amounts of free cash flow, we’re going to have
the opportunity to continue to buy back our shares and create higher lows and higher highs in the stock
price,” said Gorder. “So, if you ask me personally if I think we’re overvalued today, I would say the
answer is no. And do I think there is upside in the stock price? I’d say yes. And as a result, I think that
you should expect that we’re going to continue to balance out our payout with repurchases.”

The company plans a moderate bump in capital spending. Last year, it spent $2.4 billion on capital
expenditures, divided between $1.3 billion spent on sustaining the business and $1.1 billion on boosting
the company’s growth. This year, it will increase that amount to $2.7 billion, with $1.7 billion to sustain
the business and $1 billion on growth.

The change in tax policy could even change the calculus when considering mergers and acquisitions
because the purchase price of the property plant and equipment can be deducted in the first year of a
deal. However, since sellers are aware of this benefit, it’s likely they’ll start asking for more to sell their
assets.

Valero is a member of the S&P 500 Oil & Gas Refining and Marketing stock price index, which has
jumped 30.7% y/y (Fig. 8). The industry’s forward revenue growth is 6.3%, while its forward earnings
growth is 41.8% (Fig. 9). At 12.9, the industry’s forward P/E is just shy of some of the highest levels it
has touched over the past 20 years (Fig. 10).

Media and Telecom: More on Taxes. During the current earnings season for Q4-2017, Jackie and
Melissa are selectively reading the transcripts of company conference calls to see what they are saying
about the impact of the TCJA on their bottom lines. Jackie follows up her review of a couple of energy
companies with a couple from the worlds of media and telecom:

(1) Disney. Even Mickey is going to enjoy a lower tax bill this year. In its fiscal Q1 ended December 31,
Disney recognized a one-time $1.6 billion benefit from tax reform. That sum includes a $1.9 billion
benefit from remeasuring the company’s deferred tax balances to the new, lower tax rate. It’s offset by
a charge of about $300 million from accruing a deemed repatriation tax.

For the full fiscal year, the company expects its tax rate will decline to 24.5%, down from 35.0% last
year. The rate should drop to 21.0% in fiscal 2019, when fiscal Q1 is covered by the tax change. The
company’s “effective tax rate has closely mirrored the statutory rate, and we continue to expect that to
be the case going forward,” said Disney’s CFO Christine McCarthy on the company’s fiscal Q1
conference call.

In fiscal 2017, Disney paid $4.4 billion of taxes on $13.8 billion of income before taxes, for a 32.0% tax
rate, according to its earnings press release. If that tax rate had been only 21.0%, the tax bill would
have shrunk to $2.9 billion—a $1.5 billion savings.

Disney announced in the December quarter sharp increases in its dividend and share buybacks,
though it didn’t directly link those moves to tax changes. Disney’s semi-annual cash dividend payable in
January was increased to 84 cents a share from 78 cents in July. And the company repurchased 12.8
million shares for $1.3 billion in the quarter, boosting the ytd total repurchased to 17.6 million shares,
costing $1.8 billion.

Disney did directly link its lower tax payments to new employee bonuses. The company plans to pay
more than 125,000 full- and part-time employees a one-time cash bonus of $1,000 and make a $50
million investment into an education program for employees (executive-level employees are exempt).
The two programs will cost $175 million in the current fiscal year, according to a 1/23 CNBC report.
AT&T. With most of its operations in the US, AT&T is also a huge beneficiary of the tax cut. The company estimates that in 2018 its lower effective tax rate of roughly 23% will result in an additional $3 billion of cash from operations and allow the company to boost capital expenditures by $1 billion to a total of $23 billion.

The tax changes boosted Q4 earnings by $20.4 billion, or $3.16 a share, because deferred tax liabilities were recalculated using the new lower tax rate. Adjusted earnings per share were 78 cents, and above expectations. AT&T credited the lower tax rate when it paid in Q4 more than $200 million of bonuses to its more than 200,000 employees and made an $800 million medical plan contribution.

CALENDARS

US. Thurs: Jobless Claims 235k, Weekly Consumer Comfort Index, EIA Natural Gas Report. Fri: Wholesale Trade Inventories 0.2%, Baker-Hughes Rig Count. (Wall Street Journal estimates)

Global. Thurs: Germany Trade Balance (euros) 21.0b, China Trade Balance $54.7b, China Foreign Direct Investment, Canada Housing Starts 210k, BOE Bank Rate & Asset Purchase Target 0.50%/435b, BOE Inflation Report, ECB Publishes Economic Bulletin. Fri: UK Headline & Manufacturing Industrial Production 0.4%/1.2% y/y, UK NIESR GDP Estimate 0.5%, UK Trade Balance - £2400, Canada Employment Change & Unemployment Rate 10k/5.8%, China CPI & PPI 4.2%/1.5% y/y, RBA Quarterly Statement on Monetary Policy. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators (link): Our Bull/Bear Ratio (BBR) sank to 3.51 this week from 5.24 last week—which was the third straight week above 5.00. The BBR was at 5.25 three weeks ago, which was the highest since early April 1986. Bullish sentiment plummeted 11.6ppts this week to 54.4% after 16 weeks at 60.0% or above; it was at 66.7% three weeks ago, which was the most bulls since early April 1986. Most of the bulls fled to the correction camp—which jumped from 21.4% to 30.1%—its highest reading since the week of September 19. Bearish sentiment climbed to 15.5% this week from 12.6% last week, which was the fewest bears since early April 1986. The AAII Ratio fell for the second week last week from 71.7% to 60.9% over the period. Bullish sentiment fell from 54.1% to 44.8% over the two-week span, while bearish sentiment rose from 21.4% to 28.8%.

S&P 500 TCJA Earnings Leaders & Laggards (link): The 2018 earnings forecast has surged 6.4% for the S&P 500 in the seven weeks since the TCJA was signed into law on December 22. This outstanding performance has no comparison since consensus earnings forecasts were first derived in 1978. The top sector gainers since the TCJA was passed: Energy (21.3%), Telecom (15.2), Financials (11.0), and Industrials (7.6). Real Estate is the sole decliner, with a drop of 1.0%. Also underperforming the S&P 500 are Utilities (0.5), Tech (2.9), Consumer Staples (2.9), Health Care (4.3), Materials (4.5), and Consumer Discretionary (5.8). Higher oil prices, a.k.a. “animal spirits,” have contributed heavily to the improvement in Energy’s earnings. The remaining leading sectors are well ahead in part because their Q4 earnings season are more complete than the laggards, so analysts have already adjusted forecasts based on their companies’ post-TCJA earnings guidance. However, we expect their strong upward pace of revisions to wind down along with the Q4 earnings season in the coming weeks. We also expect that the change in the 2018 estimate for the lagging sectors will continue to trail the S&P 500.

S&P 500 Earnings, Revenues & Valuation (link): Last week saw S&P 500 consensus forward revenues and earnings rise to new record highs. The forward profit margin forecast rose 0.2ppt w/w to a record high of 11.8%. Prior to the passage of the TCJA, the profit margin had been steady at 11.1%
since October, which was the highest since September 2015 and up from a 24-month low of 10.4% in March 2016. Forward revenue growth for the S&P 500 improved 0.1ppt to a 12-month high of just under 5.8%. That reading compares to 5.8% in January 2017, which was the highest since May 2012, and a cyclical low of 2.7% in February 2016. Forward earnings growth rose 0.5ppt w/w to 16.1% from 15.6%, and is the highest since October 2010. That’s up a whopping 5.0ppts from 11.1% prior to the passage of the TCJA, and 11.3ppts from the cyclical low of 4.8% in February 2016. Telecom and Health Care had the biggest w/w improvement in forward earnings growth; Telecom surged 3.3ppts to 11.8%, and Health Care rose 3.1ppts to 12.1%. Energy’s contribution to forward growth peaked at the start of 2017. Looking at last week’s results, the S&P 500 ex-Energy’s forward growth was 5.3% for revenues and 14.7% for earnings. The S&P 500 ex-Energy forward profit margin rose to a record high of 12.4%, which is up from 11.7% before the TCJA. However, the forward P/E fell to 18.1 from a 16-year high of 18.6, which compares to the 15-month low of 14.9 in January 2016. The S&P 500 price-to-sales ratio fell to 2.14 from a record high of 2.16, and edged down to 2.22 from a record high of 2.23 on an ex-Energy basis. The ex-Energy forward P/E fell to 17.9 from a 14-year high of 18.3.

S&P 500 Sectors Earnings, Revenues & Valuation (link): Among the 11 sectors, consensus forward earnings forecasts rose last week for all but Real Estate. Forward revenues also rose w/w for 10/11 sectors, but Utilities was the sole decliner. Forward revenues and earnings are at or around record highs for 5/11 sectors: Consumer Discretionary, Consumer Staples, Health Care, Industrials, and Tech. Energy’s forward revenues and earnings are finally ticking higher now after being stalled since late 2016. Forward P/E ratios pulled back sharply to multi-month lows last week for all but Real Estate and Utilities. Energy’s forward P/E remains elevated relative to its past, but tumbled to a 29-month low of 21.7 from 23.8. Higher y/y margins are expected in 2018 for all but Real Estate, but the sector’s earnings includes gains from property sales and typically improve as the year progresses. The forward profit margin rose 0.8ppt w/w for Telecom, 0.3ppt for Health Care and Tech, and 0.2ppt for Energy, Industrials, Materials, and Utilities. Here’s how the sectors rank based on their current forward profit margin forecasts: Information Technology (21.8%), Financials (18.4), Real Estate (16.9), Telecom (13.0), S&P 500 (11.8), Utilities (11.7), Materials (11.2), Health Care (11.1), Industrials (9.9), Consumer Discretionary (8.0), Consumer Staples (7.0), and Energy (6.2).

S&P 500 Q4 Earnings Season Monitor (link): With nearly 59% of S&P 500 companies finished reporting earnings and revenues for Q4-2017, their revenue and earnings surprise metrics are better compared to the same point during the Q3 earnings season. Of the 293 companies in the S&P 500 that have reported through mid-day Wednesday, 79% exceeded industry analysts’ earnings estimates by an average of 5.1%; they have averaged a y/y earnings gain of 15.7%. At the same point during the Q3-2017 reporting period, a lower percentage of companies (75%) had beaten consensus earnings estimates by a slightly lower 5.0%, and earnings were up a lower 9.5% y/y. On the revenue side, 79% beat sales estimates so far, with results coming in 1.2% above forecast and 9.3% higher than a year earlier. At this point in the Q3 season, a lower 66% had exceeded revenue forecasts by a higher 1.6%, and sales had risen by a lower 6.6% y/y. Q4 earnings results are higher y/y for 80% of companies vs a lower 74% at the same point in Q3, and revenues are higher y/y for 88% during Q4 vs a lower 83% a quarter ago. These figures will continue to change as more Q4-2017 results are reported in the coming weeks. Q4’s early results on revenues are very encouraging, particularly with the percentage of companies growing y/y. Despite the potential negative impact of write-offs related to the TCJA, Q4-2017 should mark the sixth straight quarter of positive y/y earnings growth and the seventh quarter of positive revenue growth.

GLOBAL ECONOMIC INDICATORS

Germany Industrial Production (link): German industrial production dipped in December, but momentum was strong throughout 2017. “Industrial output was very dynamic in the course of 2017 but
has lost some momentum lately,” the ministry said in a statement. “Nonetheless, production is clearly pointing upward, and in light of strong orders in December and good sentiment indicators, strong manufacturing momentum can be expected in the coming months.” Germany’s headline production—which includes construction—slipped 0.6% after a downwardly revised gain of 3.1% (vs 3.4%) in November to a new record high; November’s was still the strongest advance since September 2009. (Excluding construction, production fell 0.5% after a 3.5% increase in November—also the best since gain September 2009.) Manufacturing output slipped 0.8% after a 4.4% surge in November, as declines in capital (-2.6%) and consumer nondurable (-0.9) goods production more than offset gains in consumer durable (1.7) and intermediate (1.5) goods output. Intermediate goods production reached a new record high at the end of 2017, while capital and nondurable goods production were just south of November’s record highs. Construction output fell 1.7% in December, while energy output rose 1.4%. Both total (6.5% y/y) and manufacturing (7.7) output recorded the best yearly gains since August 2011. Meanwhile, January’s M-PMI registered a robust 61.1, near December’s record high of 63.3—signaling one the greatest improvements in overall business conditions since the survey began in 1996. January’s report noted that: “[T]he rate of output growth at German factories remained strong and faster than at any other time since April 2011. Furthermore, there were sharp increases in overall production levels across each of the three main industry groupings covered by the survey: consumer, intermediate and investment.”