MORNING BRIEFING
March 14, 2018

Slicing & Dicing TCJA Earnings Windfall

See the collection of the individual charts linked below.

(1) More TCJA good news ahead in Q1-2018 earnings season. (2) Revenues also boosting earnings on better global growth, higher oil prices, and weaker dollar. (3) Upward earnings revisions for 2018 driven much more by TCJA than by better rvenues. (4) Profit margins jump as a result of TCJA. (5) Corporations likely to use TCJA windfall for capacity expansion, labor compensation, buy backs, and dividends. (6) While statutory tax rate was cut by 40%, effective rate was cut by 34%. (7) Repatriated earnings should bring back lots of cash, i.e., $1.9 trillion after taxes.

Strategy I: Adding up the Windfall. The Q4-2017 earnings season is over. Industry analysts received quite a bit of guidance on the positive impact of the corporate tax rate cut at the end of last year on earnings this year. There will be more to come during the Q1-2018 earnings season in April, which will provide more specific numbers showing how much the Tax Cut and Jobs Act (TCJA) boosted earnings during that quarter, and is likely to boost earnings over the rest of the year.

In other words, Joe and I suspect that neither the analysts nor investors have fully discounted the big windfall the TCJA will provide to corporate bottom lines. That's because corporate managements probably weren't sure themselves about the full impact of the TCJA during their conference calls in January, which obviously focused on last year's final results. So while many of them were giddy about the coming earnings boost in their calls with analysts and investors, they might actually have toned down their giddiness! Let's review what we know so far:

(1) *Revenues also boosting earnings.* Joe and I have noted on numerous occasions that the forward revenues of the S&P 500 strengthened coincidently with the passage of the TCJA (*Fig. 1*). Forward revenues is the time-weighted average of analysts' consensus estimates for the current year and coming year. Since the passage of the TCJA, their estimates for revenues have increased by 2.0% for this year and 1.8% for next year, implying a growth rate in revenues of 7.0% for 2018 and 4.5% for 2019 (*Fig. 2*).

We think this is a coincidence, since it is hard to see why revenue expectations would have been boosted by the tax reform act. That would make sense only if industry analysts all had turned into supply-side economists, believing that lower taxes will boost economic growth not only in the US but also abroad. Remember that more than 45% of S&P 500 earnings are derived from overseas sales.

Besides, S&P 500 quarterly revenues per share have been recovering since Q1-2016 following the energy-led recession in this series during the second half of 2014 and 2015 (*Fig. 3*). Since revenues per share bottomed in Q1-2016, this series is up 20.2%. It is up 9.4% y/y (*Fig. 4*).

(2) *Forward revenues growth accelerating.* The weekly series for S&P 500 forward revenues is a coincident indicator of the quarterly series (at an annual rate) (*Fig. 5*). The weekly series has been rising at a faster pace since the TCJA was enacted. However, that might reflect a combination of faster global economic growth, higher oil prices, and the positive impact of the weaker dollar on revenues.

The Global PMI rose to 54.8 during February, the highest since September 2014 (*Fig. 6*). Not surprisingly, the y/y growth rate of S&P 500 revenues per share is highly correlated with the Global PMI, which has been boosted since early 2016 by both its manufacturing and non-manufacturing components (*Fig. 7*). The trade-weighted dollar is down 8% y/y, and may be boosting revenues growth by half that amount since almost 50% of revenues are earned abroad (*Fig. 8*). The price of a barrel of Brent crude oil is up 26.5% y/y currently.

(3) *TCJA accounts for most of the upward earnings revisions.* S&P 500 earnings per share is equal to the profit margin times revenues for these 500 corporations. The math shows that since the passage of the TCJA through the week of March 1, the consensus estimate for 2018 earnings is up 7.9%, while the revenues estimate is up 2.0%, as the profit margin jumped 0.6ppt to 11.8% (*Fig. 9*). For 2019, the consensus estimate for earnings is also up 7.9%, while that for revenues is up 1.8%, with an implied profit margin increase of 0.7ppt to 12.4%.

The increase in revenues reflects mostly the strength of the global economy, higher oil prices, and the weakness in the dollar. If so, then most of the increase in earnings expectations is attributable to the TCJA, as reflected in the jump in 2018 and 2019 profit margins.

(4) *Profit margin leaves lots of room for spending.* The actual operating profit margin of the S&P 500 rose to a record 11.0% during Q4-2017, based on Thomson Reuters operating earnings (*Fig. 10*). As a result of the passage of the TCJA, the forward profit margin (calculated using weekly forward earnings and forward revenues) jumped to 12.0%. This weekly series tends to be a good coincident indicator of the actual quarterly series.

The profit-margin boost from the TCJA leaves companies with lots of room to spend more on capacity expansion and/or modernization. They can also increase labor compensation to retain and to attract workers, and to reduce pension liabilities. With their additional cash flow, they can also buy back shares and boost dividends. They could even lower their prices if that made sense for competitive reasons. Odds are, collectively they will do all of the above.

(5) *The bottom line.* Just before the passage of the TCJA, industry analysts were forecasting that the S&P 500 would earn $146.26 per share in 2018; 12 weeks later—during the week of March 8—their estimate is up $11.82 per share. Earnings growth has been revised up dramatically from 11.4% to 19.4% (*Fig. 11*).

Strategy II: Effective Tax Rate Math. The upward revisions in earnings estimates since TCJA passage are impressive not only in magnitude but also in their implications for corporate tax rates. They confirm our view that the effective corporate tax rate was below the statutory 35% before it was slashed by 40% to 21%. Let's do the math using $12 per share as the earnings windfall to the S&P 500. That's an 8% windfall assuming that all of it was attributable to the TCJA.

During Q4-2017, aggregate earnings for the S&P 500 was $1.2 trillion at an annual rate (*Fig. 12*). So that implies that S&P 500 corporations' tax bill will be lower by $96 billion this year. Last year, they paid $283 billion in federal corporate income taxes. This implies a 34% cut in the effective tax rate. That's still a substantial windfall.

Strategy III: Repatriated Earnings. Of course, some of the tax windfall will be offset by the requirement that profits that have been retained abroad to avoid paying the 35% corporate rate be repatriated at a 15.5% rate for liquid assets (8% for illiquid assets). The Fed's *Financial Accounts of the United States* tracks such profits data for nonfinancial corporations. Last year, foreign earnings retained abroad by these companies amounted to $213.5 billion (*Fig. 13*). The cumulative total since Q1-1980 was $3.6 trillion at the end of last year (*Fig. 14*). The Congressional Joint Committee on Taxation estimates that tax revenues will add up to $338.8 billion over the next 10 years from the repatriation of "deferred foreign income." This estimate implies that repatriated earnings are expected to be around $2.26 trillion. So corporations will have around $1.9 trillion in cash to spend.

CALENDARS

US. Wed: Retail Sales Total, Ex Autos, Ex Autos & Gas, Control Group 0.4%/0.4%/0.4%/0.5%, Business Inventories 0.5%, PPI-FD Total, Core, Core Less Services 0.2%/0.2%/0.3%, MBA Mortgage Applications, Atlanta Fed Business Inflation Expectations, EIA Petroleum Status Report. **Thurs:** Jobless Claims 229k, Empire State Manufacturing Index 15.0, Philadelphia Fed Manufacturing Index 23.0, Import & Export Prices 0.3%/0.3%, Housing Market Index 72, Weekly Consumer Comfort Index, EIA Natural Gas Report, Treasury International Capital. (*Wall Street Journal* estimates)

Global. Wed: Eurozone Industrial Production -0.4%m/m/4.7%y/y, Eurozone Employment, Germany CPI 0.5%m/m/1.4%y/y, China Retail Sales (ytd) 10.0% y/y, China Industrial Production (ytd) 6.2% y/y, Draghi. **Thurs:** European Car Sales. (DailyFX estimates)

STRATEGY INDICATORS

YRI Weekly Leading Index (*link*): Our Weekly Leading Index (WLI)—a good coincident indicator that can confirm or raise doubts about stock market swings—was little changed around its record high during the week of March 3. It edged down 0.4% after climbing six of the prior seven weeks by a total of 10.3%. Our WLI is the average of our Boom-Bust Barometer (BBB) and Bloomberg's Weekly Consumer Comfort Index (WCCI). Our BBB edged down 0.8% after jumping 16.8% over the prior seven-week period, to a new record high. Jobless claims, one of the components of our BBB, ticked up to 222,500 (4-wa) after declining six of the prior seven weeks—from 250,750 to 220,500 (4-wa)—which was the lowest level since 1969. Meanwhile, the CRB raw industrial spot price index, another BBB component, continues to rebound from its recent setback. The WCCI remains on a steep uptrend, reaching new cyclical highs.

S&P/Russell LargeCaps & SMidCaps (*link*): LargeCaps are performing about the same as SMidCaps so far in 2018, but the SmallCaps are closest to their January record highs now. Here's how they rank ytd through Monday's close, along with their 2017 performance and their percentage changes since their record highs in January: Russell SmallCap 2000 (4.3% ytd, 13.1% in 2017, -0.6 from record high), S&P LargeCap 500 (4.1, 19.4, -3.1), Russell LargeCap 1000 (4.1, 19.3, -2.9), S&P SmallCap 600 (4.0, 11.7, -0.6), and S&P MidCap 400 (2.7, 14.5, -2.2). Forward revenues and earnings are at record highs now for all the S&P and Russell indexes. Momentum remains strong, as the yearly change in forward earnings is up from six-year lows in early 2016 and should remain strong in 2018 due to the big boost from the TCJA. In the latest week, the rate of change in LargeCap's forward earnings rose to 20.2% y/y from 20.1%, which is its highest since May 2011 and compares to a six-year low of -1.8% in October 2015; MidCap's dropped to 23.1% from 23.4%, and is down from late February's 23.9%, which had been the highest since April 2011 and compares to a six-year low of -1.3% in December 2015; and SmallCap's jumped to 23.7% from 22.1%, which was the highest since July 2011 and compares to a six-year low of 0.3% in December 2015. Consensus expected earnings for 2018 and 2019 were slightly higher w/w for all three indexes. Here are the latest consensus earnings growth rates for 2018 and 2019: LargeCap 19.4% and 10.0%, MidCap 20.6% and 12.4%, and SmallCap 24.0% and 15.3%.

S&P 500 Growth vs Value (*link*): The S&P 500 Growth index is up 8.0% ytd, well ahead of the less than 0.1% decline for its Value counterpart. During 2017, Growth's 25.4% was double the 12.6% rise for Value. Growth had trailed Value in the four months following the election. Now Growth's 38.0% gain since the election is leading the 21.0% increase logged by Value. During 2016, the S&P 500 Growth index underperformed its Value counterpart by a wide margin, rising just 5.1% vs Value's 14.3% gain. Growth is expected to deliver more than double the rate of revenue growth (STRG) that Value does over the next 12 months, but forward earnings growth (STEG) is only slightly higher for Growth; specifically, 9.2% STRG and 16.7% STEG are projected for Growth, respectively, vs 4.7% and 15.7% for Value. Prior to February's selloff, Growth's P/E of 21.8 was its highest since May 2002, while Value's 16.6 was its highest since April 2002. Through Monday, Growth's P/E had recovered to 20.5 and Value's to 14.9. Regarding NERI, Growth's was positive in February for a tenth straight month, and soared to a record high of 21.2% from 11.4% in January; that compares to a five-year low of -16.2% in April 2015. Value's NERI was also positive in February for a tenth month (following 33 months of negative readings), and rose to record high of 20.4% from 12.7%; that compares to a five-year low of -20.3% in April 2015. The TCJA has boosted the consensus 2018 earnings estimate and the forward profit margin for both Growth and Value. Growth's 2018 estimate has risen 7.0% vs Value's 6.2% gain. Growth's forward profit margin has jumped to a record high of 16.2% from 14.4% prior to the TCJA's passage, and Value's has risen to a 10-year high of 9.8% from 9.1%.

US ECONOMIC INDICATORS

NFIB Small Business Optimism Index (*link*): "The historically high readings indicate that policy changes—lower taxes and fewer regulations—are transformative for small businesses. After years of standing on the sidelines and not benefiting from the so-called recovery, Main Street is on fire again," according to the National Federation of Independent Business (NFIB) president. For the first time since 2006, taxes received the fewest votes as the number-one business problem for small business; reports of few qualified workers remained the number-one problem—receiving the most votes since 2000. February's Small Business Optimism Index (SBOI) rose to 107.6, the second-highest reading in the 45-year history of the survey—just 0.4ppt below July 1983's record high of 108.0. It was at 94.9 during October 2016, just before the election. In February, seven of the 10 components posted gains, led by sales expectations (28% from 25%), expect the economy to improve (43 from 41), and current inventory (-3 from -5), while plans to increase inventories (4 from 3), expected credit conditions (-3 from -4), and earning trends (-3 from -4) each ticked up a percentage point—with the latter the highest since 1987. Hirings (18 from 20) was the lone decliner, falling for the third straight month since reaching a record high of 24% in November. The remaining two components, capital spending plans (29%) and now is a good time to expand (32), were unchanged last month—the latter remaining at January's record high.

US CPI (*link*): The core CPI rate in February remained below the Fed's target rate of 2.0% y/y for the 11th month, after 17 months at 2.0% or above. The yearly rate held at 1.8% y/y last month, where it's been four of the last five months, after five months at 1.7%. Meanwhile, the three-month rate accelerated 3.1% (saar), the fastest since January 2008. On a monthly basis, core prices rose 0.2%, slowing from January's 0.3% gain—which is also how it began 2007; in between, core prices rose either 0.1% or 0.2% last year, except for a 0.1% downtick last March. Among the indexes posting gains last month were shelter, apparel, motor vehicle insurance, household furnishings & operations, education, personal care, and air fares, partially offset by lower prices for communication, new vehicles, medical care, and used cars & trucks. The headline CPI rose 0.2% m/m, less than half January's 0.5%; the yearly rate edged up from 2.1% to 2.2%—fluctuating between 2.0% and 2.2% the past six months.

Contact us by email or call 480-664-1333.

Ed Yardeni, President & Chief Investment Strategist, 516-972-7683
Debbie Johnson, Chief Economist, 480-664-1333
Joe Abbott, Chief Quantitative Strategist, 732-497-5306

Melissa Tagg, Director of Research Projects & Operations, 516-782-9967
Mali Quintana, Senior Economist, 480-664-1333
Jackie Doherty, Contributing Editor, 917-328-6848
Valerie de la Rue, Director of Institutional Sales, 516-277-2432
Mary Fanslau, Manager of Client Services, 480-664-1333
Sandy Cohan, Senior Editor & Webmaster, 570-775-6823