



MORNING BRIEFING

December 13, 2016

Earnings in Trump World

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

(1) Raising earnings estimates on assumption of big corporate tax cuts and fewer regulations. (2) Investors have been doing the same on expectations that industry analysts will do so too when they know more about specifics. (3) So maybe recent melt-up isn't irrational exuberance. (4) Here's why earnings might be up 20% next year. (5) Modest headwinds from higher dollar and bond yields. (6) Republicans have a controversial border tax plan. (7) If WTO shoots it down, VAT might be backup plan.

Strategy: Raising Our Earnings & Market Estimates. Yesterday, Joe reported that S&P 500 earnings will get a big boost from Trump's corporate tax-cut plan if it is enacted by Congress. We've been so busy writing about the various economic proposals of the incoming new administration that it hadn't dawned on us until this past weekend that we need to actually raise our earnings estimates for 2017 and 2018. That's based on the assumption that the statutory corporate tax rate will be cut from 35% to 15% sometime next year. We've been also assessing the likelihood of Trump's various economic proposals. The tax cuts look the most likely to be implemented, and relatively quickly. Even if they aren't enacted until next summer, they most likely will be retroactive to the beginning of 2017.

So without any further ado, we are raising our S&P 500 operating earnings estimate for 2017 from \$129 per share to \$142 (on a Thomson Reuters basis). For 2018, our estimate is now \$150, up from \$136.75. Following the anemic earnings growth of 0.9% during 2016, we now expect growth of 19.8% in 2017 and 5.6% in 2018. Consequently, we are also raising our 2017 target for the S&P 500 from 2300-2400 to 2400-2500. Consider the following:

(1) *Trump P/E melt-up anticipating higher earnings.* The vertical ascent in stock prices since Election Day reflects the realization by investors that earnings will get a big and permanent boost from lower corporate tax rates. A reduction in the regulatory burden promised by Trump also will boost earnings, though that's harder to estimate. In any case, forward P/Es have soared on expectations that industry analysts soon will be raising their earnings estimates to reflect lower taxes and regulations. Once those estimates are raised, forward P/Es might come down a bit or at least stop going up. In other words, the Trump melt-up so far might be well justified by the outlook for earnings if corporate tax rates are cut. In addition, personal income taxes will be cut, which will be good for sales and earnings.

(2) *Why haven't industry analysts been raising their earnings estimates? Why haven't investment strategists been doing the same?* They all are waiting for the President-elect to move into the White House. Then we all will have a better idea of what is in store for the obligatory "first 100 days" of frenetic policymaking. What will the administration actually propose? How will Congress change the proposals? What will be the actual outcomes?

We aren't waiting. We agree with the market that significant changes are coming, and they will most likely be good for the economy, business, earnings, and stock prices. Meanwhile, we will be tracking the consensus earnings expectations of industry analysts for the S&P 500/400/600 for 2017 ([Fig. 1](#) and [Fig. 2](#)). So far, there is no sign that their earnings estimates reflect Trump's 8/8 campaign [speech](#) to the Detroit Economic Club on his economic plan, which was also outlined in his 10/22 "[Contract with the](#)

[American Voter](#).” Consensus expectations haven’t changed much for next year’s quarterly earnings growth rates. For the S&P 500, they are currently 13.7% y/y for Q1, 10.5% for Q2, 9.7% for Q3, and 14.5% for Q4.

During the week of December 8, industry analysts estimated that S&P 500 operating earnings will be \$132.63 per share in 2017 and \$148.16 in 2018, yielding growth rates of 12.2% and 11.7% ([Fig. 3](#)). We compare their estimates to ours in the [YRI S&P 500 Earnings Forecast](#). If and when industry analysts conclude that they know enough to raise their earnings estimates as a result of Trump’s tax cuts, forward profit margins are likely to show significant increases to reflect the tax cuts ([Fig. 4](#)). Looking at the profit margins for the S&P 500/400/600, we see some signs that this may be starting to happen for the S&P 400 MidCaps, but not for the SmallCaps and the LargeCaps.

(3) *Joe did the math on earnings yesterday*. In case you missed it, here is the relevant excerpt from Monday’s [Morning Briefing](#): “I asked Joe to look at the impact on S&P 500 earnings of a cut in the corporate tax rate to 15%. Using available annual data, he determined that the effective rate was 27.5% during 2015 ([Fig. 5](#)). During the past decade, S&P 500 earnings slowly benefitted from lower interest expense and share buybacks. A cut in the tax rate would yield an immediate and permanent benefit to S&P 500 earnings. The consensus currently estimates S&P 500 earnings will be around \$132 per share in 2017. Using 2015’s effective rate of 27.5%, each percentage-point decrease in the effective corporate tax rate would add \$1.82 to consensus 2017 earnings. A 5ppt reduction in the tax rate would add \$9.10 to earnings, and a 10ppt reduction would add over \$18, or nearly 14%, to earnings. The bottom line is that the ramifications of a tax-rate cut are significant and could reprice the S&P 500 index even higher.”

To be clear, our new post-election \$142 estimate for 2017 is based on our pre-election estimate of \$129 plus \$13 resulting from a combination of tax cuts and lower regulatory costs. Our new estimate now exceeds the analysts’ current estimate of \$132, which certainly doesn’t reflect the likelihood of a tax cut yet.

By the way, while Joe figures that the effective tax rate for the S&P 500 was 27.5% during 2015, it was 25.0% for all corporations during Q3 of this year based on data provided along with GDP in the National Income & Product Accounts ([Fig. 6](#)). Both measures include federal, state, and local taxes.

(4) *S&P and DB have similar estimates for tax-cut impact on earnings*. A 12/1 [article](#) posted on CNBC.com reported: “In an analysis released Thursday, S&P Global Market Intelligence estimates that, in a perfect world, the impact of slashing the highest-in-the-world U.S. corporate tax rate could be a nearly immediate 11 percent boost to the market. The effective tax rate, or the one that companies in the S&P 500 actually pay after deductions, is 29 percent, according to S&P.

“According to what were termed ‘back-of-the-envelope calculations,’ the ramifications go something like this: Current expectations for 2017 S&P 500 earnings indicate growth of 11.8 percent, or \$131 per share. So each 1 percentage reduction in the corporate tax rate would add \$1.31 to anticipated earnings. A 5 percent reduction would bump up earnings by \$6.55, while a 10 percent cut would boost EPS by \$13.09. That would translate into respective earnings gains of 17.4 percent and 23 percent.”

Also on this subject, a 11/21 [article](#) in Bloomberg reported: “Deutsche Bank Chief U.S. Equity Strategist David Bianco believes that investors are under-appreciating the ‘much higher chance now of a long lasting economic expansion that rivals the 10-year U.S. record.’” Bianco thinks the likelihood that the Trump administration will cut corporate taxes will be a major stimulus to the bottom lines of US companies. According to the Bloomberg article, “Deutsche Bank estimates that the U.S. corporate tax rate will be cut to about 25%--which would bring it in line with the Organization for Economic

Cooperation and Development (OECD) average--and suggests that every five-percentage point cut lifts the earnings per share of S&P 500 companies by a cumulative \$5.00."

(5) *The downside for earnings may be higher interest rates and an even stronger dollar.* Of course, Trump World may not be a perfect one for earnings. Corporate bond yields have already increased by about 80bps since their record lows during early July of this year ([Fig. 7](#)). The JP Morgan trade-weighted dollar is up 24% from its July 2014 low, and could conceivably rise by another 10% ([Fig. 8](#)).

Trump World: Border Tax? If you think an across-the-board tax reduction for corporations from 35% down to 15% seems too good to be true, you might be right, for some companies. There is indeed a catch. Trump has warned that companies producing goods overseas and then selling them in the US will face higher taxes. How exactly this would come about is anyone's guess. I asked Jackie to investigate this issue, focusing especially on the so-called "border tax." Here's a look at what Trump and the Republicans have said on the matter and which companies it could affect according to Jackie:

(1) *Reading between the tweets.* So far, much of the President-elect's opinion on taxes on US imports has been delivered via tweet--six [tweets](#), to be exact. On 12/4, Trump tweeted: "The U.S. is going to substantially reduce taxes and regulations on businesses, but any business that leaves our country for another country, fires its employees, builds a new factory or plant in the other country and then thinks it will sell its product back into the U.S. without retribution or consequence, is WRONG! There will be a tax on our soon to be strong border of 35% for these companies wanting to sell their product, cars, A.C. units etc., back across the border. This tax will make leaving financially difficult, but these companies are able to move between all 50 states, with no tax or tariff being charged. Please be forewarned prior to making a very expensive mistake! THE UNITED STATES IS OPEN FOR BUSINESS."

As a presidential candidate, Trump made headlines in September when he vowed to place a 35% tax on Ford's cars made in Mexico and sold in the US after Ford announced plans to shut down a US small-car plant and move it to Mexico. "When that [Ford] car comes back across the border into our country that now comes in free, we're gonna charge them a 35% tax. And you know what's gonna happen, they're never going to leave," Trump was quoted saying to Fox News in a 9/15 CNN [article](#).

(2) *Republicans have a plan.* Some believe Trump ultimately will pattern his tax proposal on the Republican's "A Better Way" [tax plan](#) crafted by a task force created by House Speaker Paul Ryan and headed by House Ways and Means Committee Chairman Kevin Brady. The plan notes that foreign governments often use value-added taxes, or VATs, which are rebated when a product is exported and imposed when a product is imported. Because the US does not use VATs, it argues, our products are at a disadvantage and our domestically based companies are incentivized to leave.

The task force proposes moving from an income tax to a "cash-flow based" approach that imposes taxes based on the destination of the product. Products sold outside of the US will not be taxed regardless of where they are produced. Products imported into the US will be subject to a US tax regardless of where they are produced. Hence, this tax is often referred to as a border tax. "This will eliminate the incentives created by our current tax system to move or locate operations outside the United States. It also will allow U.S. products, services, and intangibles to compete on a more equal footing in both the U.S. market and the global market," the plan states.

The task force believes their tax plan will pass muster with the World Trade Organization because the WTO allows border-tax adjustments with consumption-based taxes, but it does not permit those adjustments with income-based taxes.

There's speculation that the plan will be put into effect by changing how much of a company's cost of

goods sold can be deducted. Get ready, it's painful to follow: According to an 11/23 [article](#) in Politico, "An example of how the math might work: Say a company sells something for \$100. Under current law, it deducts its expenses from that sale to determine its taxable income. If the company bought \$80 in imported goods, and had an additional \$15 in other expenses, it could subtract \$95 from that \$100 sale. That would leave a \$5 profit, on which it would pay the 35 percent corporate income tax--producing a \$1.75 tax bill.

"Under the Republican plan, the company would get a much lower 20 percent corporate rate. But if it could not deduct the cost of their imported goods, they'd pay 20 percent on that \$5 profit along with the \$80 for what they bought from abroad. That would mean a \$17 tax bill--more than triple their \$5 profit."

(3) *Critics critique*. Not everyone is so sure that a move to a border tax is a great thing. Some question whether the adoption of a border tax would cause the dollar to rise, offsetting the positive impact of the tax. "If U.S. exporters, freed of tax, are able to charge less for their goods abroad, demand for them--and the U.S. dollar--could rise, leading to higher overseas prices and ultimately moderating overseas sales for those same products," a 12/9 *WSJ* [article](#) postulated. Another concern the article highlights is the response of foreign countries. They could retaliate with additional taxes or file a challenge in the WTO, leaving the US tax plan "in limbo for years."

Koch Industries recently came out against the plan, saying it would "distort the market" and raise prices, hurting the US consumer and economy. Retailers are also gearing up for a fight. According to the Politico article cited above, "Many retailers fear that, even with Republicans promising to slash the corporate tax rate, they will still face big tax increases that in some cases will exceed their profits. On high alert over the proposal, retailers have begun a big lobbying campaign on the Hill, warning lawmakers and their aides that any tax hikes will get passed on to their constituents in the form of higher prices."

Increased taxes could hurt the motor vehicle and retail industries and help chemicals and electronics companies, according to Ernst & Young LLP, the 12/9 *WSJ* article stated. So far, it's not showing up in the S&P 500 stock market results from the election through Friday's close. Since November 8, shares in the S&P 500 Automobile Manufacturers industry have risen (by 16.7%), and so have Department Stores (18.9), Home Improvement Retail (8.6), and Apparel Retail (8.1). Shares in most of those industries have outperformed shares in various chemicals industries: Commodity Chemicals (12.0%), Fertilizers & Agricultural Chemicals (9.7), Diversified Chemicals (7.9), and Specialty Chemicals (5.7). But it might help explain why the more domestically focused S&P 600's 18.1% return since the election has far outpaced the 5.6% return of the S&P 500.

(4) *Trojan Horse for VAT?* We think that tax cuts are highly likely, and it's clear that the border tax proposal fulfills both the need to raise offsetting funds and to encourage domestic production. However, if the WTO objects to the border-tax proposal, it may quickly evolve into a back-door way for Republicans to implement a VAT system in the good ole USA.

CALENDARS

US. Tues: NFIB Small Business Index 96.5, Import & Export Prices -0.4%/0.0%, FOMC Meeting Begins. **Wed:** Retail Sales Total & Ex Auto 0.4%/0.3%, Business Inventories 0.0%, Industrial Production Headline & Manufacturing -0.2%/-0.1%, Capacity Utilization Rate 75.0%, Headline & Core PPI-FD 0.2%/0.2%, MBA Mortgage Applications, FOMC Announcement. (Bloomberg estimates)

Global. Tues: Germany CPI 0.8% y/y, Germany ZEW Economic Sentiment 14, UK Headline & Core CPI 1.1%/1.3% y/y, Japan Tankan Survey. **Wed:** Eurozone Industrial Production 0.1% m/m/0.8% y/y,

UK ILO Unemployment Rate 4.8%, UK Jobless Claims Change & Claimant Count Rate 6.5k/2.3%, Australia Employment Change & Unemployment Rate 17.5k/5.6%. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings ([link](#)): Forward earnings rose last week for all three indexes for a third week--to record highs for LargeCap and MidCap. SmallCap's remained 0.2% below its mid-October record. All three indexes have been on solid uptrends since March, and two--MidCap and SmallCap--at record highs until recently since June. The yearly change in forward earnings for all three indexes has been edging higher from six-year lows in early 2016 as y/y comparisons have eased. In the latest week, LargeCap's forward earnings improved to a 22-month high of 3.3% y/y from 3.2%, which compares to a six-year low of -1.8% in October 2015; MidCap's improved to 4.3% from 4.2%, but remains near early November's 18-month high of 4.5%, which compares to a six-year low of -1.3% in December 2015; and SmallCap's rose to a 23-month high of 7.9% from 7.4%, which compares to a six-year low of 0.3% in December 2015. Growth rates now expected for 2016 and 2017: LargeCap 0.6% and 12.2%, MidCap 1.5% and 12.5%, and SmallCap 6.8% and 15.7%.

S&P 500/400/600 Forward Valuation ([link](#)): Valuations surged again last week to multi-year highs for two of these three indexes. LargeCap's forward P/E rose to a 21-month high of 17.1 from 16.7. That's up from a 15-month low of 14.9 in mid-January, but remains slightly below the 11-year high P/E of 17.2 in February 2015 (when Energy sector earnings were depressed), and well below the record high of 25.7 in July 1999. MidCap's forward P/E jumped to a 15-year high of 19.2 from 18.4; that's up from a three-year low of 15.0 in mid-January and compares to its record high of 20.6 in January 2002. SmallCap's surged to a 15-year high of 20.5 from 19.4, up from a three-year low of 15.5 in mid-February, and compares to a record high of 20.9 in April 2002.

S&P 500 Sectors Quarterly Earnings Outlook ([link](#)): Q4 earnings estimate revision activity picked up last week for the S&P 500 sectors. The Q4 consensus dropped w/w for five of the 11 S&P 500 sectors, rose for three, and was steady for three. Financials was the biggest gainer, as its Q4 forecast rose 0.2% w/w, followed by 0.1% gains for Health Care and Tech. Sectors with the biggest w/w declines in Q4 forecasts: Materials (-1.2%), Energy (-0.9), and Industrials (-0.7). The S&P 500's Q4-2016 EPS forecast dropped 6 cents w/w to \$30.87 and is down 2.1% from \$31.53 at the end of Q3. That represents a forecasted pro forma earnings gain of 6.0% y/y, down from 6.2% a week earlier and down from 8.3% at the end of Q3. Since the end of Q3, Q4 estimates are higher for 3/11 sectors and lower for 8/11. Energy's Q4 forecast has risen 1.9%, while Tech's has gained 1.7% and Financials' 0.3%. Materials is down the most (-13.5), followed by Utilities (-6.7), Industrials (-5.7), Real Estate (-5.6), and Consumer Discretionary (-4.7). The S&P 500's Q4-2016 forecasted earnings gain of 6.0% y/y would be its second straight gain after four declines and compares to Q3-2016's blended 4.3%, Q2-2016's -2.1%, Q1-2016's -5.0%, Q4-2015's -2.9%, Q3-2015's -0.8%, Q2-2015's 1.3%, and Q1-2015's 2.2%. Just four of the 11 sectors are expected to beat the S&P 500's y/y earnings gain of 6.0% in Q4-2016, but analysts expect a y/y earnings gain in Q4-2016 for 9/11 sectors. That would match the 9/11 sectors rising in Q3-2016, which was the best since Q1-2015, and compares to 6/10 rising during the quarters from Q4-2015 to Q2-2016. Energy is expected to turn positive y/y in Q4-2016 for the first time since Q3-2014. The latest forecasted Q4-2016 earnings growth rates vs. their blended Q3-2016 growth rates: Financials (15.4% vs. 8.6%), Utilities (10.5, 10.9), Tech (7.4, 11.5), Consumer Staples (6.2, 7.0), S&P 500 (6.0, 4.3), Materials (5.9, 10.7), Health Care (5.7, 7.6), Energy (4.0, -67.3), Consumer Discretionary (2.0, 8.7), Real Estate (0.2, 2.5), Telecom (-0.6, -1.8), and Industrials (-4.0, 4.0).

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