MORNING BRIEFING
December 12, 2017

Taxing Matters

See the collection of the individual charts linked below.

(1) Puzzling over a big divergence on corporate taxes. (2) Thanks to QE programs, Fed's profits soared along with its balance sheet. (3) Fed's profits included in NIPA measure of corporate taxes, not in IRS tabulation. (4) NIPA also includes corporate taxes paid to other taxing authorities besides the IRS. (5) IRS data suggest corporate federal tax rate well below 20%. (6) Work in progress. (7) S&P 500 tax data suggest big corporations aren't free-loading on the tax system as much as widely believed.

US Corporate Taxes I: Mystery Solved. Melissa and I have been puzzling over the significant difference between the NIPA measure of corporate profits taxes and the revenues actually collected by the IRS from corporations. NIPA stands for "National Income and Product Accounts," which are compiled by the Bureau of Economic Analysis to measure GDP. NIPA, therefore, has to be comprehensive to capture all components of the economy that add up to GDP. The IRS, on the other hand, is only interested in measuring how much tax revenues are being collected. Let's see how all this impacts the measurement of corporate tax revenues:

(1) The NIPA's all-encompassing approach can be seen in the way it measures corporate profits. For example, it includes the profits earned by the Federal Reserve Banks (*Fig. 1*).They are incorporated entities. There are 12 of them in the Federal Reserve system. Collectively, their profits have soared as the Fed's balance sheet was loaded up with bonds acquired through QE programs from December 2008 through October 2014 (*Fig. 2*). Over this period, the Fed's balance sheet ballooned by $2.4 trillion to $4.4 trillion. That's after it had ballooned from about $800 million to about $2.0 trillion from September to December 2008 as a result of numerous emergency liquidity facilities that were replaced by QE programs.

(2) The Fed has been earning interest on all those bonds. As a result, the NIPA show that the Fed's profits jumped from $27 billion (saar) during Q1-2009 to a record $105 billion during Q2-2014. They've come down a bit since then to $82 billion during Q3.

(3) The Fed is required to return the profits from its operations, net of expenses, to the Treasury. This item is buried in Table 4 of the *Monthly Treasury Statement of Receipts and Outlays* as "Miscellaneous Receipts: Deposits of Earnings, Federal Reserve System." Not surprisingly, the NIPA measure of the Fed's profits tends to coincide with the 12-month sum of the Table 4 item.

(4) So if we add the 12-month sum of the Fed's earnings as reported by the IRS to the 12-month sum of the corporate tax revenues reported by the IRS, the result is a series that is closer to the NIPA measure of total corporate tax revenues (*Fig. 3*).

(5) The remaining difference between the NIPA and IRS series, as adjusted by us, is mostly attributable to state and local taxes on corporations, which are included in the NIPA measure but not in the IRS tally (*Fig. 4*).

US Corporate Taxes II: Not So Taxing. The obvious conclusion is that measuring the average effective *federal* corporate tax rate using the NIPA data will overstate it by the amount of "taxes" collected from the Fed and by the amount of taxes paid to taxing authorities other than the IRS.

Nevertheless, the comprehensive NIPA-based effective corporate rate has been below 25.0% since Q1-2008 ([*Fig. 5*]). It was 20.7% during the four quarters through Q3 of this year. Even lower is the comparable tax rate based on IRS data on federal corporate tax receipts, excluding the Fed's contribution. This tax rate has been below 20.0% since Q2-2008, and was just 13.0% over the four quarters through Q3!

That's well below the current statutory rate of 35.0%. It's also well below the 20.0% rate that Republicans are aiming to enact as part of their tax reform plan. This raises two relevant questions:

(1) *Are we comparing apples and oranges?* Melissa and I now feel quite comfortable using the IRS corporate tax revenues measure as the numerator in calculating the effective federal corporate tax rate.

But what about the denominator? Removing the Fed's profits from the NIPA measure of corporate profits in the denominator doesn't make much difference. That's because those profits are a much more significant percentage of corporate tax revenues than corporate profits.

We are investigating the possibility that the treatment of sole proprietorships and LLCs in the NIPA data might be overstating the denominator relative to the numerator of our effective tax calculation. We doubt it since the NIPA include sole proprietors' income in personal income rather than in profits, as we discussed last Tuesday (*Fig. 6*). We presume (and are checking whether) the same holds true for the taxes paid by proprietors. We are quite certain they are included in the IRS and NIPA measures of individual income taxes.

(2) *Are small corporations paying full fare while large corporations are free-loading?* The IRS-based effective federal corporate tax rate suggests that corporations are using all sorts of tax deductions and dodges to very effectively lower their effective tax rate well below the 35.0% statutory rate.

The urban legend is that large multinational corporations have the resources to play this game, and are paying almost nothing in taxes, while smaller corporations are paying something close to 35.0%. I asked Joe to find the amount of taxes paid by the S&P 500 corporations. He found annual data showing that for most years since the late 1990s, taxes paid by these companies actually exceeded the federal corporate tax receipts at the IRS (*Fig. 7*). Their effective tax rate was 26.4% during 2016 (*Fig. 8*). That may reflect that the S&P 500 data aren't strictly comparable because they include taxes paid to other entities, including state and local governments, as well as to overseas taxing authorities.

The bottom line is that getting to the bottom line when it comes to matters of taxation is a very taxing exercise. We'll keep at it, but our conclusions so far are that corporations, on balance, may actually be paying less than the 20.0% statutory rate that the Republicans are aiming to enact, and large corporations may not be free-loading at the expense of small ones.

CALENDARS

US. **Tues:** NFIB Small Business Optimism Index 104.2, PPI-FD Headline, Core, and Core Less Trade Services 0.3%/0.2%/0.3%, Treasury Budget -$134.0b, FOMC Meeting Begins. **Wed:** Headline & Core CPI 2.2%.1.8% y/y, MBA Mortgage Applications, EIA Petroleum Status Report, FOMC Meeting Announcement 1.375%, FOMC Press Conference. (*Wall Street Journal* estimates)

Global. **Tues:** Eurozone ZEW Economic Sentiment, Germany ZEW Survey Expectations 18.0, UK

Headline & Core CPI 3.0%/2.7% y/y, Japan Machine Tool Orders 2.7%m/m/-3.9%y/y, Lowe. **Wed:** Eurozone Industrial Production 0.1%m/m/3.3%y/y, Germany CPI 0.3%m/m/1.8%y/y, UK Claimant Count Rate, Kuroda. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings (*link*): Forward earnings rose to yet another record high last week for LargeCap and MidCap, but SmallCap dropped from a record high for the second time in four weeks. LargeCap's forward earnings was higher for a 20th straight week and MidCap's for a 16th week. Momentum remains strong as the yearly change in forward earnings is up from six-year lows in early 2016, and should remain strong whether the new tax rates take effect in 2018 or 2019. In the latest week, the rate of change in LargeCap's forward earnings edged up to a 70-month high of 10.3% y/y from 10.2%, which compares to a six-year low of -1.8% in October 2015; MidCap's rose to a 72-month high of 16.4% from 15.8%, which compares to a six-year low of -1.3% in December 2015; and SmallCap's dropped to 10.5% from 11.1%, which compares to a 39-month high of 13.0% in mid-July and a six-year low of 0.3% in December 2015. LargeCap's consensus growth rates expected for 2017 and 2018 have remained strong throughout this year instead of falling. Furthermore, the growth rates for 2018 should improve for all three indexes if the corporate tax rate change becomes effective in 2018. Here are the latest consensus earnings growth rates for 2017 and 2018: LargeCap 11.4% and 11.2%, MidCap 11.3% and 14.2%, and SmallCap 4.3% and 20.7%.

S&P 500/400/600 Forward Valuation (*link*): Forward P/E ratios mostly edged down for the three indexes last week. LargeCap's weekly forward P/E was steady at an 11-year high of 18.2. It's up from a 15-month low of 14.9 in January 2016 and the post-Lehman-meltdown P/E of 9.3 in October 2008, but remains well below the tech bubble's record high of 25.7 in July 1999. SMidCap's P/Es had stalled for most of 2017 following the post-election meltup, but has been rising again recently. MidCap's forward P/E edged down to 18.4 from a 37-week high of 18.6, and is slightly higher than LargeCap's P/E again after being below during August and September for only the second time since 2009. MidCap's P/E remains below its 15-year high of 19.2 in late February when Energy earnings were depressed, and the record high of 20.6 in January 2002, but is up from a three-year low of 15.0 in January 2016. SmallCap's dropped to 20.0 from a 51-week high of 20.2, which compares to a 15-year high of 20.5 in December 2016 when Energy's earnings were depressed. That's up from a three-year low of 15.5 in February 2016, and just 0.7ppt below SmallCap's record-high P/E of 20.9 in April 2002. Prices remain near record highs for all three indexes, but their "E"s still remain low as the bottoms-up consensus awaits final passage of the legislative and timing changes to the tax rate. Looking at their daily forward price/sales (P/S) ratios, valuations last week were mostly steady for the three indexes: LargeCap's P/S of 2.06 on Friday is at a record high of 2.06, MidCap's 1.33 is down from a record high of 1.39 in early March, and SmallCap's 1.04 is down from 1.08 in early March and its record high of 1.17 in November 2013.

S&P 500 Sectors Quarterly Earnings Outlook (*link*): With the Q3 earnings season nearly complete, Q4 earnings revisions activity has slowed considerably. The S&P 500's Q4-2017 EPS forecast rose two cents w/w to $34.76, and is down only 0.6% from $34.98 at the end of Q3. If Q4's estimate holds to the end of the quarter, that would mark the smallest decrease in a quarterly forecast since Q1-2011. The $34.76 estimate represents a forecasted pro forma earnings gain for Q4-2017 of 11.6%, unchanged from a week earlier, and compares to Q3-2017's blended estimate/actual of 8.4%, Q2's 12.3%, and Q1's 15.3% (which was the strongest growth since Q3-2011 owing mostly to easier comps for Energy). Since the end of Q3, Q4 estimates are higher for three sectors, lower for seven, and steady for one. Energy's Q4 forecast has jumped 20.1% followed by these sectors: Utilities (up 2.7%), Tech (2.2), and Telecom (0.0). Materials' Q4-2017 forecast has fallen 9.4% for the worst decline, and is followed by: Industrials (-9.1), Real Estate (-5.9), Consumer Discretionary (-5.4), Health Care (-2.2), Financials (-

2.2), and Consumer Staples (-1.1). The S&P 500's Q4-2017 forecasted earnings gain of 11.6% y/y would be its sixth straight gain after four declines. Nine of the 11 sectors are expected to record positive y/y earnings growth in Q4-2017, and four are expected to beat the S&P 500's forecasted y/y earnings gain of 11.6%. That's because analysts expect Energy to report another large profit jump in Q4 relative to very low earnings a year ago. That's better than Q3-2017, when eight sectors rose y/y, but down from Q2-2017, when all 11 sectors rose y/y for the first time since Q3-2011. The latest forecasted Q4-2017 earnings growth rates vs their blended Q3-2017 growth rates: Energy (127.0% in Q4 vs 161.0% in Q3), Materials (26.0, 7.0), Tech (14.7, 24.0), Financials (13.8, -7.3), S&P 500 (11.6, 8.4), Utilities (9.4, -4.6), Consumer Staples (8.6, 4.8), Consumer Discretionary (5.3, 3.8), Health Care (4.7, 8.3), Industrials (4.0, 3.1), Real Estate (-1.0, 3.8), and Telecom (-1.8, -2.8). On an ex-Energy basis, S&P 500 earnings are expected to rise 9.3% y/y in Q4, up from 6.1% in Q3 (which was the slowest growth since ex-Energy earnings rose just 2.2% in Q2-2016) but down from gains of 9.6% in Q2 and 11.0% in Q1.

US ECONOMIC INDICATORS

JOLTS (*link*): After gains the prior two months (of 87,000 and 50,000), job openings fell 181,000 in October to 5.996 million, not far below July's record high of 6.140 million. Meanwhile, hirings rebounded 232,000 to a new cyclical high of 5.552 million, more than reversing the 201,000 drop the prior two months, while separations fell for the third month, by a total of 184,000, to 5.178 million. The latest hirings and separations data yielded an employment advance of 374,000 for October, 130,000 above October's payroll gain of 244,000—coming in above payroll employment for the sixth time in nine months. October's job-opening rate slipped to 4.2%, just below its record high of 4.3% recorded the prior four months, while the total hires rate (4.2%) moved back up to its cyclical high; the quit rate (2.4) held just below May's cyclical high of 2.5% for the fifth month. September's ratio of unemployed workers per job opening (1.09) sank to a new record low.

GLOBAL ECONOMIC INDICATORS

Global Leading Indicators (*link*): In October, the OECD's composite leading indicators (CLIs)—designed to anticipate turning points in economic activity relative to trend six to nine months ahead—once again pointed to stable growth momentum in the OECD (100.1) as a whole. CLIs for the United States (99.8), Japan (100.1), Canada (100.4), and the Eurozone (100.6), including France (100.5), are still anticipating stable growth momentum. Meanwhile, CLIs for Italy (100.7) and Germany (101.1) show growth gaining momentum. The UK's (99.3) CLI, on the other hand, continues to deteriorate, with stronger signals of easing growth. As for the emerging economies, CLIs point to growth gaining momentum in the industrial sector in China (99.7) and firming in Brazil (103.7), while stable growth momentum is anticipated in India (99.9) and Russia (100.9).

Eurozone GDP (*link*): Real GDP in the Eurozone reached a new record high last quarter, expanding 2.4% (saar)—its fourth straight reading above 2.0%. From the expenditure side, real gross fixed capital investment was the largest contributor to GDP growth last quarter, expanding 4.3% (saar), building on Q2's 9.0% surge. Real household spending growth slowed to 1.3% (saar) after increasing just above 2.0% in each of the prior three quarters. Real government spending advanced 1.0% (saar), fluctuating in a narrow band between 0.8% to 1.4% the past six quarters. Trade was a slight positive contributor to Q3 GDP, as exports (4.7%, saar) increased at a slightly faster pace than imports (4.5). Of the four largest economies, Germany (3.3%, saar) and Spain (3.1) exceeded the Eurozone's 2.4% pace, while GDP growth in France (2.2) and Italy (1.4) once again lagged behind.

Germany Industrial Production (*link*): German industrial production in October unexpectedly fell for the second month since reaching a new record high in August, though other indicators suggest the setback is temporary. Germany's headline production—which includes construction—sank 1.4% after a revised 0.9% decline in September, which was smaller than the initial 1.6% decline. (Excluding construction, production fell 1.4% m/m and 2.6% over the two-month period.) Manufacturing output slumped 2.0%, adding to September's 1.1% drop—reversing August's 3.1% jump. Weakness was widespread, with capital (-2.7%), consumer (-2.6), and intermediate (-1.0) goods production all recording sizable declines in October, while energy (5.1) output bucked the trend. Meanwhile, the economy ministry noted following the release of the production data that record-high factory orders and business confidence signal a continuation of good industrial momentum. In addition, Germany's M-PMI climbed to 62.5 in November, the second-highest pace since the survey began in 1996—with new orders growth the fastest since March 2010 and production the best since April 2011.

UK Industrial Production (*link*): UK industrial output in October ended its longest growth streak in 23 years, as warm weather depressed energy output. Headline production was unchanged after climbing the prior six months by a total of 2.2%, after starting the year with a three-month drop of 1.8%. Manufacturing production, on the other hand, rose for the sixth consecutive month by 0.1%m/m and 2.0% over the period, after falling by 1.6% the first four months of the year. The latest move up was led by gains of 4.6% and 2.6%, respectively, in production of capital and consumer durable goods over the six-month period. Looking ahead, Markit reports the UK manufacturing sector expanded at its fastest pace in over four years in November as both orders and production accelerated. The M-PMI climbed from 56.6 to 58.2 during the month, to its best reading since August 2013.

Japan GDP (*link*): Japan's economy expanded at a much faster pace than initially reported last quarter, posting its seventh straight quarterly gain—the longest stretch of uninterrupted growth on record going back to 1994! Real GDP grew 2.5% (saar), roughly double the pace of the initial 1.4% advance, with trade accounting for 2.0ppts and domestic demand 0.5ppt of Q3's advance. Real exports rose 6.0% (saar), while real imports fell by 6.2%, with net exports nearing a surplus for the first time since Q1-2011. Meanwhile, domestic demand grew only 0.5% (saar) last quarter, slowing from 4.0% during Q2, reflecting the first decline in household consumption (-2.0%, saar) in more than a year. Real nonresidential investment expanded for the fourth consecutive quarter, up 4.3% (saar) during Q3 and at a nine-quarter high of 3.8% y/y—accelerating steadily since dipping into negative territory a year ago. Government consumption (0.2) showed little growth during the quarter, similar to the first two quarters of the year.

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