



MORNING BRIEFING

June 5, 2018

Corporate Finance Extravaganza

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

(1) Diving into the data to see how TCJA impacts corporate finance. (2) Tax on repatriated earnings treated as capital transfer from business to Treasury. (3) Moving from worldwide to territorial corporate tax system still leaves taxes to be paid on GILTI and BEAT. (4) Tax cut and capital consumption adjustment lift after-tax profits from current production and cash flow to record highs. (5) TCJA already lifting capital spending significantly among S&P 500 companies. (6) Protectionism is a potential wet blanket.

Corporate Finance 101: Repatriated Earnings. Put on your diving suit. We are going to see how the 2017 Tax Cuts and Jobs Act (TCJA) affected corporate finance developments during Q1-2018. We will take a deep dive into the latest data. On May 30, along with the first revision in Q1 GDP, the Bureau of Economic Analysis (BEA) released lots of pertinent data showing the impact of the TCJA on corporations. Here are the key takeaways:

(1) *Tax rate on repatriated earnings.* Let's start with the BEA's [explanation](#) of "How does the 2017 Tax Cuts and Jobs Act affect BEA's business income statistics?" Despite its broad title, it focuses only on the taxation of repatriated earnings under the TCJA.

The BEA reports: "The tax rate is 15.5 percent on earnings held in cash and cash equivalents and 8.0 percent on earnings held in illiquid assets. Parent corporations may elect to pay this tax in prescribed installments over a period of eight years." It's a one-time tax on foreign earnings built up since 1986 that applies whether or not earnings actually are brought back home.

(2) *No impact on NIPA current accounts.* The BEA observes that in the National Income and Product Accounts (NIPA), the tax is classified as a one-time capital transfer from business to government. The BEA explains: "It is effectively a wealth tax in economic accounting terms. The one-time capital transfer affects net lending/borrowing of business and government, resulting in a redistribution of net worth from business to government but not affecting any measures in the current accounts." (See NIPA [Table 5.11U](#) Capital Transfers Paid and Received by Sector and by Type.)

(3) *Recorded during Q4-2017.* The BEA currently estimates that the one-time tax amounts to \$250 billion at a quarterly rate. It was all recorded (in its entirety) on an accrual basis in Q4-2017 (though at an annual rate of \$1.0 trillion, which confounds us). Melissa and I reckon that this tax estimate implies that repatriated earnings amount to around \$1.5 trillion, assuming that most of them are held in liquid assets.

(4) *New territorial system.* Prior to the TCJA, the overseas earnings of US multinationals were taxed under a "worldwide system." They were taxed at the statutory US corporate tax rate. However, the taxes were deferred until the profits were repatriated to the US.

Under the new modified "territorial system," the good news is that profits earned abroad are no longer

subject to the statutory rate (which was slashed from 35% to 21% by the TCJA). The bad news is that you need an international tax accountant to decipher the BEA's oh-by-the-way explanation of what the ongoing taxation of future earnings derived from abroad will look like, as follows: "The Global Intangible Low-Taxed Income tax (GILTI) is a minimum tax on the excess income of foreign subsidiaries over a 10 percent rate of return on tangible business assets. The Base Erosion Anti-Abuse Tax (BEAT) is effectively an alternative minimum tax applied to companies with excessive interest or services payments to related parties."

(5) *Welcome home*. While the BEA jammed the wealth tax transfer effect of the TCJA on repatriated earnings into Q4-2017, the actual estimated amount of those earnings showed up in NIPA as "dividends receipts from the rest of the world." It shot up from \$349.0 billion during all of last year to \$1.36 trillion (saar) during Q1-2018 ([Fig. 1](#)). Dividend payments received from abroad less paid abroad has been running between \$100 billion and \$200 billion (saar) in recent years ([Fig. 2](#)). It jumped to \$1.19 trillion during Q1. (See NIPA [Table 4.1](#) Foreign Transactions in the National Income and Product Accounts.)

Corporate Finance 102: Profits & Taxes. The cut in the corporate tax rate was reflected in the latest NIPA data. Pretax book profits (as reported to the IRS) edged up slightly during Q1-2018 to \$2.14 trillion (saar) ([Fig. 3](#)). Interestingly, they've actually been stuck around this level since early 2012. After-tax book profits rose more as a result of the tax cut, yet also remain remarkably flat since 2012.

In any event, corporate profits taxes fell \$117.3 billion from \$445.5 billion (saar) at the end of last year to \$328.2 billion during Q1-2018 ([Fig. 4](#)). That's a 26.3% drop, reflecting the 40% cut in the federal corporate statutory tax rate. (The NIPA tax series includes taxes paid to other government entities in the US and abroad. The profits series includes profits of solely owned corporations but excludes their taxes, which are reflected mostly in personal income taxes!)

The BEA also computes a series called "corporate profits from current production" ([Fig. 5](#)). It includes two adjustments. The Inventory Valuation Adjustment (IVA) and Capital Consumption Adjustment (CCAdj) restate the historical cost basis used in profits tax accounting for inventory withdrawals and depreciation to the current cost measures used in GDP ([Fig. 6](#)).

Profits from current production have been relatively flat on a pre-tax basis since 2012, much like pre-tax book profits. On an after-tax basis, they rose to a record \$1.87 trillion (saar) during Q1-2018, thanks to a big jump in the CCAdj from -\$97.6 billion during Q3-2017 to \$152.2 billion during Q4-2017, and held steady around there during Q1-2018. Of course, the tax cut also boosted after-tax profits from current production.

Corporate Finance 103: On the Margin. Meanwhile, both S&P 500 aggregate reported and S&P 500 operating earnings rose to record highs during Q1-2018 ([Fig. 7](#)). Historically, there was a reasonably good correlation between the after-tax S&P 500 profit margin using operating earnings and the comparable NIPA profit margin ([Fig. 8](#)). However, they've diverged significantly since 2015, with the former rising to a record 11.9% during Q1-2018, while the latter has been volatile around 9.0%. We aren't sure why this is happening, but we would put our chips on the S&P measure of the margin.

Corporate Finance 104: Cash Flow. Since NIPA is based on current production, the massive increase in dividends received from abroad (i.e., repatriated earnings) during Q1-2018 has no impact at all on net dividends paid by US corporations ([Fig. 9](#)). In another [note](#), the BEA explains: "There is only a small net effect on the current account balance and no net effect on receipts of direct investment income because the full amount of U.S. direct investors' share in the earnings of their foreign affiliates is reflected in direct investment income at the time that these earnings are earned, not when they are

distributed to stockholders as dividends. Payment of dividends affects only the form in which direct investment income is received (i.e., as distributed versus as undistributed earnings) and not its overall amount. As the accounts are constructed, the change in form is almost entirely reflected as changes in financial account flows that are largely offsetting.”

In any case, NIPA dividends in corporate profits remain remarkably flat around \$950 billion (saar), as they have for the past few years. As a result, undistributed corporate profits (including the IVA and CCAdj) rose to a record high of \$888.7 billion (saar) along with after-tax profits from current production during Q1 ([Fig. 10](#)).

Corporate cash flow rose to a record \$2.56 trillion (saar) during Q1-2018, boosted by undistributed profits as well as the CCAdj, which boosted tax-reported depreciation significantly, as noted above ([Fig. 11](#)).

Corporate Finance 105: TCJA & Capital Spending. Previously, Melissa and I have noted that the increase in capital spending in GDP over the past year through Q1-2018 has been remarkably unremarkable. It is up 8.1% in nominal terms and 6.8% in real terms ([Fig. 12](#)). Those are solid gains, but not as strong as suggested by the record high in the CEO Outlook index compiled by the Business Roundtable. More in tune with this index are the data for large public companies. As noted below, they suggest a much higher rate of increase in capital spending than the BEA data.

The TCJA certainly should boost capital spending now that much of it can be expensed immediately rather than depreciated over time for tax-accounting purposes. Melissa points out:

(1) *100% bonus depreciation.* The TCJA includes two key provisions for businesses intended to encourage business investment. One is called the “100 percent bonus depreciation,” as a 5/30 Tax Foundation article [discussed](#). It provides for the full and immediate expensing of short-lived capital investments, excluding some categories, for five years. Prior rules dictated that “short-lived” assets with a lifespan of 20 years or less were eligible for a 50% bonus depreciation. The act also increases the cap on Section 179 expensing to \$1 million from \$500,000, according to a 12/18/17 Tax Foundation [analysis](#). Further lowering the cost of capital for businesses was the drop in the US corporate statutory income tax rate to 21% from 35%. J.P.Morgan observed in a [note](#) that allowing businesses to immediately deduct the full value of their capital expenses—instead of a years-long depreciation schedule—may encourage them to accelerate planned expansions and acquisitions.

(2) *Big increase for big companies.* Data from the S&P’s Howard Silverblatt including 94% of S&P 500 companies, according to a 5/17 Reuters [article](#), showed that the growth in capital spending for Q1 was 21% y/y. That’s on track to be the highest y/y growth since Q3-2011. Silverblatt said: “These numbers are high, and I would expect higher numbers in capex this year. It takes a little bit longer for companies to plan and to execute.”

(3) *More capex to come?* In [testimony](#) before the House Ways & Means Committee on 5/16, in a panel on the effects of the TCJA, Emerson CEO David Farr discussed a recent survey of National Association of Manufacturing members. It reported that 86% of those surveyed were planning to increase investments because of the tax reform.

Corporate Finance 106: Protectionism & Capital Spending. Of course, it may be that Trump’s protectionist saber-rattling is offsetting the stimulative effect of the TCJA as some companies hesitate to spend on big-ticket items with tariff threats hanging over their heads. The Fed’s latest [Beige Book](#) implies that tariff concerns are affecting capital spending, although capital spending wasn’t the focus of most of the commentary. For the districts that did discuss capital spending, the impact of the tariffs on

current projects and plans was quite mixed. Let's review:

(1) *Atlanta*. For the contacts in the Atlanta district's transportation industry, "uncertainty over trade policy had not negatively impacted capital projects already underway." However, "a number indicated that they have tapped the brakes on projects in the planning phases."

(2) *Boston*. No manufacturing contacts in the Boston district "cited revisions to their capital expenditure plans."

(3) *Chicago*. Imports slowed for manufacturers in the Chicago district "after the steel and aluminum tariffs were enacted." Further, "contacts noted ongoing uncertainty about whether there would be further changes in tariffs policy." Chicago agriculture contacts "expressed unease over the potential impact of international trade policies on the farming sector."

(4) *Cleveland*. In the Cleveland district, contacts were concerned about future demand due to the tariffs. District manufacturers cited "uncertainty about future prices" as a reason that "finished goods inventories were down." Further down the supply chain, some Cleveland district retailers noted that the "uncertainty surrounding tariffs on Chinese imports is a source of concern," primarily for some retailers "that have operations overseas or use imported goods as inputs."

(5) *Dallas*. Outlooks in Dallas "remained fairly optimistic, but tariffs and trade-related concerns were creating uncertainty."

(6) *Minneapolis*. In the Minneapolis district, contacts in services industries "reported major disruptions in international supply-chain management" and in global import-export banking "due to uncertainty over trade policy."

(7) *Philly*. The percentage of Philadelphia district manufacturing firms expecting increases in future capital expenditures is less than one-third. One primary metal manufacturer in the Philadelphia district attributed the current slowdown in orders to "customers waiting for clarity on the issue of steel tariffs."

CALENDARS

US. Tues: Job Openings 6.543m, ISM & Markit NM-PMIs 58.0/55.7. **Wed:** Trade Balance -\$49.0b, Productivity & Unit Labor Costs 0.7%/2.8%, MBA Mortgage Applications, EIA Petroleum Status Report. (*Wall Street Journal* estimates)

Global. Tues: Eurozone Retail Sales 0.5%*m/m*/1.7%*y/y*, Eurozone, Germany, France, and Italy Composite PMIs 54.1/53.1/54.5/52.8, Eurozone, Germany, France, and Italy Nonmanufacturing PMIs 53.9/52.1/54.3/53.0, UK Composite & Nonmanufacturing PMIs 53.4/53.0, Japan Composite & Nonmanufacturing PMIs, China Nonmanufacturing PMI 52.9, RBA Cash Rate Target 1.50%, Draghi. **Wed:** Australia GDP 0.8%*q/q*/2.7%*y/y*. (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—contracted for the second week during the final week of May, after rising the prior four weeks to a new record high. Our WLI, which is the average of our Boom-Bust Barometer (BBB) and Bloomberg's Weekly Consumer Comfort Index (WCCI), sank 2.6% during the two weeks ending May 26, after a four-week jump of 3.8%. Our BBB dropped 4.4% over the two-week span, following a four-week surge of 7.8% to a new record high, as jobless claims—

one of the components of our BBB—continued to rise from its cyclical low. Claims climbed for the second week to 222,250 (4-wa) during the week of May 26, after dropping from 231,500 to 213,500 the previous four weeks—which was the lowest reading since December 13, 1969. The CRB raw industrial spot price index, another BBB component, has been climbing since bottoming in mid-May. Meanwhile, the WCCI held the prior week's 1.1% rebound, which followed a four-week slide of 6.0% from its cyclical high in mid-April.

S&P 500/400/600 Forward Earnings ([link](#)): Forward earnings for these three indexes resumed their rises last week, but MidCap and SmallCap remain slightly below their mid-May record highs. LargeCap's forward earnings was at a record high and has risen in 43 of the past 44 weeks, MidCap's is up in 39 of the past 40 weeks to 0.1% below its record high, and SmallCap's is up in 37 of the past 40 weeks to 0.4% from its record high. Earnings momentum remains healthy, as the yearly change in forward earnings is up from six-year lows in early 2016 and should remain strong in 2018. In the latest week, the rate of change in LargeCap's forward earnings rose to 21.4% y/y from 21.3%, which compares to a seven-year high of 21.7% in mid-May and a six-year low of -1.8% in October 2015; MidCap's rose to 23.1% from 22.8%, which compares to a seven-year high of 24.0% in mid-March and a six-year low of -1.3% in December 2015; and SmallCap's slipped to 28.9% from 29.1%, which compares to a seven-year high of 30.2% in mid-May and a six-year low of 0.3% in December 2015. Here are the latest consensus earnings growth rates for 2018 and 2019: LargeCap 22.1% and 9.6%, MidCap 20.3% and 12.5%, and SmallCap 24.7% and 16.5%.

S&P 500/400/600 Valuation ([link](#)): Last week saw forward P/E ratios remain mostly steady for these three indexes at levels that are not much above their recent post-election lows. LargeCap's weekly forward P/E was unchanged at 16.3, which is up from a post-election low of 16.0 in late March and down from 18.6 on January 26—the highest since May 2002. That compares to the post-Lehman-meltdown P/E of 9.3 in October 2008, but is well below the tech-bubble record high of 25.7 in July 1999. MidCap's forward P/E was steady at 16.6, which is little improved from its 25-month low of 16.1 in early April. MidCap's P/E is down from a 15-year high of 19.2 in February 2017 and compares to the record high of 20.6 in January 2002; however, it is up from a three-year low of 15.0 in January 2016. MidCap's P/E had mostly been at or below LargeCap's P/E from August to March for the first time since 2009. SmallCap's P/E increased to 18.0 from 17.9, which compares to a post-election low of 17.0 in mid-March. That's well below its 51-week high of 20.2 in December (which wasn't much below the 15-year high of 20.5 in December 2016, when Energy's earnings were depressed), but is comfortably above its three-year low of 15.5 in February 2016. Looking at daily forward price/sales (P/S) ratios, they edged up w/w for all three indexes, but remain at levels well below January highs: LargeCap's P/S of 2.02 is down from a record high of 2.19 on January 26; MidCap's 1.32 compares to its record high of 1.40, also on January 26; and SmallCap's 1.02 is down from 1.05 then, which compares to its record high of 1.17 in November 2013, when Energy revenues were depressed.

S&P 500 Sectors Quarterly Earnings Outlook ([link](#)): With less than 2% of the Q1 earnings reporting season remaining, analysts have become less busy adjusting their forecasts. The S&P 500's Q2-2018 EPS forecast dropped 2 cents w/w to \$39.04. That's up 0.2% since the end of Q1, 7.5% ytd, and 8.2% since the passage of the TCJA. The \$39.04 estimate represents a forecasted pro forma earnings gain for Q2-2018 of 20.1%, up from 20.0% a week earlier. That compares to Q1-2018's blended 26.4% (which is the strongest since Q4-2010), Q4-2017's 14.8%, Q3-2017's 8.5%, Q2-2017's 12.3%, and Q1-2017's 15.3%. Since the end of Q1, Q2-2018 estimates are higher for six sectors and down for five. Energy's Q2 forecast has risen 10.7%, followed by the forecasts for Real Estate (up 1.7%), Health Care (1.6), Materials (1.3), Tech (0.6), and Utilities (0.6). Consumer Staples is the biggest decliner, with its Q2-2018 forecast down 4.3% since the end of Q1, followed by Consumer Discretionary (-1.9), Telecom (-1.6), Financials (-1.5), and Industrials (-1.5). The S&P 500's Q2-2018 forecasted earnings gain of 20.1% y/y would be its eighth straight gain after four declines. Ten of the 11 sectors are expected to

record positive y/y earnings growth in Q2-2018—with nine rising at a double- or triple-digit percentage rate—and four are expected to beat the S&P 500's forecasted y/y earnings gain of 20.1%. That compares to all 11 sectors rising y/y during Q1-2018, when ten rose at a double-digit pace and four outpaced the S&P 500. Analysts expect Energy to report another large profit jump in Q2 relative to very low earnings a year ago, with the pace improving from Q1. The latest forecasted Q2-2018 earnings growth rates vs their blended Q1-2018 growth rates: Energy (136.2% in Q2-2018 vs 86.4% in Q1-2018), Materials (29.4, 30.0), Tech (24.0, 36.3), Financials (21.1, 30.7), S&P 500 (20.1, 26.4), Consumer Discretionary (15.5, 19.4), Industrials (15.2, 24.7), Telecom (13.0, 14.7), Consumer Staples (10.0, 12.8), Health Care (11.3, 16.3), Real Estate (2.3, 3.1), and Utilities (-0.3, 16.7). On an ex-Energy basis, analysts expect S&P 500 earnings to rise 16.6% y/y in Q2, down from a blended 24.4% in Q1; that compares to 12.7% in Q4-2017 and 6.1% in Q3-2017 (which was the slowest growth since ex-Energy earnings rose just 2.2% in Q2-2016).

US ECONOMIC INDICATORS

Manufacturing Orders & Shipments ([link](#)): Both core capital goods orders and shipments began this quarter strong. Nondefense capital goods orders ex aircraft (a proxy for future business investment) rebounded an unrevised 1.0% in April after slumping 1.0% in March; they've been on a volatile uptrend—climbing 3.2%—since posting a sharp drop during the two months ending November. Meanwhile, the comparable shipments measure (used in calculating GDP) more than reversed March's decline, rising 0.9% (vs. 0.8% advance estimate) in April to its highest reading since September 2014. Core capital goods orders accelerated 5.6% (saar) during the three months through April, based on the three-month average, after turning negative the first two months of this year. The comparable shipments measured grew 3.2% (saar), below the double-digit gains at the end of last year but a slight improvement from March's rate. Headline manufacturing orders slipped 0.8% in April after rebounding 3.8% during the two months ending March, as transportations orders sank 6.0%—driven by a plunge in volatile commercial aircraft orders (-28.9%). Excluding transportation, orders rose for the tenth consecutive month, by 0.4% m/m and 7.4% over the period, to its highest reading since July 2014.

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