Cornerstone
CAPITAL GROUP

Equity Strategy

January 19, 2018

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Equity Outlook

Tax Reform: An Earnings Wildcard in 2018

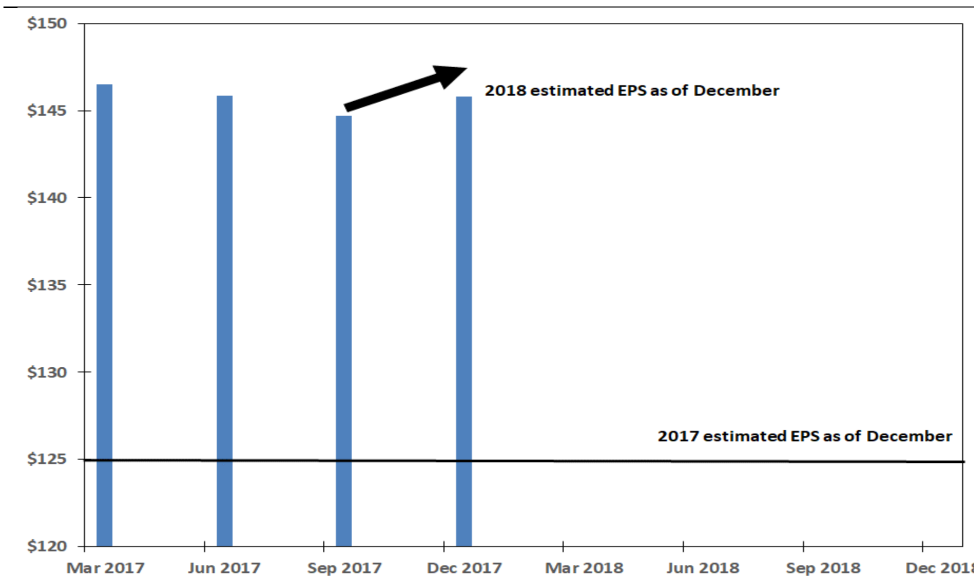
- **A Robust Earnings Environment.** The combination of favorable bottom-up factors (sales growth, margin expansion) and a solid economic environment (synchronized global growth) has created a healthy earnings environment. 2017 S&P 500 earnings growth is on track to have been the fastest since 2010.

- **Rising estimates.** Earnings estimate upgrades have been outpacing earnings downgrades lately, in the most extended period of net estimate increases since 2010. Upward estimate revisions have been most significant in the Information Technology and Energy sectors.

- **U.S. Tax Reform: A Wildcard in 2018.** Quite unusually, consensus estimates for 2018 S&P 500 EPS increased late in 2017; estimates typically decline steadily. Even a modest reduction in the effective corporate tax rate in 2018 could materially boost consensus estimates.

- **Market Outlook.** A 5% increase in current 2018 EPS estimates combined with a two-percentage point reduction in the P/E multiple (possibly driven by interest rate hikes) would suggest about a 10% gain in stock prices in 2018.

Figure 1: S&P 500 Operating EPS — Consensus Estimate for 2017 and 2018



Source: S&P

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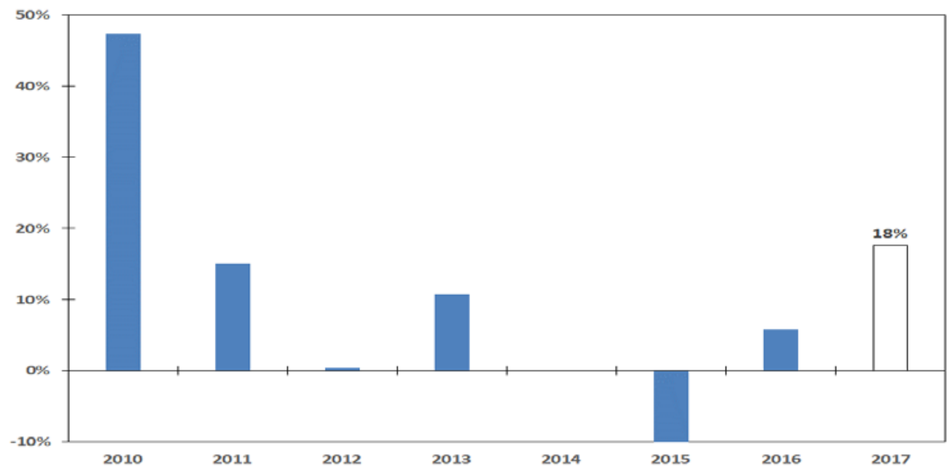
A Robust Earnings Environment in 2017

When all fourth quarter earnings reports have been released, 2017 S&P 500 earnings growth will likely have been the fastest since 2010 — Figure 2.

Figure 2: S&P 500 Operating EPS
Year-to-year percentage change in quarterly EPS



Source: S&P

From a bottom-up perspective, earnings momentum has been driven by the highly favorable combination of robust sales growth (Figure 3) and a record-high profit margin (Figure 4).

Figure 3: S&P 500 Sales
Year-to-year percentage change in quarterly sales

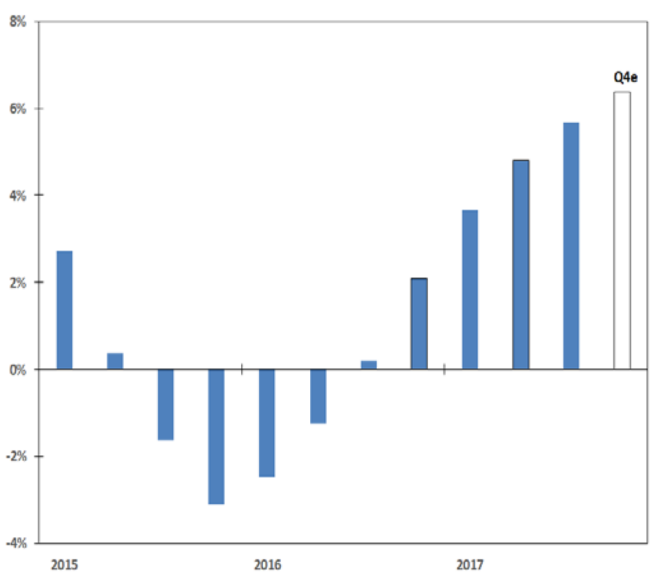
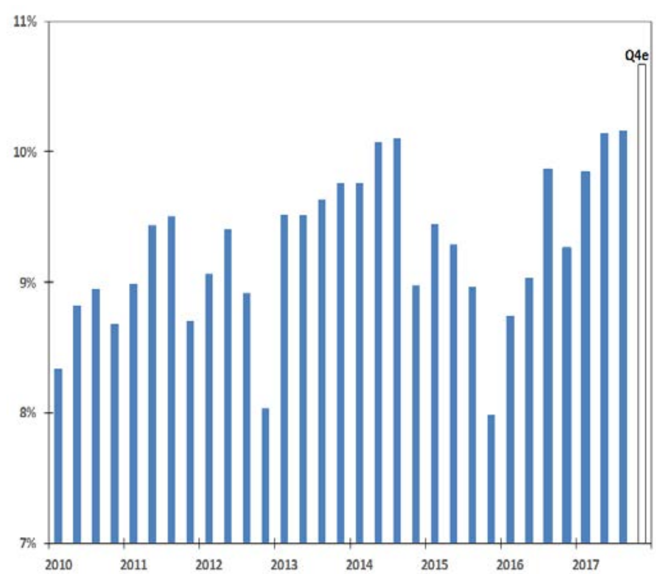


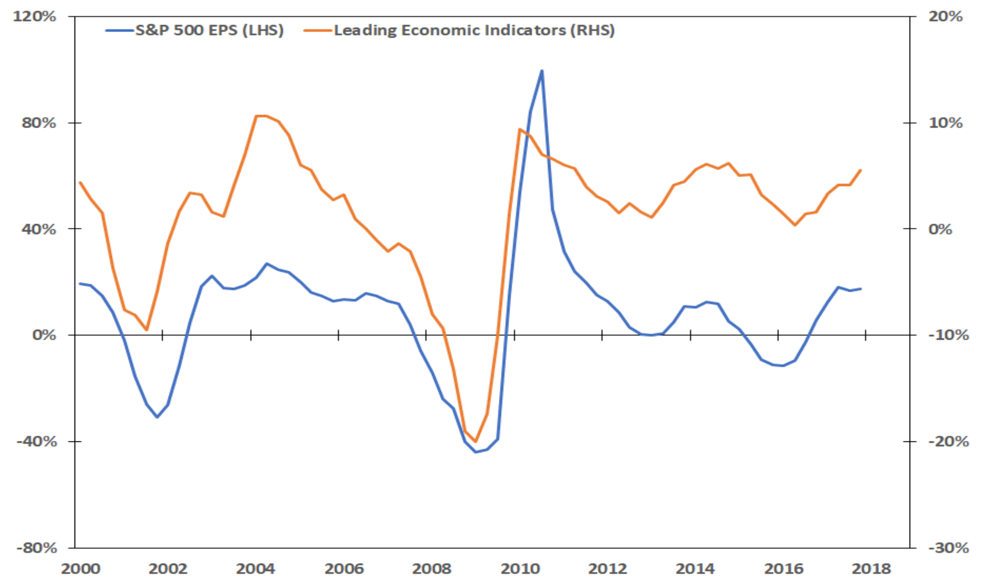
Figure 4: S&P 500 Operating Margin
Quarterly



Source: S&P

Looking forward, Figure 5 illustrates that the Conference Board's Leading Economic Index (LEI) for the U.S. has a close correlation with S&P 500 earnings growth. The LEI increased 0.4% in November, following a 1.2% increase in October and a 0.1% increase in September, suggesting that solid economic growth will continue into the first half of 2018, which would be a clear positive for the earnings outlook.

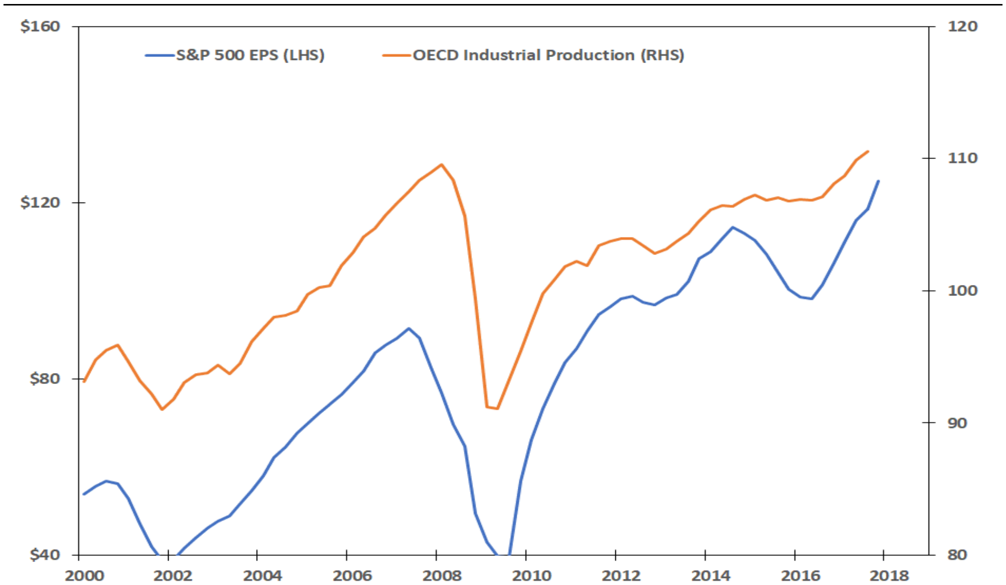
Figure 5: S&P 500 Operating EPS and U.S. Leading Economic Index
Yearly percent change



Source: S&P, Bloomberg

In addition, a significant portion of U.S. corporate profits is derived from overseas, so that strength in the global economy is an important tailwind— Figure 6.

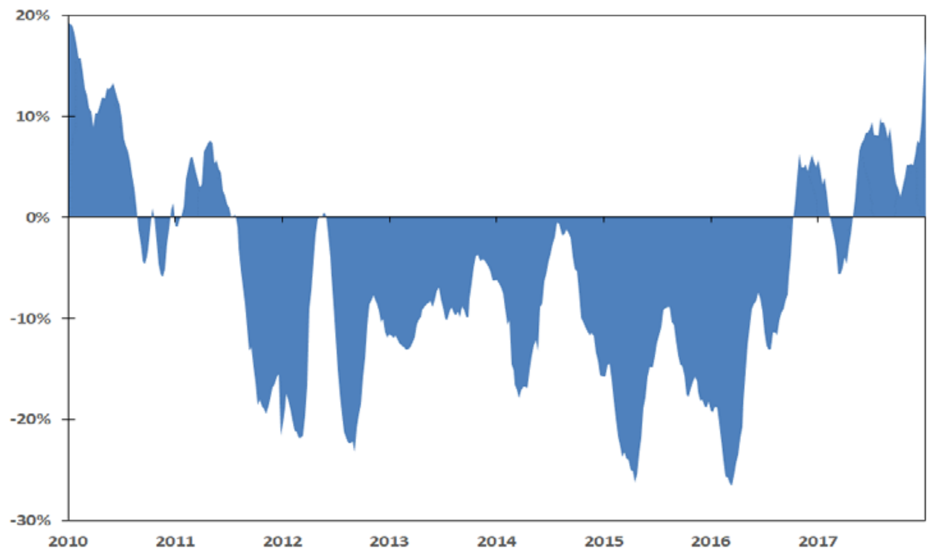
Figure 6: S&P 500 Operating EPS and Index of OECD Industrial Production



Source: S&P, OECD

Perhaps not surprisingly, since the summer of 2017 earnings estimate increases have significantly outpaced estimate decreases for companies in the S&P 500. Figure 7 illustrates this has been the most extended period of net estimate increases since 2010.

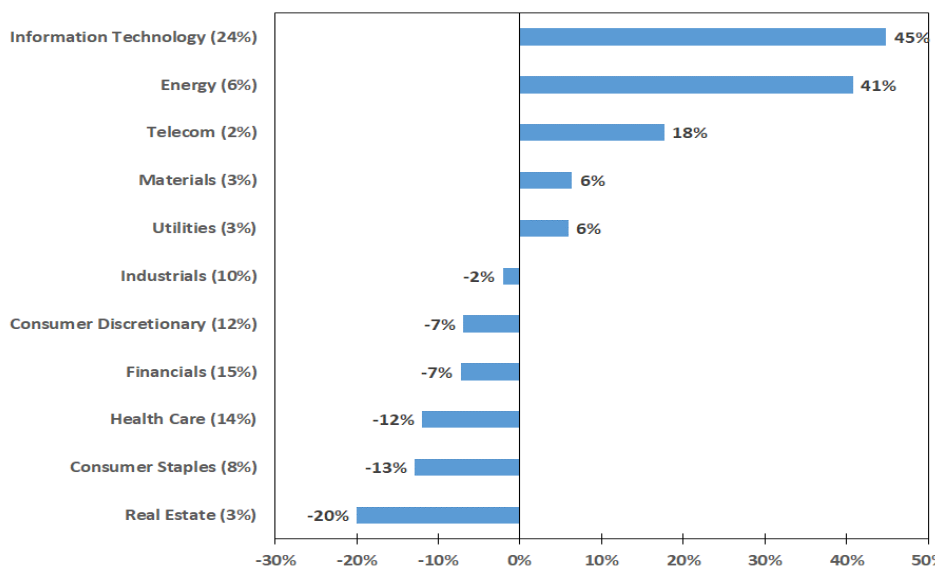
Figure 7: Percentage of Net Upward Estimate Revisions within the S&P 500
 # estimates up minus # estimates down as % of total # of estimates. Three month moving average of weekly data



Source: First Call

Figure 8 illustrates upward estimate revisions have been most prevalent in the Information Technology and Energy sectors, which combined account for almost one-third of the S&P 500.

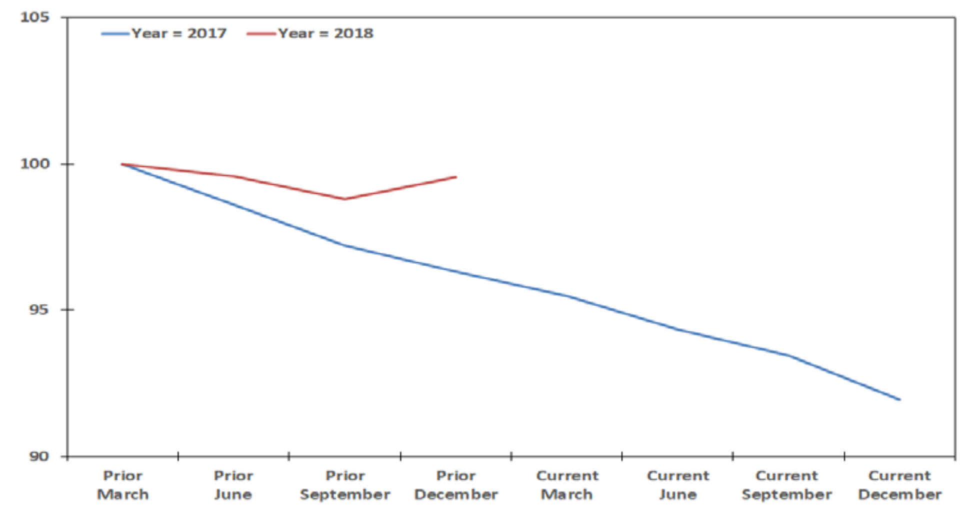
Figure 8: Percentage of Net Upward Estimate Revisions by S&P 500 Sector
Sector weight in S&P 500 in parentheses



Source: Bloomberg

Reflecting the combination of factors outlined above, Figure 9 illustrates that the consensus estimate for 2018 S&P 500 operating EPS *increased* in the fourth quarter of 2017. This is quite unusual because the usual pattern — seen in 2017 — is for the consensus earnings estimate to steadily *decline* with the progression of time.

Figure 9: S&P 500 Operating EPS – Consensus Estimates for 2017 and 2018 (Index: March = 100)

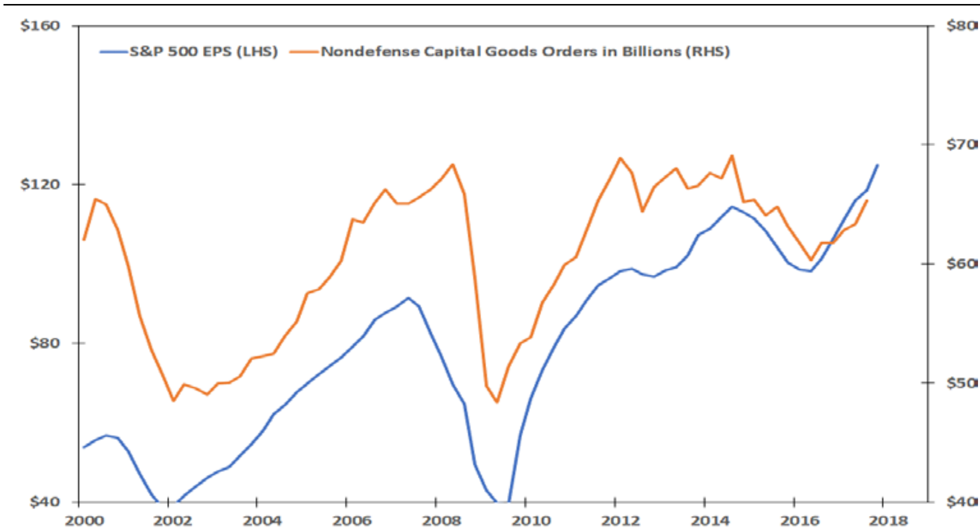


Source: S&P

Legislative Reform: A Wildcard in 2018

On top of this robust earnings environment, U.S. tax reform could give an additional boost to corporate profits. Following the passing into law of The Tax Jobs and Cuts Act of 2017, the corporate tax rate was cut to 21% from 35% effective January 1, 2018. While the full effects of the tax reform will likely not be felt in 2018, even a modest reduction in the effective corporate tax rate could boost S&P 500 operating EPS by a material amount. Moreover, reduced corporate concerns about government regulation could encourage companies to boost investment spending — nondefense capital goods orders are still 5% below their 2014 peak (Figure 10).

Figure 10: S&P 500 Operating EPS and U.S. Nondefense Capital Goods Orders



Source: First Call

Looking at it from an Environmental, Social and Governance (ESG) perspective, however, this tax reform — as well as additional legislative initiatives that could occur in 2018 — might not be the clear-cut positive it is for corporations.

- **Environmental.** Included in the new tax reform law is the provision for opening parts of Alaska's Arctic National Wildlife Refuge to drilling for oil, gas, and other energy development. Separately, it has been speculated that new legislation targeting infrastructure could also have negative consequences for the environment. For example, many conservatives argue that the Endangered Species Act hinders infrastructure projects. Similarly, the National Environmental Policy Act, which requires federal agencies to assess the environmental effects of their proposed actions, has been criticized as an impediment to development.

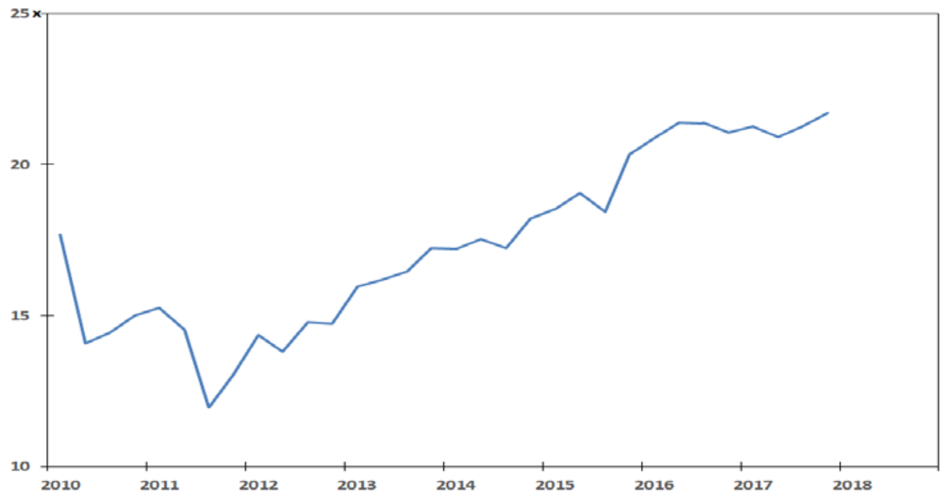
- **Social.** It had been predicted by some observers that the cut in the corporate tax rate would result in higher wages for workers. Indeed, following the passing of the tax act a number of companies — including American Airlines, AT&T, Bank of America, Comcast Corp, Fiat Chrysler, JetBlue, Fifth Third Bancorp, Southwest Airlines, Walmart— announced one-time bonuses for their employees. However, of the nine companies listed above, only two (Fifth Third Bancorp and Walmart) said they were also raising wages for their workers. A study by the president's Council of Economic Advisers said that material wage growth resulting from the tax act would take several years to go into effect. A likely reason for this is that, even in a tight labor market, employers aren't forced to pay workers more, reflecting a combination of factors including the globalization of the labor force, job automation, the decline of unions, and the rise of contract work.

- **Governance.** A group of Senate Democrats has joined Republicans to support legislation that would mark the first major revision of the Dodd-Frank Act, which was passed in the wake of the 2008 financial crisis to increase the regulation of the financial system. The intent of the current initiative is to roll back post-crisis rules and regulatory obligations. Critics argue that many of the institutions that received government assistance during the downturn would get less oversight, which would increase the risk of another taxpayer-funded bailout.

Further Gains in Stock Prices Likely in 2018

In terms of valuations, it remains the case that the price-to-earnings multiple is still elevated — Figure 11.

Figure 11: S&P 500 Price-to-Earnings Multiple



Source: S&P

Prior to the tax reform (i.e., in the summer of 2017) the consensus expectation was for a further increase in S&P 500 operating EPS in 2018. However, as noted above, even a modest reduction in the effective corporate tax rate could provide a material boost to S&P 500 operating EPS. Figure 12 illustrates that a 5% increase in the current consensus 2018 EPS estimate combined with a two-percentage point reduction in the P/E multiple — driven, perhaps, by interest rate increases by the Federal Reserve — would suggest about a 10% gain in stock prices in 2018.

Figure 12: Sensitivity Analysis – P/E Multiple and 2018 EPS

Current S&P 500 level	**2748**				
Current Trailing EPS	**$125**				
Current Trailing P/E	22				
Current Consensus 2018 EPS	$146				
P/E Multiple	22				
5% Increase in Consensus 2018 EPS	**$153**				
P/E Multiple	22	21	**20**	19	18
Implied 2018 S&P 500 Level	3366	3212	**3059**	2906	2753
% Change from Current Level	22%	17%	**11%**	6%	0%

Source: S&P, Cornerstone Capital Group

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