Confluence INVESTMENT MANAGEMENT

Current Perspectives

By Bill O'Grady and Mark Keller

2018 Outlook: Addendum

Summary:

When we wrote our 2018 Outlook, we were unable to take into account the Tax Cuts and Jobs Act of 2017[1] because the legislation had not been signed by the time we published our report. This Addendum will address the impact of the tax bill on our forecasts.

Our analysis suggests the impact will be significant. The legislation reduced the highest marginal corporate rate from 35% to 21%.

This table shows our updated forecasts[2] for the S&P 500.

	2018		
	Earnings	**P/E**	**Forecast**
Original	$129.82	21.1x	2739.20
Updated	$144.84	21.1x	3056.12

Although the tax bill will likely affect other parts of the financial markets and the economy, we expect those effects to be minimal. We do not expect any major change in economic growth nor do we anticipate that the rise in the fiscal deficit will seriously affect the fixed income markets. A rising deficit might also affect the dollar, but the historical pattern is mixed; if the deficit leads to more aggressive monetary policy tightening, it would be bullish for the dollar. This scenario characterized the early 1980s. However, the fiscal surpluses of the late 1990s also boosted the greenback. A rising fiscal deficit that does not trigger a monetary policy response is likely dollar bearish but, since our outlook already calls for a weaker dollar, we won't make any formal changes to our forecast there, either.

[1] The official name is the **Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018;** it has this unwieldy name to meet the strict parts of the Byrd Rule, which allowed the bill to pass through budget resolution by a simple majority.

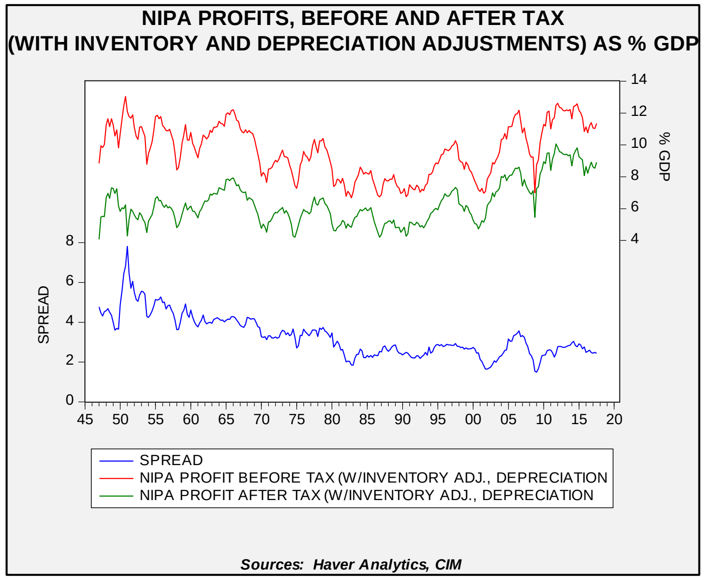
[2] This is a Standard and Poor's operating number, not a Thomson/Reuters operating number. If our forecast is correct, the latter operating forecast will rise to around $150 per share.

The Impact of the Tax Bill

We begin our analysis by using the National Income and Product Accounts (NIPA) calculation of corporate profits.

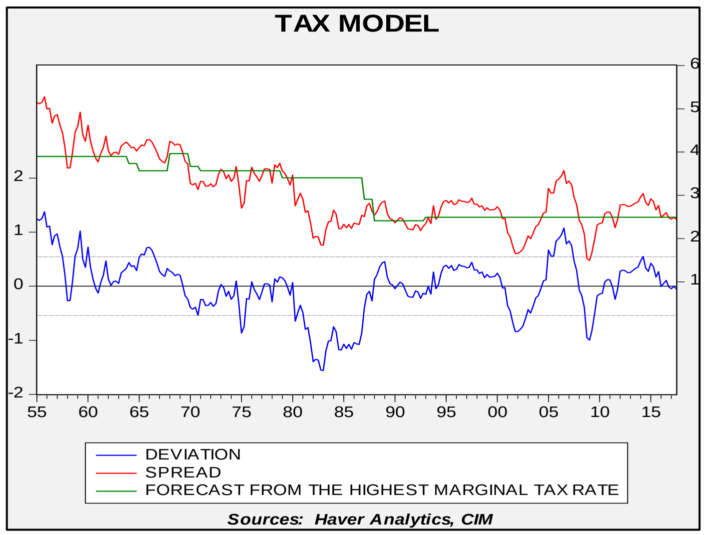
The upper two lines show NIPA corporate profits with adjustments for inventory valuation and depreciation as a percentage of GDP. Taxes make up the difference between the two lines, with the upper line pre-tax and the lower line post-tax. The lowest line on the chart shows the spread between the two measures. Note the spread narrowed steadily from the end of WWII until the mid-1980s; it has been mostly steady since the 1986 Tax Reform Act.

We use the spread to develop our forecast by comparing it to the highest marginal corporate tax rate.



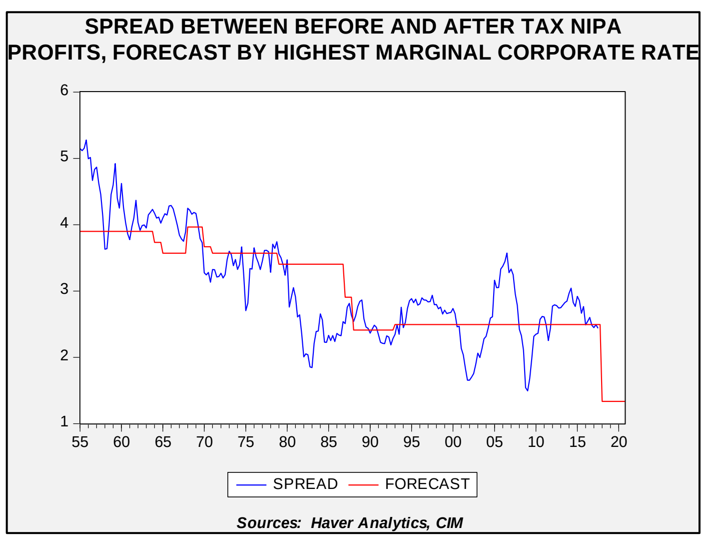
This chart shows the aforementioned spread and a regression model using the highest marginal corporate tax rate. As one would expect, cuts to the corporate rate tend to narrow the spread between pre-tax and post-tax profits.

We use this model to estimate the spread from the new legislation.



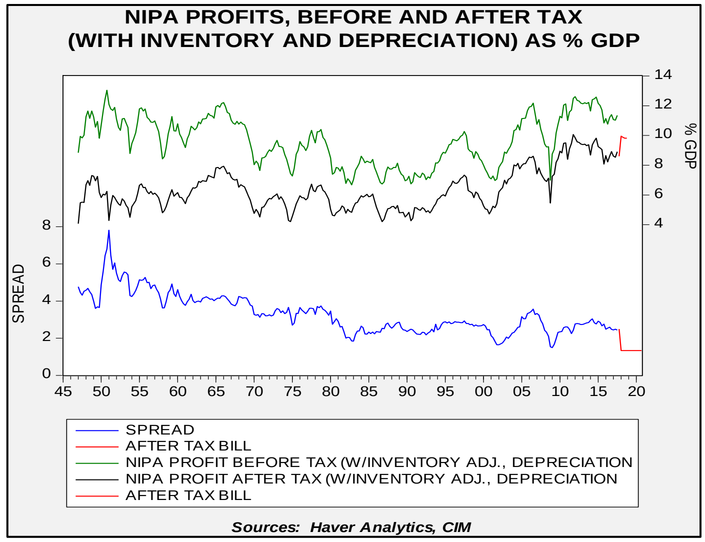
The impact of the legislation is large, cutting the forecast spread from its current level of 2.4% to 1.3%.

The next page discusses another way of examining the data.

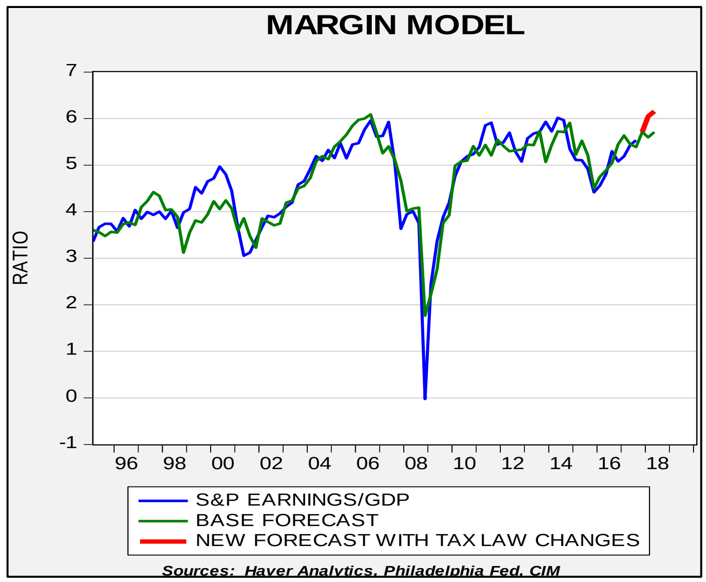


The red lines on this chart show our estimated impact of the tax cuts.

The NIPA profit data shows the profits from all corporate activity. The S&P 500 is a subset of what the government data measures. To project the impact of the legislation, we incorporated the forecast NIPA data into our S&P margin model.



On this chart, the blue line shows the ratio of total S&P 500 earnings to GDP. The green line is the forecast from our margin model. It includes productivity measures, global integration, several interest rate variables, corporate cash flow, the dollar and oil prices. And, we include the NIPA after-tax to GDP profit measure. The red line shows our forecast impact of the new legislation. As the chart shows, we are expecting a very significant effect; S&P 500 profits are expected to exceed 6%, a record level. **This is the basis for our new forecast.**



Obviously, our new forecast is aggressive. We are expecting a P/E of 21.1x (on a trailing basis) which is at the high end of the normal distribution of this measure of valuation. We don't know the path of future legislation and rule changes. If the administration decides to enact severe trade restrictions, we would not only expect a weaker multiple but also a decline in S&P 500 earnings. Although rhetoric from Washington has been elevated on this issue, to date, nothing of much significance has been enacted. In addition, as we detailed in both the 2018 Outlook and the 2018 Geopolitical Outlook, there are plenty of exogenous events that could adversely affect equity markets. However, if those adverse outcomes don't materialize, 2018 has the potential to be another good year for equities.

Bill O'Grady, *Chief Market Strategist*
Mark Keller, *CEO and Chief Investment Officer*

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This report was prepared by Bill O'Grady and Mark Keller of Confluence Investment Management LLC and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change. This information does not constitute a solicitation or an offer to buy or sell any security.