ON OUR MINDS

About That Tax Cut…

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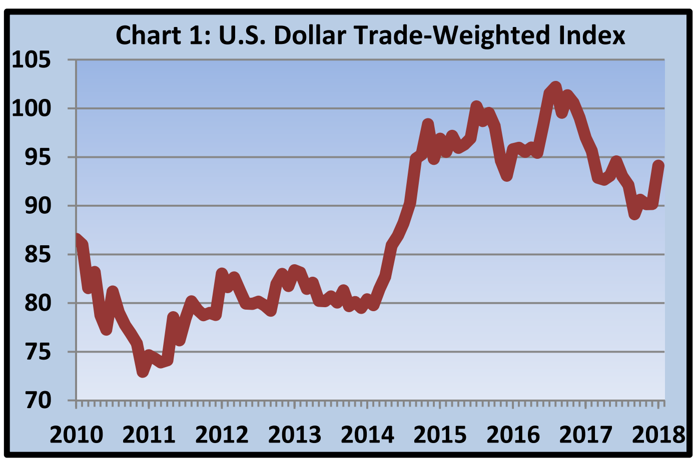
When the Tax Cuts and Jobs Act was signed into law last December, many investment strategists predicted a dramatic boost to corporate earnings growth and another blowout year for stocks.[1] They were half-right; earnings growth for the S&P 500 jumped 23% through the first quarter of 2018, but the stock market has gained less than 3% (including dividends) so far this year. What happened?

This is what the strategists got right: The TCJA was clearly responsible for much of the earnings growth. Most obviously, cutting the statutory corporate tax rate from 35% to 21% was responsible for about seven percentage points of the earnings growth. Further, the modest 13% tax on earnings repatriated from other jurisdictions encouraged companies to bring cash home, and to use it for stock buybacks; these buybacks have been accretive to earnings per share, adding another two percentage points to reported growth.

Indirectly, the TCJA's combination of repatriation incentives and favorable tax treatment of capital expenditures has proved to be an irresistible lure for companies to spend money on long-lived assets, which boosted sales for many S&P 500 companies. Durable goods orders were up 9% in the March quarter compared with a year earlier, and S&P 500 capital spending jumped 24%. Indeed, this was the first time since the recovery began in 2009 that capital spending growth exceeded earnings growth.

There were other factors at play, too, in the spectacular first-quarter earnings reports. Most notably, the U.S. dollar had lost nearly 15% of its value compared with a year ago (Chart 1), which made U.S.-made products more competitive in global markets. The softer dollar contributed almost two percentage points to earnings growth in the quarter. Finally, it's possible – but not yet evident in the data – that the reductions in individual income tax rates may have led to more consumer spending.

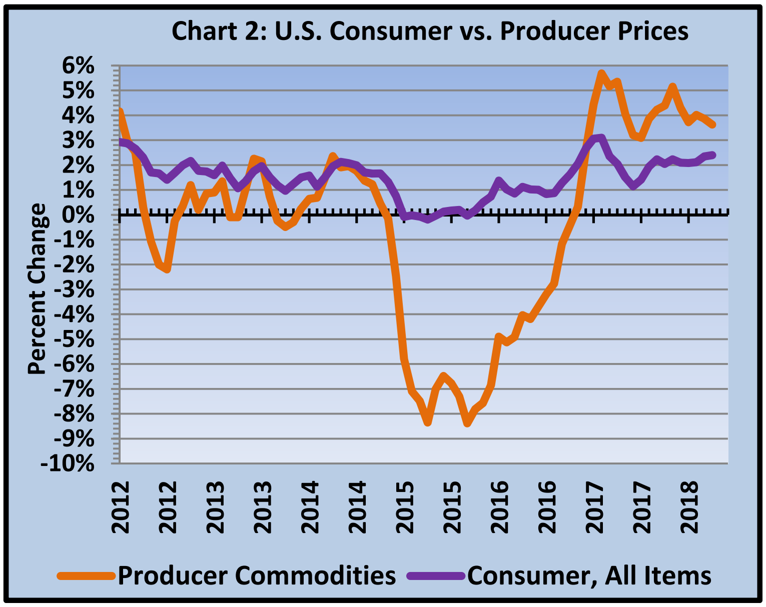


Source: FactSet

[1] Some of the pundits were especially enthusiastic in their stylistics. In Philadelphia, Linda Creed and Thom Bell wrote prospectively (back in 1971) of the TCJA: *You're a genie in disguise, full of wonder and surprise / and betcha by golly wow, you're the one that I've been waiting for forever.* The evidence so far suggests that Ms. Creed and Mr. Bell may have been a bit hyperbolic in their praise for the tax cuts.

Taking all of those factors together, it's reasonable to suggest that underlying "recurring" or "core" earnings growth was probably about 12% to 14%, which would be in line with the market's fourth-quarter 2017 earnings growth rate. The data so far suggest that companies can maintain this double-digit pace for a few more quarters, which can certainly support another boffo year in the stock market.

So why are stocks still hovering just barely above year-end levels? Here's what the strategists *didn't* see: First, profit margins may be peaking. Investors have begun to notice that commodities prices have been rising all year, led by oil's advance to $70 per barrel. Strong demand globally has meant that commodities producers have been able to pass most of these price increases on to "intermediate goods" producers. At the other end of the distribution chain, however, retailers and other "final goods" sellers have not had any pricing power. In other words, at each step of the supply chain companies have had to absorb somewhat higher costs without passing them through to their customers; that's begun to hit profit margins. As Chart 2 shows, plunging commodity prices kept a lid on consumer prices through the 2014-2016 oil price bust, but rising producer prices haven't yet pulled the CPI higher – hence the first inklings of profit margin pressure at a wide variety of firms.

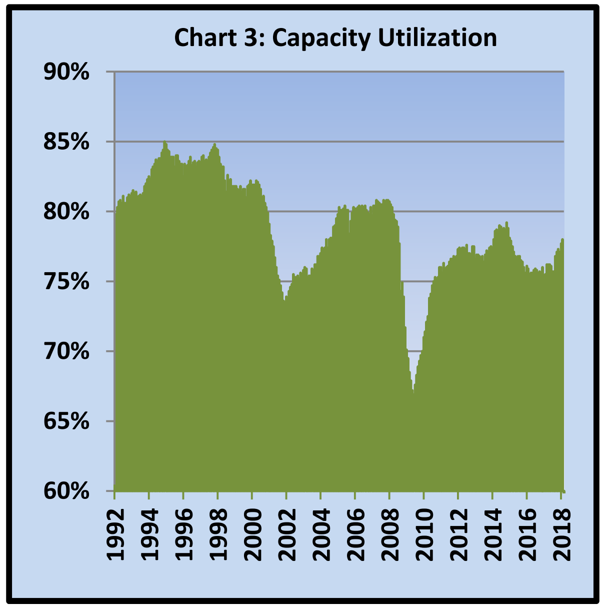


Source: Bureau of Labor Statistics

Second, some investors worry about the Federal Reserve's plans. The Fed has consistently indicated that it intends to raise short-term interest rates by a quarter-point twice more this year, on top of the first hike in March; that would be consistent with a "Goldilocks" forecast of an economy running neither too hot nor too cold. But could the economy be heating up too much? The rise in commodities prices and the decades-low unemployment rate of 3.9% have led some strategists to expect a *fourth* hike this year, causing other market watchers to fear that an overly hawkish Fed will inadvertently choke off growth and even cause a recession. Treasury futures prices currently imply about a 45% probability of that final rate hike this year, which has helped keep a lid on equity prices this year.

Finally, rising capital spending is actually a double-edged sword: While it boosts revenues for the sellers of capital goods, it also boosts costs for purchasers. Much of the remarkable record of earnings growth over the past decade can be attributed to operating leverage, i.e. the ability of firms to spread their fixed costs over ever-increasing sales. At some point, however, companies exhaust the capabilities of their existing infrastructure, and need to invest further; when they do, they create excess capacity and profit margins usually dip. The 24% jump in capital spending in the year's first quarter has scared many investors into thinking that the economy has hit this wall.

A closer look at capital spending, however, suggests that the capex surge isn't alarming. Overall capacity utilization has been rising and is currently at 78%, but Chart 3 shows that it has not yet hit the 80% to 85% levels that have previously marked the tops of prior economic and market cycles. Companies still have some spare capacity.



Source: Federal Reserve

It appears instead that spending has been driven more by opportunity than by need, and therefore won't be sustained. Firms can now write off the cost of new equipment at the time of purchase, rather than depreciating the cost over a period of years; this encourages spending as a means of reducing reported profits and therefore income taxes.

Further, the new low tax rate on repatriated earnings means that these companies now have plenty of free cash available to make significant investments. The "FAANG" stocks (Facebook, Apple, Amazon.com, Netflix, and Google's parent Alphabet) together have brought back so much cash that they increased capital spending 127% compared with a year ago, accounting for nearly 25% of the total S&P 500 increase in spending.[2] All of these factors may have acted in concert to pull capital spending forward from future years; because the nature of the surge has been opportunistic rather than necessitated by capacity utilization constraints, we think it will prove to be short-lived.[3]

The capex conundrum matters tremendously, because it will affect how the Fed interprets the impact of the Tax Cuts and Jobs Act. Chair Jerome Powell and his colleagues already know that the TCJA has flooded the economy with cash; if they see evidence that the money is being spent too quickly or if they think that higher spending rates will be sustained, they may choose to accelerate the pace of interest rate hikes in order to stave off inflation. On the other hand, if the Fed's economists believe that spending will remain in the Goldilocks zone, they will probably feel more comfortable maintaining the current pace of rate hikes.[4]

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[2] Although unrelated to the TCJA, it's also true that the modest increase in interest rates this year has caused some companies to accelerate debt-financed investments ahead of expected higher interest rates. The tax law's new limitations on deductibility of interest expense may have diminished this motive, however.

[3] For a more complete discussion of how the TCJA may affect corporate and individual behavior, please refer to "Tax Reform, Round One," by Mihir A. Desai, a professor at both Harvard Business School and Harvard Law School; it's at https://harvardmagazine.com/2018/05/mihir-desai-tax-reform.

[4] The dollar's recent strength (note the uptick beginning in April at the right edge of Chart 1), after more than a year of weakness, should guide the Fed toward restraint. With European growth slowing and Italy's political turmoil worsening, investors are flocking to dollar-based assets, driving down yields on Treasury securities. That gives the Fed less room to raise rates without raising the specter of an inverted yield curve.

The history of how the Fed has responded to tax cuts, by the way, is not encouraging. A recent empirical study[5] shows that previous tax cuts have usually backfired because the Fed typically responded too aggressively. The authors found that in the post-1980 era, the Fed quickly raised interest rates after Congress cut taxes, intending to offset excessively expansionary fiscal policy with tighter monetary policy. Unfortunately, the adverse effects of higher interest rates have historically overwhelmed the benefits of lower taxes; higher rates ate into profits, reduced the value of future profits, and discouraged borrowing and spending.[6]

In the current environment, the surge in capital spending looks on the surface like yet one more example of tax cuts overheating the economy; we hope that the Fed doesn't take the bait, and will instead continue its policy of restraint. Fear that the Fed will overreact is likely the biggest reason that stocks haven't followed earnings upward this year, but as a result stocks are now more attractively valued at only 15.5 times forward earnings. We think the burden remains on the bears, and we're sticking with our forecast for high single-digit returns from U.S. equities this year.

[5] Anthony M. Diercks and William Waller, "Taxes and the Fed: Theory and Evidence from Equities," Finance and Economics Discussion Series 2017-104. Washington: Board of Governors of the Federal Reserve System, published August 16, 2017. Available online at https://doi.org/10.17016/FEDS.2017.104.

[6] The reverse process has also been true, but the outcomes have been different. When Congress has implemented higher tax rates, the Fed has often responded with lower interest rates; however, the impact on economic behavior has been significantly muted. Congress may want to remember this good news when it decides to raise taxes to narrow the yawning federal deficit.