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## Pence Perspectives, Q4 2017

### Bottom Line Up Front:

The U.S. stock market has been mostly smooth sailing and major stock indices are positive for the year.<sup>1</sup> Meanwhile, we have had the lowest daily decline (the smallest maximum drawdown) in the history of the S&P 500 index.<sup>2</sup> There are several reasons why the markets are up and volatility is low. **First**, in the third quarter of this year, corporate profits reached an all-time high. The most obvious explanation for rising corporate profits is that the U.S. economy is well into a long, slow, and steady recovery. **Second**, less obvious, perhaps, is that international sales account for nearly half of revenue in the S&P 500 and business confidence is at a decade-high across Europe and Japan. This is because global growth is synchronized across the major economies for the first time since 2010 (see charts below). **Third**, low interest rates from central banks around the world haven't done much to move inflation higher, instead they are helping raise asset prices. The Federal Reserve (Fed) signals that the rates will continue to remain accommodative for a long period of time despite raising them "gradually" and promises to reduce its balance sheet in a non-hurried fashion. And finally, for the first time since the Great Recession, the government and the Congress are expected to introduce a major fiscal stimulus package in the form of tax reforms, a spending bill and deregulations, which is expected to further boost GDP growth and corporate earnings.



<sup>1</sup> As of November 28, 2017, MSCI world index, which is a broad global equity benchmark that represents large and mid-cap equity performance across 23 developed markets countries was up 18.0% for the year. It covers approximately 85% of the free float-adjusted market capitalization in each country and MSCI World benchmark does not offer exposure to emerging markets.

<sup>2</sup> As of October 23, 2017, maximum drawdown (MDD) of the S&P 500 index was -2.6%. MDD is the maximum loss from a peak to a trough of a portfolio, before a new peak is attained. MDD is an indicator of downside risk over a specified time period, in this case 52 weeks.

## IMF World Economic Outlook, October 2017

Selected Countries														Forecast		
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2022	
Argentina	8.9	8.0	9.0	4.1	-5.9	10.1	6.0	-1.0	2.4	-2.5	2.6	-2.3	2.5	2.5	3.2	
Australia	3.2	2.7	4.5	2.6	1.7	2.3	2.7	3.6	2.1	2.8	2.4	2.5	2.2	2.9	2.7	
Brazil	3.2	4.0	6.1	5.1	-0.1	7.5	4.0	1.9	3.0	0.5	-3.8	-3.6	0.7	1.5	2.0	
Canada	3.2	2.6	2.1	1.0	-3.0	3.1	3.1	1.7	2.5	2.6	0.9	1.5	3.0	2.1	1.8	
China	11.3	12.7	14.2	9.6	9.2	10.6	9.5	7.9	7.8	7.3	6.9	6.7	6.8	6.5	5.8	
France	1.6	2.4	2.4	0.2	-2.9	2.0	2.1	0.2	0.6	0.9	1.1	1.2	1.6	1.8	1.8	
Germany	0.9	3.9	3.4	0.8	-5.6	4.0	3.7	0.7	0.6	1.9	1.5	1.9	2.0	1.8	1.2	
India	9.3	9.3	9.8	3.9	8.5	10.3	6.6	5.5	6.4	7.5	8.0	7.1	6.7	7.4	8.2	
Indonesia	5.7	5.5	6.3	7.4	4.7	6.4	6.2	6.0	5.6	5.0	4.9	5.0	5.2	5.3	5.5	
Italy	1.0	2.0	1.5	-1.1	-5.5	1.7	0.6	-2.8	-1.7	0.1	0.8	0.9	1.5	1.1	0.8	
Japan	1.7	1.4	1.7	-1.1	-5.4	4.2	-0.1	1.5	2.0	0.3	1.1	1.0	1.5	0.7	0.6	
Korea	3.9	5.2	5.5	2.8	0.7	6.5	3.7	2.3	2.9	3.3	2.8	2.8	3.0	3.0	2.9	
Mexico	3.0	5.0	3.1	1.4	-4.7	5.1	4.0	4.0	1.4	2.3	2.6	2.3	2.1	1.9	2.7	
Russia	6.4	8.2	8.5	5.2	-7.8	4.5	4.0	3.5	1.3	0.7	-2.8	-0.2	1.8	1.6	1.5	
Turkey	9.0	7.1	5.0	0.8	-4.7	8.5	11.1	4.8	8.5	5.2	6.1	3.2	5.1	3.5	3.6	
United Kingdom	3.0	2.5	2.6	-0.6	-4.3	1.9	1.5	1.3	1.9	3.1	2.2	1.8	1.7	1.5	1.7	
United States	3.3	2.7	1.8	-0.3	-2.8	2.5	1.6	2.2	1.7	2.4	2.6	1.5	2.2	2.3	1.7	

Source: International Monetary Fund, World Economic Outlook Database, October 2017

When investor and business expectations are this high, it is harder to bring the market down. You will need a major shock to dislodge this market. And we don't see it in near future, at least, not in the form of economic downturn. In the long-run, aside from unexpected non-market events, what we see as risk to the recent market rally is the Fed's missteps in raising interest rates too soon and/or shrinking its balance sheet too fast, the government's inability to enact a legislation (especially the tax reform), and another commodity shock (oil prices plummeting) or currency shock (dollar rising too fast). At current stage, we think the likelihood of any of these events happening is relatively low, at least for the next 12 months. That is why we remain bullish and believe the markets will continue smooth sailing until the midterm elections next year in November 2018. Meantime, if/when there is a market correction with the absence of a structural issue, we expect it to be short-lived and believe that investors will most likely view it as a buying opportunity.

### Proposed Tax Reform

On November 2nd, Republican lawmakers unveiled the biggest transformation of the U.S. tax code in more than 30 years. The plan, named the Tax Cuts and Jobs Act, aims to permanently chop the corporate tax rate from 35% to 20%, compress the number of individual income tax brackets, and repeal the taxes paid by large estates starting in 2024.

On the **individual side**, the plan would collapse the total tax brackets from seven to four, with tax rates of 12%, 25% and 35%, and also keeps the top rate of 39.6% for the highest-earners over \$1 million for married couples (see table below). The plan aims to simplify and cut taxes for the middle class by doubling the standard deduction to \$12,000 for individuals and to \$24,000 for married couples filing jointly.

The mortgage interest deduction is unchanged for current homeowners, but for all future mortgages, the benefit would be capped at a home value of \$500,000, down from \$1 million under current law.

The deduction for state and local income/sales taxes would be eliminated. The deduction for state and local *property taxes* would be capped at \$10,000. A variety of other, much smaller deductions, like the medical expense

deduction and the property casualty loss deductions, are repealed. Most major tax breaks for individuals — the charitable deduction, retirement incentives like 401(k) and IRA provisions, the tax exclusion for employer-provided health care, the earned income tax credit, and the child and dependent care tax credit — would remain unchanged. The bill would also eliminate the alternative minimum tax, or AMT, which is expected to hit 4.5 million families in 2017.

On the **corporate side**, the plan sticks to President Trump’s proposal for reducing the corporate tax rate from 35% to 20. The cut would be immediate and permanent.

Perhaps the most significant, yet murky, shift is the move from a worldwide tax system to a **territorial tax system** for multinational corporations. In theory, this means that companies would not be taxed on their overseas earnings. Instead, there will be a 10% “global minimum tax”, which would apply to income that high-profit subsidiaries of American companies earn anywhere in the world. The effort is aimed at preventing companies from shifting profits abroad and grabbing back some of the tax revenue on income earned overseas. Those profits are currently not taxed until they are returned to the United States, giving companies an incentive to keep that money offshore since they are taxed at the current corporate tax rate of 35%. The White House claims that more than \$2.5 trillion in American profits are held offshore. A one-time repatriation tax would allow companies to pay a one-time, 12% tax on liquid assets held overseas, like cash. The tax would be payable over a period of eight years. For illiquid assets, like equipment or property, the tax rate would be 5%. Additionally, any money that multinational corporations move from the US abroad will be subject to a new 20% tax.

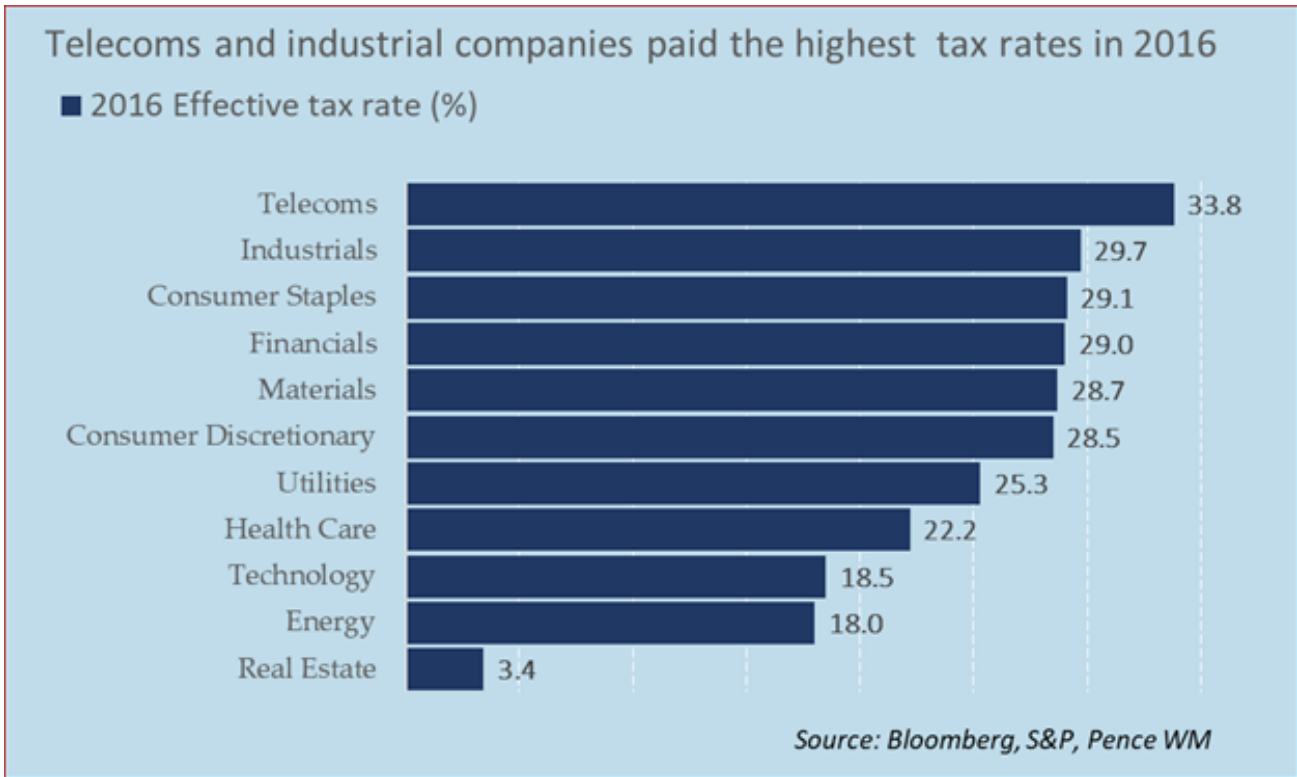
Instead of having companies “depreciate” investments by deducting them over several years, companies could immediately expense all their investments. This benefit expires after five years, presumably to save money, which dampens any positive effect it has on economic growth.

Companies paying the corporate income tax would face a limit on how much debt they can deduct from their taxable income, a significant change for highly leveraged companies like banks. They could only deduct interest worth up to 30% of earnings before interest/taxes/depreciation/amortization. But real estate firms would be exempt from that limit. Two big existing credits for corporations — the research and development tax credit and the low-income housing credit — won’t be repealed. But a deduction for domestic manufacturing is gone.

A new tax rate of 25% would also be created for so-called **pass-through businesses** such as LLCs, partnerships, sole proprietorships, and S corporations. They are currently taxed at the rate of their owners. But to prevent the rate from becoming a loophole for all sorts of individuals, tax-writers have created a formula they say will ensure that business owners will pay a higher individual tax rate on income that they receive as wages. The formula would be applied based on the circumstances of the business. The law would assume that 100% of earnings from professional services firms, like law firms and accounting firms, is wages, not pass-through income. For other businesses, people actively involved in the business as more than passive investors would see 70% of their income classified as wages and taxed normally, and 30% taxed at the pass-through rate.

Filing Single				
Current		Proposed		
Earnings	Bracket	Earnings	Bracket	
Up to \$9,325	10%	Up to \$45,000	12%	
\$37,950	15%	\$200,000	25%	
\$91,900	25%	\$500,000	35%	
\$191,650	28%	Over \$500,000	39.6%	
\$416,700	33%			
\$418,400	35%			
Over \$418,400	39.6%			
<i>The standard deduction</i>		<i>The standard deduction</i>		
\$6,350		\$12,000		
Filing Jointly				
Current		Proposed		
Earnings	Bracket	Earnings	Bracket	
Up to \$18,650	10%	Up to \$90,000	12%	
\$75,900	15%	\$260,000	25%	
\$153,100	25%	\$1,000,000	35%	
\$233,350	28%	Over \$1,000,000	39.6%	
\$416,700	33%			
\$470,000	35%			
Over \$470,000	39.6%			
<i>The standard deduction</i>		<i>The standard deduction</i>		
\$12,700		\$24,000		

Source: House Republicans



About 95% of businesses in the United States are structured as pass-throughs and they generate a majority of the government’s corporate tax revenue. Pass-through companies would still be able to deduct interest on loans in full, unlike C-corporations.

Some budget watchdogs expressed worry about the long-term impact of a plan they said could cost more than its benefits over a decade. In the absence of any base-broadening, it is estimated the plan will reduce tax revenue by \$2.4 trillion over the next 10 years and will increase deficits by \$1.5 trillion over the next 10 years.

According to Center on Budget and Policy Priorities, rather than slashing the corporate tax rate, true corporate tax reform that addressed inefficient corporate tax breaks, loopholes, and the tilt of the tax code towards debt and foreign profits would be more likely to foster growth. Such reform could help investments flow to where they are most productive. It could also raise revenues to reduce deficits and invest in national priorities like education and infrastructure, benefitting the economy and most Americans.

## What Tax Reform Means for the Market and Sectors

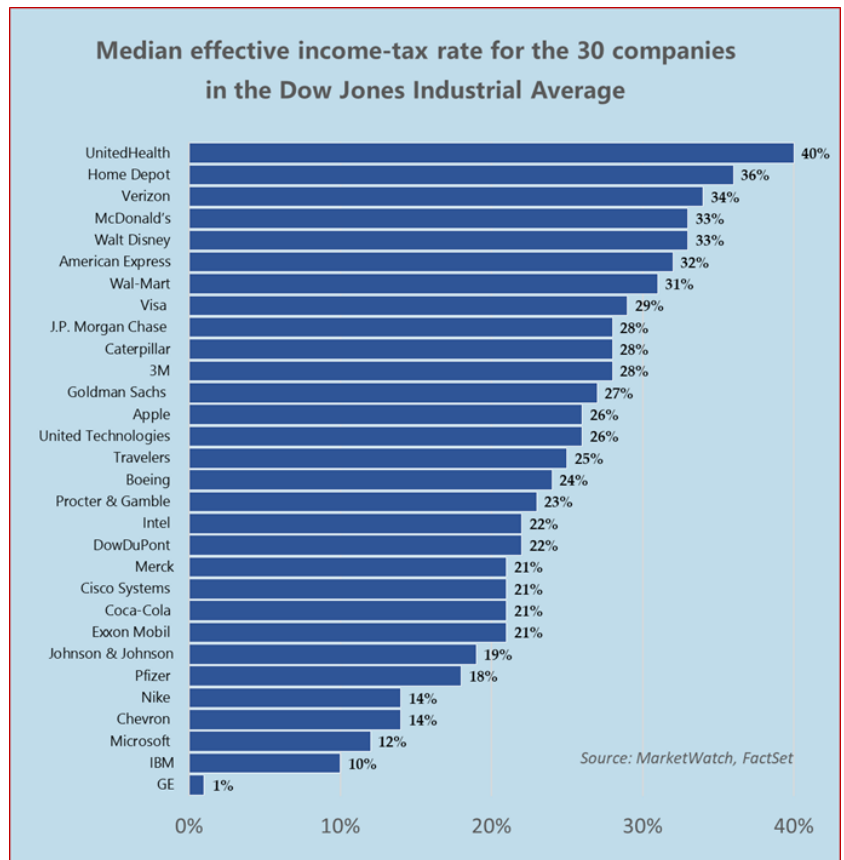
The tax plan is in an effort to repeat the success of the 1986 Tax Reform Act enacted during the Reagan administration. Overall, whatever the final version will be, the tax reform will be beneficial to businesses and therefore to the stock market.

Although the current U.S. **corporate tax rate** is at **38.9%**, which reflects the top U.S. federal rate, combined with average state and local taxes, the average **effective tax rate**—what the corporations actually paid was **28% for S&P 500** companies, according to Thomson Reuters data. This is because S&P 500 companies pay a rate close to 35% on their domestic federal income, but repatriate less than 30% of their foreign income and consequently pay only foreign taxes, which are generally lower than US taxes, on roughly 70% of foreign profits. In 2016, on average telecoms and industrial companies paid the most tax, at 30% or more and should benefit the most from the tax reform (see chart below). Energy and utilities will also benefit from a corporate tax cut these two sectors have had the highest 10-year median effective tax rates, according to Goldman Sachs.

We also believe that the **effective tax rate** for S&P 500 companies will not be much lower than the current rate. We expect the new tax bill to reduce effective tax rate to between 22% and 24% mostly due to eliminating deductions and including more restriction on profits made overseas. We estimate that one percentage point reduction in the effective tax rate may increase S&P 500 earnings by \$2. Therefore, a 5% tax reduction may boost corporate earnings as high as 8%.<sup>3</sup>

The median effective tax rate for the 30 mega-cap stocks in the Dow Jones industrial average is just **23.8%** (see chart). UnitedHealth Group has the highest effective tax rate while seven of the 30 Dow components currently pay less than a 20% tax rate.

Companies in the benchmark Russell 2000 of **small-cap companies** pay a median **effective tax rate of 32%**, according to Thomson Reuters data, which suggests that small-cap stocks will relatively benefit more than the large-cap stocks from a lower corporate tax rate.



## Conclusion

In the long-term, excluding the effect of price-to-earnings ratio (or P/E multiple) on the stock price, there is a positive correlation between the earnings and the stock price. If earnings go up, so does the price of a stock. This relationship gets stronger if the earnings growth has a positive long-term trend, meaning steady and consistent over time. In the absence of noise, multiple can be interpreted as a sign of investor confidence i.e. the higher the multiple, the higher the investor confidence about the direction of the market. We acknowledge the fact that the current market multiple is trending above its historical level but we do not see the market as overpriced. Instead, we view it as some of the future expected earnings growth and the effect of the tax reforms on future earnings being reflected in today's share prices. What we know today is that earnings of the S&P 500 index are expected to rise about 10% this year and in 2018. If the tax reform becomes a legislation, earnings growth will most likely go even higher and possibly longer into 2020. This may justify current levels of the market multiple and may validate why investors are participating in the rally.

$$\text{Price} = \text{Earnings} \times \text{Multiple}$$

Let's not forget the fact that Fed's willingness to keep the discount rate "relatively" lower for longer. Between 2014 and 2016, when interest rates were at the lowest in history, investors were looking for yield and buying value stocks. Now, as

<sup>3</sup> This year, analysts expect the S&P 500 to earn roughly \$131 per share, a 10% increase from 2016. For 2018, earnings are expected to grow a 7%, to \$140. Let's assume that the effective corporate rate goes down 5 percentage points to 23% — that would add \$10 to earnings, bumping up 2018 estimates to \$150 from \$140. That's a big boost — that's 7.5% more on top of the 7% increase that is expected without tax cuts. At a constant multiple, it represents about 15% expected returns in 2018.



interest rates are *slowly* moving higher, growth stocks have become investors' favorite given the fact that their big chunk of revenues come from overseas where growth has recently accelerated.<sup>4</sup> Rising market values in growth stocks have also contributed to the rising market multiple over time. This is because large growth companies such as Amazon and Facebook have contributed more to rising market multiple today than what IBM and Intel did 10 years ago when they had the same impact in terms of their weightings in the index.

There are two factors investors take into account before investing. One is **downside risk** (potential losses) and the other one is **upside risk** (not investing and missing out a market rally). We believe, today, upside risk is higher than downside risk. And that is why we believe markets have legs to go because those who are already invested will most likely stay invested in this market. In the absence of market-related shocks, those who have not yet participated in the rally will most likely enter the market during the smallest market correction, which is why we believe any market pullbacks will likely be short-lived and temporary as investors will view them as buying opportunities. This behavior is what gave the market smooth sailing so far since the election and we expect it to continue until the midterm election in November 2018.

*We appreciate your trust and the opportunity to be of service.*

*All the best, ❖*



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The Standard & Poor's 500 Index is a capitalization weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. Because of their narrow focus, sector investing will be subject to greater volatility than investing more broadly across many sectors and companies.

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<sup>4</sup> "Growth typically outperforms value in periods of solid but unspectacular activity" because "investors place a premium on growth stocks that are able to expand their top-line despite modest economic growth," according to Goldman Sachs report.