3Q 2017 Market Insights
Can Fiscal Policy or Financial Engineering save US Equities?
Part II – Tax Reform
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"The income tax has made liars out of more Americans than golf."
- *Will Rogers*[1]

Last quarter, in our 2q Market Insights 'Can Fiscal Policy or Financial Engineering save US Equities?', we addressed the issue of the overvalued US equity market and whether or not it could be cured by way of returning America to the glory days of 3-4% real GDP Growth. We concluded that, absent a massive demographic shift in the labor force or productivity enhancement, real GDP is likely to be more of the same, something less than 3% over the long run. Without a return to 3-4% growth, already lofty profit margins would need to expand further to create the near 40% growth in EPS required to return equities to fair value, if we are to avoid price declines. Despite what Wall Street may have you believe, sustainable long-term growth of real EPS has historically been less than 2% per year over the past 100 years. I will leave it up to you to do the math, but needless to say it will take a long time to grow our way out of this, without the pain of prices falling.

But, "Making America Great Again" was both an economic growth story as well as a tax savings story. This leads us to ask, just what effect might the tax part of the agenda have on solving our equity valuation conundrum? Let's begin to answer this question by revisiting the president's tax agenda, which includes three broad categories that may impact equity valuations. For simplicity, they are as follows:

1) Repatriation of foreign earnings at either a reduced rate or a one-time tax holiday
2) Revising the corporate tax rate
3) Personal tax reform

For those who missed last quarter's Market Insights, I encourage you to go back and read it as some of these concepts are explained more completely there. However, for the sake of time and brevity, I will provide a quick recap here.

The problem with US Equities, as we see it, is their currently lofty level of valuation (PE or price divided by earnings per share), which sits at 24x earnings vs. a historical average of about 16x earnings. This represents a 50% premium to what many consider to be fair value. Critics would argue that fair value might be higher. In fact, our own equity valuation model, allows for this, placing US equities at approximately 40% overvalued. However, as discussed last quarter, by assuming a higher fair value, one must also believe that the long-term true return from equities will be permanently impaired. The two go hand in hand. It is an error to assume one without the other. From a higher fair value, one can no longer assume a 10% rate of return. In fact, that return becomes about 7% under the best of circumstances. That is, if valuations remain elevated indefinitely. We, of course don't believe this is a reasonable expectation. Valuations ebb and flow and eventually find fair value. If this occurs over the next 10 years (a pretty safe assumption) the cost will be about 3 ½% per year to equity returns, resulting in a 10-year period where US stocks provide investors with roughly 3% per year in nominal terms. So, as the title states, can some sort of fiscal policy or financial engineering, in this case tax reform, correct this overvaluation without pain? That is, can earnings rise enough to cause valuations to decline, instead of requiring price declines to get there? That is the topic of this quarter's Market Insights letter.

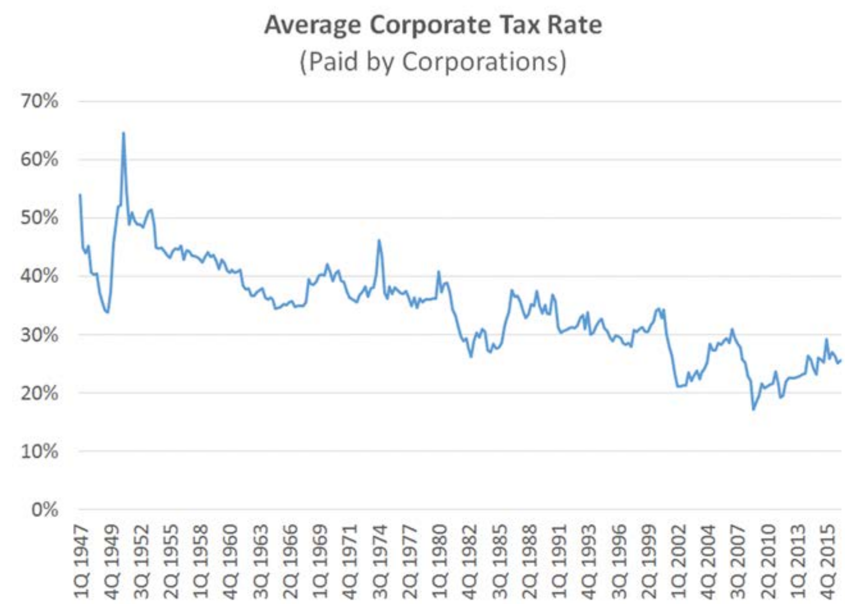
[1] William Penn Adair "Will" Rogers (November 4, 1879 – August 15, 1935) was a stage and motion picture actor, vaudeville performer, American cowboy, humorist, newspaper columnist, and social commentator. Source: Wikipedia

Disclosure: This article is not a political statement. We will discuss pro-growth policies of the current administration as a matter of relevance. This article will demonstrate the daunting task ahead for any party or administration.

<u>Introduction</u>

Tax reform, is a different animal than increasing real GDP growth. There is some crossover between the two, but as we identified last quarter, real GDP growth is caused by population and productivity growth. Tax reform overlaps through the productivity growth component, but only if one makes the assumption that people and private industry will employ those savings in higher NPV (net present value) projects than Uncle Sam will. Otherwise, it is a zero-sum game within the confines of a closed economy. What business and individuals gain, Uncle Sam will likely lose. One must also assume that any tax savings are spent/invested and not saved. Savings, at the aggregate level is a negative when it comes to profits. We'll discuss this in greater detail later. The argument here, as it pertains to equity valuations, is that taxes impact the profit channel, and thus, growth of real EPS. This impacts valuations.

Historical Perspective on Corporate Taxes



The average tax paid by corporations in the most recent quarter was 26% vs. the stated maximum tax rate of 35%. The difference is in great part due to many above the line deductions such as interest on bond payments, many of which are in the line of fire and may not be allowed going forward.

Data Source: Federal Reserve Board

<u>Repatriating Earnings</u>

Allow me to take the low hanging fruit first. Repatriation of foreign earnings, either at a reduced tax rate or completely tax free, <u>in and of itself</u> will have no positive impact on growth of Real EPS. In fact, the impact is likely to be negative. The reason…these dollars have already been counted into earnings. They just haven't been taxed within the US. To bring those dollars back to the US would most likely result in a tax bill and nothing more, negatively impacting future EPS, as corporations pay the bill on yesterday's earnings.

While out of scope for this discussion, due to the myriad of possible uses for these dollars, I want to acknowledge that this cash windfall could have a somewhat positive impact on earnings through the corporate finance channel, if it were used for things like share buy-backs or to finance profitable reinvestment activity. Essentially, mass repatriation provides US corporations with a debt free multi-trillion dollar stimulus, so long as companies make capital investments, rather than simply horde the cash on their balance sheets. This could impact profits, as we discuss later in the Personal Tax Reform section of this article, either in the form of business investment or dividends. However, since there are too many assumptions that need to be made (i.e. will dividends be spent or saved? are there positive net present value projects that need financing? are equities inexpensive enough to warrant share buy-backs by management?), we won't attempt the exercise until we have more complete information, possibly within the next few quarters. For now, we will leave it as the act of repatriating earnings in and of itself, will have zero impact on growth of real EPS as we stated previously. The secondary actions, could potentially have some positive impact.

Revising the Corporate Tax Rate

The second item on our list, reducing the corporate tax rate could have a positive impact on EPS growth. The question is how much. Taxes are linked to valuations via the profit channel and its corresponding link to earnings. To best understand we break this impact into two parts. The first, is understanding how taxes impact return on equity (ROE)[2]. For those that are interested, the formula is noted in the footnote section and can be simplified into net income per unit of equity, or the return that investors receive from the company. The impact of a tax change is relatively straight forward. Take a company with a zero-tax rate and an ROE of 20%. Now change the tax circumstance to a 10% tax rate. The ROE would then become 18%. The important take-away here is the magnitude of the change. The tax rate is applied in a relative manner (geometrically), which means that a 10% change in the tax rate moves the dial 2 ticks on an ROE of 20, not 10 ticks.

But this only gets us to a metric of profitability. What we need to understand is the long-term sustainable growth of real EPS under a different profitability level, the second part of our two-part relationship. This relationship is also a simple one and is ROE x (1-Dividend Payout Ratio) – Annual Inflation. Since 1990, ROE on the S&P 500 has been 13.14%, with a payout ratio of 53% and inflation that has averaged approximately 3%. As a result of our formula, we would expect the sustainable growth rate of real EPS to be 3.17%. The actual growth rate of real EPS over that period, measured in hindsight, was 3.13%.

Now, how President Trump's tax package will impact valuations requires some assumptions, since the full details of the deal are not known, much less approved. From the chart above, we can see that the average tax paid by corporations in our most recent quarter was 26% vs. the stated maximum tax rate of 35%. The difference here is in great part due to many "above-the-line" deductions, such as interest on bond payments (many of which are in the line of fire and may not be allowed going forward). In addition, this is aggregate level data. Since some corporations may be less profitable or not profitable at all, their tax burden may be less, explaining the difference.

Again, to spare those who prefer not to completely geek out, removing the deductibility of interest, as is currently being discussed, changes the formula footnoted on the prior page and impacts profitability substantially. Our modified Dupont formula[3] can be found below. The punch line, holding all else constant, but simply disallowing corporations from deducting interest payments would change the historical ROE from 13.14% to a modified ROE of 11.86%.

Let's assume that after eliminating many of the deductions (as is currently likely) that the proposed cut in the corporate tax rate to 15% produces an effective tax rate of 12%. If anything, those assumptions should be viewed as aggressive and at or near a best-case scenario. The modified ROE of 11.86% that we previously discussed would move upward to 14.11% due to the lower corporate tax rate. The payout ratio is currently at 46%. Depending on your inflation expectation, this places the sustainable growth rate of real EPS at

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[2] ROE = [(EBIT / sales) * (sales / assets) – (interest expense / assets)] * (assets / equity) * (1 – tax rate)

[3] Modified ROE = [EBIT/Equity x (1- Tax Rate)] – (interest expense/assets)

approximately 4.6% vs the 3.13% historical rate. In a historical context of the last 30 years, or for that matter over the longer-term, this represents a meaningful move above the average by about one standard deviation. I must remind everyone that this jump required some generous assumptions on the change in the tax rate, along with an even more generous assumption that the most profitable period in our history, the last 20-30 years, would repeat itself to arrive at an even loftier level of profitability after tax changes are applied. At a 4.6% growth rate of Real EPS it would require roughly 7 ½ years of growth to increase earnings by enough to absorb the valuation gap. This would also require zero price gains for that period.

<u>Personal Tax Reform</u>

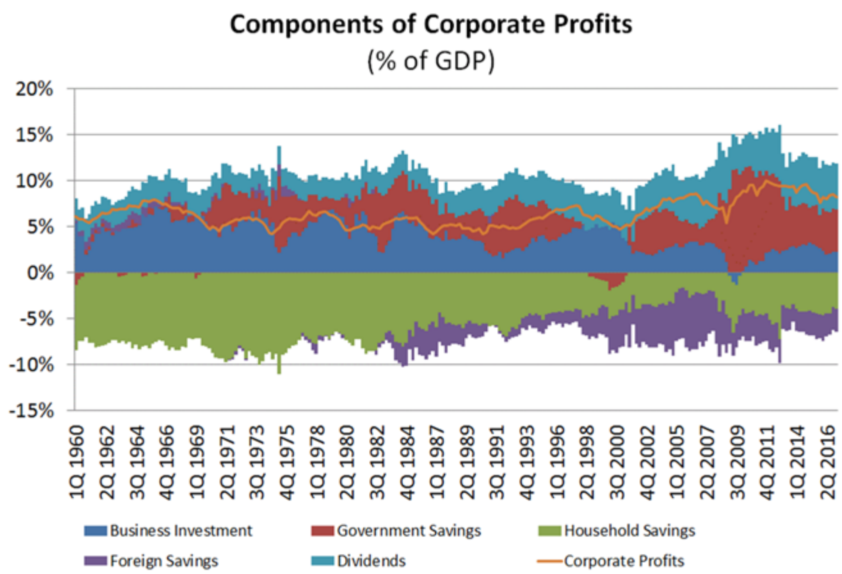
The third item, personal taxes is also a bit nebulous. To make it more concrete, we will offer a different view of the profit channel, a view from the top down. Profits at an aggregate level, in a closed economy, are detailed in the chart below and can be described via the following formula:

[4]Profits = Business Investment – Household Savings – Gov't Savings – Foreign Savings + Dividends

From the formula above we can see that Business Investment along with Dividend Income contribute positively to profits, while any form of savings, contribute negatively. Remember, think of this collectively. If money is being saved, it isn't being spent. If it isn't spent, then the lifeblood of corporations is choked off at the source. The other take-away from the chart is that the values can be positive or negative. For example, negative government savings is deficit spending, which contributes positively to the profit formula during the period.

How does this relate to personal taxes? Given the myriad of possibilities, the only real take-away at this point, as it relates to valuations is that personal tax cuts could contribute positively to profits under two conditions. 1.) Tax cuts must be spent and not saved. As discussed above, any savings removes money from circulation and will ultimately drag on profits. 2.) Any tax cut cannot come at the expense of

Top Down Perspective on Profits



In simple terms, business investment and dividends (received by consumers and spent) make a positive contribution to profits while savings of any sort remove dollars from circulation and reduce overall profits. Wages and consumption are both important pieces to the puzzle but are netted together to form savings. In this case, negative savings, or borrowing, is a positive contributor.

Source: GMO, Federal Reserve Board NIPA Accounts

[4] What Goes Up Must Come Down! James Montier, GMO 2012

reduced government(deficit) spending. That is, tax cuts cannot be met with spending cuts, otherwise the sum will be zero and the impact on profits will also be zero. Now, it's important to note that I am not advocating either. I am simply pointing out how a personal tax cut could positively impact profits, earnings growth, and correspondingly valuations. In my humble opinion, I doubt that personal tax cuts will pass if it requires expanding the deficit. Therefore, at this point and without further detail, it is my expectation that the impact of personal tax rate changes on profit margins, EPS growth, and correspondingly valuations will be negligible.

<u>Summary</u>

Since the election in November, President Trump's rhetoric relating to pro-growth, business friendly policies have been met with cheers from investors. From election day to June 30, 2017 US Stocks[5] have advanced by 15.27%. That has led us to evaluate the rationale behind today's lofty valuation levels. Typically, valuations ebb and flow over the course of the business cycle. The average valuation is just that, the average. There are periods where stocks are bargains and others where they are quite rich.

In those periods where markets are priced richly, like today, one must question what the market is anticipating and how this is being reflected in today's price. We must then, at a minimum, ask ourselves the reasonableness of those assumptions and preferably build a framework to quantify them. In the last two quarters, we've built such a framework around accelerating economic growth and decreasing taxes. We've tested both to determine if fiscal policy or financial engineering can save US equities. While there is hope for some help around the edges, to expect our current high valuations and the associated future low returns that result from those valuations over the long run to be solved by these policies is probably not reasonable.

In the end, this leaves us much where we began. That is, leaving reasonable long-term investors searching for alternative, attractively-priced sources of return, such as emerging markets equities and debt, international stocks, commodities and certain closed end funds, as the solution for an overpriced US Equity market. While this circular journey has left us back where we began, it serves to reinforce our conviction in our current portfolio positioning. As always, we encourage investors to remain focused on the long-term and avoid being emotional if adversity should arise. Thank you for your trust and confidence.

[5] Russell 3000 Index