# Market Bulletin

January 31, 2018

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## 4Q17 earnings update: Let's talk about taxes

### In brief

- While higher volatility may be on the horizon, healthy earnings growth should prevent minor pullbacks from becoming more severe and support a continued rise in U.S. equity markets against a backdrop of higher interest rates.
- The 4Q17 earnings season is off to a strong start, with the number of companies beating earnings and revenue expectations near all-time highs; financials, energy and technology were key drivers for profits in 4Q.
- The Tax Cut and Jobs Act (TCJA) has inundated 4Q17 earnings with one-time charges and benefits related to deferred taxes and cash held abroad, but these charges should be viewed as short-term pain in exchange for benefits that will be recognized over the long-term.
- Certain sectors and styles stand to benefit from tax reform more than others, suggesting an active approach to investing is warranted in the current environment.

### Safety in earnings

The U.S. equity market ended 2017 on a high note, and this momentum has carried over into 2018. Investors have embraced an outlook characterized by healthy global growth, a new U.S. tax bill, still-low inflation and a gradual normalization of monetary policy, pushing risk assets higher in the process. As the market has moved higher, volatility has remained low, leading many to ask when market gyrations will make their triumphant return. While we would not be surprised by a 10% correction at some point this year, there is good reason to believe that it would only be a correction, and not the beginning of a bear market.

The primary catalyst for such a sell-off would likely be a sharp rise in interest rates or interest rate expectations, as this would lead the risk-adjusted returns available in fixed income markets to look increasingly attractive relative to equities. Returns in 2017 were driven by nearly equal contributions from earnings growth and multiple expansion, with the improvement in sentiment leading the S&P 500 forward P/E ratio to levels not seen since 2002. While this suggests that valuations may be a risk, with the solid earnings growth seen in 2017 expected to continue during the coming year, profits should act as a safety net and catch the market if it begins to fall.

## Earnings and taxes

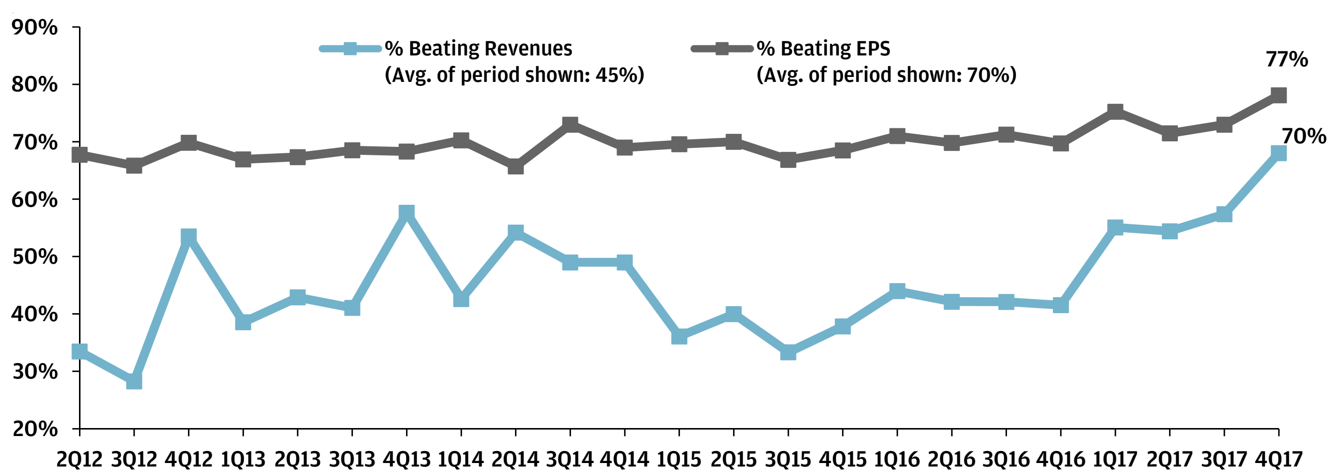
The 4Q17 earnings season is off to a good start. With 66% of S&P 500 market cap reported, 77% of companies have beaten earnings estimates, and an impressive 70% of companies have beaten revenue estimates, the highest revenue beat rate since the first quarter of 2010 **(Exhibit 1)**. Based on reported earnings and analyst estimates, operating earnings are estimated to have grown by 19% over the past year, as profit margins sit near all-time highs and revenue growth has remained solid.

Our expectation is that the financial, energy and technology sectors had a significant impact on 4Q17 profits. Within the financial sector, results have been driven by solid underwriting activity, higher net interest margins, and impressive results from wealth and asset management businesses. Trading, however, remains a sore spot, as overall volumes remain weak. Furthermore, many financial companies have taken large charges related to the new tax bill - while these charges are not captured in operating earnings, "as reported" earnings have taken a hit - but in light of this, results still look solid.

The energy sector should benefit from easy year-over-year comparisons, as the sector dragged on headline profitability in 4Q16 due to large write-offs. Weaker comparisons, coupled with higher and more stable oil prices, should lead energy earnings to look more favorable in 4Q17. Finally, technology sector sales look set to benefit from a combination of robust demand for products and services, as well as a weaker dollar; technology companies have some of the highest margins in the S&P 500, and as a result, any improvement on the revenue front should be reflected in earnings as well.

**EXHIBIT 1: EARNINGS AND REVENUE BEATS ARE AT OR NEAR ALL-TIME HIGHS**

**% of S&P 500 companies beating revenue and EPS estimates**




Source: Compustat, Standard & Poor's FactSet, J.P. Morgan Asset Management.
EPS levels are based on operating earnings per share. 4Q17 earnings and revenues beats are based on 66.3% of companies that have reported.
Past performance is not indicative of future returns. Data are as of 1/31/2018.

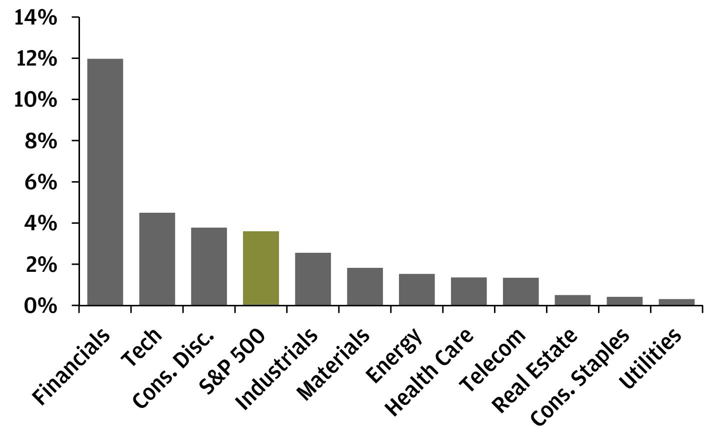
Earnings results have been impressive thus far, but questions remain around the impact of the new tax bill. As companies prepare for a headline tax rate of 21% in 2018, two notable trends this earnings season have been the revaluation of deferred tax assets and liabilities, and the taxes paid on cash that will be repatriated from abroad. From an accounting standpoint, companies are required to take charges related to new liabilities from the tax bill during the period in which the bill was enacted. This is essentially a trade-off between 4Q17 pain and a 2018 gain – these charges have dragged on 4Q17 earnings, but more optimistic corporate guidance has pushed 2018 earnings estimates 5.8% higher since the beginning of the year.

That said, the revaluation of deferred tax assets and liabilities will vary across sectors. The two charts in **Exhibit 2** look at deferred tax assets and deferred tax liabilities, both as a percentage of sales, across S&P 500 sectors. While areas like telecommunication and energy stand to benefit from a revaluation of deferred tax liabilities (the lower tax rate decreases the value of these liabilities), companies in the financial and technology sectors have taken or look set to take a hit to 4Q17 profits, as the value of their deferred tax assets has declined.

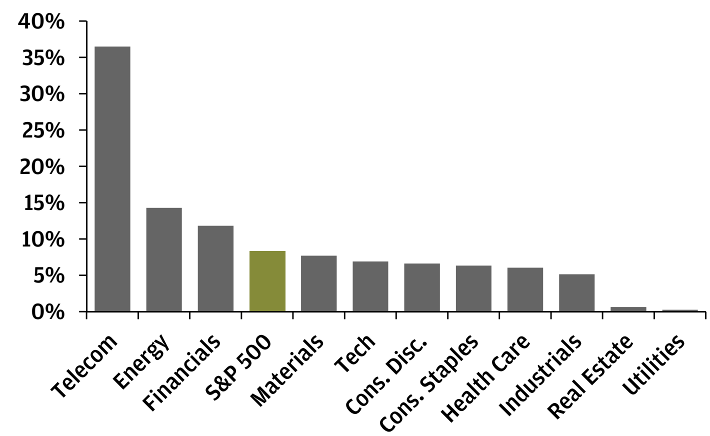
Furthermore, the anticipated repatriation of cash held abroad has impacted 4Q17 earnings. We exclude financials from this analysis as financial companies tend to have liquidity based balance sheets – in other words, the liquidity that these institutions hold abroad is collateral against the loans that they make, rather than simply cash or retained earnings. Estimates suggest that S&P 500 companies, led by the technology sector, have stashed around $1 trillion of cash outside the U.S., as shown in **Exhibit 3**.

**EXHIBIT 2: DEFERRED TAXES WILL IMPACT REPORTED EARNINGS**

S&P 500 Deferred tax assets as a % of sales



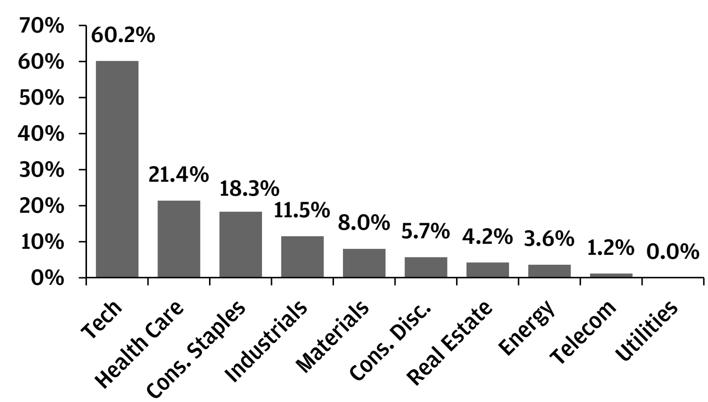

S&P 500 Deferred tax liabilities as a % of sales




Source: Bloomberg, FactSet, J.P. Morgan Asset Management.
Deferred tax assets, deferred tax liabilities and revenues based on company's most recent 10k filing. Data are as of 1/31/2018.

**EXHIBIT 3: ONE-TIME CHARGES FROM DEEMED REPATRIATION MAY CAUSE SHORT-TERM PROFIT PAIN**

S&P 500 ex-financials cash held overseas as a % of current assets




Source: Bloomberg, FactSet, J.P. Morgan Asset Management.
Cash held overseas and current assets based on company's most recent 10k filing. Data are as of 1/31/2018.

This cash is subject to a one-time repatriation tax of 15.5%. The question is how this cash, and more broadly, the savings from a lower corporate tax rate, will be used going forward. Although very few companies have provided concrete plans on how they intend to use this cash, 4Q earnings announcements have provided some guidance. In general, it sounds like this cash could be used in the following ways:

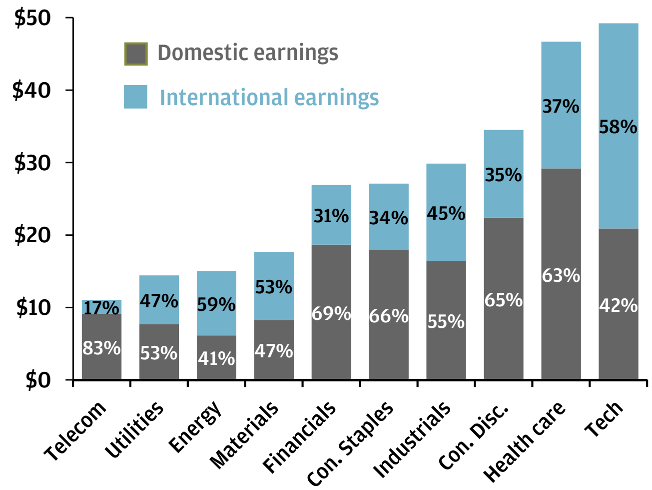
- “Opportunistically” or “strategically” - this suggests a potential uptick in M&A
- To “accelerate” investment or capex spending
- To “enhance” buyback programs
- To invest in communities and employees - some companies have announced charitable contributions, while others have paid one-time bonuses and raised wages for some employees

We have not seen too many companies discuss the possibility of a one-time dividend or raising dividend payments, but with one third of the technology sector yet to report, this could change in the coming weeks.

The one-time charges related to deferred tax assets, liabilities, and cash held abroad, serve as a reminder that the tax bill will affect different sectors in different ways. Earnings reports over the coming weeks should continue shedding light on which sectors will be impacted the most by these charges, but a longer-term consideration for investors will have to do with whether the majority of a company’s earnings are generated in or outside the U.S. As shown in **Exhibit 4**, the technology sector generates more than half of its earnings outside of the U.S., while less than one-third of financial sector earnings come from abroad. Against a backdrop of lower domestic corporate tax rates, those companies who generate the majority of their earnings in the U.S. should see a more significant boost to profitability.

**EXHIBIT 4: HIGH TAX COMPANIES TEND TO RECEIVE MORE OF THEIR EARNINGS FROM DOMESTIC SOURCES**

2017 S&P 500 operating earnings




Source: Standard & Poor's, J.P. Morgan Asset Management.
Earnings are based on actual sales for 1Q17-3Q17 and sales estimates for 4Q17. U.S. and international margins are assumed to be equal. Foreign percent of sales is from Standard & Poor’s, S&P 500 2016: Global Sales report. Data are as of 1/31/2018.

## Investment Implications

Given a backdrop of solid economic growth, healthy profit growth, and a gradual rise in interest rates, the U.S. equity market looks positioned to push higher in 2018. However, this upside will likely come with a healthier dose of volatility than the market has experienced in some time. While we believe that earnings will act as a safety net if the market comes under pressure in 2018, late cycle fiscal stimulus in the form of the new tax bill should push economic growth higher and the unemployment rate lower, leading wage growth to accelerate and putting upward pressure on both inflation and interest rates.

As wages and interest rates both rise, profit margins will come under pressure, leading earnings growth to slow from the robust pace observed over the past year. In the interim, however, equity markets can continue to rise. A macroeconomic backdrop characterized by stronger growth, rising rates, higher inflation and a weaker U.S. dollar has traditionally supported the outperformance of value over growth. However, not all value stocks are created equal, and we have a preference for sectors like energy and financials, rather than the high-dividend paying sectors like telecommunications and utilities. The bottom line is that navigating the equity market during the coming year will require an active approach – the key will be to identify those sectors which stand to benefit from healthy economic growth and lower domestic tax rates.

One final point – more and more investors we speak with have been asking if the equity market is becoming irrationally exuberant. While the market does feel a bit extended from a valuation standpoint, and the lack of volatility should not go unnoticed, the fact that investors are asking this question suggests that we are not there yet. However, as the market gradually transitions from optimism to euphoria, a focus on the fundamentals and will become increasingly important as investors gradually fall prey to their own emotions.

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