PICTET 1805

Flash Note

DM equities in hard data pricing mode

Equity markets are not discounting US tax reform and are likely to progress at the pace of 2018 earnings growth forecasts

Pictet Wealth Management - Asset Allocation & Macro Research | 28 November 2017

Recent hard macro data confirms the resiliency of the business cycle into year-end and into 2018.

We are sticking to the core scenario we set out for 2017 and for 2018, i.e. developed equity market prices should increase at the same pace as expected earnings growth, which stands at around 10%.

In the current hard data pricing mode, developed equity market prices are not pricing in proposals to cut the standard US corporate tax rate from 35% to 20%.

Valuation levels are high (S&P500 12m Fwd PE of 17.4x and 14.9x for the Stoxx Europe 600), so any disappointment would lead to a significant correction in DM equity markets.

AUTHORS

Jacques HENRY, CFA
jhenry@pictet.com
+41 58 323 2916

Wilhelm SISSENER, CFA
wsissener@pictet.com
+41 58 323 3475

Pictet Group
Route des Acacias 60
CH - 1211 Geneva 73
www.pictet.com

Equity market fundamentals are improving, with hard data confirming a strengthening of the global business cycle as we move into a new year.

Improving macro fundamentals sustain developed equities

The business cycle is one of three macroeconomic risk factors (drivers) we use for our 2017-2018 top-down central scenario. Whereas soft data supported developed-market (DM) equities earlier this year, more lately their performance has been based on improvements in hard business cycle data, including:

- **Stronger-than-expected US growth momentum** into Q4 (e.g. nominal exports and consumption), which has caused us to increase our 2017 US GDP forecast to 2.3% (+0.1pp) and our 2018 forecast to 2.0% (+0.3pp).
- **A strengthening business cycle in the euro area as well** (e.g. second estimate of Q3 GDP growth), leading us to foresee upside risks to our 2017 and 2018 GDP forecasts (2.1% and 1.7%, respectively).

Two macro risk factors we use to shape our 2017-2018 scenario provide further tangible support for DM equity prices:

- **Inflation**: recent hard data confirms **that inflation pressure** remains mild in both the US and the euro area. We expect the 2017-2018 **core consumer price index** to remain **slightly below the 2% target** set by the Fed and the ECB alike.
- **Monetary policy:** major central banks remain **market friendly**. The appointment of Jerome Powell as **the Fed's new chairman** is **unlikely to change the course of US monetary policy** (we expect three more 25bps hikes between now and end-2018). In Europe, **the ECB is likely** to continue to act cautiously.

All in all, the global macro backdrop is bolstering our 2017-2018 central scenario for equity markets. More specifically, **momentum build-up in DM hard macro data** is **improving investors' visibility** on **DM corporate profit growth,** which is expected to be the main market risk factor driving equity markets over 2018.

The drivers behind the rise in developed equity markets

From 1 January to 24 November 2017, developed equity markets rose, mainly on the back of supportive corporate profit dynamics. In local currencies, the S&P 500 rose 18.4% in that period and the Stoxx Europe 600 by 9.8%. The below table breaks down the year-to-date (YTD) return by: 1) dividend yield;

2) the 12-month forward earnings growth in January; 3) the YTD variation of the 12-month forward earnings growth; and 4) the 12-month forward PE YTD variation. It is obvious using this breakdown that the **bulk of YTD returns have been driven by earnings**.

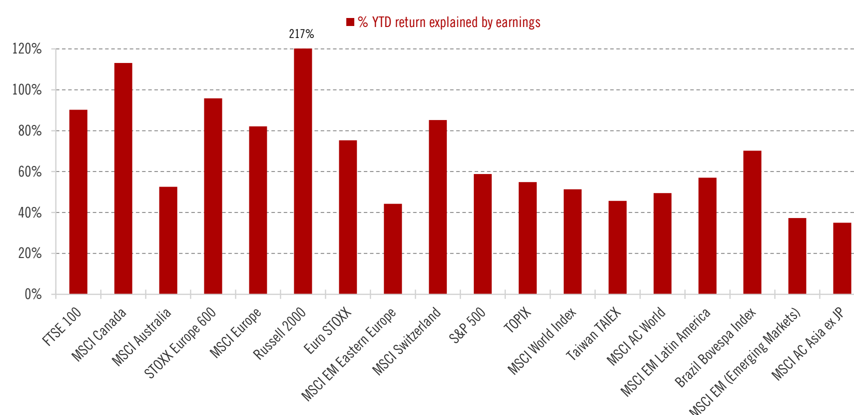
Year-to-date return drivers for US and European equity markets

	US (S&P 500)	Europe (Stoxx Europe 600)
YTD Total Return	**18.4%**	**9.8%**
Contributions to YTD Total Return:		
(1) Dividend yield	2.1%	2.8%
(2) 12-month forward earnings growth in January	11.9%	14.4%
(3) 12-month forward earnings growth YTD variation	-1.1%	-5.1%
(4) 12-month forward PE variation	5.4%	-2.4%

Source: Pictet WM - AA&MR, Factset, data as of 24.11.2017 market close

Adding up the two earnings factors ((2) and (3) in the table above) one can gauge that 96% of YTD returns on the Stoxx Europe 600 were due to earnings growth, compared to 59% for the S&P 500 *(chart 1)*. By way of comparison, only 37% of the MSCI EM's YTD returns and 35% of the MSCI AC Asia (ex Japan)'s were due to earnings growth. The Russell 2000 is an outlier, as its YTD returns have only increased by 13%, despite earnings growth of around 29%.

Chart 1: Major equity markets' earnings growth explains most of YTD returns



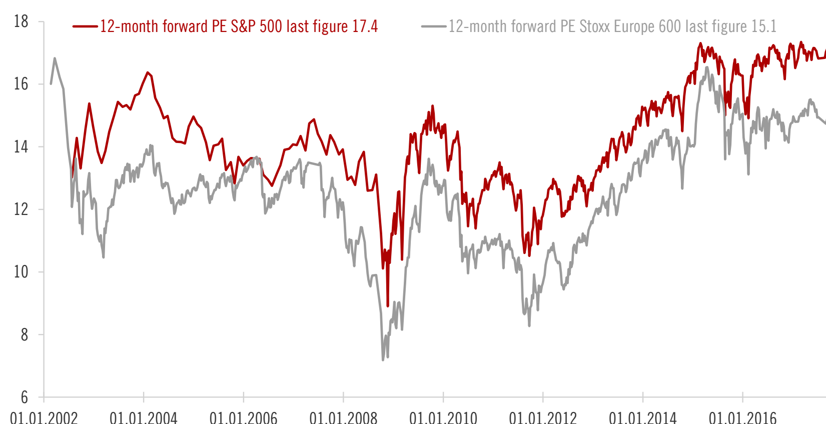
Source: Pictet WM - AA&MR, Factset, November 2017, data as of 24.11.2017 market close

Going into 2018, our central scenario is for the same trend to remain in place, i.e. **developed equity market returns should continue to be driven by earnings growth** rather than by shifts in valuations or by dividend yield.

Profit growth to continue to drive equity markets in 2018

In our 2018 equity scenario, we have considered that valuation remains a sleeping market risk factor for equities, i.e. that **valuations will remain elevated in a supportive macro environment thanks to strong hard data.**

Chart 2: Current valuation levels are set to persist within our central scenario



Source: Pictet WM - AA&MR, Factset, data as of 24.11.2017 market close

With the macro backdrop providing investors with improved visibility on the resiliency of corporate earnings growth, we expect **DM equity market returns** to match 2018 earnings growth expectations.

Specifically, 2018 consensus earnings growth estimates – and thus return forecasts - now stand at 11.6% for the S&P500, 8.7% for the Stoxx Europe 600 and 8.8% for the Topix. **In short, we expect DM equity markets in general to deliver returns of the order of 10% in 2018.**

Tax cuts are not being priced into US equities

At time of writing, the Trump administration's plans for corporate tax reform still had to be passed by Senate. As things stand, **our analysis suggests that US equity markets are still not anticipating any tax cut**, preferring instead to rely on hard data.

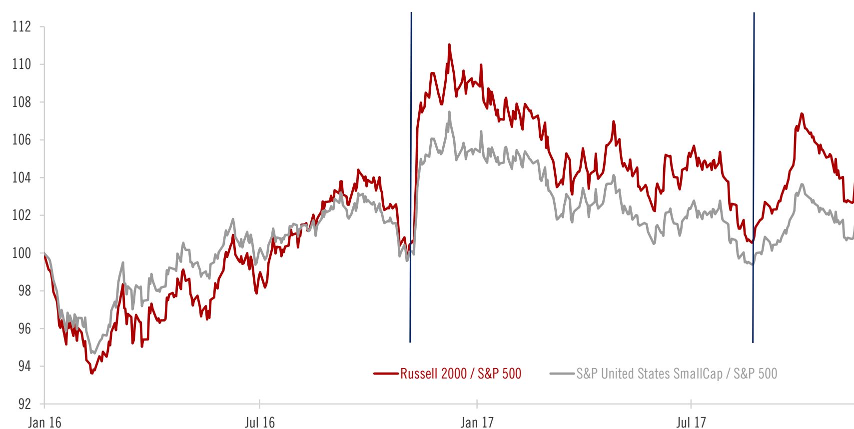
There are several reasons why current earnings estimates and equity valuations are not discounting US corporate tax cuts:

- **If the corporate tax cut from 35% to 20% currently being discussed in the US Senate were to be implemented**, our calculations show than expected **US earnings growth estimates could be as much as double** from current levels. Instead since January, 2018 earnings growth estimates for the S&P 500 haves remained range bound between 10.9% and 12.4% and 2019 earnings growth estimates have remained stable around 10%.
- If investors were anticipating US tax cuts, they would be pushing the current 12-month forward PE ratio of 17.5x for the S&P500 to even higher levels *(chart 2)*.
- **If tax reform were being priced, companies with higher effective tax rates would be outperforming those that pay lower rates**, due to the relatively higher positive effect on the formers' earnings.

  In particular, small cap indices (whose constituents, with greater exposure to the US, tend to pay higher taxation rates) would have significantly outperformed large-cap indices since Donald Trump's election.

In fact, US small caps outperformed US blue chips by 10% in the immediate aftermath of the US presidential election in November 2016, but their relative outperformance quickly faded *(chart 3)*. Fresh hopes for tax reform have led to only limited outperformance for small caps since the end of August.

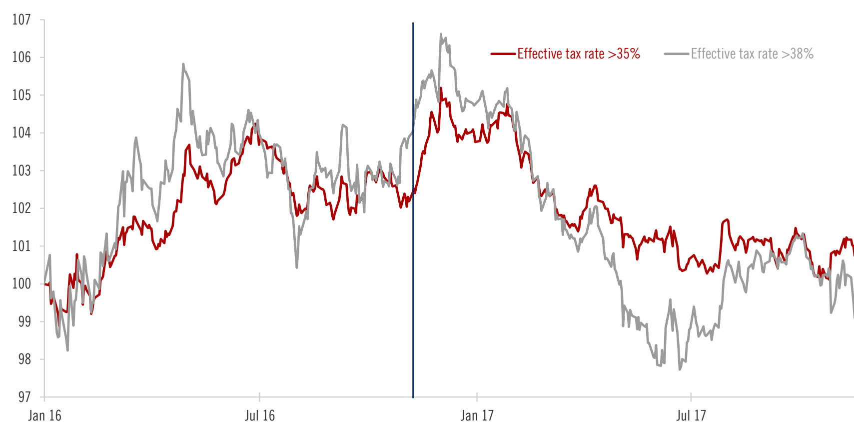
Chart 3: If tax cuts were being anticipated, small caps would outperform large caps



Source: Pictet WM - AA&MR, Factset, data as of 24.11.2017 market close

Furthermore, chart 4 shows that companies with an effective tax rate above 38% have not outperformed ones with an effective tax rate of 35%.

Chart 4: Companies with tax rates above 38% have not outperformed those with tax rates of 35%



Source: Pictet WM - AA&MR, Factset, data as of 24.11.2017 market close

These observations underscore the fact that **markets are still pricing hard data, not potential cuts to the corporate tax rate.**

DM equity valuations leave no room for disappointment

Given the current low levels of implied volatility and high valuations, **any kind of disappointment would likely trigger a significant correction in DM equity markets.**

The potential sources of such disappointment include:

- Systemic risk stemming from political turmoil in countries such as Spain or Italy (although this is not our central scenario).
- Geostrategic unrest involving North Korea, the US and/or China (although this is in no one's interest, as the global economic equilibrium would be severely jeopardized).
- A policy mistake, such as a precipitous tightening of monetary policy. This is unlikely in our view, as J. Powell is a sound central banker, the ECB will continue to act prudently, and the People's Bank of China is unlikely to deviate from its current stop-and-go policy.

While we are conscious that **risks could increase at some stage**, and while bouts of volatility are to be expected, our current scenario remains unchanged. But, overall, **the persistence of low volatility should continue to be supportive for equities**, even if our expectations are that further equity market returns are likely to slow down somewhat compared to the current pace.

Notice: This document is not intended for persons who are citizens of, domiciled or resident in, or entities registered in a country or a jurisdiction in which its distribution, publication, provision or use would violate current laws and regulations. The information and data furnished in this document are disclosed for information purposes only; Banque Pictet & Cie SA (hereinafter the Bank) is not liable for them nor do they constitute an offer, an invitation to buy, sell or subscribe to securities or other financial instruments. The information contained herein is not the result of a financial analysis within the meaning of the Swiss Bankers Association's Directives on the Independence of Financial Research, which therefore do not apply to this document.
Except for any obligations that the Bank might have towards the addressee, the addressee should consider the suitability of the transaction to individual objectives and independently assess, with a professional advisor, the specific financial risks as well as legal, regulatory, credit, tax and accounting consequences.
Furthermore, the information, opinions and estimates in this document reflect an evaluation as of the date of initial publication and may be changed without notice. The value and income of the securities or financial instruments mentioned in this document are based on rates from the customary sources of financial information and may fluctuate. The market value may vary on the basis of economic, financial or political changes, the remaining term, market conditions, the volatility and solvency of the issuer or the benchmark issuer. Moreover, exchange rates may have a positive or negative effect on the value, the price or the income of the securities or the related investments mentioned in this document.
Past performance must not be considered an indicator or guarantee of future performance, and the addressees of this document are fully responsible for any investments they make. No express or implied warranty is given as to future performance.
The content of this document can only be read and/or used by its addressee. The Bank is not liable for the use, transmission or exploitation of the content of this document. Therefore, any form of reproduction, copying, disclosure, modification and/or publication of the content is under the sole liability of the addressee of this document, and no liability whatsoever will be incurred by the Bank. The addressee of this document agrees to comply with the applicable laws and regulations in the jurisdictions where they use the information reproduced in this document.
This document is issued by the Bank. This publication and its content may be cited provided that the source is indicated. All rights reserved. Copyright 2017.