

US equity markets and tax reform

A game changer

The US Tax bill will boost 2018 earnings forecasts

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If the tax reform is adopted, the statutory tax rate is expected to fall from 35% to 21% in January 2018.

As a result, 2018 US earnings expectations should more than double from current levels, to 26.2%.

All sectors of the S&P 500 stand to benefit, except for real estate, which already has an effective tax rate below 21%.

Since discussions started at the end of August, markets have discounted fiscal reform with a 3.4% 12-month forward PE ratio expansion.

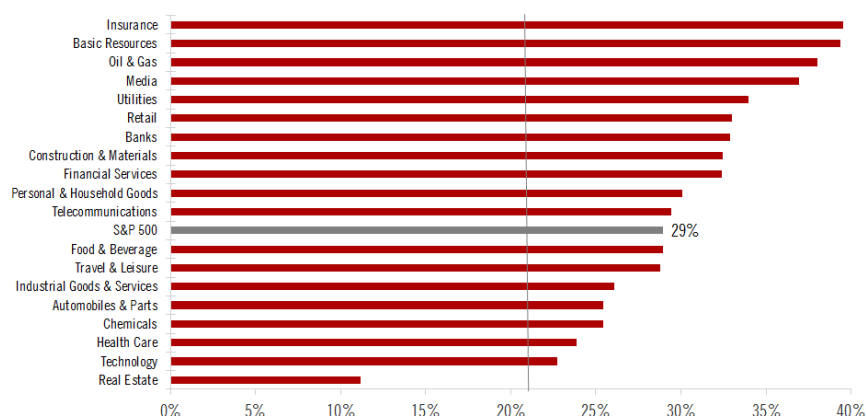
Last night, the US Senate approved the tax bill. It has since returned to the House of Representatives for administrative reasons, but, in line with an earlier vote, a green light looks now highly likely. Shortly thereafter, President Trump should sign it formally into law.

The 21% US corporate tax rate is a game changer

The statutory corporate tax rate is set to drop from 35% to 21% from January 2018, and not January 2019 as previously discussed. The 21% rate is a game changer for US earnings growth.

Ahead of the tax cuts, the expected effective tax rate for the S&P 500 stood at 29% for 2018. All US sectors will benefit from the fiscal boost, even the technology sector, which prior to the bill's passage had an effective 2018 expected tax rate of 23%. The real estate sector is the only exception, with an effective expected tax rate of 11% 2018.

2018 expected effective tax rates by S&P 500 sector



Source: Pictet-WM AA&MR, Factset, as of 19 December 2017

As a result of the tax reform, US listed companies' earnings base will rise. Ahead of the bill, S&P 500 earnings growth expectations stood at 10% for 2018 and 10.2% for 2019.

The reform could cause the 2018 expected earnings growth rate to more than double, benefitting all sector groups (see chart below). The strongest impact

AUTHORS

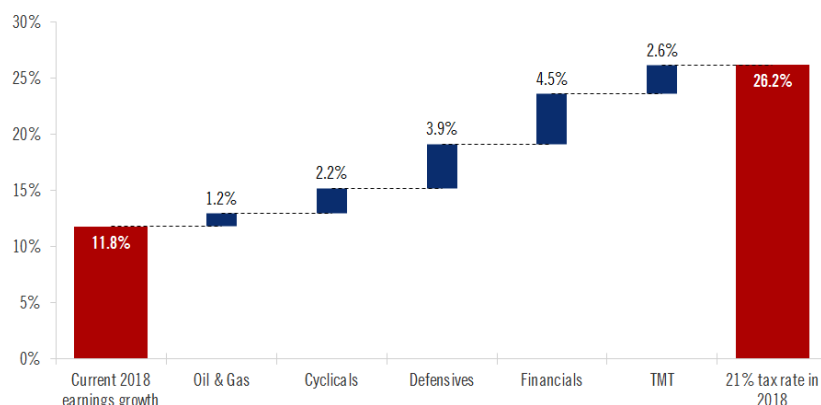
Jacques HENRY, CFA
jhenry@pictet.com
+41 58 323 2916

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

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

is expected to be on the financial sector, which should see its earnings growth almost treble.

Financials are expected to see the largest increase in 2018 earnings growth



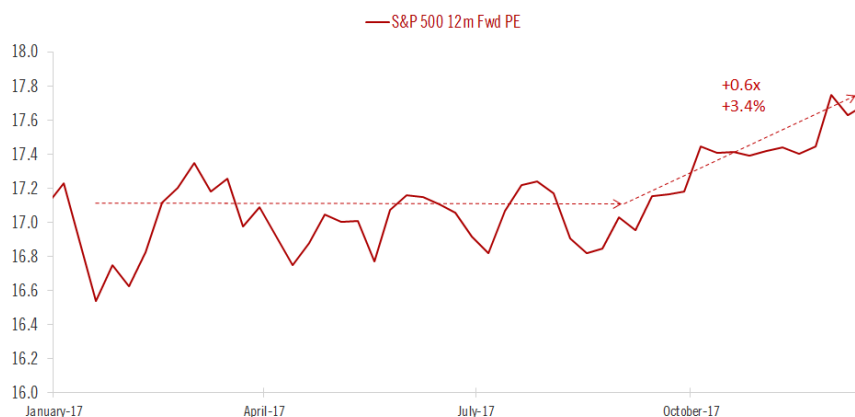
Source: Pictet-WM AA&MR, Factset, as of 14 December 2017

US tax reform talks have driven valuations up

In our 2017 equity markets' scenario (prepared in November 2016), we factored in stable valuation multiples, in both the US and in Europe. This relationship proved extremely powerful until end of August when a regime shift occurred in the US, as tax reform discussions started again.

Since then, the 12-month forward PE ratio of the S&P 500 has increased by 0.6x, i.e. adding 3.4% return to US equities (see chart below). Cyclicals were the major beneficiaries of the rerating, as well as US financials, but to a slightly smaller extent.

In anticipation of a tax reform, US valuations started to rise in September 2017



Source: Pictet-WM AA&MR, Factset, as of 19 December 2017

Growth dynamics are driven by technology in the US

Earnings growth concentration has become a major issue for the main equity markets of both sides of the Atlantic.

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Within the S&P 500, only 5% to 10% of stocks are required on average to achieve 80% of the annual earnings growth rate. Consequently, stock-picking has become a major issue for investors. In particular, serial growers clustered in the US technology sector explain most of next year's earnings growth (Apple, Alphabet, Amazon and Facebook).

Our [2018 scenario](#) for US equity markets was based on the assumption that valuation levels at the time did not offer upside potential. This led to expected 2018 total returns matching earnings growth. The US fiscal reform has slightly altered this relationship in H2, with an expansion in the multiple. Accordingly, the US fiscal reform with a major boost in earnings growth provides some further upside risk to our US equity scenario.