TrendMacrolytics

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The Tax Cut Gift that Keeps on Giving

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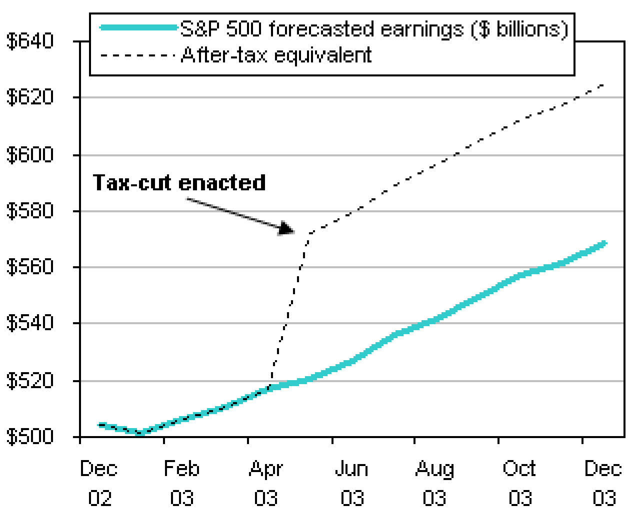
Last year's rally barely moved valuations on an after-tax basis, and stocks are still cheap.

One year ago, looking ahead to 2003, we wrote, "our model suggests that stocks would have to rise about 24% to return to historical valuation norms" (see "Gameplan for the New Year" January 6, 2003). With the S&P 500 up 28.7% in 2003, it turned out that we weren't far off.

What we described as our "conservatively optimistic" view on equities a year ago was based primary on valuation. Two weeks later, in mid-January, our optimism became less conservative when the full scope of **President Bush's** proposed pro-growth tax cuts became known. Now, looking back, a credible case can be made that the S&P 500's performance last year was due very little to changes in valuation -- *i.e.*, multiple expansion -- but rather due almost entirely to the growth in which the tax cuts have played a major role. Looking forward, we believe that the tax cuts will be a gift that keeps on giving to equity investors.

In 2003, while the S&P 500 returned 28.7%, the forward price/earnings multiple grew only 13% -- from 16.0 to 18.0. That's because forecasted earnings grew 13%, too -- from $504 to $568 billion. In other words, half the S&P 500's gains is explained by improving earnings forecasts, the other half by multiple expansion.



But now let's factor in the tax cuts. By reducing the government's share of earnings paid to investors in the form of dividends and capital gains, the tax cuts are the economic equivalent of making the amount of earnings larger. For investors in the aggregate -- both taxable and tax-exempt -- we estimate the effect as being similar to incrementing forecasted earnings by roughly 10%. Thus, on an after-tax equivalent basis, we could think of the S&P 500 earnings forecast of $568 billion as effectively being 10% higher, at $625 billion. Seen through this after-tax lens, forecasted earnings grew 24% in 2003, and the forward price/earnings multiple grow only 2% -- from 16.0 to 16.4.

Cutting somewhat against this analysis is the fact that long-term interest rates are higher today than they were a year ago (by 44 basis points on the 10-year Treasury). A given price/earnings multiple is richer under higher interest rates than it would be under lower interest rates. The relationship between multiples and earnings is integrated into a single risk-premium statistic in our Yield Gap valuation model, which is calculated as the forward earnings/price ratio (or "earnings yield") of the S&P 500 minus the long-term Treasury yield. Higher values indicate equities undervalued relative to bonds; lower values indicate equities overvalued.

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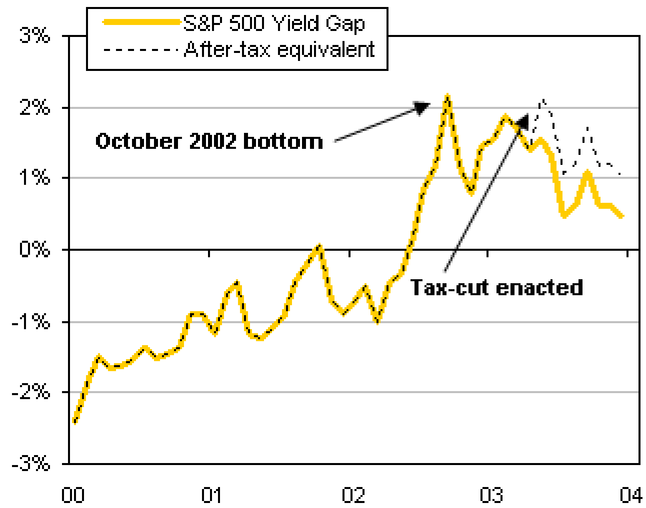
The chart at right shows the S&P 500 Yield Gap from its all-time historic *over*valued reading in January 2000, through its all-time historic *under*valued reading in October 2002, through year-end 2003. Note that on an after-tax equivalent basis, the S&P 500 was almost precisely as undervalued in May 2003 -- just after the tax-cuts were enacted -- than it was in the depths of the October 2002 panic.



While well off those levels of extreme undervaluation, on an after-tax equivalent basis the S&P 500 remains significantly undervalued -- and this after a banner year. A year ago the Yield Gap model suggested a 24% rise in the S&P 500 to reach historical valuation norms. Today, on an after-tax basis, the model is calling for 19%.

On a nominal basis, the S&P 500 is only slightly undervalued -- the model calls only for an 8% gain. But to make investment decisions on this basis would be, effectively, to act as though the tax cuts had never taken place. Not only have they indeed taken place, but their structure implies growth dynamics well beyond even the one-time step-function effects captured in our after-tax calculations.

Conventional Wall Street economic analysis has focused entirely on one-off effects. Most analyses focus on the one-time increment to aggregate demand driven by lower income and dividend tax rates. But that completely ignores the supply-side incentive effects that have been set in motion by increasing the after-tax returns to productive economic endeavor. With lower tax rates on both labor and capital, new investments of human and financial capital will be made at the margin. Such investments are the necessary raw fuel for sustained increases in economic growth rates. Considering them as incremental to our simple after-tax valuation calculation, the stock market looks even cheaper.

It must be added that we do remain concerned that **the Fed** and most market participants are in denial about the inflationary warning signs coming from gold, commodities and forex. For the moment, investors are still celebrating the S&P 500's 28.7% return last year. At least American investors are. For yen-denominated investors, the return was only 16%. For euro-denominated investors, 7%. For those who think in terms of the purchasing power of an ounce of gold, it was only 6%.

While the wave-front of a new inflationary impulse may have powerful short-term stimulative effects, long-term inflation cuts against the value of after-tax returns on capital and induces risks of chaotic policy reactions. For the moment, we continue to see the chief beneficiary of inflation being the basic materials sector, and the chief victim being long-term Treasuries. But assuming no anti-growth surprises in the 2004 elections, inflation is the only significant risk we see in the way of capturing the market's after-tax undervaluation. TM