POTUS 45

US equities: Icing on the cake

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- Both the House and the Senate have passed their own versions of tax reform. Some of the details differ between the bills and will have to be harmonized, but the broad outlines are fairly similar. As a result, we believe the odds that something gets to the president's desk are now high.
- Corporate profits should get a bump of about 8% largely due to the fall in the corporate tax rate and the repatriation of overseas cash. Companies with high domestic exposure and/or high overseas cash holdings will be the greatest beneficiaries, in our view.
- Within large-caps, financials, parts of consumer discretionary, segments within industrials, and possibly telecom stand to benefit the most. Small- and mid-caps should benefit more than large-caps. Value stocks also look well-positioned.
- In our view, markets are pricing in about half of the benefits from tax reform, suggesting further tax-related upside of about 3–5%. This would come on top of our expectations for healthy market gains in 2018 driven by 8% underlying profit growth and benign inflation trends.

POTUS 45
The acronym POTUS (President of the United States) came into use during the late 1800s by telegraph operators and is now commonly used in media. Donald Trump is the 45th POTUS.

New rules

Congress is on the cusp of finalizing the largest rewrite to the tax code since the 1980s. It now appears likely that legislation will reach the president's desk relatively soon. In this report, we offer a high-level assessment of the bill's impact on equity markets and various segments within equities. We will further flesh out or thoughts in subsequent reports in the weeks ahead.

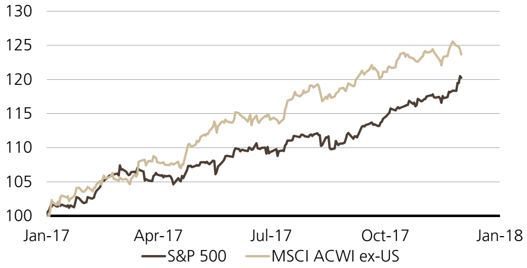
The changes in corporate taxes have the potential to boost S&P 500 profits by about 8%. The primary driver of this increase is the reduction in the corporate rate from 35% to 20%. The repatriation of overseas cash will also provide a boost as companies redeploy this cash into higher returning assets – most likely share buybacks.

A couple of caveats are necessary. First, our numbers assume no pick-up in underlying economic activity as a result of tax reform. This could prove to be conservative. Our economics team believes that the bill could boost economic growth by 0.2–0.5% next year. While this is not a game-changer relative to our forecast for real GDP growth of 2.2% in 2018, it could have positive implications.

Second, we are assuming that the benefits of corporate tax cuts only flow to shareholders. This may be a bit aggressive. In very competitive industries, the windfall may be reinvested (e.g. in marketing or R&D) or even passed on to consumers in the form of lower prices. In industries where competition is less intense (especially in parts of tech), we would expect the benefits to flow to shareholders. Finally, we – and the rest of the market – are operating with imperfect information. Publicly traded companies are not required to disclose their "tax books." So we can only infer the likely impact based on the more limited tax disclosures in publicly available financial statements. Investors will have to await guidance from management teams to get a detailed assessment of the impact on specific companies.

Fig. 1: Strong gains in non-US stocks suggests tax has NOT been the primary market driver

Year-to-date return, indexed



Note: MSCI ACWI ex-US (MSCI All Country World Index) reflects performance of non-US stocks

Source: Bloomberg, UBS as of 4 December 2017

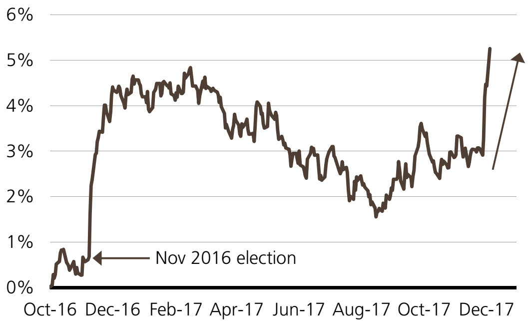
Domestic companies are relative winners

While the bottom-line earnings boost is in line with the expectations that we have had for many months, the composition is a bit different. The corporate rate of 20% is lower than the 25% that we had assumed was more feasible given budget constraints. However, in order to achieve this lower rate, Congress put in measures to limit the extent that multinational companies can shift profits to lower-tax overseas jurisdictions. The net result is that companies with high domestic tax exposure look poised to benefit even more than we expected relative to their multinational peers.

We believe the market's strong gains this year (20% total return) mostly reflect improving global economic and profit growth rather than optimism about tax reform. S&P 500 profits are on pace to rise more than 10%, which obviously excludes tax reform benefits. In addition, non-US markets are up 24% in US dollar terms, further bolstering our claim that profits, not policy, have been the primary driver of this year's gains (see Fig. 1).

Fig. 2: Stocks with high tax rates have rocketed higher in recent days

Performance of stocks with high tax rates relative to the market



Source: FactSet, UBS, as of 4 December 2017

Still more tax-related upside potential

That being said, companies that appear poised to benefit the most from tax reform have strongly outperformed recently (see Fig. 2). Based on the likely relative benefit these companies will enjoy, we believe investors are pricing in about 50% of the upside from tax reform. In other words, we believe markets are pricing in about a 4% increase in S&P 500 profits, rather than the 8% increase that we expect. Assuming that valuation multiples remain unchanged, tax reform could drive a further 3–5% gain in the S&P 500. This would come on top of the healthy market gains we expect in 2018 driven by 8% underlying profit growth and benign inflation.

In Fig. 3 on the following page, we summarize the relative winners from tax reform. Within large-caps, financials, parts of consumer discretionary, segments within industrials, and possibly telecom stand to benefit the most. Mega-cap tech companies, which hold 60% of the offshore cash, will be the primary beneficiaries of the repatriation of overseas profits. Small- and mid-caps have more domestic exposure and should benefit more than large-caps. Value stocks also look well-positioned, especially if growth and inflation pick up or even if expectations for a pick-up in growth and inflation materialize, as they did right after the November 2016 election.

Fig. 3: Tax reform impact by equity segment

Equity segment	Impact	Comment
Large-caps	+	Benefits from lower domestic corp rate and repatriation of overseas cash, offset by limitations on tax strategies used by some multi-national corporates.
Mid-caps	++	Greater benefits versus large-caps due to greater domestic exposure, less use of multi-national tax strategies.
Small-caps	++	Greater benefits versus large-caps due to greater domestic exposure, less use of multi-national tax strategies.
Large-cap growth	+	Greater benefits from repatriation offset by larger limitations on tax strategies used by some multi-national corporates.
Large-cap value	+/++	Less negatively impacted by limitations on tax strategies used by some multi-national corporates but overseas cash holdings are smaller. Could benefit from expectations for faster economic growth and firming inflation.
Large-cap sectors		
Consumer Discretionary	++	High domestic exposure benefits retailing, media, and restaurants. Possible pick-up in consumer spending would also be supportive.
Consumer Staples	+	High domestic exposure benefits food and staples retailing. Mega-cap multi-nationals also benefit from repatriation. However, competition may limit gains for shareholders.
Energy	+	Modest benefits. The sector has high overseas exposure. However, certain domestic-based oil services, refiners, and equipment manufacturers may be big beneficiaries.
Financials	++	High domestic exposure. Key potential beneficiary of any pick up in expctations for faster economic growth or firming inflation.
Health Care	+	Health insurers (managed-care organizations) likely benefit most due to high domestic exposure. Pharma and med-tech are more international but benefit from repatriation.
Industrials	++	Domestically exposed transports, industrial distributors, and environmental services will benefit most. Pick-up in capital spending could boost capital goods manufacturers
Information Technology	+	Limited change to overall tax rate (lower domestic rate will be offset by limits on shifting profits to low tax overseas jurisdictions). Key beneficiary of cash repatriation.
Materials	+	Less domestic exposure than the average sector.
Real Estate	Limited	REITs don't pay corporate taxes, so limited impact. REIT structure will likely still make sense as companies will keep full interest deductibility.
Telecommunication Services	++	High domestic exposure. Benefits from immediate capex expensing. However, competition may limit how much of the benefit will be retained by shareholders.
Utilities	Limited	Lower tax rates are passed on to consumers for regulated utilities.

Source: UBS, as of 4 December 2017

Appendix

Terms and Abbreviations

Term / Abbreviation	Description / Definition	Term / Abbreviation	Description / Definition
A	actual i.e. 2010A	COM	Common shares
E	expected i.e. 2011E	GDP	Gross domestic product
Shares o/s	Shares outstanding	UP	Underperform: The stock is expected to underperform the sector benchmark
CIO	UBS WM Chief Investment Office		