

## Positive Effect on Earnings Per Share

April 24, 2018

The recent passage of tax reform has raised the expected level of S&P 500 earnings. Looking forward, Price/Earnings ratios have declined on a forward or normalized earnings basis, thereby raising the upside potential of the S&P 500. In simple terms, tax reform should benefit markets and provide opportunity for growth. We reckon the initial effects of tax reform will be 2018 earnings growth moving from around 10% to upwards of 18%. This momentum should persist into 2019 and 2020 as lower tax rates and higher depreciation reduce the required breakeven returns on investment. Economic growth should benefit from great capital investment and higher share employee productivity.

What does all this mean for stock portfolios? From our perspective, this configuration creates a chain reaction. Higher growth creates higher earnings; normalized earnings move faster; price to earnings are lowered which remove pressure from valuations. Our opinion, a market with sustainable upside potential.

Our view may seem overly optimistic, but fundamentals tend to be the most reliable indicator of stock prices. At present, the degree of financial stress in the markets is not rising and does not indicate lasting threats. To determine financial stress, we use a number of metrics. However, our primary tool comes from the Federal Reserve Bank of St. Louis and Kansas City, which uses myriad weekly data series: seven interest rate series and six yield spreads, to name a few. Each of these variables captures some aspect of financial stress. Accordingly, as the level of financial stress in the economy changes, the data series are likely to move together.

How we Interpret the Index: The average value of the index, which begins in late 1993, is designed to be zero. Thus, zero is considered to be a representation of normal financial market conditions. Values below zero suggest below-average financial market stress, while values above zero suggest above-average financial market stress. As of this writing, both indexes are comfortably below the zero line.

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