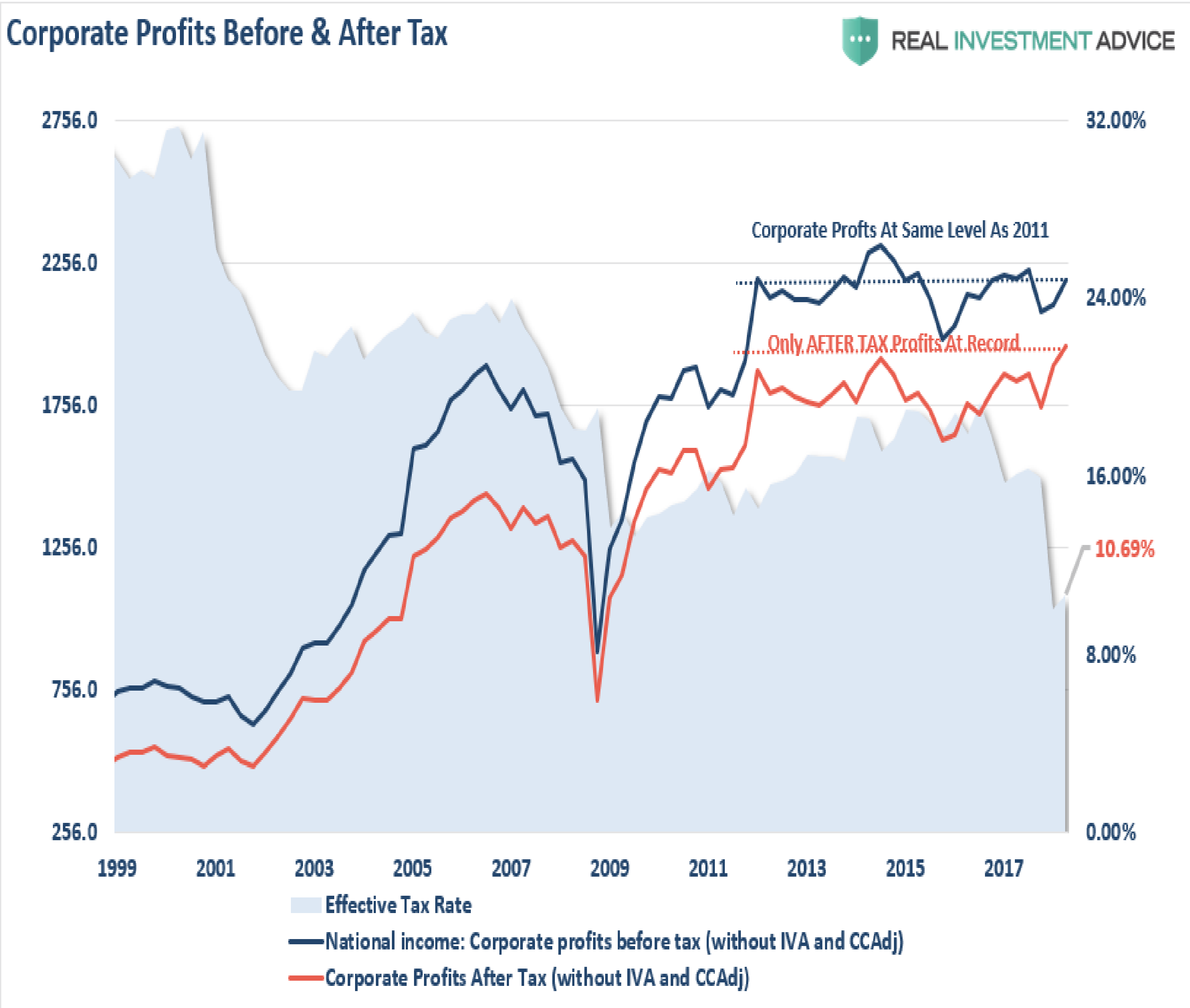
Last week, I touched on the issue of corporate profits and tax cuts. While the promise was that tax cuts were going to a massive boost to economic growth, the reality has been quite different. To wit:

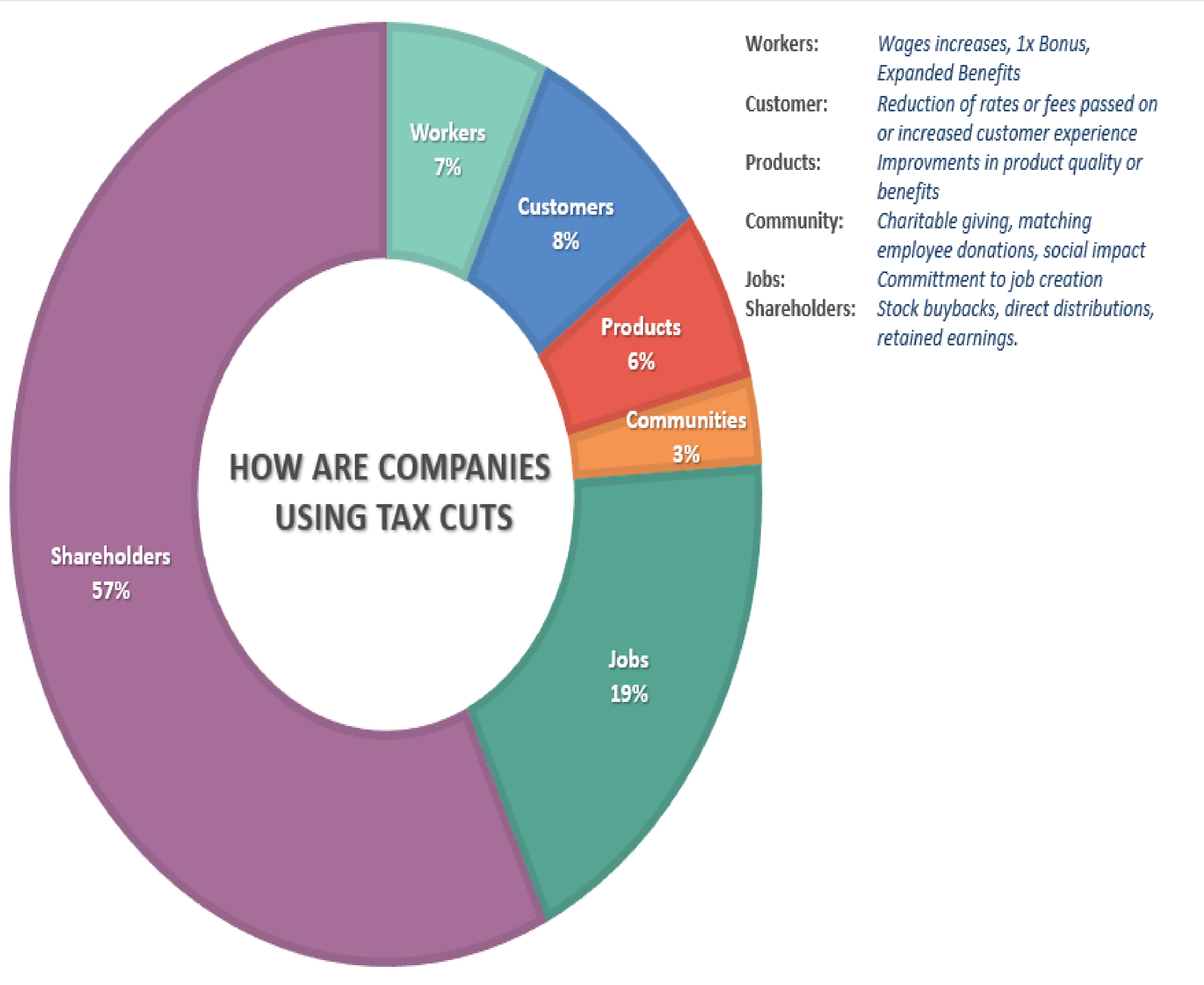
> *"The benefit of a reduction in tax rates is extremely short-lived since we compare earnings and profit growth on a year-over-year basis. In the U.S., the story remains much the same as near-term economic growth has been driven by artificial stimulus, government spending, and fiscal policy which provides an illusion of prosperity. For example, the chart below shows raw corporate profits (NIPA) both before, and after, tax."*



> *"Importantly, note that **corporate profits, pre-tax, are at the same level as in 2012.** In other words, corporate profits have not grown over the last 6-years, yet it was the decline in the effective tax rate which pushed after-tax corporate profits to a record in the second quarter. Since consumption makes up roughly 70% of the economy, then corporate profits pre-tax profits should be growing if the economy was indeed growing*

substantially above 2%."

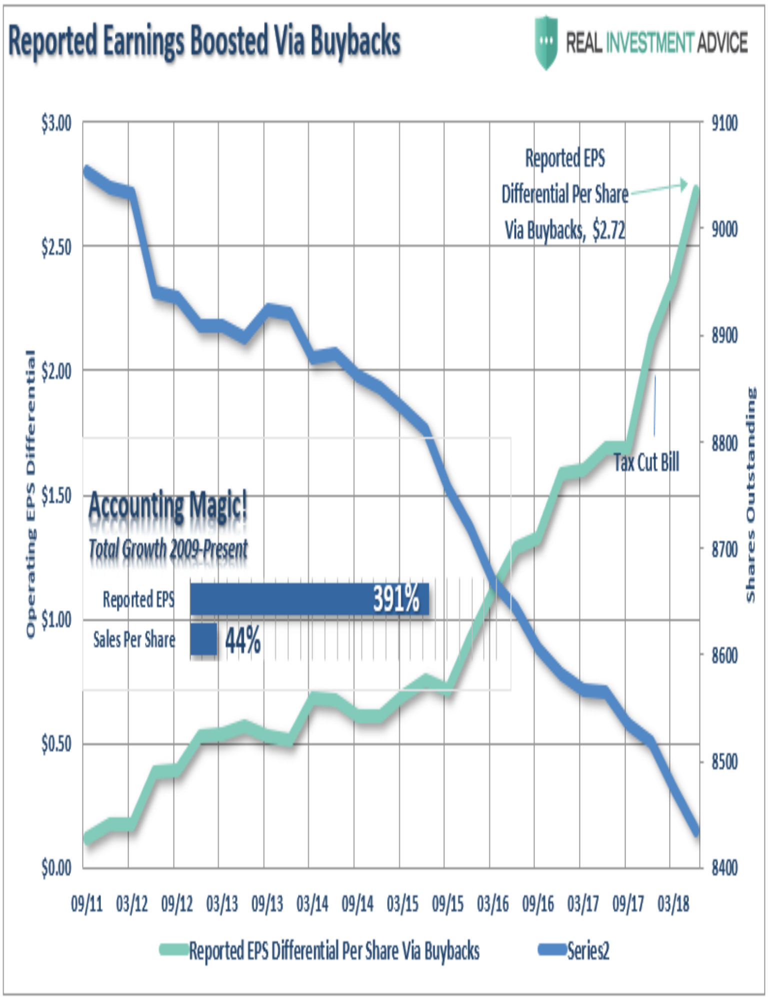
The reality is that what earnings growth there has actually been, as shown above, was indeed derived from tax cuts but also through the extensive use of share buybacks. **While the mainstream media, and the Administration, initially rushed to claim that tax cuts would lead to surging economic growth, wages, and employment, such has yet to be the case.** Instead, companies have used their tax windfall to repurchase shares instead.

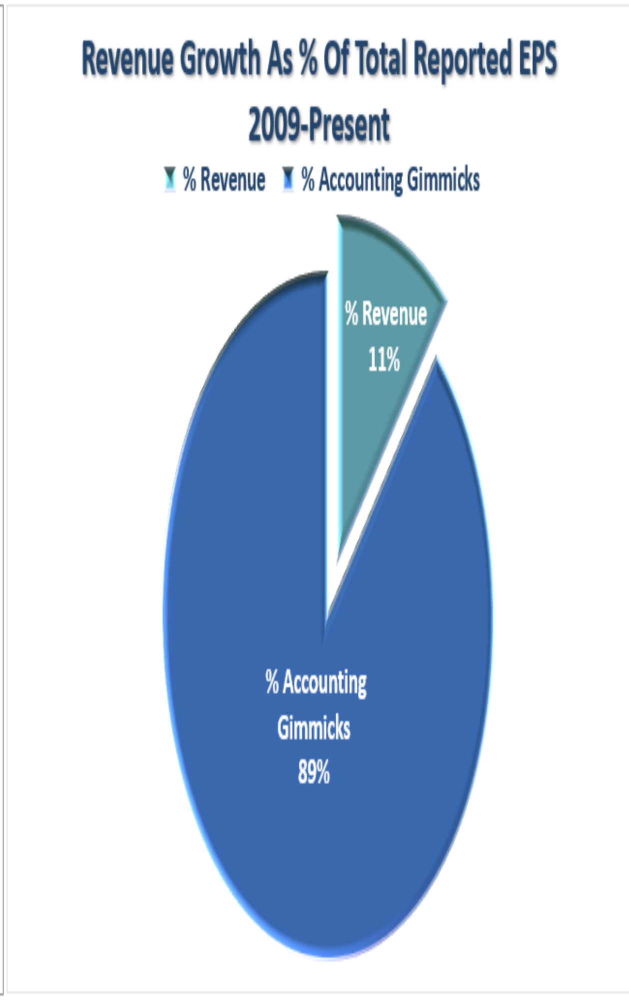


The lack of corporate profit since 2012 is just another version of the same story we have previously discussed when analyzing quarterly earnings. As noted in our recent report following the end of the Q2-2018 reporting period:

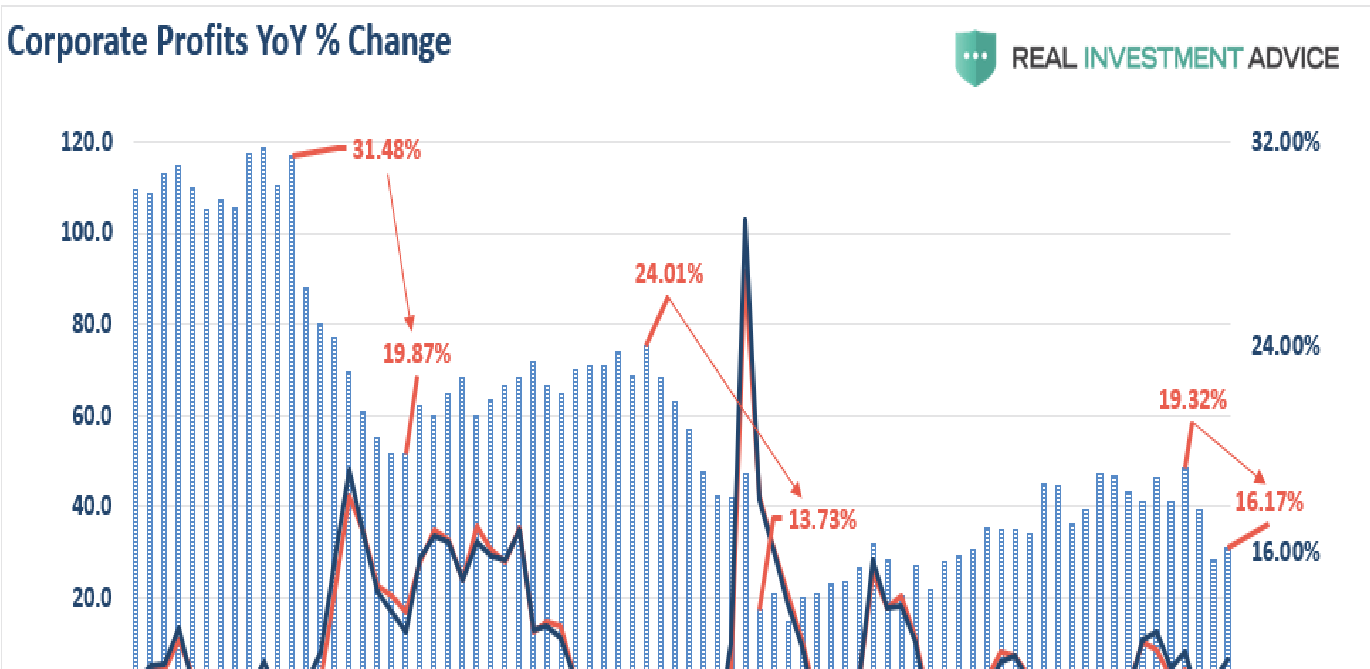
> *"Since the recessionary lows, much of the rise in 'profitability' has come from a variety of cost-cutting measures and accounting gimmicks* ***rather than actual increases in top-line revenue.*** *While tax cuts certainly provided the capital for a surge in buybacks; revenue growth, which is directly connected to a consumption-based economy, has remained muted."*

Here is the real kicker. Since 2009, the reported earnings per share of corporations has increased by a total of 391%. This is the sharpest post-recession rise in reported EPS in history. **However, the increase in earnings did not come from a commensurate increase in revenue which has only grown by a marginal 44% during the same period.** This is an important point when you realize only 11% of total reported EPS growth actually came from increased revenues.





While stock buybacks, corporate tax cuts, and debt-issuance can create an illusion of profitability in the short-term, the lack of revenue growth the top line of the income statement suggests a much weaker economic environment over the long-term. More importantly, as stated, the benefit of tax cuts lasts just one year before it is absorbed by annual comparisons. As shown below, when the effective tax rate dropped during the Bush administration from 31.48% to 19.87%, an 11.61% decline, the surge in corporate profits faded after the first year. During the Obama Administration, the effective tax rate fell again from 24.01% to just 13.73%, a reduction of 7.28%, providing a short-term profit surge as the economy began to recover from the *"Financial Crisis."*



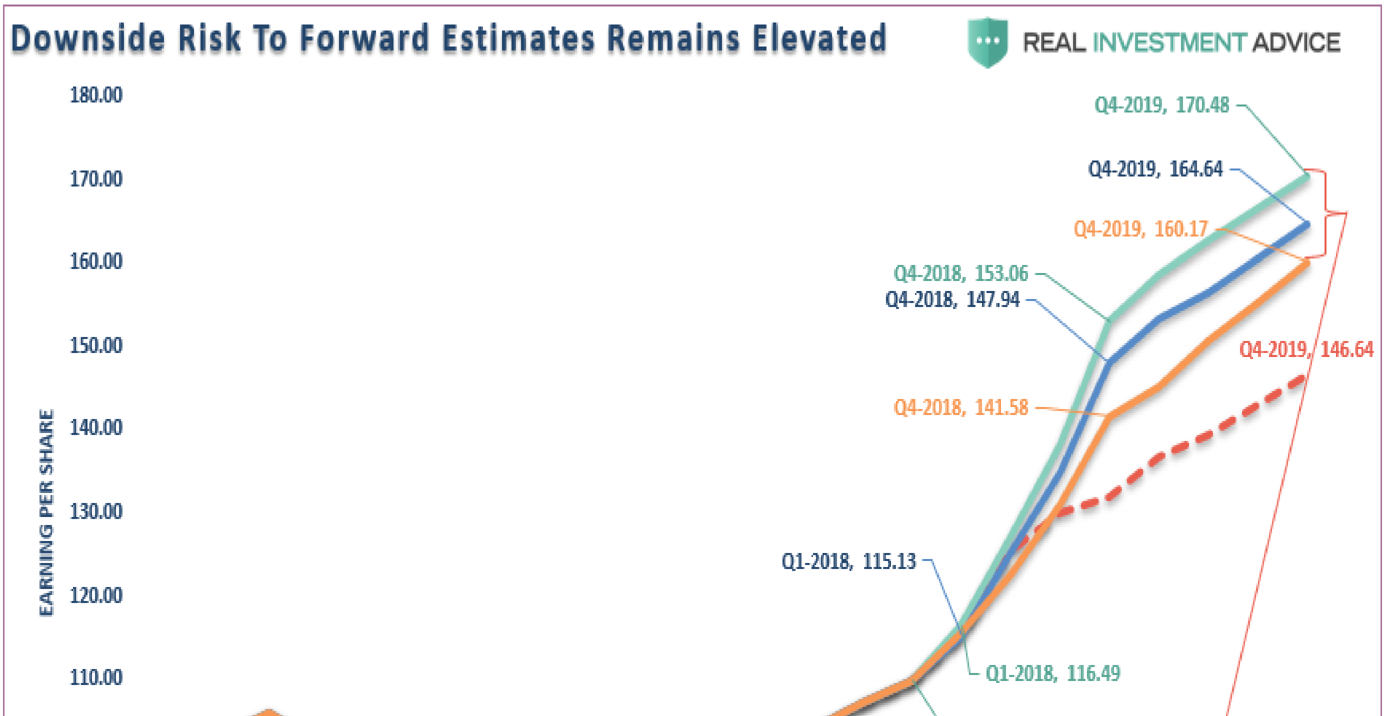
Interestingly, the most recent tax cut from the Trump Administration has had very little impact on the effective tax rate only reducing it from 19.32% to 16.17%, or just a decline of 3.15%. While profits did increase, the very low adjustment to the effective tax rate is likely why the effect of the tax cut boost has faded so quickly this time. The tax refunds were not boosted either, but anyway here are some ideas on how to spend yearly tax refund. **Going forward increasing margins will become tougher as steadily increasing labor costs, weaker global economies, higher interest costs, tariffs, and a stronger dollar weigh on bottom line profitability.**

Earnings Set To Decline

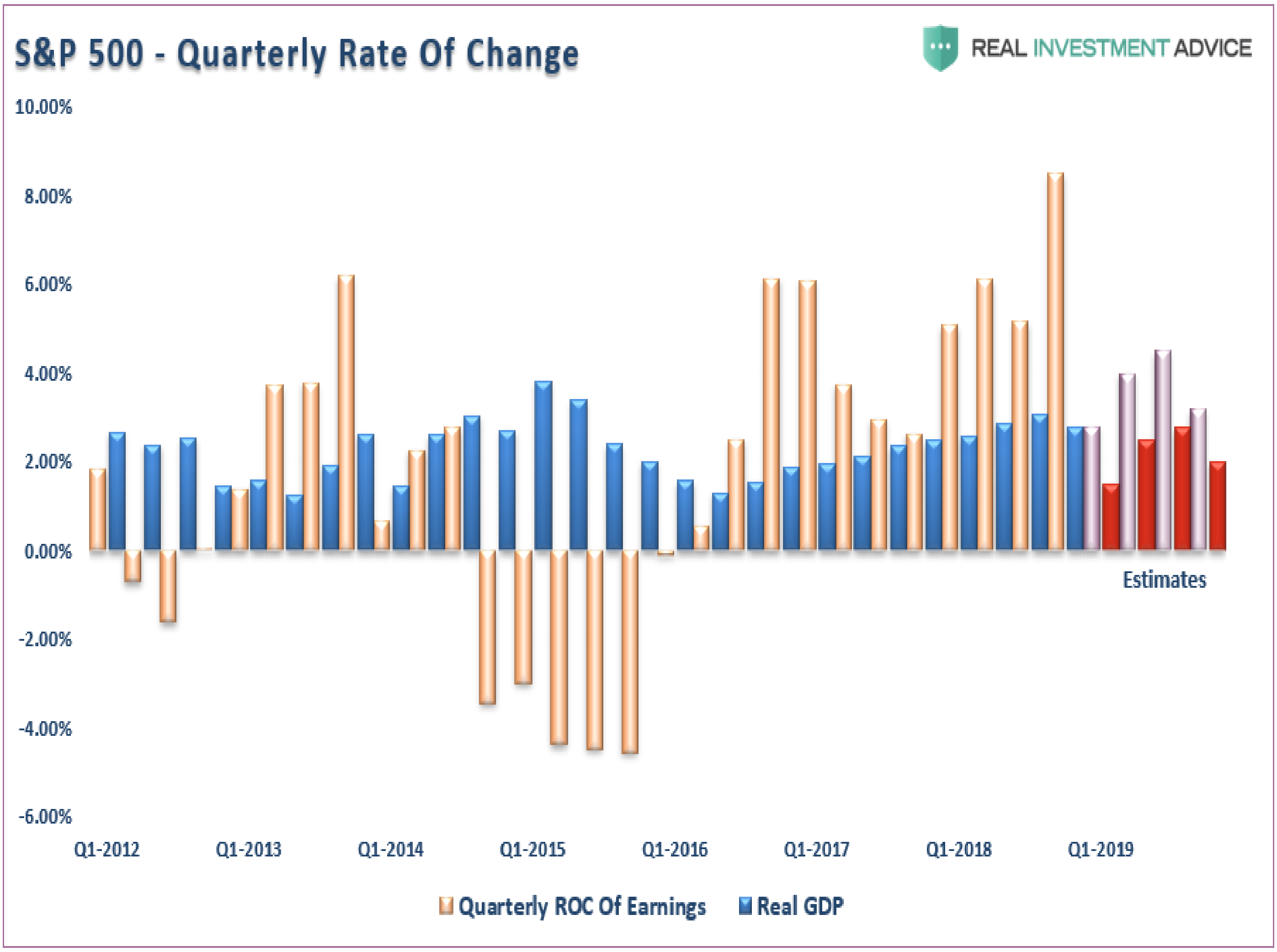
With share buyback activity already beginning to slow, the Federal Reserve extracting liquidity from the financial markets, and the Administration continuing their *"trade war,"* the risk to extremely elevated forward earnings estimates remains high. We are already seeing the early stages of these actions through falling home prices, automobile sales, and increased negative guidance for corporations. If history, and logic, is any guide, we will likely see the U.S. economy pushing into a recession in 2019 particularly as the global economy continues to weaken. This is something both domestic and global yield curves are already screaming is an issue, but few are listening. As noted last week, we can already see this in the MSCI World Market Index as well.

> *"While it has been believed the U.S. can 'decouple' from the rest of the world, such is not likely the case. The pressure on global markets is a reflection of a slowing global economy which will ultimately find its way back to the U.S."*

As stated, forward earnings estimates are still way too lofty going into 2019. As I noted in the recent [missive on rising headwinds] to the market, earnings expectations have already started to get markedly ratcheted down for the end of 2019. **In just the last 30-days the estimates for the end of 2019 have fallen by more than $10/share. The downside risk remains roughly $14/share lower than that.**



As stated, beginning in 2019, the estimated quarterly rate of change in earnings will drop markedly and head back towards the expected rate of real economic growth. *(Note: these estimates are as of 11/1/18 from S&P and are still too high relative to expected future growth. Expect estimates to continue to decline which allow for continued high levels of estimate "beat" rates.)*



The issue to focus on will be the ongoing impact of rising interest rates on major drivers of debt-driven consumption such as housing and auto sales. Combine that with a late stage economic cycle colliding with a Central Bank bent on removing accommodation and you have a potentially toxic brew for a much weaker outcome than currently expected. **The end of the boost from tax cuts has arrived.** But such was always going to be the case. As noted in a 2014 study by William Gale and Andrew Samwick:

> ***?The argument that income tax cuts raise growth is repeated so often that it is sometimes taken as gospel.*** *However, theory, evidence, and simulation studies tell a different and more complicated story. Tax cuts offer the potential to raise economic growth by improving incentives to work, save, and invest.* ***But they also create income effects that reduce the need to engage in productive economic activity, and they may subsidize old capital, which provides windfall gains to asset holders that undermine incentives for new activity. In addition, tax cuts as a stand-alone policy (that is, not accompanied by spending cuts) will typically raise the federal budget deficit.*** *The increase in the deficit will reduce national saving ? and with it, the capital stock owned by Americans and future national income ?* ***and raise interest rates, which will negatively affect investment. The net effect of the tax cuts on growth is thus theoretically uncertain and depends on both the structure of the tax cut itself and the timing and structure of its financing.?***

Since the tax cut plan was poorly designed, to begin with, it did not flow into productive investments to boost economic growth. As we now know, it flowed almost entirely into share buybacks to boost executive compensation. This has had very little impact on domestic growth. The *"sugar high"* of economic growth seen in the first two quarters of 2018 has been from a massive surge in deficit spending and the rush by companies to stockpile goods ahead of tariffs. These activities simply pull forward *"future"* consumption and have a very limited impact but leaves a void which must be filled in the future. Nearly a full year after the passage of tax cuts, we face a nearly $1 Trillion deficit, a near-record trade deficit, and empty promises of surging economic activity. It is all just as we predicted. So, while many of the mainstream punditry continue to take victory laps touting the success of the Trump agenda, the reality is that the pro-growth policies were launched too late within this economic cycle. Since the administration chose to utilize both fiscal and monetary policy tools during the economic boom, it will only ensure the next recessionary drag will likely be larger, and last longer, than most expect.