

## Tax Reform Has Released the Bulls

*P/E ratios may seem high, but policy changes augur much better earnings in the coming years.*

By Donald L. Luskin

As markets around the world surge to all-time highs, everyone is wondering anxiously whether stocks are overvalued. That's a pretty good sign they're not. Stocks are overvalued when hardly anybody is worrying.

By traditional measures of value, stocks do seem expensive right now. But those metrics have flaws, the worst of which is a tendency to look at the past rather than the future. Markets, by their nature, do the opposite.

Consider the venerable price/earnings ratio. The typical P/E ratio shows today's stock price as a multiple of the company's earnings over the past year. Yes, an investor wants to understand how much he is paying for earnings. But what counts isn't last year's earnings, it's next year's—and all the years to come.

The most flagrant offender here is Yale economist Robert Shiller's widely followed cycle-adjusted price/earnings ratio, or CAPE. In a misguided attempt not to be fooled by short-term fluctuations, the CAPE ratio is based on average earnings over the entire previous decade. At the moment, using earnings from 2007-17, the CAPE shows stocks to be valued like they were in 1929, right before the market crashed. But that's only because the past decade of earnings includes the catastrophe of 2008-09. This makes earnings look artificially low, even though it has little relevance for today.

One way to solve this problem is to use earnings estimates for the year ahead in the calculation. By that measure, today's P/E ratio is a bit above average, but nothing scary. It's well below the figures for 1999 and 2000, during the tech bubble, and generally consistent with the levels that obtained from the late 1950s to the early 1970s.

Even this more forward-looking approach, though, doesn't necessarily capture the full reality of the current historical moment. The U.S. could be at an inflection point where far higher corporate earnings become the new normal. When President Trump signed tax reform on Dec. 22, he effectively increased after-tax earnings for American companies. At a corporate tax rate of 35%, a dollar of earnings turns into 65 cents after Washington takes its cut. At the new 21% rate, the same dollar becomes 79 cents. That's earnings growth of 21.5% with the stroke of Mr. Trump's pen.

Only 15 market days have passed since the Senate passed the tax bill, ensuring it would become law, and Wall Street analysts have already upgraded their consensus forward earnings for the S&P 500 by an unprecedented 4.6%. Is it any wonder that stocks have rallied?

Moreover, this is probably just a down payment on future earnings growth. It's true that a plurality of earnings across the whole S&P 500 comes from business conducted outside the U.S., which won't be affected by the tax cuts. But my rough-and-ready estimate is that the lower corporate rates ought to raise after-tax earnings on business already being conducted by about 10% overall.

That figure actually may be low, because it leaves aside activities that the previous 35% tax rate had made unprofitable. No one can predict what new businesses, factories and jobs—not to mention earnings—will be created now that companies bear a tax cost of only 21%.

My estimate also doesn't consider business migration. Some American companies with operations in low-tax jurisdictions may bring these activities home. Some foreign companies may decide to forward-deploy their facilities into the U.S. market. All of this again will create new businesses, factories, jobs and earnings.

Finally, my estimate doesn't factor in the competitive global response to American tax reform. Nations afraid to be left behind may cut their own taxes in what could turn into a world-wide competition. That would be the delightful opposite of protectionism. Instead of trying to punish each other with reciprocal tariffs, nations could engage in a race to the top to see who can more completely liberate their productive sector from the deadweight costs of corporate taxation. Again: new businesses, factories, jobs and earnings.

Put it all together, and before you know it, that "E" in the time-honored P/E ratio will have grown so much that today's stock valuations won't look out of line at all.

Truth be told, valuation metrics are always oblivious to our dynamic world. The stock market was a great buy at the bottom, in March 2009, but not because stocks were undervalued. They only seem so in hindsight because the global economy pulled out of an existential financial crisis. If the central banks hadn't saved the world, those seemingly undervalued stocks could have gone to zero.

There's no crisis today, thankfully. But as in 2009, the economy is facing a fundamental turning point driven by profound changes in economic policy. Once again, it's policy, not valuations, that is determining stock prices. If Mr. Trump's corporate tax cuts turn out to be as powerful as I think they will be, expect a new bull market, no matter what the P/E ratios say.

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