US corporate tax cuts: What's the upside for equities?

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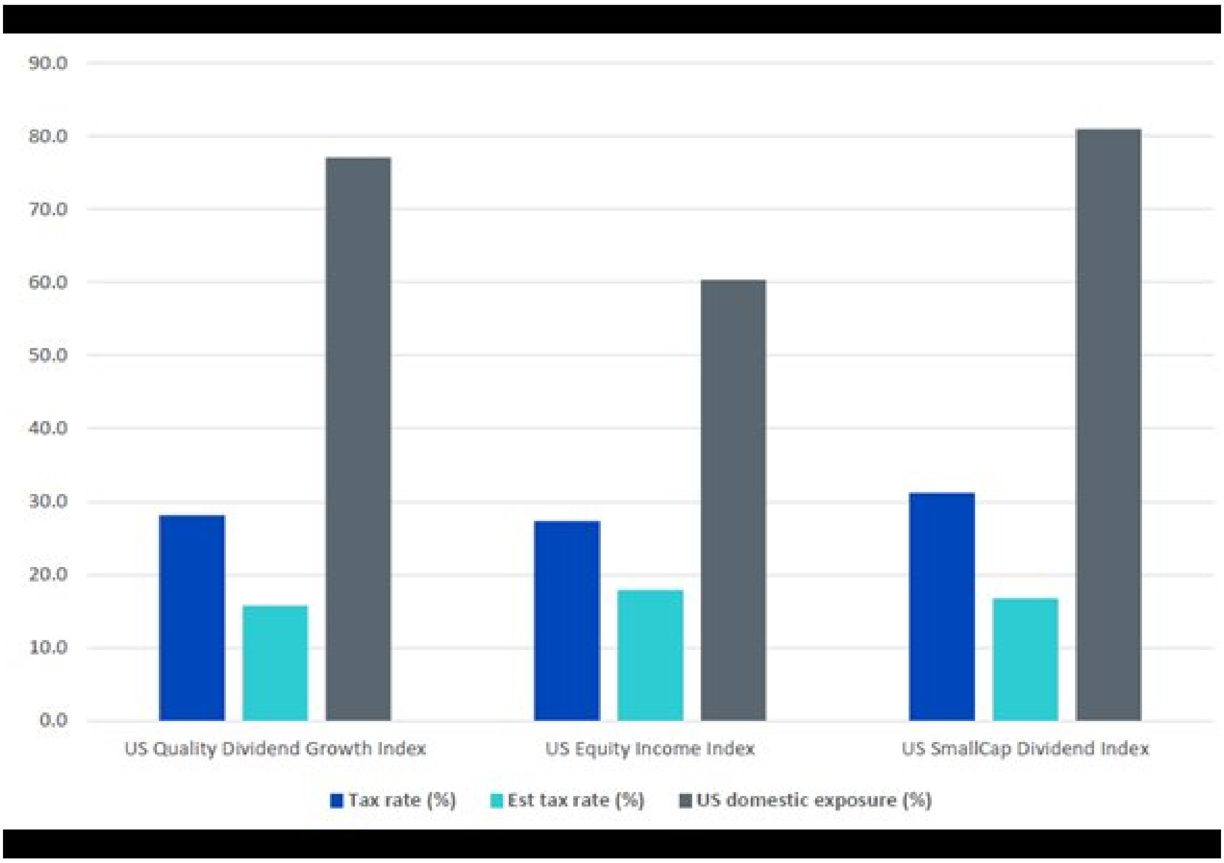
Over the past few months since the US election, markets have been driven by the expectation of the reflation trade and the positive impact on both the US economy and equities.

One of the core parts of this proposed revitalisation of US equities has been the prospects for dramatic cuts to corporation tax. The mechanics of tax cuts can be extremely powerful in terms of generating shareholder value, especially if one believes that these are permanent rather than temporary. Ultimately, whilst US equities appear to be overvalued on many metrics, especially historic PEs, there is some sense and value in considering the benefit of tax cuts.

The first consideration for investors is the potential benefit that a cut in corporation tax to 15% could have on various segments of the equity market. A key factor here is the degree of domestic exposure that companies have. As one might expect, small and mid-cap companies have a higher level of US domestic tax than large cap multinationals. In the case of the WisdomTree US SmallCap Dividend Index, 81% of profits are subject to US domestic tax, whilst 60% of the US WisdomTree Equity Income Index profits are subject to the same tax. Therefore, we expect US small cap companies to benefit disproportionately from a cut in domestic taxes from 35% to 15%. Interestingly the WisdomTree US Quality Dividend Growth Index also has a relatively high domestic component with over 77% exposure to US tax. In comparison, the equivalent statistic for the S&P 500 is 69.9%.

Figure 1: Proposed tax cuts on the effects on three US WisdomTree indices



Source: WisdomTree. Please note you cannot invest directly into an Index.

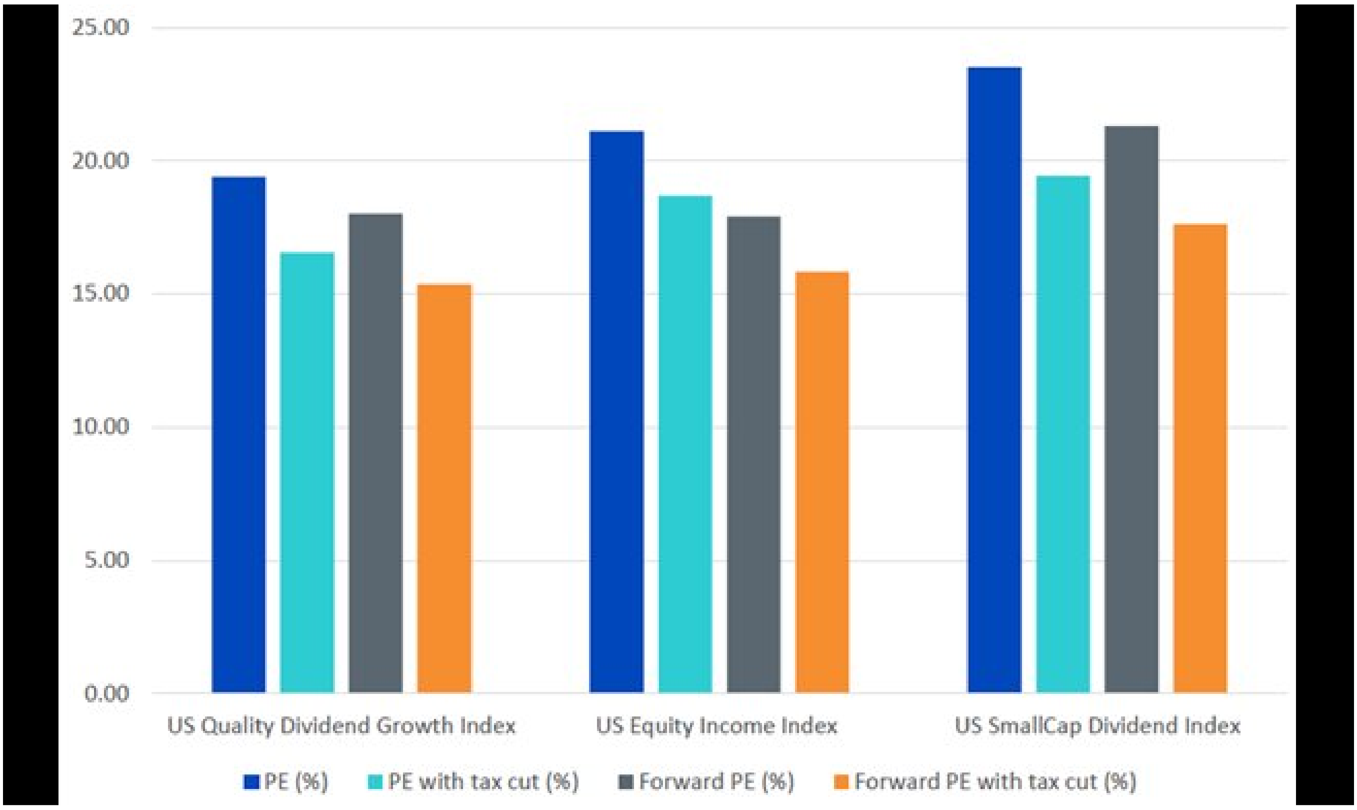
The benefits to shareholders can be quite mechanistic without accounting for any other benefits to the economy or any multiplier effect. Valuations, which have appeared stretched with historic PEs of 22x for the S&P 500, look more reasonable if taxes are cut to 15%, with the historic PE then dropping to 19x. Similarly, when considering the WisdomTree US SmallCap Dividend Index a relatively elevated PE of 23.5x drops markedly to 19.4x.

For many investors, however, the more important consideration comes with prospective PEs based on current estimates of earnings growth. This reveals the full benefits of tax cuts and the positive impact on US equities valuations. To a certain extent this applies across the board from quality dividend growth stocks, high yielding equities and small cap stocks. When one factors in both earnings expectations for the current year and the lowering of taxes, then PEs fall dramatically into what could be considered relatively normal valuation ranges.

Looking at specific WisdomTree indices reveals the extent of the potential valuation shift with the PE for small cap stocks falling from 23.5x to 17.6x on a forecast basis. Looking at high yielding equities as represented by the US WisdomTree Equity Income Index, the PE falls from 21.1x to 15.8x. Quality dividend stocks also feature with a sharply lower PE at 15.4x.

Although most of the focus has been on the impact in terms of PEs, there is a strong case to suggest that companies may maintain broadly static payout ratios with respect to dividends. This means that tax cuts can both increase earnings per share and then, as a natural consequence, this could feed through into dividends per share. Clearly increases in dividends should therefore result in higher dividend yields on a forecast basis.

Figure 2: Proposed tax cut impacts on price-earnings ratio



Source: WisdomTree. Please note you cannot invest directly into an Index.

WisdomTree's focus on dividend paying stocks and dividend weighted strategies suggests that there could be a substantial uplift in yields. WisdomTree's current US Equity Income Index, which has a historic yield of 3.61%, could potentially yield over 4.8% should companies maintain payout ratios. US small cap stocks could also see an uplift from a current historic yield of 3.6% to 4.8%. Whilst lower in absolute terms, quality dividend growth stocks could also distribute higher dividends with yields rising from 2.21% to 2.79%.

Of course, these scenarios are reliant on the administration's ability to push through tax cuts amongst the wide range of policies under consideration. Until firm and detailed proposals are sufficiently well articulated, uncertainties over substantive tax cuts are likely to prevail. Those investors willing to take a longer-term view of the value that tax cuts can deliver will be able to find opportunities in US equities.

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