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Is the stock market too rich ... overpriced?

Given the recent tax cut legislation and the current interest rate environment – not to mention world growth and inflation’s near absence – maybe not. Some market watchers even say the stock market now is as inexpensive as it was a year ago.

Hard to believe after a 10% advance for the S&P 500 and a 20% advance for the Dow?

Think about what 2018 corporate income statements will look like. The tax bill sign by President Trump on December 22 cut the top corporate rate from 35% to 21% ... so how does that help an imaginary company named, Acme Widget Manufacturing Company (AWMC)? Well, suppose that on 12/31/2018 AWMC has 2018 pre-tax profits of \$75,000,000. Under the pre-December 22, 2017 tax rates, for 2018 AWMC would send the US Treasury a \$26,240,000 check (under the old rates the first \$50,000 is taxed at 15% and all the rest at 35%). So AWMC has after-tax earnings of \$48,760,000.

Now suppose AWMC’s stock is traded on the NYSE and that there are 17,100,000 outstanding shares ... the earnings per share (EPS) is \$2.85 (i.e., $\$48,760,000 \div 17,100,000 \text{ shares} = \2.85). For many years, share prices of the S&P 500 companies have averaged about 22 times earnings or EPS. (That 22 is the Price to Earnings Ratio or P/E Ratio or just P/E.) The P/E’s of some types of companies average less than the S&P 500 average, some more.

Let’s assume the historic P/E for AWMC is 20. In that case, AWMC’s stock price should be about \$57 per share going into 2019 ($\$2.85 \text{ EPS} \times 20 \text{ P/E} = \57).

BUT WAIT! Because of the new tax law, AWMC will send \$15,750,000 to the US Treasury instead of \$26,240,000. WOW! That means AWMC now has after-tax earnings of \$59,250,000 ... and one way or the other, that’s \$10,490,000 **more** to the shareholders. Earnings are now \$3.46 per share, which means that with a 20 P/E its stock goes to \$69.30 per share ($\$3.46 \text{ EPS} \times 20 \text{ P/E} = \69.30). The 22% increase in after-tax earnings results in a 21% increase in the stock price ... from a

simple bookkeeping change caused by a lower tax rate ... even if AWMC had no actual growth in 2018.

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