U.S. stocks are off to a strong start at the beginning of 2018 with S&P 500 performance the best since 2003 after accelerating nearly 20% in 2017. Equity market strength can be attributed to continued supportive fundamentals, policy, and sentiment which we believe should persist through 2018 and possibly beyond. Improving and synchronized global growth, higher corporate earnings, modest inflation, easy financial conditions, elevated business and consumer confidence, a surprisingly weaker U.S. dollar, expanding trade, and a gradual and shallow tightening of monetary policy has helped push stock prices to new all-time highs. Along with this positive fundamental backdrop, the potential benefit from tax cuts has helped lift equity prices even further in the early trading days of 2018.

Initially, those stocks, which in our view have the ability to benefit most from lower taxes, outperformed in the wake of the 2016 elections. However, these companies began to underperform by the end of Q1 2017 as hope faded that Congress would be able to deliver. With the refocus on tax reform in the autumn of 2017, high-tax stocks began to outperform, particularly in the weeks prior to President Trump signing the new tax bill into law (see Chart 1).

The positive impact from tax reform has not yet been priced into earnings estimates.

### Chart 1

The performance of stocks with higher tax rates, or expected to benefit the greatest from lower taxes, has improved dramatically.

Two-year average effective tax rates for the 750 largest US stocks by market cap are calculated and then sorted into quintiles. The top quintile, or stocks with the highest tax rates, are then compared to the bottom quintile, or stocks with the lowest tax rates. Each stock is then indexed to 100 on June 30, 2017 and an equally-weighted average is then calculated to represent the composite large and small tax rate index. Sources: BNY Mellon Global Investment Strategy, FactSet, and Empirical Research. Data through January 16, 2018.
Consensus estimates for 2018 earnings have yet to display the renewed enthusiasm that is already being reflected in stock prices. While S&P 500 earnings forecasts have shifted directionally higher (see Chart 2), the upward revision has been a modest 3.5%. The effects from lower taxes on corporate earnings have yet to filter through analyst estimates and we see significant room for additional upside in earnings estimates. We expect to learn more during earnings season as companies announce the impact of tax reform on future earnings streams. Current 2018 S&P 500 earnings per share is projected to be $150.7\(^1\), a 16.5% gain from 2017, which is already up from the 11% earnings growth expected just four weeks ago\(^2\). With a potential 5%-10% additional boost from the new tax law, 2018 earnings growth could rise above 20%, the largest since 2010. Our view is that this positive impact has yet to be fully priced into stocks and should translate to even better-than-expected performance for 2018. We expect financials, energy, and retail to disproportionally benefit from the tax cuts in 2018 and beyond, which should be reflected in increased earnings going forward.

In addition to the positive influence on this year’s equity market, the tax bill is projected to add 0.5%-1.0% to 2018 real GDP growth. With higher economic growth, an even tighter labor market, and various major companies, such as AT&T, Wal-Mart and several banks, announcing higher wages and employee bonuses as a result of the cash savings from lower taxes, U.S. wages and inflation could rise faster than anticipated. While we expect the bull run to continue, the biggest risk to the status quo is a sudden uptick in wages and inflation and the ensuing uncertainty over how the Federal Reserve reacts.


\(^1\)FactSet. Data as of January 16, 2018. \(^2\)For 2018’s 16.5% expected gain, the 3.5% upward revision as shown in chart 2 cannot be added to the 11.0% expectation four weeks ago since it does not incorporate the change in the 2017 eps estimates.

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