US SHARE BUYBACKS: OFF TO THE RACES

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In the Marx Brothers movie, "A Day at the Races":
Tony: "Hey boss! C'mere! Sun-Up is the worst horse on the track!"
Dr. Hackenbush: "I notice he wins all the time."
Tony: "Aw, just because he comes in first."
Dr. Hackenbush: "Well, I don't want 'em any better than first."

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FINISHING LINES

How best to explain the monumental ascent in key United States stock benchmarks such as the S+P 500 that began in March 2009? What factors should guide marketplace handicappers in their opinions as to whether or not that bull climb will continue? Marketplace guides select between and evaluate assorted and intertwining variables. Their perspectives and arguments differ. However, considerations such as corporate earnings, sustained highly accommodative monetary policy (interest rate yield repression and money printing), and deficit spending stand out on many lists. In today's global scene, numerous clairvoyants extend their horizons to include other nations to help understand US equity price levels and patterns. Analysts of American stock movements may also rely on interest rate, US dollar, and commodity price levels and trends. Many players harness technical analysis of marketplace phenomena (for example, picture bar charts and moving averages) to their review.

Some gurus include share buybacks by US corporations in their inventory of bullish factors. Such marketplace observers typically focus on the last several years (or recent calendar quarters) and the billion dollar programs of noteworthy firms.

However, to better assess the influence of share buybacks by US companies, investigators should review them primarily from the standpoint of net, rather than gross, buybacks. The focus should be on whether or not there are net share buybacks (in other words, negative net issues) over a given time span. After all, some firms issue new stock. Moreover, explorers should review buybacks over a long run history as well as in relation to after-tax corporate profits and nominal GDP. Let's concentrate on the Federal Reserve Board's nonfinancial corporate business category. When reviewed in the context of corporate profits, but also (and especially) from the standpoint of nominal GDP, US net share buybacks in this domain in recent years have been very substantial. This inquiry reveals not only that net share buybacks (negative net issues) have played a particularly prominent role within that US equity arena in recent times. The noteworthy net buybacks (negative net issues) situation has persisted for a few decades. This longstanding accumulation of shares via net buybacks probably has reduced the amount of shares and thereby probably has had increasingly bullish consequences for US stocks in general.

Even if net share buybacks persist, a significant slowdown in their pace (reduction in their level) probably would be a bearish warning sign for equity signposts such as the S+P 500.

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The sustained yield repression scheme of the Federal Reserve Board and its central banking allies not only has helped to encourage many fortune hunters seeking reasonable (good) returns (yields) to purchase equities. It also has lowered corporate borrowing costs. To what extent do net share buybacks, arguably often financed by corporate debt issues, reflect a widely-embraced management opinion that investment opportunities are relatively unattractive? In this context, remember that many corporations nowadays have large cash hoards not being directly invested in their business.

Everyone knows that corporations can raise funds via issuing stock or debt securities, or by borrowing from banks or similar entities. Diverse motivations surely explain share buybacks. Yet at some companies, executive compensation links to the firm's share price and earnings per share. So perhaps some undoubtedly altruistic corporate leaders nevertheless have an alluring incentive spurring them to reduce the number of shares outstanding.

AT THE STARTING GATE

In "The Bank Dick", a famed film comedy starring W.C. Fields, Egbert Souse (Fields) majestically declares:
"Ten cents a share. Telephone sold for five cents a share. How would you like something better for ten cents a share? If five gets ya ten, ten'll get ya twenty. A beautiful home in the country, upstairs and down. Beer flowing through the estate over your grandmother's paisley shawl."

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In the interconnected global economy, America and its marketplaces obviously do not stand alone. And share buybacks and bullish stock trends do not confine themselves to America. Anyway, let's saddle up and study the American share buyback track record.

Where should data hunters run to discover comprehensive US share buyback information? Buried within the Federal Reserve Board's Z.1 "Financial Accounts of the United States" is "Flow of Funds" data on US corporate equities (Table F.213; 3/12/15, next release 6/11/15). The table's "Net issues" section details the billions of dollars of "net issues" by "nonfinancial corporate business", "domestic financial sectors", and "rest of the world".

To assess the importance of share buybacks, analysis should concentrate on the "nonfinancial corporate business" category. Many pundits probably would label such business as that of the "real economy" The "nonfinancial corporate business" ("NCB") grouping does not appear in the "Net purchases" section of Table F.213. Its presentation in the "Net issues" part of Table F.213 thus probably represents a fairly clear estimate of its net share issues (or net share buybacks).

In Table F.213's flow of funds overview of net issues, the "rest of the world" represents "net purchases of foreign corporate equities and investment fund shares by U.S. residents". So an analysis of net issues (share buybacks) should not pay much attention to that category.

The "domestic financial sectors" obviously represent an important portion of the US economy. Of course financial firms within it issue and buy back shares. However, for a long run analysis of the significance of US share buybacks based upon Table F.213, one probably should not focus on it. Why? It is challenging to produce a clear view of actual net share buybacks for that sector comparable to the "nonfinancial corporate business" group. First, two very important subsets (of the ten) within the "Net issues" of Table F.213's domestic financial group, "exchange-traded funds" and "brokers and dealers" also appear and are significant within Table F.213's "Net purchases" area as well. For the brokers and dealers (and holding companies and funding corporations), 2008's massive net issues are an exception to this lack of clarity challenge.

Exchange-traded funds have become especially important since around 1999. In addition, the ETF category, though for F.213 purposes it involves "corporate equities", these ETF equities involve not only stocks, but also those based upon (derived from) Treasury securities, corporate and foreign bonds, and municipal securities. Therefore many ETFs do not include the “shares” (think of well-known common stocks in equity benchmarks) discussed in relation to “the stock market” in general or the share buyback meadow in particular.

THE RACE TO BUY BACK

From Joseph Heller’s novel, “Catch-22” (chapter twenty-four, “Milo”):
Colonel (squadron commander: “We buy from the syndicate?”
Milo Minderbinder: “And everyone has a share.”
Colonel: “It’s amazing, positively amazing. How can you do it?”
Milo: “Mass purchasing power makes the big difference.”

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The following table devoted to nonfinancial corporate business share buybacks is derived from the Fed’s Table F.213, which provides net issue statistics in billions of dollars in nominal terms for nonfinancial corporate business (and other sectors). A positive number for net issues indicates there were net issues. Thus a negative sign for net issues manifests net share buybacks. So relative to after-tax profits and nominal GDP in the table below, a positive percentage reflects actual net issues of corporate equities (the absence of net buybacks) for the given period. A minus sign indicates that the given period showed net share buybacks as a percentage of profits and GDP. Thus for 2005-2014, because there were net share buybacks, the 2.49pc of nominal GDP receives a minus sign.

People can measure profits in various ways. In the following table, after-tax profits are from the Federal Reserve’s Z.1 (see Table F.7) and are without inventory valuation and capital consumption adjustments. The after-tax profits in the analysis are for the US as a whole, so they include both nonfinancial corporate business and the domestic financial sector. After-tax profits as a percentage of nominal GDP generally have grown in recent years. The post-World War Two average (1946-2014) is about 6.5 percent, whereas that of 2004-2014 is 9.3pc. Note the lofty levels of 2012 (10.4pc), 2013 (10.5pc), and 2014 (about 10.5pc).

Nonfinancial corporate business is “NCB” in the table below.

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Over three eras, which all stretch forward to include the most recent year (2014), the nonfinancial corporate business domain has shown net share buybacks.

Share Buybacks of NCB as PC of US After-Tax Profits, Average:	**Share Buybacks of NCB as PC of Nominal GDP, Average:**
1946-2014: -7.3 percent	1946-2014: -0.48 percent
1979-2014: -19.6	1979-2014: -1.27
2005-2014: -26.4	2005-2014: -2.49

As the briefer time spans manifest a growing percentage relative to both ATP and nominal GDP, let’s next review the share buyback scene over separated time periods.

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Share Buybacks of NCB
<u>as PC of US After-Tax Profits, Average</u>:

1946-1978: 6.0 percent
1979-2004: -17.0
2005-2014: -26.4

Share Buybacks of NCB
<u>as PC of Nominal GDP, Average:</u>

1946-1978: .38 percent
1979-2004: -.80
2005-2014: -2.49

This vista generates several significant insights. First, net share buybacks are not inevitable. Note the positive numbers (times of net issues of shares) for 1946-1978. Stock jockeys digging into the Fed's data will notice that the NCB category had net issues of shares only three times within 1946-1978's horizon.

Second, note the substantial shift to net share buybacks in 1979-2004, and how net share buybacks have raced ahead to become even more significant in 2005-2014. Thus since around 1979, the bullish aspect of these nonfinancial corporate business net share buybacks has been a bullish factor for US stocks.

The noteworthy net share buyback within the nonfinancial corporate business ("NCB") sector extends well before 2009's start of the S+P 500 bull trend. So it was a bullish variable prior to 2009.

Underline the growing percentage of NCB net buybacks in 2005-2014 versus ATP, and especially relative to nominal GDP, in comparison to the 1979-2004 era. What does this suggest, even though stock prices have not always headed higher every year since 2005 (or 1979)? The notable and increasing net share buybacks over 2005-2014, as they followed an extended period (1979-2004) of net share buybacks, arguably have played an increasingly bullish role for the American nonfinancial corporate business stock marketplace sector (and arguably therefore for the US equity marketplace as a whole).

How important are "financials" within the overall US stock marketplace relative to "nonfinancial corporate business". How to define "financial" is a matter of opinion. And the S+P 500 is not the entire US stock marketplace. However, the S+P 500's financial sector currently has a weight of around sixteen percent within the index.

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The Fed's Table F.213 presents its data in billions of dollars, not shares. Even in a time of overall net share buybacks for the NCB sector, some firms may have issued shares. However, the massive dollar sums spent on net buybacks over an extended period of time (about 35 years, from 1979 to 2014) suggest that the actual supply of shares outstanding within the NCB domain has been shrinking. All else equal, a falling share supply (and especially a reduced "free supply" of stock) would help to push US stocks upward.

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Although 1979-1993 saw six years of net issues from the NCB arena, the evolution toward net share buybacks began to emerge over that fifteen year interval. For the two decades beginning in 1994, in every single year, the NCB had negative net issues (in other words, had net share buybacks). These often were substantial. From 2005-2014, from the Goldilocks Era through the worldwide economic crisis and its aftermath, net share buybacks have averaged $374.9 billion per year, with 2007's $713.0bb the pinnacle. Relative to nominal GDP, 2007's arithmetic summit for NCB net share buybacks was -4.92pc of GDP (2006's was -3.59pc), shattering 1988's -2.47pc prior record (note also 1998's -2.37pc). Calendar 2014 generated $422.9 billion in net share buybacks, or -2.43pc of nominal GDP.

THE HOME STRETCH

The Bank for International Settlements reviews the dollar amounts of "Equity issuance and share buybacks" in the four largest advanced economies, the United States, the Euro Area, Japan, and the United Kingdom. See the BIS "Quarterly Review", March 2015 (Box 2, pp28-29). It notes: "Share repurchases have now overtaken aggregate dividend as the main form of corporate payout in the United States." It says "Share buyback booms in the United States have typically coincided with surges in net bond issuance", suggesting that "when debt financing costs are favorable and equity markets are rallying, US non-financial corporations issue bonds heavily and use some of the proceeds to finance stock repurchases."

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Factset's "Buyback Quarterly" (3/16/15, pp1-2) states that within the S+P 500, 362 companies (72 percent of the index), engaged in share buybacks during 4Q14. The average participation rate over the past five years (20 quarters) also has been 72 percent.

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Many expect share buybacks (and dividends) to remain substantial during 2015. Most American stock analysts and the media pay close attention to the S+P 500, which includes "financial" corporations, not just "non-financial" ones. Calendar 2014 dividend yields for the S+P 500 were slightly under two percent; they appear to be around that level nowadays. S&P Dow Jones Indices statistics (3/23/15) reveal that dividends for the S+P 500 totaled about $350 billion in calendar 2014, with share buybacks (apparently on a gross rather than net basis for the index) about $553bb. Of the $553 billion in share buybacks in calendar 2014, nearly $41bb (about 7.4 percent) were from the "financial" domain (2013's likewise stood at about $41bb).The Financial Times headlines: "US investors eye record $1tn in payouts as groups rein in capex" (4/13/15, p1). The article says many strategists expect dividends to climb to about $400 billion in 2015; some predictions for 2015 buybacks reach around $600bb.

The Fed's "longer run" central tendency for US real GDP growth of 2.0 to 2.3 percent is not marvelous ("Economic Projections"; 3/18/15). How attractive are foreign investment opportunities for American firms over the long run?

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Do net share buybacks find a counterpart in growing leverage linked to stock marketplace transactions in general? Take a look at NYSE margin debt. The lofty $713.0 billion in NCB net share buybacks of calendar 2007 coincided with July 2007's $381.4bb margin debt peak (S+P 500 major high reached 10/11/07 at 1576). NYSE margin debt tumbled to $173.3bb in February 2009 (S+P 500 major low 3/6/09 at 667). Calendar 2009's NCB net share buybacks of $52.5bb were the low of the 2005-14 period.

March 2015's NYSE margin debt established a new pinnacle at $476.4 billion.

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The Financial Times (5/1/15, p7), citing the Economic Policy Institute, comments that between 1978 and 2013, US chief executive remuneration, adjusted for inflation, soared 937 percent. Over that period, this more than doubled the level of stock marketplace growth, and dwarfed the 10.2pc increase in the average American worker's pay. The FT adds that the average US chief executive earned 295.9 times as much as the typical American worker in 2013, compared with only 20 times as much in 1965.

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Suppose net share buybacks play an important role in assisting and sustaining stock marketplace rallies in the US (and elsewhere). What other group in the grandstands probably is a fan of significant share buybacks?

Take a look at Swiss Re's "Financial repression: The unintended consequences" (3/26/15, p14). In speaking of US households, it concludes: "the wealthier savers have benefited more from the equity rally with the top 1% having 50% of their financial assets invested in equities (while the bottom 90% only allocates 9% on average)." And: "monetary policy and central bank asset purchases have aggravated economic inequality via equity price inflation."

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