MORNING BRIEFING
April 2, 2019

Another ‘Eureka!’ Moment on Buybacks

See the collection of the individual charts linked below.

(1) Why does a senator from Wisconsin want to ban buybacks? (2) The Baldwin report is a fundamentally flawed analysis of corporate finance. (3) Are corporate executives looters? (4) We calculate that since 2011, S&P 500 companies repurchased 72 billion shares. So why is share count down only 22 billion? (5) Roughly 2/3 of buybacks may be offsetting share dilution from employee stock plans. (6) TCJA reduced incentive to pay employees with stock. (7) Meet the intellectual godfather behind the progressive movement to limit or ban buybacks.

Strategy I: Buybacks Obsession. Progressive politicians have been obsessed with corporate share buybacks lately. They want to limit them or even ban them. The latest one to voice opposition to share repurchases is Senator Tammy Baldwin (D, WI).

Last Tuesday (3/26), Baldwin’s office released a report arguing that stock buybacks suppress wages and drive income inequality while increasing systemic risk to the economy. One of the alarming findings is that the “evidence also shows that Wall Street insiders and corporate executives have abused the American system of corporate governance, spending trillions on buybacks to benefit themselves at the expense of employees and other corporate stakeholders.” Baldwin’s report is titled “Reward Work Not Wealth” and subtitled “A Plan to Reform Corporate Governance, Empower Workers and End the Looting of Public Companies to Create Shared Prosperity in America.”

To ban buybacks, Baldwin is reintroducing the Reward Work Act in the 116th Congress, which she had first introduced a year ago. In addition to prohibiting buybacks, her bill requires that one third of the directors of each public company be elected by its employees. It would be a radical intrusion by the government into corporate finance and governance.

The report claims that “the buyback binge” has been financed by “risky” debt to buy back shares, and declares: “This dynamic has pushed corporate debt to record highs. The share-sellers reap short-term gains, yet they bear none of the risks of the other stakeholders, who are left to face the prospect of a default. Long-term retirement savers suffer the permanent loss of their investment if the company goes bankrupt. Workers face the loss of their job and pension cuts, possibly resulting in a delayed retirement. Taxpayers deal with further strain on public resources when they are used to assist workers who lose their jobs.”

Strategy II: The Truth about Buybacks, Again. Supporting the thesis of Baldwin’s 33-page report are plenty of charts and footnotes. Not supporting it is an accurate understanding of the role of buybacks in corporate finance. As Joe and I have observed previously, the majority of buybacks are used to offset the dilution of earnings per share resulting from employee stock compensation rather than to boost earnings per share.

We recently had a “Eureka!” moment that led to a simple way to quantify and support our thesis:
(1) **Share count.** About a year ago, I asked Joe for a series on the share count of the S&P 500. The S&P provides a “divisor” that is used to ensure that changes in shares outstanding, capital actions, and the addition or deletion of stocks to the index do not change the level of the index (Fig. 1). It is an index that can be used as a proxy for the share count.

Joe has been calculating a more precise count of the total basic shares outstanding for current S&P 500 companies with data for all periods and adjusted for stock splits and stock dividends. Not surprisingly, his series, which starts in 2007, is highly correlated with the S&P 500 divisor.

According to Joe, the share count rose 7.2% from a low of 278 billion shares during Q3-2008 to a peak of 297 billion shares during Q1-2011. Since then, it has dropped 7.7% to 275 billion shares at the end of last year, a decline of 22 billion shares. That’s an average annual decline of 1.1% since the start of 2011.

That’s certainly a boost to the annual growth rate of earnings per share, but a relatively small one. The same conclusion follows when we compare S&P’s measures of S&P 500 aggregate and per share earnings (Fig. 2, Fig. 3, and Fig. 4). It certainly questions the credibility of the notion that the $4.7 trillion of buybacks from Q1-2009 through Q4-2018 was aimed largely at boosting earnings per share (Fig. 5).

(We are mostly focusing on the data since Q1-2011 through Q4-2018 because that’s the period that saw the drop in the share count. During 2009, there was a big spike in share issuance by banks scrambling to raise capital following the financial crisis of 2008.)

(2) **Average price per share.** Joe’s share-count series allows us to calculate the average price per share of the S&P 500 companies. We do so by dividing the average market capitalization of the S&P 500 during each quarter by the number of shares outstanding at the end of each quarter (Fig. 6). The average price per share during each quarter has risen from a low of $25 at the end of Q1-2009 to $76 at the end of 2018 (Fig. 7).

(3) **Number of shares repurchased.** We can now easily convert the S&P 500 buybacks data into the number of shares repurchased every quarter simply by dividing the buybacks (in billion dollars) by the average price per share during each quarter (Fig. 8). Since Q1-2011, a total of 72 billion shares were repurchased.

However, over that very same period, the number of outstanding shares declined by only 22 billion! Something is missing. It’s actually hiding in plain sight. S&P 500 companies have been issuing shares at the same time that they’ve been buying them back. Why would they do so?

The answer is that they are issuing lots of stock to their employee stock compensation plans. To avoid diluting their earnings per share, they are buying back their shares at the same time. Of course, some companies have also issued stock to fund mergers and acquisitions (M&A).

(4) **Number of shares issued.** As shown above, once Joe had devised a way to measure the share count, we could derive the average price per share of the S&P 500. That allows us to derive the number of shares repurchased using the value of the buybacks. This gross repurchases series can be compared to the net issuance series (i.e., the q/q change in Joe’s shares-outstanding series).

Now we can derive gross issuance since it is equal to buybacks less net issuance (or net buybacks when the series is negative). The result is eye-opening. Since Q1-2011, S&P 500 companies repurchased 72 billion shares and issued 50 billion shares, resulting in net repurchases of 22 billion
Net issuance (actually net buybacks in this case) has fluctuated around a third of gross buybacks since Q1-2011 (Fig. 9). That explains why the contribution of gross buybacks to boosting earnings per share has been relatively small.

(5) *Buybacks driven by compensation.* It’s true that buybacks are driven by compensation, but not in the way that progressive politicians believe. They aren’t significantly boosting earnings per share to the benefit of corporations’ fat-cat executives and directors or its other large, rich shareholders.

They simply reflect an accounting procedure necessary to avoid dilution when employees are paid in company shares. We can get a rough idea of how much compensation is paid via shares. To do so, we simply multiply gross issuance by the average price per share of the S&P 500 (Fig. 10).

Assuming that the value of all gross issuance of stock is for compensation (which must be somewhat of an exaggeration), this series’ four-quarter sum has risen from $331 billion in 2011 to $532 billion in 2018. Annualizing this series and dividing it by the compensation of all employees (including wages, salaries, bonuses, and benefits—also at an annual rate) suggests that stock compensation has been accounting for an average of only 4% of total employee compensation since 2011 (Fig. 11).

(6) *Bottom line.* Banning stock buybacks would be a totally unnecessary intrusion of the government in corporate finance. The real issue for progressives isn’t buybacks, but compensation. They have no basis in fact by which to prove their assertion that stock compensation plans are limited to the top brass, who benefit much more than their employees or even at the expense of their employees.

On the contrary, according to a post on the website of the National Center for Employee Ownership:

“Data from the 2014 General Social Survey show that 22.9 million American workers own stock in their company through a 401(k) plan, ESOP, direct stock grant, or similar plan, while 8.5 million hold stock options (some employees have options and own stock through other plans, so these numbers are not additive). That means that 19.5% of the total workforce, but 34.9% of those who work for companies that have stock, own stock through some kind of benefit plan, while 7.2% of the workforce, but 13.1% of those in companies with stock, hold options.”

Besides, the entire “problem” was created by progressives in 1993 when they passed a law that limited the tax deductibility as a business expense of any executive’s pay above $1 million in cash, creating incentives for corporations to pay highly paid employees in stock. President Trump’s Tax Cuts and Jobs Act (TCJA), passed in December 2017, once again changed the rules in ways likely to alter the structure of executive compensation—this time reducing stock buybacks, as we discussed in the 3/5 Morning Briefing.

Our take is that the new rules may mean fewer stock option awards in the future, which could also mean that fewer share repurchases will be needed to offset their dilutive effect. No further government meddling is required.

**Strategy III: MIA in Fed’s US Financial Accounts.** The Fed compiles quarterly data on the flow of funds in the *Financial Accounts of the United States.* Table F.223 tracks the supply and demand for corporate equities. It shows net repurchases of $168 billion during 2018, which includes net issuance of $311 billion in shares of exchanged-traded funds and $128 billion of stock issued by foreign corporations.
Excluding both of those shows net repurchases of $606 billion by US corporations. Using Joe’s data, we get net repurchases of $275 billion. We suspect that the Fed’s accounts might not be accounting for the value of stocks issued by corporations to their employee stock compensation plans. We have reached out to the Fed and are awaiting guidance on this matter. Stay tuned.

**Strategy IV: Incriminating Evidence & Rubbish.** I have to come clean. On page 23 of the Baldwin report, you’ll find a chart showing the strong correlation between the S&P 500 and the sum of S&P 500 buybacks and dividends. We’ve been using this chart to support our bullish stance almost since the start of the bull market *(Fig. 12)*. In fact, we provided the data to the senator’s staff for her report!

Needless to say, the report manages to put a negative spin on our bullish chart as follows:

“The chart below shows buyback activity peaking and dipping in unison with the S&P 500 market index. By definition, if executives are buying high and selling low, they are managing their company’s cash poorly, which should disturb all of their stakeholders—not just shareholders, but bondholders, employees, and taxpayers—as the potential for insolvency rises.”

With the benefit of hindsight and additional research, Joe and I are amending our interpretation of this chart. The bull market in stocks has been driven by solid earnings delivered by a global economy that continues to grow. The coincident relationship between the S&P 500 and buybacks reflects that compensation—with some percentage paid in stock—is rising in a growing economy.

Apparently, the authors of the Baldwin study believe that corporate executives are dummies, and need the government’s help to manage the cash of their corporations.

The intellectual godfather of this rubbish is William Lazonick, a professor of economics at the University of Massachusetts. He authored a very influential article in the September 2014 *Harvard Business Review* titled “Profits Without Prosperity.” It’s footnoted in the Baldwin report, and he is quoted several times in the report as well as by other progressives who want to put a lid on buybacks. The professor called for “an end to open-market buybacks.”

In Lazonick’s opinion, trillions of dollars have been spent to artificially boost earnings per share by lowering the share count. The money should have been used to invest in the capital and labor of corporations to make them more productive. He seems to be under the impression that buybacks and dividends have been absorbing nearly 100% of earnings, leaving nothing for capital spending.

That is simply wrong. Dividends come out of after-tax earnings, leaving retained earnings, which are included in cash flow. The overwhelming amount of cash flow comes from the depreciation allowance. As Debbie and I have shown on numerous occasions, capital spending has been plentiful during the current expansion.

Buybacks that are offsetting stock compensation aren’t financed with cash flow. The source of funds is the labor compensation item in corporate income statements to the extent that they are related to such outlays. As we’ve explained in this and previous commentaries (see our 2/20 *Morning Briefing*, for example), they have been used to a great extent for this purpose.

**CALENDARS**

**US. Tues:** Durable Goods Orders Total, Ex Transportation, and Core Capital Goods -1.2%/0.3%/0.3%, Motor Vehicle Sales 16.7mu. **Wed:** ADP Employment Change 180k, ISM NM-PMI 58.0, MBA Mortgage Applications, Kashkari. (DailyFX estimates)
Global. Tues: RBA Cash Target Rate 1.50%. Wed: Eurozone Retail Sales 0.1%m/m/1.5%y/y, Eurozone, Germany, and France C-PMIs 51.4/51.5/49.0, Eurozone, Germany, France, and Italy NM-PMIs 52.7/54.9/48.9/50.6, UK C-PMI & NM-PMI 51.2/51.1 (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings (link): Forward earnings rose w/w for all of the market-cap indexes for the first time in 12 weeks, possibly signaling an end to the downtrend that began in late October. LargeCap’s has risen during five of the past seven weeks; MidCap’s rose for a third straight week for the first time since mid-October; and SmallCap’s gain was its first in 12 weeks. LargeCap’s forward EPS is just 1.8% below its record high of $175.48 in late October; MidCap’s remained steady at 2.6% below its mid-October high; and SmallCap’s improved to 8.1% below its mid-October high from 8.4% below a week earlier. At their bottoms, LargeCap’s forward EPS had been the most below its record high since June 2016, and MidCap’s was the lowest since February 2016. SmallCap’s had not been this far below since October 2010. The yearly change in forward earnings soared to cyclical highs during 2018 due to the boost from the Tax Cuts and Jobs Act, but is tumbling now as y/y comparisons become more difficult. In the latest week, the rate of change in LargeCap’s forward earnings edged down to a 26-month low of 6.4% y/y from 6.6%. That’s down from 23.2% in mid-September, which was the highest since January 2011 and compares to a six-year low of -1.8% in October 2015. MidCap’s y/y change was down to a 27-month low of 6.0% from 6.4%, which compares to 24.1% in mid-September (the highest since April 2011) and a six-year low of -1.3% in December 2015. SmallCap’s improved to 4.0% from a 31-month low of 3.8%, which is down from an eight-year high of 35.3% in early October and compares to a six-year low of 0.3% in December 2015. Analysts had been expecting double-digit percentage earnings growth in 2019, but those forecasts have been dropping since October. Here are the latest consensus earnings growth rates for 2018, 2019, and 2020: LargeCap (22.7%, 3.3%, 12.0%), MidCap (22.7, 3.1, 12.6), and SmallCap (22.4, 4.3, 18.7).

S&P 500/400/600 Valuation (link): Forward P/E ratios rose w/w for all these indexes and are well above their multi-year lows in late December. LargeCap’s weekly forward P/E rose to a 25-week high of 16.4 from 16.3, which is up from a five-year low of 13.9 during December. That compares to a six-month high of 16.8 in mid-September and a multi-year high of 18.6 on January 26 (highest since May 2002)—and of course is well below the tech-bubble record high of 25.7 in July 1999. Last week’s level remains above the post-Lehman-meltdown P/E of 9.3 in October 2008. MidCap’s forward P/E rose 0.3pt to 15.6. That’s up from 13.0 during December, which was the lowest reading since November 2011. MidCap’s P/E is down from a 15-year high of 19.2 in February 2017 and the record high of 20.6 in January 2002. However, MidCap’s P/E has been at or below LargeCap’s P/E for most of the time since August 2017—the first time that alignment has prevailed since 2009. SmallCap’s P/E improved to 16.6 from 16.3, which is well above its seven-year low of 13.6 during December. That’s well below its 51-week high of 20.2 in December 2017 (which wasn’t much below the 15-year high of 20.5 in December 2016, when Energy’s earnings were depressed). SmallCap’s P/E was higher than LargeCap’s P/E for an 11th straight week, after being below for much of December for the first time since 2003.

S&P 500 Sectors Quarterly Earnings Outlook (link): With the Q1 books closed, analysts continued to trim their Q1 forecasts. Last week saw the S&P 500’s Q1-2019 EPS forecast drop 3 cents w/w to $37.34. That’s down 7.0% since the end of Q4 and is the worst quarter for consensus forecast revisions since Q1-2016. The $37.34 estimate represents a forecasted pro forma earnings decline for Q1-2019 of 1.9%, compared to -1.7% a week earlier and 5.3% at the end of Q4. If it comes to pass, Q1’s y/y decline would be its first after 10 straight gains, and down from 16.8% in Q4 and 28.4% in Q3 (which marked the peak of the current earnings cycle). Just four of the 11 sectors are expected to record
positive y/y earnings growth in Q1-2019, with none rising at a double-digit percentage rate. That compares to 10 positive during Q4, when seven rose at a double-percentage rate. Six sectors are expected to match or beat the S&P 500’s Q1 growth rate, compared to just four during Q4. Utilities is the only sector expected to post better growth on a q/q basis during Q1. Here are the latest forecasted Q1-2019 earnings growth rates versus their Q4-2018 growth rates: Health Care (4.5% in Q1-2019 versus 13.3% in Q4-2018), Industrials (3.1, 27.1), Financials (2.9, 15.6), Real Estate (2.4, 6.2), Utilities (-0.3, -10.4), Consumer Staples (-1.9, 4.6), Consumer Discretionary (-3.4, 18.1), Communication Services (-5.8, 26.4), Information Technology (-6.1, 10.3), Materials (-14.3, 6.1), and Energy (-19.2, 81.4). On an ex-Energy basis, analysts expect S&P 500 earnings to drop 1.0% y/y in Q1, well below the 14.2% y/y gain in Q4.

US ECONOMIC INDICATORS

Retail Sales (link): Retail sales fell unexpectedly in February, while January sales were stronger than first reported. February sales were likely negatively impacted by the weather, as well as tax funds being smaller, on average, compared to prior years. Core retail sales—which exclude autos, gasoline, building materials, and food services—slipped 0.2% in February, following an upwardly revised 1.7% (from 1.1%) gain in January and a 2.2% drop in December. (The BEA uses this core retail sales measure to estimate personal consumption expenditures each month.) Headline retail sales also unexpectedly fell 0.2% in February after an upwardly revised 0.7% (from 0.2) increase in January and a 1.6% drop during the final month of 2018. We estimate February real core retail sales declined 0.4% following a 2.0% rebound in January, while real retail sales fell 0.4% and rose 1.0% over the same periods. We calculate that real core retail sales growth slowed to 1.1% (saar) during the three months ending February (based on the 3-month average), down from 3.2% during January; real retail sales growth contracted 0.4% (saar) over the comparable period, the first decline since last March and slowing steadily from November’s 2.4%. In February, seven of the 13 major nominal sales categories declined, led by losses of 1.0% or more in building materials (-4.4%), miscellaneous (-1.6), electronics & appliance (-1.3), and food & beverage (-1.2) retailers. The top gainers were gasoline (1.0), nonstore (0.9), and motor vehicle (0.7) establishments.

Business Sales (link): Nominal business sales in January increased for the first time in three months, while real business sales continued to reach new record highs. Nominal manufacturing & trade sales (MTS) advanced 0.3% after sinking 1.5% from October’s record high. Meanwhile, inflation-adjusted MTS expanded for the 11th time in 12 months, up 0.7% in January and 3.0% y/y. Real sales of wholesalers reached new record highs at the start of the year, while those of retailers remained stalled just below their record high; real sales of manufacturers climbed to a new cyclical high.

Construction Spending (link): Construction spending in February rose for the third month to within 0.3% of last May’s record high. Expenditures jumped 1.0% in February, and 3.7% over the three months through February—boosted by a 9.6% surge in public construction building the first two months of this year. The increase in government projects was led by state & local governments, which soared 9.8% over the two-month period, though federal government building rose a robust 6.7% over the same time span. Meanwhile, private construction spending advanced for the third month, by 0.2% during February and 2.4% over the period, led by a three-month gain of 3.5% in residential investment. The gain in residential investment was driven by home improvement spending—which skyrocketed 14.8% during the four months through February—and multi-family investment, which slipped slightly, though after a five-month jump of 14.3%. In the meantime, single-family building fell for the eighth time in nine months, by a total of 7.5%. Private nonresidential building dipped 0.5% in February after a two-month gain of 1.7%.

GLOBAL ECONOMIC INDICATORS
Eurozone CPI Flash Estimate (link): March’s CPI rate remained below 2.0% for the fifth consecutive month, according to the flash estimate, while the core rate fell below 1.0%. The headline rate ticked down to 1.4% y/y last month (from 1.5% in February); it eased steadily from a six-year high of 2.3% in October to a nine-month low of 1.4% in January. Looking at the main components, energy (to 5.3% from 3.6% y/y) once again is expected to record the highest annual rate in March, accelerating sharply. The remaining components, however, are all expected to ease from their February rates: Food alcohol & tobacco (1.8 from 2.3), services (1.1 from 1.4), and non-energy industrial goods (0.2 from 0.4). The core rate—which excludes energy, food, alcohol, and tobacco—is expected to fall to 0.8% y/y, the lowest since last April.

Global Manufacturing PMIs (link): Global manufacturing activity in March matched February’s pace, which was the weakest since June 2016. JP Morgan’s M-PMI was unchanged at 50.6 last month, after easing the prior 14 months from December 2017’s seven-year high of 54.4. Emerging nations’ M-PMI (to 51.0 from 50.6) improved for the second month since contracting in January (to 49.5) for the first time since June 2016, while developed nations’ (50.0 from 50.4) sank to the breakeven point. M-PMIs were above the global average of 50.6 in the UK (55.1, 13-month high), Greece (54.7, 12-month high), Ireland (53.9, 2-month low), Brazil (52.8, 2-month high), the Netherlands (52.5, 33-month low), US (52.4, 21-month low), Spain (50.9, 2-month high), and China (50.8, 8-month high). Austria’s M-PMI (50.0, 48-month low) fell to the breakeven point, while M-PMIs in the top three Eurozone economies and Japan contracted: France (49.7, 3-month low), Japan (49.2, 2-month high), Italy (47.4, 70-month low), and Germany (44.1, 80-month low).

US Manufacturing PMIs (link): Manufacturing activity in March remained robust according to the ISM measure, though posted its slowest growth since June 2017 according to the IHS Markit gauge. The ISM M-PMI (to 55.3 from 54.2) accelerated last month, though remains below the heady pace at this time last year. The new orders (57.4 from 55.5), production (55.8 from 54.8), and employment (57.5 from 52.3) components all improved—the latter recovering from its lowest reading since November 2016. Meanwhile, the supplier deliveries (54.2 from 54.9) measure eased for the fifth month to a 26-month low, while inventories (51.8 from 53.4) accumulated at the slowest pace this year. Meanwhile, IHS Markit’s M-PMI showed manufacturing activity slowed for the second month, from 54.9 in January to an 18-month low of 52.4 in March. According to the report, a key factor behind the lower headline figure was a slower rise in output, which was below the series trend, while new orders expanded at the slowest pace since June 2017. At the same time, new export orders growth was meager, expanding at a five-month low, “with firms noting that global trade tensions and the ongoing impact of tariffs had dampened foreign client demand.”