MORNING BRIEFING
June 27, 2017

A Matter of Some Interest

See the collection of the individual charts linked below.

(1) Republicans want to eliminate interest expensing, while granting 100% capital spending deduction. (2) Tax code favors leveraged balance sheets. (3) Dividends plus buybacks eating up earnings, but plenty of cash flow left for capex. (4) Tax subsidy worth $5.90 per share for S&P 500. (5) Record bond refinancing boosted profits over the past year. (6) Dividend yield valuation model shows stocks cheap relative to bonds. (7) Japan is the poster child for a geriatric society. (8) Japan's self-extinction by the numbers. (9) From extended families to one Carebot. (10) Basic Universal Income vs. Basic Fertility Income. (11) Make babies for fun and profit.

Corporate Finance: Buybacks & Interest Expense. The 6/25 *WSJ* included an article titled "The $1.5 Trillion Business Tax Change Flying Under the Radar." It noted: "Republicans looking to rewrite the U.S. tax code are taking aim at one of the foundations of modern finance—the deduction that companies get for interest they pay on debt. … Thanks in part to the deduction, the U.S. financial system is heavily oriented toward debt, which because of the tax code is often cheaper than equity financing—such as sales of stock. … Getting rid of the deduction for net interest expense, as House Republicans propose, would alter finance. It also would generate about $1.5 trillion in revenue for the government over a decade, according to the Tax Foundation, a conservative-leaning think tank."

Eliminating the deductibility of interest expense would be paired with the immediate deductions for capital spending. Dividend payments are not deductible as an expense, but they are subject to personal income taxation. This amounts to the double taxation of dividends. With the subsidization of borrowing, the tax code clearly favors debt over equity financing by corporations. It also favors borrowing money by corporations to buy back their equites, particularly if their after-tax cost of funding is less than their forward earnings yield. Joe and I figure that's been the case since late 2004, when S&P 500 buybacks took off (*Fig. 1*). The S&P 500 forward earnings yield has exceeded the pre-tax AA-AAA corporate bond yield since then. The former is currently 5.7%, while the latter is 4.0%.

Almost since the start of the current bull market, we have argued that from a flow-of-funds perspective, it has been driven by corporate cash used to buy back shares and pay out dividends, which often are reinvested in stocks. The correlation between the S&P 500 and the sum of the two corporate cash flows back into the stock market has been very high since 2004 (*Fig. 2*). Eliminating interest expensing could pose a threat to debt-financed buybacks as a driver of the bull market. However, that hasn't happened yet, and it might not happen at all. We are monitoring developments in Washington's sausage factory as best we can.

As Joe reports below, Q1 data for S&P 500 buybacks were released late last week. Here are some top-line observations on this and other corporate finance matters:

(1) *Buybacks & dividends.* Over the past four quarters through Q1, buybacks totaled $508.1 billion, down 13.8% from the record high of $589.4 billion through Q1-2016 (*Fig. 3*). Dividends totaled a record $400.0 billion through Q1. S&P 500 operating earnings totaled $958.1 billion over the past four

quarters. So buybacks and dividends accounted for 94.8% of this total. The dividend payout ratio of the S&P 500 remains around 50.0% (*Fig. 4*). The implication is that corporations are spending all their extra cash on buybacks rather than capital spending and wages.

The problem with this widely circulated myth is that profits are not the same as cash flow, which is the sum of after-tax profits and depreciation expense. Capital spending by nonfinancial corporations (NFCs) has been hovering at a record high over the past year because corporate cash flow has been doing the same (*Fig. 5*). In other words, there has been enough cash for buybacks, dividends, and capital spending!

The effective corporate tax rate for the S&P 500 was 26.4% during 2016 (*Fig. 6*). S&P 500 companies had pre-tax interest expense of $22.90 per share during 2016 (*Fig. 7*). This implies that the after-tax interest expense was $16.85 per share during 2016. Their after-tax reported earnings was $101.06 per share, with the expensing of interest benefitting S&P 500 corporations $6.05 last year.

(2) *Debt.* The Fed's *Financial Accounts of the United States* shows that NFCs had a record $8.6 trillion in debt at the end of Q1-2017 (*Fig. 8*). That included $2.7 trillion in loans and a record total of $5.2 trillion in bonds (*Fig. 9*). Data available annually show that NFCs had monetary interest expense of $487 billion during 2015, implying that the pre-tax interest rate paid on all their debts was 6.1%, the lowest since 1966 (*Fig. 10* and *Fig. 11*).

(3) *Bond issuance.* Monthly data compiled by the Fed show that NFCs borrowed at a near-record $855.7 billion during the 12 months through April (*Fig. 12*). However, quarterly data through Q1 show net issuance of $244.6 billion. We calculate that NFCs refinanced a record $599.5 billion in their bonds over the past four quarters at record-low interest rates (*Fig. 13*). The resulting reduction in interest expense certainly boosted earnings over this period.

(4) *Dividend yield.* The dividend yield of the S&P 500 was 1.96% during Q1 (*Fig. 14*). It has been hovering around 2% since the mid-1990s. This means that the S&P 500 has been growing at the same trend as dividends, which is around 7.0% per year (*Fig. 15*). Interestingly, the dividend yield has been about the same as the US Treasury 10-year bond yield in recent years for the first time since the late 1950s. In between, the bond yield has always been higher. The higher yield reflected a premium for inflation, which erodes bond coupons but not dividends. That's because dividends tend to grow along with nominal GDP, while coupons are fixed. Apparently today, investors believe that inflation is dead, so they don't need an inflation premium in the bond yield relative to the dividend yield. With both yielding around 2.00%, stocks are cheap relative to bonds, since dividends grow while coupons remain fixed.

(5) *Forward ho!* Meanwhile, as Joe reports below, forward earnings of the S&P 500/400/600 rose to new record highs last week.

Global Demography: Japan's Carebots. Yesterday, Melissa and I wrote about the inverse correlation between urbanization and fertility rates. As populations become more urbanized around the world, families have fewer children. People are also living longer. So populations are getting older, and there are fewer primary working-age people (15-64 years old) to support seniors (65+).

Among modern industrial economies, Japan is the poster child for the economic impact of aging demographics. Japan's overall population is now declining at the fastest rate globally. The country sells more adult diapers than baby diapers, and its dearth of workers to support an aging population is depressing economic growth.

Japan's fertility rate fell below the replacement rate of 2.1 children per woman during 1978 (*Fig. 16*). Over the past 12 months through November, marriages totaled just 52,000, the lowest on record (*Fig. 17*). The number of deaths has exceeded the number of births since July 2007 (*Fig. 18*). The working-age population peaked at a record 87.8 million during 1995 (*Fig. 19*). It fell to 78.1 million during 2015, and is projected be down to 55.6 million by 2050. In 1955, there were almost 12 workers per senior. Now the ratio is just barely above 2.0.

The good news is that robots may not extinguish lots of jobs done by humans. Instead, they may be vitally important to pitch in as shortages of working human stiffs become more prevalent. Japan is the most automated economy in the world, with a proliferation of robots doing all sorts of jobs, yet the jobless rate in Japan is down to 2.8%. The country is suffering from a chronic labor shortage.

Business Insider reports: "Carebots are robots specifically designed to assist elderly people, and it's an industry that's growing in a big way. One-third of the Japanese government's budget is allocated to developing carebots. The global personal robot market, which includes carebots, could reach $17.4 billion by 2020, according to the Merrill Lynch report."

There is increasing buzz about the need for Basic Universal Income to support people who can't compete with robots. Maybe what we need instead is a Basic Fertility Income. We need to subsidize having children. That would provide an incentive for couples to make babies for fun and profit. Otherwise, we are on the road to self-extinction. Remember: Demography is destiny!

CALENDARS

US. **Tues:** Consumer Confidence 116.7, Richmond Fed Manufacturing Index 8, S&P Corelogic Case-Shiller HPI 0.6%m/m/5.9%y/y, Yellen, Harker, Kashkari. **Wed:** Advance Merchandise Trade Balance -$66.0b, Pending Home Sales 0.5%, MBA Mortgage Applications, EIA Petroleum Status. (Bloomberg estimates)

Global. **Tues:** China Industrial Profits, Carney. **Wed:** Japan Retail Trade -1.0%m/m/2.8%y/y, Poloz. (DailyFX estimates)

STRATEGY INDICATORS

YRI Weekly Leading Index (*link*): Our Weekly Leading Index (WLI)—a good coincident indicator that can confirm or raise doubts about stock market swings—continues to hover around its record high, retreating 2.5% over the four weeks ending June 17 after a two-week jump of 2.3% to a new record high. Our WLI is the average of our Boom-Bust Barometer (BBB) and Bloomberg's Weekly Consumer Comfort Index (WCCI). Our BBB contracted 3.6% over the four-week period, following a two-week surge of 3.3%, also to a new record high, as jobless claims rose for the fourth week to 244,750 (4-wa) from 235,500 four weeks ago, which was the lowest since April 1973. The CRB raw industrial spot price index—another BBB component—remained stable. Meanwhile, the WCCI fell for the second time in three weeks, by 3.5%, after climbing 3.0% the previous three weeks.

S&P 500/400/600 Forward Earnings (*link*): Forward earnings rose last week to record highs for all three market-cap indexes. The yearly change in forward earnings is up from six-year lows in early 2016 for all three indexes as y/y comparisons have eased. In the latest week, LargeCap's forward earnings was steady at 9.8% y/y, which compares to a 64-month high of 10.2% seven weeks ago and a six-year low of -1.8% in October 2015; MidCap's was up to a 65-month high of 13.1% from 12.5%, which compares to a six-year low of -1.3% in December 2015; and SmallCap's rose to 12.1% from 12.0%, which compares to a 34-month high of 12.8% in mid-March and a six-year low of 0.3% in December

2015. Consensus growth rates now expected for 2017 and 2018 before the impact of tax-rate changes: LargeCap 11.4% and 11.8%, MidCap 11.5% and 13.7%, and SmallCap 9.5% and 19.2%.

S&P 500/400/600 Forward Valuation (*link*): Forward P/E ratios mostly edged lower for the three indexes last week. Valuations have improved from their more-than-five-month lows in mid-April, but remain below their multi-year highs in early March. P/Es have melted up since the election, but the "E" still remains low as analysts await legislative changes to the tax rate and its impact on corporate earnings. LargeCap's forward P/E was steady w/w at 17.5, which compares to early June's 11-week high of 17.7 and the 13-year high of 17.8 in early March. That's up from a 15-month low of 14.9 in January 2016 and the post-Lehman-meltdown P/E of 9.3 in October 2008, but remains well below the record high of 25.7 in July 1999. MidCap's forward P/E fell to 18.0 from 18.2, which compares to a 15-year high of 19.2 in late February and the record high of 20.6 in January 2002. MidCap's is up from a three-year low of 15.0 in January 2016. SmallCap's edged down to 19.2 from 19.3, which compares to a 10-week high of 19.7 the week before that and a 15-year high of 20.5 in early December when Energy's earnings were depressed. That's up from a three-year low of 15.5 in February 2016 and remains close to SmallCap's record-high P/E of 20.9 in April 2002. Looking at their forward price/sales ratios since data became available in 2004, valuations are similarly elevated for the three indexes: LargeCap's P/S of 1.95 is at a record high, while MidCap's 1.31 is close to its record high of 1.37 in late February. SmallCap's 1.01 is down from 1.15 in July 2015 and a record high of 1.17 in November 2013.

S&P 500 Sectors Quarterly Earnings Outlook (*link*): Q2 earnings estimates for the 11 S&P 500 sectors were mostly reduced by analysts last week as they performed their typical downward pre-earnings season adjustments, but the S&P 500 edged higher behind Tech's strength. The Q2 consensus fell w/w for six of the 11 S&P 500 sectors, rose for one, and was steady for the remaining four. Tech rose 0.7% w/w, and these four were steady: Consumer Staples, Industrials, Telecom, and Utilities. Sectors with the biggest w/w decline in their Q2 forecast: Energy (-1.6%), Real Estate (-0.8), Consumer Discretionary (-0.4), and Health Care (-0.3). The S&P 500's Q2-2017 EPS forecast rose 2 cents w/w to $31.46, and is down just 1.9% from $32.04 at the end of Q1. That represents a forecasted pro forma earnings gain for Q2-2017 of 7.9% y/y, down from Q1's blended 15.3%, which is the strongest growth since Q3-2011 owing mostly to easier comps for Energy. The Q2-2017 forecast is down from 8.1% a week earlier and 11.9% at the end of Q4. Since the end of Q1, Q2 estimates are lower for ten sectors and higher for one. Industrials' Q2 forecast has risen 0.6%. Energy's has dropped 12.0% for the worst decline, followed by the Q2 forecasts for Materials (-5.2), Telecom (-4.4), and Consumer Discretionary (-4.1). The S&P 500's Q2-2017 forecasted earnings gain of 7.9% y/y would be its fourth straight gain after four declines. Ten of the 11 sectors are expected to record positive y/y earnings growth in Q2-2017, but only three are expected to beat the S&P 500's forecasted y/y earnings gain of 7.9%. That's because analysts expect Energy to report a large profit jump in Q2 relative to very low earnings a year ago. Still, that matches the 10/11 sectors that rose y/y on a blended basis during Q1-2017. The latest forecasted Q2-2017 earnings growth rates vs their blended Q1-2017 growth rates: Energy (671.3% in Q2 vs a return to a profit in Q1), Tech (10.8% vs. 19.8%), Financials (8.1, 19.9), S&P 500 (7.9, 15.3), Materials (3.6, 19.3), Consumer Staples (3.2, 3.7), Health Care (2.3, 7.3), Industrials (2.3, 4.1), Real Estate (1.9, 2.8), Telecom (1.1, -4.9), Consumer Discretionary (0.6, 6.0), and Utilities (-3.1, 2.7).

S&P 500 Buybacks (*link*): S&P 500 quarterly buybacks edged down 1.6% q/q to $133.2 billion during Q1-2017, and was down 17.5% y/y. While Q1-2017 marked the 11th highest quarterly buyback amount on record dating back 75 quarters to Q1-1998, it was 22.6% below Q3-2007's record quarterly high of $172.0 billion, and lower q/q in three of the past four quarters since its Q1-2016 cyclical peak of $161.4 billion. Furthermore, the four-quarter buybacks sum was lower for a fourth straight quarter as it fell 5.3% q/q to $508.1 billion from $536.4 billion, and is down 13.8% from Q1-2016's record high of $589.4 billion, which at the time was its first since Q4-2007. S&P 500 buybacks in Q1 accounted for 0.66% of the total market capitalization, down from 0.70% in Q4-2016. That compares to a 26-quarter low of 0.60% during Q3-2016, a cyclical peak of 1.15% in Q3-2011, and a record high of 1.28% during Q3-2007.

S&P 500 Sectors Buybacks (*link*): Buybacks rose q/q during Q4-2016 for six of the 11 sectors and fell for five. That compares to seven rising and four falling during Q4-2016. The biggest q/q buyback gainers on a percentage basis in Q1-2017: Utilities (up 211% q/q to $158.1 million from $50.8 million), Telecom (177%, $191.0 million from $69.0 million), Energy (115%, $2.1 billion from a record low $979.5 million), Real Estate (89%, $573.7 million from $303.4 million), Consumer Staples (25%, to a five-quarter high of $14.5 billion from $11.6 billion), and Financials (10.2%, to a 40-quarter high of $29.5 billion from $26.8 billion). The biggest percentage q/q decliners: Materials (-46%, $1.4 billion from $2.5 billion), Consumer Discretionary (-21%, to a 15-quarter low of $16.2 billion from $20.6 billion), Health Care (-7%, $27.0 billion from $28.9 billion), Industrials (-4%, $14.1 billion from $14.8 billion), and Tech (-4%, $27.5 billion from $28.7 billion). Financials accounted for the biggest portion of total S&P 500 buybacks in Q1-2017, improving to a 22.2% share from 19.8% in Q4, and taking over the top slot for the first time since Q4-2006. Tech remained in second, but its share fell to 20.6% from 21.2%. Health Care slipped to third (20.3%) from first during Q4, when it was 21.4%.

S&P 500 Cash Return & Buyback Yield (*link*): During Q1-2017, the S&P 500 companies continued their long-established trend of spending more on buybacks than dividends, as buybacks of $133.1 billion outpaced the quarterly dividend payment of $100.6 billion. Buybacks have exceeded dividends in 37 of the past 42 quarters, except during the financial crisis from Q4-2008 to Q4-2009, when all sectors cut buyback spending drastically. However, with the pace of buybacks slowing, the four-quarter sum of buybacks and dividends, or cash returned to investors, of $908.1 billion during Q1 was at an eight-quarter low. The cash return was down for a fourth straight quarter from $932.0 billion in Q4-2016, and has dropped 4.4% from a record high of $974.6 billion in Q1-2016. On a positive note, companies earned more than they paid out to investors for the first time in seven quarters: Q1-2017's four-quarter sum of operating earnings of $958.1 billion exceeded the $932.0 billion returned to investors. The cash return was 5.2% lower than trailing-four-quarter operating earnings during Q1, compared to 1.3% above operating earnings during Q4-2016 and a 28-quarter high of 13.5% above during Q1-2016. The improvement in operating earnings was helped in part by the Energy sector, which recorded positive trailing-four-quarter operating earnings for the first time in five quarters. The S&P 500's figures are much better on an ex-Energy basis. Operating earnings exceeded the cash return for a third straight quarter, with the percentage dropping to an eight-quarter low of 91.1% from 95.7% in Q4-2016, and is down from a 28-quarter high of 102.2% in Q2-2016. Including Energy, the S&P 500's buyback yield was down to a 27-quarter low of 2.51% from 2.78% in Q4, and the dividend yield fell to an eight-quarter low of 1.97% from 2.05% in Q4. Adding both together, the buyback + dividend yield (or cash return) was down to a 25-quarter low of 4.47% in Q1 from 4.84% in Q4.

S&P 500 Sectors Cash Return & Buyback Yield (*link*): During Q1-2017, seven of the 10 sectors had enough operating earnings on a trailing-four-quarter basis to cover their buybacks and dividends (cash returned to investors), up from 6/10 sectors during Q4-2016. Real Estate is excluded from this analysis because it does not have four quarters of data yet, but will be covered when Q2 data is released. Consumer Staples failed to cover its cash return for a ninth straight quarter, and the Energy and Industrials sectors missed for an eighth straight quarter. However, Energy's earnings turned profitable on a GAAP operating earnings basis for the first time in six quarters. On a positive note, Consumer Discretionary covered its cash return for the first time in 13 quarters, Materials did so for just the second time since Q1-2014, and Tech for only the third time over that same time period. Here's how the sectors' four-quarter cash returns relative to four-quarter earnings ranked in Q1-2017: Energy (533.8%), Consumer Staples (110.4), Industrials (105.8), Consumer Discretionary (95.1), S&P 500 (94.8), Health Care (94.1), S&P 500 ex-Energy (91.1), Information Technology (87.0), Telecommunication Services (83.3), Financials (82.5), Materials (67.8), and Utilities (65.5) The four-quarter buyback + dividend yield rose q/q for Energy and Telecom, and fell for the remaining eight sectors. Here's how the 10 sectors ranked: Financials (5.57% [five-quarter low]), Industrials (5.26 [13-quarter low]), Consumer Staples (5.08 [four-quarter low]), Telecom (4.87 [five-quarter high]), Health Care (4.64 [two-quarter low]), Consumer Discretionary (4.62, 27-quarter low]), S&P 500 (4.48 [25-quarter low]), Tech (3.89 [28-quarter low]), Utilities (3.45 [three-quarter low]), Materials (3.33 [17-quarter low]), and Energy (3.20 [two-quarter high]).

US ECONOMIC INDICATORS

Durable Goods Orders & Shipments (*link*): Both core capital goods orders and shipments dipped in May. Nondefense capital goods orders ex aircraft (a proxy for future business investment) posted its first decline this year, edging down 0.2% last month, while nondefense capital goods shipments ex aircraft (used in calculating GDP) also fell 0.2%, after a three-month gain of 1.5% to a new cyclical high. These core orders expanded 2.6% (saar) during the three months ending May, based on the three-month average, the weakest pace this year, while these core shipments expanded 3.7% over the comparable period, half of February's 7.4% reading. Headline durable goods orders in May fell for the second month, by a total of 2.0%, after a four-month gain of 4.4%. Aircraft orders, which tend to be volatile, slumped 23.4% over the two-month period; excluding transportation, orders rose for the fourth time in five months by 0.1% m/m and 1.9% ytd. Markit's June M-PMI flash estimate showed manufacturing activity was the slowest in nine months, with the M-PMI falling for the fifth straight month from 55.0 at the start of this year to 52.1 this month. According to the report, the slowdown in manufacturing reflected softer rates of both output and new business.

New Home Sales (*link*): May new home sales rebounded after April's sharp decline. New home sales jumped 2.9% to 610,000 units (saar) after a revised 7.9% decline in April, which was narrower than the initial estimate of an 11.4% loss. May's increase was the fourth this year for a ytd gain of 11.3%. (These sales are tabulated when contracts are signed, making new home sales a timelier barometer of the residential market than existing home sales.) Regionally, sales in the West (13.3%) and South (6.2) more than offset declines in the Midwest (-25.7) and Northeast (-10.8). In May, there were 268,000 new single-family homes on the market, the highest level since July 2009 but still less than half of the peak during the housing boom in 2006. The months' supply of homes remained at 5.3 in May, a high for this year; supply was at 5.6 months at the end of last year. Meanwhile, June's NAHB's Housing Market Index shows that all three components posted losses in June but remain at healthy levels. The components gauging current sales conditions (to 73 from 75), sales expectations in the next six months (76 from 78), and buyer traffic (49 from 51) all fell 2 points. NAHB's chief economist notes, "As the housing market strengthens and more buyers enter the market, builders continue to express their frustration over an ongoing shortage of skilled labor and buildable lots that is impeding stronger growth in the single-family sector."

GLOBAL ECONOMIC INDICATORS

Germany Ifo Business Climate Index (*link*): "Sentiment among German businesses is jubilant," Ifo Chief Clemens Fuest said in a statement. German businesses confidence soared in June to yet another new record high as both the current situation and outlook brightened. The Ifo business climate index advanced for the fifth month from 109.9 in January to 115.1—the highest in the history of the survey going back to 1991. Business assessment of the current situation continued to improve, with the measure climbing for the tenth straight month from 113.2 in August to 124.1 this month, also the highest in survey history. The expectations component is still trending higher, rising from 103.1 at the start of the year to 106.8 this month—the highest since February 2014. Ifo's expectations component correlates closely with German factory orders and production; the overall index tracks exports more closely. Recent Ifo data predict a continued acceleration in German activity.

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