



MORNING BRIEFING

February 20, 2019

In Praise of Folly: Stopping Stock Buybacks

See the [collection](#) of the individual charts linked below.

(1) Mencken, Reagan & Emanuel on government. (2) Senators Schumer and Sanders are here to help. (3) Buybacks were once banned. Should they be limited now? (4) Unintended consequences of Clinton's million-dollar cap for exec pay. (5) S&P data suggest aim of buybacks is to reduce dilution from stock compensation rather than to boost earnings per share! (6) Almost 100% of profits used for buybacks and dividends, leaving "only" depreciation allowance to fund plenty of capex. (7) Labor market data belie notion that real incomes and wages have been stagnating for most households and workers. (8) The income inequality debate. (9) Workers of America, buy stocks in your 401(k)s and IRAs!

In Praise of Folly I: Government Is Here To Help. Journalist H.L. Mencken famously observed: "The whole aim of practical politics is to keep the populace alarmed (and hence clamorous to be led to safety) by menacing it with an endless series of hobgoblins, all of them imaginary." Ronald Reagan just as famously warned: "The nine most terrifying words in the English language are 'I'm from the government, and I'm here to help.'" Rahm Emanuel summed it all up neatly when he said: "You never want a serious crisis to go to waste. And what I mean by that is an opportunity to do things that you think you could not do before."

The corollary of Rahm's Law is that the government will tend to create crises so that we will need more government to fix them. A case in point is stock buybacks.

Senators Chuck Schumer (D-NY) and Bernie Sanders (D-VT), who is running for president, long for the good old days. They believe that our nation's glory days can be restored by limiting corporate stock buybacks. They said so in a 2/3 NYT [op-ed](#). According to the two senators, the 1950s-70s were a golden age for workers because "American corporations shared a belief that they had a duty not only to their shareholders but to their workers, their communities and the country that created the economic conditions and legal protections for them to thrive." However, in recent decades, corporate managements and their boards of directors have become greedy, focusing on maximizing "shareholders earnings" at the expense of workers' earnings. The result has been the "worst level of income inequality in decades," they claim.

As proof, they offer the "explosion of stock buybacks." From 2008-2017, corporations have boosted their earnings per share and the value of their stocks by spending close to 100% of their profits on buybacks (53%) and dividends (40%)—which the senators characterize as corporate "self-indulgence." They bemoan that corporations haven't been investing enough to strengthen their businesses or boost the productivity of their workers. So stock-holding managements have gotten richer at the expense of workers who don't hold stock and haven't benefitted from rising stock prices—thus exacerbating both income and wealth inequality. Adding insult to injury, "the median wages of average workers have remained relatively stagnant." While the corporate fat cats are getting fatter on buybacks, workers "get

handed a pink slip.”

The two senators, who have never managed any business, intend to fix this problem. They are planning to introduce a bill that will prohibit any corporation from buying back its shares unless it first provides a minimum wage of \$15 an hour and a basic package of employee benefits, which presumably the bill will spell out. The senators recognize that corporations would respond by paying out more in dividends if they can't buy back their shares. They promise more legislation to deal with that issue if necessary, maybe by amending the tax code.

In Praise of Folly II: Original Sin. I humbly offer our two senators a bit of good advice courtesy of Erasmus, from his essay *In Praise of Folly*: “Let not the wise man glory in his wisdom: the reason is obvious, because no man hath truly any whereof to glory.” I am from Yardeni Research, and I'm here to help.

Where shall I begin to expose the weak foundations of the senators' arguments? I'll begin at the beginning:

(1) *SEC eases the rules on buybacks.* Not widely known is that for many years after the Great Crash of 1929, the Securities and Exchange Commission (SEC) viewed buybacks as bordering on criminal activity. That was the case up until the Reagan years, when the SEC began to ease the rules on buybacks under John Shad, chairman from 1981 to 1987. He believed that the deregulation of securities markets would be good for the economy.

In a widely read September 2014 *Harvard Business Review* [article](#) titled “Profits Without Prosperity,” William Lazonick, a professor of economics at the University of Massachusetts, argued that buybacks are effectively a form of stock price manipulation. The article was a big hit with progressive politicians like Senator Elizabeth Warren (D-MA), who is running for president.

(2) *Bill Clinton inadvertently boosts stock compensation for top execs.* Granted, some corporate executives are paid too much and spend too much time boosting their stock prices—purportedly under the banner of “enhancing shareholder value.” They claim that high compensation and rising stock prices (most of them are shareholders) incent them to work hard to manage their companies very well.

Ironically, many became even bigger shareholders after President Bill Clinton changed the tax code in 1993, when he signed into law his first budget, creating Section 162(m) of the Internal Revenue Code. This provision placed a \$1 million limit on the amount that corporations could treat as a tax-deductible expense for compensation paid to the top five executives (this was later changed by the SEC under Bush to the top four execs). It was hoped that would put an end to skyrocketing executive pay.

The law of unintended consequences trumped the new tax provision, which had a huge flaw—it exempted “performance-based” pay, such as stock options, from the \$1 million cap. Businesses started paying executives more in stock options, and top executive pay continued to soar. Liberal critics, notably Senator Warren, concluded that the 1993 tax-code change had backfired badly and that soaring executive pay has exacerbated income inequality.

(3) *Buybacks don't boost earnings per share.* The widely believed notion that buybacks boost earnings per share by reducing the share count isn't supported by the data S&P provides for the S&P 500 companies.

It's true that from 2008 through 2017, S&P 500 companies repurchased a whopping \$4 trillion of their shares, as the senators state in their op-ed ([Fig. 1](#)). However, the spread between the growth rates in

S&P 500 earnings per share and aggregate S&P 500 earnings has been tiny since the start of the available data during Q4-1994 ([Fig. 2](#)).

To calculate per-share earnings, the S&P divides aggregate earnings by a “divisor,” which ensures that changes in shares outstanding, capital actions, and the addition or deletion of stocks in the index do not change the level of the price index ([Fig. 3](#)). From the start of 2008 through the end of 2017, it is down just 2.6%, or 0.3% per year on average. That certainly doesn’t support the notion that buybacks have reduced the share count meaningfully, thus boosting earnings per share.

The best explanation for this surprising development is that the S&P 500 companies are mostly buying back their shares to offset the dilution of their shares resulting from compensation paid in the form of stocks that vest over time, not just for top executives but also for many other employees.

So the latest bull market has been driven by rising earnings, but they haven’t been artificially boosted on a per-share basis by stock buybacks! Nevertheless, buybacks might have provided a lift to stock prices since the buybacks occur in the open market, while the issuance of stock as compensation has no immediate market impact, especially if not yet vested.

In Praise of Folly III: Rewarding Workers. What about the claim that corporations have been spending almost 100% of their profits on buybacks and dividends rather than expanding and improving their productive capacity and workforce? It is factually accurate ([Fig. 4](#)).

The problem is the claim’s underlying assumption that the biggest source of corporate cash flow is profits; rather, it is depreciation allowances. This is the corporate income that is sheltered from taxation to reflect the expenses incurred in replacing depreciating assets. It’s this cash that nonfinancial corporations (NFCs) mostly use for gross capital spending—which rose to a new record high during Q3-2018 and continues to rise in record-high territory ([Fig. 5](#)). Recent net capital spending by NFCs is comparable to levels in previous business-cycle expansions, though making such comparisons may understate the technological enhancements in current spending ([Fig. 6](#)).

Now I will consider the plight of all those workers whom Schumer and Sanders want to help:

(1) *Record employment & quits.* Granted, it took longer than usual for payroll employment to recover from the previous recession, which was among the worst since World War II. However, by May 2014, payroll employment did regain what was lost during the severe downturn. It too has continued to move higher, and hit 150.5 million during January, surpassing the previous cyclical peak during January 2008 by 8.8%. The unemployment rate has been running around just 4.0% since March 2018. Job openings is at a record high, exceeding the number of people unemployed since last March. The quit rate is around record highs, as workers have lots of alternative prospects for boosting their pay and their benefits.

(2) *Record income and consumption per household.* Perhaps one of the biggest myths of all about our economy is that real incomes have stagnated for most Americans over the past 15-20 years. Even Donald Trump often made this claim when he was running for president. This assertion is based on one widely followed and extremely flawed inflation-adjusted measure of median household income produced annually by the Census Bureau ([Fig. 7](#)). It is based on survey data, focuses just on money income, and is pre-tax.

From Q1-2000 through Q4-2017, real GDP per household rose 19.7%. Yet over this same period, the aforementioned income series, which is available only on an annual basis, rose just 2.2%. That’s stagnation for sure, and implies significantly worsening inequality. However, there are numerous other

inflation-adjusted measures of household income and wages that are based on hard data and are broader in scope, including nonmoney government support programs like Medicaid, food stamps, and tax credits. They are up much more over the same period.

For example, real personal income per household is up 27.0% before taxes and 29.9% after taxes. Skeptics will instantly pounce on the fact that these are means, not medians. So they might be upwardly biased by the enormous incomes of the ultra-rich. I doubt that, as evidenced by real personal consumption per household, up 28.1%. The rich don't eat much more than the rest of us. My basic assumption is that there aren't enough of them—often dubbed the “1%” for a reason—to bias the mean series I've constructed for personal income and consumption.

(3) *Record real wages and compensation.* There can be no disputing the fact that real wages haven't been stagnating at all, notwithstanding the assertions of the two senators who want to help workers. From the start of 2000 through the end of 2017, real average hourly earnings rose 17.3% ([Fig. 8](#)). I am using the series that applies only to production and nonsupervisory workers, who tend to be rich only once they win the lottery. They account for roughly 80% of all workers.

There's more: Total real compensation—which includes wages, salaries, and benefits, per worker (using the household measure of employment)—rose 19.5% from the start of 2000 through the end of 2017, and was at a record high last year, as were all the other measures mentioned above ([Fig. 9](#)).

In Praise of Folly IV: The Inequality Debate. A July 2016 [working paper](#) authored by a team of economists—three from the Bureau of Economic Analysis and one from the University of Michigan—created a median measure of personal income. The economists found that it grew by 4.0% from 2000 to 2012, while the Census' median money income fell 6.2%. That's certainly a significant difference! The study came to the following significant conclusion: “We show that for the period 2000–2012, inequality using personal income is substantively lower than inequality measured using Census Bureau money income, and the trends in both inequality and median income are different. This demonstrates the importance of using a national accounts based measure of income when examining the relationships between inequality and growth.” This extraordinary statement completely debunks using Census money income to measure not only income inequality but also the standard of living.

The data cited above strongly suggest that the standard of living of the average American household hasn't stagnated, and has increased along with real GDP since 2000. If so, then income inequality hasn't worsened much if at all since then. That doesn't mean that there isn't any income inequality, but rather that it is just as bad now as it was back then but no worse. Remember that inequality was an issue under President Clinton, who addressed it by capping cash compensation at \$1 million for top execs in 1993.

The bull market in stocks undoubtedly has worsened wealth inequality since it started in early 2009. However, lots of Americans have benefitted from the bull market through their pension programs at work, including 401(k) plans and individual retirement accounts (IRAs). The latest data available from the Investment Company Institute [show](#) that in 2016 about 55 million American workers were active 401(k) participants. The value of their 401(k) funds was \$5.6 trillion as of September 30, 2018. The Fed compiles quarterly data on the value of all IRAs, which rose to a record \$9.3 trillion during Q2-2018, up \$5.7 trillion since the start of the bull market ([Fig. 10](#)).

In Praise of Folly V: Room for Improvement. Progressives like Senators Schumer and Sanders want to reduce corporate cronyism. I wholeheartedly agree with them on that, and I have some ideas on how to do so, including limiting the number of boards on which an individual may serve and compiling a “crony scoreboard” to keep track. Corporate cronyism may become a bigger problem, in my opinion,

because shareholders are losing their influence over corporate managers and boards as a result of the outflows from equity mutual funds into equity ETFs. Active managers exert more shareholder influence over corporate governance issues than do passively managed funds.

There is certainly room for improvement in corporate governance. On the other hand, I see no need for regulating buybacks. Most corporate managers are driven to make their companies as successful as possible, as evidenced by record earnings both on a per-share basis and in aggregate. America's free-market capitalism continues to boost the prosperity of most Americans, in my opinion, without more help from the government.

Finally, let's recognize that income and wealth inequality are inevitable consequences of a system of free-market capitalism. The rich do tend to get richer, especially when the rest of us also prosper along with them, since they benefit from consumers with more purchasing power to buy what their companies produce. Socialism does create more equality, but that's because it tends to generate less growth for the economy and less prosperity for most people. Take your pick.

CALENDARS

US. Wed: MBA Mortgage Applications, E-Commerce Retail Sales, FOMC Minutes. **Thurs:** Leading Indicators 0.2%, Jobless Claims 225k, Durable Goods Orders Total, Total Ex Transportation, and Core Capital Goods 1.2%/0.3%/0.1%, C-PMI, M-PMI & NM-PMI Flash Estimates 54.1/54.2/53.9, Philadelphia Fed Manufacturing Index 14.0, Existing Home Sales 5.05mu, EIA Natural Gas Report. (Econoday estimates)

Global. Wed: Eurozone Consumer Confidence -7.7. **Thurs:** Eurozone, Germany, and France C-PMI Flash Estimates 51.1/52.0/48.8, Eurozone, Germany, and France M-PMI Flash Estimates 50.3/49.9/51.0, Eurozone, Germany, and France NM-PMI Flash Estimates 51.3/52.9/48.5, Germany CPI -0.8%/m/m/1.4%/y/y, Japan CPI Total, Core, and Core-Core 0.2%/0.8%/0.3% y/y, Australia Employment Change & Unemployment Rate 15k/5.0%, ECB Accounts of the Governing Council's January Meeting, Lowe, Poloz. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings ([link](#)): LargeCap's forward earnings rose w/w for the first time in six weeks, but MidCap's and SmallCap's fell for a sixth straight week. LargeCap's forward EPS is now 2.2% below its record high of \$175.48 in late October, while MidCap's and SmallCap's are now 2.5% and 5.8% below their mid-October highs, respectively. LargeCap's forward EPS had been the most below its record high since June 2016, while MidCap and SmallCap have not been this far below since March 2016 and December 2010, respectively. The yearly change in forward earnings remains healthy compared to the past due to the boost from the Tax Cuts and Jobs Act (TCJA), but is tumbling now as y/y comparisons become more difficult. In the latest week, the rate of change in LargeCap's forward earnings fell to a 24-month low of 7.5% y/y from 8.0%. 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 24-month low of 8.8% from 9.4%, 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 dropped to a 13-month low of 12.8% from 14.5%, 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 (22.8%, 4.2%, 11.9%), MidCap (22.5, 4.8, 11.9), and SmallCap (21.8, 10.0, 16.5).

S&P 500/400/600 Valuation ([link](#)): Forward P/E ratios rose across the board w/w for all three of these indexes, which are up now from multi-year lows in late December. LargeCap and MidCap are at their highest levels since early October, and the SmallCaps is the highest since late September. LargeCap's weekly forward P/E of 16.2 is up from 15.8 a week earlier and 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 of 15.8 is up from 15.2 last week and 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 of 16.9 is up from 16.1 a week earlier and from 13.6 during December, which had also marked its lowest reading since November 2011. 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 a sixth week after being below for much of December for the first time since 2003.

S&P 500 Sectors Quarterly Earnings Outlook ([link](#)): With the Q4 earnings season 80% finished, analysts are early done revising their Q1 forecasts. Last week, the usual positive surprise bias saw the S&P 500's Q4-2018 EPS forecast jump 13 cents w/w to \$41.03. That's down 3.6% since the end of Q3, but up 5.5% since the beginning of 2018 and 6.3% since the passage of the TCJA. The \$41.03 estimate represents a forecasted pro forma earnings gain for Q4-2018 of 16.2%, compared to 16.8% a week earlier and 20.1% at the end of Q3. While Q4's y/y gain would be its tenth straight after four declines, it marks the slowest growth since Q4-2017 and is down from 28.4% in Q3 (which is sure to mark the peak of the current earnings cycle). Ten of the 11 sectors are expected to record positive y/y earnings growth in Q4-2018, with six rising at a double-digit percentage rate due to the lower corporate tax rate. That compares to all 11 positive during Q3, when 10 rose at a triple- or double-percentage rate. Four sectors are expected to beat the S&P 500's Q4 growth rate, the same as in Q3. However, Industrials and Real Estate are the only sectors expected to post improved growth on a q/q basis during Q4. Analysts expect Energy to report another large profit jump in Q4 relative to very low earnings a year ago, but the pace is slowing substantially from Q3. Here are the latest forecasted Q1-2019 earnings growth rates versus their blended Q4-2018 growth rates: Health Care (6.2% in Q1-2019 versus 12.8% in Q4-2018), Industrials (5.7, 27.2), Financials (4.5, 14.7), Real Estate (2.4, 6.9), Utilities (0.5, -11.1), Consumer Staples (-0.1, 4.3), Consumer Discretionary (-2.1, 14.4), Communication Services (-5.3, 26.4), Information Technology (-6.2, 9.6), Materials (-12.0, 2.2), and Energy (-13.6, 85.8). On an ex-Energy basis, analysts expect S&P 500 earnings to rise 0.2% y/y in Q1, well below the 13.4% in Q4.

S&P 500 Q4 Earnings Season Monitor ([link](#)): With 80% of the S&P 500 companies finished reporting earnings and revenues for Q4-2018, y/y revenue and earnings growth remains strong, but the surprise metrics have weakened relative to Q3's results due to Q4's trading turmoil and slowing growth in China. Of the 401 companies in the S&P 500 that have reported through mid-day Tuesday, just 71% exceeded industry analysts' earnings estimates. Collectively, the reporters have exceeded forecasts by an average of 3.6% and averaged a y/y earnings gain of 14.6%. If those results hold until the end of the quarter, it would mark the smallest earnings beat since Q4-2016 and the slowest y/y growth since Q3-2017. On the revenue side, just 62% of companies beat their Q4 sales estimates so far, with results coming in 0.8% above forecast and 7.3% higher than a year earlier. That marks the smallest revenue beat since Q1-2017, and revenue growth is the slowest in five quarters. Earnings growth is positive y/y for 73% of companies, versus a higher 88% at the same point in Q3, and Q4 revenues have risen y/y for 75% versus a higher 83% during Q3. Looking at earnings during the same point in the Q3-2018 reporting period, a higher percentage of companies (78%) in the S&P 500 had beaten consensus

earnings estimates by a greater 6.9%, and earnings were up a higher 28.9% y/y. With respect to revenues at this point in the Q3 season, a lower 61% had exceeded revenue forecasts by a higher 1.5%, and sales rose a greater 9.4% y/y. Excluding the Financials' sector, the earnings surprise improves to 4.7% from 3.6%, but the revenue beat edges down to 0.7% from 0.8%. With 20% of the companies left to report, the Q4 results are not likely to change drastically. Q4-2018 should mark the tenth straight quarter of positive y/y earnings growth and the 11th of positive revenue growth, but the slowdown in revenue and earnings growth from Q3 is readily apparent.

S&P 500 Sectors Net Earnings Revisions ([link](#)): The S&P 500's NERI was negative in February for a fourth straight month and at a 34-month low. That follows 18 months of positive readings through October, which had been its longest positive streak since a 26-month string ending August 2011. NERI fell to -7.9% from -5.8% in January, and is down from a record high of 22.1% in March. NERI improved m/m for 2/11 sectors and was negative for all 11 sectors (compared to six improving and one positive in January). Utilities was negative for the first time in 11 months, ending its positive NERI streak of 10 months, its best since January 2015 when its 10-month streak ended. Consumer Staples has the worst track record, with 10 months of negative NERI, followed by Materials (5). All of the sectors are down from their TCJA-boosted highs during early 2018. Here are the sectors' February NERIs compared with their January readings: Utilities (-0.7% in February [23-month low], down from 5.2% in January), Industrials (-1.9, -7.3 [25-month low]), Health Care (-2.4 [22-month low], -1.7), Real Estate (-4.4, -3.2), Consumer Discretionary (-4.6 [14-month low], -2.4), Consumer Staples (-5.5 [nine-month high], -8.3), Communication Services (-5.9, -4.9), Tech (-10.3 [46-month low], -3.3), Financials (-11.5 [29-month low], -5.5), Materials (-20.3 [34-month low], -16.7), and Energy (-22.8 [34-month low], -20.5).

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