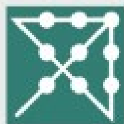
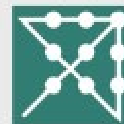


Yardeni Research



MORNING BRIEFING
April 20, 2022

Corporate Finance in Focus

Check out the accompanying chart collection.

Executive Summary: Today, we roll up our sleeves, lift the hood, and take a close look at the mechanics of corporate finance. … We show how corporate America's record levels of profits and cash flow are deployed. … We also show how a lack of understanding of corporate finance has given rise to some blatantly false notions of progressives—e.g., that share buybacks drive better stock-price performance and that money used repurchasing shares and paying dividends detracts from what's available to spend on workers and capital investments.

Corporate Finance I: Profits & Cash Flow. Corporate America is in great shape. Corporate profits and cash flow are at record highs. Profit margins are at or near record highs, and that's despite rapidly rising costs. Corporate balance sheets are flush with cash. A great deal of corporate debt was refinanced at record-low interest rates over the past two years.

The main concern facing most businesses in America is a chronic shortage of labor. Businesses are responding by spending more on capital equipment and technologies to boost productivity. They are also doing that to bring their supply chains closer to home, as global challenges have forced managements to move away from just-in-time to just-in-case supply-chain management.

From time to time, Melissa and I like to review the latest developments in corporate finance from a macroeconomic perspective. Let's do so now, starting with profits and cash flow:

(1) *Corporate profits.* According to the National Income and Product Accounts (NIPA), pre-tax corporate book profits (i.e., as reported to the IRS) during Q4-2021 remained at its record high of $3.1 trillion hit the previous quarter (*Fig. 1*).

Pre-tax corporate profits from current production includes the Inventory Valuation Adjustment (IVA) and Capital Consumption Adjustment (CCAdj), which restate the historical-cost basis used in profits tax accounting for inventory withdrawals and depreciation to the current-cost measures used in GDP (*Fig. 2*). We sometimes refer to this concept as "cash-flow profits." This measure also remained unchanged at its record high of

$2.9 trillion (saar) on a pre-tax basis at the end of last year.

(2) *Corporate tax rate.* Corporate profit taxes totaled $409 billion (saar) during Q4-2021 (*Fig. 3*). This series includes US federal taxes and taxes collected by other domestic and foreign taxing authorities. Yet the effective corporate tax rate was 12.7%, near recent record lows and well below the federal statutory rate of 21.0% (*Fig. 4*).

Some of the discrepancy between the two rates is attributable to S corporations. Their profits are included in NIPA's measure of total corporate profits, but their limited number of owners pay taxes on the dividends they receive. These taxes are included in personal income taxes, not corporate profits taxes.

Nevertheless, the effective tax rate for the S&P 500 companies, which all are C corporations, was 16.3% during Q4-2021, also well below the federal statutory rate.

(3) *Dividends.* During 2021, corporations paid a record $1.5 trillion in dividends (saar) during Q4-2021 (*Fig. 5*). NIPA includes an almost identical series in personal income. Dividends paid by the S&P 500 rose to a record $549.3 billion at an annual rate during Q1-2022.

We have previously estimated that the S&P 500 companies account for about 35% of corporate dividends and other C corporations account for 25%, while S corporations account for the remaining 40% of dividends, based on 2017 data. The dividend payout ratio of all corporations has fluctuated around 60% in recent years (*Fig. 6*). The payout ratio for the S&P 500 has fluctuated around 40%.

(4) *Cash flow.* Undistributed corporate profits is equal to after-tax profits from current production less dividends (*Fig. 7*). It remained at a record high of $1.1 trillion (saar) at the end of last year. It tends to fluctuate much more than dividends over the business cycle.

Corporate cash flow rose to a record $3.2 trillion during Q4-2021 (*Fig. 8*). It is equal to undistributed profits plus consumption of fixed capital, or economic depreciation, which totaled $2.2 trillion at the end of last year. That's about the same as tax-reported depreciation.

Depreciation is the decline in the value of fixed assets due to physical deterioration, normal obsolescence, or accidental damage. In business accounting, tax-reported depreciation is generally measured at the historical cost of the asset, whereas in the NIPAs, the economic measure of depreciation is measured at the asset's current cost. We like to think of tax-

reported depreciation as a huge and legitimate tax-shelter. Depreciation is a substantial cost of doing business that warrants sheltering from taxation, to ensure that companies have enough cash flow to replace worn, obsolete, and damaged plant and equipment.

(5) *Profit margin.* The NIPA data are often used to calculate a corporate profit margin series that divides after-tax corporate book profit by nominal GDP (*Fig. 9*). Joe and I prefer the one for the S&P 500. However, it only starts during Q1-1993. The NIPA series starts in 1948. The two series are reasonably well correlated but have sometimes diverged. Currently, both show that the profit margins peaked during Q2-2021 but remain near their record highs. The S&P 500 margin peaked at a record 13.7% during Q2-2021 and edged down to 12.8% during Q4-2021.

There's a much better fit between the S&P 500's quarterly profits margin and the index's weekly forward profit margin (*Fig. 10*). The weekly proxy for the quarterly series shows that it may just be starting to flatten out in record-high territory. It was 13.3% during the April 14 week.

Corporate Finance II: Buybacks. Progressive economists and politicians frequently rail against corporate dividends and buybacks, claiming that they have accounted for roughly all after-tax corporate profits in recent years, leaving no money for capital spending or better pay for workers. That complaint indicates that they know nothing about the simplest accounting principles in corporate finance. Dividends have always been paid out of after-tax profits, and the payout ratio has been relatively stable over time. Most corporations need to pay a growing, predictable, and competitive dividend return to attract stock investors.

Joe and I previously have explained that buybacks that are used to reduce a corporation's share count are paid for out of corporate cash flow and/or bond issuance. So they should be compared to cash flow, which includes undistributed profits. Comparing them to profits makes no sense whatsoever from a corporate finance perspective; it only makes sense from a political perspective, as it's an expedient way to press a progressive political agenda; otherwise, it's nonsense.

We also have observed that a significant portion of buybacks (as much as two-thirds) may be related to employee stock compensation. Those repurchases are made to counteract the dilution of earnings per share that results from the issuance of stocks to employees and are accounted for as compensation expense, thus requiring no financing out of cash flow or bond issuance! (See our May 20, 2019 *Topical Study* titled *Stock Buybacks: The True Story*.)

Here's more:

(1) *Aggregate vs per-share earnings growth.* Our observation helps to explain why the spread between the y/y growth rates of S&P 500 earnings in the aggregate and on a per-share basis remains fairly consistent, with the two not diverging much despite the hundreds of billions spent on buybacks every year (*Fig. 11*).

In recent years, from 2012 through 2019, the spread between the y/y growth rates of S&P 500 operating earnings per share versus operating earnings in aggregate averaged just 1.2% (*Fig. 12*). During 2020 and 2021, aggregate earnings rose faster than per-share earnings. In 2021, the difference between the two was 2.9ppts, even though buybacks totaled a record $881.7 billion!

(2) *Buybacks in perspective.* On balance, buybacks reduced the share count of the S&P 500 by only 8.6% over the period from Q1-2011 through Q4-2021, or less than 1.0% per year (*Fig. 13*). Over this same period, buybacks totaled $6.4 trillion (*Fig. 14*). That may seem like a lot of money, but it isn't relative to corporate cash flow and especially relative to the labor compensation that much of it represents. As mentioned above, a significant portion of buybacks is necessary to avoid the share dilution that results from compensating employees with stock.

During 2021, buybacks totaled a record $881.7 billion. The S&P 500 share count ticked down just 0.1% during the year. Corporate cash flow was a record $3.1 trillion during the year. Compensation of employees—including wages, salaries, and supplements—totaled a record $12.6 trillion.

(3) *Performance vs share-count change.* I asked Joe to update his analysis of the relationship between buybacks and the stock market performance of the S&P 500. He looked at 455 of the 505 issues in the S&P 500 with share-price performance data from Q1-2011 through Q4-2021 (the 50 issues not included went public after Q1-2011). Joe found that the stock prices of all companies rose an average of 446%. The 187 issues with increased share counts had a higher gain of 542%, while the 268 issues with decreased share counts rose a lower 378%.

That was a little surprising but not unexpected. We surmise that companies with higher share counts over the past 10 years issued additional shares primarily to finance M&A activity and internal growth. The additional capital raised by issuing shares was used to pursue better opportunities for revenues and earnings.

Looking at the companies with share-count decreases (and increases) and grouping them by degree of change in share count, Joe noted that their average price change was worse (better) the greater the percentage of shares were removed from (added to) their share count (*Table 1* and our *S&P 500 Share Count Changes Q1-2011 To Q4-2021*).

(4) *Sectors' share count.* The S&P 500 basic share count peaked at 308 billion during Q2-2011 and fell 9.2% through Q4-2021 to 280 billion. Here are the latest percent changes in the share counts since Q1-2011 for the S&P 500 and its 11 sectors: S&P 500 (-9.2%), Communication Services (14.0), Consumer Discretionary (-12.5), Consumer Staples (-12.4), Energy (7.9), Financials (-15.9), Health Care (-7.5), Industrials (-12.1), Information Technology (-23.9), Materials (15.8), Real Estate (55.4), and Utilities (25.1) (*Fig. 15*).

Corporate Finance III: Capital Spending & Worker Compensation. Progressives often charge that buybacks and dividend payouts are occurring at the expense of spending more on workers and on productivity-enhancing investments. Again, this argument rests on the mistaken notion that since these two forms of shareholder payouts together equal around 100% of after-tax profits, there's no money left.

In fact, there is plenty of cash flow to fully fund capital spending, which has been on the same solid uptrend for many years, rising to another record high at the end of last year (*Fig. 16*). During Q4-2021, the cash flow of nonfinancial corporations (NFCs) was $2.7 trillion (saar), well exceeding NFCs' capital spending of $2.3 trillion (saar) (*Fig. 17*). Furthermore, inflation-adjusted compensation per employee (using the household measure of employment) has been trending solidly upward for many years (*Fig. 18*).

Corporate Finance IV: Securities Issuance & M&A. The Fed's *Financial Accounts of the United States* includes lots of data tracking the activities of NFCs in the capital markets. Here's an update for 2021:

(1) *Equities.* Last year, NFCs' gross equity issuance totaled $508.8 billion, including initial public offerings (IPOs), seasoned equity offerings (SEOs), and private equity (PE) (*Fig. 19*). That matched the previous year's record high.

The Fed also compiles a monthly series of IPOs plus SEOs, which totaled $170.1 billion during the 12 months through December, down from the record high of $232.9 billion during April (*Fig. 20*). The difference between gross equity issuance and the sum of IPOs and SEOs is probably mostly PE, which totaled $332.3 billion last year.

Equity retirements totaled a record $1.13 trillion last year. Of that, stock repurchases accounted for a record $604.5 billion and M&A-related equity retirements accounted for $529.0 billion (*Fig. 21*).

Net issuance, which is the difference between gross issuance and retirements, totaled -$625 billion last year (*Fig. 22*). It's important to note that the Fed's accounts do not include employee stock plans. So it's impossible to assess how much of the repurchases reduced the share count or offset stock issuance by such plans. I've brought this issue to the attention of the folks at the Fed but haven't heard back.

(2) *Mergers & acquisitions.* Joe recently updated our *Mergers & Acquisitions* chart publication with data compiled by Dealogic. M&A activity in the US slipped to $515.6 billion during Q1-2022 (*Fig. 23*). The Russian invasion of Ukraine and rising interest rates probably put some deals on hold. We still expect that this year's M&A activity in the US will remain around last year's record $2.6 trillion pace.

(3) *Bonds.* Over the past two pandemic-challenged years, NFCs raised a record $2.4 trillion in the bond market (*Fig. 24*). That's gross borrowing. Net borrowing was $0.4 trillion over the eight quarters through Q4-2021. These numbers imply that a record $2.0 trillion of NFC bonds was refinanced at the record-low yields of the past two years (*Fig. 25*).

Corporate Finance V: Balance Sheets. Finally, the Fed's data show that NFCs' short-term debt divided by their credit market debt is relatively low around 30% (*Fig. 26*). Also comforting is that their liquid assets divided by their short-term liabilities matches its previous historical high of almost 100% (*Fig. 27*).

Calendars

US: Wed: Existing Home Sales 5.80mu; MBA Mortgage Applications; Crushing Crude Oil Inventories; Beige Book; IMF/World Bank Spring Meetings, Evans. **Thurs:** Leading Indicators 0.3%; Initial & Continuous Jobless Claims 180k/1.455m; Philadelphia Fed Manufacturing Index 21.0; Natural Gas Storage; IMF Meetings; Powell. (Bloomberg estimates)

Global: Wed: Eurozone Industrial Production 0.8%m/m/1.5%y/y; Eurozone Trade Balance;

European Car Registrations; Germany PPI 2.3%m/m/27.9%y/y; Canada CPI 0.9%m/m/6.1%y/y; Nagel. **Thurs:** Eurozone Headline & Core CPI 2.5%m/m/7.5%y/y & 1.2%m/m/3.0%y/y; Eurozone Consumer Confidence -20.0; France Business Survey 105; UK Gfk Consumer Confidence -33; Japan Core CPI 0.8%y/y; Japan M-PMI & NM-PMI Flash Estimates; Lagarde; Bailey; Sweeney; Mann. (Bloomberg estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Two of these three these indexes had forward earnings at a record high last week. LargeCap's was at a record high for a 16th week after dropping for a week earlier due to index changes. MidCap's was at a record high for a 19th straight week after dropping 0.1% below at the end of November. SmallCap's dropped for the first time in five weeks to 0.6% below its record high a week earlier. It had been steadily making new highs until mid-December, but then dropped 1.4% below its record by early March. In what has shaped up to be an extraordinary V-shaped recovery, LargeCap's forward earnings has risen during 95 of the past 99 weeks, with the down weeks due to Tesla's addition to the index in December 2020, Amazon's earnings shortfall last August, and index changes in September and December. MidCap's forward earnings is up in 93 of the past 97 weeks, and SmallCap's posted 89 gains in the past 98 weeks. Forward earnings for these indexes had been on an uptrend from November 2019 until February 2020, before tumbling to a bottom by June 2020 due to the Covid-19 economic shutdown. LargeCap's forward earnings has risen 65.9% from its lowest level since August 2017; MidCap's is now up 131.0% from its lowest level since May 2015; and SmallCap's has soared 187.2% from its lowest point since August 2013. The yearly change in forward earnings soared to cyclical highs during 2018 due to the boost from the Tax Cuts and Jobs Act but began to tumble in October 2018 as y/y comparisons became more difficult. In the latest week, the yearly rate of change in LargeCap's forward earnings weakened to a 12-month low of 26.2% y/y from 27.2%; that's down from a record-high 42.2% at the end of July. That's up from -19.3% in May 2020, which was the lowest since October 2009. The yearly rate of change in MidCap's forward earnings dropped to 40.6% y/y from 40.9%, but is up from an 11-month low of 39.9% in late March. That's down from a record high of 78.8% at the end of May and compares to a record low of -32.7% in May 2020. SmallCap's rate fell to a 12-month low of 45.0% y/y from 46.4%. It's down from a record high of 124.2% in late June and up from a record low of -41.5% in June 2020. Companies have been beating consensus estimates quite handily since the Q2-2020 earnings season, causing analysts' consensus earnings forecasts for 2021 and 2022 to improve instead of decline as is typical. Here are the latest

consensus earnings growth rates for 2022 and 2023: LargeCap (9.2%, 10.0%), MidCap (10.8, 8.6), and SmallCap (9.7, 12.6).

S&P 500/400/600 Valuation (*link*): Valuations were mixed for these three indexes last week. LargeCap's forward P/E fell 0.4pts to a five-week low of 18.8 from 19.2. That's up from a 23-month low of 18.2 in early March and down from a six-month high of 21.5 in early November. LargeCap's forward P/E also compares to a 19-year high of 22.7 in January 2021 and is up from 13.3 in March 2020, which was the lowest since March 2013. MidCap's remained steady w/w at a 24-month low of 13.7. That's down from a 13-week high of 17.1 in early November. That also compares to a seven-month high of 20.5 in March 2021 and is 8.5pts below its record high of 22.9 in June 2020. SmallCap's rose 0.2pt w/w to 13.3 from a 24-month low of 13.1. That's down from a 13-week high of 16.1 in early November and is now down 13.4pts from its record high of 26.7 in early June 2020 when forward earnings was depressed. During March 2020, MidCap's 10.7 and SmallCap's 11.1 were their lowest readings since March 2009. LargeCap's forward P/E in February 2020—before Covid-19 decimated forward earnings—was 18.9, the highest level since June 2002. Of course, that high was still well below the tech-bubble record high of 25.7 in July 1999. Last week's level compares to the post-Lehman-meltdown P/E of 9.3 in October 2008. MidCap's P/E was below LargeCap's P/E yet again last week, as it has been for most of the time since August 2018. In contrast, it was last solidly above LargeCap's from April 2009 to August 2017; MidCap's current 29% discount to LargeCap is near its biggest since September 2000. SmallCap's P/E was below LargeCap's for an 87th week. That's the longest stretch at a discount since 1999-2002; SmallCap's current 29% reading is near its biggest discount since February 2001. SmallCap's P/E had been mostly above LargeCap's since 2003. Looking at SmallCap's P/E relative to MidCap's, it was at a discount for a 44th straight week; the current 2% discount is up from a 9% discount in December but remains near its lows during 2000-01.

S&P 500 Sectors Quarterly Earnings Outlook (*link*): Since the Q3-2020 earnings season, analysts as a whole have been raising their consensus forecasts for future quarters instead of lowering them as is the norm through the earnings warnings seasons. That six-quarter streak of positive revisions throughout the quarter officially ended with Q1-2022. In the latest week, the Q1-2022 earnings-per-share forecast dropped 16 cents w/w to $51.30, and is down 1.8% from $52.22 at the start of the quarter. Analysts expect S&P 500 earnings growth to weaken substantially to 4.4% y/y on a frozen actual basis and 6.3% on a pro forma basis. That's down from Q4-2021's 26.9% y/y on a frozen actual basis and a 32.1% y/y gain on a pro forma basis. Double-digit growth is expected for just four sectors in Q1-2022, and three are expected to record a y/y decline. That compares to Q4-2021's count of

eight sectors with double-digit growth and one sector with a y/y decline. Here are the S&P 500 sectors' latest earnings growth rates for Q1-2022 versus their Q4-2021 growth rates: Energy (241.2% in Q1-2022 versus 12,611.0% in Q4-2021), Industrials (37.2, 43.8), Materials (34.2, 64.2), Real Estate (17.6, 17.6), Health Care (9.6, 28.0), Information Technology (8.6, 24.6), Utilities (7.0, -1.3), S&P 500 (6.3, 32.1), Consumer Staples (2.0, 7.7), Communication Services (-9.8, 16.6), Consumer Discretionary (-12.6, 54.1), and Financials (-19.4, 9.9).

S&P 500 Q1 Earnings Season Monitor (*link*): With nearly 10% of S&P 500 companies finished reporting revenues and earnings for Q1-2021, revenues are beating the consensus forecast by a 1.4% and earnings have exceeded estimates by 9.1%. We expect these figures to change markedly in the coming weeks because companies in the Financials sector typically weigh more heavily on the early season results. At the same point during the Q4 season, revenues were 2.4% above forecast and earnings beat by 6.4%. For the 49 companies that have reported Q1 earnings through mid-day Tuesday, the aggregate y/y revenue and earnings growth rates have slowed considerably from their double-digit percentage readings from Q2-2021 to Q4-2021. The small sample of Q1 reporters so far collectively has a y/y revenue gain of 7.5% and an earnings decline of 8.9%. We expect Q1 earnings growth will turn positive soon as more non-financial firms report. While just 69% of the Q1 reporters so far has reported a positive revenue surprise, 80% has beaten earnings forecasts. However, fewer companies have reported positive y/y earnings growth in Q1 (59%) than positive y/y revenue growth (80%). We expect to see revenue and earnings surprises moderate q/q due to missed deliveries, higher costs, and increased company guidance ahead of the earnings season.

US Economic Indicators

Housing Starts & Building Permits (*link*): Housing Starts & Building Permits (link): Housing starts in March climbed for the fifth time in six months, reaching its highest level since mid-2006, while building permits remained stalled around January's level, which was the highest since 2006. Overall starts climbed an unexpected 0.3% in March and 15.7% during the six months through March to 1.793mu (saar), with multi-family units climbing 4.6% and 28.6% over the comparable periods to 593,000 units (saar)—nearly matching its recent peak of 597,000 units during January 2020. Multi-family starts have jumped 134.4% from its April 2020 low. Meanwhile, single-family starts fell 1.7% in March to 1.200mu (saar), following a 4.6% gain and a 3.0% loss the previous two months. Building permits ticked up

0.4% in March to 1.873mu (saar), not far from January's 1.895mu—which was the highest since May 2006—led by a 10.9% increase in multi-family permits to 672,000 units (saar); single-family permits fell for the second month, by 5.4% over the period to 1.147mu. Completions last month fell by 4.5%, with single-family completions sinking 6.4% and multi-family ones rising 1.0%. Data for April show builders' confidence fell for the fourth time this year, from 84 at the end of 2021 to a seven-month low of 77 this month. Builders remain challenged by rising mortgage rates and supply-chain problems—which are boosting housing costs. "Policymakers must take proactive steps to fix supply chain issues that will reduce the cost of development, stem the rise in home prices and allow builders to increase production," noted NAHB Chairman Jerry Konter. Here's a look at the ytd changes in the three components of NAHB's Housing Market Index: traffic of prospective homebuyers (-11 points to 60 in April), current sales (-5 points to 85), and future sales (-12 points to 73, albeit with a 3-point gain this month).

Contact us by *email* or call 480-664-1333.

Ed Yardeni, President & Chief Investment Strategist, 516-972-7683
Debbie Johnson, Chief Economist, 480-664-1333
Joe Abbott, Chief Quantitative Strategist, 732-497-5306
Melissa Tagg, Director of Research Projects & Operations, 516-782-9967
Mali Quintana, Senior Economist, 480-664-1333
Jackie Doherty, Contributing Editor, 917-328-6848
Valerie de la Rue, Director of Institutional Sales, 516-277-2432
Mary Fanslau, Manager of Client Services, 480-664-1333
Sandy Cohan, Senior Editor, 570-228-9102

Copyright (c) Yardeni Research, Inc. Please read complete copyright and hedge clause.