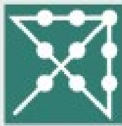
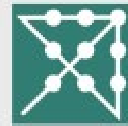
 Yardeni Research 

MORNING BRIEFING
September 14, 2022

Corporate Finance Review

Check out the accompanying chart collection.

Executive Summary: An Austrian assessment of August's CPI. … And: It's time again to focus on US corporate finance. We find American businesses in great shape—with record-high profits and cash flow on income statements and solid balance sheets. The effect of the chronic labor shortage on profit margins is businesses' biggest challenge, but workarounds are coming that should boost productivity. … Also: Progressives give share buybacks a bad name, but they play a key role in corporate finance: counteracting the dilution from stock compensation plans. … And: Both worker compensation and capital spending remain on healthy uptrends, also contrary to popular (progressive) belief. … Finally, we recap capital markets activity from Fed data.

On The Road. I read about August's bearish CPI report on my smartphone as my wife drove us in a rental car from Salzburg to Vienna's airport Tuesday afternoon to catch a flight back home from our European vacation. I came to the same conclusions as almost everyone else did: The FOMC now is more likely to hike the federal funds rate range by 100bps, to 3.25%-3.50%, than by 75bps at its September 20-21 meeting. That assessment was confirmed by the two-year US Treasury note yield, which jumped from 3.62% on Monday to 3.76% after the CPI report was released. We agree with the market's perception that 3.75%-4.00% should turn out to be the peak in the federal funds rate. We are likely to see the Fed get there sooner rather than later as a result of the CPI report.

After the report, the yield-curve spread between the 10-year bond and the two-year note widened to -30bps, suggesting that a recession is coming. Debbie and I continue to believe that a "rolling recession," hitting different sectors of the economy at different times, is more likely than an economy-wide "official recession." Inverted yield curves tend to predict financial crises that turn into economy-wide credit crunches, which cause recessions. We don't expect a credit crunch this time for reasons we have discussed before. Below, Melissa reviews the corporate sector's financial condition and concludes that it remains in very good shape.

In our scenario, we still expect that the S&P 500 will be range bound between the June 16 low of 3666 and the August 16 high of 4305, probably through the end of the year, before rising to a new record high by the end of next year. We expect the 10-year yield to remain around 3.50%.

Corporate Finance I: Profits & Cash Flow. Corporate profits and cash flow reached new highs during Q2. Profit margins were at or near record highs despite rapidly rising costs, which firms so far have been mostly able to pass on to customers. Corporate balance sheets, like their income statements, are also in good shape. A great deal of corporate debt was refinanced at record-low interest rates during 2020 and 2021, and the pace of borrowing is beginning to slow.

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, as we discussed in Monday's *Morning Briefing*. 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 review the latest developments in corporate finance from a macroeconomic perspective. Here is Melissa's update 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 Q2-2022 rose to a new record high of $3.4 trillion (*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 reached a new record of $3.0 trillion (saar) on a pre-tax basis during Q2.

(2) *Corporate tax rate*. Corporate profit taxes totaled $427.5 billion (saar) during Q2, which was near the recent peak during Q4 and the previous two peaks (*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 13.2%, 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 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, all of which are C corporations, was 18.4% during Q2, also well below the federal statutory rate.

(3) *Dividends*. During Q2, dividend payments from corporations remained at its previous record high of $1.5 trillion (saar) (*Fig. 5*). NIPA includes an almost identical series in personal income. Dividends paid by the S&P 500 rose to a record $600.0 billion at an annual rate during Q2.

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 latest available). 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) during Q2. It tends to fluctuate much more than dividends do over the course of a business cycle.

Corporate cash flow rose to a record $3.4 trillion during Q2 (*Fig. 8*). It is equal to undistributed profits plus consumption of fixed capital, or economic depreciation, which totaled $2.3 trillion through Q2. That's roughly 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 NIPA's 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 and currently is available only through Q1. The NIPA series starts in 1948. The two series are reasonably well correlated but sometimes have diverged. The NIPA series reached a new high of 12.1% during Q2. The S&P 500 margin peaked at a record 13.7% during Q2-2021 and edged down to 12.8% during Q4-2021, but then picked up again to 13.4% during Q2.

(6) *Forward profit margins*. 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 pull back from record-high territory. It was 13.1% during the September 1 week.

Digging into the forward profit margins, industry analysts have been shaving their profit margin estimates for nine of the 11 sectors in the S&P 500 (*Fig. 11*). Only Energy and Real Estate margins have been revised higher. We aren't expecting margin estimates to fall much further this year as long as there's no economy-wide recession.

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. But that stance ignores that dividend payments always come 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.

As Joe and I have explained in the past, share buybacks 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, as progressive politicians tend to do, does not make sense from a corporate finance perspective. It makes sense only from a political perspective—i.e., as a way to press a progressive political agenda.

Surely, it's a perspective that helped to pass the excise tax on stock buybacks by corporations included in the Biden administration's *Inflation Reduction Act of 2022*. Because it is only a 1% tax, it likely won't have much impact on corporations' share repurchase, investment, or spending plans for now. But now that we have the first instance of this tax, the excise tax rate has the potential to go higher, driving up corporations' effective tax rates.

In any event, most buybacks (as much as two-thirds) are made to reduce a corporation's share count and thereby counteract the dilution of earnings per share that results from stock compensation. When that's the case, the buyback is accounted for as a stock compensation expense, requiring no financing out of cash flow or bond issuance! (We've discussed this often in the past; see our May 20, 2019 Topical Study titled *Stock Buybacks: The True Story*.) The only good news is that buybacks related to employee stock compensation plans are exempt from the new tax.

We should have Q2 data on buybacks shortly; but for now, let's update our previous Q4-

2021 analysis with the latest data from Q1-2022:

(1) *Aggregate vs per-share earnings growth*. Our observation that buybacks counteract dilution effects 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 relatively and consistently small, with the two not diverging much despite the hundreds of billions spent on buybacks every year (*Fig. 12*).

In recent years, from 2012 through 2019, the spread between the y/y growth rates of S&P 500 operating earnings per share and operating earnings in aggregate averaged just 1.2% (*Fig. 13*). 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 Q1-2022, or less than 1.0% per year (*Fig. 14*). Over this same period, buybacks totaled $6.7 trillion (*Fig. 15*). 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.

(3) *Sectors' share count*. The S&P 500 basic share count peaked at 316 billion during Q2-2011 and fell 8.6% through Q1-2022 to 289 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 (-8.6%), Communication Services (14.7), Consumer Discretionary (-6.2), Consumer Staples (-12.6), Energy (7.7), Financials (-16.6), Health Care (-7.5), Industrials (-12.4), Information Technology (-23.9), Materials (14.7), Real Estate (56.7), and Utilities (26.7) (*Fig. 16*).

Corporate Finance III: Capital Spending & Worker Compensation. Contrary to the claim of progressives that buybacks and dividend payouts are occurring at the expense of spending more on workers and on productivity-enhancing investments, there is plenty of cash flow left for funding these things. Capital spending has been on the same solid uptrend for many years, rising to another record high at the end of last year (*Fig. 17*). During Q2, the cash flow of nonfinancial corporations (NFCs) was $2.8 trillion (saar), well exceeding NFCs' capital spending of $2.9 trillion (saar) (*Fig. 18*).

Furthermore, inflation-adjusted compensation per employee (using the household measure

of employment) has been trending solidly upward for many years. It fell only slightly from a recent peak during the pandemic (when expanded benefits were extended) and returned to historical norms through July (*Fig. 19*).

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 through Q1-2022:

(1) *Equities*. The four-quarter sum of NFCs' gross equity issuance cooled slightly through Q1-2022, though remained near record territory, totaling $456.0 billion, including initial public offerings (IPOs), seasoned equity offerings (SEOs), and private equity (PE) (*Fig. 20*). Equity retirements totaled a record $1.3 trillion. Of that, stock repurchases accounted for a record $714.1 billion and M&A-related equity retirements accounted for $547.9 billion (*Fig. 21*).

Net issuance, which is the difference between gross issuance and retirements, totaled -$819 billion in the four quarters ending Q2-2022, the lowest on record (*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.

(2) *Mergers & acquisitions*. M&A activity in the US slipped to an eight-quarter low of $463.86 billion during Q2-2022 (*Fig. 23*). The Russian invasion of Ukraine and rising interest rates likely 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.

It's worth noting that August has seen the best monthly deal activity since 2021, according to data compiled by Bloomberg, which *attributed* the big causes for previous delays or terminations of pending transactions to stock market volatility and financing disruptions, which deal makers now have a better handle on.

(3) *Bonds*. During the pandemic-challenged 24 months through June 2021, NFCs raised a record gross $2.5 trillion in the bond market (*Fig. 24*). That figure dramatically came off record highs to $1.8 trillion in the 24 months through July. Net borrowing was $0.1 trillion over the eight quarters through Q2. These numbers imply that a record level of bonds was refinanced at the record-low yields of the past two years, and that the pace of borrowing is beginning to taper off with interest rates on the rise (*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%-35% as of Q2-2018 (*Fig. 26*). Slightly concerning is that their liquid assets divided by their short-term liabilities recently has declined during the H1-2022 (*Fig. 27*). Yet we attribute that to the fact that the Fed includes stocks held by corporations in the measure of liquid assets.

Calendars

US: Wed: Headline & Core PPI -0.1%m/m/8.9%y/y & 0.3%m/m/7.1%y/y; MBA Mortgage Applications; Crude Oil Inventories; EIA Monthly Report. **Thurs:** Retail Sales Total, Core, and Control Group 0.2%/0.1%/0.5%; Import Prices -1.2%; NY Empire State & Philadelphia Fed Manufacturing Indexes -13.0/2.8; Headline & Manufacturing Industrial Production 0.1%/0.1%; Capacity Utilization Rate 80.3%; Business Inventories 0.6%; Initial & Continuous Jobless Claims 226k/1.475m; Natural Gas Storage. (Bloomberg estimates)

Global: Wed: Eurozone Industrial Production -0.8%m/m/0.6%y/y; UK Headline & Core CPI 0.6%m/m/10.2%y/y & 0.8%m/m/6.3%y/y; UK PPI Input & Output 0.2%m/m/23.9%y/y & 1.0%m/m/16.2%y/y; Japan Industrial Production 1.0%; Japan Trade Balance; Australia Employment Change 35k; Australia Unemployment & Participation Rates 3.4%/66.6%; RBA Bulletin; EC President Ursula von der Leyen; Enria; Lane; McCaul. **Thurs:** Eurozone Trade Balance –€20b; Germany WPI 0.5%; France CPI 0.4%m/m/6.5%y/y; China Retail Sales 3.5% y/y; China Industrial Production 3.8% y/y; China Fixed Asset Investment 5.5% y/y; China Unemployment Rate 5.4%. DeGuindos; McCall; Mauderer. (Bloomberg estimates)

Strategy Indicators

S&P 500 Growth vs Value (*link*): The S&P 500 Growth price index was in a bear market as of Monday's close, while the Value index was out of a correction. Growth has fallen 5.9% from its recent high on August 15 to 20.9% below its December 27 record high. Value is down 3.1% from its August 16 high to 8.3% below its January 12 record high. Looking at their ytd performance, Growth has tumbled 19.8% ytd, well behind the 7.0% decline for the S&P 500 Value index. Growth's underperformance relative to Value began on November 30 when its price index peaked at a record high. Since then, Value's price index has dropped 0.6%, while Growth's is down 17.9%. Looking at the fundamentals, Growth is expected to

deliver higher revenue growth (STRG) than Value over the next 12 months, but Value is expected to have higher earnings growth (STEG). Growth has forecasted STRG of 7.6%, but its STEG is lower at 7.3%. Value has forecasted STRG and STEG of 4.9% and 7.4%, respectively. Growth's forward P/E peaked at a 20-year high of 30.4 on January 26, 2021, and tumbled 40% to a 27-month low of 18.4 on June 16. After rebounding to 23.3 in mid-August, it was down to 21.8 on Monday. Over the similar time period, Value's forward P/E fell 24% from 17.6 to a 26-month low of 13.4, and was down to 14.6 on Monday from mid-August's high of 15.2. Regarding NERI, Growth's and Value's were negative for a second straight month in August following 26 positive monthly readings. Growth's dropped to -8.4% from -2.4% in July, and Value's was down to -8.6% from -2.4%. Growth's forward profit margin of 18.3% is down 0.8ppts from its record high of 19.1% in mid-February and compares to its prior pre-Covid record high of 16.7% during September 2018. Value's has held up better, dropping to 0.4ppt to 11.0% from its record high of 11.4% in December.

US Economic Indicators

Consumer Price Index (*link*): August's CPI inched up 0.1% after no change in July, following gains of 1.3% and 1.0% the prior two months, but core prices rose 0.6%, double July's 0.3% gain. The CPI yearly rate eased, but only slightly, up 8.3%, slowing from 8.5% in July and 9.1% in June —which was the highest rate since November 1981, while the core rate accelerated 6.3% after easing steadily from 6.5% in March (the highest since August 1982) to 5.9% in both June and July. *Food costs* (11.4% y/y) accelerated at the fastest pace since April 1979, while energy costs (23.8) continued to ease from June's 41.6%, which was the fastest pace since April 1980. Within food, the rate for food at home (13.5) was the highest since March 1979, while the rate for food away from home picked up to 8.0% y/y—the highest since fall 1981. *In energy*, yearly rates eased virtually across the board. The rate for fuel oil slowed for the third month to 68.8% from May's record-high 106.7%, while the rate for gasoline prices eased to 25.6% y/y, down from June's 59.9% (fastest since March 1980). Meanwhile, the rate for natural gas prices picked up a bit to 33.0%y/y after easing from 38.4% in June (highest since October 2005) to 30.5% in July; electricity costs accelerated 15.8% y/y—the highest since August 1981. *Consumer durable goods inflation* slowed for the sixth month, from 18.7% in February (highest since early 1940s) to a 16-month low of 7.8% in August. The rate for new cars (10.9) eased for the fourth month from April's near record high of 14.2%, while the rate for used cars & trucks ticked accelerated 7.8% y/y after slowing sharply from 41.2% in February to 6.6% in July—the lowest since August 2020; it was at a record-high 45.2% during June 2021. The rate for apparel prices

was little changed again in August at 5.0%, slowing from its recent peak of 6.8% in March—which was its fastest rate since the end of 1980. The rate for furniture & bedding (12.8) is down from February's record high of 17.1%, though has been moving sideways the past couple of months, while the rate for major appliances slowed to 4.2%, the lowest since mid-2020 and down from its recent peak of 12.4% in March. *Consumer nondurable goods* inflation slowed for the second month, to 12.0% y/y, after shooting up to 16.2% in June, which was more than double June 2021's rate and the highest since the 1940s. *Services inflation* shot up to 6.8%—the highest since the early 1980s—rising steadily from January 2021s 1.3%. Within services, owners' equivalent and tenant-occupied yearly rates accelerated 6.3% and 6.7%, respectively, in August—up from recent lows of 2.0% and 1.8%—with the former at a new record high and the latter the highest since April 1986. Over the three months through August, the owners' equivalent rate accelerated 8.2% (saar) and tenant rent 8.9%—far exceeding their yearly rates. Meanwhile, the yearly rate for lodging away from home picked up a bit to 4.0% y/y in August after plummeting from a record high of 25.1%, posted in both February and March, to 1.0% in July. Turning to medical care, the yearly rate for hospitals' (4.0) services has been moving in a relatively flat trend, while the physicians' (1.1) services rate is down sharply from last March's 5.3% peak. Meanwhile, the yearly rate for airfares picked up to 33.4% y/y last month after easing from May's cyclical peak of 37.8% to 27.8% in July.

NFIB Small Business Optimism Index (*link*): "The small business economy is still recovering from the pandemic while inflation continues to be a serious problem for owners across the nation," said Bill Dunkelberg, NFIB chief economist. "Owners are managing the rising costs of utilities, fuel, labor supplies, materials, rent, and inventory to protect earnings. The worker shortage is impacting small business productivity as owners raise compensation to attract better workers." August's Small Business Optimism Index (SBOI) rose 1.9 points to 91.8, building on July's 0.4 point gain, after dropping 9.4 points the first half of the year to 89.5. August's level was its eighth successive month below the 48-average of 98.0. In August, seven of the 10 components of the SBOI improved, while only earnings trends (-7ppts to -33%) and expected credit conditions (-1 to -8) deteriorated, with current job openings unchanged at 49%. The biggest positive contributions came from two components, expect the economy to improve (+10ppts to -42%) and sales expectations (+10 to -19), followed by capital outlay plans (+3 to 25) and plans to increase inventories (+3 to 4). The remaining components were all up a percentage point—plans to increase employment (21), current inventory (3), and now is a good time to expand (5). Inflation continued to be small business owners single biggest problem in August, though the percentage dropped 8ppts (to 29% from 37%) from July's record high, while quality of labor was the second biggest concern for small businesses, with the percentage jumping to 26%

from 21% in July. In August, 46% of firms reported increasing compensation, holding around its record high of 50% reported at the start of the year, while 26% are planning to raise compensation, easing slightly from December's record high 32%.

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