ClearBridge Investments

Credit-Fueled Buybacks Keep Equity Rally Flowing

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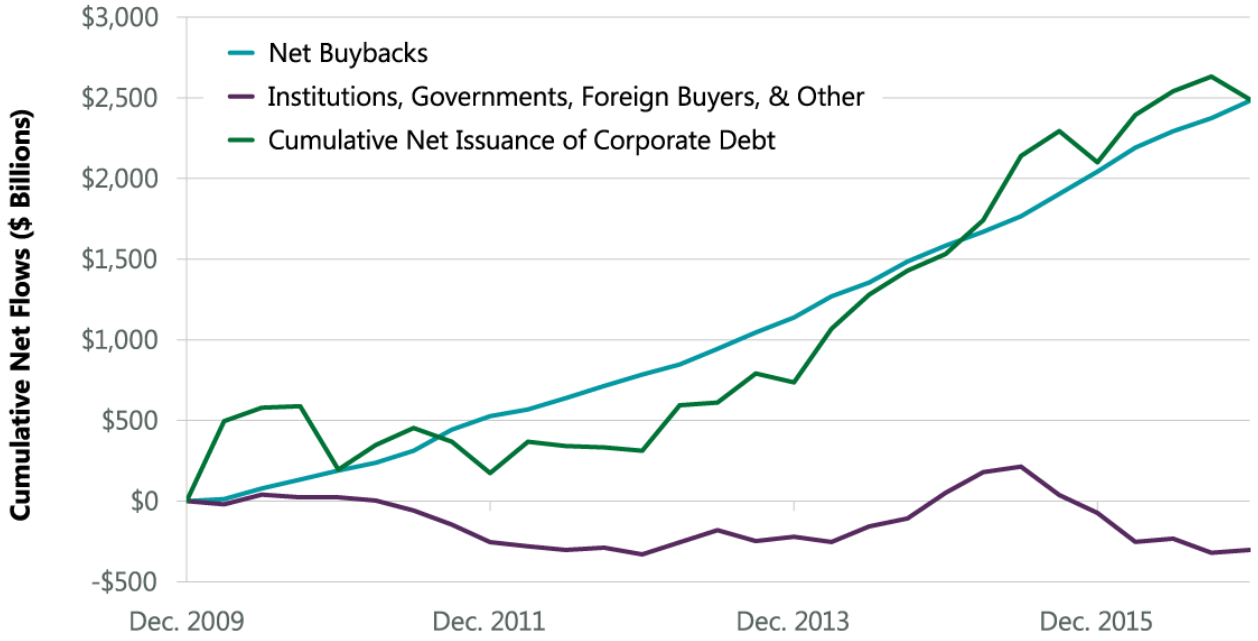
Just as all rivers are slaves to gravity, capital flows don't like to fight gravity either: investor decisions tend to be driven by past realized returns that solve for a dominant current narrative and primary emotional concern. All market cycles are born on fear and low expectations, but this cycle was marked understandably by extreme fear – understandably, because we had barely missed the abyss of another great depression as the largest asset class in the world, U.S. housing, collapsed. At the same time, 10-year rolling returns for equities had gone negative for the second time in U.S. market history, while Treasury bonds had generated historically high real returns with low volatility. Even after the recent bull market for stocks, real Treasury bond returns are twice that of equities since 2000. Not surprisingly, these outcomes have left people wanting the yield and safety of bonds, while shunning equities.

At the corporate level, managements and boards have been equally scared. They have observed a busted equity bubble in 2000 that led to massive excess capacity in tech hardware and long-haul fiber, a busted debt bubble that erased Bear Stearns and Lehman from the corporate landscape, and more recently, the resulting stresses of the busted commodity boom. For mature companies, making major capital bets in an uncertain and low-growth world has looked suspect, and the low-risk option has been to hoard cash and use it to buy existing companies, including the one they know best: their own.

This desire for yield and safety has led to this cycle's Colorado River for capital flows, which is a more Amazon-sized $2.5 trillion river of credit. As seen in Exhibit 1, since the beginning of 2010 there have been roughly $2.5 trillion in U.S. corporate debt issuance, and a remarkably equivalent amount of net U.S. share buybacks. Just as with dominant physical rivers, capital flows are self-reinforcing as deep channels of behavior are formed and continually justified by higher prices and demand. Although this dynamic has been super-charged by central bank activity, global yields have followed the powerful gravity of this channel to historic lows across asset classes. As the purple line shows, all outside investors have wanted nothing to do with stocks in aggregate, which has transformed the privileged companies with access to this gigantic river of cheap debt into incredibly active equity investors: single stock portfolios financed by debt!

A key characteristic of net share buyback activity is that it shrinks the amount of shares outstanding. When you combine this direct "de-equitization" with robust mergers and acquisitions activity, which is also facilitated by cheap debt, and a historically low number of initial public offerings, the structural change in the U.S. stock market is dramatic. How dramatic? According to a recent Credit Suisse report,[1] the number of publicly listed U.S. stocks has dropped roughly 50% since 1996. Not surprisingly, U.S. stocks peaked during the great 1990s equity bull market and subsequent bubble, as Wall Street exists to cater to the cyclical whims of investor behavior by supplying what is in demand.

Exhibit 1: Cumulative Purchases of U.S. Stocks by Buyer Type and Total Corporate Debt Issuance



Source: Federal Reserve, FactSet. Data as of Dec. 31, 2016.

About the Author

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- 24 years of investment industry experience
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