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*In this week's recap: Earnings build while GDP slows.*

# Weekly Economic Update

*Presented by Ed Papier, November 1, 2021*

## THE WEEK ON WALL STREET

A fresh wave of positive corporate earnings surprises sent markets to new record highs last week.

The Dow Jones Industrial Average increased 0.40%, while the Standard & Poor's 500 rose 1.33%. The Nasdaq Composite index picked up 2.71% for the week. The MSCI EAFE index, which tracks developed overseas stock markets, was up 0.68%. [1,2,3]

## EARNINGS DRIVE MARKET

The week kicked off with the Dow Jones Industrials and S&P 500 index setting record highs as the financial markets carried over the previous week's price momentum. [4]

Stocks continued to climb on a string of forecast-beating earnings results. With about half of the S&P 500 constituent companies having reported earnings, more than 80% of them have beaten Wall Street analysts' consensus estimates. Based on these results, earnings for all S&P 500 companies are expected to come in approximately 39% above the third quarter of last year. (Forecasts are based on assumptions, and may not materialize.) Stocks overcame disappointing earnings from two mega-cap tech names on Friday to maintain the week's solid gains. [5]

## GDP GROWTH SLOWS

While businesses managed to post strong earnings in the third quarter, the first look at economic growth came in below consensus estimates. The Gross Domestic Product (GDP) grew at a 2.0% annualized rate in the third quarter, a slowdown from the two previous quarters, each of which posted annualized growth rates in excess of 6%. [6]

The spread of the Delta variant and backlogs in the supply chain were two major factors dragging on economic activity.

## THE WEEK AHEAD: KEY ECONOMIC DATA

Monday: ISM (Institute for Supply Management) Manufacturing Index.

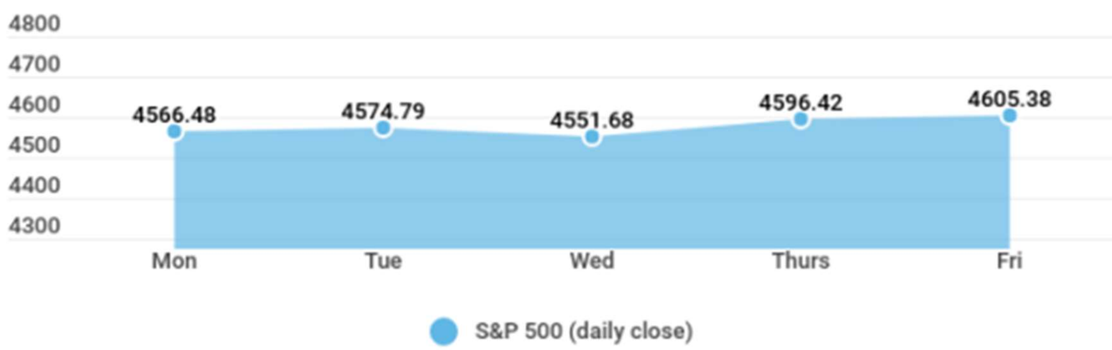
**Wednesday:** ADP (Automated Data Processing) Employment Report. Factory Orders. ISM (Institute for Supply Management) Services Index. FOMC (Federal Open Market Committee) Announcement.
**Thursday:** Jobless Claims.
**Friday:** Employment Situation.

## QUOTE OF THE WEEK

*"Inflation is when you pay fifteen dollars for the ten-dollar hair-cut you used to get for five dollars when you had hair."*

*SAM EWING*

| Market Index | Close | Week | Y-T-D |
|---|---|---|---|
| DJIA | 35,819.56 | +0.40% | +17.03% |
| NASDAQ | 15,498.39 | +2.71% | +20.25% |
| MSCI-EAFE | 2,354.51 | +0.68% | +9.64% |
| S&P 500 | 4,605.38 | +1.33% | +22.61% |




| | Treasury | Close | Week | Y-T-D |
|---|---|---|---|---|
| | 10-Year Note | 1.55% | -0.11% | +0.62% |

Sources: The Wall Street Journal, October 29, 2021; Treasury.gov, October 29, 2021
Weekly performance for the Dow Jones Industrial Average, Standard & Poor's 500 Index, and NASDAQ Composite Index is measured from the close of trading on Friday, October 22, to Friday, October 29, close. Weekly performance for the MSCI-EAFE is measured from Friday, October 22, open to Thursday, October 28, close. Weekly and year-to-date 10-year Treasury note yield are expressed in basis points.

## OF NOTE

Is it conceivable 40% of the bull market rally over the last decade derived from stock buybacks alone? The problem for companies in a weak economic environment is the lack of topline revenue growth. Given higher stock prices compensate corporate executives, it is not surprising to see companies opt for the short-term benefit of buybacks versus investment.

While it may seem share repurchases are a non-event, they are more insidious than they appear. Let's examine a simplistic example.

- *Company A earns $1 / share and there are 10 / shares outstanding.*
- *Earnings Per Share (EPS) = $0.10/share.*
- *Company A uses all of its cash to buy back 5 shares of stock.*
- *Next year, Company A earns $1 again, however, earnings are now $0.20/share ($1 / 5 shares)*
- *Stock price rises because EPS jumped by 100% on a year-over-year basis.*
- *However, since the company used all of its cash to buy back the shares, they had nothing left to grow their business.*
- *The next year Company A still earns $1/share and EPS remains at $0.20/share.*
- *The Stock price falls because of 0% growth over the year.*

While an extreme example, it shows share repurchases have a limited, one-time effect on the company. Unfortunately, firms end up being trapped into continuing to repurchase shares in order to keep share prices elevated. The problem is the continued diversion of ever-increasing amounts of cash from productive investments that could have created long-term growth.

The reason that companies do this is simple: stock-based compensation. Today, more than ever, many corporate executives have a large percentage of their compensation tied to company stock performance. As a result, a *"miss"* of Wall Street expectations can lead to a hefty penalty in the company's stock price and therefore executive compensation. In a previous Wall Street Journal study, 93% of the respondents point to *"influence on stock price"* and *"outside pressure"* as reasons for manipulating earnings figures. The use of stock buybacks has continued to rise in recent years and following the pandemic shutdown, they skyrocketed.

As the Financial Times previously penned: *"Corporate executives give several reasons for stock buybacks but none of them has close to the explanatory power of this simple truth: Stock-based instruments make up the majority of their pay and in the short-term buybacks drive up stock prices."* A recent report on a study by the Securities & Exchange Commission found the same, finding many corporate executives sell significant amounts of their own shares after their companies announce stock buybacks.

What is clear is that the misuse of share buybacks to manipulate earnings and reward insiders has become problematic. As John Authers recently pointed out: *"For much of the last decade, companies buying their own shares have accounted for all net purchases. The total amount of stock bought back by companies since the 2008 crisis even exceeds the Federal Reserve's spending on buying bonds over the same period as part of quantitative easing. Both pushed up asset prices."* In other words, between the Federal Reserve injecting a massive amount of liquidity into the financial markets, and corporations buying back their shares, there have been effectively no other real buyers in the market. Exactly how much are we talking about? The Market Should Be 40% Lower: The decomposition of returns for the S&P 500 breaks down as follows:

- 21% from multiple expansion
- 31.4% from earnings
- 7.1% from dividends
- 40.5% from share buybacks

In other words, in the absence of share repurchases, the stock market would not be pushing record highs of 4600 but instead levels closer to 2700. While share repurchases by themselves may indeed be somewhat harmless, it is when they get coupled with accounting gimmicks and massive levels of debt to fund them in which they become problematic.

Michael Lebowitz noted the most significant risk: *"While the financial media cheers buybacks and the SEC, the enabler of such abuse idly watches, we continue to harp on the topic. It is vital, not only for investors but the public-at-large, to understand the tremendous harm already caused by buybacks and the potential for further harm down the road."*

Money that could get spent spurring future growth, benefitting shareholders, instead gets wasted benefitting only senior executives. As stock prices fall, companies that performed un-economic buybacks are now finding themselves with financial losses on their hands, more debt on their balance sheets, and fewer opportunities to grow in the future. Equally disturbing, the CEOs who sanctioned buybacks are much wealthier and unaccountable for their actions. For investors betting on higher stock prices, the question is what happens if stock buybacks reverse? [7]

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Please consult your financial professional for additional information.



CITATIONS:

1. The Wall Street Journal, October 29, 2021
2. The Wall Street Journal, October 29, 2021
3. The Wall Street Journal, October 29, 2021
4. CNBC, October 24, 2021
5. CNBC, October 28, 2021
6. The Wall Street Journal, October 28, 2021
7. realinvestmentadvice.com/40-of-the-bull-market-is-due-soley-to-buybacks/