Market Letter

MOUNTING HEADWINDS

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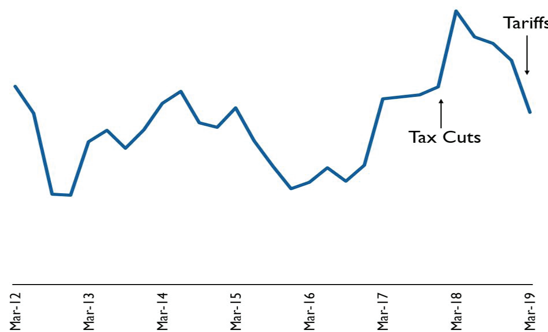
Unexpected turbulence from the trade war precipitated a mid-quarter pullback in equities that proved fleeting. While U.S.-China trade remains a wildcard, investors' anticipation of interest rate cuts has rejuvenated their interest in stocks — a change in sentiment owing to slower economic growth that increasingly has the attention of central bank policymakers across the globe.

CEO Confidence Falls



Source: Bloomberg

The Fed seems to be acknowledging a slowdown in manufacturing and the increasingly negative impact existing and threatened tariffs have had on business confidence. With inflation below targeted levels and an inverted yield curve demanding action, the Fed has cover for rate cuts which will likely begin later this year.

Amid slowing job growth evidencing a U.S. economy near full employment, labor-saving capital investment is increasingly necessary to sustain what will become the longest economic expansion on record next quarter. Productivity growth is paramount at this juncture, but given the correlation between CEO confidence and the capital spending needed to deliver it, executives have to believe the economy will allow for a fair return on new technology and facilities before making these expensive new investments.

Corporate investment is also being impacted by the reality of more sluggish earnings. Having lapped the benefits of tax reform and with tariffs and rising wages now impacting profit margins, bottom-line growth slowed to a crawl in the first quarter. We expect modest, mid-single digit profit growth for the year and believe that for stocks to make further progress, companies will need to deliver on the revenue line.

Our neutral allocation to large cap U.S. equities, and less-cyclical sector positioning therein, recognizes the challenges of later-cycle growth amid equity valuations that appear fair – neither expensive nor cheap.

Bonds have outperformed expectations this year, but now appear expensive relative to our forecast for the economy to remain aloft. We project coupon-minus fixed income returns for the rest of 2019. Accordingly, our overweight to Treasuries and underweight of benchmark duration remain in place.

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Founded in 1975, Ferguson Wellman is a privately owned registered investment advisory firm, established in the Pacific Northwest. As of January 1, 2019, the firm manages over $5 billion for more than 830 clients that include individuals and families; Taft-Hartley and corporate retirement plans; and endowments and foundations with portfolios of $3 million or more. West Bearing Investments, a division of Ferguson Wellman, serves clients with assets starting at $750,000.

INVESTMENT EXCELLENCE
LIFELONG RELATIONSHIPS

Everything we hear is an opinion, not a fact. Everything we see is a perspective, not the truth. – Marcus Aurelius

DIVIDENDS, AND THE ROLLING MBO*

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"A cow for her milk, A hen for her eggs, And a stock, by heck, For her dividends. An orchard for fruit, Bees for their honey, And stocks, besides, For their dividends."
~A poem from *The Theory of Investment Value* by John Burr Williams (1900 – 1989)[1]

As much as legendary investor Benjamin ("Ben") Graham was considered the father of value investing, John Burr Williams is generally recognized as the father of dividend investing. His seminal work, "*The Theory of Investment Value*" was first published in 1938. Williams was by trade a securities analyst, who as a PhD student at Harvard sought to understand the stock market crash of 1929, and the Great Depression that followed. Williams's theory was that the intrinsic value of a company was equal to the present value of its future dividends.[1]

In Berkshire Hathaway's 1992 Annual Report, Warren Buffet wrote: *"In The Theory of Investment Value, written over 50 years ago, John Burr Williams set forth the equation for value. That is, the value of any stock, bond, or business today is determined only by the cash inflows and outflows – discounted at an appropriate interest rate – that can reasonably be expected to occur during the remaining life of the asset."* Williams's lessons are timeless concepts on the nature of intrinsic value, the importance of dividends, and the value of a long-term perspective. In an era of heightened volatility and low expected investment returns, Williams's lessons are now as important as ever.[1]

There's an old saw on Wall Street that goes something like this: Any company can lie about their earnings, but they *can't lie about a check*. Dividends matter. Since 1927 income received from dividends accounted for fully *40 percent of the overall annualized returns from stocks*. This metric has changed over time, however. The proportion of total investment returns from dividends was an astonishing 60 percent from 1927 thru 1981. Although still a very healthy proportion of total returns, from 1982 until today the total returns provided by dividends have declined to about 25 percent.[2]

But there is another way for companies and managements to reward shareholders. That is, through *share buybacks*. Williams could be excused for ignoring the impact of share buybacks on investment returns in his work, since prior to 1982 share repurchases were considered a form of *market manipulation*. As such, buybacks were eschewed as a tool to enhance shareholder value. But in that year, the SEC passed rule 10-b-18 which provided a safe harbor for companies to repurchase their own shares.[2] The impact of this change on the financial markets has been both long lasting and indeed, quite profound.

In 2018, the S&P 500 *set a new record* for annual share buybacks, with U.S. companies purchasing over $800 billion worth of their own shares. This was a 50 percent increase over 2017. In the latest quarter, over 350 companies repurchased shares. Over 80 percent of the companies in the technology, financials and industrials sectors repurchased their own shares. According to the Fed's flow of funds accounts, corporate buybacks accounted for $573 billion of net new demand for equities in 2018.[2] Bank of America operates a trading desk whose sole function is to help corporate clients with the execution of their share repurchases. Orders have been running *71 percent higher this year compared with the same period in 2018.*[3]

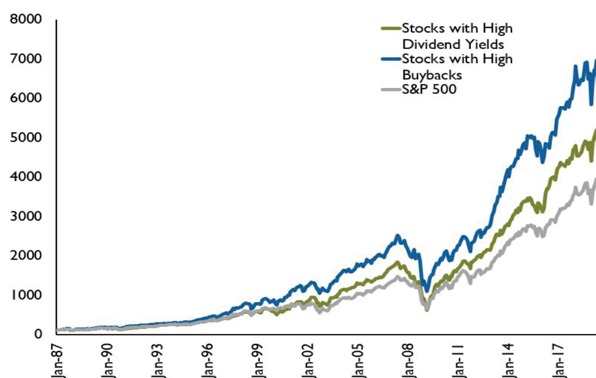
For the last two decades, share buybacks by U.S. companies have dwarfed initial public offerings, or IPOs. The resulting decline in share counts has been dramatic, and has served to spread more earnings, cash flows and dividends over increasingly fewer shareholders. One could argue that with all of these funds being directed to share repurchases, capital spending would undoubtedly suffer. However, in the last decade, there have been only two years (2007 and 2018) where companies *spent more on share repurchases than on capital expenditures.*[2,3]

Never let the future disturb you. You will meet it, if you have to, with the same weapons of reason which today arm you against the present. – Marcus Aurelius

According to Tobias Levkovich, Citibank's chief U.S. equity strategist, it's more profitable in the long run to stick with companies that consistently buy their own shares: "*Our focus remains on serial share shrinkers or companies that reduce their share counts every year. Episodic buybacks are less interesting to us versus companies that seem to have the excess cash flow and strategic desire to return cash regularly. Sustained share shrinkage typically rewards investors via outperformance.*"[4] Indeed, a study published last year in the Financial Analysts Journal by three researchers from the Abu Dhabi Investment Authority, "*Net Buybacks and the Seven Dwarfs*," strongly bolstered this view.[5]

Dividends and Buybacks

More Than One Way to Get Paid



Sources: Capital IQ, FactSet

These researchers found that net buybacks – the number of shares that companies repurchased across the entire stock market, minus the number of new shares issued – explain the bulk of the intermediate and longer-term differences in market returns around the world. This comes as something of a surprise, since conventional wisdom is that economic growth is by far the most important variable in determining return outcomes. China is perhaps the best illustration of their conclusions. China's real GDP grew at an 8 percent annualized rate over the last decade thru 2018, versus 2.1 percent for the U.S. Yet despite these huge differences in growth rates, *U.S. equities' annualized returns were more than double that of China's.*[5]

The researchers found that *net buybacks dominated other factors*. Once again, China provided a perfect illustration. They calculated that newly issued shares in the Chinese market (issued as state-owned enterprises gone public) had a massive "dilution effect" of nearly 24 percent per year between 1997 and 2017. Over the same two-decade period, the comparable dilution rate for the U.S. stock market was just 1.8 percent per year. This modest dilution was concentrated in the first years of the period they measured, however. Since 2006, buybacks have resulted in net shrinkage of the U.S. share base. Buybacks have an outsized impact since they increase the share of corporate profits accruing to existing shareholders, just at net issuance leads to a dilution of their requisite share. China's equity market struggled over this time period, this in spite of incredibly rapid GDP growth in both absolute and relative terms.[5]

In a world where risk-free returns are abysmally low and where common stocks can often yield more than bonds, we are indebted to John Williams for his pioneering work on the value of dividends. We are also keenly aware of the outsized impact that share repurchases can have on shareholder values: The Wilshire 5000 now has only 3,816 stocks in its universe, and there are now *fewer companies listed on an exchange today than in 1976*. This despite the fact that U.S. GDP is *three times larger today than it was back then.*

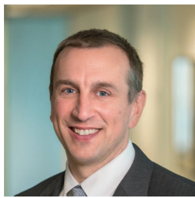
In one form or another, we blend these two considerations in the management of our equity strategies every day. It is no wonder then, that some have labeled the market's current state of affairs, a "*rolling management buyout*" or MBO. Indeed, we continue to monitor both its health and progress with great interest.

There is, after all, more than one way to get paid.

Weapons of Reason Footnotes and Sources:

1. David Larrabee, CFA, "The Theory of Investment Value: Four Enduring Takeaways on Dividend Investing from John Burr Williams," The Enterprising Investor/CFA Institute, August 3rd, 2012.
2. Jason DeSena Trennert, "11 Facts About Share Repurchases and Dividends You Might Not Know," Investment Strategy Report, May 13, 2019.
3. Lu Want, "Stock Buybacks Top Capex for First Time Since 2008," Bloomberg Markets, March 3, 2019.
4. Akin Oyedele, "Two Ways to Dole out Cash to Investors," Business Insider, March 23, 2018.
5. Mark Hulbert, "A Surprising Connection Between the Bull Market and Stock Buybacks," The Wall Street Journal, April 7, 2019.

*MBO stands for management buyout



TRADE SKIRMISH OR TRADE WAR?

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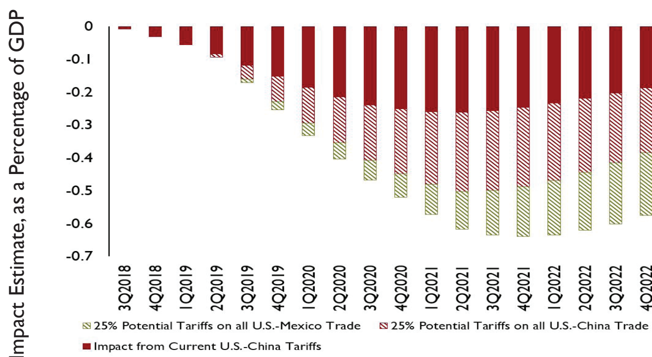
"We need a level playing field, but not a new battlefield."
– Tom Friedman, *The New York Times*, June 4, 2019

The bark of escalating trade tensions between the United States and its major trading partners began to bite in the second quarter, and its impact shifted from primarily psychological and anticipatory into real economic terms. Global manufacturing continued its slowdown, while May hiring data in the United States broke from its strong trend. What first appeared to be a trade skirmish that was expected to be short-lived, has metastasized into a trade war that may now last through the 2020 U.S. elections.

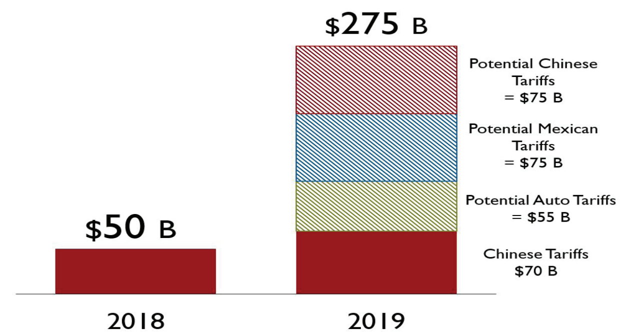
Trade War Impact



Source: Bloomberg

Tariffs are relatively easy to add up and assign a dollar value of impact. However, the much more complicated calculation is evaluating the follow-on effects from diminished confidence. To that end, CEO confidence has roundtripped back to 2016 levels after enjoying a tax cut-driven boost in 2017. When evaluating their companies' plans for capital expenditures, CEOs may now decide to wait for greater certainty before committing to the large-scale projects and spending that typically lead to productivity gains and stronger economic growth.

Increasing Impact of Tariffs



Source: Strategas

Additional consequences of the heightened trade rhetoric are also revealing themselves. Recent examples include threats to ban rare-earth mineral exports and the potential bifurcation of the technology and telecom industries into countries that either will or will not purchase Chinese equipment ... which would be disruptive to the global economy.

China is certainly feeling the economic consequences of this trade war as their most recent measure of industrial output cooled to a 17-year low. As the expectation for the trade wars extend in duration, market participants are being forced to speculate not only on the potential gains from any trade deal, but also which side can absorb the most economic pain and for how long. That is a political calculation with no easy answers.