MacroMavens

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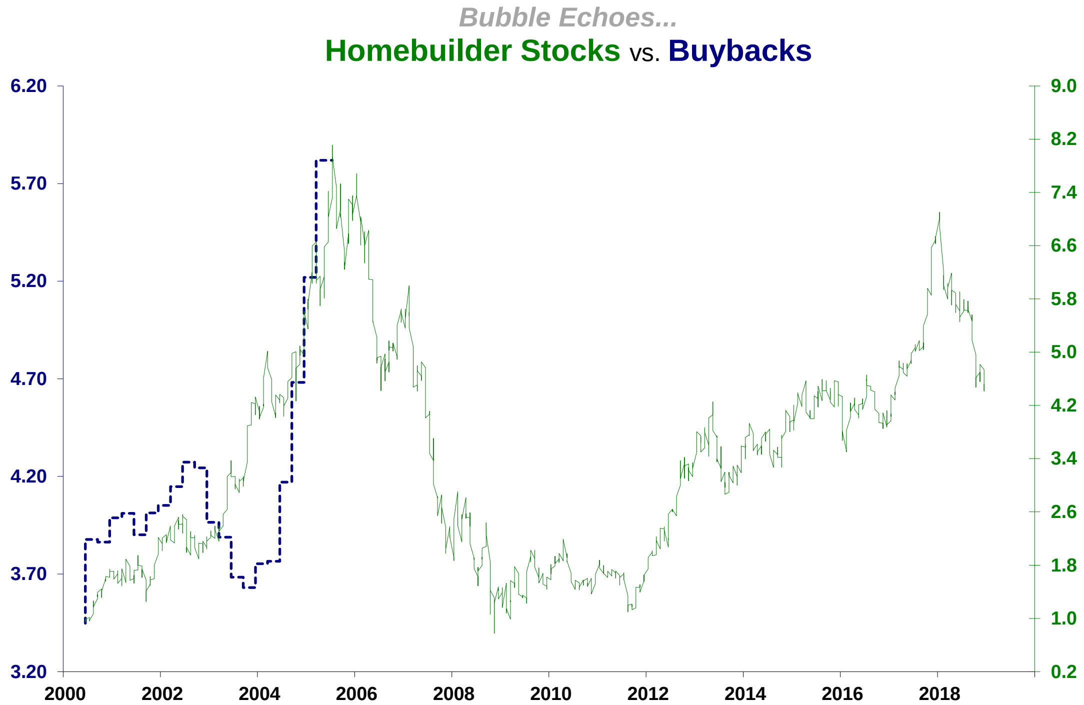


The Not-So-Everything Bubble…

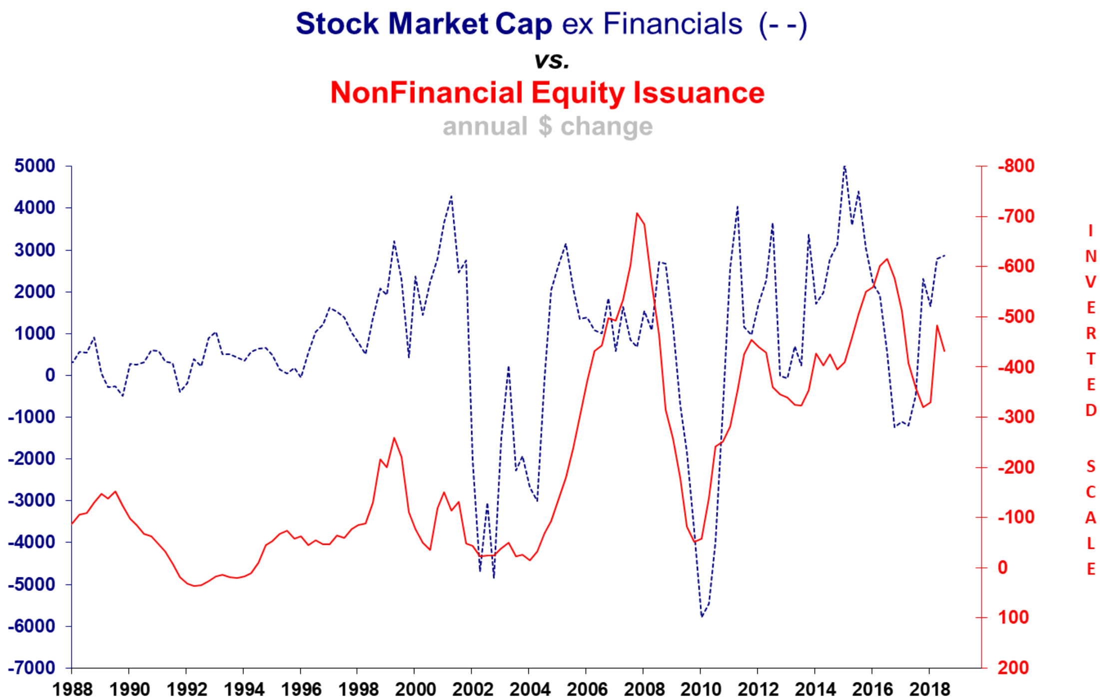
It was *years* ago that Wall Street cheerfully concluded that the Fed's unprecedented monetary largesse had failed to inflate any conspicuous bubble. Against all odds and historical precedent, we have been repeatedly assured, no one specific asset or market has been inflated in a way that might wreck material havoc upon its destruction. **"This time", the mal-investment has been spread across a broad array of assets via the innocuously-dubbed: 'everything bubble'**. An innocent smidge here. A manageable dab there. No taxi drivers making more their annual income trading Enron and Pets.com. No nannies out-earning their employers by flipping homes. Nope. Aside from a couple (momentary) Bitcoin billionaires, there was really nothing to see here**. *Pay no attention to the chart above.***

As is always the case with bubbles, this one's existence will be revealed only as it bursts. But that shouldn't be too long now. For even though it took 11 months of sharply shrinking issuance, **investors are now finally waking-up to the deflation of the credit bubble that fueled the buyback bonanza—the bubble in corporate debt. It's just a matter of time before they connect the dots and ask the obvious question: *What did all this debt fund???*** Obviously, companies didn't just borrow money and sit on it. The money was spent. And as we all know, it wasn't spent on capex.

Having posted a 6-fold increase during the post-crisis recovery, buybacks would seem to fit the very definition of a bubble. Indeed, at more than $700b, the buyback total for this year ALONE is already larger than the entire subprime mortgage market was back in 2007.

Buybacks? A bubble?? Gimme a break. I can hear the pushback already. First off, buybacks are an income stream, not an asset. Plus, you don't lever-up buybacks. And it's the levering-up of expected gains where the real trouble lies.

Alas, those assurances are far less comforting when one takes a closer look. So let's. *Shall we?*



While it's true that buybacks are *technically* an income stream, that's not how they are perceived. Like dividends, buybacks are increasingly viewed as permanent -- a base upon which to build. So there's danger right there as the evaporation of the financing for these repurchases challenges this expectation. But more important by far is **the artificial boost that buybacks provide to valuation and pricing metrics. <u>All of which are widely understood, yet for reasons unbeknownst have been a source of ZERO exploration much less consternation.</u>**

I can only assume **that's because the enormity of the role buybacks have played supporting the market isn't fully appreciated yet. But it will be, *in its absence.***

As I quipped prior to the tax cut-fueled profit boomlet, the best thing the market had going for it was that there was less of it to hate every day. To see how much, consider this: **from the point when profits and the market had returned to their pre-crisis levels**, in early 2011, **the S&P 500 has tacked-on $12.5t. Buybacks over that stretch have totaled $4t, or nearly 1/3rd the gain in market cap.**

But that arguably *understates* the impact. Buybacks are gross (not net). So they essentially exclude the **financials which have been massive net ISSUERS** of equity these last several years ($1.8t over the recovery stretch, according to the Federal Reserve). Not surprisingly, **comparing non-financial sector buybacks to the nonfinancial S&P Industrial Index reveals a far larger impact, with the $4t in buybacks comparing to an $8.6t increase in non-financial market cap.**

Half of the recovery gain due to buybacks??? I don't think that's on anyone's radar.

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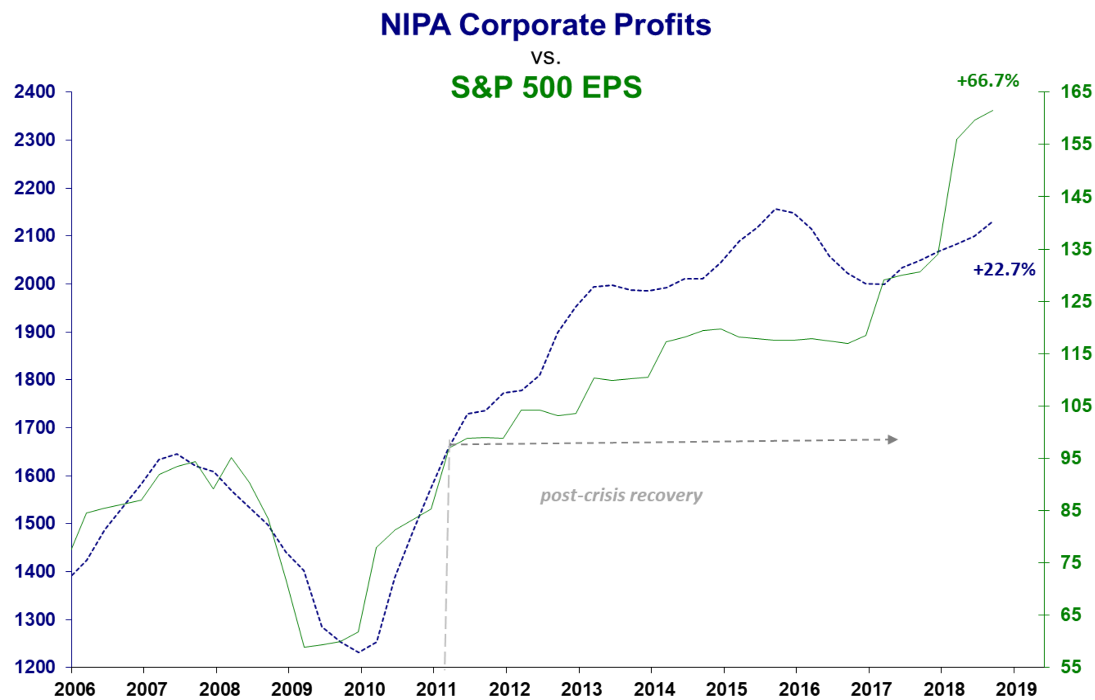

Moving right along…we come to **the second obvious support that buybacks provided the market** -- silently boosting profits. **The role buybacks have played in inflating per-share earnings metrics has been the subject of considerable lip service.** And that's about all. **Here again, there has been no genuine consternation, much less any rigorous effort to quantify the buyback bubble impact**. *And, hey, why would there be?* Buybacks are only ever going to go up (like home prices).

Oops. **With the corporate bond market upon which these share repurchases depend now blowing up, it's just a matter of time before the full effect is revealed**. And if the profit data produced by the BEA are a window into what we will see, it won't be pretty. **As noted here *ad nausea*, the government's profit figures (which are reported on a total $, rather than per-share basis and therefore are not inflated by buybacks) show a much more restrained recovery in profits than the S&P figures that are the obsessive focus of Wall Street**. Since 2011, when the crisis losses were recouped and the recovery began, profits by the government measure have increased 22.7%. That compares to a 67% gain for buyback-inflated S&P earnings.

Had S&P earnings climbed the same amount as the BEA's numbers, they would be -30% lower, the p/e ratio would have peaked at 24.8x in the 3rd quarter and a return to the 10-year average p/e of 14.6 would require the S&P to decline to 1722. *Eek!* Again…on no one's radar.

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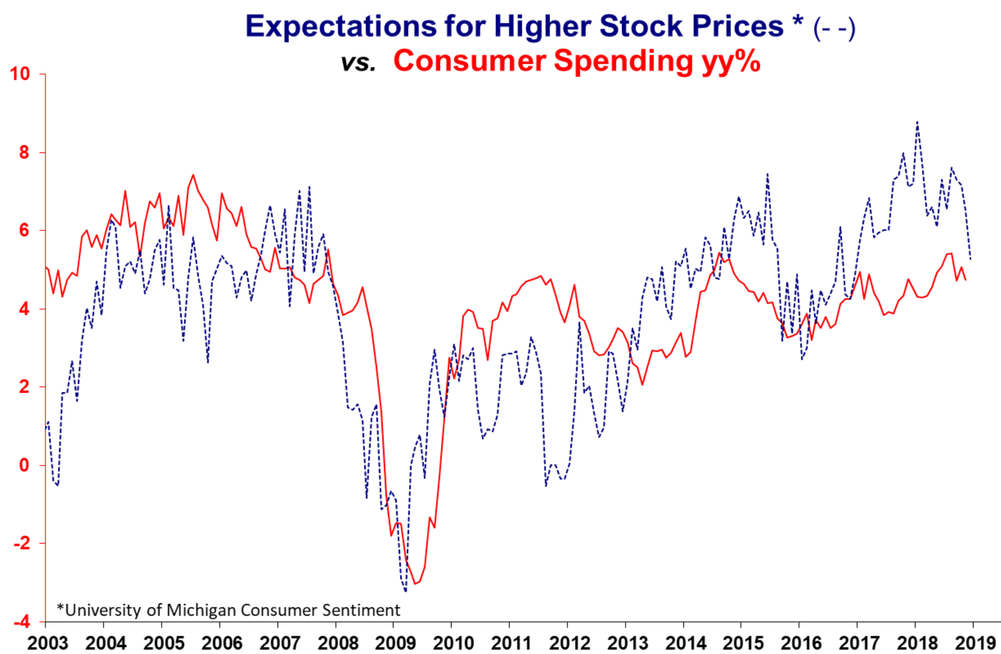

To be sure, these simple metrics may overstate the role buybacks have played in supporting the market. But **even if the truth lies somewhere in the middle, the impact on the market of the buyback bubble bust is going to prove *far* more material than popularly perceived.** ***And its impact on the economy far larger as well.***

For while it's true that the wealth effect on equities is much lower than it is on real estate (an estimated 4 cents for every $1, versus 10 cents for home prices) and that it only accrues to the haughty high-end (the top 10% of households holding 84% of equity assets) there are reasons to anticipate a larger and broader impact. First, **that demonized high-end does the majority of the spending. The top 20% now spend more than the bottom 60%.**

2017 Consumer Expenditure Survey			
	Average After tax Income	Average Annual Spending	Share of Total Spending
Bottom Quintile	$11,933	$26,019	9%
Next Quintile	30,315	39.300	13
Middle Quintile	49,339	50,470	17
Next Quintile	77,103	67,604	22
Top Quintile	$149,504	$116,988	39%

Source=Bureau of Labor Statistics

Second, for reasons discussed here repeatedly over the last year, **'this time' the average Joe is going to get socked hard as well, thanks to the hits pensions are going to take on their outsized exposure to 'risk' assets.** It's the New Year so I'll spare you another rant on the topic. But it seems inevitable that these retirement benefits are going to be aggressively renegotiated—and not, I regret to add, to the benefit of workers.

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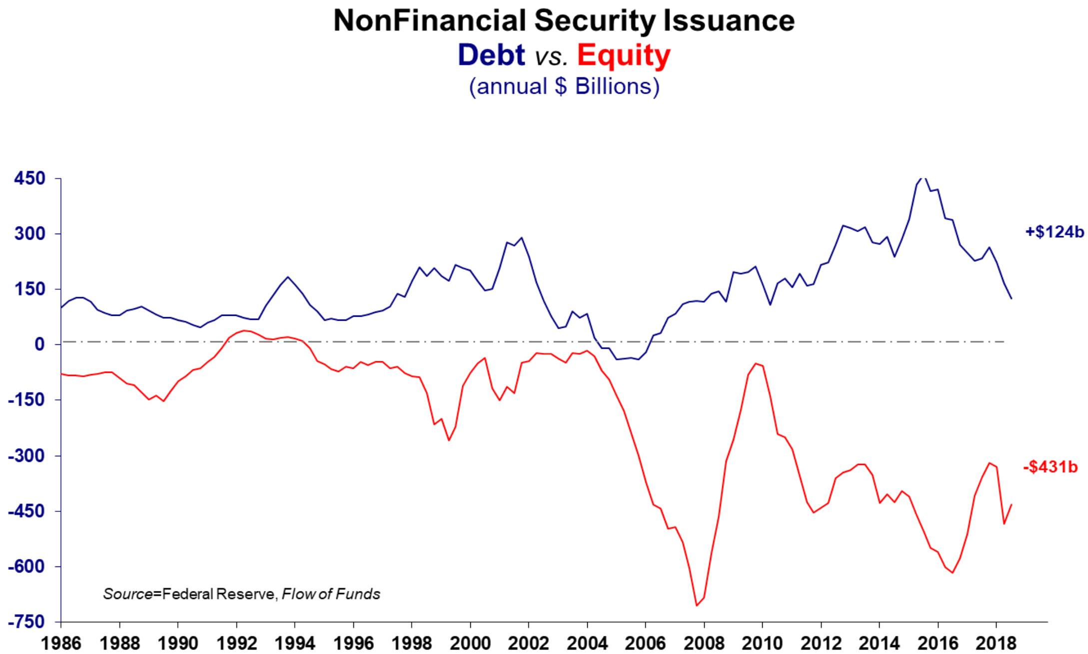

Then there's the impact of leverage – the magic *sumthin' sumthin'* that turns innocent mal-investment into an outright bubble. **Here again, the impact is sure to be larger than many expect.** Admittedly not sayin' much, *since most expect nada.* But, **by shrinking *supply* while simultaneously stoking *demand* with alluringly-inflating earnings metrics, buybacks surely green-lighted more aggressive exposure to equities and leverage than otherwise would have been.**

Look no farther than the boom in margin debt and wealth-management lending for proof. The former has tripled in the post-crisis stretch, rising from roughly $200b to $650b at its recent peak. And while cumulative statistics aren't available for the latter, well-heeled brokers have reported triple-digit annual increases in their wealth-lending businesses over the last several years. **These increases are rendered all the more impressive in light of the competition that conventional securities lending now faces from the advent of leveraged ETFs**. I mean, why pay to borrow on margin if you can get the same hair-raising experience for free? We won't know just how much until after the bubble bursts, but these new and untested vehicles seem sure to amplify the pain via their de facto leverage.

Right now, **Wall Street is scrambling to get its head around the corporate debt bust.** (*Who could possibly have seen that coming amid relentless Fed tightening and QT?) Sigh.* **But they still haven't connected the dots to what all that debt financed.** I guess **the fact that nonfinancial companies borrowed $3.29t and bought back $3.37t of stock during the post-crisis recovery is just a happy coincidence**. ☺

Of course, with buybacks forecast to hit a record this quarter, it's no wonder there's no concern. The collateral damage simply hasn't been felt. *But it will*.

As leveraging and *de-equitization* gives way to deleveraging and *re-equitization* (see above) investors will be chagrined to discover that the 'everything' bubble was far more concentrated…and closer to home.