

## Equities

23 September 2011 | 11 pages

# Monday Morning Musings

## Cash Considerations

### ■ Equities

- **Corporate cash coffers continue to swell.** The recent release of the Fed's 2Q11 Flow of Funds report acts as a reminder that American nonfinancial corporations are sitting on \$2 trillion of cash that can be used across a wide spectrum of options. While there has been criticism that these monies are not being used to finance new capital expenditures and job creation, hard data suggests otherwise, though one could argue that even more could be spent.
- **Capex has stepped up though our recent study of planned 2H11 spending is worrisome.** Amidst uncertainty about economic trends, government policy and currency fluctuations, corporate leaders look to be scaling back the pace of capital investment and holding on to a larger cushion for challenging times most likely as a result of the 2007-09 credit crisis. With fears of a potential banking quandary emanating out of Europe, some of this caution is to be expected but balance sheet strength now protects investor downside risk.
- **A review of dividend increase versus stock buyback programs is not conclusive.** Fascinatingly, there has been much focus on higher dividend yields relative to bond yields, but a study analyzing a basket of companies that have consistently reduced their share count every year have outperformed dividend leaders. Accordingly, one should nuance stock buyback opportunities to outstanding share shrinkage rather than just containment of shareholder dilution.
- **The hoped for merger & acquisition boom has not materialized and higher junk bond yields could be acting as a new headwind.** For the past year or more, investors have been anticipating a surge in M&A activity to act as a catalyst for the equity market as a whole but it has not come about even as some deals have occurred. A degree of defensiveness and now higher financing costs argues that such hopes may stay dashed for a bit longer especially as anti-trust restrictions and the notion that buyouts lead to employment consolidation can be significant deterrents.
- **US households also appear to be building and hoarding cash in spite of low deposit rates.** With nearly \$8 trillion of household deposits (including roughly \$1 trillion of money market funds) currently, it seems as if holding on to a very liquid safety net is trumping most forms of risk taking even if stocks look attractively priced and dividend yields can generate higher investor income.

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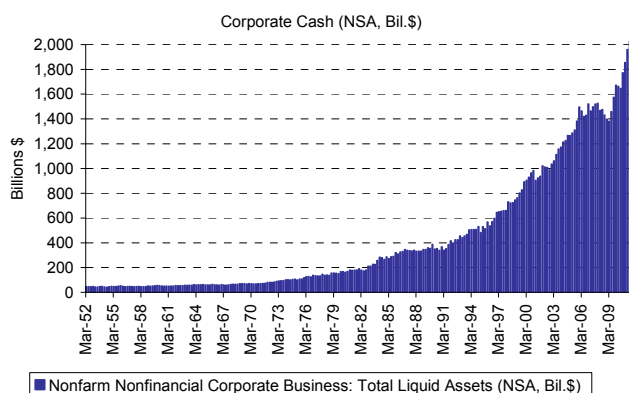
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## A Herd of Cash Cows

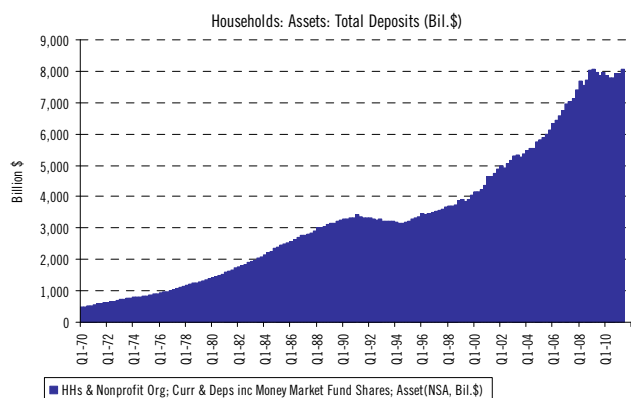
It is quite amazing to peruse Figures 1 and 2 and notice just how much cash American corporations and households are sitting on, offsetting what is often perceived as a highly leveraged society. Moreover, balance sheets of S&P 500 companies look quite healthy (see Figure 3) and household net worth has recovered very impressively from the 2009 lows (see Figure 4) even as home prices have continued to erode. Thus, we suspect that the alleged demise of American stability and wealth is way overdone even as a good chunk of the corporate cash is overseas and thus subject to higher taxation if that money is repatriated currently.

Figure 1.



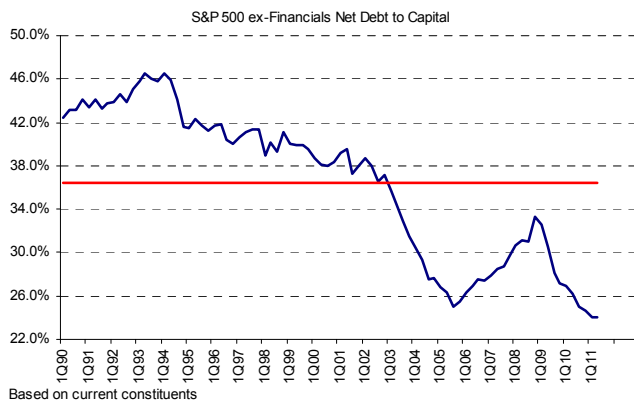
Source: Haver Analytics and CIRA – US Equity Strategy

Figure 2.



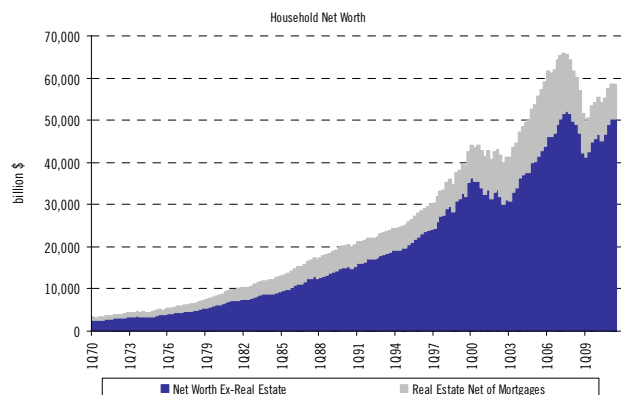
Source: Haver Analytics and CIRA – US Equity Strategy

Figure 3.



Source: FactSet and CIRA – US Equity Strategy

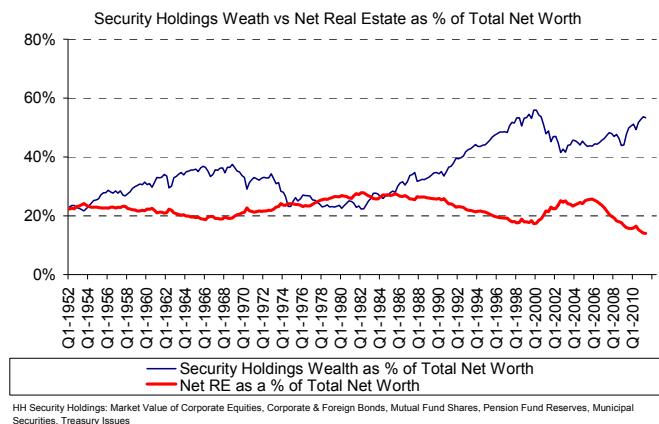
Figure 4.



Source: Haver Analytics and CIRA – US Equity Strategy

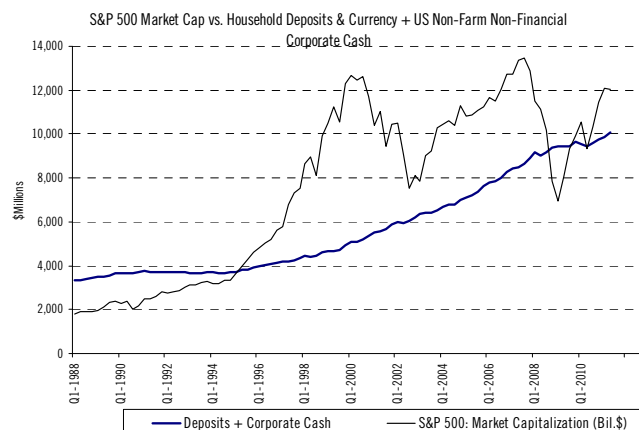
Keep in mind that the investment community regularly misses the reality that net equity in real estate accounts for only 14% of household net worth versus something closer to 60% of that wealth is influenced by directly and indirectly held securities (see Figure 5). Admittedly, such wealth is skewed to upper income Americans but that cohort of the population accounts for roughly half of discretionary consumer spending in the country. Most intriguingly, the combination of cash held by households and corporations equal about 80% of the S&P 500's equity market capitalization (see Figure 6), well above the levels seen in both 2000 and 2007 when stock prices peaked out, suggesting that some of this cash could be used to enhance shareholders and that risk aversion is still very much in place for both groups. Indeed, sitting on the cash cushion seems to have become the order of the day.

Figure 5.



Source: Haver Analytics and CIRA – US Equity Strategy

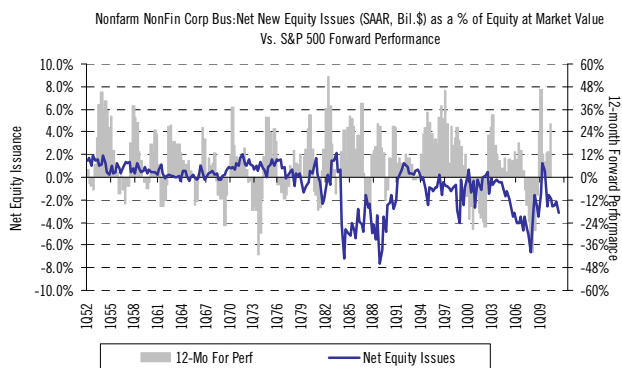
Figure 6.



Source: Haver Analytics and CIRA – US Equity Strategy

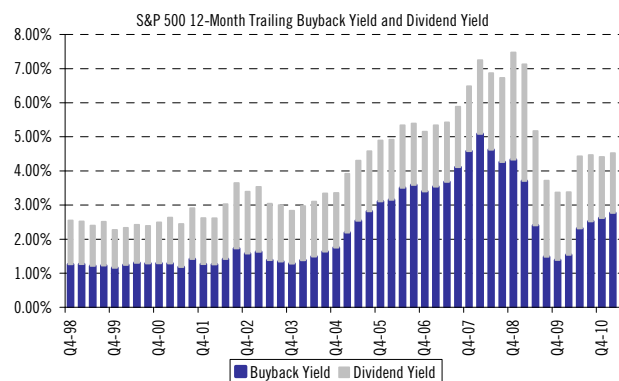
Yet, such a view negates some other realities. The Fed data shows that net equity issuance (new issues less stock buyback or M&A activity) is negative (see Figure 7), in line with the de-equitization theme first espoused by Citi's chief global equity strategist Robert Buckland several years back. In addition, Figure 8 highlights that companies in the US have been relatively active in lifting dividends and stock purchases over the past two years in spite of suggestions that they have been absent.

Figure 7.



Source: Haver Analytics and CIRA – US Equity Strategy

Figure 8.



Source: Haver Analytics, FactSet and CIRA – US Equity Strategy

Admittedly, we are concerned that the pace of capex is slowing meaningfully from the past couple of years with 2H11 capital spending intentions of roughly 700 nonfinancial US companies covered by Citi's equity research analysts showing a dramatic year-over-year gain drop off versus very robust 1H11 spending trends (see Figure 9). It is nearly impossible to determine specifically why the second half slowdown is occurring though one can cite global economic uncertainty as Citi's Economic Surprise Indices have shown us substantive misses over the past few months from projected economic expectations both in the US and in Europe, with recent European weakness being quite sharp (see Figure 10).

Figure 9.

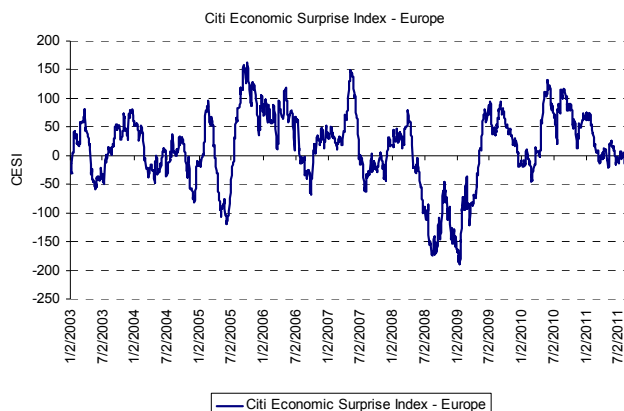
S&P 500	Aggregate Capex			
	1H10	2H10	1H11	2H11
Consumer Discretionary	28,263	35,632	31,540	39,565
Consumer Staples	18,967	22,190	19,594	25,137
Energy	70,997	99,455	95,502	92,029
Financials	NA	NA	NA	NA
Health Care	9,884	12,677	11,186	14,077
Industrials	15,619	27,508	23,956	20,776
IT	16,656	26,450	26,037	30,161
Materials	7,923	11,700	11,065	13,845
Telecom Services	21,054	27,072	23,980	27,959
Utilities	27,873	31,682	31,594	37,353
<b>Total</b>	<b>217,237</b>	<b>294,366</b>	<b>274,454</b>	<b>300,904</b>

	Aggregate Capex Y/Y Change	
	1H11	2H11
Consumer Discretionary	11.6%	11.0%
Consumer Staples	3.3%	13.3%
Energy	34.5%	-7.5%
Financials		
Health Care	13.2%	11.0%
Industrials	53.4%	-24.5%
IT	56.3%	14.0%
Materials	39.7%	18.3%
Telecom Services	13.9%	3.3%
Utilities	13.3%	17.9%
<b>Total</b>	<b>26.3%</b>	<b>2.2%</b>

Source: DataCentral, FactSet and CIRA – US Equity Strategy

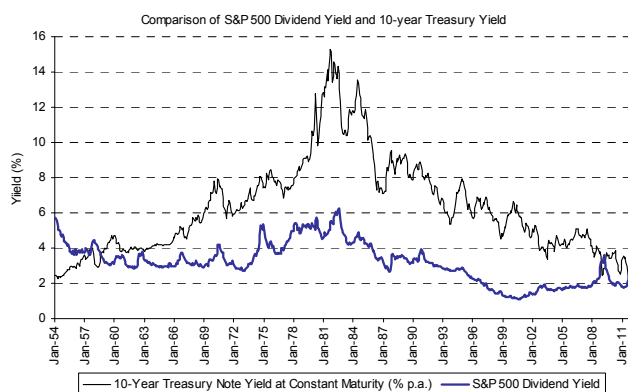
Figure 10.



Source: Bloomberg and CIRA – US Equity Strategy

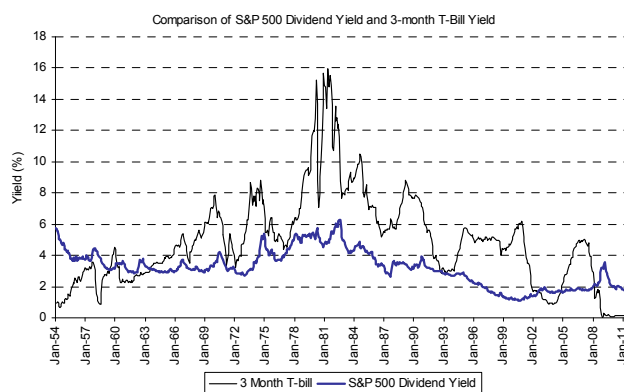
Investors have been arguing for companies to be even more aggressive on dividends especially as dividend yields are competitive with bond yields (see Figure 11) and much higher than short-term paper (see Figure 12), it seems as if consistent share buybacks and actual outstanding share shrinkage can beat out the dividend yield argument. Figure 13 provides a list of companies within CIRA's US coverage universe that have bought back stock and reduced outstanding shares every year over the past 10 years. We then compared that basket's performance against the S&P Dividend Aristocrats and found that buybacks won out (see Figure 14) but only if the number of shares actually go down annually.

Figure 11.



Source: Citi Investment Research and Analysis

Figure 12.



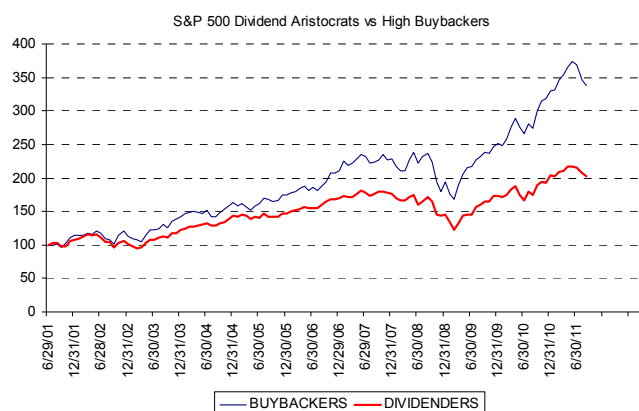
Source: Citi Investment Research and Analysis

Figure 13. Stocks Under CIRA Coverage with Shrinking Share Count

		09/22/11			2001 to	2002 to	2003 to	2004 to	2005 to	2006 to	2007 to	2008 to	2009 to
	Ticker	Closing	CIRA Target	CIRA	2002	2003	2004	2005	2006	2007	2008	2009	2010
	Symbol	Price	Price	Rating									
AUTOZONE INC	AZO	\$316.13	\$377.00	1M	-8.79%	-10.40%	-8.71%	-3.68%	-7.88%	-10.61%	-9.04%	-13.87%	-11.05%
BMC SOFTWARE INC	BMC	\$38.70	\$50.00	2M	-3.91%	-3.50%	-1.60%	-3.93%	-4.16%	-5.47%	-4.10%	-1.19%	-2.08%
GRAINGER (W W) INC	GWW	\$154.49	\$131.00	2M	-1.90%	-0.60%	-0.47%	-0.97%	-6.30%	-5.48%	-5.89%	-3.35%	-4.01%
INTL BUSINESS MACHINES CORP	IBM	\$168.62	\$205.00	1M	-0.05%	-1.62%	-2.89%	-4.35%	-4.29%	-8.05%	-3.33%	-2.52%	-5.93%
INTUIT INC	INTU	\$46.70	\$53.00	1M	-3.22%	-3.29%	-5.57%	-6.31%	-0.73%	-4.57%	-3.80%	-1.20%	-1.77%
KROGER CO	KR	\$21.73	\$25.00	2M	-4.38%	-3.27%	-0.95%	-0.96%	-2.48%	-4.81%	-3.71%	-0.31%	-2.17%
PROGRESSIVE CORP-OHIO	PGR	\$17.09	\$24.00	1M	-1.00%	-0.73%	-7.39%	-1.55%	-5.22%	-9.06%	-0.54%	-0.58%	-1.52%
ROCKWELL COLLINS INC	COL	\$51.71	\$61.00	2H	-1.96%	-1.00%	-0.11%	-3.20%	-2.44%	-2.97%	-3.13%	-0.51%	-1.65%
ROSS STORES INC	ROST	\$78.38	\$78.00	2M	-2.48%	-2.50%	-2.93%	-1.53%	-3.31%	-3.06%	-4.50%	-4.26%	-3.87%
SHERWIN-WILLIAMS CO	SHW	\$69.99	\$78.00	2M	-3.29%	-3.70%	-1.83%	-4.00%	-1.16%	-8.05%	-4.71%	-6.49%	-2.21%
TORCHMARK CORP	TMK	\$34.44	\$46.00	1L	-3.76%	-4.70%	-4.23%	-4.05%	-3.57%	-7.71%	-8.10%	-2.20%	-4.34%
WATERS CORP	WAT	\$74.27	\$99.00	2M	-3.11%	-4.85%	-0.71%	-12.10%	-3.76%	-0.39%	-3.05%	-3.85%	-2.41%

Source: DataCentral and CIRA – US Equity Strategy

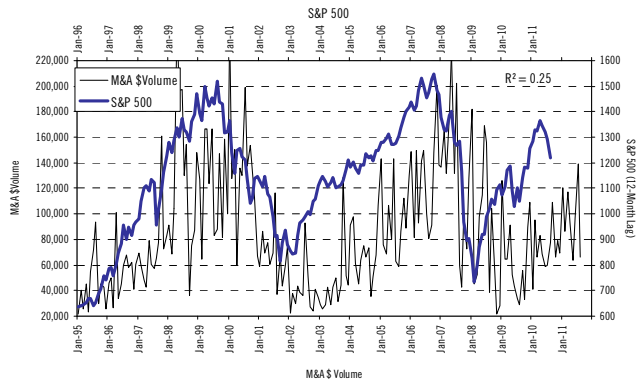
Figure 14.



Source: FactSet and CIRA – US Equity Strategy

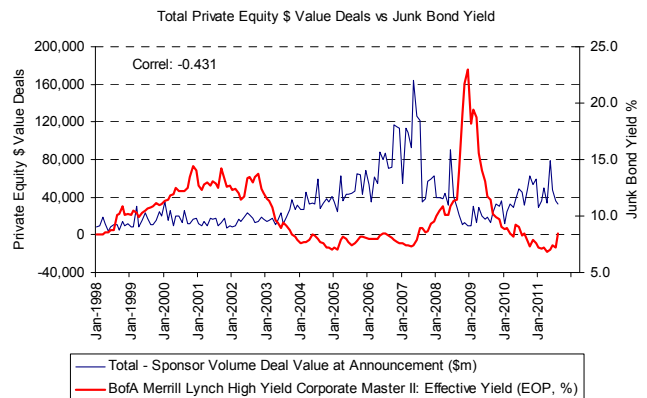
There has also been some level of anticipation of the cash being used for M&A. However, the surge has not occurred (see Figure 15) and that is not entirely surprising. Many securities law firms that specialize in deal making have not experienced any major increase in pre-merger legal advisory work that normally leads transactions by three-to-six months. Some blame concerns around antitrust oversight with a current large telecom deal being challenged, while others see large gaps between what buyers are willing to pay and the prices that sellers want. There's also worry about bad publicity if a merger leads to employee consolidation and layoffs when there's pressure to hire. It is important to realize that US private sector employment is up by roughly two million jobs since early 2010 but the news flow would suggest otherwise. Yet, the recent pickup in junk bond yields argues for some higher hurdle rates for deal activity especially for private equity purchasers (see Figure 16). Thus, one cannot expect a huge uptick in M&A to drive share prices in the near term.

Figure 15. Dollar Value of M&A Volume vs. S&P 500 (12-Mo. Lag)



Source: Dealogic

Figure 16.



Source: Dealogic, Haver Analytics and CIRA – US Equity Strategy

In summary, cash is being used but confidence is also needed to see corporate leaders use it more aggressively. At the very least, though, it does protect shareholder downside and could unleash substantive upside when CEOs feel more empowered.

## Appendix A-1

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