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Something to Think About

OAKWORTH CAPITAL BANK

COMMON CENTS

This morning, I saw a headline which used the word surreal to describe the US economy. According to Merriam-Webster, the definition of surreal is: "marked by the intense irrational reality of a dream; unbelievable, fantastic." This is apt.

When I pour through the data and look at trends, I keep coming back to a modestly growing economy that is vulnerable to external shocks. In other words, yes, the economy is growing at a mediocre, but sustainable rate, but the underlying strength is anything but that, strength. I will stop short of saying the economy's foundations are built on sand, but the pilings aren't as deep as anyone would like either.

Couple this with the current amount of turmoil in the world, including Europe and Japan's recent economic woes, and the recent resurgence in the US stock market has assumed an almost dreamlike quality. So much so, a line from Viktor Komarovsky in the film version of "Doctor Zhivago" has come to mind on more than one occasion: "No doubt they'll sing in tune after the Revolution." *If you have seen the movie, you will probably understand the context. If you haven't, it would take the remainder of this newsletter to explain it.*

However, that is a line from a fictional character in a movie, and not the here and now. Just what is going on here?

The truth of the matter is pretty simple: the markets rely on liquidity. Asset values tend to go up when money flows are positive. Conversely, asset prices go down when money leaves the markets. How is that for complicated? So, I figured I had to find out just where the money has been coming from this year. True, the markets aren't up 30%+ like they were last year, but is economic and/or income growth really so strong as to have a 117% total return in the S&P 500 from 7/31/2009—7/31/2014? Or a 59% return for a 3-year total return ending in July 2014?

Those are great questions. Sure, you could argue the rout in 2008 contributed to a market bounce in 2009 and even 2010. But, both the 5-year and 3-year annualized returns are right at 16%, with an economy growing around 2%, or so, over all time periods in question. So, just what has been fueling the stock market recently?

Well, it hasn't been US equity mutual fund inflows, which appear to have been negative for the year to date, and negative for the last 13 weeks, according to the Investment Company Institute. Perhaps mutual fund managers have been putting a lot of cash that has been on the sidelines to work. However, net cash balances, on average, amongst large cap funds tracked by Morningstar are currently hovering around the 2% mark. So, maybe that has been a source of liquidity for the market at times this year, but there isn't a ton of "dry powder" left.

What about foreign inflows? Yeah, this have been mostly positive for the last couple of

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To all, to each, a fair good-night, and pleasing dreams, and slumbers light.

Walter Scott

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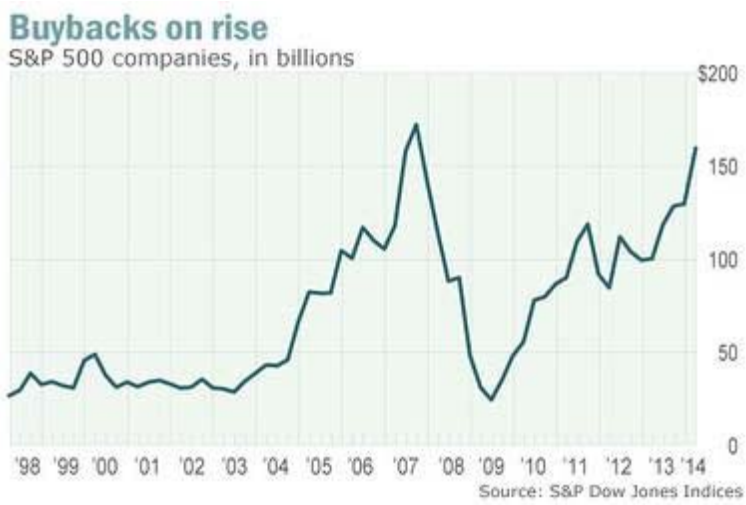
years, but the most recently announced TIC flows were outrageously negative. While not a trend, it is hard to imagine the spigot opening wide in the near term, what with all the turmoil in the world and our apparent inability to do anything substantive about it. So, what is left?

Have you heard about the so-called hoards of cash corporate America has on its collective balance sheet? While left-leaning journalists fail to grasp a great chunk of it remains in overseas subsidiaries, businesses do have a fair amount of liquidity, and have been borrowing money in the bond market like crazy to lock in these 'below long-term inflation' interest rates. Obviously, this increases the pile of cash that much more, but it doesn't appear businesses are using it to expand capacity in the US significantly? So, where is it going?

Well, one place this money is going is into share buybacks. Put another way, companies are using excess funds to purchase their shares on the open market. This decreases the amount of shares remaining, which increases earnings per share...all other things being equal. So, if earnings growth is, say, 5%, Company X can increase its earnings per share by more than that by decreasing the number of shares outstanding. As a result, this obfuscates the company's true performance, as earnings can be mediocre in an absolute sense BUT fantastic IF the company has reduced its publicly traded stock by a sizable enough amount.

So, just how much money has corporate America funneled into buying back shares? Consider this chart from S&P Dow Jones Indices:



Wow, huh? If this data is accurate, and I have no reason to believe it isn't, perhaps we are onto something here. Perhaps this has been the steady stream of inflows into the stock market.

After all, through July, it appears as though mutual fund inflows into all equity mutual funds has been around $46.3 billion whereas US equity only funds have seen about $18.7 billion in net redemptions.

Those are preliminary numbers, but they will be close enough to accurate to prove this point: thus far in 2014, it appears corporate America has been buying more US equities than US investors. Further, it would further appear corporate America has provided a substantial amount of liquidity for the US markets since the 2nd Quarter of 2009. Interestingly enough, that is about when the recent bull market started. Hmm.

Now, look at that chart again: what were share buybacks like up until, really, 2005? While not insubstantial, there were nothing like we have seen since the end of 2009 AND the 3 years leading up to 2008's disaster.

In academic circles, you might see this type of thing referred to as "financial engineering." In the CFO's office, it is called: "what in the [heck] else are we supposed to do with the money?" After all, any for-profit company is in business to maximize shareholder value, and if the CFO can most effectively maximize shareholder value by buying back shares, it will do so.

Therefore, when you peel back the layers on the onion, you can surmise: corporate America thinks the highest and best use of corporate cash is to buyback shares of the company from the open markets as opposed to expanding capacity in an economy which has been resilient in its mediocrity.

Clearly, this is short-term thinking, but it is what it is. But why? Frankly, given the current construction of the US economy, it is highly unlikely growth will accelerate to a significantly higher sustainable rate. Con-

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sider my submission to the Montgomery Advertiser this week:

> **After years of what I would consider a mediocre overall economy, I have to ask: when are we going to see meaningful growth, if ever? This is killing the middle class. So, what can be done?**
>
> I make a pretty fair number of economic presentations, and always tell audiences to expect subpar economic growth for the foreseeable future. That sounds more complicated than it actually is, because I am being necessarily vague. After all, while I want to be realistic, I don't want folks to be despondent either.
>
> Do you want to know the skinny? Okay, our economy is largely based on consumption. That is how the equation works, and it is nothing more than relatively easy math. Therefore, it is fair to say how goes the American consumer is how goes the American economy. So, how is the consumer?
>
> Now, I can get down into the nitty gritty about inflation-adjusted wages and the lack of meaningful career-type job creation, and all of it would be absolutely true. We haven't been hitting on all cylinders for a while, but why? After all, we have had some pretty amazing new technologies come into existence over the last decade, and things still seem soft.
>
> Where the rubber meets the road, a lot of the mediocrity has to do with age. As a society, we are aging. According to the Census, the median age in the United States increased to an estimated 37.3 years in 2013 from only 32.8 in 1990 and 30.0 in 1980. That might not sound like a huge shift, but it is.
>
> You see, wealth in our country has become increasingly concentrated in the older age demographics. Perhaps these generations were better at managing their money than the youngsters, but that isn't really the issue. After all, what happens to spending patterns over time?
>
> According to numerous studies and the Life-Cycle Hypothesis, consumer spending tends to peak between the ages of 45-54. Obviously, everyone is different, but this is what the data suggests. After that, spending decreases gradually, but discernibly, until age 75, when it falls off the table.
>
> While some academics take issue with the Life-Cycle Hypothesis, it makes perfect sense. After decades of spending and accumulating, at some point the consumer slows down. They don't need the new home, car, or counter top. Why? Because they already have it. As a result, the older people get, the more they spend on consumables and, gasp, healthcare.
>
> Now, if wealth is more heavily concentrated in the older demographics and this group is growing as a percentage of the overall population, what must this mean for overall consumer expenditures? That's right. They will stagnate or go down, and will probably be more skewed to food, recreation, and healthcare. Hmm. Where has the country been creating the most jobs over the last decade again?

Disclosure

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Coincidence? I don’t think so. Couple this with the aging Baby Boomer generation, and voila! With each passing year, the country gets a little older. As such, with each passing year, the consumer is prone to spend less money, particularly on those high ticket, durable goods which seem to spur economic growth that much more rapidly.

Since the American economy is based on consumption, and since our aging demographics suggest we will be spending less with each passing year relatively speaking, how can anyone forecast rapid economic growth for, again, the foreseeable future?

Hey, this is just the math.

As such, perhaps I shouldn't be looking a gift horse in the mouth. If stocks can surge 16% (annualized) for 5 years while the economy grows 2%, without valuations getting completely out of whack, you know, perhaps I should just shut my trap...bite my tongue...keep my opinions to myself, you name it.

It being what would appear to be a beautiful late summer’s day in central Alabama, I think I will...for now. However, this is all so surreal, which means dreamlike, and many of my dreams are recurring. I just hope this doesn’t turn into a nightmare.