
Why Equity Averages are So High

By Kerry Pechter *Wed, Sep 12, 2012*

In the face of a mass exodus to bonds, buybacks and dividends explain the health of the major stock indices, Goldman Sachs' David Kostin told Insured Retirement Institute members in San Diego this week.

“Stunning” was the word that Goldman Sachs equity strategist David Kostin used to describe the current incongruity in the equity market, where the S&P 500 and Dow Jones Industrials indexes have held up nicely despite a “persistent outflow” of assets from stock mutual funds.

What’s propping up equity prices in the face of a \$200 billion flow to bonds and “net zero” to equities, he said, is the fact that companies are using their huge cash reserves to buyback their stocks and pay dividends.

Kostin, a frequent guest on financial TV shows, was a keynote speaker at the Insured Retirement Institute annual conference, held in San Diego on September 9-11. About 320 executives and senior managers as well as 17 exhibitors were listed on the program. (Click [here](#) for a pdf of his slides.)

The organization, called NAVA until 2008, has broadened its original focus on variable annuities to embrace virtually the entire range of annuity manufacturers and distributors, including fund companies, insurance companies and broker dealers.

Under the direction of president Cathy Weatherford, it has also emerged as a key retirement industry lobbyist, focusing on issues like the harmonization of the fiduciary standard and the preservation of favorable tax treatment for retirement savings.

Regarding the stock buybacks mentioned above, companies “are sitting on huge amounts of cash,” one-third of which is overseas, Kostin said, “and they’re returning cash to shareholders.” The dividend trend is strong in the tech sector, where, in only a short time, Apple Computer has gone from paying zero dividends to being a major dividend payer.

Asked how long such a situation could be sustained, Kostin didn’t express any alarm that it might be likely to end anytime soon. This year, he said, S&P 500 firms have spent about 13% of their cash, and an estimated 22% to 24% of it has been spent on stock buybacks.

Net corporate demand for equities was \$500 billion, he said. “That can offset a lot,” he said. International investors generally invest about \$100 billion a year in U.S. equities. Between demand from U.S. companies and from overseas, the current trend “could persist for awhile” even if individual investors in the U.S., who directly or through mutual funds own about half of all equities, continue to sell equities, he said.

Other factors affecting the markets, Kostin added: The share of equities in defined benefit pension funds has dropped to 37% from 59% since 2002, and as people move from their 40s to their 60s, their equity allocation drops to less than 50% from 65%. On the other hand, he thinks many equity owners will

bequeath stocks to heirs to take advantage of the step-up in basis, and that the heirs' will tend to hold the equities, thus "slowing the diminution" of equities.

Where is the corporate cash coming from? Though profits have been flat since the second quarter of 2012, "net profit margins are near all time highs," Kostin said. Productivity gains from new technology and the economies of off-shoring have been driving them. Companies aren't hiring or making capital investments because they are uncertain about U.S. tax policy and the euro crisis, so "unemployment will remain at about 8% next year regardless of who wins the election," he added. Though 4.6 million jobs have been created in the last four years, he said, that's only about half the number of jobs that were lost in the financial crisis.

Financial services companies, however, are exceptions to the trend. Until 2008, they were major contributors of dividends. But since the financial crisis, when many of the firms received federal assistance, regulators have restricted their ability to pay out dividends, Kostin said.

Equity prices also do not reflect the risks posed by the so-called "fiscal cliff" that is represented by a potential increase in taxes next year if the Bush tax cuts expire, the potential drop in government spending if cuts are automatically triggered, and a potential showdown over the debt ceiling in early 2013.

Although Kostin said that the worst case scenario—a failure by Congress to resolve any of the fiscal cliff issues, resulting in a 3.5% drop in GDP—"isn't likely to happen," he reminded the audience that the dispute over the debt ceiling in the summer of 2011 resulted in a 17% drop in the equity indices in a single month. "The market hasn't appreciated these risks," and has instead focused on the probability of more quantitative easing.

GDP and earnings growth in 2013, he added, would depend on how well Congress and the administration dealt with the nation's thorny fiscal issues: 2.7% GDP and 10% earnings growth if the issues were handily resolved, 0.4% and -6% if they were botched, and 2.0% and 7% if the government muddles through. "My expectation is that it will be resolved in a messy way," he said, adding that as a rule of thumb, a 1% swing in the GDP growth rate translates into a \$5/share swing in corporate earnings.

Goldman Sachs' outlook for equity indices for 2013 ranged anywhere from a 4% gain to a 12% gain, depending on what happens politically. Kostin expects an ongoing shift from actively managed funds to indexing. Having seen the close correlations of equity class performance in 2008, investors now recognize that "alpha generation is extraordinarily difficult" and so are giving up on stock selection.