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US equities: A record-breaking $1 trillion in buybacks?

Whilst Apple made headlines this summer for becoming the first US listed company to have a market capitalisation of over $1 trillion, Goldman Sachs predicts that share buybacks will also cross the unprecedented $1 trillion level in 2018.

The buyback desk at US investment bank Goldman Sachs recently estimated that corporate boards may authorise a record-breaking $1 trillion in share repurchases this year. Year-to-date, buyback authorisations have reached $754 billion, catalysed by Republican amendments to US tax law as more companies are repatriating cash from overseas whilst paying lower domestic taxes.

If the predictions from Goldman come to fruition and this number swells to $1 trillion, this will represent a 46% increase in the number of buybacks compared to the previous year. According to the report, August – when earnings season is almost done and dusted – has historically been the strongest month in terms of buyback announcements (representing 13% of annual activity).

Buybacks (also termed 'share repurchase programs') are when companies engage in buying their own shares, thereby reducing the overall volume of outstanding shares in circulation. The company can either buy shares on the stock market or offer its shareholders the option of tendering their shares directly to the company at a fixed price.

Large buyback volumes are normally viewed as a positive signal in markets, primarily because they can keep the share price buoyed or even cause it to inflate. For example, take Apple. When the company announced share buybacks in April 2012, its stock price rose 9% in one day. When it did the same in April 2014, it rose 8% in one day. More recently in May, after the company announced a $100 billion buyback scheme (as well as strong iPhone revenues), the shares rose by more than 13% in 5 days.

This can be explained by the fact that when a company is buying back its shares, it increases demand – due to the law of supply and demand, with a constant or reduced supply, the buybacks will result in a higher price. Additionally, share buybacks can also signal to investors that the corporation thinks its stock is undervalued, that it foresees a low probability of economic trouble on the horizon and/or that it is financially stable in that it has sufficient cash set aside for a rainy day.

That said, if using buybacks in the investment decision process, an investor should do the necessary homework with regards to the company's financials and fundamentals. On occasion, a company may engage in a share repurchase program because it lacks profitable opportunities for growth. Investors should also be aware that if a company funds the buyback with debt (sometimes seen as a favourable option because the loan interest is tax-deductible), this will change the capital structure of the company and might also affect the "health" of its balance sheet which in turn could impact its credit rating.

Despite these caveats, we view an overall rise in buybacks favourably. Our portfolios are fashioned in a way that gives us a large exposure to US equities, especially in sectors that continue to benefit from the strong economic backdrop, and in which we believe growth and profitability should continue to be strong throughout 2018 (for example Information Technology). A rise in buybacks could give an extra boost in the second half of the year.

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