Buybacks to Dividends at Risk With Record-Low U.S. Yields Ending

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Sept. 3 (Bloomberg) -- U.S. companies, which have almost doubled profits since the financial crisis, are losing the benefit of record-low debt expenses as Federal Reserve plans to taper bond purchases send borrowing costs higher.

Borrowing costs for Standard & Poor's 500 Index companies fell to 1.4 percent of sales the last 12 months, a record low in 11 years of data compiled by Bloomberg. While interest rates on corporate bonds are below the 5.7 percent average since the start of the financial crisis, yields are increasing the most since 2009 and rose to about 4.3 percent from a 17-year low of 3.35 percent in May, as economists project the Fed will start reducing economic stimulus this month.

Higher debt costs will reduce buybacks and dividend increases that have boosted returns in the four-year bull market, investors say. Companies that repurchased the most shares or regularly increased payouts beat the benchmark for U.S. equity by more than 27 percentage points since 2009. S&P 500 members returned $82.4 billion to shareholders in dividends last quarter, up from $71.2 billion a year earlier, Bloomberg data show.

"Part of the profitability story will start eroding," Paul Zemsky, the New York-based head of asset allocation for ING Investment Management, which oversees $180 billion, said by phone Aug. 28. "It'll have more of an impact on financial transactions, like buybacks and dividends."

August Drop

Stocks dropped last week, sending the S&P 500 down 1.8 percent to 1,632.97 and making August the worst month in more than a year. Tensions rose over possible military action in Syria. Reports showing better-than-estimated consumer confidence and economic growth added to speculation that quantitative easing will end.

Although the benchmark gauge is still up 15 percent in 2013, about $3 trillion was erased from global stock markets in the six days after Fed Chairman Ben S. Bernanke said June 19 that he may reduce bond purchases and halt the program by mid-2014. The 10-year Treasury yield rose to a 22-month high of 2.66 percent on June 24 and stayed above 2.6 percent most of last month.

The central bank will probably cut its $85 billion in monthly bond purchases by $10 billion at its next meeting, according to the median estimate in a Bloomberg survey of 48 economists conducted Aug. 9-13.

Central bankers have kept the target rate for overnight loans between banks near zero since 2008 to promote economic growth, enticing companies from Apple Inc. to Home Depot Inc. to sell bonds and use the money for share repurchases with their stocks trading at some of the lowest valuations on record.

Debt Financed

Authorized U.S. buybacks reached a six-year high of $505 billion so far this year after more than $1.7 trillion of repurchases since 2009, data from Birinyi Associates Inc. show. The 100 stocks in the S&P 500 with the most buybacks relative to market value have beaten the index since March 2009, advancing 236 percent compared with 141 percent for the benchmark, data compiled by Bloomberg show.

Companies that have increased dividends every year for the last 25 years rallied 169 percent in this bull market. The dividend yield on the S&P 500 averaged 2.12 percent for the 12 months through May, about 0.38 percentage points higher than the 10-year Treasury. That relationship has shifted the last few months, with bonds yielding 2.74 percent, compared to stocks at 2.14 percent.

Higher Rates

The average rate for high-yield and investment-grade U.S. corporate debt surged almost a full percentage point from May to June, according to Bank of America Merrill Lynch index data. Even with the jump to 4.3 percent, rates are below the average of 6.9 percent in the decade before the start of the bull market.

Buyback plans have slowed as the Fed prepares to curtail the bond-buying program. Less than $50 billion was announced in each of the past two months, compared to more than the $68 billion average of January through June, according to Birinyi data. Repurchases dropped 3.2 percent to $118.5 billion in 2003, the last year before the Fed started raising rates.

Corporate bond sales also have started to slow, after reaching a global record of $3.99 trillion in 2012. After $1.1 trillion was issued in the first quarter this year, sales slipped to $925.8 billion in the second, data compiled by Bloomberg show. June’s $196.8 billion was the slowest month since December 2011.

Earnings Slowdown

The rise in borrowing costs has little to do with corporate credit quality as the economy, profits and margins improve. Earnings per share for S&P 500 companies have surged to more than $100 a share last year, compared to about $60 in 2008. One reason is that net income has risen faster than sales, as margins expanded for nine straight quarters from 2009 through 2011.

Falling debt costs are another reason. Interest expense for companies in the S&P 500 totaled $128.2 billion in the last 12 months, or about 1.4 percent of sales, Bloomberg data show. That compares with 2.4 percent in September 2012.

Profit expansion has slowed to an average 4.2 percent the last six quarters, compared with the 28 percent mean during 2010 and 2011 when the economy was recovering for the global credit crisis, data compiled by Bloomberg show.

“Now that profitability has been basically pushed up toward peak levels, in order to get earnings to go higher from here, who else are you going to fire? What else are you going to cut?,” Kevin Caron, a Florham Park, New Jersey-based market strategist at Stifel Nicolaus & Co., which oversees about $150 billion, said by phone Aug. 29. “The trillion-dollar question is what drives the rally from here?”

Better Investment

The Fed has committed to keeping rates low until the economy is expanding fast enough on its own, saying it wouldn’t raise rates so long as unemployment is above 6.5 percent and inflation doesn’t exceed 2.5 percent.

Any rate increase would be a sign of improving confidence, leading to more corporate investment, according to Jim Paulsen, the Minneapolis-based chief investment strategist at Wells Capital Management, which oversees about $340 billion. By the time rates get back to normal, U.S. executives will want to reinvest in their business instead of buying stock, he said.

Reports are showing faster improvement. Gross domestic product expanded more than estimated in the second quarter and initial jobless claims fell to the lowest level in five years. Analysts project S&P 500 earnings will bounce back from the slowdown, growing at 10.6 percent in 2014 and 2015, or twice the pace of this year, according to more than 11,000 estimates compiled by Bloomberg.

Animal Spirits

“When the Fed starts raising rates, and suddenly all these Armageddon stories are no longer Armageddons, that lends itself to corporations acting with more animal spirits,” Paulsen said by phone Aug. 28. “Bond yields would rise, but it would reflect greater confidence in the economy so it would lead to an acceleration of corporate activity into capital investment.”

Repurchases have been popular during this bull market because valuations have been low relative to past rallies. While price-earnings ratios for the S&P 500 rose 14 percent to 16 times earnings in the last 12 months, they have averaged 15.5 since March 2009, compared to the 18.8 mean in the 2002-2007 rally and 28.1 in the last two years of the 1990s, data compiled by Bloomberg show.

Apple, based in Cupertino, California, borrowed an unprecedented $17 billion in its first bond sale since 1996 to help fund a $55 billion addition to its capital return plan. The offering was the largest bond sale on record and the first since 1996 for the world’s largest company by market value. While the announcement helped the shares rally from the 2013 low, they have underperformed the S&P 500 for this year.

Home Depot

Home Depot, the largest U.S. home-improvement retailer, sold $2 billion of bonds in April for share repurchases. The company boosted its dividend 34 percent and announced the $17 billion stock buyback in February. After outperforming the S&P 500 by 13 percentage points the first six months of the year, the stock dropped 3.9 percent the last two months, while the index is up 1.7 percent.

The most indebted companies in the S&P 500, which had beaten the index by 6 percentage points through May, are starting to lag behind. In the last three months they have declined 3 percent, compared with a 0.1 percent gain in the gauge, according to data compiled by Bloomberg.

Corporate executives should have locked in record-low borrowing costs by now, according to Mark Luschini, the Philadelphia-based chief investment strategist at Janney Montgomery Scott LLC, which oversees about $58 billion of assets, said by phone Aug. 30.

“If they haven’t taken advantage of this window of low rates already,” he said, “then shame on them.”

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