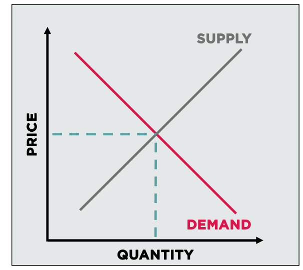
SCHLINDWEIN ASSOCIATES
INVESTMENT COUNSEL

Market Observations
October 2016

ECON 101



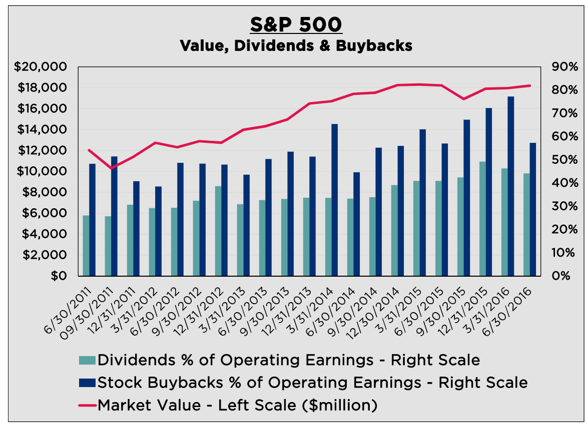
Q. Why did the stock market go up yesterday?
A. More buyers than sellers.
Q. Why did the market go down today?
A. More sellers than buyers.

When at a loss for answers, pundits turn to these responses, often with tongue-in-cheek. In reality, prices and quantities of financial assets can be influenced by basic economic principles of supply and demand. The recent high level of two financing activities – stock buybacks and corporate debt issuance – have garnered attention. Approaching these activities with the supply and demand principles of basic economics can provide some useful perspective.

Stock Buybacks

Corporations distribute cash to shareholders in two primary ways, dividends and stock buybacks. Historically, dividends have been the larger distribution source but in recent years the dominance has shifted to stock buybacks. Chart I shows trends over the past five years for the companies in the S&P 500 stock index. Buying back stock reduces the quantity of shares outstanding. If demand remains the same, i.e., investors prefer to maintain stock ownership, the price of stocks should increase as buyers bid for the reduced quantity of shares. The market value of all S&P 500 stocks has risen over the past five years for many reasons, likely including the impact of stock buybacks.

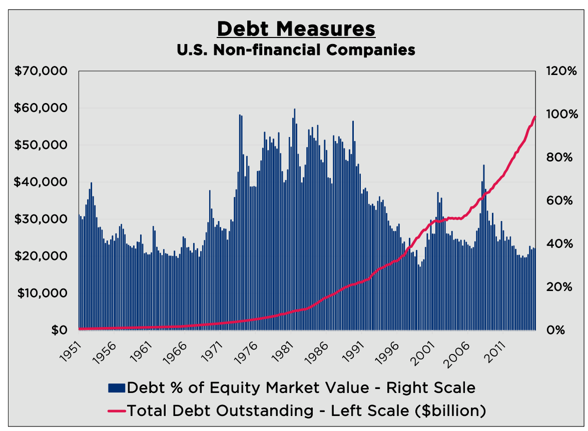
Chart I



Corporate Debt Issuance

Chart I also reveals that in five of the six quarters to June 30, 2016, S&P 500 companies have distributed cash to shareholders in excess of 100% of operating earnings. This outcome was made possible by issuing debt. Chart II shows debt measures for U.S. non-financial companies. With very few exceptions, total debt outstanding has moved ever higher year-by-year. The current debt level, however, appears reasonable relative to the market value of corporate equity. With the price of debt (interest rates) near historical lows, a 41% increase in supply (outstanding debt) over the past five years is understandable. Demand for debt (buyers) at these prices (interest rates) can be explained in part by lower yields for investment alternatives and low expectations for inflation.

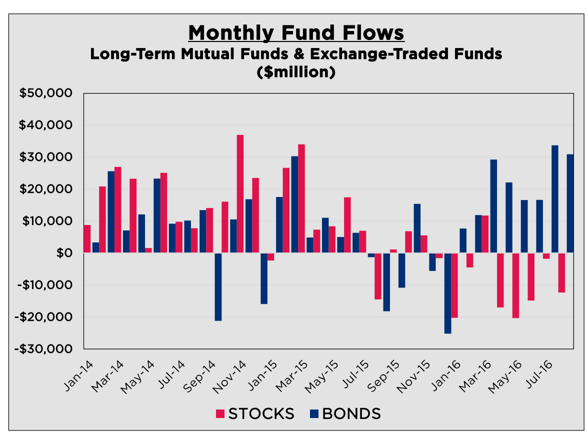
Chart II



Investment Implications

Measures of aggregate investor preferences for stocks and bonds are shown in Chart III. During this period, stock prices have risen more than bond prices. As a result, regular portfolio rebalancing could provide some explanation for more recent stock sales and bond purchases. Rebalancing is important to keep portfolios aligned with individual goals, time horizons and risk tolerances.

Chart III



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