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The Makings of a Bull Market

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It has been ten years since the stock market crash of 2008. Since then, the market has been on a tear. From hitting a low of 676.53 in March 2009, the S&P 500 Index has risen 331%, reaching 2,913.98 at the end of September 2018. While there have been occasional selloffs due to international events, unexpected election results, or fears of a trade war, the market has been resilient. All of this has investors asking, "Why has the market done so well?"

A lot has changed over the past decade. According to *Bloomberg Businessweek*, today the market is ruled by three giants, "Vanguard, State Street, and BlackRock, which manage 80 percent of the $2.8 trillion invested in U.S stock ETFs [exchange-traded funds]." A decade ago, the market was run by brokers who offered insight into the market and relayed their orders to trading floors. Today, computers have replaced many of the people on the trading floors, leaving them eerily quiet.

Perhaps the most noticeable change in the stock market has been the sheer decline in the number of publicly traded companies. Currently, there are roughly 3,600 publicly traded companies in the U.S., which is half the 7,600 that existed in 1997. With continued mergers and acquisitions and a drop-off in new companies coming to market, the stock market is a lot smaller today.

Many market analysts claim that the decline in the number of new companies being listed on the U.S. stock exchanges is the result of the Sarbanes-Oxley Act of 2002. This act, also known as the Public Company Accounting Reform and Investor Protection Act, was put in place to address the many corporate and accounting scandals that occurred in 2001

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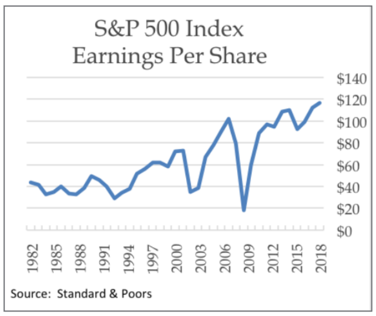
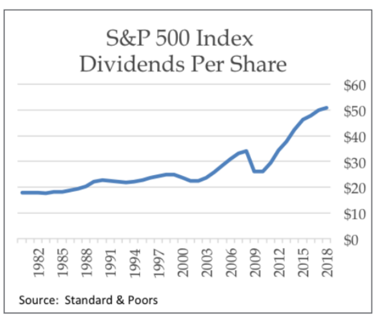
and 2002, such as with Enron and WorldCom. Others believe that the drop-off is the result of the hundreds of venture capital firms that have been created over the past decade, who gladly offer capital to young companies in exchange for a percentage of ownership. While there are fewer companies listed on the U.S. stock exchanges, the overall earnings and dividends of the 500 publicly traded companies represented in the S&P 500 Index has increased, significantly.

Helping earnings growth this year has been the Tax Cuts and Jobs Act of 2017, which cut the corporate tax rate by 40% and included language that encourages companies to repatriate oversees profits back in to the U.S. Nine months after President Trump signed the act, we are beginning to see the impact it is having on the U.S. economy and the stock market.





As we anticipated in our Spring 2018 Newsletter, *A Cash Windfall,* the tax cut has considerably improved corporate earnings for 2018. Our analysis of the S&P 500 Index reveals that after-tax income has grown twice as fast in 2018 (for the first two quarters) than in 2017. In 2017, net income for the index grew 8.7%. For the first two quarters of 2018, net income was up 21.4% compared to the first two quarters of 2017! Much of this growth is the result of companies paying a lower tax rate; however, revenue growth has also been strong, as the growing economy and low unemployment have led to greater consumer confidence and spending. With such growth in income, it appears that 2018 is shaping up to be a very good year for corporate earnings and a reason why investors have continued to view stocks favorably.

The other element of the act that has contributed to rising stock prices this year is the repatriation of profits held overseas by U.S. companies. According to J.P. Morgan strategists, $270 billion has already been repatriated, with the bulk being realized at the beginning of this year. When they parsed the data, they discovered that of the $270 billion already repatriated to the U.S., a little less than half ($124 billion) was used for stock buybacks. Another $133 billion was earmarked for debt reduction and a paltry $13 billion, or 5%, will actually be used for capital expenditures that will help the economy grow. With companies buying back their own stock and lowering their debt (and in turn lowering their interest expense), stock prices have been propelled to new heights. J.P. Morgan estimates that by the end of the year, $400 - $500 billion will have been repatriated. It is safe to assume that the bulk of this money will be used for more stock buybacks and debt reduction.

One thing that has not changed and frankly, has only gained recognition over the past ten years, is the importance of dividends. As the chart at left shows, dividend payments have increased significantly (98%) since 2008. Ten years ago, we wrote in our October 2008 letter that stocks that pay growing dividends would be a safe harbor in uncertain times. Within a year, this opinion was validated. As time progressed, dividend-paying stocks gained greater recognition by Wall Street. There are more dividend-paying companies in the S&P 500 today than there were ten years ago. Also, the amount of profits being distributed as dividends has increased over the past ten years, raising the payout ratio to the historic norm of roughly 40%. With companies posting record earnings this year, we would assume that dividend payments will rise as well.

If there is anything to be learned from the past ten years, it is that while it may be impossible to predict the future, companies that pay growing dividends are a wise choice in good times and bad.

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