

# Investing in the upturn

How to **play the boom** in US companies' cash coffers

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Strong fundamentals and tax reforms mean US companies' cash piles will grow through 2018. But what should companies do with the money and how can investors benefit?

While many companies look to be ramping up capital spending for future growth, is it wise to invest in them if the economic cycle appears to be peaking?

Ultimately, investors should consider companies that use their cash wisely, and there's an attractive investment case for those companies offering buybacks and dividends.

## Positive profit prospects in 2018

Despite the recent dip in US markets, improving global growth, increasing employment, strengthening consumer confidence, and accelerating productivity are all signaling positive profit prospects for companies and investors in 2018.

While fundamentals indicate wider margins and larger cash balances, historic tax cuts enacted on January 1 have boosted the outlook for company coffers, particularly in the retail, telecoms, and industrial industries, where effective tax rates have been higher than other sectors.

## Capex sentiment is on the rise

But what will corporate America do with the extra money? The following choices stand out: paying employees special bonuses, boosting capital expenditure, engaging in mergers & acquisitions, and/or returning cash to shareholders via dividends or buybacks. Looking at surveys, capital expenditure looks a popular choice because spending intentions are at a 20-year high.

And that's not surprising because cash flow to enterprise value differentials are high vs. historic averages, and capital expenditure growth has lagged earnings growth in the past.

## Consider the cycle

But is capital spending the right choice? Maybe not, and especially if the economic cycle is peaking. If it is, companies will find it difficult to maintain high returns on invested capital and that means higher reinvestment risk.

## Buybacks and dividends come into view

Companies offering dividends and buybacks may be a attractive option, particularly for investors wary of firms making heavy capital spending commitments. In the past two years, dividends have grown in line with the market and offered yields around the long-term average of 2%<sup>1</sup> but buyback volumes have grown less.

<sup>1</sup> MSCI USA, gross of withholding tax

### Buyback activity increasing dramatically

But there's clear evidence that buyback activity is now increasing. Investment banks have begun to see increased repurchase volumes as companies come out of earnings' blackouts. For instance, Goldman Sachs in early-February reported that share repurchase volumes hitting their desk were at the highest levels since August 2015.

This increase in activity is likely a result of aforementioned strong earnings and supportive tax legislation, but also a response to "buy the dip" and therefore suggests that companies do indeed have dry powder they are looking to employ.

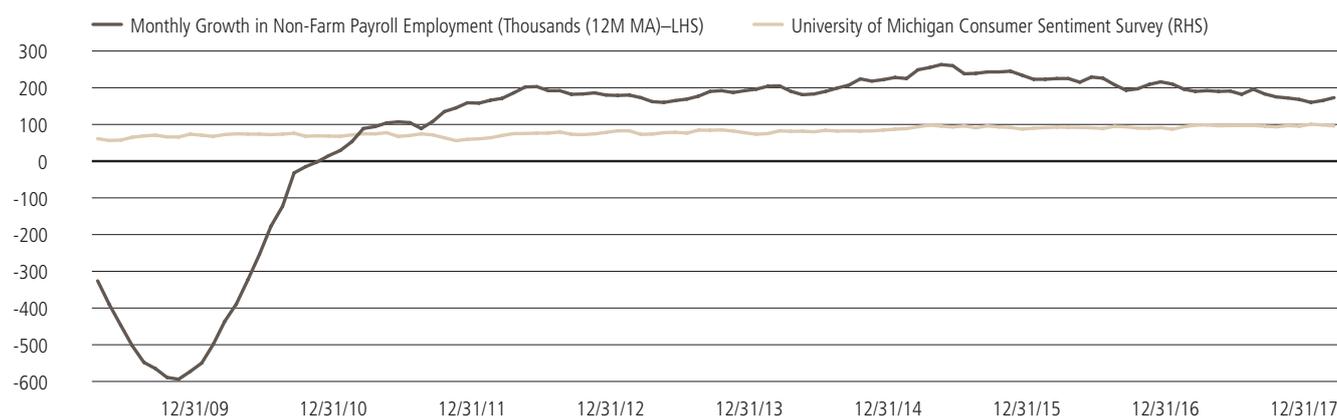
### Buybacks continue to look attractive

The combination of high free cash flow, high margins, large cash positions and increasing payouts should be attractive for companies returning capital to shareholders.

So, while strong fundamentals, plus tax savings, are boosting the outlook for US companies' cash coffers, investors might question the wisdom of companies increasing their capital expenditure, particularly if the upturn in the economic cycle has entered its final stages.

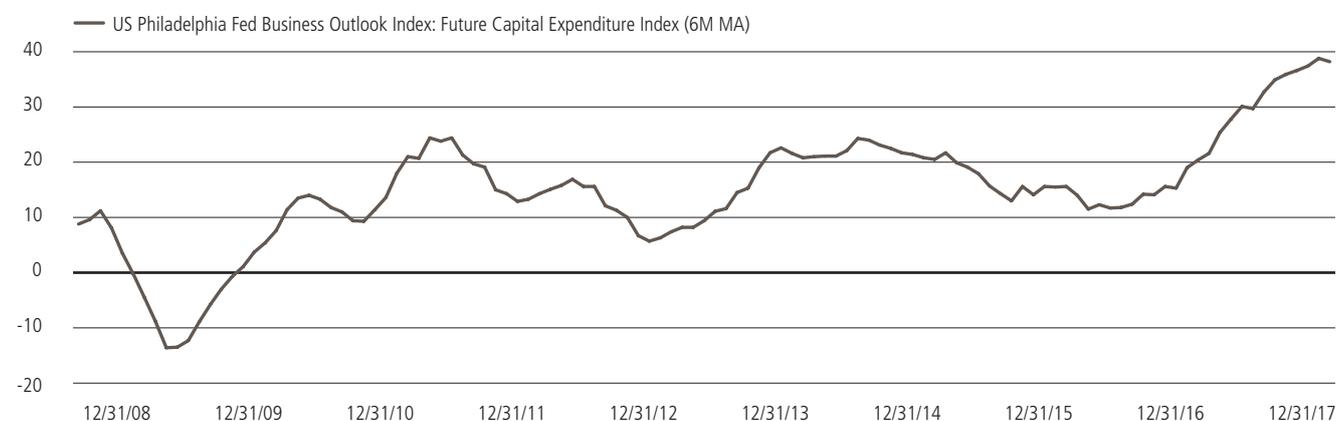
As such, dividends and buybacks look comparatively attractive and equity investors should take this into account when selecting stocks.

**Exhibit 1: Sustained jobs growth is feeding strong consumer confidence in the US**



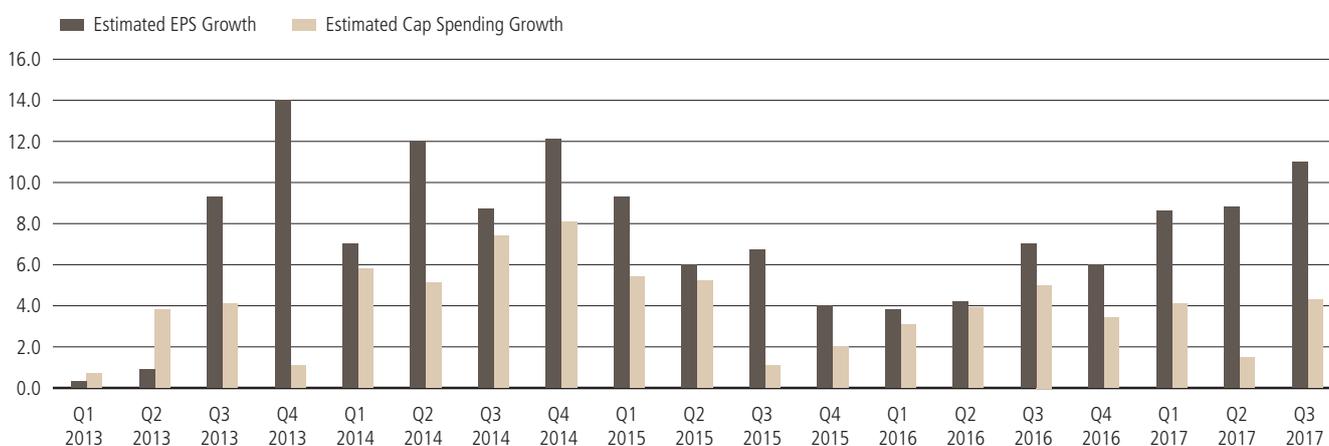
Source: Bloomberg, February 2018.

**Exhibit 2: Capital spending intentions are at a 20 year high**



Source: Bloomberg, February 2018.

### Exhibit 3: EPS Growth has consistently exceeded cap spending growth since Q3 2013



Source: ERP, December 2017

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