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The incredible shrinking stock market...and why it's a good thing

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A left over vestige from the late 1980s to about 2007 is the huge amount of publicly traded stocks available. This United States saw a tremendous rise in the number of new stock market investors thanks to the advent of the 401(k), Internet brokerages, and a giant size sales push by the financial services industry. Fast forward to today's post-recession era, the investment industry is mature and almost anyone who could, should, or would be a new stock market investor has most likely become one already.

But this is the case after every bust period; resulting in too much stock that can be supported by the investment community. This state of over capacity may take years, even decades, to reduce in other industries, but one should always appreciate and never underestimate the ability of the stock market to shrink its capacity and right size its own supply/demand equation. (Notice I used "always" and "never" in the same sentence!)

The tools of choice are familiar; mergers and acquisitions activity and stock buybacks. And it happens fast! What is noticeably absent is IPO activity, meaning very little new stock is hitting the market. Yes, commercial banks have issued new shares in order to bolster their capital, but these offerings were well received and easily absorbed by the market.

First, M&A activity is akin to Economic Darwinism, whereby mature industries remove excess capacity from the market place. And just like every other post-recession era, this activity is starting to rev up big time. Almost everyday now we hear of another takeover; recent takeover announcements came from industries like oil services, financial services, pharmaceuticals, beverages, and technology. This is driven primarily by mature industries looking to consolidate or enter new markets. The end result is healthier companies with fewer publicly traded companies competing for investor's dollars. No doubt, a good thing for stock prices.

Second, stock buy back programs are making a big comeback and are another proven and effective way to remove stock from the market place while simultaneously raising corporate earnings. As of March 1st, the year to date tally is $68.5 billion versus $125 billion of new authorization for all of 2009 (CNBC.com).
What makes these two activities possible? A huge cash hoard on corporate balance sheets. Excluding financial companies, according to JPMorgan, the amount is a little over $1 trillion. In mature industries, where there is little room for growth that exceeds GDP, acquiring competitors, slashing costs, reducing capacity and hence, raising prices is often the only way to grow earnings.

The recent strong financial performance of U.S. airlines and Ford Motor Company are recent examples of how this has worked.

Most important is the signal that mergers and acquisitions and buybacks send to investors, that day to day corporate managers are optimistic about the future. The question for investors though is where they think stock prices will go when they see healthier companies and fewer companies left to choose from in mature sectors? While there are no guarantees, historically, prices rose...every time.

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Mitchell Goldberg is the president of ClientFirst Strategy, Inc., Woodbury, N.Y.