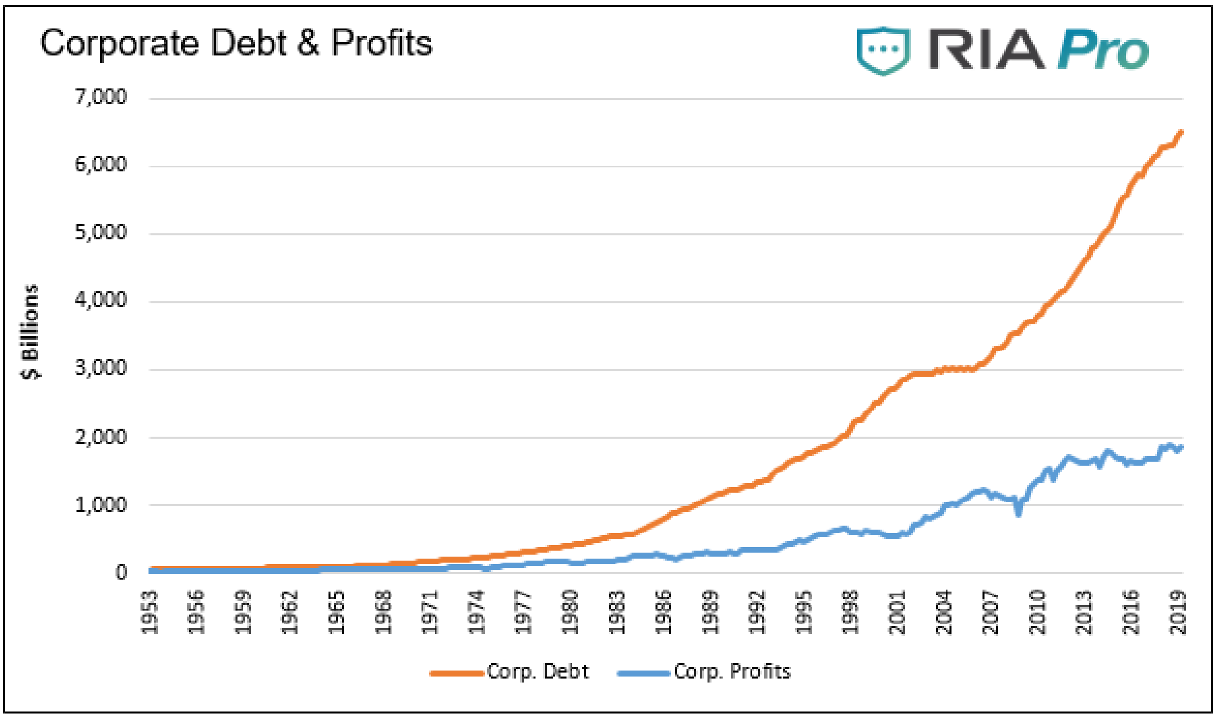
We recently published [Corporate Profits Are Worse Than You Think]() to expose stock prices that have surged well beyond levels that are justified by corporate profits.

A topic not raised in the article, but a frequent theme of ours, is the role that share buybacks have played in this bull market. Corporations have not only been the largest buyer of stocks over the last few years, but share buybacks result in misleading earnings per share data, which warp valuations and makes stocks look cheaper. Over the last five years, corporations have been heavily leaning on the issuance of corporate debt to facilitate share buybacks. In doing so, earnings per share appear to sustain a healthy upward trajectory, but only because the denominator of the ratio (number of shares) is being reduced as debt on the balance sheet rises. This corporate shell game is one of the most obvious and egregious manifestations of imprudent Federal Reserve policies of the past decade.

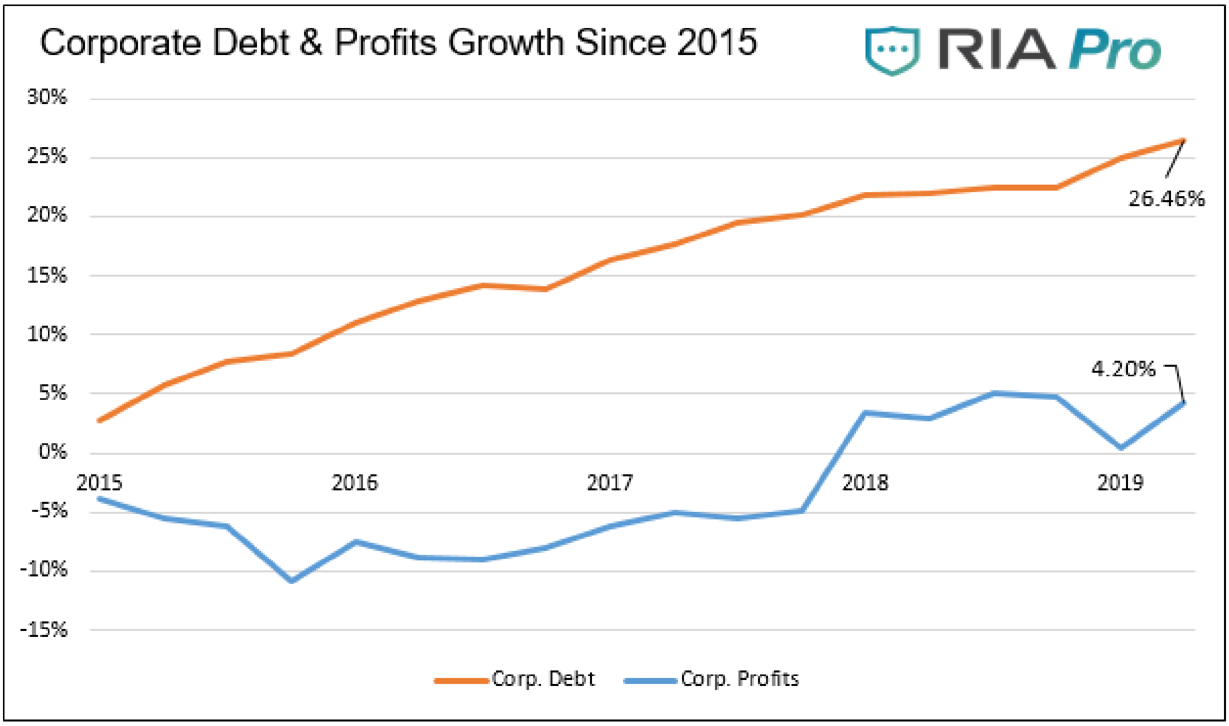
Given the importance of debt to share buybacks, we provide two graphs below which question the sustainability of this practice.

The first graph below compares the growth of corporate debt and corporate profits since the early 1950s. The growing divergence, especially as of late, is a clear warning that debt is not being used for productive purposes. If it were, profits would be rising in a manner commensurate or even greater than the debt curve. The unproductive nature of corporate debt is also seen in the rising ratio of corporate debt to GDP, which now stands at all-time highs. Too much debt is being used for buybacks that curtail capital investment, innovation, productivity, and ultimately profits.



Data Courtesy St. Louis Federal Reserve

The next graph uses the same data but presents the growth rates of profits and debt since 2015. Keep in mind the bump up in corporate profits in 2018 was largely due to tax legislation.



Data Courtesy St. Louis Federal Reserve

Lastly, we present a favorite chart of ours showing how the universe of corporate debt has migrated towards the lower end of the investment-grade bucket. Many investment-grade companies (AAA - BBB-) are issuing debt until they reach the risk of a credit downgrade to junk status (BB+ or lower). We believe many companies are now limited in their use of debt for fear of downgrades, which will naturally restrict their further ability to conduct buybacks. For more on this graph, please read [The Corporate Maginot Line](#).