The standard equity valuation model stipulates that the intrinsic value of a share reflects the present value of dividends expected to be paid in the future. The growth of these dividends is determined by expected growth in earnings, which ultimately depends on nominal economic growth. According to this basic representation, when the outlook for real GDP and inflation rates are low, and as is currently the case, equity valuations should theoretically suffer. Yet it is the opposite that is observed in recent years. It must be said that the low interest rate environment has inflated valuations by lowering the discount rate of future profits.

Certain valuation models nonetheless expand the standard model to incorporate the effect of share buybacks. By concentrating the firm’s value in a lower number of shares outstanding, buybacks constitute an alternative way to redistribute value to the remaining shareholders. These enlarged models explain more fully the performance of stocks in the current context of weak growth.

Share repurchases have indeed increased at a significant rate over recent years. In the United States, S&P 500 companies pay a substantially higher portion of their profits in the form of buybacks than dividends.

Canada is no exception to the trend, and high-buyback-rate shares have greatly appreciated in recent years. Note that the dividend payments have also increased, and in parallel, the cash allocated to fixed capital investments has decreased lately.

**Implications:** With weak growth prospects, companies are reluctant to invest, preferring buybacks and dividend payments as methods of maximizing valuations. Many take advantage of very low interest rates to finance these initiatives. This underscores the degree to which the market’s performance has come to rely on highly accommodative monetary policies. A too rapid tightening would possibly provoke significant financial instability and it is one of the reasons prompting the Federal Reserve to exercise great caution in its normalization.

---