LPL RESEARCH
WEEKLY ECONOMIC COMMENTARY

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THE CURRENT STATE OF CAPEX

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KEY TAKEAWAYS

Domestic capex growth has slowed in recent months as companies grapple with trade uncertainty.

The recent slowing has interrupted an otherwise solid two years for capital spending growth.

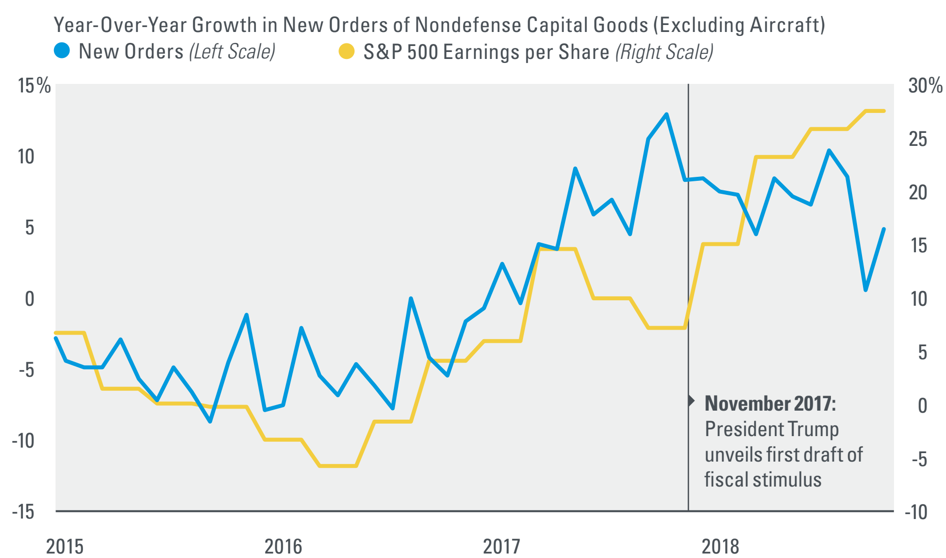
We expect robust capex growth to resume once U.S. businesses get more clarity around trade.

Business capital expenditures (capex) have grown solidly over the past two years after an oil-related contraction in 2015 and 2016. Part of the turnaround has been a natural rebound from those two years of slowdown, but fiscal stimulus is also playing an increasingly important role. Tax and spending packages passed in late 2017 and early 2018 have provided the economy with a $350 billion windfall that has helped raise business confidence and boost firms' earnings, leading them to focus more on investing in their businesses for future growth [Figure 1]. Changes in tax laws have also allowed businesses to expense capital purchases, making them less expensive, and to bring their overseas profits back to the United States (known as repatriation), providing an additional lift to business spending. As a result, some measures of capex, manufacturing, and business confidence climbed to their highest levels of the business cycle in 2018.

SPENDING GROWTH SLOWS

Recently, trade tensions have started to hinder the promising improvement in business spending. Underlying economic data have pointed to a deterioration in

1 CAPEX GROWTH COOLS, EVEN AS PROFITS JUMP



Source: LPL Research, Thomson Reuters, Institute for Supply Management 11/23/18

All indexes are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results.

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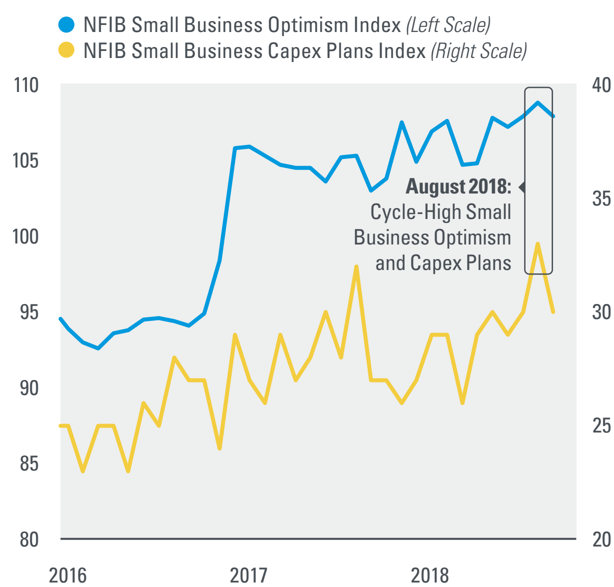
corporate demand and equipment production as input costs rise and supply chain disruptions create new challenges. Investors took notice of this trend when declining capex weighed on gross domestic product (GDP) last quarter. Nonresidential fixed investment added about 0.1% to 3.5% in third-quarter output growth, its smallest contribution since the fourth quarter of 2016. In that quarter, business spending as a percentage of total GDP dropped the most since 2015, indicating that corporations had pulled back on expenditures significantly, even as the economy expanded at one of its fastest paces of the cycle.

Since then, economic data have showed that the U.S.-China trade dispute has increasingly hindered business plans for domestic corporations. As shown in Figure 1, new orders for nondefense capital goods (excluding aircraft), our best proxy for future capex, increased 4.8% year over year in October. Last month's growth rebounded from a disappointing September, in which new orders slowed the most in 18 months, even as S&P 500 Index companies posted 20% profit growth in the third quarter. Domestic new orders have increasingly succumbed to the cooling effect of tariffs, which have weighed on international business orders over the past several months. The Institute for Supply Management's (ISM) gauge of new business orders fell to the lowest level since April 2017 last month, hampered by steep declines in export orders as overseas manufacturers cut production in preparation for lower demand. New orders are viewed as a leading component for manufacturing and the economy, so the drop in new orders could foreshadow weakness in output.

2 BUSINESS OPTIMISM AND CAPEX PLANS STILL SOLID



Source: LPL Research, National Federation of Independent Business (NFIB) 11/23/18

POSITIVE SIGNS PAST THE ROADBLOCK

Even though recent data on business spending have been discouraging, we see trade tensions as the primary roadblock, one that may be removed with a U.S.-China agreement. The trade dispute has been difficult to navigate for U.S. corporations, and many have opted to put future expansions on hold until there is more clarity on the tangible and intangible effects of tariffs on demand and profits. It also takes time for fiscal stimulus to flow through to capex, and we likely have only started to see the impact.

U.S. companies remain optimistic, leading us to think the U.S. economy is in the early stages of a larger capex surge [Figure 2]. As of October, ISM reports about 30% of firms expect to increase capex over the next three months, the highest percentage of the cycle. General small business optimism also remains near the highest level of the cycle (reached in September). We think it's feasible that companies are still planning for capital projects. Fiscal stimulus was implemented only 11 months ago, and major spending would require at least several months of consideration. A tightening U.S. labor market also points to stronger capex. With wages growing at their fastest pace of the cycle (and a labor shortage becoming more widespread), firms may turn to investing in better equipment and productivity-enhancing software to boost output.

The few signs of deterioration we've seen recently in economic data have been in indicators of corporate and manufacturing health, convincing us that the slowdown in business spending is from corporations and producers bracing for trade uncertainty. U.S. consumers are the healthiest financially they've been in years: Personal spending and incomes have accelerated at the fastest pace since 2015, and consumer confidence has risen to an 18-year high. Solid domestic economic conditions and strong profit growth also support business spending, especially as labor costs remain manageable and the Federal Reserve tightens monetary policy. Because of this, we believe the slowdown in spending may be temporary, and the fundamentals largely support business expansion.

The global trade environment has yet to weaken significantly, which also supports the case for strong future business spending. In September, U.S. exports and imports both grew at the strongest pace since the trade dispute began in March. Also in September, U.S. imports (adjusted for inflation) grew at the fastest pace year over year since 2015 amid strong consumer demand. U.S. exports, which reflect the health of other regions, grew 6% year over year, a solid pace of growth and well above the 4.3% average growth in 2017. Even as producers reduce new orders, trade data show demand remains strong globally.

CONCLUSION

We believe that fiscal tailwinds and economic momentum should continue to offset the trade headwinds in the coming year, especially given the combined power of tax breaks, increased government spending, deregulation, and tax law provisions encouraging the repatriation of corporate profits. Capital investment is an important trend to monitor, as we expect business spending to be one of the main drivers of future output. Once U.S. businesses have clarity on trade, they may be able to focus more on boosting growth and productivity, which may fuel the next leg of the U.S. economic expansion. ■

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