LPL RESEARCH

WEEKLY ECONOMIC COMMENTARY

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CAPEX RISING
MEANS, MOTIVE, AND OPPORTUNITY

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KEY TAKEAWAYS

Both surveys and hard data have been signaling that businesses are increasing capital expenditures.

Capex expansions may receive continued support from lower tax rates and repatriated profits.

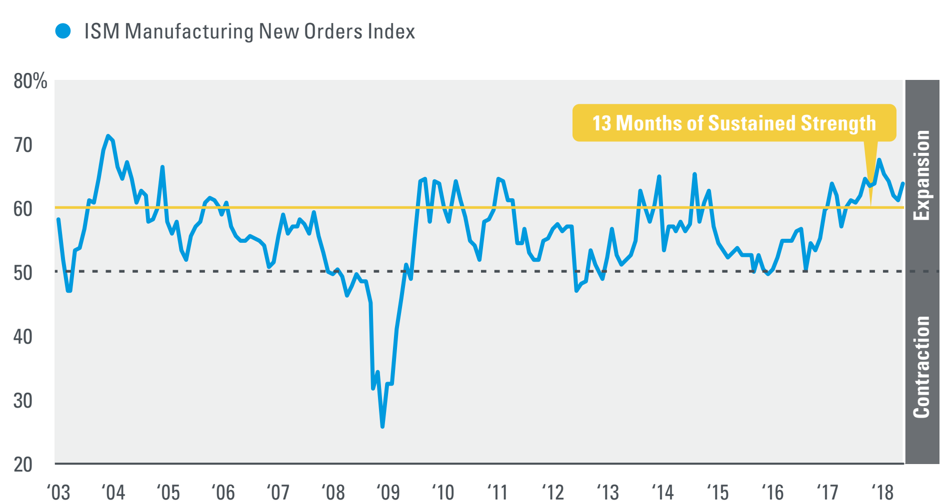
Incentives in the new tax law and strong business confidence may help encourage businesses to focus on capex to increase efficiency and improve competitiveness.

Increased business capital expenditures, or "capex," remain one of the most important pieces for improving the long-term growth trajectory of the U.S. economy. Capital expenditures help increase productivity, and improved productivity is the foundation for sustainable higher growth for developed economies. Both survey and hard data continue to confirm that we might be seeing a rebound in capex, but how can we know it's sustainable? The answer may be in our beach reading. Like the veteran detective in a favorite page-turner, we look for means, motive, and opportunity. For capex spending, means translates to additional sources of funding for projects, motive comes from increased business confidence and tight labor markets, and opportunity from fiscal incentives and global growth.

THE SETTING: HARD DATA, SOFT DATA

Clues that capex may be rebounding have been increasingly apparent in both survey-based "soft" data and in "hard" data that represent actual economic activity. One of our favorite soft data indicators is the new orders component of the Institute for Supply Management's (ISM) Manufacturing Purchasing Managers' Index [Figure 1], which tends to be a leading indicator both for capex and the overall economy. While off its recent peak in December 2017, it's held above 60 for 13 consecutive months (above 50 indicates expansion), the longest sustained level of strength since 2004.

1 LONGEST STRETCH OF NEW ORDERS STRENGTH SINCE 2004



Sources: LPL Research, Institute for Supply Management, Bloomberg 06/15/18

Illustration is historical, and no guarantee of future results.

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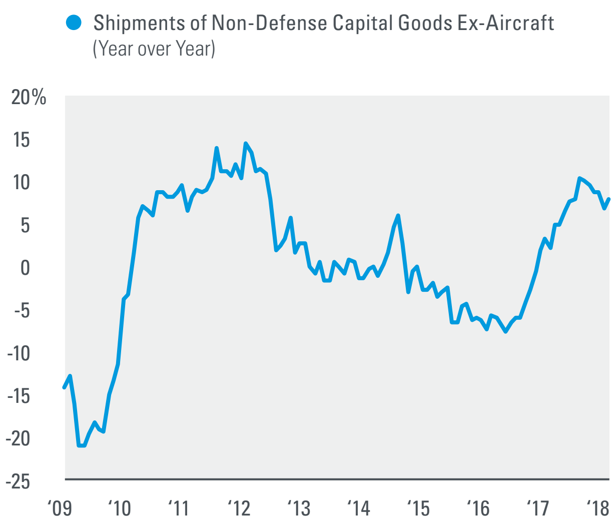
We are also starting to see the impact of that change in the hard data. Shipments of non-defense capital goods ex-aircraft flows, the best proxy we have for actual capex investment, have been accelerating since the end of 2016 [Figure 2]. While the acceleration has only taken the level of shipments to where it was from 2012–2014, we believe further gains are possible. But in order to get there, means, motive, and opportunity must all be in place.

MEANS, MOTIVE, AND OPPORTUNITY

Means for a business is about access to cash, which can be from cash on hand, cash flow from operations, or borrowing capacity. Right now, there's potentially additional cash available across the board.

- **Lower taxes** – Lower corporate tax rates following the passage of the Tax Cuts and Jobs Act of 2017 have allowed companies to keep more of the profits they earn, which may then be put to use, potentially by investing in capex.
- **Repatriated profits** – The tax law also allows companies to bring home overseas profits ("repatriation") at reduced tax rates, which may make added funds available for investment. We estimate that as much as $500 billion in profits held abroad could be brought back to the U.S. under this provision.
- **Supportive financial conditions** – While financial conditions have tightened somewhat, interest rates remain historically low and lending standards reasonable for growing companies.

2 SHIPMENTS OF CORE CAPITAL GOODS ACCELERATING



Sources: LPL Research, U.S. Bureau of the Census 06/15/18

While businesses may have more cash at their disposal, there are many potential uses for that cash outside of capex. Companies can use it to increase dividends, buy back their own stock, or reduce debt. They could increase salaries as competition for labor intensifies, or even just let it gather interest given the slow normalization of interest rates. More available cash will have businesses looking for potential opportunities, but having additional means won't do the job. Motive and opportunity also matter.

Companies are motivated to invest by both the need to find ways to boost productivity and the confidence that it's a good time to invest.

- **Business confidence** – Business confidence remains elevated across a wide range of surveys, even factoring in rising concerns about trade. The National Federation of Independent Business's Small Business Optimism Index just posted its strongest reading in over thirty years and the Conference Board's quarterly CEO Confidence Index remains elevated, although off of all-time highs.
- **Tighter labor conditions** – Tight labor markets also motivate businesses to invest, as they search for alternative ways to drive growth. With the unemployment rate near a multi-decade low, available labor resources for driving growth become scarcer and capital expenditures become an increasingly attractive option.

Even with means and motive in hand, the policy and economic environment must also be attractive for investing; we believe both are currently more supportive for capex than they have been in some time.

- **Tax law expensing provision** – One of the aims of the new tax law was not only to lower taxes, but to structure the law in a way that encourages businesses to invest in order to create sustainable growth. One of the most important ways the law aims to accomplish this is by allowing immediate expensing of capex. Usually, capital expenditures can only be expensed gradually over time through depreciation. By allowing immediate expensing, the new tax law incentivizes companies to invest now to pull the tax advantage forward.
- **Global growth environment** – While the economic outlook outside the U.S. has slowed, global growth still points to a positive investing environment, as does stabilizing oil prices. While trade policy is a concern, businesses are likely to see the improved economic environment as an opportunity.

CONCLUSION

Accelerating capex remains one of the keys to lifting a decades-long slump in productivity growth, and productivity is the key to sustainable improvement in economic growth. Business spending remains one of our key economic themes for 2018, and we have seen plenty of improvement, with the level of spending now matching what we saw in 2012–2014. We believe the means, motive, and opportunity are in place for further increases, and will be monitoring business spending to help gauge whether the growth rates experienced in 2017 and early 2018 are sustainable into 2019 and beyond. ■