Special Commentary

Tim Quinlan, Senior Economist
tim.quinlan@wellsfargo.com • (704) 410-3283
Sarah House, Senior Economist
sarah.house@wellsfargo.com • (704) 410-3282

Down, Not Out: Late Cycle Business Spending

Executive Summary

Business fixed investment has shifted into a lower gear, but despite late cycle dynamics like fading profits and elevated debt levels, we have measured optimism for business spending in the second half of the year.

The boost to business confidence and profits from the tax cuts is fading, but we argue that because the tax cuts were not terribly consequential to capex spending in the first place, there is little reason to expect a major unwinding now that the tax cut sugar high has worn off. There is, however, a reasonable case to be made for sustained outlays in categories that cannot be put off until the next cycle like intellectual property spending in the service sector or equipment spending by manufacturing firms to become more capital intensive at a time of rising labor costs.

The ongoing trade war is the most obvious roadblock we see that could present downside risk to our forecast, and not just for business spending.

We have measured optimism for business spending in H2-2019.

Tax Cuts Were Great for Profits, but What About Capex?

When we talk about capex in economics, we are concerned with business fixed investment (Figure 1), which includes spending on equipment, nonresidential structures and intangibles like intellectual property. Other uses of capital, like M&A activity or stock-related maneuvers like share buybacks and increased dividend payouts, are not captured explicitly in the GDP accounts. It is evident that capital spending had a strong year in 2018, although the trend running toward the zero line at present is not terribly encouraging.

Figure 1

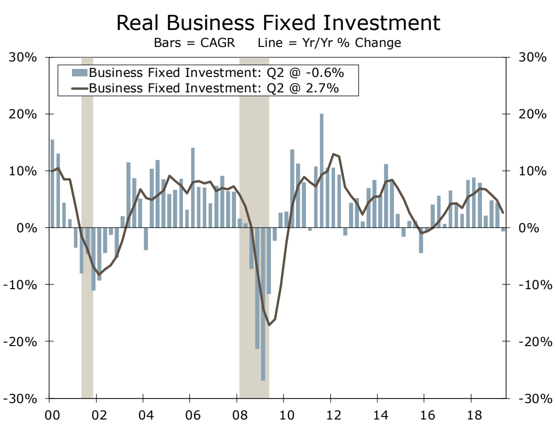
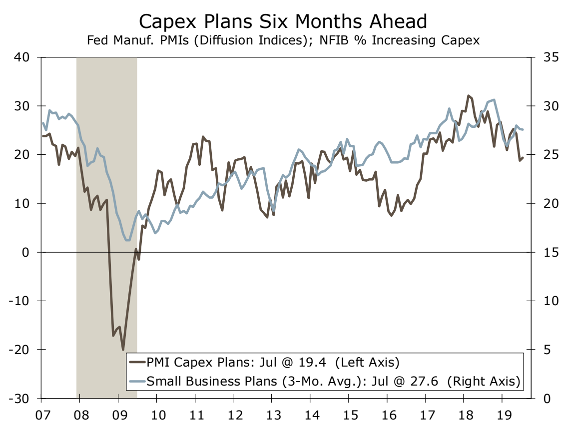


Figure 2



Source: U.S. Department of Commerce, Federal Reserve System, NFIB and Wells Fargo Securities

After-tax corporate profits jumped in 2018, thanks in no small part to the Tax Cuts and Jobs Act (TCJA). The boost to corporate profitability was touted by lawmakers as a way to rev-up capital spending. After all, profits serve as an internal source of financing new investment. So did the tax cuts play a meaningful role in lifting capital spending in 2018? If so, the recent slowdown in capex may be a mere fading of the tax bump; a more robust rate of capex investment as after-tax profits jumped in 2018 would make for tougher base comparisons today. If the TCJA had little to no effect on capex over the past year, however, the slowdown would appear more worrisome.

Just the Crash from a Sugar High?

There does appear to be some rough evidence that last year's tax cuts lifted capital spending. For example, growth in business fixed investment spending strengthened to a year-over-year rate of 6.8% in Q2-2018, the fastest pace in about four years. Business sentiment soared in 2018, with manufacturers' and small businesses' capital spending plans reaching a cycle high in January (the month after the TCJA was passed) and July 2018, respectively (Figure 2). A survey by the Federal Reserve Bank of Atlanta done in cooperation with Stanford University and the University of Chicago early in 2018 found that nearly a quarter of executives planned to raise capital spending specifically because of the tax cuts.

Capex does not appear to have gotten a meaningful boost from the tax cuts.

But that means three-quarters of respondents, however, did *not* plan to increase capital outlays because of the tax cuts. At the same time, what people say and do are often two different things. A simple regression shows that the pace of business investment in 2018 was not stronger in a statistically significant way than what our model would have otherwise predicted without the tax cuts. In other words, capital spending does not appear to have gotten a meaningful boost from the tax cuts.

So if tax cuts did not provide a significant lift to capital spending last year, the more recent slowdown looks to be driven by other factors. What then should be consulted to inform forward guidance on capital spending plans for the broader economy at this late stage of the economic cycle and in this fast-moving policy environment?

Trade Skirmishes Before the War

The global environment has shifted dramatically over the past year. Global growth was on the upswing in early 2018, giving further reason for businesses—especially those with international exposure—to increase investment (Figure 3).

Figure 3

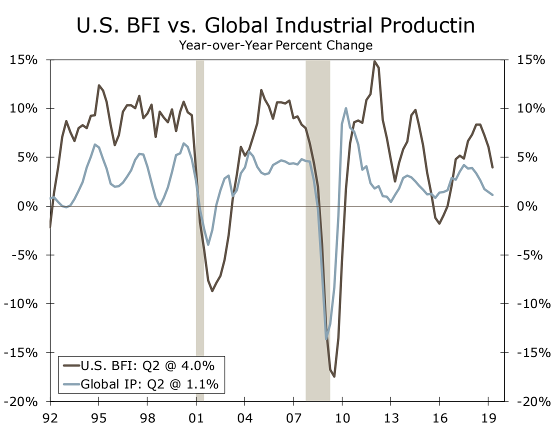
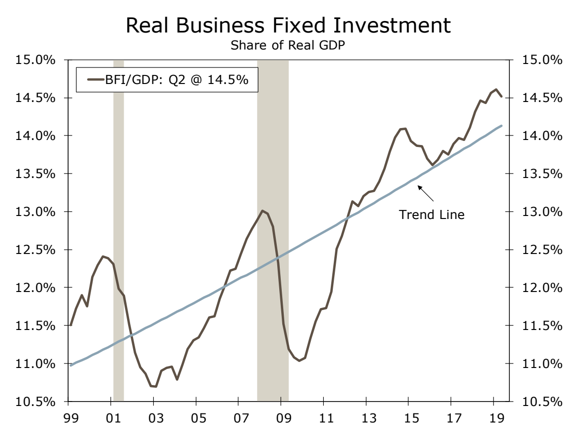


Figure 4



Source: U.S. Department of Commerce, IHS Markit and Wells Fargo Securities

It is not surprising to see capex plans weakened as trade tensions flared.

Perhaps it is not a coincidence that the peak in manufacturers' capital spending plans occurred just before the trade war began ramping up. Tariffs on solar panels and washing machines went into effect in February 2018, followed by steel and aluminum tariffs in March. The first tariffs on Chinese goods were put in place in July 2018. Although each of these rounds of tariffs was rather small, ($65 billion worth of goods in a $21 trillion economy), they highlighted major risks to existing supply chains as well as domestic and foreign sales. With a cloudier sales outlook, it is not surprising to see capital spending plans at both manufacturers and small businesses more generally began to weaken as the trade tensions flared in earnest.

Was Capital Spending in That Much Need of a Boost Anyway?

More broadly, another rationale for why we have not seen more of a tax cuts-related boost could have to do with the fact that business spending was actually already in good shape. When we look at real businesses fixed investment as a share of GDP, we find that capex spending was already above prior cycle peaks and its long-term trend (Figure 4).

Business spending was already in good shape.

Contrary to conventional views, businesses investment has not been unusually weak this expansion. What perhaps has felt like a disappointing pace of capital investment must be viewed in the context of a generally slow sales environment. While this is the longest expansion in American history, it is also ranks dead last compared to prior cycles in terms of the pace of growth, with an average annual growth rate of just 2.3% (Figure 5).

Easy credit conditions and historically low borrowing costs have certainly been supportive of investment this cycle, but can only spur investment so much if end markets are growing at a relatively slow pace. Unless businesses expected the tax cuts to lead to permanently stronger growth, the deal was unlikely to do much for current spending given credit conditions were already fairly easy, and financing was generally available at a low cost. That may help to explain why among public companies, capital expenditures rose less than half as much as share repurchases did last year (Figure 6). Tax cuts were great for corporate profits, but the notion that tax policy could save capex is akin to sending in a lifeguard after a swimmer who doesn't need saving.

Figure 5

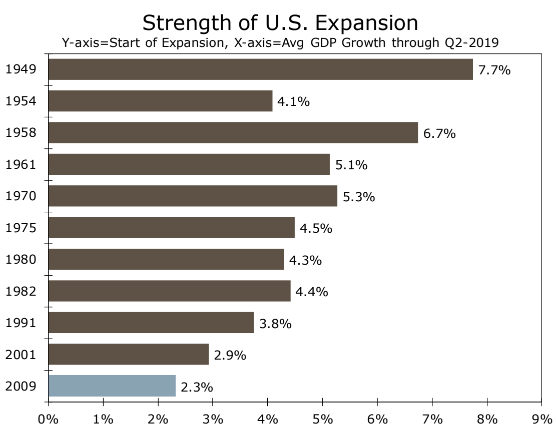
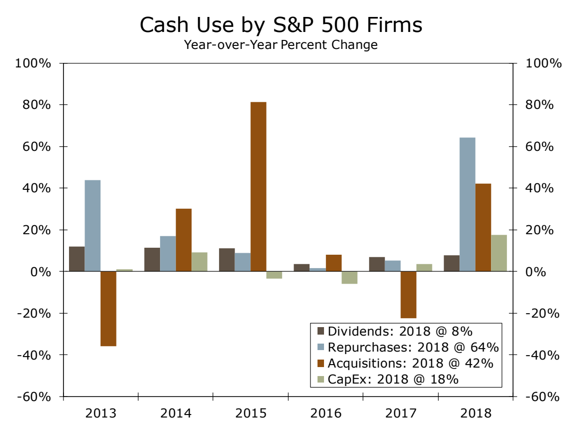


Figure 6



Source: NBER, U.S. Department of Commerce, Bloomberg LP and Wells Fargo Securities

Outlook: Investment Weakness to Persist, But Not Fully Retrench

Looking ahead, expectations for sluggish growth in end markets suggest capital spending is set to struggle more in the coming months. Although trade tensions have ebbed and flowed over the past year and half, the direction of travel has been toward an increasingly contentious environment. Policy uncertainty does not make for easy business planning, and therefore we would expect to see a further pullback in investment plans. More generally, the pall cast by trade tensions over global growth will serve as a headwind to the investment environment.

A tougher profit picture serves as an additional hurdle to near-term investment. Corporate profits have slipped over the past two quarters. The financing gap—the difference between capital expenditures and profits—has risen to levels last seen in the midst of the financial crisis and points to a growing need to finance new investment externally.

It isn't all bad news, however. Although profits are not going far enough to cover investment, credit remains generally supportive. Even after tightening in recent weeks, financial conditions are not overly restrictive, and banks are not reporting tightening standards (Figure 7). At the same time, core capital goods orders, an indication of near-term equipment spending, is heading into the third quarter with some momentum (Figure 8). While it is true that capex spending plans have been trending lower since the first quarter of 2018, it is also true that at 19.4, this measure remains higher than it was throughout much of the current expansion. It also bears noting that manufacturers report difficulty in finding labor and face accelerating labor costs. On that basis, labor-saving equipment makes increasingly more financial sense.

Figure 7

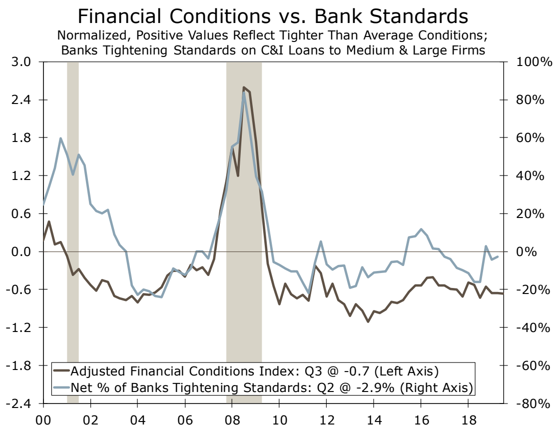
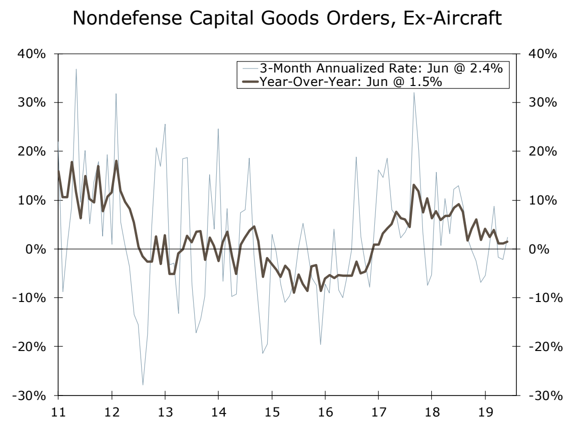


Figure 8



Source: Federal Reserve System, U.S. Department of Commerce and Wells Fargo Securities

We see business investment eking out modest growth in H2-2019.

The takeaway for the current period is that businesses may be down, but they are not out. On net, we see business investment eking out modest growth in the second half of the year. Equipment and structures spending are most directly impacted by the unfavorable global environment, which should lead to outlays growing more slowly than the broader economy in H2. However, spending on intellectual property, which is more closely tied to services and cannot be deferred as long as new equipment and structures, should continue to grow at a rate that exceeds overall GDP growth in coming quarters.

Wells Fargo Securities Economics Group

Jay H. Bryson, Ph.D.	Acting Chief Economist	(704) 410-3274	jay.bryson@wellsfargo.com
Mark Vitner	Senior Economist	(704) 410-3277	mark.vitner@wellsfargo.com
Sam Bullard	Senior Economist	(704) 410-3280	sam.bullard@wellsfargo.com
Nick Bennenbroek	Macro Strategist	(212) 214-5636	nicholas.bennenbroek@wellsfargo.com
Tim Quinlan	Senior Economist	(704) 410-3283	tim.quinlan@wellsfargo.com
Azhar Iqbal	Econometrician	(212) 214-2029	azhar.iqbal@wellsfargo.com
Sarah House	Senior Economist	(704) 410-3282	sarah.house@wellsfargo.com
Charlie Dougherty	Economist	(704) 410-6542	charles.dougherty@wellsfargo.com
Erik Nelson	Macro Strategist	(212) 214-5652	erik.f.nelson@wellsfargo.com
Michael Pugliese	Economist	(212) 214-5058	michael.d.pugliese@wellsfargo.com
Brendan McKenna	Macro Strategist	(212) 214-5637	brendan.mckenna@wellsfargo.com
Shannon Seery	Economic Analyst	(704) 410-1681	shannon.seery@wellsfargo.com
Matthew Honnold	Economic Analyst	(704) 410-3059	matthew.honnold@wellsfargo.com
Jen Licis	Economic Analyst	(704) 410-1309	jennifer.licis@wellsfargo.com
Hop Mathews	Economic Analyst	(704) 383-5312	hop.mathews@wellsfargo.com
Coren Burton	Administrative Assistant	(704) 410-6010	coren.burton@wellsfargo.com

WELLS FARGO SECURITIES