

ECONOMICS: US PERSPECTIVES—AUGUST 27, 2010

A Stall in Capital Spending?

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July's sharp decline in nondefense capital orders has raised fears that capital spending will slow, undermining economic growth. We believe, however, that pent-up demand for capital spending remains strong, and is likely to continue supporting the US economic recovery in the second half of the year.

Capital spending was exceptionally strong in the first half of 2010, with each quarter registering annualized gains in excess of 20%, the best back-to-back quarterly gains since 1983. Business spending on capital equipment and software has been particularly important, contributing roughly one percentage point to overall real GDP growth, or about a third of the total gain in economic output.

Yet despite this strong surge in spending and record levels of company cash flows, there is some evidence that capital spending has suddenly slowed, which could weaken US growth prospects for the second half of 2010. In July, nondefense capital orders dropped a sharp 8% from June, largely driven by a 15% decline in order bookings for machinery.

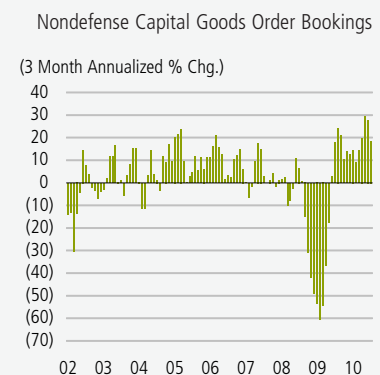
Uncertainty Contributes to Volatility

One of the reasons for the sharp drop in machinery orders was a substantial and late upward revision to machinery orders for June. According to a senior official at the Census Bureau, a company that

operates in the mining, oil field and gas machinery sector did not provide complete order data for June, delaying the information until the announcement of its second-quarter earnings report. The Census Bureau was compelled to estimate their June number, only to find out that the actual level of order bookings was more than \$2 billion higher than the initial estimate. The new data meant revising nondefense capital goods order bookings for June to a gain of 3.4% from the previous estimate of -0.3%. The sharp drop in July was really a result of order bookings moving back in line with the levels of previous months.

Capital goods orders are generally volatile on a month-to-month basis, making it more useful to look at the underlying trend over a longer time span—three months or longer. Even with the sharp drop in order bookings for July, three-month annualized gains in new nondefense capital goods orders are running at a 19% rate over the previous three-month period. This is slower than the peak growth rate recorded earlier

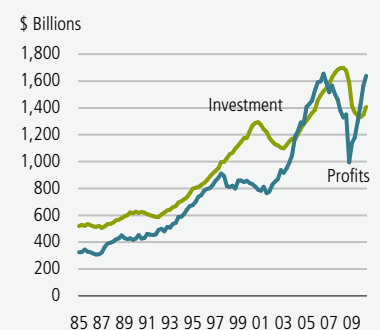
Display 1
Slowing, but Still Strong



Source: Census Bureau and Haver Analytics
Through July 31, 2010

Display 2
Profits Lead Investment Spending

Operating Profits vs. Total Fixed Investment



Source: Census Bureau and Haver Analytics
Through June 2010

in the year, but not evidence of a near-term collapse (**Display 1**).

More significantly, we cannot rule out the possibility that capital spending will weaken further in the short run given uncertainty about the sustainability of the economic recovery and confusion created by Congress's failure to deal with the expiration of a long list of tax provisions. This would result in slower-than-expected real GDP growth and less job creation than we are currently forecasting.

Pent-up Demand Remains Large

We think any slowdown will prove to be temporary, however. Changes in operating profits normally lead changes in investment spending, and the recent surge in profits—along with strong cash flows—suggest that spending should rise as well (**Display 2**).

The need to stay competitive domestically and globally will also drive capital spending.

According to data supplied by the Census Bureau, manufacturing and mining account for the lion's share of investment in America, with the combined expenditures of both sectors totaling nearly 30% of all investment. There is no question that investment in the mining sector should remain robust, given all of the private and public energy initiatives that are underway at this time.

In the manufacturing sector, however, the pent-up demand for capital spending has never been larger. In 2009 overall business investment for equipment and software failed to at least cover depreciation allowances, resulting in a reduction in the net capital stock for the first time in the postwar period (**Display 3, top**). All of that under-investment appears to have occurred in the industrial sector, with the industrial equipment (**Display 3, middle**) and transportation (mainly motor vehicles) industries showing the largest gap between investment and depreciation

(**Display 3, bottom**). Firms in these industries need to substantially increase their investment plans to replace aging equipment or run the risk of falling behind competitively, losing market share and profits.

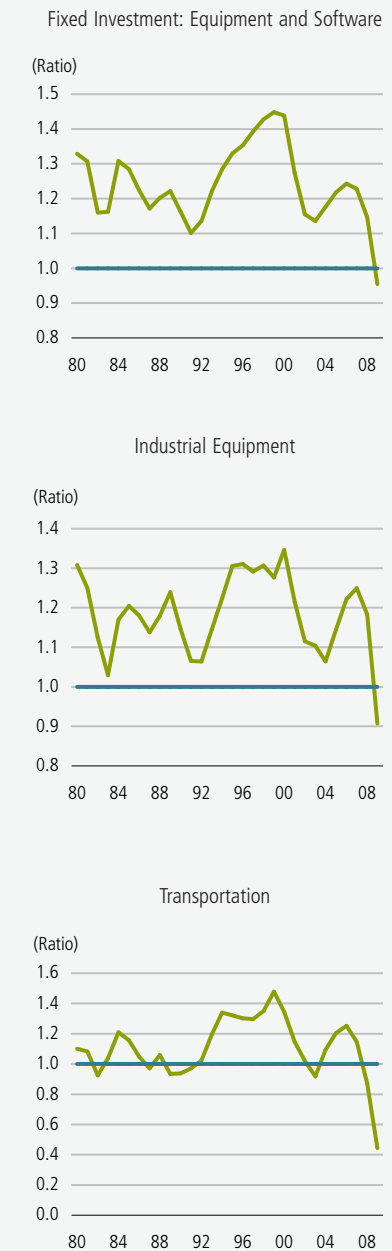
Capital Spending Should Boost US Growth

Some critics have argued that US firms are more likely to put the bulk of their capital budgets in economies that have better growth prospects—and in some cases lower taxes—than in the US. While we agree that is a risk, a 2005 study by Professors Hartman, Liedtka and Snyder of Lehigh University ("The Impact of US Tax Depreciation Law on Asset Location and Ownership Decisions") found that decisions on where to manufacture products or locate a facility often fail to account for differences in tax depreciation rules across countries. According to their analysis, US depreciation law "can indeed have a non-trivial impact on facility locations and ownership decisions." Additionally, they suggest that in most cases, "direct ownership of foreign assets appears to be relatively less attractive once depreciation law is taken into account."

In our view, the fundamental backdrop for investing in capital equipment and software in America remains solid. Our second-half GDP forecast included gains in real capital spending of around 10% to 12% annualized, less than half the pace seen in the first six months of the year. Current data continue to support gains of that magnitude, but we must acknowledge that the downside risks to our estimates have risen lately. Quick congressional action on tax policy would reduce the level of uncertainty in the economic and investment environment, but odds of that occurring seem low at this point. Thus, we believe the transformational shift in the US economy—towards exports and capital spending and away from consumption and housing—is still underway, but the path is not as straight or as smooth as we would like it to be. ■

Display 3: Huge Pent-up Demand for Investment Spending

Investment-to-Depreciation Ratio



Source: Bureau of Economic Analysis and Haver Analytics Through December 31, 2009

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