MORNING BRIEFING
May 16, 2018

Capital Ideas

See the collection of the individual charts linked below.

(1) From giddy about tax cut to confused about full impact, while worrying about trade war. (2) Short wait-and-see period? (3) CEO survey is more bullish for capex than are capex indicators. (4) Capex as a percentage of cash flow is down from previous highs. (5) Business spending on high tech is flying high, not counting computer hardware, stalled by the cloud. (6) Plenty of cash for capex and buybacks. (7) Will NAFTA exist mañana? (8) Italy remains ungovernable and a thorn for EU.

US Capital Spending I: More Capex To Come? Melissa and I have described the mood of corporate managements during their Q4-2017 earnings calls in January as "giddy." Managements were elated by the cut in the corporate tax rate passed into legislation at the end of last year, as it means that companies will keep more of their profits. In our 2/28 *Morning Briefing*, we noted that business investment is among DJIA companies' top expected uses of the tax reform windfall.

Yet on the latest batch of earnings calls, for Q1, the honeymoon seemed over. Executives seemed less focused on the rosy benefits of tax reform and more focused on the uncertain logistics of how best to apply the new tax code and the impacts once they do. As we observed in our 4/25 *Morning Briefing*: "So it seems that the real clarity on tax reform might not come until 2018 taxes come due! It may also take time for corporations to assess whether and how the tax reform will positively impact consumer spending and small business investment." In addition, the business uncertainty attributable to President Donald Trump's protectionist threats must be offsetting some of the giddiness resulting from the tax cuts.

The latest indicators suggest that there might be a short wait-and-see period for capital spending. But more likely than not, greater business investment is ahead. Consider the following:

(1) *Remarkably unremarkable*. The Q1 CEO Outlook Index compiled by Business Roundtable tends to be a leading indicator of the yearly percent change in capital spending in both nominal and real terms. The index jumped from 69.6 during Q3-2016 (just before Trump was elected) to 118.6, the highest on record for this series, which started in Q1-2003 (*Fig. 1*).

However, the expected big boost to capital spending from tax reform hasn't shown up in GDP just yet. Nevertheless, nominal and real capital spending increased 7.3% and 6.1% y/y during Q1, according to Bureau of Economic Analysis (BEA) data. That's solid growth, but we attribute most of it to the rebound from the "rolling recession" that hit the global commodity sector during late 2014 through early 2016.

That was a nice pickup from that slump, but nothing remarkable. The historical relationship between these data suggest greater capital spending to come.

(2) *Very wary of tariffs*. For now, companies may be on pause because of the recent trade spats around the globe. A 5/1 *FT* article discussed the Association for Financial Professionals' findings that corporate

treasurers who three months ago had signaled plans to step up their spending instead have opted to build up their cash reserves, having grown warier of spending in the face of tariff threats.

(3) *Investment slump.* Trade aside, companies have not been investing as much of their cash flow back into their businesses as in the past, based on Federal Reserve data. Nonfinancial corporations (NFCs) invested about 105% of their cash flow back into their businesses from 1980 until 2000, peaking at 126.6% during Q4-2000. Since then, their gross investment has been more cyclical and mostly below 100% (*Fig. 2*). NFCs' net fixed investment as a percent of their cash flow was at 15.4% at the end of last year, down from its recent peak of 21.9% during Q4-2014 and the prior peak of 34.1% at the end of 2007 (*Fig. 3*).

(4) *Capital goods orders not good*. Revealing a similar trend, the US Commerce Department reported that orders for nondefense capital goods—an indicator of business investment—posted its third decline in four months during March, after rebounding nicely during 2016 and 2017 (*Fig. 4*).

(5) *Concentrated capex spending.* Even so, capex by S&P 500 companies that have reported Q1 results increased an average of 20% y/y during the quarter, a Credit Suisse analyst found according to a 5/7 MarketWatch article, though the increase is not broad based: "Two-thirds of the first quarter's dollar increase in capex comes from just 10 companies."

The outlays are "concentrated in small cluster of companies in tech and energy sectors," the 5/1 *FT* article pointed out. For example, Google parent Alphabet reported a jump in capital spending from $2.5 billion to $7.3 billion, including the cost of new offices in New York. Energy companies are spending again now that the price of oil has risen.

US Capital Spending II: High-Tech Shift. The BEA data show an extraordinary shift toward technology in capital spending. These trends are not new, as I discuss in Chapter 3 of my book, *Predicting the Markets*. Nevertheless, let's have a look at the latest data:

(1) *More high tech in capex*. Business spending on technology equipment plus software as a percentage of total capital spending in nominal GDP dipped from a recent peak of 33.4% during Q4-2009 to 28.1% during Q1. However, technology spending continues to compose more than a quarter of capital spending in GDP. For historical context, this percentage was just 16% during Q1-1980 before the technology boom of the 1990s further shifted the mix. Adding in R&D shifts the mix higher still to more than 40% during Q1 from about a quarter at 1980's start (*Fig. 5*).

(2) *Real high-tech capex at record highs*. On an inflation-adjusted basis, technology capex in real GDP—including information processing equipment plus software—rose 6.8% y/y as of Q1 to yet another record high. From the start of 2010, such spending rose 47.3%. Businesses have been getting more and more bang for their bucks on all that technology spending, as the related implicit price deflators have fallen dramatically (*Fig. 6* and *Fig. 7*).

(3) *Hardware & software capex running neck-and-neck*. During Q1, real capital spending on information processing equipment rose 9.7% (saar). It rose 47.2% from 2010 through the start of 2018. Real capital spending on software during Q1 increased 3.0% (saar) from the Q4-2017 level and 47.4% from the start of 2010 through the start of 2018 (*Fig. 8*).

(4) *Capex on computers stalled*. In the information equipment category, it's interesting to see that business spending on computers and peripherals was basically flat from the start of 2010 through Q1, while capex on other information processing equipment rose 62.7% (*Fig. 9* and *Fig. 10*).

Some of the flatlining of computers spending may simply reflect a shift into other information processing equipment. It is also possible that technology equipment spending has become harder to capture in the GDP accounts. With technology increasingly embedded into all sorts of equipment, technology spending has become more difficult to isolate.

Moreover, spending in real terms may be taking companies much further than before. For example, innovations like the cloud have enabled businesses to spend less on computers and extract more value out of software spending than in the past. Innovations like these have greatly reduced the need for large IT departments to maintain bulky and expensive mainframe computers.

(5) *Consumers are techies too*. It's not just technology spending by businesses that has increased. Consumers' technology spending has too. In nominal GDP terms, personal consumption expenditures on computers and peripheral equipment plus computer software and accessories has increased by 1.4% (saar) during Q1 and, more impressively, by 52.9% since 2010 (*Fig. 11*).

US Capital Spending III: Buybacks by the Way. Several Street analysts have performed separate calculations for actual and expected capital spending among large companies. Some have also attempted to reflect that against the growth in spending on buybacks. No clear consensus exists on whether the growth in capex will outpace the growth in spending on buybacks.

For the 130 companies in the S&P 500 that had reported Q1 results as of April's end, capital spending increased by an average of 39% y/y during the quarter, per UBS AG data as reported by Bloomberg, while net buybacks rose by 16% y/y. According to the *FT's* account, Goldman Sachs analysts estimated in February that capital spending would increase 11% y/y, outpaced by a 23% y/y increase in buybacks. Morgan Stanley researchers recently estimated that companies would spend about 43% of their tax savings on buybacks and dividends, compared to about 30% on capital expenditures and labor, according to the *WSJ*.

What do we say? We think that the current bull market will continue to be driven by significant buybacks, as it has been almost since it started.

Trade: Hasta La Vista NAFTA? The new NAFTA is beginning to look a lot like the old NAFTA (*Fig. 12*). Unless, of course, the new NAFTA is no NAFTA at all*.* The May 17 deadline set by US House Speaker Paul Ryan for the Republican-controlled Congress to have enough time to consider a revised free-trade agreement this year is fast approaching, while sticking points among the US, Canada, and Mexico remain unresolved.

With the Mexican presidential election scheduled for July 1 and mid-term elections in the US this fall currently favoring the Democrats, this could be the last chance for a revamped North American free-trade agreement that would bear Trump's imprimatur, as we pointed out in the 4/26 *Morning Briefing*. There's an outside chance, too, that US trade representative Robert Lighthizer might withdraw the US from NAFTA if certain provisions favored by the Trump administration aren't likely to be approved, an effort to try and bully Congress to choose between a "bad" NAFTA versus no NAFTA, according to a 4/20 article on Politico. With one day left to go, I asked Sandra Ward, our contributing editor, to review where things stand on NAFTA:

(1) *Autos.* Rules on cars and auto parts are center stage (*Fig. 13*). Negotiators from the US, Canada, and Mexico have agreed to increase the percentage of content in a vehicle that has to be sourced from North America, a 5/10 *WSJ* piece explained. New rules would also require that a significant percentage of cars be produced by laborers earning higher wages, a condition that would penalize Mexican factories.

But the devil is showing up in the details. US proposals call for 40% of a car's content and 45% of a light truck's to be produced by workers earning at least $16 an hour in order to qualify for duty-free treatment, in an effort to boost automobile jobs in the US. On the other hand, Mexico proposes that 20% of a car be assembled by workers earning around $16 an hour. That is significant when you consider Mexican vehicle-assembly workers earned less than $8 an hour on average in 2017 and those at auto parts plans made less than $4 an hour.

White-collar work could represent up to 15% of the US's proposed 40% threshold, allowing duty-free treatment for cars in which 25% of the physical content was produced by higher earners. Again, that detail benefits US automakers because the bulk of their research, design, and marketing is done in North America, a 5/7 *WSJ* article reported.

Global vehicle makers with factories throughout the Southeast US have voiced concerns about some of these provisions. An official at Global Automakers—a group that includes Toyota Motor and Kia Motors—said "It is important that the agreement create feasible automotive rules that treat all US auto producers equally."

(2) "*The skinny.*" With the focus on overhauling critical auto rules, a "skinny" deal is possible: Rules governing auto and auto parts trading would take precedence while more controversial areas would face fewer changes, according to the 5/10 piece in the *WSJ.*

(3) *Other issues.* One of the thorniest issues outside the auto rules under negotiation is a US proposal to scrap a dispute-resolution system known as the "investor-state dispute resolution," which protects businesses and their interests abroad. A US demand for a sunset clause in which the agreement would be renegotiated every five years is seen as onerous and frustrating negotiators. Also, agricultural interests are alarmed that Trump could pull out of NAFTA, throwing US agricultural exports to Canada and Mexico into upheaval.

(4) *Dollar threat.* As the US is determined to change the global trading landscape, its partners are increasingly striking their own independent deals. Some warn that this ultimately may erode the US dollar's position as the world's dominant reserve currency, according to a 5/13 *WSJ* article, as more and more countries diversify their reserves, increasing holdings of the euro and Chinese yuan. At the end of 2017, central banks held about 63% of their reserves in US dollars, the lowest in four years, according to International Monetary Fund data, while euro reserves had risen to 20%, and Japanese yen investments to 5%.

There are a lot of ways to improve and modernize NAFTA without jeopardizing an agreement that has benefited many interests in all three countries. Let's see what happens when Ryan's deadline occurs tomorrow.

Italy: Post-Election Update. More than two months after Italians voted by a wide margin for the anti-establishment and populist Five Star Movement in general elections held on March 7, the group is on the verge of forming a coalition with The League, a far-right, anti-immigration party, to govern the country. A government could be formed by the end of the week, staving off new elections, according to a 5/14 article in *The Independent.*

In agreeing to generous tax cuts and big increases to entitlement programs, the two groups appear to be putting Italy on a collision course with the budgetary constraints of the European Union. Yet Italian 10-year bond yields traded below recent six-week highs on Monday, according to a 5/14 Reuters article

(*Fig. 14*). Investors remained focused on the stronger economy and held fast to some of the highest yields in the European investment-grade debt market.

CALENDARS

US. Wed: Headline & Manufacturing Industrial Production 0.6%/0.3%, Capacity Utilization 78.3%, Housing Starts & Building Permits 1.324mu/1.350mu, MBA Mortgage Applications, Atlanta Fed Business Inflation Expectations, EIA Petroleum Status Report, Bostic, Bullard. **Thurs:** Leading Indicators 0.4%, Jobless Claims 215k, Philadelphia Fed Manufacturing Index 21.0, Weekly Consumer Comfort Index, E-Commerce Sales, EIA Natural Gas Report. (*Wall Street Journal* estimates)

Global. Wed: Eurozone CPI 1.2%/0.7% y/y, Germany CPI 0.0%m/m/1.6%y/y, Japan Machine Orders 0.6% y/y, Draghi, Jordan. **Thurs:** European Car Sales, Japan CPI Headline, Core, and Core-Core 0.7%/0.8%/0.4% y/y, Australia Employment Change & Unemployment Rate 20k/5.5%. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500 Q1 Earnings Season Monitor (*link*): With over 91% of S&P 500 companies finished reporting earnings and revenues for Q1-2018, the earnings metrics are stronger compared to the same point during the Q4 season and the best in seven years, but revenues are a tad weaker than during Q4. Of the 456 companies in the S&P 500 that have reported, 79% exceeded industry analysts' earnings estimates by an average of 7.3%; they have averaged a y/y earnings gain of 24.9%. At the same point during the Q4-2017 reporting period, a lower percentage of companies (76%) in the S&P 500 had beaten consensus earnings estimates by a lower 4.8%, and earnings were up a lower 16.3% y/y. On the revenue side, 76% beat sales estimates so far, with results coming in 1.1% above forecast and 8.3% higher than a year earlier. At this point in the Q4 season, a higher 79% had exceeded revenue forecasts by a higher 1.3%, and sales rose by a tad-higher 8.5% y/y. Q1 earnings results are higher y/y for 86% of companies vs a lower 79% at the same point in Q4, and Q1 revenues are higher y/y for 87% vs 88% a quarter ago. These figures will likely change little as the rest of the Q1-2018 results are reported in the coming weeks. With the season now winding down as investors await retailers' results, it looks like Q1-2018 will mark the seventh straight quarter of positive y/y earnings growth and the strongest since Q4-2010 in part due to lower tax rates.

US ECONOMIC INDICATORS

Retail Sales (*link*): Consumers kept shopping in April after taking a break from December through February. Retail sales expanded 0.3% last month after an upwardly revised 0.7% (from 0.6%) gain in March, following no growth in February and slight declines in January and December. Core retail sales expanded 0.4% last month, following upward revisions to March (to 0.5% from 0.4%) and February (0.1 from 0.0). (The BEA uses this core retail sales measure to estimate personal consumption expenditures each month.) We estimate real retail sales were flat in April after a two-month gain of 1.4%. These sales rose 0.7% (saar) during the three months through April, based on the three-month average, after contracting 2.5% over the equivalent March period. We estimate real core retail sales were flat in April, after climbing 1.4% during the two months ending March. These sales rose 0.4% (saar) over the comparable three-month period after sinking 2.3% last quarter. Nine of the 13 major nominal sales categories rose in April, led by the biggest gain in clothing store (1.4%) sales in more than a year, while miscellaneous (0.9), furniture (0.8), gasoline (0.8), and nonstore (0.6) retailers also posted solid gains. Declines in the four categories in the red—health & personal care (-0.4), restaurants (-0.3), electronic & appliance (-0.1), and sporting goods (-0.1) stores—were relatively small.

Business Sales & Inventories (*link*): Nominal business sales in March climbed to another new record high, while real sales in February ticked up after retreating in January from December's record reading. The details: Nominal manufacturing & trade sales (MTS) more than reversed January's 0.3% decline, rebounding 0.9% in the two months through March, with the yearly growth rate accelerating 6.4%. Inflation-adjusted MTS edged up 0.1% after sinking 1.0% in January—which was its first decline in nine months. These sales had rebounded 3.9% during the last eight months of 2017. Real sales of both retailers and wholesalers held below November's record high, while manufacturers' sales remained stalled at their cyclical high. February's real inventories-to-sales ratio remained at 1.42, up from 1.40 during the final two months of last year—which were the lowest readings since mid-2013. March's nominal inventories-to-sales ticked down from 1.35 to 1.34, near its three-year low of 1.33 during the last two months of 2017.

Regional M-PMI (*link*): Activity in the New York Fed district, the first to report on manufacturing for this month, accelerated in May, remaining firmly in positive territory. The composite index climbed from 15.8 to 20.1 this month—fluctuating just below October's 37-month high of 28.1. Both new orders (16.0 from 9.0) and shipments (to 19.1 from 17.5) showed faster growth than last month, while delivery times (13.7 from 15.6) continued to lengthen and inventory levels (10.1 from 8.1) continued to accumulate. As for labor conditions, the employment (8.7 from 6.0) measure showed faster, but still modest, jobs growth, while the average workweek (11.1 from 16.9) was longer. The prices paid (54.0 from 47.4) index accelerated to its highest reading since June 2011, while prices received (23.0 from 20.7) remained elevated. Looking ahead, the index for future business conditions (31.1 from 18.3) improved, but fell short of levels enjoyed in recent months.

GLOBAL ECONOMIC INDICATORS

Eurozone GDP Flash Estimate (*link*): The Eurozone economy expanded 0.4% during Q1, according to the GDP flash estimate, slowing from gains of 0.7% during each of the prior three quarters. Among the four largest economies, Spain (0.7%) was the only one to record growth above the Eurozone's 0.4% pace, while Germany, France, and Italy all fell short, rising 0.3% during the quarter. Both Spain and Italy matched their Q4 growth rates, while France and Germany slowed from advances of 0.7% and 0.6%, respectively, during Q4.

Eurozone Industrial Production (*link*): Output in March increased for the first time since reaching a new cyclical high in November. Industrial production (excluding construction) recovered 0.5%, after falling 1.6% during the three months ending February—which was the longest stretch of declines since fall 2012. March's advance was led by a rebound in consumer durable (1.5%) and nondurable (1.1) goods production, along with a 0.8% gain in energy output—which was the fourth advance in five months, for a total surge of 4.3%. Partially offsetting these gains, were continued declines in capital (-0.6) and intermediate (-0.1) goods production, with the former falling three of the past four months, by a total of 5.2%, and the latter down 2.2% during the three months through March. Data available for the top four Eurozone economies showed sizable production gains in Spain (1.4), Italy (1.2), and Germany (1.1), while output fell in France (-0.4) after a 1.2% jump in February. The largest gains were recorded in in Estonia (+4.1), Portugal (+3.7) and Greece (+2.6), and the largest decreases in Ireland (-7.0) and Latvia (-3.5).

Contact us by email or call 480-664-1333.

Ed Yardeni, President & Chief Investment Strategist, 516-972-7683
Debbie Johnson, Chief Economist, 480-664-1333
Joe Abbott, Chief Quantitative Strategist, 732-497-5306

Melissa Tagg, Director of Research Projects & Operations, 516-782-9967
Mali Quintana, Senior Economist, 480-664-1333
Jackie Doherty, Contributing Editor, 917-328-6848
Valerie de la Rue, Director of Institutional Sales, 516-277-2432
Mary Fanslau, Manager of Client Services, 480-664-1333
Sandy Cohan, Senior Editor, 570-775-6823