As we close out the year, a robust US economy, revised tax code and repatriation of foreign earnings has provided many US companies with a boost to profit growth which typically signals a resurgence of capital-expenditure spending (capex) and a strong growth outlook. However, as we approach 2019, companies’ capex spending is slowing slightly. While it will still be one of the key drivers to growth in the next year, we believe that capex is not as robust as the headlines imply. In fact, we believe the risk in the downside predictions is that they are not realistic enough, due largely to masked modest trends in growth, uncertainty in trade, and waning foreign direct investment (FDI).

Not the full story

After record spending by companies in the S&P 500 Index in the first half of the year, capex is not as strong as many believe it to be. Consider structure and equipment (S&E) capex—the tangible components accounting for two-thirds of total capex—which is currently at $1.9 trillion. Exhibit 1 illustrates that structure and equipment (S&E) industry capex has grown 6-7% year on year. But, this has been significantly boosted by the recovery in energy capex after an enormous decline in 2015 and 2016. Ex-energy, the rally in S&E capex has been less thrilling. Energy is only 8% of total S&E capex, but it is growing 20% year on year—down from 60%. When the energy component from capex is removed, tangible capex is growing at less than 5%. In short, the 30-50% year-on-year growth in energy capex—after a 60% decline in absolute levels over the past few years—is masking modest capex trends elsewhere.

Exhibit 1. Impact of Energy CapEx on Overall Structure & Equipment CapEx

![Chart showing impact of energy capex on overall structure & equipment capex]

Source: BEA and Haver Analytics. As of September, 2018.

Trade wars

Uncertainty surrounding tariffs and trade could affect capex and FDI as projects that typically have long lead times and changing trade landscape can dramatically alter the economic viability. This, coupled with Democrats threatening to reverse the corporate tax cut and it is understandable that capex surveys have seemingly peaked, reflecting growing caution by management teams to increase capex spending. Economic symptoms of lower trend growth also indicate increased caution. What is also not helping is the high relative hurdle rate—return on equity of S&P 500 is currently at 15%, making the argument for stock buybacks quite compelling. With these factors in motion, we think the skew of risk distribution to consensus growth forecasts is to the downside.

What does it mean?

Capex is a key driver to above-trend growth in 2019. If capex falls below consensus expectations, downside risks to current gross domestic product forecasts could force the Federal Reserve to lower the dots on its projected interest rate dot plot and hike rates less than the dots will imply. After a year of strong capex spending buoyed by Trump’s tax law, the US’ solid rule of law and advantaged energy costs, the outlook on capex should tell a more robust story. While the general consensus sees a slight slowing of capex spending, we are more cautious going into year-end as we think the risk is asymmetrically skewed to the downside.
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