SPECIAL REPORT

TD Economics

September 6, 2016

U.S. BUSINESS INVESTMENT: DOWN, BUT NOT OUT

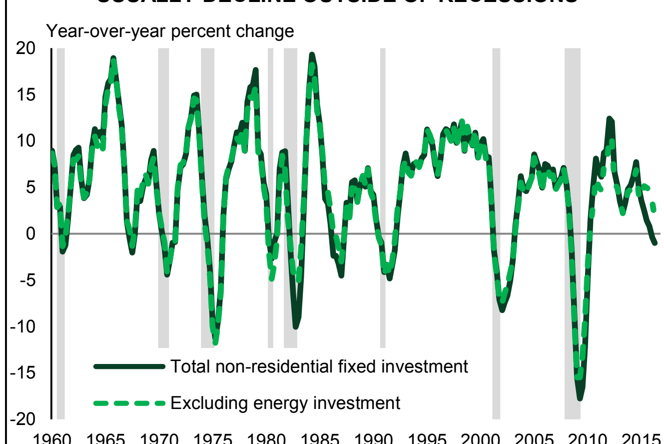
Highlights

- Despite record-low interest rates, businesses in the United States have been pulling back on investment. Depressed activity in the mining sector explains some of the weakness, but not all of it. Over the past year, it has spread to other sectors as well.
- In addition to falling commodity prices, the rapidly rising dollar, tighter lending standards in oil-producing regions, and changes in tax policy have contributed to the recent downturn.
- As headwinds dissipate, investment is likely to rebound in the second half of this year. With the bulk of the adjustment in commodity prices and the dollar now in the rear-view mirror, investment should benefit from a more stable profit outlook and a broad improvement in financial conditions.
- A lower rate of trend economic growth relative to history implies a slower rate of investment growth. This is a global phenomenon and explains the persistence of low interest rates both in the United States and around the world.

Investment has been a soft spot for the American economy. Over the past year, business investment in equipment and structures has fallen 1.3%. This is not a dramatic decline, but it is notable. Over the past 64 years (for which there is quarterly data), investment has only declined on a year-on-year basis twice outside of recessions, once in the mid-1980s and once in the late 1960s (Chart 1). On both of these occasions, investment came off several quarters of strong double-digit growth. No such boom has taken place recently.

Much of the weakness in investment has been concentrated in the mining sector (and oil and gas in particular). However, over the first two quarters of this year it appears to have spread to other areas as well. This is worrisome. A decline in investment not only subtracts from near-term economic growth, but also threatens the productive potential of the country by reducing the stock of equipment available to a growing pool of workers. Perhaps even more than that, declining investment casts doubts about the expansion itself. If businesses lack the confidence or ability to invest, hiring may not be far behind.

CHART 1: BUSINESS INVESTMENT DOES NOT USUALLY DECLINE OUTSIDE OF RECESSIONS



Source: Bureau of Economic Analysis, TD Economics.

So, where is investment likely to go? The good news is that several headwinds to investment earlier in the year have begun to dissipate. For businesses that export, a rapidly rising dollar not only cut into profits, but, without an end in sight, made investing in future production even more precarious. Since reaching a high early this year, the dollar has moved lower. This development has been matched by a broader improvement in financial conditions over the past several months.

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At the same time, the domestic demand backdrop has improved markedly from early in the year. Consumer spending accelerated in the second quarter and, supported by income growth, is likely to remain robust over the second half of the year. This, in turn, should put upward pressure on capacity utilization, incenting greater business investment.

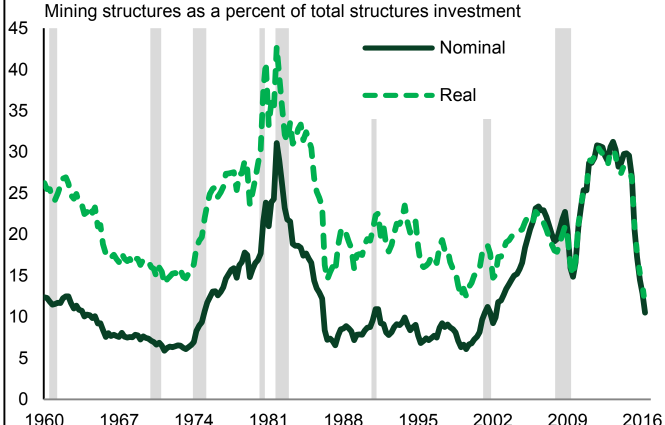
The bottom line is that with a more stable commodity price environment, investment is likely to stage a comeback over the next several quarters. Nonetheless, with an aging population and weak productivity weighing on economic growth (both domestically and globally), the pace is likely to remain modest. Slow investment growth does not preclude the Federal Reserve from raising interest rates, but it is another argument for it to proceed with caution.

Drag from oil-related cutbacks was deep, but the worst is over

The weakness in investment is most apparent in areas directly related to mining and oil and gas. As the price of oil and other commodities declined over the past two years, investment in mineral exploration and new oil wells fell a whopping 63%, hitting its lowest level in 45 years.

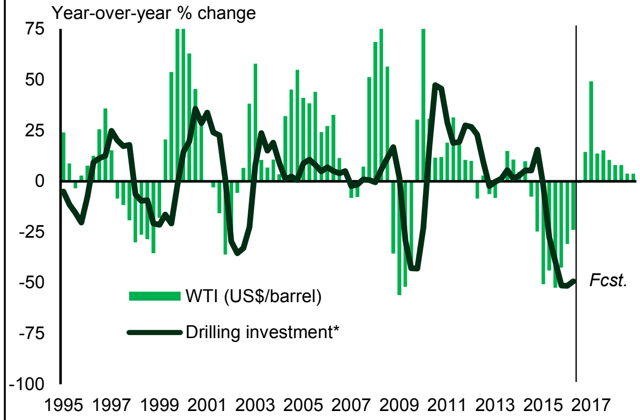
While mining activity is a small part of the overall American economy, it had become a significant part of investment spending. Within structures, mining investment (including petroleum and natural gas) rose to represent over 30% of total investment through 2013 (Chart 2). Within equipment investment, the most directly-related category, "oil-field equipment investment" rose to 5% of overall equipment investment at its peak in 2014. After six consecutive quarters of double-digit declines, however, the share of direct oil-related investment has fallen considerably. Within structures it now represents just 11% of the total and within equipment, oil-field equipment is just 1.4%.

CHART 2: MINING INVESTMENT HAS FALLEN OFF A CLIFF IN PAST TWO YEARS



Source: Bureau of Economic Analysis, TD Economics.

CHART 3: DRILLING INVESTMENT TENDS TO FOLLOW OIL PRICES



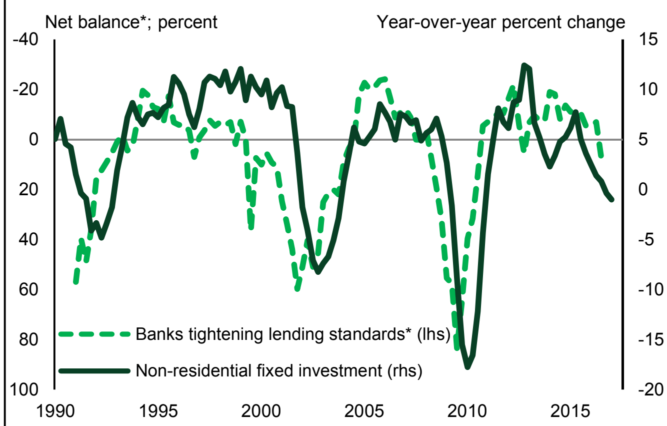
Real investment in petroleum and natural gas exploration/wells.
Source: Bureau of Economic Analysis. WTI forecast by TD Economics

With a considerably smaller footprint, the oil-sector will play a smaller role in determining future investment. It is also unlikely to continue to decline much from here. Investment in oil exploration has followed the price of oil closely with a lag of one to two quarters (Chart 3). After averaging $34 in the first quarter, the benchmark WTI oil price rebounded in the second quarter to $44 and has remained relatively range bound between $45 and $50 since. The rebound has contributed to a modest turn up in active oil rig count, which is used in the calculation of structures investment. As long as the price of oil remains relatively stable at current levels, the drag from oil-related investment is likely to cease. With a gradual rebound in oil prices, this will likely even to contribute marginally to economic growth in the year ahead.

Tighter lending standards appear limited to oil-producing regions

Over the last two quarters, investment has fallen for a broader set of categories including information processing equipment (ie. computers), transportation equipment, and other (non-oil field) equipment. Some of the decline in investment likely took place within the oil sector. Unfortunately, without timely data on investment by industry, it is difficult to say how much. But, even outside of this direct effect, there is some evidence that the difficulties faced by this sector have contributed to the weakness observed elsewhere.

CHART 4: TIGHTER LENDING STANDARDS CONTRIBUTE TO INVESTMENT WEAKNESS



*Tightening standards for C&I loans for large and medium firms. Inverted axis.
Source: Bureau of Economic Analysis, TD Economics.

One channel of transmission is through lending standards (Chart 4). In April, the Federal Reserve's Senior Loan Officer Opinion Survey asked a special set of additional questions about loans to the energy sector. The results indicated that the weakness in the energy sector had contributed to tighter lending standards within oil-producing regions.

Fortunately, outside of oil-producing regions, lending standards do not appear to be a significant constraint. The most recent survey in July noted that for the most part the level of lending standards are "easier than the midpoints of the ranges that have prevailed since 2005." The July survey also reported that demand for commercial and industrial loans remained strong into the third quarter. With the tightening in lending standards appearing to be limited to oil-producing regions, some stabilization within this sector should limit any further contagion.

Business spending on vehicles was ripe for a pullback

One of the specific areas to see investment pull back over the first half of this year was transportation equipment. This includes spending on everything from cars and trucks to airplanes and railroad equipment. The drop in railroad equipment appears directly related to the decline in energy prices, which reduced demand for moving oil by rail. However, outside of this, investment in new autos, and business purchases of light and heavy trucks also fell over the past two quarters.

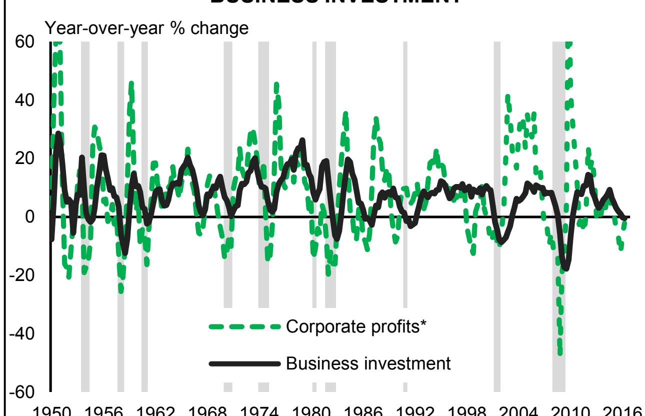
Business purchases of vehicles grew swiftly in the latter half of 2015, with a level of sales reaching a cyclical high. Some of the increase in vehicle purchases in the later part of the year likely reflected the potential expiry of the bonus depreciation allowance at the end of the year. While it was eventually extended by a last minute act of Congress, it would have made sense for businesses to lock in these purchases beforehand. We find some evidence for year-end seasonality in investment that is consistent with this moving around of expenditures. In any case, the pullback in sales over the past several quarters has put the level of sales at a more sustainable level.

Lower borrowing costs and more stable dollar should provide a fillip to profits and investment

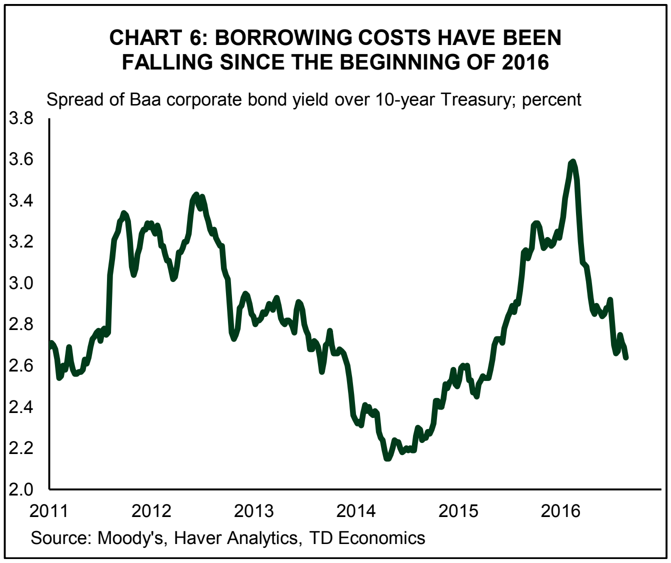
Perhaps the biggest factor weighing on investment growth over the past several quarters has been the decline in corporate profits, driven by both the collapse in commodity prices and the steep rise in the dollar (Chart 5). Over the course of 2015, pre-tax corporate profits fell 12%[1]. Taken together, the decline in the profits of mining and petroleum and coal manufacturing industries explains about half of this decline. Within manufacturing the impact is larger, representing about 80% of the decline over the course of 2015.

The remainder of the decline took place in non-energy industries where the rising dollar played a leading role. The dollar's ascent over the past two years has been steep. To its peak in early 2016, the trade-weighted dollar rose over 20% from its level at the beginning of 2014. The dollar has pulled back since, and, as of writing, is down 4% from its early-year high. While the dollar may continue to edge higher from its current level, any future increases are likely to be modest compared with the those of the past two years. In the meantime, the pullback in the dollar has contributed to a 4% rebound in corporate profits over the first half of

CHART 5: CORPORATE PROFITS LEAD BUSINESS INVESTMENT



*Pre-tax corporate profits without inventory adjustment and capital consumption allowance. Source: BEA, TD Economics



this year. Profit growth tends to lead investment by one two quarters. The rebound augurs for a fillip to investment growth in the second half of this year.

Just as encouraging, financial conditions, as measured by the performance of the equity market, and corporate bond spreads, have improved substantially since early in the year. The spread between the Moody's Baa corporate bond index and the 10-year Treasury yield rose substantially over the final months of 2015 and early 2016 (Chart 6). This spread has fallen measurable since then and is now below its average since 2010. With the decline in Treasury yields, corporate borrowing costs have fallen considerably with the highest quality Moody's Aaa bond yield falling 75 basis points, and lower quality Baa bond yields falling an even greater 125 basis points since their early-year peaks.

The combination of better financial conditions and ongoing support from domestic spending, business investment is likely to rebound in the upcoming quarters. This is backed up by monthly capital goods orders, which rebounded in June and July of this year. Based on this and expectations for investment by businesses themselves, as reported in regional Federal Reserve manufacturing surveys, our leading indicator for business investment suggests a return to positive growth in the third quarter of this year.

Weak economic growth = slow investment = low interest rates

At a high level, business investment is dependent on two primary factors: the cost of capital, which is influenced by borrowing rates, tax rates and changes in relative prices of investment goods, and the overall pace of demand growth. As mentioned, the first factor is broadly supportive of investment. However, the second is less so (Chart 7). The rate of economic growth in the United States and globally is likely to remain modest over the next several years.

With unemployment close to its natural rate, economic growth domestically will be determined primarily by underlying growth in the labor force and trend labor productivity. Both of these appear slower than they have been historically. As the population ages and more baby boomers exit the labor force, trend labor force growth is likely to slow to a rate around 0.5%. Trend productivity growth, meanwhile, also appears lower than it has been historically. While some of this is attributable to the weakness in past investment growth, much of it appears related to a slowdown in the rate of technological change as measured by total factor productivity. Over the past five years, this has averaged just 0.5%, less than half its long run average of 1.3%.

Investment may be further impeded by a heightened level of uncertainty. Some of this is simply a function of a slower growth rate, which implies a smaller buffer between gains and losses. But, economic and political uncertainty appears particularly elevated right now in the run up to the Presidential election, the aftermath of Britain's vote to leave the European Union, and China's ongoing growth re-balancing. So, while business investment is likely to rebound, with elevated uncertainty, and a timid rate of global economic growth, the rate of growth is likely to remain in the single-digits.

The bottom line

The persistence of low investment demand and relatively

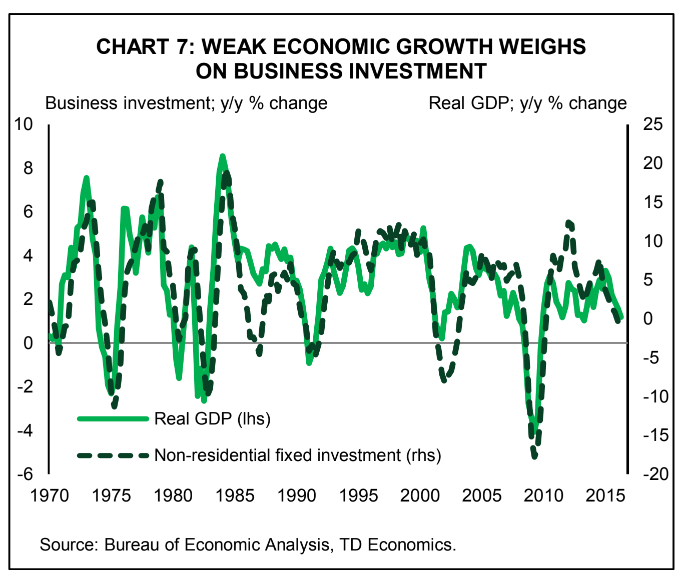
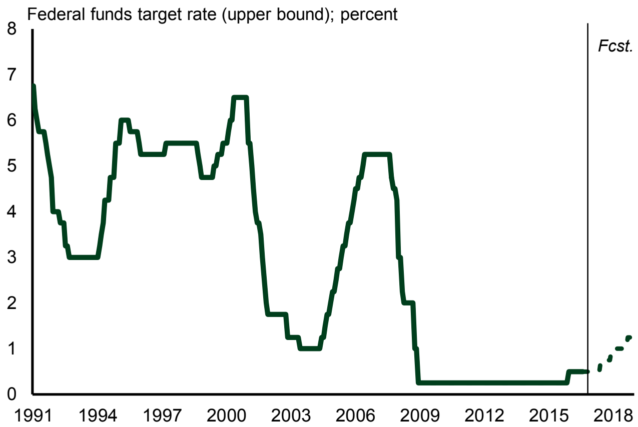


CHART 6: AS LONG AS THE FED IS THE ONLY GAME IN TOWN, RATES WILL REMAIN LOW



Source: Federal Reserve, TD Economics.

high savings explains the current low interest rate environment. Some of this is due to the lingering uncertainty created by the global financial crisis, while some it pre-dates it and reflects longer-lasting structural challenges. To these challenges, the last two years have added a swift reversal in global commodity prices that have caused an equally rapid decline in mining and related investment.

Investment is likely to recover from the shock to profits brought on by falling commodity prices and a rising dollar. However, with continued weakness in the overall level of demand growth, the rebound will be modest. Two key takeaways come from this. First, with interest rates likely to remain low, there is role or public infrastructure investment to compliment private investment. Second, in the absence of a change in fiscal policy, the Federal Reserve will remain the only game in town. So, while continued improvement in the labor market may lead the Fed to nudge up interest rates, the path higher is likely to be extremely gradual.

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ENDNOTES

1 This refers to pre-tax profits excluding the inventory valuation adjustment, the more relevant measure for business investment.