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MARKET INSIGHTS

The latest Market Insights
from the Connected Wealth team

Capex, Where art thou?

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The economy, or GDP, has a rather straight forward calculation:

$$GDP = C + G + I + (X - M)$$

Sorry, you probably weren't expecting some simple algebra. C is private consumption, G is government investment and X-M is net exports. Today we are going to talk "I" or gross investment. "I" has a number of components and also tends to be one of the more volatile in the economy. Included in "I" is residential and non-residential construction. But we are going to narrow our focus even more, down to what corporations are investing in their own business, corporate spending or Capex, such as a plant, equipment, technology, etc. It not only is an indication of corporate behaviour and outlook for demand growth, but has an oversized impact on the equity markets and earnings.

Capex Disappearing Act

This cycle was not all that different than past cycles. In the 2003 to 2008 cycle, Capex grew from $650B to just over $900B. Capex then dropped from $900B down to $630B, clearly showing how volatile this piece of the economy can be. The current cycle saw Capex growth from $630B to over $1 trillion but then it started to turn south (chart right). Since mid-2014, Capex stalled and more recently started moving lower. This also coincided with the onset of negative earnings growth for the S&P and the drop in oil prices. This is not a spurious correlation, they are very connected.

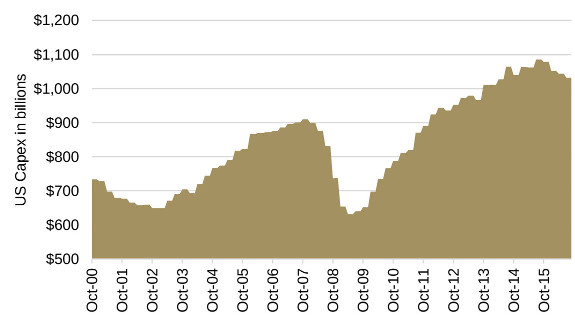
Energy Capex had been the primary driver of Capex during this cycle thanks to the shale revolution. Money was pouring into the space and materially stopped in 2015. Non-energy Capex was growing but at a more muted pace than past cycles. This cycle has seen very low end demand growth, which is evident in GDP expanding only 2% since 2009. The fact is if demand is not rising, companies don't need to spend money to increase production capabilities. Instead, they have opted to take excess cash flow and return it more and more to shareholders in the form of higher dividends and share buybacks.

We believe this is poised to change in 2017 as Capex makes a comeback.

Market Outlook 2017

Next week we will be publishing our Market Outlook so get ready. The report takes a quick look back at 2016 and then dives right into what the Connected Wealth team believes are the market movers ahead. Where we are in the market cycle, as the bull turns eight years old, and whether or not it is set to end anytime soon. Plus some key themes including a look at the reflationary environment we have been in during the past couple quarters. Other key themes include a return of government and corporate spending growth, earnings recovery, the Canadian dollar and bonds. Plus, the three risks that could trigger a bout of market weakness. Now back to our regular scheduled report.

The Capex cycle in action - but why the recent drop?



Capex Growth Returns – why now?

Capex had declined over 4% in 2016 as of the third quarter GDP report, so why do we believe now is the time?

Confidence is one. The Philly Fed Capex Intentions survey was the highest we have seen in over 15 years and this index correlates very well with Capex or corporate spending patterns (top chart).

Aggregate **economic growth** does appear to be gaining momentum. Again, there is no need for Capex unless there is rising demand for what companies are producing. We have been seeing better economic data globally, manufacturing has been rising, GDP revisions are positive. The evidence that we may be looking at better economic growth in 2017 continues to mount, and a better economy does entice companies to increase Capex.

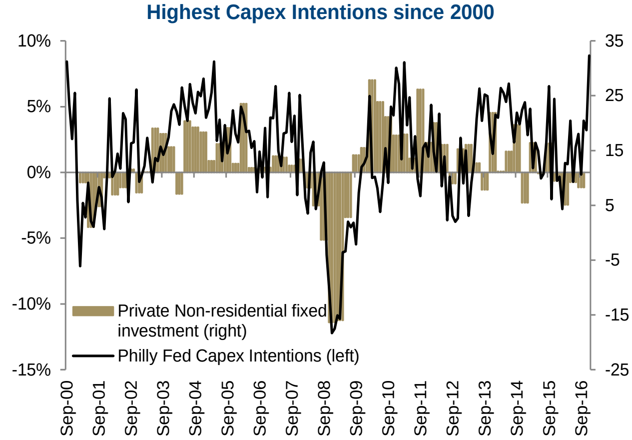
Energy Capex has returned as well, a little. The number of active drilling rigs bottomed in June of last year and have been rising steadily (2nd chart). Also, the Capex intentions of E&Ps plus Integrated oil companies are expected to be higher in 2017 than 2016. This is based on the Capex guidance from each of the companies in the industry. To put this in perspective, these companies were spending about half a trillion dollars on Capex each year from 2012 to 2014. It then dropped to $350B in 2015 and $243B in 2016. Year 2017 is forecast to be $253B, not great but higher is much better than lower.

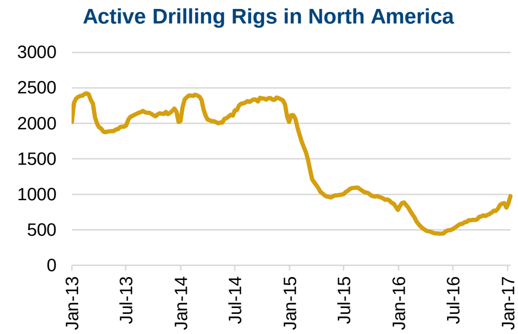
Trump may be helping. Maybe a little due to the tactics to keep more plants in the U.S. but more so from tax reform. Details are light and vague, but lower tax, repatriation of overseas capital, potentially accelerated depreciation, all bode well for Capex spending.

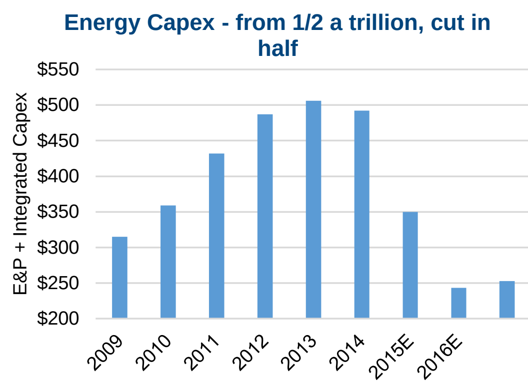
Who Wins with Capex Returning?

The two sectors that stand to benefit the most are Industrials and Technology. However, not across the entire sectors. In Industrials it is building products, construction and engineering, electric equipment, machinery, conglomerates and professional services, to mention a few. Technology software and hardware would benefit, however it is the companies or sub-industries that cater more to servicing businesses.

The market wins as well, given how sensitive overall S&P 500 earnings are to corporate spending.







Charts are sourced to Bloomberg unless otherwise noted.