Louisiana Corporate Credit Union

ECONOMIC & FINANCIAL DIGEST

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Missing Ingredient: Investment Spending

The Federal Reserve had second thoughts about its plans for interest rates that it proposed in December. At the policy meeting held that month, the central bank raised its benchmark short-term interest rate by a quarter-percent, the first increase in nearly a decade, and indicated that it would raise it four more times in equal quarter-point increments, most likely starting in March. But as they say, the best-laid plans often go astray. Instead of following up with the second installment, the Fed punted at its March meeting, opting instead to keep rates unchanged for a while longer.

This is not the first time the central bank altered its plans, nor will it be the last. Stuff happens. Between December and March, the financial markets were hit with a wave of turbulence that saw stock prices plunge and then recover, the dollar soar and then sink and oil prices swing between $30 and $40 a barrel. Meanwhile, the global headwinds gathered force: the International Monetary Fund lowered its forecast for global growth, with a major drag coming from the ongoing slowdown in China and a deepening recession in Brazil, and central banks in Japan and Europe continued to grapple with deflationary forces, sending interest rates into negative territory. So far, the U.S. has emerged relatively unscathed from these developments. But there may be lagged effects; Fed officials understandably feel it's best to wait a month or two to see how well the economy holds up before deciding on the next move.

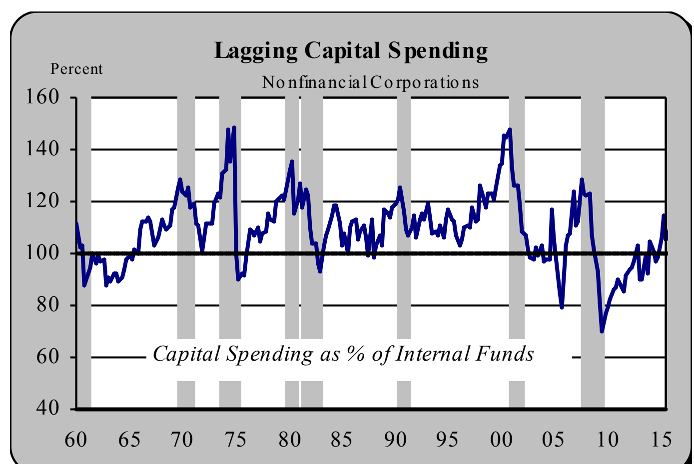
That said, policy makers have to be mostly pleased with the economy's performance since they met in December. The job market continued to improve, not only by generating a healthy number of new jobs but also by luring new and discouraged job seekers back to the labor force. Lifting the labor force participation rate from its 38-year low – a measure of how much slack there is in the job market – has been one of the key goals of the Fed. Another is boosting the inflation rate, which has languished well below the elusive 2 percent target for nearly four years. Here too, the news is getting better; inflation is still running too low, but unlike in Europe and Japan it is fitfully moving up. The latest figures put inflation within reach of where the Fed would like it to be. If recent trends stay on track, the Federal Reserve can resume its aborted plan to restore a more normal monetary policy in coming months. Still, there are hurdles to overcome, most notably the reluctance of businesses to step up capital spending.

Holding Back

Seven years into a recovery, the economy should be operating on all cylinders. Sadly, that's still not the case. Forget for the moment that none of the main growth drivers has been running at speeds normally seen during upturns. Housing activity has finally revved up over the past year or so, but its contribution is coming much later than it normally does during recoveries. What's more, this sector has shrunk so much during the housing bust that its influence on overall growth is greatly reduced. The economy's primary motor, consumer spending, has been on a persistent, if erratic, forward glide path; but it too has been cruising at speeds well below past recovery yardsticks. The government, of course, has been an absentee tailwind for some time, only recently emerging from an austerity mindset that has hobbled growth.

But a critical outlier throughout the recovery has been the business sector. Despite racking up hefty profits, companies spent a much smaller proportion of their cash flow on investments than in past cycles. Indeed, this has been the only upturn since at least as far back as 1960 that nonfinancial corporations plowed less than 100 percent of their internal cash flow into spending on plant and equipment. On average capital spending equaled 93 percent of cash flow from the start of the recovery in mid-2009 to the end of 2015. The average share over the previous seven upturns was 111 percent.

To be sure, the balance reversed in 2015, with capital spending finally exceeding internal funds. But that was mainly because profits slumped during the year, dragged down by plunging revenues in the energy sector. That drag affected the other side of the ledger as well, as investment in oil drilling and exploration also ground to a halt. Still, the resistance to spend was broadly based in both dollars and real terms. Even worse is that the recovery received less of a boost from capital spending over



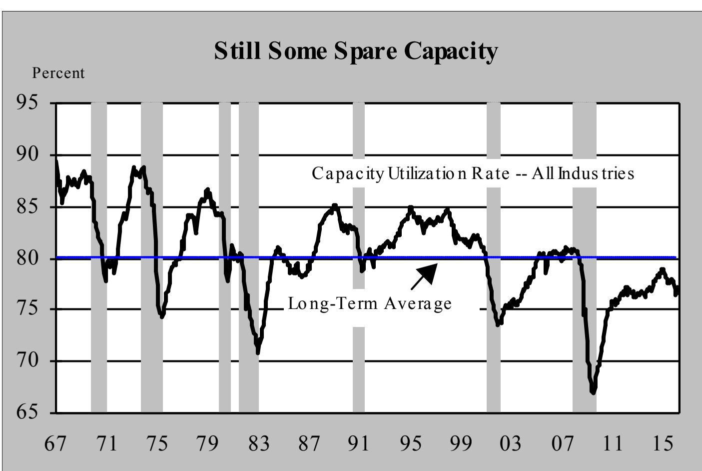
the past year than in the previous one. In 2015, real nonresidential outlays increased by just 2.9 percent, less than half the 6.2 percent gain in 2014. In the fourth quarter, such spending actually declined for the first time since the second quarter of 2012.

Unusual Pattern

The weak contribution of business spending to the recovery has been bad enough. But the sputtering out so late in the upturn is even worse, as that is when capital spending usually steps in as a key driver of growth. Underscoring this time-honored role is that late in a recovery companies tend to be operating at or near full capacity, spurring the need for expansion. Additionally, aging equipment needs to be replaced and software needs to be upgraded with the latest technology to maintain productivity.

But these spurs to spending have not kicked in this time. One reason: the unprecedented plunge in production during the Great Recession left industry with a huge amount of excess capacity. Compounding the problem, the vigorous rebound in activity that usually follows a severe downturn never materialized. Instead, the recovery progressed in fits and starts, with growth averaging about half the pace of previous postwar upturns.

As a result, it has taken longer to whittle down spare capacity than usual. Even now, the capacity utilization rate, at 76.7 percent, is 3.3 percentage points below its long-run average, and even further below the 83-85 percent typical of late-stage expansions, when supply bottlenecks force companies to rev up expansion plans. The shortfall is even more striking considering that private companies are adding to their capital stock at a historically low rate. According to the Commerce Department, net additions to the stock of buildings, equipment and software of private companies have averaged 3.9 percent a year between 2010 and 2014 compared to a 7 percent average since 1960.



Productivity Slowdown

The reluctance of companies to invest in structures, equipment and software has not just deprived the economy of a much-needed cyclical boost. It also deprives workers of more efficient tools of production and, hence, contributes to weaker productivity, the indispensable condition leading to rising living standards over the longer-run. After all, when companies can squeeze more output from the labor force they can afford to give larger pay raises to workers without hurting profits or raising prices. That's a win-win situation for both workers and consumers, who ultimately are the very workers with more cash to spend.

It may be no accident that the historically low additions to capital stock since the Great Recession have coincided with a significant slowdown in productivity. Over the last six years, productivity growth among nonfarm businesses slowed to 1.0 percent from a 2.5 percent annual rate from 1990 through 2005. Nor is the stagnant growth in worker pay unrelated to the productivity slowdown. Companies alter the mix of capital and labor to generate output according to the relative costs of these inputs. When labor is cheap, as has been the case during the recovery, it is more cost effective for employers to substitute labor for capital. As the ratio of hours worked per unit of output increases, productivity suffers. Indeed, the productivity slowdown in recent years helps explain why job growth has been so much stronger than economic growth. More workers were needed to generate each unit of output.

The good news is that there is a point of diminishing returns to this tradeoff. As the supply of workers is drawn down, worker pay increases, driving up unit labor costs and prompting companies to recalculate the advantage of substituting labor for capital. It's unclear if that inflection point has yet been reached. The increase in worker earnings accelerated towards the end of last year, but the momentum faded in February. Reflecting the productivity slowdown, however, unit labor costs increased by an average of 2.4 percent over the last three quarters of 2015 compared to a 1.4 percent average since 1990.

Tepid Outlook

To be sure, the decision of companies to increase capital spending is not just based on relative input costs. If corporate CEOs believe that demand for their products would justify the additional spending, they would gladly open their budgets to avoid losing future sales either through lack of capacity or because of costly and inefficient production methods, which diminishes their ability to compete with rivals. That, of course, is where the rubber meets the road. According to the latest Business Roundtable Survey of leading CEOs, the economy is expected to perform below its potential again this year, suggesting they see little trouble in meeting demand. That said, the survey also revealed a 7 percent increase in plans to increase capital spending over the next six months even as hiring plans were cut back.

Simply put, companies are not particularly optimistic, but they do expect continued modest growth this year, enough to justify padding their capital budgets a tad. But a significant acceleration in investment spending is still not in the near-term cards; without this important contribution it is hard to see the economy's growth engine kicking into a higher gear.

It may well be that the corporate mindset of cautious behavior echoes the widespread notion that the nation is mired in secular stagnation, a persistent period of subpar growth. While the Fed does not explicitly subscribe to this notion, it has nonetheless downgraded its growth forecast and lowered the path of future interest rates it expects over the next few years. That doesn't mean the central bank has abandoned its plan to normalize monetary policy. It's just that the new normal embodies a much more modest economic outlook than was the case last year.

KEY ECONOMIC AND FINANCIAL INDICATORS

FINANCIAL INDICATORS*

	February	January	December	November	October	September	August	12-Month Range High	Low
Prime Rate	3.50	3.50	3.37	3.25	3.25	3.25	3.25	3.50	3.25
3-Month Treasury Bill Rate	0.31	0.26	0.23	0.12	0.02	0.02	0.07	0.31	0.02
5-Year Treasury Note Rate	1.22	1.52	1.70	1.67	1.39	1.49	1.54	1.70	1.22
10-Year Treasury Note Rate	1.78	2.09	2.24	2.26	2.07	2.17	2.17	2.36	1.78
30-Year Treasury Bond Rate	2.62	2.86	2.97	3.03	2.89	2.95	2.86	3.11	2.57
Tax-Exempt Bond Yield	3.30	3.41	3.57	3.68	3.67	3.78	3.74	3.82	3.30
Corporate Bond Yield (AAA)	3.96	4.00	3.97	4.06	3.95	4.07	4.04	4.19	3.52
Conventional 30-Year Mortgage Rate	3.66	3.87	3.96	3.94	3.80	3.89	3.91	4.05	3.66
Dow Jones Industrial average	16300	16305	17543	17724	17182	16340	17062	18125	16300
S&P 500 Index	1918	1918	2054	2081	2025	1944	2040	2112	1918
Dividend Yield (S&P)	2.31	2.28	2.30	2.12	2.12	2.29	2.22	2.31	1.99
P/E Ratio (S&P)	17.5	17.5	18.3	18.6	18.6	17.0	17.4	18.6	17.0
Dollar Exchange Rate (vs. Major Currencies)	93.2	95.3	94.1	94.0	91.2	91.7	91.9	95.3	89.1

** Monthly Averages*

ECONOMIC INDICATORS

	February	January	December	November	October	September	August	12-Month Range High	Low
Housing Starts (In Thousands)	1178	1120	1159	1176	1071	1207	1116	1211	900
New Home Sales (Thousands of Units)		494	544	503	480	457	507	545	457
New Home Prices (Thousands of Dollars)		279	296	304	299	308	300	308	279
Retail Sales (% Change Year Ago)	3.6	3.2	2.8	1.6	1.8	2.2	1.9	3.6	1.5
Industrial Production (% Change Year Ago)	-1.0	-0.7	-1.7	-1.2	0.5	0.8	1.3	3.5	-1.7
Operating Rate (% of Capacity)	76.7	77.1	76.5	77.0	77.6	77.8	77.9	78.4	76.5
Inventory Sales Ratio (Months)		1.40	1.39	1.38	1.38	1.37	1.37	1.40	1.36
Real Gross Domestic Product (Annual % Change)			1.0			2.0		3.9	0.6
Unemployment Rate (Percent)	4.9	4.9	5.0	5.0	5.0	5.1	5.1	5.5	4.9
Payroll Employment (Change in Thousands)	242	172	271	280	295	149	150	295	84
Hourly Earnings (% Change Year Ago)	2.2	2.5	2.6	2.4	2.6	2.4	2.3	2.6	2.0
Personal Income (% Change Year Ago)		4.3	4	4	4.3	4.4	4.5	4.7	4.0
Savings Rate (Percent of Disposable Income)		5.2	5.2	5.0	5.2	5.0	5.1	5.4	4.8
Consumer Credit (Change in Mil. Of Dollars)		10537	6384	14092	16155	28470	14699	28470	6384
Consumer Prices (% Change Year Ago)	1.0	1.4	0.7	0.5	0.2	0.0	0.2	1.4	-0.2
CPI Less Food & Energy (% Change Year Ago)	2.3	2.2	2.1	2.0	1.9	1.9	1.8	2.3	1.7
Wholesale Prices (% Change Year Ago)	0.0	-0.2	-1.0	-1.1	-1.6	-1.1	-0.8	0.0	-1.6

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