The case for rising US corporate capex

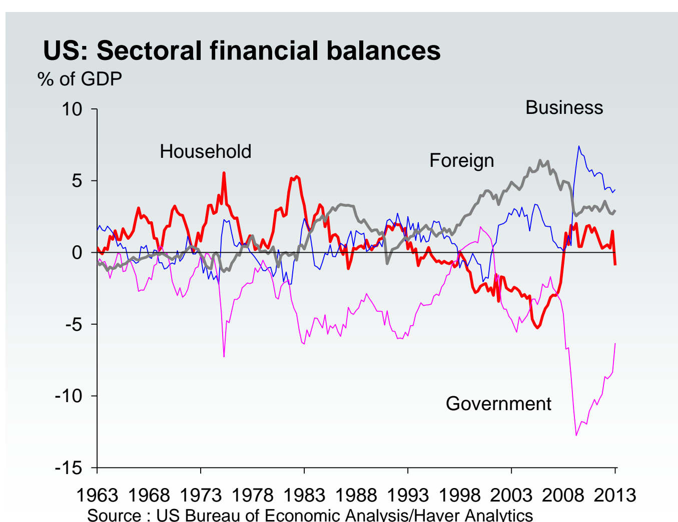
Shifts in financial balances between sectors of the economy are worth watching because they can signal broader cyclical changes. The US household financial balance turned negative in Q1. But that was mainly due to distortions in income related to tax increases in 2013. Taking the average of Q4 2012 and Q1 2013, households still have a positive balance. More importantly, the conditions are in place for a rise in capital expenditure (capex) by the corporate sector. This would allow both household and public sector savings to increase. It would also mean an upside risk to our main scenario for the US economy.

US household sector balance turned negative in Q1…

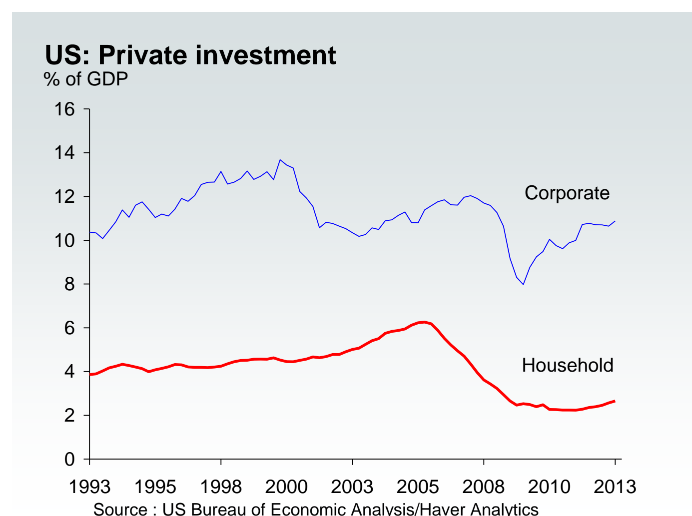
With the publication on 30th May of the second estimate of US GDP for Q1, we could update US sectoral financial balances for the first quarter. They included a surprising development: the household sector financial balance – savings less residential investment – turned negative, falling to -0.9% of GDP from 1.5% in Q4 2012. The surprise was not that the household sector had a negative balance. That had been the norm in the US from Q1 1994 until Q1 2008. Nor was the surprise that household financial balances had previously been positive for so long. After all, households have to repay their debt and usually do so out of current income. The surprise was rather that after 19 straight quarters of net savings, households suddenly invested more in housing than they saved.

…but this was a reflection of one-off factors

The explanation may be quite simple. January this year saw the reversal of a two percentage point payroll tax cut and changes to capital gains taxation. This meant that bonuses and dividends that otherwise would have been paid out in early 2013 were distributed in December 2012 instead to avoid the higher tax rate. Hence incomes and savings were artificially inflated in Q4 2012 and artificially depressed in Q1 2013. Averaging the two quarters leaves the household sector financial balance just positive (0.2% in each quarter). This is a more likely 'true' picture, as households still seem wary of taking on housing loans. What does it mean for US financial balances?



Source : US Bureau of Economic Analysis/Haver Analytics



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Sectoral financial balances are interdependent

The financial balances held by US households, companies and government and the rest of the world are interdependent. The sum of their savings and investment must by definition add up to zero. For much of the 15 years before the Great Recession, there was a global savings surplus. This forced the domestic US sectors to run a deficit. Since the corporate sector was busy rebuilding its balance sheets after the excesses of the late 1990s and early 2000s, the household and public sectors were pushed further into the red.

After the crisis, first households became the driver…

But with the outbreak of the financial crisis, the household and corporate sectors both hit the investment brakes. Since the foreign sector resisted cutting its savings, the debt had to be – and was – rotated into the public sector, which now was reacting to the other three sectors' movements.

…then the public sector

This was an unstable equilibrium, however, and from early 2009, the public sector switched from reacting to acting as it began to reduce its debt. This time, the reacting sector was the corporate sector, whose financial surplus shrank from a post-war high of 7.4% of GDP in Q3 2009, to 4.5% in Q1 2013. However, this is still very high by historic standards. The best development for the US right now would be a pickup in corporate capex. This would narrow the corporate sector surplus further, allowing both the household and the public sectors to save more, and possibly also reducing the foreign sector's excess savings. (The foreign sector is of course the US current account balance with a reversed sign.)

And now corporate capex is starting to rise

There are some valid arguments why this would happen. Household confidence is picking up. Although federal spending is weakening, state and local government (which is 50% larger than federal) seems stable. The sequester will eventually affect federally-funded state and local programmes as well, but this does not yet seem to have occurred. A better outlook than expected has led to increased speculation that the Fed will start tapering its quantitative easing sooner rather than later. However this is done, it will lead to higher bond yields, on treasuries as well as on corporate bonds. For companies wishing to tap markets for further funds, there is no time like the present. That there is a strong demand for corporate bonds – which have higher yields than Treasuries – is an extra advantage.

Moreover, various regional Fed surveys – notably the Empire State and Philly Fed surveys, as well as, more erratically, the Richmond Fed survey – show company capex plans trending up. Not surging – although the Empire Fed capex plans number is above its long-term average – but moving in the right direction. This outlook is also supported by the high corporate liquidity ratio. Non-financial companies' cash was historically high at the end of 2012 (new data will be released in June); and while cash relative to total financial assets is lower is edging up too. Finally, capital goods orders are rising more strongly than expected.

No guarantee – but it's an upside risk

The fact that everything is in place for a pickup in corporate capex does not mean that it will automatically happen. However, if it does occur – and the auguries look good – it will have a very positive effect on US output growth, further supporting the case for a stronger dollar and US equities. It also represents an upside risk to our main forecast for the US economy. The Oxford Economics baseline scenario is for US private sector real investment to rise by a quarterly average of just under 6.9% (seasonally-adjusted annualised change) in H2 1013, accelerating to slightly below 7.3% in 2014 and slightly above that in 2015. However, in the past, the 'gaining traction' phase of

recoveries has generally seen stronger performance than that, usually in excess of 8% per quarter. This was also the case in the six quarters from 2010 Q3 to 2011 Q4, when the average change was close to 10%. Stronger household demand – which already is taking place – and stronger capex, coupled with recent US improved export performance, could potentially combine to push overall GDP growth above our main forecast of around 3% annualised quarterly rate in H2 2013 and throughout 2014.

Watch out for…

Stronger US private sector investment would be good for US equities; and, at least initially, would see corporate bond spreads narrow further vis-à-vis Treasuries. It would also be likely to bring forward the Fed’s removal of QE, however, which of course would be bad news for fixed income in general.

A move into this more positive investment scenario could be signalled by:

- continued strengthening of corporate capex plans in regional fed surveys
- increased corporate bond issuance to lock in current interest rates
- improving business confidence in the wake of surging household sentiment.

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