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Slow Business Investment Is Holding Back Growth

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Key Takeaways

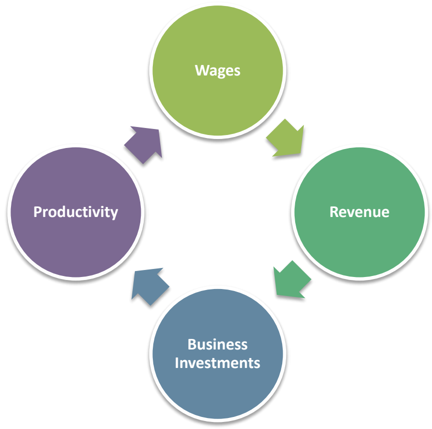
- *Businesses tend to invest in property, plant, and equipment after their revenue growth increases. Since the 2008 recession, sales growth has been slow, and businesses have been reluctant to make those investments.*
- *Lack of technological advances, and the reluctance of companies to invest in property, plant, and equipment, has been attributed to lower-than-expected productivity improvement in this cycle.*

What It May Mean for Investors

- *For U.S. corporations, we believe that earnings will increase in the coming year, but at a slower pace than in 2017. We expect U.S. equity markets to advance to new highs, although we believe that investors will remain cautious and market returns likely will be modest.*
- *Productivity is unlikely to gain much momentum in the near term. In this environment, larger firms, like those in the S&P 500 Index, are more attractive to us than smaller firms, because of their ability to enhance their profitability through business investment and cost reduction.*

In some of our recent reports, we discussed how balance sheet tapering by central banks—both in the U.S. and across the globe—is likely to affect the economy. Today's report will focus on how business investment can influence the economy and markets. One way corporations directly impact economic growth and markets is by increasing reinvestment in their businesses (through capital expenditure, or capex). This serves the U.S. economy in two ways. In the short term, it boosts gross domestic product (GDP) through increased business spending on such things as property, equipment, and software. In the long term, it can improve productivity by helping workers to be more efficient. Productivity is a key source of economic growth. It can help workers to produce more goods through better equipment or technology. Firms that invest in capex typically expect improved production capabilities that can lower costs and increase firm profitability. Greater productivity also can lead to higher wages for workers and spur greater consumption, resulting in a business investment cycle like the one illustrated in Chart 1.

Chart 1. Example of Business Investment Cycle

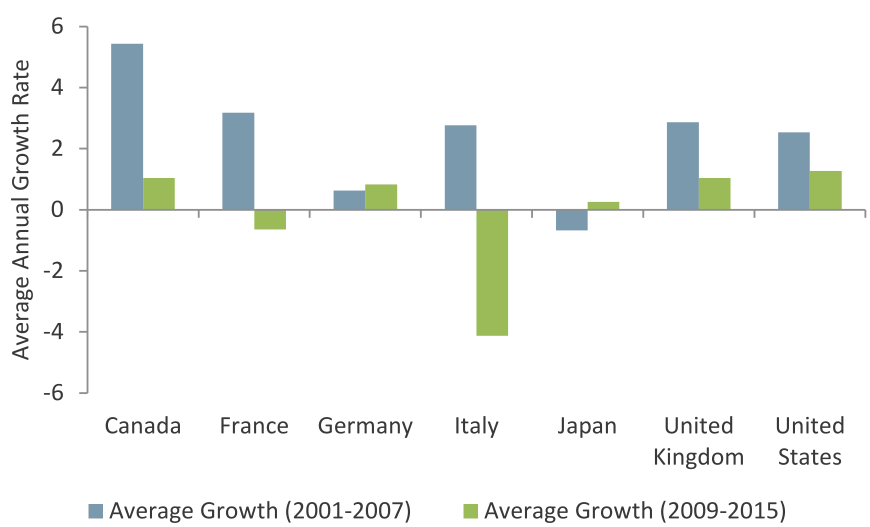


Source: Wells Fargo Investment Institute, 9/8/17

Investments Spark the Growth Engine

Business investment makes up roughly 13 percent of U.S. GDP. As Chart 2 illustrates, it has been growing at a slower pace in the U.S. and abroad than it grew prior to the recession. In past business cycles, corporate investment in property, equipment, and software came on the heels of sales growth. Yet, sales have grown more slowly in this recovery than in previous recoveries. Consumers have been reluctant to increase spending on goods and services, perhaps because of the lackluster growth in their wages. Typically, at times of full employment (which the U.S. is currently experiencing), we see acceleration in wages as there are more jobs than workers. Yet, this recovery has been anything but normal. Wages have remained stubbornly low as more experienced labor participants have begun to retire and companies have hired less experienced (and less expensive) workers. In addition, workers are hesitant to leave their current jobs to search for new ones. This is an important factor, because empirical evidence suggests that more voluntary turnover can lead to wage inflation as employees seek higher-paying jobs.

Chart 2. Slow-Growing Business Investment is a Global Phenomenon

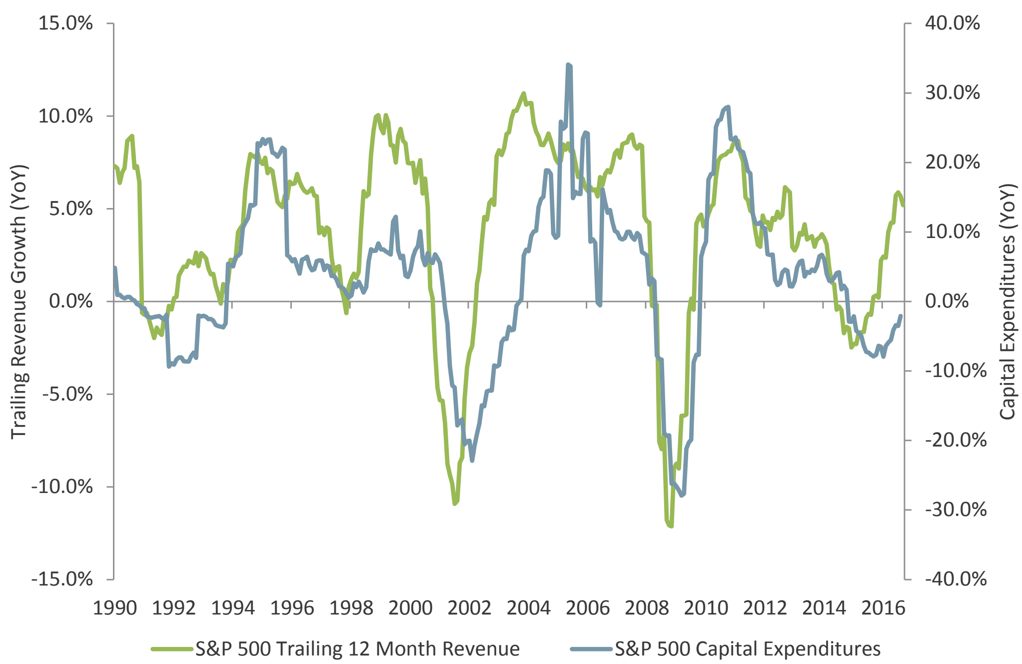


Source: Organization for Economic Co-operation and Development, 9/8/17

Regulatory uncertainty also has made companies reluctant to invest in capex. According to a study conducted by George Washington University in January 2017, the cumulative number of economically-significant regulations enacted since the U.S. recession increased by more than 130 percent from prior years. Complying with these regulations has become a larger portion of many companies' expenses. This limits the amount that firms can spend on capex. If the current administration follows through on its pledge of achieving deregulation and corporate tax reform, these actions could be a game changer for capex and productivity.

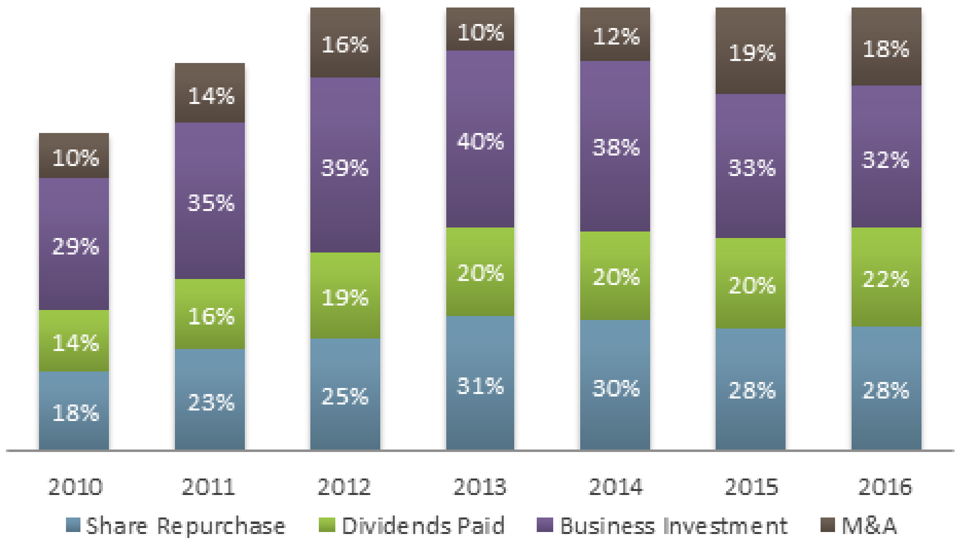
The good news is that companies have trillions of dollars in cash on their balance sheets that could be reinvested in their businesses, should they gain confidence in revenues and future demand. In the recent past, companies have spent more on dividends and share repurchases than on capital investment. Yet, neither of these expenditures increases long-term profitability. As Chart 3 implies, improving sales growth could result in an uptick in business investment in the short term. Yet, we don't anticipate that the magnitude or duration of the increase will be enough to have a major impact on economic growth, productivity or earnings. In other words, in the near term, investors should anticipate more of the same: continuing expenditures on dividends and share repurchases, combined with modest spending on new productivity-enhancing equipment and technology. Until productivity increases, we anticipate only modest returns for most equity assets.

Chart 3. Recent Uptick in Sales May Result in Higher Business Investment



Source: Bloomberg, 9/8/17

Chart 4. Business Investment Has Lagged Expenditures on Dividends and Buybacks



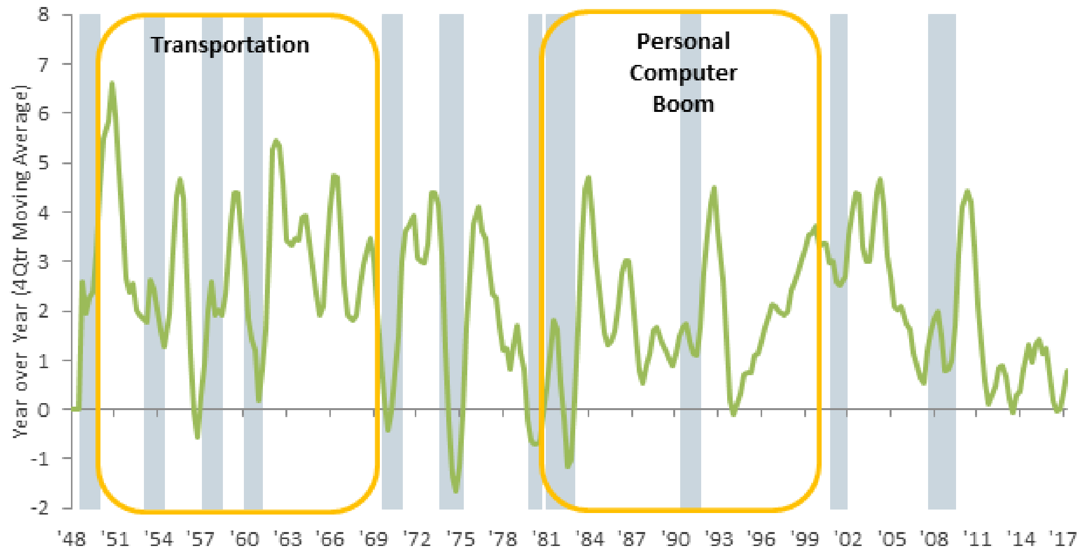
Source: Bloomberg, Wells Fargo Investment Institute, 9/8/17

Why is Productivity so Important?

Productivity measures how efficiently workers use technology and machines, and how well machines use raw material. The most common productivity measure in the U.S. is the U.S. Nonfarm Business Sector Output index. This measure reflects output (goods and services) divided by inputs (labor). While the role that business investment plays in raising productivity is not explicitly stated in the calculation, business investment (capex) tends to increase workers' effectiveness and helps them to produce more goods.

Typically, during recessions, businesses reduce their workforce. Once economic activity picks up, productivity increases as fewer workers produce more goods and services. As Chart 5 illustrates, in the 1950s and 1960s, we saw a trend of high sustained productivity gains. Many economists attribute this to the creation of the interstate highway system, and the advances in transportation technology (trucking and air cargo). In the 1980s and 1990s, high productivity was attributed to the development of the personal computer and related technology. During these two periods, new technologies, adapted into the U.S. economy, led to meaningful productivity gains. By contrast, in the 1970s and 2010s, U.S. productivity lagged. Both of these periods were characterized by significant economic headwinds: inflation in the 1970s, and slow demand growth in the 2010s. Since the latest recession, productivity growth has averaged only 1.2 percent, which is substantially below its historical long-term average of 2.2 percent. For context, in the two most recent cycles, productivity growth averaged 2.7 (2000s) and 2.2 (1990s) percent, respectively. Lack of productive and sustained innovation, and the reluctance of companies to reinvest in their businesses, has contributed to the lower productivity levels that we have observed in this cycle.

Chart 5. Innovation Produces Higher Levels of Productivity



Sources: Bloomberg, Bureau Labor of Statistics, 9/8/17. Recession shaded in blue.

Currently, we expect only a slight increase in productivity in the short term. As a result, U.S. economic growth should continue at a slow pace. Corporate sales will be a key indicator to watch as it clearly has an impact on business spending, productivity and wage growth. For U.S. corporations, we believe that earnings will increase in the coming year, but at a slower pace than in 2017. We also expect that U.S. equity markets should advance to new highs, although we believe that investors will remain cautious and market returns likely will be modest. In this environment, larger firms, like those in the S&P 500 Index, are more attractive to us than smaller firms, because of their ability to enhance their profitability through business investment and cost reduction. We recommend that investors remain evenweight large-cap equities and underweight small-cap equities until we see sustained changes in sales growth.

Economic Calendar

Date	Report	Estimate	Previous
9/12/2017	NFIB Small Business Optimism	104.9	105.2
9/12/2017	JOLTS Job Openings	5975	6163
9/13/2017	MBA Mortgage Applications	--	3.30%
9/13/2017	PPI Final Demand MoM	0.30%	-0.10%
9/13/2017	PPI Ex Food and Energy MoM	0.20%	-0.10%
9/13/2017	PPI Ex Food, Energy, Trade MoM	0.10%	0.00%
9/13/2017	PPI Final Demand YoY	2.50%	1.90%
9/13/2017	PPI Ex Food and Energy YoY	2.10%	1.80%
9/13/2017	PPI Ex Food, Energy, Trade YoY	--	1.90%
9/13/2017	Monthly Budget Statement	-$130.5b	-$42.9b
9/14/2017	Initial Jobless Claims	300k	298k
9/14/2017	CPI MoM	0.30%	0.10%
9/14/2017	Continuing Claims	1980k	1940k
9/14/2017	CPI Ex Food and Energy MoM	0.20%	0.10%
9/14/2017	CPI YoY	1.80%	1.70%
9/14/2017	CPI Ex Food and Energy YoY	1.60%	1.70%
9/14/2017	CPI Core Index SA	--	251.914
9/14/2017	CPI Index NSA	245.35	244.786
9/14/2017	Real Avg Weekly Earnings YoY	--	1.10%
9/14/2017	Real Avg Hourly Earning YoY	--	0.70%
9/14/2017	Bloomberg Consumer Comfort	--	52.6
9/15/2017	Empire Manufacturing	18	25.2
9/15/2017	Retail Sales Advance MoM	0.10%	0.60%
9/15/2017	Retail Sales Ex Auto MoM	0.50%	0.50%
9/15/2017	Retail Sales Ex Auto and Gas	0.30%	0.50%
9/15/2017	Retail Sales Control Group	0.30%	0.60%
9/15/2017	Industrial Production MoM	0.10%	0.20%
9/15/2017	Capacity Utilization	76.80%	76.70%
9/15/2017	Manufacturing (SIC) Production	0.50%	-0.10%
9/15/2017	U. of Mich. Sentiment	96	96.8
9/15/2017	U. of Mich. Current Conditions	--	110.9
9/15/2017	U. of Mich. Expectations	--	87.7
9/15/2017	U. of Mich. 1 Yr Inflation	--	2.60%
9/15/2017	U. of Mich. 5-10 Yr Inflation	--	2.50%
9/15/2017	Business Inventories	0.20%	0.50%
9/18/2017	NAHB Housing Market Index	67	68
9/18/2017	Total Net TIC Flows	--	$7.7b
9/18/2017	Net Long-term TIC Flows	--	$34.4b

Source: Bloomberg as of 9/8/17

Risks Considerations

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. The prices of mid-cap and small company stocks are generally more volatile than large company stocks. They often involve higher risks because smaller companies may lack the management expertise, financial resources, product diversification and competitive strengths to endure adverse economic conditions.

Definitions

An index is unmanaged and not available for direct investment.

S&P 500 Index is a market capitalization-weighted index composed of 500 widely held common stocks that is generally considered representative of the US stock market.

The **US Nonfarm Business Sector Output Index** measures domestic economic output and excludes the economic activities of the following: general government, private households, nonprofit organizations serving individuals, and farms.

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