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Macro Roundup Artcile

Headline: Cost of Capital and Capital Allocation: Investment in the Era of "Easy Money"

Article Link: https://www.morganstanley.com/im/publication/insights/articles/article_costofcapitalandcapitalallocation.pdf?1709234146999

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Tweet: Between 2009 and 2021 Russel 3000 firms didn't respond to low interest rates and a lower weighted average cost of capital by raising their investment in capex, M&A;, and investment SG&A; relative to 1996-2008. @mjmauboussin

Summary: We estimate that the weighted average cost of capital (WACC) for companies in the Russell 3000 dropped to 6.9% in the time of easy money [2009-21] from 7.5% in the prior period, based on annual averages. Standard corporate finance dictates that companies fund projects that have a positive net present value (NPV), defined as when the present value of the future cash flows from an investment exceeds the initial outlay. The aggregate return on invested capital (ROIC), defined as net operating profit after taxes divided by invested capital, averaged 9.5% in the easy money period and 9.2% in the preceding time. Companies earn an ROIC in the aggregate that is roughly 50-60% of the hurdle rate they use. That means a lot of investments fail to earn the hurdle rate. But, on average, companies in the U.S. do earn an ROIC in excess of the actual cost of capital. The average spread between the ROIC and WACC was 2.6 percentage points in the easy money era and 1.7 percentage points in the prior period. Related: Data Update 4 for 2024: Risk Enters the Equation and Cost of Capital and The Corporate Debt Maturity Wall: Implications for Capex and Employment

Primary Topic: Business Cycle

Topics: Business Cycle, Database, Financial Markets, GDP, Important!, Investment, Op-Ed/Blog Post, Productivity, Weekly

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