Aegon Asset Management

THE GREAT CAPEX RESURGENCE— A CAUTIONARY TALE

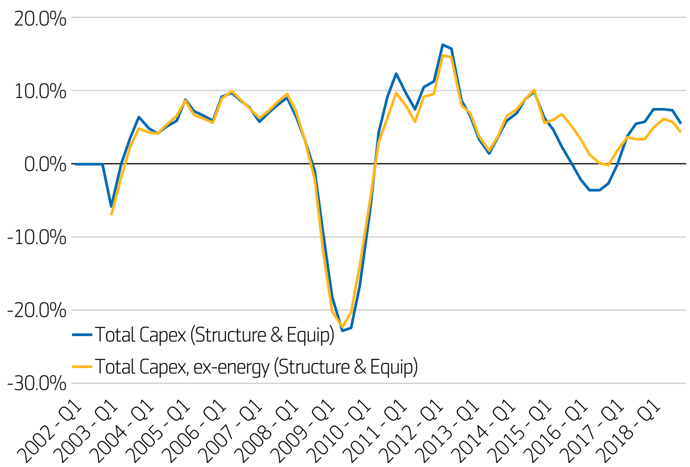
By Francis P. Rybinski, CFA, Chief Macro Strategist & D. Harris Kere, CFA, Investment Strategist

As we close out the year, a robust US economy, revised tax code and repatriation of foreign earnings has provided many US companies with a boost to profit growth which typically signals a resurgence of capital-expenditure spending (capex) and a strong growth outlook. However, as we approach 2019, companies' capex spending is slowing slightly. While it will still be one of the key drivers to growth in the next year, we believe that capex is not as robust as the headlines imply. In fact, we believe the risk in the downside predictions is that they are not realistic enough, due largely to masked modest trends in growth, uncertainty in trade, and waning foreign direct investment (FDI).

Not the full story

After record spending by companies in the S&P 500 Index in the first half of the year, capex is not as strong as many believe it to be. Consider structure and equipment (S&E) capex—the tangible components accounting for two-thirds of total capex—which is currently at $1.9 trillion. Exhibit 1 illustrates that structure and equipment (S&E) industry capex has grown 6-7% year on year. But, this has been significantly boosted by the recovery in energy capex after an enormous decline in 2015 and 2016. Ex-energy, the rally in S&E capex has been less thrilling. Energy is only 8% of total S&E capex, but it is growing 20% year on year—down from 60%. When the energy component from capex is removed, tangible capex is growing at less than 5%. In short, the 30-50% year-on-year growth in energy capex—after a 60% decline in absolute levels over the past few years—is masking modest capex trends elsewhere.

Exhibit 1. Impact of Energy CapEx on Overall Structure & Equipment CapEx



Source: BEA and Haver Analytics. As of September, 2018.

Trade wars

Uncertainty surrounding tariffs and trade could affect capex and FDI as projects that typically have long lead times and changing trade landscape can dramatically alter the economic viability. This, coupled with Democrats threatening to reverse the corporate tax cut and it is understandable that capex surveys have seemingly peaked, reflecting growing caution by management teams to increase capex spending. Economic symptoms of lower trend growth also indicate increased caution. What is also not helping is the high relative hurdle rate—return on equity of S&P 500 is currently at 15%, making the argument for stock buybacks quite compelling. With these factors in motion, we think the skew of risk distribution to consensus growth forecasts is to the downside.

What does it mean?

Capex is a key driver to above-trend growth in 2019. If capex falls below consensus expectations, downside risks to current gross domestic product forecasts could force the Federal Reserve to lower the dots on its projected interest rate dot plot and hike rates less than the dots will imply. After a year of strong capex spending buoyed by Trump's tax law, the US' solid rule of law and advantaged energy costs, the outlook on capex should tell a more robust story. While the general consensus sees a slight slowing of capex spending, we are more cautious going into year-end as we think the risk is asymmetrically skewed to the downside.

Disclosure

This material is to be used for institutional investors and not for any other purpose. This communication is being provided for informational purposes in connection with the marketing and advertising of products and services. This material contains current opinions of the manager and such opinions are subject to change without notice. Aegon AM US is under no obligation, expressed or implied, to update the material contained herein. This material contains general information only on investment matters; it should not be considered a comprehensive statement on any matter and should not be relied upon as such. If there is any conflict between the enclosed information and Aegon AM US' ADV, the Form ADV controls. The information contained does not take into account any investor's investment objectives, particular needs, or financial situation. Nothing in this material constitutes investment, legal, accounting or tax advice, or a representation that any investment or strategy is suitable or appropriate to you.

Past performance is not indicative of future results. All investments contain risk and may lose value. Investors should consult their investment professional prior to making an investment decision. Results for certain charts and graphs are included for illustrative purposes only and should not be relied upon to assist or inform the making of any investment decisions. Index performance does not include the effect of fees and performance would be lower if it did. It is not possible to invest in an unmanaged index.

Specific sectors mentioned do not represent all sectors in which Aegon AM US seeks investments. It should not be assumed that investments of securities in these sectors were or will be profitable.

Aegon AM US may trade for its own proprietary accounts or other client accounts in a manner inconsistent with this report, depending upon the short-term trading strategy, guidelines for a particular client, and other variables.

There is no guarantee these investment or portfolio strategies will work under all market conditions or are suitable for all investors and each investor should evaluate their ability to invest over the long-term, especially during periods of increased market volatility.

This document contains "forward-looking statements" which are based on the firm's beliefs, as well as on a number of assumptions concerning future events based on information currently available. These statements involve certain risks, uncertainties and assumptions which are difficult to predict. Consequently, such statements cannot be guarantees of future performance and actual outcomes and returns may differ materially from statements set forth herein. In addition, this material contains information regarding market outlook, rates of return, market indicators and other statistical information that is not intended and should not be considered an indication of the results of any Aegon AM US-managed portfolio.

Aegon Asset Management US is a US-based SEC registered investment adviser and is also registered as a Commodity Trading Advisor (CTA) with the Commodity Futures Trading Commission (CFTC) and is a member of the National Futures Association (NFA). Aegon Asset Management US is part of Aegon Asset Management, the global investment management brand of the Aegon Group.