ECONOMIC OUTLOOK
REGIONS
December 2017

Business Investment On A Long Overdue Roll – Will It Last?

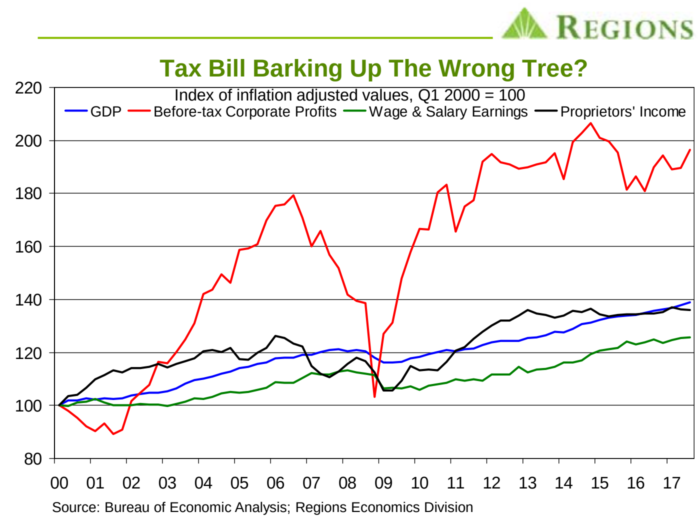
In this month's *Outlook*, we return to a topic we've discussed frequently over the years, especially over the course of the current economic expansion. Sure, we get that business investment spending may not seem the most interesting topic of discussion, let alone frequent discussion. We'd disagree there, but, then again, given that our idea of riveting bedtime reading is *The Complete Unabridged History of GDP Accounting*, we may not be the best arbiters of what's interesting and what's not. But, regardless of how interesting, or not, one finds the topic, there is no debating that business investment is one of the more critical elements of any economy, particularly an economy's capacity for sustaining growth without generating inflation.

There are actually two reasons why we think it worthwhile to devote the bulk of this month's *Outlook* to business investment; no, neither one of those reasons is "can't think of anything else to spend four pages on." One reason is that for the past several months, business investment has been on a nice roll. Indeed, for some time now we've been telling anyone who would listen that the most encouraging element of the economic data has been the pickup in business investment spending. The second reason is that the major tax legislation now working its way through Congress and soon to be signed into law contains provisions designed to stimulate faster growth in business investment. The degree to which this happens will be of special interest to private sector analysts such as us and to the FOMC.

We put so much emphasis on business investment spending because not only does faster growth in capital spending contribute to faster growth today, but it also contributes, in the form of enhanced labor productivity, to faster (noninflationary) growth tomorrow. Labor productivity growth is also the key driver of the rate of improvement in workers' living standards over time given that, in the absence of market distortions, the rate of wage growth over time is largely driven by the rate of productivity growth.

Anyone who has been a regular reader of our quarterly write-ups of the data on labor productivity knows that we see significant underinvestment on the part of firms as the primary culprit behind what has been an anemic trend rate of productivity growth over the course of the current economic expansion. This is one reason we have been encouraged by the pick-up in business investment spending over the past several months. But, in order to have a meaningful impact on longer-term labor productivity growth, this run of better business investment spending will have to be sustained for much longer than we have seen thus far.

This is where changes in the tax code may come into play. We're not going to spend this space passing judgment on the legislation in its entirety – the short version is that there is a lot to like in the tax bill, and there is a lot to not like in the tax bill. For our purposes here, we'll concentrate on looming changes in corporate taxes which, depending on one's point of view, reflect a large handout to a sector of the economy that needs no such help or a welcome boost that will stimulate further capital spending and significant hiring, and in turn wage growth. As is usually the case, the truth lies somewhere between the two extremes.



As noted above, many question the need for, or wisdom of, corporations getting any form of tax relief given corporate profit margins, though past their cyclical peak, remain notably elevated relative to historical norms. The above chart shows inflation adjusted values, indexed to Q1 2000, of GDP, wage & salary earnings, before-tax corporate profits, and proprietors' income. We show pre-tax corporate profits to be more consistent with proprietors' income, a measure of pre-tax profits of small businesses reported in the GDP data.

Clearly, growth in corporate profits has dramatically outpaced overall economic growth as well as growth in wages and small business profits. As a side note, the very first edition of our *Monthly Economic Outlook* (September 2012) was titled "One Standout In A Not So Great Recovery" and our topic was how corporate profits were significantly outperforming what was shaping up to be a historically weak expansion. Not a lot has changed since then, but that does not, at least in our view, make the case against meaningful changes in the corporate tax system.

As for lowering the corporate tax rate from the current 35 percent rate to 20 (or 22) percent, the distinction many fail to make is between statutory and effective tax rates. Sure, at 35 percent, the U.S. has one of the highest statutory corporate tax rates of any nation, but the reality is that for many, if not most, corporations

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the effective tax rate is well below the statutory rate. Lowering the statutory rate while at the same time either closing or narrowing many of the loopholes that enable corporations to pay much lower effective tax rates leaves overall corporate tax burdens roughly the same. Some corporations will pay higher effective rates while others pay lower effective rates, but in principal (and saving for another day a discussion of our view that the optimal corporate tax rate is zero) the corporate tax system should be far more efficient than has been the case for quite a long time.

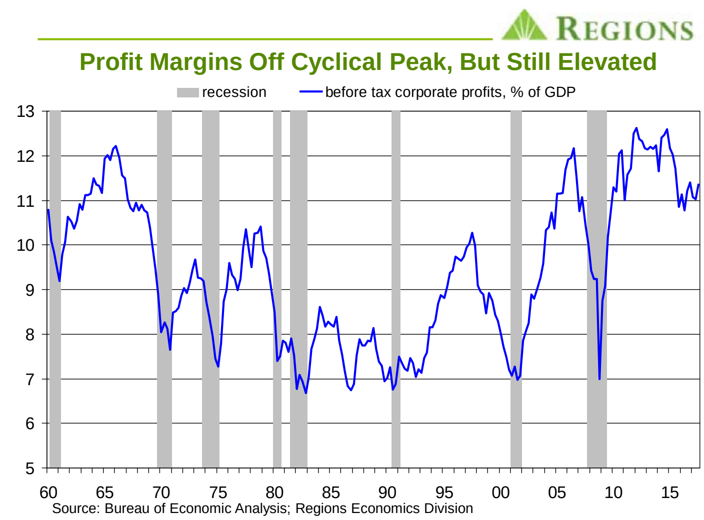
In that sense, then, a lower statutory corporate tax coupled with far fewer exemptions won't have any meaningful impacts on hiring and investment decisions in the aggregate. But, one provision of the tax bill for which we hold out high hopes is the immediate expensing of capital investment (though we give two thumbs down to this provision ultimately being phased out). Our hope, indeed our expectation, is that this will fuel business spending on much-needed upgrades to the economy's capital stock.

There are some who argue this is neither likely nor necessary given how the economy has evolved over the past few decades. This line of argument is based on the economy being less capital intensive now than was the case in the past so that, for many firms, people are the most important resource. While we don't necessarily disagree with this characterization, that does not alter the fact that even the most talented workers need tools, in the form of an up to date capital stock, to operate efficiently and effectively. No matter what that capital stock looks like.

As it is, data from the Bureau of Economic Analysis show an already old, relative to historical averages, capital stock has aged even further since the end of the 2007-09 recession, which is not at all surprising given how weak business investment has been for much of that time. Moreover, in addition to spending on physical capital, business investment also includes spending on intellectual property products, which includes research and development, which in many cases ultimately translates into enhanced labor productivity. In other words, there is still ample justification for making expensing of investment more liberal than it has been, even if the capital/labor mix of the economy has shifted.

Indeed, we've argued that this shift has been more pronounced in the years since the end of the 2007-09 recession than would have been the case in a more robust growth environment. U.S. firms came out of the 2007-09 recession facing an anemic growth outlook – domestic and global – which in and of itself diminished the incentive to expand their capital stocks. That incentive was further diminished by firms having access to an abundant pool of readily available and relatively cheap labor, which enabled them to meet growth in demand without having to add to their capital stocks. In other words, firms had the incentive to aggressively substitute labor for capital, which helps explain why, outside of a burst of energy-related investment in the early phases of the expansion, business investment has been so persistently weak.

What was a monumental degree of labor market slack in the early phases of the post-recession period enabled firms to make this shift from capital to labor and still see profit margins expand, even in the face of notably slow growth in top-line revenue. One way to think about it is that growth in aggregate wage and salary earnings was slightly slower than growth in nominal GDP. It was never a matter of firms being "able to afford" to pay higher wages, which for some time has been a common refrain from some quarters; the reality is firms were able to hire pretty much at will without having to pay wage premiums. Nor was it a matter of firms not being able to afford to undertake capital investment, they simply had little or no incentive to do so. What we did see was firms returning more and more capital to shareholders, increased M&A activity (firms in essence trying to buy growth), and firms holding more cash on their balance sheets.

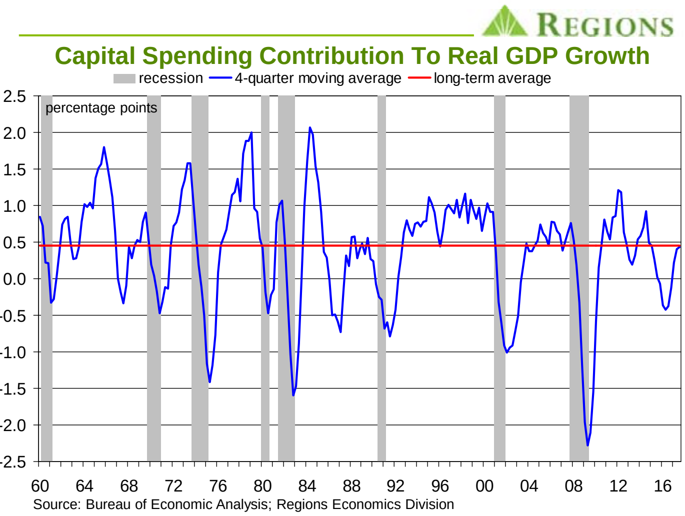


That set of circumstances could not persist indefinitely, and indeed growth in aggregate labor costs (which, rather than average hourly earnings, is the relevant measure to focus on in this context), began to accelerate as labor market conditions began to tighten to a meaningful degree. This has been reflected in slimmer, though by no means slim, profit margins, as shown in the chart above. While we do believe, tax relief or not, corporate profit margins have passed their cyclical peak, they nonetheless remain elevated relative to historical norms.

As noted above, the past several months have seen solid growth in business investment spending. This can be seen in the high frequency data on core capital goods orders, which show year-on-year growth steadily accelerating over the course of 2017 and topping 8.0 percent in September and October (the last available data point). It is also seen in the GDP data, which show annualized growth in real business investment in equipment and machinery of 8.8 percent in Q2 and 10.4 percent in Q3 (our baseline forecast anticipates another double-digit gain in Q4).

The questions, however, are what led to this spurt in investment and whether or not it will be sustained. While some point to rising optimism driven by prospects of tax relief and significantly faster economic growth being behind the spurt in business investment, we don't buy this. We think that, rather than undertaking capital investment on the basis of what they hope might happen, firms make those decisions based on what they see happening.

We can point to three factors that are far more likely to have contributed to the recent growth in capital spending. First, it is likely that, having deferred capital spending for so long, firms are, even if at a modest pace, playing catch-up, i.e., engaging in replacement investment. Second, as labor market conditions have tightened, there has been increasingly less incentive to substitute labor for capital, and indeed the incentives now are pointing in the opposite direction. Finally, for the first time in over a decade, we are seeing synchronized global economic growth, which has likely made firms more confident about prospects for sustained growth, giving them greater incentive to undertake capital investment.

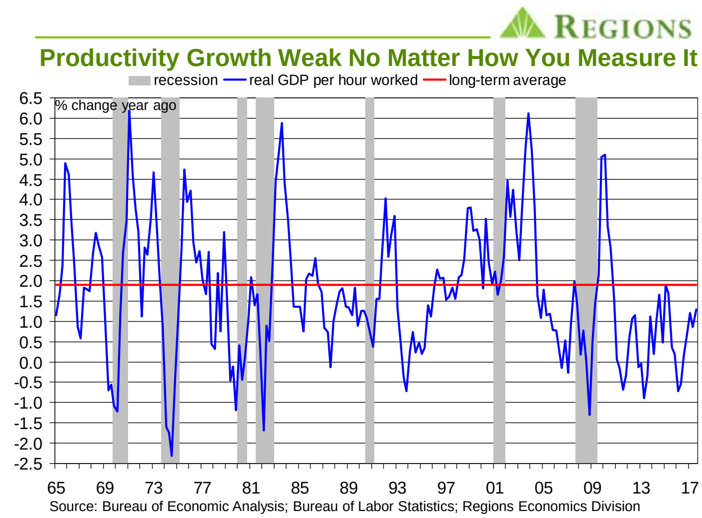


It is reasonable to ask why, if firms are facing an incentive set that favors capital spending and they are indeed stepping up such spending, they should now be given even greater incentive to do so in the way of tax relief. This is where we think it helps to put the recent growth in business investment in proper perspective, which we do in the chart above. The chart shows the contribution of business capital spending to top-line real GDP growth dating back to 1960. That contribution has been well below the historical average over much of the current expansion, after allowing for the energy-related growth in capital spending earlier in the cycle.

Even with the robust growth in business investment over the past two quarters, the contribution to top-line real GDP growth is only now bumping up against the historical average. In our view, there is ample room to the upside for additional capital spending. Not only do firms still have catching up to do after years of underinvestment, but if they do indeed think firmer global growth can be sustained there is cause for enhancing their capital stocks, particularly as labor market conditions get even tighter. We think the sooner this happens, the better, and hence see considerable value in the immediate expensing provision in the tax legislation.

One reason we say the sooner the better is that the U.S. economy has fallen considerably behind the curve in terms of productivity growth. Again, our view is that underinvestment on the part of firms over the past several years is the primary culprit behind what has been an anemic trend rate of productivity growth. To be sure, there is a lag between stepped-up business investment spending translating into faster labor productivity growth, a longer lag for industrial equipment and machinery and a shorter lag for computer equipment and software. But, given that new capital equipment has to be manufactured, transported, and set up for use, the first visible effect of firms deciding to step up capital outlays comes in the form of increased employment.

Ultimately, however, productivity growth will respond to an upgraded and expanded capital stock. The chart below shows year-on-year growth in real GDP per hour worked, conceptually similar to the typical measure of labor productivity reported by the Bureau of Labor Statistics (BLS). We prefer to look at real GDP per hour worked as the relevant gauge of productivity for the broad economy as opposed to the BLS data that are prone to measurement issues. It is worth noting that the trends in the two series closely mimic each other, in terms of direction and timing, though the peaks and troughs tend to vary in magnitude.

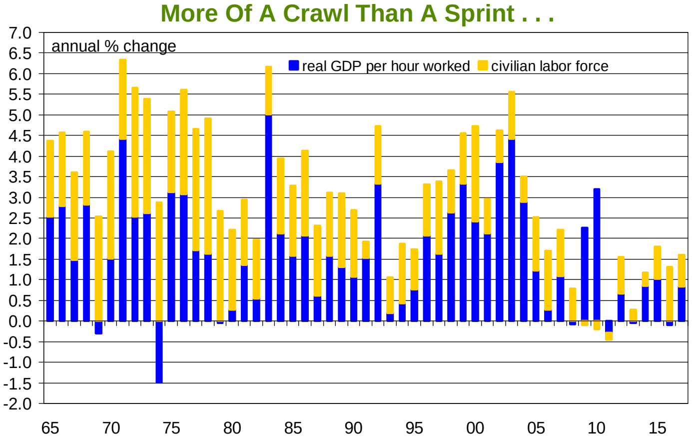


The broader point is that, regardless of which measure you prefer, productivity growth has been well below historical norms over much of the current expansion. We'd argue any incentive that helps remedy this deficit is worth offering. We'd also argue any such incentives cannot be adequately assessed without also accounting for the benefits to workers, and for the benefits to the broader economy. This is an assessment that has been notably lacking in much of the discussion around the tax bill.

Over time, the rate of growth of labor productivity is a key driver of growth in workers' wages. Productivity growth enables firms to increase workers' wages and preserve profit margins without resorting to raising output prices. It isn't mere coincidence the last period of sustained growth in real (i.e., inflation adjusted) wages across all major industry groups was the late-1990s, i.e., in the midst of a sustained period of above-average productivity growth. That productivity growth has lagged so badly over the course of the current expansion is one reason wage growth has been so sluggish. And, even to the extent wage growth picks up over coming quarters as labor market conditions tighten further, it will likely still fall short of historical norms for as long as productivity growth continues to do the same.

The above paragraph highlights another important implication of the trend rate of productivity growth. The rate of productivity growth is one of the main determinants of what we refer to as the economy's "speed limit," i.e., the rate at which it can grow over a sustained period without sparking faster inflation. The other main determinant of any economy's speed limit is the rate of labor force growth, and here too the trend rate of growth has slowed notably over the past several years.

More Of A Crawl Than A Sprint . . .



Source: Bureau of Economic Analysis; Bureau of Labor Statistics; Regions Economics Division

The above chart takes our series on real GDP growth per hour worked (shown with the blue bars) and adds to that growth in the labor force (shown with the yellow bars), with the sum being a rough gauge of the economy's noninflationary speed limit. We use an annual frequency to keep the volatility inherent in the quarterly data from deflecting attention away from our underlying point. As seen in the chart, the economy's speed limit has been frustratingly slow over the past several years, the longest period of such sustained weakness in both productivity and labor force growth.

To be sure, the economy has grown at a rate above this speed limit over the past several years without there having been a sustained acceleration in inflation. This isn't to say the speed limit is not a binding constraint, but it is the case that an economy with a high degree of slack can grow at a rate above its speed limit while that slack is being pared down. The U.S. economy is approaching, or some would say is at, the point where the high degree of slack that was the legacy of the 2007-09 recession has been fully pared down. This means inflation will become more of an issue even at a middling rate of real GDP growth.

This has implications for the FOMC and the path of the Fed funds rate. A lower speed limit means inflation can accelerate even at a low rate of GDP growth, which in turn means tighter monetary policy at a lower rate of GDP growth than would be the case in an economy with a higher speed limit. This is one reason we constantly stress the need for a sustained period of meaningful growth in capital spending. This is the surest way to increase the economy's speed limit, especially given that demographics will be a drag on labor force growth for years to come.

This is, based on public comments by several members, the manner in which the FOMC will evaluate the implications of the looming changes in the tax code for monetary policy. In other words, changes to the tax code that yield only a burst of demand without stimulating the economy's productive capacity would be seen as inflationary, hence warranting a more aggressive monetary policy stance. In contrast, changes in the tax code seen as prompting greater business investment, and thus expanding the economy's productivity capacity, would be seen as raising the economy's speed limit, thus allowing the FOMC the latitude to follow a more patient course of Fed funds rate hikes.

These are the grounds on which the looming changes to the tax code will be discussed and debated within the FOMC. They are also the grounds on which these changes deserve to be discussed and debated amongst a wider audience. Unfortunately, for the most part we have instead been "treated" to a vacuous shouting match between those looking to score political points by either overselling or undercutting the likely effects on the labor market and the broader economy. We've laid out our view that there will be a boost to business investment and, in turn, labor productivity. Coming quarters, if not years, will show whether we're correct.

As a final point, refer back to the chart on Page 3 showing capital spending's contribution to top-line real GDP growth. Note that in most cycles, there has been a sharp increase in capital spending topped off by a well-defined peak followed by a sharp decline. What would be ideal would be a sustained period of above-average capital spending, such as that seen during the 1990s, which would lay the groundwork for a sustained period of faster productivity growth. We point this out because one concern we have is that, with the provision for immediate expensing set to begin phasing out after five years, we could see a "barbell effect" on capital spending. In other words, we could see rapid growth over the next year or so and rapid growth in the last year in which full expensing is allowed, with little or no growth in between. This is obviously a less than optimal result. For now, though, we'll take whatever comes along that would prompt stronger capital spending.

Labor Market Firmly On Track

After two monthly reports significantly skewed by noise from Hurricanes Harvey and Irma, a relatively noise-free November employment report shows the labor market, like the broader economy, remains firmly on track. Total nonfarm employment rose by 228,000 jobs in November, with private sector payrolls up by 221,000 jobs. As has been the case over the current expansion, job growth was notably broad based in November. Consistent with other indicators of activity in the manufacturing sector, manufacturing payrolls rose by 31,000 jobs in November and are up by 189,000 jobs over the past 12 months.

Another encouraging detail of the November employment report is that the average length of the workweek rose by one-tenth of an hour. While this may seem a trivial change, keep in mind that each one-tenth of an hour increase in the workweek is equivalent to adding over 300,000 private sector jobs in terms of the economy's productive capacity. But, at 34.5 hours, the workweek is still short relative to past instances of tight labor market conditions. We have often referred to the shorter workweek as an underappreciated form of labor market slack, and firms still have ample capacity to add to their total labor input by adding hours for their current workers, which you would expect to be the case if firms were truly "running out of workers."

We've consistently argued there was more slack remaining in the labor market than implied by the headline unemployment rate, and we continue to hold this view. Growth in hourly earnings, which were up 2.5 percent year-on-year in November, remains slower than would be the case in a labor market at full employment. That said, with overall economic growth remaining solid, the labor market slack that does remain is being steadily pared down and as this continues to be the case earnings growth will respond.

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Q2 '17 (a)	Q3 '17 (p)	Q4 '17 (f)	Q1 '18 (f)	Q2 '18 (f)	Q3 '18 (f)	Q4 '18 (f)	Q1 '19 (f)		2016 (a)	2017 (f)	2018 (f)	2019 (f)
3.1	3.3	2.4	2.3	2.6	2.5	2.3	2.1	Real GDP[1]	1.5	2.3	2.6	2.1
3.3	2.3	2.4	1.8	2.4	2.3	2.2	1.9	Real Personal Consumption[1]	2.7	2.7	2.3	2.0
								Business Fixed Investment:				
6.7	8.5	9.2	5.2	5.0	4.3	3.7	3.4	Equipment, Software, & IP[1]	0.3	4.6	6.2	3.6
7.0	-6.8	2.0	3.4	2.8	3.0	2.8	3.1	Structures[1]	-4.1	5.4	1.8	2.8
-7.3	-5.1	6.2	7.7	8.8	12.0	11.7	9.2	Residential Fixed Investment[1]	5.5	1.3	5.8	8.9
-0.2	0.4	1.8	0.3	0.6	0.8	0.8	0.8	Government Expenditures[1]	0.8	0.0	0.7	0.8
-613.6	-594.4	-616.2	-624.1	-627.9	-636.6	-645.4	-653.6	Net Exports[2]	-586.3	-611.6	-633.5	-667.0
1.167	1.164	1.230	1.243	1.286	1.339	1.382	1.405	Housing Starts, millions of units[3]	1.177	1.200	1.313	1.437
16.8	17.1	17.4	16.7	16.6	16.5	16.5	16.3	Vehicle Sales, millions of units[3]	17.5	17.1	16.6	16.2
4.4	4.3	4.1	4.1	4.0	4.0	3.9	3.8	Unemployment Rate, %[4]	4.9	4.4	4.0	3.8
1.6	1.4	1.4	1.4	1.3	1.3	1.2	1.1	Non-Farm Employment[5]	1.8	1.5	1.3	1.0
1.6	1.8	1.8	1.8	2.1	2.1	2.0	2.1	GDP Price Index[5]	1.3	1.8	2.0	2.1
1.6	1.5	1.6	1.6	2.0	2.2	2.1	2.1	PCE Deflator[5]	1.2	1.7	2.0	2.1
1.9	2.0	2.0	2.0	2.7	2.9	2.6	2.5	Consumer Price Index[5]	1.3	2.1	2.5	2.3
1.5	1.4	1.5	1.5	1.8	2.0	2.1	2.1	Core PCE Deflator[5]	1.8	1.5	1.9	2.1
1.8	1.7	1.7	1.6	2.0	2.2	2.3	2.4	Core Consumer Price Index[5]	2.2	1.8	2.0	2.3
0.93	1.13	1.17	1.42	1.67	1.90	2.13	2.17	Fed Funds Target Rate, %[4]	0.39	0.97	1.78	2.40
2.26	2.24	2.36	2.50	2.60	2.70	2.80	2.90	10-Year Treasury Note Yield, %[4]	1.84	2.33	2.65	2.98
3.98	3.88	3.92	4.05	4.20	4.37	4.48	4.54	30-Year Fixed Mortgage, %[4]	3.65	3.99	4.27	4.69
-2.6	-2.4	-2.6	-2.6	-2.5	-2.6	-2.8	-2.9	Current Account, % of GDP	-2.4	-2.5	-2.6	-2.9

a = actual; f = forecast; p = preliminary

Notes:
1 - annualized percentage change
2 - chained 2009 $ billions
3 - annualized rate
4 - quarterly average
5 - year-over-year percentage change

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