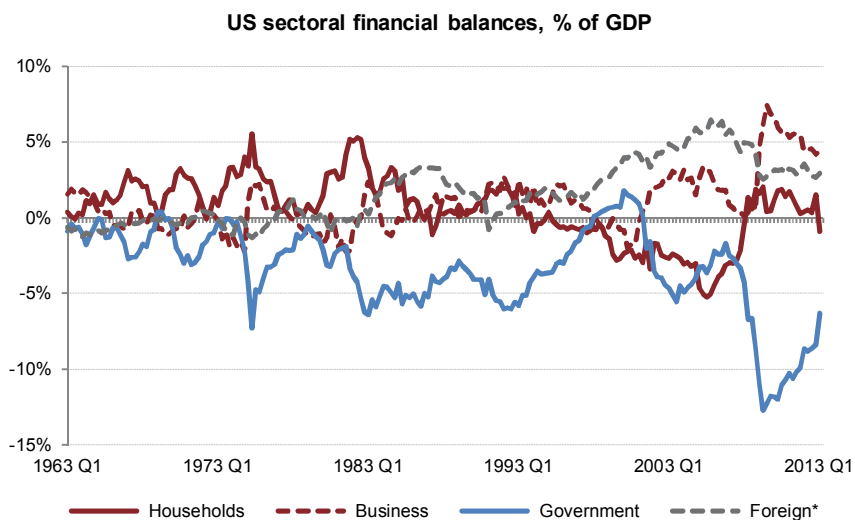


The case for a surge in US corporate cap-ex

- **Household sector financial balance turned negative in Q1**
- **Corporate sector now needs to become acting, rather than reacting**
- **There could be a corporate cap-ex surge**

There was a surprising development in US sectoral financial balances (SFBs) in Q1: 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 because the household sector had a negative balance. That was the norm in the US from Q1 1994 until Q1 2008. Nor was it because the household sector long-term in most countries should have a positive balance of savings over investment – after all, households have to repay their debt and usually out of current income. The surprise was rather that after 19 straight quarters with a positive balance, households suddenly invested more in housing than they spent.

However, the number is almost certainly misleading. January this year saw reversal of the 2 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 in order not to be subject to the higher tax rate. Hence incomes and savings were artificially inflated in Q4 2012 and equally artificially depressed in Q1 2013. Averaging the two quarters would leave the household sector financial balance marginally in positive territory in Q1 as well (0.2% in each quarter). This is a more likely ‘true’ picture, in that households still seem wary of taking on housing loans. But what does it mean for US SFB developments in coming quarters?

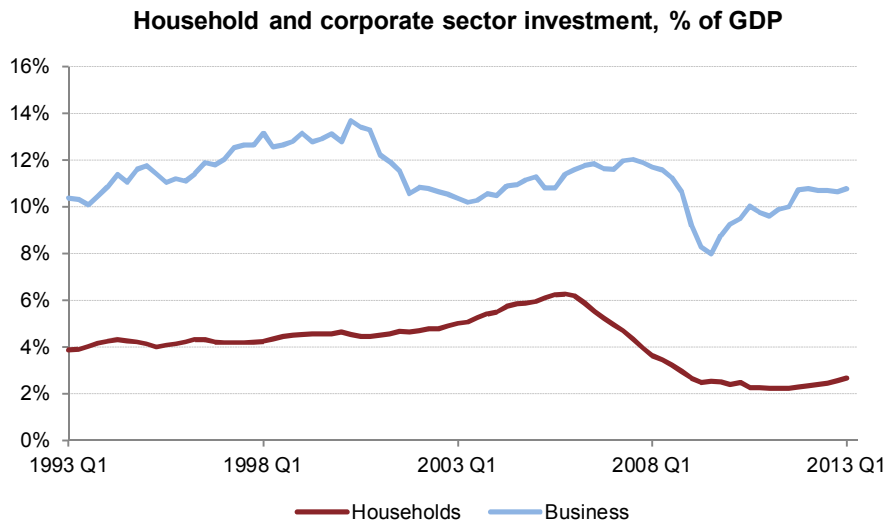


Bear in mind that SFBs cannot be modelled, since we have four sectors (household, corporate, public and foreign), each of which can at any given time be acting or reacting to the actions of others. For much

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of the 15 years until the Great Recession, the acting sector tended to be the foreign sector through the 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/early 2000s, the household and public sectors were pushed further into the red.



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.

However, this was an unstable equilibrium. From early 2009, the public sector switched from reacting to acting. 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. That is still very high by historic standards. The best development for the US right now would be a pick-up in corporate cap-ex. This would narrow the corporate sector surplus, allowing both the household and the public sectors to save more – and possibly also reduce the foreign sector excess savings. (The foreign sector is of course the US current account balance with a reversed sign.)

There are some very valid arguments why this could happen. Household confidence is picking up. Although federal spending is weakening, state and local government (which is 50% larger than federal) seems stable. There will eventually be some impact of the sequester on federally-funded state and local programs as well, but this does not yet seem to have occurred. The better than expected outlook has led to increased speculation that the Fed will begin to taper 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

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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 cap-ex plans trending up. Not surging – although the Empire State cap-ex 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 released in June with the Q1 Flow of Funds); and while cash relative to total financial assets is lower, it too is edging up. Finally, capital goods orders are rising more strongly than expected.

The fact that everything is in place for a pick-up in corporate cap-ex does not mean that it will automatically happen. However, if it does occur – and the auguries look good – it should have a very positive effect on US output growth, further supporting the case for a stronger dollar and US equities. But, it is also likely to bring forward the end of quantitative easing.

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