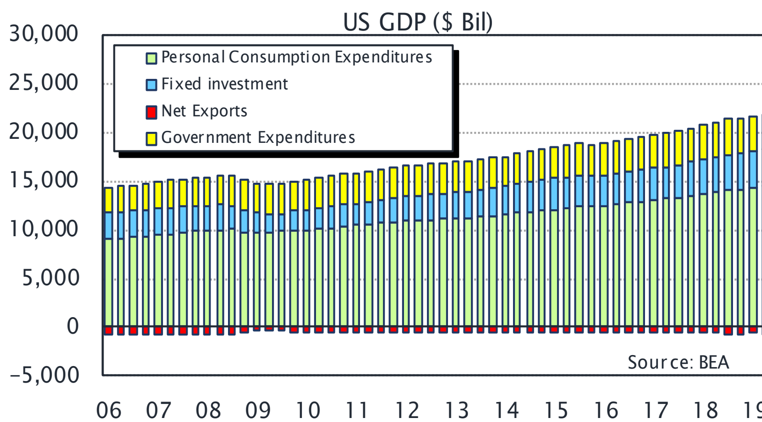
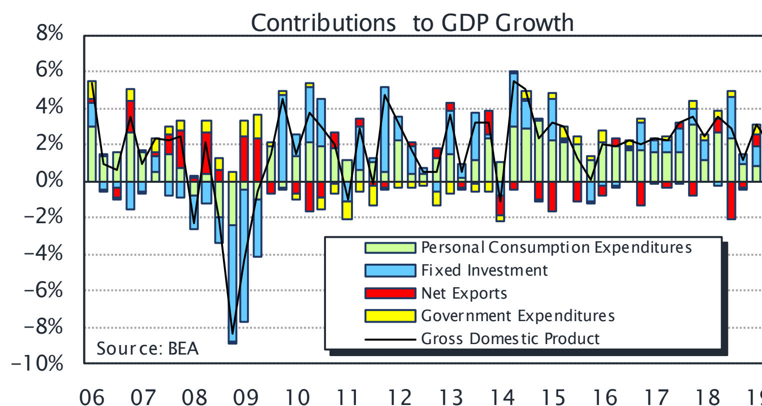
# INVESTMENT UPDATE

While there are some areas of strength currently in the global economic landscape (notably the US labor market), there are other areas that are moving sideways (the US housing market), and other areas that are weak and getting weaker. Clearly, the manufacturing sector is in this last group, as tariffs and trade disputes, especially between the US and China, are disrupting the global trade landscape at the same time that economic growth is slowing worldwide due to normal cyclical factors. When economists talk about the possibility of a recession in the next year or two, they are most likely focusing on a significant decline in the manufacturing sector.




How big is the manufacturing sector, and how vulnerable is the US to a weakening industrial base? As we often do, it's helpful to take a step back and define some terms. Some of us remember from college Econ 101 that the US economy's total output, its gross domestic product (GDP), is the total of "C+I+G+NX." The "C" is consumption—or "personal consumption expenditures," using the government's statistical term. It's the largest component of US GDP, representing 68% of total output. It includes consumer purchases for services and durable and non-durable goods. The "G" is government spending, including defense, health care, social security, education, plus all the various federal and local agencies, infrastructure spending, and interest on federal and local debt. The "NX" is net exports, the difference between what we receive in revenues from selling goods and services abroad minus what we buy from non-US producers. That leaves "I," fixed investment, which is the total money spent on capital-intensive structures (both residential and commercial), equipment, and intellectual property (including software). It's important to note that any changes in US inventories from period to period are netted out against fixed investment for that period, in order to measure only what occurred during the particular time period in question.

The top chart shows the growth of US GDP, by quarter, and includes these major components of US output and how they've changed over recent years. In the second quarter of 2019, the US generated more than $21 trillion in annualized output. Again, consumption is (and has historically been) the biggest component of US GDP, while net exports are a negative—the US imports more than it exports, a net drain on our economy. Yet most of the components of GDP are fairly stable, and their relative sizes haven't changed by more than a percent or two over this 13+ year period.

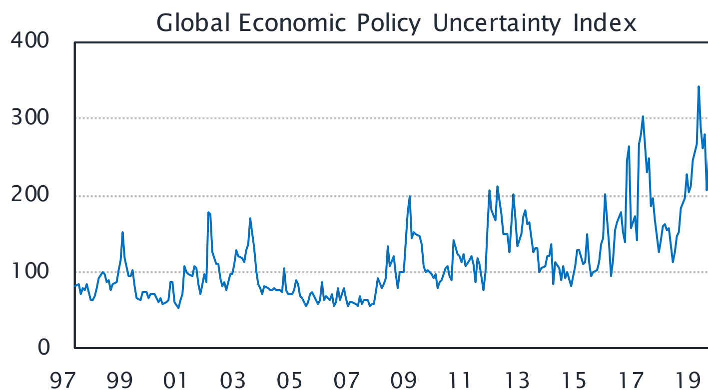



The bottom chart shows annualized change in GDP on a quarterly basis (the black line) as well as how much each component has contributed to total GDP for that period. Clearly, there is a lot more going on in these components than what is revealed in the gross numbers in the top graph. There are some interesting details: Government spending was a negative contributor for years after the financial crisis (state and local governments were in belt-tightening mode) but has more recently been a fairly reliable, if small, contributor to the US economy. Net exports, on the other hand, have operated in the opposite direction. As one would expect, the US consumer has been the primary driver of economic growth throughout this recovery, providing positive growth for 38 consecutive quarters.

But what is perhaps the most important factor is the variability of the fixed investment component, and how that can

translate into trouble for the economy. More than the other components of economic growth, capital investment is tied to psychology and confidence. When a company makes a capital investment, it's doing so because it's necessary to keep up with technology, or to meet an increase in demand, or to pursue a new opportunity, or simply because the organization's current "plant and equipment" needs replacement. In any case, capital investment is a bet on the future. Organizations will ramp up fixed investment when prospects are good, and back off when the future looks more problematic. Capital investment is a useful leading indicator of an economy's health.

Factors impacting fixed investment differ in important ways from those affecting personal consumption, which tend to be more tied to current employment conditions. When households have relatively secure jobs, consumer spending is fairly stable. And since companies hire only when they have to (months, if not years into a recovery) and layoffs of permanent employees don't typically occur until sales and revenues begin to drop (hiring and training new workers is so costly, it's often a last resort), consumer spending tends to be a lagging indicator of an economy's health.




Taking a second look at the bottom chart on page one, we see that prior to the great recession (which lasted from December 2007 to June of 2009), consumer spending was contributing positively to economic growth, albeit at a slowing pace, throughout 2006 and 2007. Fixed investment, on the other hand, turned negative in the second quarter of 2006, more than 18 months prior to the official start of the recession, and remained a negative contributor to GDP for 13 of the next 14 quarters. In the first few months of the recovery, fixed investment was the main contributor to US economic growth, pulling the US out of recession while the consumer was still reeling, and employment was lagging.

Even though fixed investment is a relatively small (17%) component of US GDP, it is the most important swing factor in pointing to the future direction of the economy. It's no wonder that alarm bells are going off now that investment appears to be falling. But one negative reading doesn't make a trend; can we make any predictions about the future direction of fixed investment, and thus, the broader US economy? Let's look a little closer at the numbers.

The fixed investment component of the economy can be further subdivided into residential structures (approximately 3.5% of GDP, less than half its relative size pre-housing crisis), and nonresidential (that is, business) fixed investment. Business fixed investment (roughly 13.5% of GDP), in turn, is comprised of three main categories: structures, equipment, and intellectual property. As the economy has cooled over the past few quarters, we've seen both residential and non-residential structures turn from positive to negative contributors to US GDP, and equipment spending has slowed to near-zero growth. Intellectual property investments have held up relatively well, but are slowing as well, and have not been enough to lift the entire fixed investment group in the most recent period.

It will come as no surprise that the slowdown in capital investment coincided with the escalation of the US' trade dispute with China. Since the summer of 2018, when tariffs on steel and aluminum imports began to be collected, fixed investments have fallen from contributing 0.90% to US GDP to only 0.36%. With future increases in tariffs looming, sentiment has soured, with important leading indicators for the manufacturing sector (e.g., new exports orders) falling steeply over the past year. Intellectual property/tech spending has been the sole area of strength among the major components of fixed investment, and further disruptions (including price hikes on imports) caused by heavy tariffs could do significant damage to the US tech industry, as China buys 45% of US exports of computer and electronic products. As the chart on this page shows, the global Economic Uncertainty Index stands at the highest level since its inception in 1997. As we all know, uncertainty is bad for business.

Yes, there are some bright spots. Consumers continue to drive US economic growth at a modest (2%-ish) growth rate, and consumer confidence about present conditions remains high (although there has been a drop in expectations). China is motivated to avoid an all-out trade war with the US, and appears to be ready to make concessions on intellectual property protections, a key factor for US negotiators. And, of course, the Federal Reserve has moved towards a more accommodative stance for US monetary policy, with two rate cuts over recent weeks. In the press conference after the September 18th rate cut, Fed Chair Jay Powell cited softness in capital investment and manufacturing as key reasons for the Fed's easier monetary policy and agreed that more extensive cuts may be needed if the economy weakens further.

Only time will tell if "mid-cycle adjustments" (as the Fed optimistically calls them) will be sufficient to keep the economy on a path of sustainable growth, especially given that certain other major economies (Germany, for one) are already contracting. Recession or not, there are plenty of challenges for policymakers and investors in the coming months.