April 09, 2018

Economics Group

Special Commentary

Jay H. Bryson, Global Economist
jay.bryson@wellsfargo.com • (704) 410-3274
Tim Quinlan, Senior Economist
tim.quinlan@wellsfargo.com • (704) 410-3283
Sarah House, Senior Economist
sarah.house@wellsfargo.com • (704) 410-3282
Shannon Seery, Economic Analyst
shannon.seery@wellsfargo.com • (704) 410-1681

Global Investment Outlook: Part I
Could Over-Investment Derail This Global Expansion?

Executive Summary

Because investment spending has important implications for the short-run sustainability of the current cycle as well as for long-run potential economic growth, we should be concerned if there are signs of excessive capital spending. In a series of four reports, we look at the investment outlook in the advanced economies of the world. In the first report of the series, we find little evidence to suggest that advanced economies have over-invested over the past few years, which augurs well for continued growth in investment spending in those economies in the years ahead.

The Importance of Investment Spending for Economic Growth

A key driver for global economic growth in the years to come will be investment spending. Not only does investment spending contribute to the short-run sustainability of the current cycle, but capital investment is an important determinant of an economy's long-run potential growth rate. Specifically, labor force growth and the improvement in the productivity of those workers determines the long-run potential growth rate for any economy.

The productivity growth piece can be further divided into two drivers: growth in capital spending (the actual equipment and facilities utilized by the workers) and growth in total factor productivity (the intangibles that affect output per hour worked, such as education or new innovations). If labor force growth is weak, as it is in most advanced economies, then investment becomes more important, everything else equal, in determining the long-run growth potential of an economy.

Levels of capital spending in many advanced economies are not yet running meaningfully above their respective trends.

In a series of four reports we look at the investment outlook in the advanced economies of the world.[1] Not only do we analyze the outlook for overall investment spending in this first report, but we also disaggregate investment spending into its three principal components (equipment and machinery, non-residential construction, and intellectual property) in subsequent reports. The key takeaway of our analysis is that levels of capital spending in many advanced economies are not yet running meaningfully above their respective trends despite the longevity of the current global expansion, which augurs well for continued growth in investment spending in advanced economies in the years ahead.

Little Evidence of Over-Investment at This Time

We constructed a time series of real investment spending in advanced economies that spans Q1-1995 to Q3-2017, to which we then fitted a trend line.[2] As shown in Figure 1, real investment

[1] Data limitations prevent us from analyzing the investment outlook in the developing world. We constructed our aggregate investment series from investment spending data from the United States, the Eurozone, Japan, the United Kingdom, South Korea, Canada, Australia, Denmark, Israel, Norway, Singapore and Sweden. In aggregate, these economies account for nearly 60 percent of global GDP (aggregated using market exchange rates). We focus on the first seven economies listed above in this and subsequent reports because they account for about 95 percent of investment spending in our 12-economy sample.

[2] The raw data on real investment spending were expressed in the currencies of the individual economies. We aggregated the data into U.S. dollars using PPP exchange rates.

spending in the advanced economies has doubled over the past 22 years. Although aggregate investment spending currently stands at an all-time high, it is essentially at its long-run trend. Actual investment spending in advanced economies exceeded its long-run trend by about 8 percent in the global expansion that ended in late 2000 and by 12 percent at the end of the last cycle. If the past is any guide, then investment spending in advanced economies has more room to run in the foreseeable future. Although investment spending may not eventually exceed its trend as much as it did during the past two expansions, there is no reason to think that it will peter out anytime soon either.

Figure 1

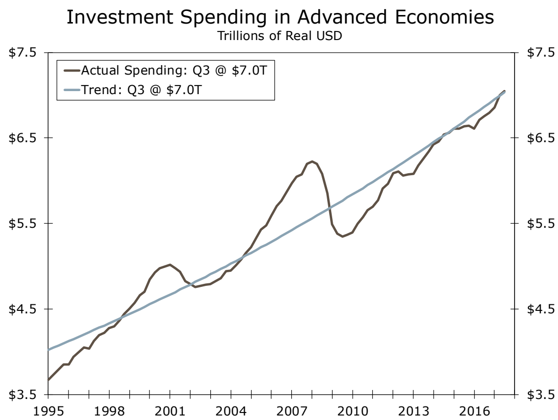
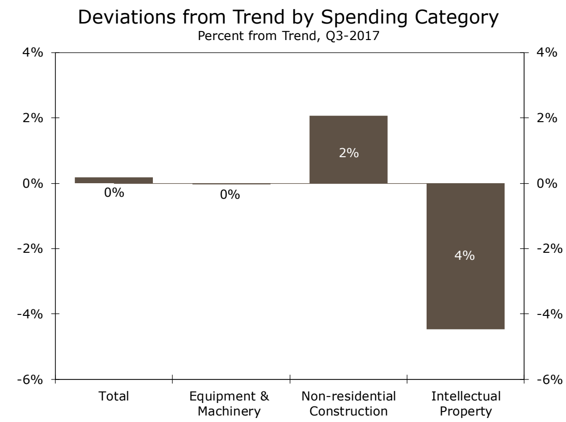


Figure 2



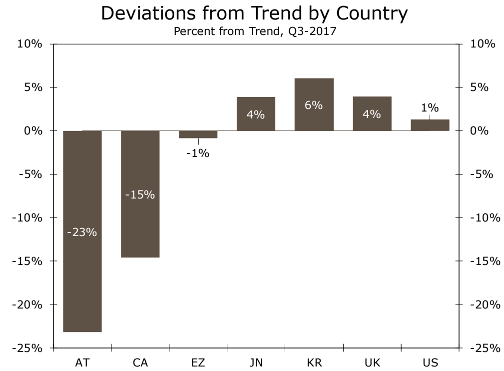
Source: U.S. Department of Commerce, Eurostat, IMF, IHS Markit and Wells Fargo Securities

As noted above, overall investment spending is comprised of three components. We will provide more detailed analysis of each component in our forthcoming reports, but Figure 2 shows current deviations from trend for each of the components. Spending on equipment and machinery, which accounts for about 40 percent of total investment spending in the advanced economies, is at trend at present, and non-residential construction spending (about 30 percent of the total) is just 2 percent above trend at present. This latter spending category exceeded trend by 6 percent in 2000 and by as much as nearly 12 percent in 2008. Consequently, spending on equipment and machinery as well as on non-residential construction would seem to have further room to run. Spending on intellectual property (roughly 30 percent of total investment spending) is currently about 4 percent below trend, suggesting that this spending component clearly could strengthen further.

There is little evidence of over-investment in the aggregate, but could there be over-investment in individual economies?

In sum, there is not much evidence of over-investment in advanced economies, at least not in the aggregate. But could there be over-investment in individual economies? Figure 3 shows deviations of actual investment from trend investment in individual advanced economies. Australia and Canada stand out with their significant degrees of under-investment relative to trend. We will have more to say about Australia and Canada in subsequent reports, but it appears that the commodities price bust of 2015-2016 depressed investment spending in these two economies in which the commodities producing sector is large. Investment spending is currently above trend in Japan, the United Kingdom and South Korea, but there were larger deviations from trend in these economies in previous cycles. Overall investment spending in the United States and the Eurozone is more or less at trend in both economies. In short, none of individual economies appear to be experiencing an investment "bubble" at present.

Figure 3



Source: U.S. Department of Commerce, Eurostat, IMF, IHS Markit and Wells Fargo Securities

What Could Go Wrong?

As noted above, there is little evidence to support the notion that advanced economies, either individually or in aggregate, have over-invested over the past few years. In theory, investment spending in most advanced economies should continue to expand for the foreseeable future. But are there any reasons to be concerned about a premature stall in capital spending in the next year or two?

Investment spending in most advanced economies should continue to expand for the foreseeable future, but will it?

Investment spending tends to be interest rate sensitive, so monetary tightening could eventually weigh on growth in capital spending. The Federal Reserve has lifted its target rate for the fed funds rate 150 bps so far in this tightening cycle, and the Bank of Canada has hiked rates 75 bps since July (Figure 4). Most analysts, ourselves included, look for further rate hikes by these central banks going forward. That said, interest rates in the United States and Canada remain low in a historical context, and we do not expect that either central bank will hike rates in such an aggressive manner that it torpedoes investment spending. Central banks in other advanced economies have either not started to tighten policy (Australia, the Eurozone and Japan) or they have done so only slowly (the United Kingdom and South Korea). In short, it does not appear that monetary tightening will short-circuit the expansion in investment spending in advanced economies anytime soon.

Figure 4

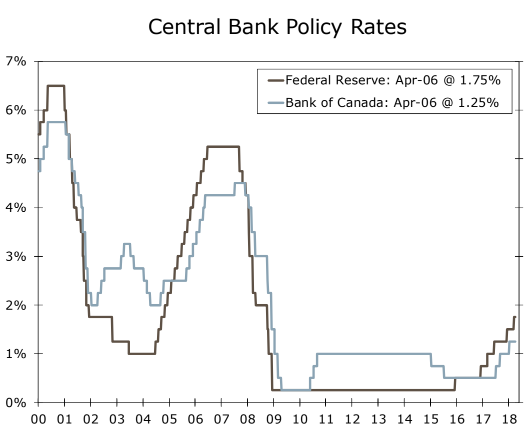
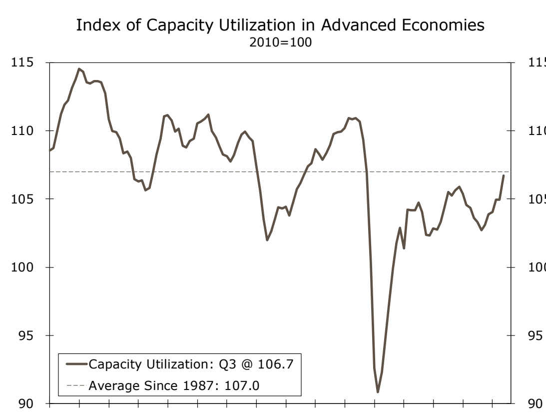


Figure 5



Source: Bloomberg LP and Wells Fargo Securities

Could excess capacity constrain growth in investment spending? As shown in Figure 5, an index of industrial capacity utilization in advanced economies that we constructed has rebounded markedly since the depths of the Great Recession.[3] That said, it is only at its average level of the past 30 years, which suggests that there may still be some excess capacity in advanced economies. Although measures of capacity utilization are currently above average in the Eurozone, the United Kingdom and Canada, they are below average in the United States, Japan and South Korea.

There are two caveats to keep in mind, however. First, capacity utilization does not need to be above average before industrial companies start to invest. Growth in investment spending turned positive in many economies shortly after the Great Recession ended. Second, the capacity utilization index that is shown in Figure 5 is for the industrial sector, which comprises a relatively small share of advanced economies. Services account for the majority of value added in advanced economies, but there generally are not good measures of capacity utilization in this sector. But with unemployment falling to its lowest rates in years, if not in decades, across advanced economies, it does not appear that service sectors are swimming in excess capacity in those economies. In short, we do not believe that capacity concerns will act as a meaningful brake on investment spending in advanced economies.

Of course, the outlook for investment spending in advanced economies could turn south if the overall cycle were to stall. Although we and most other forecasters expect the global economic expansion to continue through at least the end of 2019, unforeseen events could potentially lead to another economic downturn. In that regard, the world is full of geopolitical risks that, if disruptive enough, could lead to a premature end to the global economic expansion. Because those events are more or less impossible to forecast, we will eschew further discussion of them in this report.

Conclusion

Overall investment spending in advanced economies can continue to grow for the foreseeable future.

Investment spending in advanced economies tumbled 14 percent between Q1-2008 and Q3-2009. Although total investment spending has grown more or less continuously since mid-2009, it is only back to the upward trend that it has followed for the past 20 years or so. In short, there is little evidence to suggest that advanced economies have over-invested over the past few years. In our view, overall investment spending in advanced economies can continue to grow for the foreseeable future. Everything else equal, continued growth in investment spending should enhance the sustainability of the current global expansion.

Although the aggregate amount of investment spending in advanced economies appears to be more or less "normal" at present, individual components in some individual economies could be at excessive levels. We will drill down further into individual components of investment spending in subsequent reports to ascertain if there are any pockets of concern regarding the investment spending outlook.

[3] To construct the index we use data on capacity utilization rates in the overall industrial sector in the United States, the Eurozone, the United Kingdom, Canada and Australia. For Japan and South Korea, however, we only have data on capacity utilization in the manufacturing sector. Because manufacturing accounts for the vast majority of value added in the industrial sector in most economies, we do not believe that we have introduced a material omission in our index of capacity utilization in advanced economies.

Wells Fargo Securities Economics Group

Diane Schumaker-Krieg	Global Head of Research, Economics & Strategy	(704) 410-1801 (212) 214-5070	diane.schumaker@wellsfargo.com
John E. Silvia, Ph.D.	Chief Economist	(704) 410-3275	john.silvia@wellsfargo.com
Mark Vitner	Senior Economist	(704) 410-3277	mark.vitner@wellsfargo.com
Jay H. Bryson, Ph.D.	Global Economist	(704) 410-3274	jay.bryson@wellsfargo.com
Sam Bullard	Senior Economist	(704) 410-3280	sam.bullard@wellsfargo.com
Nick Bennenbroek	Currency Strategist	(212) 214-5636	nicholas.bennenbroek@wellsfargo.com
Eugenio J. Alemán, Ph.D.	Senior Economist	(704) 410-3273	eugenio.j.aleman@wellsfargo.com
Azhar Iqbal	Econometrician	(704) 410-3270	azhar.iqbal@wellsfargo.com
Tim Quinlan	Senior Economist	(704) 410-3283	tim.quinlan@wellsfargo.com
Eric Viloria, CFA	Currency Strategist	(212) 214-5637	eric.viloria@wellsfargo.com
Sarah House	Senior Economist	(704) 410-3282	sarah.house@wellsfargo.com
Michael A. Brown	Economist	(704) 410-3278	michael.a.brown@wellsfargo.com
Charlie Dougherty	Economist	(704) 410-6542	charles.dougherty@wellsfargo.com
Jamie Feik	Economist	(704) 410-3291	jamie.feik@wellsfargo.com
Erik Nelson	Currency Strategist	(212) 214-5652	erik.f.nelson@wellsfargo.com
Michael Pugliese	Economist	(212) 214-5058	michael.d.pugliese@wellsfargo.com
Harry Pershing	Economic Analyst	(704) 410-3034	harry.pershing@wellsfargo.com
Hank Carmichael	Economic Analyst	(704) 410-3059	john.h.carmichael@wellsfargo.com
Ariana Vaisey	Economic Analyst	(704) 410-1309	ariana.b.vaisey@wellsfargo.com
Abigail Kinnaman	Economic Analyst	(704) 410-1570	abigail.kinnaman@wellsfargo.com
Shannon Seery	Economic Analyst	(704) 410-1681	shannon.seery@wellsfargo.com
Donna LaFleur	Executive Assistant	(704) 410-3279	donna.lafleur@wellsfargo.com
Dawne Howes	Administrative Assistant	(704) 410-3272	dawne.howes@wellsfargo.com

WELLS FARGO SECURITIES