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Economics Group

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Do Rising Rates Spell Trouble for Equipment Spending Ahead?

The recent climb in borrowing rates, in isolation, presents a headwind to capital investment. Equipment spending, however, should remain strong in light of solid sales, rising profits and elevated spending plans.

Capital Costs Rising

A rebound in inflation, tighter monetary policy and a surge in net Treasury issuance have pushed borrowing rates to multi-year highs. Does the increase spell doom for rate-sensitive areas of the economy like equipment spending?

After rising at a double-digit pace in the second half of 2017, equipment spending looks to have cooled in Q1. The slowdown may lead to some concerns that higher interest rates are beginning to take a bite out of what was an impressive run for equipment spending last year. Conventional economic theory tells us that firms curtail investment as the real cost of capital rises. That assumes, however, that other conditions are equal, which they seldom are.

When Ceteris Isn't Paribus

As illustrated in the top chart, Fed tightening has hardly been a death knell for business spending. Equipment spending has actually strengthened since the Fed began raising rates in late 2015 and, in previous cycles, remained buoyant as interest rates rose. We expect the impact of higher rates to be marginal given otherwise favorable conditions for equipment outlays.

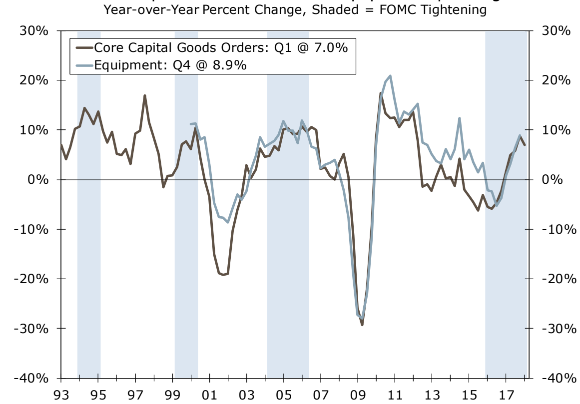
For starters, spending decisions are not only based on the cost of capital, but the total return on investment, which is influenced by final demand. Real final sales are expected to pick up over the coming quarters as household income benefits from an increasingly tight labor market and last December's tax bill. The bill's lowering of corporate tax rates should similarly help investment spending as firms—specifically financially constrained ones—have more funds on hand for new equipment. Capital spending plans, as measured by the Fed's regional PMIs, sit well above the highs registered in the past two expansions (middle chart).

Financial conditions also remain supportive of business spending. The Fed's Senior Loan Officer Opinion Survey shows banks on net easing business lending standards over the past year, while the Chicago Fed's National Financial Conditions Index indicates conditions are easier today than when the Fed began normalization in 2015. Moreover, even as rates have been rising, spreads have been falling—at least until recently (bottom chart).

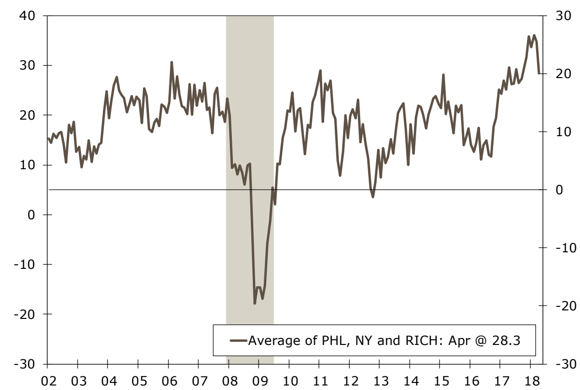
Equipment Spending to Slow, but Not Just Because of Rates

While we do not expect rising rates to crush equipment spending, a slowdown nevertheless appears in store. Higher interest rates will hurt at the margin, and the initial rebound in commodity-related investment following the partial recovery in prices is beginning to fade. At the same time, capital spending plans have wobbled in April as the initial euphoria regarding the tax plan has faded and trade-war concerns have grown. We anticipate the tailwinds to win out over the headwinds, but for equipment spending to moderate to around a six percent pace later this year.

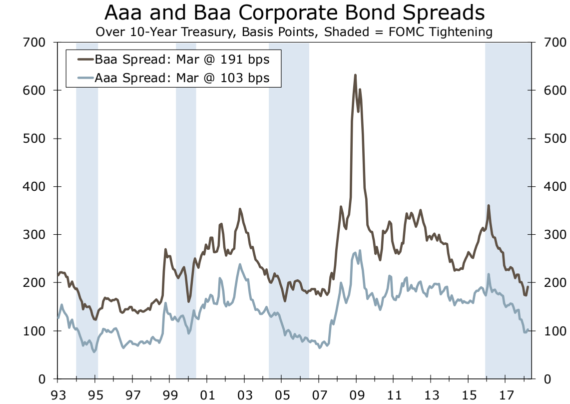
Core Capital Goods Orders vs. Equipment Spending
Year-over-Year Percent Change, Shaded = FOMC Tightening



U.S. Regional Fed Surveys
Capital Expenditure Plans- Manufacturing, Diffusion Index SA



Aaa and Baa Corporate Bond Spreads
Over 10-Year Treasury, Basis Points, Shaded = FOMC Tightening



Source: U.S. Department of Commerce, Federal Reserve System, Moody's Analytics and Wells Fargo Securities

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