

MACROCOSM

## The Brightening Capex Outlook

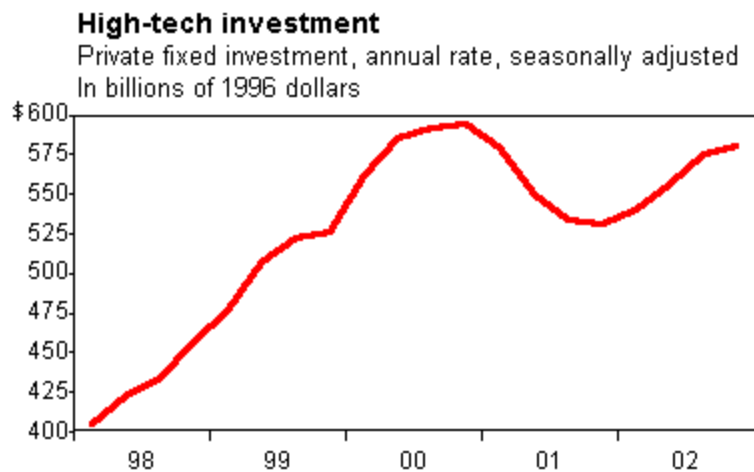
Tuesday, February 11, 2003

David Gitlitz

**The recession's signature malady -- depressed capital investment -- is quietly beginning to turn around.**

Among factors weighing on market perceptions about the economic outlook, none probably is more critical than the continuing doubts about prospects for recovery of capital investment activity. This is understandable: after all, memories of the devastation of the late-1990s capital investment boom -- and with it the decimation of the market values of capital goods industries, particularly in high tech -- remain all too fresh. And with asset prices at the peak of the bull market having been based on expectations for sustained growth that turned out to be wildly unrealistic, it's not terribly surprising that many portfolio investors remain highly skeptical of any but the least favorable scenarios for capex growth.

From our contacts in the portfolio management community, however, it's also apparent that an important contribution to this dour sentiment is the faulty analysis of business investment fundamentals coming off the cookie-cutter assembly line of Wall Street economics research. In meetings last week in New York with some two dozen senior-level PMs, at least half cited the conventional consensus that capex is likely to remain depressed due to the "overcapacity" created by the investment splurge of the '90s boom. We find little in this rendering, however, that coherently explains the boom-went-bust phenomenon of the two-plus years. If this story line fails to adequately account for events in the recent past, it's not likely to prove prescient in discerning the factors likely to shape the trends in real investment activity going forward. In fact, the available data already appears to be refuting key elements of this downcast conventional wisdom, with some indicators of technology investment now showing levels last seen more than two years ago.



We're no Pollyannas on this issue. Over the past year, we produced several reports pointing to the ongoing depression in technology investment as emblematic of an economic environment characterized by imposing obstacles to new capital formation. Those obstacles showed through as a risk premium in the cost of capital that raised to prohibitive levels the hurdle rates of return required to justify new investment and risk-taking. In our analysis, that was explained primarily in the

context of **the Fed's** deflationary siege of 1997-2001, which ultimately crushed nominal revenue

streams and, in the process, dragged profits through the wringer. The lingering uncertainty could be seen as the aftermath of deflation, with confidence in the Fed's willingness to sustain the reflation of the unit of account remaining in doubt through much of last year.

Contrast that with the one-dimensional conventional analysis being churned out by the Wall Street economics factory. According to that view, capex is still being retarded by the investment overhang of late last decade that left firms with more capacity and technology than they could profitably use. But this formulation offers no more of a convincing rationale for the current investment climate than it did for the demise of the boom. Up until the point when the economy slowed so sharply in late 2000, planned growth of technology investment remained at double-digit levels. Those investments, though, could only be justified to the extent that expected returns justified the capital outlays. With the sudden braking of growth expectations, the capex plans of scores of firms were quickly rendered uneconomic. There was no investment "overhang" until the economic downturn rendered previously planned investments superfluous.

Meanwhile, the available evidence strongly suggests that the technological upgrade of the capital stock was only partially finished at the time the investment collapse hit more than two years ago. Widely accepted estimates suggest that the task of adapting the information technology innovations of the 1990s is still less than 50% complete. And while the returns available from completing those investments were overwhelmed by the risks imposed by the attendant uncertainties, that is now changing. According to the fourth quarter '02 GDP estimates released last month, spending on information processing equipment and software, after troughing at a \$532 billion annual rate in fourth quarter '01, increased to \$581 billion by year-end, for a year-over-year growth rate of some 9.2%. Moreover, the high-tech investment total in the fourth quarter was just some 2.2% below the peak recorded in the fourth quarter of 2000. At the same time, the broader fixed-investment category of equipment and software finished the year with three consecutive quarters of growth, for a four-quarter growth rate of 3% on the year. That's no boom by any means, but it represents significant improvement from the four-quarter plunge of nearly 9% recorded in '01.

In his testimony today, **Fed chairman Alan Greenspan** offered a guarded assessment of capex prospects, telling the **Senate Banking Committee** that the "heightening of geopolitical tensions" has created "formidable barriers to new investment and thus to a resumption of vigorous expansion of overall economic activity." Perhaps. But it's also possible that Greenspan is constructing this rationale to hold down expectations and leave himself with an out if growth fails to meet the **FOMC's** "central tendency" of 3.25% to 3.5% this year. For our part, it seems unlikely that the longer-run expected returns upon which most capital investment decisions turn will be long affected by a possible -- and most likely, quick -- war with Iraq. After an abrupt and ruthless retrenchment, in other words, the capex outlook is brightening. **TM**