

CAPEX BOOMS !

Market Viewpoint: June 6, 2018

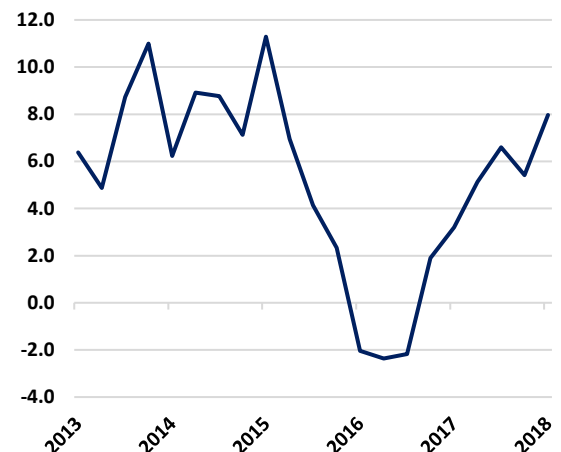
A capital spending boom is underway in America and around the world! The first quarter saw aggregate capex up a record 24% YoY, according to Bank of America Merrill-Lynch, and estimates by factory purchasing managers project a jump of more than 10% for the entire year. Prior projections in December 2017 had that number at 2.7%. The Philly Fed Manufacturing index has also risen to its strongest level in years as readings for new orders in May soared to 40.6 from 18.4. Manufacturers anticipate sales will rise 6.6% this year which, along with greater pricing power, will improve profitability.

Companies' ability to create downstream investment is usually contingent on profitability and the resulting cash flow, and right now, both have surged. S&P 500 companies have a record high \$1.78 trillion in cash, with spending estimated to rise 18% this year to \$641 billion.

Many have credited the emerging boom to recent tax cuts which have saved US companies around \$13 billion thus far. The upturn from the 2015-2016 capex slump began a year or so before these cuts passed, no doubt in anticipation of the upcoming fiscal change. The reforms also led to the repatriation of hundreds of billions of dollars held overseas. Although a large amount of this cash has been used for stock buybacks or cash mergers, the new expense provision included in the bill still incentivizes capex by allowing companies that make certain capital investments to take a 100% deduction for the next five years, greatly reducing after-tax cost. As such, the spending may just be getting started.

Also, the new tax on global intangible low-taxed income (GILTI) effectively imposes a minimum level of tax on the foreign profits of U.S. multinationals, which is intended to discourage U.S. companies from

U.S. CAPEX REBOUNDS
Gross Private Domestic Investment,
YoY % Change
Q1 2013 - Q1 2018

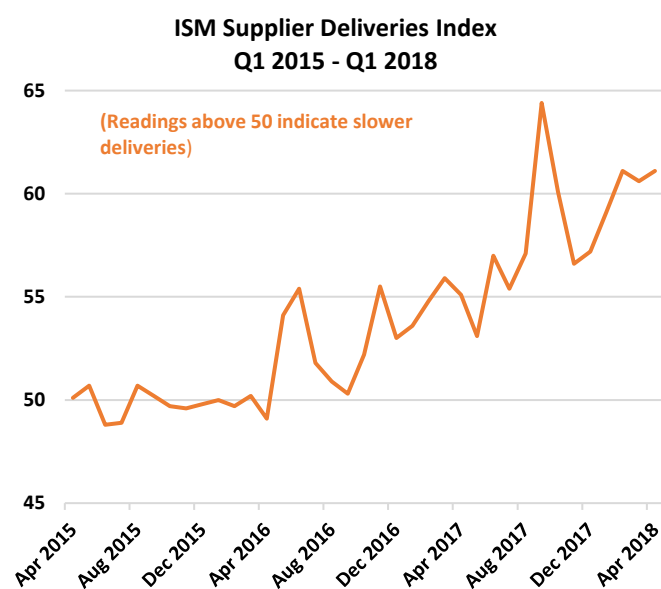


Joseph J. McAlinden, CFA, is the founder of [McAlinden Research Partners \(MRP\)](#) and its parent company, Catalpa Capital Advisors. He has 50 years of investment experience. Mr. McAlinden founded Catalpa Capital in March 2007 after leaving Morgan Stanley Investment Management where he had spent 12 years, serving first as chief investment officer and later as chief global strategist. During his 10 year tenure as chief investment officer, he was responsible for directing MSIM's daily investment activities and oversaw more than \$400 billion in assets. As chief global strategist, he developed and articulated the firm's investment policy and outlook. Prior to Morgan Stanley, Mr. McAlinden held positions as chief investment officer at Dillon Read and as President & CEO of Argus Research. Mr. McAlinden frequently appears in the financial media including Bloomberg Television.

moving value-generating activities to low-tax jurisdictions outside the United States. It may further discourage some companies from moving future assets offshore. This makes companies more likely to put this money toward research and development. Goldman Sachs is predicting that, while large US companies will spend \$1.2 trillion on buybacks and dividends, an additional \$1 trillion will still be spent on capital expenditures.

Capacity utilization in the “old economy” continues to climb higher, already up 2.3% YoY to the highest level since March 2015. Manufacturing has seen a YoY increase of about 1% in factory operating rates. At the same time, new orders for non-defense capital goods excluding aircraft rose 1% in April, offsetting a March decline. The Purchasing Managers Index was also up in May with a reading of 58.7%, up 5.8% from the previous year.

SUPPLIERS' SLOWING DELIVERIES CAN'T KEEP UP WITH MANUFACTURERS' DEMAND



Bolstering the case for new investments is a prolonged slowdown in deliveries. The delivery performance of suppliers to manufacturing organizations was slower in May, as the Institute for Supply Management's (ISM) Supplier Deliveries Index registered 62% (a reading above 50 indicates slower deliveries). This is higher than the 61.1% reported for April, marking the 20th straight month of slowing supplier deliveries in the face of a demand surge, a continuing constraint to production growth. Labor shortages and uncertainty in the steel and aluminum markets could continue to restrict production output for the foreseeable future, strengthening the case for greater downstream capital investment in supplier infrastructure.

Energy is another industry that should see a rebound in capex, although it may take some time since investment usually lags price increases in oil and gas and, therefore, the subsequent gains in cash flow. Even after an extended period of low oil prices, energy companies are believed to have boosted capital spending by 15% in the first quarter.

The “New economy” is playing a large role in this wave of capex. More than half of growth in 2018's spending drive is from the tech sector. S&P 400 tech companies posted 48% growth in first-quarter capex, led by internet and software companies that are pushing tech capex to 5-year highs via investments in data centers, real estate, underwater cables, etc. Amazon tops the list of spenders with plans to invest

\$28 billion in capex this year, Alphabet/Google is second with a planned capex spend of \$23 billion, followed by Facebook with \$15 billion in planned capex, an especially steep increase of 123% YoY. Capital spending in semiconductors alone is projected by IC Insights to increase by 14%, up from 8%. If this increase occurs, it would be the first time that semiconductor industry capital outlays exceed \$100 billion.

The capex drive is not just a US phenomenon either. Rather, corporate profitability around the world is on the rise. Japan's ongoing labor shortage, for instance, is driving investment into labor saving technologies such as robotics and automation. Industries from dairy to construction have no choice but to invest in new robotics projects to maintain their productivity. Investment intentions in the UK's manufacturing sector reached their highest level in four years. In July 2016, one month after the EU referendum, the UK Treasury predicted that total investment would fall, on average, by 3.5% last year. However, overall investment actually grew by 4% – the fastest rate in the G7.

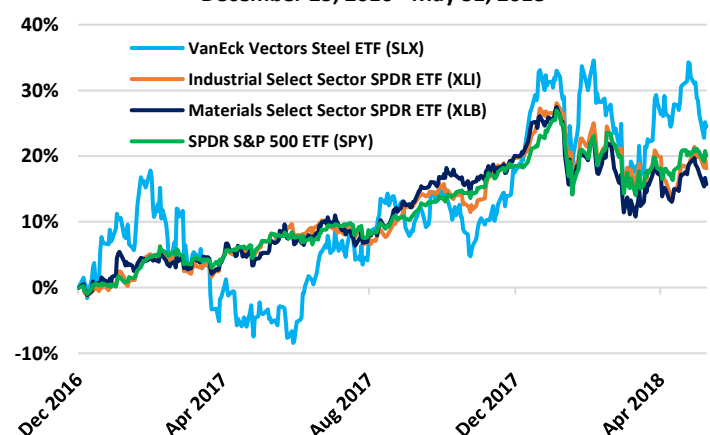
Capital investment is especially essential in emerging markets where it is not only about cash, but also rapidly growing populations. After five years of decline, emerging markets capex growth is forecasted to turn positive. EM finished 2017 with an estimated capex growth of 6% after declining capex growth in each of the past five years. It is expected that, in 2018, EM corporations will spend 37% more than last year. India alone aims to generate an investment of \$100 billion in the telecom sector over the next five years to ensure that an adequate number of telecom towers, estimated at 100,000, are constructed to accommodate its emerging middle class. State oil companies also spent a record \$19 billion in 2017-18 on acquisitions as well as expanding oil production, refining and distribution facilities. Capex was 22% more than the previous year. In Southeast Asia, over \$46.3bn is expected to be spent on upstream capex for oil and gas through 2020. Asia, as a whole, will spend \$102 billion on oil and gas capex in 2018.

The ongoing strength in capital spending underpins MRP's "long" themes in industrial materials and industrial machinery. The Industrials ETF (XLI) and Materials ETF (XLB) have just barely underperformed the S&P since launch, returning 18% and 16%, respectively, versus the S&P's 20%. The VanEck Vectors Steel ETF (SLX) has done better with a return of over 24%, outperforming the S&P, but with higher volatility and a big draw down last year. The capex boom and tariffs, however, should inspire better performance.

STEEL, INDUSTRIALS, MATERIALS STOCKS PREPARE TO TAKE OFF

Steel (SLX) vs Industrials (XLI) vs Materials (XLB) vs
S&P 500 (SPY)

December 23, 2016 - May 31, 2018



MRP believes the capex gains we have seen thus far are only the beginning, as the tax cuts have only been in effect for a few months, and corporate behavior has yet to actually change. As a percentage of cash flow, companies are still spending about what they usually spend on capital investments and other expenditures. Boards of Directors often take a while to start approving big new projects. Capital investments are usually planned months or years in advance of the actual project start date. While the uptick in projected capex is indicative of the fact that there is simply more cash to go around, how it is spent may not have changed on paper yet, but, in MRP's view, it will. Our expectation is that planned investments should sustain a growing capex drive that will bolster relative returns in the capex-sensitive themes for the next several years.

A handwritten signature in black ink that reads "Joe Mac". The signature is written in a cursive, flowing style.

For MRP's research disclaimer, please go to www.mcalindenresearchpartners.com/disclaimer.html