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Why Business Investment Could Break Out

More Companies Appear Likely to Step Up Spending as Signs Point to Faster Economic Growth

By NEIL SHAH

America's businesses have been caught in a vicious circle when it comes to investment.

Many say they want to see the economy growing faster—generating sustained growth in demand for their goods and services—before they would be willing to splurge on new equipment, software and buildings. But lackluster business spending is one thing holding back growth.

That could change this year. If U.S. gross domestic product, the sum of all the goods and services produced in the economy, comes in at a 3% growth pace for the final three months of 2013, as many economists are forecasting, the economy could see the best half of a year in a decade.

Rising stock prices and real-estate values, sturdier household finances and lower gas prices should help consumers spend more in the months ahead. And the two-year budget deal reached by

Congress late last year should reduce the risk of another Washington-made crisis when lawmakers tackle the nation's borrowing limit again next month. While Friday's jobs report was a big disappointment, the larger picture in the labor market has been steady albeit unimpressive growth.

It is against this backdrop that more companies appear likely to step up their spending. One gauge of business investment—new orders of nondefense capital goods, excluding aircraft—grew 4.1% in November, the biggest jump in nearly a year, after shrinking for two months. A broader measure of business spending that includes buildings and software grew at an annualized pace of 4.8% in the third quarter of 2013 and 4.7% in the second, after declining 4.6% in the first quarter.

Economists now expect business spending to keep accelerating. **Bernard Baumohl, chief global economist with The Economic Outlook Group**, expects the broader measure of business investment to expand 7.3% in 2014, versus 2.5% in 2013; IHS Global Insight sees this gauge speeding up to 4.9% this year and then to 6.3% in 2015 and 7.8% in 2016.

"The incentives to invest are there," said Doug Handler, IHS's chief U.S. economist.

Several things are pushing economists' forecasts for business spending higher. For one, businesses often follow consumers when it comes to spending, not the other way around. When the economy began growing again after the 2007-2009 recession, spending on equipment shot up—but then flagged when it became clear, by 2011, that the recovery had stalled. If the economic recovery now shifts into higher gear, businesses will expand capacity to meet demand.

Apogee Enterprises Inc., which makes glass for commercial buildings, is among those firms ramping up.

The firm, with annual revenue of just under \$800 million, plans roughly \$45 million in capital expenditures in its fiscal year ending March 1, 2014, up from about \$35 million in its previous fiscal year. While two-thirds of this spending is on long-term projects aimed at upgrading technology, including a \$30 million investment last year in a glass facility in Minnesota, the rest is a response to increasing customer demand, Chief Executive Joe Puishys says. If the economy's performance picks up more than he expects, Apogee will boost its spending even further, he says.

"The economy is improving, and it's probably improving more than the market metrics indicate," he adds.

Companies also will need to replace machinery that is getting old, in the same way many Americans are spending money to replace aging cars.

Businesses have retained old equipment longer than usual during this expansion, according to Torsten Slok, chief international economist at Deutsche Bank Securities, pushing the average age of equipment to the highest level since the mid-1990s.

To be sure, there are reasons to be wary. Business investment perked up at the end of 2012—only to peter out. That could happen again. Also, the longer term trend has been away from heavy spending. During the 1980s, spending on equipment, for example, grew at an average of 3.5% a year—then accelerated to 8.3% a year during the economic boom of the 1990s. But after that surge, there was a general slowdown, which began long before the most recent recession. Between 2000 and 2012, spending grew an average of just under 3% a year.

IHS's Mr. Handler says slower growth in business spending likely reflects deeper changes in the economy. These include falling prices of technology (a growing part of business investment); the increasing role of service businesses in the U.S. economy (which often require less capital spending); and more "short-termism" among CEOs (who, according to some economists, are incentivized to please shareholders by buying back shares rather than making long-term investments).

These caveats aside, there is one more strong reason why spending could finally pick up: Money remains very cheap.

With economic and political risks easing, more U.S. companies may take advantage of the fact that they can borrow at low rates and pour that money into expansions.