

Capex: A corporate confidence signal



David Bianco
Americas Chief
Investment Officer

IN A NUTSHELL

- We revisit a data set and signal that proved valuable to heed over the past year
- S&P capex shifted from resource sector dominance to Tech, digital, and electric
- Investment is key difference between earnings and FCF: Will returns be good?
- Encouraging signs at soft side of capex: R&D strong at Tech and Health Care
- The pre pandemic rollback: Where justified, overdone or more to go
- Optimism Gauge: Normal for S&P investors ex Tech, but exuberant at Tech

We revisit a data set and signal that proved valuable to heed over the past year

S&P 500 capital expenditures (capex) data from financial reports illustrates where U.S. investment spending is strong and where it's modest today relative to pre pandemic norms given inflation since then and deferred maintenance capex during the pandemic.

Strong capex that is investment for growth, not profit maintenance, signals management's confidence in profitable growth prospects. Over the past year, investors embraced that confidence by raising valuations at these companies despite slowing gross domestic product (GDP) and higher interest rates. This note revisits our capex as a signal note from summer 2022.

S&P capex shifted from resource sector dominance to Tech, digital, and electric

On a trailing 4-quarter basis as of 1Q23, S&P capex grew 26% from 2019. This growth was led by Tech and other businesses involved in digitalization and electrification. Capex growth was modest at Energy, Materials and most capital and consumer goods manufacturers.

Trailing 4-quarter capex at Energy is down 11.3% from 2019, up only 5.8% at Industrials and up 15.3% at Materials. Capex is up a much stronger 55.4% at Tech, 34% at Communications and 42.9% at Consumer Discretionary, the latter being internet retailing and electric vehicle led. These industries are planning for the future with capex that is 120-150% of depreciation & amortization (D&A) expense. Utilities standout with 27% growth and over 200% capex/D&A.

In the last 4-quarters, only 22% of S&P capex is from Energy, Materials and Industrials (23% profit share) vs. 46% in 2013 (25% profits). Whereas, 45% of S&P capex is from Tech, Communications and Consumer Discretionary (33% profits) vs. 27% in 2013 (31% profits).

Energy and much of Materials and Industrials (except Industrial Gases and Aerospace & Defense), barely have capex in-line with D&A and this is despite elevated inflation greatly raising the cost of building/repairing their assets relative to book value based depreciation expense. It appears to us that the Energy sector sees no growth and likely slow decline. Capping capacity might protect Energy pricing, but production by others globally or alternatives are threats. At current oil prices and capex trends, profits and free cash flow (FCF) at Energy are set to sharply decline from trailing 4-quarter levels.

This information is subject to change at any time, based upon economic, market and other considerations and should not be construed as a recommendation. Past performance is not indicative of future returns. Forecasts are not a reliable indicator of future performance. Forecasts are based on assumptions, estimates, opinions and hypothetical models that may prove to be incorrect. Alternative investments may be speculative and involve significant risks including illiquidity, heightened potential for loss and lack of transparency. Alternatives are not suitable for all clients. Source: DWS Investment GmbH.

Investment is key difference between earnings and FCF: Will returns be good?

Beware of FCF per share based valuation metrics when some companies are aggressively investing for growth and others retrenching. We generally prefer earnings metrics, but we consider both and evaluate return prospects on difference from investment.

Encouraging signs at soft side of capex: R&D strong at Tech and Health Care

Research & development (R&D) spending remains brisk, above 3% of S&P sales overall, but over 10% of sales at Tech and within Health Care at the medicine and medical device makers. R&D is fully expensed in financial reports, but it's a mix of spending to both maintain and grow profits.

The pre pandemic rollback: Where justified, overdone or more to go

The pandemic supercharged S&P EPS growth led by its digital businesses and consumer goods producers and retailers upon work and lifestyle shifts and huge government stimulus to households. Three years later, it's clear that goods manufacturing and retailing cooled and many work and lifestyle changes stuck. We think share price rollbacks are appropriate at Retail, Office, and Basic Materials. We expect more rollback at Auto, Building Products/Materials, Machinery. We see rollbacks at Communications, Rails and Biotech as overdone. We think return to travel, restaurants, etc. will be sustained. We think the pandemic Tech earnings surge is sustainable, but see valuations as too demanding. We see underappreciated areas of growth at Health Care, Internet Services, Electric Utilities.

Optimism Gauge: Normal for S&P investors ex Tech, but exuberant at Tech

Sluggish cycles favor growth stocks, but valuations still matter and we're concerned about 30x+ price-to-earnings (P/E) ratios at mega-cap Tech; especially if a sluggish cycle comes with secularly rising long-term interest rates. Also, some growth stocks are cyclically sensitive and we expect at least a small recession. We think overvalued S&P segments are Auto, Tech, particularly Semiconductors and Hardware and Software. While we're excited about Tech's long-term growth potential, it surprises us that investors will pay these valuations at a time of slowing growth and rising interest rates. The S&P PE is slightly above its fair-steady state 18x, but Tech trades at a 50%+ premium, essentially the highest growth premium or optimism since 1999.

Glossary

Amortization is an accounting term which refers to the periodical reduction of the book value of intangible assets (such as patents) or bank loans.

Capital expenditure (Capex) are funds used by a company to acquire or upgrade physical assets such as property, industrial buildings or equipment.

In relation to currencies, **depreciation** refers to a loss of value against another currency over time.

Consumer discretionary is a sector of the economy that sells non-essential goods and services.

Earnings per share (EPS) is calculated as a company's net income minus dividends of preferred stock, all divided by the total number of shares outstanding.

Free Cash Flow (FCF) is a measure of financial performance calculated as operating cash flow minus capital expenditures. It shows how much cash a company is able to generate after deducting the money required to maintain or expand its asset base.

The **gross domestic product (GDP)** is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

The **price-to-earnings (P/E) ratio** compares a company's current share price to its earnings per share.

A **recession** is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

The **S&P 500** is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

Important information – EMEA, APAC & LATAM

DWS is the brand name of DWS Group GmbH & Co. KGaA and its subsidiaries under which they do business. The DWS legal entities offering products or services are specified in the relevant documentation. DWS, through DWS Group GmbH & Co. KGaA, its affiliated companies and its officers and employees (collectively "DWS") are communicating this document in good faith and on the following basis.

This document is for information/discussion purposes only and does not constitute an offer, recommendation or solicitation to conclude a transaction and should not be treated as investment advice.

This document is intended to be a marketing communication, not a financial analysis. Accordingly, it may not comply with legal obligations requiring the impartiality of financial analysis or prohibiting trading prior to the publication of a financial analysis.

This document contains forward looking statements. Forward looking statements include, but are not limited to assumptions, estimates, projections, opinions, models and hypothetical performance analysis. No representation or warranty is made by DWS as to the reasonableness or completeness of such forward looking statements. Past performance is no guarantee of future results.

The information contained in this document is obtained from sources believed to be reliable. DWS does not guarantee the accuracy, completeness or fairness of such information. All third party data is copyrighted by and proprietary to the provider. DWS has no obligation to update, modify or amend this document or to otherwise notify the recipient in the event that any matter stated herein, or any opinion, projection, forecast or estimate set forth herein, changes or subsequently becomes inaccurate.

Investments are subject to various risks. Detailed information on risks is contained in the relevant offering documents.

No liability for any error or omission is accepted by DWS. Opinions and estimates may be changed without notice and involve a number of assumptions which may not prove valid. DWS does not give taxation or legal advice.

This document may not be reproduced or circulated without DWS's written authority.

This document is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction, including the United States, where such distribution, publication, availability or use would be contrary to law or regulation or which would subject DWS to any registration or licensing requirement within such jurisdiction not currently met within such jurisdiction. Persons into whose possession this document may come are required to inform themselves of, and to observe, such restrictions.

For institutional / professional investors in Taiwan:

This document is distributed to professional investors only and not others. Investing involves risk. The value of an investment and the income from it will fluctuate and investors may not get back the principal invested. Past performance is not indicative of future performance. This is a marketing communication. It is for informational purposes only. This document does not constitute investment advice or a recommendation to buy, sell or hold any security and shall not be deemed an offer to sell or a solicitation of an offer to buy any security. The views and opinions expressed herein, which are subject to change without notice, are those of the issuer or its affiliated companies at the time of publication. Certain data used are derived from various sources believed to be reliable, but the accuracy or completeness of the data is not guaranteed and no liability is assumed for any direct or consequential losses arising from their use. The duplication, publication, extraction or transmission of the contents, irrespective of the form, is not permitted.

© 2023 DWS Investment GmbH

Issued in the UK by DWS Investments UK Limited which is authorised and regulated in the UK by the Financial Conduct Authority.

© 2023 DWS Investments UK Limited

In Hong Kong, this document is issued by DWS Investments Hong Kong Limited. The content of this document has not been reviewed by the Securities and Futures Commission.

© 2023 DWS Investments Hong Kong Limited

In Singapore, this document is issued by DWS Investments Singapore Limited. The content of this document has not been reviewed by the Monetary Authority of Singapore.

© 2023 DWS Investments Singapore Limited

In Australia, this document is issued by DWS Investments Australia Limited (ABN: 52 074 599 401) (AFSL 499640). The content of this document has not been reviewed by the Australian Securities and Investments Commission.

© 2023 DWS Investments Australia Limited

as of 6/16/23; 096468_1 (06/2023)

Important information – North America

The brand DWS represents DWS Group GmbH & Co. KGaA and any of its subsidiaries, such as DWS Distributors, Inc., which offers investment products, or DWS Investment Management Americas Inc. and RREEF America L.L.C., which offer advisory services.

This document has been prepared without consideration of the investment needs, objectives or financial circumstances of any investor. Before making an investment decision, investors need to consider, with or without the assistance of an investment adviser, whether the investments and strategies described or provided by DWS, are appropriate, in light of their particular investment needs, objectives and financial circumstances. Furthermore, this document is for information/discussion purposes only and does not and is not intended to constitute an offer, recommendation or solicitation to conclude a transaction or the basis for any contract to purchase or sell any security, or other instrument, or for DWS to enter into or arrange any type of transaction as a consequence of any information contained herein and should not be treated as giving investment advice. DWS, including its subsidiaries and affiliates, does not provide legal, tax or accounting advice. This communication was prepared solely in connection with the promotion or marketing, to the extent permitted by applicable law, of the transaction or matter addressed herein, and was not intended or written to be used, and cannot be relied upon, by any taxpayer for the purposes of avoiding any U.S. federal tax penalties. The recipient of this communication should seek advice from an independent tax advisor regarding any tax matters addressed herein based on its particular circumstances. Investments with DWS are not guaranteed, unless specified. Although information in this document has been obtained from sources believed to be reliable, we do not guarantee its accuracy, completeness or fairness, and it should not be relied upon as such. All opinions and estimates herein, including forecast returns, reflect our judgment on the date of this report, are subject to change without notice and involve a number of assumptions which may not prove valid.

Investments are subject to various risks, including market fluctuations, regulatory change, counterparty risk, possible delays in repayment and loss of income and principal invested. The value of investments can fall as well as rise and you may not recover the amount originally invested at any point in time. Furthermore, substantial fluctuations of the value of the investment are possible even over short periods of time. Further, investment in international markets can be affected by a host of factors, including political or social conditions, diplomatic relations, limitations or removal of funds or assets or imposition of (or change in) exchange control or tax regulations in such markets. Additionally, investments denominated in an alternative currency will be subject to currency risk, changes in exchange rates which may have an adverse effect on the value, price or income of the investment. This document does not identify all the risks (direct and indirect) or other considerations which might be material to you when entering into a transaction. The terms of an investment may be exclusively subject to the detailed provisions, including risk considerations, contained in the Offering Documents. When making an investment decision, you should rely on the final documentation relating to the investment and not the summary contained in this document.

This publication contains forward looking statements. Forward looking statements include, but are not limited to assumptions, estimates, projections, opinions, models and hypothetical performance analysis. The forward looking statements expressed constitute the author's judgment as of the date of this material. Forward looking statements involve significant elements of subjective judgments and analyses and changes thereto and/or consideration of different or additional factors could have a material impact on the results indicated. Therefore, actual results may vary, perhaps materially, from the results contained herein. No representation or warranty is made by DWS as to the reasonableness or completeness of such forward looking statements or to any other financial information contained herein. We assume no responsibility to advise the recipients of this document with regard to changes in our views.

No assurance can be given that any investment described herein would yield favorable investment results or that the investment objectives will be achieved. Any securities or financial instruments presented herein are not insured by the Federal Deposit Insurance Corporation ("FDIC") unless specifically noted, and are not guaranteed by or obligations of DWS or its affiliates. We or our affiliates or persons associated with us may act upon or use material in this report prior to publication. DB may engage in transactions in a manner inconsistent with the views discussed herein. Opinions expressed herein may differ from the opinions expressed by departments or other divisions or affiliates of DWS. This document may not be reproduced or circulated without our written authority. The manner of circulation and distribution of this document may be restricted by law or regulation in certain countries. This document is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction, including the United

States, where such distribution, publication, availability or use would be contrary to law or regulation or which would subject DWS to any registration or licensing requirement within such jurisdiction not currently met within such jurisdiction. Persons into whose possession this document may come are required to inform themselves of, and to observe, such restrictions.

Past performance is no guarantee of future results; nothing contained herein shall constitute any representation or warranty as to future performance. Further information is available upon investor's request. All third party data (such as MSCI, S&P & Bloomberg) are copyrighted by and proprietary to the provider.

For Investors in Canada: No securities commission or similar authority in Canada has reviewed or in any way passed upon this document or the merits of the securities described herein and any representation to the contrary is an offence. This document is intended for discussion purposes only and does not create any legally binding obligations on the part of DWS Group. Without limitation, this document does not constitute an offer, an invitation to offer or a recommendation to enter into any transaction. When making an investment decision, you should rely solely on the final documentation relating to the transaction you are considering, and not the [document – may need to identify] contained herein. DWS Group is not acting as your financial adviser or in any other fiduciary capacity with respect to any transaction presented to you. Any transaction(s) or products(s) mentioned herein may not be appropriate for all investors and before entering into any transaction you should take steps to ensure that you fully understand such transaction(s) and have made an independent assessment of the appropriateness of the transaction(s) in the light of your own objectives and circumstances, including the possible risks and benefits of entering into such transaction. You should also consider seeking advice from your own advisers in making this assessment. If you decide to enter into a transaction with DWS Group you do so in reliance on your own judgment. The information contained in this document is based on material we believe to be reliable; however, we do not represent that it is accurate, current, complete, or error free. Assumptions, estimates and opinions contained in this document constitute our judgment as of the date of the document and are subject to change without notice. Any projections are based on a number of assumptions as to market conditions and there can be no guarantee that any projected results will be achieved. Past performance is not a guarantee of future results. The distribution of this document and availability of these products and services in certain jurisdictions may be restricted by law. You may not distribute this document, in whole or in part, without our express written permission.

For investors in Bermuda: This is not an offering of securities or interests in any product. Such securities may be offered or sold in Bermuda only in compliance with the provisions of the Investment Business Act of 2003 of Bermuda which regulates the sale of securities in Bermuda. Additionally, non-Bermudian persons (including companies) may not carry on or engage in any trade or business in Bermuda unless such persons are permitted to do so under applicable Bermuda legislation.

© 2023 DWS Investment GmbH, Mainzer Landstraße 11-17, 60329 Frankfurt am Main, Germany.
All rights reserved.

as of 6/16/23; 096474_1 (06/2023)