CIO View

Americas CIO View

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Marketing material

Capex: A corporate confidence signal

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IN A NUTSHELL

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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.

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.

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