Capex as long-term prospects signal: Boom at digital, not physical industries

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IN A NUTSHELL

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The S&P is correcting again on cyclical risk, but what about long-term prospects?

In our previous Aug 22 note, we emphasized that this summer's equity rally from June lows came too early and went too far. We signaled high risk of a 10%+ decline from S&P 4300 given deteriorating macro and earnings conditions expected to persist into next year. The market fell 8.1% from its 4305 mid-August high after Chair Powell's Jackson Hole speech left no room for misinterpreting the message that hikes will continue and rates will not be cut for some time afterward to ensure inflation subsides despite the pains of recession. The macro data continues to weaken; dollar is stronger and oil sinking. This bodes ill for profits together with wage, tax, regulation and lingering input cost pressures. We see 3700-4100 the likely 2H22 S&P 500 range with the lower half likely until after the mid-term elections. But which industries are signaling growth prospects beyond the recession with capital expenditure (capex)?

Capex spending shifts from resource sectors to Tech, Comm. and Cons. Disc.

After the pandemic's capex slump, S&P capex rebounded with 18% y/y growth on a trailing 4-qtr basis as of 2Q2022. However, the big capital investment spenders shifted from commodity producers and other heavy industries to the digital/ virtual/ electrified industries.

Despite oil prices surging in 2022 to over and still near $100/bbl, highest since 2011-2014, only 1/3rd of S&P capex is now from Energy, Materials, Industrials and Utilities, down from nearly 2/3rd in 2012 and also 2006. Now, capex at Tech, Communications and Consumer Discretionary share of total S&P 500 capex doubled from 25% to 50%. Although capex is up from very depressed levels, Energy and Industrials are still 40% and 15% lower than their pre-pandemic 2019 levels. Materials capex just got back to its pre-pandemic level.

In contrast, capex at Consumer Discretionary (led by internet retail and auto), Tech and Communications is 48%, 36% and 24% higher than their 2019 levels. These industries are planning for the future with growth capex that is 100-150% of depreciation & amortization (D&A) expense. Utilities are a standout growth investor with 200% capex/D&A as they prepare for an electrified future.

The Energy sector is signaling dim long-term prospects with capex/D&A at about 80%, which suggests that wells and downstream assets are not being maintained, especially considering the greatly inflated costs of building/repairing such assets vs. book value based depreciation. It appears to us that the Energy sector is planning for its demise and milking its assets. This and high oil prices make for great free cash flow, but how long will it last?

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

Research & Development is a form of investment spending, often with high return on investment, but it's expensed in profits. Tech and Health Care remain R&D standouts with high R&D at 10% and higher of sales. Much of this R&D is required to retain leadership, but it also raises barriers to competition and fuels growth as Tech titans have demonstrated for many years. Given very differing R&D and CAPEX/D&A conditions across sectors, we think it important to be very careful when using free cash flow based valuation metrics.

Capex and exports are key to US mfg. ISM and S&P Industrials and Materials

Strong capex boosts manufacturing, as most US manufacturing is capital goods and cars. Deploying new capital goods helps boost labor productivity, which supports the structural growth in consumption. The S&P is highly levered to investment activity and 25-30% of S&P sales is investment spending related. However, more of this is Tech related than ever.

When capex is healthy, S&P sales growth tends to be ~1.5x U.S. nominal gross domestic product (GDP) growth as seen in past cycles. S&P sales growth is past the post-recession bounce with only high inflation keeping it strong at 11.7% in nominal terms. But if stripping inflation off, real GDP, real S&P sales and real capex growth have all slowed sharply to low single digit growth, which we see further slowing in the coming quarters as US goes through a mild recession.

Sluggish cycles favor secular growth stocks, we like R&D driven industries

What to favor if willing to "look-though" the near-term cyclical risks? We look to R&D driven sectors for secular growth, like Health Care, Tech, Communications, some Consumer Discretionary service industries, consistent with the industry capex trends observed; many industries we are overweight now. We also OW Utilities as an attractive bond substitute that benefits from high natural gas prices, electrification trends and policies, with non-cyclical inflation protected dividend yields. We also OW Banks as we don't expect a surge in credit costs despite the U.S. Federal Reserve (Fed) hikes. We underweight Industrials, Materials, many Consumer Staples and some Tech and Consumer Discretionary industries with either too expensive valuations or profits most at risk. We remind investors that protection against stubborn broad based inflation exists beyond Energy and other heavy industries and perhaps best.

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.

Book Value is the net value of a company's physical and intangible assets

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

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.

The ISM Purchasing Manager Index, published by the Institute for Supply Management, measures economic activity by assessing the sentiment among purchasing managers. It is an important indicator of the economic health.

The U.S. Federal Reserve, often referred to as "the Fed," is the central bank of the United States.

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