Current Economic Conditions

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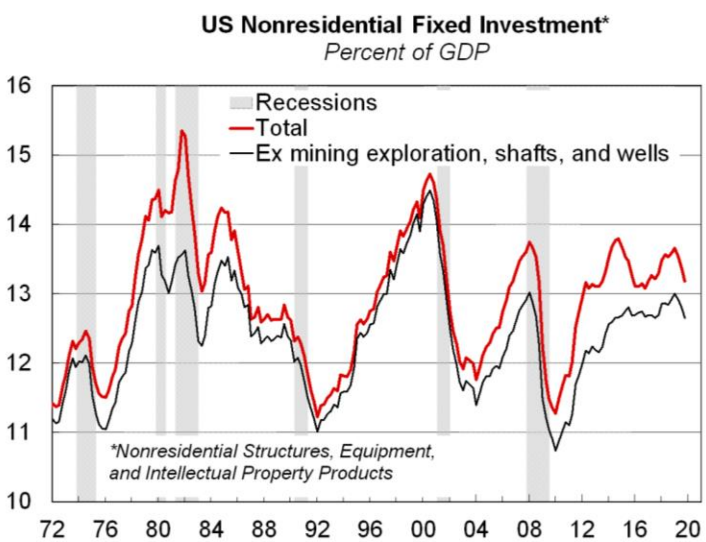
THE GIFT THAT KEEPS ON GIVING

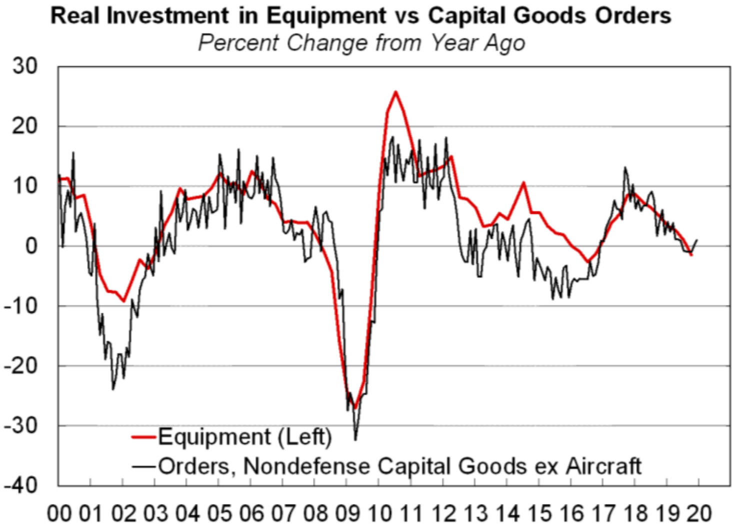
The biggest disconnect between what I learned in my academic training and what I observed in my 30 years in the corporate sector concerns business investment in structures, equipment, and intellectual property products, known in the business world as capital expenditures or simply capex. My professors, and economists generally, have tended to advocate more business investment in the United States. Republicans might favor cutting taxes on businesses and on interest, dividends, and capital gains, and Democrats might favor targeted investment subsidies and limits on stock buybacks, but most seem to agree that more investment is good for productivity, for wages, and for economic growth. Businesses, on the other hand, seem to dwell obsessively on the bad investments they've made. For publicly traded companies, this probably results from the fact that analysts can easily see (and criticize) the bad investments that have been made, but don't know about (and thus can't criticize) the good investments that haven't been made. The result is too little investment, at least from an economist's standpoint.



A second disconnect involves attitudes towards acquisitions. Businesses regard acquiring a business (and its plant, equipment, and intellectual property) as investment. From a macroeconomic standpoint, that's silly. An acquisition is just a juggling of ownership claims; it does not involve the purchase, installation, or construction of new capital. It could result in economic gains through increased efficiency but could just as easily result in economic losses (e.g., to consumers) through reduced competition. You only have to be a little bit cynical to believe that in the rare cases where the shareholders of the acquiring company benefit from an acquisition, someone is getting away with an antitrust violation.

Investment is key because it is the economic gift that keeps on giving. Investment increases Gross Domestic Product (from the demand side) when it is being purchased. Then it increases GDP (from the supply side) after installation/construction when it is used to produce goods and services. Unlike a purely demand-side boost to personal or government consumption, which can be inflationary, the supply-side boost from investment tends to keep inflation in check. Because investment is so cyclically volatile, it plays a big role in determining how strong the economy is at any moment in time. The downshift in economic growth in late 2018, following five quarters of strong growth, was due mostly to a softening in business investment, including declines in investment in equipment in the last two quarters. President Trump has blamed the slowdown on the Federal Reserve, but business investment, outside of commercial real estate, President Trump's area of expertise, is not especially sensitive to interest rates. Democrats, who tend to be skeptical about tax cuts investment, would argue that, except for a short-lived boost, the Tax Cuts and Jobs Act has failed to stimulate investment. Traditional free-trade Republicans believe that the tax cuts were working, but that President Trump's tariffs on steel, aluminum, and most goods imported from China

– and uncertainty about future tariffs – have offset the benefits from tax cuts and caused investment to decline. The Phase 1 trade deal with China signed in January takes the worst-case scenario off the table and thereby reduces uncertainty a bit, but it still leaves most of President Trump's tariffs in place. Only time will tell whether the trade deal (and last year's rate cuts by the Fed) will result in a significant acceleration in investment.



Whether investment accelerates or continues to stagnate is especially key in this election year. Investment will be the primary determinant of economic growth this year, and because investment boosts productive capacity and the productivity of workers, it will determine potential growth beyond this year. The Congressional Budget Office estimates that potential GDP – the highest level of GDP the economy can maintain without an acceleration in inflation – will grow by less than 2% per year over the next ten years. I believe that the U.S. economy can do significantly better than that, but only if there is a significant jump in investment and a significant increase in immigration. (The decline in immigration, legal as well as illegal, since President Trump took office has reduced growth in the labor force, an important determinant of potential growth, by 0.6 percentage points.)

Because economic growth in the first three quarters of an election year is an important determinant of election results, business investment will largely determine who wins the Presidential election this fall. If business investment accelerates enough to produce 3% growth in real GDP, President Trump will be hard to beat. If investment falls further and the economy falls into recession, any Democratic nominee will beat him. (I don't think either of those extreme growth cases is likely; I expect growth close to 2% and a close election.) The election results will, in turn, determine whether the Tax Cuts and Jobs Act remains in place (or is expanded by a second Trump Administration) or whether it is repealed by a Democratic President. I'd go a step further. Because increasing investment was the main rationale for cutting taxes, business investment will determine whether the TCJA **should** be retained or repealed. The message for CEOs and business owners is clear: If you want President Trump to win reelection and the TCJA to remain in place, you need to boost capital spending now. If you want a new President and think the tax cuts were a bad idea, you should hold off on investing until after the election. Your decision will determine who wins.

The coronavirus that developed in Wuhan, China in December and caught the world's attention in January introduces a new source of uncertainty into the economic outlook. Since uncertainty is the enemy of investment, it is likely to put the brakes on investment spending until we have more clarity into how the coronavirus will affect the U.S. economy. What isn't uncertain is that the coronavirus will have a big negative impact on Chinese economic growth in the short run and a smaller, but still significant, negative impact in the long run. Companies that were already diversifying their sources of supply in response to President Trump's tariffs will further diversify in response to the coronavirus. The lean manufacturing model, popularized by Toyota, emphasized reliance on a single supplier. That now seems too risky. Diversifying sources of supply will lessen risk but at the cost of reduced efficiency and higher costs. And since China is **the** major supplier of many materials, components, and finished goods, diversification away from a single supplier will disproportionately hit a Chinese economy that is already suffering from a declining working age population, massive government debt, and a government that has turned away from the policies that worked for 30 years and towards those that didn't work over the previous 30 years.

If the coronavirus fades before spreading to America, I expect U.S. growth to pick up a little this year, but that will only happen if investment in equipment and structures turns up after its recent decline.