

3 reasons for weak investment in the US

US economic growth has been good, but it could have been so much better had businesses not been as cautious on investment. Economic and political uncertainty and high borrowing costs appear to be the main reasons for businesses not wanting to put money to work and this will continue to deter capex this year. We expect a more favourable environment in 2025



The November election may well be a factor that has impacted US investment decisions over the past 12 months

The US rebound should have been stronger

The US and eurozone economies have enjoyed contrasting fortunes since their respective governments relaxed Covid containment measures. The US economy has been the top performer in developed markets with output up nearly 9% on pre-pandemic levels, fuelled by robust consumer spending. The eurozone economy has seen output rise by less than 4% over the same period with households far more conservative with regards to their willingness to run down savings and use debt to fund spending.

But for all the positives surrounding the US household sector, supported by generous government handouts, a strong jobs market and massive wealth gains, the economy could and perhaps should have done even better. This is down to the disappointing performance of business investment.

Business equipment investment has flatlined

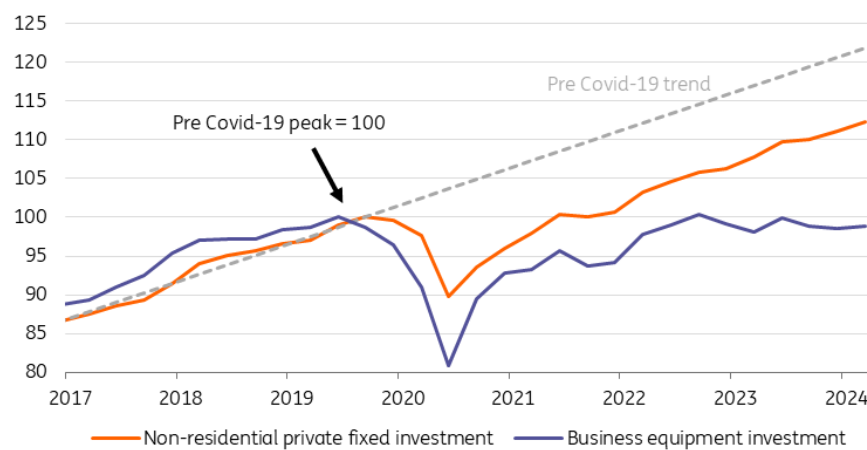
Business equipment investment spending – the blue line in the chart below – is actually below the levels of 2019 when looking in real (volume) terms, despite the economy having performed so strongly and with equity markets and corporate profits at record highs.

If we include structures and intellectual property, non-residential fixed investment is performing better, but is still tracking more than eight percentage points below its pre-pandemic trend (the orange line in the chart below). This improved performance is primarily down to \$1tn of government support from the Creating Helpful Incentives to Produce Semiconductors (CHIPS) Act and the Inflation Reduction Act.

Historically, the durable goods report has been watched as a signal regarding business capex plans. Non-defence capital goods orders ex-aircraft have flatlined at around \$74bn per month for the past two years but prices have risen considerably. So if we deflate it by capital investment goods PPI we see that in volume terms, orders continue to fall and are at their lowest level since 3Q 2020.

This suggests business equipment investment will remain weak with the rather gloomy prognosis reflected in the ISM's latest semi-annual survey of members which showed businesses expect only a 1% increase in manufacturing capex this year versus the 11.9% increase that was forecast in December 2023 and a 1.4% increase in service sector capex versus 2.9% six months previously.

Business investment relative to pre-pandemic trend

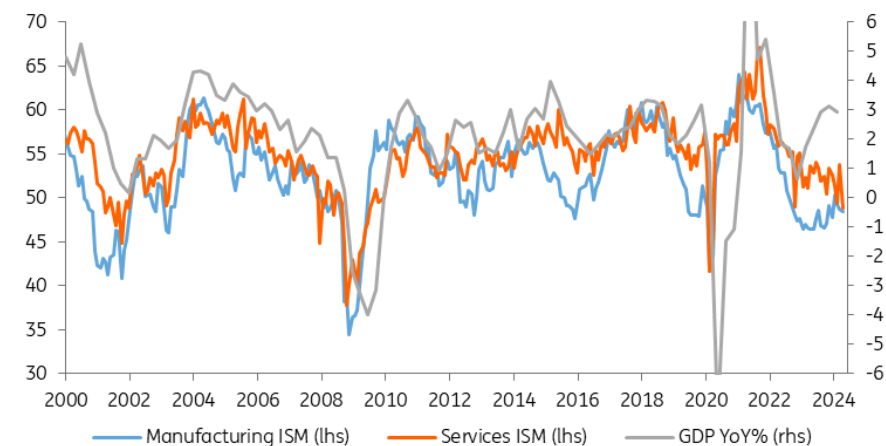


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3 reasons for US investment disappointment

So what has made businesses reluctant to put money to work in a strong and vibrant economy where the government is providing incentives? Well, the heart of the issue appears to be highlighted in the chart below. Historically, the ISM business surveys were viewed as being among the very best leading indicators for turning points in the economic cycle, but this relationship appears to have broken down, just as it has with the NFIB's small business survey on business profits and GDP growth. Companies are clearly not feeling the strength in economic activity, or at the very minimum, don't think it will last.

ISM business surveys are not reflecting the strength seen in GDP growth



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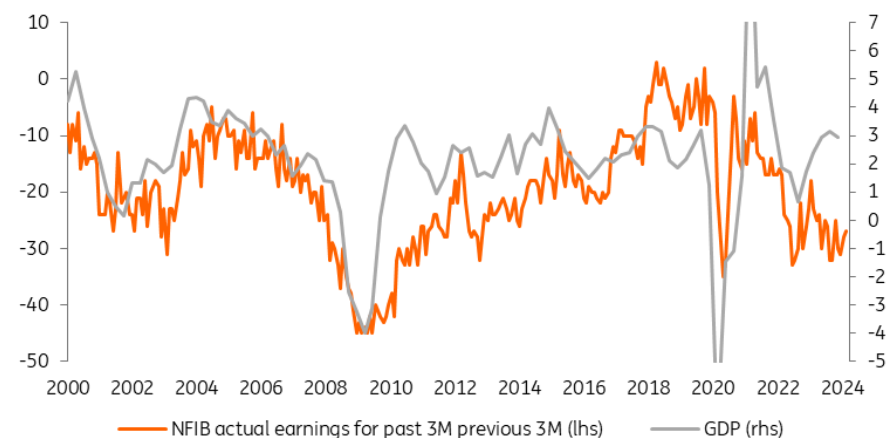
1. Concerns about an economic downturn

Economists had been warning of recession throughout much of 2023 due to high interest rates and reduced credit availability. It was thought that this would act as a brake on economic activity, potentially leading to a substantial downturn or recession. This hasn't happened, with huge fiscal transfers from the government sector to the private sector helping to cushion the blow.

Nonetheless, low and middle-income households are feeling more financial pain. Real household disposable income is barely growing, pandemic-era accrued savings are increasingly being exhausted while high borrowing costs are prompting a clear slowdown in consumer credit with loan delinquencies on the rise. We expect this to translate into weaker consumer spending growth and it appears businesses are also worried.

Higher rents and property taxes are adding to financial pressures for small businesses with actual earnings falling outright, based on the National Federation of Independent Business survey (see chart below). Given this situation, it is likely that economic concerns have been a significant constraint on investment, especially in the small business sector of the US.

NFIB net % of small businesses reporting higher earnings versus GDP growth YoY%



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2) Borrowing costs are too high

If you think borrowing costs are going to fall, you may choose to wait before putting money to work. However, we would argue there is a big split between cash-rich, large corporates which can access the bond markets at still historically cheap levels versus small businesses which are more reliant on relatively expensive bank financing.

Indeed, the National Federation of Independent Business, representing the small business sector, suggests that 6% of small businesses find that financing is their top business problem – the highest it has been since June 2010. The most aggressive and rapid pace of Federal Reserve interest rate increases in 40 years, coupled with the tightening of credit conditions in the wake of bank failures in the spring of 2023 has hurt. Bank lending growth for commercial and industrial loans has contracted in year-on-year terms for eight consecutive months. This lack of borrowing appetite appears to be a major reason for the lack of investment spending.

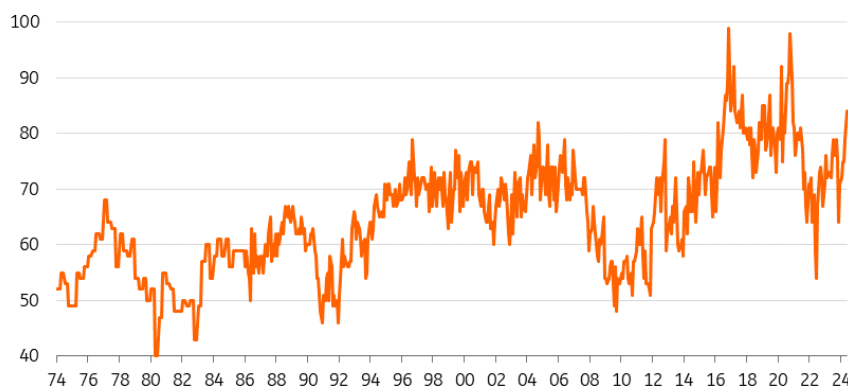
3) Political risk around the election

We have the US election coming up on 5 November and potential changes in government can certainly influence investment decisions. A company may decide to delay a project if it believes regulations are going to change significantly under a new administration. This includes, for example, the approval of oil and gas exploration licenses or large battery manufacturing plants with foreign entities of concern.

The proximity to the November election may well be a factor that has impacted investment decisions over the past 12 months. In this regard, the NFIB's small business optimism survey indicates that "uncertainty" is rising and since the survey's inception in 1974, it has only been higher in the lead-up to the 2016 and 2020 elections and during the pandemic. This perhaps underscores the damage wrought by increasingly partisan politics in America today – implying that elections are more impactful on sentiment than ever before and this makes companies wary about putting money to work.

We sense that uncertainty will increase and deter small business owners from making major new investments until there is clarity on the political/tax/regulatory environment.

NFIB uncertainty index underscores business caution



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Other possibilities

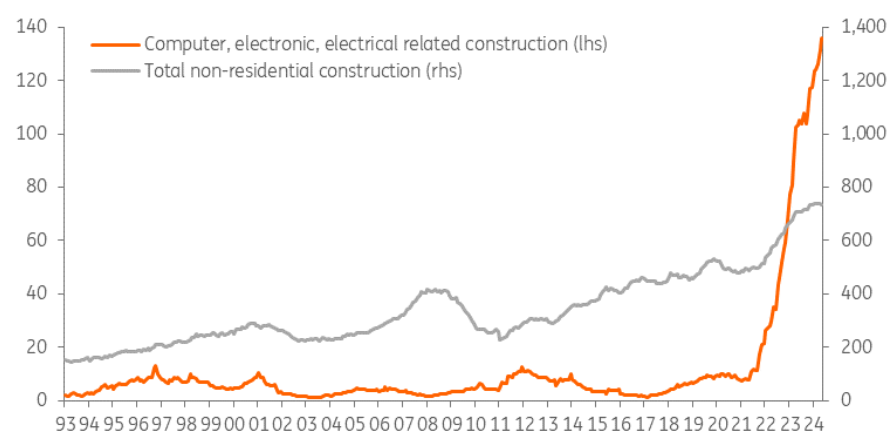
Other factors have been mentioned as possible reasons for low investment, but we are somewhat sceptical. “Bad” or overly burdensome regulation can increase the costs and risks surrounding decisions on investment. However, the incentives (CHIPS & IRA) that have been introduced under the Biden administration should have outweighed the negatives associated with regulation. And while permitting backlogs have been a bottleneck for the advancement of many clean energy projects, the current effort of permitting reforms has bipartisan support as it would be beneficial to traditional energies as well.

The use of share buybacks has also been cited. S&P Global reported that share buybacks by S&P 500 companies totalled \$795.1bn in 2023 relative to total non-residential fixed investment of \$3.7tn. This suggests a significant uplift to business investment could have been generated had companies not instigated share buybacks. However, we would argue against this as being a major reason for weak investment spending given share buybacks were actually higher in 2022, totalling \$922.7bn.

Government support has prevented things from being even worse

As already mentioned, the government has provided more than \$1tn of support via the CHIPS Act and the Inflation Reduction Act. The chart below suggests the boost from the CHIPS Act has had a large and immediate impact in supporting investment in new business structure. It provides around \$280 billion of new funds to boost research, development and manufacturing of semiconductors in the United States – effectively incentivising onshoring of activity. However, given the speed at which it was tapped, the growth impulse from the CHIPS Act is already starting to fade with investment spending on structures, as measured within the GDP report, slowing to an annualised 0.4% growth rate in 1Q 2024 having recorded growth rates of 30.3% in 1Q 2023, 16% in 2Q23 and 11% in both 3Q and 4Q 2023.

Monthly construction spending (\$bn)



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The second pillar of President Biden's policy plan to boost investment was the Inflation Reduction Act, billed by the White House as "the largest investment in clean energy and climate action ever." The IRA initially plans to spend a little less than \$400bn on energy security and transition programmes and mitigating climate change spread over 10 years, though actual spending is estimated to be able to potentially get closer to \$1tn.

The IRA has spurred about \$200bn of investment in clean technology manufacturing since its signing into law, as well as other investments in supply chain procurement and project development. But it appears this has not had a significant impact on the investment climate of the economy as a whole. The IRA has incentivised substantial reshoring of clean energy investment, with about half of the investment in clean energy projects under the IRA having foreign involvement, but for the entire US economy, there is still a net FDI outflow from the country. This means that while the IRA's impact on the clean energy industry is huge, it might take longer for that positive impact to be reflected on a larger scale.

Scope for catch-up

Primarily, we attribute the weakness in investment spending to worries that the robust economic environment may not endure and in a current high interest rate environment many businesses believe it makes sense to wait. Government support programmes are waning as a driver of new investment spending while the presidential election throws up the possibility of a significantly changed regulatory, tax and trade environment, which fosters more uncertainty. Consequently, investment spending is not going to be a meaningful contributor to economic growth this year.

Nonetheless, we are optimistic that the investment environment will look more encouraging from mid-2025. The Federal Reserve believes monetary policy is restrictive, thereby acting as a brake on economic activity. The inflation story is starting to look a little more favourable while increased slack in the jobs market has led to a rise in the unemployment rate and is leading to a cooling of wage pressures. We also expect consumer spending growth to cool further over coming months. The Federal Reserve doesn't want to cause a recession if it can be avoided so if the data allows, we look for the central bank to cut interest rates in 25bp increments from September onwards, down to 4% by mid-2025.

Early, swift action to lower interest rates will increase the chances that the US achieves the Fed's targeted glide path to a "soft landing" for the economy. If that is indeed the outcome, this should allay business worries about the economic environment. Following the election there will be much more clarity on the tax and regulatory environment that businesses face. With less uncertainty and lower interest rates, it may well be that businesses start contemplating investment spending more proactively and we start to see stronger growth from the second half of 2025 onwards.

A stronger investment spending story will also have more positive knock-on effects. For example, it can contribute to an improving labour productivity story that can help facilitate a lower inflationary environment without the need for high interest rates over the longer term.

Authors

James Knightley

Chief International Economist, US

james.knightley@ing.com

Coco Zhang

ESG Research

coco.zhang@ing.com

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