Investment conundrum – why businesses are reluctant to put money to work

Investment in the US and eurozone has been underwhelming in the post-pandemic era. Despite a strong recovery in the US and structural investment demand from defence, the energy transition and a tight labour market, investment remains well below the pre-pandemic trend. Here, we investigate the reasons for this on both sides of the Atlantic

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United States | Video

Watch: Why a global downturn in business investment matters

ING's James Knightley and Bert Colijn look at a surprising lack of business investment on both sides of the Atlantic and tell us what needs to change

Why a global downturn in business investment matters

It's a global investment conundrum. In the States, the economy's doing well, but business investment is way down from what we might expect. It's a similar story in Europe but for somewhat different reasons. So what's going on? And what needs to change? Our economists in New York and Amsterdam have some answers.

Watch video

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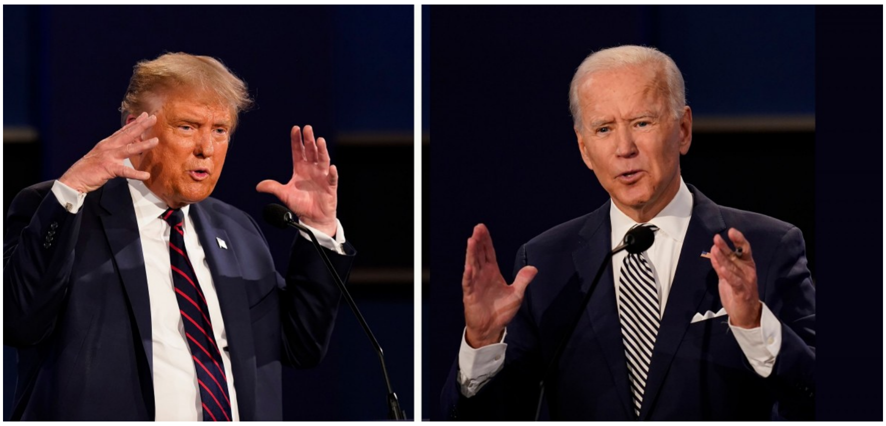
3 reasons for weak investment in the US

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

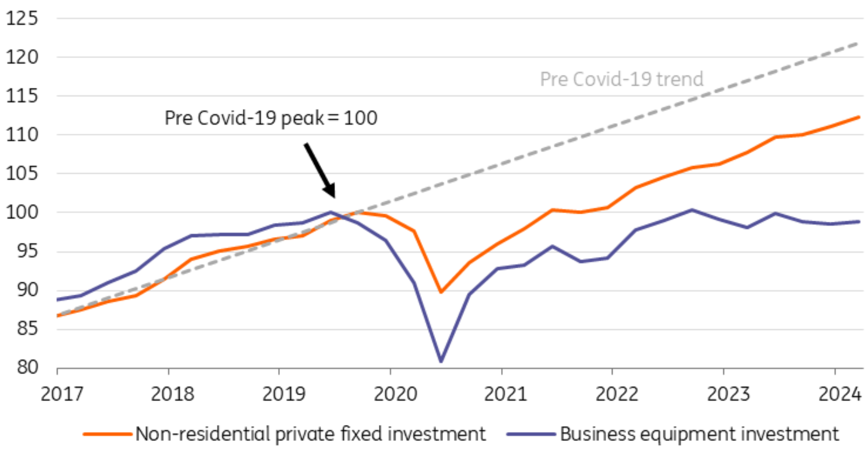
Business equipment investment spending – the blue line in the chart below - is actually below the levels of 2019 when looking in real (volume) terms, despite the economy having performed so strongly and with equity markets and corporate profits at record highs.

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

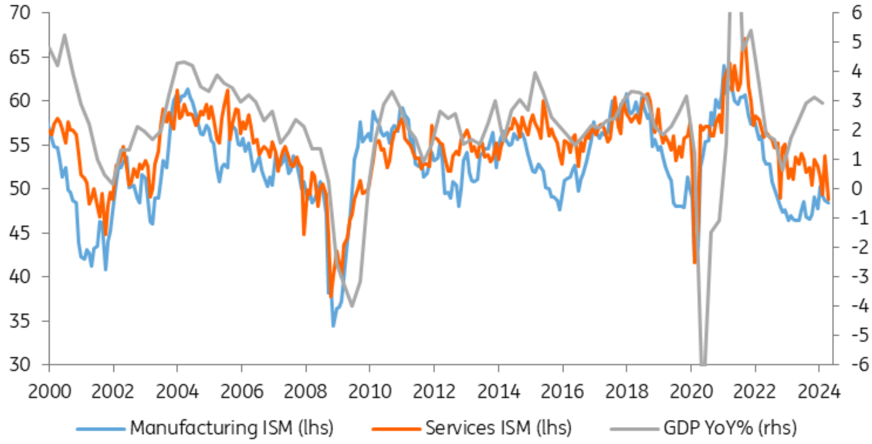


Macrobond, ING

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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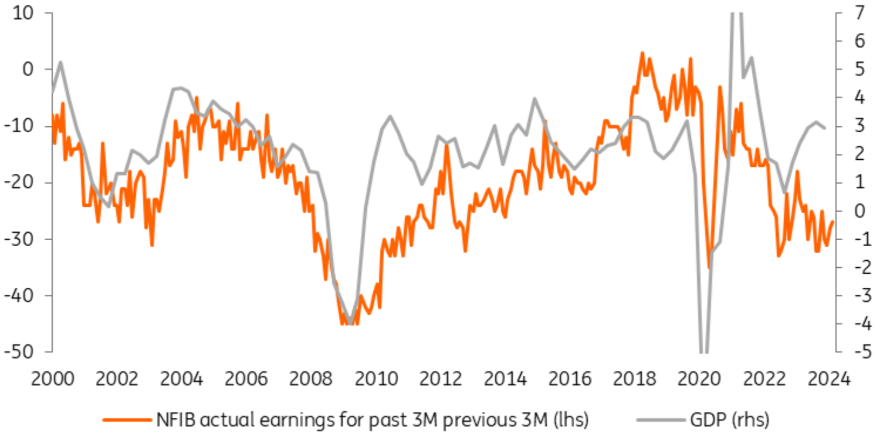
1. **Concerns about an economic downturn**

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.

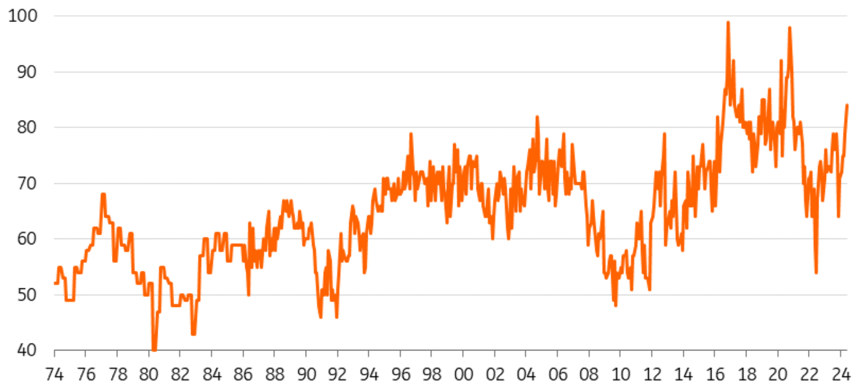
3) Political risk around the election

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

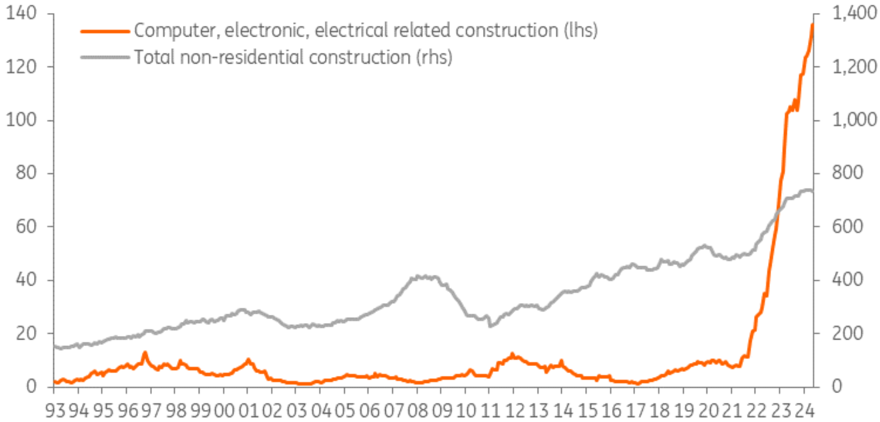
Other factors have been mentioned as possible reasons for low investment, but we are somewhat sceptical. "Bad" or overly burdensome regulation can increase the costs and risks surrounding decisions on investment. However, the incentives (CHIPS & IRA) that have been introduced under the Biden administration 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.

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3 reasons for weak investment in the eurozone

Eurozone investment has fallen behind its pre-pandemic trend because of the underperformance of capital-intensive industries, high interest rates and policy uncertainty. Governments are now also starting to tighten their belts, leaving little room for a vigorous recovery in the near term

With populists gaining ground in Europe, traditional government expenditure on health and welfare will be harder to cut which means that government investment and incentives for business investment are under pressure

Like in the US, investment is underperforming in the eurozone. Investment (gross fixed capital formation) is about 10% below where it would have been had it followed the pre-pandemic trend, and keep in mind that the trend was already very weak before the pandemic started. Unlike the US, the eurozone suffered from an energy crisis, which explains to a large extent the divergence in economic developments after the pandemic. Still, the weak investment performance in the eurozone cannot be explained by the energy crisis and energy uncertainty alone. For a region that needs to overhaul defence spending, requires an urgent energy transition, and faces structural labour shortages, shouldn't investment be higher?

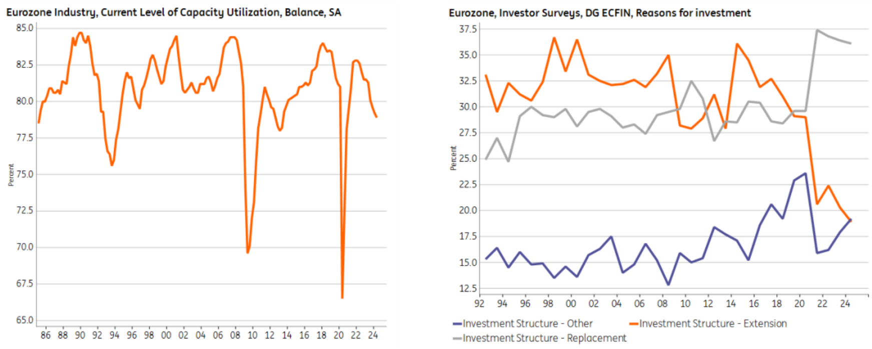
1 Weak demand and a bleak outlook push investment below trend

For the eurozone, weak investment seems to make more sense than in the US. The economy recovered less quickly from the pandemic and eurozone industry is going through a much larger correction than in the US. With industry being particularly capital intensive, it is easy to see why investment needs at this point are relatively low. Capacity utilisation in the eurozone has been steadily declining since the first quarter of 2022 and is currently at 78.9%, well below the historical average of 80.8%. Part of this decline can clearly be attributed to the energy crisis since the start of the Russian invasion of Ukraine.

With supply exceeding demand in capital-intensive industries, it is logical that we see very weak investment demand for expansion purposes in the eurozone. According to an annual European Commission survey, investment for extension purposes stands at the lowest level since the beginning of the survey in 1992.

Also, expectations for the near term are not necessarily very strong. Businesses remain worried about the limited potential for the eurozone economy in the near future and are not only concerned about structurally higher energy prices in the eurozone compared to the US but also about energy supply since the start of the energy crisis. This has put the brakes on investment in the eurozone.

Eurozone investment is weak due to sluggish economic performance



Source: European Commission DGECFIN, ING Research

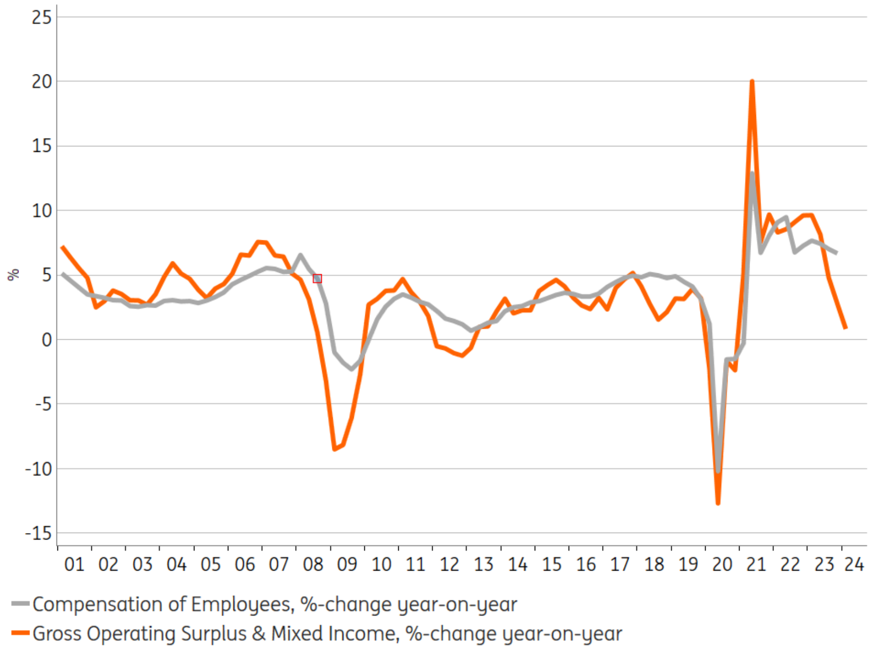
2 High interest rates create a hurdle to investing

Like in the US, interest rates matter. As a driver of investment, the financial picture is currently deemed very unattractive, according to the same European Commission survey mentioned earlier. This means that while interest rates in the eurozone may be lower than in the US in absolute terms, they are still considered to be a considerable barrier to investment right now. The same can be seen when looking at reasons for bank lending, according to the European Central Bank, which indicates that high interest rates are contributing negatively to borrowing decisions. While we do expect modest declines in interest rates on the short end of the curve, we expect longer-term interest rates to remain around current levels for the foreseeable future, which means that the effects of monetary easing remain rather limited.

Still, other costs are also rising, which would lead to stronger investment requirements regardless of limited expansion opportunities. Wages, for most businesses the largest cost, have started to rise and labour shortages are large in the eurozone. So investing to replace labour with capital would be a logical consideration. Then again, during the period of particularly pressing shortages, profits were very strong. This has limited the immediate need for businesses to invest during a time of high interest rates. Wage growth in the eurozone also picked up more slowly than in the US, allowing businesses the relative luxury of waiting for a while. With profits dropping quickly at the moment and wage growth stubbornly high, some investment to substitute labour for capital could be seen in the quarters ahead.

Falling profits and stubbornly high wage growth could boost capital spending

Eurozone non-financial corporates



Source: Eurostat, ING Research calculations

3 Government investment under pressure as fiscal prudence returns

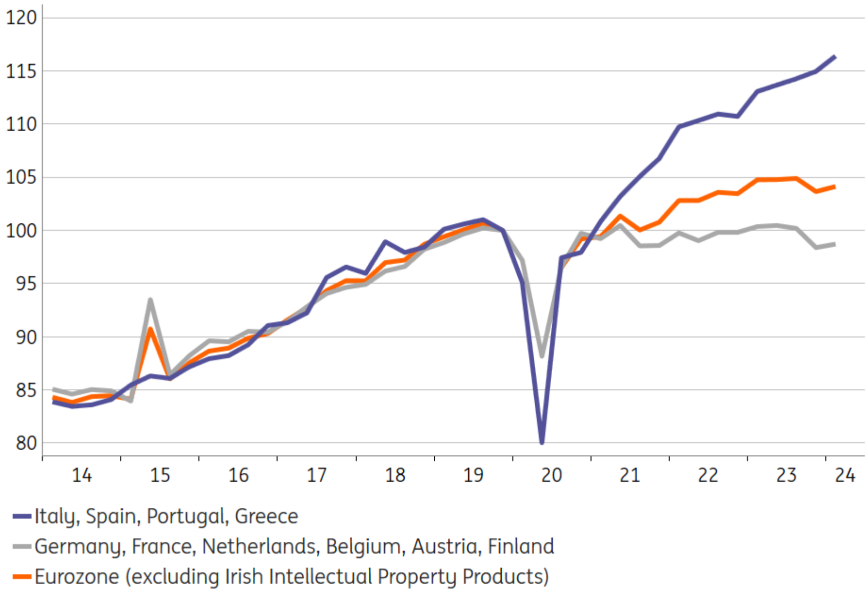
In Europe, it's not just business investment that's under pressure. Government investment has been recovering somewhat but spending and incentives are set to get squeezed in eurozone economies as fiscal prudence returns. While the US is still running a 6%+ budget deficit, eurozone economies are supposed to adhere to budget rules, which is reducing opportunities to boost investment. With populists gaining ground in many countries, traditional government expenditure on health and welfare will be harder to cut, which means that government investment and incentives for business investment are at risk. A logical exception seems to be defence as countries scramble to get their spending budgets in order as the Russian war in Ukraine continues. But even there, progress remains slower than hoped for in terms of increasing structural spending, and given modest European defence production capacity, orders have gone elsewhere.

This is not the case everywhere though. The EU Recovery and Resilience Fund plays an important role in funding private and public investment. In southern and eastern European countries, this is sizable, which is visible in the recovery of investment after the pandemic. Southern eurozone countries have raced ahead and are now beating their pre-pandemic trends in investment, while northern countries are driving the overall lacklustre recovery. In fairness though, a large part of this is because of the Italian “super bonus” isolation incentive scheme, which had a significant impact on investment. Through 2026, we do expect recovery fund projects to be completed, resulting in a sizable investment boost for most southern economies.

This is not the only way that governments impact investment though, policy uncertainty has increased in the eurozone with politics becoming more fragmented and traditional parties losing ground. This is the case globally of course, with protectionism on the rise, including the increasing threat of tariffs. This creates an extra hurdle to business investment.

Southern Europe has moved to a faster investment trend, in part because of the sizable EU Recovery Fund investment

Eurozone investment (gross fixed capital formation), indexed to Q4 2019 = 100



Source: Eurostat, ING Research calculations

Note: eurozone GFCF excludes Irish IPP because of the large volatility due to multinational accounting activity

Will eurozone investment catch up to the pre-pandemic trend?

Catching up to the pre-pandemic trend in the eurozone is likely going to be a challenge. With a sluggish economic outlook over the medium term, interest rates expected to remain higher than before the energy crisis, and slowing opportunities for government support, it is quite possible that a lower trend will materialise. At the same time, businesses could now start to invest in capital-labour substitution with wage growth trending higher and labour shortages still very much in play. Also, defence, energy and climate transition investment is still on the cards. The need for more investment in the eurozone is evident. However, the extent to which this investment will accelerate into a faster growth trend remains uncertain.

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