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PLAYING THE CAPEX THEME

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KEY TAKEAWAYS

Capital spending is picking up, which we believe should benefit the industrials and technology sectors.

Industrial companies have not benefited from the strong manufacturing environment this year, putting the sector in position to potentially play catch-up.

We expect technology to get its fair share of capital spending as companies seek to enhance productivity.

Escalating trade tensions are a key risk to both sectors.

Capital investment is accelerating, a trend we believe should continue.

One of the most encouraging aspects of the U.S. economy currently is that capital spending is accelerating just as some tailwinds are starting to kick in. As we discuss in this week's Weekly Economic Commentary, capital expenditures (capex) are being supported by several factors, including strong earnings growth, corporate tax cuts, immediate expensing of capital investments, repatriation of overseas cash, high business confidence, and deregulation. So how should investors play this theme?

INDUSTRIALS IN THE SWEET SPOT?

Industrials are the most straightforward play on capital spending. But despite the recent pickup in capex and robust manufacturing activity, the sector has struggled [Figure 1]. Escalating trade tensions have played a large role because of the sector's significant exposure to global trade.

1 INDUSTRIALS YET TO BENEFIT FROM RECENT MANUFACTURING STRENGTH



Source: LPL Research, FactSet, Bloomberg 06/15/18

Monthly data.

All indexes are unmanaged and cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment. All performance referenced is historical and is no guarantee of future results.

ISM - Institution for Supply Management

Though the implementation of tariffs is a clear negative for the sector, the likely economic impact is minimal relative to the size of the fiscal stimulus going into the economy. All bets are off should this trade “spat” escalate into something much bigger; but for now, we are comfortable with this risk and continue to view tariffs as part of a broader negotiation strategy (as uncomfortable as it may be). The sector’s price-to-earnings ratio (PE) is about 7% cheaper relative to the S&P 500 Index than it was at the start of the year, so this risk may be largely discounted.

Trade policy aside, the industrials sector is well positioned to benefit from strength in the manufacturing sector. The Institute for Supply Management (ISM) survey in May came in just shy of 59, not far from the highs of the current economy expansion at 60.8 and well above the breakpoint between expansion and contraction at 50 (low 40s has historically been recessionary). As shown in [\[Figure 1\]](#), the industrials sector, which should be the biggest potential beneficiary of that healthy manufacturing environment, has underperformed recently. We think the sector has an opportunity to play catch-up.

We do not expect the strong manufacturing environment and capex pickup to be short-lived. According to the latest semiannual ISM survey, manufacturers plan to increase capex by 10% this year. The impact of the new tax law is just kicking in. Nearly \$300 billion was repatriated from overseas in the first quarter, according to Strategas Research Partners’ tally of Federal Reserve data, with more to come. Companies can now fully expense capital equipment, effectively making it cheaper. Booming profits give companies spending power at a time when their leaders are confident. Finally, oil’s rebound is supporting a recovery in energy investment.

Trade policy remains a big risk for the industrials sector and recent performance has been disappointing, but we believe the underlying fundamentals are strong enough to justify a positive 6–12 month view for the sector.

CAPEX BOOST MAY HELP TECH STAY AHEAD

The technology sector is the other potential big beneficiary of improving capital spending. One of the reasons we like the sector, which is this year’s best-performing sector in the S&P 500 with a 15.3% return, is its ability to help companies increase productivity. Productivity growth (output per hour worked) has stalled over the past decade. To get more productivity, companies will have to invest in capex. In the late 1990s, 3% productivity gains were the norm, compared with 1% on average the past few years. Technology should get its fair share of this investment, especially given trends such as artificial intelligence/machine learning, robotics/automation, cloud computing, and others.

Companies are saying they plan to spend more on technology, based on a Duke University/CFO Magazine survey that asked chief financial officers about their capital spending plans over the next year. The latest results showed respondents expected to increase investment 8.3% in 2018 [\[Figure 2\]](#). When asked about technology spending specifically, respondents signaled a slightly lower but still strong expected increase of 7.2%. This projection could prove to be light, based on some of the drivers of capex discussed above.

The Duke survey also asks these same companies about their expectations for earnings growth over the next 12 months. There you see an even stronger average growth forecast of 9.5%, underscoring that companies are in a strong position to spend on capex.

The technology sector has gotten a bit expensive relative to the S&P 500, in our view. But given the sector is well positioned to potentially benefit from more capex, is enjoying strong earnings growth (over 30% in the first quarter), and has a significant cash hoard which is getting bigger thanks to repatriation of overseas cash, we think the sector appears well positioned to continue to outperform the broad stock market over the rest of this year and possibly longer.

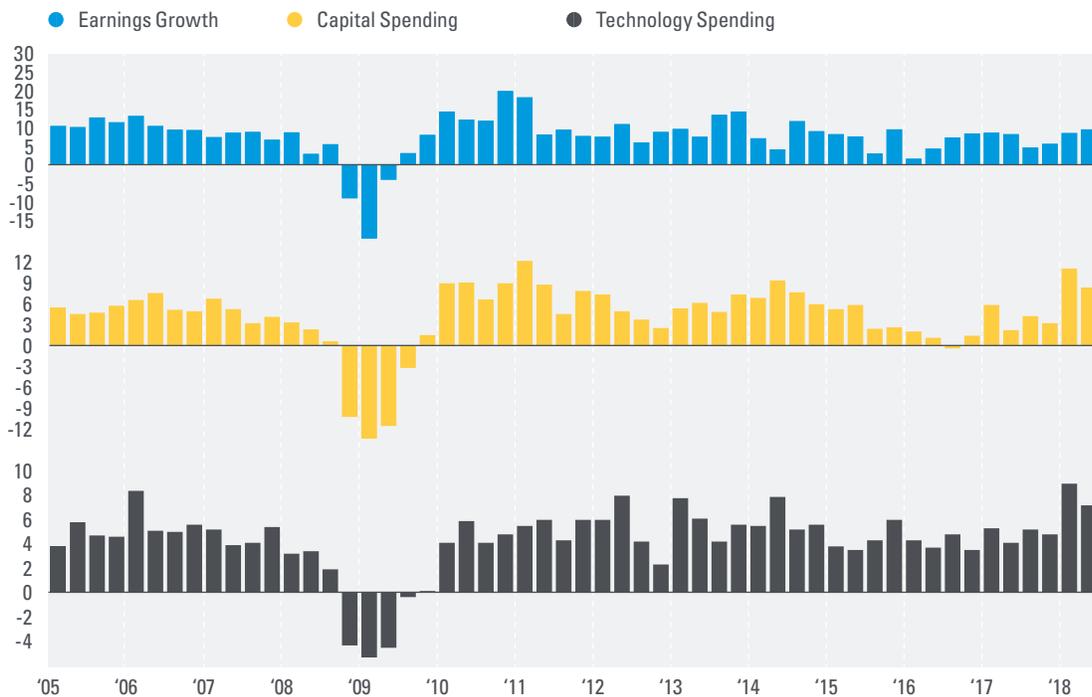
CONCLUSION

Capital spending is ramping up nicely, a trend we think will continue, potentially benefitting the industrials and technology sectors. Escalating trade tensions remain a key risk to both sectors, and the market as a whole, after the Trump administration placed tariffs on about \$50 billion in Chinese goods on Friday (June 15) and China immediately retaliated with tariffs of its own. Meanwhile, metal tariffs have gone into effect on Mexico, Canada, and the

European Union, while NAFTA negotiations have not gone well. With industrials and technology among the most global sectors, they are in the middle of the trade war crosshairs. Even if a trade war is averted and bilateral agreements are reached that preserve most of global trade with the U.S., it may take a good chunk of the summer to get there.

All that said, bolstered by accelerating capex, we think the underlying fundamentals of both sectors are strong enough to carry them to returns above the broad market over the rest of the year. ■

2 COMPANY CFOs PLAN TO RAMP UP CAPEX AND TECH SPENDING



Source: LPL Research, Ned Davis Research, Haver Analytics, Duke/CFO Magazine Global Business Outlook 06/15/18

Firms' changes expected over the next 12 months.

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance referenced is historical and is no guarantee of future results.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

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Because of their narrow focus, specialty sector investing, such as healthcare, financials, or energy, will be subject to greater volatility than investing more broadly across many sectors and companies.

All investing involves risk including loss of principal.

DEFINITIONS

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, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments and exports less imports that occur within a defined territory.

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The Institute for Supply Management (ISM) index is based on surveys of more than 300 manufacturing firms by the Institute of Supply Management. The ISM Manufacturing Index monitors employment, production inventories, new orders, and supplier deliveries. A composite diffusion index is created that monitors conditions in national manufacturing based on the data from these surveys.

The Industrials Sector consists of companies whose businesses manufacture and distribute capital goods, including aerospace and defense, construction, engineering and building products, electrical equipment and industrial machinery. Provide commercial services and supplies, including printing, employment, environmental and office services. Provide transportation services, including airlines, couriers, marine, road and rail, and transportation infrastructure.

The Technology sector consists of companies that primarily develop software in various fields such as the Internet, applications, systems and/or database management and companies that provide information technology consulting and services; technology hardware & Equipment, including manufacturers and distributors of communications equipment, computers and peripherals, electronic equipment and related instruments, and semiconductor equipment and products.

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