ARTICLE FOR THE EDGE

ON THE CUSP OF A NEW GLOBAL INVESTMENT CYCLE

The global economy continues to power ahead, helping elevate stock markets to new multi-year highs this week. Economic growth in the third quarter for both the United States and Europe was at the fastest pace in three years. Moreover, indices of consumer and business confidence in both these large economies have soared to their highest levels since 2001. Now, we are beginning to see tentative signs that the missing ingredient in the global recovery – capital spending – might be kicking in. If this does indeed materialise, it would be a huge positive for the global economy and, most of all, for Asian exporters.

Why is a rebound in capital spending important?

First, the global economy is certainly in a sweet spot but there remain pockets of fragility in the recovery:

- In China, the conclusion of the pivotal 19th Communist Party of China Congress leaves the government a freer hand to intensify reform efforts. Policies such as more rigorous pollution controls and restrictions on housing and bank lending are necessary for the long term good of the country but will tend to slow the economy in the near term. Since China was until recently among the biggest sources of growth for the world economy, it becomes more vital that new engines of growth emerge in the global economy.

- In the United States, the recovery in consumer spending has been going on for a while and there are some signs that consumer borrowing is reaching a peak.

- In Europe, political concerns are rising as a result of continuing uncertainty over Brexit, the Catalonian separatist movement in Spain with its potential for instability and the rise of nationalist parties in central Europe.

- More generally, the International Monetary Fund (IMF), among others, has warned of growing financial risks. The IMF is worried that a prolonged period of low volatility in financial markets has encouraged important financial institutions to take on more risk than they should. Other analysts have detected the growth of derivative products which could cause downward spirals in financial markets under certain conditions.

These risks mean that new drivers of growth are needed to ensure that the global upswing can continue.

Second, while the global economy has recovered, the recovery in trade volumes has not been in line with previous recoveries. Trade-dependent Asian economies need a stronger bounce in export demand to sustain their economic revival. One reason for the less-than-expected vigour in exports is the weakness in capital spending as Asian exports of manufactured goods are high correlated with business spending on new plant and equipment in the developed economies. Stronger capital spending would give Asian exporting economies a high-octane boost.

Why we think a new upcycle in investment could be unfolding

Some of the indicators of capital spending in the large developed economies are beginning to stir back to life after a long period in the doldrums:

- **In the United States, durable goods orders are now growing at their fastest rate since 2014**, increasing 8.3% y/y in Sep 17, accelerating from 5.5% in August. Core capital goods orders are growing at a 7% annualised pace. Encouragingly, the gains have become more broad-based.
- **In the Eurozone, easing credit conditions** will provide more support for companies' investment plans in the world's largest import market. Easier credit conditions are a key inflection point for greater sustainability in the Eurozone recovery. Just as banks are becoming more willing to lend, rising business confidence suggests that firms will be more willing to borrow to expand – the economic confidence index for the Eurozone rose to 114.2 recently, its highest level since January 2001. A survey by UBS found capital spending is poised to rise after two years of lacklustre performance. As an example, Volkswagen is reported to be planning to invest EUR1.4bn (USD1.6bn) in new technology for commercial vehicles.
- **There are signs of a pickup in spending on high-tech equipment**: The Federal Reserve's Tech Pulse Index rose an annualized rate of 13.8% in Sep 17 to reach its highest level since August 2008.
- **In Japan, the incentive to step up capital spending is rising**: The Tankan survey showed that the national production capacity index had fallen by one point to -3, its lowest since 1991, indicating that, for the first time since the bursting of its stock market bubble in 1990, Japanese companies did not have sufficient production capacity to meet demand. In fact, Japan's core machinery orders expanded are expanding strongly, especially in the manufacturing sector.

Some would say that these are just data points, tantalising as they are. But, if we look deeper at the underlying forces at work in the global economy, the case for a material uptick in investment becomes a bit clearer:

First, there are good reasons to expect a rebound in capital spending in the United States. The recent recovery in oil price is likely to boost investment in oil/gas related capital spending – especially as Saudi Arabia and Russia, the two largest oil exporters in the world, appear to have agreed to extend production cuts beyond their expiry early next year. That makes the current rise in oil prices likely to persist.

In addition, if planned tax reforms do materialise, we could see a surge in investment by American corporations. Not only is Congress hoping to secure agreement soon on a massive tax cut for corporations but the tax cuts are likely to be front loaded into 2018 which would hugely boost demand in the economy at a time when overall capacity utilisation in the economy is reaching its limits. Companies would have to invest in new production capacity to meet this demand. Furthermore, the tax reforms could include inducements to invest such as allowing companies to write off all capital expenses within the first year, instead of depreciating it gradually over many years.

Second, there are multiple new technologies that are reaching commercialisation points simultaneously – and which require substantial capital spending. Whether it is renewable energy such as solar or wind, or new composite materials, or rapid advances in automation and artificial intelligence, or transformational improvements in bio-medical equipment and therapies or the new advanced manufacturing processes such as 3D printing, more and more companies will find that they simply have to invest if they are to keep ahead of their competitors.

Third, we expect a surge in actual spending on China's hugely ambitious Belt and Road Initiative (BRI). In his keynote address to the 19th Party Congress, Chinese President Xi Jinping outlined a bold and ambitious plan for China to gradually emerge as the pre-eminent world power. A key plank in this strategy is the BRI which would vastly increase China's soft power and standing in the world. Although Xi first outlined his vision for the BRI three years ago, it has taken some time for the bureaucracy in China to translate their leader's bold thoughts into an actionable programme. The BRI has now reached a point where major projects have been identified, funding agencies established and agreements made with recipient countries on how to proceed – which means a surge in spending is imminent. Given the sheer scale of the BRI and its wide geographic reach, the impact will be extraordinary as well. Fitch has estimated that the BRI will include about USD900 billion worth of projects, with more projects likely to be added over time. China has lined up USD62 billion worth of projects in Pakistan alone. In addition to these state-sponsored investment, private Chinese companies are also jumping on the bandwagon, to launch projects of their own.

Fourth, after many years of talking and planning, several Asian countries are now at a stage where mega infrastructure projects will actually be launched. For example, in Thailand, large contracts are being awarded as the government prepares for a general election by year-end. In the Philippines, President Duterte's "Build, Build, Build" programme is also about to take off. India has just announced a massive road building programme, followed by Prime Minister Modi launching an ambitious plan to bring electricity to every village in India. These public sector projects are large enough in scale to persuade private companies of burgeoning new business opportunities, which would encourage them to also step up capital spending to expand their capacity.

Conclusion: positive except for one risk

We think that the world economy is set to enjoy a new global investment cycle which will have important effects.

The first impact is that global growth will improve beyond current expectations: Investment spending has high multiplier effects in the short term and, by boosting production capacity, generates long term growth as well. More than that, growth should also become more resilient to potential shocks. A global economy that is growing vibrantly is more likely to be able to take the odd political or financial shock in its stride.

Second, the trade effects of growth driven by capital spending are more significant than growth that is driven mostly by consumer demand: production of capital equipment requires components that are manufactured in complex supply chains that span across many countries. Asian exporter such as Korea, Taiwan, Malaysia, Thailand, Singapore and Vietnam will be big beneficiaries.

Third, however, higher investment spending could come with some risks as well – particularly in the United States. One concern is that a burst of capital spending in the United States whose economy is already running close to its full potential, could raise inflationary pressures. That could prompt the Federal Reserve Bank to raise rates and withdraw liquidity faster than planned – which could take away a lot of the current exuberance in financial markets. Another concern is that a rise in investment spending without a corresponding rise in domestic savings would lead to a sharp widening of America's current account deficit. Would the nationalistic Trump Administration react to that by accusing its trading partners of unfair trading and currency practices – and intensify its protectionist actions? That is certainly a risk but one that is more likely to be felt in 2019 or 2020 rather than in the next year.

All in all, then we believe that the stars are aligned for stronger global growth.

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