Smith Group
ASSET MANAGEMENT

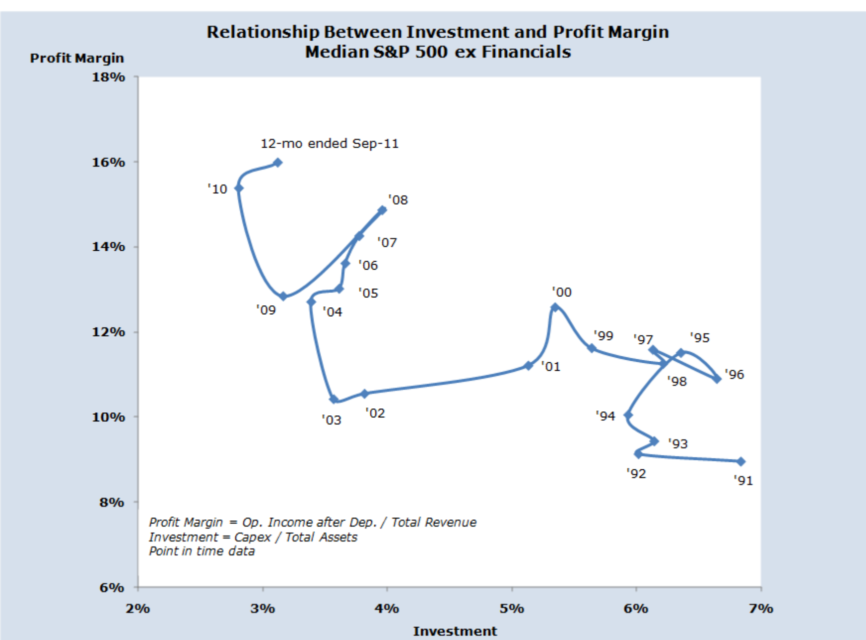
Market Perspectives Excerpt

Two Decades of Pent-up Demand?

BILL KETTERER, CFA
OCTOBER 2011

It is a common misconception that one of the reasons unemployment has been so stubborn in this recovery is that companies have replaced workers with technology and automation. However, the data does not support that conclusion—capital expenditures (CAPEX) as a percentage of assets are at a multi-decade low (see graph below). Granted there has been a shift in our economy from manufacturing to services over that period, which is less capital intensive. But that does not explain the last couple of years, during which manufacturing has made a comeback. In fact, as they did after the tech wreck in 2000, companies cut back dramatically on CAPEX to protect profit margins in 2009 and 2010, a trend that has continued in 2011. They have been hording cash and booking record profit margins.

Companies have done a phenomenal job of squeezing more output from existing employees and infrastructure. Record low investment and labor share of profits tells that story. But how much more output can the contemporary business complex produce before it just plain runs out of capacity? Note in the graph that investment picked up in 2005 after profitability recovered and about the time when computers and equipment was worn or obsolete. This time profitability snapped back quickly in 2010 and moved to new highs. Some contend that the equipment replacement cycle was not complete when the economy dipped in 2008. One can only imagine workers with no spare time, crammed into closet size cubes, hammering out products or services on computers far past their prime. So is there pent-up demand? We think the rubber band is getting stretched pretty tight.



Unfortunately, capital is on strike and management hesitates to take bold cash deployment actions. It appears the animal spirits of capitalism have been caged for the time being by uncertainty. The result is businesses with little room to accommodate rising sales unless they expand capacity via investment and employment. At the same time, low CAPEX relative to replacement needs means there is little room to cut further in the unlikely occurrence of a double dip. Frankly, investment is apt to have a floor below which it will not fall.

Once some of the uncertainty in the global economy dissipates an investment cycle will eventuate, which is normally followed by a hiring spurt. If uncertainty does not clear and companies need levers to pull to defend margins, they may find the levers available in the past are not there to help out. In this case, margins are apt to be under pressure.