Weekly Economic Commentary

May 7, 2012

License to Spend

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Highlights

Corporate cash flows are at all-time highs.

We continue to expect solid capital spending in 2012.

Weather and legislation likely affected businesses' spending decisions in the early part of the year.

In our *2012 Outlook* we wrote, "U.S. gross domestic product (GDP) is likely to produce below-average growth of about 2% in 2012, supported by solid business spending and modest, but stable, consumer spending" and that U.S. business spending would grow at several times the pace of consumer spending in 2012. With data on GDP now in hand for the first quarter of 2012, it appears that business capital spending has plenty of catching up to do over the final three quarters of 2012. While businesses have been generating record profits, leaving corporate cash flows close to all-time highs, they have been reluctant to add to staff or do much capital spending in early 2012, preferring other uses for their cash.

The Skills to Pay to the Bills

- **Acquire other companies.** Merger and acquisition (M&A) activity, while nowhere near as robust as it was prior to the Great Recession, has ramped up quickly since the end of the recession. Global M&A activity has increased by close to 40% since the middle of 2009, according to Bloomberg data.
- **Initiate or increase dividend payments to shareholders.** According to Standard & Poor's Index Services, 677 companies either initiated or increased dividends to shareholders in the first quarter of 2012, the most in any first quarter since 2007. S&P 500 companies paid out $240 billion in dividends to shareholders over the four quarters of 2011, the best four quarters for dividends since the four quarters ending in the third quarter of 2008, when many financial institutions slashed or eliminated their dividends as the Great Recession worsened. As we have noted in prior commentaries, corporate dividend strategies face uncertainty at the end of this year as the Bush tax cuts (which put the tax rate on dividends at 15%) are set to expire. Many firms may want to issue special dividends ahead of this date, thus diverting funds that could be used for capital spending.
- **Buy back shares.** According to Standard & Poor's Index Services, share buybacks, another way companies can deploy cash to shareholders, totaled $409 billion for S&P 500 companies in 2011, a 40% increase from the $299 billion in buybacks in 2010. The year 2011 saw the most buyback activity since mid-2008, prior to the onset of the worst of the Great Recession in the fall of 2008. Although share prices have increased 25% since the fall of 2011, making it more expensive for corporations to buy back shares, share buybacks should at least match 2011 levels in 2012.

Fight for Your Right. Corporate revenue is again growing strongly and is generating large amounts of free cash that is available to finance investment. Yet, tight credit markets are limiting the ability of small and medium-sized companies, those generally without access to financial markets, from taking on new investment projects.

LPL Financial Research Weekly Calendar

2012	U.S. Data	Fed	Global Notables
7 May	■ Consumer Credit (Mar) ■ Congress Back in Session	Lacker*	■ **French Presidential Elections (Sunday 5/6)** ■ **Greek Parliamentary Elections (Sunday, 5/6)**
8 May	■ Small Business Optimism (Apr) ■ **JOLTS (Mar)** ■ U.S. House of Representatives Holds Hearings on Overhauling the Fed	Fisher Lacker*	■ Indonesia: GDP (Q1) ■ **Netherlands: Debt Auction**
9 May		Kocherlakota Pianalto* Plosser	■ **Germany: Debt Auction** ■ Brazil: Central Bank Meting ■ Brazil: Inflation (Apr) ■ Mexico: Central Bank Meeting
10 May	■ Merchandise Trade Deficit (Mar) ■ **Initial Claims (5/5)** ■ Monthly Budget Deficit (Apr)	**Bernanke*** Kocherlakota	■ **China: Imports and Exports (Apr)** ■ China: Money Supply (Apr) ■ U.K.: Bank of England Meeting ■ South Korea: Central Bank Meeting ■ Indonesia: Central Bank Meeting ■ Norway: Central Bank Meeting
11 May	■ PPI (Apr) ■ Consumer Sentiment (1H May)	Fisher	■ **China: CPI (Apr)** ■ China: Industrial Production (Apr) ■ China: Retail Sales (Apr) ■ Malaysia: Central Bank Meeting ■ **Belgium: Debt Auction**

Hawks: Fed officials who favor the low inflation side of the Fed's dual mandate of low inflation and full employment

Doves: Fed officials who favor the full employment side of the Fed's dual mandate

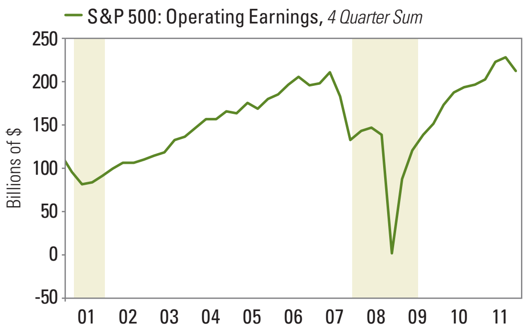
* Voting members of the Federal Open Market Committee (FOMC)

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.

Job Openings and Labor Turnover Survey (JOLTS) is a survey done by the United States Bureau of Labor Statistics to help measure job vacancies. It collects data from employers including retailers, manufacturers and different offices each month. Respondents to the survey answer quantitative and qualitative questions about their businesses' employment, job openings, recruitment, hires and separations. The JOLTS data is published monthly and by region and industry.

The Producer Price Index (PPI) program measures the average change over time in the selling prices received by domestic producers for their output. The prices included in the PPI are from the first commercial transaction for many products and some services.

1 After Dropping Precipitously in the Great Recession Corporate Profits Are Back to All Time Highs

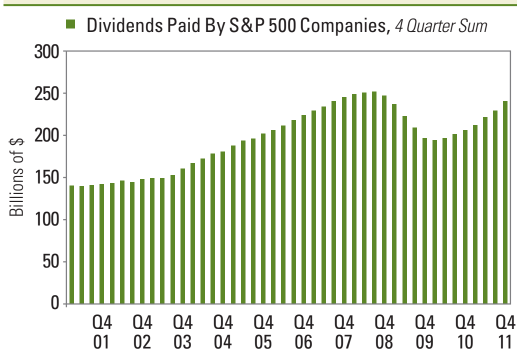


Source: Standard & Poor's Index Services, Haver Analytics 05/07/12

Shaded areas indicate recessions.

The S&P 500 is an unmanaged index, which cannot be invested into directly. Past performance is no guarantee of future results.

2 Dividend Payments by S&P 500 Companies to Shareholders Are Almost Back to Pre Recession Highs, And Have Increased Sharply Over the Past Two Years



Source: Standard & Poor's Index Services 05/07/12

Risk Factors For Robust Capital Spending in 2012: Sluggish economic growth in the United States, the ongoing uncertainty in Europe, the slowdown in China, as well as the large range of outcomes for business capital related legislation in the wake of the upcoming Presidential and Congressional elections in the United States, among other factors, are likely to continue to weigh on businesses' willingness to commit to more capital spending in 2012.

Legislation and Weather May Have Sabotaged Business Capital Spending in Early 2012

Part of the slowdown in business capital spending in early 2012 relative to the robust pace seen in 2011 (and to the pace of consumer spending) may have been related to legislation and the weather. As we have discussed on several occasions in these pages, the much warmer-than-usual weather in the first three months of 2012 likely pulled forward some consumer spending into the winter months from the spring months, artificially boosting consumer spending, which grew at a 2.9% annualized rate in the first quarter. Business capital spending, which is not as weather sensitive, grew at just a 1.7% annualized rate in the first quarter of 2012.

The slow pace of business capital spending growth in the first quarter of 2012, in part, reflects the strength in capital spending in late 2011 which, in turn, may be related to legislation. Business spending was strong in 2011, especially in the final two quarters of the year, as spending rebounded from the supply chain disruptions triggered by the devastating earthquake, tsunami, and nuclear disaster in Japan in March of 2011. Business capital spending surged by 16% and 8% in the final two quarters of 2011, respectively, and increased by 10% over 2011. The year 2011 marked the second consecutive robust year of business spending, after business spending all but dried up in 2007, before declining sharply in both 2008 (4%) and 2009 (-16%). Business capital spending surpassed its previous all-time high (set just prior to the onset of the Great Recession) in the third quarter of 2011, and continued to set new all-time highs in both the fourth quarter of 2011 and the first quarter of 2012.

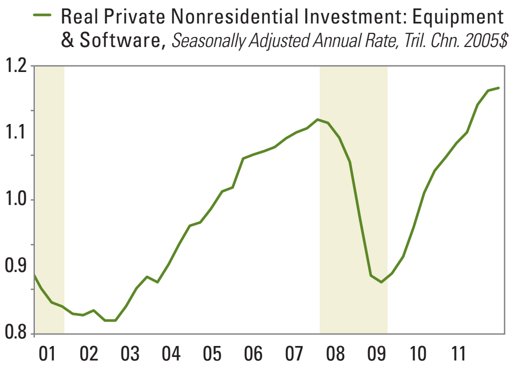
As noted above, part of the surge in business capital spending in late 2011 may have been related to legislation passed by Congress in December 2010, which allowed businesses to fully expense (for tax purposes) capital equipment purchased before the end of 2011. This probably pulled some capital spending that would otherwise have occurred in early 2012 into the latter half of 2011. The law allows companies to expense only 50% of capital equipment purchased before December 31, 2012 and, as the law stands now, even this provision would expire at the end of 2012, as part of the "fiscal cliff" we have discussed in recent weeks. This uncertainty may have the same impact on business spending this year, especially as we approach the 2012 Presidential and Congressional elections.

Check it Out: What May Boost Business Capital Spending Throughout 2012

Moving beyond legislation, many of the factors we forecast would be in place in 2012 to continue to boost capital spending remain in place. They include:

- **Record cash levels.** The aforementioned record level of cash and corporate profits, combined with very low rates of return on these cash assets, is forcing corporate boards to ask corporate managements to put the cash to a more productive use.

3 Business Capital Spending Surpassed Its Pre-Great Recession High in Late 2011, and Is at an All-Time High

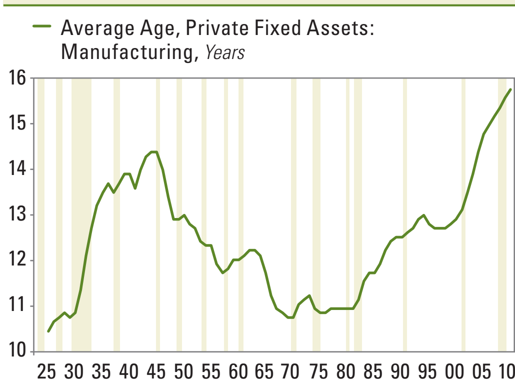


Source: Bureau of Economic Analysis, Haver Analytics 05/07/12

Shaded areas indicate recessions.

Nonresidential real estate: Commercial structures constructed for use as factories, office buildings, warehouses, utilities, hospitals, retail stores, etc.

4 The Average Age of Manufacturing Infrastructure Rose Sharply During the Great Recession and Is at an All-Time High



Source: Bureau of Economic Analysis, Haver Analytics 05/07/12

Shaded areas indicate recessions.

- **Near-record low financing rates for businesses.** The Federal Reserve (Fed) has promised to keep rates at "exceptionally low levels" until at least 2014. In addition, the Fed's Operation Twist has kept long-term rates lower for longer, aiding both business and consumer borrowers.
- **Steadily increasing loan growth.** Commercial and industrial loans by banks to businesses, a key weekly metric of bank lending activity, is at a three-year high, and is up more than 13% from a year ago, the strongest pace of growth in nearly four years.
- **Gradually easing lending standards.** Lending standards for loans by banks to finance capital spending, especially for commercial real estate, are easing, though still tight. As noted above, corporate revenue is again growing strongly and is generating large amounts of free cash that is available to finance investment. Yet, tight credit markets are limiting the ability of small and medium-sized companies, generally those without access to financial markets, from taking on new investment projects.
- **Equity prices.** The 100%-plus gain in equity prices over the past three years and the 25%-plus gain in stocks over the past six months are notable. No sector of the economy is more highly correlated with movement in equity prices than business capital spending. Further gains in equity markets should fuel more capital spending over the remainder of the year.
- **"Onshoring" trend.** We have observed ongoing anecdotal evidence of "onshoring" of jobs, especially in the manufacturing area. Aided by: 1) poor quality control in China, 2) relatively high unemployment, and lowered wage and benefit demands in the United States, and 3) the low cost of fuels like natural gas to help run the plants, an increasing number of big and small companies have moved production back to the United States in recent quarters. Political considerations are also hastening this trend.
- **Capital for labor.** An ongoing substitution of capital for labor is occurring, as businesses continue to compete globally using the latest in technology and production processes. In addition, adding new workers often involves paying benefits along with salaries. New machinery, of course, does not require benefits like health care.
- **Average age of productive infrastructure at multi-year highs.** The average age of the nation's productive infrastructure is at multi-year highs, especially in traditional manufacturing, but in many other areas as well. Industries including transportation and warehousing, wholesale trade, retail trade, accommodation, and food services all have seen the average age of their productive infrastructure hit new multi-decade highs since the onset of the Great Recession, as businesses cut investment to protect their shareholders in the downturn.

The sweeping regulatory and legislative changes and prospects for additional changes, affecting sectors such as Financials, Energy, Utilities, and Health Care, that took place in 2010 are fading and may even be reversed—with the outcome of the 2012 election. Therefore, in 2012, business spending may continue to enjoy what may be a new multi-year cycle supported by this clearer regulatory and legislative environment. ■

LPL Financial Research 2012 Forecasts

- GDP 2%*
- Federal Funds Rate 0%^
- Private Payrolls +200K/mo.†

Please see our *2012 Outlook* for more details on LPL Financial Research forecasts.

* 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.

^ Federal Funds Rate is the interest rate at which depository institutions actively trade balances held at the Federal Reserve, called federal funds, with each other, usually overnight, on an uncollateralized basis.

† Private Sector – the total nonfarm payroll accounts for approximately 80% of the workers who produce the entire gross domestic product of the United States. The nonfarm payroll statistic is reported monthly, on the first Friday of the month, and is used to assist government policy makers and economists determine the current state of the economy and predict future levels of economic activity. It doesn't include:
- general government employees
- private household employees
- employees of nonprofit organizations that provide assistance to individuals
- farm employees

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