



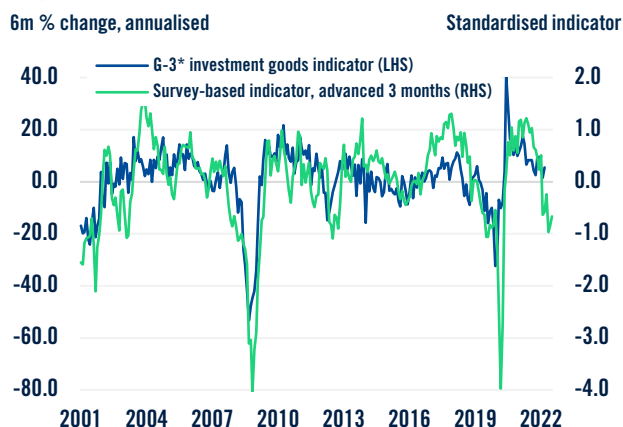
Risks to global investment

Key indicators point to G7 investment growth slowing sharply this year. A combined estimate based on survey evidence, financial market developments, credit conditions and corporate liquidity suggests G7 investment could decline at an annualised pace of around 1.5%, adding to global recession risks.

Declines in capital spending are often key drivers of economic downturns, as investment fluctuates much more over the economic cycle than GDP. As a result, near-term trends in investment are of particular importance given the concerns about a possible global recession. So, what do the various indicators of investment that we have tell us?

Our survey-based indicator. A coincident indicator of investment activity in the G3 (US¹, Germany², and Japan³), based on capital goods orders still looks solid. For July, it suggests investment goods orders across the G3 rising at a 5% annual pace, albeit with a much weaker outlook in Germany. A more forward-looking indicator, based on business surveys, looks far less encouraging. This indicator leads capital goods orders by around three months and has turned clearly negative in recent months (Fig. 1). The current level is consistent with G7 investment falling at an annual pace of -1.8%.

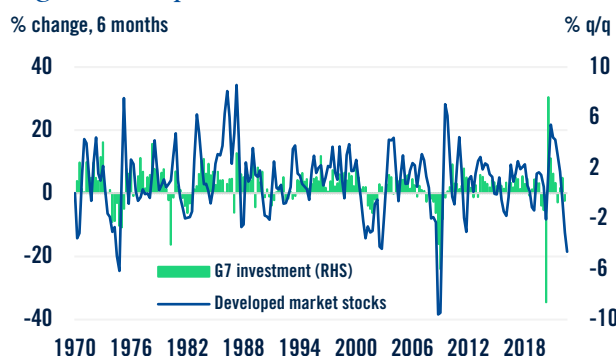
Fig. 1: G3 investment indicator



Source: Oxford Economics
As of 8 October 2022

Stock prices. The six-month change in developed economy stock prices explains 20% of the variation in G7 quarterly investment growth since 1998. Currently, the six-month change is running at around -19%, a rate that has only been seen a few times in the last half-century: in 1974, the early 2000s, and in the global financial crisis (Fig. 2). Historically, this is consistent with quite a sharp drop in G7 investment of around 3% annually.

Fig. 2: Stock prices and investment

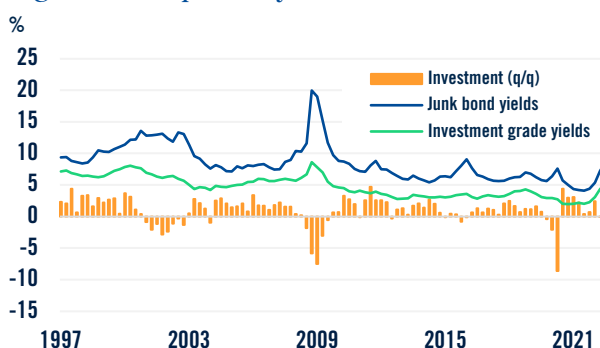


Source: Oxford Economics/Haver Analytics
As of 8 October 2022

Corporate profits. Buoyant profits usually mean stronger investment, while profit squeezes are often associated with weaker capital spending. But the relationship is not very tight. About 14% of the variation in US private non-residential investment since 1948 is explained by profits. Our baseline forecast is for US corporate profits to drop by 33% from Q4 2021 to Q4 2022. This is historically consistent with US investment falling 4%.

Corporate bond yields. Rising interest rates ought to have a negative impact on capital spending, by discouraging fresh borrowing and encouraging firms to cut back on investment to ensure they can meet rising interest charges on existing debt. So, the recent rise in corporate borrowing costs could be an indicator of falling investment ahead. The historic statistical relationship between non-investment grade corporate yields and investment in the US is relatively strong (Fig. 3). Levels of junk bond yields explain around 25% of

Fig. 3: US corporate yields and investment



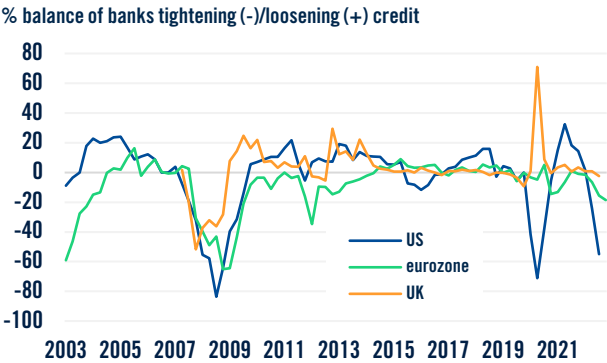
Source: Oxford Economics/Haver Analytics
As of 8 October 2022

the quarterly variation in US private non-residential investment. Current levels of yields are consistent with US investment running at a weak 0.9% annualised pace.

Bank credit standards. Bank credit standards are a useful indicator of near-term economic prospects, including investment. Since 1990, movements in bank standards for corporate lending in the US have explained around 30% of the quarterly variation in US private non-residential investment, making this one of the better potential indicators of investment in our set. However, as surveys of bank credit standards take place only quarterly it's not a very timely one.

The latest surveys for the UK⁴, eurozone⁵ and especially the US⁶ have shown banks starting to restrict corporate credit (Fig. 4). Using the historic relationship between standards and investment for the US (where the data runs are by far the longest) and plugging in the average change in standards for the US, eurozone, and UK from the latest surveys implies zero G7 investment growth.

Fig. 4: Corporate credit standards

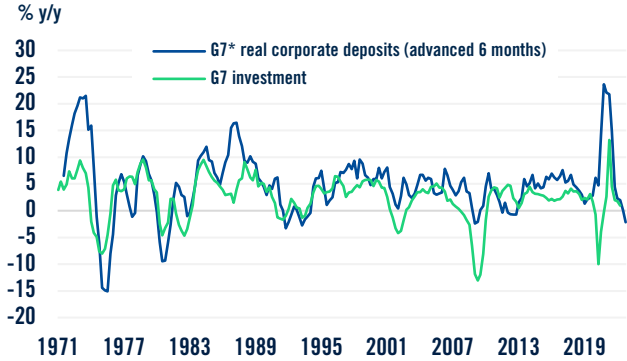


Source: Oxford Economics/Haver Analytics. Note: US Q3 figure based on special forward-looking question in latest survey
As of 8 October 2022

Real corporate liquidity. The recent surge in inflation poses a risk to investment (and consumption) by eroding the real value of money balances held by firms and households. This erosion amounts to a squeeze on corporate liquidity. Looking at the G7 aggregate from 1971, movements in real corporate money holdings explain around 30% of shifts in G7 investment – a similar level of explanatory power to that of US banks' corporate credit standards.

Recently, G7 corporate liquidity has, on this measure, worsened notably. It grew at a 20% pace in 2020 but slipped to single figures in 2021. And in Q2 2022, preliminary data suggest an annual decline in real corporate deposits of 2.2%. This is the weakest figure since the global financial crisis and historically consistent with G7 investment dropping at an annual pace of 0.2%. Real money holdings seem to lead investment by around six months (Fig. 5) implying investment starting to shrink around the end of 2022.

Fig. 5: Real corporate money and investment



Source: Oxford Economics/Haver Analytics
As of 8 October 2022

Looking across our six indicators, their historic links with investment suggest that G7 capital spending is likely to turn negative in the latter part of 2022 or early 2023. The simple average annual growth rate of investment predicted by these indicators is -1.4%, with a range from -4% to +0.9% (Table 1).

Table 1: Investment growth based on different indicators

Indicator	% annualised pace
US corporate profits	-4.0
Developed market stocks	-3.1
Surveys	-1.8
Real G7 corporate deposits	-0.2
G7 corporate credit standards	0.0
US junk bond yields	0.9
US junk bond yields	-1.4

Source: Oxford Economics
As of 8 October 2022

Given the relatively good track record of some of these indicators, the danger of an investment 'freeze' in the G7 in the latter part of 2022 and early 2023 looks to be very real. This adds to the risk of a global recession, with recession risks looking especially elevated in parts of Europe where additional shocks such as the energy price surge have been largest and where the relationship between investment drops and GDP declines is particularly tight. In Germany, 56% of quarters where investment fell since 1970 saw GDP fall as well – well above the G7 average figure since 1980 of just under 40%.

Pricoa Private Capital

This update was researched and written by Oxford Economics, 121 St. Aldates, Oxford, OX1 1HB, England, as of 8 October 2022.

¹ Institute for Supply Management. (2022). September. [online] Available at: <https://www.ismworld.org/supply-management-news-and-reports/reports/ism-report-on-business/pmi/september/> [Accessed 8 Oct. 2022].

² IFO Institute. (2022). ifo Business Climate Index for Germany. [online] Available at: <https://www.ifo.de/en/survey/ifo-business-climate-index-germany> [Accessed 8 Oct. 2022].

³ Cabinet Office. (2022). Economy Watchers Survey - Cabinet Office Home Page. [online] Available at: <https://www5.cao.go.jp/keizai3/watcher-e/index-e.html> [Accessed 8 Oct. 2022].

⁴ Bank Of England. (2022). Credit Conditions Survey - 2022 Q3. [online] Available at: <https://www.bankofengland.co.uk/credit-conditions-survey/2022/2022-q3> [Accessed 8 Oct. 2022].

⁵ E.C.B. (2022). The euro area bank lending survey – Second quarter of 2022. [online] (2022). Available at: https://www.ecb.europa.eu/stats/ecb_surveys/bank_lending_survey/html/ecb.blssurvey2022q2~ce6d1a4597.en.html [Accessed 8 Oct. 2022].

⁶ Board of Governors of the Federal Reserve System. (2022). The Fed - Senior Loan Officer Opinion Survey on Bank Lending Practices. [online] Available at: <https://www.federalreserve.gov/data/sloos.htm> [Accessed 8 Oct. 2022].

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