

## GS Global Capex Survey Points to Higher Spending and Highlights Risks to Our Rates View

**A proprietary survey of GS equity research analysts shows robust growth in capital spending this year. Expectations for 2006 are more muted, although we see scope for a pickup given the favourable macroeconomic environment. Reliance on internally generated cash flow helps to explain why real rates have not risen this year. But greater corporate reliance on debt financing, along with tighter monetary policy, could put upward pressure on rates in 2006.**

Until the start of the year, global capital spending had experienced only a muted upswing, even after one of the steepest corporate financial adjustments in post-war history. In our view, this set the stage for a solid rise in capital spending in 2005. The macroeconomic environment has been favourable, and our first GS Global Capex Survey, conducted in February, showed that GS equity research analysts expected higher capital spending around the world.

As the year has progressed, companies have finally begun to capitalize on this favourable environment. In fact, the global capex recovery has exceeded our expectations. To check our forecasts against developments in the intervening nine months, we have again surveyed analysts' capex expectations.

Results of this second survey indicate that stronger demand has driven higher-than-anticipated investment, particularly in Europe and non-Japan Asia, and that companies have overwhelmingly relied on internal cash flow to finance capex.

Looking ahead, early expectations for capital spending in 2006 are more subdued than for 2005, with expectations focused on single-digit growth. But the combination of upward revisions this year and a still-favourable macro environment suggests that the risks for capex spending in 2006 are on the upside—particularly if the market starts more obviously rewarding companies for investment.

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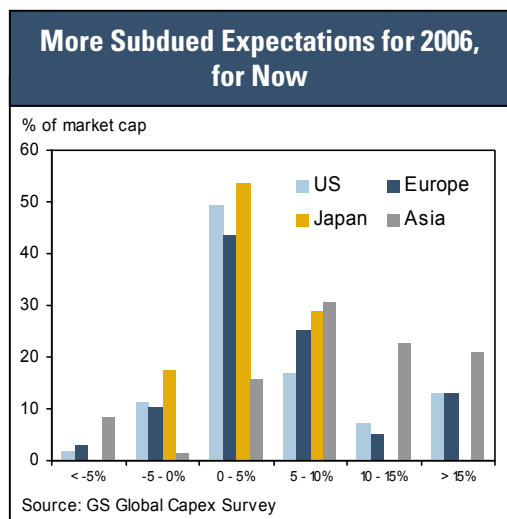
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Continued reliance on internal funding helps to explain why the predicted rise in real bond yields this year has not materialised. We still believe real yields could head higher, particularly if lower profit growth forces firms to turn to external sources of finance for capex. Tighter global monetary policy should also push real bond yields up from today's levels.

### The Outlook Early in 2005: Cautious Optimism

At the start of the year, the macro environment offered a compelling case for a solid recovery in capital spending. Despite above-trend economic growth, well-repaired corporate balance sheets and rising capacity utilisation rates, investment was low, both as a share of profits and as a share of GDP.

Our first survey of GS analysts, conducted in February, pointed to cautiously optimistic corporate spending plans, with US firms the most aggressive and European firms the most cautious. Globally, Industrials were seen as the most likely sector to increase capex, and Consumer the least likely. The survey

also pointed to continuing risk aversion, with a clear preference for funding capex through free cash flow everywhere but in Asia (where there was some preference for debt).

Perhaps most importantly, the survey flagged a disconnect between managements' and investors' views of the world. While corporates favored capex as the preferred use for cash flow, our analysts worried that equity investors might not agree. The need to return cash to shareholders was cited as the principal restraint on capex in the US and Asia; it was a close second behind overcapacity or a lack of profitable opportunities in Europe and Japan.

This pointed to an important upside risk to our views: if and when the market started more obviously to reward companies for investment, then the upswing in capex could be quite marked.

### Capex Recovery Stronger Than Expected at the Macro Level ...

After several years of tepid performance, global investment spending has finally begun to post a more robust recovery. G3 investment growth has averaged 4.6% on an annualised basis in the first three quarters, compared to our February forecast of 3.2%.

The upside surprise has been broad-based, with only Europe disappointing, at least on the macro data. We now forecast G3 capex spending growth of 4.5% in 2005. Forward-looking indicators in the US and Europe, as well as Japanese bank lending, M&A activity and our own CEO Confidence Index, provide further signals that investment spending could remain firm in the months ahead.

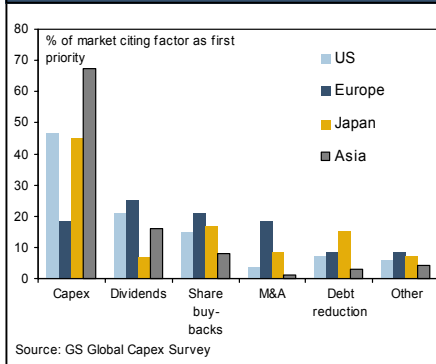
### ... and at the Micro Level

Nine months on from our first survey, we revisited the question of capital spending with GS equity research analysts. More than 185 responses to a survey conducted in late October give a broad and detailed picture of capital spending this year and the prospects for 2006.

Overall, the outlook for 2005 is more strongly positive now than in February. The wide majority of analysts in Europe and Asia, and half the analysts in Japan, have revised up their expectations for 2005. The picture is more mixed in the US—the most optimistic region at the start of the year—where about 40% have revised up but another 25% have revised down. As a result:

- In both the **US and Europe**, more than half the market now expects capital spending to rise by 10% or more this year, and about one-quarter expects the increase to be 15% or more above 2004 levels. The downside is starker in the US, where nearly one-third of the market anticipates flat-to-negative spending compared to 2004 levels—against just 18% anticipating flat or negative growth in Europe.
- **Asia outside Japan** is now the most optimistic region, reflecting an upward re-rating of expectations across the board. As in the US and Europe, more than half the market anticipates double-digit increases in capex—but Asian expectations are firmly on the higher side, with 44% expecting more than 15% growth. Only 10% of Asian firms expect no or negative growth this year, by far the smallest share globally (and just one-third of the US figure).

**Corporates' Primary Use for Cash Flow in 2005**



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■ **Japan** is the most cautious region, with half the market expecting only single-digit increases. A mere 6% of the market forecasts 15%+ gains.

Looking at the results by industry, the **Resources** sector overwhelmingly—and not surprisingly—is a key source of these higher expectations. Virtually all firms in this sector in both the US and Europe are forecasting yoy increases above 15%. **IT and Communications** is also slated for double-digit growth around the world.

**Industrials**, which earlier this year looked to be the major focus of higher capex, is now poised for significant increases in the US and Europe, but a more moderate pickup in Asia and especially Japan. Finally, the outlook for the **Consumer** sector is relatively poor, particularly in the US and Japan. More than one-third of the sector in both markets expects flat or negative growth.

How Will Corporates Finance Capital Spending?								
% citing response as first choice	2005				2006			
	US	Europe	Japan	Asia ex Japan	US	Europe	Japan	Asia ex Japan
<b>Cash flow</b>	<b>88</b>	<b>95</b>	<b>66</b>	<b>43</b>	<b>95</b>	<b>86</b>	<b>79</b>	<b>55</b>
Cash on balance sheet	2	2	30	13	0	0	0	0
Debt	0	2	0	30	1	14	0	27
Cash flow + debt	0	0	0	0	4	0	21	17

Source: GS Global Capex Survey

**Why and how?** Stronger demand has been the main driver of higher-than-anticipated capex around the world, particularly in Europe and Asia. In the US, capex seems to have been driven by higher maintenance needs as well as stronger demand. Nearly two-thirds of companies in Japan indicate that markets are rewarding firms for investing, but this is a negligible factor elsewhere.

Risk aversion persists, with an overwhelming majority of firms in Europe and the US financing capital spending out of internal cash flow. Asian firms have also used debt and Japanese firms have turned to cash on balance sheets, but both regions still rely primarily on internal cash flow.

**Capex the key priority.** Capital spending has been the preferred use for cash everywhere but in Europe. Dividends are a distant second in the US and Asia, and share buybacks a distant second in Japan. In Europe, however, companies prefer to use cash flow for dividends and share buybacks, and rate M&A an equal third priority with capex.

Interestingly, this, along with the upward revisions to capex forecasts, suggests that profit growth in Europe has been much higher than we had earlier anticipated. It is also interesting to note that buybacks have been noticeably lower than earlier expectations in the US and Japan.

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Our survey shows that the disconnect between investors and managers over the importance of capex persists. In Japan, nearly two-thirds of companies cite the market response as a positive driver behind capex; elsewhere, this explanation barely figures.

### 2006: More Subdued Expectations, But Scope for a Stronger Outturn

Expectations for capex in 2006 are, for now, more subdued than the current forecasts for 2005. In fact the preliminary outlook for 2006 is similar to our start-of-the-year expectations for 2005.

- Globally, two-thirds of companies expect single-digit increases in 2006, with 13% expecting no or negative growth and, at the other end of the scale, 21% seeing double-digit growth.
- Non-Japan Asia is the most optimistic region, with more than 40% of the market forecasting double-digit increases.
- Japan is generally the gloomiest, with the highest share expecting a year-on-year decline and the most

robust forecasts topping out at 10% growth.

- Once again, cash flow rather than external financing is expected to be the principal source of funding globally.

The upside risk that we flagged last winter—the disconnect between companies' focus on capex and the markets' appreciation of it—remains an issue for 2006. Our survey shows that analysts still feel the markets are not rewarding capex. But companies with more aggressive spending plans have in fact begun to outperform over the last six months in the US and Europe. If this outperformance continues—and if corporates start to recognize it—then we could see a meaningful increase in capital spending again in 2006.

### Higher Yields in the Pipeline, But Survey Highlights Persistent Risks

Our survey points to slower capex growth in 2006 on a global basis, but with a regional shift toward higher spending in Asia outside Japan. This is broadly consistent with our economic forecasts, which show G3 capex growth slowing from 4.5% this year to 3.4% in 2006 whilst spending growth in Asia outside Japan could rise from 6.8% to 7.5%.

One reason why real bond yields have not risen much in the past few years—despite better growth, tighter monetary policy and rising government budget deficits—is that corporate demand for capital has been weak. Strong profits and cash flow have been more than adequate to cover the (until recently) limited investment outlays.

We see two sets of risks to our capex and rates outlook. On the downside,

slower US and global economic growth and weaker housing markets remain material risks to our view that the fundamentals will support higher bond yields. Recent signs that the US housing market is at last starting to turn will add to these risks.

On the upside is the fact that the global capex upswing could accelerate if markets increasingly reward companies for investment. Although persistent risk aversion suggests that companies would prefer to rely on internal financing, higher capex amid lower profit growth would further erode the financing gap in the corporate sector, putting upward pressure on US and global real long-term yields.

Moreover, in the absence of a serious deterioration in the growth outlook, long rates will remain under upward pressure simply from tightening global monetary policy. In the US, the onward march of Fed tightening continues, with the most recent hike taking the Fed Funds rate to 4.0% (though even after 300bp of tightening rates are barely positive in real terms).

We see the Fed Funds rate at 5% and long rates at similar levels by mid-2006. Elsewhere, our forecasts suggest that the Bank of Japan and the Bank of England will tighten monetary policy next year, though we expect the European Central Bank to remain on hold. ■

**Markets Starting to Reward Companies for Capex in the US and Europe**

