Business Spending Is Lining Up to Reinforce Growth

Swings in corporate spending are a material reinforcing mechanism to growth on both the upside and the downside. As conditions have strengthened and profits have improved, businesses are now increasing plans to spend, particularly across sectors with secular tailwinds.

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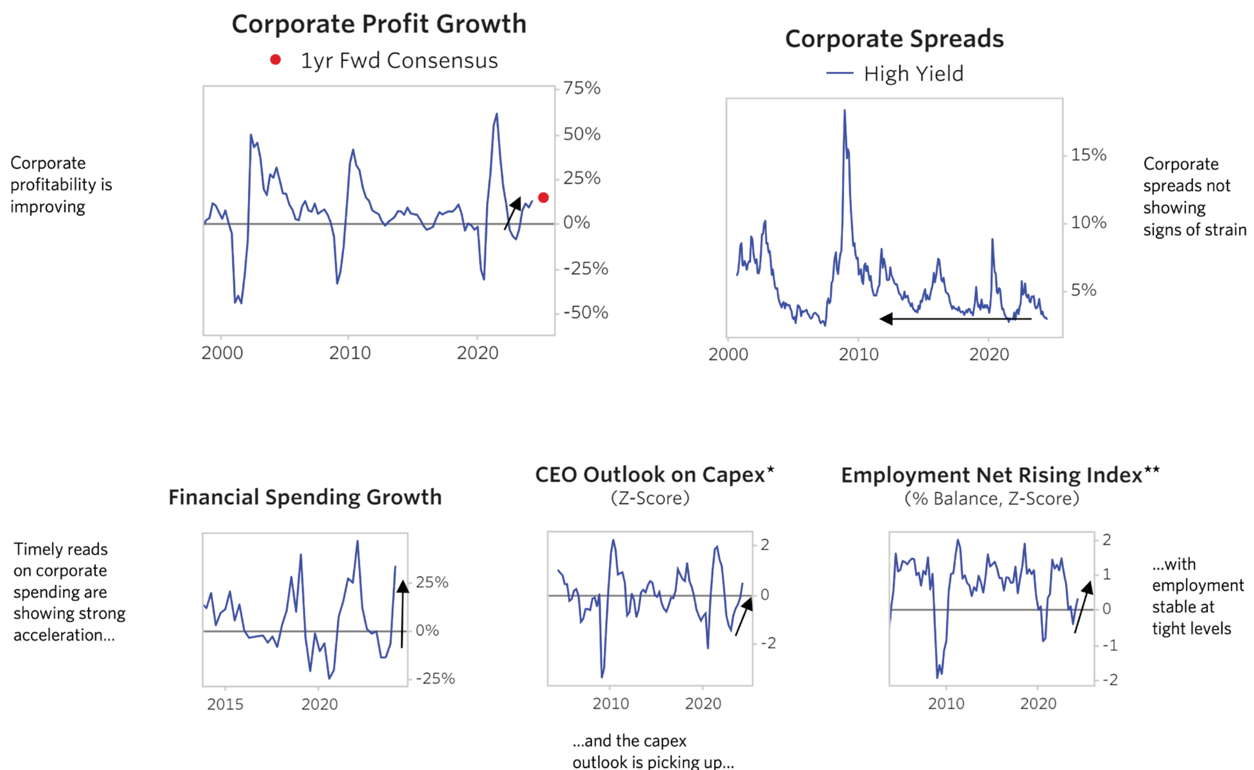
As economic conditions have come in stronger than the Fed expected and what markets discounted, conditions in the corporate sector appear to be on the upswing. Preparing for a recession in 2023, a wide swath of companies retrenched. Since then, **as demand has been sustained and profits have improved, we see the beginning of a recovery in capital spending, bolstered by the race to take advantage of AI and the need for climate investing**.

Corporate spending tends to be reactive, generally magnifying the impacts of economic swings already underway. Now, in the face of stronger-than-expected economic conditions, this season's earnings results confirm that corporates are willing and able to respond to and reinforce the economic upswing. Profitability has improved across a broad range of sectors, with most sectors also seeing positive demand growth. The outlook for future demand and spending plans are increasingly optimistic, particularly across sectors where the build-out of increasing compute power for AI is either directly or more indirectly an important secular tailwind.

High rates and borrowing costs are the main opposing pressures on corporate spending. Though, even on that front, we don't see meaningful impediments absent a material slowdown in demand. Corporate fundamentals look healthy, with low funding needs on aggregate thanks to strong cash flow growth and relatively low net leverage. And on top of that, borrowing conditions look benign despite the higher rates, with corporate spreads near all-time lows and banks' willingness to lend tracking upward.

As the first two charts below illustrate, corporate profitability has improved, and corporate credit strains look limited despite higher rates. The second set of charts scans across the three main ways corporates impact the economy and markets—financial spending, capital investment, and hiring—which tend to occur roughly in that order in response to their flow of funds. Across all three measures, we see signs of either acceleration or continued strength.

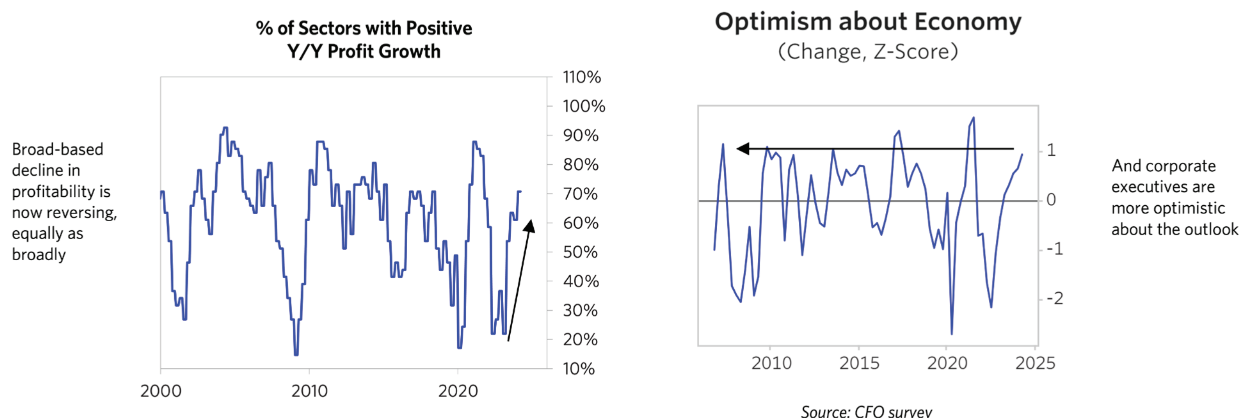


**Business Roundtable CEO Economic Outlook Survey **NABE survey*

The Turn Up in Profits Has Been Broad-Based

Last year, as the tightening worked its way through the economy, we saw a broad-based turn down in corporate profits. In response and fearing a recession, corporates pulled in their horns, though the pullback was more muted than typical, as companies' cash stockpiles allowed them to operate without materially cutting jobs and wages and allowed high spending on capex to continue.

Now, we're seeing the same in reverse—across most sectors (outside of the resource sector), profit growth has turned positive and corporate executives' optimism about the economy is looking up. In year-over-year terms, around 70% of sectors have experienced positive profit growth. While big tech firms have had the most significant acceleration in demand and profits in the economic upswing so far, last quarter's growth shows broad-based strength. Cyclical sectors saw the highest boost, but all sectors outside of resources are seeing positive profit growth for the start of 2024.



Earnings calls commentary provides anecdotal support for this optimism. Strong backlogs, steady demand, and plans for increased spending were all reflected in commentary from Q1 earnings calls:

> **GE Aerospace:** *"We're experiencing a **tremendous demand cycle** for services as more people fly and fly more often. In the quarter, GE/CFM departures were up low double digits and **we're revising our expectations upward for the year**."*
>
> **NextEra Energy, Inc.:** *"**The US domestic solar panel industry is getting stronger and stronger than it's ever been.** One of the points that I made also in the prepared remarks is at the end of '21, solar panel module capacity in the US was about 8 gigawatts. That's expected to be about 50 gigawatts by the time we get to 2026...If you talk **to most US domestic solar panel manufacturers, they're sold out through 2026. So they're certainly not having any trouble with demand.**"*
>
> **Motorola Solutions, Inc.:** *"Look, at the end of the day, the print is great in Q1, but I'm actually **more excited about our momentum, raising the year, strong backlog, but also strong funnel of opportunity and a strong balance sheet**."*
>
> **Texas Roadhouse, Inc.:** *"There is no doubt that **2024 is off to a great start** with first quarter revenue over $1.3 billion and same-store sales growth of 8.4%...Our investment and commitment to opening new restaurants at a more even pace has been successful. In the first quarter, we opened nine company-owned Texas Roadhouses. **We currently expect to open an additional six company-owned restaurants during the second quarter. For the full year, we remain on track to open approximately 30 company-owned restaurants across the three brands.**"*
>
> **American Tower Corporation:** *"Finally, revenue in our Data Centers business increased by 10.6%, continuing the outperformance versus our initial underwriting plan as **strong demand for hybrid***

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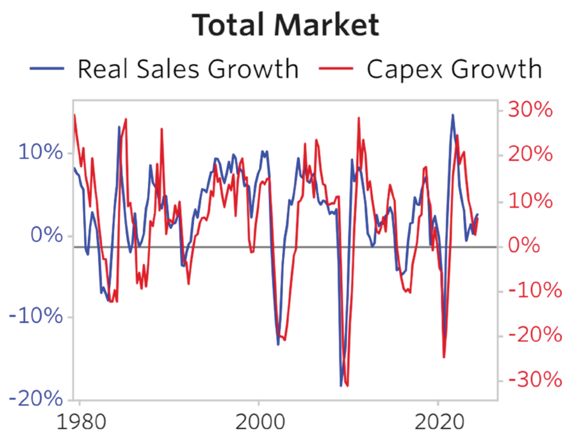
and multi-cloud IT architecture continues and the backlog of record new business signed over the last two years begins to commence in a meaningful way*...consolidated organic tenant billings growth was 5.4%, supported by* ***strong demand across our global footprint.****"*

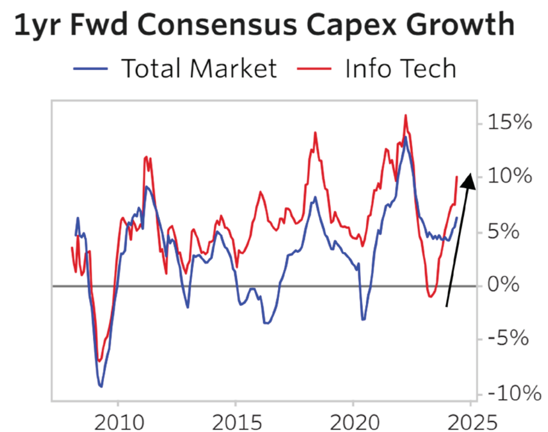
Even in the segments of the market where there was less strength, executives are noting that the weakness is mostly on the margin:

> **The Coca-Cola Company:** ***"Overall, in terms of the consumer and how that fed into the channels, the US still remains in good shape.*** *There is some purchasing power compression in the lower-income echelons...* ***I would emphasize this is at the periphery rather than a big shift.****"*
>
> **Procter & Gamble:** *"Let me start with overall consumption strength because it really is and continues to be strong. The* ***consumption trends in the markets are stable despite multiple headwinds****."*
>
> **Mattel, Inc.:** *"We believe the industry benefited from—in the first quarter—an earlier Easter. And year-to-date to mid-April has been comparable to last year [with regard to demand]. But* ***we do expect some decline in 2024, although at a lesser rate than last year****. The decline is due to the same factors that impacted 2023 in terms of a lighter toyetic theatrical film slate and the impact of a shift in consumer spending...toward experiences and services,* ***but that trend is moderating. And we believe it will further improve, and that the industry will return to growth and continue to grow over the long term****."*

Increased Optimism, Bolstered by the AI Race, Is Leading to Plans to Increase Capex

Even though we're still early in the upswing of corporate profitability, we're already seeing corporates respond, with capital spending growth ticking back up and with increasingly optimistic capital spending plans. As the chart on the left below shows, as real demand picks up, corporates typically respond (with a slight lag) by investing in building out additional capacity. We're relatively early in that movie, with profitability and capex growth just beginning to reaccelerate, but consensus is for further strength from here—capex growth is expected to accelerate. The tech sector (which already accounts for the largest share of capex spending across sectors) is a clear notch above the rest of the market in both earnings growth and capex growth expectations; the market ex-tech looks just as strong relative to its history.





In addition to the strong economy, the AI build-out is a key tailwind for capex spending during this cycle. The dynamics are most notable in the tech sector, where there's a direct need to build out increased compute capacity to take advantage of generative AI opportunities:

> **Meta:** *"We continue to see compelling investment opportunities to both improve our core business in the near term and capture significant longer-term opportunities in generative AI and Reality Labs... **We expect that we will invest significantly more in infrastructure over the coming years."***

> **Alphabet, Inc.:** *"So the increase in capex...**really reflects the opportunity we continue to see across the company**. It starts with all that we're doing in support of the Gemini foundational model but then also, clearly, the work across Cloud, on behalf of Cloud customers, and the growth that we're seeing with GCP and the infrastructure work there, and then, of course...the application across Search, YouTube, and, more broadly, the services that we're able to offer."*

We also see companies beyond tech—primarily across industrials, materials, and energy—making plans to increase capacity in response to strong demand, both related to AI innovation (growing desire for data centers) and the energy transition driving up demand for electricity:

> **Eaton Corporation plc:** *"I'd say, as we look forward, as you know, **we've made a number of announcements around capacity expansion**. We're making some investments in commercial front end. We're making investments in technology. So there's a number of programs that we've made announcements [about] last year and that we're investing in this year...**I mean everybody is obviously adding capacity. The market is good for everyone right now.**"*

> **NextEra Energy, Inc.:** *"But the other thing I would say, and we'll talk a lot more about this at our investor conference in June, is **this electricity demand is real**. We've been in a period of static demand for decades. And the **demand is not only coming from data centers. It's coming from decoupling, creating more domestic manufacturing around industry, around chip manufacturing, oil and gas industry continues to electrify. We continue to, even beyond data centers, see significant electric demand.**"*

> **Caterpillar Inc.:** *"Obviously, **power gen is the fastest-growing business today** within Energy & Transportation, just to note, and actually as a percentage of E&T sales, it has gone up from 25% in the first quarter of last year to 29% this year. So it is an area of exciting opportunity even before we build the capacity, and obviously, an area where there's potential for further growth as well...We're making this **capacity investment in large engines...not just based on one opportunity in the marketplace, but upon multiple opportunities in different industries**."*

> **Willdan Group, Inc.:** *"Recent headlines nearly everywhere point toward the rapid electricity load growth caused by AI data processing. The swift commercialization of AI requires massively more electricity than most people expected...**This compounding effect of higher electricity prices and higher electricity load is providing a new catalyst for Willdan solutions.** We're clearly excited about the energy transition capabilities that we've assembled here—planning, software, energy efficiency, and engineering. We are in the right market and we **look forward to adding even more capabilities through M&A in the quarters ahead**."*

A broader set of industrials are also noting their plans to increase capital spending, with support from defense as another clear theme:

> **Honeywell International Inc.:** *"In Aerospace, **we will invest more than $80 million to expand our Olathe plant in Kansas**. This project will enable the production of next-generation avionics technology and directly create hundreds of jobs at the site and in the local economy."*

> **GE Aerospace:** *"We also recently announced we're **investing more than $650 million in both our manufacturing facilities and our supply chain this year**, reflecting our commitment to strengthening quality and increasing production to better support our customers' long-term needs. At the same time, both airlines and our Defense customers are expanding and modernizing their fleets and choosing to do so with us, adding to our $150 billion-plus backlog and continuing to build our installed base of engines and services."*

Tight Employment Levels Look Here to Stay

Corporates also typically support the economic flywheel with faster hiring and more spending on labor. With resilient demand, labor markets are set to remain relatively tight, albeit with a more moderate pace of hiring than the extremely fast hiring we saw in the initial phase of the pandemic recovery. Company commentary triangulates this story. In general, corporates made little mention of imminent plans to either expand or compress their workforce. Instead, most seem to be coming off of a phase of intensified hiring and are now well set up to continue hiring at a normal pace but continue to register tightness in the labor market.

> **Hawaiian Holdings, Inc.:** *"**We are continuing to hire, but it is at a slower pace than we've seen over the last 18 months to two years**...I would characterize that as a more **normalized environment, an environment of ramping up staffing for a little bit of growth going forward** as well as dealing with more normalized attrition and not the sort of hyperkinetic...hiring environment that we had coming out of COVID."*

> **HCA Healthcare, Inc.:** *"On the labor cost, we continue to be pleased with the trends in contract labor. The teams have a number of initiatives as we've seen. **Turnover has stabilized, recruiting and hiring still up.** As I mentioned, our contract labor is down still 20% year-over-year. We think there's still more room to go as we go forward. So again, I think we're pleased, and we're again in a good position in overall labor trends."*

> **Eaton Corporation plc:** *"It's one of the things that's, quite frankly, tempering our outlook for the year is the fact that we do believe that **labor continues to be a bottleneck in certain industries and really in the economy overall**. And so at this point, I think it's really too early to say to what extent it's going to resolve itself. One of the things that we're looking at as well is particular—**total labor participation rates in general, those numbers, I would say, have been growing over time at a rate of 2% to 3%**."*

> **Cedar Fair Entertainment Company:** *"The importance of labor availability and the recruiting process is an area of our business that is often overlooked; it was a hot-button issue coming out of the pandemic when labor supply was limited, and we saw a structural shift in labor rates. **At the time, we made the strategic decision to increase our rates to market leading to ensure our parks are adequately staffed, so that all our rides are operating and all our revenue centers were open. As attendance has recovered and labor markets have stabilized, we have successfully optimized both seasonal labor rates and seasonal staffing levels**, largely due to the decisions we made back in 2020 and '21."*

> **Performance Food Group Company:** *"So I think going into this Q4 with 5.5% more people will be good for us. **I would hope that we get back up closer to that 6% or 7% number as we get into next fiscal year.**"*

> **Mondee Holdings, Inc.:** *"Amid this growing demand there remain supply-side challenges for airlines, hotels, and other suppliers, who are facing high-cost capital constraints for renovations and upgrades, **while trying to solve for labor shortages** and aircraft delivery delays."*

Consistent with tight levels of labor markets, companies continue to report high wage inflation rates:

> **McDonald's Corporation:** *"**That said, we do continue to see there's certainly labor inflation.** Much of that is coming out of what happened in California. And on a national level, you could probably see **we're expecting high single-digit labor inflation**."*

> **Waste Management, Inc.:** *"**We're currently at about 5% wage inflation** for our driver population, and that's certainly down from low double digits at its peak."*

> **Six Flags Entertainment Corporation:** *"**Finally, we expect full-year average cost inflation to be around 4%.** Keep in mind, many of the parks in jurisdictions with the largest minimum wage increases were either closed or did not have significant operations in the first quarter but will be ramping up operations in the second quarter...Yes, the 4% is a blended overall average which includes the wage rate increases, and it also includes merit increases for our full-time staff."*

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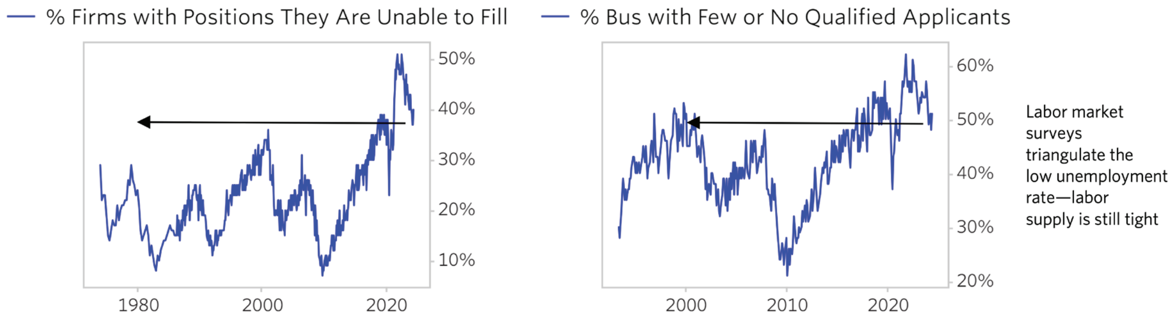
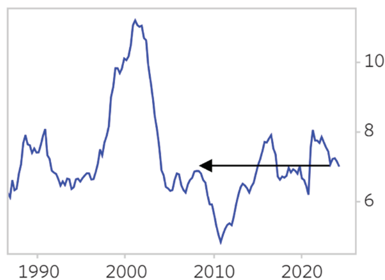
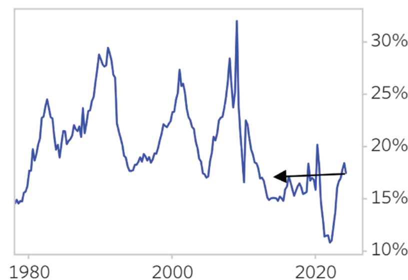


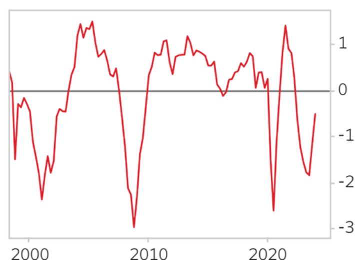
The Biggest Pressures on the Other Side Remain High Rates and High Borrowing Costs, Though These Look Benign

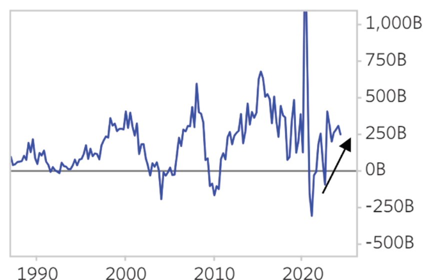
With rates rising again this year, the biggest pressure pushing against corporate spending and an upswing in the capex cycle is high borrowing costs. However, corporates aren't especially squeezed due to both strong fundamentals and improving borrowing conditions. On the former, net leverage is at relatively low levels, and, although interest expense has been rising outright, it's been in tandem with strong cash flow growth, such that interest expense is roughly back in line with pre-pandemic costs relative to incomes.

On the supply side, after an initial sharp contraction, we're now seeing an improvement in banks' willingness to lend to corporates despite the higher rates. This is in response to banks' concern over losing market share to the private credit industry. The benign corporate credit environment is triangulated by corporate spreads sitting near all-time lows and corporate borrowing recovering from the contraction following the initial tightening.









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