Signs Point to Slowing Capex

We anticipate decelerating capex among investment-grade corporate issuers.

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KEY INSIGHTS

- We do not expect capital expenditure growth in investment-grade corporates to boost broader U.S. economic growth.
- Capital spending in commodity-related sectors is particularly susceptible to slowing; coupled with better productivity in these industries, this is positive for credit quality.
- We favor shorter-maturity debt and are overweight the energy sector within the investment-grade corporate bond asset class.

Several trends among issuers of investment-grade corporate debt, including decelerating growth in EBITDA[1] and increasing prioritization of share buybacks, lead us to expect capital expenditures (capex) in the asset class to slow. As a result, capex among investment-grade companies is unlikely to provide meaningful support to economic expansion. Our outlook for decelerating capex growth contributes to our defensive positioning in the asset class, where we favor shorter-maturity debt to reduce exposure to potentially deteriorating credit quality.

Capex Strongly Correlated With EBITDA

Investment-grade corporate capex growth is strongly correlated (R^2=0.82) with EBITDA growth on a two-quarter lag.[2] Year-over-year EBITDA growth has been slightly decelerating since the second quarter of 2018. While year-over-year capex growth has been accelerating modestly, we expect capex to follow EBITDA by downshifting to a flat or declining pace later in 2019.

Industries Related to Commodities Drive Capex

Commodity-related industries, including energy and metals and mining, account for 32% of capex within investment-grade corporates, so these sectors drive capex trends within the broad asset class. Also, commodity-related sectors tend to be more volatile, so they also have a disproportionately large effect on the rate of change for investment-grade corporate capex. Earnings growth in these industries has been slowing, which contributes to our outlook for decelerating capex.

32%

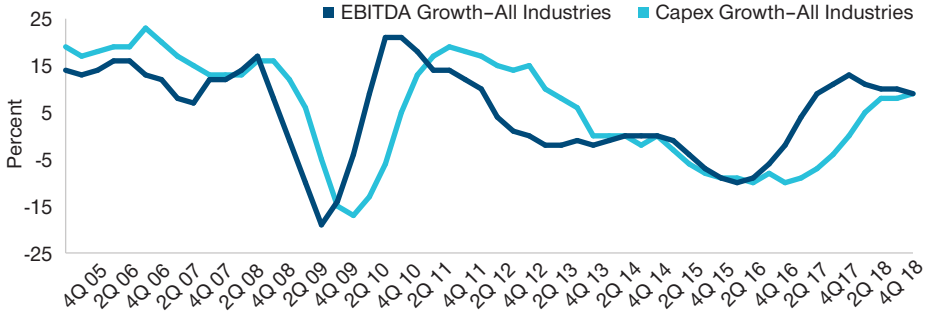
Percent of capex within investment-grade corporates that commodity-related industries account for.

[1] Earnings before interest, taxes, depreciation, and amortization.
[2] R^2 measures the degree of correlation in regression analysis, with 1 indicating perfect correlation and 0 indicating no correlation.

(Fig. 1) Capex Trails EBITDA With Two-Quarter Lag

EBITDA and capex growth (two-quarter lag)

As of December 31, 2018



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> Corporate management teams tend to use stock buybacks as a discretionary tool to support equity prices, contributing to the volatility of these actions.

In addition, T. Rowe Price's metals and mining and energy credit analysts point out that productivity improvements in these sectors has allowed companies to achieve similar growth with lower capital spending. As a result, we hold overweights to energy-related issuers in our investment-grade corporate portfolios as the combination of productivity improvements and improved capital discipline is positive for credit quality.

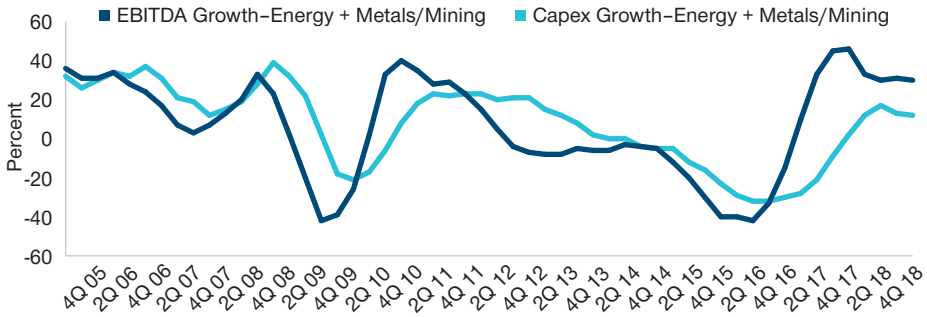
Shareholder-Friendly Actions Back in Vogue

Our credit analysts covering investment-grade issuers also note that companies have been prioritizing share buybacks and dividend increases—shareholder-friendly actions—over capex following the implementation of U.S. tax reform at the beginning of 2018. While we see no immediate catalyst for this trend to turn in favor of capex, shareholder payouts have historically been more volatile than capex, rising more quickly during periods of growth and falling more rapidly in contractions. Corporate management teams tend to use stock buybacks as a discretionary tool to support equity prices, contributing to the volatility of these actions.

(Fig. 2) Capex to Slow With Energy EBITDA Growth

Commodity EBITDA and capex growth (two-quarter lag)

As of December 31, 2018

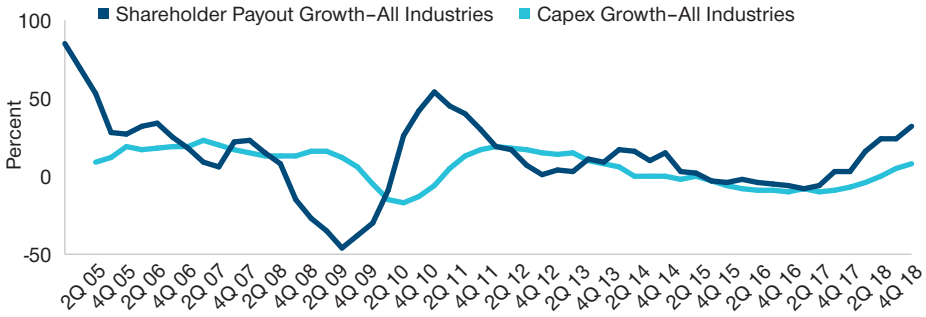


Source: J.P. Morgan (see Fig. 1).

(Fig. 3) Higher Shareholder Returns Weigh on Capex

Capex and shareholder payout growth

As of December 31, 2018



Source: J.P. Morgan (see Fig. 1).

> We broadly favor shorter-maturity positions that reduce our exposure to the deteriorating credit quality that is common in the later stages of the economic cycle.

Investment-Grade Corporate Capex Unlikely to Support Economy

All of these trends indicate that capex growth in investment-grade corporates is likely to flatten out or gradually decelerate in the latter part of 2019. Because business investment is a key component of gross domestic product (GDP), capex ultimately can lead to higher GDP. However, based on our analysis of the investment-grade corporate asset class, capex is unlikely to accelerate, so we believe it is doubtful that an increase in business investment will contribute a meaningful boost to GDP.

Favor Shorter Maturities, Energy Issuers

In terms of the positioning of our investment-grade corporate bond portfolios, this outlook for decelerating capex is a factor in our overall defensive stance. The pickup in shareholder-friendly corporate actions that has come at the expense of capex has limited improvements in credit quality, with leverage remaining elevated in the asset class. We broadly favor shorter-maturity positions that reduce our exposure to the deteriorating credit quality that is common in the later stages of the economic cycle.

At the industry level, we favor the energy sector because of its improved corporate efficiency and capital discipline. At the individual security level, our credit analysts incorporate their knowledge of corporate management's tendencies toward spending on stock buybacks or dividends versus capex into their credit quality profiles.

WHAT WE'RE WATCHING NEXT

If the trend continues, the sharp upturn in the prices of oil and other commodities in the first quarter of 2019 could affect both productivity and capital spending at investment-grade companies in the energy and metals and mining industries. T. Rowe Price's energy analysts believe that further gains for oil are possible in the shorter term, but productivity improvements at U.S. shale oil producers are likely to boost supply and push prices down in the longer term.

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