Insight

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Are Bond Investors Ready for a US Industrial Revolution?

Exploring the potential impact of increased US corporate capital spending and fixed-income investing.

One of the key questions that markets are currently trying to answer is whether central banks will be able to engineer a soft landing for the global economy. While this is an important consideration, I think investors shouldn't overlook the broader structural shifts that are reshaping the investment landscape in this new economic era. Take for instance the dramatic pickup in all types of corporate capital spending we're witnessing in the US. If sustained, this trend could trigger a new industrial revolution in the US and beyond, with major implications for fixed-income investing.

A Potentially Structural Story

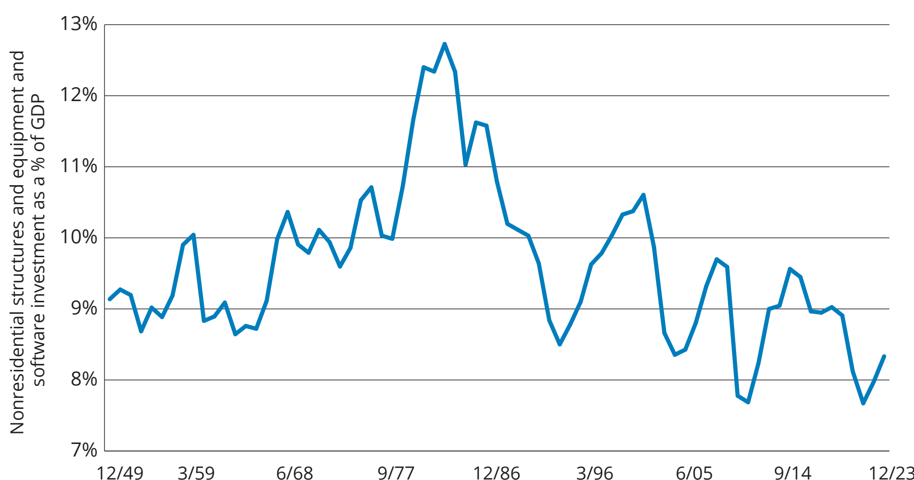
I think today's significant increases in capital spending aren't a temporary phenomenon but, instead, are being driven by long-term factors such as:

- **Rapid developments in AI**, which are driving exponential increases in corporate capital expenditure (capex) far above consensus estimates.
- **Deglobalization**, prompted by escalating geopolitical rivalry—especially between China and the US—and concerns about the fragility of global supply lines.
- **Growing demand for power**, which is amplified by both energy-intensive AI and reshoring of manufacturing.
- **Electrification of the grid** combined with a continued drive to invest in alternative sources of energy generation.
- **"Revenge" spending on physical assets** after a prolonged period of underinvestment where markets favored asset-light business models with a focus on research and development and intellectual property investments.

Impetus for Higher Economic Growth

In combination, the size of these additional private nonresidential investment flows (**FIGURE 1**) is such that they could materially alter the course of the US economy. Typically, investment in physical assets tend to have much larger positive multiplier effects on economic growth than the asset-light business models that until now have dominated the market.

FIGURE 1: US Private Nonresidential Structures and Equipment Investment as a % of GDP



As of 1/24. Data Source: US Bureau of Economic Analysis.

Insight from sub-adviser, Wellington Management

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Fixed Income Portfolio Manager

Key Points

- US corporate capital spending is increasing significantly, driven by factors such as AI advancements and deglobalization.
- This surge in investment could lead to a new industrial revolution with major implications for economic growth and fixed-income investing.
- Investors may want to consider a flexible, total-return approach to navigate the potential risks and opportunities in this evolving economic landscape.

It's too early to tell whether this new industrial revolution will materialize, given the long history of false starts in the US industrial renaissance and the risk that heightened geopolitical turmoil could derail the global economy. Nevertheless, I see several reasons why—for now—data has been surprising on the upside relative to surveys, including:

- **The nature of the capex** — The amounts announced already exceed the money spent during the last capex pickup, when shale gas production was ramped up. Based on the amounts committed alone, we may see an above-inflation growth rate in private nonresidential structure and equipment spending for several years to come. Importantly, some of the mega-caps are able to finance their capex without external funding, thus sidestepping public credit markets as these have become less willing to fund capital-intensive infrastructure projects with long payback periods.
- **Productivity gains resulting from AI capex** — AI is already delivering productivity gains, with companies reporting return on their investment (ROI) at a much faster rate than was the case for previous technology breakthroughs. This acceleration in ROI, in turn, further reduces the need for external funding.
- **The urgency and scale of the investments needed** — After a prolonged period of underinvestment, there's an urgent need for physical investments to upgrade aging US infrastructure.
- **The resilience of the US consumer** — A weakening US consumer would undo much of the additional growth momentum generated by this incipient industrial revolution given how crucial consumer spending is to the overall economy; therefore, I'm monitoring this risk closely. However, despite some signs of increased vulnerability, consumers—even at the lower-income spectrum—appear to be more resilient than markets assume. Consumer balance sheets remain robust, though excess savings are now largely spent, and while AI may eventually lead to job losses, workers' bargaining power has increased for now. Many consumers also still benefit from the wealth effect of increased house prices, while real incomes are continuing to rise thanks to the drop in inflation.

On balance, therefore, I think the US economy may be structurally positioned to deliver higher-than-anticipated growth, and that even if a recession were to materialize, it would likely be shallow.

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Important Implications for Monetary Policy

This structural growth momentum coincides with still extraordinarily loose fiscal policy and growing public-debt levels across much of the developed world. And while central banks have started an easing cycle to support economic growth, inflation remains above target in many cases and may pick up again. Thus, I believe the yield curve[1] could eventually steepen and that rates will remain at higher levels than markets currently price in, as a combination of stubborn inflation and the need for additional government deficit funding may curtail the ability of the Federal Reserve and other developed central banks to cut rates. The eventual adjustment to this reality of what our macro strategists call "the new economic era"—with higher and more volatile inflation and shorter and more pronounced economic cycles—could entail more volatility.

Portfolio Positioning for this New Reality

How can investors position for the significant risks and opportunities this new environment may bring? There's no uniform answer, but one potentially attractive avenue, in my opinion, is to consider adopting a total-return approach that enables dynamic pivots across a wide opportunity set.

Specifically, at this unpredictable stage of the cycle, I think such an approach allows investors to:

- Avoid taking on excessive credit or duration[2] risk while still achieving attractive yields, by taking positions at the shorter end of the curve and away from those segments of the credit market where I think spreads[3] have become exceedingly tight.
- Avoid having to make an "all-or-nothing" call on whether we'll see a continuation of growth surprises or move into recession.
- Lean into either scenario. While I'm bullish that the growth scenario will prevail, I think such a positioning also offers investors the potential to take advantage of the associated volatility when other market participants may be forced sellers. Such flexibility could be particularly advantageous if we're truly entering a new era of industrialization with the US as its epicenter.

To learn more about opportunities in fixed income, talk to your financial professional.

[1] The yield curve is a line that plots interest rates of bonds having equal credit quality but differing maturity dates; its slope is used to forecast the state of the economy and interest-rate changes.

[2] Duration is a measure of the sensitivity of an investment's price to nominal interest-rate movement.

[3] Spreads are the difference in yields between two fixed-income securities with the same maturity but originating from different investment sectors.

Important Risks: Investing involves risk, including the possible loss of principal. • Fixed income security risks include credit, liquidity, call, duration, and interest-rate risk. As interest rates rise, bond prices generally fall.

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