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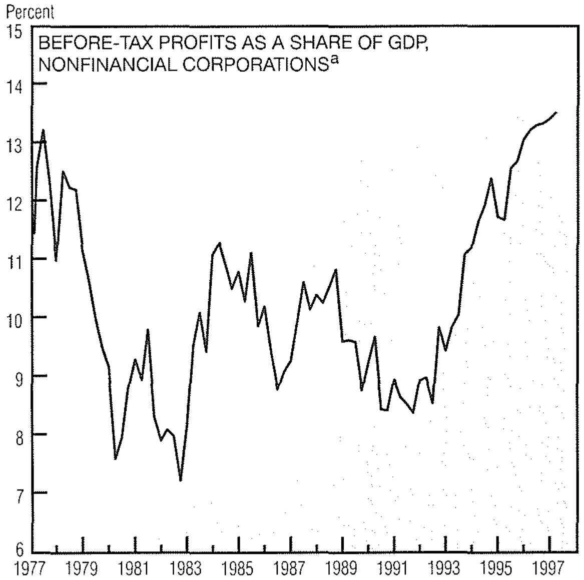
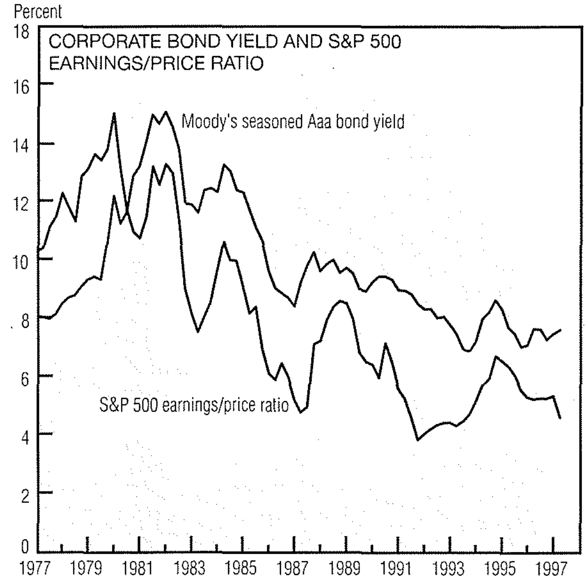
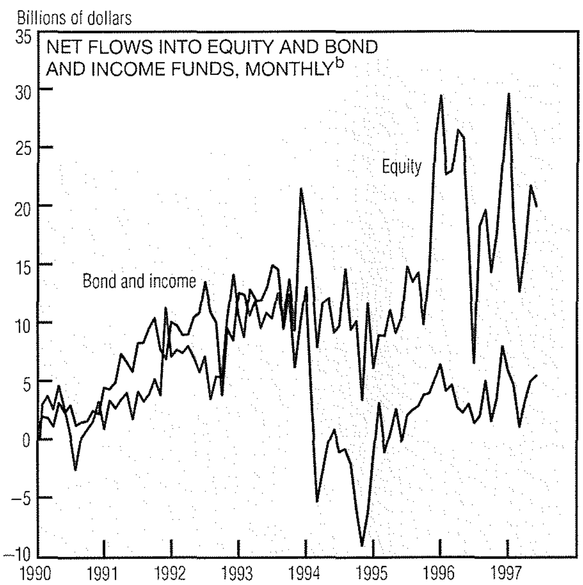
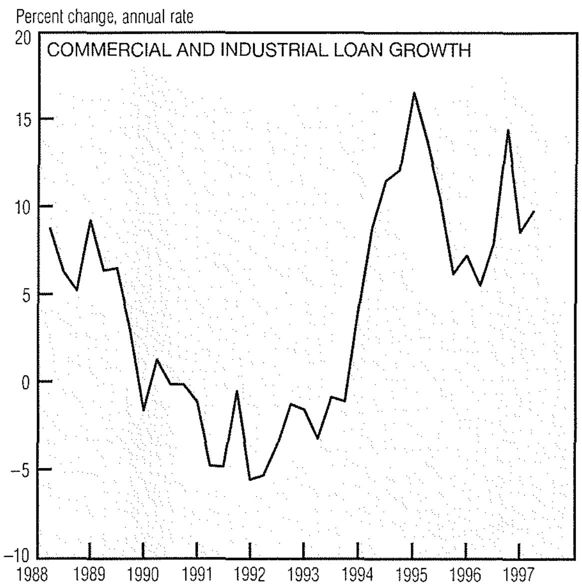
Financing the Investment Boom









a. Profits from domestic operations with inventory valuation and capital consumption adjustments, divided by GDP of the nonfinancial corporate sector.
b. Sum of net sales and net exchanges.
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Board of Governors of the Federal Reserve System; DRI/McGraw–Hill; and Investment Company Institute.

The current expansion has been characterized by an extraordinary advance in business investment, financed through both strong cash flow and substantial borrowing. Economic profits (book profits after inventory valuation and capital consumption adjustments) of nonfinancial domestic firms have increased to more than 13% of their output, the highest share in over 20 years.

Robust profit growth, however, has not been sufficient to finance both the investment boom and the retirement of equity through stock repurchases and mergers. The financing gap for this sector—the excess of investment over internally generated funds—has widened over the past year. Nonfinancial corporations have thus increased their debt and, given the plentiful supply of credit, have done so at relatively favorable terms.

Interest rates on both investment-grade and higher-yielding bonds have stayed low in the face of solid investor demand. Stock and bond mutual-fund growth has been buoyed by strong savings flows.

The Federal Reserve's most recent survey of business lending revealed that the spreads between loan and market rates have held steady for all sizes of loans, with spreads for large loans near the lower end of the range seen in the past decade. And after years of restructuring, banks are in a good position to lend. Their profits have been strong, and their rates of return on equity and assets are high.