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Excess Capacity and Policy Change

A key challenge of the big-picture, top-down investment analysis that we do at Confluence is tracing the real-world impact of a country's economic policy initiatives. Whether policymakers are trying to boost economic growth, bring down price inflation, or achieve another goal, our aim is to figure out if the reform will be successful and the unintended consequences, be they positive or negative. Our ultimate objective, of course, is to determine the implications for financial markets and investment strategy.

One thing we've noticed is that many strategists attempting top-down analysis make overly simplistic assumptions about the likely effect of specific policy changes. They often ignore the fact that the same policy can be wildly successful or unsuccessful, depending on the pre-existing economic structure or conditions in place at the time. In this report, we show that one vital issue is the level of excess capacity in an economy. Many vaunted reforms in history were successful only because they were implemented when the economy had plenty of excess capacity to accommodate them. Many then conclude that those reforms would always be successful no matter what. We caution here that a deeper analysis is required to really understand any reform's success and its financial market implications.

Measures of Capacity Utilization

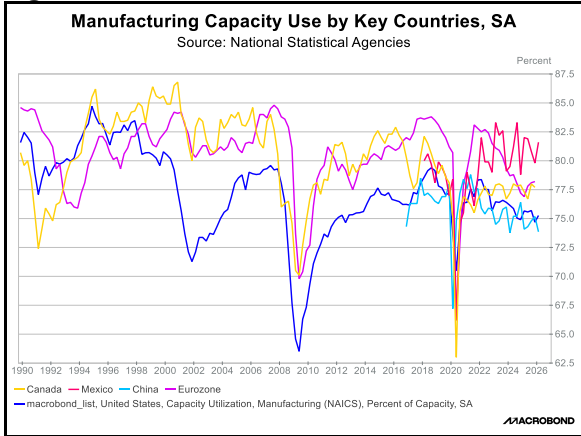
In this section, we provide an overview of important measures of excess capacity in an economy. To draw broader conclusions, we examine the various trends across not just the US, but also several other key countries that generally track the same gauges of capacity utilization and use relatively comparable methodologies.

Industrial Capacity. Major economies with sophisticated statistics agencies have long tracked their industrial production and how it related to overall industrial capacity over time. In general, "industrial" output and capacity refers to mining, manufacturing, utilities, and, in some countries, construction. Excess capacity is thought to equate to economic "slack" and could signal a decline in activity. Low excess capacity could signal overheating and higher inflation.

- However, as service industries came to account for a larger share of economic activity across developed and developing countries, industrial capacity utilization has become relatively less important.
- As shown in Figure 1 (next page), which focuses on manufacturing, many countries have also seen a structural fall in capacity utilization over time. This general decline could reflect improved technologies that allow firms to produce more with the same facilities. It could also mean that today's measurement methods understate the obsolescence of old facilities. In any case, the apparent rise in excess capacity shown here might tempt policymakers to think they should

adopt more stimulative policies and can do so without sparking inflation. As we show below, that assumption may not be correct.

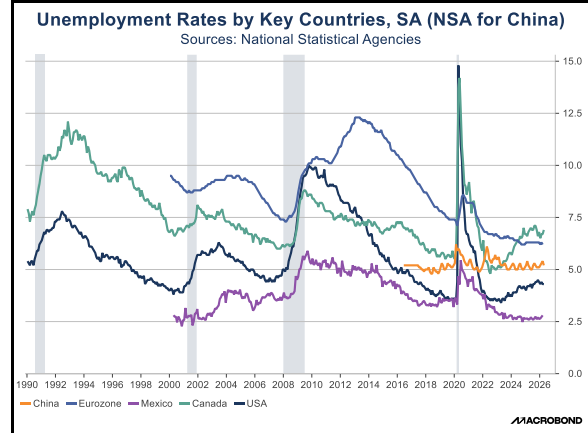
Figure 1



Unemployment. Since industrial output now accounts for a smaller share of economic activity across countries, and since service sector activity has become much more important, it may be better to focus on unemployment rates as a gauge of an economy’s production capacity. In contrast with industrial capacity utilization rates, low unemployment rates equate to high utilization of a country’s labor force, and vice versa.

- As shown in Figure 2, the trends in our representative countries have generally been toward lower unemployment rates (higher labor force utilization). In large part, this probably reflects population aging and the mass retirement of workers born in the first decades after World War II.
- As those workers leave the labor force, more of the remaining participants can find jobs, pushing down the rate of joblessness.

Figure 2



Consumer Prices. Another data series that can provide evidence of capacity utilization rates and economic slack is the consumer price index (CPI). This gauge doesn’t try to estimate capacity utilization rates per se. Rather, it measures the price impact of greater or lesser utilization rates. When utilization rates are high and excess capacity is low, one would expect higher price inflation as firms try to take advantage of strong demand by raising prices, all else being equal. When utilization rates are low and excess capacity is great, firms are incentivized to keep their prices in check.

- In Figure 3 on the next page, we show that CPI inflation rates for most of our representative countries are elevated compared with the levels seen in the decade or so prior to the coronavirus pandemic. CPI inflation for all countries listed except China hasn’t spiked nearly as badly as it did decades ago, but it is significantly higher than before the pandemic.
- In China, a country that is widely believed to suffer from enormous excess capacity, inflation rates remain low or are even lower than before the pandemic.

Figure 3

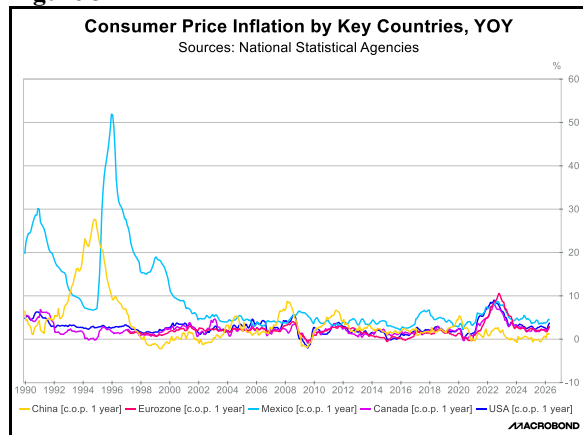
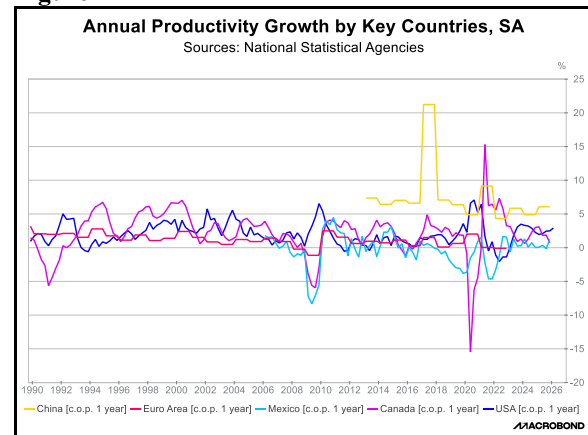


Figure 4



Productivity. Finally, the average value of output per hour worked — productivity — is another potential indicator of capacity utilization rates in an economy. As with CPI inflation rates, the growth of productivity doesn't measure capacity utilization directly. Instead, it reflects the ability of an economy's workers to increase their output. In theory, when workers can rapidly boost their output per hour worked, it should be a sign that there was more excess capacity in the economy. When productivity grows slowly, it could be evidence that the economy is already producing at close to its maximum rate.

- Of the indicators we address in this report, productivity probably has the widest range of differences in calculation methods across countries. For example, some countries focus on output per hour worked while others focus on output per worker.
- Nevertheless, as shown in Figure 4, there has basically been no change in average productivity growth rates in our representative economies in recent decades. This is more consistent with economic capacity utilization being high rather than for it being low.

The Impact of Policy Change

On balance, we judge that the indicators above point to our representative countries having relatively little economic slack. Historically low unemployment rates, elevated price inflation, and flat productivity growth all point in that direction despite relatively low levels of capacity use in manufacturing. We would note that other indicators probably also reflect economic resources being fully utilized, especially in the US. One of the key additional indicators for the US is the historically high corporate profits as a share of gross domestic product.¹

Importantly, capacity utilization rates have huge implications for the effectiveness of stimulative economic policies. Historically, perhaps the best example of this was the Great Depression and how the New Deal's economic stimulus policies played out. Beginning in the late 1920s, the Depression left vast swaths of US industrial capacity unused as it was estimated to have fallen to roughly 50%, and the unemployment rate shot up to approximately 25% (tantamount to a labor force utilization rate of 75%).

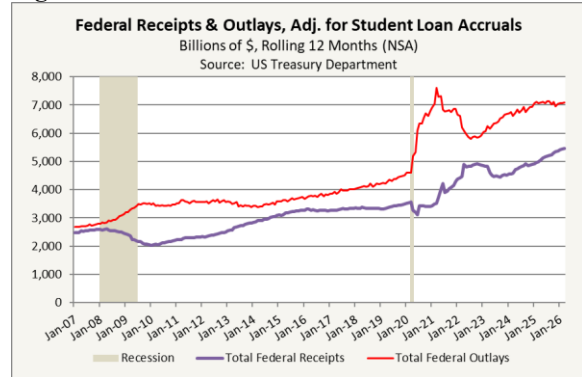
¹ Economists at the International Monetary Fund and some other major institutions also calculate the "output gap," which measures actual economic output versus "potential" output. However, the estimates are only available for a limited number of countries and have other methodological issues.

Against this backdrop, the Roosevelt administration and Congress pushed through a series of fiscal stimulus programs to bolster growth and make use of the excess capacity. Coupled with loose monetary policy, the flood of federal spending went toward programs ranging from public works projects to unemployment insurance. While these programs appeared to boost economic activity, at least until the recession of 1937, inflation as measured by the CPI was negative for several years running.

What about today’s economic policies? We think major countries over the last several years have adopted especially expansive, stimulative fiscal and monetary policies. In truth, their policies have been stimulative for much longer than that, but the policies became much more stimulative in the face of the pandemic. Governments cut tax rates and simultaneously adopted massive spending programs to shield their economies from the impact of mass pandemic shutdowns and support their citizens until their economies recovered. However, even after the recovery was well established, key economies have kept their policies loose. (Again, China is widely seen as having significant excess industrial capacity, but its stimulative policies are probably less aggressive than desired.)

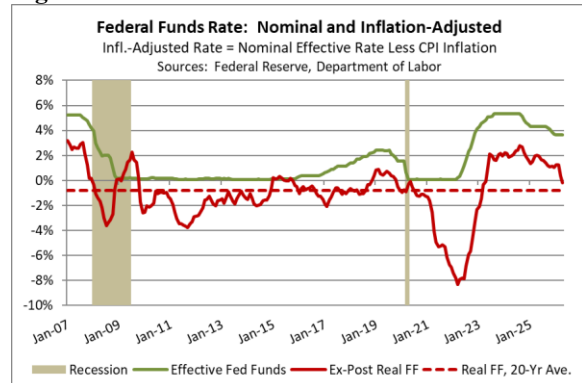
Using the US as an example, the scale of today’s stimulus is clear. For example, Figure 5 clearly shows how the US federal budget deficit exploded at the time of the pandemic. The deficit has contracted modestly since then, in part due to a plateau in spending as revenues continue to rise, but it remains much larger than in previous periods.

Figure 5



Monetary policy in the US has also begun to ease, especially as measured by real (inflation-adjusted) interest rates. Figure 6 shows that real rates have declined for more than two years, and they began to fall very quickly once inflation started to spike in response to the war in Iran. The Federal Reserve’s real benchmark fed funds rate is still above its long-run average, but only barely.

Figure 6



In sum, this analysis suggests that today’s highly stimulative economic policies in the US and several other key countries are being imposed on economies that probably have limited excess capacity. At best, that means that any payoff in terms of faster economic growth or job creation will be limited. At worst, as higher government spending and looser monetary policy are applied to an economy that can’t quickly boost output, the result could well be continued high price inflation. Of course, the

situation is reversed in China, where the government's stimulus policies probably remain overly cautious. Chinese policies seem unlikely to dramatically boost true economic growth or lead to accelerating inflation.

Over time, we see two potential developments that could reverse these economic implications. First, we think a sustained, mass program of deregulation in any particular economy could boost its capacity to grow, accelerate production gains, and help hold down prices. However, the prospects for such deregulation are uncertain, especially given the rise of more populist policies and increased geopolitical threats (higher national security concerns often imply greater government intervention in the economy).

Second, there is some potential for artificial intelligence (AI) to unlock greater output for any given level of capacity. Currently, the AI boom in the US is boosting economic growth mostly via capital investment, while also contributing to higher inflation by driving up the price of semiconductors, construction materials, and electricity. In a best-case scenario, AI would boost productivity and temper inflation, but it remains unclear whether that will occur.

Implications for Investment Strategy

On balance, the application of today's stimulative policies onto an economy with

relatively constrained production capacity will likely play out by keeping inflation elevated. For **US stocks**, we think this will help push down valuations over time. If bond vigilantes or other forces lead to an abrupt austerity program that sharply cuts government spending and/or hikes interest rates, valuations could also reverse. The best case for US stocks would probably be if policy is modestly tightened alongside a cut in regulation and successful implementation of AI in the private sector. For **international stocks**, we would expect similar dynamics, but if the dollar continues to weaken because of investor concern over US policies, then foreign equities would likely outperform US stocks.

For bonds, the stagflation that may be around the corner and the potential pullback in stock prices may spark some safe-haven buying. However, if inflation accelerates too much, we think bonds could still be poor performers. The best-performing fixed income obligations would likely be shorter-term issues. Meanwhile, we believe that **precious metals and other commodities** should offer solid returns in this environment. We continue to believe that gold will perform especially well because of the heightened geopolitical tensions today.

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