MORNING BRIEFING

January 11, 2017

Zoology

See the collection of the individual charts linked below.

(1) Trump and animal spirits. (2) More than 2 million Google links. (3) Government vs. business experience. (4) Keynes was a zoologist too. (5) Small business owners (SBOs) are going wild. (6) SBOs matter because they do lots of hiring. (7) New problem for SBOs: Shortage of workers. (8) Earnings season should confirm recovery that started during Q3. (9) Why small stocks are beautiful. (10) US frackers sending thank-you notes to Saudis.

Animal Spirits I: Theory. Yesterday, I compared the lyrics in the song "Physical" by Olivia Newton-John with Janet Yellen's "Fiscal" lyrics during her press conference performance at the end of last year following the December 13-14 meeting of the FOMC. The word "physical" appears 20 times in Olivia's song, and "fiscal" is mentioned 20 times during Janet's press conference.

What I didn't mention is that the hot lyrics get hotter near the end of "Physical." It starts with "Let's get physical" and ends with "Let's get animal, animal / I wanna get animal / Let's get into animal." That's not appropriate or relevant language in a discussion about the Fed chair. However, President-elect Donald Trump is fair game.

After all, a Google search of "Trump and animal spirits" yields over 2 million links. They include lots of prim and proper ones such as a 1/5 *FT* article by Gillian Tett titled "Donald Trump unleashes business's animal spirits." She reported that Trump's top eight officials (president, vice-president, chief of staff, attorney-general, and secretaries of State, Commerce, Defense, and Treasury) had only 55 years of government experience but 83 years in business. Obama's comparable team had 117 years in government, but ONLY five years in business IN TOTAL.

As I've observed before, this is a radical change in governing regimes. As one of our accounts observed, government by dealmakers is about to replace government by community organizers. So far, this has all revived lots of animal spirits in the stock market. While the country may be split on Trump, his election has boosted overall consumer confidence. Purchasing managers were also more upbeat after the election, and so were small business owners, as discussed in the next section.

By the way, the term "animal spirits" was popularized by none other than John Maynard Keynes in *The General Theory of Employment, Interest, and Money* (1936) in the following passage: "Even apart from the instability due to speculation, there is the instability due to the characteristic of human nature that a large proportion of our positive activities depend on spontaneous optimism rather than mathematical expectations, whether moral or hedonistic or economic. Most, probably, of our decisions to do something positive, the full consequences of which will be drawn out over many days to come, can only be taken as the result of animal spirits—a spontaneous urge to action rather than inaction, and not as the outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities."

This passage has been widely discussed and interpreted. Cutting through the jargon, I think Keynes was saying that the business cycle is driven by the instability of human nature. He seemed to agree that booms might reflect "spontaneous optimism," which cause instability in a similar fashion as speculation, setting the stage for a bust. Keynes added: “Thus if the animal spirits are dimmed and the spontaneous optimism falters, leaving us to depend on nothing but a mathematical expectation, enterprise will fade and die;—though fears of loss may have a basis no more reasonable than hopes of profit had before.” Of course, his book heralded the idea that government spending could stabilize the business cycle by at least minimizing the downside of the cycle.

Animal Spirits II: Reality. Yesterday’s release of December’s survey of small business owners by the National Federation of Independent Business (NFIB) was full of animal spirits. This group tends to be conservative. They generally don’t like government. When they are asked about the “most important problems small businesses face,” taxes and government regulation tend to be at the top of their list (*Fig. 1*). They were still the top concerns in December, but Trump’s victory was clearly reflected in the extraordinary ascent in the Small Business Optimism Index from 98.4 during November to 105.8 in December, the highest since the end of 2004, as Debbie discusses below (*Fig. 2*).

There’s more: The net percentage of firms expecting the economy to improve soared from 12% during November to 50% last month, the highest since March 2002 (*Fig. 3*). The percentage saying now is a good time to expand jumped from 11% to 23%, the highest since June 2005 (*Fig. 4*). The net percentage expecting to increase employment rose to 16%, the highest since January 2007 (*Fig. 5*).

So who cares? Aren’t these just a bunch of anti-government conservatives who are running minor little businesses and are looking forward to paying less than their fair share of taxes under the new Trump administration? Not so fast: Small businesses account for a very significant portion of jobs and hiring. Consider the following:

(1) *Small business is big employer.* ADP, the payroll processing company, compiles data series on employment in the private sector of the U.S. labor market by company size (*Fig. 6*). At the end of 2016, the shares of employment attributable to small, medium-sized, and large firms were 40.5%, 37.7%, and 21.8%.

(2) *Small business drives jobless rate.* There has been a very high correlation between “poor sales” reported by small business owners and the national unemployment rate (*Fig. 7*). If Trump succeeds in boosting their sales by cutting personal income tax rates, the jobless rate should remain low.

There is also a high correlation between the earnings of small businesses and the inverse of the poor sales (*Fig. 8*). Trump’s proposed tax cuts would boost their earnings, which are inversely correlated with the national unemployment rate (*Fig. 9*).

(3) *A new problem for small business.* Before we put any more twists in this pretzel, let’s conclude that the biggest problem facing small business owners in 2017 is likely to be finding workers. Indeed, during December, 29.0% said that they have openings for jobs that they aren’t able to fill (*Fig. 10*).

Animal Spirits III: Earnings. The job of small business owners, as well as of the managers of larger companies, is to be profitable no matter who is in the White House. However, very often, they’ve had to do so despite anti-business laws, regulations, taxes, and other policy measures. Actually, more often than not, big business has been in cahoots with Washington to create barriers to entry for potential smaller competitors. That system is known as “crony capitalism.” Hopefully, the new administration will fight this system rather than reinforce it. Let’s hope they feed the revival of the animal spirits that were triggered by Trump’s victory.

In any event, even before Trump was elected, S&P 500 earnings started to recover from the Energy-led recession during Q3-2016. The recovery likely continued during Q4-2016, as we will soon find out during the current earnings season. Consider the following:

(1) *Earnings season.* Although industry analysts are currently expecting Q4 earnings to be 1.1% below the Q3 result, their estimate is 4.5% above a year ago, following Q3's 4.1% growth rate (*Fig. 11* and *Fig. 12*).

(2) *Forward earnings.* It's especially encouraging to see that the forward earnings of the S&P 500/400/600 are all at record highs (*Fig. 13*). So are the forward revenues of the S&P 500/600 (*Fig. 14*).

(3) *Sectors derby.* Yesterday, Joe reported that S&P 500 Energy is expected to show positive y/y earnings for the first time since Q3-2014. He also reported the latest analysts' forecasts for Q4-2016 earnings growth rates vs their blended Q3-2016 growth rates: Financials (15.7% vs. 8.5%), Utilities (10.3, 10.9), Tech (7.8, 11.5), Materials (6.4, 10.9), Consumer Staples (6.2, 7.0), S&P 500 (4.5, 4.1), Health Care (5.4, 7.6), S&P 500 (4.5, 4.1), Energy (2.1, -67.5), Consumer Discretionary (2.0, 8.6), Real Estate (-0.8, 2.4), Telecom (-0.8, -1.8), and Industrials (-3.5, 4.0).

(4) *Small is beautiful.* Since Election Day through Monday, the S&P 500/400/600 stock price indexes are up 6.0%, 10.4%, and 14.6%. Smaller companies have outperformed because they are likely to benefit more from lower taxes and deregulation than larger ones. In addition, they are less exposed to the stronger dollar. They also aren't likely to be the subject of any hostile tweet by the incoming President.

Animal Spirits IV: Frackers. Animal spirits in the US energy sector certainly have been revived by President-elect Trump. Throughout his campaign, he promised to take the regulatory shackles off of the US oil & gas industry, including frackers. His 100-day action plan includes the following pledge: "I will lift the restrictions on the production of $50 trillion dollars' worth of job-producing American energy reserves, including shale, oil, natural gas and clean coal."

Meanwhile, OPEC remains dysfunctional. The oil cartel once again may fail to cut production, raising questions about its viability. Even if the latest agreement to do so is fulfilled, two OPEC members, Libya and Nigeria, are exempt from the deal and intend to ramp up their output.

OPEC also continues to face intense competition from US frackers, who have been cutting their production costs, allowing them to keep pumping at lower prices. Last summer, we expected the price of a barrel of Brent crude oil to trade in a $40-$50 range. It was $54.94 on Monday, but we still think that the ample supply of oil will lower the price back to our range. The fact that US oil field output is down just 8.7% from its 2015 peak confirms that oil producers continue to use technology to cut costs.

CALENDARS

US. Wed: MBA Mortgage Applications, Atlanta Fed Business Inflation Expectations, EIA Petroleum Status Report. **Thurs:** Jobless Claims 255k, Import & Export Prices 0.7%/0.2%, Weekly Consumer Comfort Index, Yellen, Evans, Harker, Bullard. (Bloomberg estimates)

Global. Wed: UK Headline & Manufacturing Industrial Production 0.6%/0.4% y/y, UK Trade Balance (pounds) -3500, Japan Trade Balance (yen) 587.6b, Japan Coincident & Leading Indexes. **Thurs:** Eurozone Industrial Production 0.5%m/m/1.5%y/y, Germany GDP 1.8% y/y. (DailyFX estimates)

STRATEGY INDICATORS

YRI Weekly Leading Index (*link*): Our Weekly Leading Index (WLI)--a good coincident indicator that can confirm or raise doubts about stock market swings--rebounded 2.0% during the final two weeks of 2016 to a new record high. Our WLI is the average of our Boom-Bust Barometer (BBB) and Bloomberg's Weekly Consumer Comfort Index (WCCI). Our BBB nearly reversed recent losses, jumping 3.2% the last two weeks of 2016, to within a fraction of its record high posted during the first week of December. Jobless claims fell for the second week to 256,750 (4-wa) after climbing from 251,000 to 263,750 the prior four weeks. The CRB raw industrials spot price index--another BBB component--weakened late last year but is climbing again. Meanwhile, the WCCI fell for the first time in six weeks after a five-week jump of 4.2%.

S&P/Russell LargeCaps & SMidCaps (*link*): All these prices indexes attained record highs following the election as the SmallCap and MidCap market-cap indexes outperformed LargeCaps. However, SmallCaps are underperforming so far in 2017. Here's the ytd score and their percentage changes since Election Day: Russell LargeCap 1000 (1.4% ytd, 6.3% since election), S&P LargeCap 500 (1.3, 6.0), Russell MidCap (1.3, 7.1), S&P MidCap 400 (0.6, 10.4), Russell SmallCap (0.0, 13.6), and S&P SmallCap 600 (-0.7, 14.6). The yearly change in forward earnings for all three indexes has been edging higher from six-year lows in early 2016 as y/y comparisons have eased. In the latest week, LargeCap's forward earnings improved to a 24-month high of 4.7% y/y from 4.6%, which compares to a six-year low of -1.8% in October 2015; MidCap's slowed to 5.2% y/y from a 21-month high of 5.6%; which compares to a six-year low of -1.3% in December 2015; and SmallCap's rose to a 25-month high of 9.6% from 9.2%, which compares to a six-year low of 0.3% in December 2015. Growth rates now expected for 2016 and 2017: LargeCap 0.5% and 12.3%, MidCap 1.5% and 12.5%, and SmallCap 6.7% and 15.9%.

S&P 500 Growth vs. Value (*link*): The S&P 500 Growth index is up 2.1% ytd, ahead of the 0.7% gain for its Value counterpart. Since the election, Growth's 4.0% gain has trailed the 8.1% increase for Value. During 2016, the S&P 500 Growth index underperformed its Value counterpart by a wide margin, rising just 5.1% vs Value's 14.3% gain. Growth is expected to deliver higher forward revenue (STRG) and lower forward earnings growth (STEG) than Value over the next 12 months (6.1% STRG and 10.7% STEG, respectively, versus 5.6% and 12.5% for Value). Growth's P/E of 18.8 is up from the October 2015 low of 16.8, and approaching its 10-year high of 19.1 in February 2015, while Value's, at 15.7, is up from January's two-year low of 13.2 and slightly below late November's 12-year high of 15.9. Regarding NERI, Growth's has been positive in five of the past eight months, but fell to an eight-month low of -5.0% in December from -4.9% in November; that compares to a five-year high of 5.8% in June 2016 and a five-year low of -16.2% in April 2015. Value's NERI was negative for a 29th straight month in December, but improved to -2.1% from -2.8% in December; that compares to a 10-month low of -18.0% in February 2016 and a five-year low of -20.3% in April 2015.

US ECONOMIC INDICATORS

NFIB Small Business Optimism Survey (*link*): "We haven't seen numbers like this in a long time. Small business is ready for a breakout, and that can only mean very good things for the US economy," according to the NFIB. December's Small Business Optimism Index (SBOI) jumped a record 7.4 points, building on November's 3.5-point gain, soaring to 105.8--the highest reading since the end of 2004! Leading the charge was a 38ppts jump in those expecting better business conditions to 50% (the highest since March 2002)--after net negative readings from March 2015 through October of last year. The other two big movers were sales expectations (to 31% from 11%) and now is a good time to expand (23 from 11), which reached their highest readings since October 2005 and June 2005, respectively. Earnings trends (-14 from -20) and capital spending plans (29 to 24) in a more typical month would have been major contributors to the gain. Despite the higher optimism, hiring activity (16 from 15) was relatively flat, while job openings (29 from 31) dropped 2ppts, reflecting a tightening labor market.

JOLTS (*link*): Job openings in November remained stalled around record highs, climbing 71,000 to 5.522 million after a 180,000 loss and a 178,000 gain the previous two months. It's within 323,000 of April's record high of 5.845 million. Hirings rose for the second month, up 59,000 m/m and 98,000 over the period to 5.219 million; separations also rose for the second month by 62,000 and 92,000 over the comparable periods to 5.028 million. The latest hirings and separations data yielded an employment advance of 191,000 for November, 13,000 below November's payroll gain of 204,000--coming in below the payroll gain for the second time in three months. The job-opening rate (3.9%) remained just below its record high of 4.2% in April, while the total hires rate (3.9) also held just below its cyclical high of 4.2%. The quit rate was back at its cyclical high of 2.4% after six months at 2.3%. The ratio of unemployed workers per job opening fell to 1.34 in November, down from 1.44 in August but above its cyclical low of 1.33 in July.

Consumer Credit (*link*): Consumer credit beat expectations in November, posting its second-highest monthly change during 2016. Consumer credit expanded $24.5 billion (above expectations of $18.5 billion), accelerating from October's $16.2 billion. Revolving credit soared $11.0 billion--nearly triple Q3's average monthly gain--as consumers stepped up credit card use during the holiday season. Nonrevolving credit, which includes student and auto loans, advanced $13.5 billion, nearly matching October's pace--below the average monthly increase of $17.8 billion during Q3.

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