MORNING BRIEFING
June 14, 2017

Small Is Beautiful

See the collection of the individual charts linked below.

(1) S&P 1500 is up $16.7 trillion since start of bull run. (2) Small companies have lots of employees. (3) Might small company hiring explain weak productivity? (4) Profits driving business cycle as profitable companies continue to expand payrolls and capacity. (5) Earnings of S&P 400/600 well outpacing S&P 500 earnings. (6) May survey finds small businesses' earnings improving on balance. (7) Finding qualified applicants for job openings is a major challenge.

Small Business I: SmallCaps Are Big Employers. The S&P 1500 stock price index has 1,500 companies. On June 12, it had a total market capitalization of $23.3 trillion. Remarkably, this index's market cap is up 251.9% since March 9, 2009, by a whopping $16.7 trillion from a low of $6.6 trillion (*Fig. 1*). It is up 48.5% from the previous bull market's peak. Weighing in at $20.9 trillion currently, the S&P 500 accounts for nearly 90% of the S&P 1500's market cap (*Fig. 2*).

The S&P 400 MidCaps and S&P 600 SmallCaps currently have market values of $1.7 trillion and $0.7 trillion, respectively. They account at present for just 7.2% and 3.1% of the S&P 1500 (*Fig. 3*). The S&P 500 comprises corporations with market caps of at least $6.1 billion. MidCaps represent those with market caps of $1.6-$6.8 billion, and Small Caps $450 million-$1.8 billion.

Yet small and medium-sized companies are disproportionately big employers according to ADP's monthly tally of payrolls. In May, the former accounted for 41.3% of private-sector payrolls, while the latter accounted for 36.0% (*Fig. 4*). So large companies employed just 22.7% of all private-sector employees.

The ADP data by company size start in 2005. So there isn't much history. Since then, total employment is up 13.0 million, led by gains of 6.3 million and 5.4 million among small companies and medium-sized ones (*Fig. 5*). Employment at large companies rose only 1.3 million over this period.

This might be one plausible explanation for the significant slowing in productivity growth in the US. Consider the following:

(1) Smaller outfits that are growing probably can do so mostly by hiring more workers, while larger companies may have access to more productive ways of expanding their capacity and output. It's hard to test this hypothesis since we don't know whether smaller firms were outsized employers or not prior to 2005, when productivity was growing at a faster clip.

(2) ADP data are available since 2001 for employment by goods-producing and service-producing companies (*Fig. 6*). The former is actually down 4.2 million over this period through May of this year, while the latter is up 16.8 million. This suggests that productivity has weakened in recent years mostly because service companies with small and medium-sized payrolls have done all of the hiring. The big problem with this theory is that manufacturing productivity growth has averaged zero for the past five years (*Fig. 7*)!

Small Business II: Profits Cycle Booming. Debbie and I believe that the profits cycle drives the business cycle. Profitable companies expand their payrolls and capacity, while unprofitable ones are forced to retrench. Obviously, during economic expansions, there are many more profitable than unprofitable companies.

The forward earnings data for the S&P 1500 and its three major components show that all are rising in record-high territory (*Fig. 8*). Since the start of the weekly data at the beginning of 1999 through early June of this year, the forward earnings of the S&P 500/400/600 are up 168.1%, 349.6%, and 327.7% (*Fig. 9*).

The monthly survey of small business owners conducted by the National Federation of Small Business (NFIB) includes a question on whether earnings are higher or lower over the past three months. The resulting net earnings series is volatile from month to month, with the 12-month average very much driven by the ups and downs of the business cycle (*Fig. 10*). The series starts during September 1974, and has been negative since then. In other words, on balance more small business owners lose than earn money!

Nevertheless, the 12-month average of this series is highly correlated with the 12-month average of the percent of small business owners who plan to increase employment (*Fig. 11*). In May, the former rose to the highest since May 2007, while the latter rose to the highest since September 2007.

Small Business III: Help Wanted. The problem with all this wonderful news is that the economy is running out of warm bodies to employ as Debbie and I have been arguing of late. May's NFIB survey found that 34.0% of small business owners had one or more job openings, the highest since November 2000 (*Fig. 12*). Furthermore, 51.0% said that there were few or no qualified applicants for the positions.

The three-month average of the NFIB job openings series is highly inversely correlated with both the unemployment rate and the jobs-hard-to-get series included in the monthly consumer confidence survey (*Fig. 13* and *Fig. 14*). The bottom line is that the labor market is tight, and may pose a challenge for the expansion plans of small businesses and dampen the growth rate of the overall economy.

CALENDARS

US. Wed: Retail Sales Total, Ex Autos, Ex Autos & Gas, and Control Group 0.2%/0.2%/0.3%/0.3%, Business Inventories -0.1%, Headline & Core CPI 2.0%/1.9% y/y, MBA Mortgage Applications, EIA Petroleum Status Report, FOMC Announcement. **Thurs:** Jobless Claims 243k, Headline & Manufacturing Industrial Production 0.2%/0.2%, Capacity Utilization Rate 76.8%, Philadelphia Fed Manufacturing Index 26.0, Empire State Manufacturing Index 5.0, Import & Export Prices -0.1%/0.1%, Housing Market Index 70, Treasury International Capital, Weekly Consumer Comfort Index, EIA Natural Gas Report. (Bloomberg estimates)

Global. Wed: Eurozone Industrial Production 0.5%m/m/1.4%y/y, Germany CPI -0.2%m/m/1.5%y/y, UK ILO Unemployment Rate (3M) 4.6%, China Retail Sales 10.7%, China Industrial Production 6.4% y/y, Japan Industrial Production. **Thurs:** UK Retail Sales 1.9% y/y, Australia Employment Change & Unemployment Rate 10k/5.7%, BOE Rate Decision 0.25%, BOE Asset Purchase & Corporate Bond Targets 435b/10b, Carney. (DailyFX estimates)

STRATEGY INDICATORS

S&P/Russell LargeCaps & SMidCaps (*link*): All these price indexes have attained record highs again in June after mostly stalling since March. Since the election, the SmallCap and MidCap market-cap indexes have outperformed LargeCaps. Here's the ytd score and their percentage changes since Election Day: S&P LargeCap 500 (8.5% ytd, 13.5% since the election), Russell LargeCap 1000 (8.4, 13.7), Russell MidCap (7.2, 13.4), S&P MidCap 400 (5.9, 16.2), Russell SmallCap (4.6, 18.7), and S&P SmallCap 600 (2.9, 18.8). The yearly change in forward earnings is up from six-year lows in early 2016 for all three indexes as y/y comparisons have eased. In the latest week, LargeCap's forward earnings edged down to 9.7% y/y from 9.9%, which compares to a 64-month high of 10.2% four weeks ago and a six-year low of -1.8% in October 2015; MidCap's was down to 12.0% from a 32-month high of 12.6%, which compares to a six-year low of -1.3% in December 2015; and SmallCap's eased to 11.1% from 11.2%, which compares to a 34-month high of 12.8% in mid-March and a six-year low of 0.3% in December 2015. Consensus growth rates now expected for 2017 and 2018 before the impact of tax-rate changes: LargeCap 11.4% and 11.8%, MidCap 11.0% and 13.5%, and SmallCap 8.6% and 19.7%.

S&P 500 Growth vs. Value (*link*): The S&P 500 Growth index is up 12.6% ytd, well ahead of the 3.9% gain for its Value counterpart. Growth had trailed Value in the four months following the election. Now, Growth's 14.7% gain since the election is leading the 11.7% 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 growth (STRG), but lower forward earnings growth (STEG), than Value over the next 12 months: 7.0% STRG and 10.9% STEG for Growth, respectively, vs 4.4% and 11.7% for Value. Growth's P/E of 20.1 is at a 14-year high, while Value's 15.2 is down from early March's 14-year highs of 16.2. Regarding NERI, Growth's was positive in May for the first time in seven months as it improved to a six-year high of 7.7% from -0.4% in April; that compares to a five-year low of -16.2% in April 2015. Value's NERI was positive in May for the first time in 34 months, improving to a six-year high of 4.1% from -2.2%; that compares to a five-year low of -20.3% in April 2015.

US ECONOMIC INDICATORS

NFIB Small Business Optimism Index (*link*): "The remarkable surge in optimism that began last year right after the election shows no signs of slowing down," said NFIB President and CEO Juanita Duggan. "Small business owners are highly encouraged by the President's regulatory reform agenda, and they remain optimistic there will be tax reform and health-care reform. This is a policy-driven phenomenon." The Small Business Optimism Index (SBOI) was unchanged at 104.5 last month, remaining at a historically high level for the sixth straight month since rebounding from its reading of 94.9 just before the November election. Five components contributed positively to May's SBOI (hirings, capital spending plans, expected business conditions, sales expectations, current job openings), four contributed negatively (current inventory, plans to increase inventories, earnings trends, now is a good time to expand), while expected credit conditions was unchanged. All moves in the components last month were small. The report noted that the tight labor market has been a persistent problem for small business owners for several months, and the problem appears to be getting worse.

Producer Price Index (*link*): The PPI for final demand was flat in May after rising 0.5% in April and falling 0.1% in March—which was the first decline since last August. Prices for final demand goods (-0.5%) posted its biggest decline in 15 months, while prices for final demand services (0.3) rose for the fourth time this year. Most of the decline in the former can be attributed to a 3.0% drop in energy prices, reflecting a double-digit drop in gasoline prices (-11.2). About half the increase in final demand services can be traced to margins for fuels & lubricants retailing, which jumped 16.1%. The yearly inflation rate for the headline series was 2.4%, holding near April's 2.5%—which was the largest increase since February 2012. The goods rate slowed to 2.9% y/y from a five-year high of 4.0% the prior two months; while the services rate (2.1% y/y) accelerated to a 29-month high. The rate for the core (2.1) jumped to its highest reading since May 2014, while the core ex trade services (2.1) held at April's high.

GLOBAL ECONOMIC INDICATORS

Global Leading Indicators (*link*): In April, the OECD's composite leading indicators (CLIs)—designed to anticipate turning points in economic activity relative to trend six to nine months ahead—once again pointed to stable growth momentum in the OECD (100.1) as a whole. CLIs for the Eurozone (100.4)—particularly France (100.6) and Italy (100.0)—Japan (100.1), the US (99.7), and UK (99.7) continued to point to stable growth momentum, with Canada (100.6) joining the list since the last assessment. Germany's CLI (100.7) continues to point to growth gaining momentum. As for the major emerging economies, the CLIs for Brazil (102.3) and Russia (101.6) are still showing growth gaining momentum, while CLIs for China (98.8) and India (99.7) continue to signal stable growth momentum.

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