Yardeni Research

MORNING BRIEFING
April 21, 2020

Small Companies Are Beautiful & Distressed

Check out the accompanying chart collection.

(1) Oil demand and prices plummet along with global economy. (2) When was the last time you were at a gas pump? (3) Running out of oil storage capacity. (4) Industrial commodity prices ex-oil are down but not plunging like oil so far. (5) The Fed is bailing out BBB fallen angels, not the other zombies in the junk pile. (6) LargeCaps, Growth, and Stay Home stocks have been outperforming, and may continue doing so. (7) ADP numbers show small-sized companies account for about a quarter of employment and paychecks. (8) Unintended consequences: Government's Paychecks Protection Program runs into some snags. (9) Not enough lifeboats.

Commodities: Gasoline Is Cheaper than Water. Add another casualty on the economic front of VWI, i.e., the world war against the virus. Demand for petroleum products is plunging along with economic activity all around the world. Here in the US, petroleum products supplied (a good proxy for demand) collapsed by 4.7 million barrels a day (mbd) from 21.1 mbd during the March 13 week of this year to 16.4 mbd during the April 10 week (*Fig. 1*). Included in that remarkable drop is a 2.9 mbd drop in gasoline supplied, from 9.3 mbd to 6.4 mbd (*Fig. 2*). There's no doubt that Americans aren't driving much of anywhere but staying in place to maintain social distancing, as ordered by the governors of every state.

Last Wednesday, April 15, the International Energy Agency warned, in its closely watched monthly report, that demand in April could be 29 mbd lower than a year ago, hitting a level last seen in 1995.

The freefall in demand is outpacing the record 9.7 mbd cut in production by the major oil exporters, which was announced on April 12. As a result, the nearby futures prices of a barrel of Brent and West Texas Intermediate (WTI) crude oil dropped to $28.08 and $18.27 on Friday (*Fig. 3*). The nearby futures price of a gallon of gasoline fell to $0.71 on Friday (*Fig. 4*).

Instead of Freaky Friday, we had Mad Monday. WTI crude for May delivery fell to settle at negative $37.63, meaning producers would pay traders that much to take the oil off their hands. This negative price has never happened before for an oil futures contract. On the other hand, Brent settled at $25.57 for the June contract yesterday. The nearby futures price of gasoline fell to $0.67 yesterday.

The basic problem is that the world is running out of storage capacity, as supply has well exceeded demand. In the US, the ratio of inventories of petroleum products supplied (including crude oil) to demand jumped to a record 82 days, up from 62 days at the beginning of this year (*Fig. 5*). It's the highest since the start of the data in 1990.

Apparently, US oil frackers just got the memo about the devastating impact that the Great Virus Crisis is having on demand for petroleum. They've continued to produce at record highs around 13.0 mbd since the start of this year (*Fig. 6*). During the April 10 week, US crude oil field production dropped to 12.2 mbd. It's undoubtedly heading much lower in coming weeks.

Meanwhile, consider the followed related developments:

(1) *Industrial commodity prices.* While the latest batch of global economic indicators is signaling a depression-like collapse in global economic activity, the CRB raw industrials spot price index (which does not include petroleum or lumber products) remains above its 2016 low and well above its 2008 trough (*Fig. 7*). The same can be said for the price of copper, which is the most economically sensitive of the index's 13 components. The rebound in China's economy probably explains the relative strength of non-petroleum industrial commodity prices.

(2) *Credit-quality spreads.* Melissa and I will be keeping an eye on credit-quality spreads in the junk-bond market, which includes a significant portion of energy companies' bonds (*Fig. 8*). They blew out during 2015 when the price of oil took a dive. They may do so again, notwithstanding the Fed's commitment to support BBB investment-grade bonds that have recently fallen into junk territory. So far, the Fed hasn't committed to support the entire junk bond market, but then anything is possible.

Strategy: Style Guide Update. Since the bear market from February 19 through March 23 and even through the rebound since then, LargeCaps, Growth, and Stay Home stocks have outperformed SMidCaps, Value, and Go Global stocks. Joe and I expect that may continue to be the case over the rest of this year for these three investment styles. Here is a brief update:

(1) *LargeCaps vs SMidCaps.* Actually, the S&P 500 has been outperforming the S&P 400/600 since the stock market's big correction that started on September 20, 2018 and lasted through December 24 of that year (*Fig. 9*). Usually, LargeCaps outperform during risk-off periods, especially during recessions, when investors fear that smaller companies may not have the resources to survive an economic downturn. When most of them do so, with their outlooks turning brighter during recoveries, they tend to outperform. That may be starting to happen now following the enormous amount of fiscal and monetary stimulus provided since late March. However, the outlook for many SMidcaps (and even some LargeCaps) remains especially uncertain, since much depends on how much longer the viral pandemic lasts, on when the economy will open up, and on how gradually it will do so.

(2) *Growth vs Value.* Since February 19, S&P 500 Growth is down 12.0% through Friday's close, while Value is down 18.9%. The ratio of the two soared from 1.64 to 1.78 over this brief period (*Fig. 10*). So it slightly exceeds the record peak in this ratio during 2000. Growth includes lots of Information Technology companies with strong balance sheets and cash flow. Value includes lots of companies that aren't as blessed. Many are in Finance and Energy, and many pay dividends, which they may have to suspend. If so, then Growth may continue to outperform Value.

(3) *Stay Home vs Go Global.* Since the start of the bull market during March 2009 through the recent bear market, and now since the recent rally, Stay Home has outperformed Go Global, especially when comparing the US MSCI stock price index to the All Country World ex-US stock price index in dollars rather than in local currencies (*Fig. 11*). The dollar tends to do well when the US economy is outperforming the rest of the world, as most clearly evidenced by weak commodity prices. That seems to be the case now, as evidenced by the recent collapse in oil prices. As in 2008, the US is most likely to emerge from the latest crisis in better shape than most other major economies around the world.

US Economy I: Small Business Is Big Business. Below, Melissa analyzes the US government's attempt to provide lifeboats to small business owners. Before we go there, let's get some perspective on this segment of corporate America by reviewing ADP's data on nonfarm private payrolls by company size:

(1) *Small, medium, and large payrolls.* As of March, ADP data show total nonfarm private payrolls totaled 129.4 million, with 33.0 million working for small-sized companies (1–49 employees), 30.2 million working for medium-sized companies (50–499), and 66.2 employed by large-sized companies (over 500). In other words, small accounted for 26% of employment, medium accounted for 23%, and large accounted for 51% (*Fig. 12*).

(2) *Earned income by company size.* Pre-tax private wages and salaries totaled roughly $8 trillion (saar) during February. That suggests that small firms had payrolls of around $2 trillion. The government's Paychecks Protection Program (PPP) is aimed at providing small businesses with enough support to cover their payrolls for two months. That would require $333 billion in such support.

(3) *The government is here to help.* Someone in the US Treasury department must have done the math and figured that $350 billion should do the trick. The program ran out of money in 13 days, leaving lots of small businesses out of luck. Part of the problem is that businesses with good relationships with their banks received preferential access to the funds, even if they have the resources to weather the two-month projected storm on their own. Below, Melissa explains why PPP hasn't worked out as planned.

US Economy II: Not Enough Lifeboats. "Small businesses are an anchor of the US economy," to borrow a phrase from JP Morgan's Small Business dashboard. Such companies employ millions of Americans and represent a large share of businesses in the US. Small businesses' share of private non-farm GDP was estimated recently to be around 50%, according to sources compiled by Bureau of Economic Analysis (BEA) in a March 2020 Working Paper. The smallest of small businesses—i.e., with 0–99 employees—accounted for an estimated 30% of wages and 35% of employment in the US economy over 2012-16 timeframe, the BEA estimated.

Policymakers generally agree that small businesses operate at a competitive disadvantage relative to larger firms yet generate a disproportionately large share of economic activity. So it makes sense that small businesses are a large focus of the bailout programs aiming to buoy the US economy during this tumultuous time.

"A quarter of small businesses across the country were already closed at the beginning of April, with many more shutting since then," an April 17 *Barron's* article observed. In a worst-case scenario, the pandemic's knock-on effects could force bankruptcy for many small and mid-sized businesses. Many others might be forced to dramatically cut payroll, leading to mass unemployment.

Lots of businesses, big and small, are adapting to the pandemic era by offering remote or curbside services. But that isn't possible for all of them. *Barron's* reported that of the most contact-intensive occupations, barbers, hair stylists, and cosmetologists top the list, according to analysis by the Federal Reserve Bank of St Louis. Market data cited in *Barron's* from Statista show that hair, skin, and nail salons in the US generated roughly $5.24 billion in total revenue in 2018. Anecdotally, a salon owner explained that many customers have grown used to styling their hair themselves, and job losses around the country may reduce the demand for salon services.

The challenges for pandemic-era policymakers trying to find enough lifeboats to rescue small businesses from drowning are many. For one, the first round of small business bailout funding initiated by Congress already has run dry, and the second round may not even be enough to keep small businesses afloat. Secondly, targeting aid to small business is not straightforward. Thirdly, the Fed's lending programs may not be much of a boon for small business owners who are losing their confidence in the future.

Consider the following latest developments related to the government's efforts to bail out small businesses:

(1) *Smaller businesses pushed out*. The first round of fiscal stimulus aimed at helping small businesses stay afloat totaled $349 billion. The US Small Business Administration (SBA), the program administrator, reported that more than 1.6 million PPP loans were approved by last Thursday at noon. Of the loan count, 74.0% were made for amounts less than $150,000. But 83.0% of the loan value was allocated to loans above $150,000, with 44.5% allocated to loans over $1 million. The loan max was $10 million. In just 13 days, the funds ran dry, with many small businesses still mired in the loan approval process. Many of those locked out seem to have been the smallest of small businesses like florists and pizza shops, as economist Lawrence Summers suggested in a tweet.

(2) *Bigger firms overrun funding*. Much of the first round of the PPP was gobbled up by bigger firms than classically would be considered small due to a loophole in firm size eligibility, reported Bloomberg. Specifically, larger restaurant groups as well as energy, mining, manufacturing, cruise, and travel companies benefited from PPP loans. More than a dozen of these companies trade publicly and show annual revenue of over $100 million. On Sunday, President Trump explained that much of the funds were absorbed into larger firms that represent owner-operated franchise establishments.

The PPP is intended to cover two months of payroll and other related expenses generally for companies that employ up to 500 people. But the definition of size varies by industry based on the SBA’s standards. Because the employee-count cap refers to a single location for restaurants and hotels, the larger chains were eligible. Yesterday, after much criticism, Shake Shack, the publicly traded 7,000+ employee burger joint, announced that it will return the $10 million PPP loan it received on Friday, citing confusion over the rules of the loan program.

(3) *More funds on the way*. Senators on both sides of the aisle are negotiating a $370 billion deal, $310 billion of which would be allocated incrementally to the PPP, reported CNBC. Specific details of the bill underway include the setting aside of $60 billion for rural and minority groups (as a part of the $310 billion). Another $60 billion would go toward the SBA-administered Economic Injury Disaster Loan program. Bloomberg reported that the Federation of Independent Business, the largest group representing small businesses in the country, wants Congress to approve $400 billion more for the program, with at least $200 billion set aside for firms with less than 20 employees.

Democrats also have pushed for the bill to include funding to aid hospitals and for coronavirus testing as well as for financially sinking state and local governments and for individuals without banking relationships. Reportedly, the last two items are off the table for these negotiations. But funding for hospitals and testing will likely make it into this bill, while state and local funding will likely be part of future aid packages, according to CNBC’s Republican sources. The Fed already has established lending facilities for state and local governments, as we recently discussed. Treasury Secretary Steven Mnuchin told CNN that he hopes the deal will be passed by Tuesday, with funds opened up to small businesses by Wednesday.

(4) *Unforgiving loans for SMID firms*. Successful or not, policymakers actively have pursued the bailout of major corporations and small business. But what about mid-sized firms? About 19,000 American companies have 500-10,000 employees, and they employ 30.3 million workers, according to Census Bureau data cited in an April 17 *NYT* article. Businesses with less than 10,000 employees may benefit from the Federal Reserve's $600 billion Main Street Lending program. Double-dipping is allowed for small businesses that benefit from the PPP. Businesses that were either locked out of the PPP or were not eligible for it may also apply.

The program offers eligible small and mid-sized companies inexpensive four-year bank loans, with payments deferrable for up to one year. PPP loan payments are deferred for six months. But since the Fed's loans are not forgivable—as the PPP loans are under certain conditions—they're less appealing to businesses that doubt their own sustainability, according to the *NYT*. That's indeed the case for some mid-sized businesses in the FRB-Minneapolis district, President Neel Kashkari told reporters, adding that the Fed is "just very limited because we are a lender, not a grant-maker."

(5) *What is small?* No wonder there's been confusion over how best to keep small businesses from drowning; even what constitutes a small business is unclear. No consistent and comprehensive measure of economic activity for small businesses currently exists, according to the BEA's work. Despite the vital nature of small businesses to the US economy, the available data on small businesses are limited. Presumably inspired by the need for better data to best direct policy during the COVID-19 pandemic, the BEA is developing small business economic statistics to complement its official statistics, such as GDP and personal income. But these data are not yet available.

CALENDARS

US: **Tues:** Existing Home Sales 5.30mu. **Wed:** MBA Mortgage Applications, DOE Crude Oil Inventories. (DailyFX estimates)

Global: **Tues:** Germany ZEW Survey Current Situation & Expectations -75/-42, UK Employment Change & Unemployment Rate 100k 3/m/3m/3.9% 3m, Canada Retail Sales, Lowe. **Wed:** Eurozone Consumer Confidence -20.0, UK Headline & Core CPI 1.5%/1.6% y/y, Canada CPI. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings (*link*): These three indexes had their forward earnings tumble yet again last week, but at a tad slower rate than their worst-ever drops on record the week before. LargeCap's forward earnings dropped 3.9% to its lowest level since January 2018; MidCap's fell 4.1% to its lowest level since July 2017; and SmallCap's tumbled 5.8% to the lowest point since March 2017. These indexes had begun a forward-earnings uptrend during March 2019 but stumbled from July to November before rising until mid-February. LargeCap's is now 15.6% below its record high at the end of January; that's the most since May 2010. MidCap's and SmallCap's are 21.2% and 30.9% below their October 2018 highs; that's the most since January 2010 and October 2009, respectively. The yearly change in forward earnings soared to cyclical highs during 2018 due to the boost from the Tax Cuts and Jobs Act (TCJA) but began to tumble in October 2018 as y/y comparisons became more difficult. In the latest week, the rate of change in LargeCap's forward earnings dropped to -12.9% y/y from -9.0% the week before. That's the lowest since November 2009 and down from 23.2% in September 2018, which was the highest since January 2011. MidCap's fell w/w to -19.8% y/y from -15.1%. That was the lowest since October 2009 and compares to a TCJA-boosted 24.1% in September 2018 (the highest since April 2011). SmallCap's dropped w/w to -25.6% y/y from -20.5%; that's also the lowest since October 2009 and compares to the TCJA-boosted eight-year high of 35.3% in October 2018. Analysts' y/y earnings growth forecasts for 2020 are down substantially in the past six weeks, and further declines are still ahead. Here are the latest consensus earnings growth rates for 2020 and 2021: LargeCap (-13.5%, 23.2%), MidCap (-15.5, 23.9), and SmallCap (-25.2, 31.7).

S&P 500/400/600 Valuation (*link*): Valuations moved higher last week, but the gains were primarily due to lower forward earnings. LargeCap's forward P/E jumped 1.2pts w/w to 19.0 from 17.8. That's the highest level since May 2002 and is up from 13.3 in mid-March, which was its lowest since March 2013. MidCap's 15.9 and SmallCap's 17.1 were up 0.4pts and 0.5pts w/w. That compares to MidCap's 10.7 and SmallCap's 11.1 in mid-March, which were their lowest readings since March 2009. LargeCap's forward P/E based on normalized earnings had been at 18.9 during mid-February, which was the highest level since June 2002. Of course, that high was still well below the tech-bubble record high of 25.7 in July 1999. Last week's level compares to the post-Lehman-meltdown P/E of 9.3 in October 2008. MidCap's P/E is down from a 22-month high of 17.4 in mid-December and the record high of 20.6 in

January 2002. However, MidCap's P/E has been at or below LargeCap's P/E for most of the time since August 2017—the first time that alignment has prevailed since 2009. SmallCap's P/E is down from mid-December's 16-month high of 18.1 and a 15-year high of 20.5 in December 2016, when Energy's earnings were depressed. However, SmallCap's P/E is still below LargeCap's. It has been mostly below since last May—the first time that has happened since 2003. During mid-March, SmallCap's P/E was briefly below MidCap's for the first time since July 2008.

S&P 500 Sectors Quarterly Earnings Outlook (*link*): The March quarterly earnings books have been closed for three weeks now, but analysts continue to slash their estimates amid a "withdrawn guidance" environment in what's sure to be the worst season in many years. The Q1 EPS forecast tumbled 184 cents w/w to $33.38. That represents a decline of 14.7% y/y on a frozen actual basis and -13.5% y/y on a pro forma basis. That compares to a 3.1% gain in Q4-2019, a 0.3% decline in Q3-2019, and y/y gains of 3.2% in Q2-2019, 1.6% in Q1-2019, 16.9% in Q4-2018, and 28.4% in Q3-2018 (which marked the peak of the current earnings cycle). Besides the small y/y decline in Q3-2019, the last time earnings fell markedly y/y was during the four quarters through Q2-2016. Six of the 11 sectors are still expected to record positive y/y earnings growth in Q1, but none are forecasted to rise at a double-digit percentage rate. That compares to eight positive during Q4, when two rose at a double-digit percentage rate. Six sectors are expected to beat the S&P 500's pro-forma 13.5% decline in Q1. That compares to six in Q4 and seven in Q3, and is still up sharply from just three beating the S&P 500 during Q2-2019. All sectors are expected to post worse growth on a q/q basis during Q1. On an ex-Energy basis, the consensus expects earnings to drop a smaller 11.9% y/y in Q1. That compares to ex-Energy gains of 6.1% in Q4, 2.2% in Q3, 3.9% in Q2, and 3.0% in Q1 but is well below ex-Energy's 25.0% and 14.2% y/y gains in Q3-2018 and Q4-2018, respectively. Here are the latest Q1-2020 earnings growth rates versus their final Q4-2019 growth rates: Communication Services (5.4% in Q1-2020 versus 8.2% in Q4-2019), Health Care (2.4, 10.1), Utilities (1.9, 17.8), Consumer Staples (1.8, 2.6), Information Technology (0.9, 9.2), Real Estate (0.4, 7.0), Materials (-16.5, -12.4), Financials (-32.4, 10.2), Industrials (-33.9, -9.3), Consumer Discretionary (-36.5, 2.5), and Energy (-58.4, -41.2).

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