



MORNING BRIEFING

February 15, 2017

Running Hotter

See the [collection](#) of the individual charts linked below.

(1) Small Business Optimism Index goes vertical. (2) Reagan, Volcker, and now Trump. (3) Small business owners don't like big government. (4) Business owners saying jobs are hard to fill, while workers are saying jobs are plentiful. (5) Let's see how far China's rooster can fly in the new year. (6) China's trade data, PPI, and stock prices all are upbeat. (7) Yellen is pleased and signaling more rate hikes coming. (8) No more talk about hysteresis.

US Economy: Hot Sauce. There is only one obvious explanation for the remarkable vertical ascent in the Small Business Optimism Index over the past three months through January: Donald J. Trump ([Fig. 1](#)). The index, which is compiled by the National Federation of Independent Business (NFIB), jumped from 94.9 during October to 105.9 during January, the highest since December 2004. That 11.0-point increase is reminiscent of a comparable leap higher during 1980 when business owners started to anticipate that Ronald Reagan might beat Jimmy Carter in that year's November presidential election. There was another similar outsized increase during 1982 and 1983 when Fed Chairman Paul Volcker lowered interest rates to revive the economy from a severe recession.

Small businesses add up to a big portion of our economy. They currently employ 49.9 million workers, accounting for 40.5% of private-sector payrolls, according to data compiled by ADP ([Fig. 2](#) and [Fig. 3](#)). Since the start of the data during January 2005, small business payrolls have increased by 5.9 million, surpassing the gains by medium-sized (5.0) and large (1.2) companies over the same period ([Fig. 4](#)). Below, Debbie reviews the NFIB survey. Here are a few of the key highlights:

(1) *Problem solver?* Each month, the NFIB survey includes a question on the most important problem faced by small businesses ([Fig. 5](#)). Since early 2013, taxes and government regulation have been alternating between first and second places. Trump has pledged to lower both for small businesses. Apparently, small business owners expect that's what he will do. Now all he has to do is deliver.

(2) *A new problem.* The NFIB survey also lists "poor sales" as a problem. That was the number-one complaint from October 2008 to July 2012. The survey doesn't ask about the availability of labor. Nevertheless, that is actually becoming a big concern among small business owners according to another question in the survey. During January, roughly 30% of them said they have job openings that they aren't able to fill right now ([Fig. 6](#)). That's the highest such reading since February 2001 based on a three-month average. It confirms that the economy is at full employment, as also evidenced by the unemployment rate, which is inversely correlated with this series and has been below 5.0% for the past nine months through January.

(3) *Wages, prices, and profits.* The NFIB's jobs-hard-to-fill series is also highly correlated with the jobs-plentiful series included in the Conference Board's survey of consumer confidence ([Fig. 7](#)). All these labor market indicators suggest that wage inflation should be running hotter ([Fig. 8](#)).

So far, there isn't much evidence that wage inflation is picking up in the average hourly earnings data that are released by the Bureau of Labor Statistics in the monthly employment report. Previously,

Debbie and I have shown that there is more wage pressure showing up in the Atlanta Fed's Median Wage Tracker ([Fig. 9](#)).

In any event, so far over the past six months on average, only 3.3% of small business owners said they were actually raising their selling prices ([Fig. 10](#)). So far, Joe and I aren't seeing any pressure on the forward earnings of the S&P 600 SmallCap's stock composite, which is rising in record-high territory ([Fig. 11](#)). However, the composite's forward profit margin is currently down to 5.2% from a cyclical peak of 6.1% during October 2013.

China: Hot Wings. Pigs can't fly. However, roosters can fly, though not very far. This is the Year of the Rooster in China, and the economy is showing more signs of flying. Prior to September, the country's PPI had been declining on a y/y basis for 54 consecutive months ([Fig. 12](#)). This rate has been flying since then, reaching 6.9% during January, the highest since August 2011. This could be a harbinger of higher prices for Americans buying imported Chinese goods, though the weak yuan may offset some of those pressures. The increase in China's PPI is broad-based, with gains in coal (38.4% y/y), ferrous metals (23.7), nonferrous metals (17.7), raw materials 12.9), and manufacturing (5.9).

On Monday, we reviewed China's January trade data, which also showed strength. The China MSCI stock price index (in yuan) is up 34.7% y/y ([Fig. 13](#)). It is positively correlated with the CRB raw industrials spot price index, which has become quite sensitive to China's economy. The bottom line is that the economy's momentum has turned up in recent months.

Yellen: Hot Streak. Fed Chair Janet Yellen [testified](#) before a Senate committee yesterday and will do so again today before a House committee to present the Fed's semi-annual [Monetary Policy Report](#) to Congress. All in all, it was probably one of her more upbeat assessments of the economy since assuming her top position at the Fed on February 1, 2014. She said, "Incoming data suggest that labor market conditions continue to strengthen and inflation is moving up to 2 percent, consistent with the Committee's expectations."

Most importantly, she said that if this continues, then more rate hikes are coming, and implied that the next one might even come at the next meeting of the FOMC, on March 14-15: "At our upcoming meetings, the Committee will evaluate whether employment and inflation are continuing to evolve in line with these expectations, in which case a further adjustment of the federal funds rate would likely be appropriate."

She seems to have come a long way in changing her mind about the economy and monetary policy in a short time. Just last year in a 10/14 [speech](#), she discussed "hysteresis," the idea that persistent shortfalls in aggregate demand could adversely affect the supply side of the economy. She concluded that "if strong economic conditions can partially reverse supply-side damage after it has occurred, then policymakers may want to aim at being more accommodative during recoveries than would be called for under the traditional view that supply is largely independent of demand."

Well, never mind. Yesterday, she kept it simple: "As I noted on previous occasions, waiting too long to remove accommodation would be unwise, potentially requiring the FOMC to eventually raise rates rapidly, which could risk disrupting financial markets and pushing the economy into recession."

CALENDARS

US. Wed: Retail Sales Total, Ex Autos, and Ex Autos & Gas 0.1%/0.5%/0.3%, Business Inventories 0.4%, Headline & Manufacturing Industrial Production 0.0%/0.2%, Capacity Utilization 75.5%, Empire State Manufacturing Index 7.5, Atlanta Fed Business Inflation Expectations, Housing Market Index 68,

MBA Mortgage Applications, EIA Petroleum Status Report, Treasury International Capital, Yellen, Harker. **Thurs:** Jobless Claims 246k, Housing Starts & Building Permits 1.232mu/1.233mu, Philadelphia Fed Manufacturing Index 19.3, Weekly Consumer Comfort Index, EIA Natural Gas Report. (Bloomberg estimates)

Global. Wed: Eurozone Trade Balance (euros) 22.0b, UK Jobless Claims Change & Claimant Count Rate 1k/2.3%, UK ILO Unemployment Rate 4.8%, Australia Employment Change & Unemployment Rate 10k/5.8%. **Thurs:** European Car Sales, Japan Machine Tool Orders, G-20 Finance Ministers Meeting. (DailyFX estimates)

STRATEGY INDICATORS

S&P/Russell LargeCaps & SMidCaps ([link](#)): All these price 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 MidCap (4.5% ytd, 10.5% since the election), Russell LargeCap 1000 (4.1, 9.2), S&P LargeCap 500 (4.0, 8.8), S&P MidCap 400 (3.9, 14.0), Russell SmallCap (2.6, 16.5), and S&P SmallCap 600 (1.6, 17.3). 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 rose to a 28-month high of 7.6% y/y from 7.3%, which compares to a six-year low of -1.8% in October 2015; MidCap's was steady at a 25-month high of 8.1%, which compares to a six-year low of -1.3% in December 2015; and SmallCap's jumped to a 29-month high of 11.4% from 10.0%, which compares to a six-year low of 0.3% in December 2015. Growth rates now expected for 2016 and 2017: LargeCap 1.1% and 10.8%, MidCap 2.0% and 11.9%, and SmallCap 7.8% and 14.5%.

S&P 500 Growth vs. Value ([link](#)): The S&P 500 Growth index is up 5.3% ytd, ahead of the 2.5% gain for its Value counterpart. Since the election, Growth's 7.3% gain has trailed the 10.2% 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: (6.2% STRG and 9.6% STEG for Growth, respectively, versus 5.5% and 11.9% for Value). Growth's P/E of 19.1 is down slightly from late January's 10-year high of 19.2, while Value's, at 15.5, is down from December's 14-year high of 16.2. Regarding NERI, Growth's has been negative for three straight months and fell to a nine-month low of -5.5% in January from -5.0% in December; 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 30th straight month in January, but improved to -1.7% from -2.1% 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 Survey ([link](#)): "The stunning climb in optimism after the election was significantly improved in December and confirmed in January. Small business owners like what they see so far from Washington," according to NFIB's president. January's Small Business Optimism Index (SBOI) edged up 0.1 point to 105.9—the highest since December 2004—following gains of 7.4 points and 3.5 points the previous two months. Last month, there were no big moves up or down among the 10 components of the index (with the range between 2ppts and 3ppts); five of the components contributed positively, five negatively. NFIB's chief economist noted that the very positive expectations seen in the data already have begun translating into hiring and spending in the small business sector. Job openings (to 31% from 29%) and job hirings (18 from 16) climbed to their highest readings since 2006. Small businesses' capital-spending plans (27 from 29) dipped slightly last month, but is still close to the highest readings of the recovery. Meanwhile, small businesses saying now is a good time to

expand has soared from 9% in October to 25% in January—its highest reading since the end of 2004.

GLOBAL ECONOMIC INDICATORS

Eurozone GDP Flash Estimate ([link](#)): The Eurozone economy grew 0.4% last quarter, according to the GDP flash estimate, matching Q3's rate. Among the four largest economies, real GDP growth in Germany (to 0.4% from 0.1%) and France (0.4 from 0.2) accelerated from Q3's pace, while Italy's slowed (0.2 from 0.3); Spain's grew 0.7% for the second month. Meanwhile, Greece's (-0.4) GDP is contracting again after two quarters of expansion.

Eurozone Industrial Production ([link](#)): Output in December retreated after climbing to its highest reading since September 2008 in November. Industrial production (excluding construction) sank 1.6% after a two-month climb of 1.7%. December's decline was widespread as output of capital goods (-3.3%), energy (-1.4), nondurable consumer goods (-1.2), and intermediate goods (-0.2) all contracted; consumer durable goods production expanded for the third month by 2.9% m/m and 4.7% over the period. Production of the four largest Eurozone economies show that Germany (-3.1%) had the second-largest decline in the region; losses in France (-0.9) and Spain (-0.4) were smaller, while Italy (1.4) posted its third straight production increase. Of the remaining countries for which data are available, Ireland (-11.7) had the largest drop, though it followed a 15.3% jump in November. The strongest production advances occurred in Greece (2.4), Malta (2.4), Slovenia (1.3), Portugal (1.2), and Lithuania (1.1).

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