

July 13, 2010

Small Business Sentiment Worsened; No Regulatory Relief

In June, small businesses said their outlook worsened after some improvement earlier in 2010. This coincided with relatively high levels of jobless claims and the disappointing payroll data on private sector hiring.

- We continue to expect moderate growth from the low economic base established in the 2009 recession, not a V or a double dip. We're at 3% growth for the second quarter (below consensus, but today's trade data will push the Q2 and Q3 GDP consensus down).
- Supporting some U.S. growth, we note growth in Asia (which, outside Japan, continues to make market-oriented improvements), plentiful liquidity at low interest rates for governments, banks and big companies, and the easy comparisons from 2009. In this environment, we expect strong corporate profit growth.
- Holding back a normal V-shaped rebound, however, we note the federal government's rapid expansion, the looming tax increase, regulatory drag and the particular problems facing small businesses -- the credit crunch, high taxes and red tape.

Fed Chairman Bernanke and the Administration continue to talk about the importance of small business job growth, but we don't see any key policy improvements on the horizon.

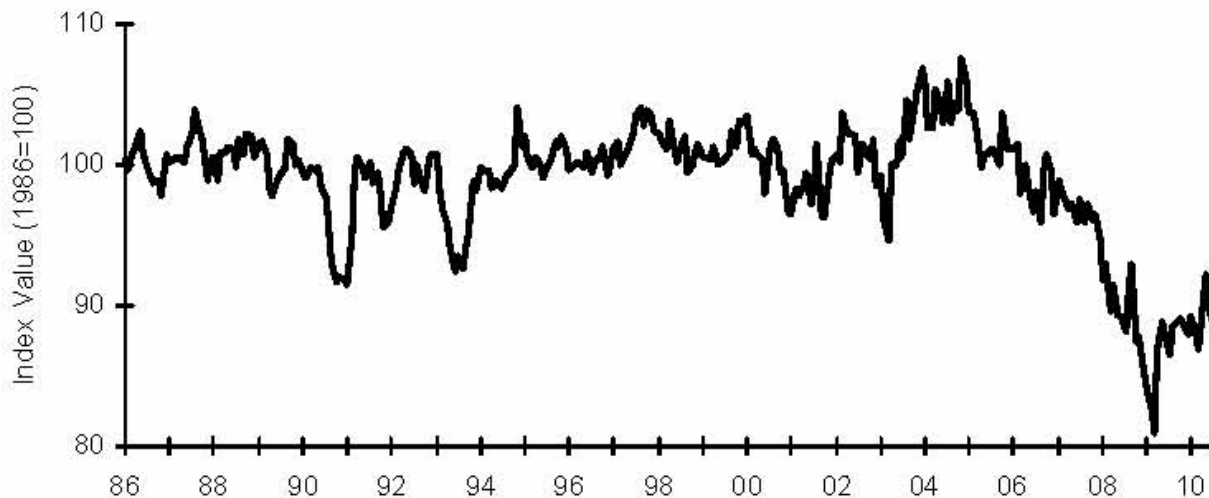
- A late-2010 tax bill may include many targeted benefits for small businesses like equipment expensing or credits, but the overall thrust of tax law looks devastating – higher top marginal rate, substantially more complexity, and higher cost of capital through the dividend and capital gains rates.
- The bank lending problem relating to the harmful interplay between mark-to-market and bank regulatory capital has been well-known since 2008 (Paulson and Bernanke gave major speeches in 2008 ruing regulatory pro-cyclicality.) Yet regulators and FASB are still making these problems worse, channeling capital away from small businesses (see graphs below showing the decline in bank lending).
- The health care law and the financial regulatory reform bill, both about 2000 pages, are huge new burdens for small businesses.
- We expect small business hiring to remain sub-par in this recovery, leaving unemployment high for the foreseeable future.

Business Confidence and Bank Lending Down

The National Federation of Independent Businesses released its June survey today. The optimism index fell to 89.0 from 92.2 in May and 90.6 in April. This cycle's low was 81 in March 2009. The NFIB chief economist William Dunkelberg said "The U.S economy faces hurricane force headwinds and the government is at the center of the storm, making economic recovery very difficult."

NFIB Optimism Index (last obs. June 2010)

Based on Ten Survey Indicators
(Seasonally Adjusted 1986=100)



Source: NFIB

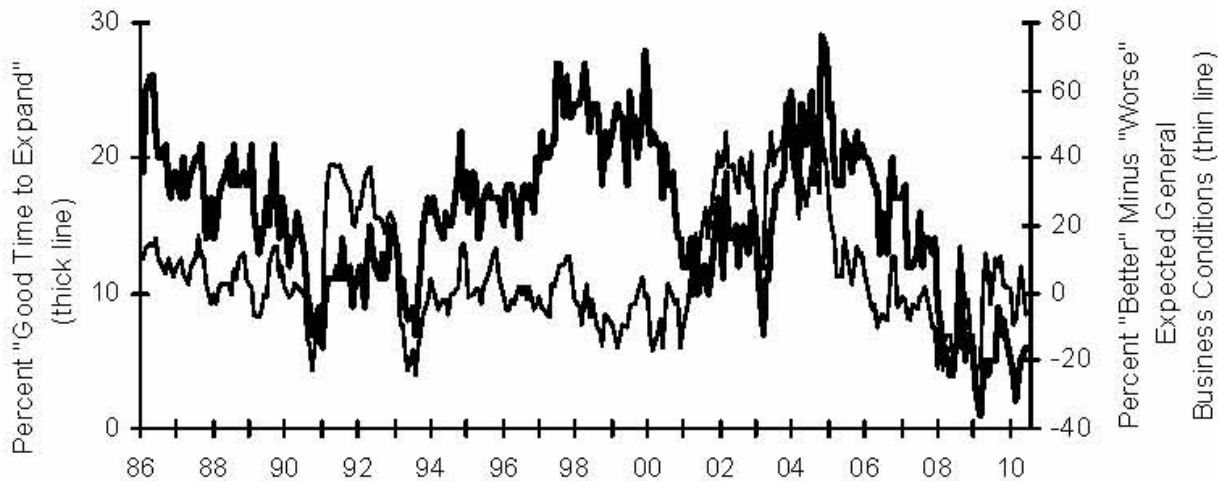
- The outlook for general business conditions (those who expect conditions to get better minus those who expect conditions to get worse) fell sharply to -6% in June down from 8% in May (thin line, right scale, in graph below). The decline is in line with other recent macroeconomic indicators that have shown a soft patch in the recovery.
- The NFIB survey for June found that the percentage of small businesses who thought the next three months were a "good time to expand" rose to 6% in June from 5% in May (bold line, left scale in graph below). In better times, this survey finds 25% or more responding that it is a good time to expand. NFIB respondents overwhelmingly (43%) cited economic conditions as the reason for their expansion outlook, while the political climate was the second most often cited reason (by 12%).

NFIB Small Business Outlook (last obs. June 2010)

Good Time to Expand and Expected General Business Conditions

January 1986 to June 2010

(Seasonally Adjusted)



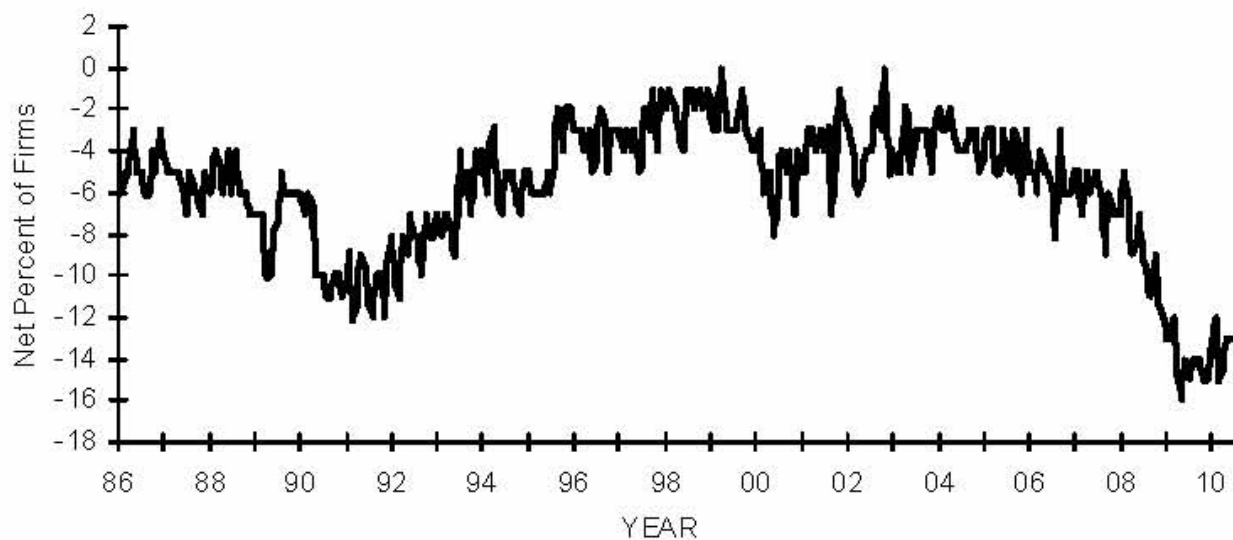
Source: NFIB

- Credit conditions stayed at a net negative 13% (companies finding loans easier to get in the last three months minus those finding loans harder to get.) The low of this cycle was set in May 2009 at -16%

NFIB Credit Conditions (last obs. June 2010)

Loan Availability Compared to Three Months Ago*

January 1986 to June 2010

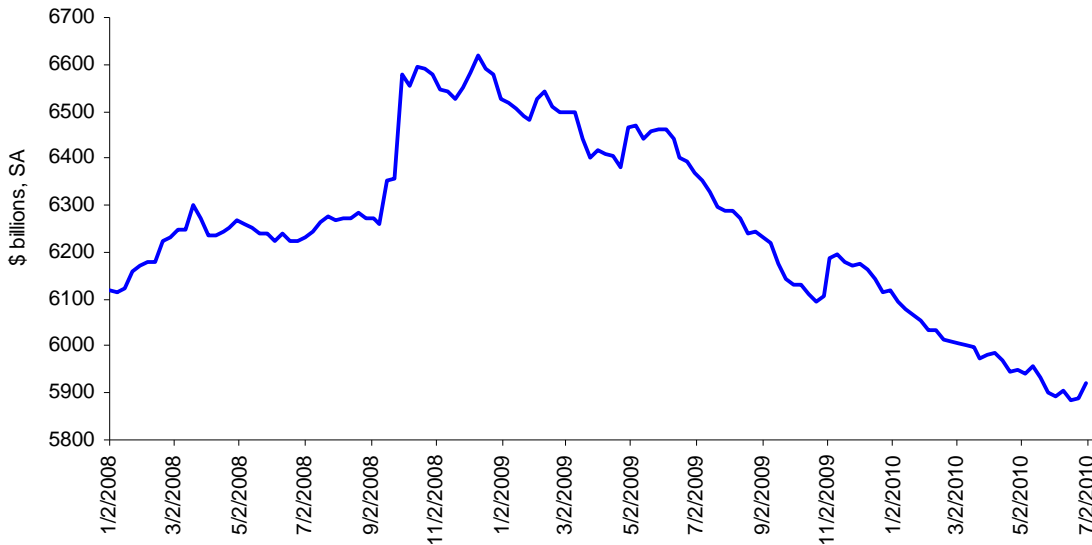


* For the population borrowing at least once every three months.

Source: NFIB

- Bank loans and leases outstanding have fallen to \$5.9 trillion from a peak of \$6.6 trillion in December 2008. Some versions of this data series show a recent spike, but it is a one-time re-classification of off-balance-sheet vehicles (revolving pools) into loans rather than actual loan growth.

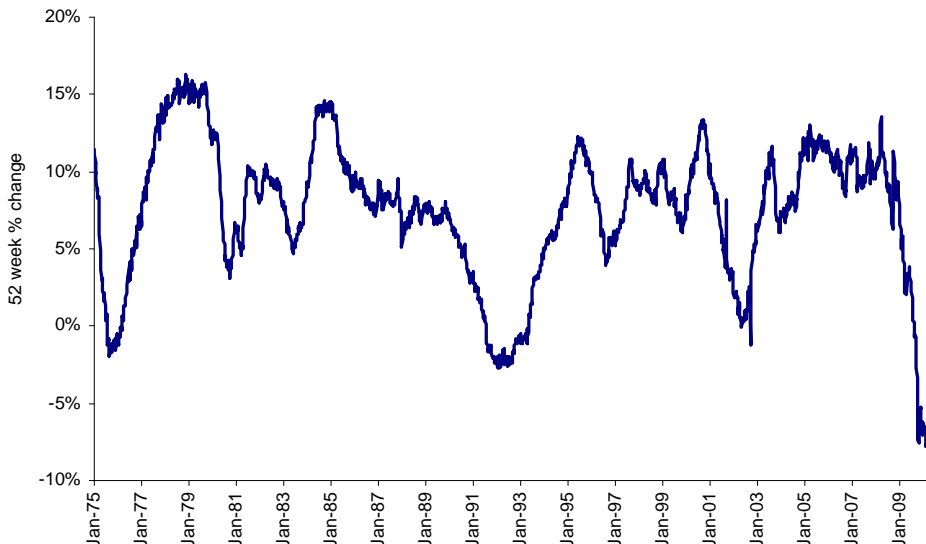
Loans and Leases at Banks (last obs. June 30, 2010)



Source: Federal Reserve Board; Encima Global

- Loans and leases outstanding contracted 7% in the last year, just above the worst year-over-year decline on record. We think Washington's accounting, regulatory and tax policies are contributing to this weakness.

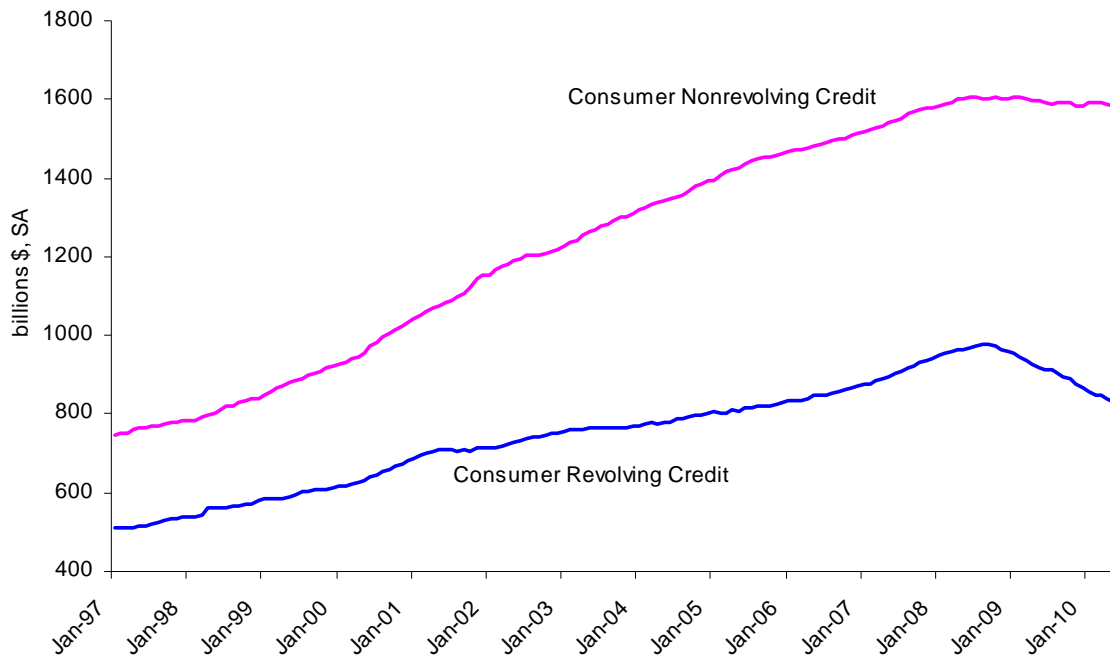
Loans and Leases at Banks 52 week change (last obs. June 30, 2010)



Source: Federal Reserve Board; Encima Global

- Consumer revolving credit outstanding, sometimes used for small business financing, fell to \$830.8 billion in May, down \$7.4 billion for the month. It has fallen \$144.9 billion from the peak in September 2008. Overall, consumer credit fell slightly more in May because consumer non-revolving credit, helped by rising auto sales, fell only \$1.8B for the month reaching \$1.585T.

Consumer Credit (last obs. May 2010)



Source: Federal Reserve; Encima Global

- The NFIB's survey of net changes in employment in the last three months (not graphed) improved to a minus 10%, two points better than May's reading. The net hiring plans for the next three months (thin line in chart below) stayed at a seasonally adjusted positive 1%, remaining positive for a second month in a row for hiring plans after staying at zero or below for 19 months from September 2008 to April 2010.
- Job openings (bold line in the chart below) stayed at 9% in June, the same as May, and remains one point above the low of 8% where it had stayed for the August to November 2009 period.

NFIB Employment (last obs. June 2010)

Planned Next Three Months and Current Job Openings

January 1986 to June 2010

(Seasonally Adjusted)



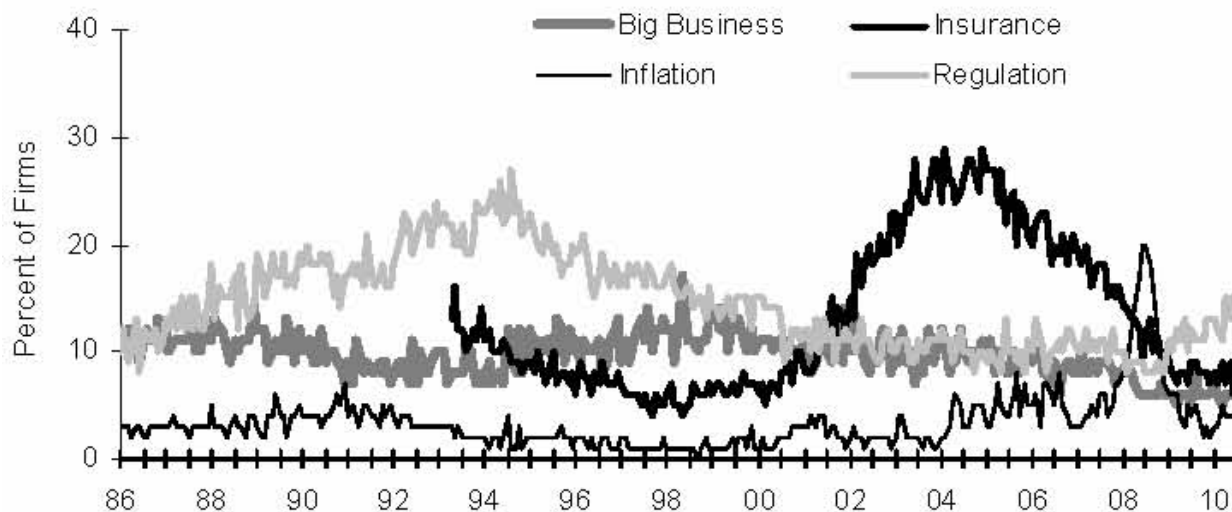
Source: NFIB

- In the NFIB survey, small businesses were asked “what is the single most important problem facing your business today?” Poor sales ranked first at 30%, the same as May. Taxes came in second, at 20%, a problem that is expected to get worse by 2011. Government requirements and red tape came in third at 15%, a 2% rise from May’s figure and a trend that will likely continue into the future.

NFIB Single Most Important Problem (last obs. June 2010)

Inflation, Big Business, Insurance and Regulation

January 1986 to June 2010



Source: NFIB

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