Third Party Research **August 14, 2018**

Small Business Optimism Is Huge

***e*Research Corporation** is pleased to provide an article by Scott Grannis for his Blog, "Calafia Beach Pundit".

In this article, Mr. Grannis explains that U.S. economic growth is dependent upon increased business investment and not consumer spending.

The article is reproduced below, beginning on the next page, or you can go to this specific Blog at the following link: [Small business optimism is huge]

You can also visit Scott Grannis' Home Page for his Blog at the link below:
http://scottgrannis.blogspot.ca/

***e*Research** was established in 2000 as Canada's first equity issuer-sponsored research organization. We write on a variety of small- and mid-cap, under-covered companies. We also provide unsponsored research reports on middle and larger-sized companies, using a combination of fundamental and technical analysis. We complement our corporate research coverage with a diversified selection of informative, insightful, and thought-provoking research publications from a wide variety of investment professionals.

Bob Weir, CFA: Director of Research

Note: All of the comments, views, opinions, suggestions, recommendations, etc., contained in this Article, and which is distributed by *e*Research Corporation, are strictly those of the Author and do not necessarily reflect those of *e*Research Corporation.

Tuesday, August 14, 2018

Small Business Optimism Is Huge

Economic growth is a function of two major factors: growth in the number of people working, and growth in the output of those working (i.e., the productivity of labor).

For most of the current business cycle expansion, which has been the weakest post-war expansion on record, productivity has been unusually weak, averaging about 1% per year. Prior to the Great Recession, productivity averaged over 2% per year. Productivity and jobs growth are, in turn, a function of investment, and investment—no surprise—has been unusually weak for the past 9 years, despite the fact that corporate profits have been unusually strong. Investment is the seed corn of future growth, since investment builds new businesses, creates new jobs, and gives workers the advanced tools necessary to increase their productivity.

Something has been holding back the economy, and it might be as simple as a general unwillingness on the part of business to expand and invest in new plant and equipment. Confidence is key, and confidence has, until fairly recently, been low. Risk aversion, by the same token, has been rather high.

(Note my supply-side bias: Supply-side economists believe that investment, hard work, and risk-taking are what drive the economy, not spending. In our global economy, total spending can never exceed total production. Increased production (supply) is the key to increased spending (demand). Beware of all those economists who say the economy is weak because the consumer is not spending enough; they are not seeing the whole picture.)

If the economy is going to grow by 3% or more, productivity is going to have to increase (and maybe jobs growth, but not necessarily), and that means that investment is going to have to increase. Increased investment is likely to follow from lower corporate tax rates, and from increased confidence and an increased willingness to take risk. Thanks to the bulk of Trump's policies, we have the essential ingredients for a stronger economy: lower tax rates on business and business investment, reduced regulatory burdens, and a more business-friendly climate in Washington. There are early indications that the economy is picking up steam (e.g., business investment is up in the past 18 months, and real yields are up), but it is still premature to declare victory.

Here are two charts which are particularly impressive in this regard, since they document a pronounced and sustained increase in small business optimism and hiring intentions—an increase that dates to December 2016, just days after Trump was elected. Small businesses generate the vast majority of new jobs, and they are a vital source of innovation and productivity.

These charts argue convincingly for a stronger economy in the months and years to come, thanks to increased business optimism and investment. (Both charts reflect survey results as of July 18, released today.)

Chart #1

Chart #2

Unfortunately, things are never so straightforward. While we undoubtedly have the essential ingredients in place for a significant pickup in economic growth, we also have—from the same pro-growth Trump who advocated for lower tax and regulatory burdens—an escalation of tariffs, which suppress growth by making imports more expensive for everyone.

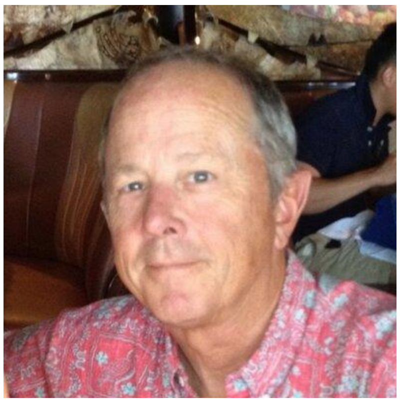
I think Trump's ultimate objective is to reduce tariff barriers. I think he sees higher tariffs as a negotiating tool to arrive eventually at a reduced and even zero-tariff world. But, for his negotiations to succeed, he has to convince our trading partners (particularly China) that he is willing to sacrifice some portion of U.S. growth to achieve a result that would eventually be a win-win for all concerned.

Suffice to say that this is a delicate balancing act. I am optimistic he will succeed, but my confidence in that belief is not as strong as I would like it to be.

In short, Trump's tariffs are, for the time being, a headwind to growth, while his other policies are a tailwind.

BW: See ABOUT THE AUTHOR on the following page.

ABOUT THE AUTHOR



Scott Grannis was Chief Economist from 1979-2007 at Western Asset Management, a Pasadena-based, global manager of fixed-income portfolios for institutional clients.

He now enjoys keeping up on economics, markets, and politics from his condo overlooking Calafia Beach on the southern California coast, where he likes to think that he is immune to Wall Street group-think.

Married for 45 years to his Argentine wife, Norma, he has four children and five grandchildren (four boys and one girl).

He is a believer in supply-side economic theory, as practiced by his mentors, the late Jude Wanniski, Art Laffer, and Larry Kudlow. John Rutledge is another of his mentors, from the days that they worked together at Claremont Economics Institute.

#####