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Small Change

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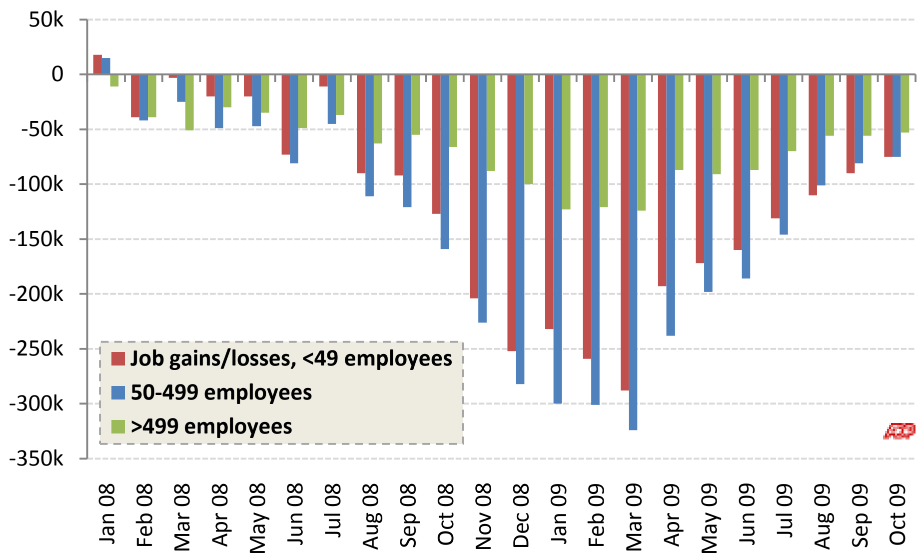
The economy can't grow without the small business sector -- and it's hardly recovering.

Update to strategic view
US MACRO: As the recession has ended, the small business sector has been the slowest to recover -- beset both by extreme risk aversion and the potential unavailability of credit due to CRE exposure of smaller banks. Robust overall recovery is unlikely without a turnaround at the small end.
[see Investment Strategy Dashboard]

As the economy enters at least a subdued recovery (see "On the October Jobs Report" November 6, 2009 and "On Q3 GDP" October 29), one of the more important indications that a more robust expansion is in the works will come when and if we see a revival in the small business sector. A vibrant and entrepreneurial small business economy has historically been a key driver of job creation and investment, but to date the best that can be said about the sector is that things are less bad than they were at the worst of the recession. Moreover, the outlook is clouded by deep uncertainty over the stability of regional and community banks serving the small business community.

The halting course to small business recovery can be seen in the job market. According to



private sector employment data gathered by ADP, in August and September, after the apparent end of recession, companies with fewer than 50 employees eliminated more jobs (110,000 and 90,000 respectively) than medium-sized or large (those with more than 500 workers) employers . Prior to August, that had never happened since ADP began tracking the data in 2001 (see the chart at left). Last month, small business payrolls fell by

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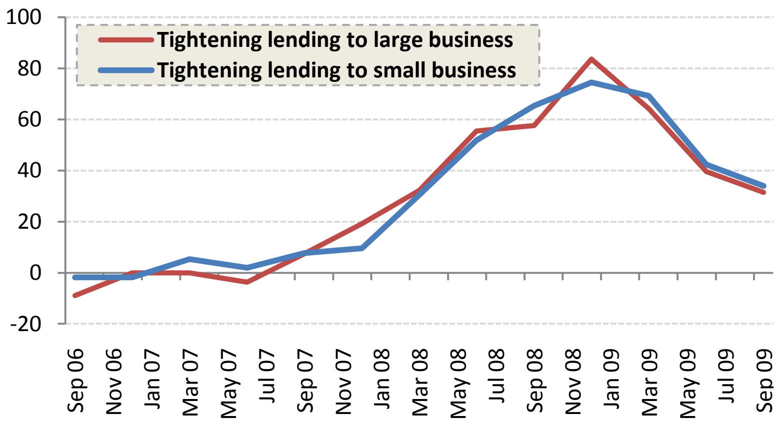
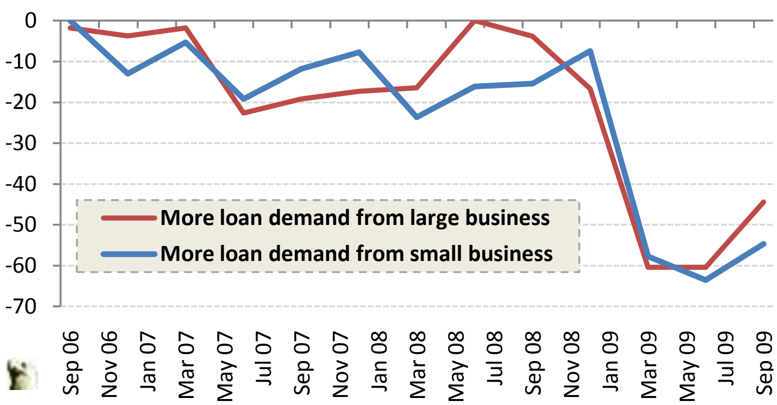
75,000, the same as at medium-sized firms. That was the slowest rate of job elimination among small firms since August 2008, but still, small firms have made up the largest portion of job losses since the recession ended last spring. Small firms have little confidence about the outlook. According to a survey by the National Federation of Independent Business last month, 9% of small business owners think this is a good time to expand. That was up 4% from August, but only 8% said they expect business conditions to improve over the next six months. Those planning to make capital expenditures in the next few months rose by 2% last month to 18%, off a 35-year low the previous month.





Lending by small banks has fallen only moderately, about 2%, since September 2008. The NFIB characterizes this as primarily a matter of weak loan demand due to widespread postponement of investment in inventories and capital projects. The Fed's most recent senior loan officer survey in July found that about 35% of banks tightened standards on loans to small firms, down from more than 40% in April and 70% in January. About 55% of respondents indicated weaker loan demand from small firms, down from 65% in April.

But the question arises: if the current small business credit environment is primarily characterized by weak demand, what happens when loan demand revives as the economic recovery becomes more firmly established? Will banks have the capacity to expand lending? The pressure bearing down on smaller bank balance sheets due to their commercial real estate exposure is palpable. As we reported several months ago, the 19 "systemically critical" institutions covered by the Fed's stress test were not considered at risk due to their CRE exposure (see "Signs of Life in the CMBS Rubble" August 20, 2009). Not so in the smaller bank universe. "Prices of existing commercial properties have declined substantially from the peak in 2007 and will likely decline further," Jon Greenlee, associate director of the Fed's Division of Banking Supervision and Regulation, said in House testimony last week. "As job losses have accelerated, demand for commercial property has declined and vacancy rates have increased." As a result, he said, Fed examiners "are reporting a sharp deterioration in the credit performance of loans in banks' portfolios." In addition to losses caused by declining cash flows, losses will also be boosted by the falling collateral values underlying the loans. "The losses will place continued pressure on banks' earnings, especially those of smaller regional and community banks that have high concentrations of CRE loans," Greenlee said. The FDIC has already shuttered more than 100 banks this year primarily due to their CRE exposure, and many more can be expected.

As if things were not difficult enough for the small business community, it also must face the prospect of health care "reform" which would impose new mandates, penalties and taxes on entrepreneurs. The House bill passed over the weekend includes a 5.4% surtax on adjusted gross incomes above $500,000 (see "Health Care Deform" July 16, 2009). Some 75% of small business proprietors pay taxes at the individual rate. The Congressional Joint Committee on Taxation estimates that one third of the $460.5 billion that would be raised by the tax would come from "business income," which as they define it, should be understood as primarily the income of small businesses. But that's a low-ball estimate, because the JCT analysis explicitly excludes business income arising from dividends and capital gains -- which would both be subject to the surtax, imposing a further penalty on entrepreneurial risk-taking. The penalty is all the greater in what we anticipate will be an inflationary environment, considering that the capgains tax is not indexed for inflation. Fortunately, at this point, the prospects for Senate action are highly uncertain. And the Senate legislation, though it would create burdens of its own, is significantly less interventionist than the House bill. Should a measure pass the upper chamber, reconciling the two in conference committee will be highly challenging.

BOTTOM LINE: As the recession has ended, the small business sector has been the slowest to recover -- beset both by extreme risk aversion and the potential unavailability of credit due to CRE exposure of smaller banks. Robust overall recovery is unlikely without a turnaround at the small end.