Powell's Next Victim

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We've made the case all year long that the Fed was primarily watching the labor market as a critical inflation indicator. Labor has been tight since 2020 for a variety of reasons. Boston University research shows over 1,179,000 excess deaths occurred between March 2020 and February 2022 as a direct result of COVID and COVID lockdowns. Further, U.S. net migration trends have just finally returned to 2020 peak levels, a trend that has choked labor supply, especially in the services industry, the past three years. The third factor affecting labor was early retirees during 2020 and 2021 that saw their 401(K) balances increase 40% in less than 18 months. These factors combined have led to record low unemployment of 3.5% and a labor force participation rate nearly 1% lower than it was in 2020.

Low supply of labor has led to record high employment costs which is why AI is such a hot topic. Compensation costs for employers are up 4.6% since last year. At the same time, real median earnings are only up 1.7%. Simply put, employers are feeling the pain of hiring costs, while workers are feeling far worse pain keeping up with inflation. The question for the next election will be – "Are you better off today than you were four years ago?" For many Americans the answer will be no.

As we've pointed out in Weekly Insights before, the small guy gets hit the worst during high inflation, high tax and high regulatory environments. We think Powell's next victim and the next economic breaking point before rates plateau or come down, will be small business. We've long cautioned against owning small cap stocks that are facing three core threats to their long-term profitability.

Threat #1: High interest rates – large companies that are well capitalized have enough cash to pay down existing debt and finance new projects without taking on loans at 10+ interest rates. Small companies don't have the same luxury because they usually have lower credit ratings that require higher interest payments to bond holders. Further, many expansion projects for capital intensive businesses become unwise when risk free rates are 5.5%. For example, Apple has $60 billion, Tesla has $23 billion, Berkshire Hathway has $164 billion, Microsoft has $111 billion, and Nvidia has $15 billion in cash that operates as a war chest during bad times. For some perspective, Berkshire Hathaway has more cash on its balance sheet than T-Mobile, Disney, Wells Fargo, Nike, UPS, Intel, Morgan Stanley, Caterpillar, Verizon, ConocoPhillips, or Boeing is worth! Publicly traded small caps will have a tough time competing with the sheer balance sheet size of these massive multi-national companies without significant technological investment.

Threat #2: Regional bank crisis – small cap companies primarily work with regional banks to finance projects. Not only are they waking up to significantly higher rates than 2020 and 2021, but worse, a complete lack of available financing. That's why many small companies are pressing the brakes on growth. At a time where producing sustainable growth is important, revenues are likely to decline at the same time costs are going up.

Threat #3: Regulation – we all agree a certain level of red tape is important for maintaining the rule of law, however too much regulation hinders small business formation, a key competitive force for driving down cost. The Trump administration cut regulation by 25%, similar to Clinton and Reagan's cuts. The Bush & Obama administrations increased them by 33%. When you talk with CEOs and small business owners, they don't mind regulation – what they want though, is one set of rules, not 5. Large companies can afford teams of lawyers to stay compliant while small business ultimately pays the price for an ever-expanding Federal Government.

The easiest lever for small caps to pull during these times is labor. We expect more layoffs the rest of the year that will drive loan balances higher and spending lower. Thankfully, there are still plenty of unfilled jobs. Even if that number drops to 2020 rock-bottom levels, we have 4.7 million positions available for workers (today's number is 9.8 million). In the short run we still expect some volatility and at least a 10% correction, but in the long run we are bullish on large cap stocks. S&P 500 Index earnings estimates for 2025 are now $277 which would place the market around 5,000-5,300 points by year-end 2024.

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