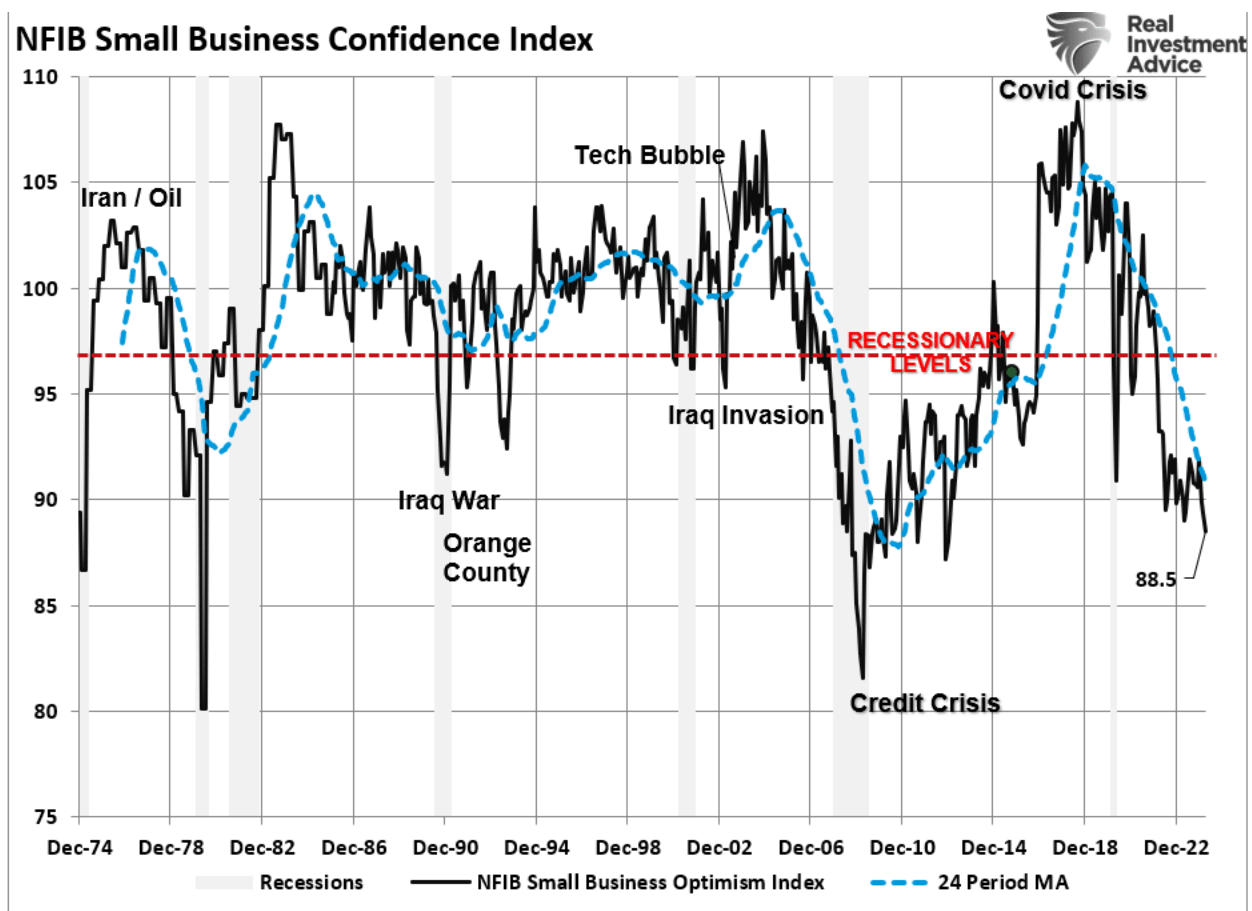


The latest National Federation of Independent Business (NFIB) survey was an economic warning that departed widely from more robust governmental reports. In [a recent analysis](#) of small businesses, we discussed the importance those business owners play in the economy.

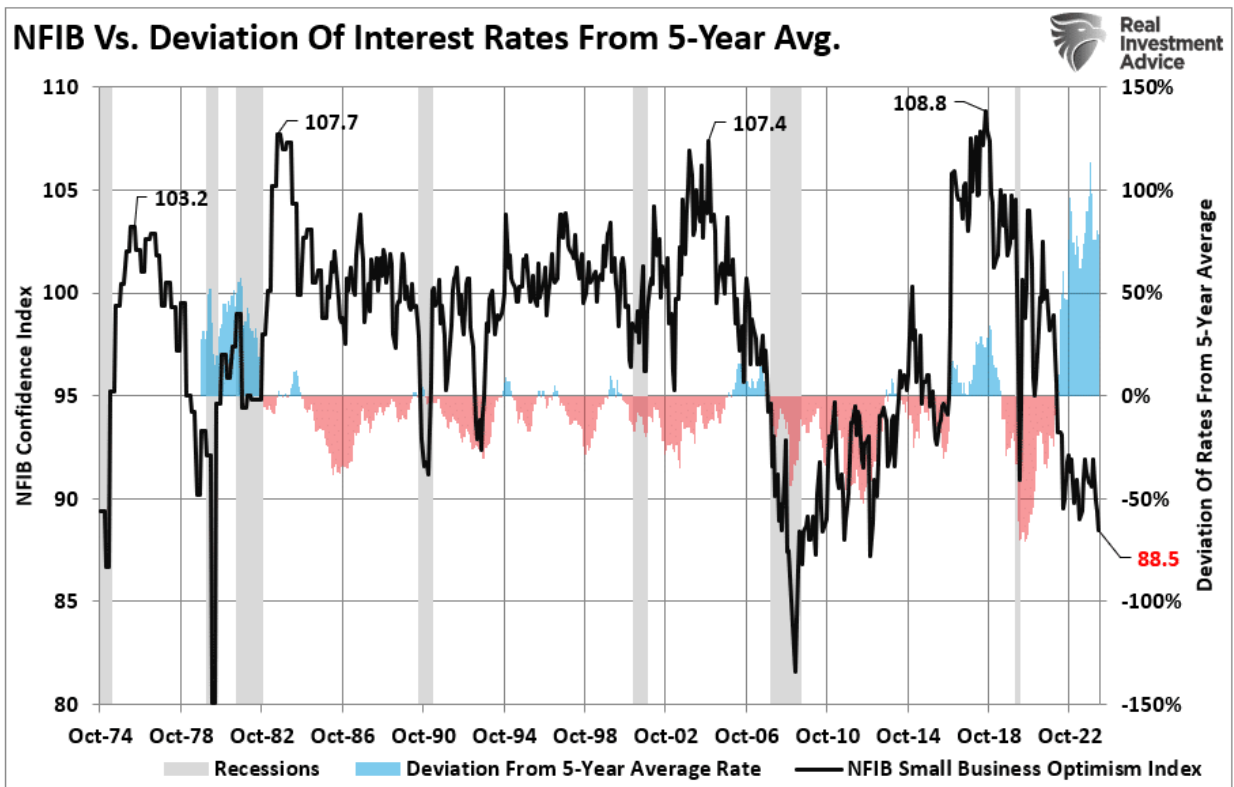
*"It is crucial to understand that small and mid-sized businesses comprise a substantial percentage of the U.S. economy. **Roughly 60% of all companies in the U.S. have less than ten employees.***

***Small businesses drive the economy, employment, and wages. Therefore, the NFIB's statements are highly relevant to the economy's current state** compared to the headline economic data from Government sources."*

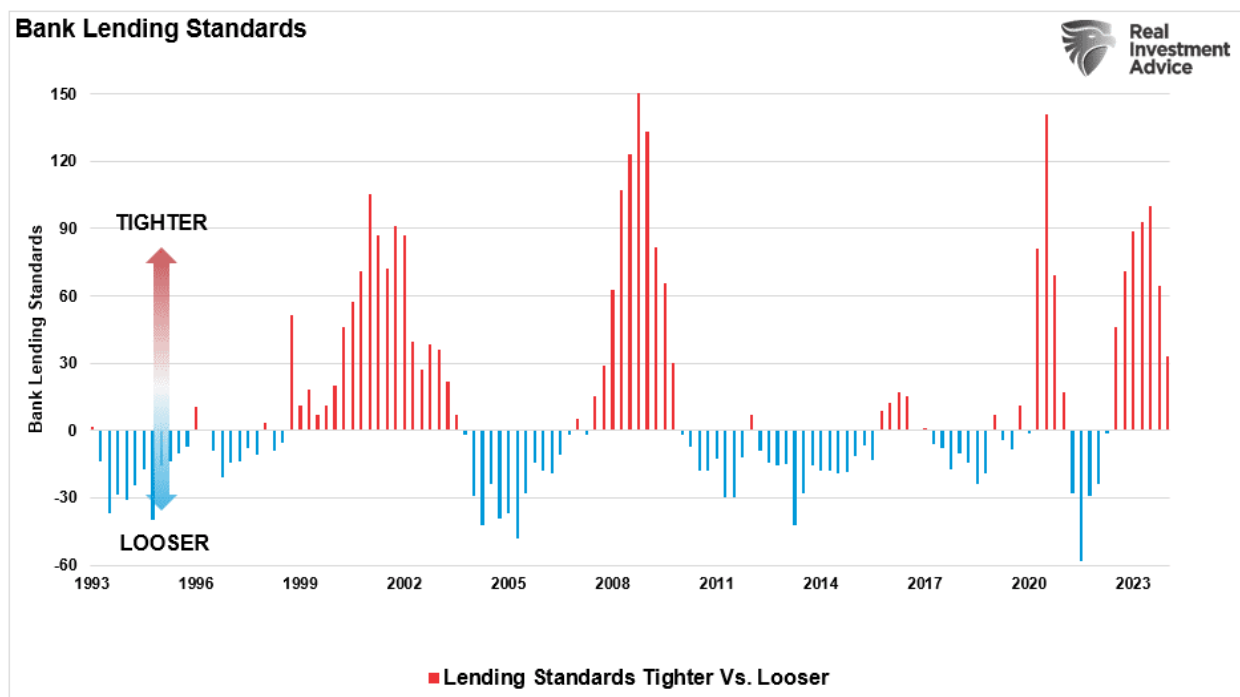
While recent government data on economic growth and employment remain robust, the NFIB small business confidence survey declined in its latest reading. Not only did it fall to the lowest level in 11 years, but, as far as an economic warning goes, it remained at levels historically associated with a recessionary economy.



The decline in confidence should be unsurprising given the largest deviation of interest rates from their 5-year average since 1975. Higher borrowing costs impede business growth for small businesses, as they don't have access to the bond market like major companies.



Therefore, as the economy slows and interest rates rise, small business owners turn to their local banks for operating loans. However, higher rates and tighter lending standards make access to capital more difficult.



Of course, given that capital is the lifeblood of any business, decisions on hiring, capital expenditures, and expansion hang in the balance.

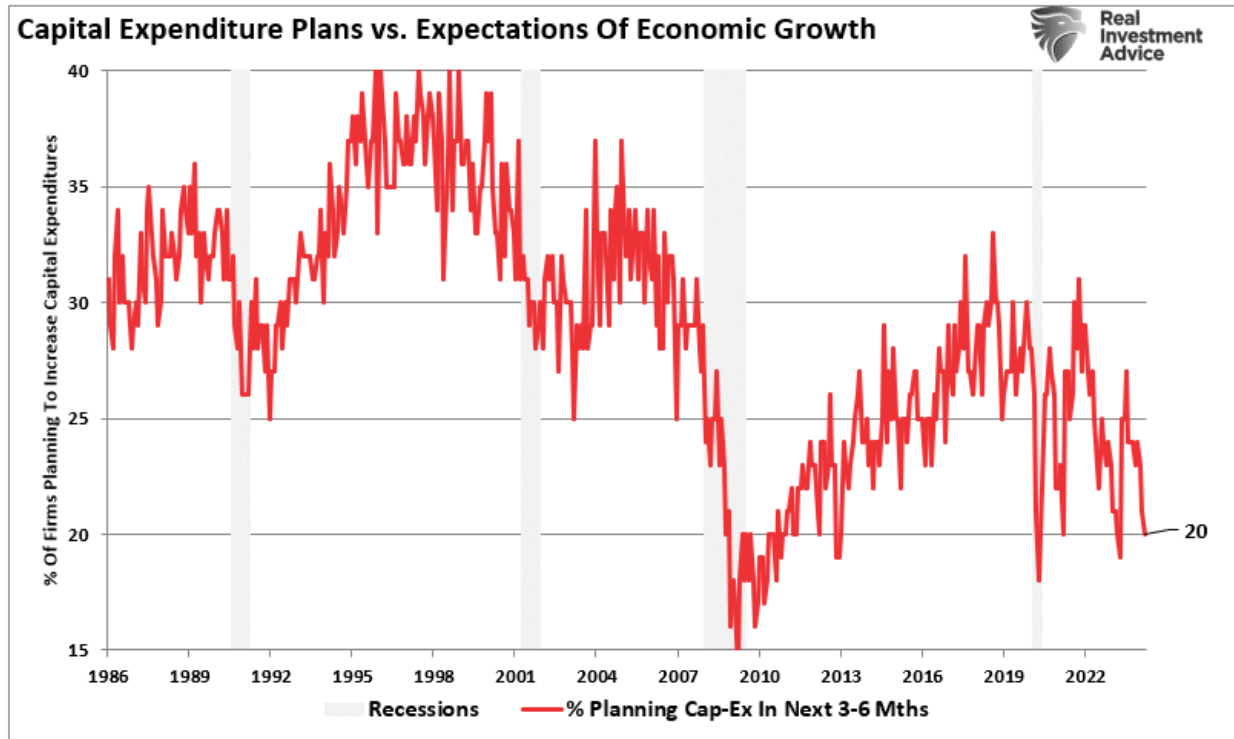


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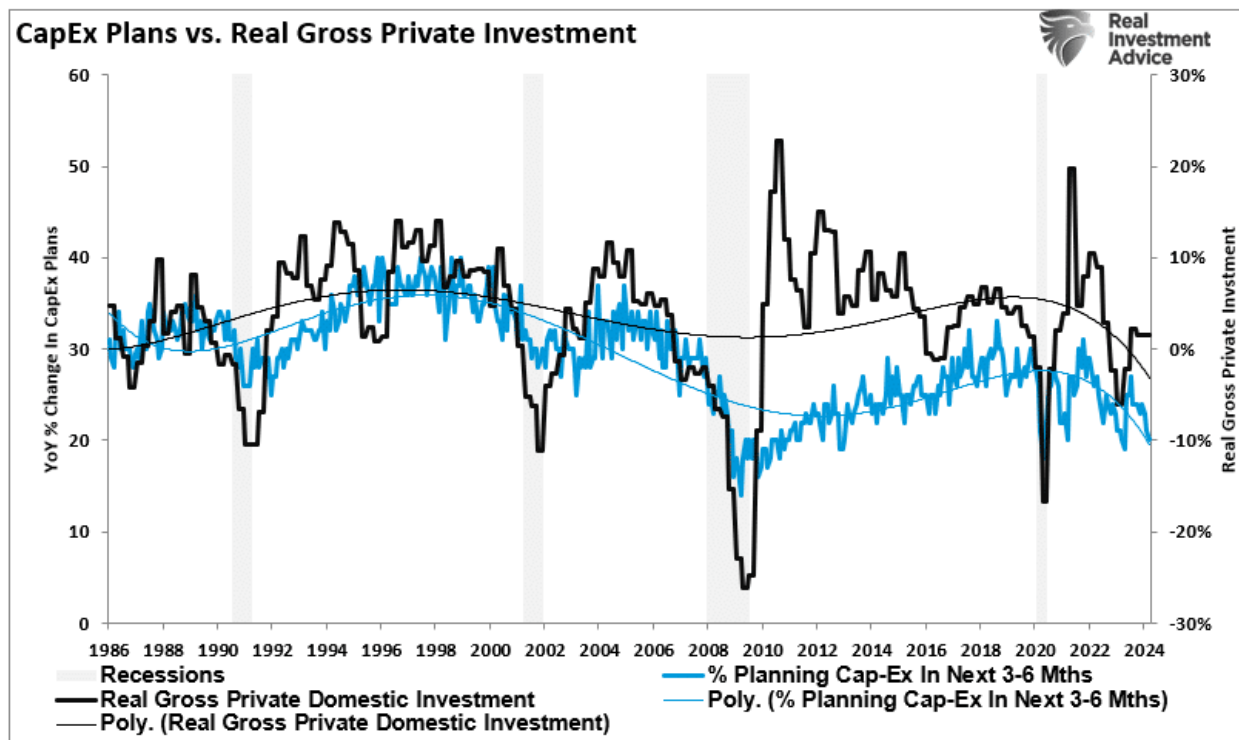
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Economic Warning - Capital Expenditures

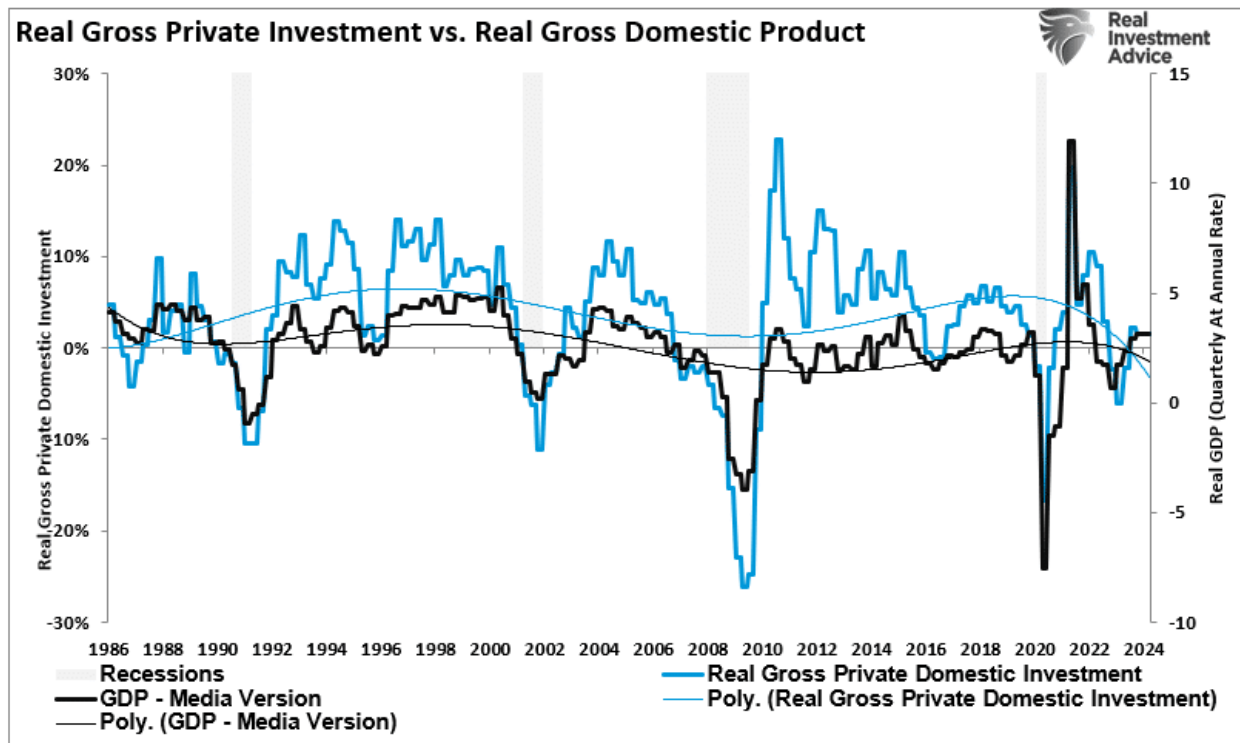
It should be unsurprising that if the economy were expanding as quickly as headline data suggests, business owners would be expending capital to increase capacity to meet rising demand. However, in the most recent NFIB report, the percentage of business owners planning capital expenditures over the 3-6 months dropped to the lowest level since the pandemic-driven shutdown.



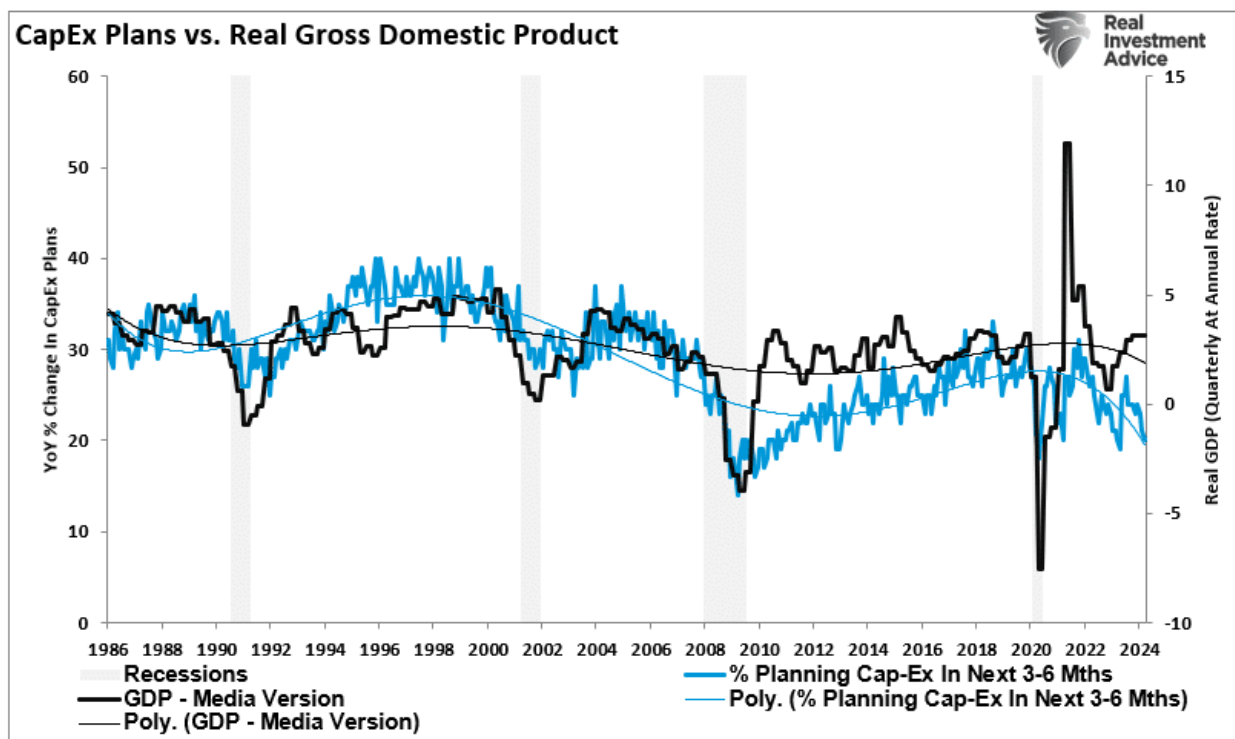
Again, given that small businesses comprise about 50% of the economy, there is more than just a casual relationship between their capital expenditure plans (CapEx) and real gross private investment, which is part of the GDP equation.



In other words, if small businesses cut back on CapEx, this will eventually translate into slower rates of private investment and, ultimately, economic growth in coming quarters.



As shown, the correlation between small business CapEx plans and economic growth should not be dismissed. While mainstream economists are becoming increasingly optimistic about an ["economic reflation,"](#) the economic warning between real GDP and CapEx suggests caution.



Of course, if small businesses are unwilling to increase CapEx, it is because there is a lack of demand to justify those expenditures. Therefore, if CapEx is falling, we should expect economic warnings from employment and sales.

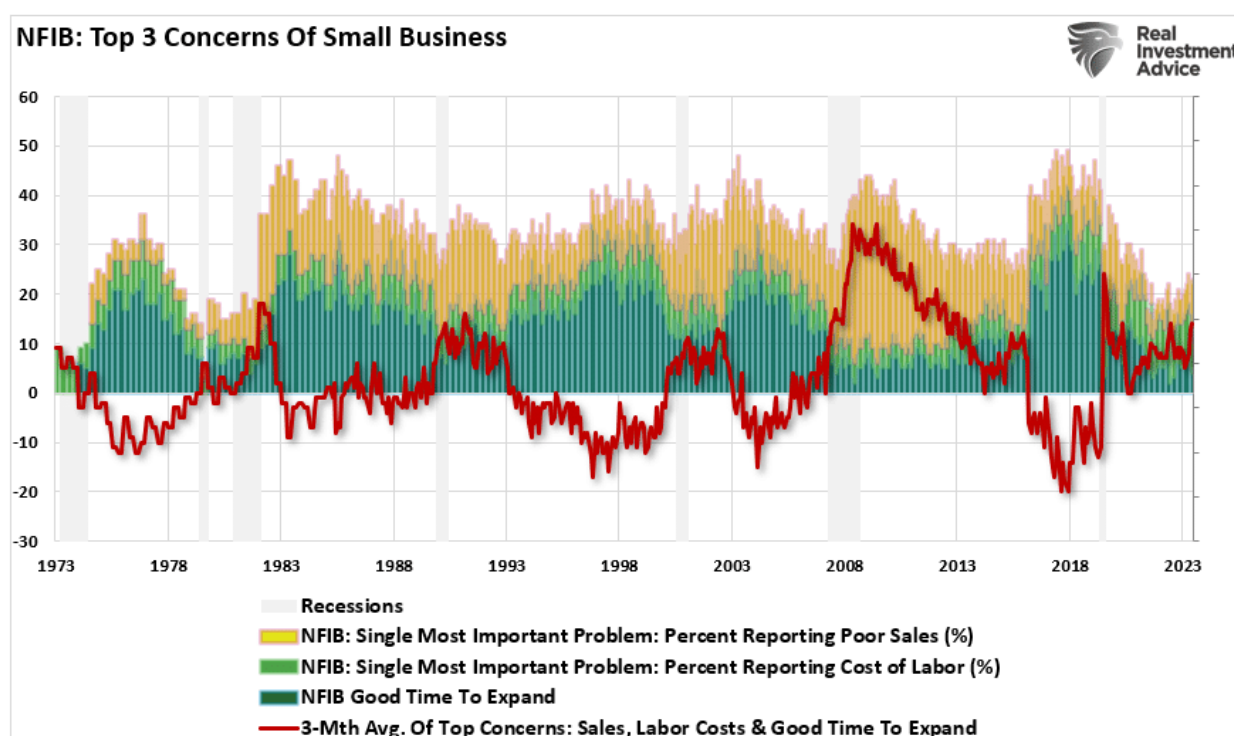
Something Amiss With Sales

Many reasons feed into a small business owner's decision NOT to invest in their business. As noted above, tighter bank lending standards and increased borrowing costs certainly weigh on that decision. However, if *"business is booming,"* business owners will find the capital needed to meet increased demand. However, looking deeper into the NFIB data, we find rising concerns about the *"demand"* side of the equation.

The NFIB publishes several data points from the survey concerning the *"concerns"* small business owners have. These cover many concerns, from government regulations to taxes, labor costs, sales, and other concerns confronting business owners. When it comes to the *"demand"* side of the equation, there are three crucial categories:

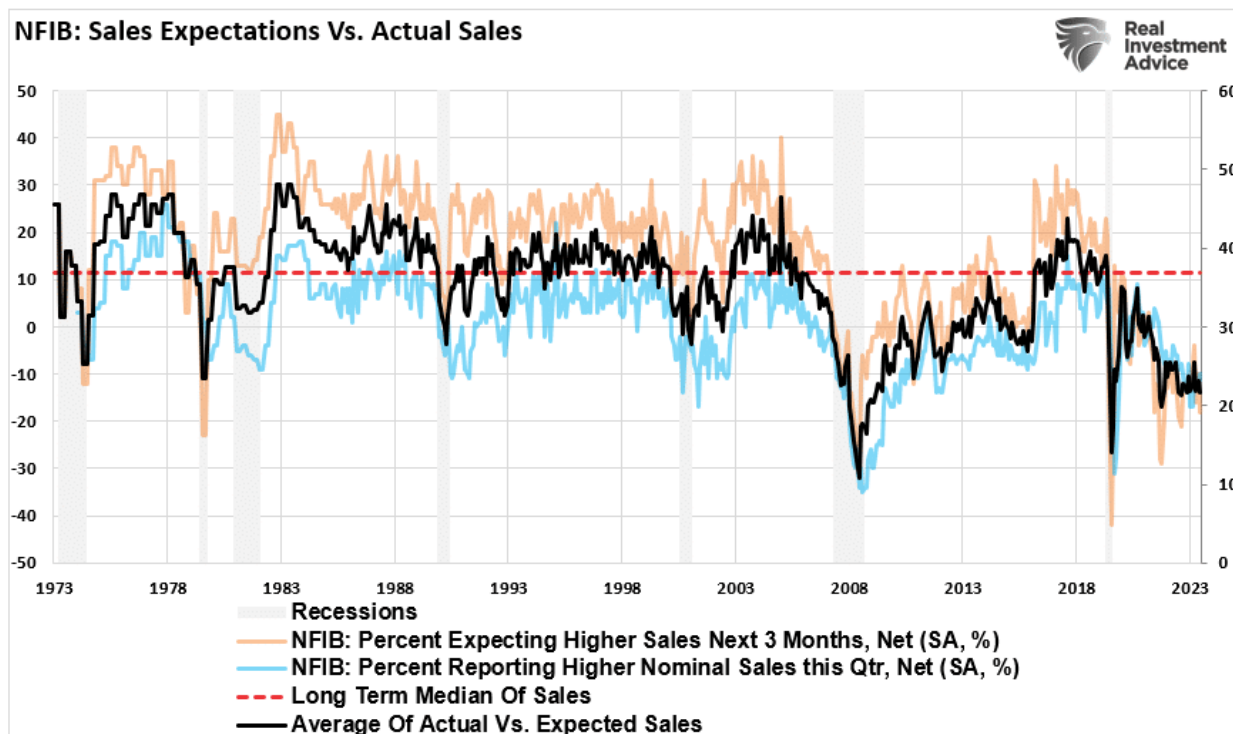
1. *Poor sales (demand),*
2. *Cost of labor (the most significant expense to any business), and*
3. *Is it a "Good time to expand?" (Capex)*

In the chart below, I have inverted *"Good time to expand,"* so it correlates with rising concerns about the cost of labor and poor sales. What should be obvious is that the average of these concerns escalates as economic growth weakens (*recessionary periods*) and falls during economic recoveries. Currently, these rising concerns should provide an economic warning to economists.

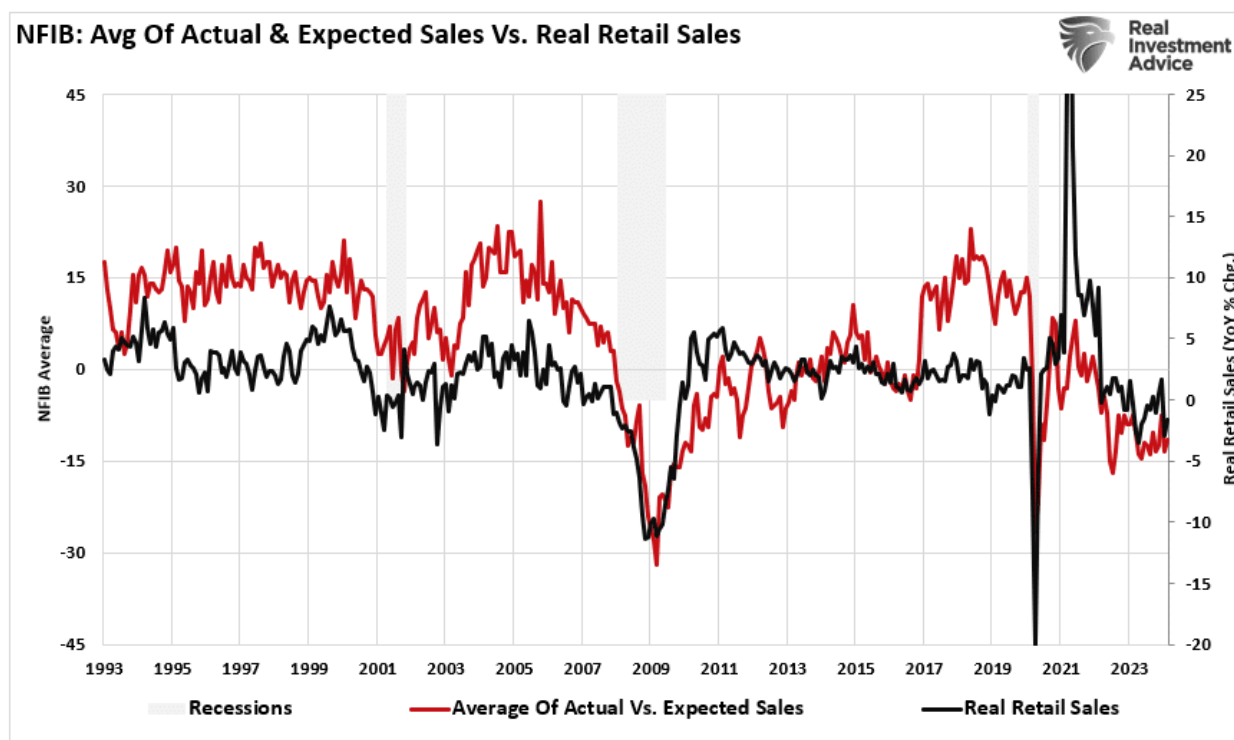


Examining sales and employment figures can help us understand why business owners remain pessimistic about the overall economy. The chart below shows the NFIB members' sales expectations over the next quarter compared to the previous quarter. The black line is the average of both with a long-term median.

Unsurprisingly, business owners are always optimistic that sales will improve in the next quarter. However, actual sales tend to fall short of those expectations. The two have a very high correlation, which is why the average of both provides valuable information. Sales expectations and actual sales are well below levels typically witnessed during recessions. With sales (*demand*) weak, there is little need to increase production (*supply*) substantially.

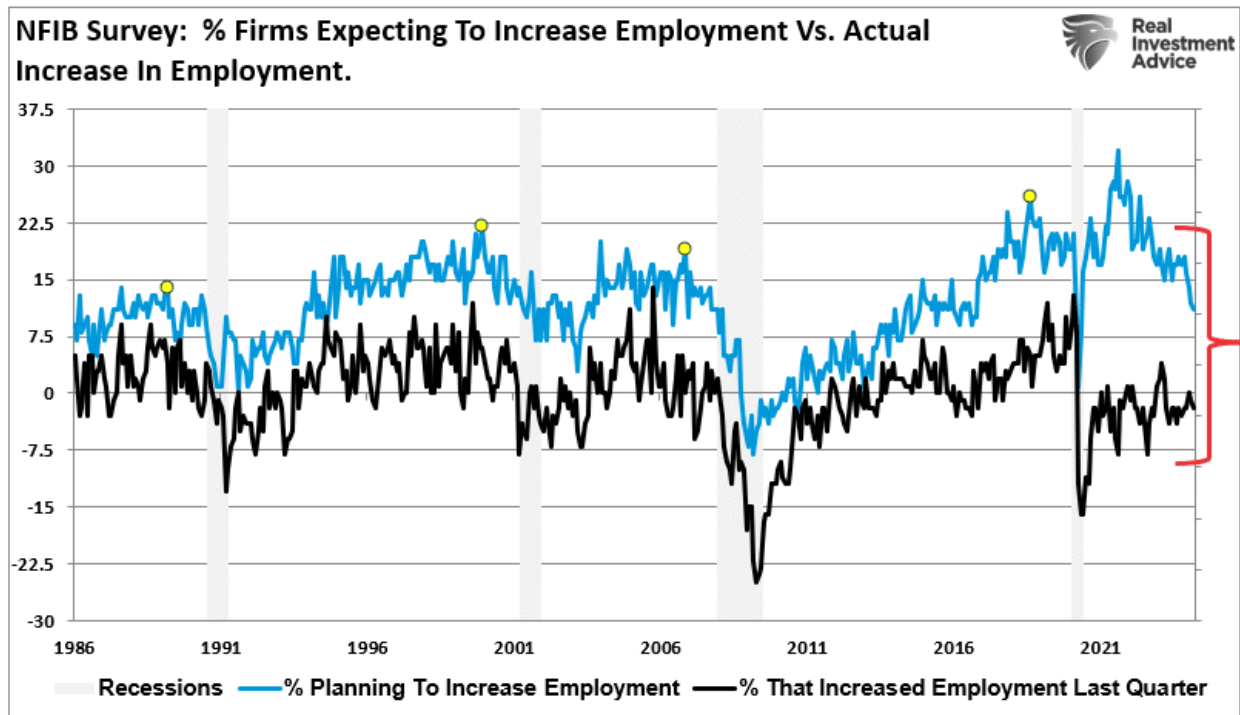


Here is the economic warning to pay attention to. Real retail sales comprise about 40% of personal consumption expenditures (PCE), roughly 70% of the economic growth rate. The decline in the average of actual and expected sales of small businesses suggests weaker retail sales and, by extension, a slower economic growth rate.

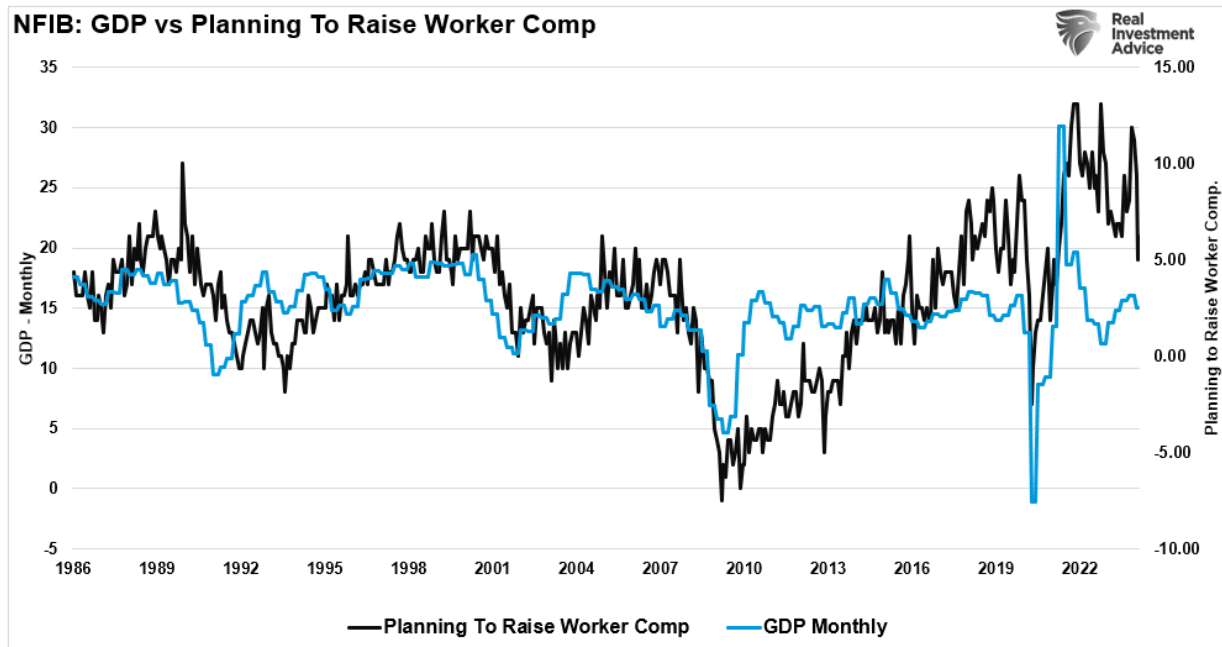


Employment Warning

The demand side of the economic equation is crucially important. If the demand for a business owner's products or services declines, there is little need to increase employment. Therefore, if economic growth was as robust as headlines suggest, why are small businesses' plans to increase employment declining sharply?



Furthermore, when demand falls, business owners look to cut operating costs to protect profitability. While cutting future employment is part of that equation, so are plans to raise worker compensation.



The last chart is crucial. The U.S. is a consumption-based economy. However, consumers can not consume without producing something first. Production must come first to generate the income needed for that consumption. The cycle is displayed below.



As employees receive fewer compensation increases (*raises, bonuses, etc.*) amid rising living costs, they cut consumption, which translates into slower economic growth rates. In turn, business owners cut employment and compensation further. It is a virtual spiral that historically ends in recession.

While this time could certainly be different, the economic warnings from the NFIB survey should not be dismissed. The data could explain why the Fed is adamant about cutting rates.