

A Snapshot of Small Business Enthusiasm: Part 1

Michael Taylor, CFA

Investment Strategy Analyst

Ken Johnson, CFA

Investment Strategy Analyst

Key Takeaways

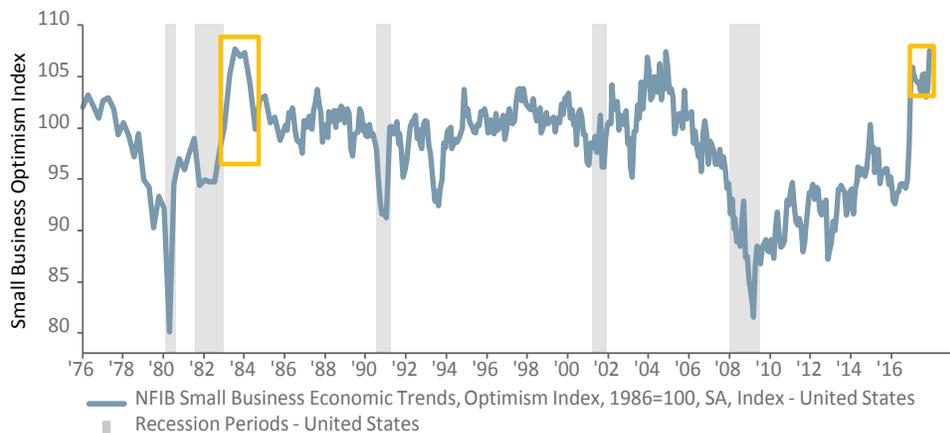
- » *Small business optimism in the U.S. is near record highs. This is important for investors as small-business vitality is a critical component of domestic economic growth; more than 99% of all U.S. firms are small businesses.*
- » *Yet, there are some genuine concerns that small businesses face. The recently passed Tax Cuts and Jobs Act should help alleviate some concerns about taxes.*

What it may mean for investors

- » *The Trump tax plan should bode well for small business owners as it lowers effective tax rates and increases pass-through deductions.*

In the past year, optimism among U.S. small business owners has soared. This is important, because small businesses often are considered the backbone of the U.S. economy. A recent study from the Small Business Administration (SBA) found that small businesses (with fewer than 500 employees) make up 45% of U.S. gross domestic product (GDP). Furthermore, the study showed that more than 99% of all U.S. firms are small businesses, so small business vitality is a critical component of economic growth and key to extending the current recovery. Yet, alongside the renewed enthusiasm of small business owners, they also face some concerns. In the first installment of our series on the state of U.S. small businesses, we discuss the optimism among small business owners and how the recently passed Tax Cuts and Jobs Acts should support small business optimism and growth going forward.

Chart 1. NFIB Small Business Optimism Index



Source: Bloomberg, December 23, 2017. NFIB = National Federation of Independent Business. SA= seasonally adjusted.

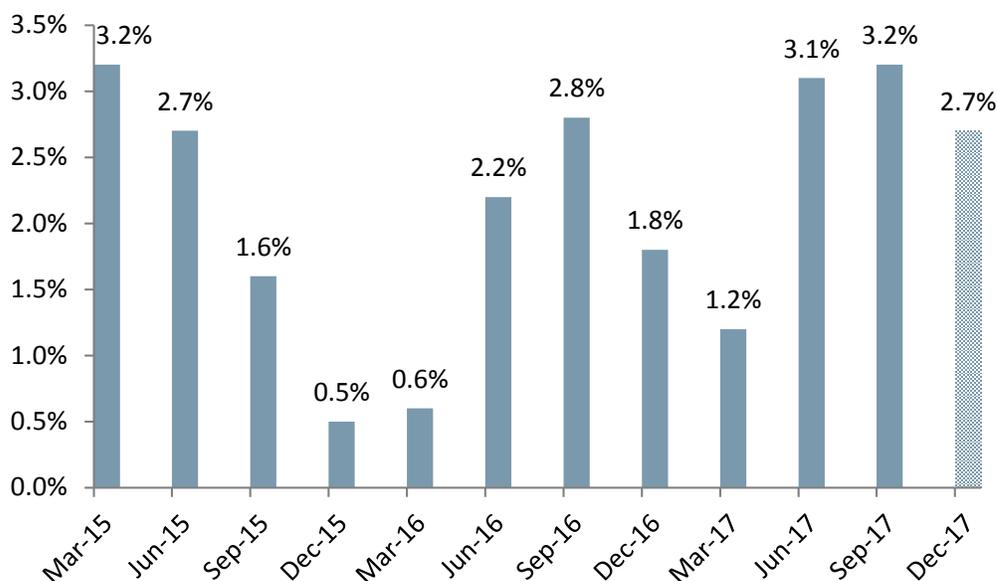
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A revival of small business optimism

The National Federation of Independent Business (NFIB) Small Business Optimism Index recently reached the second strongest level in its history. This index is a gauge of how small business owners feel about the economy and the outlook for their firms. When optimism is robust—as it is currently—owners feel better about investing in their businesses and are willing to take on more risk through hiring more workers or making capital outlays. Fiscal policies and political promises have had a notable influence on this recent surge in business confidence.

Part of this jump in optimism comes as a result of the U.S. presidential election last year, which led to hopes of deregulation, infrastructure spending, and tax reform. Yet, it would be inaccurate to suggest that the exuberance among small business owners is entirely a product of Washington D.C. Upbeat economic and market data should not be overlooked as another important factor contributing to this confidence. For instance, the U.S. GDP report for the third quarter surpassed analyst expectations by coming in with an annualized growth rate of 3.3%.

Chart 2. Annualized U.S. GDP growth (quarter-over-quarter)



Source: Bloomberg, December 19, 2017. December 2017 bar represents a consensus of survey respondents' estimates for fourth-quarter GDP growth of 2.7% (as reported by Bloomberg).

Additionally, U.S. corporate profits rose by \$90.2 billion in the third quarter, compared with an increase of \$14.4 billion in the second quarter. The third-quarter profit level represented roughly 9% of total domestic GDP.

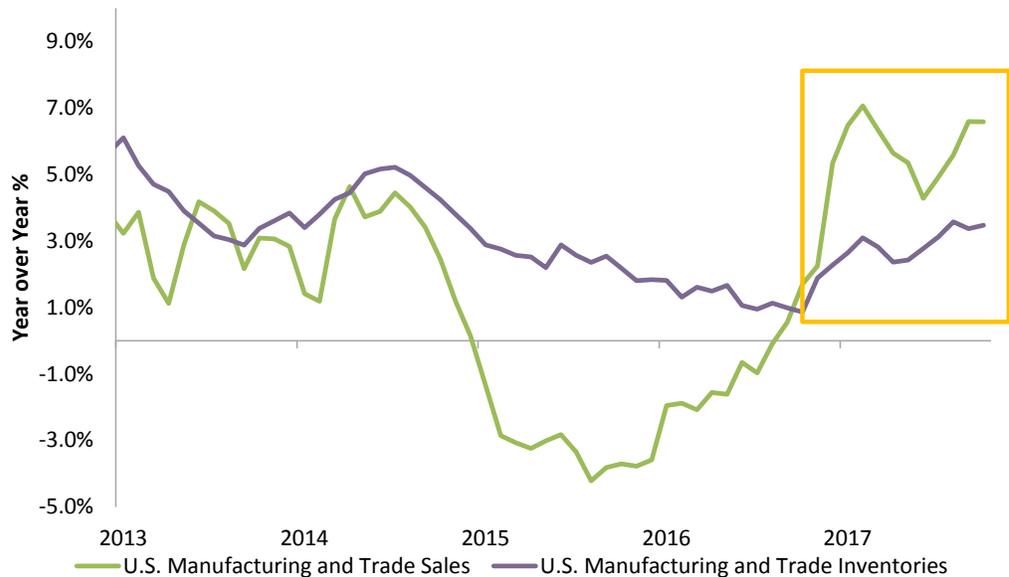
Chart 3. U.S. corporate profits as a percent of GDP



Source: Bloomberg, December 19, 2017.

Taken together, better-than-expected GDP growth, rising earnings, and a resilient labor market are positives for small business owners. Additionally, business sales have risen sharply over the past year, while inventories have increased only modestly. Inventory control and rising consumer demand should bode well for small business performance.

Chart 4. Ratio of U.S. business inventory to sales



Source: Bloomberg, January 2, 2018.

Addressing the concerns of small business owners

The current enthusiasm of small business owners likely stems in part from the administration’s plans to tackle some of their most pressing concerns. As Table 1 illustrates, certain concerns such as taxes and the cost of health insurance have presented more persistent challenges. The recently passed Tax Cuts and Jobs Act should address some of the concerns small business owners have about taxes. Below, we discuss how the tax reforms should be a positive for small business owners. (Note: We will address other issues such as the cost of health insurance in our next report in the series.)

Table 1. Top five issues for small business owners from 1982-2016

2016 (Jan/April)	2012 (Jan/April)	2008 (Jan/Mar)	2004 (Jan/Feb)	2000 (Feb/Mar)	1996 (May/June)	1991 (Oct/Nov)	1986 (Jan)	1982 (Nov)
Cost of Health Insurance	Cost of Health Insurance	Cost of Health Insurance	Cost of Health Insurance	Cost of Health Insurance	Cost of Health Insurance	Cost of Health Insurance	Cost of Health Insurance	Interest Rates
Unreasonable Government Regulations	Uncertainty over Economic Conditions	Cost of Natural Gas, Propane, Gasoline, Diesel, Fuel Oil	Cost and Availability of Liability Insurance	Federal Taxes on Business Income	Federal Taxes on Business Income	Federal Taxes on Business Income	Cost and Availability of Liability Insurance	Cost of Liability Insurance
Federal Taxes on Business Income	Cost of Natural Gas, Propane, Gasoline, Diesel, Fuel Oil	Federal Taxes on Business Income	Workers' Compensation Costs	Locating Qualified Employees	Workers' Compensation Costs	Cash Flow	Cash Flow	Cost of Natural Gas, Gasoline, Fuel Oil
Uncertainty over Economic Conditions	Uncertainty over Government Actions	Property Taxes (Real, Inventory, or Personal Property)	Cost of Natural Gas, Propane, Gasoline, Diesel, Fuel Oil	Unreasonable Government Regulations	Unreasonable Government Regulations	Workers' Compensation Costs	Federal Taxes on Business Income	Telephone Rates (Costs)
Tax Complexity	Unreasonable Government Regulations	Tax Complexity	Federal Taxes on Business Income	FICA (Social Security) Taxes	FICA (Social Security) Taxes	Cost and Availability of Liability Insurance	Telephone Costs and Service	Cash Flow

Source: National Federation of Independent Business, Small Business Problems and Priorities, August 2016.

President Trump’s Tax Reforms Should Benefit Small Businesses

Taxes are an important element of any country’s economy. Clearly, from a firm’s perspective, the higher the tax rate, the lower its profitability is. Therefore, it is no surprise that when tax-policy reform leads to lower tax rates, businesses tend to benefit. Chart 1 shows that the two highest readings of small business optimism over the past 40 years came at times of major tax reform—the first during the 1980s under the Reagan-administration’s tax cuts, and the second reflecting expectations for the recent U.S. tax cuts. Congressional passage of the Trump-administration tax plan (now law) has major implications for small businesses. Tax rates paid by smaller, mainly domestic, companies exceed rates paid by their larger counterparts (on average). Smaller companies also have less to lose from limits on interest deductibility than larger firms do. They generally have lower margins than those of larger companies, so increases in the bottom line should lead to higher annualized earnings increases.

One significant change that will affect small business owners specifically is the pass-through tax deduction. Partners and shareholders of S-corporations, limited liability companies (LLCs), and partnerships pay their share of business taxes through their individual tax returns. Under the previous law, if the effective tax rate of the business owner was 39.1%, the income from the business was taxed at that same rate. The new U.S. tax law allows a 20% deduction applied to taxable income, available to all businesses owned by individuals making less than \$157,500 per year and joint filers making less than \$315,000 per year. The break is phased out above those thresholds for professional service businesses such as law or accounting firms. This modification, coupled with lower individual tax rates, is likely to have been welcome news for many small business owners following the law's passage.

Looking ahead, if implemented effectively, these tax reforms should support small business optimism and growth and result in increases in personal income and in consumers who are more confident about spending. Investors, in turn, should benefit from a growing economy, a reviving consumer, and small-business growth.

Don't miss the second installment of our series on small businesses that will cover other challenges for small businesses, including health care costs—the number one issue over the past three decades. The second installment is scheduled to be published in February.

Economic Calendar

Date	Report	Estimate	Previous
1/8/2018	Consumer Credit	\$17.750b	\$20.519b
1/9/2018	NFIB Small Business Optimism	108.3	107.5
1/9/2018	JOLTS Job Openings	--	5996
1/10/2018	MBA Mortgage Applications	--	0.70%
1/10/2018	Import Price Index MoM	0.40%	0.70%
1/10/2018	Import Price Index ex Petroleum MoM	0.10%	0.10%
1/10/2018	Import Price Index YoY	--	3.10%
1/10/2018	Export Price Index MoM	0.20%	0.50%
1/10/2018	Export Price Index YoY	--	3.10%
1/10/2018	Wholesale Inventories MoM	--	0.70%
1/10/2018	Wholesale Trade Sales MoM	--	0.70%
1/11/2018	PPI Final Demand MoM	0.20%	0.40%
1/11/2018	PPI Ex Food and Energy MoM	0.20%	0.30%
1/11/2018	PPI Ex Food, Energy, Trade MoM	0.20%	0.40%
1/11/2018	PPI Final Demand YoY	3.00%	3.10%
1/11/2018	PPI Ex Food and Energy YoY	2.50%	2.40%
1/11/2018	PPI Ex Food, Energy, Trade YoY	--	2.40%
1/11/2018	Initial Jobless Claims	248k	250k
1/11/2018	Continuing Claims	--	1914k
1/11/2018	Revisions: Philadelphia Fed Manufacturing Index		
1/11/2018	Bloomberg Jan. United States Economic Survey		
1/11/2018	Bloomberg Consumer Comfort	--	51.8
1/11/2018	Monthly Budget Statement	-\$49.0b	-\$138.5b
1/12/2018	CPI MoM	0.20%	0.40%
1/12/2018	CPI Ex Food and Energy MoM	0.20%	0.10%
1/12/2018	CPI YoY	2.10%	2.20%
1/12/2018	CPI Ex Food and Energy YoY	1.70%	1.70%
1/12/2018	CPI Index NSA	246.349	246.669
1/12/2018	CPI Core Index SA	--	253.724
1/12/2018	Retail Sales Advance MoM	0.50%	0.80%
1/12/2018	Retail Sales Ex Auto MoM	0.40%	1.00%
1/12/2018	Retail Sales Ex Auto and Gas	0.60%	0.80%
1/12/2018	Retail Sales Control Group	0.50%	0.80%
1/12/2018	Real Avg Weekly Earnings YoY	--	0.80%
1/12/2018	Real Avg Hourly Earning YoY	--	0.20%
1/12/2018	Business Inventories	0.30%	-0.10%
1/16/2018	Empire Manufacturing	--	18

Source: Bloomberg as of 1/5/18

Risk Considerations

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stock markets**, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. **Small-cap stocks** are generally more volatile, subject to greater risks and are less liquid than large company stocks.

Definitions

NFIB Small Business Optimism Index is the small business optimism index is compiled from a survey that is conducted each month by the National Federation of Independent Business (NFIB) of its members. The index is a composite of ten seasonally adjusted components based on questions on the following: plans to increase employment, plans to make capital outlays, plans to increase inventories, expect economy to improve, expect real sales higher, current inventory, current job opening, expected credit conditions, now a good time to expand, and earnings trend.

An index is unmanaged and not available for direct investment.

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