experian OXFORD ECONOMICS

# MAIN STREET REPORT

Your window into small business health

Q4 2022

# MAIN STREET REPORT

# The Fed's work isn't done

## Executive summary

Consumer sentiment improved even as spending behavior softened in Q4 2022. Consumer spend has been a driver of small business financial health and growth perspective heading into 2023. The strength of the U.S. labor market created an inflation buffer for most Americans allowing the consumer to maintain discretionary spending. U.S. small business health and overall positive small business market sentiment are supported by this positive behavior leading to stable cashflow performance. The fourth quarter boasted open commercial lending markets, inclusive of all tiers of credit risk, even as measured commercial delinquencies returned to pre-pandemic levels. An increasing number of commercial lenders are developing product and underwriting strategies to limit the expected exposure in a near term recession. The Fed is unlikely to cut rates in the near term as heightened inflation lingers. Higher costs of goods and services will pressure spending behavior as affordability tightens and personal cashflows thin.

## Macroeconomic Overview

The economy grew strongly in Q4 2022, but most of the advances occurred early in the quarter, and the core of the economy was soft, meaning a repeat performance in early 2023 is unlikely. This confirms Experian and Oxford Economics' view that the economy isn't in the midst of a recession. Real GDP grew 2.9 percent annualized in Q4 2022, only a modest cooldown from the third quarter's 3.2 percent advance. Inventories and net trade boosted growth but cannot be relied on in 2023. Stripping out the volatile components, the economy ended 2022 on a soft note. Real final sales to private domestic purchasers – a better measure of underlying momentum that strips out GDP's volatile components – rose only 0.2 percent annualized.

Nonfarm payrolls spiked 517k in January, but this likely overstates the strength of the labor market. The trend in job growth has decelerated, and this is what the Fed needs to engineer a soft landing, which is achieving their 2 percent objective without pushing the economy into a recession. There have been a significant amount of layoff announcements recently, but they don't always translate into actual layoffs. Initial claims for unemployment insurance benefits remain extremely low as businesses continue to hoard labor because labor supply constraints remain binding.

The Fed is pushing back against market expectations that rate cuts are coming. The Fed needs financial market conditions to tighten; therefore, any easing doesn't sit well with them. The central bank is clearly signaling that it will err on the side of doing too much than too little to tame inflation. Risks are weighted that the Fed, hikes more than we or financial markets anticipate as the January post-meeting statement continued to reference "ongoing increases" in rates, which implies multiple additional hikes.

## U.S. Business Sector

U.S. nonfinancial business will be tested over the next year as corporate profit margins will come under pressure from rising interest rates, weaker GDP growth, elevated inflation, and solid nominal wage growth. Also, financial market conditions won't be supportive as banks look at strategies to tighten lending standards. Investment grade and high-yield corporate bond spreads need to be monitored. Still, nonfinancial corporate balance sheets are in good shape, and this will help limit the severity and duration of a near term recession.

The Q4 2022 Small Business Credit Sentiment (SBCS) Survey conveyed some warning signs regarding business credit and lending dynamics, but none were overly worrying, nor did they suggest a severe recession is on the horizon. Commercial installment originations remained south of $225,000 on average, but little has changed since early 2022. Late-stage delinquency rates have risen, but the weakness is most pronounced in the South and Northeast. Late-stage delinquency rates in the Southwest and West remain low.

With the economy softening, delinquency rates will rise as they were artificially low during the expansion because of the robust economy and significant fiscal stimulus in response to the pandemic and subsequent recession; however, we do not expect delinquencies to rise sharply.

## U.S. Consumer

The consumer will be tested, particularly if inflation remains higher than anticipated next year. A noticeable deceleration in inflation is key to supporting real disposable income, which is the key driver for real consumer spending. Experian and Oxford Economics are less concerned about the noticeable increase in household debt and its implications for consumer spending.

Calls for a weaker consumer have resounded to no avail in recent months, but the latest data offers among the first tangible signs that the economy's main engine is slowing. Looking ahead, a cooling labor market, a depleted savings cushion, and less willingness to rely on credit cards alongside a high inflation environment will cause consumers to pull back. Inflation is cooling, but we expect income gains to slow faster than consumer prices, challenging real purchasing power.

Nominal personal spending was down 0.2 percent in December on a significant drop in goods outlays that more than offset an increase in services spending. Real spending declined 0.3 percent as prices ticked higher. A downward revision to real spending in November corroborates our view that the consumer ended 2022 on a weak footing and that the handoff to Q1 2023 was weak.

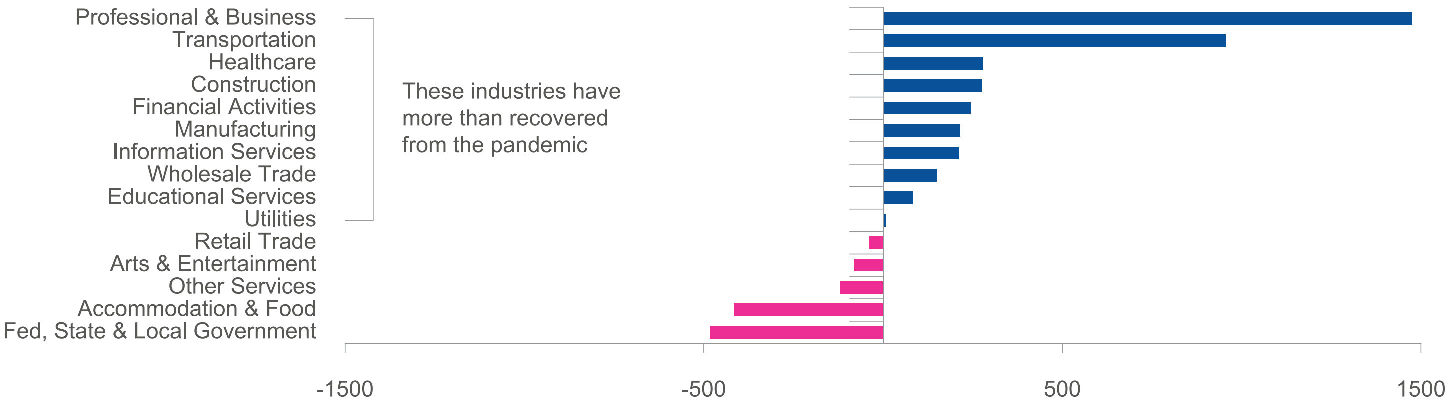
There is still $1.5 trillion in excess savings, but it is concentrated with high income households, which will treat this largely as wealth rather than cash. Therefore, a good portion of this excess savings won't be spent. Separately, there are some concerns about the increase in household debt. However, it's not the level of debt that matters for consumers; it's the monthly payments needed to finance the debt. Consumers focus on their monthly debt obligations, not the total amount of outstanding debt. Debt-service and financial obligation ratios are at their lowest since the 1980s, a testament to the strength of household finances. The strength of household finances is a key reason why a near term recession will be very mild.

## Tight labor market and rising costs

Despite the surge in job growth in January, the level of payrolls remains below the pre-pandemic employment trend. The shortfall is explained by below-trend growth in jobs in accommodation and food service and state and local government. Employment in other sectors is above the pre-covid trend.

### U.S.: Employment recovery by industry

Employment change by industry, from Feb 2020 level



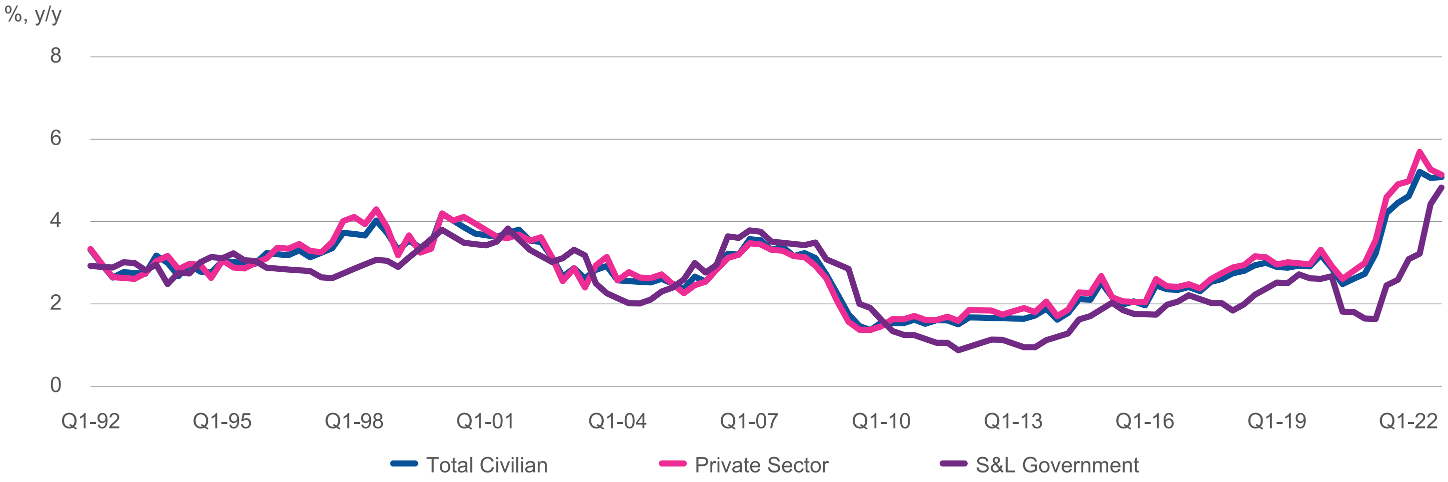

Source: Oxford Economics/Haver Analytics

The private sector added 443k jobs in January. Employment in goods-producing industries rose 46k, with solid gains in jobs in both manufacturing and construction. Manufacturing employment rose 19k, up from 12k in December, with the increase concentrated in nondurable goods; while, employment in the motor vehicle sector declined. The increase in manufacturing employment is at odds with signs of weakness in manufacturing, and we expect slower job growth and some job losses in the sector later in the year. Construction employment rose 25k, down slightly from December's 26k gain, mostly in nonresidential construction.

The Employment Cost Index (ECI), which measures changes in total compensation costs for businesses, increased less than either we or the consensus anticipated in Q4 2022 and allows the Federal Reserve to raise the target range for the fed funds rate by an additional 50 basis points going forward before pausing.

The strength of the labor market and nominal wage growth is a thorn in the Fed's side. The ECI was up 1 percent in Q4 2022 following a 1.2 percent gain in the prior three months. This is the sixth consecutive quarter that the ECI increased by at least 1 percent. Wages and salaries also rose 1 percent in Q4 but this is a deceleration from the 1.3 percent gain in Q3.

## U.S.: Employment cost index, annual wage growth




Source: Oxford Economics/Haver Analytics

Though the labor market is tight, there are clear signs that wage pressures are moderating. For example, the ECI for private workers excluding incentive paid was up 5.2 percent y/y in Q4, which is still higher than that seen before the pandemic, but it was recently running around 5.6 percent. Overall, wage inflation remains well above the Fed's goal.

## Housing correction

The housing market is critical to small business formations as many small businesses use their homes as collateral for loans; therefore, the weakness in the housing market is in focus. The good news is that we are not highly concerned about a significant correction in house prices. We anticipate that a limited supply of housing inventory will prevent a sharp fall in house prices. The ratio of existing homes for sale relative to actual sales of existing homes (85 percent of total home sales) was only 2.9 months in December 2022 – roughly half the six months that historically have signaled a balanced market. Separate data from the NAR show that a rise in active home listings has been driven solely by homes sitting on the market for longer. New listings continue to decline as sellers have primarily retreated to the sidelines.

The stock of housing supply for sale has remained very low as potential sellers currently have little incentive to sell. There will always be a subset of homeowners needing to sell their homes regardless of market conditions, due to factors like job changes, divorce, or illness. Homeowners with any flexibility in the current environment, particularly those with a mortgage, have little incentive to list their homes. The majority of homeowners with mortgages have rates well below current market rates.

American Housing Survey data shows that two-thirds of homeowners with mortgages had rates below 4 percent at the end of 2021 (latest data); that share may have ticked up in 2022, given the rise in mortgage rates, but it is unlikely to have changed significantly given the sharp falloff in homebuying and refinancing activity. All told, selling a home and obtaining a new mortgage for many households today would significantly increase monthly mortgage payments.

Meanwhile, recent declines in home prices and mortgage rates have been met with an increase in mortgage purchase applications and pending home sales, showing that even a small improvement in affordability will bring buyers off the sidelines. Mortgage applications have climbed 15 percent since the end of October in response to a nearly 1ppt decline in mortgage rates, and pending home sales rose 2.5 percent in December, pointing to a rise in existing home sales in January, which would be the first increase since January 2022.

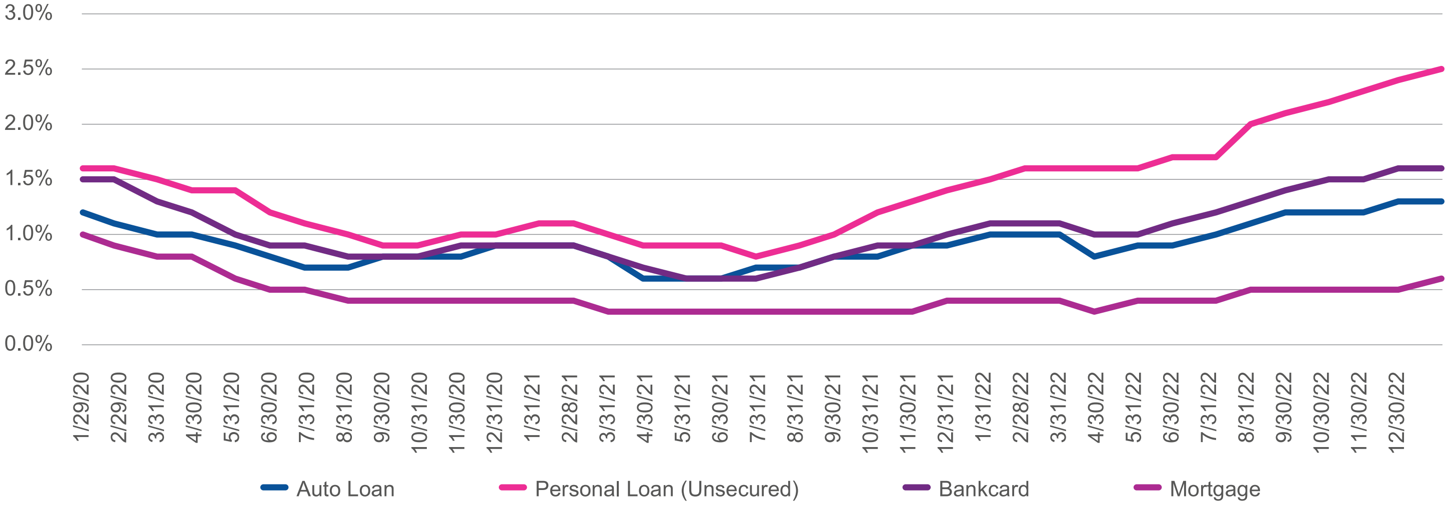
## U.S. regional outlook — Tech struggles will have varying effects across the country

Consumer spending is expected to slow in 2023, despite higher inflation and interest rates, but remain positive in the 50 largest metros. Spending will focus on services, travel, and dining out due to pent-up demand.

Consumer spending will be driven as much by income levels as by income growth, as high-income metros on the west and east coasts are expected to see the highest consumer spending growth rates; meanwhile, several metros in Florida will see much slower growth. Not only have Tampa and Miami started to see slowdowns in job creation, but the relatively large leisure and hospitality sectors in these metros typically pay lower wages, and the metros are expected to see declines in per capita disposable incomes.

A further factor influencing the outlook for 2023 is the housing market. The forecast is for most metros will see house prices fall in 2023. Indeed, about half started to see declines in Q3 2022, according to the Federal Housing Finance Agency (FHFA) purchase-only house price indices. Most of the metros that we forecast will see the steepest declines in 2023, namely in the West and Mountain regions where prices surged during the pandemic. Metros that we expect to see less of a decline in prices include many in the Midwest and Northeast that saw less appreciation. Higher mortgage rates relative to the post-Global Financial Crisis era are likely to deter buyers over the next two quarters, but as rates fall later this year, buyers should return to the market.

### U.S. % Balance 60+ Delinquency rates




Source: Experian Commercial Benchmarking

## Consumer trends and the effect on small business

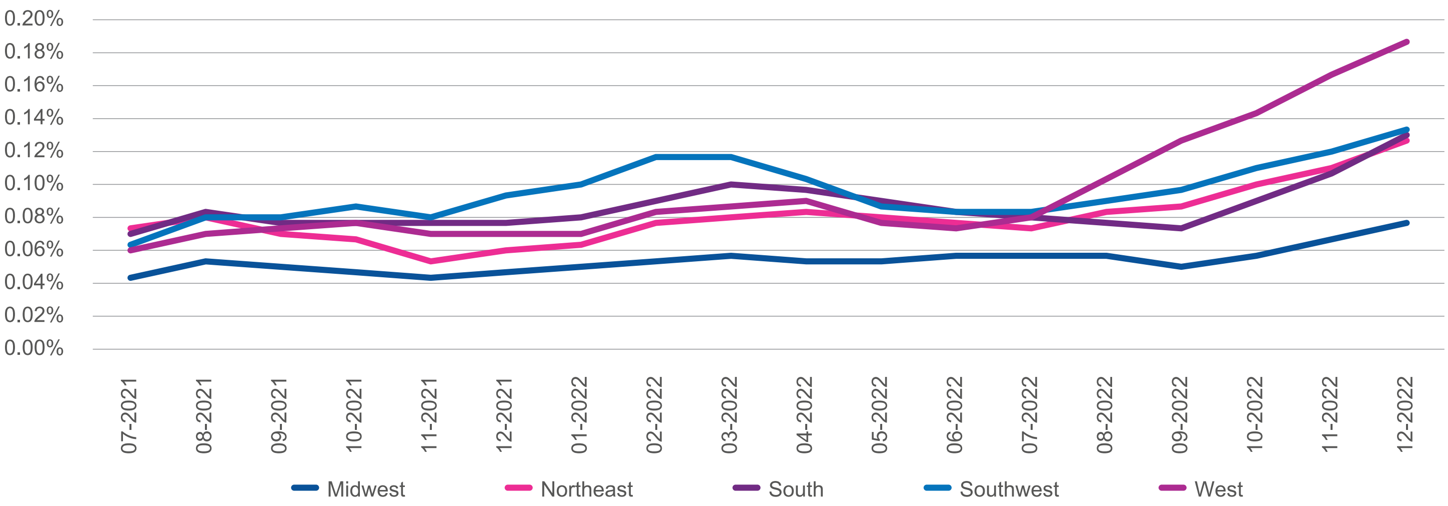
Rising interest rates are putting some pressure on consumers, but the stress isn't significant. The latest SBCS data shows signs that delinquency rates are normalizing, not surprising considering they were extremely low over the past few years. A weakening economy has historically put upward pressure on consumer delinquency rates and that is what the SBCS is showing now.

Delinquency rates for auto loans, bank cards, personal unsecured loans and mortgages have all picked up recently. Not surprising, the share of balances 60 days or over that are delinquent are the highest among unsecured personal loans. Delinquencies for bankcard and auto loans have also risen but both remain at, or below 1.5 percent.

Delinquency rates for mortgages have only edged higher and remain very low, at 0.5 percent. Mortgage delinquencies are unlikely to spike even with a recession and a drop in U.S. house prices. There are a few reasons behind this. First, lending standards have been very tight since the Great Recession and this has improved the quality of outstanding first mortgages. Also, many homeowners locked in low mortgage rates and the use of adjustable-rate mortgages is nowhere near that seen leading up to the housing bubble in the mid-2000s.

Experian and Oxford Economics expect a cutback in spending this year as softer hiring and wage growth weigh on incomes. There will be a continued shift in the composition of spending away from goods toward services. Services spending as a share of total consumption is still below that seen leading up to the pandemic and there isn't any compelling evidence that there is has been a structural shift in consumer spending behavior. Services make up the bulk of total consumption.

### Percent of balance 91+ delinquent for commercial credit cards




Source: Experian Commercial Benchmarking

## Recommended focus areas

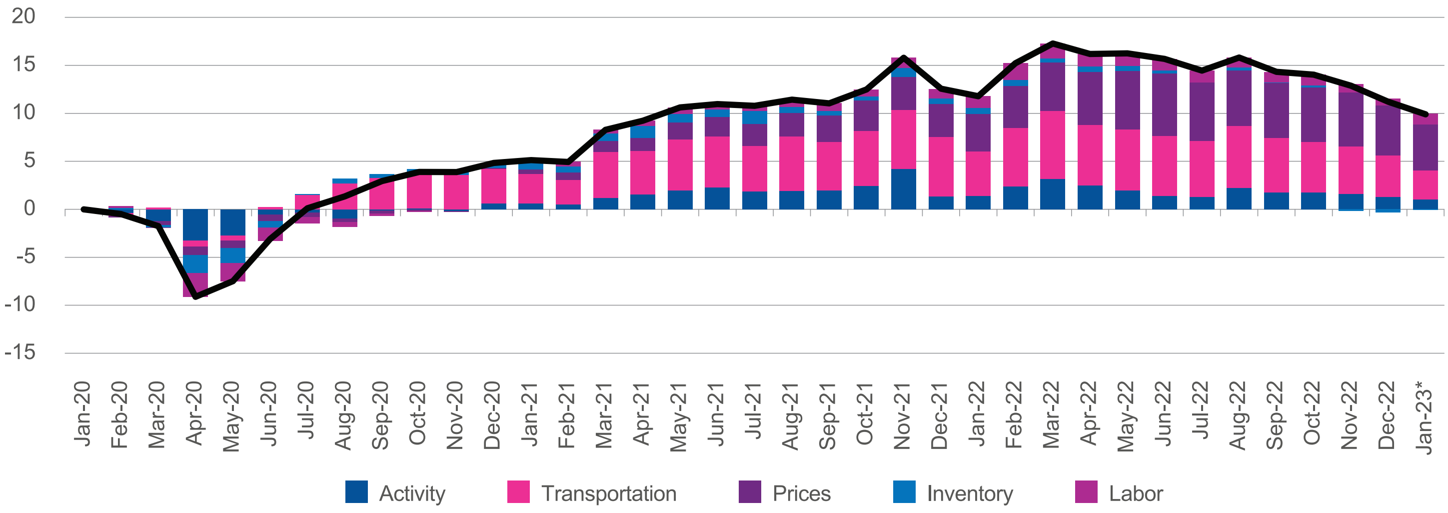
**Less supply-chain stress**

Supply chain stress fell at the beginning of the year and further easing is likely due to weaker domestic and global demand. As the U.S. economy enters a mild recession, softening consumer demand and cooling business activity will continue to unwind supply chain strains.

The Oxford Economics supply chain stress indicator fell to its lowest level in nearly two years in January. Easing in transportation pressures was the main impetus for the improvement, with a pullback in consumer demand opening capacity in ocean and air freight routes.

### U.S.: Supply chain stress tracker

Index; 0 = Heightened stress




Note: *estimate based on preliminary data and OE estimates

Source: Oxford Economics/Haver Analytic

**Conclusion**

A mild recession this year is likely, with sluggish GDP growth in Q1 followed by outright contractions in Q2 and Q3. The ebullient January employment report needs to be interpreted with caution but is a reminder the economy won't abruptly change course in the absence of an extreme shock. Looking ahead, the unemployment rate will rise by just under 1.5ppts to end the year around 4.7%.

Also, The January CPI is a reminder that returning inflation to the Fed's 2% target will have its bumps. However, the Fed has telegraphed that they're not done tightening monetary policy as its likely not restrictive enough to ring out some of the inflation, particularly in services. For this, they likely need trend job growth south of 100k per month and nominal wage growth to be 3.5%. The Fed is not so subtly signaling two additional 25bps rate hikes. This is more than in our February baseline but considering the January CPI and employment report, odds are we will be adjusting the forecast.

Inflation could be stronger than expected in the first half of the year, suggesting more rate hikes are coming. However, rents will peak in the second half of the year and then roll-over quickly. Therefore, it could be the tale of two halves for inflation this year. Stronger than expected inflation in the first half and a more significant deceleration in the second half. Market rents feed into the CPI with roughly a one-year lag and they point toward a significant decline later this year. Patience is needed but the current pace of inflation won't be around for long.

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**About the report**

The *Experian/Oxford Economics' Main Street Report* brings deep insight into the overall financial well-being of the small-business landscape, as well as providing commentary around what specific trends mean for credit grantors and the small-business community. Critical factors in the *Main Street Report* include a combination of business credit data (credit balances, delinquency rates, utilization rates, etc.) and macroeconomic information (employment rates, income, retail sales, industrial production, etc.).

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