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OXFORD ECONOMICS

MAIN STREET REPORT

Your window into small business health

Q1 2023

MAIN STREET REPORT

This will sting

Executive summary

U.S. positive economic growth, elevated inflation, a strong labor market, positive consumer spend behavior, and credit accessibility remain the main drivers in decisions being made surrounding the evaluation of U.S. commercial health. The small business ecosystem is enjoying higher levels of consumer engagement keeping cashflows flowing as stimulus turns to normalized funding options for market participants. Businesses and owners have positive liquidity and access to funding from expanding public and private sources but are leveraging a higher percentage of debt as they enter the 2nd quarter. Domestic and international headwinds have begun to create industry specific credit market tightening that is not impacting all segments, but place pressure on supply chain participants as the quarter comes to an end. Recession fears ebb and flow with the Federal Reserve activities and government spending creating an extended environment of higher than intended U.S. inflation.

Macroeconomic Overview

GDP was up 1.1% annualized in Q1 following a 2.6% gain in Q4 2022, but recent data is tainted by a weather-related boost to consumer spending and quirky seasonal adjustment factors. Q1 GDP also doesn't capture any of the impact of the recent tightening in lending standards, which affects the economy with a lag.

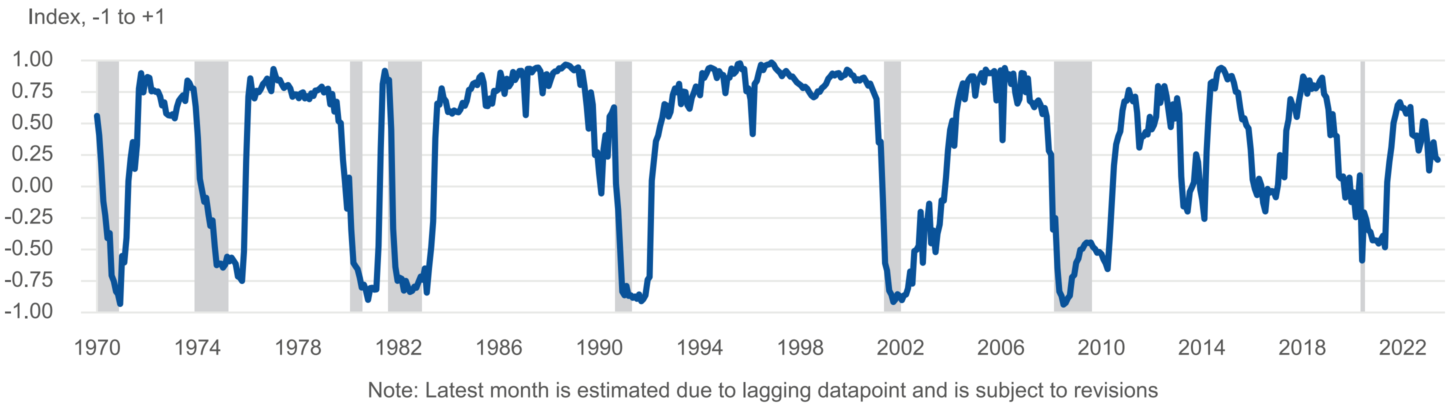
The core of the economy was strong as real final sales to private domestic purchasers — our preferred measure of underlying economic momentum — rose a solid 2.9% annualized. Stronger consumer spending drove much of the Q1 advance, though monthly data show growth was concentrated in early Q1. Spending also got a temporary lift from the largest cost-of-living payments in decades.

Inventories posed a large 2.3ppts drag on GDP growth in Q1. We think inventories will remain a drag going forward because businesses will draw down existing stockpiles to meet demand.

The Oxford Economics U.S. Business Cycle Indicator fell for the second consecutive month in March, showing the economy ended Q1 on a weak footing. The trend in the BCI points toward weak growth in Q2 and a recession in H2 2023.

The Oxford Economics forecast assumes that the downturn begins in Q3, but risks around the timing have turned roughly balanced. Tighter lending standards will be a big hurdle to overcome as they will come on top of past tightening in monetary policy and financial market conditions, though the tight labor market might delay the start to the recession.

U.S.: Oxford Economics' U.S. Business Cycle Indicator



Source: Oxford Economics/Haver Analytics

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.

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.

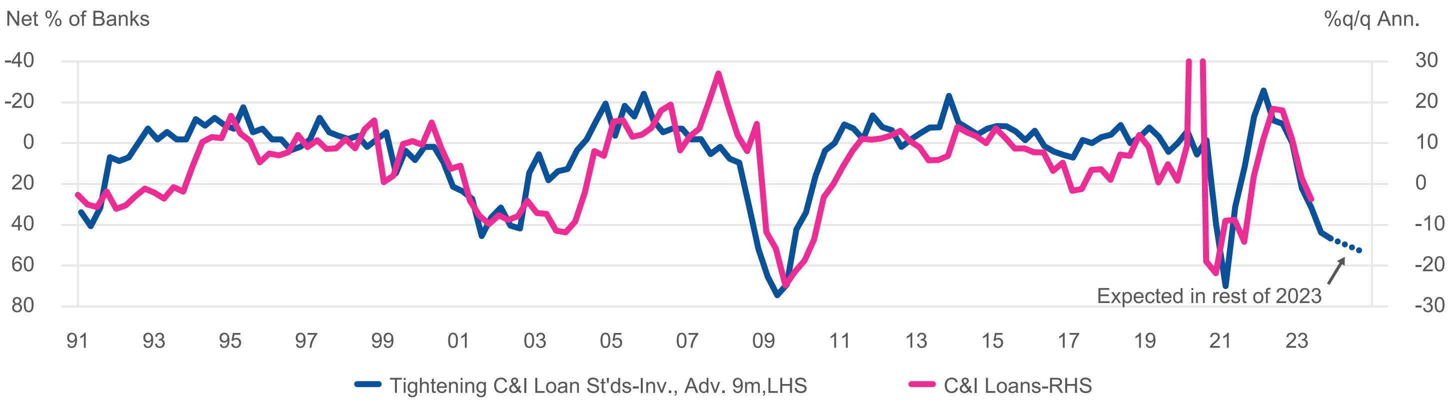
While stress in the U.S. banking system may have eased, the hit to the economy is yet to come, with the main drag on growth set to materialize in the second half of the year. Bank lending standards will determine the magnitude of the blow, but the good news is that lending standards may not have tightened as much as initially feared. Still, loan criteria are constricting from an already tight level, posing downside risk to the forecast for H2 and early 2024.

The risks continue to be weighted towards a larger hit to GDP, as banks may not be done tightening lending standards, which will restrict access to credit, hurt business investment, reduce business formation, and weigh on job growth and consumer spending on durable goods, particularly autos and homes.

Stress among small banks will be felt disproportionately, with small businesses taking the brunt of the hit. Unlike midsize and large companies that can tap alternative sources of lending, smaller businesses rely on regional and small banks for financing. So, it is likely that the number of business formations, including those with a high propensity to hire, will weaken soon.

With banks tightening lending standards, it's not surprising that the availability of credit is shrinking. The Fed's weekly data on C&I loans is trending lower. Potential homeowners are still able to get mortgages, with weekly purchase applications jumping recently as the 30-year fixed mortgage rate fell. Any improvement in mortgage rates is causing a rush of buyers into the housing market because of the fear of missing out.

U.S.: Lending Standards & C&I Loans



Source: Oxford Economics/Fed/Haver Analytics

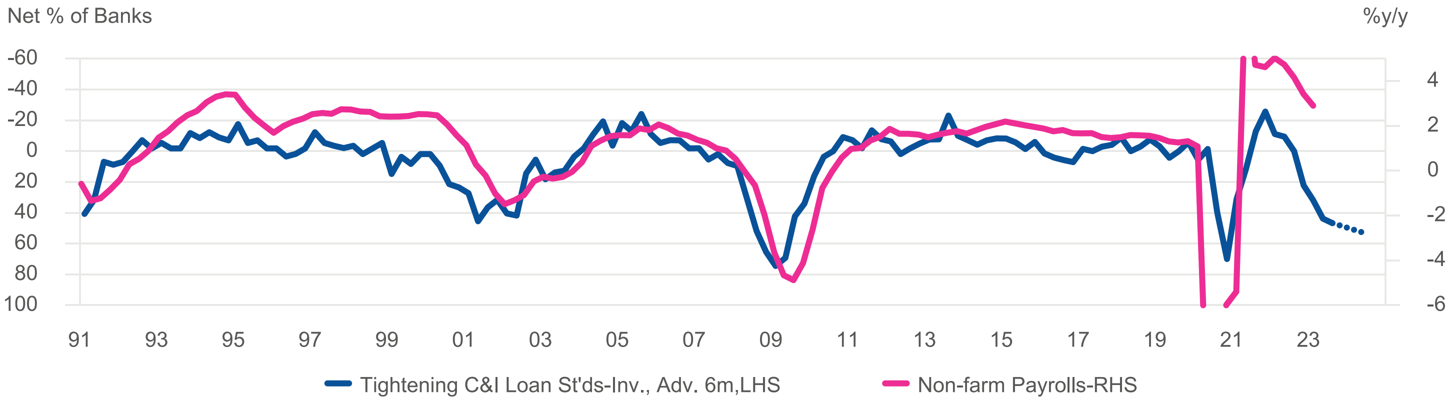
Through a business cycle, the relative importance of certain data can ebb and flow. One source of information that is becoming key to watch is the Senior Loan Officer Opinion Survey (SLOOS). Even before the recent stress in the banking system, the SLOOS showed banks tightening lending standards and breaching the threshold that in the past was consistent with a recession. The next SLOOS will likely show a further tightening that, notwithstanding, could have been even worse. Still, lending standards pose a downside risk to our near-term forecast.

There is a strong correlation and causal relationship between the net percent of banks tightening lending standards on C&I loans and business fixed investment. Business investment is sensitive to changes in lending standards and real interest rates. It's also often the first economic indicator to drop ahead of recession, followed by consumer spending. The SLOOS points toward a drop in business fixed investment later this year.

The labor market isn't immune either. Tighter lending standards will reduce the number of business formations, particularly among small firms. Entrepreneurs typically use their home as collateral for a small business loan.

We will be closely tracking the weekly data on business formations, particularly among those with a high propensity to hire. Small firms, or those with fewer than 100 employees, account for roughly one-third of total private employment. There is a short lag between tighter lending standards and a weakening in job growth.

U.S.: Lending Standards & Payrolls

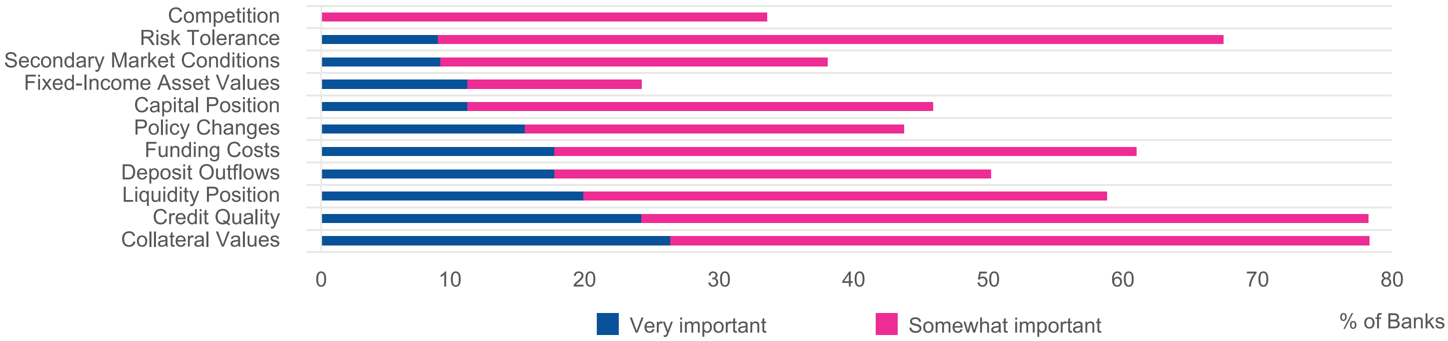


Source: Oxford Economics/Fed/Haver Analytics

The Senior Loan Officer survey confirmed that many banks tightened lending standards across a wide range of loans in Q1, which was hardly surprising, but the bigger concern is that a majority of banks plan to tighten standards further over the rest of the year.

The survey also revealed more detail around what categories of lending are likely to be hit hardest in the wake of regional bank failures. An overwhelming majority of banks tightened standards for commercial real estate lending in Q1 and plan the same for the rest of 2023, which is unsurprising given the bleak outlook for capital values and the outsized importance of lending from smaller regional banks, which are tightening standards the most for this sector.

Reasons for Tightening Lending Standards in 2023



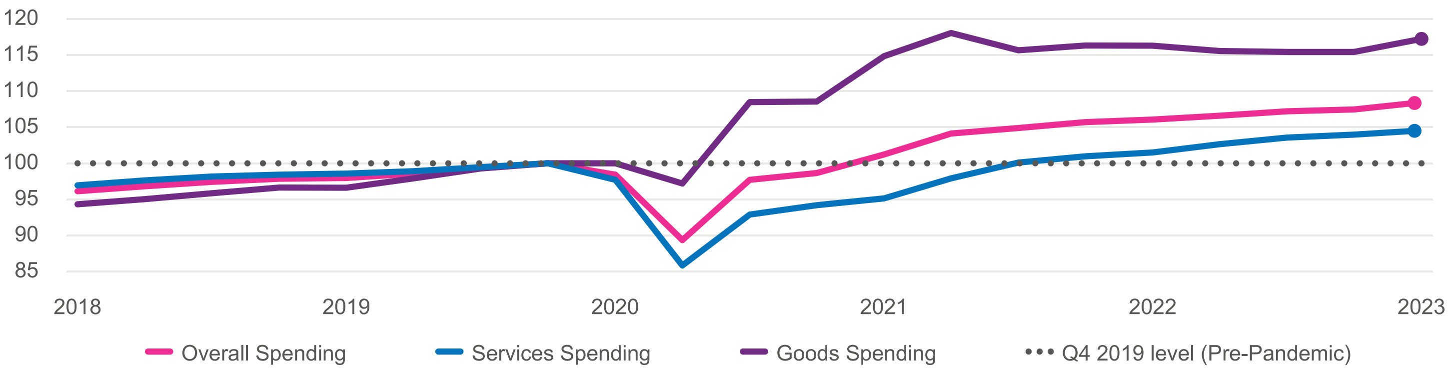
Source: Oxford Economics/Fed/Haver Analytics

Consumer loans are relatively less exposed to tighter standards, particularly for conventional mortgages which already come with relatively strict conditions imposed by the government-sponsored enterprises. But it also reflects our view that any further decline in house prices is likely to be modest given the lack of available inventory, which will help curtail delinquencies and foreclosures.

Soft landing could run through the consumer

Feeling the initial signs of relief potential in housing, energy, and goods in the next year helped the U.S. consumer post pandemic spending behavior to remain elevated through the first quarter propelling the consumer confidence upward as consumers felt recession fears push out further into the future.

Consumers spend — Real Personal Consumption Expenditures



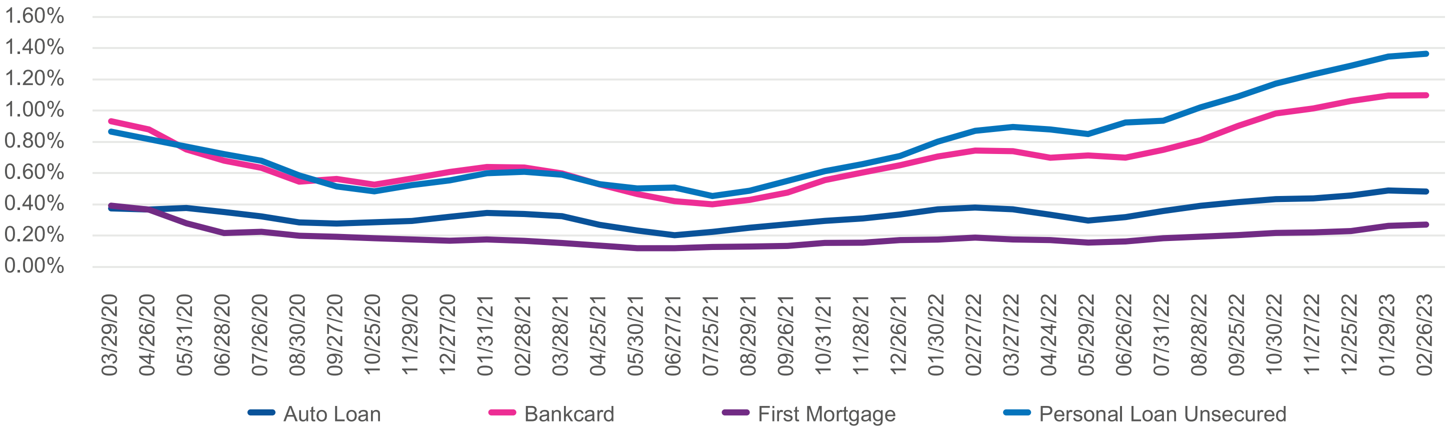
Source: Bureau of Economic Analysis and Author's Calculation

This level of spending required consumers to leverage a higher percentage of their available credit lines to cover the behavior. Delinquencies are on the rise but are in line with expected delinquency levels in a growing market. 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 mortgages have only edged higher and remain very low, at around 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. Therefore, it's unlikely that there will be a significant number of foreclosures or distressed sales, helping limit the peak to-through decline in US house prices.

Delinquency rates for auto loans, bank cards, personal unsecured loans and mortgages have all picked up recently. The share of balances 90 days or over that are delinquent is higher than this time last year. The share of balances 90 days or over are highest among unsecured personal loans followed by bankcard and autos. Delinquencies among autos warrant close watch as the forecast is for used vehicle prices to decline, which could leave some owners underwater.

Consumer delinquencies % Balance 90+



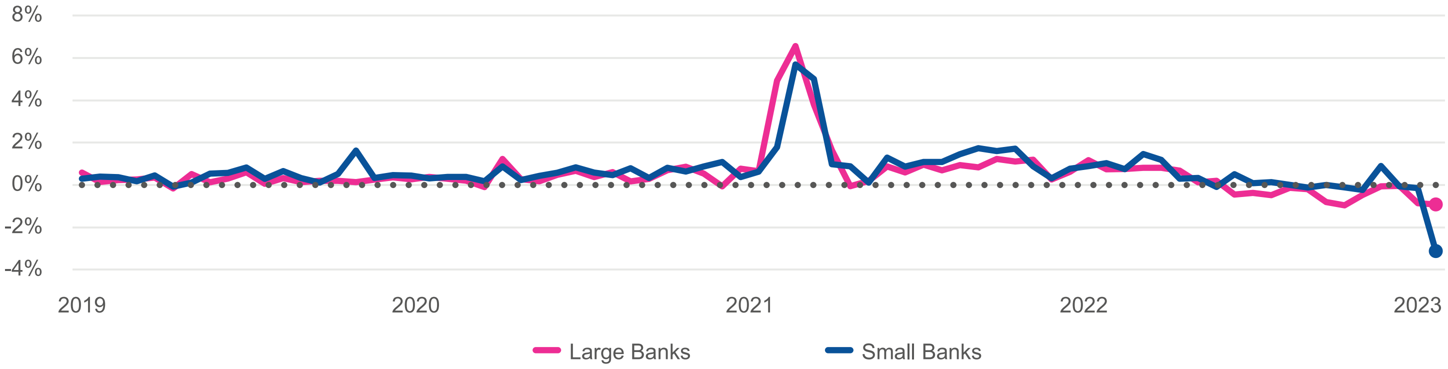
Source: Experian Consumer State of Credit

These higher debt ratios and elevated delinquency rates will create downward pressure on consumer credit scores and could lead to more consumers inability to qualify for the programs they are currently leveraging for funding. This will have the appearance of credit tightening but is an expected normalization of risk for the market as liquidity becomes leaner.

U.S. consumers still have excess saving delivered in the form of pandemic stimulus and payment moratoriums. Consumers in the U.S. have been spending down those excess savings (in contrast to households in the euro-zone and UK). There's no single way to measure the size of excess savings. Oxford Economics' preferred measure is to compare the savings reported in the income and spending data with a counterfactual where the saving rate remained at its pre-pandemic (2018-2019) average. On that basis, we calculate that households have spent just over half of the $2.2trn of excess savings accumulated over the pandemic, with close to $1trn, or 5.5% of consumption, left in the coffer. This has the potential to buffer consumer spending and help limit the rise in delinquency rates. As bank accounts become leaner the search for deposits will grow.

Small and regional financial institutions have felt the pressure to protect and develop deposit relationship strategies toward current customers as bank failures tempt customers to seek larger institutions for perceived security of deposits.

Deposits at Small and Large Banks: MoM % Change



Source: Federal Reserve Board of Governors

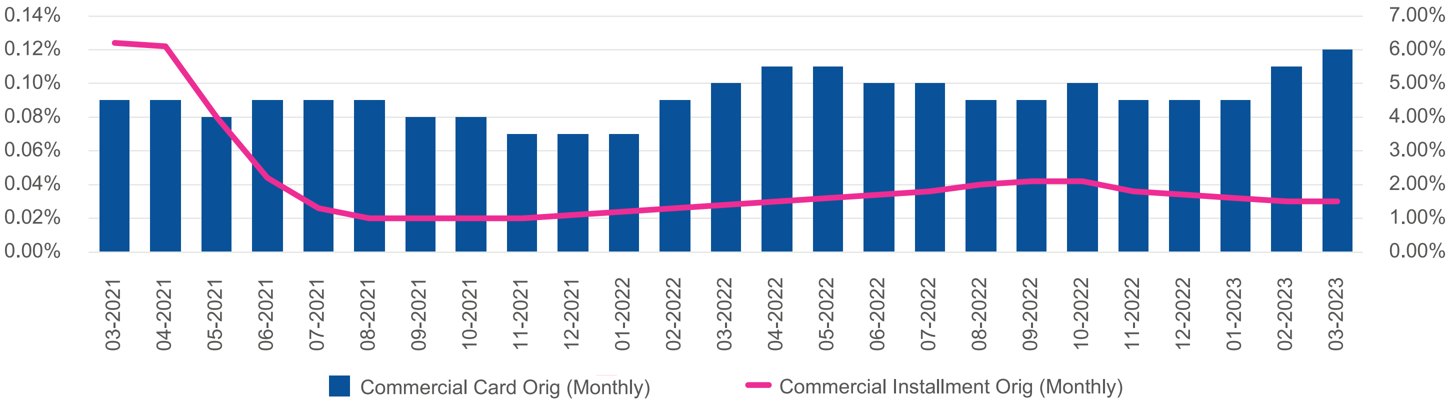
Experian observed lenders pivoted deposit acquisition offers for new account openings that offered 2-3X bonus dollars to open a deposit account more than they offered just 6 months ago. These strategies have stemmed the flow of deposits from smaller institutions and are beginning to normalize the balance in new account openings between large and midsized banks.

U.S. Business lending

As deposits rise as a focus of small and mid-tier banks, credit markets remain open as a mechanism to draw customers. Commercial bank account offers have sweetened for small business owners as the reward for opening a new account with an institution increased ~200% as offers just 6 months ago averaged $250 dollars, today those rewards are closer to $800. Fueled by fear of lost depositers, banks are taking more action to create attractive and safe places for customers to land.

Commercial lending remains open to small businesses as cashflows are challenged only in a handful of industries where supply chain normalization placed downward pressure on utilization of service. Commercial unsecured and secured credit stabilized in February, increasing to meet demand across the spectrum of credit.

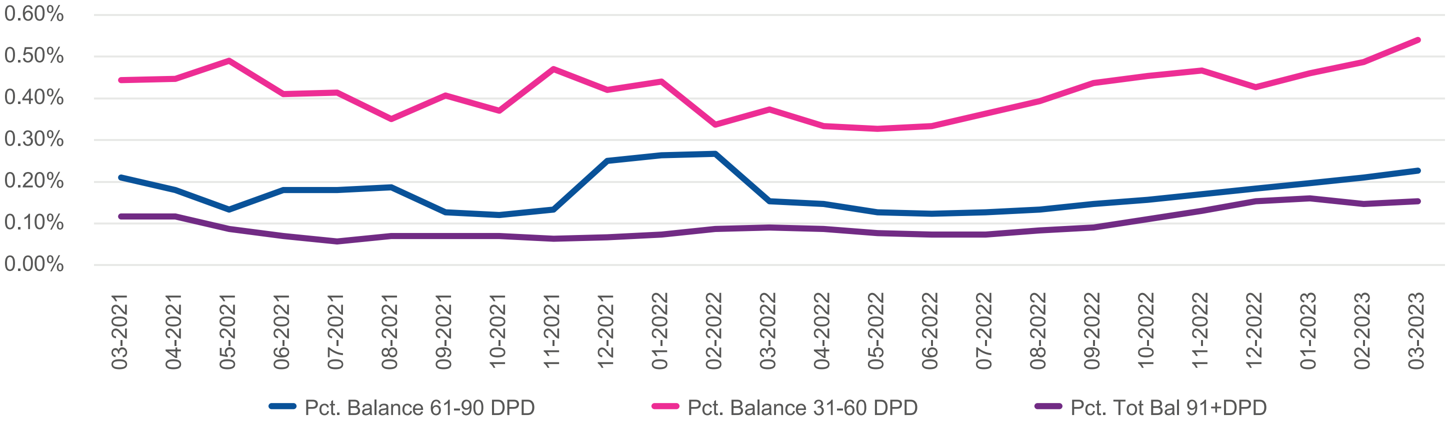
Commercial origination trends for both Commercial Card and Installment products on a (3 Month moving average)



Source: Experian Small Business Credit Share Commercial credit data

Lenders carefully tightened core product underwriting to limit exposure placing additional emphasis on limiting overwrite activity and monitoring more closely accounts in their portfolios for cracks in performance. Delinquency levels have risen in the past quarter, but the levels of delinquency are appropriate for the levels of growth we have seen in the industry and economy over the past year.

U.S. Commercial Delinquency — Percent of small business balances delinquent



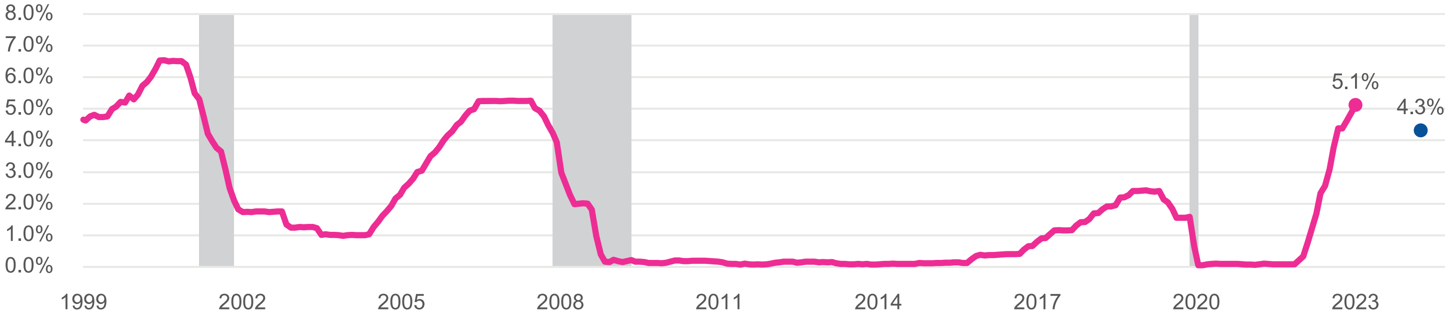
Source: Experian Small Business Credit Share Commercial credit data

Noting the delinquency trends stack from sloppy pay (.54%) down to 91+ (.16%) percent of balances delinquent highlights the ability of small businesses to cure delinquency and not roll into higher delinquency buckets at an elevated rate. This trend is where you would expect it to be during a solid economic cycle of growth.

Will inflation remain elevated?

The Federal Reserve continued to raise rates in the first quarter and inflation has remained stubbornly high for much longer than expected, raising fears among businesses and investors about whether price pressures will remain permanently high and whether the Federal Reserve will be able to successfully rein in inflation pressures.

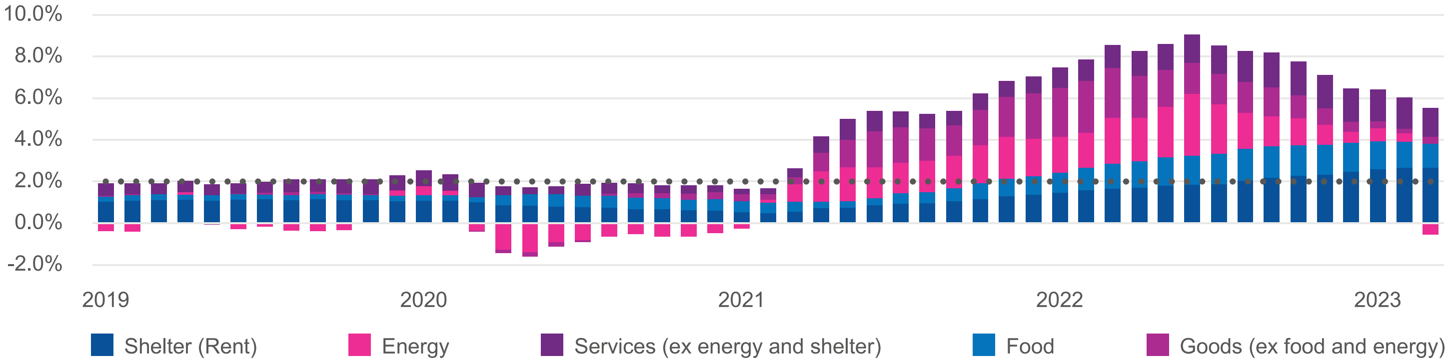
Midpoint of Fed Funds Rate and Fed Projections



Source: Experian Small Business Credit Share Commercial credit data

There has been some initial success as tightening credit conditions price a small segment out of the market. The board of governor is divided, as initial success has been seen, to pause tightening activities or to continue to raise rates as upward pressure continues through a strong labor market, lingering elevated shelter costs, and consumer and commercial credit markets still positioning for growth.

CPI headwinds to deflation



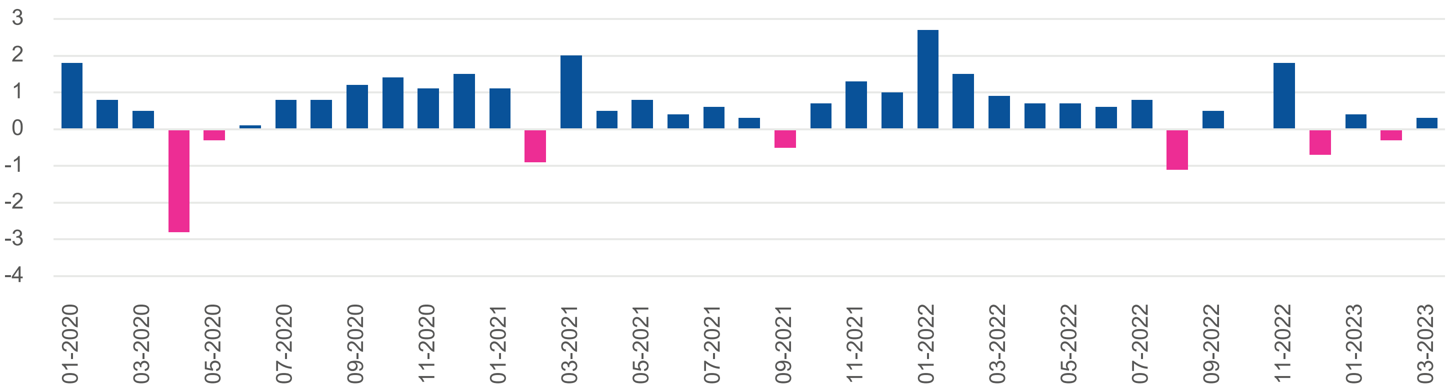
Source: Bureau of Economic Analysis

The Federal Reserve may push through the market noise to raise rates as markets may see the pause as a precursor to rate decreases and push through with investment. This will keep inflation rates elevated through 2024. The Fed will need to consider a new normal target as the have focused on the 2/2 (2% inflation/ 2% unemployment) over the last 2 decades their new target may rest to a 3/3 structure.

Construction Industry

U.S. Construction spending rose 0.3% MOM surpassing market expectations of a 0.1% increase. Public spending, boosted by government program spending, expedited construction spending in manufacturing, educational, and lodging while private construction spending pulled back in residential and small business construction projects.

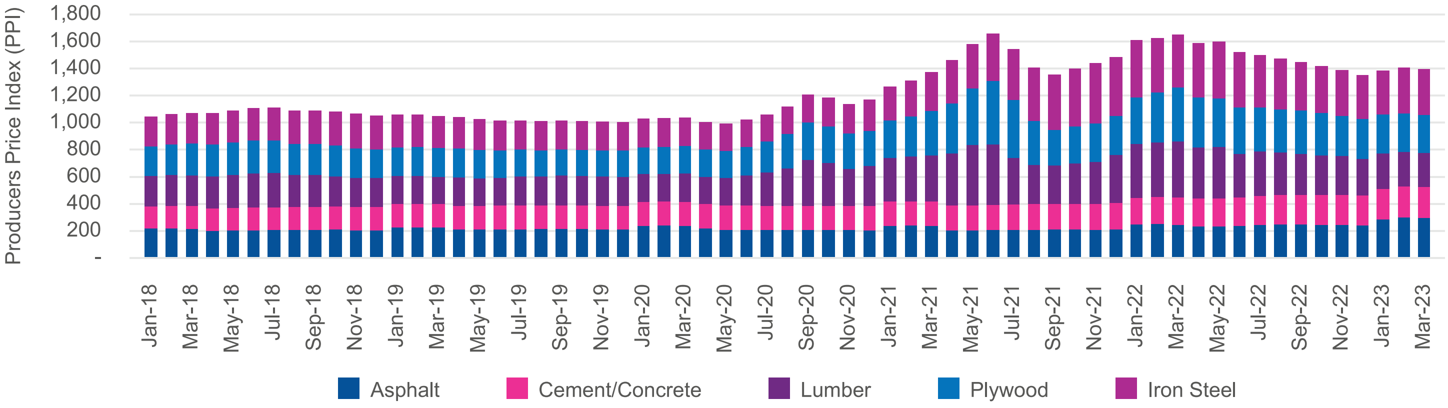
Construction spending



Source: U.S. Census Bureau

Inflation increased the cost of construction materials which partially drove the increase in total construction spend and impacted construction demand.

The cost of building materials remains higher than pre-pandemic



Source: Experian Small Business Credit Share Commercial credit data

Higher cost of materials linked with a backlog of construction projects means that construction companies will be asking for higher loan amounts to cover escalating labor and building costs. The construction industry is one of the few industries that saw increased demand throughout the pandemic. The labor force shifted to a remote, work from anywhere in the world format, creating a need for more space at home and room to work and live. In the 1st quarter of 2023, businesses began to push for their employees to return to the office. This shift in home usage, as well as increased cost in material and labor, meant that home improvement projects supported by residential construction providers hit a wall in engagement. Home Depot and Lowes, as well as their smaller counterparts, called down expectations for the second half of 2023 as sales began to slip dramatically in the first quarter.

"Given the negative impact to first quarter sales from lumber deflation and weather, further softening of demand relative to our expectations, and continued uncertainty regarding consumer demand, we are updating our guidance to reflect a range of potential outcomes," said Richard McPhail, Executive Vice President and Chief Financial Officer

Home Depot expects sales and comparable sales to decline between 2% and 5% compared to fiscal 2022.

Source: https://ir.homedepot.com/news-releases/2023/05-16-2023-110108461

Even though over the past few months both residential and non-residential experienced some minor volatility in construction starts and construction spending, the volumes remain above pre-pandemic levels. High construction demand is being met with the formation of many new construction companies. New construction companies are seeking credit at a higher rate but with default probabilities much higher than established companies that have been operating for 5+ years. Higher risk and higher interest rates are causing commercial lending to tighten, and construction companies are seeing fewer loan originations and smaller loans/lines of credit.

Transportation Industry

The trucking industry has been hit over the past 8 quarters with high gas prices, high insurance costs, a lack of drivers and equipment such as container access. (Source: https://www.cloudtrucks.com/blog-post/trucking-trends) This transportation sector is expected to see consistent and steady growth of 6% over the next 10 years, as reliance on trucking to move goods and serves increases with enhancements in online shopping and delivery options with expectations of faster and more efficient deliveries. The construction industry relies on the trucking industry for 92% of deliveries to sites for projects. As inflation and labor availability slow residential projects, that translates to volatility in the engagement with transportation, pressuring cashflows downward for the industry operators. Trucking companies will be plagued in 2023 with rising costs for both equipment and wages as labor shortages increase. This industry will experience higher pressure on lenders to enhance underwriting to accommodate risk in a volatile market segment. Consumer demand followed by spending will keep drivers on the road and trucking companies positively engaged through 2023, but margins will be tighter this year than in the prior two.

Expectations

Inflated costs for businesses to provide their goods and services will continue to be passed on to the consumer. A tight labor market will mean that consumers will have positive cashflow and spending will remain positive. The velocity of spending may slow into the 2nd quarter as savings dwindle and utilization rises causing credit market access to slowly tighten. This tightening will make consumers think more about the types and volume of purchases they make in 2023. This slowdown in the purchase volume will place more and more pressure on supply chain participants as will find the level of orders slow.

Lenders are well capitalized for a downturn, even though we have seen some specialty and regional banks stumble with their heavy investment in treasuries through a high-rate cycle, to continue to serve customers and keep the lending windows open. Small businesses have access to expanded product set from lenders, as the lender looks for ways to limit exposure, but still grow customers as well as securing their deposit business.

As they look to attract depositors, fraudulent actors will use synthetic identities and account takeover activities to increase pressure on lenders to add more friction to acquisition.

The Federal Reserve is counting on a slowdown in the second half of 2023 to cool inflation. Depending on their decision, to pause or continue to raise rates, will set the tone for the next two quarters as the U.S. market looks for the board to cut rates after a pause. The Fed will likely raise rates another 25bps to keep the market from pricing in rate cuts too soon and elongating overheated market conditions that keep inflation high.

Small business lenders are already reviewing underwriting criteria and adjusting to fit exposure targets for the year as the economy begins to cool. Portfolio risk managers must step up their efforts to monitor and enhance the touch methodologies and tools they utilize to ensure they are at the top of the payment hierarchy as conditions tighten.

Consumers were still spending in the first quarter of 2023. Retail spending remained strong, and consumers are making high end purchases and traveling for the summer. Post pandemic spending behavior has continued to outpace wage and savings growth in the lowest income segments creating a greater reliance on credit versus cash. This behavior creates downward pressure on credit scores and increases lender exposure. Lower credit scores will mean that some consumers will fall outside of credit products they may have been eligible for in that last quarter adding to the feeling of tightening, even though this is a result of consumer behavior versus a lender change in credit underwriting.

Look for inflation to remain at a heightened level through the end of the year with the Federal Reserve poised to take further action to maintain control of prices. A tight labor market will keep consumers employed and their ability to repay debt intact even if they pay a little slower than they have been over the past year. This remains a positive cashflow environment for small businesses and they will leverage the tools and programs to fund and supplement moderate growth opportunities in 2023.

MAIN STREET REPORT

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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Experian's Business Information Services is a leader in providing data and predictive insights to organizations, helping them mitigate risk and improve profitability. The company's business database provides comprehensive, third-party-verified information on 99.9 percent of all U.S. companies. Experian provides market-leading tools that assist clients of all sizes in making real-time decisions, processing new applications, managing customer relationships and collecting on delinquent accounts. For more information about Experian's advanced business-to-business products and services, visit www.experian.com/b2b.

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Contact Experian Business Information Services

T: 1 877 565 8153
W: experian.com/b2b

Contact Oxford Economics

T: 646 503 30 50
E: mailbox@oxfordeconomics.com
W: oxfordeconomics.com