BCMA WCA

Authorized Experian Direct Sales Representative

experian

Beyond the Trends

Understanding the Commercial Economy

Fall 2022

About this report

Beyond the Trends is a quarterly report written by Experian Business Information Services. The report offers a unique view of the small business economy based on what we see in the data. With up to date information on over 25 million active businesses and how they perform from a credit standpoint. Experian will share insights and commentary on how economic conditions, public policy, and other factors might shape future small business performance.

The Sales are coming!!

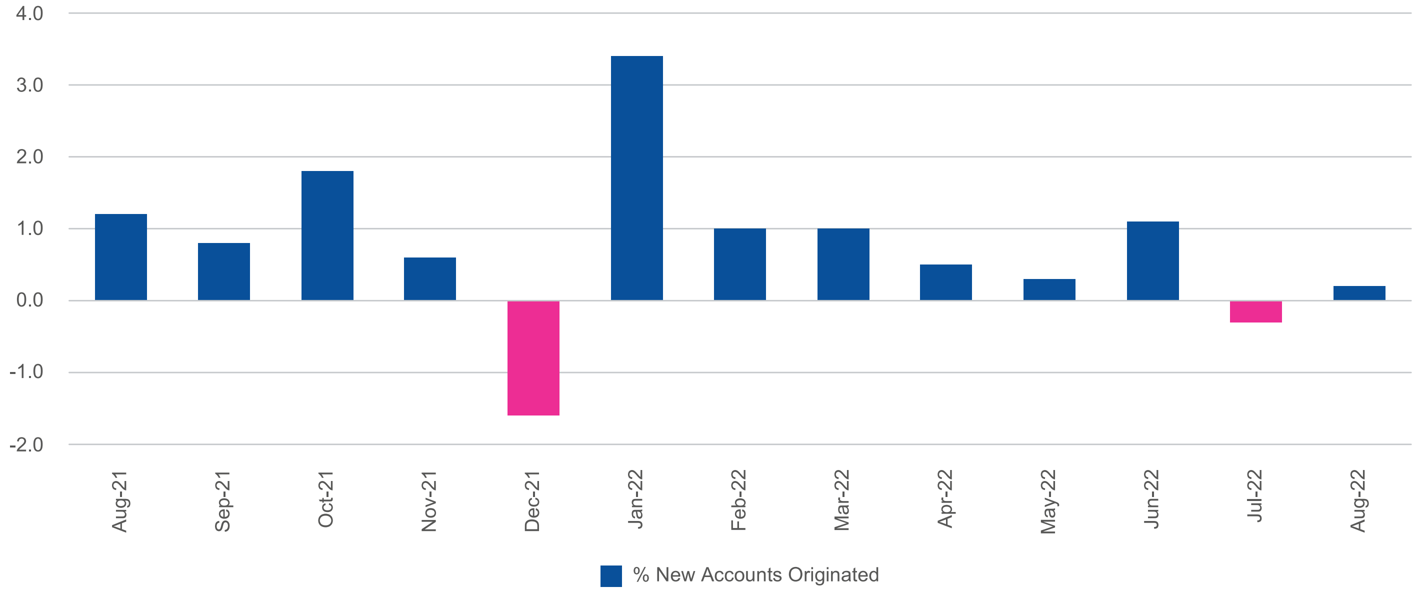
Small businesses have been building inventory over the last year, driven by fears that the global supply chain could break down at any moment. This anxiety created an environment of pre, and over-ordering behavior intended to elevate the worry felt during the height of the Pandemic that their business would fail not due to a lack of shoppers but an empty shelf. Global economic environments change quickly, and our world is seeing heightened inflation. This increase in the price of goods and services is leading to softened consumer demand. Small businesses have been stockpiling inventory, and now with consumer demand softening, they will need to find a way to reduce stockpiles of goods and keep consumers spending. Retail sales in the U.S. grew 16.1% during the 2021 holiday season, the fastest growth rate in more than 20 years (eMarketer, February 2022). Retail sales during the 2022 holidays are expected to increase 4-6% over 2021. A slow down from prior years driven by an extended season and inflation forcing consumers to drop fewer items in their cart. The retail industry, and the supply chain that supports their success, will find opportunity and challenges in a more competitive market, fighting for dwindling consumer discretionary spend. SALES!!! Deflationary pricing, discounts, are expected to be more prominent during the 2022 holiday shopping season as retailers look to unload a glut in inventories as demand cools.

The Year of Revenge Spending

The U.S. economic environment for growth has been strong as consumers embark on revenge spending — pent up spending, driven by limited access during the pandemic and supply chain disruptions. Small businesses and consumers are seeking credit as utilization begins to rise. They are more often dipping into savings to cover this behavior as market prices are outpacing wage growth. This spend behavior has already begun to soften as access to funding wanes.

As interest rates climb, home sales are falling. The number of consumers purchasing a new home will continue to fall. This will reduce the demand into supporting retail markets for home goods and services. Retail sales are up .2% in August recovering from a small -.4% reversal in July. Growth in retail sales in 2022 have been sluggish and expected to be lower than previous years, through the holidays.

Change in Retail Sales Month over Month



Source: https://fred.stlouisfed.org

Retails sales were down 1.6% in August for furniture and home furnishing stores and down 5.7% for retail electronics. (WSJ Print, Housing Slowdown Weighs on Retailers Sept 19) Inflation is changing consumer product types, which will impact higher-end brands that depend more heavily on discretionary spending. Consumers are shopping, but we see that the volume of products purchased is decreasing. On average, inventories for retail stores have 1.3 months of inventory available, up from 1.1 months last year.

Small businesses have found little consumer pushback to price increases through the 1st quarter of 2022, but as we move into the 4th quarter, this consumer spend behavior is changing to focus on lower-cost brands and services. Business owners struggle to access quality labor, strengthen operations, and create backup supplier networks as supply chain disruption and inflation hampers delivery. Small businesses adjusted to a high-demand low-supply market early in 2022, but as demand softens, inventories feel bloated.

The stumble: Retailers will fight for consumer spend, but as interest rates increase, consumers will find their purchasing power limited. U.S. small businesses are already facing an extended period of higher cost and weakening demand. All eyes will continue to focus on the Federal Reserve's actions to slow U.S. economic growth, fueling small business development. The focus will be on cooling inflation in the next few years.

Supply chain challenges stemming from heightened global tensions are slowing production and raising the costs of materials and inventories. Orders are down even as businesses fight to keep the product on the shelf through the following year. All this activity will lead to product inventory irregularities as consumer behavior adjusts to higher prices and wage growth stumbles to keep up with inflation. The increase in borrowing costs, a change in consumer spending behavior, and continued global and domestic supply chain challenges will pressure small business cash flow. Owners will prioritize which debts get paid. Lenders and creditors must assess how they will respond to struggling small businesses in 2022.

The insights shared in this report are presented to take you from a high-level macro view of the market drivers and U.S. small business commercial credit health to insights we see Beyond the Trends.

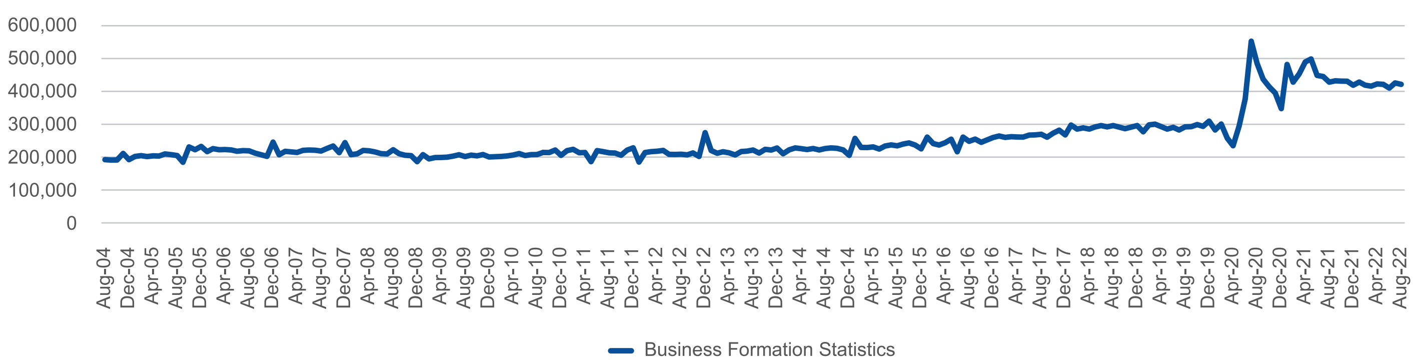
Why are Small Businesses important to the market?

Small businesses in the U.S. (A corporation, limited liability company, or proprietorship with 500 employees or less) make up 99.9% of all businesses in the U.S. employing more than 58 million people in the U.S. according to the Small Business Administration. They generate almost 1.5M new jobs annually, and a large portion of this job growth comes from companies with less than 20 employees. **67.6% of newly established businesses survive at least 2 years**. Small business survivability improved during the Pandemic due to an increase in SMB emergency stimulus available.

These small businesses provide essential goods and services across industries. These businesses are very inclusive of all gender and minority segments which broadens socioeconomic success, independence, and innovation. Small businesses, and the entrepreneurial spirit they present to the U.S. market, have great influence on the health and growth of the U.S. and the global economies they serve.

Creation of new small businesses is still elevated but a prolonged high inflation environment has already begun to cool new entrants into the market.

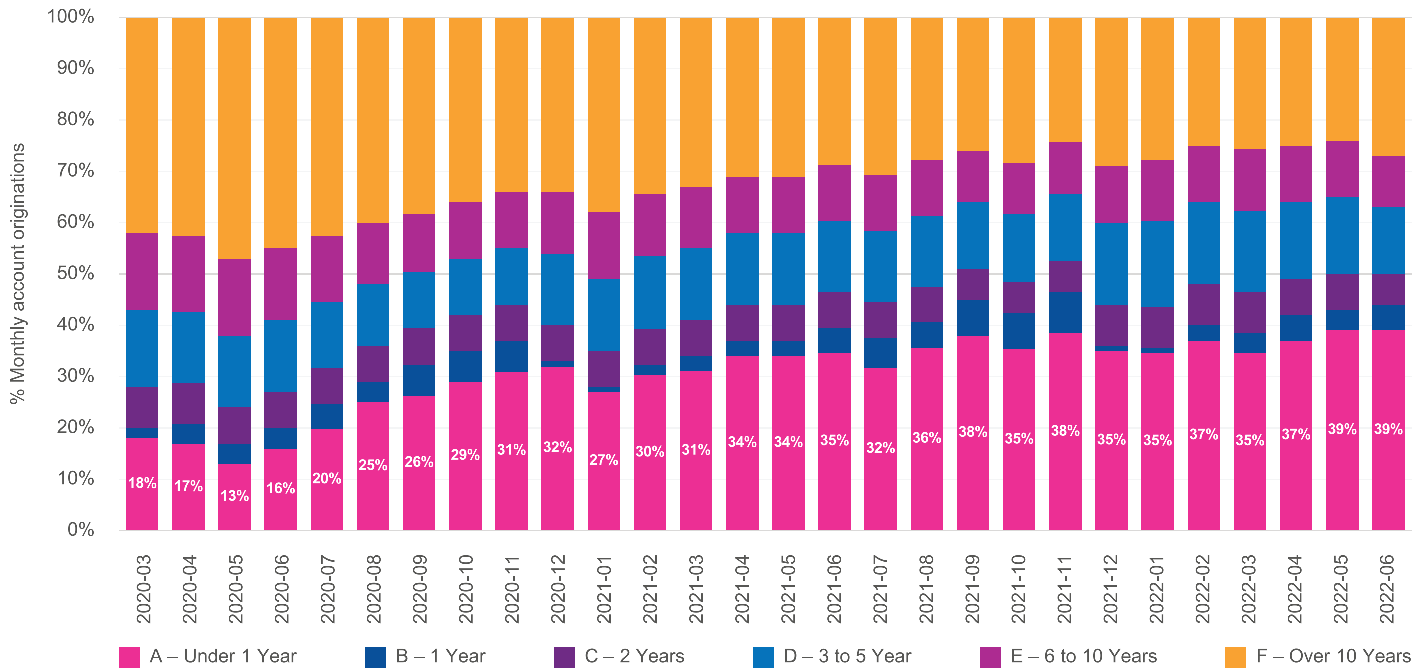
New business applications in the U.S.



Source: Census.gov

Retail continued to be the leader in the types of new businesses opening in the U.S. This industry had the most new business applications with 21.6% month-to-month growth. Overall new business applications have slowed in the past few months but are still elevated significantly over pre-pandemic levels of opening. This explosion of new business starts during the Pandemic has changed the landscape of commercial lending. Almost 40% of businesses in the market have been open less than one year.

Businesses less than a year old continue to be a large portion of the U.S. marketplace



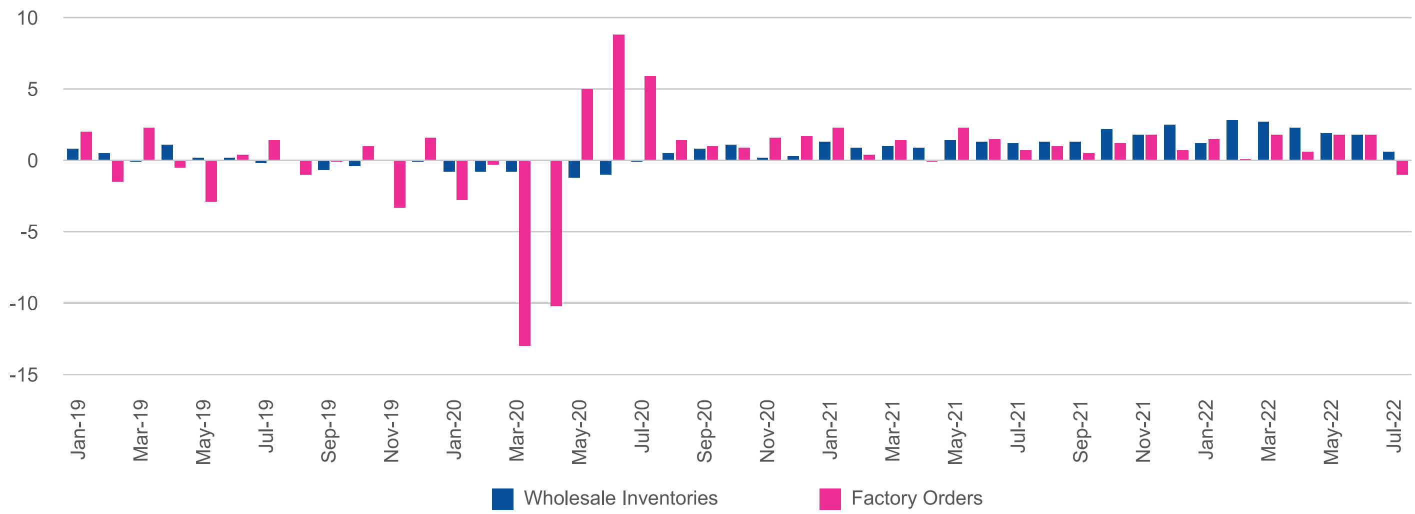
Source: Experian Commercial Benchmark

These small businesses are in a race to become stable, viable businesses. As they emerge in their first years in the market, these businesses are more susceptible to market events. Pandemic stimulus programs provided initial protection to businesses as they developed over the past two years, but those programs are behind us.

The stumble: Next year will bring continued higher than target inflation and a softening of consumer goods and services spending. Commercial credit will likely be harder to acquire as businesses struggle with lighter cashflows. Small businesses will need to be prepared to weather this leaner environment without the support of stimulus as the Federal Reserve works to control inflation.

Manufacturers are working hard to cash in on higher prices and borrowing to deliver in a high-demand market. Those high demand days are coming to an end as consumer cashflows begin to tighten. Wholesalers and retailers have been stockpiling inventory to prevent shortages and the risk of disenchanted customers, but disenchantment will be less of an issue than consumer spending power evaporating with prolonged inflation. The elevated level of preordered products is already hitting manufacturing as the orders slow due to bloated inventories and less need to preorder as the U.S. supply chain finds some late traction.

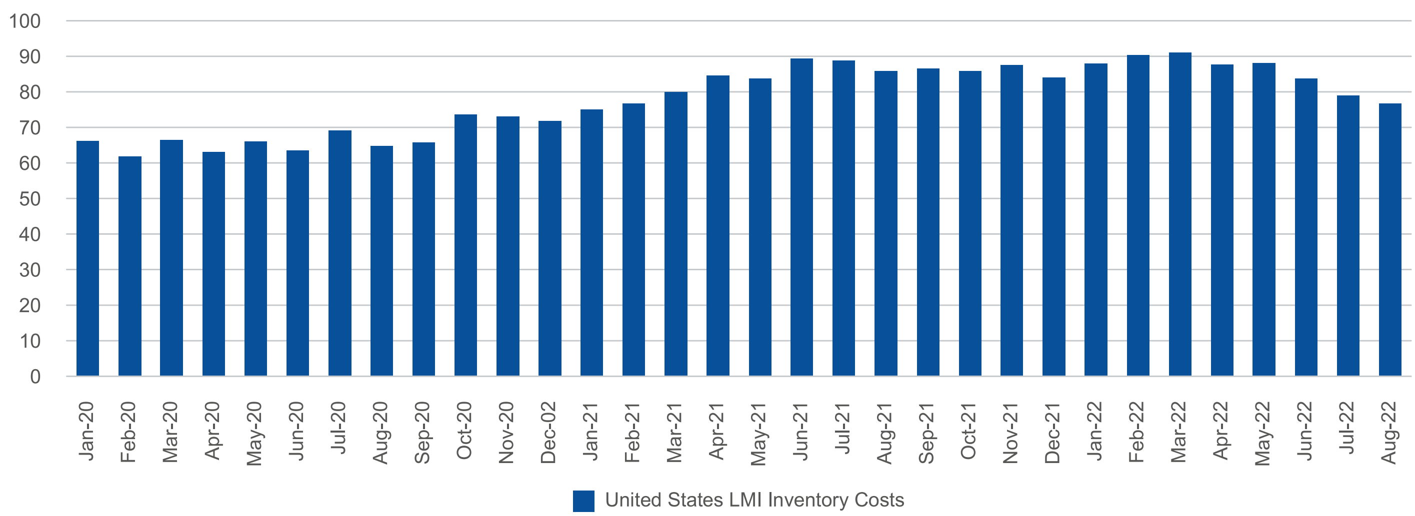
Orders and inventory demand weakening with softening consumer demand



Source: Census.gov

Small businesses are slowing orders due to softening demand which in turn drives down logistic costs. This is expected as the Fed's activities begin to cool the demand side of the economic environment.

Inventory costs follow consumer demand



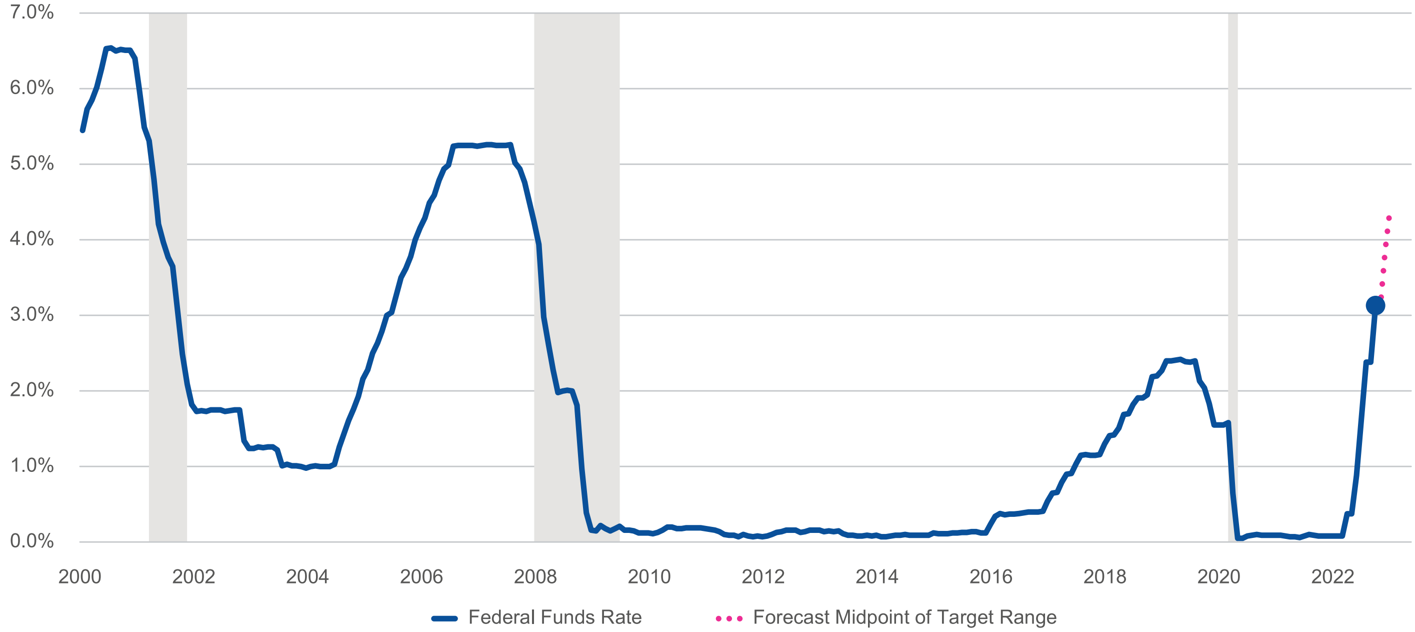
Source: Logistics Managers' Index

Lender performance weakens for the commercial segment

Access to funding is critical for small business growth. The price of funds is going up as the Federal Reserve begins to aggressively work to control inflation velocity in the U.S. Commercial lenders see the costs of funds rising and are beginning to pass that cost to customers.

Federal Reserve actions began in March 2022 to address accelerating U.S. inflation. Rates began to rise at a 50 basis point increments and continued to accelerate with additional 75 bases point hikes heading into the 4th quarter of 2022. This intervention activity is expected to continue into 2023, so don't be fooled by the leveling of inflation trends. The Fed's goal is focused on a target of 2%, and the global economic conditions and a strong dollar are headwinds small businesses will continue to fight by raising the costs of funds.

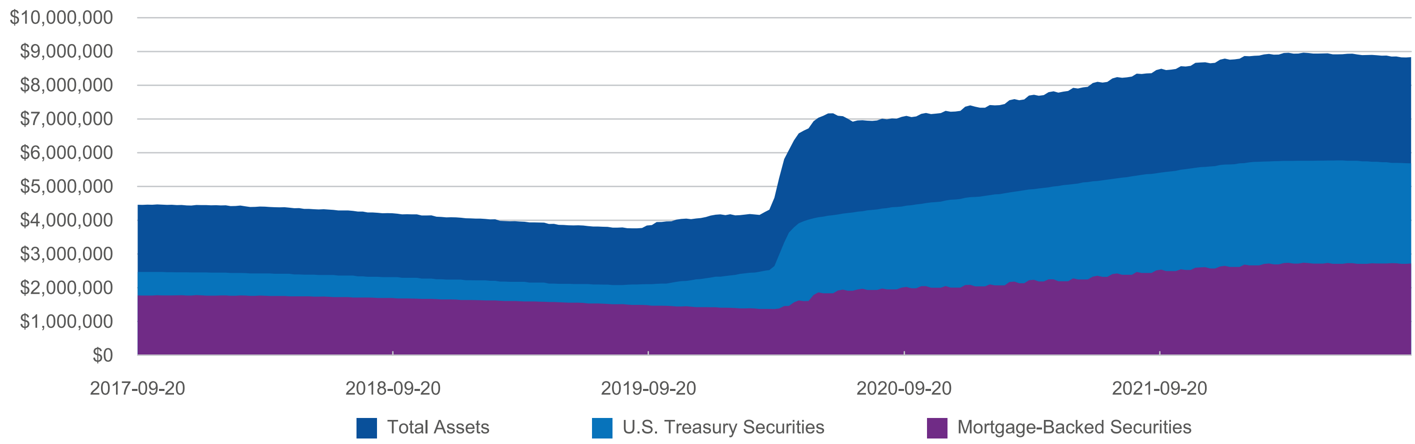
Federal Funds Rate and Forecast



Source: Bureau of Economic Analysis and Federal Reserve Open Market Committee

The Fed began its quantitative tightening activity. Their initial focus will be to discontinue purchasing of debt followed by a reduction in debt held on the government balance sheet. This activity will create a reduction in available public funding and put pressure on markets to cool the economy.

Quantitative tightening

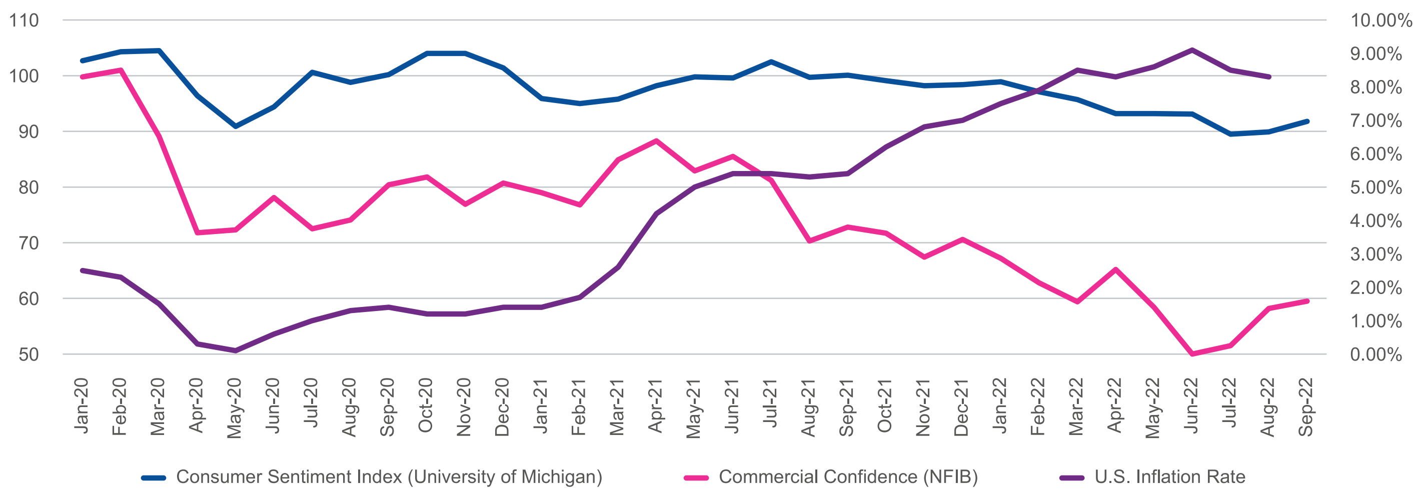


Source: FRED Economic Data/St. Louis Fed

Even with these actions, inflation is expected to be above the Fed 2% target through 2025.

Consumer vs Commercial Confidence

U.S. Consumer confidence at a 20 year low and small business confidence is following



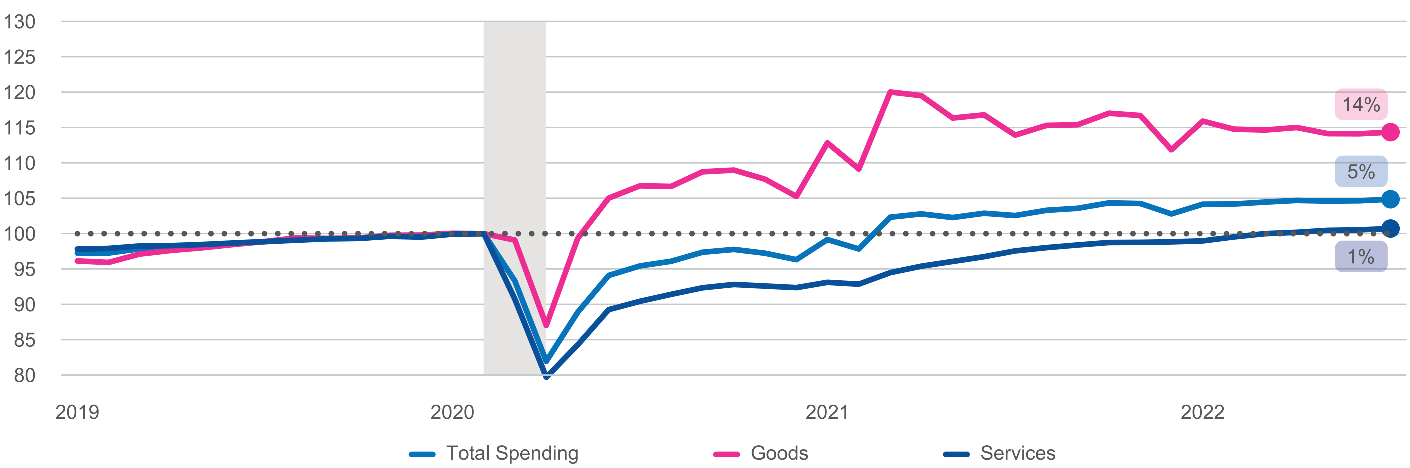
Source: University of Michigan, NFIB, U.S. Bureau of Labor Statistics

Consumer reliance on credit for core expenses will increase with inflationary pressure, and this will create upward pressure on forbearance and modification programs as consumer cash flow tightens. The U.S. market will feel the pressure of supply gaps for inventory creation in the auto industry, keeping demand high but supply very low. The consumer mortgage market will be impacted by higher borrowing rates as the Federal Reserve slows U.S. growth, affordability, and low inventory. Unsecured lending will see growth as consumers look to credit products to fill cashflow gaps, but as delinquencies increase, the consumer credit market will begin to tighten.

Consumers are pessimistic about the markets and don't like the inflation pressure. Consumers have seen recent relief in energy prices for gasoline, but that relief will soon be overtaken by higher home energy costs (Doubling in the Fall) and shelter costs as rents catch up to bloated home prices. The higher consumer costs are putting downward pressure on consumer confidence. Small business confidence follows close as businesses make future bets on inventory and growth based on consumer demand. Over the past few months, both consumer and commercial confidence have improved, but that improvement is slowing as inflation persists and purchasing power weakens.

The weakening in confidence has historically been followed by a weakening in spending behavior. For consumers, it meant changes in spending on premium products with discretionary dollars.

Consumers spend



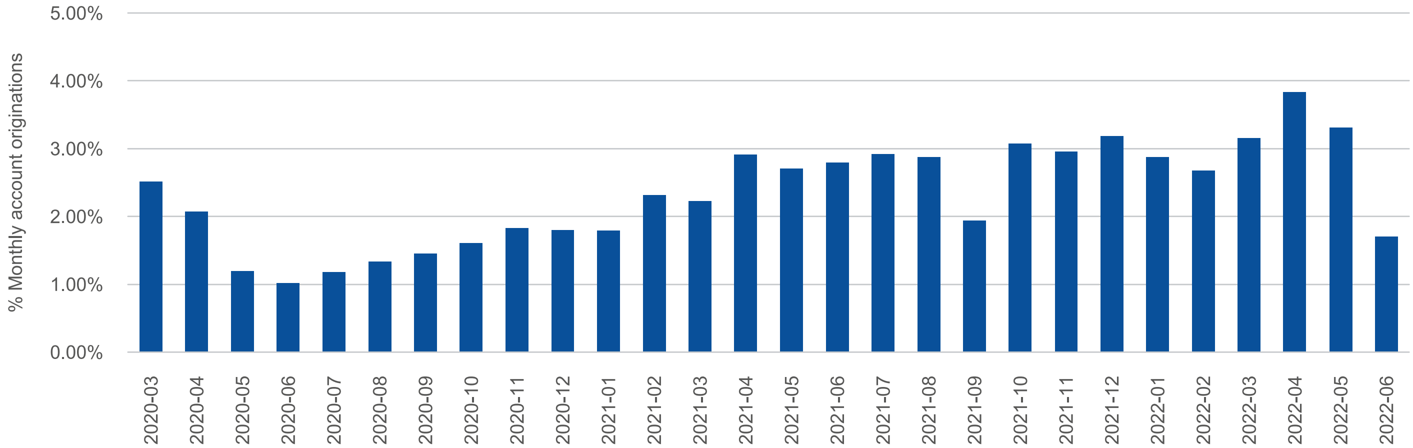
Source: Bureau of Labor Statistics, Bureau of Economic Analysis and Author's Calculation

Consumers have been fighting this behavioral change by dipping into their savings and seeking out credit through traditional credit products and reenergized products becoming more available, Buy Now Pay Later (BNPL). Even with these additional credit products, consumer velocity is slowing.

Small businesses are watching the consumer and holding firm to the notion that strong spending behavior will persist through 2022, but cracks in their confidence are forming over the past quarter. Commercial confidence is down 8.3% YOY as small businesses reassess inventories and expected consumer engagement during the holidays.

Commercial lending has been accelerating through 2022 but has seen cooling in the 3rd quarter as small businesses access their short-term outlook. Unsecured debt product engagement trends are an excellent leading indicator on the health of small businesses.

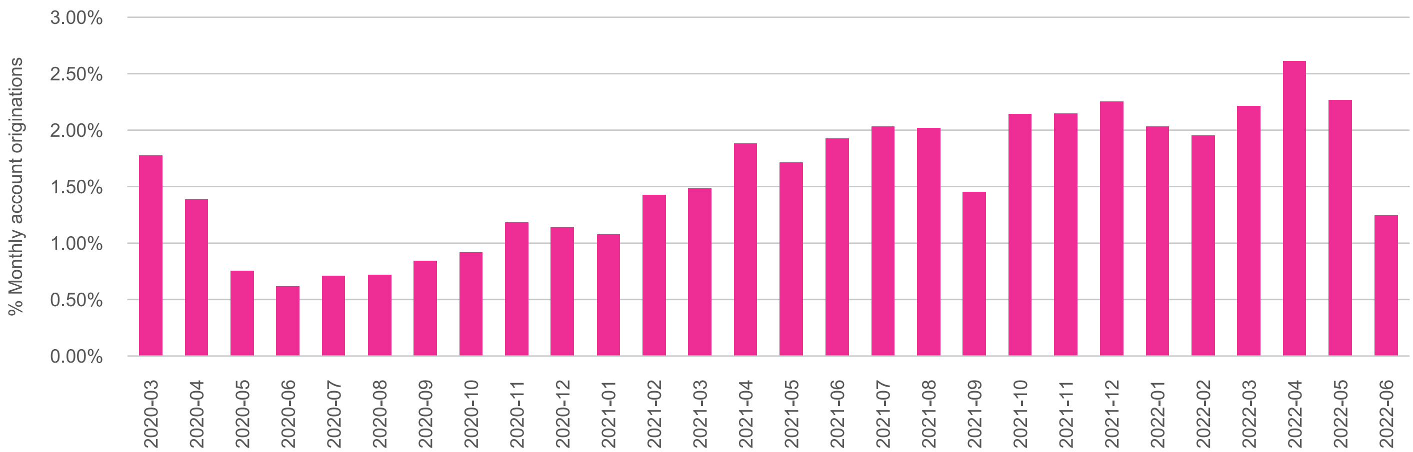
Unsecured commercial credit softens



Source: Experian Commercial Benchmark

Originations have been accelerating through 2022, but stalling in the last few months as small businesses rethink their growth strategies, consumer demand weakens, and hold off on taking on new debt focused on investment and growth. If we focus directly on the Retail industries' unsecured debt, the pattern for origination volume reduction and lower average credit lines aligns with the U.S. view above.

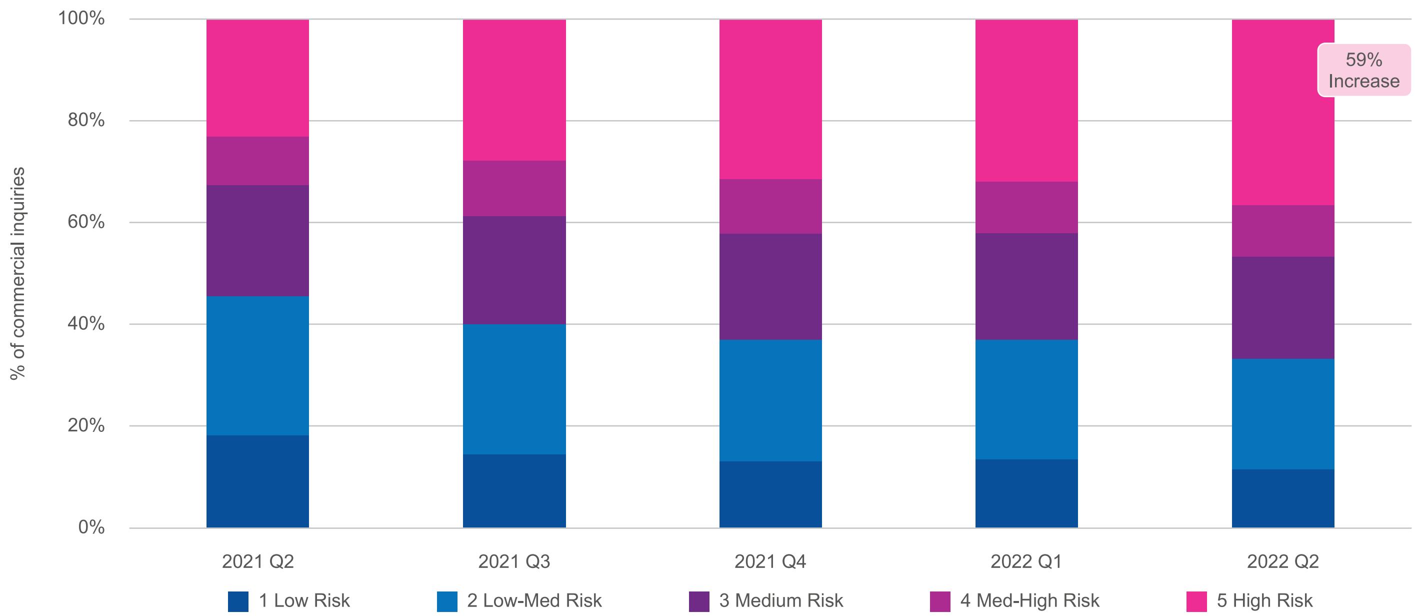
U.S. Retail unsecured credit card originations



Source: Experian Commercial Benchmark

Commercial lenders also have a hand in the slowdown. As the Fed begins to cool the economy, a number of small businesses will not be in a position to absorb the increase in the cost of doing business. As small businesses run lean on cash flows, they will seek credit at a higher rate. We see a 59% increase in the number of high credit risk inquiries in the 3rd quarter leading to lower than normal average credit lines across the industry.

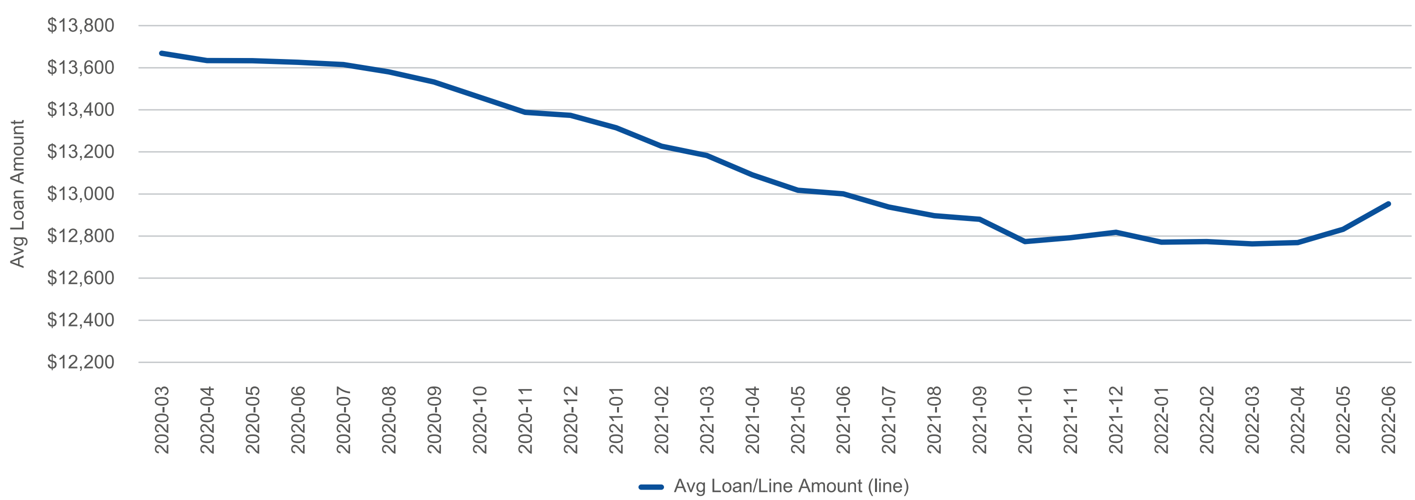
Small businesses credit seekers are riskier than a year ago



Source: Experian Commercial Benchmark

This means that higher-risk companies are pressured to seek credit before credit markets tighten. The decrease in the average credit line for unsecured debt is also driven by the high number of new small businesses in the market across the credit spectrum, presented with lower initial line amounts due to their available credit history.

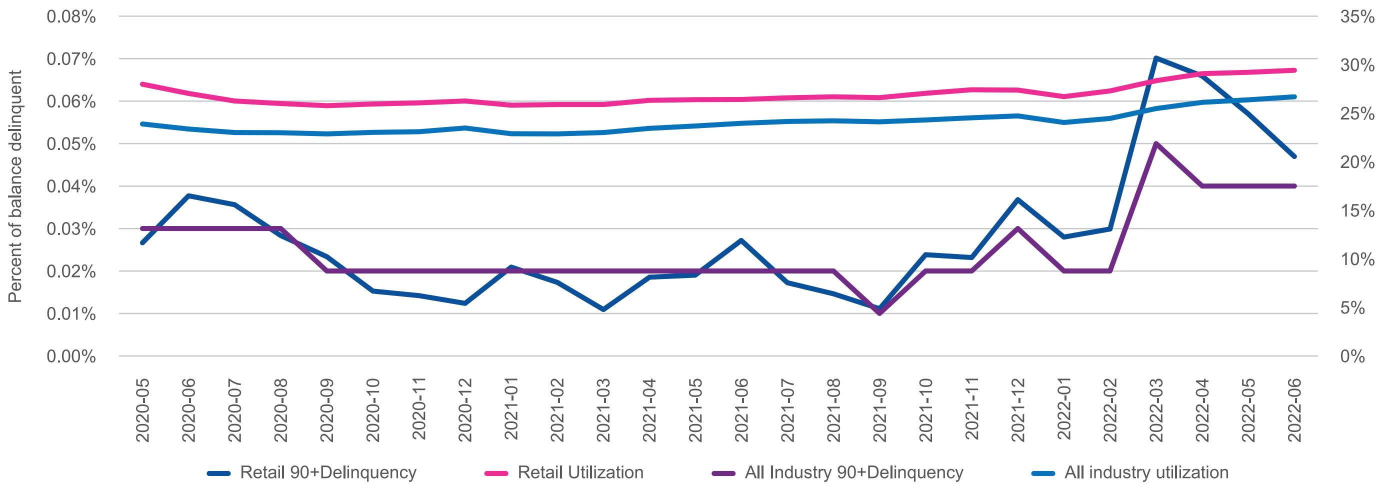
Unsecured commercial credit lines feel the pressure of new businesses



Source: Experian Commercial Benchmark

Lenders have been noticing utilization and delinquency increasing across products and industries.

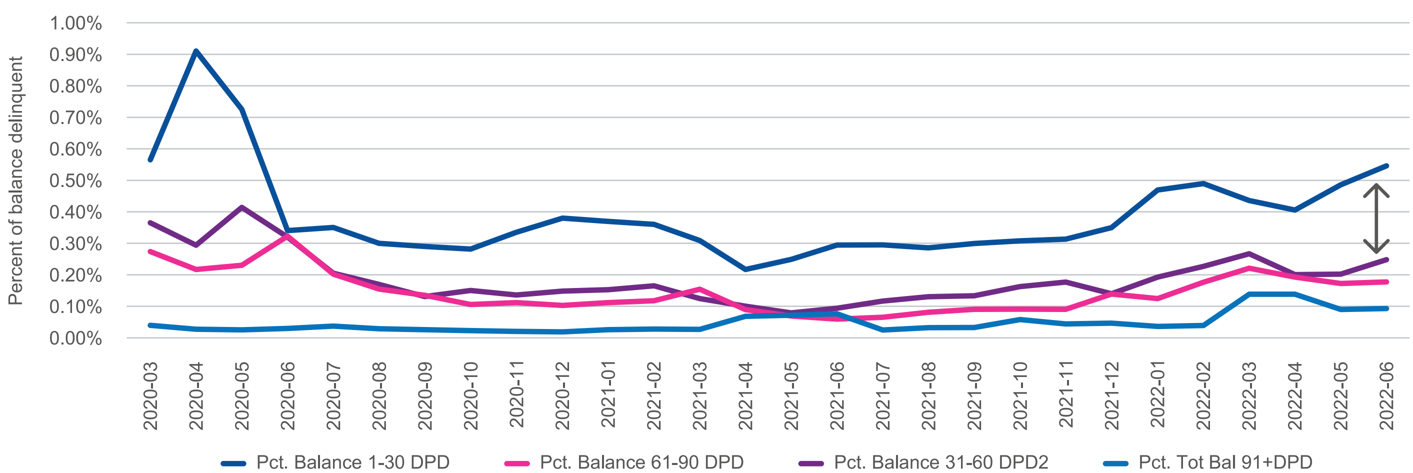
Relationship between utilization and 90+ delinquency



Source: Experian Commercial Benchmark

Even though commercial delinquencies and utilization are rising, they are still seen as being historically low. Good capitalization, aided by stimulus and short-term payment relief, has kept higher delinquencies in check. 1-60 day delinquencies are on the rise, but 90+ have stayed low.

Volatility in delinquency rates (Rolling buckets)

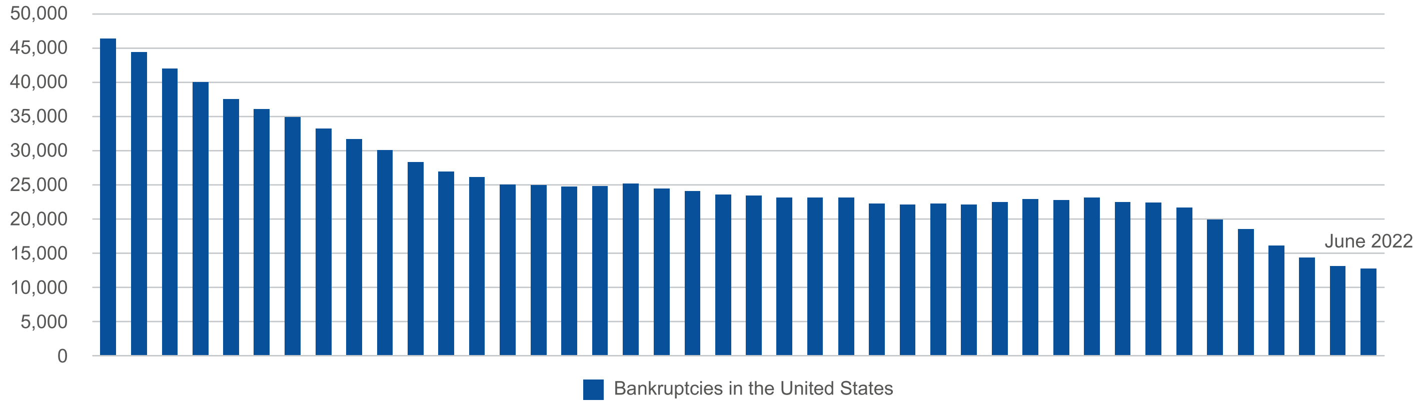


Source: Experian Commercial Benchmark

This view of the delinquency behavior highlights business's ability to make strategic repayment decisions, by delaying repayments, but not allowing them to roll into later-stage delinquency buckets that activate collection and litigation by lenders. If the 90+ remains low, private commercial funding will remain open.

Those rolling into the later stages of delinquency and bankruptcy remain low and are not significantly impacting markets.

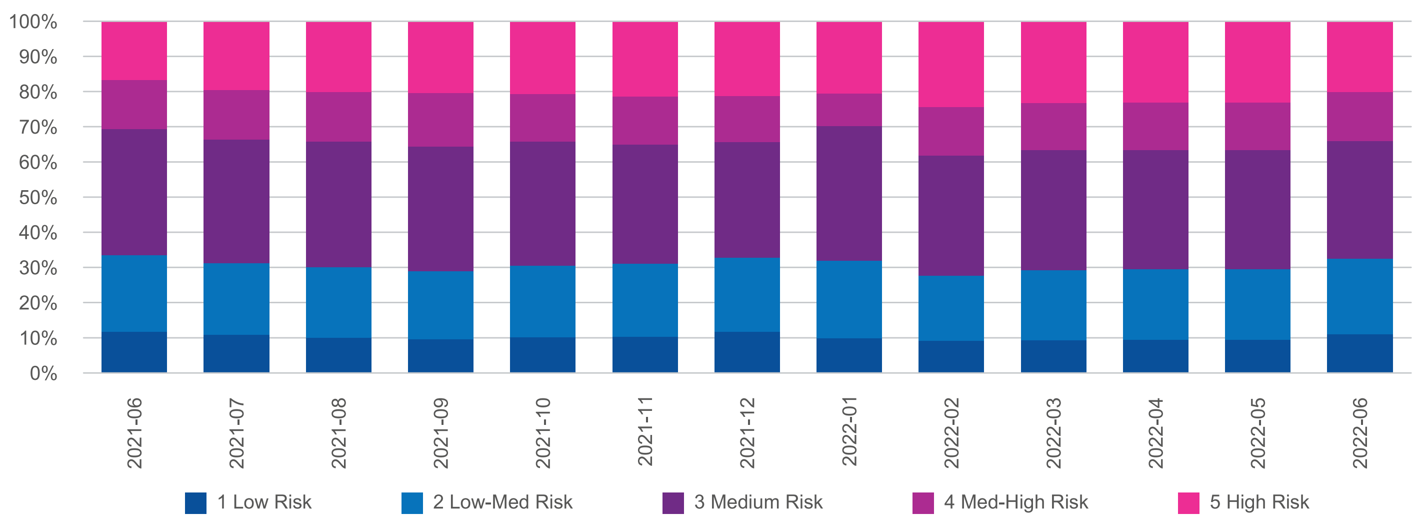
Bankruptcy rates remain low



Source: Administrative Office of the U.S. Courts

Lenders are beginning to tighten credit criteria for underwriting new commercial debt. Over the past 6 months lenders are originating 13% less high risk loans and super prime loans are up 22%.

Commercial credit tightening



Source: Experian Commercial Benchmark

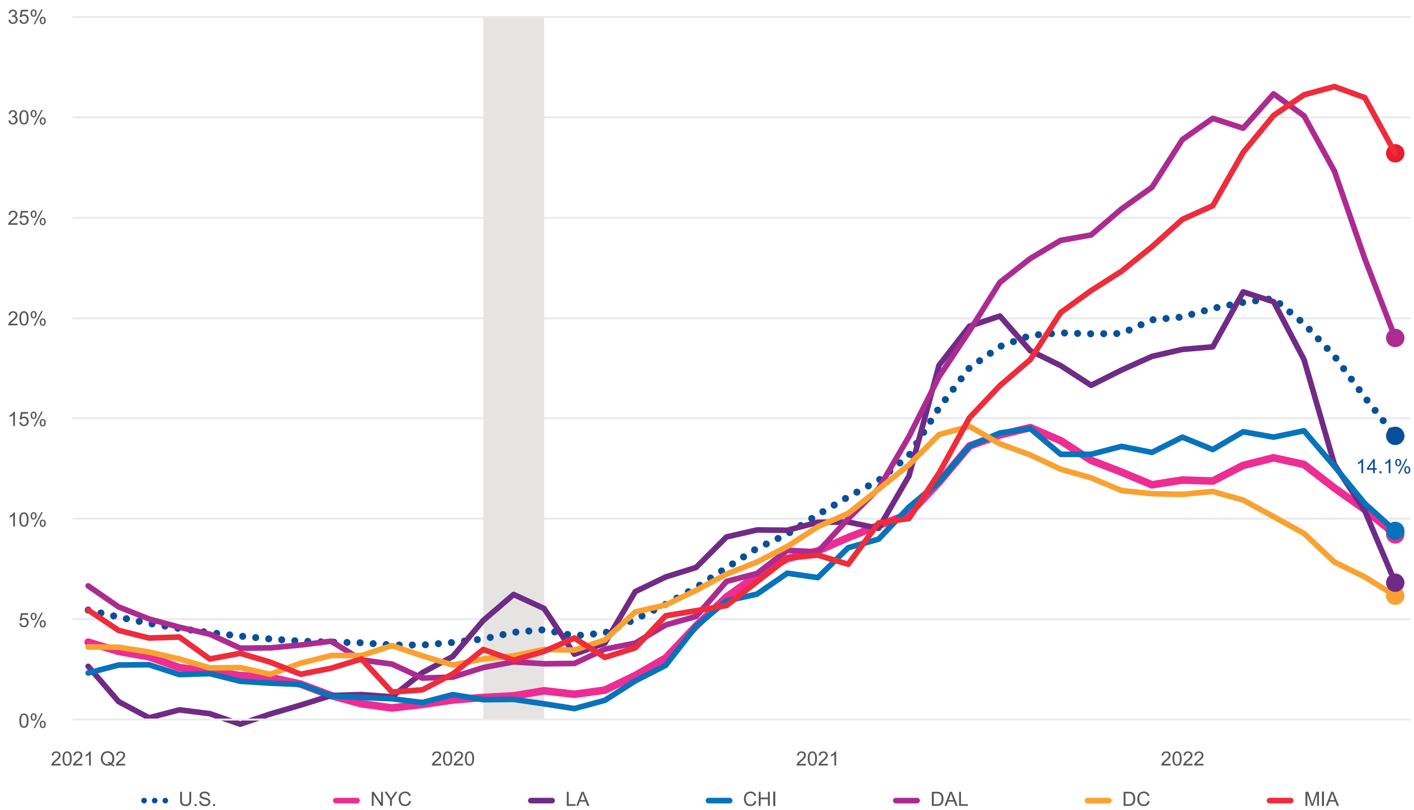
In a recent survey of small business lenders 53% said they were already tightening or were considering tightening their underwriting criteria. Small businesses and market investors will be watching how lenders will handle increasing delinquency pressure in their underwriting of new debt to continue growth as the U.S. and global economies slow.

What will likely cause small businesses to run out of steam

Small business owner access to credit and equity is eroding as we enter the 4th quarter of 2022. Commercial credit markets have already begun to tighten, and assets that business owners often use to secure quick cash to fill cashflow gaps are evaporating. An example of this is highlighted in the housing market. Home values are dropping rapidly following a rapid acceleration.

After huge pandemic surge, home price growth is rapidly slowing

(Home Values: YoY % Change)

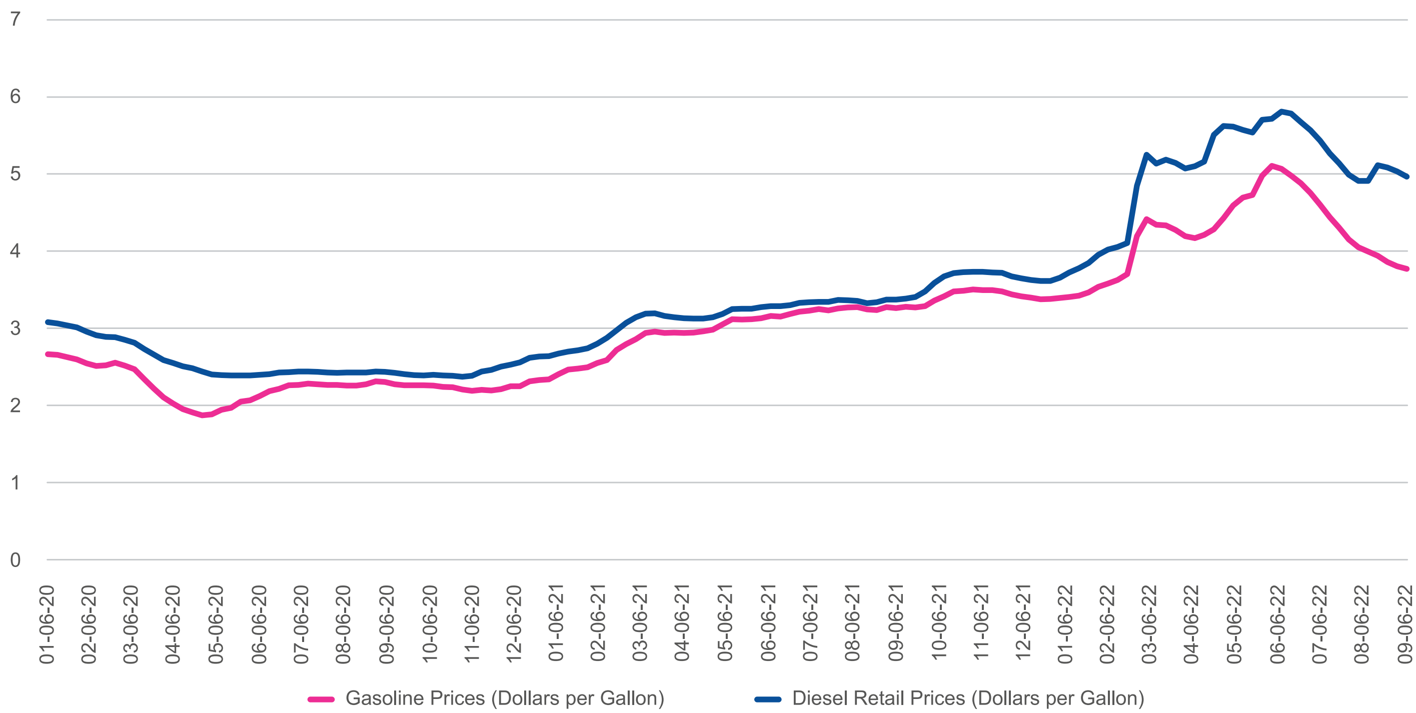


Source: Zillow Research and Author's Calculation

This deflation in home values erodes home equity availability for owners to pull cash out to inject into their business in tight economic cycles.

Weakening consumer demand as pressures like fuel prices smashing through the 4 dollar a gallon high water marks, driving consumers to cut into discretionary spending to cover core costs. While fuel prices are elevated, they have been coming down over the summer.

Weekly U.S. Regular All Formulations Retail Gasoline Prices (Dollars per Gallon)

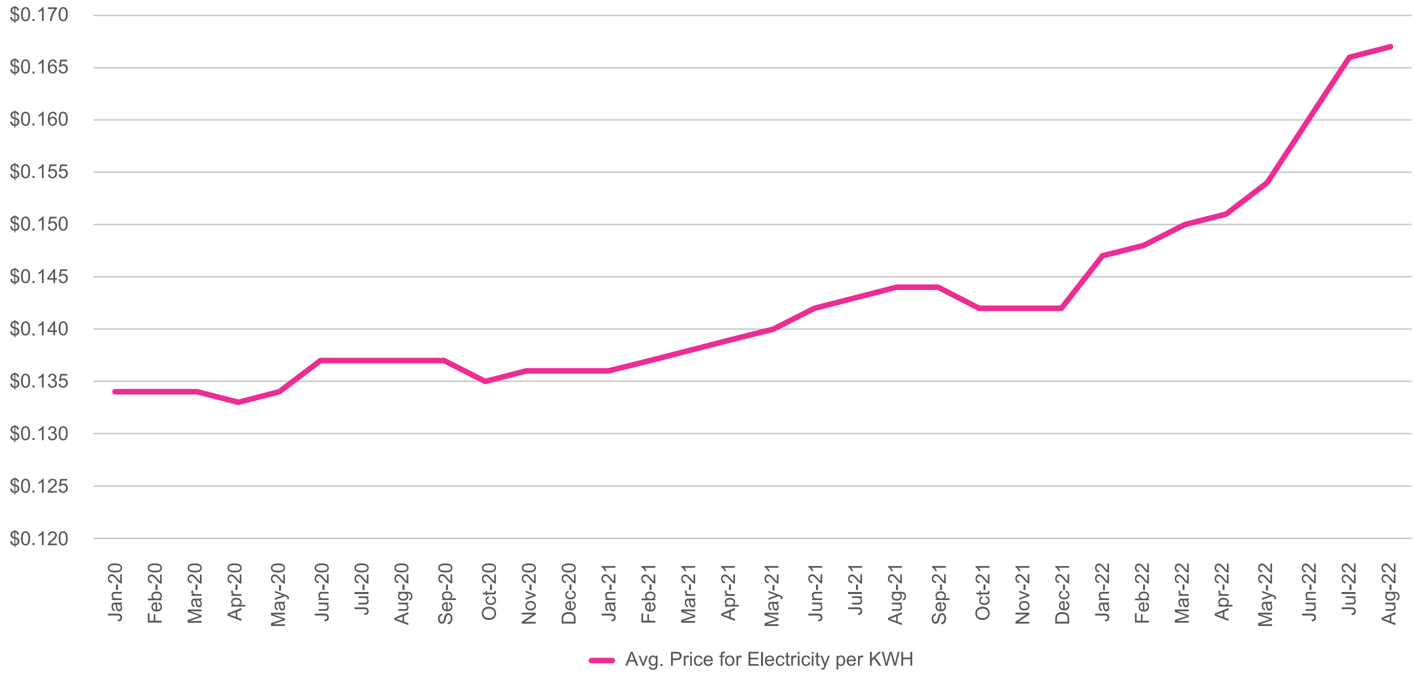


Source: https://www.eia.gov/petroleum/gasdiesel/, https://www.eia.gov/dnav/pet/pet_pri_gnd_dcus_nus_w.htm

Weakening consumer spending is already playing into the energy futures market as fuel prices drop on the expectation of decreased demand as the U.S. economy cools. Although cooling, the pressure will continue for consumers through 2023 as the global energy trade is disrupted by reactive policy changes and sanctions leveraged toward Russia, a top producer and distributor of energy around the globe. Sanctions leveraged on developers and producers of Russian-supplied oil and the banks that fund them will create supply shortages in the U.S. and other regions. Fuel impacts more than the transportation of goods. This elevated cost will impact farmers and food-producing industries as the production cost will rise.

The weaponization of natural gas supply is already impacting Europe, driven by the conflict in Ukraine, it will create a short-term increase in home energy prices in the U.S. as global prices increase.

Electricity per KWH in U.S.



Source: https://data.bls.gov/timeseries/APU000072610?amp%253bdata_tool=XGtable&output_view=data&include_graphs=true

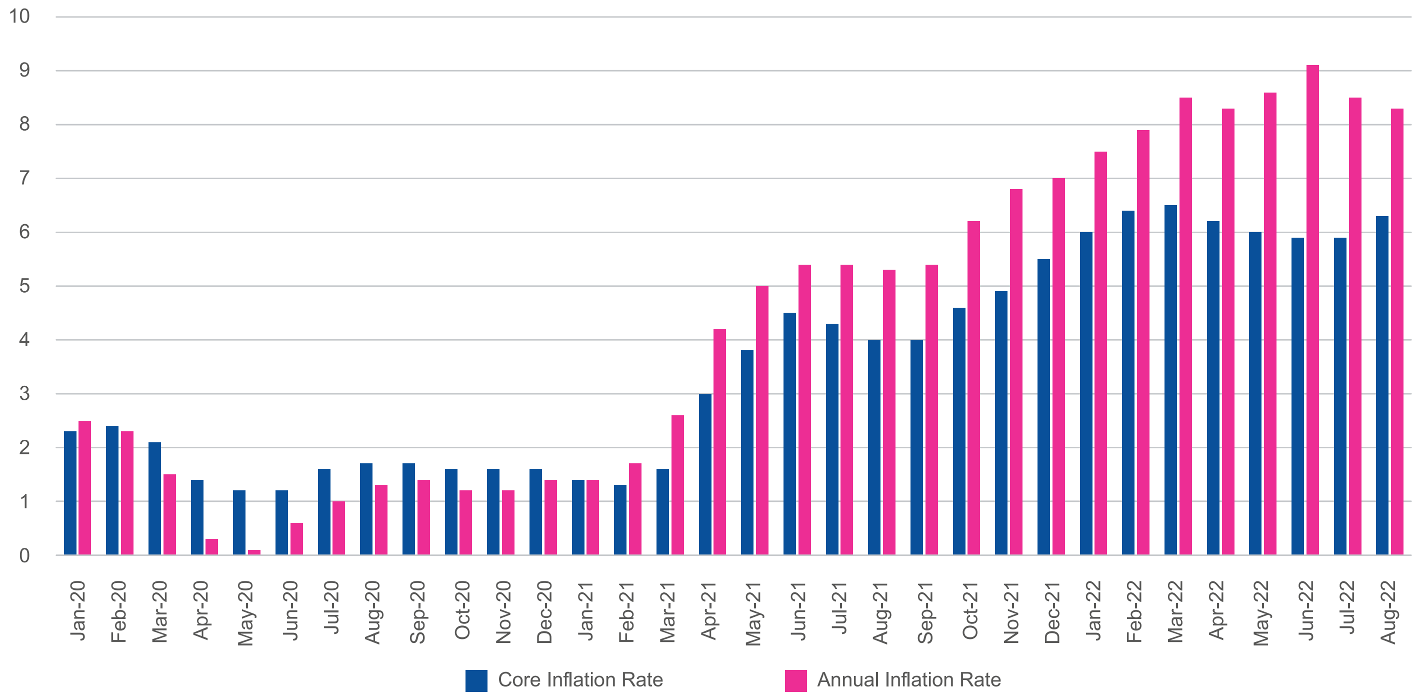
This will place additional pressure on U.S. household cashflow as winter arrives.

A strong dollar will continue to put pressure on our global trading partners as products exported from the U.S. will be more expensive. This cooling of exports will impact U.S. businesses who interact with markets outside the U.S. However, the strong dollar does allow those operating within U.S. markets to see some price relief on offshore production costs in the short term.

If these global pressures persist, as expected through 2024, U.S. households will burn through savings, and a more significant spending reduction for goods and services will be noticeable, enhancing the economic cooling effect that the Federal Reserve is working toward throughout the next year. Inflation remains above 8%, with a target of 2% coming into the 4th quarter.

Persistent Inflation/Supply chain disruption

Inflation elevated



Source: https://www.bls.gov/charts/consumer-price-index/consumer-price-index-by-category-line-chart.htm

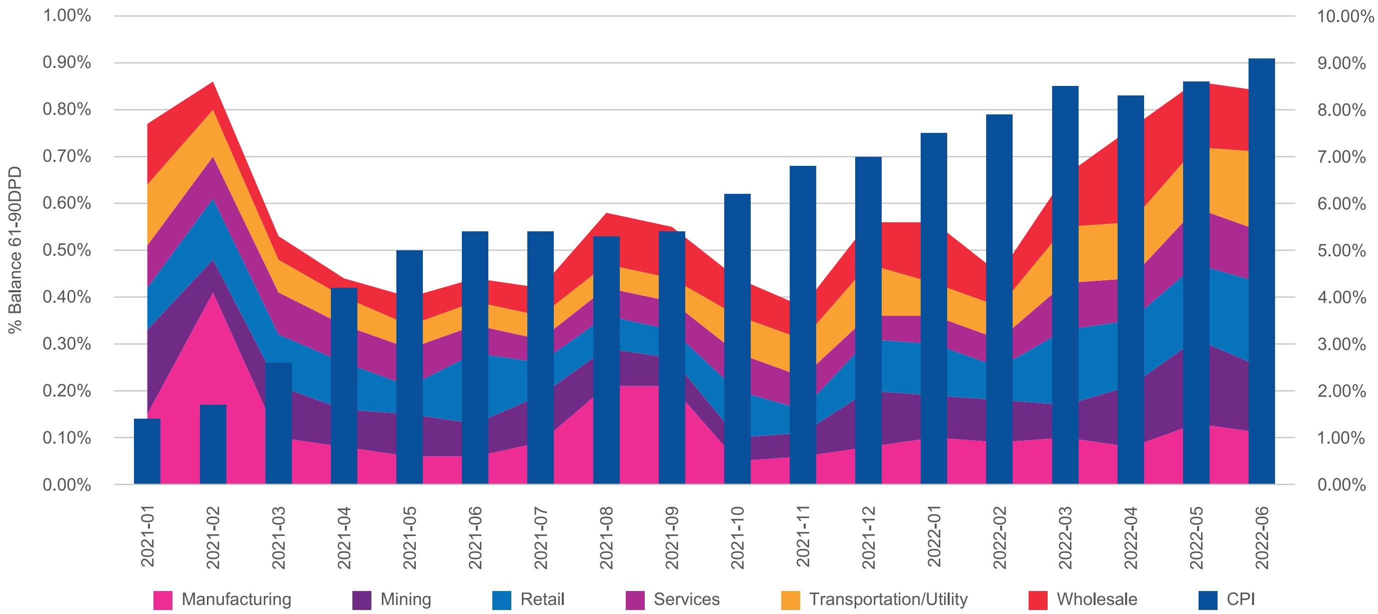
Consumers feel the tangible economic strain of rising food and energy costs, increasing at rates not felt since the early 90s. These strains are not felt evenly across income segments in the U.S. Low-income families will feel the brunt of the impact.

A volatile domestic and global supply chain will continue beyond the 4th quarter but is beginning to see some stability as global pandemic scenarios ease. Prices for international shipping and domestic logistics are starting to normalize. From mining critical resources to delivering final inventory, businesses will feel the squeeze of global conflicts, sanctions, and global U.S. trade policies. Volatility in these industries will persist through 2023.

Staffing will continue to be a challenge for small businesses. U.S. has 11.2M job openings in July. Job openings continue to outpace applicants almost two to one. Job seekers rejoin the employment market as inflation impacts retirement values and cost of living increases force the remaining holdouts back into the market. Even with a new job, consumer wage growth is being eaten away by inflation in the U.S. Employers continue to offer special incentives for candidates, but the number of open positions significantly outpaces the number of job seekers. As a result, people are reentering the U.S. job market, pushing the unemployment rate towards ~4% in 2022 from its 3.5% low. High inflation combined with reduced benefits/stimulus will place millions of people in a tighter fiscal position, reducing their ability to spend. These near-term risks will impact consumers' discretionary spending willingness and capacity. This changes the labor dynamics of the U.S. and will create pockets of full employment while other regions struggle to find workers. Wages will continue to rise as employers fight to attract and maintain a labor force for the worker.

Increased labor and inventory costs have been creating repayment pressure on small businesses as inflation persists at an unusually high level. Retailers will try to counteract the sunk costs in inventory with holiday sales starting as early as September.

Inflation impacts on supply chain delinquency trends



Source: Experian Benchmarking

The increased challenges in repayment on both the consumer and commercial sides will begin to weigh on lender balance sheets, and credit will begin to tighten. This tightening has already begun for small business lending amid weaker consumer spending. Consumer credit tightening will drag the economic outlook for 2023 for small business performance as discretionary spending dries up.

Have a plan after the sales

Lenders should evaluate their credit criteria for underwriting as delinquencies increase and consumer spending weakens. Now is the time to turn on monitoring portfolios to identify areas of risk and develop strategies to either create accommodations with profitable customers or look for opportunities to engage less stable customers with pre-treatment strategies.

Small businesses will need support and guidance as their environment becomes more challenging. As costs rise and consumer demand weakens, businesses will begin to make decisions on whom to repay first. Lenders and creditors will monitor customer performance and plan pre-treatment and potentially collection strategies for accounts with delinquent balances. Accessing these strategies before the economy begins to slow and small business cashflows are affected is key to customer support and service. Simple strategies using collection scores and commercial credit scores can segment a portfolio into risk and repayment groups where more targeted contact and engagement strategies will improve success and customer experience.

How long does holiday spending last?

Consumers have been spending into their savings during 2022, but that velocity is slowing. Holiday sales have already begun. Lowes has Christmas decorations on sale right next to Halloween starting mid-September. Businesses are working to reduce the amount of overhead in inventories before consumers start to really change discretionary spending behaviors.

Delinquencies are rising for small businesses across regions and products. These delinquencies are most significant in the early-stage delinquency buckets. Late-stage delinquencies, although growing, have remained historically low. Small businesses are making repayment decisions as cashflow starts to tighten. But they are working hard to prevent rolling into later-stage delinquencies because that would limit their ability to access additional funding at critical points in the cycle by significantly lowering their commercial credit score.

A weak recession in the U.S. is likely as activities by the Federal Reserve focus on slowing a hot economy and cooling inflation velocity. 2022 will be a reset and growth year for the U.S. market, filled with risks and big opportunities.

Time to start your holiday shopping, the bargains are plentiful!

About the author

Brodie Oldham
Vice President Commercial Data Sciences
Experian Business Information Services

Brodie leads a team of statistical consultants, scientist, modelers, and engineers with diverse skills to provide clients with leading edge analytic-driven information solutions, services, and visualization of actionable insights. His is an industry expert, who speaks on behalf of Experian at industry conferences.

Authorized Experian Direct Sales Representative

Beyond the Trends

WISCONSIN CREDIT ASSOCIATION
15755 West Rogers Drive • PO Box 510157 • New Berlin, WI 53151
Phone: 262.827.2880 Web: www.wcacredit.org

BCMA/WCA is an Authorized Experian Direct Sales Representative