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Beyond the Trends

Understanding the Commercial Economy

Summer 2023

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.

Summer sunshine poking through the clouds brings hope, but be mindful of the weather.

When I plan my week, I always look first at the weather forecast to have a sense of how I should prepare for each day. Shorts and a T-shirt are best on hot days for ease of movement and maximum efficiency in cooling. An umbrella for other days when protection from the elements and a barrier from the storms is needed. As we look outside, should we be preparing for sunshine or rain. Outside the U.S., economies have struggled to find footing and feel the pressure of reduced order volumes and higher costs. These same challenges are being felt by U.S. small business owners, but optimism in U.S. market performance has kept investment advancing and cashflow protectionist activities at a minimum. Commercial creditors are adjusting underwriting criteria to limit exposure as we enter the second half of the year, but small businesses still have options when looking for funding. Fintech lending remains poised to fill the gaps large lenders create when tightening. Public sector funding has broadened products and providers to expand the safety net for U.S. businesses even as the market softens. Additional funding brings enhanced and expanded government oversight. This expansion will require businesses and commercial lenders to increase spending to accommodate the new regulatory demands. Advancement in generative A.I. is a shining light of transformational efficiency and innovation that is boosting tech companies and raising excitement around investors to stay in the U.S. market.

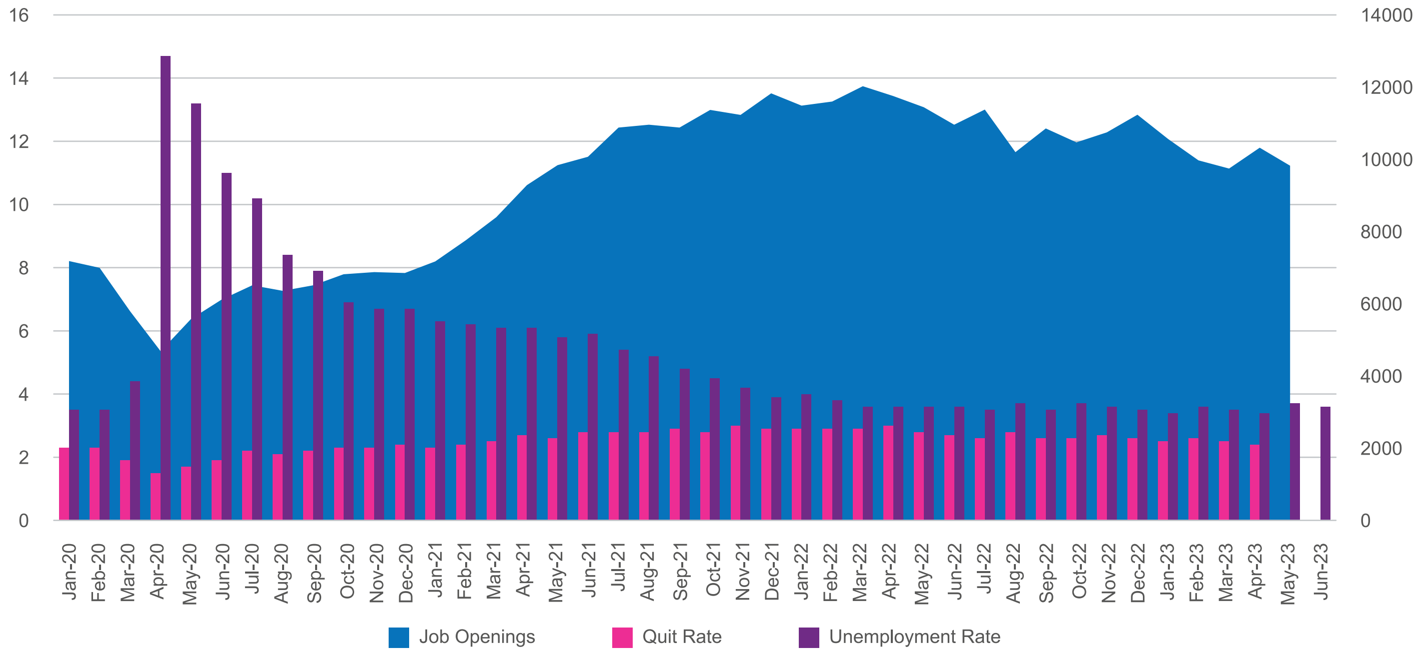
The insights shared in this report take you from a high-level macro view of the market drivers and U.S. small business commercial credit health to insights we see Beyond the Trends.

The success of small businesses will heavily depend on the resiliency of the U.S. consumer. Spending behavior, although softening has remained strong, and continues to demand investment to keep store shelves full. These increasing costs are expected to continue through 2025, even as early success by the Federal Reserve has created downward pressure on inflation. Small businesses will feel the pressure to expand as they weigh the fear of overleveraging as tangible increases in core expenses challenge consumers behaviors. Over the past quarter, there has been a break in the clouds of doom and gloom economic forecasts. The economy has persevered even as summer rain cools growth expectations in targeted industries.

Did economic reality rain on the Great Resignation's parade? Do I need an umbrella?

News of layoffs, higher-than-expected inflation, a cooling job market, and recessionary storm clouds constantly on the horizon, have begun to cool the labor force migratory acceleration and wage growth. Resources have become less likely to shop for higher wages, and employers are beginning to cool hiring as cashflows decelerate.

Unemployment rate, quit rate, job openings

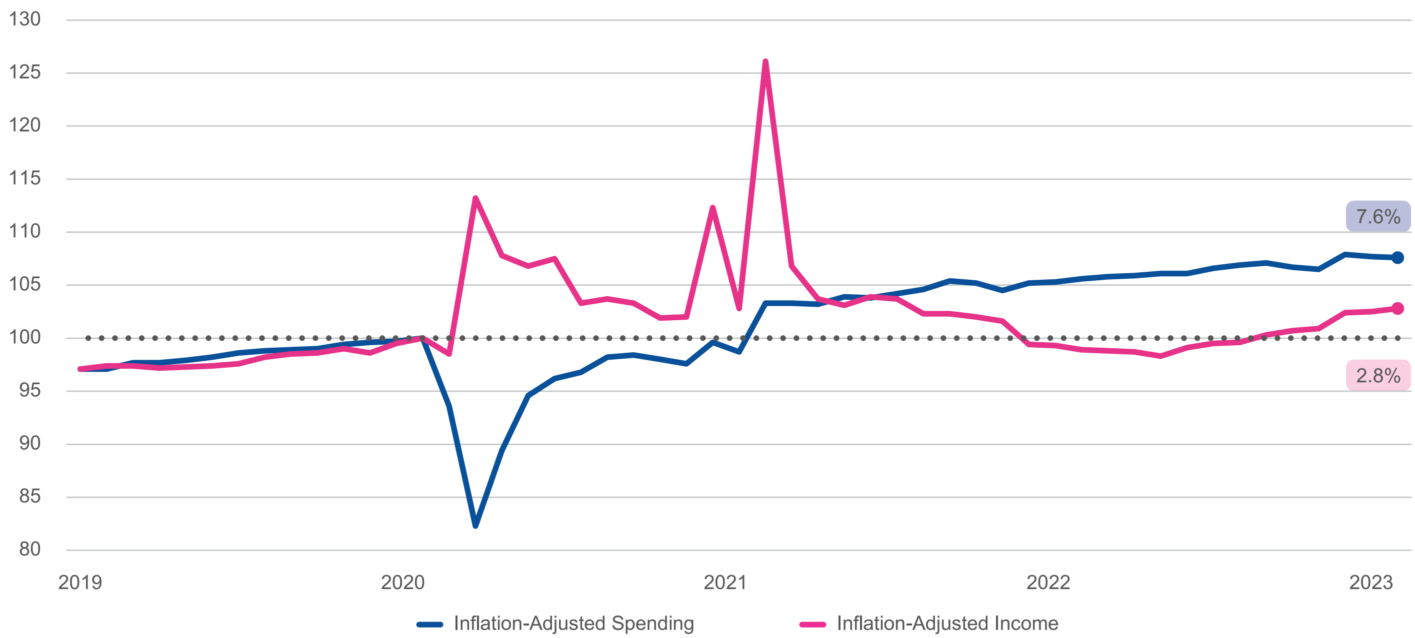


Source: U.S. Bureau of Labor Statistics

These cooling trends in the labor market do not mean that the market is under control. Employers added 209k jobs in June, and the number of job openings in the U.S. is still well over 9 million. The fear of an economic slowdown has cooled the Quit Rate but looking at a year-over-year trend, the rate of resources leaving a company is still elevated. The average hourly wages for private sector workers were up 4.4% in June, which continues the trend of employers offering higher wages to attract employees. Preliminary figures out of the St. Louis Fed show consumer paychecks are growing at a faster pace than market price growth for the first time in two years. This upward pressure will continue to challenge the Federal Reserve's efforts to calm inflation as the workforce demands higher wages. Higher wages mean consumers can continue to spend in a rising inflationary environment. This trend in growing wages is not keeping up with consumers' spending level.

Consumers are leveraging unsecured lending tools to accommodate higher prices on products they have grown accustomed to purchasing. The positive expenditure is not an increase in units purchased but a result of rising prices on products the consumer would have purchased regardless. Not moving the volume of units forecasted by many small businesses in the U.S. over the past quarter places pressure on unit pricing as businesses look for ways to make their products more attractive to the consumer with recessing spend power.

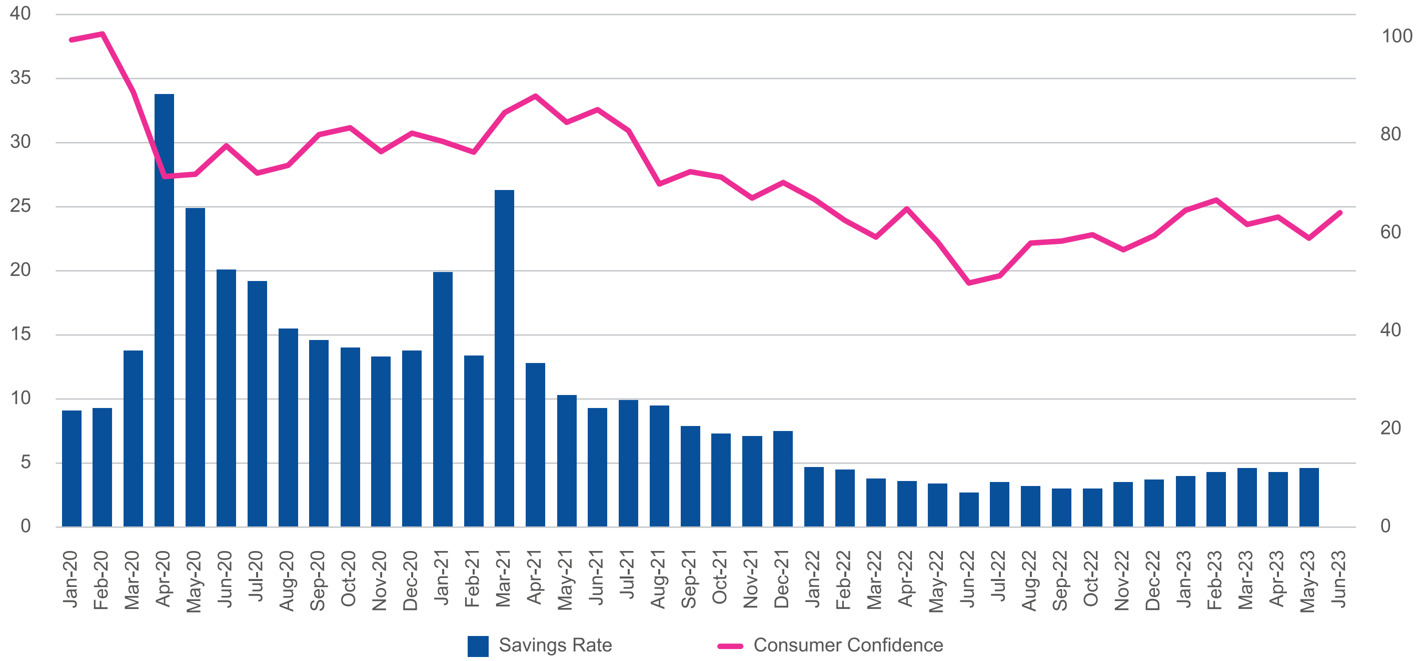
Consumer spend in U.S.



Source: U.S. Bureau of Economic Analysis

Small business success relies on the ability of the consumer to continue spending. Consumer income growth has remained positive, leading to more spending and savings. The savings rate has rebounded as investors continue to feel positive, and the labor market remains strong. Consumer savings increased to 4.6%, up 35% from the same time last year, extending the consumer's ability to repay debt longer and prolonging positive U.S. consumer spending growth.

Consumer Savings Rate



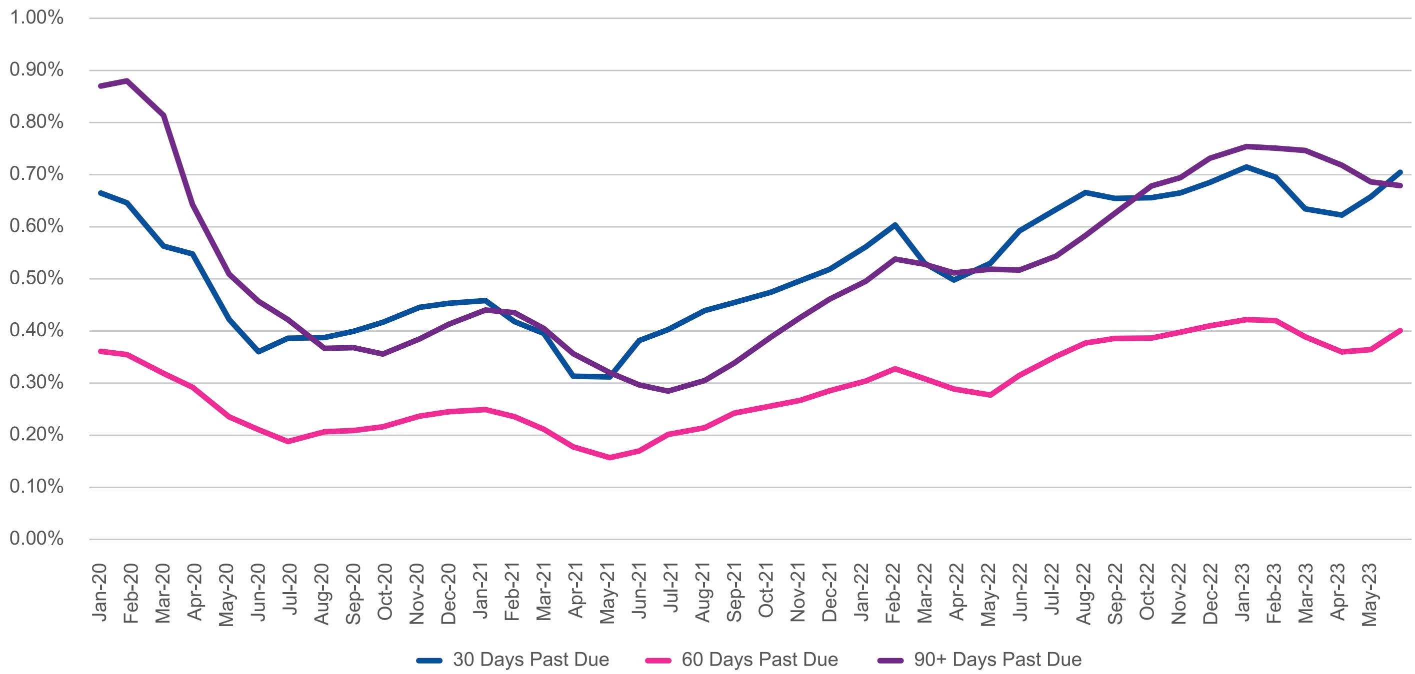
Source: U.S. Bureau of Economic Analysis

Recession noise in the market will often drive marginal growth in savings rates as consumers pack a little away for a near-term rainy day. The impact of this trend is not exceptional in the second quarter because consumers have been hearing about the recession threat for a while.

Delinquency Rates

A growing savings rate does not mean that all consumers are paying on time. Delinquency rates in the U.S. have been rising as a hot U.S. economy brings competition to dig deeper to secure new business and protect current customers. Over the past two years, lenders have used machine learning models and methodologies to dig deeper into risk segments to find pockets of less risky customers to engage. Digging deeper still brings a higher risk of repayment disruption or default. The expansion of secondary and fintech lenders to cover higher-risk populations, increases the funding coverage for underserved and often higher-risk borrowers. This expanded coverage brings with it higher default potential. As the U.S. economy cools and consumer spending behavior changes to accommodate higher costs and less purchasing power, these higher-risk consumers and small businesses will see disruption in cash flow. This disruption leads to an increase in delinquency rates when looking at financial markets.

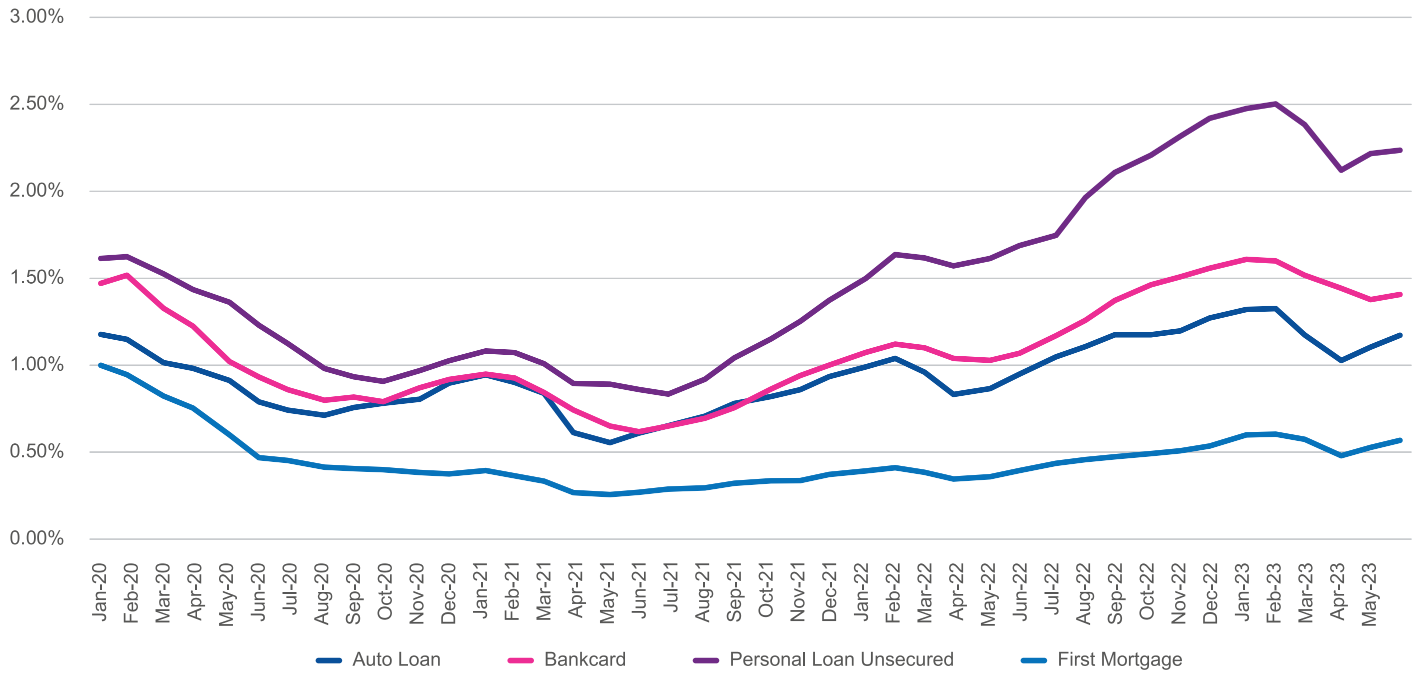
U.S. Consumer delinquency rates over all



Source: Experian State of the Market

Repayment challenges are on the rise, surpassing the rates we saw pre-pandemic. A higher percentage of consumer accounts rolling into 60-day delinquency buckets are now going 90+. This trend is noteworthy for consumers and not yet seen for commercial accounts.

U.S. Consumer delinquency rates across products



Source: Experian State of the Market

Within the auto lending segment, car payments have risen dramatically over the past 24 months as inventory disruptions and lending rates challenged the consumer. Consumers are now reassuming debt payments, such as student loan debt, that will impact their ability to make these high monthly auto payments as agreed, as consumer savings rates were high and debt obligations looked to be forgiven.

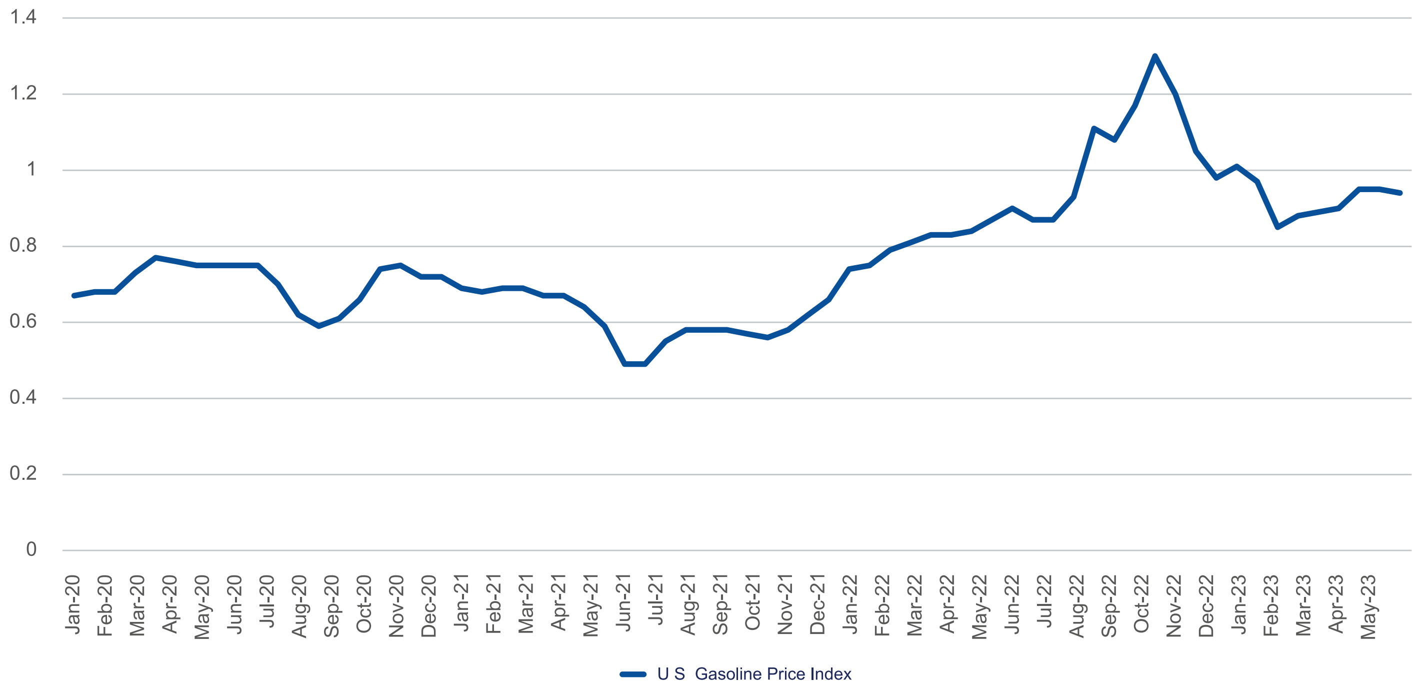
Unsecured lending products are seeing increased velocity of repayment disruption as consumer spending outpaces an ability to repay. Utilization has increased in high-risk segments, limiting consumers' ability to access additional credit. Lending markets are still open to most consumers and small businesses, even as lenders take steps to limit exposure. For the consumer, these delinquency trends are at the expected levels for a hot economy.

While there are showers across the U.S., a few rainbows bring hope

Energy prices

Consumers and small business owners will see continued relief in fuel prices in the coming months. The U.S. has increased production by 9% YOY as OPEC cuts production expectations globally to increase barrel pricing. (WSJ July 8) Countries like Iran and Russia are also increasing production and adding globally available supply to the market. A weaker than expected growth performance by China is lowering demand expectations for the global market. Compound that trend with a higher efficiency exploration and drilling infrastructure in the U.S., means fuel prices should remain low in the near term.

Relief in consumer fuel costs



Source: U.S. Energy Information Administration

This combination of global and domestic factors will provide more affordability in fuel costs for U.S. consumers and small businesses. This relief will help producer costs decline, and those cost savings can be passed onto the consumer through lower prices of food and goods. This activity created a continued cooling effect on food inflation in the past quarter, a silver lining for consumers as they cope with returning debt payments (like student loan debt), segment focused persistent inflation, and higher shelter costs.

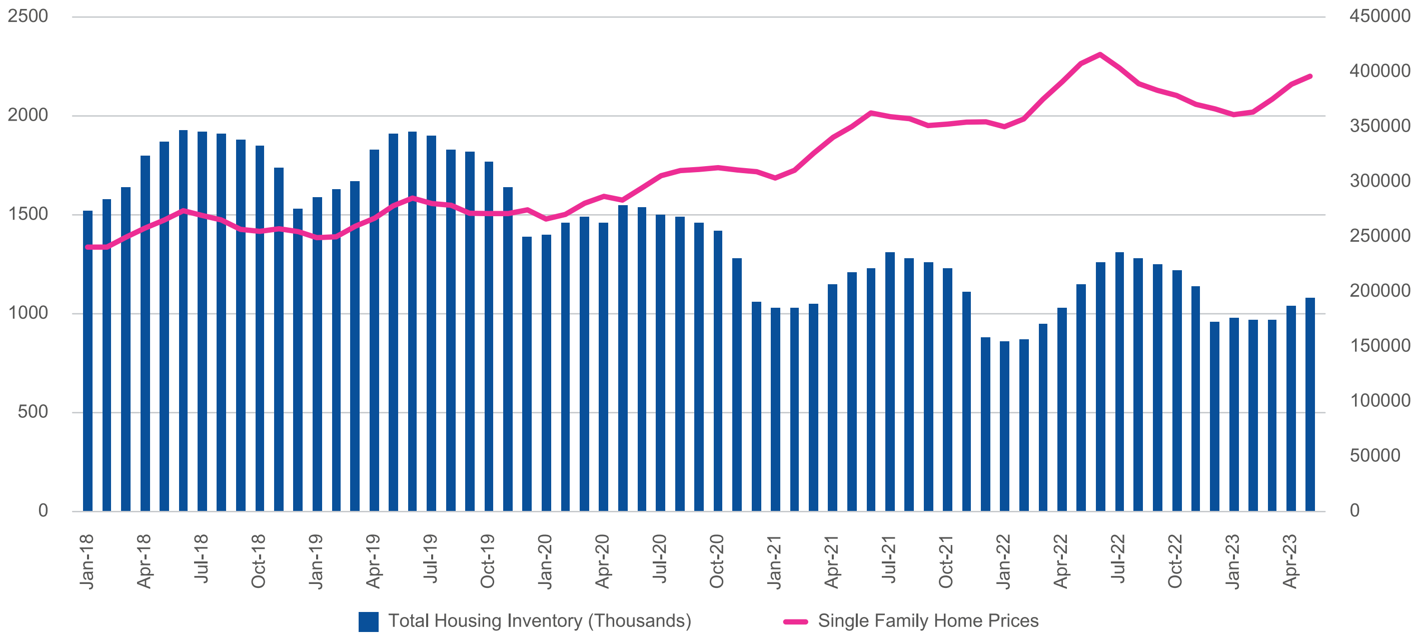
Student loan debt

Student loan interest will begin to accrue on September 1 and loan payments will begin following on October 1. The nearly three-year moratorium on student debt payments will end. Twenty-seven million borrowers, with a little over one trillion in student loan debt, will add a payment back into their monthly repayment obligation, creating downward pressure on consumer spending behavior as we enter the 4th quarter. The administration stepped in on July 14, 2023, and forgave loans that borrowers had been paying consistently for 20 years. This segment of loans accounts for $39 billion of the one trillion in outstanding debt for 804,000 consumers. The reassumption of the remaining debt will still impact consumer spending.

Housing

Inventories and inflated rates were a challenge in the last quarter. Costs of building materials have come down over the past year for builders, but rising borrowing costs have created affordability gaps for potential buyers.

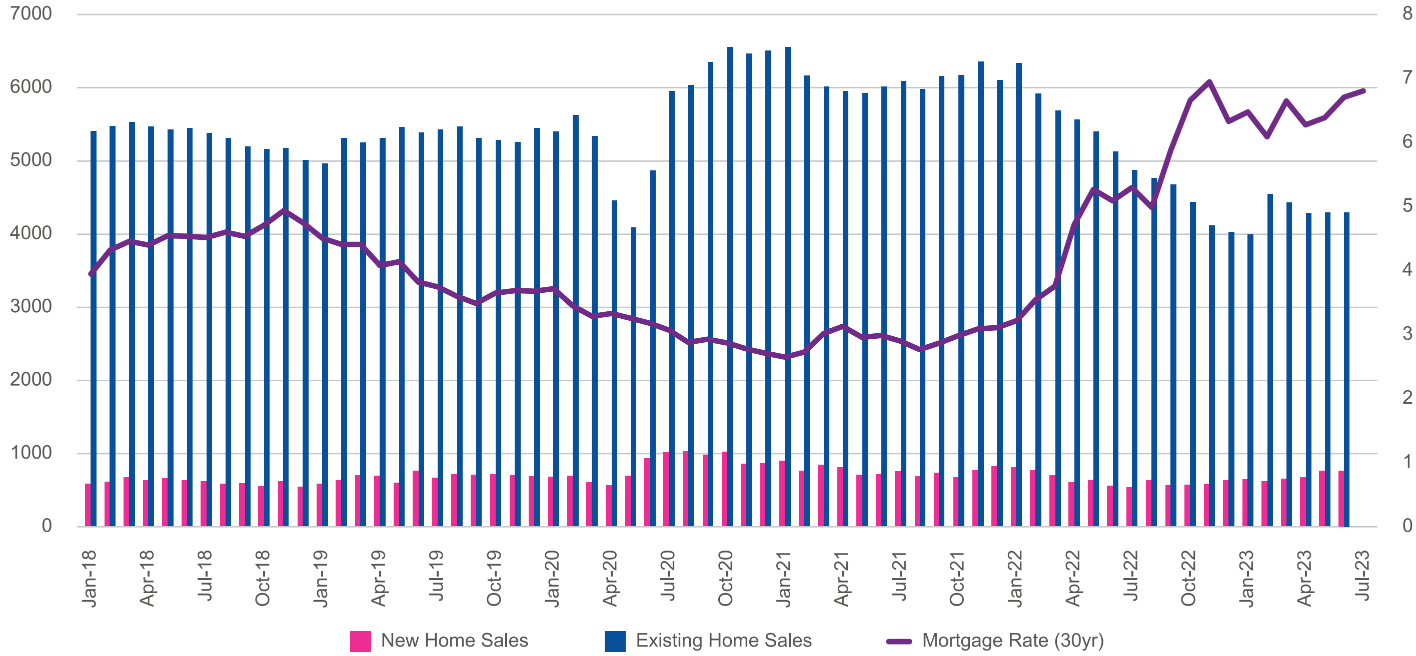
U.S. Housing Inventory and Prices



Source: National Association of Realtors

Builders will release inventory homes and complete homes that have been slow to deliver as margins begin to feel some pressure. Consumers are staying in their homes a little longer as mortgage rates approach 7% on a 30-year fixed rate and new home prices slowly rise. Affordability and value will place additional downward pressure on existing home sales. Refinance activity will be slow as rates remain 2.5X higher than consumer historical expectations.

Mortgage Rates (30yr) New and Existing Home Sales



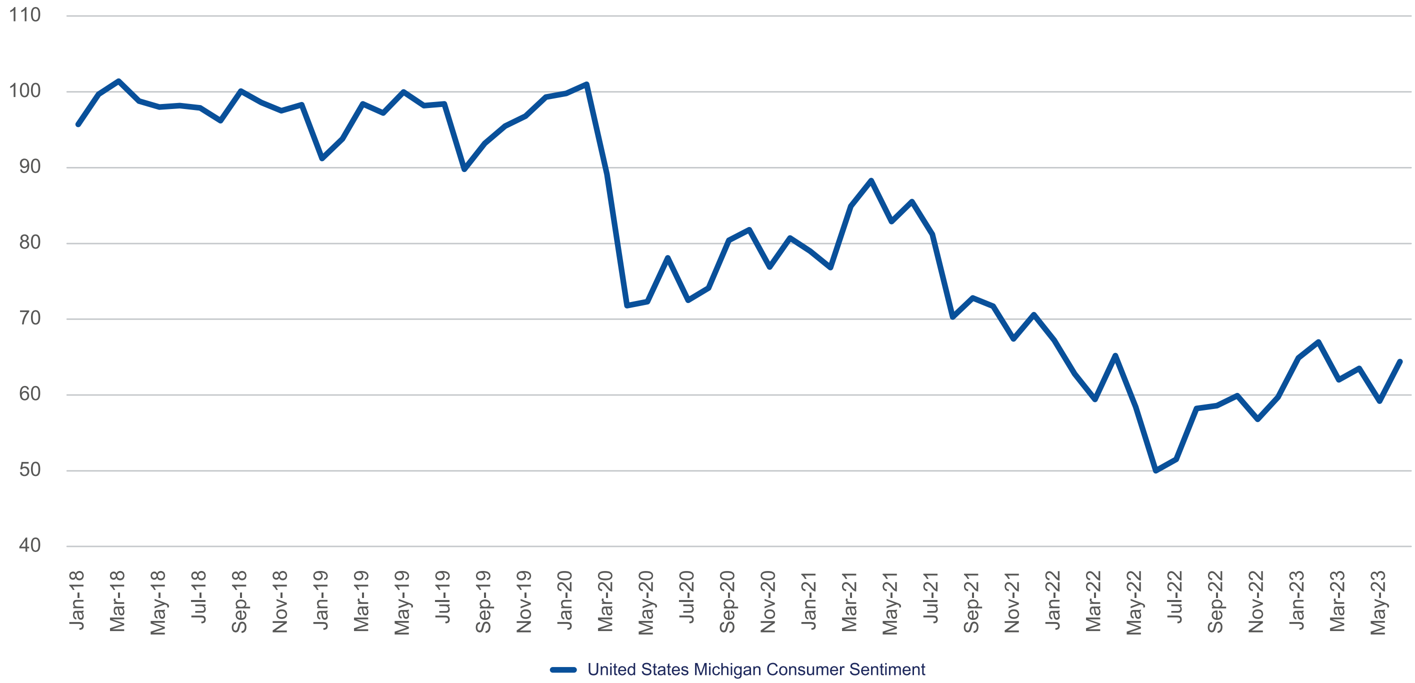
Source: National Association of Realtors, U.S. Census Bureau, Freddie Mac

These trends highlight a housing market transition in buyer profiles, as pent-up demand for housing continues to be consistent. Investors see builders as a growth segment with potential to expand inventory availability to accommodate demand as recession fears weaken.

Consumer sentiment forecast looks cloudy

Consumers will see the clouds and continue to carry the umbrella, but a sunnier forecast is creating a more positive outlook.

Consumer confidence



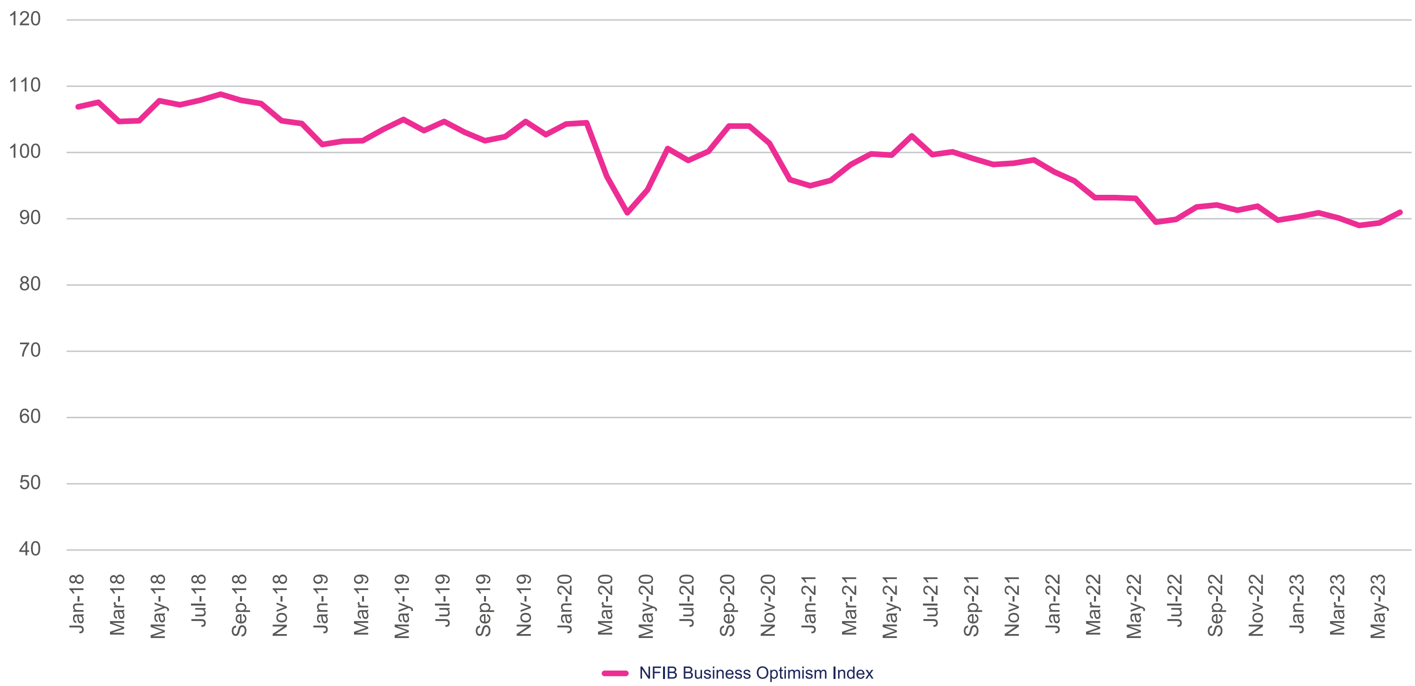
Source: University of Michigan

Consumer feeling towards the economy is improving as the labor market remains strong and wages slowly rise. As fears of a significant recession fade from the news consumers continue to spend.

Small businesses confidence heats up the U.S. economy

Small businesses standing in the sunlight still feel confident but many are preparing for showers in the second half of 2023. The latest NFIB Small Business Optimism survey highlighted an improved outlook on the economy with growth back in focus.

Small business confidence



Source: National Federation of Independent Business

This positive uptick in the last month was not as significant as hoped; the positivity in the market is not moving orders and inventory creation upward yet.

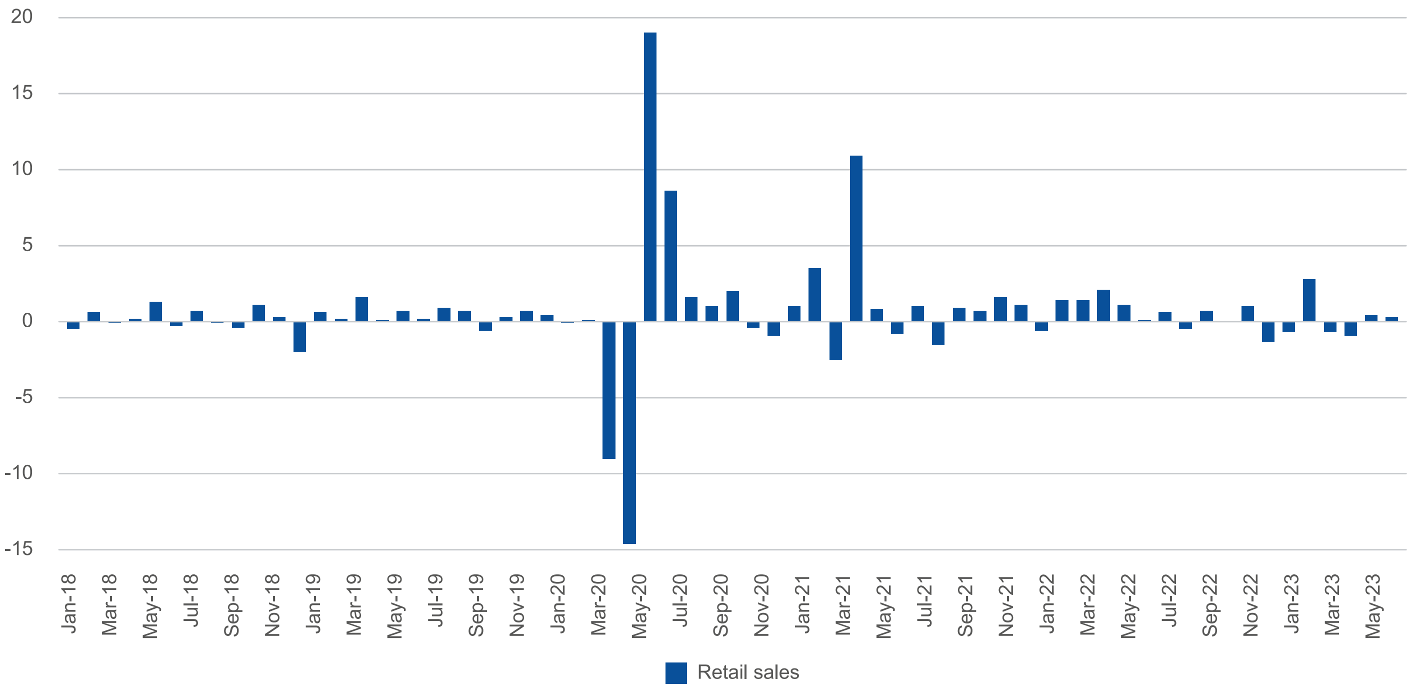
Small businesses in the U.S. (33.2M) make up 99.9% of all businesses in the U.S., employing more than 61.5 million people in the U.S., according to the Small Business Administration. They generate almost 1.5M new jobs annually, and a large portion of this growth comes from companies with less than 20 employees.

67.6 percent of newly established businesses survive at least 2 years. Small business survivability improved during the pandemic due to an increase in SMB emergency stimulus funding. As we get farther from the pandemic, businesses that were surviving on that artificial cash flow are beginning to close.

These small businesses provide essential goods and services across industries. They are very inclusive of all genders (21.4% women-owned) and minority segments (19.9%), which broadens socioeconomic success, independence, and innovation. Small businesses, and the entrepreneurial spirit they present to the U.S. market, greatly influence the health and growth of the U.S. and the global economies they serve.

Retail trade is the leading type of new businesses opening in the U.S., up 3.4% in May YOY. This industry had the most significant percentage of business applications. Consumers continue retail spending at unexpected positive levels...

Retail spend

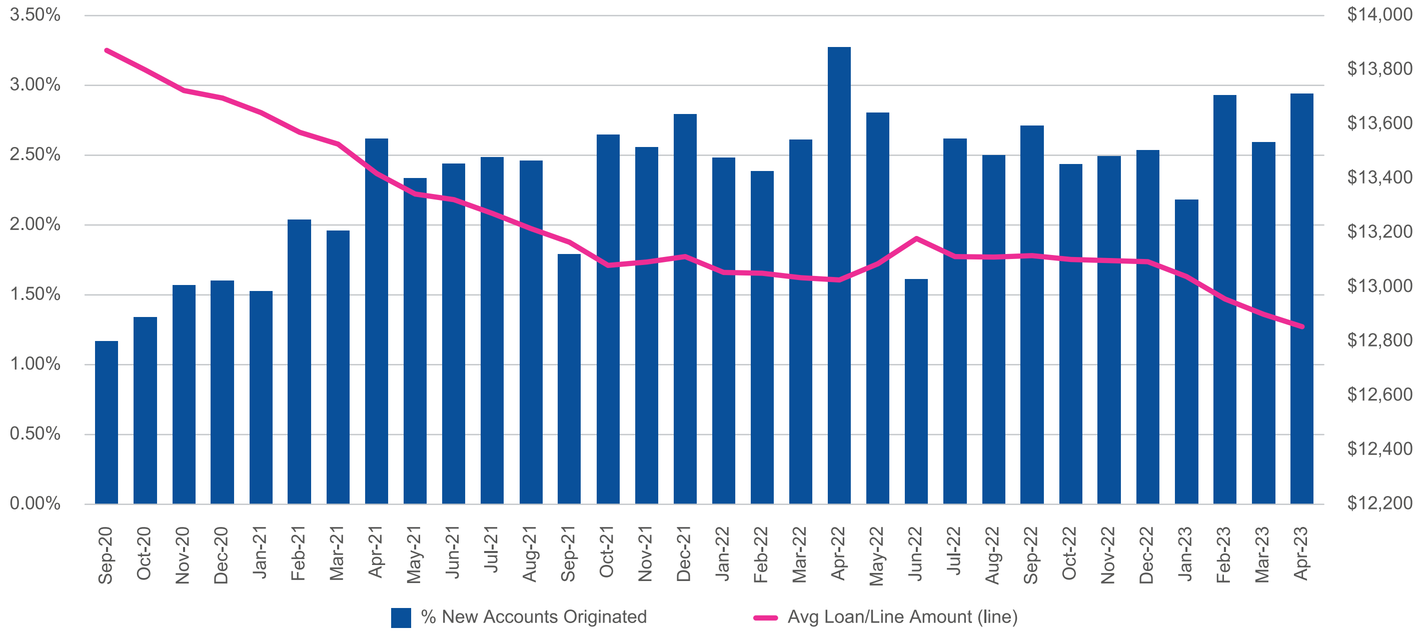


Source: U.S. Census Bureau

...creates bright spots for entrepreneurs to engage consumers. This highlights the fertility of the market to generate open opportunities for new businesses.

Overall new business applications have increased in the past few months, maintaining north of 400,000 new applications a month. This explosion of new business starts during, and post pandemic have changed the landscape of commercial lending. These new businesses account for 38% of all new credit applications. New businesses need funding.

Small business credit card originations

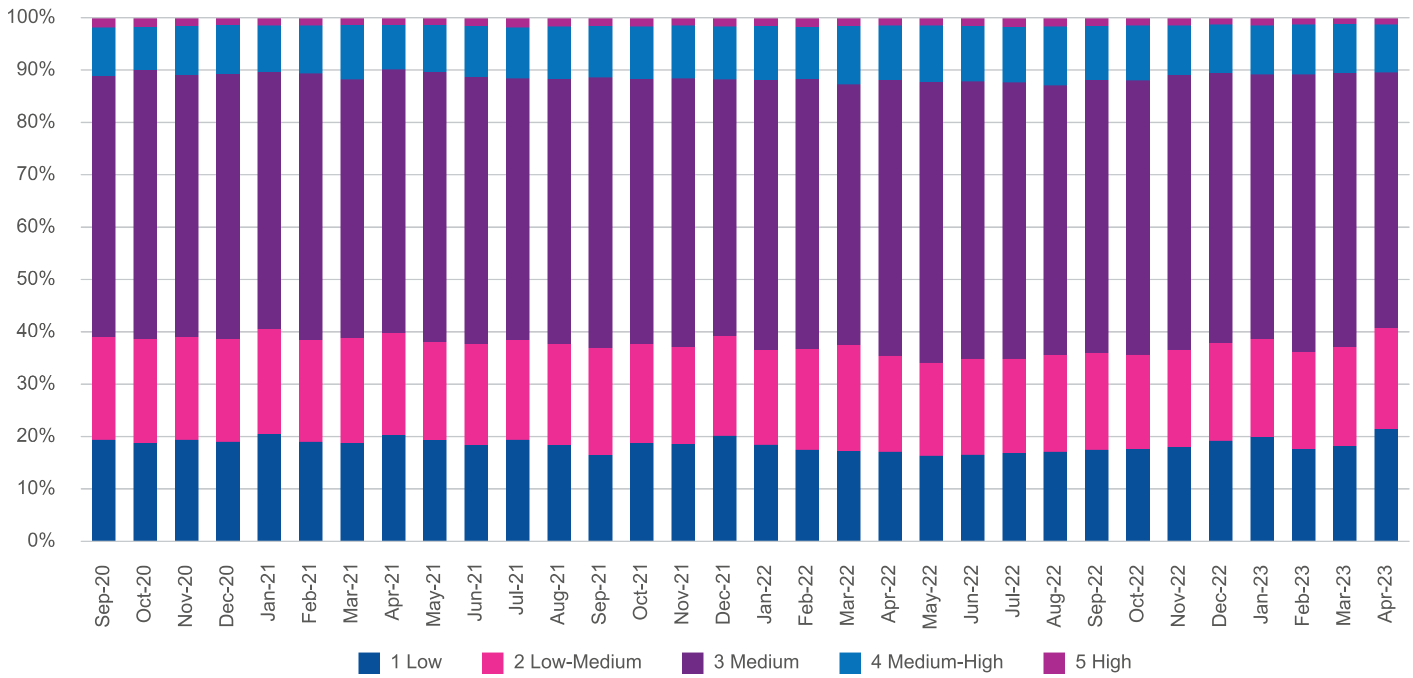


Source: Experian U.S. Commercial Benchmarking

This can come in the form of private funding as a startup scales for growth or in the form of business owner-guaranteed credit. The need for credit has expanded as these businesses enter the market.

As lenders look to expand market reach in a highly competitive market, they will look deeper into segments to identify customers on the fringe of their current policies to review and approve. This trend of "dig deeper" has been the battle cry for lenders over the past two years. Lenders knew that small businesses, coming out of the pandemic season, had access to free or low-cost money to supplement cash flow in a down market, but the market was booming. This meant that small businesses might look a little riskier but had reserves to cover any cashflow softening. Lenders could lend confidently, knowing the probability of repaying was high.

Lending trend into higher risk tiers



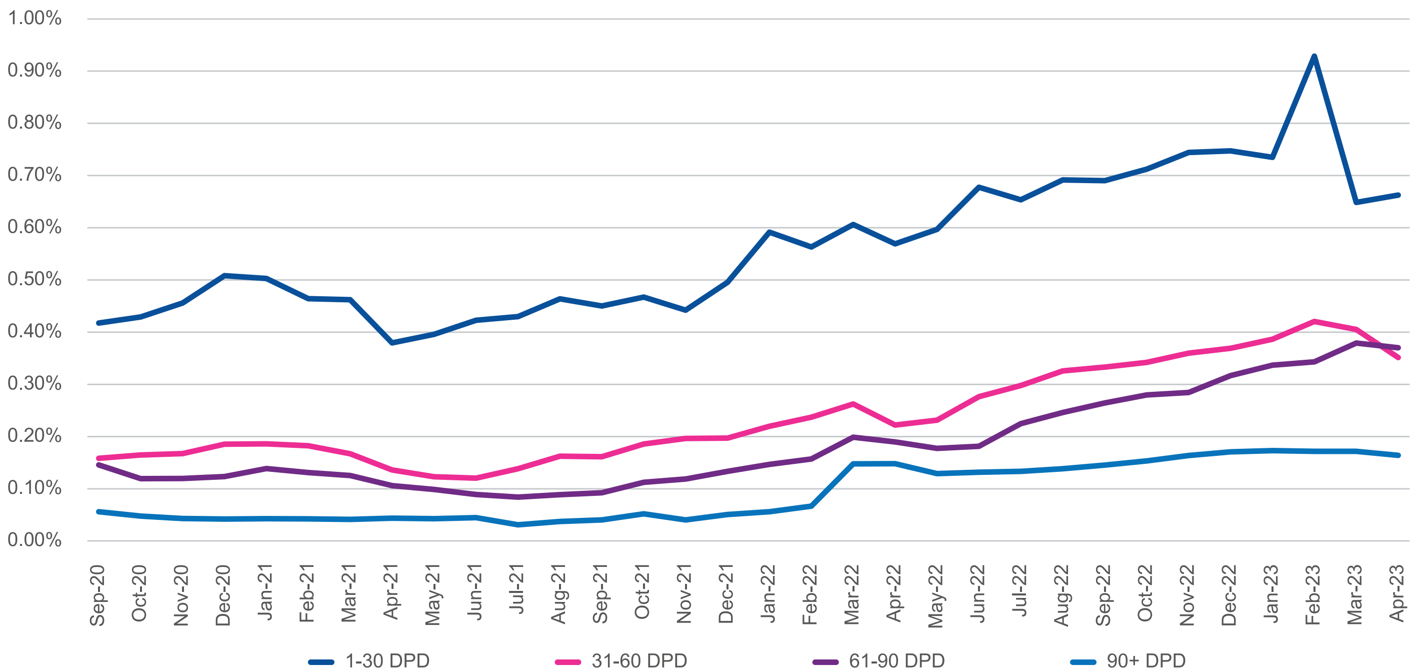
Source: Experian U.S. Commercial Benchmarking

As stimulus and margins run thin through an extended period of elevated costs, lenders are seeing delinquency levels rise, leading them to reach for their umbrella. Limiting exposure by tightening underwriting criteria or repositioning products to accommodate higher-risk applicants. That has been in the works during the first quarter of 2023. Lenders have been well-capitalized and successful.

Rainclouds

Small businesses' savings are running lean as inflation eats into margins as growth remained a focus for small business success in the past two quarters. This meant that delinquencies began to rise. The velocity of delinquencies seemed steep as the levels rose over the preceding quarters to the expected level as those Zombie Businesses (Businesses that should have closed but are remaining open through synthetic cashflow) that had been held up by stimulus money finally felt the pinch of a tightening market.

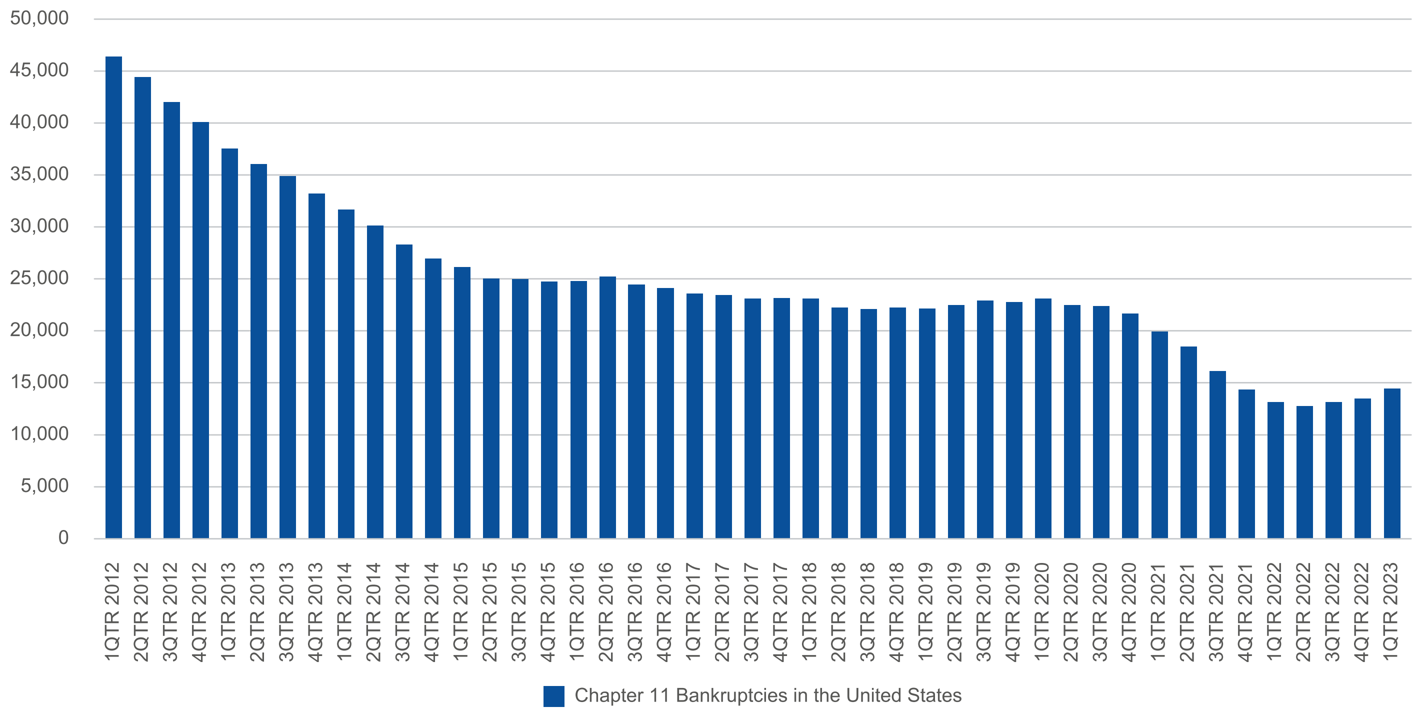
Small business delinquency levels



Source: Experian U.S. Commercial Benchmarking

Delinquency rates are now above pre-pandemic levels but are still where we would expect them to be in a growing economy, where lenders are in growth mode. The small business' sloppy payment behavior, 1-30 days past due, reflects a market where small businesses have the money but hold onto repayments a bit longer. The roll rate has remained consistent and aligned, where rolling into a higher delinquency bucket is not accelerating. Where we see acceleration is in commercial collections. A large percentage of the collection activity is seen in the United States's southeastern region where a significant percentage of new business starts from March 2020, are more susceptible to changing market conditions. As collection volumes rise the average collection amount decreases, highlighting the impact of younger business delinquency repayment risk as the economy cools. What follows heightened delinquency rate and cashflow disruptions can be a closure or small business bankruptcy event. These types of events are beginning their path to normalization.

Small Business Bankruptcy Rate



Source: Administrative Office of the U.S. Courts

The bankruptcy rate in the U.S. has been decreasing as an expanded safety net of government programs and specialty lenders has expanded in the last 24 months. That trend is beginning to change as the economy cools and small businesses begin to feel the pressure of consumers reevaluating their discretionary spending.

This increase in delinquency and business failure will lead small business lenders to focus on portfolio risks in the coming months to ensure their businesses remain stable and have room to grow. Lenders will steer the cadence of due diligence checklists to include regular reviews of underwriting policies. A review of underwriting rules and in-house policies can be a wake-up call to lost opportunity. Refreshing outdated underwriting rules is the best way to identify profitable customers left on the floor by legacy policies. In addition, interrogating new commercial credit applications for irregularities, highly correlated with fraudulent behavior, are necessary to identify active risk pre-boarding and lingering exposure hiding in managed accounts. As macroeconomic pressures increase, these exposure-busting activities will become critical to mitigating risk deeper in the credit lifecycle and keeping collection agents focused on recoverable debt.

Regulatory oversight

What outside factors, unrelated to consumer and commercial lending or the customer, have the potential to tighten credit availability to customers in the next 12 months? Expanding oversight, data collection requirements and mandated changes to credit tool functionality.

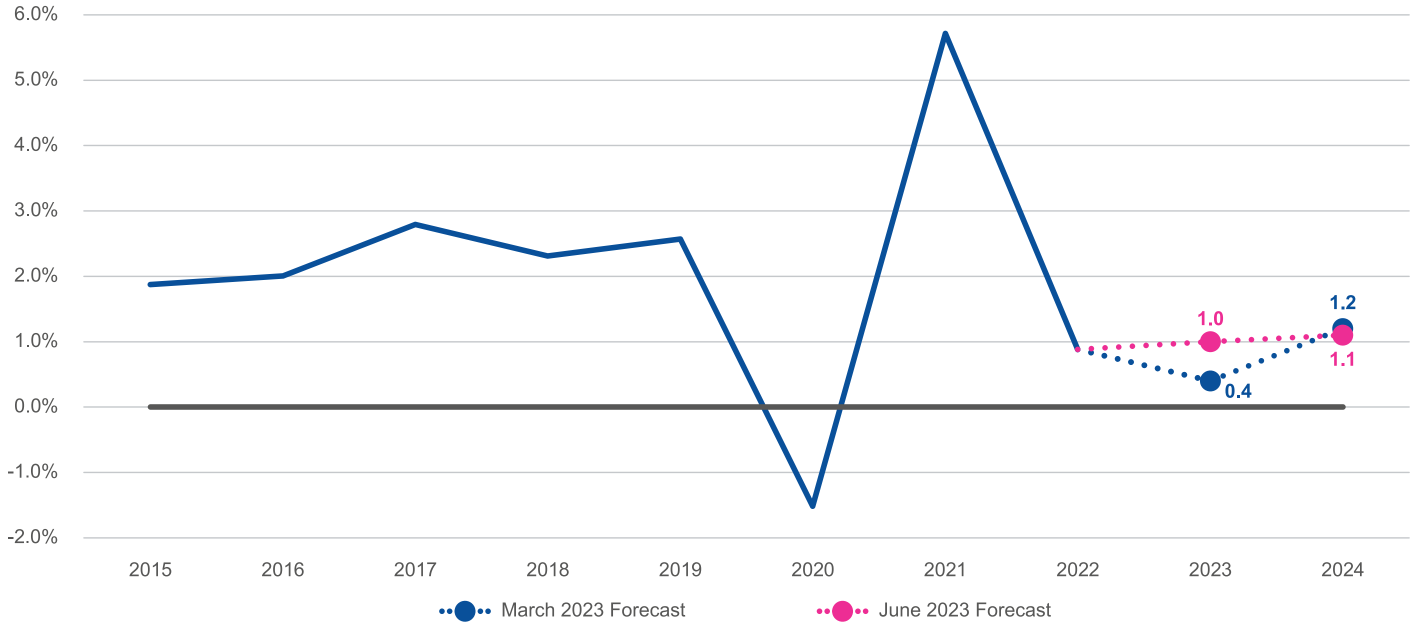
- The CFPB proposed rule activity focused on supervision of consumer payments providers (Example: Venmo) as a part of the CFPB's nonbank supervision program. This positive move to create more standard rules will create pressure on these service providers.
- The bureau is focused on NSF fees, credit card penalty late fees, and proposing amendments to Regulation Z surrounding the representation of overdraft fees. These fees represent a significant source of revenue for the industry. These fees also help to offset the risk lenders face when providing additional flexibility and functionality in products for higher-risk customers.
- Expansion of capitalization and stress test requirements outside the largest financial institution to include regional lenders following the SVB failure. The increase in reserve requirement and overhead will lead to higher costs for the customer.
- The CFPB released a 1071 Dodd-Frank Act final rule to expand data collection requirements for the small business lending. This new rule will require reporting from small business lenders regarding new credit applications made by woman-owned and minority-owned small businesses. This will require significant lender expenditure and will likely create friction in the application process. Exclusions include large businesses, dealer finance, trade finance, insurance, and Insurance finance.

These well-intentioned regulations and oversight will create downward pressure on small business lender's ability to engage small businesses more broadly.

There was a break in the clouds, but a little more rain is coming

As we enter the second half of 2023, economic data and market expectations suggest a lower probability of recession. How should we define a rainy day in the U.S.? The U.S. Federal Reserve defines a recession period as a significant decline in economic activity across the country. It is characterized by a contraction in the Gross Domestic Product (GDP), increased unemployment rates, and reduced business investments. The Federal Reserve closely monitors various economic indicators, such as employment, inflation, and industrial production, to determine the onset and duration of a recession. The U.S. experienced 2 consecutive quarters of GDP decline in the first and second quarters of 2022. Still, most economists dismissed this period as a recession because the labor market was very strong, and consumers were spending at elevated levels. Not seen as a rainy day but cloudy indeed. GDP growth has leveled out and performed above expectations in the first quarter of 2023. This resilience in GDP provided the momentum for a potential rebound and avoidance of negative growth in the second half of the year.

Avoiding recession



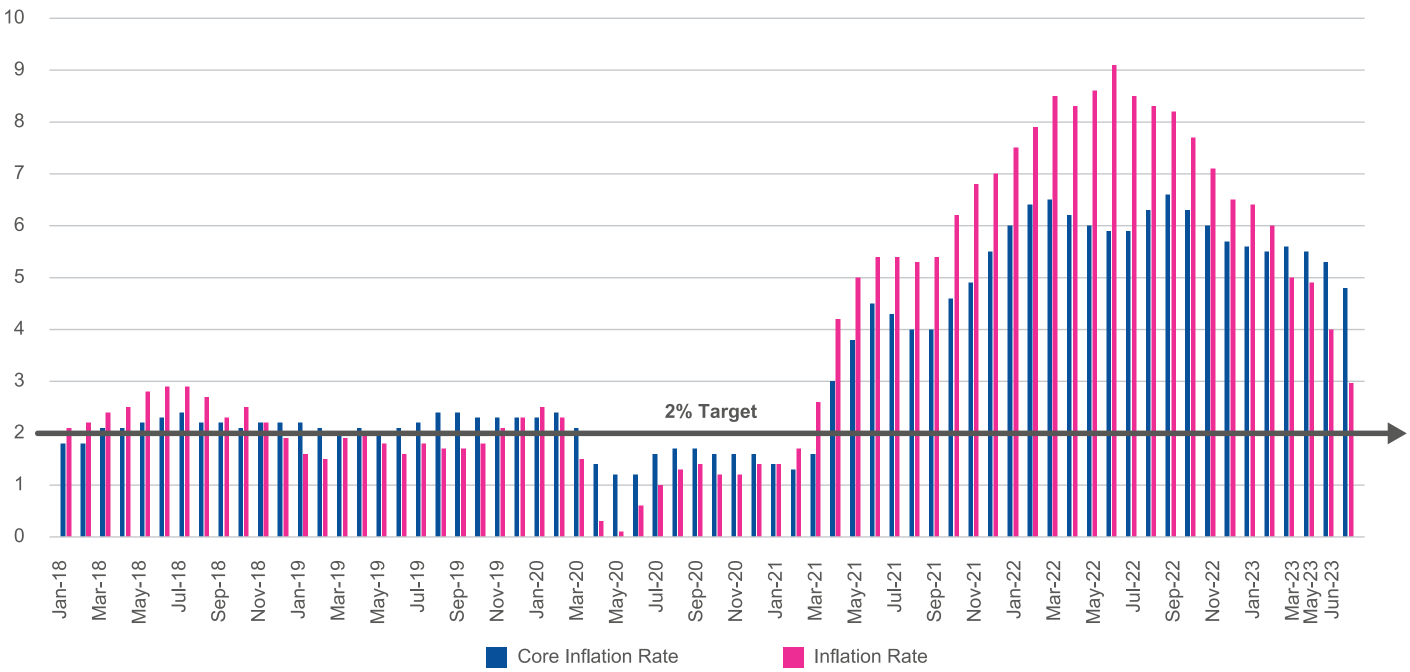
Source: U.S. Bureau of Economic Analysis

Gross Domestic Product (GDP) is a measure of a country's economic performance, representing the total value of all goods and services produced within its borders during a specific period. It is often used as an indicator of a nation's overall economic health and growth. GDP is influenced by a wide range of other factors, including exports, imports, inventories, and fluctuations in investment and government policies. Additionally, economic indicators such as inflation, employment levels, and interest rates can also impact GDP.

Inflation

While headline inflation has come down over the last year, core inflation (Excluding food and energy) has proven difficult for the Federal Reserve to wrangle down to its' 2% target. The annual inflation rate in the U.S. slowed to 3% in June of 2023. The high base effect from last year is helping the inflation number appear to decrease more quickly. Last year at the same time a surge in energy and food prices pushed the headline inflation rate to 9.1%, which had not seen rates that high since 1981. There should be some relief coming for housing/shelter, the largest driver of inflation, toward the end of 2023. Expanded funding to consumer and commercial lending programs and agencies will create backpressure in the system, tempering the speed at which inflation could reach more normal levels.

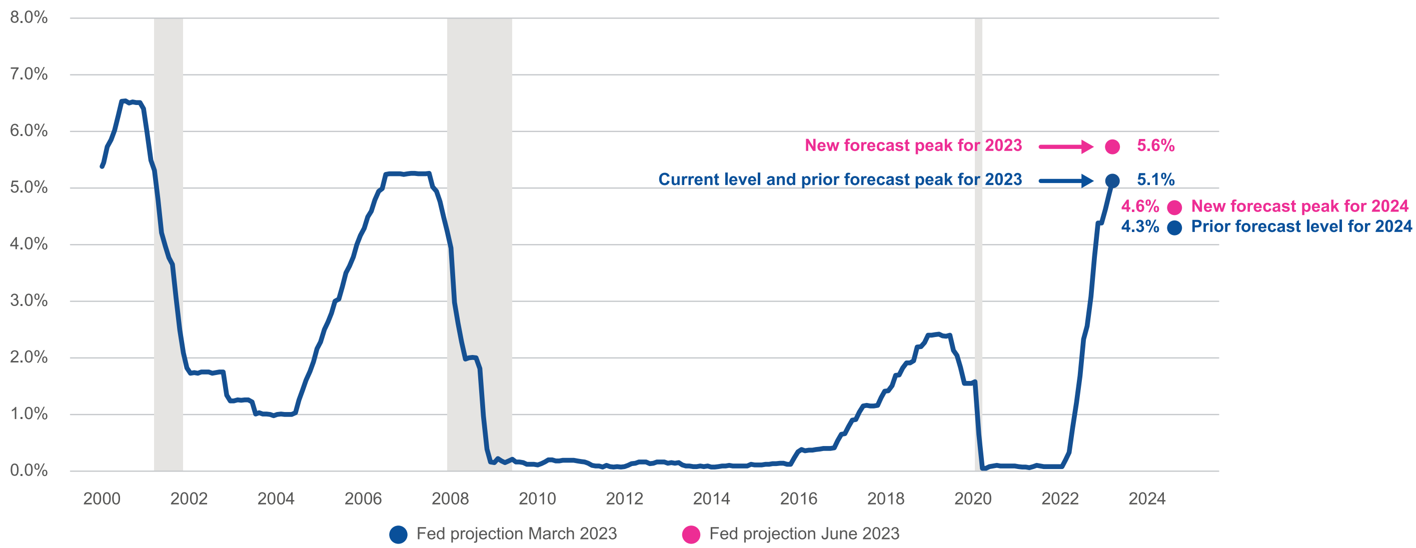
Inflation and Core Inflation Rate



Source: U.S. Bureau of Labor Statistics

While there has been some improvement in inflation, the market's expectation of a rate cut in 2023 is unlikely given the stubbornness of core inflation and resiliency of the labor market and spending.

Midpoint of Fed Funds Rate and Fed Projections

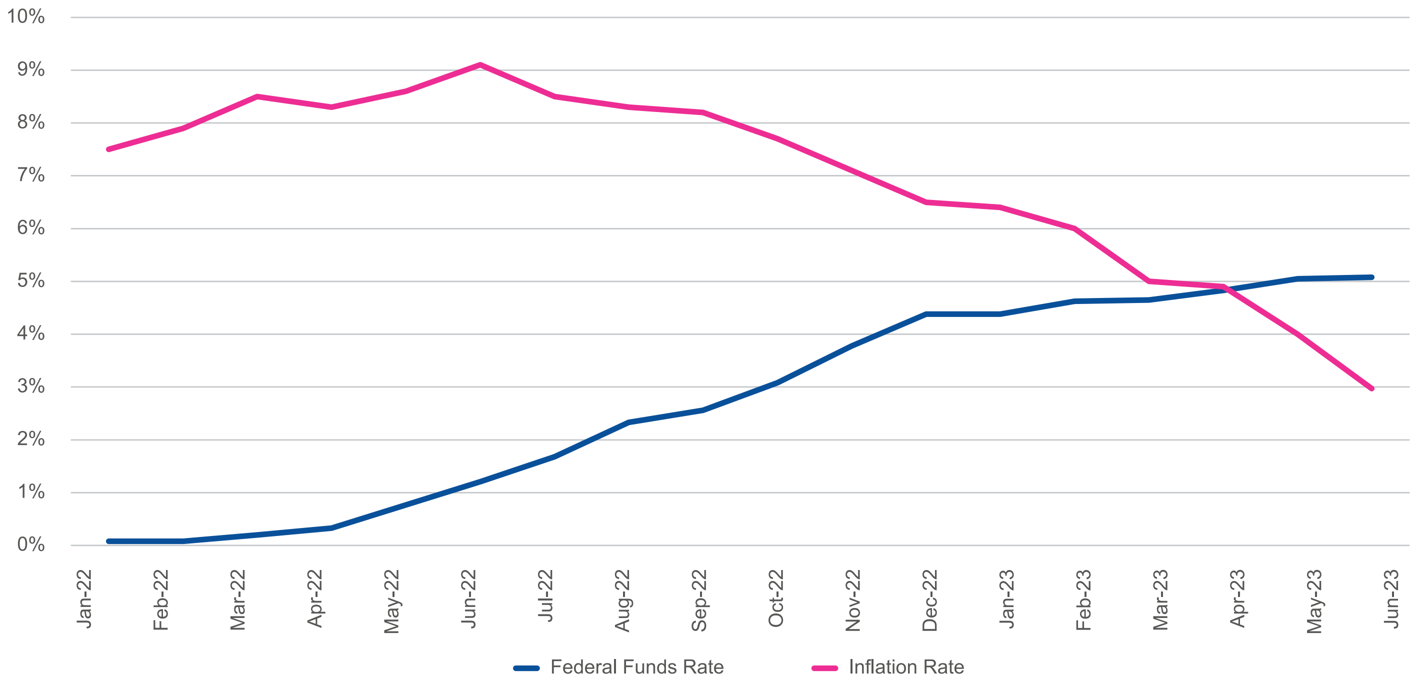


Source: Federal Reserve Board of Governors, Summary of Economic Projections March 2023 and June 2023

Global economic pressures, U.S. government activities focused on inflation/labor, and extended availability of open U.S. credit markets will accelerate or delay the U.S. market reset.

The Federal Reserve paused its federal funds rate tightening activities in June. The U.S. is feeling relief in inflationary pressure since the Fed began its activities, but the economy is not reacting as quickly to its efforts as hoped. The Federal Reserve will continue to be resolute in its directive to reduce inflationary pressure on the U.S. Economy by increasing the federal funds rate one or more times within the year.

Weather Forecast: Impact of Fed activities



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

The intersection of the funds rate and the U.S. inflation rate generally signals that the Federal Reserve's tightening is near an end.

I can see clearly now

The sun is shining through the clouds. The most recent tranche of economic data paints a promising forecast of better weather, suggesting a decreased probability of a recession in 2023. This optimistic outlook emerges despite several economic challenges that continue to loom large on the horizon.

Inflation, one of the most significant concerns, remains elevated above the Federal Reserve's target. This surge in the general price level of goods and services can erode purchasing power and lead to economic instability if unchecked. Additionally, heightened interest rates, a tool often used to combat inflation, pose their own set of challenges. While they may cool down overheated markets and restrain inflation, they can also lead to higher borrowing costs, squeezing both consumers and businesses.

Further compounding these issues are the current cautious and exposure-limiting credit conditions. As lenders tighten their belts, borrowing becomes more difficult, which can slow economic growth as companies find it harder to finance expansion plans, and consumers pull back on spending.

However, amidst these economic headwinds, two significant sources of resilience emerge that continue to drive growth. Firstly, the labor market remains robust. Employment levels are high, and wages are growing, providing consumers with the necessary income to maintain their spending levels.

Secondly, consumer behavior has demonstrated remarkable resilience. Despite economic uncertainties, consumer spending, a critical engine of U.S. market growth, has remained strong, bolstering the economy.

There's a silver lining in the sky visible in the housing sector. A recent revival in new home sales and construction activity offers promising signs for residential fixed investment. After dragging down the economy for eight consecutive quarters, this sector is expected to bounce back into positive territory, potentially serving as a cushion against economic shocks and providing a much-needed buffer to sustain growth.

In summary, while economic challenges persist, a combination of a strong labor market, resilient consumer behavior, and a rebound in the housing sector points towards continued growth in the economy and a reduced likelihood of a 2023 recession. The combination of a still-strong labor market and elevated inflation means that the Fed is likely to keep rates higher for longer, a result that will exert more pressure on the economy in 2024. **Will you pack an umbrella or sunscreen?**

About the author

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Brodie leads a team of statistical consultants, scientists, 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.

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