MAIN STREET REPORT

Your window into small business health

Q2 2023

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Is a soft landing real for small business?

Executive summary

Lenders adjust underwriting criteria to limit exposure as delinquencies remain elevated for consumers and small business. The markets deal with inflation above target and customers reevaluate their discretionary spending and growth investment strategies. Not all segments of the market will be impacted by environmental forces. Technology focused companies are leading investment and growth, while logistic, utility, and healthcare will struggle, Supply chain disruptions are smoothing but lighter forecasted demand is already impacting inventory reorders. This softening in demand is hitting trucking and logistic companies hard as tonnage and mileage are lighter than forecast as consumers return to the in-person experience and engage with eroded purchasing power. The bright spot is consumer resiliency. This prolonged spending strength is fueled by a tight labor market, wage growth, relief in energy and food costs. Dwindling savings, increased reliance on unsecured debt to support spending behavior, reassumption of monthly debt servicing obligations (student loan payments), and prolonged inflation will all place downward pressure on the consumer. Recession fears may be calming, but the several indicators are still flashing for 2024.

Macroeconomic Overview

The number of forecasters that are ditching a recession scenario for one with a soft landing is growing, but we're not ready to make this change. Oxford Economics forecast is for a mild recession to start in Q4, but risks are that it could be delayed until next year. The upcoming August forecast will not include large revisions to our forecast for a peak-to-trough decline in GDP of 0.9% during the recession. The severity of the recession is limited by the strength of the economy's balance sheet.

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

Source: Oxford Economics/Haver Analytics

The incoming data has reduced our subjective odds of a recession occurring in the next 12 months. Real GDP growth over the past three quarters has averaged 2.3% and the unemployment rate has remained at less than 4%. Inflation has slowed and nominal wage growth is moderating, fueling speculation of a soft landing.

A challenge for any soft-landing scenario is that stronger-than-expected GDP growth would keep inflation elevated, pushing the Fed to raise rates over the second half and delay the pivot to easing until well into 2024.

Consequently, our modeling shows that a stronger consumer this year would most likely result in economic weakness down the line. The lags between changes in monetary policy and when it hits the economy are likely to be longer than in the past. So, the drag from tighter lending standards has yet to hit the economy, but it is coming.

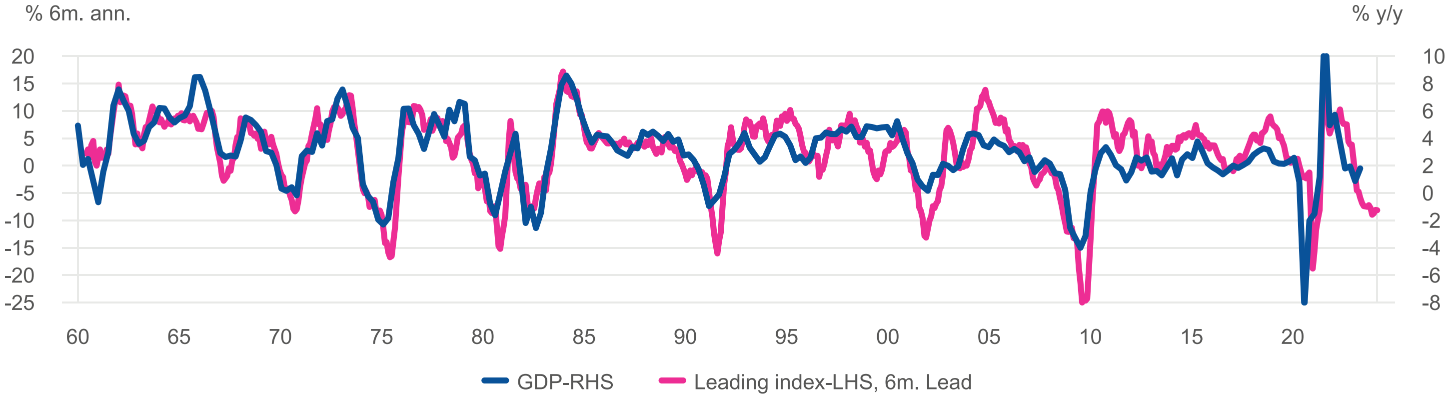
The economic and financial market impact of Fitch Ratings' decision to cut the U.S. long-term foreign currency issuer default rating to AA+ from AAA should not be significant and will not result in a change to our upcoming August baseline forecast.

The Oxford Economics business cycle indicator signals that the economy ended Q2 with more strength than it began, and now sits at its highest level since September 2022 (Chart 1). Until there is a marked turn in the labor market or consumer spending, it seems unlikely the BCI will approach its recessionary threshold of -0.25 to -0.5 until Q4 or early next year.

May's reading was upwardly revised from 0.17 to 0.32, driven largely by an unexpectedly substantial increase in real manufacturing and trade sales. There was a small upward revision to personal income and spending. Still, this is an unusually large revision in the BCI. The June BCI edged higher, rising from 0.32 to 0.35.

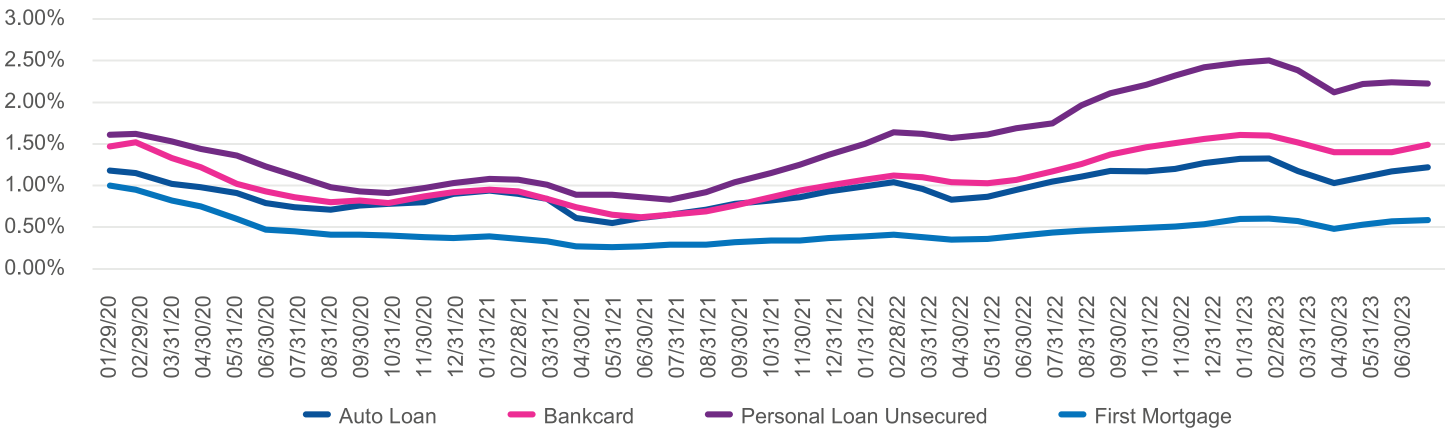
Though coincident indicators suggest that the economy is doing well, leading indicators are raising a red flag. The Conference Board's leading economic indicator has fallen for 15 consecutive months, something that has never happened without the economy eventually falling into a recession.

U.S. Conference Board Leading Index & GDP Growth



Source: Oxford Economics/The Conference Board

Consumer credit % Balance 60+ delinquency



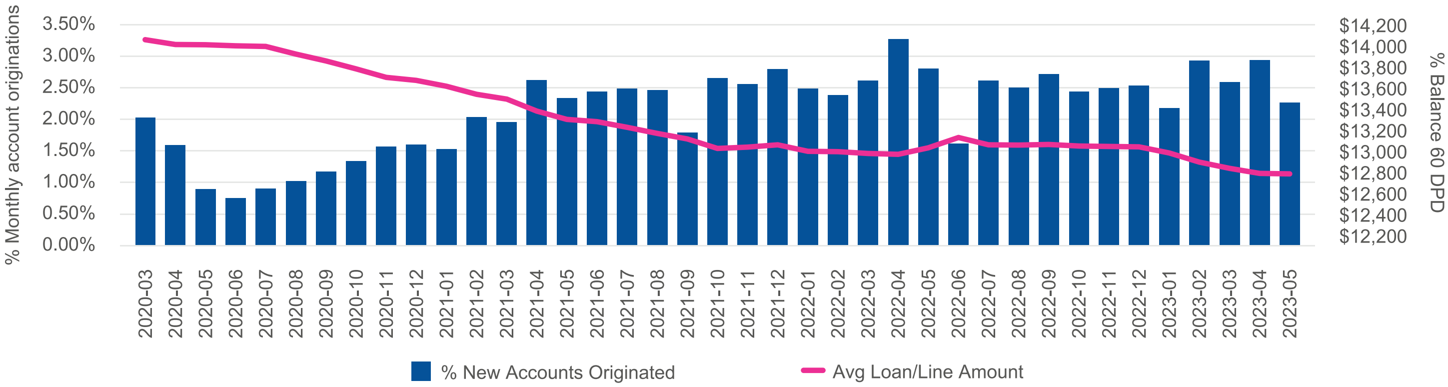
Source: Experian State of Credit

Experian's latest consumer data do not suggest an imminent retrenchment in spending. Delinquency rates for bank cards and personal unsecured loans held steady. Meanwhile, delinquency rates for auto loans and mortgages ticked higher, though both are holding below their recent peaks. These indicators are not signaling a decline in consumer spending, but they will need to be monitored closely as they could provide a leading indication of weaker outlays ahead. Further, an increase in loan originations for all types of loans is encouraging and mitigates worries of a downturn in the very near term.

U.S. Business lending

Commercial lending remains open to small businesses. Open does not mean that the funding available is cheap. U.S. inflation is above the Federal Reserve's 2% target. The most recent market cooling has not translated to borrowing savings as lenders manage exposure, pricing in macroeconomic bumps in the near term. Businesses weigh the cost of funds more carefully as they look for a pathway to grow in 2023. Small business originations have been stable from an overall market perspective.

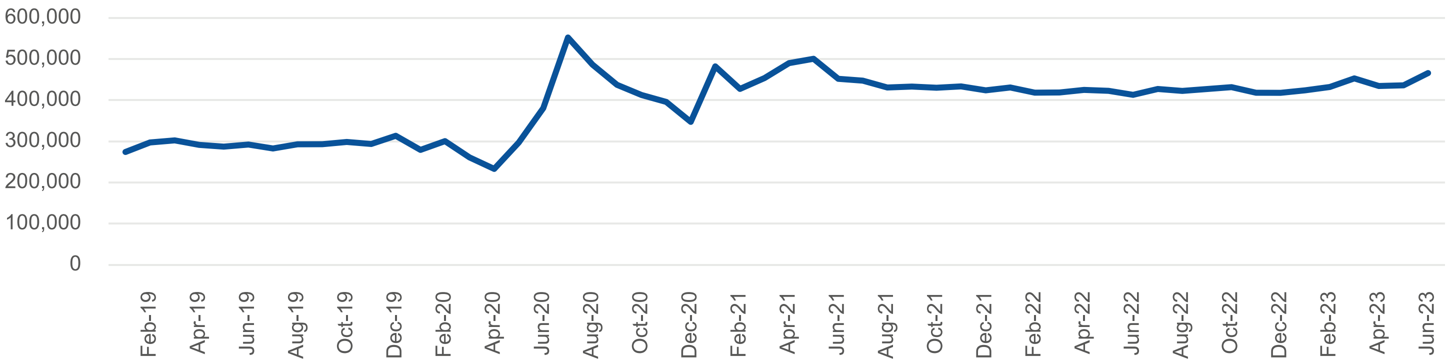
Commercial origination trends for both Commercial Card and Installment products



Source: Experian Commercial Benchmarking

Unsecured lending market engagement has been stable and following a normal credit cycle over the preceding 24 months. A crowded lending space has been helpful to keep funding available for customers even as lenders limit some segments for exposure as market pressures build. These unsecured products are the first to feel pressure in a down market for sloppy pay and selective payment strategies as markets slow. The average credit lines on unsecured products have been falling, down 1.8%, as the percentage of new and emerging businesses in the market surged to well over 30% of the active U.S. businesses.

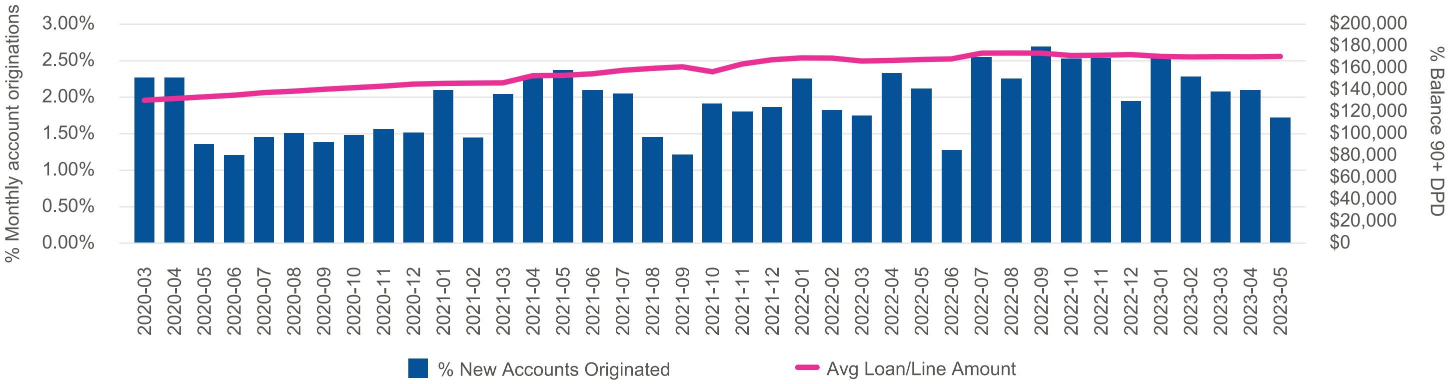
New business formation applications in the U.S. monthly (Seasonally adjusted)



Source: U.S. Census Bureau

The rate of new business applications has not begun to slow, up 12.8% since the same time last year, as funding for new ventures becomes more competitive. Businesses will continue to look to credit markets for short-term funding facilities to keep businesses engaged.

Commercial origination trends for Commercial Installment products

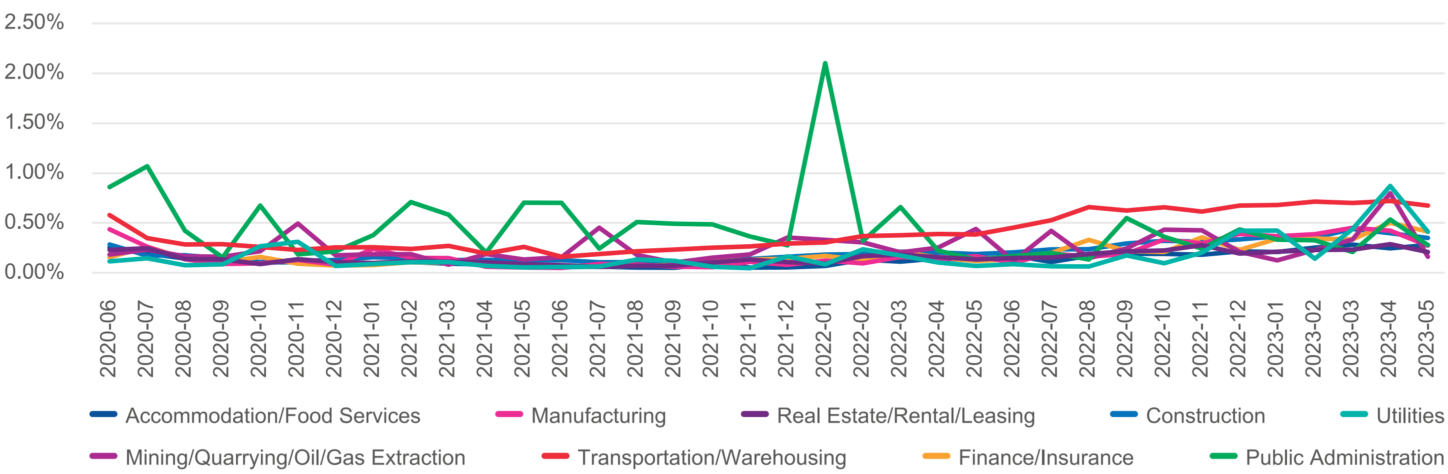


Source: Experian Commercial Benchmarking

Longer term installment products will fill the gap in venture capital shortfalls as investors pull back as markets become more volatile. Businesses have used these products to buy equipment, support operations, and build inventory as the market heated up. The challenge for some small businesses, outside a near zero rate market, will be the costs of funds rising. These products become less attractive for growth as small business weighs the cost benefit of high-rate capital.

A decision to pay some creditors more slowly and hold onto capital longer will continue to increase delinquency rates across the U.S. Start-ups will experience investors pulling out to look for safer haven investments as market volatility increases. This investor and lender exposure limiting behavior will put more pressure on a businesses ability to maintain positive cashflows. Delinquencies will rise across market segments, with some segments feeling the pain right up front.

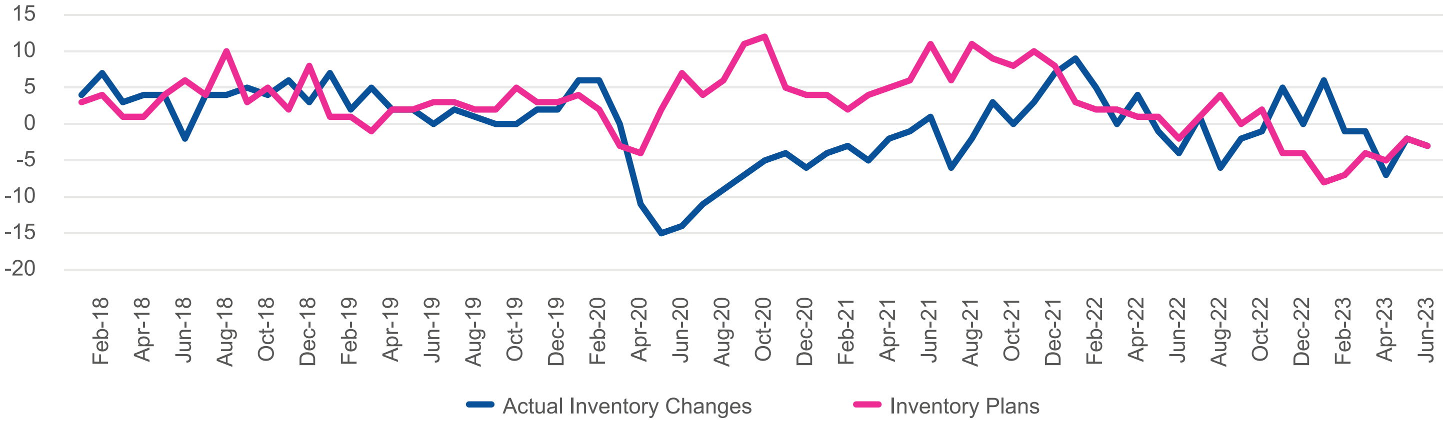
U.S. Commercial Delinquency — Percent of small business balances delinquent by NAICS



Source: Experian Commercial Benchmarking

Transportation and utilities are pressing against both foreign and domestic headwinds. Delinquencies will pressure these segments well into 2024. Transportation companies, delinquencies up 71.8%, are challenged by higher labor, fuel, and material costs while tonnage volumes are dropping. According to the National Federation of Independent Business (NFIB) survey, business owners report declining inventories and plan to lower inventory in the next three to six months.

U.S. Commercial Inventories — Actual vs future order



Source: National Federation of Independent Business (NFIB)

Actual Inventory Changes = Net percent ("increase" minus "decrease") during last three months (Seasonally adjusted)

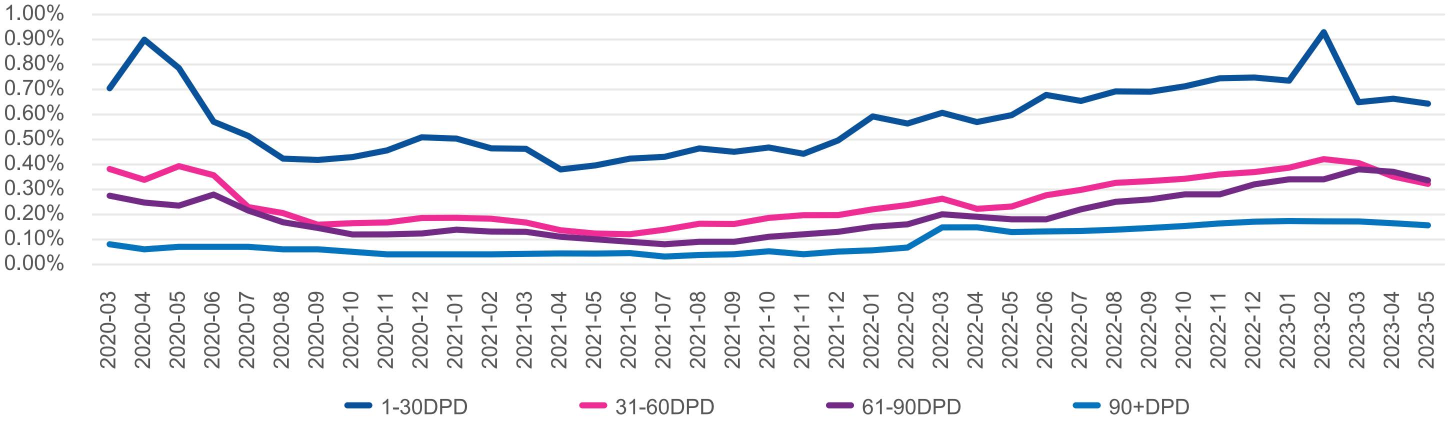
Inventory Plans = Net percent ("increase" minus "decrease") in the next three to six months (Seasonally adjusted)

Consumers continue to fuel the economy with retail sales hitting a record high in Q1 2023. E-commerce is a growing portion of sales, thus resulting in increased demand for last-mile delivery to consumers. In contrast, major retailers are coming off a post-pandemic inventory bubble created by supply chain shocks and elevated consumer demand, forcing them to now decrease inventory levels which is adversely impacting the commercial freight industry. High retail inventory levels and high interest rates are reducing orders so demand for commercial deliveries is down. This dynamic is negatively impacting the earnings of large freight companies and smaller carriers are beginning to exit the industry. Yellow was the third largest less-than-truckload carrier and is the largest trucking bankruptcy in the history of the U.S. It is widely expected that Yellow's customers will drive up demand among other trucking companies and thereby increase prices across the industry. It is yet to be determined if increased shipping costs will be passed to consumers as the beginning of the holiday season approaches.

Utilities faced coal and natural gas cost volatility over the past 5 years with increased regulation, limited lease availability, and supply chain disruption as Russia invaded Ukraine. Suppliers passed on cost to consumers as investors flocked to the utilities as a safe investment as fear of a recession grew. Fuel costs in past 12 months have been dropping but suppliers are weary of returning these savings to customers as the short-term outlook for stability continues to be murky. Utilities will see increased delinquency rates as monthly obligations on consumers increase through the end of 2023 with the resumption of student loan debt payments and lingering inflation driving food and shelter costs upward.

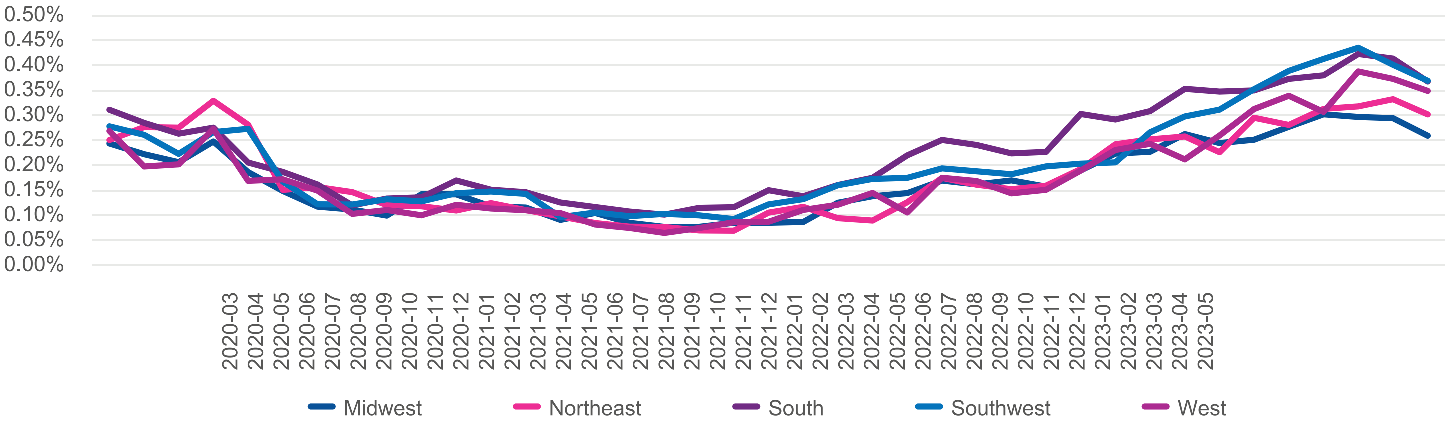
U.S. Delinquency rates for small businesses overall have been increasing steadily over the past 12 months. Delinquency trends stack appropriately from sloppy pay down to 91+ DPD percent of balances delinquent, highlights the ability of small businesses to cure delinquency and not roll into higher delinquency buckets at an elevated rate. This trend is where you would expect it to be during a solid economic cycle of growth. Where we see a subtle inversion of the 31-60 and 61-90 days past due buckets begin to materialize, this will signal that more businesses, once they pass the 30 DBT mark will roll into a higher delinquency band.

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



Source: Experian Commercial Benchmarking

Regional Commercial Card 60+ Delinquency Trends



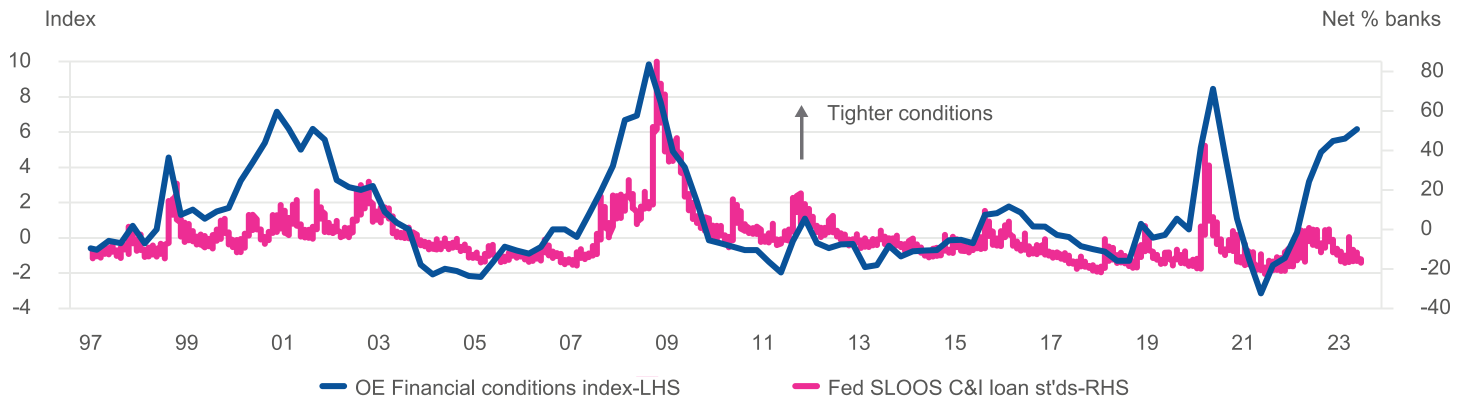
Source: Experian Commercial Benchmarking

We continue to see the southern regions lead the country in elevated delinquencies, 32% higher on average. These regions saw the largest development of small and micro business formations during the pandemic. This trend of business formation geolocation focus has become more distributed across the U.S. The newer businesses that began 2-3 years ago, within a stimulus and moratorium laced environment, meant that business could survive with minimum cash flow. Investors with extra cash could invest in these startups and the business survival rate surged. As cash runs thin, investors look for safe havens for capital as the market churns. A higher ratio of new businesses within a region will highlight the heightened exposure to funding deserts.

Large lenders have surgically tightened core product underwriting to limit exposure, placing additional emphasis on limiting overwrite activity and monitoring accounts in their portfolios more closely for cracks in performance. A crowded funding market including fintech lenders and credit unions entering the small business lending space has created a broader safety net for small businesses. The SBA (Small Business Administration) has also broadened the availability and ease of program engagement to lenders beyond the largest financial institutions to allow small businesses to engage a variety of lending options at price and risk levels appropriate to their industry and repayment behavior.

The latest Senior Loan Officer survey showed most banks tightened standards on lending to firms and commercial real estate in Q2, but the details offer a nuanced picture of the fallout from banking sector stress for the rest of the economy. Lending standards for mortgages tightened far less and household loan demand is holding up, reflecting the resilience of the consumer.

U.S. Financial conditions & lending standards



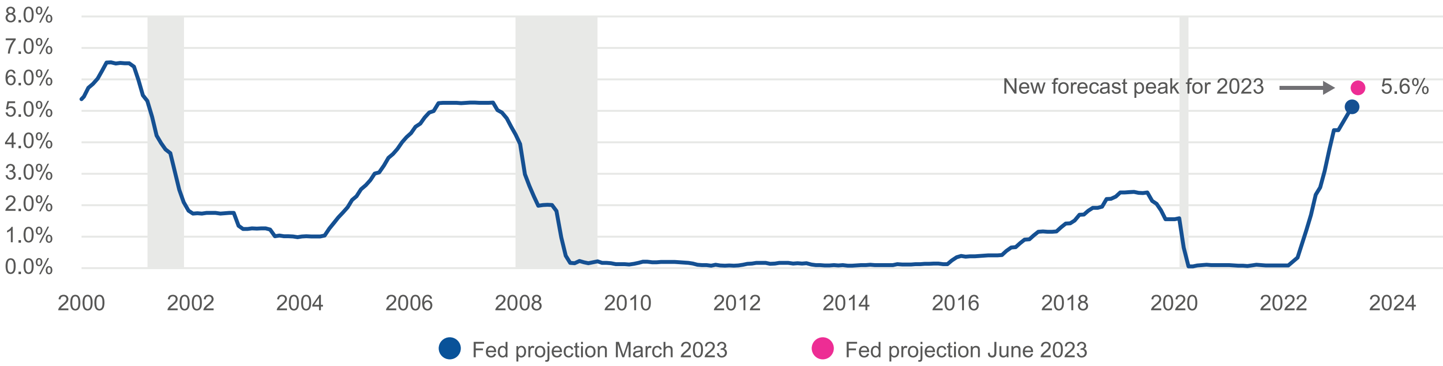
Source: Oxford Economics/Haver Analytics

The share of firms tightening standards on lending to firms was slightly larger than in the last quarter and shows that the legacy of the banking turmoil earlier this year will be a long-running but slow burning drag on credit availability. That will be a drag on investment and hiring later this year, but the extent of that headwind is still uncertain.

What is becoming clear, however, is that the hit to credit availability is focused on lending to firms and commercial real estate. In part that reflects the fact that the hard-hit regional banks are outsized players in those markets, but it is also due to the strength of households' balance sheets, which has so far helped keep the taps on consumer credit firmly open.

The Federal Reserve continued rate increases in the third quarter even as inflation has begun to ease, raising fear among businesses and investors pricing in that cost pressures, the Federal Reserve may not be able to successfully rein in inflation to hit their 2% goal in 2024. After the July rate hike, the rate increases since March 2022 total 525bps, driving the Fed Funds rate to the highest level in 22 years.

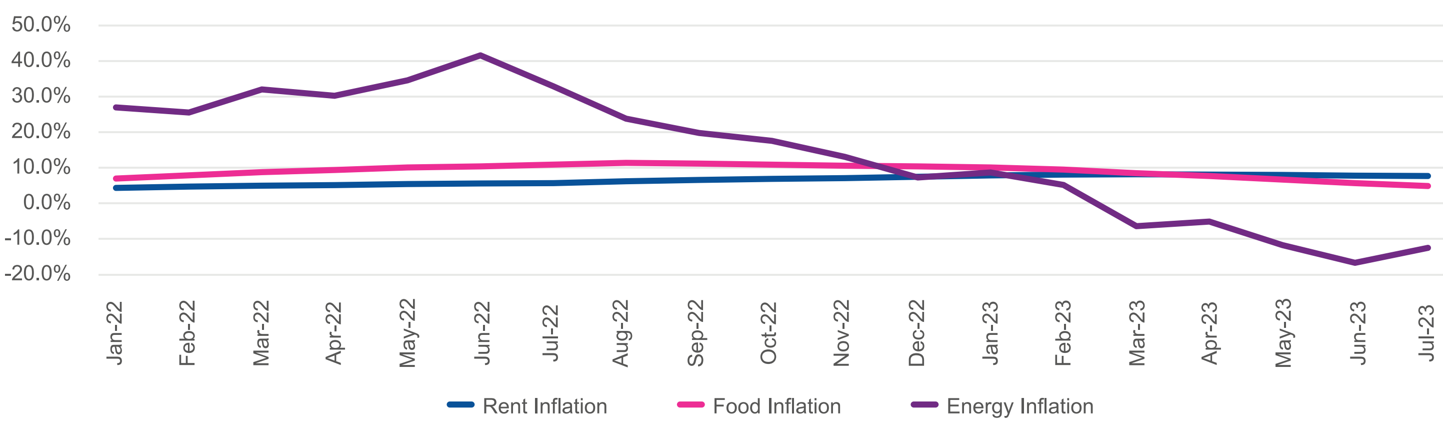
Midpoint of Fed Funds Rate and Fed Projections



Source: Federal Reserve Board of Governors

There has been some initial success as tightening credit conditions price a small segment out of the market. The board of governors has been nearing the end of its tightening activities even as the labor market continues to be resilient, and consumers deal with elevated shelter, food and energy prices. The cost of housing has been persistently high. The limited inventory of residential properties kept prices high despite rising interest rates. Low vacancy rates in the rental market are keeping rents high and the low inventory of houses to purchase are keeping prices up even as inflation in other areas retreats. These pressures will keep the shelter costs front and center for the Fed as a key sector impacting their activity performance.

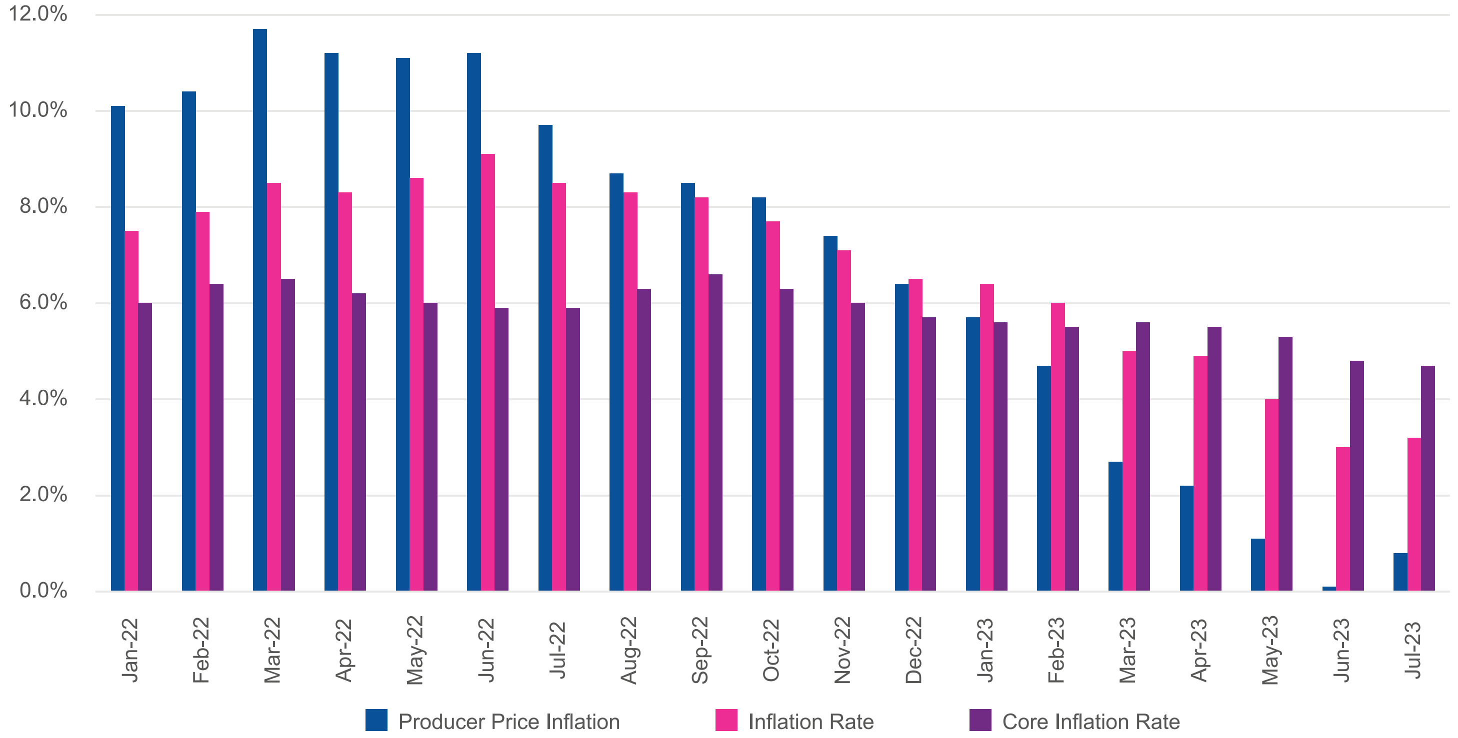
Tangible impacts of inflation year over year



Source: U.S. Bureau of Labor Statistics

Energy inflation saw significantly cooling, down 130%, in the last 12 months. Rent and food inflation appear to have peaked and are on the decline. Regional conflicts surrounding Ukraine will apply additional pressures on global food and energy markets which may cause this positive progress to reverse. The global energy market is receiving some relief as China's economic slowdown is reducing demand for energy and creating some cost relief for small business owners. Energy costs are already rebounding as global conflicts impact the supply chain and oil suppliers limit production to boost global prices. Consumer prices increased, in the last 30 days, with gasoline up 9% and diesel up 8%, hitting over $4 per gallon for the first time in several months. (Source: AAA)

CPI headwinds to deflation



Source: Bureau of Economic Analysis

The PPI (Producer Price Index) has been in decline, down 93%, meaning that consumers will likely see relief in food and energy costs from suppliers because supplier costs have been in decline. This trend has been a driving force in the last 6 months to help the US economy feel some pressure release from inflationary metrics. This does not mean that consumers have less demand, but that the prices they may pay would be lower per unit in some segments of the market. Inflation progress has stalled as the long tail of shelter normalization remains a headwind to progress toward the 2% target. This is still seen as progress and a sign a recession may be weaker than projected 12 months ago.

Expectations

As we prepare for the fall, consumers will be spending and utilizing credit to enable activity as inflation limits their purchasing power. They will increase the utilization of their credit cards and balances will continue to expand. The velocity of credit delinquency rates has cooled as wages increase and the U.S. economy cools. Where we see the risk to the consumer will be in their monthly debt obligations. For 37 million U.S. consumers, these obligations will increase in October, as student loan payments will resume. Fuel prices are expected to rise and will create a tangible impact on consumers ability to spend at 2022 levels.

The Federal Reserve will "Stay the course" as its monetary tightening activities show progress. Housing costs are a large blocker to short term inflation progress, but a boost to the construction industry. Higher than target (>2%) inflation will be with us into 2025 unless the U.S. enters a more significant period of recession.

The Construction industry will improve U.S. housing inventory as pent-up demand for residential properties is high even in a high-rate environment. Commercial construction will thrive on a backlog of public/infrastructure stimulus and private contracts into 2025 even with commercial vacancy rates remaining high as back to work programs make marginal progress.

The Transportation industry will be challenged as fuel and wage costs rise and delivery costs tumble. Consumer deliveries are on the rise but are not enough to compensate for the pullback in commercial deliveries and operational costs in the current U.S. marketplace. Inventories are not being replenished at the same rate as they were in 2021. Special consideration is being given to the high cost of commercial warehouse space and orders for new inventory reflect the cautious demand cycle as we enter the fall. Large transportation companies are struggling as they ramped up overhead costs to meet 2021-2022 heightened demand. Now that high inflation has eroded the purchasing power of the consumer, the volume of units ordered is down. The transportation industry is set for another reset as we close out 2023.

Small business lenders will be engaging the market to grow even as the economy cools. Margins and deposit volumes have been positive over the last twelve months. The volume of small businesses in the market provides both opportunity and exposure risk as the economy cools and investor funding tightens. Large financial institutions have been strategically adjusting their underwriting criteria to limit exposure. This leads to small business customers not receiving the same low-cost funding offers they might have received six months ago. There are an abondance of regional, fintech, and credit union lenders available to offer alternative funding options to these small businesses that do not meet the premium funding requirements of a large institution. Commercial and consumer credit markets are still open for business at all credit tiers, it may just take customers a little bit longer to find the product that matches their needs.

What needs to happen to change the forecast? To drop a recession from the baseline, several conditions would have to play out. Inflation would have to decelerate more quickly than either we or the Federal Reserve anticipate. This would put upward pressure on real disposable income, which matters for consumer spending. If consumer spending reaccelerates over the next few months, a recession is unlikely late this year or early next. The rebalancing between labor demand and supply would need to accelerate and credit would need to be more readily available.

Consumer and small business sentiment is improving as fear of a recession is pushed further into the future. Consumers are continuing to spend at elevated levels and small businesses are investing in growth strategies, although at a more cautious pace. The resilience of the U.S Consumer, as holiday shopping ramps up, will provide insight into the health of the U.S. economy and small business stability entering 2024. A soft landing is possible for small businesses as a safety net of government programs and alternative lenders crowd the market. Consumers spending will be the tailwind to push them through any near-term turbulence.

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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