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Beyond the Trends

Understanding the Commercial Economy

Spring 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.

Brakes or gas? Small businesses accelerated performance through 2022, but the curves and twists of 2023 will challenge the perseverance of young drivers.

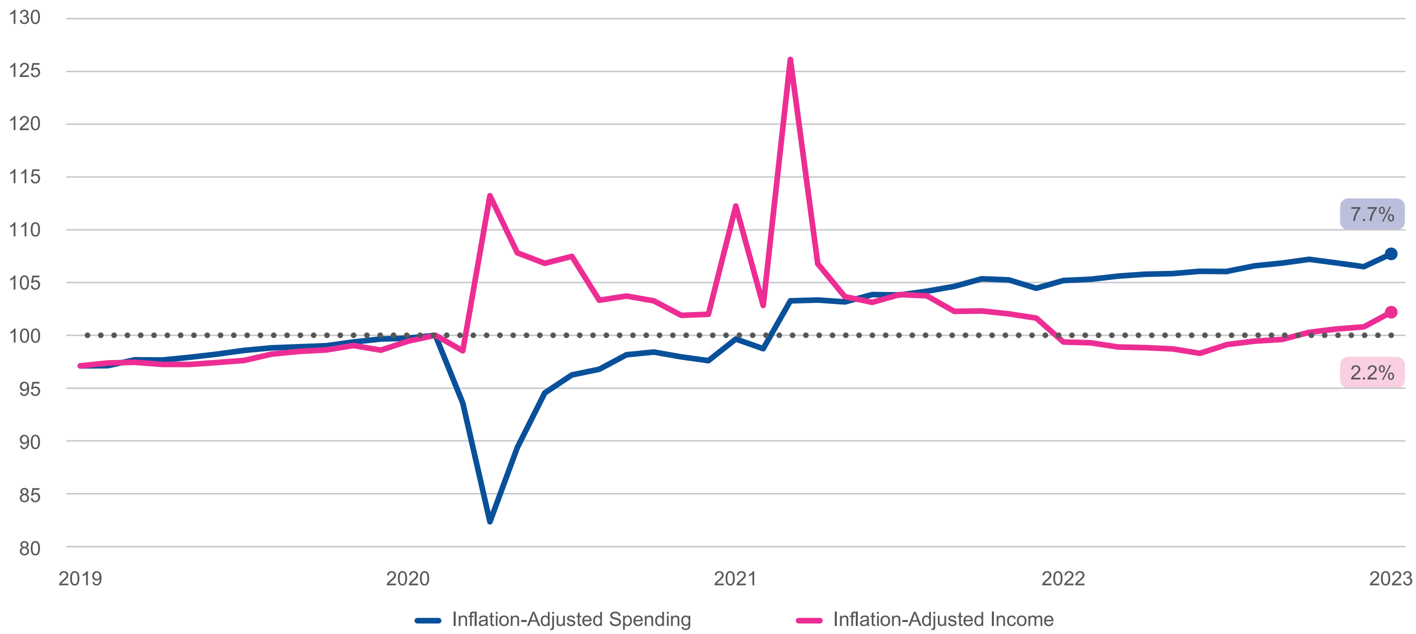
Small businesses entering this year are questioning new-year strategies. Global and macroeconomic obstacles are changing and adding to the uncertainty of the second half of the year. The prior year, 2022, ended with consumer spend increasing and small business delinquencies at near pre-pandemic levels as consumer spending behaviors adjusted to rising prices. The new year added pressure to an anxious consumer, creating volatility in discretionary spending behavior as fiscal reserves run lean. Small business strategies are starting to transition in preparation for this expected volatility in 2023. Decerning the risks and opportunities early in 2023 will guide the commercial markets and businesses' adjusted view of the rewards in growth and obstacles to success that will lead to a calculated acceleration to close out the first half of the new year. Over 36% of active businesses operating in 2023 are less than one year old. Some of these speedy upstarts are looking in the rearview at the prior year's stimulus support and baking that into their strategy for the year ahead; however, the credit market tightening, new tax regulations, and consumer spending pressure may take them on an unplanned detour.

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.

Credit markets remain largely open across risk tiers, but the small business lender will be more sensitive to market factors such as labor, wages, inflation, global supply chain disruptions, sanction activity, and rising delinquency trends as small businesses look for growth as consumer spending although strong, begins to moderate. Cashflows will be tested in industry segments focused on home-based work/life as the labor force returns to the office. This re-emergence of in-the-office staff will provide needed cashflow to businesses in surrounding urban areas. The Kastle back to work report cites ~50% occupancy for business, but some softness is starting to form again in March. Some businesses require hybrid work schedules to encourage collaboration and a more connected work environment, mobilizing consumers back into retail brick and morter market places, where they previously had limited touch when remote work was full time.

Inflation-adjusted income has risen for seven-consecutive months

Real Disposable Income and Consumer Spending: Index, Feb 2020 = 100

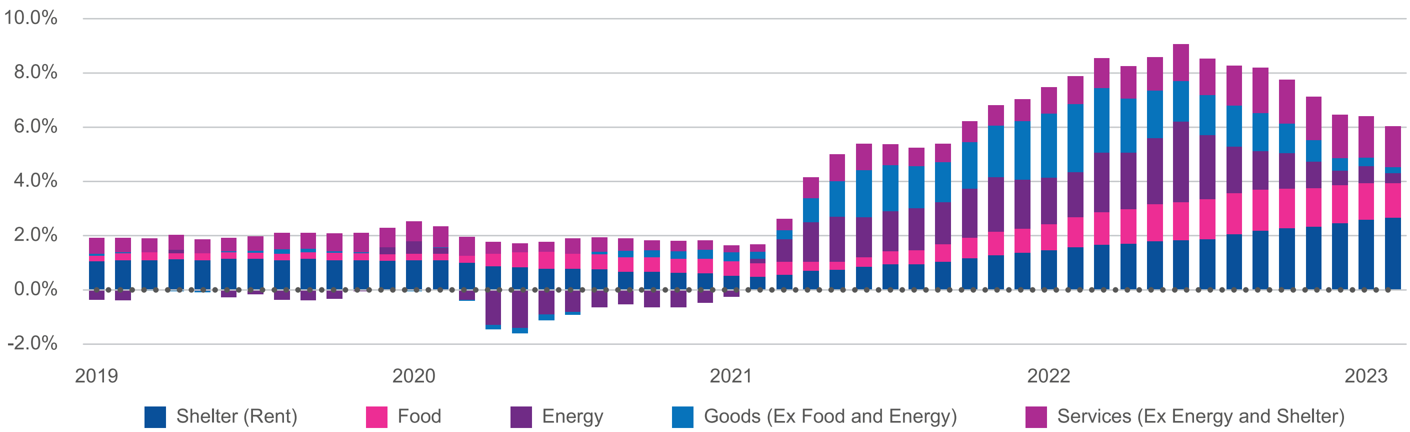


Source: Bureau of Economic Analysis and author's calculations

Consumers spend as income acceleration continues. This spending increase does not mean that consumers are getting more value or products for the purchase volume. It also does not mean that spending is hitting all sectors of the market. Retail spending slowed in February for department stores, restaurants, and bars. Consumers continue to spend on vacations, up 17% (Bureau of Economic Analysis), and luxury goods through the first part of the new year. This behavioral volatility in spending may have retailers reconsidering their strategy for the remainder of the race. Costs are still elevated, and that cuts into the buying power of the average consumer.

Home prices and wage pressure pin shelter and service inflation at high levels

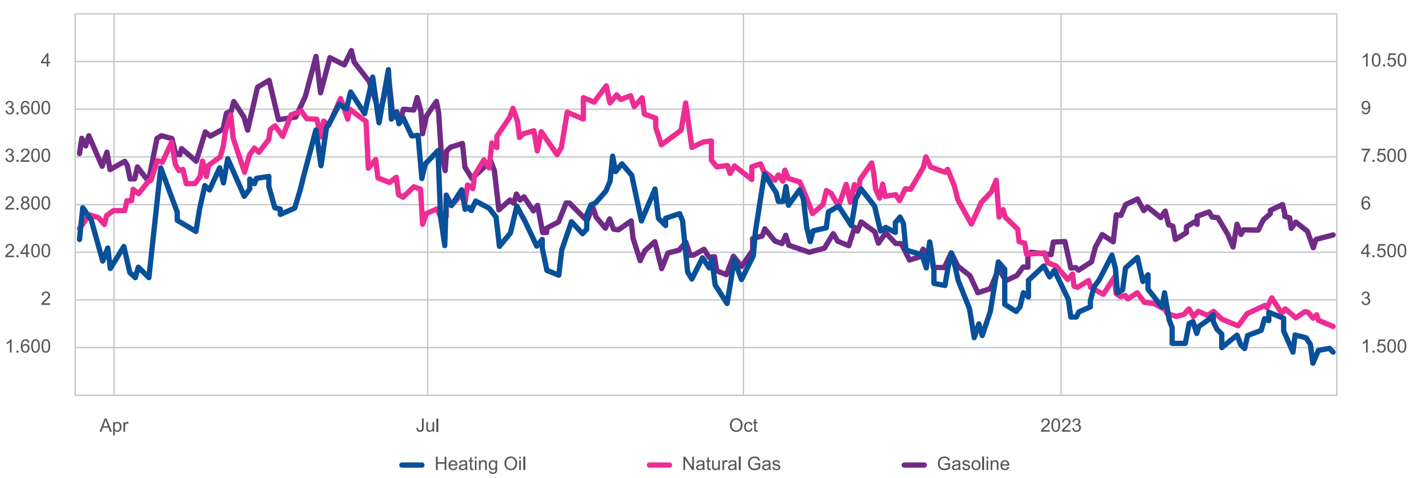
Select Contributions to YoY Consumer Price Index



Source: Bureau of Labor Statistics and author's calculations

The GAS: The good news in the numbers is that consumers will start to feel price acceleration begin to ease. They will see some goods on sale as retailers start to clear out remaining bloated supply chain disruption avoidance inventories. Relatively mild winter weather globally and a re-engaged and accelerating production infrastructure relieved consumers as fuel stockpiles grew and fuel costs declined. U.S. Crude futures experience ups and downs as a slowdown in global and domestic economies projected for the second half of 2023 will soften demand. A decline in fuel prices is a nice relief for consumers struggling to keep up with rising prices on core obligations.

Energy price decline with weaker market demand

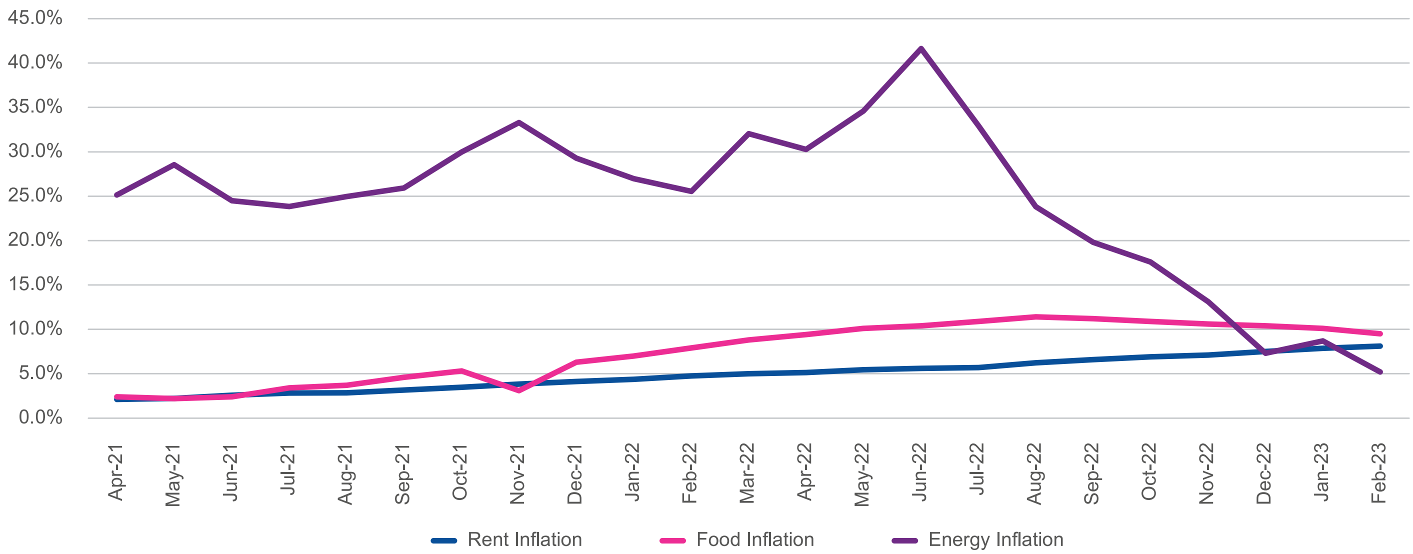


Source: Trading Economics

As fuel cost declines, producer cost declines can be passed onto the consumer through lower prices on food and goods. This activity created a cooling effect on food inflation in the past quarter, a silver lining for consumers as they cope with higher shelter costs and cross-segment inflation.

Short reprieve in energy costs

Year-Over-Year Rate of Inflation



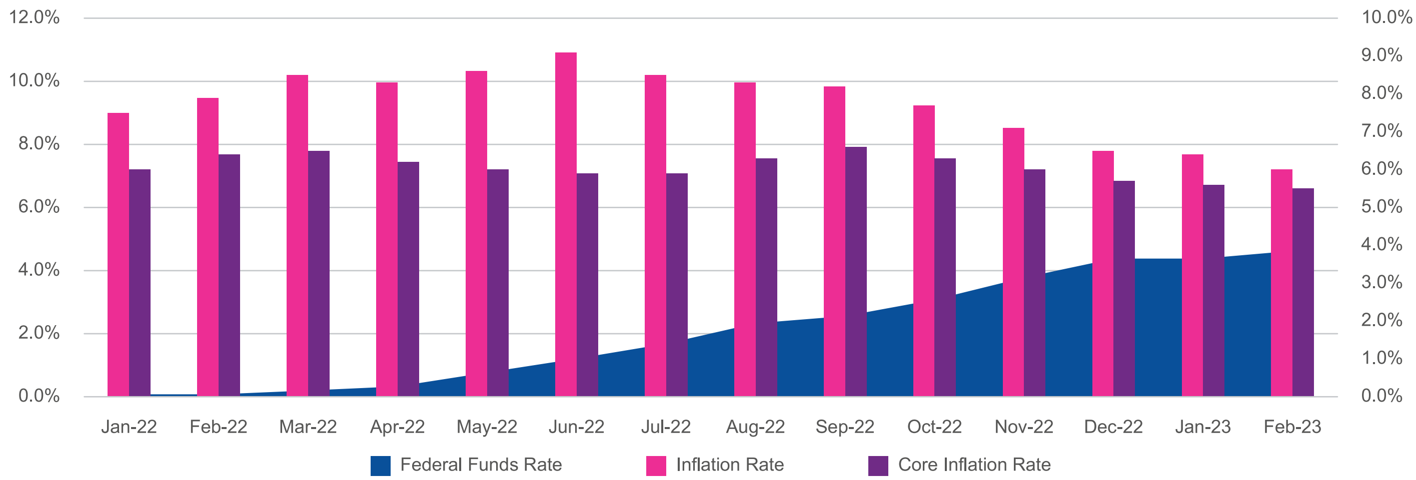
Source: AAA

Inflation surrounding the service industry will remain elevated as rising labor costs will keep prices moving upward. Shelter will continue to remain elevated even as home prices begin to decline and held inventory enters the market as builders look to unload properties while prices are still high. Higher mortgage rates are keeping some buyers on the bench because escalating rates will cancel gains made in lowering the cost of the home. Rents will continue to lag home prices and are projected to remain elevated through most of 2023.

Inflation began to moderate in June 2022 as the Federal Reserve began its activities to cool the U.S. economy. Core inflation is slower to budge, in a declining trajectory, as contributing factors that would influence a deflationary trend will experience the impact of Federal Reserve actions over the next 8-12 months, as they unwind.

Inflation peaked, but the moderation has proved slower than expected

Year-Over-Year Rate of Inflation

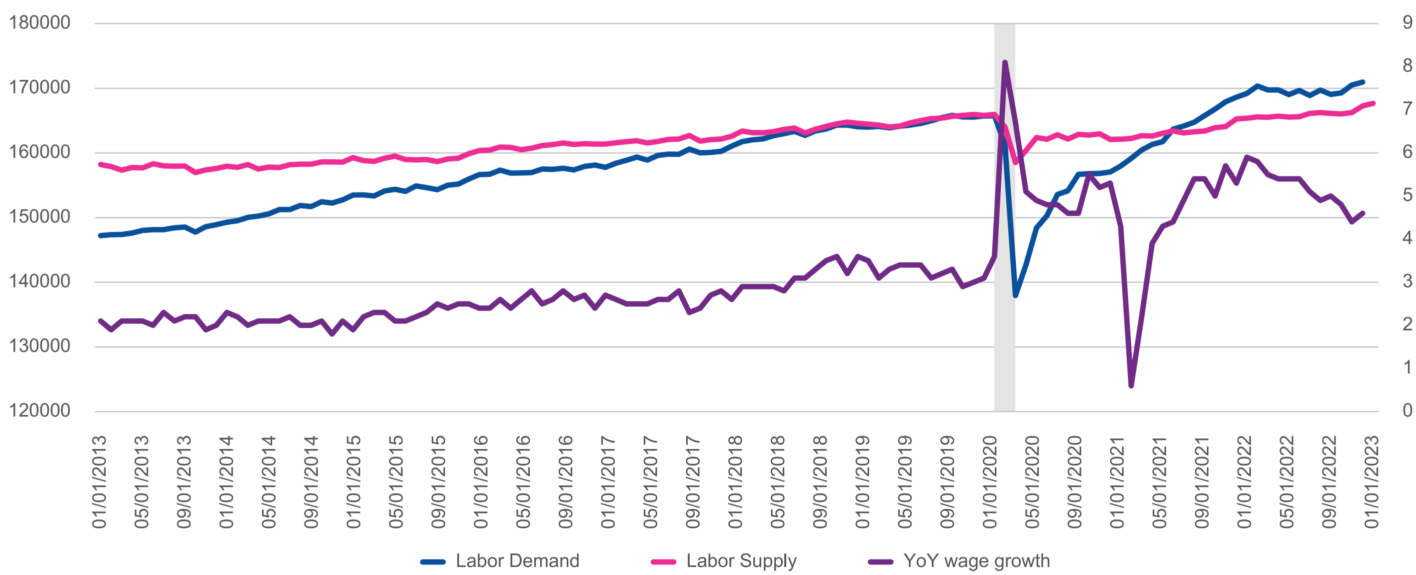


Source: Bureau of Labor Statistics and author's calculations

A tight labor market is an effectiveness detractor of the Federal Reserve policy, as it keeps wages rising and consumer spending on a positive track. We continue to see layoffs in focused market segments that experienced pandemic-related growth. So far, these workers are quickly picked up in a high labor-demand environment.

Labor shortages continue as demand for workers outstrips supply

Labor demand vs supply as wages increase



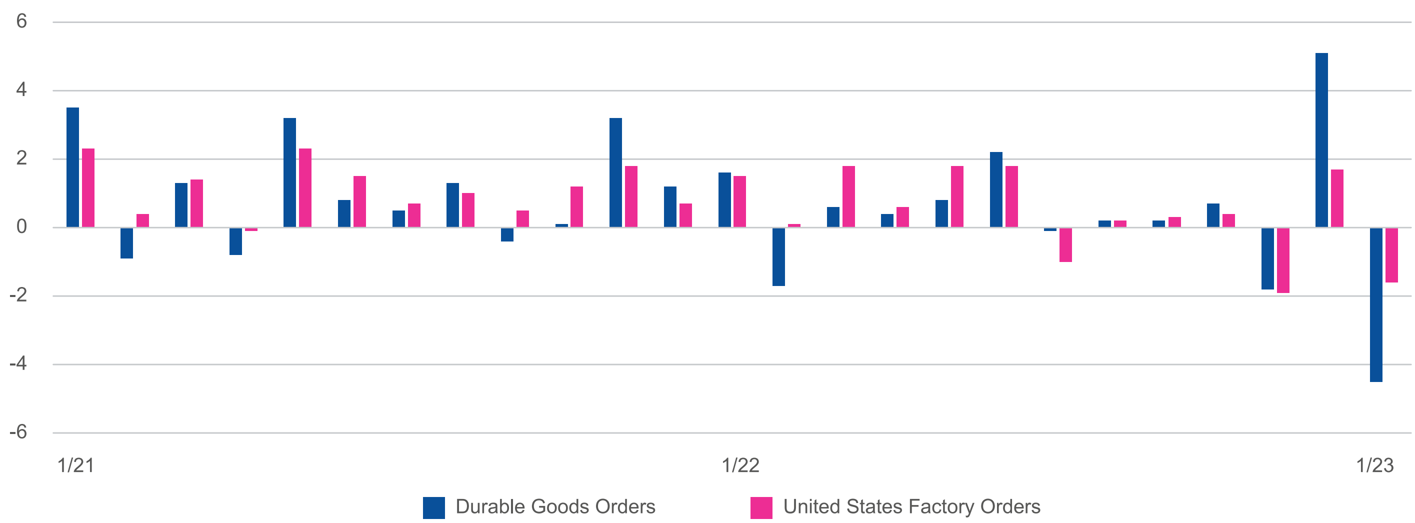
Source: BLS, Author's calculations: Labor Demand = Employment level + Job openings, Labor supply = Labor Force level + Marginally attached (avail to work now)

The market competition for labor will keep wage growth elevated and consumers employed, leading to improved consumer access to capital and credit markets as cashflows remain uninterrupted in most cases.

Tapping the brakes: Businesses slowed orders due to softening consumer demand in the fourth quarter of 2022 for the volume of goods sold compared to prior years, attributed to the higher costs of goods and inflation that impacted incomes. As retail-focused supply chains continued their progress toward pre-pandemic efficiency, shipping container costs declined. In 2021, an average container cost >$20k, in 2022 <$3k with a continued decline in 2023 (Freightos) on the Asia pacific route, as energy prices fell and soft consumer demand slowed wholesaler and retailers' willingness to replace inventories at the same pace as 2022.

Factory and manufacturing velocity follow consumer demand

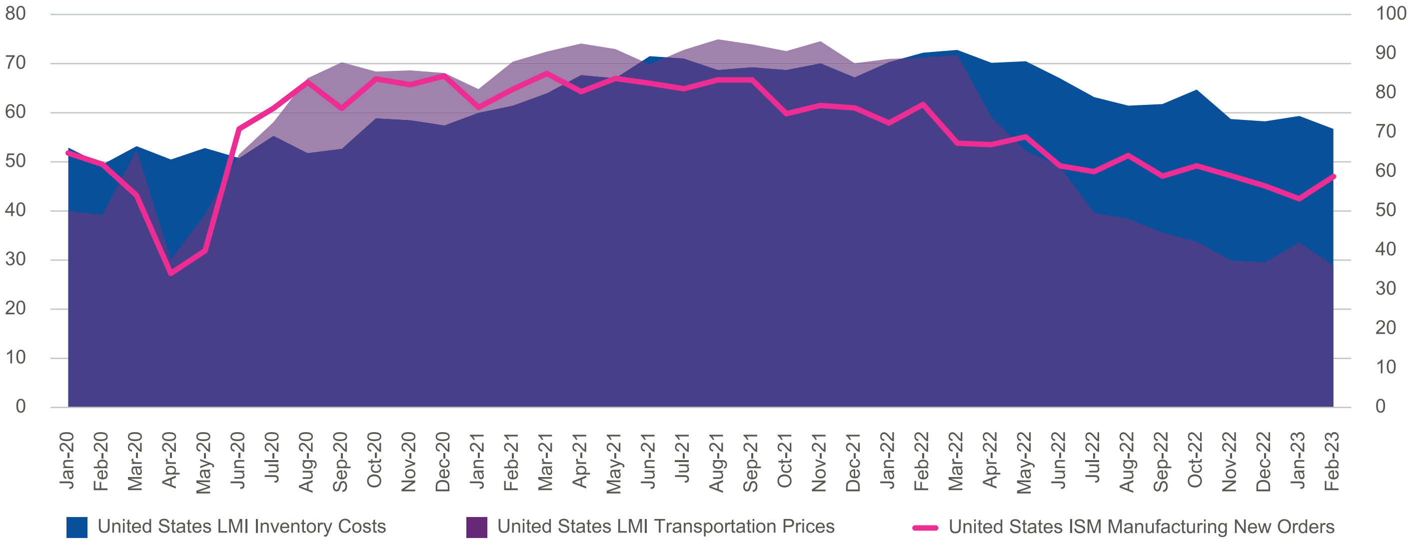
Small business inventory costs



Source: Logistics Managers' Index

Retail spending slowed in February (According to Commerce Dept, WSJ March 16). Retail sales were down 4% for department stores, while online retail sales were just over 1%. Retailers are tightening their belts in expectation of economic instability in the short run. They will be cautious in the volume of pre-order inventory to support sales in 2023.

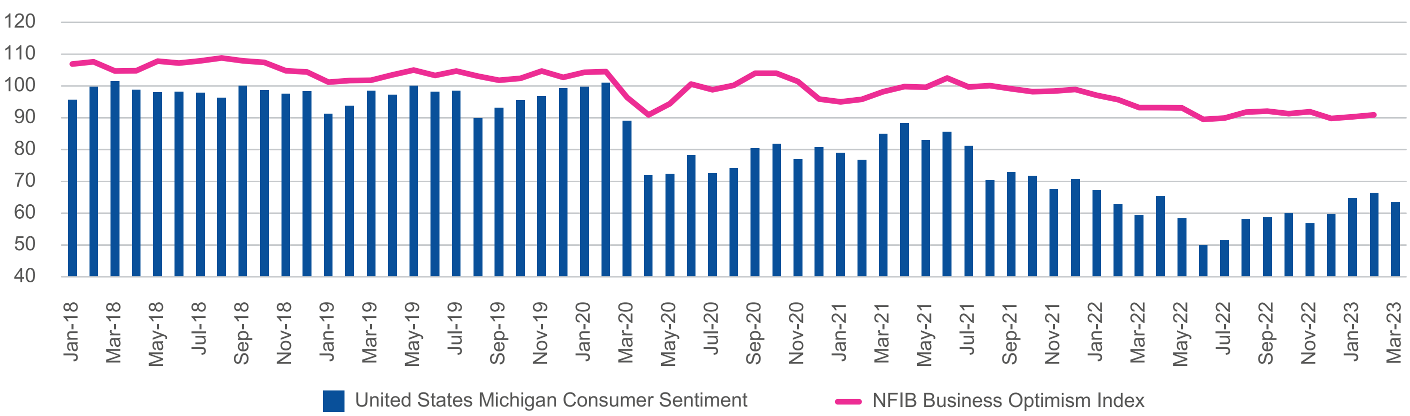
Inventory orders follow consumer demand



Source: Logistics Managers' Index

As we emerge from the pandemic, manufacturers are making a quick comeback with the reopening of offline facilities. This is happening in response to the overwhelming amount of post-pandemic orders, leading to a trend of new orders on the rise in the first quarter of 2023. Surprisingly, the expectation of a recession has been pushed back to the second half of 2023, resulting in a positive shift in consumer and commercial sentiment. This has helped propel new order metrics upwards.

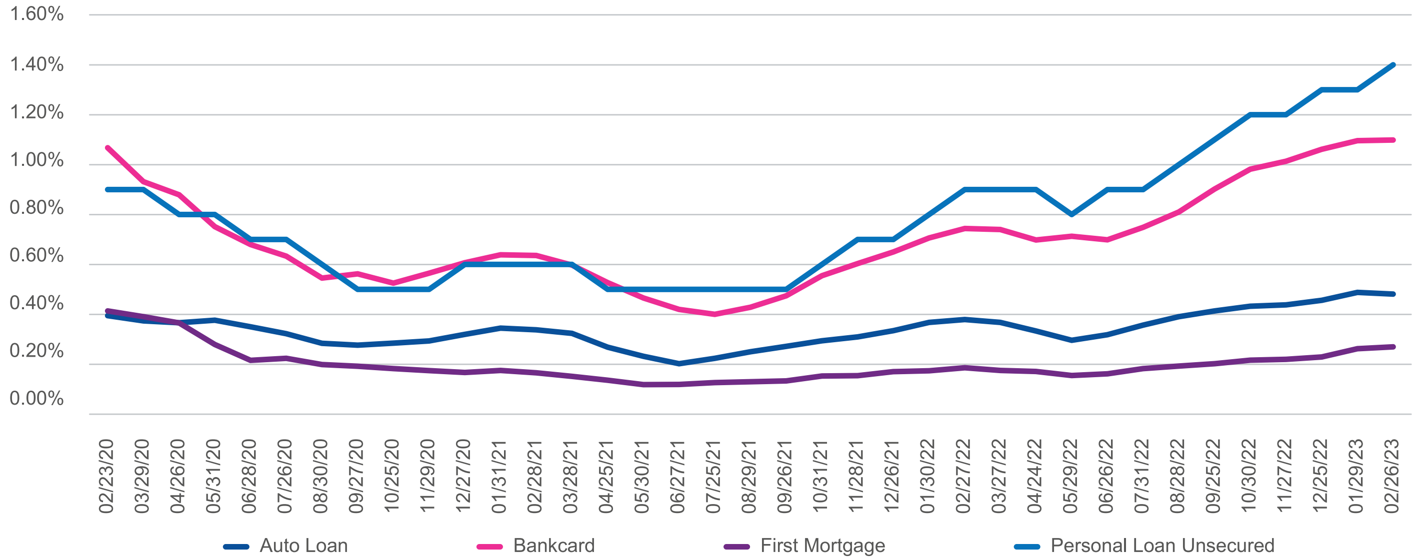
Consumer and commercial sentiment turning upward



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

Feathering the gas: Commercial confidence will lag the consumer because at this point in the U.S. financial cycle, consumer spending is the main driver in commercial cash flow stability. Small business sentiment will stumble when commercial credit markets tighten, and consumers pull back on spending just before a recession. These trends are encouraging in the short term as unemployment rates remain low and credit markets are slow to turn off growth. Other factors beyond employment impact the consumers' ability to repay debt, creating an environment of rising delinquency.

Consumer delinquency rates on the rise (U.S. % Balance 90+ delinquency rates on the rise)



Source: Experian State of Credit

Credit cards and installment-type loans are still readily available in the market; however, small businesses are utilizing these forms of credit as the use of available asset equity becomes less attractive in the coming months due to rising mortgage and home equity loan rates. As the market rate increases for these types of cash-out funding opportunities, small business owners will find this old behavior too expensive as an emergency cashflow option.

SVB (Silicon Valley Bank) hydroplanes as Treasury takes the wheel

The Federal Reserve's current dominant objective is to apply downward pressure on inflation while slowly returning the economy to status without putting markets into a spin towards a recession. That objective was tested with the U.S. Silicon Valley Bank failure. These were not the same circumstances as banks failing during the 2008 recession. SVB and other large depositor ratio banks with account balances >$250k the FDIC's limit experienced some liquidity challenges and took action to address them. Depositors noticed the banks were in trouble and began withdrawing their cash, creating a run on the bank, and exacerbating the liquidity challenge. This caused the bank to fail. The U.S. Treasury stepped in and created a soft landing for SVB customers to recover their uninsured deposits, even if above the FDIC (Federal Deposit Insurance Corporation) limit. This action and the large bank cooperative lending action that followed for other high deposit ratio banks averted a catalyst event that was projected to lead more quickly to a financial system collapse. The market weathered the immediate impact of a bank failure; however, it was still weakened from the perspective of global and domestic analysts as the weakness in the U.S. banking industry was exposed. By the numbers, the market stands in a similar state to the position it was in several months prior, heightened inflation and a strong labor market. This state of the U.S. market will present the Fed with signals to pressure them to continue to pull interest rate levers and resolve to continue their lean into lowering inflation to target. Consumers need to believe the Federal Reserve's actions will create change in the markets to maintain investor confidence and keep consumer spend flowing to soften the slowdown targeted by the agency.

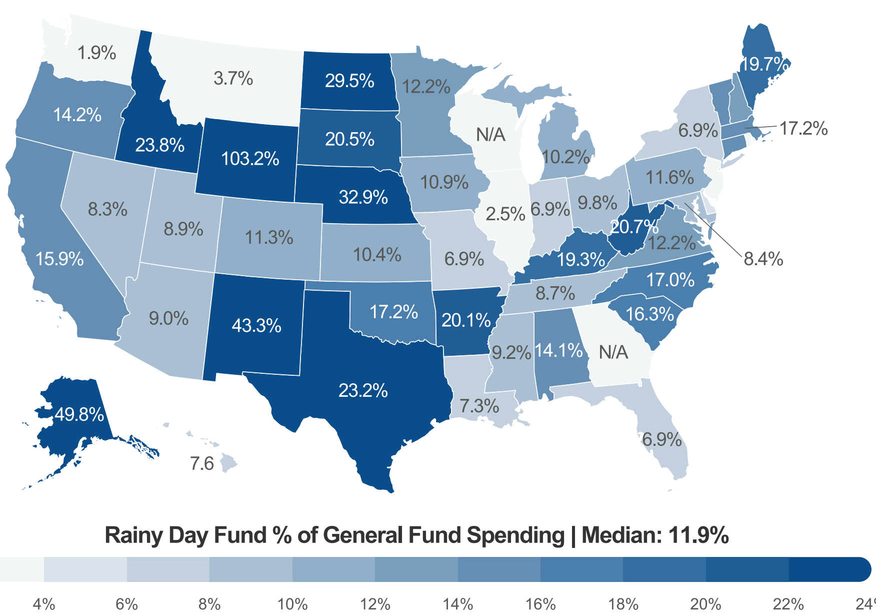
The Brakes: Consumer reliance on credit for core expenses has increased with inflationary pressure throughout the 4th quarter of 2022, spilling into 2023. Those with student loan debt in a hold status will see payment expectations resume, adding more stress to monthly debt servicing obligations. Consumers have seen recent relief in energy prices for gasoline and natural gas. Still, that relief was eroded by higher food, shelter, and reassumed debt obligations from the pandemic and government-directed payment holidays. The higher, and in some cases, unexpected monthly consumer payment obligations will put downward pressure on consumer confidence. Small business confidence follows closely 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 due to tangible deflation in core consumer expenses, wage growth and strong employment, but that improvement is slow as high inflation persists.

Small business will look for opportunities to capture consumer spending, but consumers will find their purchasing power limited as elevated shelter costs lag home price deceleration, interest rates increase, and assumption of unexpected debt payments linger. U.S. small businesses are already facing an extended period of higher costs 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. This focus on cooling inflation will persist for the next 18-24 months. Lenders and creditors will need to assess how they will respond to struggling small businesses in 2023 as consumers tighten their belts.

Small business performance fuels the U.S. economy

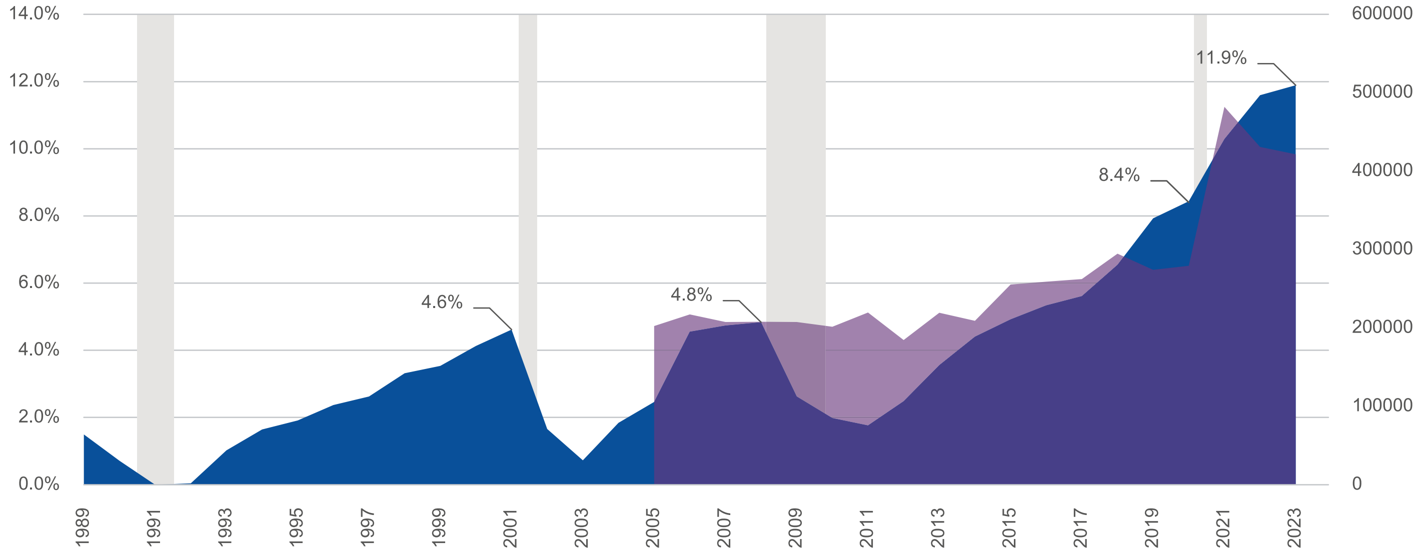
Upgrading performance: The quality of fuel we put into the U.S. economy will dictate how smoothly we will run over the next five years. Small businesses in the U.S. (31.7M A corporation, limited liability company, or proprietorship with 500 employees or less) make up 99.9% of all businesses in the U.S., 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 substantial portion of this growth comes from companies with less than 20 employees. In addition, 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 (Small businesses) emergency stimulus available. Heightened rainy day fund savings at the state level will be a second line of local support when the economy slows and small businesses cashflows are put under pressure.

High level of state savings should provide buffer if the economy enters a recession



Rainy Day Fund % of General Fund Spending | Median: 11.9%

Median Rainy Day Fund Balance as a Share of General Fund Spending

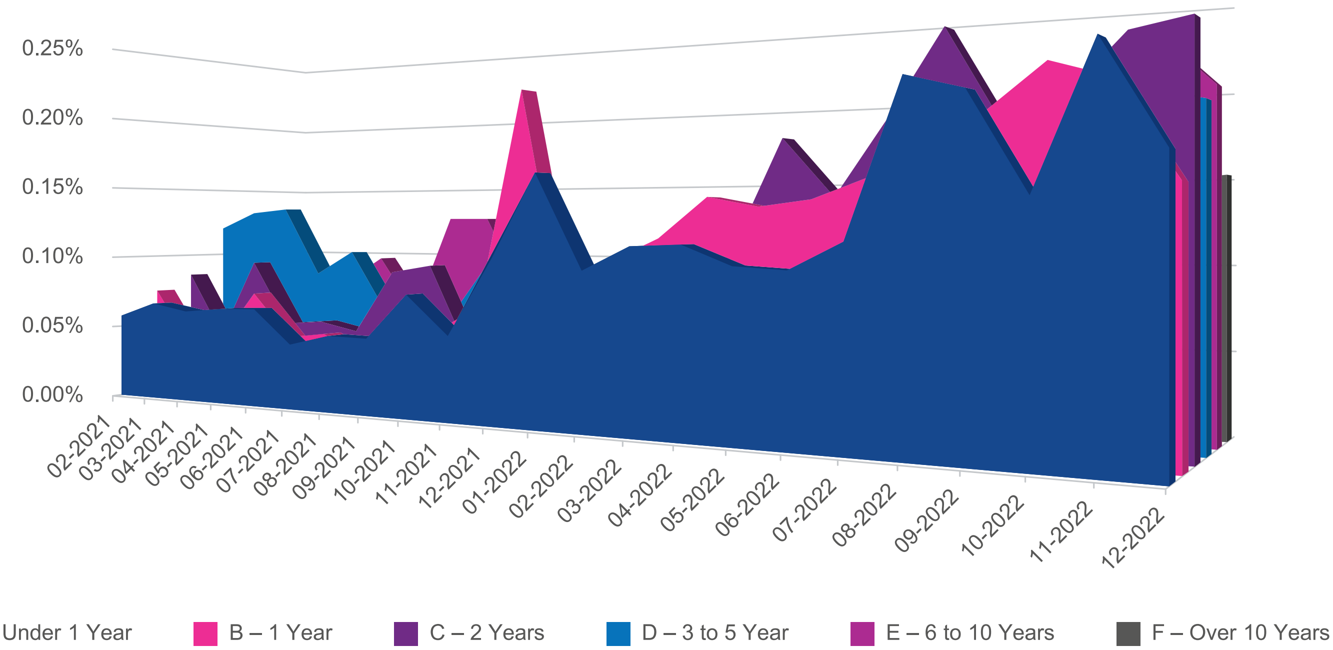


Source: National Association of State Budget Officers

These programs could divert funding to local business development activities that spur entrepreneurs to engage in new ventures. Small businesses provide essential goods and services across industries. These businesses are very inclusive of all gender and minority segments, broadening 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.

These year-old emerging small businesses are in a race to become stable, viable businesses. As they emerge in their first years in the market, the rookies are more susceptible to market events. A prolonged high inflation environment has already begun to create cracks in stellar small business repayment performance reflective of a cooling market.

Delinquency levels by years in business



Source: Experian Commercial Benchmark

Higher-than-target inflation and softer consumer goods spending will lay the framework for a volatile year of small business performance. Privately sourced commercial credit is already becoming harder to acquire in 2023 as businesses struggle to keep consistent positive cash flow and market lenders look to shore up portfolio exposure. Small businesses will need to be prepared to weather this leaner cashflow environment and educate themselves about accessing emergency funding, as consumers slow their discretionary spending behavior in preparation for market volatility that will impact employment and demand. Access to funding is critical for small business growth. Unfortunately, the price of funds is rising as the Federal Reserve continues to aggressively control inflation velocity. In the U.S., Commercial lenders see the costs of funds rising and are beginning to pass that cost along to customers through increased APR (Annual Percentage Rate) on unsecured products and risk-adjusted terms for longer-term installment products.

Lenders are preparing products and portfolios for volatile markets

Credit market participants weigh criteria and products for exposure and limit slip through minor adjustment

Source: Experian Commercial Benchmark

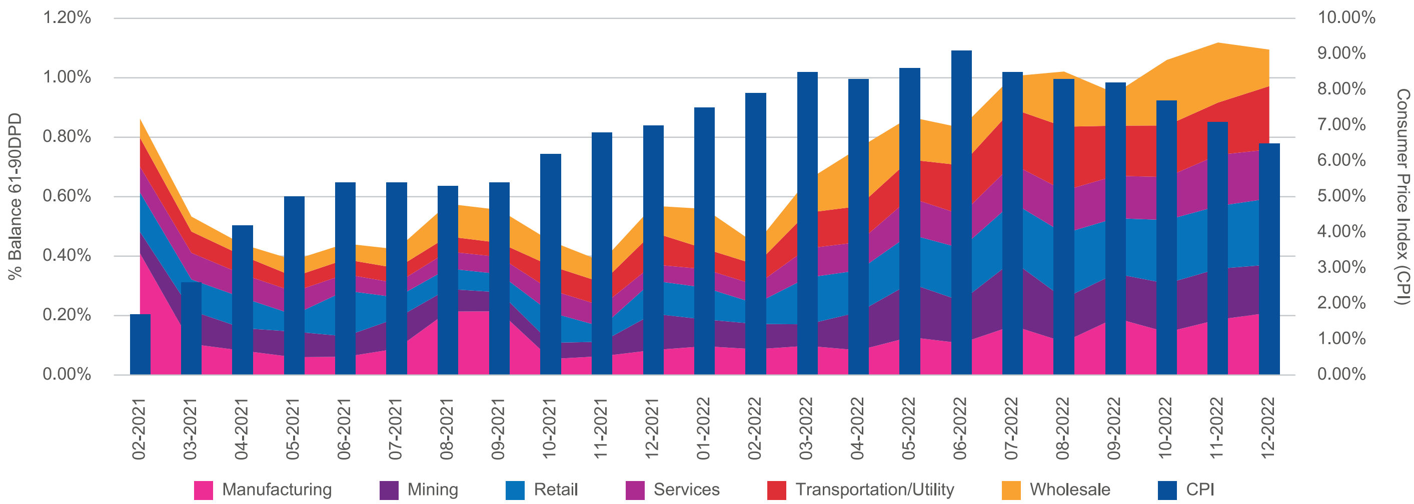
Lenders surveyed in a recent SLOOS report responded (more than 33.4%) that they were already tightening credit criteria, corroborated through Experian client feedback, providing insight into recession preparedness portfolio exposure reviews and underwriting adjustments for a tighter commercial credit environment.

Consumer and small business lenders are talking about what levers they are considering in the near term and willing to pull to avoid portfolio exposure as the risk of recession increases for the second half of 2023. We see lending expand product offerings and enhance decisioning to keep accelerating toward growth. Some have already let off the gas and are coasting for a more cautious growth and limited exposure target. The strategy of broader product availability and pricing risk into the decision will keep cashflows moving, even if seen as artificial inflows, in a lean consumer spending environment. That strategy assumes consumers will significantly change their behavior. Current trends in consumer spending are accelerating, meaning small businesses can continue to operate in growth mode. The challenge is that lenders are seeing the brake lights of their competitors flash.

Originations have been accelerating through 2022, but in the last few months, stalling as established small businesses rethink their growth strategies, and look to hold off on taking on new debt focused on investment and growth. As a result, new small and micro businesses will be a more significant percentage of the credit-seeking population in 2023, as the levers these emerging businesses have at their fingertips during the lean times are more limited.

Lenders have been noticing utilization and delinquency increasing across products and industries as declines but remains well above the Federal Reserve's 2% target.

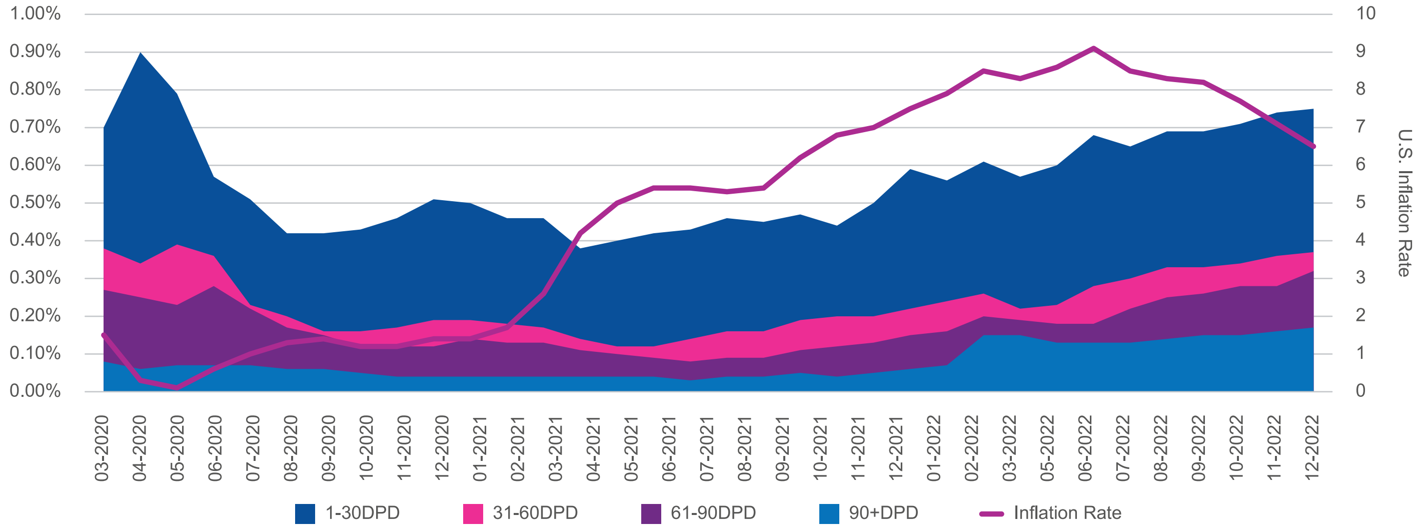
Relationship between rising rates and 60-90 days beyond term



Source: Experian Commercial Benchmark

Commercial delinquencies and utilization have broken past their pre-pandemic levels but are on par historically with levels of growth experienced in a growing economy. Well-capitalized companies and lenders, aided by government backstop activities, kept higher delinquencies in check and business health in a good position as we traverse the obstacles in a twisted 2023 growth track. Rookie businesses will not have the credit history to qualify for traditional credit products, nor the experience to know where they can find emergency funding as their wheels hit the rumble strips of slow inflows or supply chain disruption.

Volatility in delinquency rates unsecured card (Rolling buckets)

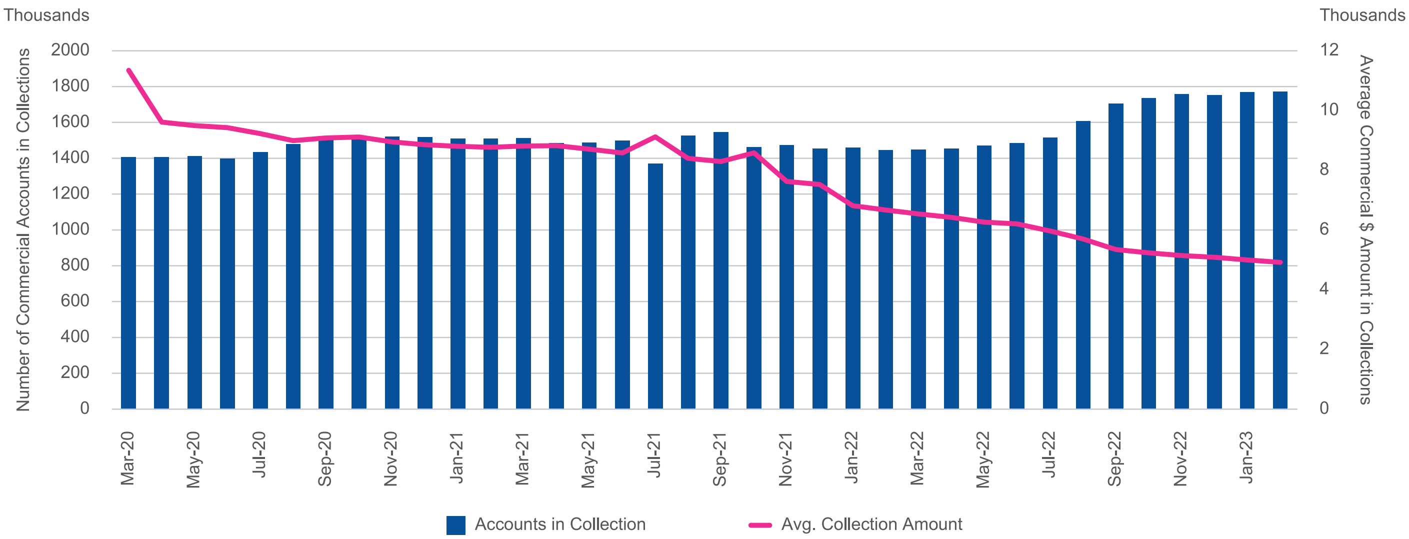


Source: Experian Commercial Benchmark

This view of 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 responses by lenders. As a result, if the 90+ remains low, private commercial funding will remain open. Despite the increased frequency of delinquent balances, there's no need for alarm as they are not escalating into more serious delinquency statuses. Bankruptcy rates aren't posing a significant obstacle to market growth, because of the ability of customers to service debt even debt that is beyond term.

Collection activity in the commercial lending market has been slowly rising over the past couple of months. The accounts placed into a recovery bucket have lower credit amounts aligning with the small credit amounts originated by rookie drivers in new emerging businesses.

Small Business collections rates increase as emerging businesses struggle to gain footing



Source: Experian commercial collection data

Small businesses and market investors will watch how lenders handle increasing delinquency pressure in their underwriting of new debt to continue growing as the U.S. and global economies slow.

Portfolio exposure activity taps the brakes to avoid a slide

Small business lenders will 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.

By leveraging customer attrition modeling, combined with ranking your most profitable customers, you can stay focused on eliminating any potential risks to your business. Don't let distractions hinder your progress. Use this powerful strategy to stay on track and drive success.

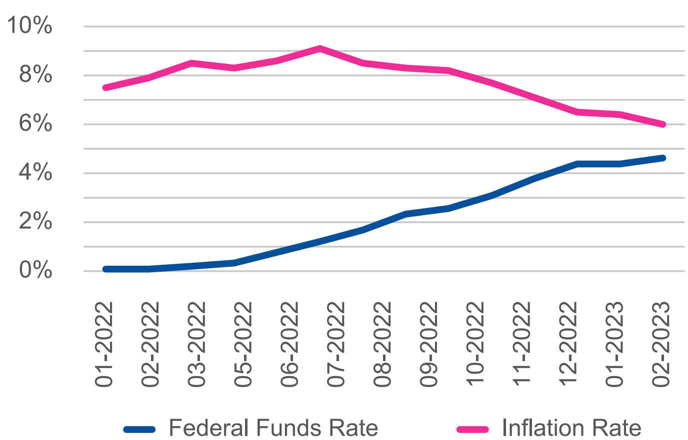
The willingness and ability of a customer to repay will change the lender's offer strategy to maintain the most profitable and loyal customers. Pretreatment strategies will be critical to maintaining the portfolio's most reliable and profitable customers. Identifying the right customers will make the difference in recovery or loss; therefore, frequent portfolio review activity will highlight those customers at the highest risk and focus recovery activity on those accounts with the greatest recovery potential and lifetime value.

Customer loyalty through a troubled period in the economy can create great opportunities for future growth and success in periods of heightened market strength.

What are the signs telling us as we plan for the next curve?

Federal Reserve actions began in March 2022 to address accelerating U.S. inflation. As a result, rates began to rise at 50 basis point increments and continued to accelerate with additional 75 bases point hikes into the 4th quarter of 2022. The activity has continued into 2023, but funds rate escalation has slowed in the first quarter to a 25 bases point increase at the end of March with the expectation of one to two small additional increases in the coming months. The U.S. is beginning to see 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, in the new year, to be resolute in its directive to reduce inflationary pressure on the U.S. Economy. 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.

Federal Funds Rate and Forecast



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

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

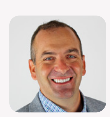
Delinquencies are rising for small businesses across regions and products. These delinquencies are most significant in the early-stage delinquency buckets. Late-stage delinquencies, although growing, have remained historically low. As a result, businesses are making decisions about how they repay debt, being careful not to roll into late-stage delinquency, which would impact credit scores and hinder access to capital.

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 economy will slow in 2023. Consumer and small business credit health and spending behavior will adjust to the new reality and resolve to be more future-state-driven when making fiscal decisions in 2023.

We are entering a moment in history where innovation and ideation are accelerating at a breakneck pace. New artificial intelligence tools are changing how we interact with data and form artifacts, tools, decisions, and deeper thought around the known and unknown. Insights extracted from these new methodologies are helping us to see multiple turns ahead instead of just what is in front of our eyes. Machine learning models provide expanded inclusion of underserved and often invisible small businesses (Rookies) as well as help us cultivate and protect our loyal veteran SMB drivers. Our goal will be to use the newest techniques to evaluate broader sets of data more quickly to create more wholistic decisions. These new techniques will force the industry to take more frequent pit-stops to evaluate the downstream impacts and decision volatility as prescriptive insight speed accelerates, with less human interaction, adds risk to the system. All drivers will benefit from enhanced information availability and lighting fast funding options. The key to a planted launch, will be our thoughtful exploration and critical valuation applied science that will safely create products developed exponentially faster within secure validated systems for stable outcomes, we will stay in the guardrails while WINNING!!

Engines are revving, are you poised to accelerate?

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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