MAIN STREET REPORT

Your window into small business health

Q1 2022

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US economy faces new challenges, but will persevere

Executive summary

Experian begins a new chapter with the release of the Q1 2022 Main Street Report through our collaboration with the leading economists at Oxford Economics. During Q1, small businesses kept average commercial loan balances healthy and stable. At the same time, moderate delinquency inched up but remained low overall as business and consumer travel returned to form, offering major tourist destinations a boost.

Macroeconomic Overview

The US economy contracted in Q1 for the first time since the pandemic-driven recession ended, but the domestic economy showed resilience in the face of Omicron, lingering supply constraints, and high inflation. Looking ahead, intensifying headwinds from aggressive Fed tightening and tighter financial conditions will slow activity this year without stalling it. Business spending and hiring will stay buoyant as companies learn to live with Covid. Consumers' tolerance of high inflation will be tested, but robust wage growth and ample excess savings should support an increase in outlays. The economy is expected to grow a healthy 2.5 percent and create more than 4 million jobs in 2022. However, risks to the economic outlook are tilted to the downside and we see a greater risk of a harder landing in 2023 when growth cools to around 2 percent.

US business sector

Business investment growth will moderate in 2022, in line with cooler demand prospects. But the need to expand productive capacity and increase inventories will support solid growth above 5 percent in 2022. The war in Ukraine and Covid-related lockdowns in China have added pressure to already highly-strained supply chains and bottlenecks won't ease anytime soon. This will remain a key challenge for the business sector and suggests that the US economy's productive capacity will be challenged.

Businesses are still fairly confident despite this challenging backdrop, according to the latest Small Business Credit Sentiment (SBCS) Survey. Installment lending maintained steady momentum and approached its pre-Covid peak, while delinquencies inched up but remained low overall. There was more stress in commercial card lending, but lenders didn't adopt a recessionary stance. There were some findings, however, that suggest vigilance is warranted – namely a minor uptick in delinquencies in the wake of higher inflation, and businesses, mainly in the West, revealing an exposure to supply chain risk.

US consumer sector

Consumers — the bedrock of the US economy accounting for about two-thirds of GDP — are facing hard choices as surging costs for staple goods and shelter pressure their budgets and lead them to pare back on some purchases and dip into their savings. But robust labor income growth, record levels of household wealth, and ample excess savings worth more than 10 percent of GDP mean that consumer spending should remain well-supported. The results of the latest SBCS survey corroborate these findings, with delinquencies and forbearance participation low and credit origination remaining elevated. Further, lenders' posture doesn't suggest fears of an imminent consumer retrenchment.

Covid fears have taken a backseat to elevated inflation and severe geopolitical tensions, but the virus remains a downside risk for the economy. The wave of Omicron subvariant infections requires close monitoring as it could lead to renewed virus fear and dampen services activity, namely in the leisure and hospitality industry.

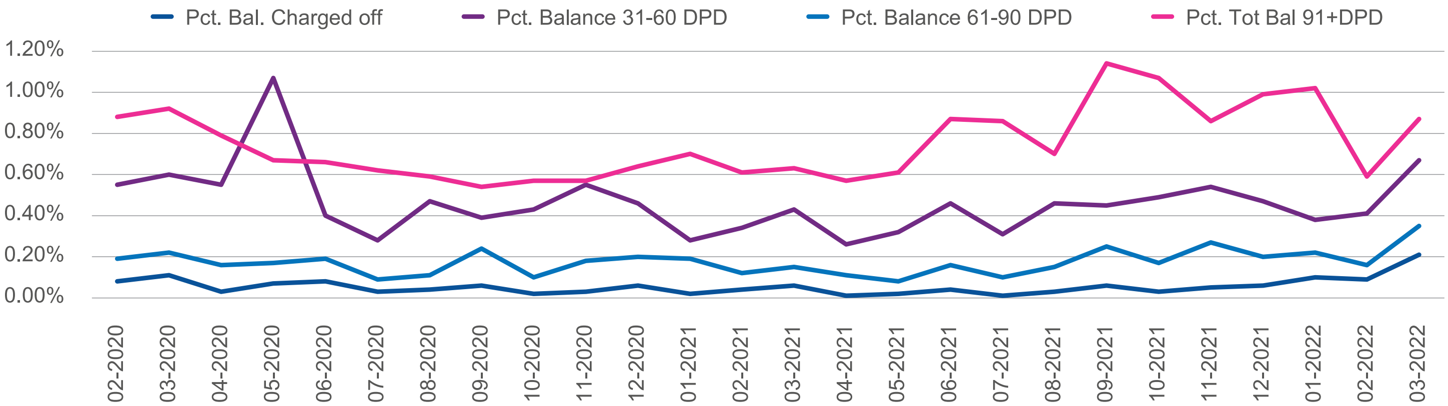
Highlight on specific pressures that effect small businesses — Recession risk

Although the coronavirus recession ended only 18 months ago and global growth ended 2021 well above long term averages, some commentators are already signaling the verge of the next downturn. While this economic cycle has matured quickly, the triggers or vulnerabilities that could pull global growth below population growth, our definition of a global recession, don't pose material risks currently. What's more, the latest SBCS survey shows no significant sign of lenders positioning for US recession. The average commercial loan origination balances were healthy and stable at $200,000 in Q1, and commercial card usage was up in the quarter. And underwriting risk declined; some firms increased their underwriting risk, a positive sign for business sector activity. Overall, the survey doesn't point to a slowdown in business investment. To be sure, delinquency rates rose across the term periods; the 90+ days past due (DPD) climbed to 0.9 percent. However, these dynamics aren't significant enough to trigger alarm bells.

Of the three major recession triggers identified in our outlook — the Fed's expected aggressive tightening, lockdowns in China, and high commodities prices — no single trigger is likely to provoke a US domestic recession in our view. And, the combination of all three triggers simultaneously is unlikely.

Further, Oxford Economics' suite of global recession models suggest a low probability of global recession over the next few quarters. The US is most progressed in the economic cycle and so arguably is most at risk, but more so in 2023 than 2022.

Delinquency trends for commercial installment lending



Source: Experian Business Information Services

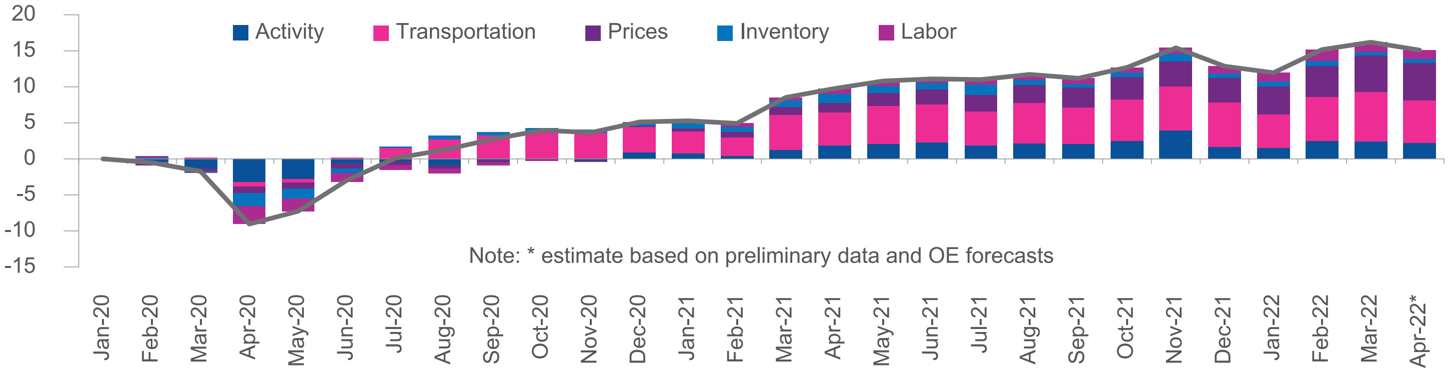
Highlight on specific pressures that effect small businesses — Supply chains

Supply chain challenges have proven more stubborn and difficult to resolve than initially hoped. What began as global and domestic challenges stemming from Covid have metastasized as the war in Ukraine raised inflation stress, and US businesses also feel ripple effects from China's zero-Covid policy. Only about 1 in 10 US small businesses are currently experiencing no ramifications from supply chain travails, according to the NFIB. Further, industries with a high reliance on supply chains are showing a rise in delinquencies rates for commercial cards. Namely, the retail and wholesale trade industries are feeling the greatest reverberations, according to the latest SBCS survey; portfolio risks for both these industries rose last quarter.

Supply chain conditions were highly stressed in Q1 2022, with challenges enduring into early Q2. News on the inflation front has been increasingly discouraging as production costs climb while inventories remain lean relative to demand. Pressure within logistics remains high. Meanwhile, dynamics on the activity front have been more reassuring and labor market stress is showing signs of easing, though the jobs market remains extremely tight overall.

US: Supply chain stress tracker

Index; > 0 = rising stress



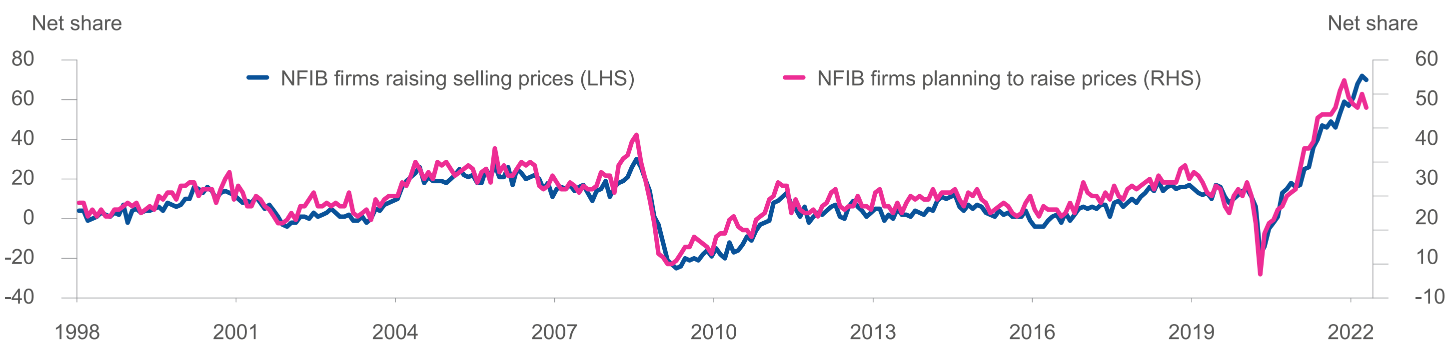
Source: Oxford Economics Supply Chain Stress Tracker

Highlight on specific pressures that effect small businesses – Pricing power

US businesses are experiencing the hottest inflationary environment in 40 years, and those with the strongest pricing power will ride the inflation wave best. Certain sectors, namely financial services, technology, real estate, basic necessities, industrial goods and services, chemicals, insurance, and consumer goods and services — representing about 25 percent of US GDP and jobs — are best positioned if high inflation persists. Margins in those industries are highest and most stable, and production within them is concentrated among fewer firms. Plus, their equity returns outperformed as inflation worries began to rise, a sign investors believed they could exercise pricing power.

Looking ahead, inflation will continue running hot as high energy and non-energy commodities prices and a growing wage bill keep costs elevated across industries. The latest expectation is for producer prices to rise a very lofty 13 percent on average this year, while consumer prices climb 7 percent, with risks tilted decidedly to the upside.

US: Small business optimism survey — Inflation gauges



Source: Oxford Economics/Haver Analytics

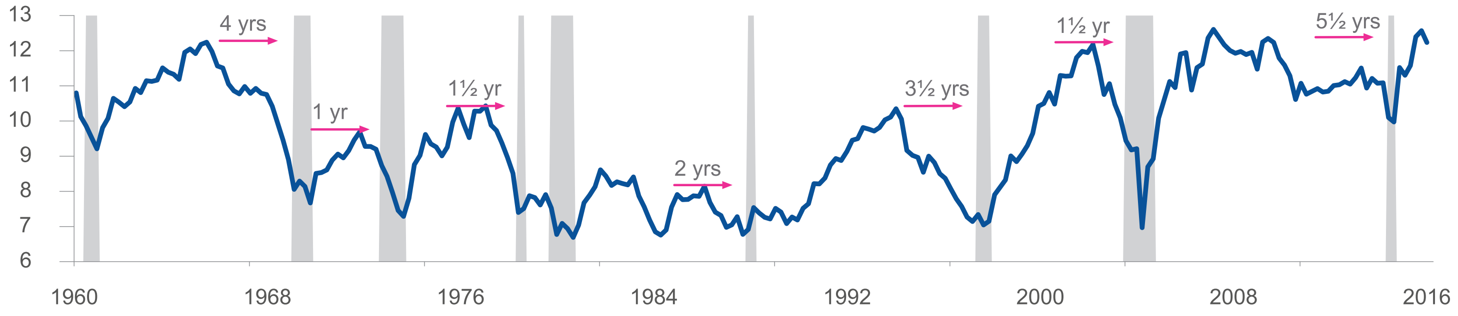
Highlight on specific pressures that effect small businesses — Profits

Corporate profit margins have shown remarkable resilience to acute labor cost pressures, thanks to strong revenue growth and unusually high pricing power. However, some margin compression should be expected moving forward in the current business cycle as wage growth stays elevated, productivity gains fade, and companies' pricing power moderates. Peak margins will be an additional headwind for business investment and the broader economy in 2022.

Whether margins stay elevated in the quarters ahead or the extent to which they will erode depends on firms' ability to continue to pass on soaring input costs — especially of labor — to consumers. And, given our expectation for productivity growth to remain subdued in coming quarters as the recovery in the labor market outpaces overall output growth, productivity is unlikely to provide an offset to rising labor costs. For now, the historically-high level of profit margins is still sending a positive signal about the expansion, but a peak in margins points to a maturing economy that is entering the latter phase of the business cycle. With the economy facing significant headwinds, the degree and speed of margin erosion will be important to monitor when assessing the risk of an economic hard landing.

US: NIPA profit margins and recessions

Corporate profits before tax with IVA and CCadj % GDP



Source: Oxford Economics/Haver Analytics

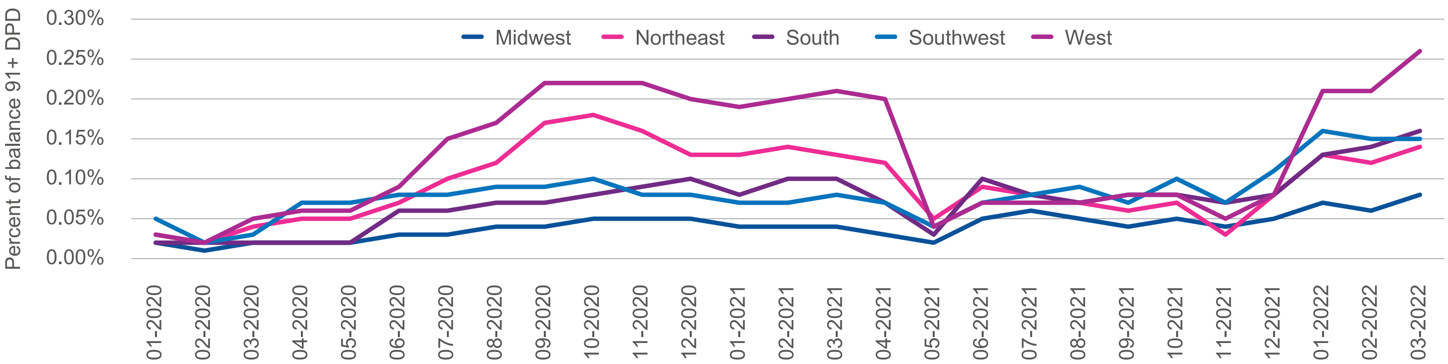
US regional outlook — leisure and hospitality powering job growth

The scars from the Covid pandemic faded further in the opening months of 2022, namely among hard-hit leisure and hospitality businesses. This sector will drive much of the economy's growth in 2022. As such, regions with a reliance on leisure and hospitality will grow the strongest this year as consumers shift spending towards traveling, entertainment, and dining out as they are learning to live with Covid. With renewed demand for travel and restaurants, we estimate that the restaurant and hospitality sector will drive around a quarter of the job growth in most of the top 50 metros in 2022.

Regions with the largest tourism sectors — including metros such as Orlando, Honolulu, and Las Vegas — are expected to see the strongest GDP as well as job growth this year as their economies recover from the pandemic-driven drop in travel. Other metros expected to see healthy GDP growth in 2022 include Tucson, New Orleans, and the big three tech metros — San Jose, San Francisco, and Seattle. These, along with New York, Los Angeles, and San Diego, also rank in the top 10 for fastest job growth this year. Beyond 2022, these metros are expected to see slower growth in line with their pre-pandemic pace.

Regional lending dynamics remain generally encouraging, even as delinquency rates on installment and commercial loans climbed in all regions, reflecting higher inflation and interest rates. Greater exposure to supply chain vulnerabilities in the West contributed to pushing the region's commercial card delinquencies above other regions.

Late state delinquency



Source: Experian Business Information Services

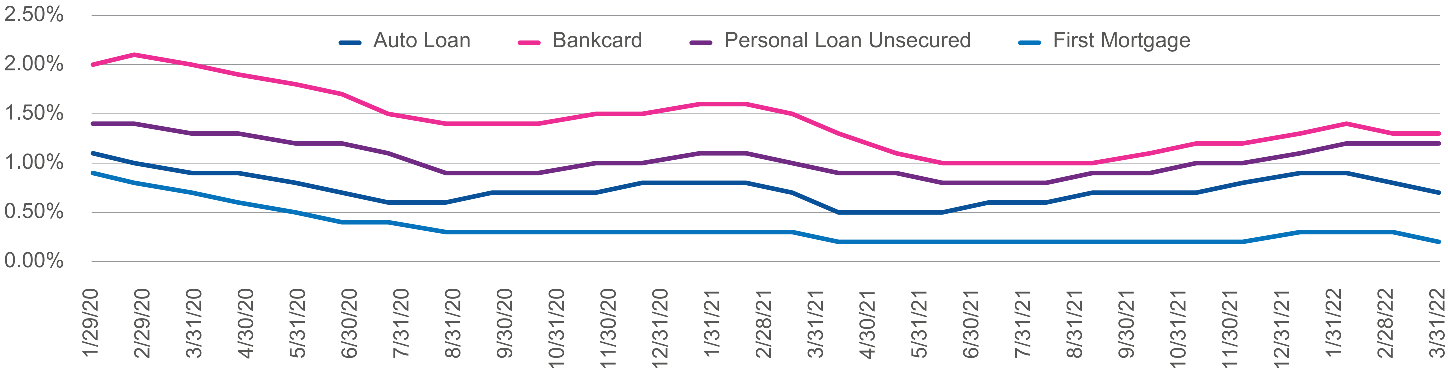
The tech sector differentiates the leading metros on job growth from the laggards beyond 2022: software publishing, data processing, computer and electronic manufacturing, and computer systems design. Aggregating these industries shows that the big three West Coast tech metros — San Jose, San Francisco, and Seattle — along with Orlando, Las Vegas, Austin, San Diego, and Portland — will lead medium-term job growth due largely to healthy tech employment growth. In contrast, many Midwest metros with a reliance on traditional manufacturing — Chicago, St. Louis, and Detroit — will trail on both measures along with Virginia Beach, Tampa, Providence, and Philadelphia.

Consumer trends and the effect on small business

Consumer spending remains fairly resolute despite hot inflation, spiking interest rates, and supply chain snarls, a reassuring sign for small business. The job market, in particular, is providing key support for the consumer. The economy added 1.7 million jobs last quarter, and wage growth averaged a buoyant 5.4 percent y/y. Despite some expected slowdown in the pace of employment gains in the months ahead, the economy should still add over 4 million jobs and the unemployment rate come in under 3.5 percent by year-end. Wage growth will also soften, but the gains will partially offset the damage to disposable income from higher consumer prices.

The latest SBCS survey corroborates these macroeconomic dynamics — consumers wanted to go out and spend in Q1 2022. Loan originations for credit cards, auto loans, and personal unsecured loans remained high relative to history. Mortgage loan originations fell, but this wasn't because demand softened, rather because very low housing inventory constrained homebuyers' purchase opportunities. According to government data, there was only 1.9 months of supply of existing homes given the pace of sales in Q1, a very low number relative to history. Further, low forbearance participation alongside steady or lower loan delinquencies reinforce that higher prices and interest rates didn't spark a meaningful change in consumer behavior. Looking ahead, consumers will likely spend more on services and less on goods, but outlays will remain fairly healthy for this stage of the economic cycle, offering a tailwind for small business.

US: % Balance 60+ delinquency rates on the rise



Source: Experian

Special industry focus that affect SMBs

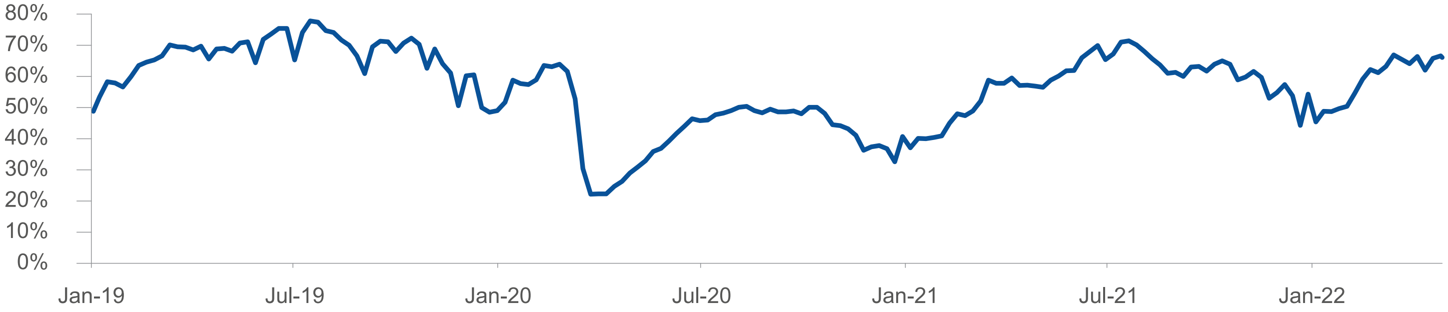
Travel industry

Omicron cases curtailed the travel industry's recovery in early 2022. However cases have fallen significantly from the peak. As a result, economic growth will pick up in Q2 and the latter half of 2022 as restrictions ease, domestic travel increases and consumers continue to return to in-person services. However, high inflation, exacerbated by the Russia-Ukraine war, is expected to reduce real incomes, leading consumers to cut back partly on discretionary spending and dampening the recovery to some extent.

One of the features of the recovery will be a widening gap between domestic and international travel demand. We continue to expect a strong rebound in domestic air and land-based travel in H2, as more people become vaccinated and the effect of Covid fade. This will support a return to in-person dining and accommodation services. However, a slower relaxation of international travel restrictions and continued global COVID uncertainty means foreign visitors are not expected to reach 2019 levels again before 2025. This will hold back the recovery in demand.

Meanwhile, business travel will also struggle to recover. The pandemic drove tremendous advances in virtual conference and convention participation which has accelerated the shift to remote attendance. This is not expected to end in the next year and will have a continued impact on business travel, hurting hospitality and restaurant spending.

US: Hotel occupancy rate



Source: Oxford Economics/Haver Analytics/Smith Travel Research

If > then analysis – What if the major central banks overreact to inflation?

Central banks across the globe are monitoring inflation developments with great concern. The Fed, in particular, has stressed that it will move expeditiously to bring inflation back in line with its target. The Fed has offered assurances it can achieve a "soft landing", though its track record on avoiding recessions while tightening monetary policy isn't great.

Oxford Economics has modelled a scenario where the withdrawal of central bank policy support triggers market turmoil and property market correction, weighing on activity in the near term. In this scenario, consumer price inflation surprises to the upside in the very near term as the supply-chain crisis intensifies, triggering the Federal Reserve to raise policy rates more quickly than expected while also adopting a faster pace of balance sheet reduction. In this scenario, other central banks also bring forward policy tightening. In turn, business, household and market sentiment deteriorate. Bond markets sell off sharply and bond yields jump. Equity markets fall markedly — with a double-digit percentage point peak -to - trough fall in the US — and property markets correct. The US economy is damaged considerably in this type of environment. US GDP growth is 1.3ppts lower than our baseline in 2022 and 1ppt lower in 2023.

Recommended focus areas

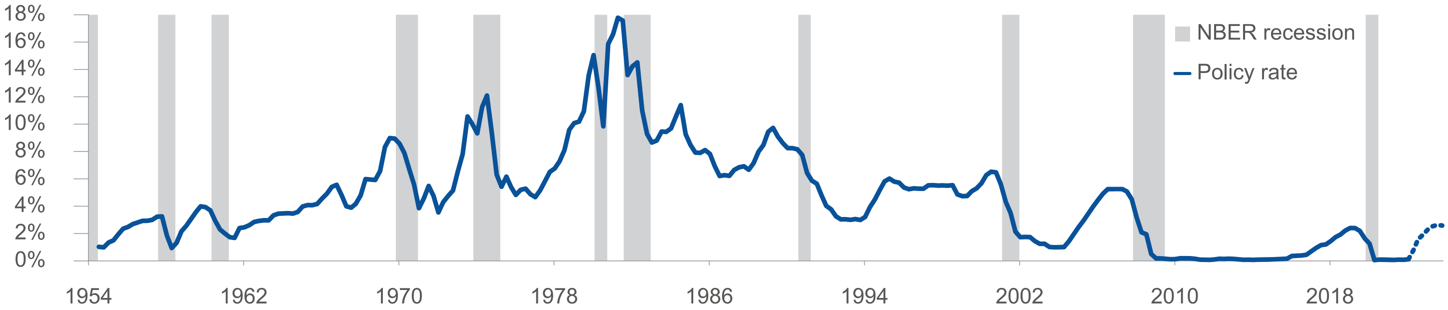
Is the pandemic over?

Covid immunity may already be waning at the global level. According to a rigorous, quantitative methodology, Oxford Economics' scores suggest immunity peaked earlier in the year, with the decay of previously accrued protection outweighing the extra protection provided by more recent vaccine doses and infections. Of the major economies, China ranks among the most exposed for a range of plausible alternative assumptions. The combination of less effective vaccines and limited natural immunity is amplifying China's vulnerability to extended lockdowns, based on how protection against the virus varies across countries. The US is in a better position than China, though it too remains exposed to a significant wave of Covid infections.

The Fed might be able to pull off a "soft landing"

Fears are running high about whether the Fed can achieve an elusive "soft landing" as policy makers don't want to let inflation spiral but they also don't want to raise interest rates too much so as to choke off the economic expansion. Most rate tightening cycles are associated with recessions. While the risk of a policy-induced recession has risen, policy tightening is only one factor behind recessions and a broader assessment supports our baseline view that central banks should be able to dodge recession. Current inflation rates contain a significant temporary element and long-term inflation expectations have not yet been significantly dislodged. Further, there is evidence that inflation has become more sensitive to smaller changes in output and also that the economy is less sensitive to higher interest rates than in past cycles.

US: Rate cycles and recession periods



Source: Oxford Economics/Haver Analytics

Why Covid's productivity gains will stick

The Covid crisis has accelerated the US economy's automation in a way that will outlast the pandemic, leading to fairly healthy productivity gains. Industries with traditionally weak productivity and considerable scope to accelerate digitalization stand to benefit most, but others could also experience reduced labor demand from automation. Most industries have responded to the pandemic by adopting productivity-enhancing technologies, and we don't expect firms to abandon these labor-saving tools. While automation is likely to disrupt existing business models and eliminate jobs, the productivity boost will also lead to the creation of new jobs in a process of creative destruction. There may be some bumps along the way, but solid investment in technology, greater business dynamism, and lasting remote work all point to upbeat productivity gains.

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.).

About Experian's Business Information Services

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

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Oxford Economics is a trusted adviser to corporate, financial, and government decision-makers and thought leaders. Their worldwide client base comprises over 2,000 international organizations, including leading multinational companies and financial institutions; key government bodies and trade associations; and top universities, consultancies, and think tanks. Their insights into the global economic and business environment helps clients cut through market complexity and uncertainty and build a solid base for decision-making. They offer a sophisticated portfolio of subscription services, providing insights and forecasts that are delivered through reports and analytical pieces, databases, and rigorous models on 200+ countries, 100 industrial sectors and over 7,000 cities and regions.

Contact Experian Business Information Services

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

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Contact Oxford Economics

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

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