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OXFORD ECONOMICS

MAIN STREET REPORT

Your window into small business health

Q3 2022

MAIN STREET REPORT

Labor market gives the Fed cover to keep hiking

Executive summary

Sustained consumer spending and strong job market performance have perpetuated U.S. small business health and positive market sentiment. The third quarter highlighted open and growing commercial lending markets, inclusive of all tiers of credit risk, even as measured commercial delinquencies returned to pre-pandemic levels. Signals in the financial market point to heightened risk of a more significant U.S. economic slow-down in 2023, as consumers change spending behavior as affordability tightens and personal cashflows are challenged first in the lower income segments.

Macroeconomic Overview

The U.S. economy grew a buoyant 2.6% annualized in Q3, confirming Experian and Oxford Economics' view that the economy was not in recession. Indeed, the economy created a robust 261k jobs in October, while the unemployment rate came in near a historically low of 3.7%. However, looking ahead, we expect the U.S. will experience a mild recession in 2023. The recession will be caused by the Fed's aggressive tightening cycle and the drag from tighter financial market conditions. Higher borrowing costs will also weigh on corporate profits, hiring, and business investment. The consumer will feel the effects of an increase in unemployment and a reduction in excess savings. Experian and Oxford Economics expect the economy to grow 1.8% in 2022 and then contract 0.4% in 2023 as recessionary headwinds bite.

U.S. business sector

U.S. nonfinancial business will be tested over the next year as corporate profit margins will come under pressure from rising interest rates, weaker GDP growth, elevated inflation, and strong nominal wage growth. Also, financial market conditions won't be supportive as banks consider the right time to tighten lending standards. Something to keep an eye on are investment grade and high-yield corporate bond spreads, especially the latter. U.S. high-yield corporate bond spreads should be wider than they currently are based on their historical relationship with the VIX and bond market volatility. There is the potential that morale hazard has crept into the corporate bond market as some central banks, including the Fed, intervened in the market during the last recession. However, the next recession won't be anywhere as significant. Therefore, the Fed is unlikely to step into the corporate bond market. The risk is that corporate bond spreads suddenly widen, cutting into business investment and hiring.

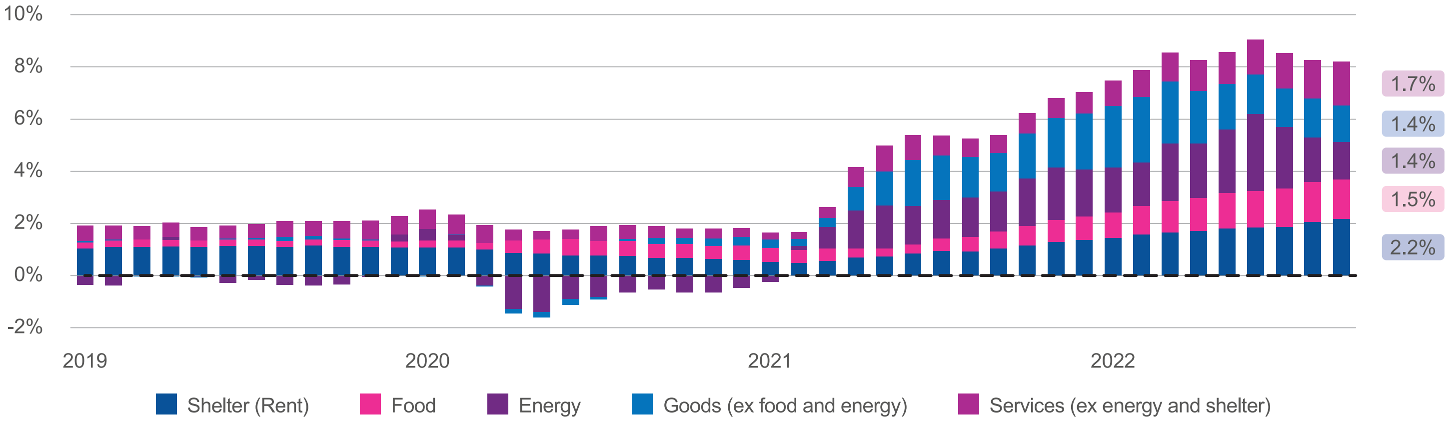
U.S. supply chain volatility remained a challenge for the commercial market as pre-orders for the holiday season were inflated as businesses planned for perceived future bottle neck in inventory attainment. This behavior left many businesses with cash tied up in swollen inventories combined with a U.S. consumer with less spending power , driven by inflation. Inflation remains a key headwind to businesses as margins compress and consumers reach affordability and willingness ceilings for costs passed by retailers. Employment remains elevated, 3.6%, keeping consumer spend flowing, but behaviors are changing as consumer discretionary spend declines. Consumers will likely continue heightened spend behavior through the holidays before they tighten their belts for 2023, cooling spend. Consumer spend behavior will signal an eminent change in small business performance.

The Q3 2022 Small Business Credit Sentiment (SBCS) Survey conveyed some warning signs regarding business credit and lending dynamics, but none were overly worrying, nor did they suggest a severe recession is looming. Installment loan origination balances moderated at the end of Q3 to around $225,000 on average while extremely delinquencies (90 days past due) edged higher. Delinquency rates for commercial card lending rose but that it was mostly concentrated to those 31 and 60 days past due. With the economy softening, delinquency rates will normalize as they were artificially low recently because of the robust economy and significant fiscal stimulus in response to the pandemic and subsequent recession.

U.S. consumer sector

The consumer will be tested, particularly if inflation remains higher than anticipated next year. A noticeable deceleration in inflation is key to supporting real disposable income, which is the key driver for real consumer spending. Experian and Oxford Economics are less concerned about the noticeable increase in household debt and its implications for consumer spending. A substantial driver of the rise in household debt is an increase in revolving credit (i.e., credit cards) and that is partially attributed to higher gasoline prices, food and hard to reduce shelter.

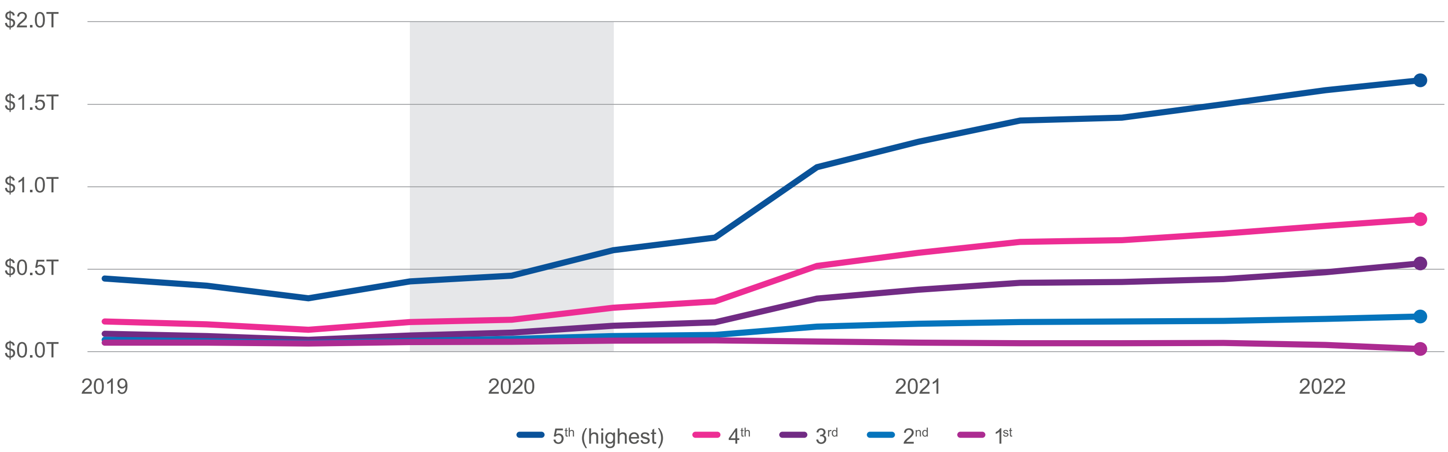
Select Contributions to YoY Consumer Price Index Change



Source: U.S. Bureau of Labor Statistics and Author's calculation, Experian internal calculations

Also, it's not the level of debt that matters for consumers, it's the monthly payments needed to finance the debt. Debt-service and financial obligation ratios are at their lowest since the 1980s, a testament to the strength of household finances. However, we do have some concern for households on the lower end of the income and wealth distribution as these cohorts have already exhausted most of their excess savings.

Checkable Acct Assets by Income Quintile (Q1 2019 – Q2 2022)



Source: U.S. Bureau of Economic Analysis and Federal Reserve Distributed Financial Accounts

Looking ahead, growth in goods spending will be weak next year. One reason is the ongoing shift away from goods and towards services spending. More broadly, it's unlikely that the pandemic has caused a structural change in consumers' spending patterns. Nominal consumer spending on services is currently 66% of total consumption; it is normally closer to 70%.

Recession looms

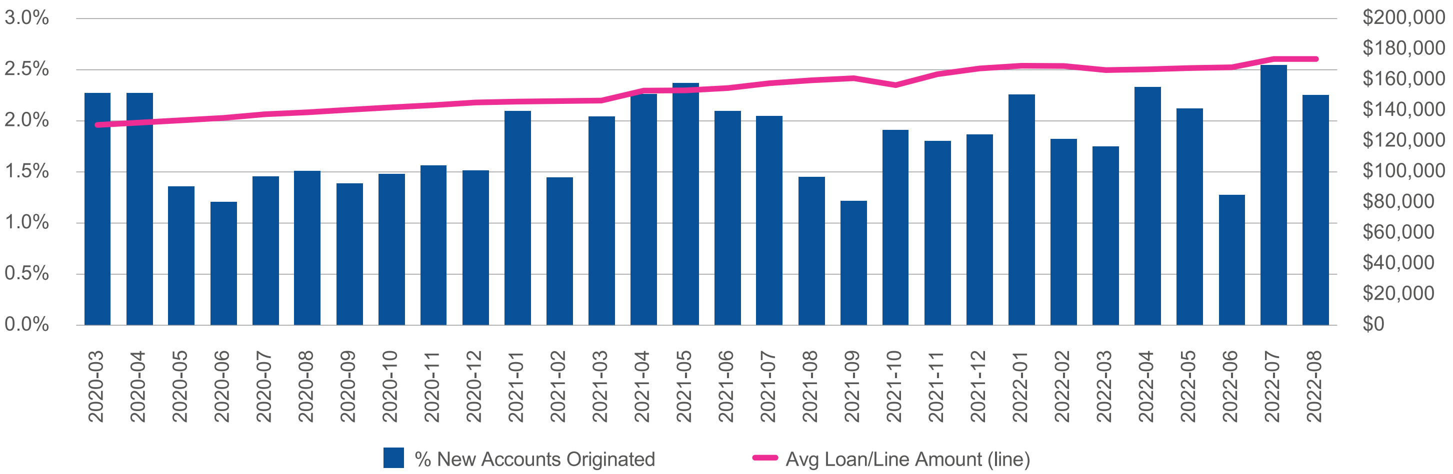
Next year will be challenging for small businesses as the economy is expected to fall into a mild recession. Though this will loosen the restraints around a very tight labor market, the recession will weigh on sales and raise bankruptcies and delinquencies. The pain won't be anywhere near the hardship endured in the prior two recessions because the catalyst of the downturn will be significantly different. The next recession will be likely be caused by a policy error and be more of the "garden variety" type, whereas the previous to recession were caused by a housing market shock and a global pandemic.

Small businesses are pessimistic. The NFIB's small business optimism index fell 0.8 points to 91.3 in October-snapping a streak of three consecutive increases. The index has shed a cumulative 5.8pts in 2022 and remains well below the series historical average of 98.0 amid elevated prices and a still-tight labor market. The uncertainty index remained unchanged at 72.0 in October, well below the pandemic high of 98.0 from 2020.

Banks continued to tighten their standards for Commercial and Industrial (C&I) loans in the third quarter, with the largest percentage of banks tightening standards since the start of the pandemic. Demand for C&I loans also weakened for the first time since the beginning of 2021, particularly from smaller firms. A significant share of banks also tightened their standards for all types of commercial real estate loans in Q3 – multifamily, construction and land development, and nonresidential –and demand plummeted.

Given that credit tends to lead the economic cycle, the latest commercial credit data collected by Experian does not flash warning signs of a recession. Installment loan originations ticked lower at the end of Q3, but loan growth remained encouraging overall. Commercial loan originations, meanwhile, remained healthy at around $13,100 on average in the quarter. Delinquencies rose but not enough to portray a sharp deterioration in credit market dynamics. There are pockets of concern among certain industries, namely wholesale and retail trade, but from this perspective are also not overly concerning.

Commercial Installment Originations

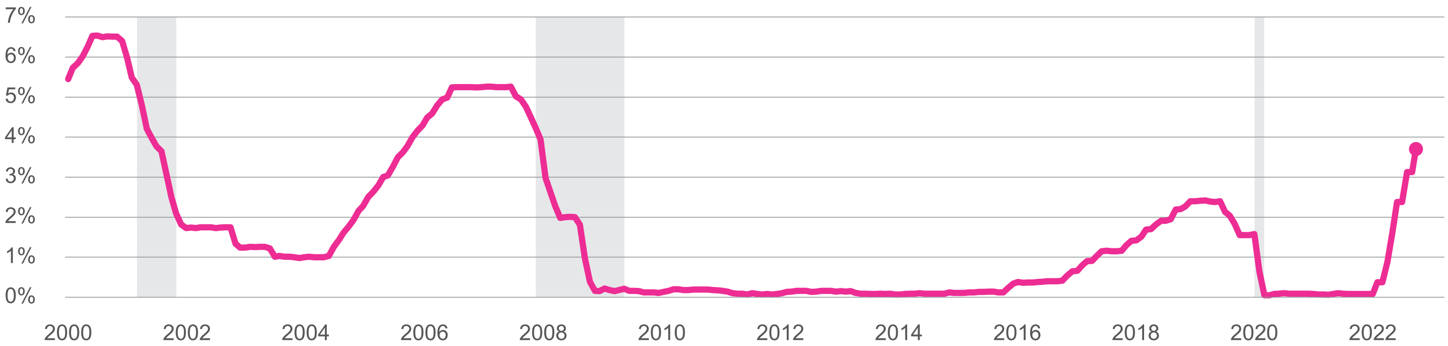


Source: Experian Commercial Benchmarking

Labor market outlook

The U.S. labor market is tight and wage growth is strong but this explains only part of the inflation problem. Monetary policy can only affect the demand side of the economy, but supply shocks are underpinning uncomfortably high inflation. The Fed is going to keep tightening monetary policy until inflation is clearly moving toward their 2% objective. Experian and Oxford Economics' baseline forecast assumes a 50 basis point rate hike at the December meeting of the FOMC, but the central bank could keep raising rates in the first half of 2023 if the labor market does not loosen soon.

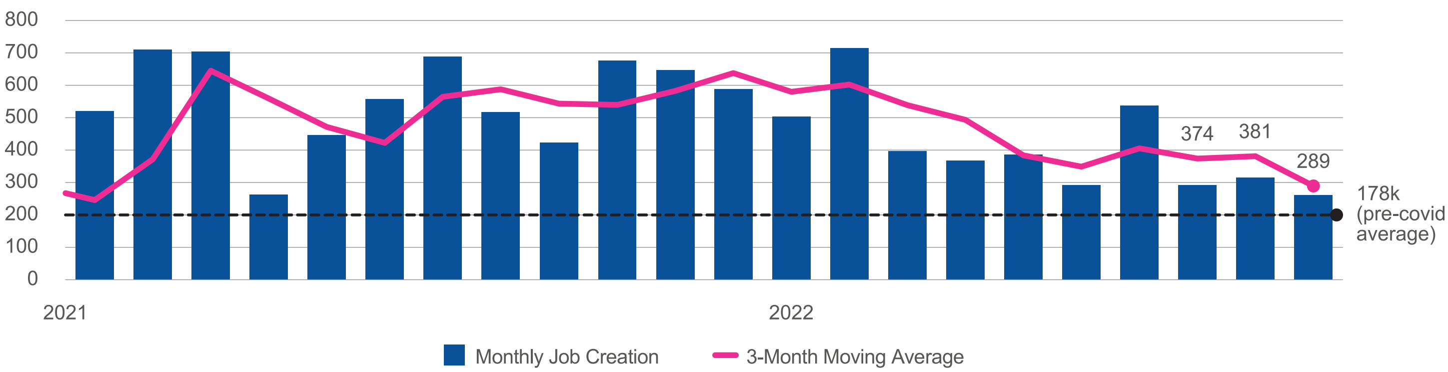
Federal Funds Rate



Source: Federal Reserve Board of Governors, Bureau of Labor Statistics and Experian's October 2022 Macroeconomic Scenarios Forecast

How quickly the economy keeps adding jobs and whether wage growth moderates, depends on labor supply. The labor force edged lower in October, but the decline was not statistically significant. More telling was the decline in the prime-age to employment population ratio, which dropped from 80.2% in September to 79.8% in October. Historically, a prime-age employment to population ratio at, or slightly north of 80%, has been consistent with an economy at full employment.

Job creation (in thousands)



Source: Bureau of Labor Statistics and Author's calculations

Since the 1960s, changes in wages have had a strong correlation and causal relationship with labor force growth. Workers normally have a sense of the minimum wage they will accept, known as the reservation wage. Strong nominal wage growth means that more reservation wages should be met. Recently, growth in the labor force has slowed and it appears that the strong wage growth is keeping people in the labor force rather than pulling a larger number of workers in. The labor force data show the number of people going from not in the labor force to unemployment isn't significantly higher than prior to the pandemic. The same holds for those going from not in the labor force directly to being employed.

Do not worry about a spike in corporate defaults

Higher interest rates alone won't be sufficient to spur a significant jump in defaults. Businesses are well-positioned to stand the heat due to a high degree of liquid assets and long debt maturity profiles, plus healthier interest coverage and lower leverage ratios than pre-pandemic. Overall, nonfinancial corporate balance sheets are in fairly good shape. Also, credit quality in the high-yield corporate bond market is noticeably better than it was in the past decade. Similar to households, it is not the level of debt that matters but the cost of servicing it that matters and that remains fairly low for nonfinancial corporations.

A recession will cause some stress, but it won't be nearly as significant as that seen in each of the prior two recessions.

U.S. regional outlook — tech struggles will have varying effects across the country

The 50 largest U.S. metros will not escape a recession in 2023. Experian and Oxford Economics forecast a shallow recession for 25 of 50 metros given the Fed's hawkish tone on raising interest rates. Of the top 20 metros, eight will see marginal GDP declines.

Layoff announcements by large U.S. technology companies has garnered a lot of attention recently but there are plenty of instances where parts of the economy do worse than others without pulling the broader economy into a downturn. Therefore, increased layoff tech notices in does not justify any changes to our near-term forecast for either U.S. GDP or employment growth. Also, layoff announcements need to be taken with a grain of salt as they're not set in stone and businesses can adjust them. Still, if the most significant layoffs announced in November were to occur this month, it would raise the unrounded unemployment rate a little, all else being equal. This would not spur be a statistically significant change in the unemployment rate, highlighting the small effect of the layoffs in tech will have on the U.S. labor market.

To gauge the potential risk tech poses to the labor market, Experian and Oxford Economics used detailed U.S. employment data by industry and identified those would broadly fit in with tech. There were four industries that were selected, including computer/electronic manufacturing, software publishing, data processing, hosing/other info services along with computer systems designs. We did not include e-commerce because this mostly people employed as bike-riding or car-driving delivery.

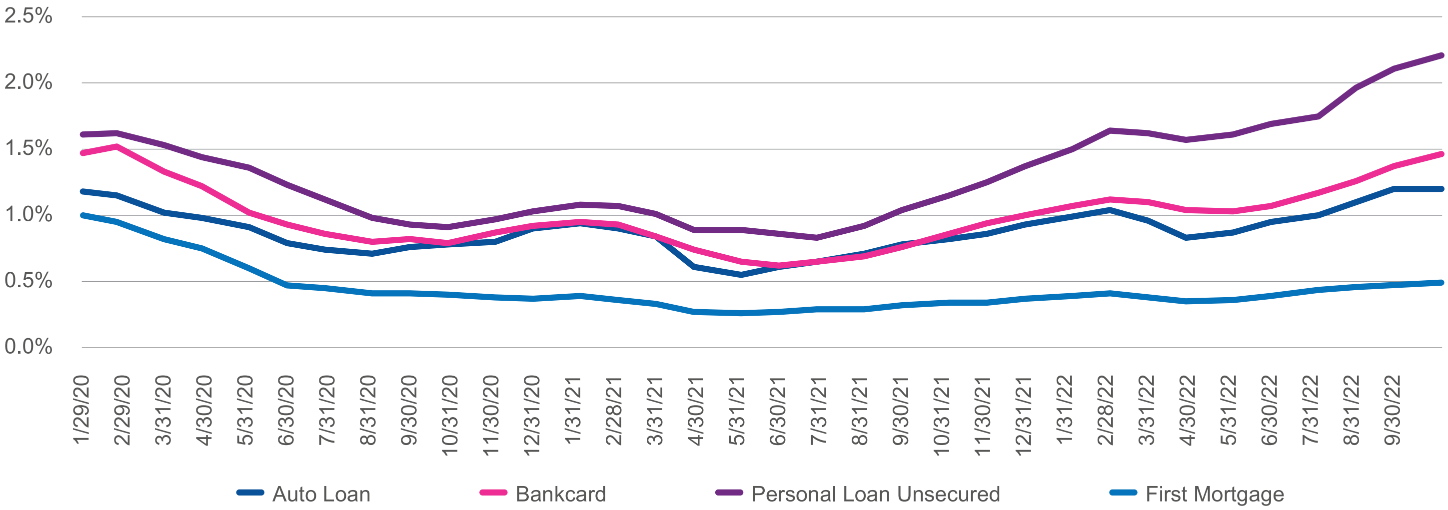
Based on this definition, tech accounted for 3.2% of total U.S. employment in 2021, compared with the 2.7% in 2016. The forecast is for this share to remain little changed and rise modestly through the end of 2025 to 3.3% but the risks are weighted toward a smaller increase.

While the drag on the U.S. economy is modest, some metro areas will be hit harder than others. The largest share of tech employment is in San Jose, 27.4%, followed by San Francisco at 17.2%. Tech employment accounts for 14.1% of total employment in Boulder, CO and 11.2% in Seattle and 9.9% in Austin. Tech's share of employment is higher than the U.S. average in roughly 50 metro areas.

Consumer trends and the effect on small business

Consumer spending will soften in response to higher interest rates, a drawdown in savings and negative wealth effects, although declines in real disposable income present the greatest risk to consumer spending. In fact, a simple model of consumer spending based on real disposable income, household leverage, consumer confidence and wealth effects show that changes in real disposable income have the greatest influence on consumption. Therefore, if inflation remains stubbornly high, it would lend downside risk to the forecast for real consumer spending next year.
The latest Experian consumer credit data does flash some warning signs. Delinquency rates for auto loans, bank cards, personal unsecured loans and mortgages have all picked up recently.

U.S. % Balance 60+ delinquency rates on the rise



Source: Experian Commercial Benchmarking

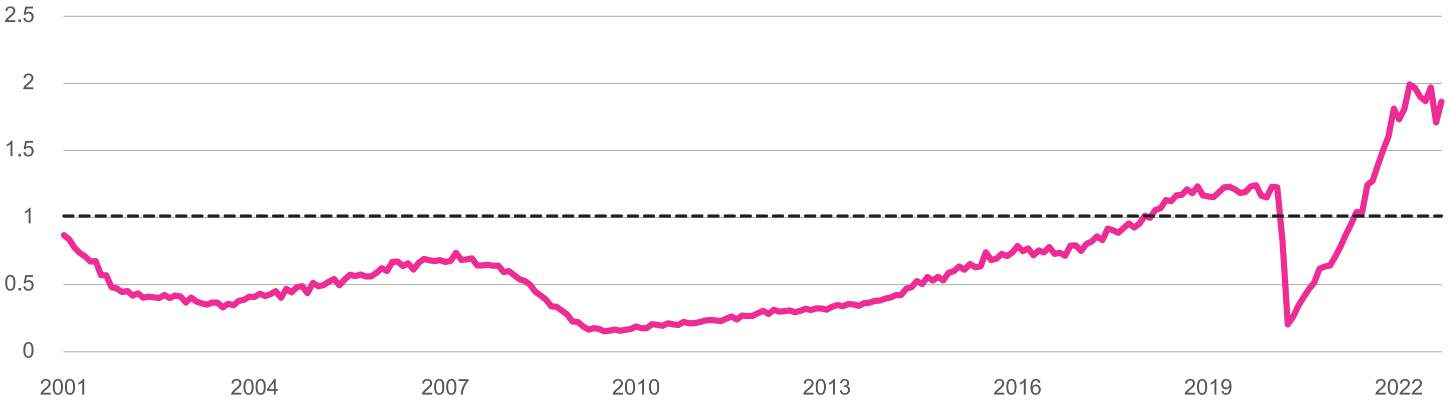
While these indicators are not flashing a retrenchment in consumer spending just yet, these data need to be monitored closely. What's more, flat loan originations for most types of loans suggest consumers are more circumspect about taking out more credit amid greater uncertainty about the economy's health.

Experian and Oxford Economics expect a cutback in spending in H1 2023 as softer hiring and wage growth weigh on incomes, and pandemic-related savings are wound down. Credit lines have also buoyed spending, but that boost won't persist as the economy weakens. Relatively high interest rates will drag on interest rate-sensitive components of spending, namely durable goods.

Special industry focus that affects SMBs: Wage price or price-wage spiral

The Federal Reserve can't catch a break. Recent data shows that labor demand remains very strong: the number of job openings increased from 10.3 million in August to 10.7 million in September. This means the number of job openings per unemployed worker rose to 1.9 in September, notably higher than the pre-pandemic average just north of 1. But is the Fed right to focus so much on the labor market – is it really a good guide to the underlying inflation problem?

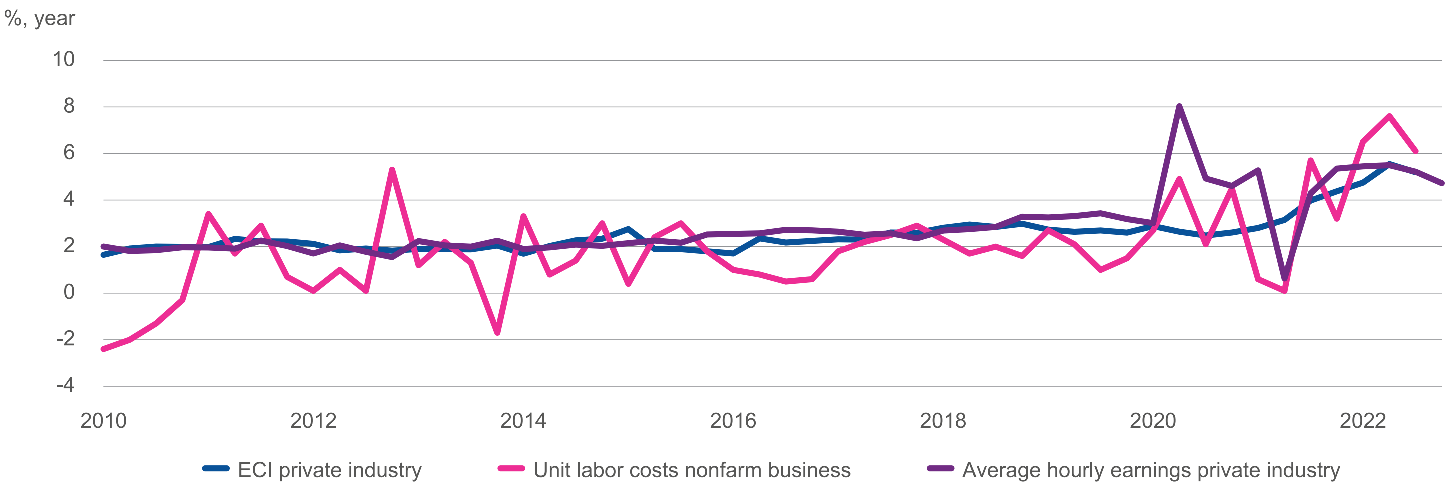
U.S.: Number of job openings per unemployed



Source: Oxford Economics/Haver Analytics

To engineer a soft landing, the Fed needs to tighten monetary policy sufficiently to slow GDP growth to a below-potential pace to reduce labor demand and nominal wage growth and put downward pressure on inflation. Real GDP growth is helping rebalance supply and demand in the labor market, but progress has been gradual so far and Experian and Oxford Economics' baseline forecast is that, on balance, the Fed won't achieve its goal. It still has a shot, but the labor market needs to cooperate soon. A modest rise in the unemployment rate is necessary to put downward pressure on U.S. nominal wage growth, which has been strong. There are various measures of nominal wage growth but they're mostly sending the same message that the tight labor market, with a high quit rate, is translating into strong nominal wage growth.

U.S.: Nominal wage growth remains strong



Source: Oxford Economics/Haver Analytics

Further, although the Fed puts a lot of weight on the labor market, we don't think that it's a direct cause of the current inflation dynamic. Statistically, sharply rising prices are forcing wages up – not the other way round.

Ongoing high inflation increases the risk that a wage-price spiral will develop, which is why the Fed needs to monitor labor markets closely. Too much of a focus on labor, when there may be more pertinent causes of inflation, risks missing the turning point. This is particularly true when more than half of the U.S.' inflation problems can be attributed to supply-shocks, something that monetary policy can't directly address – as the Fed has told us before.

What if inflation stays high?

Inflation has remained high for much longer than expected, raising fears among businesses and investors about whether price pressures will remain permanently high and whether the Federal Reserve and the broad cohort of central banks will be able to successfully rein in inflation pressures.

Oxford Economics has modelled a scenario where inflation expectations become de-anchored from central bank targets and remain elevated for a protracted period. Long-term inflation expectations rise globally by 150bps, driving core inflation persistently higher. Policy rates rise by at least 150bps above baseline across the world (and by even more in the U.S.), remaining elevated until inflation expectations begin to ease late in the scenario.

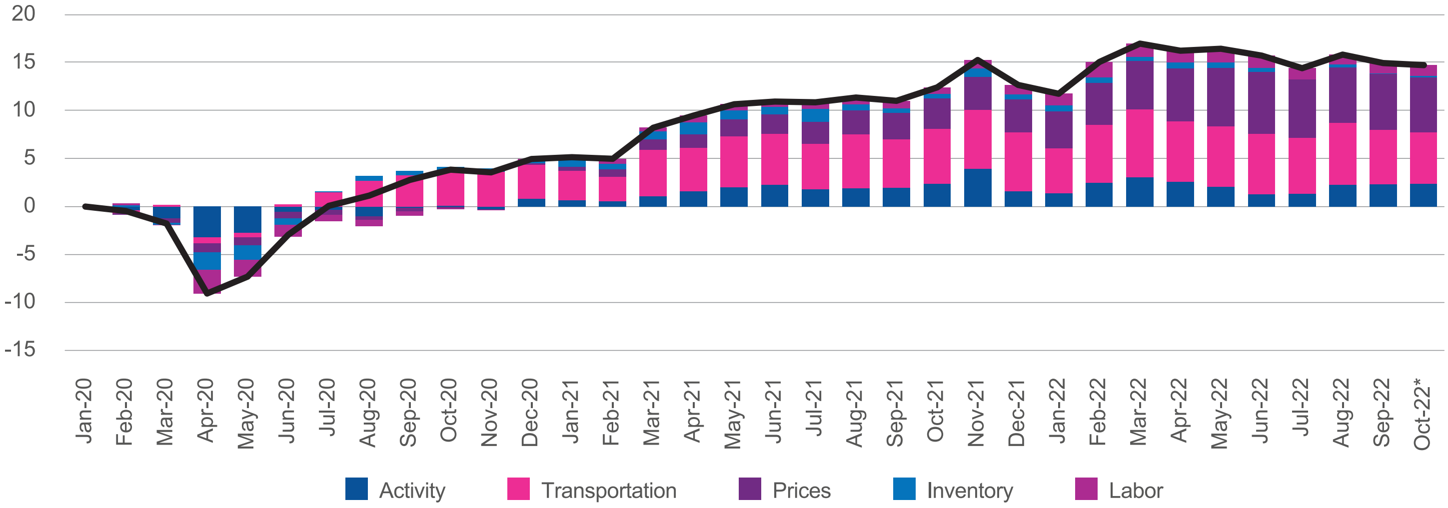
Financial markets are rocked, with marked and persistent increases in market interest rates and falls in equities. Demand slows as real disposable incomes are squeezed. By the middle of the scenario, the real income shortfall relative to baseline in around 1%. U.S. GDP growth is 1.1pts lower in 2023. Globally, equities fall as much as 25% below baseline, while the U.S. dollar appreciates significantly against the Japanese yen and vulnerable EM currencies. World GDP is significantly weaker in the medium term.

Recommended focus areas

Supply chain stress is easing
U.S. supply chain stress is falling, which, all else being equal, will ease inflationary pressures and loosen supply-side constraints on GDP growth.

While the ISM services prices paid index registered a monthly advance, manufacturing prices fell and the cost of key commodities declined – offering more evidence that goods inflation will slow. Spot rates for ocean and air freight continued to slide, and trucking rates eased.
The infamous backlog of cargo ships off the Southern California coast looks to be nearing an end, and the impact of lower ocean borne shipping volumes is spreading downstream, with trucking companies seeing muted volumes despite entering the peak shipping season and warehouse vacancy rates creeping higher.

U.S.: Supply chain stress tracker



Note: *estimate based on preliminary data and OE estimates
Source: Oxford Economics/Haver Analytic

Jobs growth and wage inflation moderated in October. While an increase in the unemployment rate may be an encouraging sign, we believe the October jobs report, as a whole, increases the risk that the Fed tightens monetary policy more than assumed in our November baseline forecast.

Global economy is likely already in a recession

A worse near-term outlook for Chinese GDP growth has prompted Experian and Oxford Economics to lower their global GDP growth forecast. We now expect the global economy to grow by just 1.3% in 2023, well below this year's 2.9% gain and 0.2ppts lower than our forecast in October. Our 2023 GDP forecasts for advanced economies and emerging markets remain well below consensus.

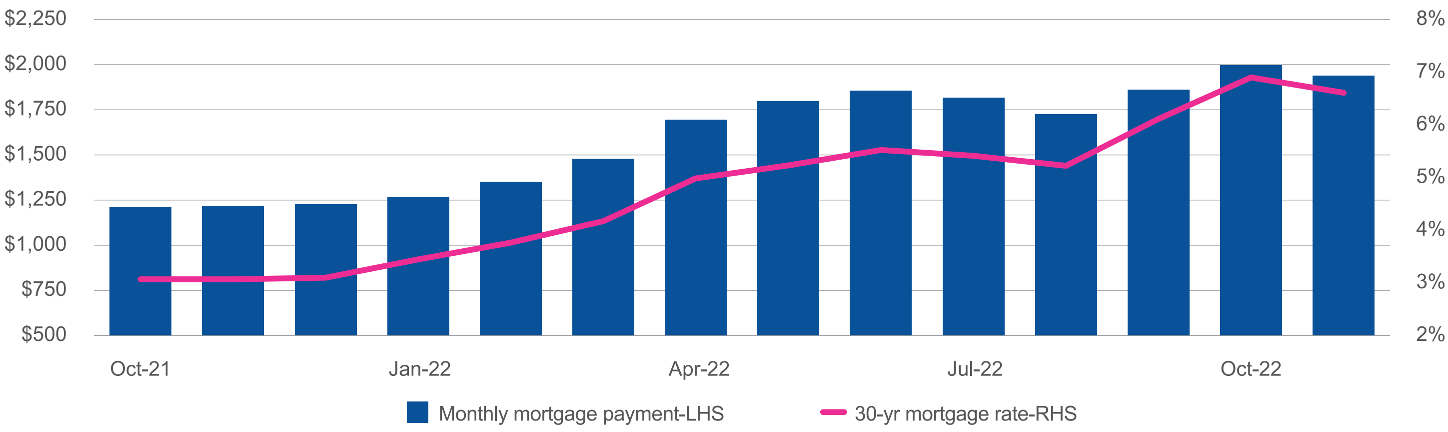
Despite mounting pessimism about the economic outlook, we have raised our advanced economy CPI inflation forecasts a bit further. At a global level, CPI inflation in 2023 is expected to slow to 5.3%, 0.2ppts higher than our forecast a month ago, from 7.9% in 2022.

Inflation in both the U.S. and eurozone is now expected to average about 5% in 2023. However, it should be noted that compared to the U.S., eurozone headline CPI inflation is expected to fall more sharply and from a higher level over the next 12 months or so. We expect eurozone inflation to fall below target by Q4 next year, while in the U.S. it is expected to still be above target at about 3.5%.

Rising mortgage rates have pushed housing to the brink

The ongoing surge in mortgage rates threatens to push the housing markets into a steep downturn. Housing price inflation has weakened sharply, and downward pressures are set to intensify as bank credit standards tighten and recessions start to bite. Other indicators are also worrying. Mortgage approvals and applications are dropping rapidly, and bank credit standards for mortgages in the U.S. are tightening. A further significant tightening is likely in the months ahead. One positive factor is that mortgage debt-to-income ratio is lower today than in 2007.

U.S.: 30-year mortgage rates and montly mortgage payment



Source: Oxford Economics/Haver Analytics

Overall, this is the most worrying housing market outlook since 2007-2008, with markets poised between the prospect of modest declines and much steeper ones. Among key factors determining which scenario may come to pass include the scale of any rise in unemployment and the degree of exposure to floating mortgage rates or to fixed rates resetting at much higher levels.

Expectations

Small businesses are well capitalized, in good health, and have a credit market open and pursuing their business going into the winter as delinquency rates remain historically low and commercial lenders keep funding available across SMB risk tiers, albeit at rising cost. Consumers are still spending, but as inflation outweighs wage growth, but that spend is coming from pandemic savings. This level of consumer spend is unsustainable. Changes in consumer spend behavior will likely not be significant until after the end of 2022. This will be the turning point for inflation as the market begins to cool.

Small business owners continue to have elevated equity in homes and assets to pull from if their business struggles over the next six months. This will maintain healthy business survival rates through the initial economic cooling cycle. Factory orders and supply chain pressure will ease as retailers churn through bloated inventories pressured by cooling consumer discretionary spend.

The U.S. is expected to experience a longer tail on this slow down recovery as a strong labor market and low unemployment persist in the face of rising rates. The expectation of a light yet elongated recession is rising for 2023. The expectation of a rise in business closures is increasing as younger boutique businesses will be under pressure first as consumer discretionary spend is pinched. These emerging businesses, less than 1 year old, make up 29% of the small businesses in the U.S.

The third quarter of 2022 has a strong labor market with a strong consumer spend. These two factors drive the success of the U.S. economy and mean small businesses cashflow will remain in a strong position into the 2022-2023 winter. Signals are starting to surface that 2023 will be more challenging economic environment for small businesses, but current third quarter 2022 conditions are telling small businesses to continue to grow and invest on the strength of a consumer willing to spend.

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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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.

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