2020

Q3 Update - July

Equipment Leasing & Finance U.S. Economic Outlook

EQUIPMENT LEASING & FINANCE
FOUNDATION
Your Eye on the Future

EQUIPMENT LEASING & FINANCE ECONOMIC OUTLOOK

July 2020

Key Trends to Monitor

Delinquency & financial stress

Consumer behavior

More fiscal stimulus?

This outlook acknowledges the substantial uncertainty stemming from both the epidemiology of COVID-19 and the U.S. economy's response to social distancing measures. As such, projections for certain economic indicators are provided as ranges.

Equipment and Software Investment: After collapsing in the first quarter (and likely the second as well), E&S investment is expected to improve relative to the first half of the year as businesses reopen. Though investment growth is likely to remain weak by historical standards in most sectors, some verticals, including Computers, could see stronger demand.

Momentum Monitor: Momentum readings are below the five-year average in 11 of 12 verticals (Computers is the lone exception), while all 12 are decelerating.

Manufacturing Sector: U.S. manufacturers suffered in March and April based on various measures of activity, but there were signs of improvement in May as new orders, shipments, and the ISM manufacturing index all rose. Whether this improvement can be sustained remains to be seen and will hinge on the trajectory of the virus, both domestically and globally.

Small Businesses: Stimulus efforts have helped forestall a wave of Main Street bankruptcies, but new virus flare-ups are disrupting some reopening efforts, further stressing small businesses.

Fed Policy: The Federal Reserve has implemented historic measures to boost liquidity in financial markets. The federal funds rate remains at its zero-lower bound, the Fed's balance sheet has expanded by $3 trillion, and the Fed has implemented a new program to backstop loans to nonfinancial firms. These actions will ensure ultra-low interest rates for the foreseeable future.

U.S. Economy: The U.S. economy entered a deep recession in March, and while the worst of the downturn appears to be behind us in large part due to an unprecedented level of federal assistance, a full economic recovery is unlikely until 2021 at the earliest. Recent job growth is encouraging, but the scale of job losses in March and April will take years from which to recover.

2020 Annual Projections

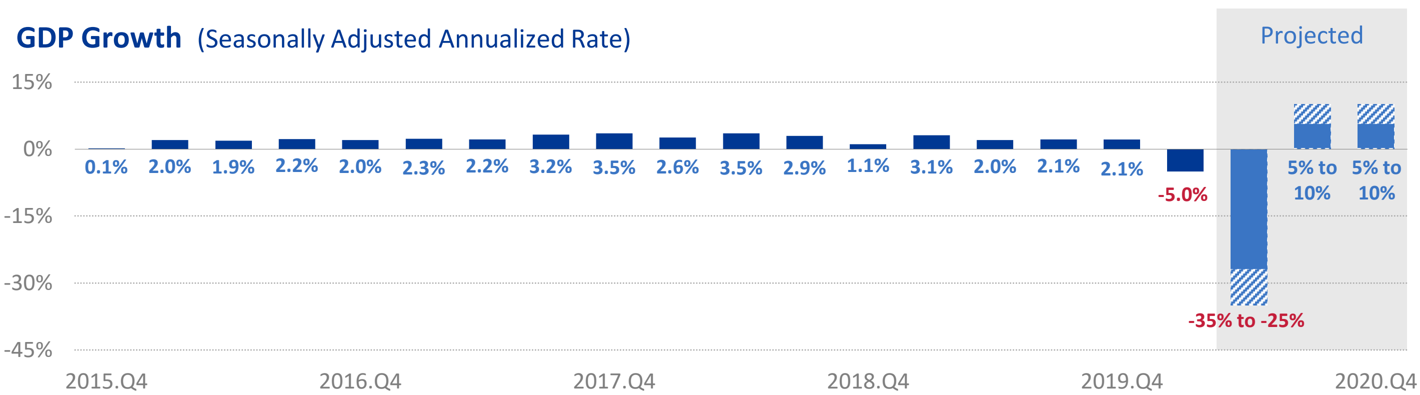
-4.0 to -7.3%
GDP Growth

-5.6 to -9.6%
E&S Investment Growth

0.9%
Inflation

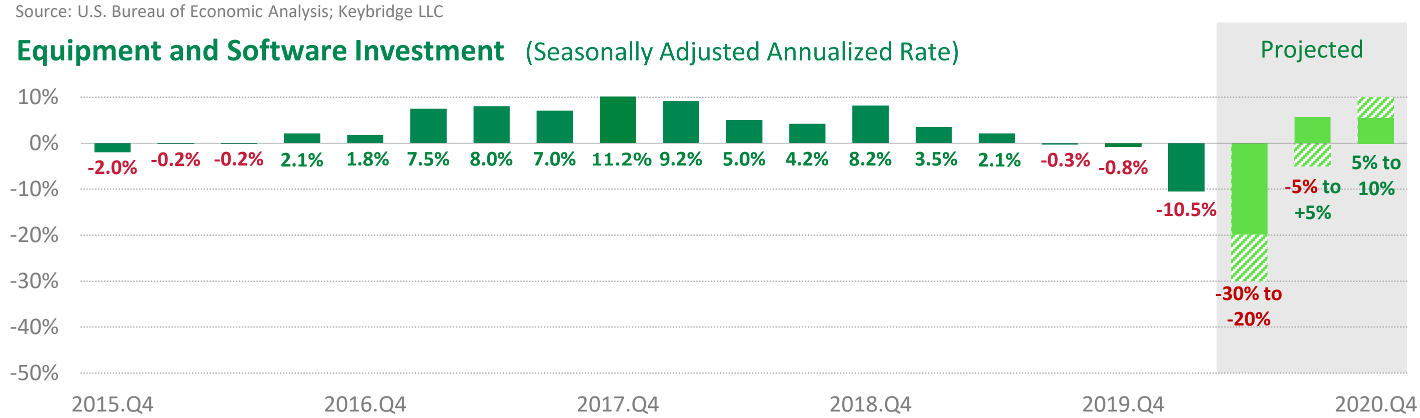
0 bp
Change in Fed Funds Rate from Current Range

GDP Growth (Seasonally Adjusted Annualized Rate)



Source: U.S. Bureau of Economic Analysis; Keybridge LLC

Equipment and Software Investment (Seasonally Adjusted Annualized Rate)



Source: U.S. Bureau of Economic Analysis; Keybridge LLC

Sectoral Performance

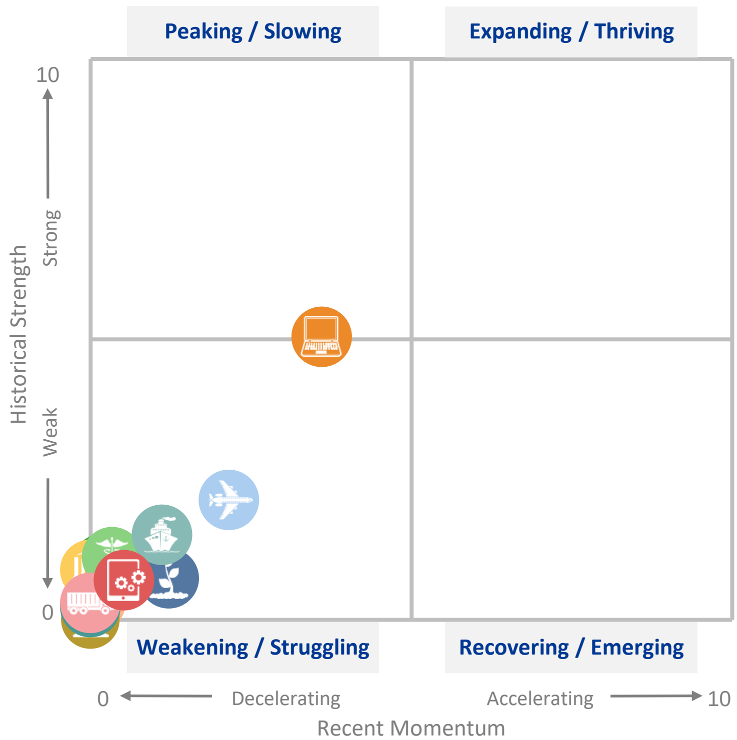
E&S underperformed expectations last quarter

Equipment and Software investment contracted 10.5% (annualized) in Q1 2020, the sharpest decline since the Great Recession.

Of the 12 verticals tracked by the Foundation, nine experienced negative investment growth in Q1 with five posting double-digit declines (Agriculture, Construction, Materials Handling, Trucks, and Computers). Of the three verticals that experienced positive investment growth, Mining & Oilfield and Railroad equipment fared the best.

Based on the Foundation's U.S. Equipment & Software Investment Momentum Monitor, most verticals are experiencing exceptionally weak momentum heading into the second half of the year. The pandemic stalled business investment in Q1 and Q2, and the near-term outlook for most verticals — particularly in the transportation and industrial sectors — is bleak. Verticals that were relatively healthy before the outbreak, such as software and medical equipment, are now showing signs of weakness as well. Computers may be a rare bright spot if work-from-home policies spur a wave of investment in the latter half of the year.

Momentum Monitor Sector Matrix



For more information on how to interpret the Momentum Monitor, please refer to the Appendix B (p. 17). A full breakdown of each industry vertical is available at https://www.leasefoundation.org/industry-resources/momentum-monitor/

Movements to Monitor

Equipment Vertical	Q1 Investment Growth		Next 6 Months	Short-Term Outlook
	Q/Q	Y/Y		
Computers	-21%	-0.6%	▲	Widespread adoption of work-from-home policies in the first and second quarters may insulate computers investment through 2020.
Medical Equipment	-0.2%	+0.5%	▼	Although the pandemic was expected to boost spending on medical equipment, reduced demand for voluntary procedures has offset heightened demand for ventilators and PPE.
Mining & Oilfield	+44%	+14%	▼	While oil prices have recovered from their all-time low in April, mining & oilfield investment will likely remain weak due to muted energy demand.
Trucks	-39%	-12%	▼	Transportation equipment investment — especially in trucks — already was weak before the outbreak. Dampened domestic and international demand has further dimmed the outlook for the industry.

Credit Supply

Consumer and business conditions tighten in Q1

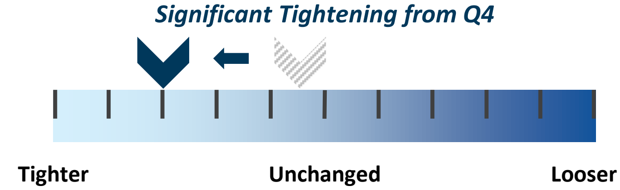
As the pandemic-fueled recession began in Q1, borrowing conditions tightened across most loan categories according to the Fed's Senior Loan Officer Survey.

- A significant net share of banks tightened standards on C&I loans to firms of all sizes (42% among medium to large firms; 40% among small firms).
- Likewise, a majority net share of banks reported tightening commercial real estate (CRE) loans: 52% tightened lending standards for both construction & land development and nonfarm nonresidential properties.
- Across loan categories, lenders noted that they are focused on serving existing clients rather than expanding lending efforts to new clients.

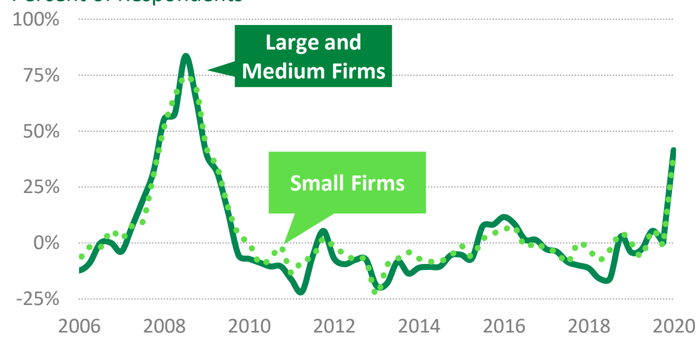
Meanwhile, consumer credit conditions also tightened considerably.

- A net share of banks tightened standards on credit card loans (38%) and auto loans (15%).
- However, residential real estate (RRE) borrowing standards remained largely unchanged.

Net Change in Credit Supply Conditions
Fed Senior Loan Officer Survey



Tightening Standards on C&I Loans
Percent of Respondents



Source: Federal Reserve Senior Loan Officer Survey

Credit Demand

Demand conditions were mixed in Q1

Demand for business loans was mixed at the onset of the recession, with some sectors stronger than others in Q1.

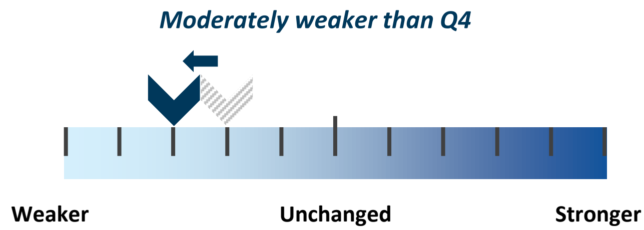
- On net, 7.6% of banks reported stronger C&I loan demand among medium & large firms in the first quarter, while demand was unchanged for small firms.
- A substantial net share of banks reported weaker demand across all CRE loans, particularly for loans secured by construction & land development (48%).

Likewise, household credit demand was mixed among residential mortgages and consumer loans in Q1.

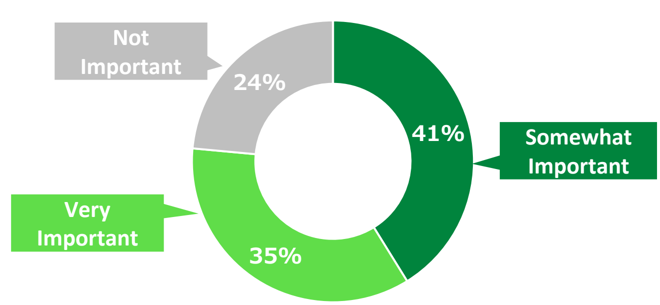
- A solid net share (22–27%) of banks reported stronger demand for most mortgage types.
- However, a significant net share of banks reported weaker demand for auto loans (35%) and credit card loans (23%).

Given that the most severe economic consequences of the recession were felt in the first half of Q2, credit conditions may have changed significantly relative to the Q1 report.

Net Change in Credit Demand Conditions
Fed Senior Loan Officer Survey



Falling Business Investment as Reason for Weaker Demand
Fed Senior Loan Officer Survey, Percent of Respondents



Source: Federal Reserve Senior Loan Officer Survey

Consumer Finances

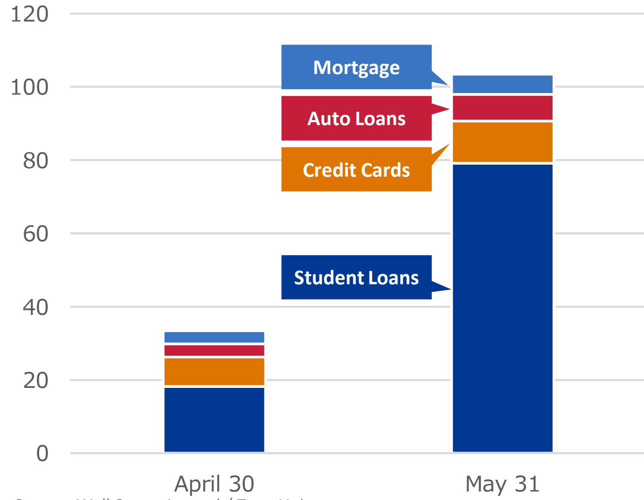
Financial stress remains low for the time being

Federal stimulus programs and temporary loan relief programs have helped to mitigate consumer financial stress thus far. However, financial stress is likely to rise as assistance programs are wound down and debt payments deferred during the pandemic are restarted.

- More than 4 million homeowners are currently enrolled in forbearance programs, representing 8.5% of mortgages.
- An April Fed survey shows that only 64% of adults who lost their job or had hours reduced could pay their current month's bills in full. Even with May and June's strong job growth, the unemployment rate is expected to remain exceptionally high for the foreseeable future.
- Nearly 80 million student loan accounts are in deferment or other relief status as of May. Credit card and auto loan deferments are also elevated.

Delayed Payments

Accounts in deferment or other relief status (millions)



Source: Wall Street Journal / TransUnion

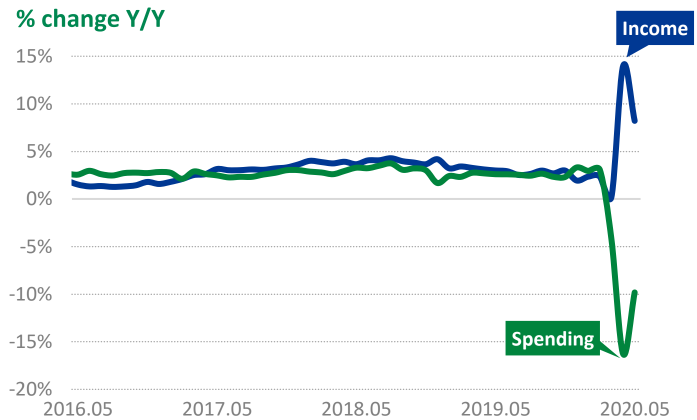
Income surged in May as spending dropped

Although tens of millions of Americans lost their jobs or were temporarily laid off in the first half of the year, government efforts to replace lost income have softened the blow.

- Real disposable income surged to nearly $17 trillion SAAR in April due to stimulus payments and enhanced unemployment benefits. This represented a 13% increase from the previous month and a nearly 14% increase from a year prior (both all-time highs).
- At the same time, real consumer spending plunged 17% in April from a year ago, while the personal savings rate jumped to an all-time high of 33%. Though these trends eased somewhat in May, there remains a substantial divergence between spending and income.

Real Disposable Income and Real Consumer Spending

% change Y/Y



Source: Bureau of Economic Analysis

Fed Policy Corner

Fed expands asset purchases and lending programs

- The Fed has engaged in an unprecedented level of asset purchases, increasing its balance sheet by more than $3 trillion in less than four months.
- The Fed's new Main Street Lending Program aims to support small- and medium-sized firms that were not able to obtain CARES Act funding via guaranteed loans.
- The Fed recently announced the purchase of individual corporate bonds, triggering a stock market rally but raising concerns that the Fed is "picking winners" among publicly-traded private-sector companies.

> *"Much of [the] economic uncertainty comes from uncertainty about the path of the disease and the effects of measures to contain it. [U]ntil the public is confident that the disease is contained, a full recovery is unlikely."*
>
> — Fed Chair Jerome Powell

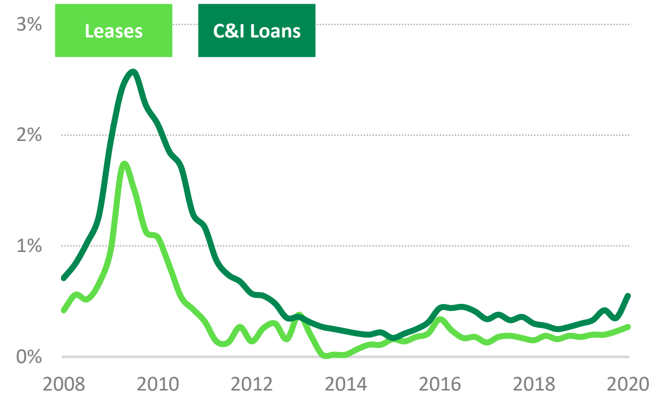
Business Performance

Financial stress rose in Q1, will likely surge later in 2020

Measures of financial stress inched up in Q1 2020 as the recession began and businesses began to feel the strain on their bottom line.

- C&I loan delinquencies held at 1.12% in Q1 while charge-offs rose to 0.55% — the highest level since early 2012, but far below 2008-2010 levels. Likewise, delinquencies on leases rose to their highest reading in nine years.
- Nonfinancial corporate debt reached a new all-time high in Q1, but the St. Louis Fed Financial Stress Index fell back to pre-pandemic levels after spiking in March.
- Although businesses are not yet exhibiting the elevated financial stress typically associated with a recession, payment deferral policies have temporarily obscured traditional indicators of business loan health.

Charge-Off Rates on Leases and C&I Loans



Source: Federal Reserve Board

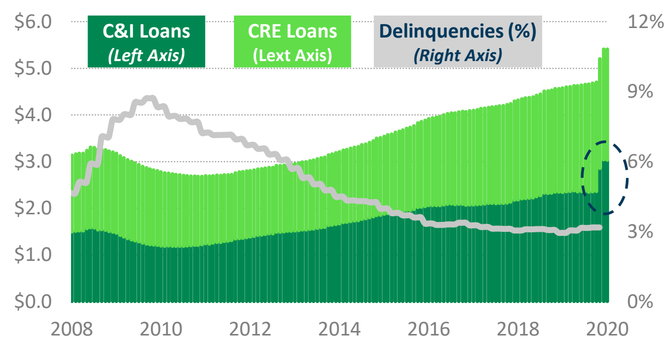
Business loan volume spiked, and deterioration in loan health will likely follow

C&I loan volume surged during the pandemic despite worsening business conditions and tighter credit.

- C&I Loan volume jumped in April and May and is now more than 28% above pre-pandemic levels. However, this increase was mostly due to firms drawing down existing lines of credit to shore up funding needs.
- According to the April Fed Senior Loan Office Survey, nearly every bank that reported stronger demand for C&I loans cited "customer precautionary demand for cash and liquidity" as a very important factor.

Although loan demand has risen due to the outbreak, the quality of C&I loans is likely to deteriorate as the effects of the pandemic continue to spread through the economy.

Business Loan Volume
$ Trillions



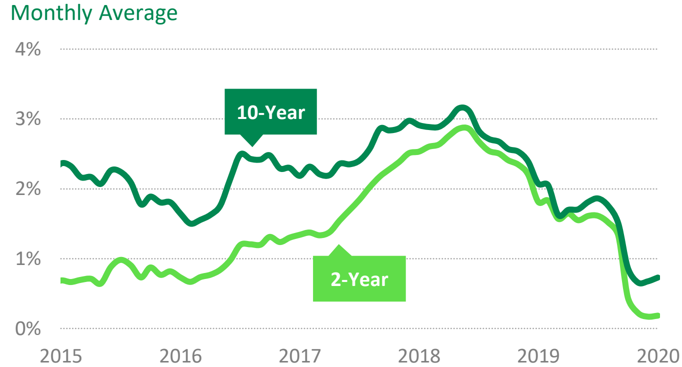
Source: Federal Reserve Board

Treasury yields fall sharply

Treasury yields have been driven down by a massive expansion of the Fed's balance sheet and investors fleeing to safer assets.

- Treasury yields have fallen sharply this year, with the 10-year rate roughly 100 basis points below January levels and the 2-year rate down 130 points over the same time.
- Treasury yields are expected to remain historically low: the Federal Reserve has signaled it will keep rates at or near zero for the foreseeable future.
- The Fed has repeatedly distanced itself from the idea of negative interest rates, though some market watchers continue to believe they remain possible down the road.

Treasury Yields
Monthly Average



Source: U.S. Treasury

Main Street Outlook

Small business recovery at risk of stalling

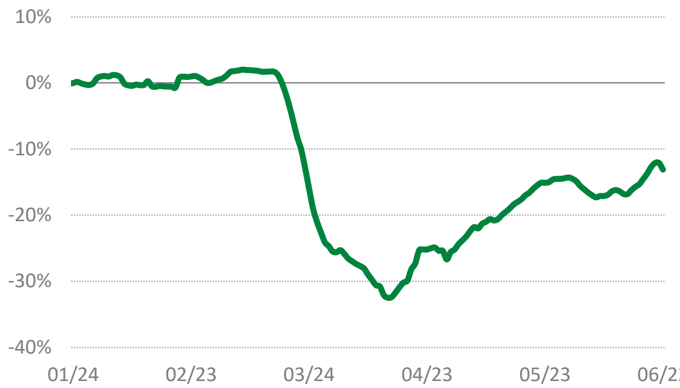
Main Street has been acutely impacted by COVID-19. 3.1 million small business employees are still out of work and the PayNet SBDI and SBDFI show that delinquencies and defaults have risen to 2.37% and 2.73%, respectively — up 86 and 74 basis points from a year ago. Many small business owners expect more pain down the road: a recent U.S. Chamber of Commerce survey found that 36% of small business owners believe their firms can continue to operate for less than six months before shutting down permanently.

Small businesses have benefited as states have reopened, but the initial surge in new activity has slowed. Two months after states began lifting lockdowns, small business closures remain ~15% above normal. The pandemic is ongoing, and as a result "reopening" does not entail a return to normal activity.

- **Consumers are still wary:** 58% of consumers think it is too early to return to pre-COVID consumption patterns.
- **Operating costs are rising:** 80% of small businesses are making or planning to make adaptations in response to COVID (e.g., testing employees, limiting occupancy, increasing sanitation requirements).
- **And subdued demand is expected to persist:** According to a recent Harvard study, small business owners expect demand to be 35% below pre-crisis levels in September.

Fortunately, PPP loans have helped many millions of small businesses, despite a few hiccups along the way (see box below). Meanwhile the Fed's $600 billion Main Street Lending Facility is off to a slow start; the program has experienced limited up-take from both lenders and businesses thus far, which may lead to rules adjustments.

Percent Change in Number of U.S. Small Businesses Open
Compared to January 2020; 7-day moving average



Source: Womply via Opportunity Insights

The recent surge in COVID cases across the country threatens to undercut state efforts to restart their economies and is particularly troubling for Main Street. While another economic lockdown appears unlikely at present, a pause in reopening plans would be a significant setback for the 30% of small firms that, according to the Census Bureau, had less than one month of cash reserves available in June. Further, without additional federal support to households, consumer spending is likely to fall significantly due to high unemployment, which will add further stress to small businesses.

Despite these headwinds, most Main Street businesses should survive (and some will thrive), and there will be new opportunities for entrepreneurs. That said, the pandemic will have lasting effects on business models and entire industries, and Main Street will need to adjust accordingly.

Paycheck Protection Program (PPP)

- **Status:** Congress recently reached a deal to extend the PPP application window through August 8th. As such, more than $100 billion in untapped funds remains available.
- **Successes**: According to NFIB, 67% of PPP recipients have found the loan "very helpful" in financially supporting their business, and there is evidence that the program contributed to the strong May jobs report. For many small businesses, the program was a critical lifeline.
- **Shortfalls**: Restrictions on how funds could be used discouraged some businesses from applying (though these restrictions were eventually eased). Program funds went disproportionately to less impacted regions and industries, and bank efforts to process forgiveness applications have been delayed due to unclear SBA guidance.
- **Next Steps:** Additional aid to small businesses may be necessary to avoid widespread business failures, as 43% of PPP recipients could be out of cash in a month or less.

42% of loans went to the service industries that were **most affected** by social distancing

Source: S&P Economic Research

MLFI-25

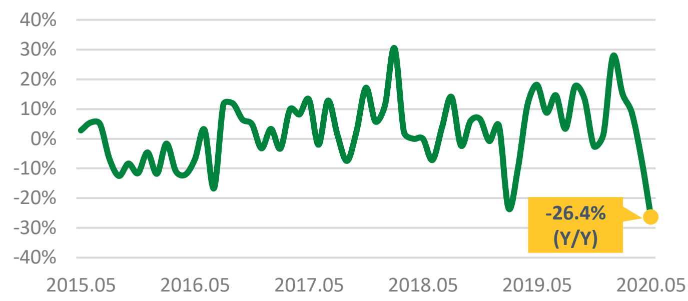
New business volume likely to decline amid COVID

ELFA's May Monthly Leasing and Finance Index reported that new business volume significantly weakened as the pandemic continued to weigh on business conditions.

- May new business volume fell to $6.7 billion and is down 26% year-over-year. However, despite falling 18% from April, on a cumulative basis new business volume for the year is still up 2% compared to January–May 2019
- 30-day delinquencies surged to 4.3% and are up 2.6 percentage points from a year ago.
- Charge-offs fell 19 basis points to 0.61% but are up 15 basis points from a year ago.

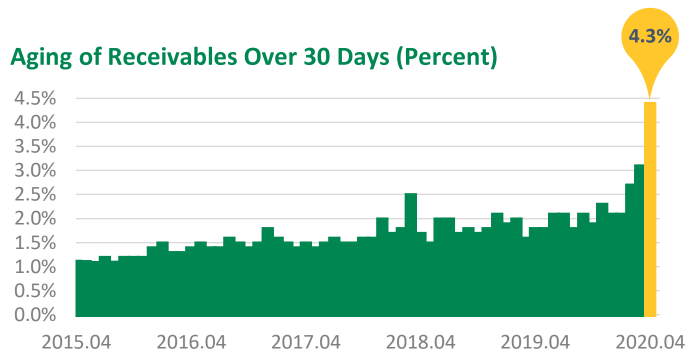
> *The downturn in the economy precipitated by the COVID-19 pandemic crisis is responsible for new business softening in the equipment finance space during the month of May. This is evident in segments serving in the construction, hotel, tourism, leisure and food service industries in particular.*
>
> **Ralph Petta, President & CEO, ELFA**

New Business Volume % change Y/Y)



Source: ELFA

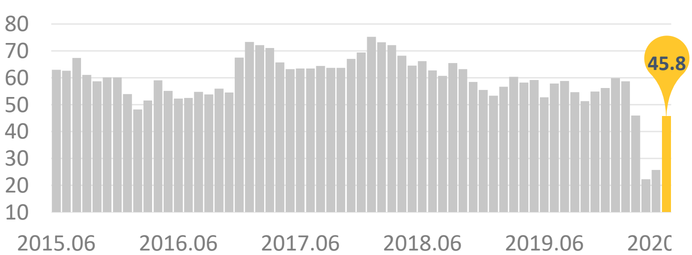
Aging of Receivables Over 30 Days (Percent)



Source: ELFA

MCI-EFI

Industry confidence rebounded strongly in May



Source: ELFF

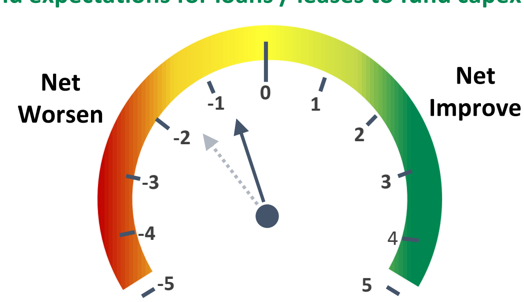
The June Monthly Confidence Index for the Equipment Finance Industry ("MCI-EFI") jumped 20 points to 45.8 — still below pre-pandemic levels, but a clear indication that industry leaders are more upbeat about the recovery.

- In June, 44% of executives responded that they believe business conditions will worsen — elevated by historical standards, but a huge improvement from 87% in May.
- Over a third of respondents (37%) expect demand for loans and leases to fund capital expenditures will fall over the next four months, down nearly 50 points from May.
- 19% of executives expect U.S. economic conditions to worsen in the next six months, down from 50% in May.

ELFF's new monthly COVID-19 Impact Survey illustrates the effect of the pandemic on equipment finance firms thus far. According to the June survey (which received 98 responses):

- 92% of respondents have offered payment deferrals.
- Less than one in five respondents have furloughed or laid off employees.
- Though just 14% of respondents anticipate zero defaults in their portfolio (down from 46% in 2019), nearly all expect default rates to remain under 5% in 2020.

Demand expectations for loans / leases to fund capex*



Source: ELFF. *Diffusion index of the difference in the share of respondents who believe demand for loans / leases will increase vs. decrease.

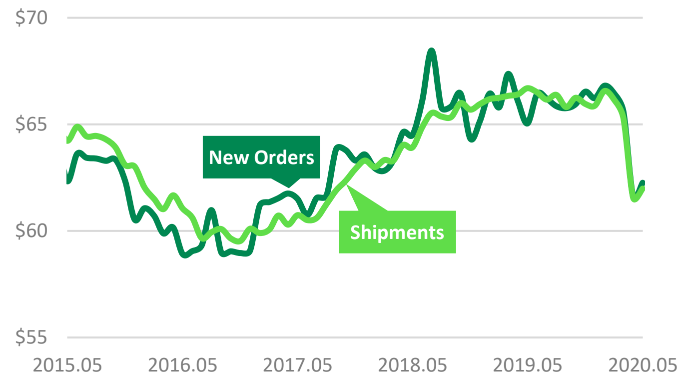
Manufacturing Focus

New manufacturing orders point to slow recovery

Demand for new orders and shipments plunged in April but began to recover in May.

- New orders for nondefense, non-aircraft manufactured goods (a leading indicator of industry performance) rose in May but remain 2.7% below their year-ago level.
- Shipments of nondefense capital goods excluding aircraft (a coincident indicator of industry performance) also improved in May but are 3.5% below their May 2019 level.
- One encouraging sign: as states began to reopen, the manufacturing sector added more than 600k jobs in May and June. This improvement is quite strong, though the sector remains down more than 700k jobs from last year. Time will tell whether the gains can be sustained.

Shipments vs. New Orders of Core Capital Goods
$ Billion (seasonally adjusted)



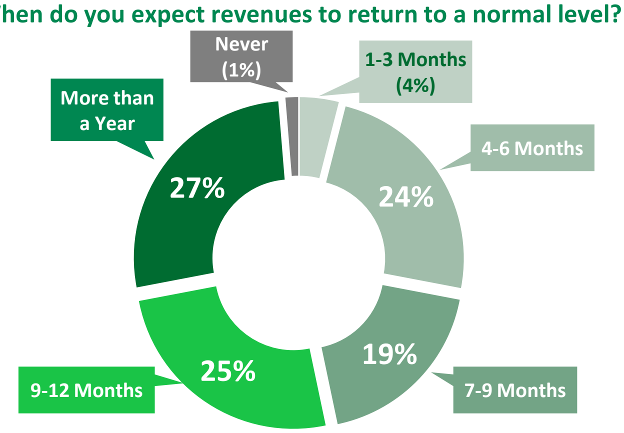
Source: Census Bureau

Texas-area manufacturing firms suffer double hit of virus and low oil prices; still see modest rebound

The Dallas Fed's Texas Manufacturing Outlook Survey showed a return to growth in June, though production remains low and risks skew to the downside.

- 40% of businesses increased production from May to June, the highest reading since 2018.
- However, the General Business Activity Index remained in contraction territory for the fourth straight month.
- Further, firms are expecting to continue shortening average workweeks to contain labor costs.
- More than half of manufacturing firms in the Dallas Fed survey expect that revenues will remain below normal for at least another nine months (chart).

When do you expect revenues to return to a normal level?



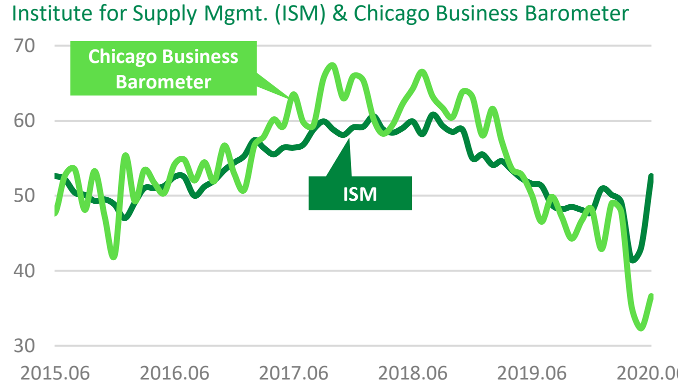
Source: Dallas Fed

Manufacturing indices improve, but stories diverge based on regional economic activity

The ISM and Chicago Business Barometer present differing stories about the health of the U.S. manufacturing sector. The ISM index indicates a return to growth, albeit from a deep trough. The Chicago Business Barometer suggests that activity is still declining, a divergence that likely can be explained by the slow reopening process in the Chicago area.

- The ISM manufacturing PMI surged 9.5 points to 52.6 in June, the first growth since February. The New Orders sub-index jumped more than 20 points in June and now signals an expansion, though the employment sub-index remains deep in contractionary territory.
- The Chicago Business Barometer improved to 36.6 in June as the Production and New Orders sub-indices improved. Overall, however, the index remains severely depressed.

Purchasing Managers' Indices (PMI)
Institute for Supply Mgmt. (ISM) & Chicago Business Barometer



Source: ISM; MNI

An Unprecedented and Unavoidable Recession

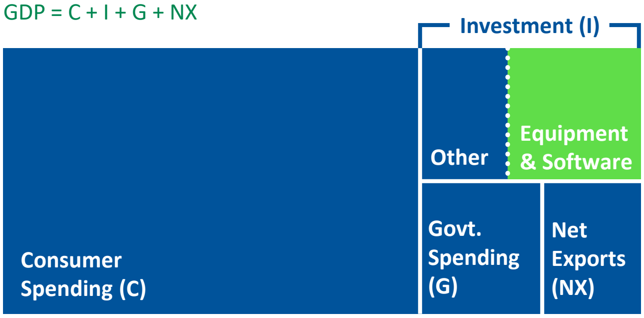
The pandemic collapsed the economy in Q1 and Q2

The U.S. economy contracted 5% (annualized) in the first quarter and is expected to shrink by 25-35% (annualized) in the second quarter. Some parts of the economy were particularly hard hit, but the pain is widespread.

- **Consumer spending**, the largest component of the economy, dropped 6.8% (annualized) in Q1 and almost certainly fell even more in Q2 as widespread business closures in April and May severely curtailed spending.
- **Equipment and software (E&S) investment**, a subset of overall business investment and the lifeblood of the equipment finance industry, plunged more than 10% in Q1, the largest decline since 2009.
- **Net exports** contributed positively to GDP in Q1, though for the wrong reasons: exports plummeted, but imports collapsed even more.
- **Government spending** rose 1.1% in Q1 as the effects of the coronavirus triggered stabilization programs.
- **Other investment** was a drag on Q1 GDP, as an inventory drawdown and weak structures investment more than offset another improvement in residential investment.

Composition of Gross Domestic Product (GDP)

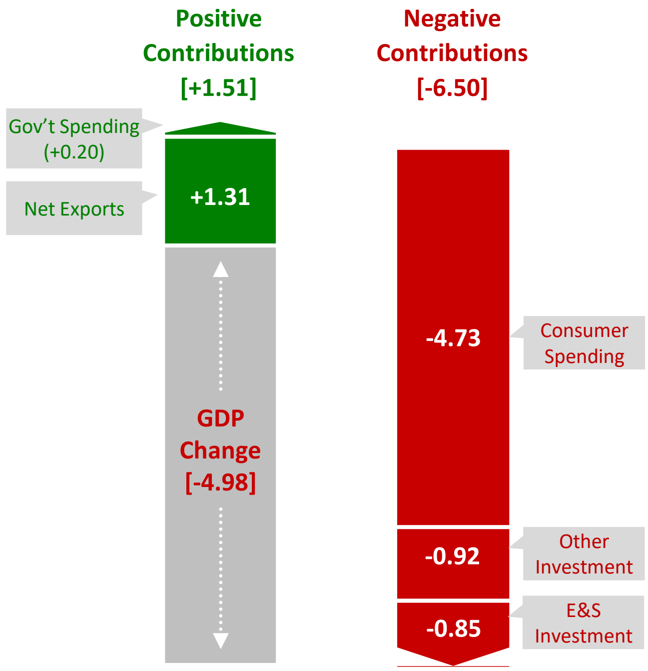
GDP = C + I + G + NX



Source: Bureau of Economic Analysis (BEA)

Contributions to GDP Growth

Q1 2020



Source: Bureau of Economic Analysis (BEA)

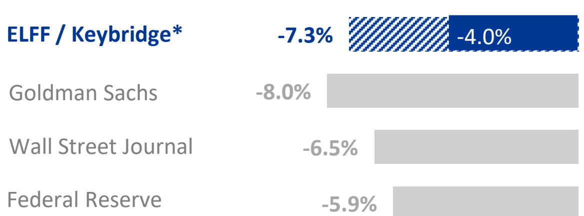
How Strong Will the Recovery Be?

Historic uncertainty for the rest of the year

Though economic activity should improve in Q3 and Q4, the COVID-19 infection rate (and, by extension, the response from consumers, businesses, and policymakers) will be a critical factor in determining the strength of the rebound.

- Given that GDP growth is measured relative to the prior quarter, unless Q3 involves an extended nationwide economic shutdown, a positive growth rate is highly likely.
- However, if the infection rate accelerates, consumers will be less willing to resume economic activity and businesses will suffer, even if state economies remain technically "open."
- Consumer and business financial stress will almost certainty rise in the months ahead, particularly if federal assistance and lender-provided payment deferrals are not extended.

2020 Growth Forecasts



*Range reflects heightened uncertainty due to the trajectory of the pandemic.

> *The outlook for the rest of the year depends on whether consumers feel safe enough to get out and spend again. The virus will still be calling many of the shots.*
>
> **Dr. Robert Wescott**
> **President, Keybridge LLC**

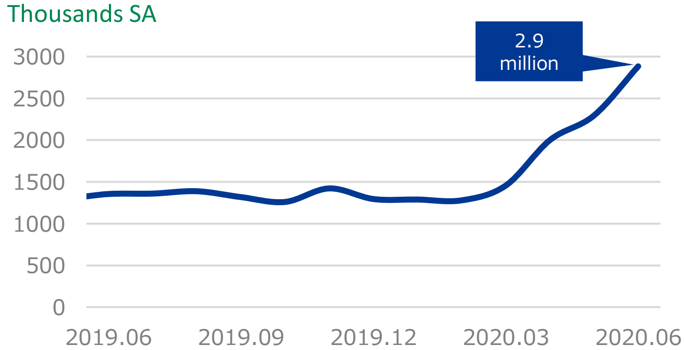
Labor Market

Unemployment spikes, likely to remain elevated

As states gradually reopen, the worst of the job losses are likely behind us. However, there are signs that some temporary job losses are becoming permanent, and that industries which have been mostly insulated from the initial effects of the recession will be susceptible to future job cuts.

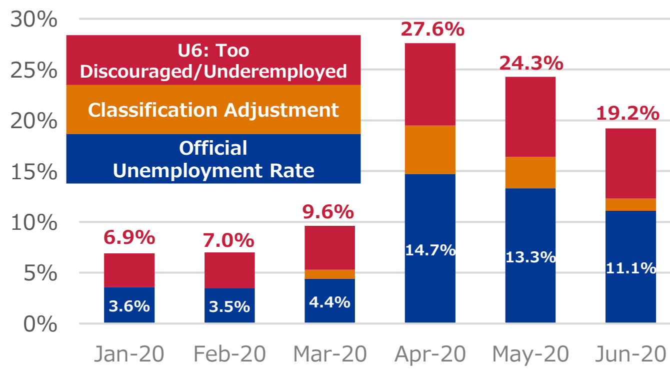
- Initial claims for unemployment insurance were 1.43 million in the week ending June 27 and exceeded 2.2 million when claims filed under the new Pandemic Unemployment Assistance program are included. This is significantly lower than the 6.6 million peak in late March, but still six times higher than pre-recession levels (and more than double the pre-pandemic record). Moreover, jobs lost at this stage in the pandemic are less likely to quickly return than those lost in March and April.
- Although the headline unemployment rate declined to 11.1% in June, permanent job losses increased, providing additional evidence that the unemployment rate will remain elevated for the foreseeable future (e.g., through 2021). Further, there are many millions more workers (chart) who are either misclassified due to data collection issues, too discouraged to look for work, or working part-time because they can't find a full-time job.

Permanent Job Losses
Thousands SA



Source: Bureau of Labor Statistics

Headline vs. Alternative Measures of Unemployment



Source: Bureau of Labor Statistics

Mobility and Consumer Confidence

Consumer outlook rebounds after hitting low

Consumer confidence has been slowly recovering from its lows in March and April. However, there is some evidence that the positive trend slowed and potentially reversed in late June and early July amid a new surge in COVID cases.

- Spurred in part by state re-openings as well as significant fiscal stimulus from the CARES Act, retail sales were up a record 17.7% in May after suffering historic declines in March and April. However, sales remain well below pre-pandemic levels.
- Google mobility data shows that consumers are leaving home to travel to retail and recreational sites, workplaces, and transit stations more often than they were in April, consistent with improving confidence.
- However, progress appears to have slowed during the second half of June, and recent data point to a plateau or reversal in spending (chart). A full recovery of consumer spending hinges on the country's ability to control the spread of the virus so that businesses can remain open and consumers feel safe to resume economic activity.

National Credit/Debt Spending Relative to Jan 4-31
% SA

Source: Opportunity Insights Economic Tracker

A Morning Consult survey conducted the week of July 3rd shows that most adults remain uncomfortable engaging in a variety of economic activity, underscoring the challenge facing the U.S. economy in the months ahead. While some states have seen infection rates continue to fall and continue reopening, others are experiencing sharp increases in new cases, notably Florida, Texas, California, Georgia, and Arizona.

Policy Action Keeping Bankruptcies Low, For Now

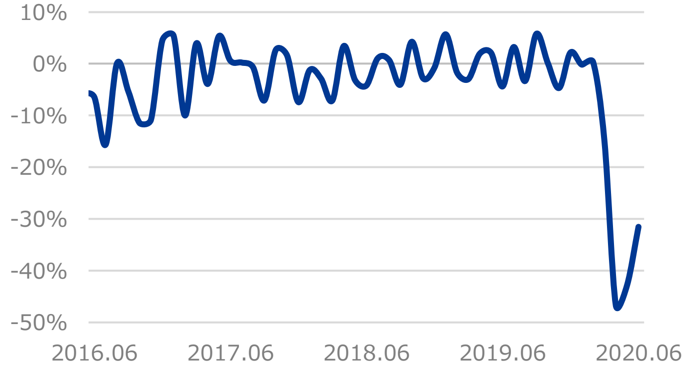
Temporary measures could soon expire

The rise in consumer bankruptcies that appeared likely after tens of millions of workers lost their jobs in March and April has not yet materialized, in large part due to the CARES Act stimulus payments, the Paycheck Protection Program, and various lender-provided payment deferral programs. In fact, consumer bankruptcies plummeted to a 14-year low in April before edging up in May and June, but are now 31% below their level a year ago despite decades-high unemployment.

Similarly, most large banks in the U.S. reported decreases in charge-off and delinquency rates in May, another sign that the worst of the damage has been mitigated, at least for now. This improvement was driven by direct payments to taxpayers, expanded access to unemployment benefits through the new Pandemic Unemployment Assistance program, and an extra $600/week in unemployment benefits. Designed to fully replace the median worker's wages and encourage shelter-in-place activity to fight the pandemic, these unusually generous payments have caused aggregate income (and spending) to surge, particularly among lower-income households that have been acutely impacted by the pandemic-fueled job loss. However, they also have likely encouraged some workers to remain on the sidelines.

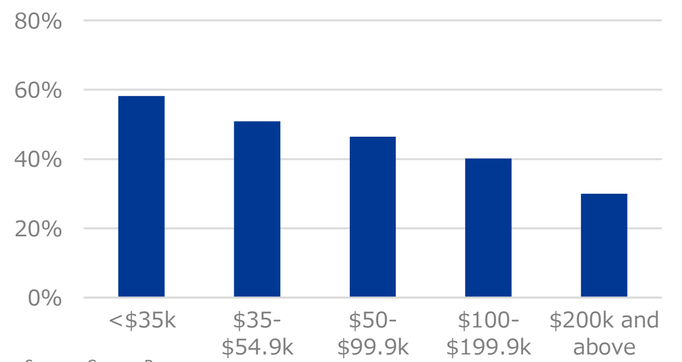
Looking ahead, it is unclear whether Congress will extend the temporary measures that have reduced financial stress, phase them out, or allow them to expire in August. Without them, the unemployed may have a stronger incentive to return to work, but financial stress would likely rise — and infection rates could surge if businesses reopen too quickly.

US Consumer Bankruptcy Filings
% change Y/Y



Source: Macrobond Financial

Share of Households Reporting Lost Income Since March 13th
% by income bracket

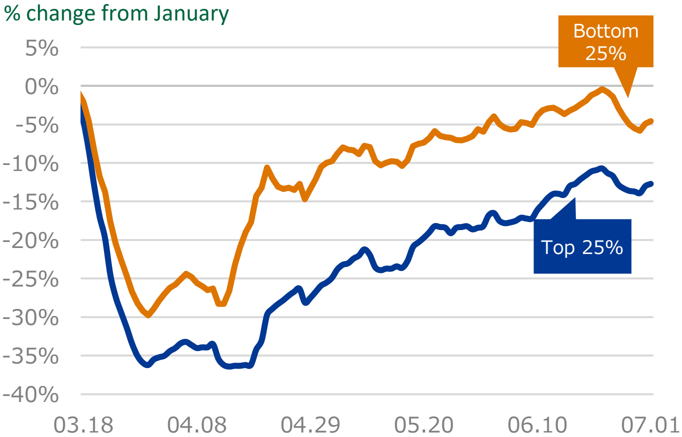


Source: Census Bureau

A tale of two halves

Spending by income level reveals stimulus support

Consumer spending by zip-code income quartile
% change from January



Source: Opportunity Insights Economic Tracker

Consumer spending plunged in March and April as the effects of stay-at-home orders and millions of job losses reverberated through the economy. While spending rebounded in May and June, the recovery was not uniform: spending by consumers living in lower-income zip codes recovered more robustly than spending by consumers living in higher-income zip codes. By late June, spending in the bottom quartile based on income was nearly even with pre-pandemic levels, while spending in the top quartile was still down more than 10%. This divergence reflects the unprecedented level of federal government assistance offered through the CARES Act. Congress has not yet decided whether to extend this aid, phase it out, or allow it to expire, but without it, consumer spending is likely to fall sharply — particularly among economically vulnerable populations — and financial stress will rise.

Industry Impact

Service industry rebounds in June, but will it last?

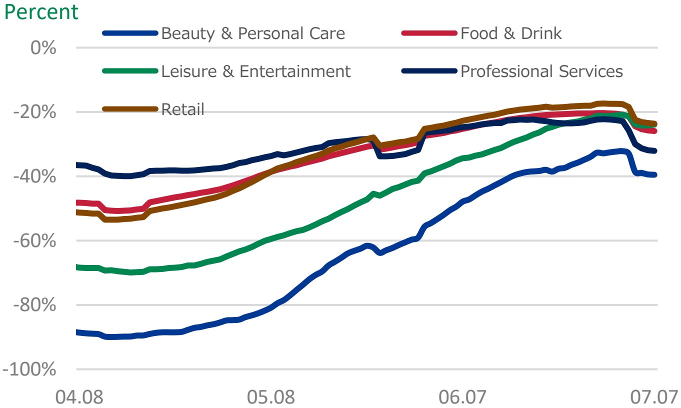
As parts of the U.S. reopen following lockdown measures, the service industry is slowly returning. The ISM Non-Manufacturing index surged to 57.1 in June, the first reading indicating expansion since March. The improvement in this and several other measures of activity generated increased optimism in the economic recovery in May and early June.

However, several recent developments suggest that the recovery may not be as smooth and robust as hoped. For example, the nearly-3,500 chapter-11 bankruptcy filings in the first half of 2020 were roughly equal to the number of filings in the first half of 2008. Bankruptcies have been spread across a wide range of industries, including entertainment, energy, retail, and automobile rentals. Further, the number of firms defaulting on debt has already eclipsed the total for last year. These bankruptcies will leave lasting marks on the U.S. economy and appear likely to continue and potentially accelerate, particularly in the service-sector industries most heavily impacted by social distancing.

Commercial mortgage-backed securities' delinquency rates offer some insight into the ability of certain sectors to pay their rent on time — a reasonable proxy for financial stress — and the picture is not pretty. Data show that CMBS delinquency rates (30+ days) in the lodging industry jumped to nearly 20% in May, up from just 1.5% in March. Likewise, delinquency rates on retail-sector CMBS surged to 10.1% from 3.9% in March. These spikes are not surprising given that these industries are among the hardest hit by the pandemic, but they are by no means one-off exceptions: Homebase data (chart below) show that more than 20% of small businesses across a variety of industries remain shuttered, and recent trends are negative. As long as firms cannot safely operate at full capacity, rising delinquencies are likely and bankruptcy risk will remain elevated.

Share of Local Businesses Open vs Same Day in January

Percent



Source: Homebase

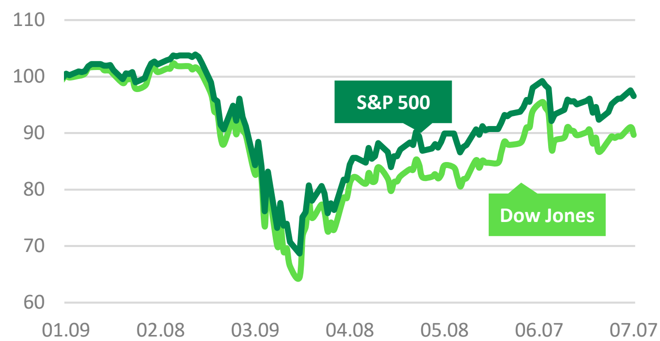
Financial Market Turmoil

Fed action boosts prices, lowers rates into future

Though volatility remains elevated, equity markets have climbed in recent months and have nearly reached pre-pandemic levels. The only exceptions are companies in heavily-impacted industries like airlines, hotels, and some restaurant chains.

S&P 500 and Dow Jones Industrial Average

Indexed (1/1/20 = 100)



Source: Macrobond Financial

Heightened investor optimism in the face of a historic global recession reflects the "kitchen sink" approach the Fed has taken to boost liquidity and transfer financial-market risk to its own balance sheet. In addition to lowering the fed funds rate to zero and promising near-zero rates for an extended period, the Fed has begun purchasing corporate bonds, lending directly to non-financial firms, and entertained the idea of capping yields on other, longer-dated maturities of debt to reinforce forward guidance.

These policies mean that the equipment finance industry will face ultra-low interest rates for the foreseeable future — though just how long is an open question.

Growth During Pandemic

Online retailers, PPE producers see growth

Amazon and other online retailers have benefitted from consumers switching from brick-and-mortar stores to e-commerce. Likewise, the widespread adoption of work-from-home policies could help boost investment in computers and software in the near-term.

As the pandemic worsens, demand for medical PPE equipment is expected to remain high. Masks, cleaning supplies, and other protective equipment for workers returning to offices will likely tick up as well, though there is a risk that this could crowd out other investment in non-essential medical equipment.

Federal Government Response

How Effective Has Government Stimulus Been?

Federal assistance has played an important role in supporting economic activity through the first three months of the pandemic. Policy measures including direct payments to households, enhanced unemployment benefits, and the Paycheck Protection Program have helped mitigate the worst of the economic damage thus far, as evidenced by:

- 94.2% of renters in multifamily units making at least a partial payment in June (though the first week of July showed signs of a potential weakening);
- 7.0% Y/Y personal income growth in May (second-largest in last seven years);
- 17.7% M/M growth in May retail sales (largest monthly increase on record);
- 7.5 million jobs added to the labor market since April;
- 12 million Americans prevented from being pushed into poverty per the Colombia University Center on Poverty.

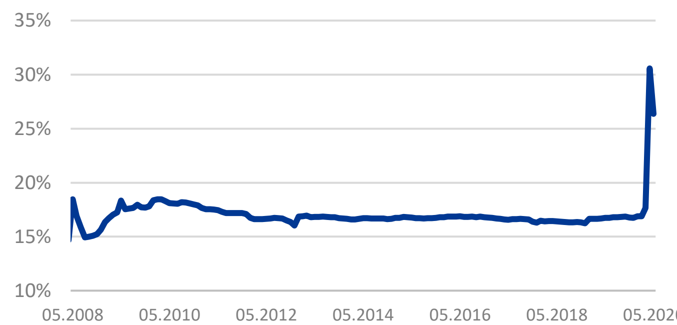
What's Next?

Improved economic data in May and early June have been a welcome development, but whether this progress can be sustained in the months ahead is an open question. Given the role of the CARES Act in shoring up economic activity, some policymakers have advocated for additional federal assistance in a "Phase IV" economic package. Others have expressed concerns about the skyrocketing deficit and potential distortionary effects on the labor market from unusually generous unemployment benefits.

The administration is similarly divided over the need for additional stimulus. As a result, the exact size and scope of a Phase IV stimulus package is uncertain. Among the key issues that will frame the debate in July include:

- **Unemployment benefits.** While Democrats want an extension of the $600/week enhanced unemployment benefits, a reduction in weekly payouts is more likely.
- **Direct Payments.** The President and some Democrat lawmakers have voiced support for another round of stimulus checks, but GOP leadership has expressed skepticism given stronger economic data in May and June.
- **State and local government aid.** State and local governments are suffering due to the recession *(see bottom section and chart);* shoring up their finances is a primary focus of Congressional Democrats.
- **Business liability.** Republican lawmakers and business groups have expressed the need for temporary and targeted liability relief to safeguard employers from lawsuits related to COVID-19 exposure.

Share of Personal Income from Government Benefits



Source: Macrobond Financial

State & Local Government Impact

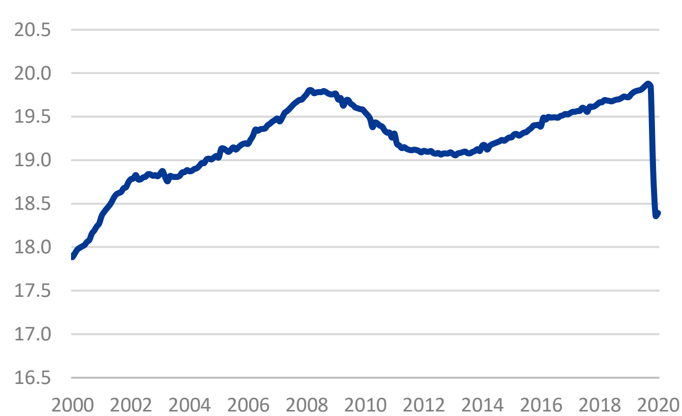
States and cities in dire straits

The pandemic has put state and local governments in a bind. While they received $150 billion from the CARES Act, these funds couldn't be used to offset budget gaps stemming from tax revenue shortfalls and higher public health and unemployment benefit expenditures. State budgets are increasingly strained:

- State revenues are forecasted to decline by 25% by June 2021 per the Center for Budget and Policy Priorities.
- State / local governments have lost 1.5 million jobs since March. Employment is at its lowest level since June 2001.
- 75% of cities are slashing spending to make up budget gaps, per a recent National League of Cities survey.

Given the budget crisis facing state and local governments, job cuts and postponed investments are a near-certainty without additional federal assistance in a Phase IV package.

State and Local Government Employment
Millions, SA



Source: Bureau of Labor Statistics via Pew

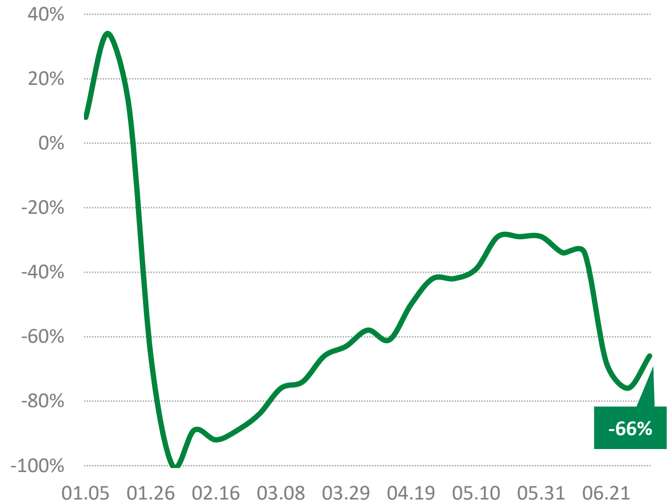
China Recovery and 2nd Wave Risks

Recovery remains rocky and risks abound

After spreading rapidly in the Wuhan province, China was able to control its COVID-19 outbreak with a draconian lockdown policy and strict social distancing requirements made possible in part by its authoritarian Communist regime. However, despite its apparent success in driving new case counts to near-zero, China's economic recovery has been slow and uneven. For example, retail sales in China improved steadily after bottoming out in February but remain well below pre-pandemic levels — a significant slowdown compared to 8%+ annual growth in 2019. Similarly, traffic congestion in Beijing rose steadily from March – May but remains substantially below 2019 levels. These data suggest that Chinese consumers may not be ready to venture out and resume spending at pre-pandemic levels.

Worryingly, China has also shown the first signs of a "second wave" in Beijing. A surge in cases triggered a shutdown of all schools in Beijing and set off a massive test-and-trace effort to quash the virus again, resulting in another massive decline in mobility in Beijing (chart). If this hotspot forces another broad shutdown of economic activity as occurred in February, demand for U.S. exports — especially in the agricultural and aircraft sectors — could take another hit.

Beijing Weekly Average Congestion Levels
% change from 2019



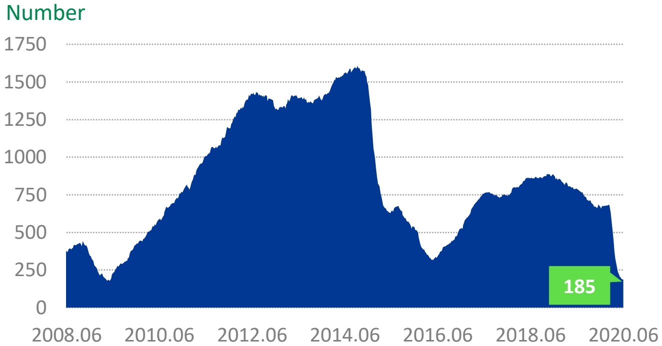
Source: TomTom

Oil sector turmoil

Supply-demand mismatch to remain

The global oil market will suffer its largest-ever decline in demand this year due to the pandemic. Though much of that demand is expected to return next year if the virus is controlled effectively, the market remains fragile and could nosedive again in a second wave scenario. In the meantime, the U.S. oil rig count has plunged below 200 as exploration and production firms slash investment and shut in production (chart). The oil sector is unlikely to be a source significant new investment in the coming months; the focus of many firms will instead be on remaining solvent.

US Oil Rig Count
Number



Source: Macrobond Financial

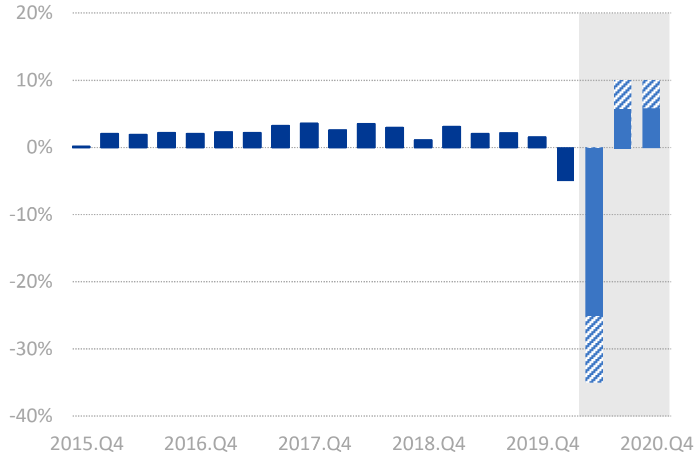
Emerging markets hardest hit

Drivers of global GDP growth slammed

The top-ten emerging market economies after China were expected to have accounted for more than 30% of world GDP growth over the coming ten years. This growth, much like the robust growth China has experienced over the last few decades, was expected to drive demand for U.S. exports of agricultural goods, computers, software, and more.

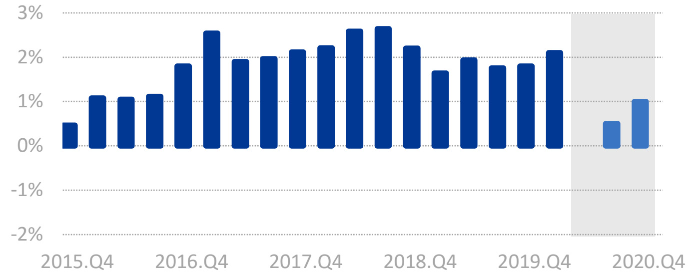
However, the pandemic has severely stressed the healthcare sectors and overall economies of several key emerging-market countries including India, Turkey, and Brazil. These countries lack much of the medical infrastructure necessary to combat the virus' spread, and they also have less fiscal space to enact the kind of massive stimulus seen in advanced economies. Volatility in global financial markets could cause a debt crisis, destabilize a currency, or otherwise cause economic strife beyond the lockdowns of early 2020. If the global institutions led by advanced economies are unable to help emerging markets weather this storm, worldwide economic activity may become even more fragmented in the years to come, with negative effects on U.S. supply chains and export demand.

Real GDP Growth (% SAAR)



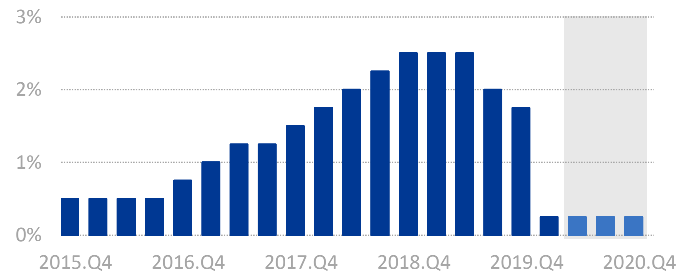
Source: Bureau of Economic Analysis; Keybridge LLC

CPI Inflation (year-on-year %)



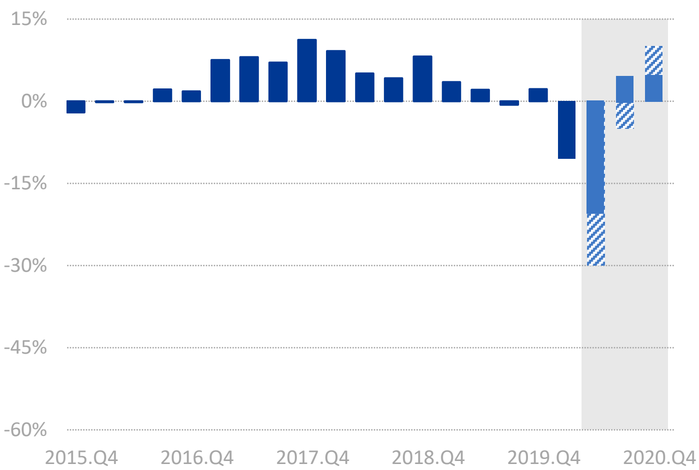
Source: Bureau of Labor Statistics; Keybridge LLC

Fed Funds Target (upper bound, end of period)



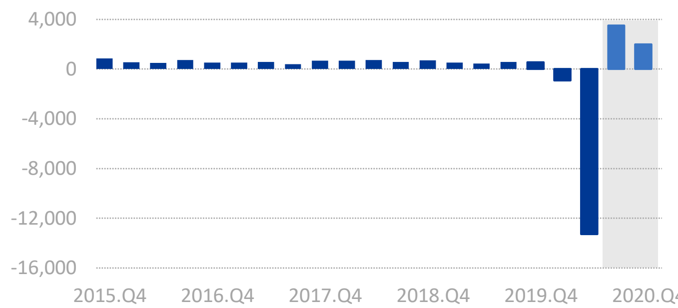
Source: Federal Reserve Board of Governors; Keybridge LLC

Real Investment Growth (% SAAR)



Source: Bureau of Economic Analysis; Keybridge LLC

Total Payroll Growth (thousands)



Source: Bureau of Labor Statistics; Keybridge LLC

INDICATOR	2018	2019	2020 QUARTERLY ESTIMATES				2020e
			Q1	Q2e	Q3e	Q4e	
Real GDP (SAAR %)	*2.9%*	*2.3%*	-5.0%	-25 to -35%	5 to 10%	5 to 10%	**-4.0 to -7.3%**
Real Investment in Equipment & Software (SAAR %)	*7.7%*	*3.4%*	-10.5%	-20 to -30%	-5 to 5%	0 to 10%	**-5.6 to -9.6%**
Inflation (year-on-year %)	*2.4%*	*1.9%*	2.1%	0.0%	0.5%	1.0%	**0.9%**
Federal Funds Target Rate (upper bound, end of period)	*2.5%*	*1.75%*	0.25%	0.25%	0.25%	0.25%	**0.25%**
Total Payroll Growth (thousands)	*2314*	*2133*	-908	-13,288	3,500	2,000	**-8,696**

Note: SAAR% refers to the annualized rate of change in seasonally adjusted data from one quarter to the next, which is the Bureau of Economic Analysis' standard method for reporting growth in the national accounts data.

About the Momentum Monitor

Business leaders require actionable forward-looking intelligence to make strategic decisions. Accordingly, the Foundation commissioned Keybridge LLC to develop a series of custom leading indicators for the equipment sector. The Foundation-Keybridge Equipment & Software Investment Momentum Monitor consists of indices for 12 equipment and software investment verticals. These indices are designed to identify turning points in their respective investment cycles with a 3–6-month lead time.

The Momentum Monitor is based on Keybridge's extensive research which shows that not all movements in economic data are reliable signals of future economic trends. Keybridge has operationalized its research by constructing indices, each comprised of between 10 to 20 high-frequency indicators. These indicators undergo rigorous testing to determine the optimal thresholds at which their short-term fluctuations are economically meaningful. In simpler terms, the Momentum Monitor sifts out the "noise" in the data and identifies the dominant trends. As a result, each Momentum Monitor index is statistically optimized to signal turning points in the investment cycle without giving false readings of shifts in momentum.

How to Read the Momentum Monitor

The Momentum Monitor Matrix summarizes the current values of each of the 12 Equipment & Software Investment Momentum Indices based on two factors: Recent Momentum (x-axis) and Historical Strength (y-axis):

- "Recent Momentum" indicates a vertical's recent acceleration or deceleration in the past month relative to its average movement during the previous 3 months. Ratings closer to "0" indicate rapid deceleration, while ratings near "10" represent rapid acceleration.
- "Historical Strength" reflects a vertical's strength in the past month relative to its typical level since 1999. Ratings closer to "0" represent an indicator that is weaker than average, while ratings closer to "10" represent an indicator that is stronger than average.

The matrix consists of four quadrants based on readings for each vertical's recent momentum and historical strength. If a vertical falls in the top-left quadrant, its momentum reading is higher than average, but positive movement has slowed (and perhaps reversed) in recent months — suggesting that investment levels may fall over the next 1-2 quarters. Verticals in the bottom-right quadrant, however, have momentum readings that are below average, but recent movement shows promise — suggesting that investment levels may rise over the next 1-2 quarters.