2023 Q3 Update
Equipment Leasing & Finance U.S. Economic Outlook

EQUIPMENT LEASING & FINANCE
FOUNDATION
Your Eye on the Future

EQUIPMENT LEASING & FINANCE ECONOMIC OUTLOOK

July 2023

Key Trends to Monitor

Housing Rebound?

Inflation

Labor Market

EXECUTIVE SUMMARY

Equipment and Software Investment: At the midway point of 2023, E&S investment is struggling amid volatile industry conditions. E&S investment fell 4.5% in Q1, and although things may have improved somewhat in Q2, industry conditions are far from ideal. High interest rates and slowing economic growth will continue to impact investment plans as the year progresses.

Momentum Monitor: The latest Momentum Monitor reading suggests that equipment and software investment growth is likely to remain subdued across most equipment verticals over the next two quarters. Of the 12 verticals tracked, all but one is below its historical average. On a more positive note, the Atlanta Fed projects positive E&S investment growth in Q2.

Manufacturing: Measures of manufacturing sector activity have held firm in recent months. However, while production and sales may have been solid in Q2, several leading indicators point to weakness later this year, including reduced demand from abroad — though the recent boom in manufacturing construction is a notable exception that should continue.

Small Businesses: Main Street has held its own during one of the most turbulent periods in recent economic history. However, a growing share of small firms are reporting weaker sales, tepid capital investment plans, and rising borrowing costs. The looming credit crunch that is expected to set in later in 2023 is likely to disproportionately impact small businesses.

Fed Policy: The Fed held interest rates steady at its most recent meeting, the first such pause of the current tightening cycle. However, Chair Powell and the FOMC have made it clear that their work is not done and that additional rate hikes are likely later this year — even though the full effect of previous rate hikes has probably not yet been realized across the economy.

U.S. Economy: The economy has been stronger than anticipated thus far in 2023, driven by a robust labor market and resilient American consumer. At the same time, strong job growth may complicate the Fed's efforts to reach its inflation target. While inflation has improved, core inflation remains well above target (and Keybridge's custom measure is higher still). The ongoing manufacturing construction boom is a bright spot for the industry and should continue, but a looming credit crunch and slower global economic growth remain significant headwinds.

While a soft landing is still achievable, we continue to believe that a mild recession beginning later this year is the most likely base case, likely triggered by tighter credit conditions and increasing financial stress on consumers and businesses.

2023 Annual Projections

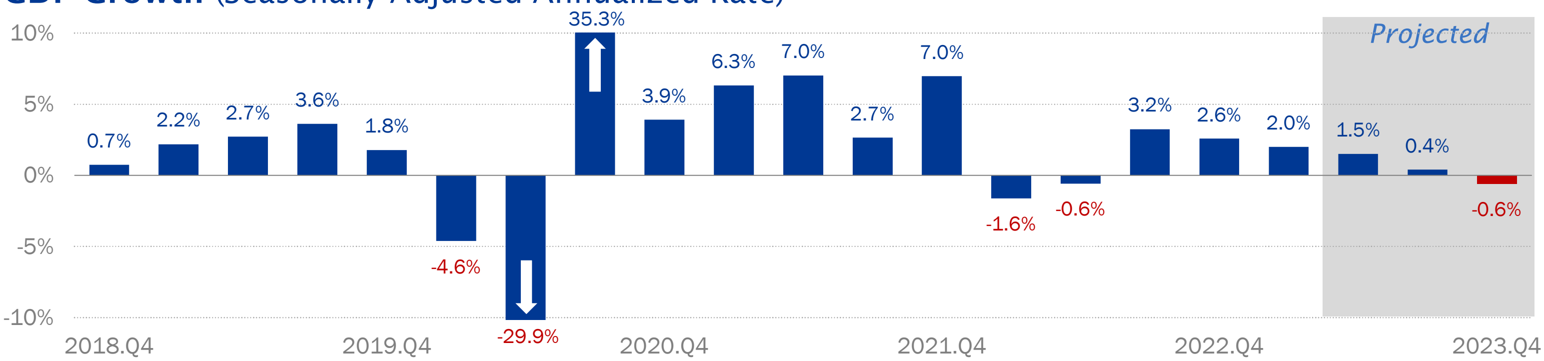
1.6%
*GDP Growth**
*see explanation on p. 13

0.9%
E&S Investment Growth

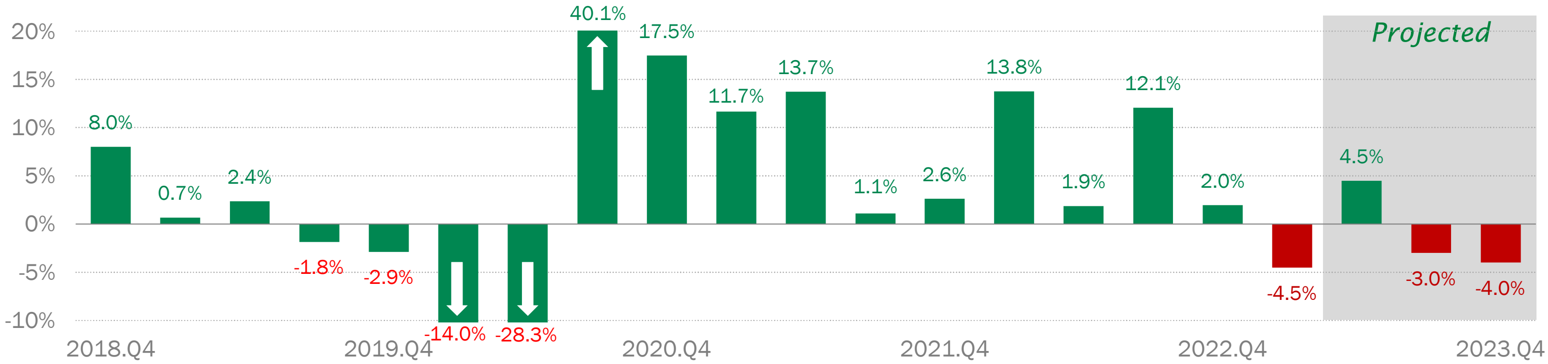
4.3%
Inflation (CPI)

+25bp
Change in Fed Funds Rate from Current Range

GDP Growth (Seasonally Adjusted Annualized Rate)



Equipment and Software Investment (Seasonally Adjusted Annualized Rate)



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

Sectoral Performance

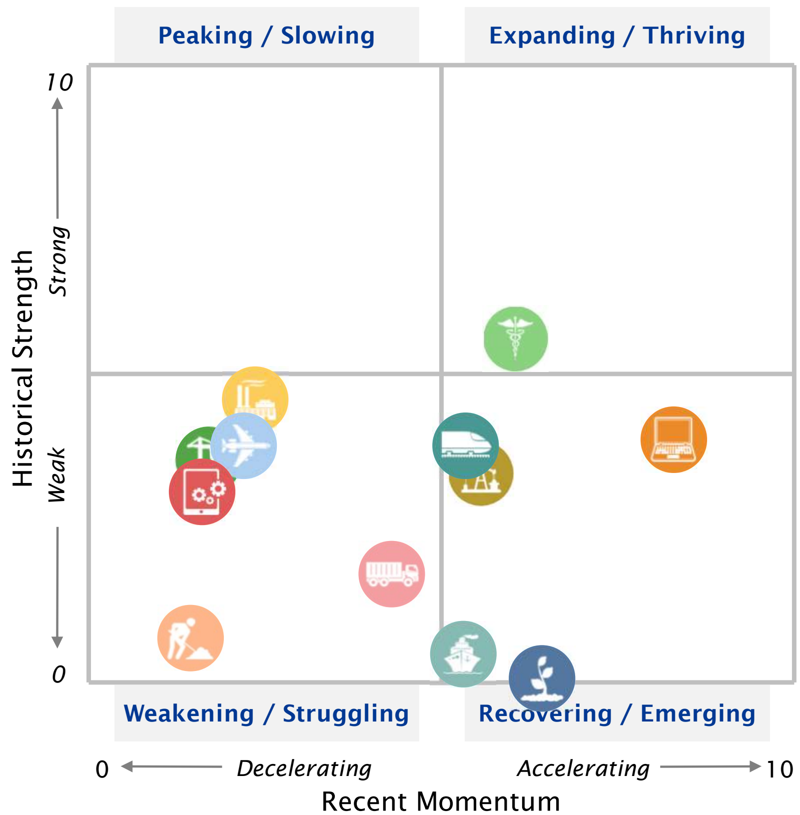
E&S investment slows in Q1

Equipment and Software investment fell 4.5% (annualized) in Q1, contracting for the first time since the onset of the COVID-19 pandemic. Investment growth was negative in 7 of 12 equipment verticals tracked by the Foundation in Q1, with both Aircraft and Agricultural Machinery experiencing the largest declines (-51% annualized). Still, investment growth improved in some sectors, including Mining & Oilfield Machinery (+51% annualized) and Railroad Equipment (+40% annualized).

Looking ahead, the Momentum Monitor Sector Matrix (see chart) indicates that the current readings for 11 of 12 equipment verticals are below their historical average, suggesting that the climate for investment growth is likely to remain weak in the near term.

Despite the near-term storm clouds, there are reasons for guarded optimism that investment conditions will improve later in the year and in 2024. First, preliminary data suggest that E&S investment picked up in Q2. Second, in April, eight equipment vertices were in the bottom left quadrant of the Sector Matrix; presently, that number is now six — still weak, but improving. Finally, half of the tracked verticals improved in July compared to their average reading over the previous three months, an early indication that green shoots may be forming.

Momentum Monitor Sector Matrix



For more information on how to interpret the Momentum Monitor, please refer to the Appendix B (p. 14). 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		
Agricultural Machinery	-51%	-26%	▼	Agricultural Machinery investment growth has worsened in recent months, and further declines are expected later this year. While the July reading is near historical lows, it is somewhat improved compared to the last three months.
Medical Equipment	-9.8%	+0.1%	▲	Although Y/Y Medical Equipment investment growth was flat in Q1, movement of the sector Index suggests that growth may improve over the next six months relative to the first half of the year.
Computers	-14%	-14%	▲	After significant contraction in Computers investment during Q4 2022 and Q1 2023, the latest Index reading suggests that investment growth may improve in the coming months. However, a return to pandemic-era breakout growth is unlikely.
Construction Machinery	+8.6%	+21.6%	▼	Construction Machinery investment growth increased from a year prior and was elevated in Q1. However, the current Index reading is weak by historical standards and has fallen consistently for more than a year, suggesting that investment growth will slow.

Credit Supply

Lending standards tighten further in Q1

Business lending standards tightened further in Q1 due to greater economic uncertainty as the Fed continued to raise interest rates in response to high inflation.

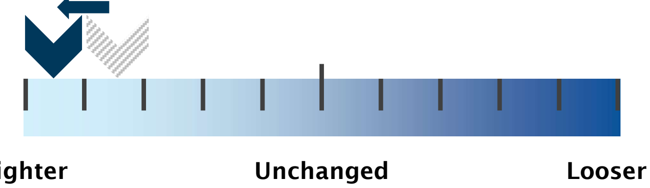
- Lending standards for Commercial and Industrial ("C&I") loans tightened at nearly half of banks. For loans to large and middle-market firms, a net 46% of banks reported tightening lending standards, while a net 47% reported tighter standards for loans to smaller firms.
- Lending standards also tightened further for commercial real estate ("CRE") loans in Q1. A net 74% of banks reported tightening standards for construction and land development loans, while a net 67% reported tightening standards for loans secured by nonfarm nonresidential properties.

In consumer credit markets, lending standards tightened across the board.

- Regarding credit card approvals, a net 30% of banks tightened credit standards.
- For auto loans, a net 27% of banks tightened standards.
- Mortgage standards also tightened: a net 19% of banks tightened lending standards for jumbo mortgage loans, while a net 21% tightened standards for conforming mortgages.

Credit Supply Conditions

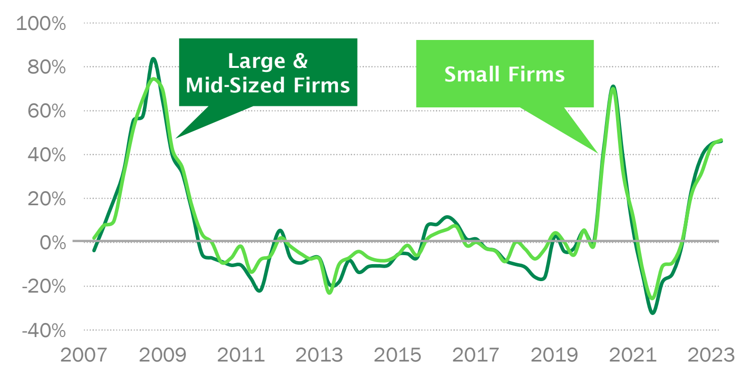
Banks report tighter lending standards in Q1



Source: Federal Reserve Senior Loan Officer Survey

Lenders Tighten Standards for C&I Loans

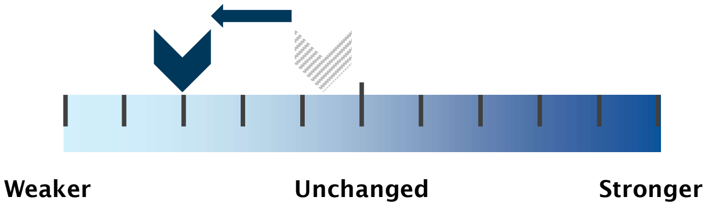
Percent of Respondents



Source: Federal Reserve Senior Loan Officer Survey

Credit Demand Conditions

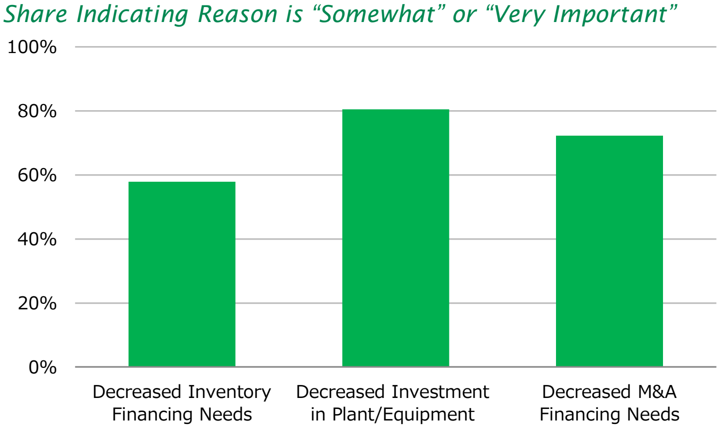
Demand for credit eases in Q1



Source: Federal Reserve Senior Loan Officer Survey

Top Reasons for Weaker C&I Loan Demand

Share Indicating Reason is "Somewhat" or "Very Important"



Source: Federal Reserve Senior Loan Officer Survey

Credit Demand

Demand for credit weakens in Q1

Demand for business loans weakened in Q1.

- On net, 56% of banks reported weaker C&I loan demand among medium and large firms in Q1. For smaller firms, a net 53% of banks reported weaker demand. Among those reporting weaker demand, the most common reasons cited were decreased investment in equipment and decreased merger or acquisition financing needs (see chart).
- In Q1, demand for CRE loans fell sharply. A net 67% of banks reported weaker demand for construction and land development loans, and a net 74% of banks reported weaker demand for loans secured by nonfarm nonresidential properties.

Credit demand also weakened among households, particularly for autos and mortgages.

- Credit demand fell for auto loans (net 27% decline), jumbo mortgage loans (net 55% decline), and non-jumbo mortgage loans (net 57% decline).
- Conversely, demand for credit card loans was mostly unchanged: a net 2.2% of banks reported weaker demand in Q1.

Fed Policy Corner

Fed Pauses Rate Hikes Amid Turbulence

The Fed's challenge to tame inflation without over-straining the U.S. economy grows increasingly complicated. After ten consecutive rate hikes, Fed officials chose to keep the target interest rate between 5.0% and 5.25% at their June FOMC meeting. Multiple factors contributed to the pause:

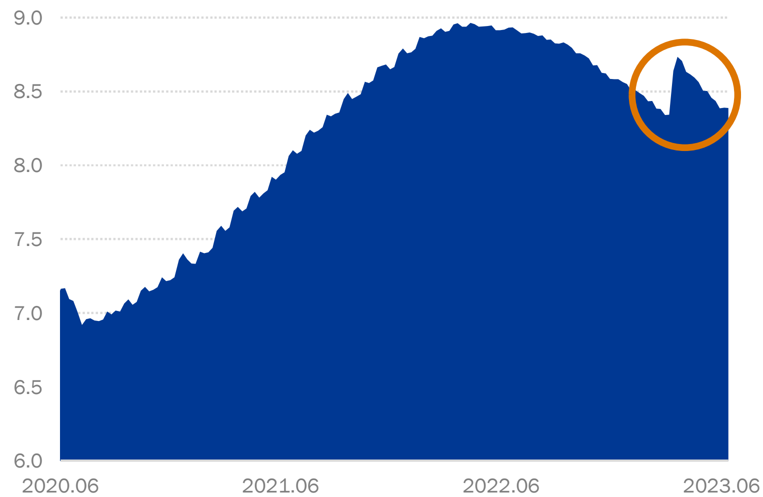
- **Stress in the banking industry:** The rapid collapse of Silicon Valley Bank and Signature Bank in mid-March rattled financial markets and cast a spotlight on the mounting stress faced by some banks, as higher rates reduced the value of their bond portfolios. As banks scrambled to reassess their balance sheets, lending standards tightened and are expected to tighten further over the remainder of the year. Amid this landscape, Fed officials considered the possibility of further turbulence when they chose to pause rate hikes (at least temporarily). According to chair Jay Powell, "We don't know the full extent of the consequences of the banking turmoil that we've seen."
- **Balance sheet drawdown:** After the high-profile bank failures in March, the Fed established the Bank Term Funding Program (BTFP). This program led to a rapid $400 billion expansion of the Fed's balance sheet and reversed several months of tightening (see top chart). Since then, the Fed has worked to shrink their balance sheet by nearly $350 billion and intends to maintain the current pace of tightening for the foreseeable future. The balance sheet drawdown will complement rate hikes and is estimated to have the same effect as a 25-50 bp rate hike.
- **Lower inflation**: Inflation numbers have eased since peaking last summer. Through June, monthly headline CPI has been running at a 3-4% annualized rate in 2023, and while the corresponding rate for core CPI is higher (around 5%), both metrics have improved since 2022. The PCE price index (the Fed's preferred measure of inflation) shows a similar trend.

The combination of the factors above prompted smaller rate hikes in the spring and, ultimately, a pause at the June FOMC meeting. However, Powell suggested that rate hikes will likely resume later this year given that core inflation remains elevated and that the labor market is still historically strong. According to market-implied rate hike probabilities for December 2023, the Fed is expected to hike rates at least one more time in 2023 (see chart).

All told, the full effects of tighter monetary policy — which has been achieved through both higher interest rates and a reduced Fed balance sheet — have likely not yet materialized. We continue to believe that labor markets will weaken substantially later this year, and a mild recession will ultimately commence. Still, the case for a "soft landing" has strengthened in recent weeks, and while it is not our base-case scenario for 2023, it remains a welcome possibility.

Federal Reserve Balance Sheet

$ Trillions



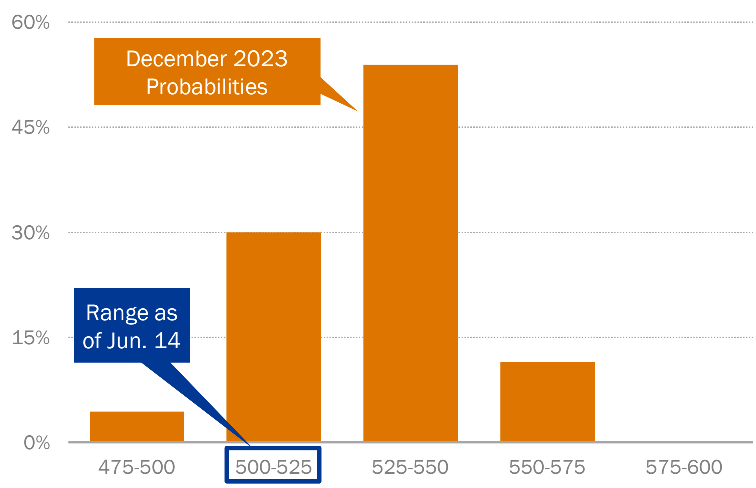
Source: CME Group

"We have raised our policy interest rate by five percentage points, and we've continued to reduce our security holdings at a brisk pace. We've covered a lot of ground and the full effects of our tightening have yet to be felt."

- Jerome Powell, Fed Chairman, 6/14/2023

Q4 2023 Federal Funds Rate Probabilities

Bps, set by December 2023 FOMC meeting



Source: Federal Reserve, Keybridge calculations

"Nearly all Committee participants view it as likely that some further rate increases will be appropriate this year to bring inflation down to 2 percent over time."

- Jerome Powell, Fed Chairman, 6/14/2023

Main Street Outlook

After a better-than-expected start, Main Street braces for mounting headwinds

Though inflation has improved this year and consumer spending continues to hold up, Main Street businesses continue to face headwinds in the form of higher interest rates and persistent hiring problems. As a result, small business optimism and plans for capex spending remain muted by historical standards.

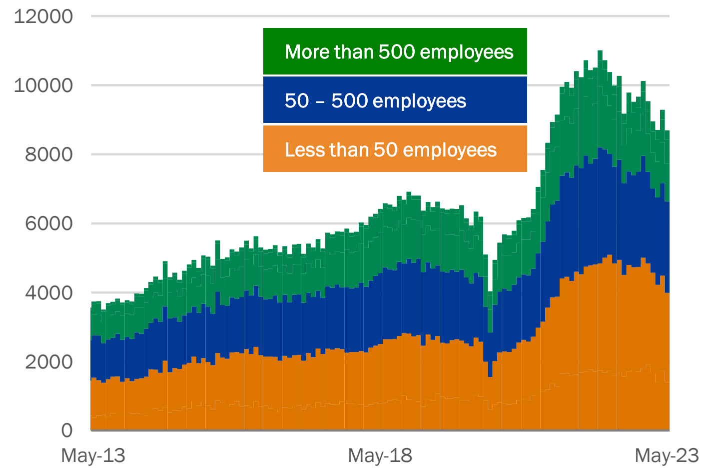
Hiring remains a major headache for small businesses. As the worst of inflationary pressures recede, businesses are increasingly citing hiring as the biggest obstacle they face, particularly with respect to filling open positions and contending with rising labor costs. Hiring has been especially problematic for small businesses with fewer than 50 employees; these firms account for nearly half of all job openings (and most of the post-pandemic increase).

A newer stressor that threatens to exacerbate hiring issues is credit availability. For example, bank lenders are expected to grow even more cautious during the second half of the year according to the American Bankers Association's Credit Conditions Index. Borrowers likely have fewer options than they did prior to the pandemic, as the highest fed funds rate in more than a decade has put significant pressure on the average interest rate for loans. Rates for SBA loans (which tend to be lower than rates for bank loans) have jumped above 10%, prompting some Main Street business owners to pause or delay borrowing. This helps to explain why capex plans for the next three to six months were muted in the NFIB's most recent survey (see bottom right chart).

One positive trend is easing inflation. Although recent CPI readings likely look better than they actually are due to favorable year-ago comparisons, it is still true that price growth has slowed compared to last year. The improvements are reflected in recent survey data, which indicate that inflation is no longer the top concern facing small businesses or households.

Job Openings by Firm Size

Thousands, SA



Source: Bureau of Labor Statistics

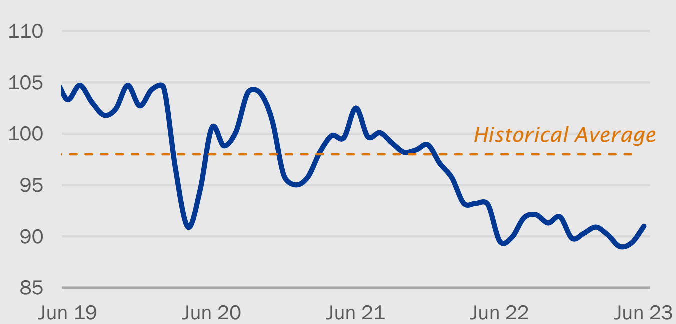
Cooling price pressures may help support consumer spending in the near term. By most measures, spending growth has slowed this year compared to last but remains healthy enough to support Main Street growth — indeed, a big reason why so many small business owners continually cite hiring as their biggest challenge is because they need more workers to keep up with demand. Lower inflation means more purchasing power, and with real wage growth now back in positive territory, a key factor to watch will be whether spending data will continue to hold up.

Still, most small business owners appear to remain wary of near-term economic conditions. NFIB's Small Business Optimism Index points to significant pessimism about the economic outlook (see bottom left chart), and the share of owners who expect real sales growth fell to a net -21%. These responses suggest that Main Street businesses are skeptical that consumer demand will hold up.

Small Business Plans for Capex Dampen; Optimism Remains Subdued

Small Business Optimism Index

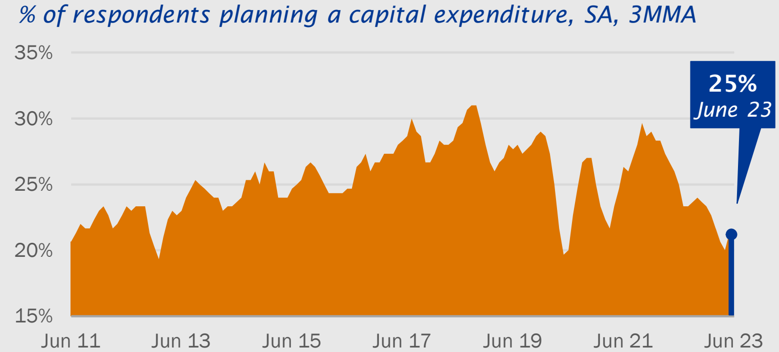
1986 = 100



Source: National Federation of Independent Businesses

Capital Expenditure Plans for Next Three to Six Months

% of respondents planning a capital expenditure, SA, 3MMA



Source: National Federation of Independent Businesses

MLFI-25

NBV softened in early 2023

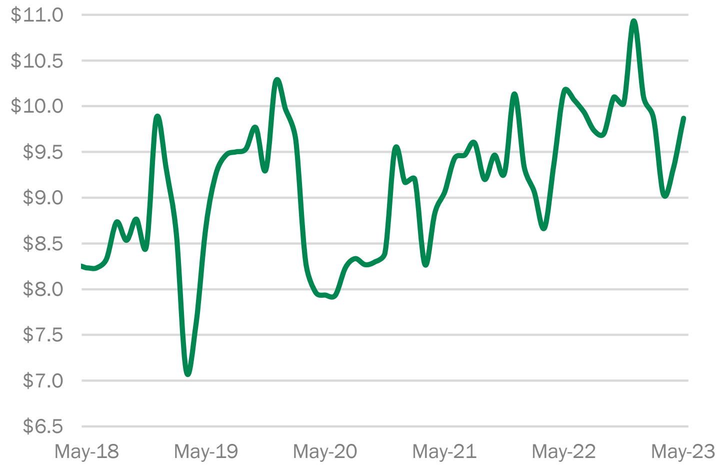
ELFA's Monthly Leasing and Finance Index (MLFI-25) reported new business volume totaled $9.5 billion in May, down 2% from April but up 1% on a Y/Y basis. The 3-month moving average was down 3% Y/Y (see chart).

After showing resilience in early 2023, new business volume growth has softened. High interest rates and tightening lending standards are likely contributing to the sluggishness, and growth is remains negative in real terms.

Separately, portfolio performances appears to be slipping, at least somewhat. Receivables over 30 days were 2.0% in May (up from 1.8% in April and 1.6% a year prior), while charge-offs were 0.33% (unchanged from April but up from 0.12% a year ago). Lagging portfolio performance may partially explain the decline in credit approvals, which fell significantly in May (from 77.3% to 76.4%) and are down Y/Y as well.

MLFI-25 New Business Volume

Billions, 3-month moving average



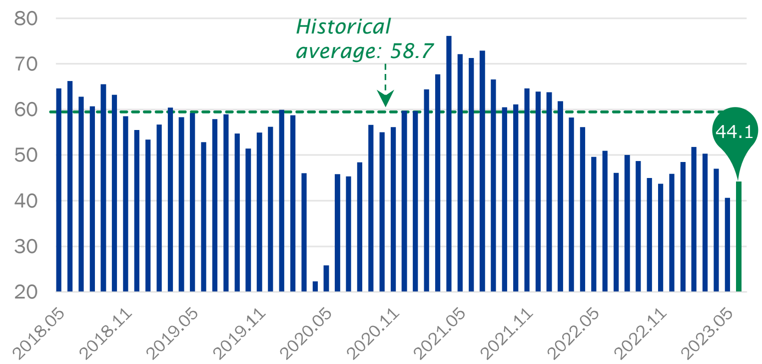
Source: ELFA

> "As the Fed puts a pause on interest rate hikes and the U.S. economy refuses to accede to a recession—at least for the time being—equipment finance companies continue to do what they do best: provide the necessary capital for businesses to grow and prosper. [There is] a sense of heightened optimism [among executives] that the industry will continue to show steady growth, at least in the near term."
>
> **— Ralph Petta, President and CEO, ELFA**

MCI-EFI

Industry confidence bottoms as economy slows

Monthly Confidence Index – Equipment Finance Industry



Source: ELFF

> "The industry is resilient and will weather the liquidity shortage that we are currently in, as well as the looming recession. There are and will continue to be opportunities that exist in this environment, and nimble organizations that are capitalized will be well positioned to grow."
>
> **— David Normandin, President/CEO, Wintrust Specialty Finance**

In June, the Monthly Confidence Index for the Equipment Finance Industry (MCI-EFI) improved to 44.1, up 3.5 points from its May nadir. While the current reading is well below the index's long-term average, the June improvement could suggest that the index has bottomed out after declining for three consecutive months.

- In June, 23% of respondents believed business conditions would worsen over the next four months, a significant improvement from 48% in May. However, just 3% of respondents expected that business conditions would improve.
- Two-thirds of respondents expected no change in demand for leases and loans to fund capex over the next four months (up from 54% in May).
- Plans for hiring weakened further in June. 13% of respondents expected to hire more employees in the next four months, down from 17% in May.
- Most respondents (83%) rated the current economy as "fair," with all other respondents (17%, up from 14%) rating the economy as "poor."

Industrial Focus

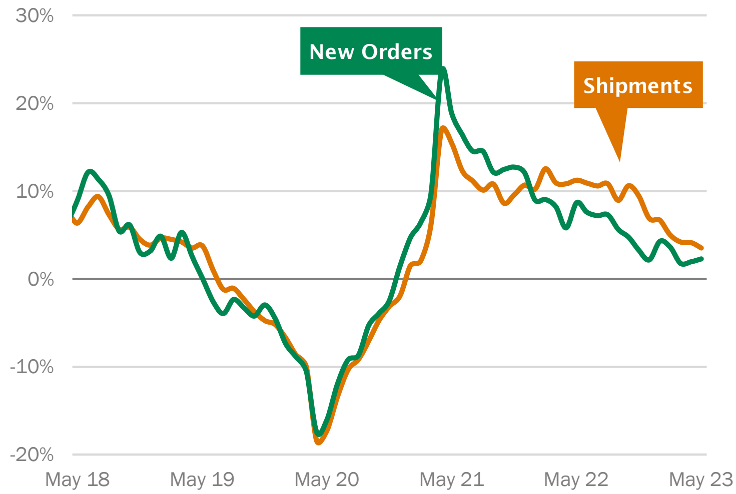
Growth in shipments and new orders slowing

Annual growth in both new orders and shipments of core capital goods has trended downward for roughly two years after spiking in early 2021, though annual growth rates for both measures remain positive (see chart).

- New orders for nondefense, non-aircraft capital goods (a leading indicator of industry performance) increased 0.7% M/M in May, a solid reading. On an annual basis, growth accelerated slightly to 2.3% Y/Y.
- Shipments of nondefense capital goods excluding aircraft (a concurrent indicator of industry performance) improved by 0.3% M/M in May, while annual growth decelerated to 3.5% Y/Y.

A softening economic outlook and higher interest rates are expected to weigh on investment growth further this year, though some equipment verticals should benefit from an influx of federal funding and incentives (see Tailwinds section on page 10).

Shipments vs. New Orders of Core Capital Goods
Year-on-year percent change



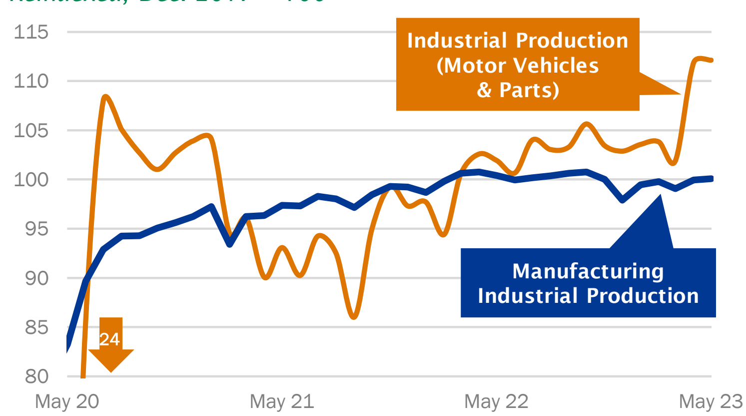
Source: Census Bureau

Manufacturing output holding steady

Manufacturing industrial production ticked up 0.1% in May (see chart).

- After cooling somewhat early this year from its peak in late 2022, manufacturing output has improved slightly.
- Capacity utilization for manufacturing held steady at 78.4% in May. This reading is below last year's average utilization rate of 79.2% but well above 2019 levels and near its peak reading from 2010 – 2020.
- Industrial production for motor vehicles & parts spiked in April and May to its highest level in the history of the series. Pent-up demand for automobiles, supply chain recoveries, and funding from the CHIPS act for EVs are driving growth in the industry.

IP: Total Production vs. Motor Vehicles & Parts
Reindexed, Dec. 2017 = 100



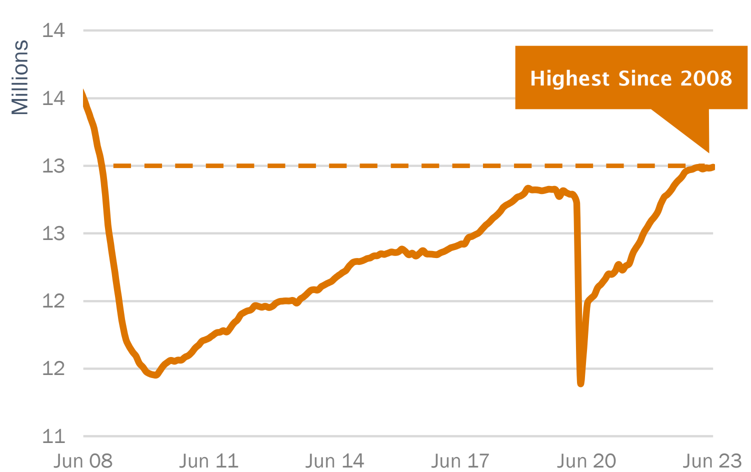
Sources: Federal Reserve Board of Governors; G17 report

Manufacturing hiring resilient amid stress

Manufacturing employment has remained resilient so far this year despite mounting stress, falling sales, and high interest rates. Government data show that manufacturing employment has held at a post-2008 high for several months.

- Though the average workweek for manufacturing employees has shortened (which is often a leading indicator for weakening demand), manufacturers remain hesitant to lay off workers.
- In fact, in June manufacturing employment edged up after decreasing slightly in May. Though hiring growth is modest in 2023, employment levels remain at their highest point in over a decade.
- Recent legislation has helped bolster manufacturing employment and is expected to provide further support in 2023 and beyond.

Manufacturing Payroll Employment
Millions SA



Source: Institute for Supply Management

State of the U.S. Economy

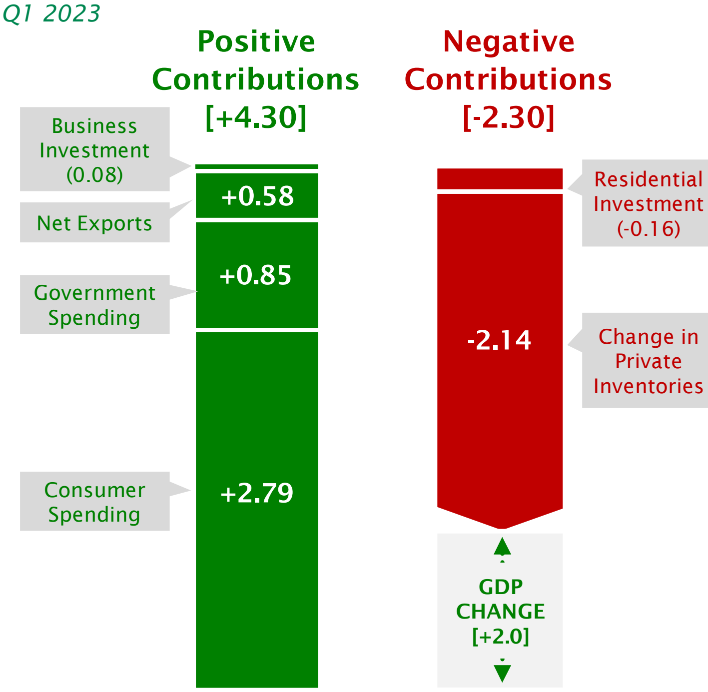
Economy shows steady growth in Q1

Economic growth in the first quarter was stronger than initially estimated, as BEA revised its estimate from 1.3% to 2.0% due to upward revisions to export and spending data. Overall, growth in Q1 was broad-based, fueled by consumer and government spending, net exports, and business investment. Meanwhile, residential investment and private inventories subtracted from growth.

- **Consumer spending**, the economy's largest component, expanded 4.2% (annualized), the strongest growth in nearly two years. Spending on durable goods surged, driven by purchases of motor vehicles and parts.
- **Net exports** made a positive contribution to growth in Q1 as export growth (7.8% annualized) outpaced growth in imports (2.0% annualized).
- **Government spending** grew at its fastest pace in two years, rising 5.0% (annualized).
- **Private inventories** were a large drag on GDP growth, subtracting more than 2 percentage points.
- **Residential investment** eased in Q1, though the decline was the smallest contraction in a year.
- **Equipment and software investment**, a subset of business investment, fell 4.5% (annualized), its first contraction since Q2 2020.

Contributions to GDP Growth

Q1 2023



Source: Bureau of Economic Analysis (BEA)

U.S. economic growth solid against headwinds

The U.S. economy posted solid growth in Q1, with revised estimates revealing surprisingly strong consumer demand despite a turbulent global economy and tightening lending standards. Although GDP faltered during the first half of 2022, U.S. consumers have remained steady throughout the post-pandemic era, a byproduct of a strong labor market.

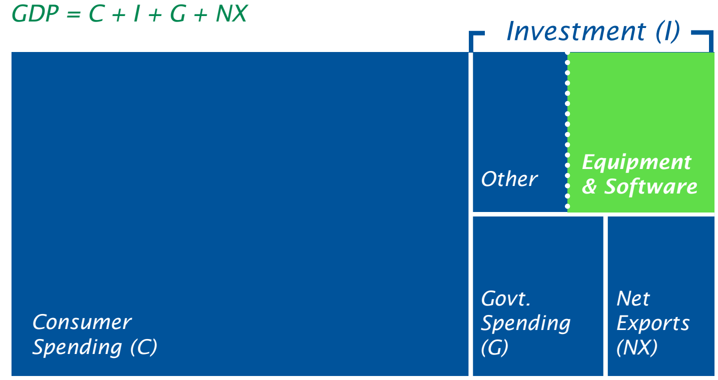
Nevertheless, the near-term horizon remains clouded and various headwinds continue to threaten a recession later this year or early next year. Global economic growth is sputtering, particularly in Europe (where inflation is far worse than here), and China (where government efforts to stimulate a flagging property sector are likely to fall flat).

Without question, the core factor keeping the growth engine turning is the strong labor market. Despite a rapid rise in interest rates, job growth has been robust this year. What's more, with recent improvements to inflation, real wage growth is now positive once again. Indeed, there is some evidence that the Fed may have turned the corner in its fight to tame inflation — though core inflation remains well above target and Keybridge's custom measure is higher still. Elsewhere, a manufacturing construction boom has been a surprise tailwind and should benefit several verticals.

Overall, while the economy is still above water, most indicators suggest that the tide is going out. We continue to expect a recession to begin before the end of the year.

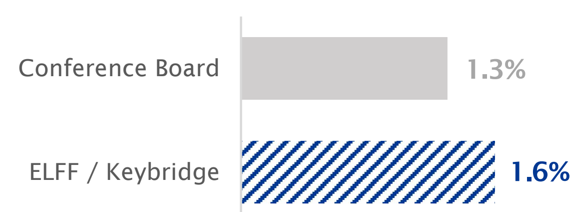
Composition of Gross Domestic Product (GDP)

GDP = C + I + G + NX



Source: Keybridge LLC, based on BEA data

2023 Growth Forecasts*



*Note: Due to BEA's method of calculating annual GDP growth (i.e., the percent change in the average quarterly level of GDP), positive growth earlier in the year (and in Q4 of the previous year) has a larger impact on overall annual GDP growth in the current year. As a result, annual GDP growth can be positive even when a recession is forecasted.

Job Growth Defies Expectations Despite Softening Economy

The U.S. job market remains tight as wage growth moderates.

After more than a year of steady rate increases from the Fed to combat inflation, the labor market remains a key point of strength for the U.S. economy. Through June, employers have already added nearly 1.7 million jobs this year, and the labor force participation rate (LFPR) remains healthy. The headline LFPR has risen modestly this year despite recession worries, and among prime age workers (25-54) the LFPR is at its highest point since 2007.

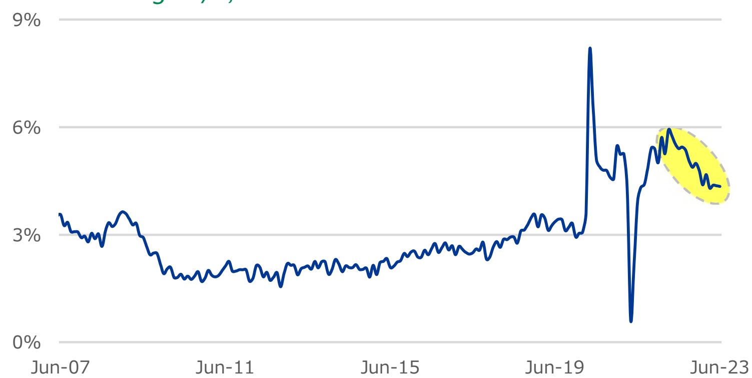
Despite the headline strength of the labor market, there are some areas worth monitoring:

- **Wages**: While wage growth remains solid, this is a double-edged sword: it helps consumers, but complicates the Fed's efforts to battle inflation. During the pandemic, wage growth was not the key driver of inflation, but with supply chain issues mostly resolved and energy prices under control, it is an increasingly important factor now. Over the last year, wage growth has eased steadily, but remains elevated (see chart).
- **Average Work Week**: In response to lower demand, employers have reduced their employees' hours. In May, the average workweek fell to its lowest level since April 2020, and though June saw a slightly improvement, this metric is nearing territory associated with a downturn.

Overall, however, the labor market continues to exceed expectations and fuel consumer spending. Historically, when interest rates rise in response to high inflation, the demand for labor falls, putting downward pressure on wages and job growth. Thus far, the Fed's rate hikes have helped drive down inflation but have left the labor market relatively unscathed, raising hopes that the Fed may be able to achieve its desired "soft landing" and control inflation while avoiding a major labor market downturn.

Average Hourly Earnings

Percent change Y/Y, SA



Source: Bureau of Labor Statistics

Manufacturing Construction Spending Boom

Influx of federal spending boosting EV, battery, and chip-building plants

Non-residential construction spending boomed during the first half of the year, driven by new federal policy priorities enshrined in the Inflation Reduction Act, the CHIPS Act, and the Infrastructure Investment and Jobs Act (IIJA). The spending increase should provide positive momentum for several equipment verticals in the months ahead.

Manufacturing construction spending has been by far the biggest beneficiary of this boom. Since the end of 2021, manufacturing construction spending has more than doubled and shows no signs of slowing (see chart). Spending on computer, electronic, and electrical manufacturing has been the main driver of this manufacturing renaissance as multinational firms race to take advantage of new tax credits for EV, battery, and semiconductor plants. These segments have historically comprised a relatively small share of manufacturing construction, but new legislation (particularly the CHIPS Act) enacted in response to pandemic-related supply shortages and heightened tensions with China have rapidly and dramatically increased their prominence.

Although manufacturing construction is the largest beneficiary of the non-residential construction boom, other industries are also benefitting. For example, spending on public and private infrastructure has increased substantially, and non-residential construction spending is up roughly 25% over the last year overall. Though the nominal value of construction spending is helped along by inflation, even after adjusting for price increases, there are still significant real gains in non-residential construction.

The emergence of this construction boom in an environment of higher interest rates is unusual but demonstrates that federal policy priorities can spur private sector investment. Most indicators suggest that the sure in non-residential construction is likely to continue.

Total Manufacturing Construction Spending

Million $ SAAR

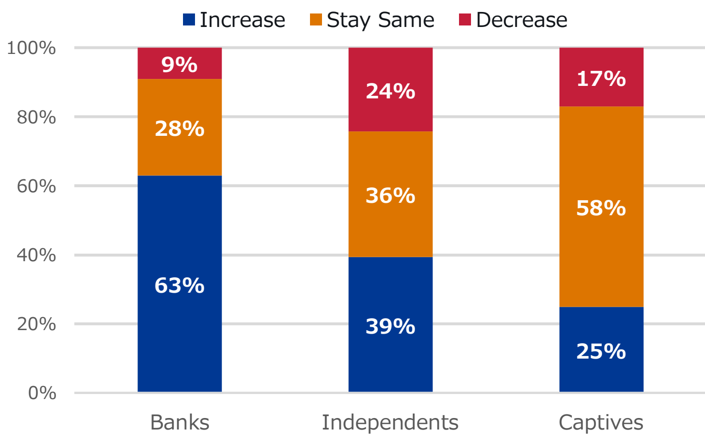
Source: U.S. Census Bureau

Credit Crunch

High interest rates, banking turmoil expected to pressure spreads and increase stress

The combination of rising interest rates and a slowing economy (particularly in the tech sector) led to heightened balance sheet pressure at several prominent regional banks this spring, resulting in several high-profile bank failures. While the government response was sufficient to contain the near-term threat of contagion (at least for now), the episode is expected to result in tighter lending standards at many banks, particularly smaller and mid-sized banks.

"Our Spreads Are Expected to…"
Respondents to ELFF's April Liquidity Survey



Source: ELFF Impact of Bank Liquidity on the Equipment Finance Industry Survey

The effects of lenders tightening their belts is likely to have broad-based effects on the U.S. economy. For example, according to the American Bankers Association's *Credit Conditions Index*, credit availability and quality will worsen for both consumers and business in the next six months as economic conditions worsen and lenders pull back. Among the expected impacts:

- The industry-specific effect of reduced bank liquidity depends on the type of firm, as highlighted by a recent Foundation survey. Banks are more likely to benefit from tightening credit conditions, as their cost of capital is somewhat lower and their ability to pass on higher interest costs is somewhat greater than that of other lender types. In contrast, 60% of independents expect their spreads to narrow or stay the same, and one-quarter anticipate a decline.
- Financing will become more costly across the board, putting downward pressure on new business volumes and overall equipment investment.
- While some equipment finance firms may benefit from the tighter credit environment, the effect on consumers will be generally negative. Recent buildup in credit card debt, especially among younger borrowers, will lead to rising financial stress in the months ahead.

Overall, the credit crunch that is already underway will drag on growth this year. Lenders may consider reading ELFF's Summer 2022 JELF issue that explores what higher interest rates mean for the equipment finance industry.

Global Economic Slowdown

U.S. economy bucking the trend of weakening growth

While the U.S. economy has been remarkably resilient thus far in 2023, the same cannot be said for other major economics around the world. Global growth is slowing due to many of the same factors that have plagued the U.S. economy over the last few months.

In Europe, the German economy saw consecutive quarters of negative GDP growth in Q4 2022 and Q1 2023. The German central bank acknowledged that this decline in activity was in fact a recession, a development triggered by sharp increases in food and energy prices that pressured households and businesses alike. Though growth may have rebounded modestly in Q2, the largest economy in Europe is expected to limp through the rest of the year.

Elsewhere, China's economy — which briefly boomed after the lifting of draconian COVID restrictions late last year — has hit the skids once again. Warning signs for near-term growth prospects abound, from flagging retail sales to weakening industrial output to a cooling housing market. In response, the Chinese government is pushing through more stimulus measures, including increased infrastructure spending and looser rules for personal property investors. These stimulus measures harken back to an era when China was less indebted, had a younger population, and had a more cooperative relationship with other global economies. All told, these measures are likely to give a temporary boost to growth, at best. More likely will be a build up of pressure in the Chinese construction sector in particular, a sector that is already under intense pressure (see chart).

Residential Floor Space Under Construction, China
% change YTD

Source: China National Bureau of Statistics

Have We Turned the Corner on Inflation?

Headline inflation has eased, but core inflation remains stubbornly elevated

Headline inflation softened significantly in the first half of 2023, easing to 3.0% Y/Y in June (see chart). Goods prices drove much of the decline as energy prices cooled and supply chains normalized. Thus far, the Fed's efforts to tame inflation have been largely successful.

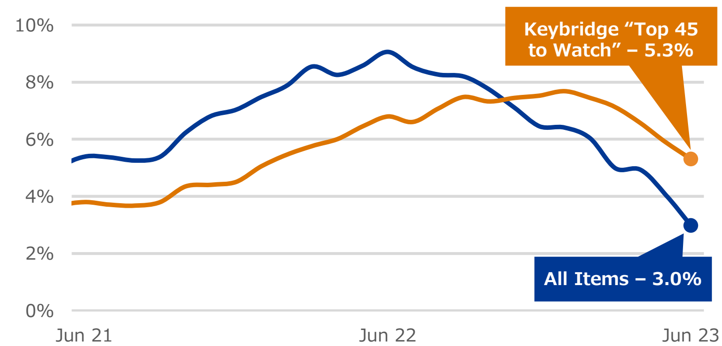
However, despite encouraging readings in recent months, core inflation is still well above the Fed's target rate. This is partially due to the tight labor market: wage growth for nonsupervisory employees is holding above 4%, and while this is good news for most consumers, it complicates the Fed's task of achieving its 2% target.

Meanwhile, there are indications that recent improvements in inflation could be short-lived. Keybridge's "Top 45 to Watch" inflation metric, which is designed to capture trends in underlying structural inflation, is currently running nearly two percentage points above headline CPI (see chart). This indicates that price pressures, particularly in the service sector, may be more firmly entrenched in the economy than the headline measure suggests. We expect headline inflation to climb back to around 4.0% later this year, triggering more tightening from the Fed.

All told, the Fed's efforts and a cooling global economy have brought inflation down to a healthier level, but Keybridge's preferred inflation metric suggests that there is significantly more work to do. Falling shelter prices should help, but additional rate increases this year will likely be necessary.

Change in Consumer Prices by Category

Year-over-year % change, monthly



Source: BLS, Keybridge Analysis*

* Keybridge has analyzed monthly data from the Bureau of Labor Statistics and selected from 70+ components of the Consumer Price Index for a "Top Series to Watch" based on which goods and services are indicative of longer-term inflation (e.g., electricity, food away from home, pet care).

Could the Housing Market Soon Provide a Tailwind?

New sales and construction showing life

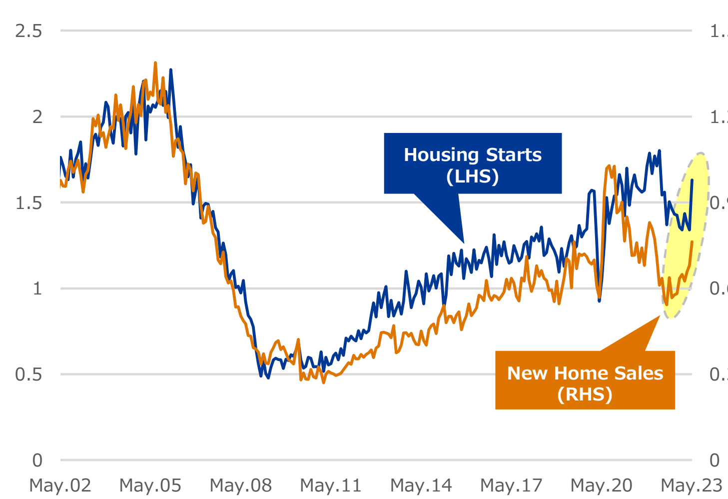
The housing market has been a significant drag on U.S. economic growth for the last two years. After peaking in early 2021, residential investment contracted sharply as the Fed raised interest rates. Earlier this year the housing market was still in rough shape: mortgage rates were north of 7% and demand for housing was subdued. Even worse, prices in many major markets refused to budge because of supply constraints: active listings were holding near historic lows, while single-family housing starts were 20% below pre-pandemic levels. In short, both supply and demand were subdued, prices were high, and with additional rate increases on the horizon, there was little reason for optimism that a turnaround was imminent.

However, over the last 3-6 months a new housing paradigm may have emerged. First, the housing industry is growing more confident: the NAHB/Wells Fargo Housing Market Index — which measures homebuilder sentiment and is a leading indicator of new housing construction — has increased every month this year and reached a 12-month high in June. Second, the uptick in builder confidence aligns with a recent surge in both housing starts and new home sales (see chart). Though these measures remain below their pandemic-era highs, the improvement is noteworthy given that interest rates and the cost of raw building materials and construction labor remain elevated.

To be clear, the housing recovery is in its early stages and is not yet reflected in sales of previously occupied homes (which comprise more than 80% of total home sales, as opposed to newly constructed homes). Time will tell if the housing market recovery will sustain itself, particularly if inflation proves stickier than hoped and the Fed raises rates later this year. Still, recent signs are encouraging.

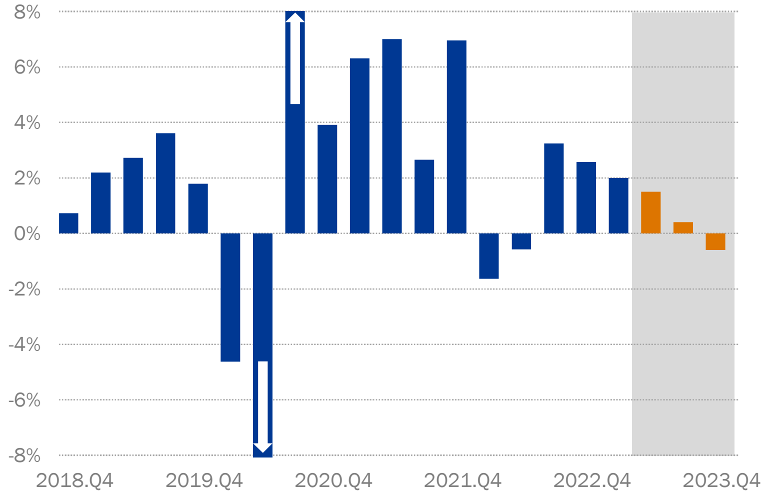
Housing Starts *(left axis)* & New Home Sales *(right axis)*

Millions SAAR



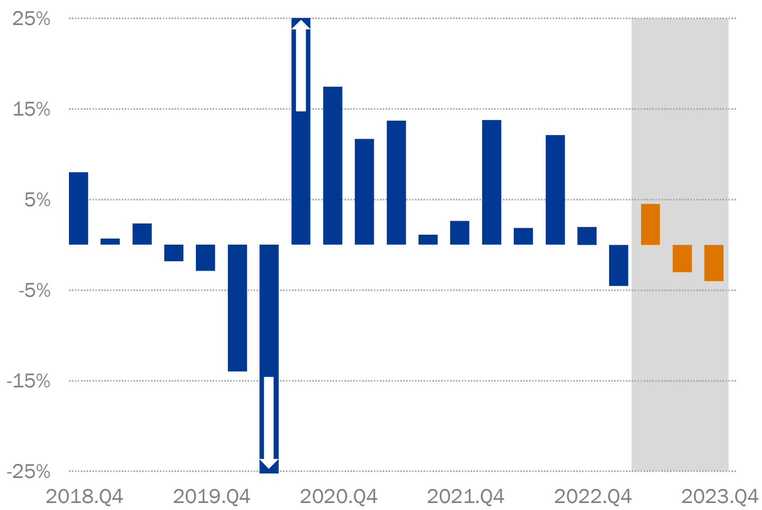
Source: Census Bureau

Real GDP Growth (% SAAR)



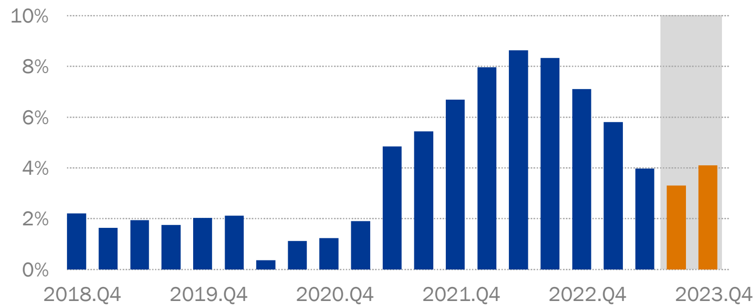
Source: Bureau of Economic Analysis; Keybridge LLC

Real E&S Investment Growth (% SAAR)



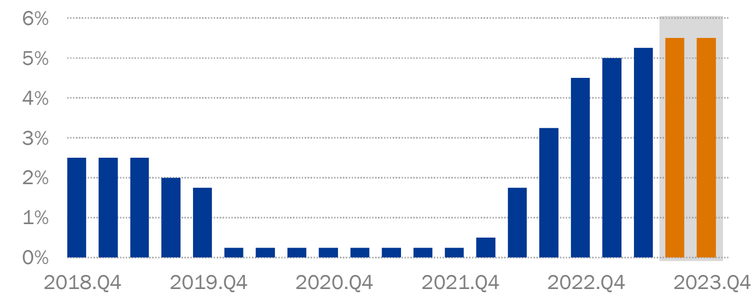
Source: Bureau of Economic Analysis; Keybridge LLC

CPI Inflation (year-on-year %)



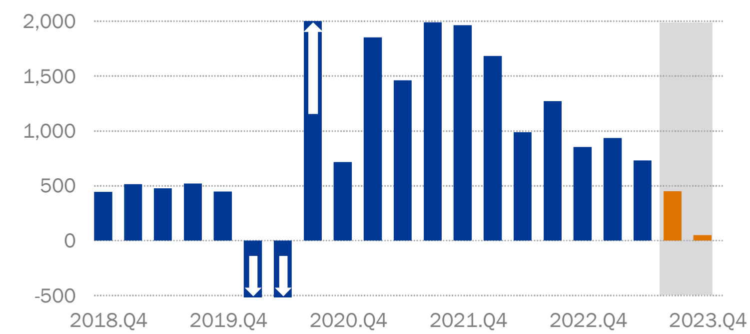
Source: Bureau of Labor Statistics; Keybridge LLC

Fed Funds Target (upper bound, end of period)



Source: Federal Reserve Board of Governors; Keybridge LLC

Total Payroll Growth (thousands)



Source: Bureau of Labor Statistics; Keybridge LLC

INDICATOR	2021	2022	2023 QUARTERLY ESTIMATES				2023e
			Q1	Q2e	Q3e	Q4e	
Real GDP* *(SAAR %)*	*5.9%*	**2.1%**	2.0%	1.5%	0.4%	-0.6%	**1.6%**
Real Investment in Equipment & Software *(SAAR %)*	*11.1%*	**6.8%**	-4.5%	4.5%	-3.0%	-4.0%	**0.9%**
Inflation *(year-on-year %)*	*4.7%*	**8.0%**	5.8%	4.0%	3.3%	4.1%	**4.3%**
Federal Funds Target Rate *(upper bound, end of period)*	*0.25%*	**4.50%**	5.00%	5.25%	5.50%	5.50%	**5.50%**
Total Payroll Growth *(thousands)*	*7,267*	**4,793**	937	732	450	50	**2,169**

*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' ("BEA") standard method for reporting growth in the national accounts data. The BEA defines annual GDP growth as the % change in the average level of quarterly GDP from one year to the next. Some organizations (including the Federal Reserve) report GDP growth on a Q4/Q4 basis, which can result in differing reported growth rates.

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 ~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 15 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 Y/Y investment growth may slow over the next two quarters. Verticals in the bottom-right quadrant, however, have momentum readings that are below average, but recent movement shows promise — suggesting that Y/Y investment growth may increase over the next two quarters.