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On the Rise: How Inflationary Pressures and Rising Interest Rates Could Impact the Equipment Finance Industry

By Jeff Jensen, Elizabeth Rust, and Serena Mackool

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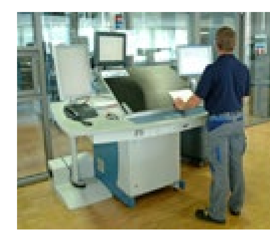
The Business Guide to Improving Information Security

By Joseph Granneman

The continuing increase in large-scale cybersecurity breaches has businesses searching for solutions to reduce their risk. Despite an explosion of new information security products and services, no single tool can reduce risk. Equipment financing companies must build a formal information security framework, complete with policies and procedures.



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Inflation, Interest Rates, and Equipment Finance: Anticipating and Adapting to a Changing Economic Environment

By Jeff Jensen, Elizabeth Rust, and Serena Mackool

Over the last decade, the equipment finance industry and the U.S. economy have operated in a climate of low interest rates and low inflation. How will the industry respond in the face of rising interest rates and inflationary pressures? Here are three scenarios, with ideas on how industry leaders might adjust their business operations in response.

After an extended period of decent growth, low inflation, and low interest rates, the economic environment is changing. As of August 2018, unemployment is historically low at 3.9%; job growth remains strong, averaging 185,000 jobs per month for June through August; and economic growth is accelerating, estimated at 4.2% in the second quarter of 2018.

At the same time, some economists worry that the combination of rising aggregate demand, a years-long buildup of "easy money," and rapidly rising deficits could send inflation on a tear. If these worries prove correct, the Federal Reserve may raise interest rates faster than the market currently expects in order to combat inflation. If so, it is unclear whether businesses and consumers are adequately prepared.

This article explains how a world of rising inflation and interest rates may affect the equipment finance industry, including customer demand, portfolio performance, spreads, and the propensity to finance. It explores three distinct scenarios for inflation and interest rates over the next one to three years, describes the likely and potential scenario-specific ramifications, and provides insights into ways industry leaders could consider adjusting their business operations in response.

For a more detailed examination of the topic, please refer to the Equipment Leasing & Finance Foundation's new study developed by Keybridge LLC titled "On the Rise: How Inflationary Pressures and Rising Interest Rates Could Impact the Equipment Finance Industry."

LIKELY SCENARIOS FOR INFLATION AND INTEREST RATES

The potential for near-term inflation is rising. As the current business cycle matures and wage and inflation pressures build, the Fed is likely to push ahead with its plans to normalize interest rates. However, while most economists agree that the current environment of ultralow interest rates and inflation is unlikely to persist, there are multiple scenarios for inflation and interest rate levels that could conceivably develop.

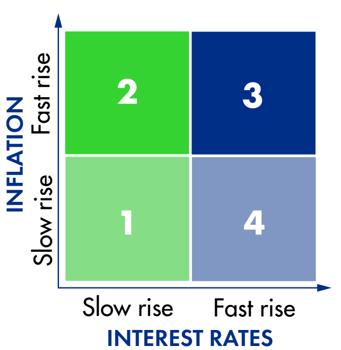
Each scenario is likely to affect the equipment finance industry differently and will consequently require a different firm-level response. These scenarios revolve around (1) the pace at which interest rates and inflation rise and (2) the way in which these two measures move in relation to one other (i.e., whether inflation outpaces nominal interest rates and drives the real interest rate — that is, the nominal interest rate adjusted for inflation — downward, or vice versa).

This point can be illustrated using a matrix that describes four different environments for rising interest rates and inflation (Fig. 1). The matrix's x-axis represents the pace of interest-rate hikes, ranging from little to no acceleration on the left (e.g., 25 to 50 basis points per year) to fast acceleration on the right (e.g., 125+ basis

Editor's note: This article is based on a Foundation research report titled On the Rise: How Inflationary Pressures and Rising Interest Rates Could Impact the Equipment Finance Industry, *published in June 2018. It is available at www.leasefoundation.org.*

Alternatively, the Fed may correctly interpret evidence of a buildup in inflationary pressures but decide to raise interest rates faster than inflation for other reasons, such as a desire to normalize interest rates.

Figure 1. Four Different Environments



points per year). The y-axis represents the pace at which inflation accelerates, ranging from a theoretically slow, gradual increase on the bottom to rapid increases at the top.

Together, the relative speed of interest rate and inflation increases creates four different market environments, each represented by a numbered quadrant in the matrix.

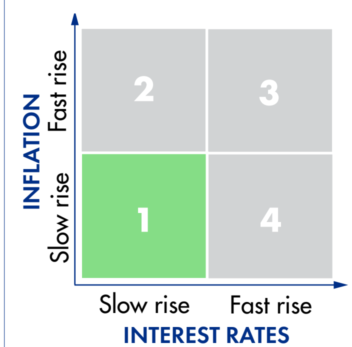
- **Quadrant 1** represents an environment of slow increases in both inflation and interest rates. Although inflation and interest rates may rise, they do so gradually and predictably. This quadrant should feel familiar to the industry, as it corresponds to the state of the U.S. economy over the last three years.
- **Quadrant 2** represents an environment where inflation begins to accelerate rapidly, but nominal interest rates do not rise quickly enough to keep inflation in check. Here, an unexpected surge of inflation — caused by mounting wage growth, an oil price shock, or other factors — either occurs so quickly that it takes the Fed and the market by surprise, or the Fed intentionally adopts a dovish posture and delays action to avoid harming the labor market.
- **Quadrant 3** represents an environment of rapidly mounting inflation combined with fast increases in nominal interest rates. In this environment, inflationary pressures remain strong, but an aggressive response from the Fed and proportionate market reaction results in interest rates rising quickly in an effort to prevent inflation from accelerating further.
- **Quadrant 4** represents an environment in which nominal interest rates rise more rapidly than inflation. This situation often arises due to a mistiming or misstep on the part of the Fed, which anticipates breakout inflation and raises interest rates to preempt the acceleration. Alternatively, the Fed may correctly interpret evidence of a buildup in inflationary pressures but decide to raise interest rates faster than inflation for other reasons, such as a desire to normalize interest rates to allow for more policy flexibility during the next economic downturn.

It remains reasonably likely that a shift from quadrant 1 (where the U.S. economy has stood for the last three years) to another quadrant will occur in the next one to three years. Three potential scenarios are described below.

Scenario 1: Status Quo

The first potential scenario for interest rates and inflation is a continuation of the status quo, with the U.S. economy remaining firmly in quadrant 1 of the matrix (Fig. 2). Although inflation and interest rates may rise, they would do so gradually and predictably.

Figure 2. Scenario 1: Status Quo



This scenario is the likeliest outcome if U.S. gross domestic product reverts to a modest or moderate pace in the next six to 12 months (i.e., 1.5% to 2.5%). If this scenario materializes, wage pressures are likely to remain muted despite a generally healthy labor market, as (1) slower revenue growth would cause businesses to be more cautious about raising wages, and (2) stagnant labor productivity growth would hinder employee efforts to command higher salaries. As a result, the Fed would have little rationale to raise interest rates more than once or twice per year (i.e., 25 to 50 basis points).

This scenario should feel the most familiar to equipment finance professionals, as the same trends that have characterized inflation and interest rates over the last several years would likely continue, including weak investment demand, favorable lease-versus-buy conditions, and an ambiguous (though likely marginal) effect on spreads.

Scenario 2: Breakout Inflation Prompts Strong Fed Response

Under this second scenario, the U.S. economy would initially slide up into quadrant 2 of the interest rate-inflation matrix, where an acceleration in inflation outpaces interest rates (Fig. 3). However, a rapid response from the Fed and corresponding reaction in the credit markets would quickly pull the economy over into quadrant 3.

In other words, a sudden, unanticipated surge in inflation prompts the Fed to accelerate its rate hike schedule, leading to

Figure 3. Scenario 2: Sudden Surge in Inflation

five or more nominal interest rate increases (125+ basis points) per year. The real interest rate would fall initially, but, as nominal interest rates rise to catch up to rapid inflation increases, it would soon return to more familiar levels.

This scenario would likely arise due to some combination of tighter labor markets, rising energy prices, and rising inflation expectations.

Scenario 2 entails the U.S. economy passing through two separate market environments: first, moving briefly through quadrant 2 as inflation accelerates, and then shifting quickly into quadrant 3 after the Fed responds. Each quadrant would likely present distinct effects on the equipment finance industry.

While in quadrant 2, the industry would be likely to experience rising labor costs, a decline in the real value of loan and lease payments, and higher residual values (which may have implications for leases that have end-of-term purchasing options).

As the economy moves into quadrant 3, the industry should expect to experience increased demand for investment, increased customer demand for longer-term and fixed-rate leases, added complexity in loan and lease valuation and negotiation, and a decline in portfolio values.

Scenario 3: Interest Rates Rise Faster Than Inflation Justifies

Under this third scenario, the U.S. economy moves directly from quadrant 1 to quadrant 4 (Fig. 4). In this scenario, the Fed would move forward with raising interest rates at a moderate or even accelerated pace, despite a weak inflationary environment. Depending on the speed and duration of the rate hikes, the U.S. economy would likely slow and could contract.

Even though inflationary pressures appear to be building, this scenario could nonetheless arise, given that (1) the Fed has committed to a policy of interest rate normalization in the interests of "reloading" for the next recession, even if inflation remains subdued; (2) unwinding the Fed's policy of quantitative easing may exert stronger-than-expected upward pressure on bond yields, which could drive interest rates higher even in the absence of inflation; and (3) the Fed is likely to take a more hawkish approach to monetary policy under the leadership of Jerome Powell than it pursued under Janet Yellen.

Figure 4. Scenario 3: Rising Rates and Weak Inflation

A pronounced rise in interest rates in an environment of relatively muted inflationary pressures poses different implications for the equipment finance industry from the other two scenarios. The effects are likely to include compressed spreads, deteriorating portfolio performance, and falling demand for equipment investment.

WHAT EACH SCENARIO MEANS AND HOW LEASING FIRMS CAN ADAPT

The most successful equipment finance firms are able to adjust their business strategies and operations in anticipation of and response to changing macroeconomic conditions, and the prospect of increasing inflation and/or interest rates is no exception.

The Keybridge–Foundation report offers several concrete actions that individual firms should consider under each scenario, and some of these recommendations are presented in tables 1, 2, and 3. These actions are not intended to be exhaustive, nor are they likely sufficient to ensure profitability if inflation and/or interest rates rise.

As always, industry leaders are best positioned to know how to successfully manage their own businesses. However, these recommendations provide a starting point for industry firms to consider how to adjust their business strategies and should spur additional ideas for discussion in strategic planning sessions.

> The most successful equipment finance firms are able to adjust their business strategies and operations in anticipation of and response to changing macroeconomic conditions.

In addition to reviewing the full report, equipment finance professionals are also encouraged to consult with the Foundation–Keybridge *Applied Economics Handbook*, first published in 2016 and updated in summer 2018. It offers tips for how equipment finance firms can make better business decisions by incorporating economic data into their strategies and tactics.

For a complete list of firm-specific actions to consider

Table 1. Firm-Specific Actions to Consider Under Scenario 1: Status Quo

Anticipated industry effects	Firm-specific actions to consider
Ambiguous effect on spreads	**Consider shifting toward a borrow-long, lend-short mind-set.** Gradually rising interest rates could allow some leasing firms to operate on a longer time horizon and increase profitability by borrowing long and lending short. While a more traditional matched-funds approach is generally associated with lower risk, a borrow-long strategy may be viable for some firms, particularly given that portfolio performance would likely remain strong. This approach may not be appropriate for all lenders, but it is something to consider if the status quo operating environment persists.
Weak investment demand	**Achieving new business volume targets could require a higher tolerance for risk.** Relatively weak demand for equipment investment means that the number of equipment leasing opportunities grows more slowly or potentially stagnates. As a result, equipment lessors should expect to see a continuation of strong industry competition as firms vie for market share. To meet new business volume targets, some firms may need to accept a higher tolerance for risk and/or thinner profit margins. Company forecasts for new business volume growth may need to be revised downward. Senior leadership should discuss the implications on firm operations in quarterly and annual planning discussions.

Table 2. Firm-Specific Actions to Consider Under Scenario 2: Breakout Inflation Prompts Strong Fed Response

Anticipated industry effects	Firm-specific actions to consider
Decline in real value of loan and lease repayments	**Include inflation hedges in loan and lease terms.** Declines in the net present value of a lease or loan due to rising inflation will be exacerbated for deals with fixed rates and long terms. Leasing firms should consider pursuing variable rate agreements or including excise payment provisions to offset the risk of higher-than-expected inflation. Firms may also hedge against inflation risk by adopting shorter terms.
Increased complexity in loan/lease valuation and negotiation	**Incorporate a rate lock fee or related provision to offset risk of interest rate increases during negotiations.** Every capital investment that a business undertakes involves making explicit or implicit assumptions about the level of inflation and interest rates that will prevail over the investment's life. In a rapidly rising interest rate environment, interest rates may rise substantially during the lock period (e.g., 90 days). To protect against this increased risk, leasing firms should consider charging a fee for the rate lock, shortening the rate-lock period, indexing the offered rate to LIBOR, or requiring a higher margin on rate-locked transactions.

Table 3. Firm-Specific Actions to Consider Under Scenario 3: Aggressive Fed Action While Inflation Lags

Anticipated industry effects	Firm-specific actions to consider
Compressed spreads	**A borrow-long, lend-short strategy could increase profitability, but timing is critical.** Some leasing firms could gain a competitive edge by borrowing long and lending short, as short-term interest rates will likely rise faster than long-term rates. However, such a strategy would carry more risk, as an overly aggressive Fed could trigger an economic downturn that would presumably lead to a rapid reduction in the federal funds rate once it becomes apparent that the Fed acted inappropriately. As such, the success of a borrow-long strategy will depend on a lessor's ability to time interest-rate movements correctly.
Deteriorating portfolio performance	**Prepare to tighten lending standards as delinquencies and defaults rise.** Interest rates rising faster than economic conditions warrant will result in many firms struggling to make their loan and lease payments. Lenders and lessors should closely monitor their delinquency and default rates, particularly for more recent deals that have higher interest rates. Firms should consider imposing more stringent loan and lease approval requirements to avoid being overextended in the event of an economic downturn.
Falling demand for investment	**Lower expectations for new business volume growth.** If the Fed raises rates too quickly, it will likely deter capital expenditures, particularly among small businesses. Equipment lessors and lenders should prepare themselves for the possibility that investment demand could slump suddenly, despite relatively strong growth in recent quarters. If this scenario appears to be unfolding, firms should hold more frequent strategic planning meetings, closely monitor internal performance metrics, and consider reducing their risk tolerance (at least temporarily) to avoid becoming overextended in the event of a recession.

under each scenario, read the full report.

CONCLUSION

Every capital investment that a business undertakes involves making explicit or implicit assumptions about the level of inflation and interest rates that will prevail over the investment's life. If these assumptions turn out to be wrong, certain types of investments could be at risk and business performance could suffer. As such, understanding the key drivers of inflation and interest rates and how they affect the economy is a critical part of making sound business decisions.

Over the last decade, the equipment finance industry and the U.S. economy have been operating in a low-interest-rate and low-inflation setting. Although this environment has contributed to increased competition within the industry, it has also provided a relatively stable climate for investment in equipment and software. Equipment finance firms have become accustomed to this low-rate environment, and many may be ill-prepared for the possibility of a more rapid rise in inflation and interest rates in the near future.

However, change is in the air, and uncertainty abounds. The industry is sure to face new challenges and opportunities in the years ahead, and a key factor to watch will be how it responds in the face of rising interest rates and inflationary pressures. The new report produced by Keybridge and the Foundation is designed to help industry leaders understand the risks and opportunities presented by increasing inflationary pressures and rising interest rates.

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