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Higher Inflation, Rising Interest Rates Mean New Challenges and Opportunities for the Equipment Finance Industry

With the recent spike in inflation, some key trends should be of interest to equipment finance professionals. Expect the Federal Reserve to continue to raise rates, and expect some end-user markets to see reductions in demand. However, we expect to see industry firms continue their streak of innovation even as they contend with structural changes during these uncertain times.

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By Robert Wescott, PhD, Desmond Dahlberg, and Julie Coen

For the past couple of decades inflation has been well anchored, interest rates have been historically low, and the equipment finance industry has operated in a generally stable business environment. Lenders have been able to focus on dealmaking and customer management while enjoying relatively predictable pricing patterns and comfortable access to credit.

Further, steady gains in construction and capital spending, investment in new technologies, and strong consumer spending have produced healthy opportunities for business growth since the Great Recession. Recently, however, inflation has spiked, and the Federal Reserve has launched a campaign to significantly tighten monetary policy to contain inflation. These developments will bring rougher waters for the equipment finance industry to navigate.

However, the equipment finance industry is resilient and highly entrepreneurial. It has proven it can adapt to and thrive in varying business conditions—including recessions, periods of high unemployment, and even a global pandemic. The equipment finance industry should be able to handle higher inflation and interest rates if industry leaders carefully prepare for coming changes and adapt their businesses accordingly.

Four key findings of this article are that:

1. Inflation is likely to be higher for longer than many market-watchers expect.
2. The Federal Reserve will be forced to raise interest rates higher and more quickly than financial markets are currently forecasting.

Although the rate of inflation was higher in the late 1970s and early 1980s, it is worth noting that the acceleration in the rate of CPI inflation experienced over the past couple of years has been faster than any period since the late 1940s, in the immediate aftermath of World War II.

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3. Certain end-user markets—including residential construction and automobiles—will suffer comparatively larger reductions in demand due to higher interest rates.
4. There are a number of opportunities for equipment finance firms to continue their streak of innovation during these uncertain times.

SOURCES OF RISING INFLATION

The sharp rise in inflation, from roughly 2% before the pandemic to more than 8% today, reflects a profound increase in prices. Although the rate of inflation was higher in the late 1970s and early 1980s, it is worth noting that the *acceleration* in the rate of consumer price index (CPI) inflation experienced over the past couple of years has been faster than any period since the late 1940s, in the immediate aftermath of World War II.

Economists have several theories about the sources of inflation. A core theory is that inflation accelerates when aggregate demand exceeds aggregate supply—or in layman's terms, when the economy overheats. This theory is based on the view that if consumers and businesses want to purchase more goods and services than the economy can produce, prices will be bid up to temper demand, stimulate supply, and thereby reconcile the discrepancy.

Another popular theory sees *cost-push* as a source of inflation. If one major industrial sector, like energy, experiences a price shock, it can drive up inflation across the whole economy and lead to price increases in seemingly unrelated sectors. Many economists would cite the oil price surges in the 1970s, including spikes caused by oil embargos, as a key source of high inflation during that period, for example.

A third theory sees a critical link between *wages and prices,* whereby rising inflation can stoke worker demands for higher wages, which then can become embedded in future business costs and thus future price increases. The fact that wages represent about 70% of business costs across the U.S. economy means that many businesses may feel compelled to raise their prices if the wages they pay their workers are steadily increasing.

Yet another theory of inflation arises from *monetary economics,* which sees a strong link between the money supply and inflation. In this view, excessive "printing of money" by the Fed will ultimately lead to higher prices because there are more dollars chasing a fixed amount of goods and services.

Finally, economists see several other factors that could amplify inflationary pressures. The loss of access to cheap goods from an external source, like China, could worsen inflation. A massive shift in consumer demand, from, say,

Virtually every theoretical source of inflationary pressure has been signaling higher inflation over the past couple of years. The root cause was the massive shock from the global pandemic, but other factors include Russia's invasion of Ukraine and the ensuing spike in energy prices.

services to goods because of a global pandemic could cause an unexpected surge in goods prices. And supply-chain disruptions, caused, say, by factory shutdowns would also be expected to boost inflation.

Unfortunately, virtually every one of these theoretical sources of inflationary pressure has been signaling higher inflation over the past couple of years. The root cause was the massive shock from the global pandemic, but other factors have been important also, including Russia's invasion of Ukraine and the ensuing spike in energy prices, along with the rising cost of labor in China, which has removed a key source of disinflation from global markets.

Highly Stimulative Fiscal Policy

A key inflationary driver has been the public policy response to global shutdowns and the spike in the U.S. unemployment rate, which jumped to roughly 15% almost overnight when Covid hit. The size and scope of the support and stimulus measures enacted during the pandemic, at about $6 trillion, were unprecedented and exceeded even the scale of fiscal injection (as a share of GDP) that the U.S. economy experienced in 1942 as it shifted to a wartime footing in the first year of World War II.

Pandemic programs included three rounds of stimulus checks to most American households, expanded unemployment insurance programs that in some cases replaced more than 100% of a worker's prepandemic earnings, and generous child tax credits that were distributed monthly to mostfamilies.

A critical fiscal component was the Paycheck Protection Program (PPP), a lending program designed to keep workers on payrolls even while their employers suffered from pandemic-related revenue declines. PPP loans were 100% forgivable if basic stipulations were observed, and ultimately about $800 billion was disbursed across the life of the PPP—roughly 4% of GDP.

The combination of suppressed consumer spending early in the pandemic and increased incomes put large amounts of spending power in the pockets of U.S. consumers. According to our calculations, even now, in early summer 2022, households retain about $2 trillion of "dry powder": spending power that continues to boost aggregate demand well ahead of increases in aggregate supply.

Monetary Stimulus

The Federal Reserve was also instrumental in providing support during the pandemic. The Fed started by cutting its policy interest rate to zero and launching several new lending programs. However, the Fed's most significant action was its quantitative easing (QE) program, which entailed large-scale purchase of financial assets to tamp down long-term interest rates. The purchases included U.S. government bonds, mortgage-backed securities, and even corporate bonds.

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Rolling shutdowns of key industrial cities and major ports in China suggest that shortages of key materials and products will continue. These factors are likely to remain headwinds for inflation over the rest of 2022 and perhaps well into 2023.

The Fed's balance sheet ultimately expanded from $4.2 trillion in February 2020 to roughly $9 trillion in April 2022, a sharp run-up that easily exceeded the three rounds of QE following the Global Financial Crisis in the late 2000s and early 2010s.

Higher Energy Prices and Other Cost-Push Pressures

Energy prices had begun trending upward over the course of 2021 as global travel started to rebound, but oil prices jumped from the $70 to $80 range before Russia invaded Ukraine to the $110 to $130 range once hostilities commenced. Higher energy costs quickly become embedded in domestic transportation fees, especially for jet and diesel fuel.

A related issue is rapidly rising grain and food prices brought about by the looming loss of the roughly 30% of global wheat exports that originate in Russia and Ukraine. At the same time, China locked down millions of its citizens and shuttered whole cities because of virus outbreaks.

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Wage-Price Dynamics

As the economy recovered after the initial wave of the pandemic, the U.S. labor market not only healed but boomed, leading to what many now call the "Great Resignation." By April 2022, there were 1.9 job openings for each unemployed worker in the United States—the highest number since the U.S. government began collecting this data 70 years ago. Small businesses have been particularly pinched, with 47% of U.S. small businesses currently reporting job openings they cannot fill. The resulting competition for workers has pushed up wages.

Indeed, in the first four months of 2022, hourly earnings growth for production and nonsupervisory workers averaged 6.6%, the fastest four-month growth rate since the early 1980s. Wage gains have been most pronounced among job classifications that historically have experienced the lowest average wage rates, including leisure and hospitality workers and retail trade workers, according to the Bureau of Labor Statistics (BLS) (Figure 1).

A policy challenge for the Fed is that once wage gains start to accelerate, they are not easily moderated. Even if wage growth slows, higher labor costs can become embedded into prices, especially in the service sector.

Other Factors Affecting Inflation

In the early months of the pandemic, many manufacturers cut back on production as a combination of demand uncertainty and worker outages forced factories

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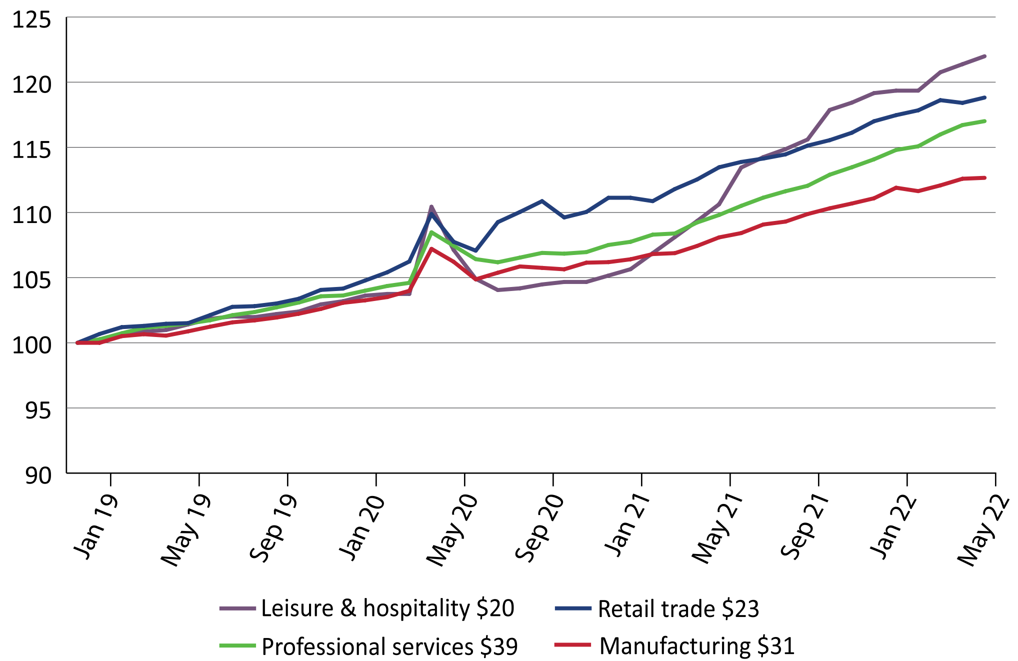
Annual inflation for goods began to accelerate in June 2020 and has surpassed both the headline rate and annual inflation for services in each month since January 2021.

Figure 1. Average Hourly Earnings by Industry



Note. SA = seasonally adjusted.
Source. Bureau of Labor Statistics.

to halt operations. Manufacturing capacity utilization plunged from about 76% in 2019 to 61% in April 2020 and was below 75% for another eight months, putting production in a deep hole.

At the same time, the pandemic led consumers to spend less on services and more on goods, especially durable goods. Rather than booking travel, hair appointments, or elective medical procedures, Americans bought home office equipment, furniture, consumer electronics, sporting goods, and vehicles.

Spending on durable goods, adjusted for inflation, was 13% higher in the six months after the start of the pandemic than its trend from the previous decade, and this sudden surge in demand for the products affected by production slowdowns put upward pressure on prices.

Annual inflation for goods began to accelerate in June 2020 and has surpassed both the headline rate and annual inflation for services in each month since January 2021.

WHERE IS INFLATION LIKELY TO GO?

Nearly every factor described above suggests that inflation is likely to remain elevated for some time. Figure 2 shows different measures of six-month annualized rates of inflation. *Constrained items* are goods and services that have

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“Top 25 to Watch” prices now are increasing at a 6% annualized rate—a rate that suggests inflation is likely to remain in at least the 5% to 6% range over the rest of 2022 and likely well into 2023.

been particularly affected by the pandemic, including energy prices, prices of new and used vehicles, and rental car prices.

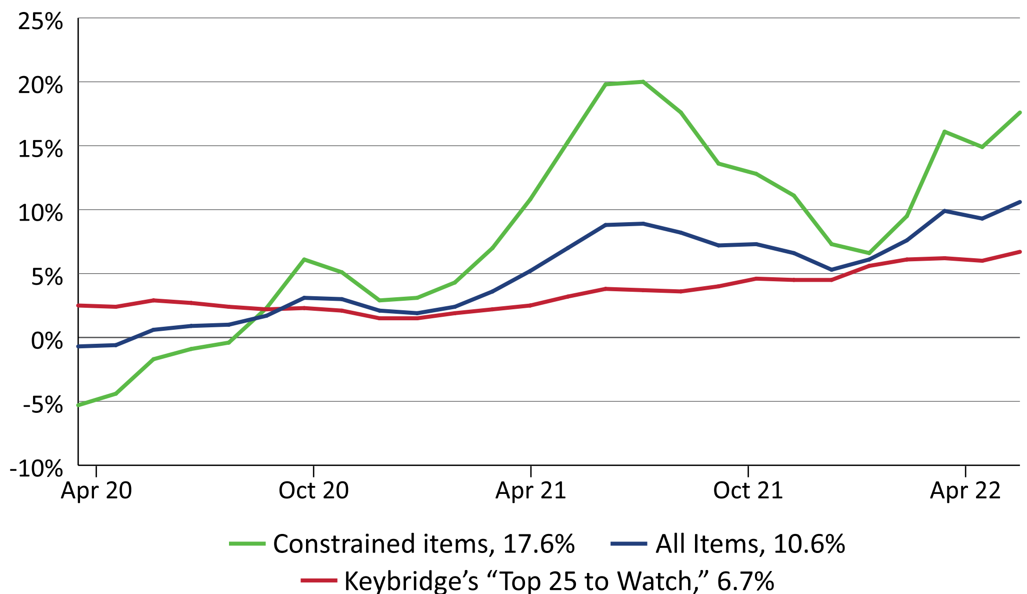
Keybridge’s “Top 25 to Watch” is a set of CPI components that should not be particularly affected by pandemic-related disruptions. These include rents, the costs of owner-occupied housing, water and trash collection bills, and a wide range of consumer services, like financial services, veterinary services, and wireless phone services. Together, these spending categories account for about 60% of the overall CPI and should proxy underlying inflation. “Top 25 to Watch” prices now are increasing at a 6% annualized rate—a rate that suggests inflation is likely to remain in at least the 5% to 6% range over the rest of 2022 and likely well into 2023.

LIKELY MOVEMENTS IN INTEREST RATES

Analytical Frameworks Suggest Interest Rates Need to Go Higher Than Many Believe

Recently both Federal Reserve Chair Jerome Powell and Treasury Secretary (and former Fed Chair) Janet Yellen have acknowledged that inflation is running hotter than they

Figure 2. Change in Consumer Prices by Catetory



Note. In August 2021 Keybridge conducted an analysis of data from the Bureau of Labor Statistics and assigned 70+ components of the Consumer Price Index to the categories “constrained” and/or “Top 25 to Watch” based on our thinking about which goods and services are only temporarily constrained by pandemic-era factors, versus which are likely to show longer-term inflation (e.g., electricity, rent, and a variety of services). Additional data and discussion is available upon request.

Source. Bureau of Labor Statistics, authors’ calculations.

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The real federal funds rate today is on the order of negative 7%, suggesting that the Fed's monetary policy will remain highly stimulative if the Fed simply raises its nominal federal funds rate to the 3% to 4% range.

expected and have stated that the Fed made a mistake in not moving earlier to raise interest rates.

Market players now expect that the Fed will need to raise the fed funds rate to the range of 3% to 4% by the end of 2022 to begin to bring inflation back down toward the Fed's long-run target of about 2%.

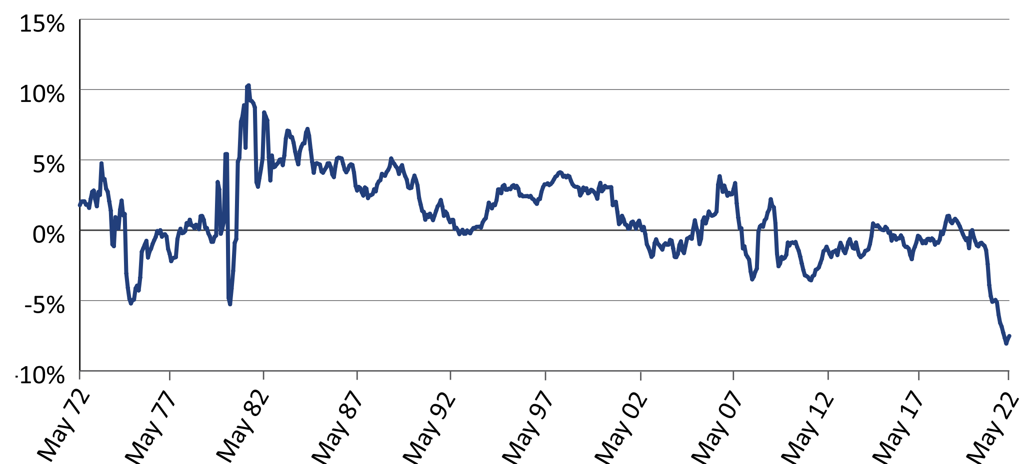
However, two useful analytical frameworks suggest this target range will be insufficient to bring about a decline in inflation of this magnitude. First, the real federal funds rate (the federal funds rate adjusted for CPI inflation) is an instructive shorthand measure of the stance of monetary policy, with a real rate of 2% considered roughly neutral, a *real* rate of 3% to 4 % considered tight, and a real rate of 0% to 1% considered easy.

As seen in Figure 3, the *real federal funds* rate today is on the order of negative 7%, suggesting that the Fed's monetary policy will remain highly stimulative if the Fed simply raises its nominal federal funds rate to the 3% to 4% range.

Second, Federal Reserve reaction functions—or so-called *Taylor Rules*—are useful for showing what federal funds rate the Fed would be likely set if it were true to its own historical experience, given current inflation and unemployment data. According to a recent reaction function estimated by the Federal Reserve Bank of St. Louis, the federal funds rate should be in the high single digits and approaching double digits given today's CPI inflation rate of more than 8% and an unemployment rate of 3.6%.

Together these frameworks suggest that the federal funds rate will need to be in the 5% range by late 2022 even to begin to put inflation on a

Figure 3. Real Federal Funds Rate



Source. Adapted from Federal Reserve and Bureau of Labor Statistics.

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For monetary policy to work in its normal fashion, it must curb demand sufficiently to alleviate price pressures, which ultimately will create a measure of pain in labor markets and product markets.

path back toward the Fed's target range. This is well above the Fed's forecast.

Further, we believe that the balance of inflationary risks—including from Russia's invasion of Ukraine, an accelerating wage-price spiral, and China's Covid-zero policy—skew toward higher inflation for longer. Therefore, we believe the fed funds rate could rise in 2023 as well, likely approaching 5% to 6% (a level not seen since 2007), unless a recession emerges in the coming quarters.

The Fed Is Not Likely to Engineer Immaculate Disinflation

Some financial analysts are optimistic that the Fed can engineer *immaculate disinflation*—that is, a perfectly smooth path to lower inflation that avoids triggering an economic slowdown or recession. While this is possible in theory, in our judgment it is not likely.

For monetary policy to work in its normal fashion, it must curb demand sufficiently to alleviate price pressures, which ultimately will create a measure of pain in labor markets and product markets.

This is especially true in our view once inflation is firmly embedded in the services sector.

NEW CHALLENGES AND OPPORTUNITIES FOR THE EQUIPMENT FINANCE INDUSTRY

Higher inflation and higher interest rates will present challenges and opportunities for the equipment finance industry. Some capital-intensive business sectors are likely to face squeezes they have not seen in many years. At the same time, productive assets, like equipment, should remain in demand as economic conditions tighten.

Meanwhile, industry veterans we interviewed for this report emphasized the need for firms in the equipment finance industry to find new opportunities to grow their businesses by designing and offering new products that help their customers manage their risks better—something the industry has a proven track record of doing.

The Equipment Finance Industry May Benefit, at Least for a While, From Rising Interest Rates

Several factors may actually increase the demand for financing in the short run, including strong equipment demand and favorable lease-versus-buy conditions. Industry experts we interviewed pointed out that higher interest rates could pull forward equipment acquisitions as lessees and borrowers seek to limit their interest costs before those costs increase even more.

Meanwhile, inflation tends to be positively correlated with demand for real assets. The reason is that physical assets, like equipment, tend to hold their value better during inflationary periods, thanks to the widening spread between the cost of owning or financing

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Borrowers and lessees value certainty in uncertain times, and equipment finance firms will continue to provide access to financing products that help reduce uncertainty.

the equipment (a constant) and the revenue generated by the equipment (which typically rises with inflation).

Further, historically high costs for key inputs, such as steel and aluminum, along with substantial supply-chain disruptions have driven up equipment replacement costs. According to the BLS, average input costs for machinery manufacturing were up 19% in the first four months of 2022 compared to the same period a year prior. High replacement costs have in turn propped up used equipment values, a boon for lessors.

Elsewhere, rising labor costs and a record-high number of job openings have forced many businesses to automate more tasks, accelerating a transition that was already under way prepandemic—especially in high-touch service-sector industries like food service and retail. This should represent potential new demand for equipment.

The Lease-Versus-Buy Decision Still Should Favor Leasing

There are several reasons to think that equipment users will still view leasing favorably as interest rates rise and inflation remains high. First, leasing will continue to provide cost certainty in a volatile macroeconomic and financial environment. The last two years have been rife with uncertainty thanks to the pandemic, a sharp recession, domestic policy shifts, and even geopolitical conflict. Borrowers and lessees value certainty in uncertain times, and equipment finance firms will continue to provide access to financing products that help reduce uncertainty.

Aside from reducing uncertainty, new accounting changes favor leasing in the lease-versus-buy debate. As is well known, ASC 842, FASB's new lease accounting standard, brings most operating leases onto firms' balance sheets, whereas they used to exist as off-balance-sheet items.

Though leases are now being pulled onto balance sheets, operating leases can be capitalized at a discount to an asset's true cost (often less than 90%, according to industry veteran Bill Bosco), and for assets with significant residual values, especially transportation and infrastructure assets, the amount capitalized on-balance-sheet often will be significantly less than the asset's cost. This in turn will help support measures of profitability, cost of capital, and other financial performance metrics.

Effects of Rising Interest Rates on Equipment End-User Markets

Despite the possibility that the equipment finance industry could experience positive demand early in an environment of rising interest rates, the Fed's goal of cooling inflation is likely to bring a slowdown in demand for interest-sensitive businesses, including housing,

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Rising mortgage rates will weigh on demand for new homes, slowing demand for construction equipment. In typical interest rate cycles, housing starts fall by one-third to one-half as the Fed tightens, suggesting that starts could decline to the 1.0 to 1.2 million-unit level from the current 1.6 million-unit level.

automobiles and light trucks, and capital goods in general.

Residential and Nonresidential Construction

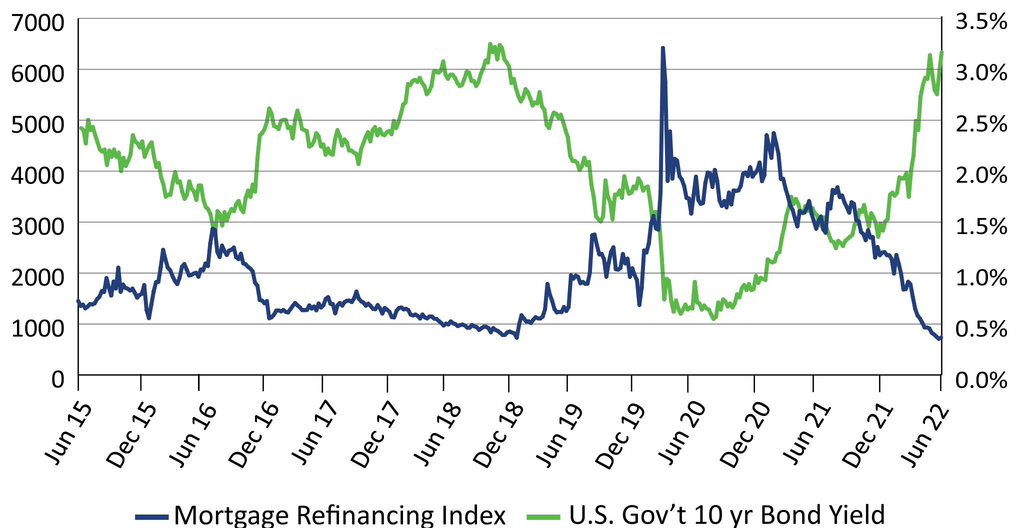
The housing market is suffering from both rapidly rising input costs and higher mortgage rates. According to the BLS, input costs for residential construction were up 20% year-on-year in April 2022 (and up 41% from April 2019).

Rising construction costs have begun to weigh heavily on homebuilding activity; sales of new homes under construction dropped in April 2022 to the lowest level since the onset of Covid. As long-term interest rates have increased, mortgage refinancing activity has dropped to multiyear lows as shown in Figure 4, a likely precursor of trends with mortgage originations as well.

Rising mortgage rates will weigh on demand for new homes, slowing demand for construction equipment. In typical interest rate cycles, housing starts fall by one-third to one-half as the Fed tightens, suggesting that starts could decline to the 1.0 to 1.2 million-unit level from the current 1.6 million-unit level.

Nonresidential construction is also likely to soften as economic growth slows. Demand for construction equipment, but also equipment that goes into construction projects like electrical and mechanical

Figure 4. Mortgage Refinancing Activity and Long-Term Interest Rates



Note. LHS = left-hand side; RHS = right-hand side.

Source. Adapted from Mortgage Bankers Association and Macrobond Financial.

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Rising interest rates may help shore up portfolio performance in the near term. Essential-use equipment with existing leases or loans becomes even more valuable during periods of rising interest rates as the terms of a new lease or loan become less favorable.

equipment, is likely to slow in response.

Automobiles and Light Trucks

Likewise, the automotive sector is likely to see demand weaken as interest rates rise. In a normal interest rate increase/economic growth slowdown cycle, sales of new vehicles tend to decline by about a quarter—from the 16 million to 17 million-unit level to the 12 million to 13 million-unit level.

One twist in 2022 is that the pandemic-induced shortage of key inputs (especially semiconductors) has left pent-up demand for perhaps 3 million units still to be met, and this may moderate the downturn in demand for new vehicles. However, the combination of record prices and falling real disposable income is already forcing some lower-income consumers out of the market for both new and used cars.

Capital Goods in General

In a typical business cycle downturn caused by Fed tightening, the demand for capital goods tends to decline by about 15%—less than the roughly 30% decline experienced during the Great Recession of 2008–2009—but still a significant reduction in demand, and much greater than the 1% to 2% reduction in real GDP typical in recessions.

Portfolio Performance May Benefit in the Short Run, but Then Is Likely to Worsen

Balance sheets currently are very strong. According to the Federal Reserve, delinquency rates for lease financing receivables on banks' balance sheets fell through the end of 2021 to just over 1.0%. Similarly, according to ELFA data, as of April 2022, charge-offs among equipment finance firms were 0.05%—a series low. Healthy balance sheets give the industry a solid jumping-off point as the Fed hikes rates.

Further, rising interest rates may help shore up portfolio performance in the near term, according to industry veterans interviewed for this report. Indeed, essential-use equipment with existing leases or loans becomes even more valuable during periods of rising interest rates as the terms of a new lease or loan become less favorable. This will likely incentivize operators of essential equipment to stay current on their payments.

However, if the Fed raises interest rates steadily to cool off the economy, as expected, many key end-user markets will be hit. Equipment finance lenders should look back at their historical portfolio experience during the recessionary periods of 1991–1992, 2001, 2008–2009, and the manufacturing sector slowdown in 2016 for indications of what they might see in delinquency and loss experiences in a potential economic slowdown in the coming one to two years.

Experiences during the pandemic recession of 2020 are probably not very instructive because of the historic stimulus and support measures discussed earlier.

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Rising interest rates may pinch smaller, independent financing operations sooner and with more force than in past periods of rapid rate hikes because independent lenders are less likely to be able to pass on rising cost of funds as fast as they may have in the past.

Structural Changes Coming to the Equipment Finance Industry

Spread Compression Will be Around for a While, Especially for Independents

One of the ways in which today's equipment finance industry differs from the industry of the 1970s and 1980s, when inflation was high, is the prevalence of banks. Rising interest rates may pinch smaller, independent financing operations sooner and with more force than in past periods of rapid rate hikes because independent lenders are less likely to be able to pass on rising cost of funds as fast as they may have in the past.

Lower spreads, especially in the independent space, will mean that lessors will have to be sure to prioritize their most profitable deals—especially when labor shortages and equipment shortages are limiting transaction volume in the near term.

Over time, as interest rates increase, there should be more scope for lenders to widen spreads, but firms will have to keep a close eye on competitors that may have better access to capital and a lower cost structure.

Lenders and Lessors Will Need to Monitor Residual Values More Closely

Another factor that will require increasing attention during inflationary periods is residual value. Equipment prices are high and rising for several reasons, including broad-based inflation, strong demand, and the inability to procure replacement equipment. Equipment finance firms will have to consider whether current asset prices are indicative of future asset prices—especially for assets with useful lives measured in years.

Indeed, many of the headwinds plaguing the equipment sector today may dissipate faster than expected if the Fed's action proves to be more effective than expected. As a result, lessors and lenders might consider developing new probabilistic models of valuation that explicitly take heightened uncertainty into account when forecasting residual values, as in Rode, Fischbeck, and Dean (2002).

Shifting Industry Structure

The effects of high inflation and rising interest rates will not be felt evenly across the industry. According to equipment finance veterans, industry consolidation typically happens "from the middle out" when interest rates are rising. Firms operating mainly in the mid-ticket space may see increased competition from larger financial institutions with lower costs of funds.

At the same time, substantial volatility and uncertainty could cause some larger financing firms to pull back, leaving smaller, more nimble lenders and lessors to gain market share.

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Further, the prospect of delayed delivery times for new equipment has led to many lessees requesting month-to-month extensions of existing contracts. Equipment finance firms may include specific provisions in new contracts that lay out the terms of short-term extensions of leases or loans.

Opportunities for the Equipment Finance Industry From Heightened Uncertainty

The equipment finance industry has a long history of developing innovative new products, and an environment of rising interest rates is likely to create opportunities for more of this activity. In past eras of high inflation and rising interest rates, equipment finance firms introduced financing products that allowed their customers to lease or borrow according to their individual risk profile and, importantly, according to their own inflation expectations.

These new products might include a floating-rate product, a float-plus-fixed product, or a fixed-and-fixed product where the interest rate resets after a given period.

Expanding one's menu of available financing products will demonstrate to customers that a lender is evolving with changing financial conditions and likely will generate goodwill that encourages repeat business, according to industry veterans interviewed for this report.

Another aspect of the uncertainty worth monitoring is the risk arising from the period between generating a quote and closing a deal. If lessors are not doing so already, they should consider shortening the quote-to-close window and/or implementing a safety valve that automatically reprices a deal in the event of a substantial rate shift.

Risks stemming from the quote-to-close window may also be compounded by significant equipment delivery delays that are likely to continue through 2022 and beyond. Further, the prospect of delayed delivery times for new equipment has led to many lessees requesting month-to-month extensions of existing contracts. Equipment finance firms may want to consider including specific provisions in new contracts that lay out the terms of short-term extensions of leases or loans.

Broadening Labor Pools

Finally, by some measures the labor force is as tight as it has ever been. For example, according to the BLS, in April there were more than 500,000 openings in the financial activities sector, just shy of a record set in July 2021. According to the Foundation's 2021 Industry Future Council report, *Looking Ahead to the Post-Pandemic Economy,* younger generations have different priorities when it comes to where they work, who they work for, and how they work. For more insight into recruiting the next generation of equipment finance workers, see Section III of the 2021 IFC report.

A tight labor market and high inflation mean that firms will have to broaden their outreach to make sure they can recruit and retain world-class talent. This may involve reaching out to diverse applicant pools that may not have been major sources of workers in prior years. Firms will also need

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One fruitful area, foreshadowed by finance firms in the higher inflation era of the late 1970s and early 1980s, would be to offer customized lending products that allow customers to match loan terms to their inflation and interest rate risk tolerance levels.

to closely monitor wage and salary adjustments to make sure they remain competitive in the marketplace. Inflation adjustments of 2%, 3%, or 4%, which may have been adequate in past years, are unlikely to satisfy employees given that inflation is running at 8%.

CONCLUSION

The equipment leasing and finance industry will likely feel significant effects from rising inflation and the Fed's actions to fight that inflation. The industry may experience some short-run benefits in the early stages of rising interest rates, as this may bring more scope for spreads to widen.

However, rising interest rates will almost certainly bring softness and possibly outright downturns in key end-use markets for equipment, including the construction sector, the motor vehicle sector, and the capital goods sector more broadly. Industry players need to be aware that in a typical recession, U.S. real GDP tends to decline by 1 or 2 percentage points from peak to trough, but business fixed investment tends to decline by 15%.

There will be plenty of opportunities for equipment finance companies to offer new products to their customers. One fruitful area, foreshadowed by finance firms in the higher inflation era of the late 1970s and early 1980s, would be to offer customized lending products that allow customers to match loan terms to their inflation and interest rate risk tolerance levels.

The industry veterans interviewed for this report are confident that equipment finance firms will continue to innovate and succeed in this new era of high inflation and rapidly rising interest rates. ■

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