Equipment Finance in 2020
Special COVID-19 Impact Issue

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Established in 1989, the Equipment Leasing & Finance Foundation is a 501c3 non-profit organization dedicated to inspiring thoughtful innovation and contributing to the betterment of the equipment leasing and finance industry. The Foundation accomplishes its mission through development of future-focused studies and reports identifying critical issues that could impact the industry.

Foundation research is independent, predictive, and peer-reviewed by industry experts. It is funded solely through contributions. Contributions to the Foundation are tax-deductible. Support the Foundation by making a 100% tax-deductible gift today at www.leasefoundation.org.

Revised November 4, 2020

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Message from the Chair

The Equipment Leasing & Finance Foundation (Foundation) presents *Equipment Finance in 2020: Special COVID-19 Impact Issue*. This limited edition report, issued in lieu of the annual Horizon Report, contains forward-looking economic and industry insights related to the U.S. economy — including near- and medium-term economic risks and emerging industry trends — based on input provided by industry leaders and Keybridge, the Foundation's economic researchers. This year, the report focuses on the impacts of the COVID-19 pandemic and the related recession.

The report begins by reviewing the state of the economy in 2019 and summarizing the economy heading into the pandemic. It also provides key industry metrics, including an industry sizing estimate and the propensity to finance equipment and software acquisitions.

The report's next section discusses COVID-19 and the pandemic-induced recession, with a focus on the equipment finance industry. After two months of slow but steady growth in early 2020, the virus brought much of the U.S. economy to a halt in March and April, driving more than 20 million Americans out of work. However, historic federal stimulus efforts and lender flexibility helped consumers and most businesses remain afloat, likely preventing a more severe downturn. The Federal Reserve also stepped in, targeting a fed funds rate of 0% for the first time in almost five years. Business conditions for equipment finance firms differ greatly by industry: demand for construction equipment has increased in response to demand for single-family homes in less populated areas, and we all know how demand increased virtually overnight for computer equipment and software as tens of millions of workers transitioned to remote work. At the same time, many industries have been hit hard, including travel- and tourism-related businesses, oil and gas production, and in-store retail, just to name a few. Unfortunately, small, local businesses have borne the brunt of pandemic-caused behavior changes.

The report concludes with a peek at 2021. While the economy will face substantial headwinds and heightened uncertainty, especially regarding the path of the pandemic and the effect of post-election policies on the economic climate, I am optimistic about the outlook for our industry. Low interest rates and the related potential for inflation are considerations to keep in mind, and we may see increased consolidation and weaker portfolio performance in some segments as the business cycle resets. Nonetheless, severe disruptions also bring great opportunity, and I believe the leaders in our industry will adapt to the current economic challenges we face and help guide the economy to brighter days in the year ahead.

We hope you find *Equipment Finance in 2020: Special COVID-19 Impact Issue* useful, along with the Foundation's many other research publications.

Scott A. Thacker
Chair, Equipment Leasing & Finance Foundation

Executive Summary

The U.S. economy expanded in 2019, albeit at the slowest pace since 2016. The economy was a tale of two sectors: while consumers enjoyed the fruits of a historically strong labor market and sub-4% unemployment rates, the industrial core of the economy weakened due to soft business investment and trade uncertainty. However, despite decelerating business investment spending in 2019, the equipment leasing and finance industry saw new business volume growth accelerate to 4.7% in 2019, up from 4.1% in 2018. The increase was at least in part due to a rising propensity to finance equipment and software acquisitions, which in turn was supported by the Federal Reserve's decision to lower interest rates in the second half of the year.

Low interest rates and a rising propensity to finance led to solid growth in the equipment finance industry in 2019. The industry expanded from an estimated $903 billion (revised) in 2018 to $992 billion last year. This figure represents roughly 53% of total equipment and software investment in 2019, up from just below 50% in 2018. Heading into January 2020, expectations were for a year of slower but positive growth in the U.S. — though the deterioration in certain equipment verticals was cause for some concern.

Hopes for another year of growth were quickly dashed, however, as the economy cratered at the onset of the coronavirus pandemic. In a matter of weeks, 22 million jobs were lost, more than double the number lost during the entirety of the 2008–09 recession. Millions of small businesses were forced to shutter — most temporarily, but some permanently — in an effort to control the virus's spread. Supply chains were severely disrupted, and non-essential travel was halted. In response, the Federal Reserve slashed rates to zero and Congress enacted $3 trillion in stimulus measures for consumers, businesses, and state and local governments. Meanwhile, many lenders and most equipment finance firms offered temporary payment relief in an effort to "pause the payment clock" until the economy could restart. The outlook was grim.

However, the industrial core of the economy — and several key equipment verticals along with it — rebounded more quickly than initially anticipated. While consumers waited to see whether the government would pass another relief bill, new business volume in the equipment finance industry staged a comeback, with some verticals (e.g., computers and software) benefitting from the pandemic as 30–40% of the U.S labor force transitioned to new remote work arrangements. At the same time, other equipment verticals, such as aircraft, office equipment, and oil and mining equipment, continued to struggle due to the pandemic and resulting fallout.

After the U.S. economy suffered its steepest and deepest decline in GDP since 1946, the outlook for the U.S. economy in 2021 is among the most uncertain on record. Equipment finance sector leaders expect moderate portfolio growth, though performance will be highly sector-dependent. Banks are widely expected to step back from smaller-ticket deals and focus on core markets, which may provide an opportunity for independents to increase market share. While a near-term spike in inflation appears unlikely, it is a potential development worth monitoring given the impact it could have on the industry. Likewise, some consolidation may occur, particularly among firms with outsize exposure to sectors that are heavily impacted by COVID-19. For the U.S. economy at large, much will depend on the availability of additional economic stimulus and the timeliness of an effective and widely disseminated vaccine. Overall, the business environment for equipment finance firms is expected to be more favorable in 2021 than it was in 2020.

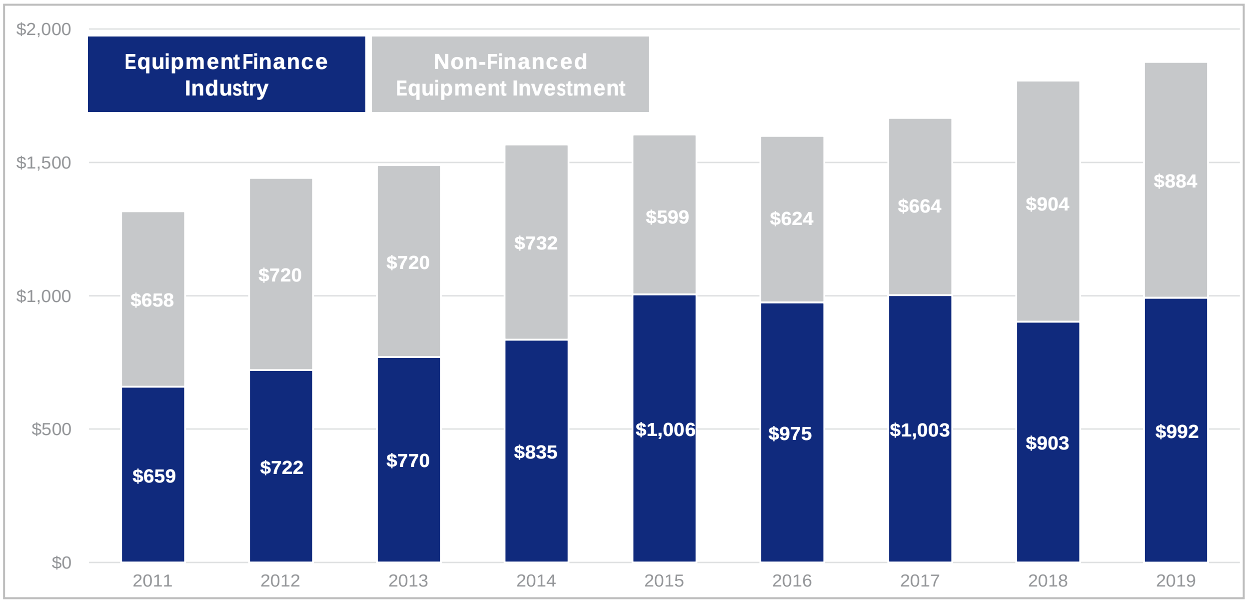
Sizing the Industry in 2019

The U.S. economy in 2019 was a tale of two halves, with the year beginning on a much stronger note than it ended. During the second half of the year, while consumers continued to enjoy one of the strongest labor markets in half a century, the manufacturing sector stagnated. The weakening economic momentum and rising uncertainty were largely due to sluggish business investment and a slowing global economy. Declining business investment weighed on economic activity, while trade uncertainty stemming from an ongoing trade war with China and increased trade frictions with several other countries dampened export growth. Consumer spending continued to propel the economy forward despite these headwinds, but discussions of a potential recession late in 2019 or 2020 floated to the top of the economic and financial news cycle.

However, despite weakness in the economy's industrial core, new business volume growth accelerated to an annual rate of 4.7% in 2019, according to the Equipment Leasing and Finance Association's (ELFA) Monthly Leasing and Finance Index (MLFI-25), the strongest annual growth since 2014. Growth was driven by plunging long-term interest rates, which helped the industry expand despite a more modest 3.5% increase in nominal private sector equipment and software investment (down from 8.5% in 2018, which was aided by changes to the tax code). The difference can be explained by the propensity to finance, which rose in 2019 as long-term interest rates fell sharply in the latter half of the year. Based on Foundation estimates, the industry's size was approximately $992 billion in 2019 (see Figure 1).

Figure 1: Equipment Finance Industry Size

(Billions of dollars)



Sources: BEA; previous Foundation end-user surveys; Keybridge LLC. Note: The generic term "equipment finance" is used to denote public and private equipment and software acquired via lease, secured loan, or line of credit. Non-financed equipment is acquired through cash, credit card (paid in full), or another method.

How was the industry sizing estimate calculated?

The estimation of the size of the equipment finance industry relies on two components: total public and nonresidential private sector equipment and software investment, and the propensity to finance those investments.

- Equipment and software investment is estimated by the U.S. Bureau of Economic Analysis (BEA). Estimates are subject to regular revisions.

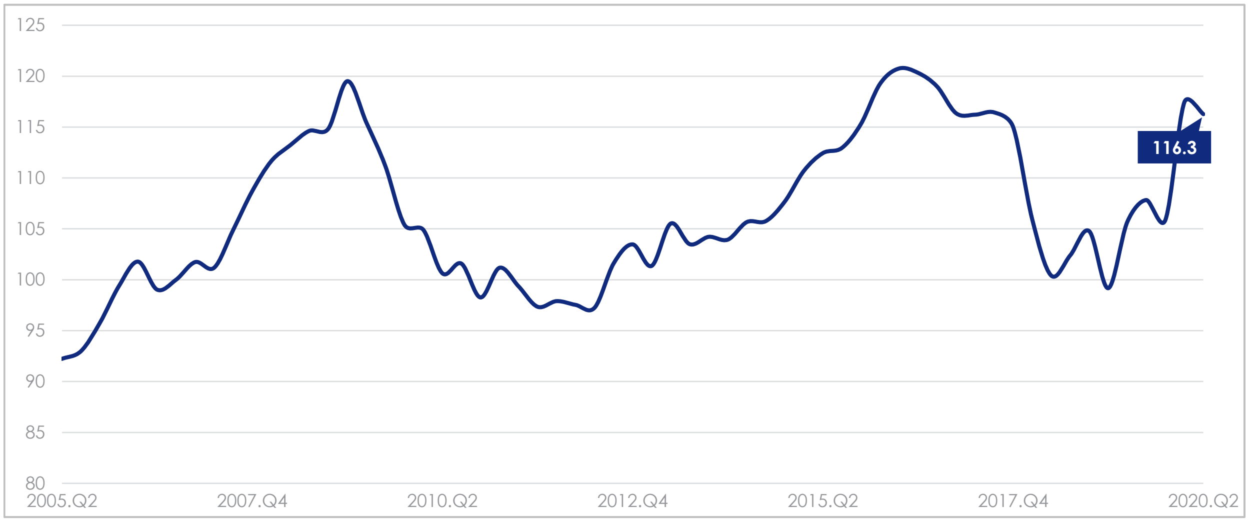
- The propensity to finance is estimated by an index constructed by Keybridge (the Propensity to Finance Equipment Index, or PFEI). The methodology for the PFEI is described below.

For the Foundation's *2019 Equipment Leasing & Finance Industry Horizon Report*, the propensity to finance component was derived from a survey of over 500 businesses that acquired equipment or software in 2018. For this report, Keybridge used the PFEI to estimate the propensity to finance equipment and software acquisitions.

The PFEI is a composite of two different metrics. The first estimates the share of commercial and industrial (C&I) loans that go towards equipment purchases and compares that share to total equipment and software investment in the U.S. economy. The second metric compares trends in new business volume per ELFA's *Monthly Leasing and Finance Index* to trends in total equipment and software investment per the U.S. Department of Commerce. The two metrics are converted into index values and then averaged to produce the final PFEI.

Figure 2: Foundation-Keybridge Propensity to Finance Equipment Index (PFEI)

(Index, 2005=100)



Sources: ELFF, Keybridge LLC.

Interpreting the PFEI

After reaching a post-recession low in 2012, the PFEI rose steadily as the U.S. economy continued its slow recovery from what was at the time the worst recession since the Great Depression. C&I loans for equipment mirrored this trend, growing strongly through the end of 2015. However, propensity to finance began to plateau in late 2015, likely reflecting a slowdown in manufacturing activity. C&I loan growth was falling, and the Fed was raising interest rates (albeit slowly), which likely put some downward pressure on the propensity to finance on the margins.

After the Trump administration took office in 2017, Republicans in the House, Senate, and White House joined forces to pass the Tax Cuts and Jobs Act (TCJA), the most comprehensive reworking of the U.S. tax code since the Reagan administration. The TCJA contained a number of competing provisions that impacted the relative tax advantage of financing or leasing equipment, but in the end the reduction in the corporate tax rate from 35% to 21% appears to have won out given the PFEI's sharp decline in 2018. The Fed continued raising rates through the end of 2018, putting further downward pressure on the propensity to finance equipment acquisitions. However, even before the pandemic-induced recession began, the Fed eased rates in late 2019 and dropped them to zero as the pandemic approached and equity markets tanked.

Still, the 2020 PFEI readings may imply that the industry outlook is more positive than it truly is. This index, like many other indicators, has been distorted by the exceptional economic and financial stress of the coronavirus pandemic. The first quarter of 2020 saw a record surge in C&I loans in the last three weeks of March as firms drew down existing lines of credit to create a cash buffer against the looming recession. The simultaneous surge in C&I loans and collapse in investment caused the PFEI to jump in Q1 and Q2, even though the economic conditions were not conducive to a broad-based increase in new equipment and software financing. As such, while the propensity to finance equipment acquisitions is likely higher than it has been in recent years, the current PFEI reading of 116.3 may be an overstatement due to these one-off factors.

The COVID-19 Recession and Aftermath

Summary: Heading into 2020, the U.S. economy was still a tale of two sectors. On the positive side, the labor market was exceptionally healthy, and strong income gains helped support consumer spending. However, the manufacturing sector was struggling: industrial production was flat or declining throughout the year, business fixed investment contracted, and the global economy was showing signs of fraying, especially in emerging markets. Despite worries of recession, Keybridge expected the economy to grow a modest 1.7% in 2020.

However, this narrative was upended by the coronavirus pandemic, as widespread shutdowns led to mass layoffs beginning in early March. Efforts to reopen the economy with appropriate safeguards to contain the virus' spread have been reasonably successful in some areas, but in others have led to new outbreaks, renewed containment efforts, and uneven economic performance. The economy boomed in the third quarter as roughly half of the job losses of the spring were recouped —a faster bounce-back than many economists anticipated. At the same time, however, business and consumer confidence remain significantly lower than pre-pandemic levels, and consumer spending, buoyed by trillions in now-expired federal stimulus, is slowing. As the longer-term effects of the recession set in, a V-shaped recovery in which employment and economic output quickly return to pre-pandemic levels looks increasingly unlikely. Instead, a "swoosh" recovery in which output and employment return to pre-pandemic levels sometime in 2022 is the more likely scenario.

Overall, the equipment finance industry has managed to hold its own, all things considered, and as of September, year-to-date cumulative new business volume was $73.6 billion, down just 5% compared to 2019. However, the economy's underlying weaknesses will present challenges to the industry next year, including high unemployment and increased financial strain on millions of small businesses. Fortunately, low interest rates should encourage equipment finance activity in sectors that have been less affected by the downturn, but other sectors will face sustained weakness.

January-February 2020: Slow and Steady Growth

The U.S. economy was poised to continue its longest-ever expansion in 2020, albeit at a slower pace. Noticeable weaknesses had begun to emerge in the industrial sector, driven by a faltering global economy and trade frictions. These vulnerabilities were particularly visible in the manufacturing and oil sectors, which saw steadily declining rig counts throughout 2019. In late 2019 and early 2020, the Foundation/Keybridge U.S. Equipment & Software Investment Momentum Monitor indices — which forecast equipment and software investment growth with a 3- to 6-month lead time — were mixed. Some verticals, including aircraft, ships & boats, mining & oilfield equipment, and trucks, were expected to remain weak during the first half of the year. Others (e.g., agricultural equipment and materials handling equipment showed signs of likely improvement, but the balance of investment growth forecasts had shifted to the downside as the new year began.

While the industrial sector of the economy was a drag on growth, most U.S. consumers were in good shape. Unemployment was at a 50-year low, and wage growth was accelerating. Median household income had increased 6.8% in 2019 to $68,703, one of the largest jumps on record. Job growth in January and February averaged more than 230,000 each month, well above 2019's average pace, and consumer confidence was in the top 10% of readings all-time. Credit card and mortgage delinquencies were historically low, and most consumers reported that they were better off than they had been a year prior, suggesting that the strong consumer base would support modest growth in 2020 and help avert the growth pause or recession conditions suggested by several industrial sector indicators.

This split between the industrial and consumer sectors of the economy was most evident in the Recession Watch Tool published in the Foundation's 2019 Equipment Leasing & Finance Industry Horizon Report. The Recession Watch Tool consists of eleven indicators that together have a consistent track record of acting as an "early warning" system for recessions in the U.S. economy. The indicators include data points like consumer expectations about the economy, the yield curve, capital investment plans by small firms, and several measures of industrial-sector activity.

At the end of 2019, 4 out of 11 indicators in the Equipment Finance Industry Recession Monitor, including the yield curve, were flashing red. Only two additional indicators would have needed to cross their thresholds before a recession became more likely than not in the next six months. Based on a preponderance of economic data, Keybridge believed that while a recession did not appear to be imminent, a downturn over the subsequent 12–24 months was more likely than not.

The outlook began to get gloomier in February, and by mid-March, the economic impact of the coronavirus pandemic was coming into view. As equity markets cratered, the Federal Open Market Committee (FOMC) cut the fed funds rate by 150 basis points in the span of two weeks, returning interest rates to the zero-lower bound for the first time since December 2015. As the lockdowns began in March and April, it was clear that the economy would suffer greatly, but the duration of the downturn was still uncertain.

The Initial Response to COVID-19

The first laboratory-confirmed case of COVID-19 was reported on January 22, and by mid-March, the pandemic had shut down major sports leagues, triggered a national state of emergency declaration from President Trump, and led to widescale "shelter in place" policies across the country that required many businesses to close. These shutdowns extended to every corner of the U.S. economy: roughly 40% of small businesses were closed in March and April, according to Womply data. The effects of these measures were evident in several economic indicators between February and April:

- New claims for unemployment insurance totaled more than 23 million in a four-week period;
- OpenTable restaurant seatings plunged 100% year-over-year;
- The official unemployment rate jumped to nearly 15% (though BLS later estimated that the rate was likely closer to 20% due to misclassification errors);
- Retail sales fell more than 15%;
- Manufacturing output declined by more than 20%;
- Exports plunged nearly 30%;
- Housing starts collapsed 40%;

- Hotel occupancy rates fell by 70%; and
- Airline passenger volume fell by more than 90%.

As the economy crumbled, Congress moved quickly to shore up consumers and businesses. First, Congress appropriated $8 billion for the development of vaccines and the procurement of personal protective equipment (PPE), as well as to support hospital systems overwhelmed by COVID-19 patients. A second bill allocated nearly $100 billion for paid sick leave, tax credits, free COVID-19 testing, and expanded SNAP benefits, among other provisions.

While these bills were welcome developments, the most impactful legislation was the Coronavirus Assistance, Recovery, and Economic Relief Act, or CARES Act. The CARES Act provided $2.3 trillion in relief measures for the U.S. economy, including:

- $510 billion in loans and aid to large businesses, a portion of which was directly targeted to airlines and strategic firms;
- $377 billion in forgivable loans to small businesses via the Paycheck Protection Program;
- $300 billion in tax relief ($280 billion of which was directed at businesses);
- $290 billion in direct household payments via tax rebates;
- $260 billion in expanded unemployment benefits;
- $180 billion in hospital, Medicare, and health-related funding;
- $150 billion in state and local government support; and
- $72 billion in support to transportation and transit providers.

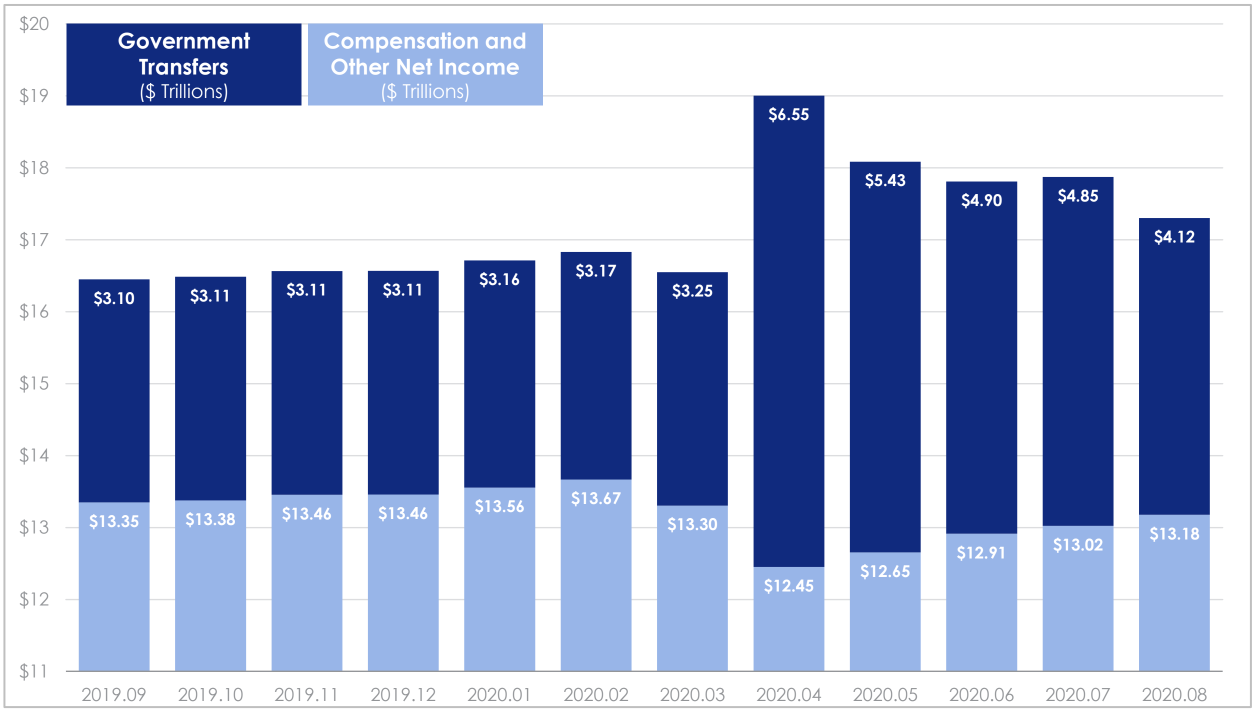
Consumers Fare Better Than Expected

Although a disproportionate share of spring job losses occurred in lower-wage industries like food service, accommodation, and travel, the expected increase in consumer credit delinquencies has not yet materialized. For example, in the previous recession, the delinquency rate on credit cards tended to rise about 0.7 percentage point for every 1 percentage point increase in the unemployment rate. However, in the second quarter, the delinquency rate for credit cards fell by the largest amount since 2011, according to Federal Reserve data. This development is not surprising given the magnitude of the income boost consumers received from the CARES Act. Real disposable personal income surged 15.5% in April, sending real disposable personal income to its highest level ever (see Figure 3).

This massive jump in income, together with a suite of temporary, consumer-friendly policies such as payment deferrals, debt forbearance, and eviction and foreclosure moratoria, kept delinquencies, defaults, and bankruptcies well below levels typically seen during a recession. Among the most important measures from the CARES Act was the extra $600 per week in unemployment benefits, which kept furloughed and laid-off workers afloat and avoided a consumer spending collapse. However, the nascent recovery is highly segmented. Lower-income households, buoyed by fiscal measures that in many cases lifted their incomes above pre-recession levels, quickly began spending again. By late June, households in the bottom 25% of zip codes by income had returned to their January spending levels. Conversely, spending by households in the top income quartile of zip codes was still 10% below January levels.

Figure 3: Real Disposable Personal Income by Source

(Trillions of dollars, SA)



Source: Bureau of Economic Analysis

Equipment Finance Industry Sees Huge Jump in Payment Deferrals

While consumers were offered various lifelines, many equipment finance firms had to scramble to avert potential disaster. One industry executive interviewed for this report said that when the pandemic began, it was "all hands on deck" to approve payment assistance and forbearance requests. The suddenness of the pandemic meant that firms were unable to take the time to determine whether a request for assistance should be approved, so in the initial weeks of the downturn most requests were approved. In fact, many lessors enacted automatic three-month deferrals in anticipation of short-term financial stress. As a result, by October, 92% of companies had offered payment deferrals in 2020, according to the Foundation's COVID-19 Impact Survey (see Figure 4).

As lockdown measures eased and consumers and businesses benefitted from fiscal stimulus contained in the CARES Act, the labor market began to recover. The private sector experienced unprecedented job growth beginning in May, with firms hiring 3.2 million workers in May, 4.7 million in June, and another 1.5 million in July. The hiring rebound was stronger than many economists expected but also paled in comparison to the

21 million private-sector jobs lost during March and April. The jobs recovery was also uneven: by August, the service sector had recovered 51% of the jobs lost in March and April. The goods sector, on the other hand, had recovered 54% of jobs lost over the same period (Figure 5). Among specific private-sector industries, the best performing in terms of job loss since January include financial activities (-2%) and trade and transportation (-4%), while the poorest-performing industries include leisure and hospitality (-22%), mining and logging (-14%), and information services (-10%).

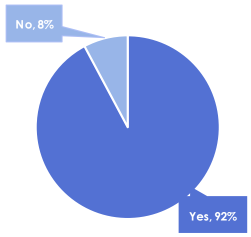
Figure 4: Payment Deferrals Offered (as of October 2020)

Payment Deferrals Offered

Has your company offered any payment deferrals — including extensions, modifications, or restructuring — in 2020, either voluntarily or at the request of a lessee / borrower?

Number of Responses:	77

	Yes	No
Percent	92%	8%
Count	71	6



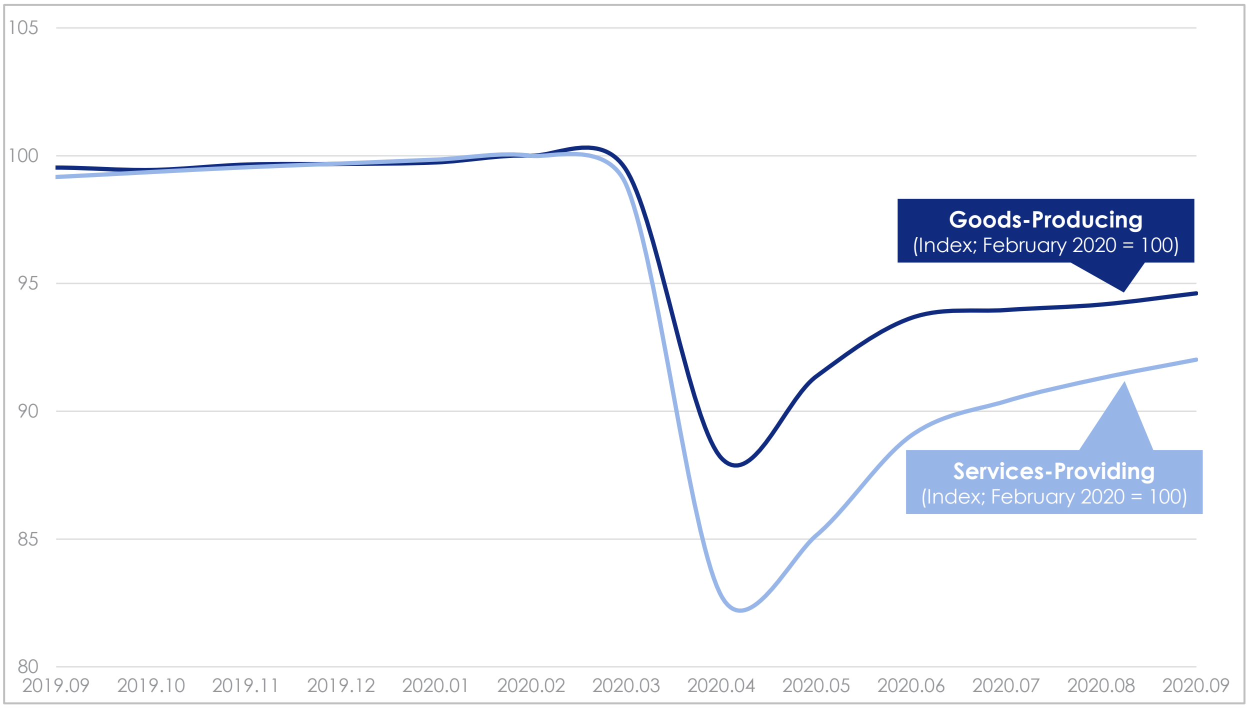
Payment Deferrals Offered By Organization Type

	Yes		No		Number of Responses
	Percent	Count	Percent	Count	
Bank	100%	26	0%	0	26
Captive	100%	9	0%	0	9
Independent	86%	25	14%	4	29
Other	0%	0	0%	0	0
Total	94%	60	6%	4	64

Source: ELFF COVID-19 Impact Survey

Figure 5: Employment in Goods-Producing and Service-Providing Industries

(Index, Feb. 2020 = 100)



Source: Bureau of Labor Statistics

Industry Performance

After the widespread shutdowns of March and April, the U.S. economy began the arduous process of reopening. The near-term outlook at the time was dim for most sectors, and the equipment finance industry was no exception. The Foundation-Keybridge Equipment & Software Investment Momentum Monitors from May-August suggested near-universal negative investment growth in the latter months of 2020, with the lone exception of investment in computers. Similarly, after plummeting to all-time lows in April and May, the Foundation's Monthly Confidence Index (MCI-EFI) rebounded in June but was still well below pre-pandemic levels by August.

Despite continued uncertainty surrounding new COVID-19 cases and rising financial stress in the U.S. economy, the environment for business investment for the fourth quarter has improved. New orders for nondefense capital goods excluding aircraft, a reliable leading indicator of business fixed investment, has staged an impressive recovery and is now nearly 3% above year-ago levels despite a huge drop in April. This promising recovery was echoed by industry executives in the October MCI-EFI: the index registered its second-highest post-pandemic reading (55; down slightly from 56.5 in September) and is 3.6 points above its year-ago level. Similarly, while ELFA's MLFI-25 reflects the stress the industry has felt this year — year-to-date new business volume is down more than 5% from 2019 —the aging of receivables over 30 days (2.00%) has steadily fallen since May and credit approvals (72.9%) are at their highest level since March.

However, for equipment finance firms, business conditions are highly industry-dependent.

- For example, the pandemic has driven a flight to the suburbs and exurbs as many Americans who have the means to do so move out of major cities. During interviews, industry leaders mentioned that this development has increased demand for construction equipment in some areas as builders scramble to keep up with historic demand for single-family homes. Similarly, industry leaders also described that the surge in online retail sales and a commensurate rise in demand for last-mile delivery services has generated a need for transportation equipment, and investment in computers and peripherals jumped sharply as segments of the economy shift to remote work.

- On the other hand, the pandemic has crushed discretionary travel of every sort. Interviews with industry experts reveal that lenders are avoiding any industry that depends on the ability to travel freely. Tourism, lodging, retail, and restaurants all have bleak outlooks given the inability to travel internationally and the unwillingness of many Americans to resume normal spending patterns until the pandemic is over.

- Commercial real estate is also expected to be weak for the foreseeable future, especially in major cities. Although the longer-term impacts of remote work remain unclear, many employees report that would prefer working from home at least part of the time once the pandemic is over. As a result, the commercial real estate sector may face a permanent downward shift in demand for floor space, which, per multiple industry leaders, could reduce demand for office equipment.

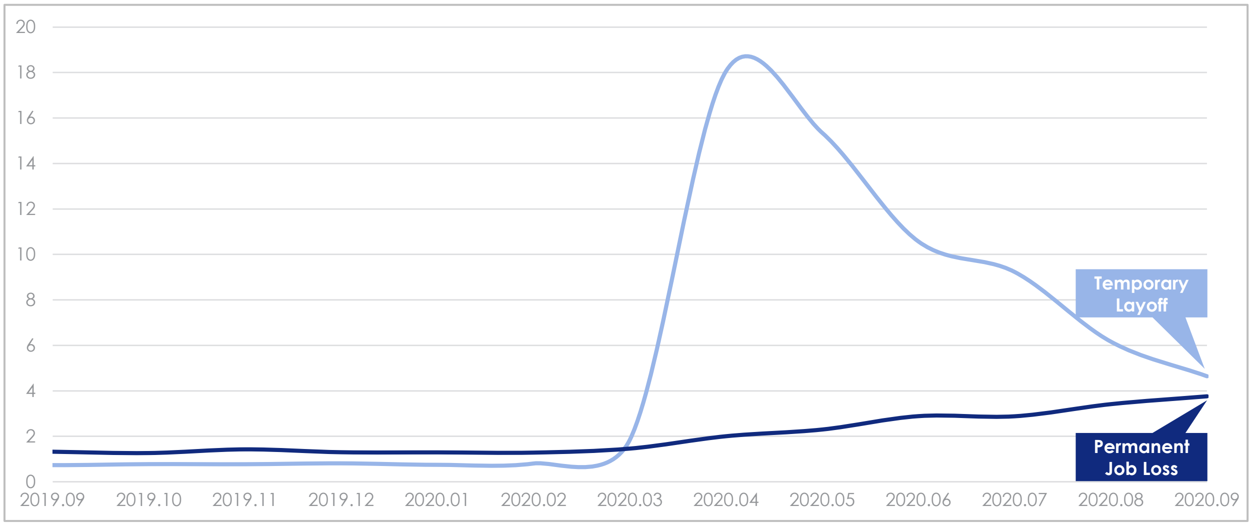
Stronger than Expected Recovery, But Uncertainty Remains

So far, the recovery from the pandemic-induced recession has exceeded expectations. Many economists, including the Congressional Budget Office, anticipated that unemployment could have remained at or near double-digits through the end of 2020 after peaking near 15% in April, but official data show that unemployment is already below 8% as of mid-September (though the pace of future improvements is likely to slow). Perhaps most surprisingly, the housing market is in the midst of a boom as home sales have spiked amid record-low interest rates, triggering a surge in single-family homebuilding activity. Finally, underpinning the recovery is the CARES Act, which has helped consumers and business alike weather the storm through the summer and fall.

Though the recovery was stronger than expected during the summer and early fall, a key question hangs heavily over the remainder of the year: what happens to at-risk consumers and small businesses now that many relief measures have expired? The extra $600 in weekly unemployment insurance expired at the end of July, and while a $300 weekly plus-up from FEMA's coffers offered a stopgap, it provided only a few extra weeks of help (and eligibility requirements were more stringent). Payment assistance periods, many of which had 90-day terms, have largely expired, and lenders are more discerning in granting deferrals than they were initially. Meanwhile, according to federal data, many temporary layoffs are becoming permanent (see Figure 6), a trend that could hamstring the recovery in 2021 if it continues unabated.

Figure 6: Reason for Unemployment

(Millions of workers, SA)



Source: Bureau of Labor Statistics

One interesting development in the wake of the pandemic has been that traditional economic indicators — which often lag current events by several weeks and in many cases rely on data collection methods that are more difficult to undertake during a pandemic — have been less helpful than usual in determining the current health of the economy. To supplement these indicators, economists have turned to new, high-frequency data to shape their views of the months ahead. Cell-phone location data, restaurant reservations, daily "open for business" status updates among small businesses, and data from payment processors are just a few examples of new alternative datasets that can offer valuable insights into the economy's health in near-real-time. Equipment finance professionals should take advantage of these data (which are available through private firms such as Google, Yelp, Womply, and Affinity Solutions) along with traditional indicators of industry performance to monitor the U.S. economy and environment for equipment leasing and financing.

2021: A Sneak Peek at the Year Ahead

Summary: The 2021 economic outlook is among the most uncertain on record. On the positive side, most industry leaders interviewed for this report expect modest to moderate new business volume growth in 2020. Likewise, certain sectors such as transportation and computers are expected to receive boosts from new pandemic-driven demographic shifts. Spreads are wider for the time being, and independents may find opportunities to gain market share. However, growth has clearly slowed as the effects of the CARES Act have waned: many consumers and small businesses are under increasing financial stress, and most economists believe additional stimulus is needed to keep the recovery on track and avoid a rash of small business failures. Portfolio performance is expected to weaken as payment deferrals expire and typical business cycle effects set in, particularly in industries that are most directly impacted by the pandemic. Whether the recovery can pick up speed and stay on track will depend on two key unknowns: the trajectory of the pandemic and the size, scope, and duration of additional stimulus measures.

Tenuous Labor Market Recovery

The main concern for 2021 is the possibility that the temporary labor market shock caused by the coronavirus pandemic could lead to further business failures and a pattern of self-reinforcing layoffs, which could stall and potentially reverse recent improvements to the unemployment rate. Although businesses are attempting to reopen and roughly half of workers laid off in March and April are now back at work as of October 2020, roughly 25 million people in the U.S. are still receiving unemployment insurance benefits — benefits that are now more than $2,000/month lower than they were during the summer due to expiration of CARES Act provisions. Lower incomes will translate to weaker spending among the unemployed, which would in turn, put pressure on revenues for U.S. businesses, particularly small firms. Many small businesses are already feeling the pinch: as of late September, one-fourth of U.S. small businesses had enough cash on hand for one month or less of operations, according to the Census Bureau. And, as of mid-September, nearly 100,000 businesses had closed permanently because of the pandemic, according to Yelp, a 34% increase in permanent closures since mid-July. Colder weather may lead to another wave of infections, as outdoor activities will be more difficult in many parts of the country, thereby increasing the risk of transmission. This risk, combined with the public health impact of the annual flu season, is another X-factor that could affect the labor market recovery.

Figure 7 illustrates some labor market recovery scenarios. Each dashed line represents a hypothetical scenario in which the rate of recovery of private-sector employment in a given month is extrapolated until employment returns to its February 2020 level. As the chart illustrates, the likely date of a full labor market recovery is becoming increasingly distant based on employment trends in recent months. Private hiring has slowed considerably since June, and even if September's growth rate were sustained (a highly unlikely scenario, private sector employment would not recover until August 2021. In reality, hiring is likely to slow further, which means that private-sector employment is unlikely to fully recover until late 2021 at the earliest — and more likely in 2022.

Figure 7: Labor Market Recovery Scenarios

(% of February private payroll employment given private payroll growth in a given month)

To keep the labor market recovery on track, the U.S. economy will likely require one of two developments: an effective and widely-available vaccine, or additional federal stimulus to keep consumers and businesses afloat until the pandemic is controlled and normal economic activity returns. Health concerns remain central to consumers' spending decisions: per an October 13 Morning Consult survey, just 38% of U.S. adults are comfortable going out to eat, while the numbers are even lower for going on vacation (31%), going to a movie (22%), and going to a concert (17%). While these activities represent a small fraction of the U.S. economy, the poll underscores the concern a majority of Americans still have about contracting the virus and contributing to its spread. Moreover, these statistics are quite similar to consumer sentiment from May, which suggests that a major breakthrough (e.g., an effective vaccine or more effective treatments) is needed to convince Americans to return to pre-pandemic levels of economic activity.

The bottom line is this: if the virus's spread can be controlled through a combination of social distancing, masks, and/or an effective vaccine, the economy will be much better positioned to bounce back in 2021 — particularly if Congress agrees on a targeted fiscal support package. However, if the virus is not contained and an effective vaccine is delayed or distrusted by the public, the economy will be at far greater risk of descending into a self-reinforcing pattern of layoffs, business closures, and financial stress — and the need for federal stimulus will be greater.

Equipment Finance in 2021: Sneak Peek

Though the labor market and consumer-facing service-sector industries are under substantial pressure heading into 2021, equipment leasing and finance firms may find opportunities to grow. Several interviews for this report revealed a common narrative heading into the new year: a likely pullback by larger financial institutions as lending standards tighten could open the door for independents, particularly in the middleticket, small-ticket, and micro-ticket space. While access to capital could be more difficult due to economic conditions, smaller firms with capital to deploy are likely to find business conditions generally favorable in 2021, particularly in lesser-impacted industries and those likely to benefit from the pandemic's economic effects, including last-mile transportation, pharmaceutical manufacturing, and technology products that facilitate remote work and the "office of the future."

Another factor to monitor in 2021 is inflation. In a historic policy shift, the FOMC announced that it would target an average inflation rate of 2%, which would mean that "…appropriate monetary policy will likely aim to achieve inflation above 2% for some time." As such, the FOMC has committed to keeping the fed funds rate at zero through at least 2023 amid expectations of a prolonged economic recovery. All else equal, this should produce upward inflationary pressures.

Though a spike in inflation appears unlikely in 2021, equipment finance industry members should keep in mind the effects that a higher rate of inflation might have on portfolio performance, given that the economy has been in a low-inflation environment for so long. Higher inflation would eat away at yields via lower real interest rates, and this effect would be more pronounced for fixed-rate deals and deals with longer time horizons. However, low real interest rates will also make the lease vs. buy decision more favorable for the equipment finance industry. Low rates and inflation for 2021 could also mean that lenders and lessors may be able to widen spreads while still offering borrowers an appealing rate on their loan or lease. For more detail on how different interest rate and inflation environments affect the equipment finance industry, visit the Foundation's *online library* to download the report *"On the Rise: How Inflationary Pressures and Rising Interest Rates Could Impact the Equipment Finance Industry"* for free.

Finally, the equipment finance industry should prepare for some degree of consolidation in 2021. Most interviewees expressed expectations that smaller players with major portfolio exposure to COVID-impacted industries such as retail, travel, and tourism will face substantial stress over the course of 2021. Though pandemic-related uncertainty in 2020 meant that strategic acquisitions took a back seat to portfolio management and restructurings, industry professionals expect that as some of this uncertainty unwinds, the pace of acquisitions will pick up. Opportunities for consolidation that are normally snatched up by financial institutions with deeper pockets may now fall to independents willing to tolerate a higher risk profile.

Overall, the lending environment is expected to be favorable to equipment finance firms in 2021. Though the U.S. in 2020 will have suffered its largest annual decline in GDP since 1946, the quick bounce-back for equipment and software investment has acted as a cushion for those in the industry. The Foundation's forthcoming *2021 Equipment Leasing & Finance U.S. Economic Outlook*, to be published in early December, will provide more insight into the economic recovery, including forecasts for equipment and software investment growth in 2021 and the key economic and policy trends that will shape the equipment finance industry over the next year.

Acknowledgements

We extend our gratitude to the industry volunteers who guided this project and provided comments and suggestions throughout the drafting process.

- Bill Choi, Equipment Leasing and Finance Association
- Anneliese DeDiemar, Equipment Leasing & Finance Foundation
- Jeff Elliott, Huntington Equipment Finance
- Dave Farrell, Bank of America Global Leasing
- Stephanie Fisher, Equipment Leasing & Finance Foundation
- Troy Graziani, Toyota Industries Commercial Finance, Inc
- Kelli Nienaber, Equipment Leasing & Finance Foundation
- Ralph Petta, Equipment Leasing and Finance Association
- Ricky Rios, Commercial Equipment Finance, Inc.
- Shannon Stangl, DLL
- Scott Thacker, Ivory Consulting Corporation
- Amy Vogt, Equipment Leasing and Finance Association
- Tom Ware, Tom Ware Advisory Services, LLC

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