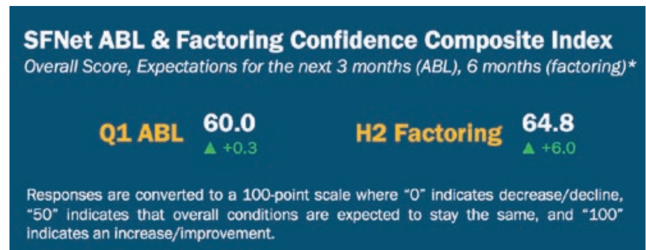
FEATURE STORY

Navigating Economic Uncertainty: Key Insights from the SFNet Market Pulse Report

BY SFNET'S DATA COMMITTEE

As we delve into the second quarter of 2024, the financial landscape is marked by both challenges and opportunities. The latest SFNet Market Pulse Report provides a comprehensive analysis of various economic indicators, trends, and projections that are crucial for stakeholders in the secured finance (notably asset-based lending and factoring) industries. This article synthesizes the key findings and insights from the report, offering a detailed overview of the current economic outlook, credit markets, consumer finances, sector activity, and global economic trends.

The U.S. economy experienced a modest growth of 1.3% in the first quarter of 2024, driven by consumer spending and business investment. However, the growth fell short of expectations due to subdued consumer spending, inventory reductions, and declining net exports influenced by a strong dollar. Despite these challenges, there is optimism in certain areas, such as the improving global economic outlook and stable portfolio quality in the secured finance industry. The SFNet ABL and Factoring Confidence Indices indicate a cautiously optimistic outlook among lenders, with expectations for stable conditions in the near term.



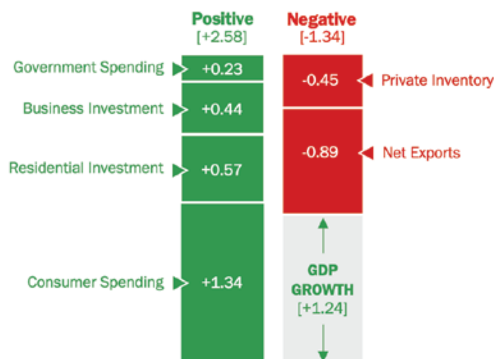
Economic Outlook

The U.S. economy grew at an annualized rate of 1.3% in Q1 2024, nearly a full percentage point below consensus estimates. This muted growth was due to softer consumer spending, businesses paring back inventories, and declining net exports as a strong dollar increased the cost of U.S. goods. If there is a silver lining to slower growth, it is that progress on disinflation is looking more promising than it was earlier in the year. The latest CPI report showed 0% month-over-month (M/M) price growth in May, easing concerns that inflation is reigniting. However, it will take a few more months of disinflation to confirm that price growth is returning to a more sustainable rate.

Achieving the Fed's target is a double-edged sword. Disinflation may stem from reduced consumer demand, but if demand drops too far, the U.S. could dip into a recession. The preponderance of evidence, however, indicates that the U.S. economy is achieving a "soft landing"—a reduction in inflation with a still-healthy labor market and no recession.

Over the next six months, four factors will shape the trajectory of the U.S. economy:

1. Stubborn Inflation. Progress on inflation stalled in early 2024, sparking fear that the Fed could raise rates again. However, fears have abated as CPI and Core PCE inflation (the Fed's preferred measure) have cooled.
2. Consumer Financial Stress: Cracks are beginning to show in consumer spending as debt burdens rise and real disposable income growth eases.
3. Cooling Labor Market: Despite surprisingly strong payroll growth in May (+272K jobs), the labor market is not as hot as it has been. The unemployment rate rose to 4%, job postings continue to fall, and voluntary "quits" are declining.
4. Political Uncertainty: With the close 2024 U.S. presidential race kicking into gear, political uncertainty is high.



Source: Bureau of Economic Analysis

Consumer Finances

Household financial stress is rising, evidenced by tepid real disposable income growth, increasing delinquency rates, and a low personal savings rate. The resilience of consumer spending, a primary driver of economic growth since the pandemic, is under pressure from these factors.

Resilient consumer spending has been the predominant force fueling economic growth since the pandemic recession of 2020. However, recent data suggest a spending slowdown may be underway, with the economy posting notably slower GDP growth in Q1 2024 than it did in Q4 2023. Declining economic activity was due in large part to lower-than-expected spending as consumers have started to balk at high prices and feel the pinch of high interest rates.

Several trends are contributing to this slowdown:

1. Tepid Real Disposable Income Growth: Even as the labor market has remained strong, inflation-adjusted disposable income growth slowed to just 1% year-over-year (Y/Y) in April. Consumers are stretching their budgets as they struggle to maintain their current spending.
2. Rising Financial Stress: Delinquency rates for most types of debt have risen steadily from 2021. This rise is particularly pronounced for credit cards, as climbing APRs—sometimes upwards of 30%—make paying off debt more difficult,

Source: U.S. Bureau of Economic Analysis

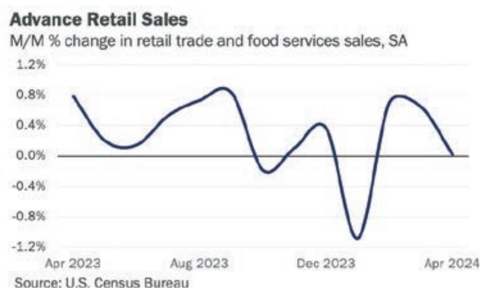
particularly for younger and lower-income households. Auto loan delinquencies are also up, with high monthly payments overstretching more household budgets.

3. Low Personal Savings Rate: The combination of elevated prices and moderating disposable income has led to a decline in the personal saving rate. It now stands at 3.6%, roughly half its 10-year average.

Sector Activity

Retail sales growth has moderated, indicating waning consumer demand. Despite this, retail employment has increased, suggesting some resilience in the sector.

Retail sales declined by more than 1% month-over-month (M/M) in January, bounced back slightly in February and March, but flattened in April. Overall, slowing growth may indicate that consumers are becoming more cautious in the face of growing financial stress and higher interest costs on credit cards. Despite weaker sales at many retailers, payroll employment in the retail sector has increased steadily over the past six months but is now more in “tepid growth” mode.



The manufacturing sector also shows signs of softening. Though the ISM Manufacturing Index entered expansionary territory for the first time since 2022 in March, it has since returned to contractionary territory for the past two months. Meanwhile, only 69% of manufacturers were positive about their company’s outlook in the National Association of Manufacturers’ Outlook Survey for Q1 2024, well below the long-term average of 75%.

Production data tells a similar story. Industrial production for the sector declined 0.5% Y/Y in April, with petroleum & coal products, motor vehicles & parts, and electrical equipment manufacturers seeing the largest drops. There are some pockets of optimism as computer and electronic product manufacturing, which includes semiconductors, is expanding. With a softer overall outlook, a manufacturing slowdown is a risk to watch for the broader U.S. economy.

The trucking industry is still reeling from pandemic-era shockwaves. Trucking was in high demand by mid-2020 as homebound consumers shifted their spending from services to goods but when the U.S. reopened, spending swung back towards services. Battered by this swing, the industry has been in a “freight recession” for the past two years.

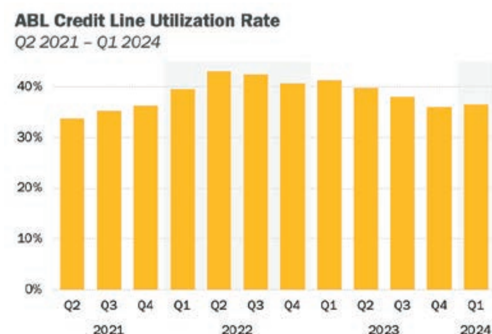
Credit Markets

Credit Demand & Growth

With interest rates remaining “higher for longer,” business demand for credit has been muted. According to the Federal Reserve’s April 2024 Senior Loan Officer Opinion Survey (SLOOS), a net 27% of banks reported weaker demand from large and medium firms for commercial and industrial (C&I) loans, and a net 23% reported weaker demand from small firms. When explaining weaker demand, banks continue to cite decreased customer needs to finance plant/equipment investment, inventory, and mergers & acquisitions.

There is scant evidence that a demand recovery is just around the corner. Nearly six in 10 banks reported that the number of inquiries from potential business borrowers around new credit lines or increasing existing lines has not changed, while another 27% report that inquiries have decreased.

Asset-based lenders have a relatively positive but, measured, outlook for new business demand. Just over half of the respondents to the Q1 SFNet ABL Confidence Index expect demand for new business to increase over the next three months. Lenders are less optimistic around client utilization, with most expecting utilization rates to remain unchanged over the same period. Utilization rates have been flat and hovering around 37% for the past three quarters. As with the SLOOS results, asset-based lenders also cite lower merger & acquisition activity as a reason for softer demand.



Factors have a similar outlook for new business demand for the first half of 2024. About half the respondents to the latest Confidence Index expect demand to improve, while the other half expects it to hold steady. With retailers facing challenges, factors do not expect this key client industry to spur a major increase in demand in the near term.

Looking forward, two developments could lead to an uptick in demand. As interest rate cuts become more probable later in the year, lower costs will likely drive more borrowing activity. Additionally, many firms that took advantage of low rates in 2020 and 2021 will need to refinance their loans as they approach maturity in 2025 and beyond.

If these conditions that could spark increased demand materialize, the secured finance industry appears poised to respond.

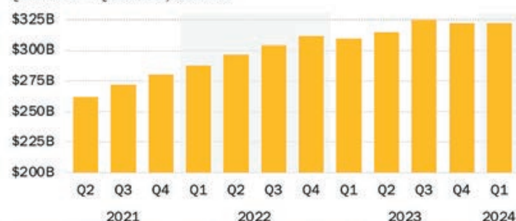
Credit Supply

Lending standards remain tight but unchanged, reflecting cautious optimism among banks. Asset-based lending commitment growth has slowed, and regulatory changes are contributing to cautious capital management among lenders.

Most banks are not changing their lending standards or terms after having steadily tightened since July 2022. In the latest SLOOS, a net 16% and 20% of banks reported tighter standards for large/medium and small firms, respectively. Nearly four in five banks say that their lending standards are unchanged. Of the banks that report tighter standards, most explained their change by citing an unfavorable or uncertain economic outlook or reduced tolerance for risk. Along with muted demand, steady but tight lending standards also explain the tepid growth in C&I loans.

Focusing on asset-based lending, commitment growth has been slower in recent quarters. Total commitments were essentially flat from Q4 2023 to Q1 2024, while new originations with new clients fell by 29.7% over the same period. Though much of the slower growth in commitments stems from weaker demand, regulatory changes may also play a role as lenders manage their capital with greater caution. A similar dynamic is at play with C&I loans, where nearly half of banks explained their tightening in the SLOOS by pointing to regulatory factors. Policy changes may be creating a barrier to lending, but asset-based lenders are largely ready for new business.

At its June meeting, the Federal Open Market Committee (FOMC) announced that it would maintain the target range for the federal funds rate at 5.25 to 5.5% for the 7th meeting in a row. The FOMC also released updated rate projections, with officials now expecting just one cut in 2024. According to CME Group's latest analysis of futures prices, markets predict a roughly two-thirds chance for at least two cuts by year-end.



Source: SFNet Q1 ABL Survey. Values above cover lenders that have reported on the referenced field in all quarters shown.

Lender Profitability

Most banks report that spreads between loan rates and costs of funds did not change in the latest SLOOS. Loan spreads may not have changed much, but net interest income at FDIC-insured commercial banks and savings institutions declined by 1.7% from Q4 2023 to Q1 2024.

In its statement on the Q1 results, the FDIC continued to highlight the "resilience" of the banking industry, pointing to recovering net income, "favorable" asset quality metrics, and "stable" liquidity. However, the FDIC also identified several challenges, including declining net interest margins and volatility in market interest rates, and observed that "deterioration" in office properties and credit card loans were risks to watch.

Portfolio Performance & Outlook for Business Conditions

Portfolio performance has deteriorated slightly in recent quarters but remains within its historical range. The charge-off rate on C&I loans at all commercial banks rose to 0.43% in Q1 2024, while the delinquency rate increased to 1.13%. Both rates are near their pre-pandemic levels and below their 20-year averages. Meanwhile, ABL non-accruals as a share of outstandings dipped to 0.57% in Q1 after peaking in Q4. Portfolio performance is weaker than it was a year ago, but there is not a major cause for concern. Indeed, Confidence Index scores have increased as a growing share of asset-based lenders and factors expect performance to improve. With performance returning to pre-pandemic norms, the outlook is positive, but lenders are closely monitoring portfolios for signs of stress.

The outlook for general business conditions is more mixed. Asset-based lenders have a slightly negative outlook for business conditions, while factors have a slightly positive one. Nonetheless, both outlooks are close to neutral, and most asset-based lenders and factors expect business conditions to remain the same. The secured finance industry performs well in a variety of economic conditions, but it may take a meaningful shift in business conditions to spark new demand.

Conclusion

The SFNet Market Pulse Report highlights a complex, but navigable, economic landscape. While challenges such as rising household financial stress and soft credit demand persist, there are areas of cautious optimism, particularly in the global economic outlook and stable portfolio performance. Stakeholders in the secured finance industry should remain vigilant and adaptable as they navigate these economic conditions.

This article provides a summary overview of the key findings from the SFNet Market Pulse Report, offering valuable insights for stakeholders in the secured finance and asset-based lending industries. To download the full report visit: https://www.sfnet.com/home/industry-data-publications/industry-insights-trends/market-pulse or scan code below: