ProfitGuard
Know The Risk *Before* You Ship

CREDIT RISK NEWSLETTER

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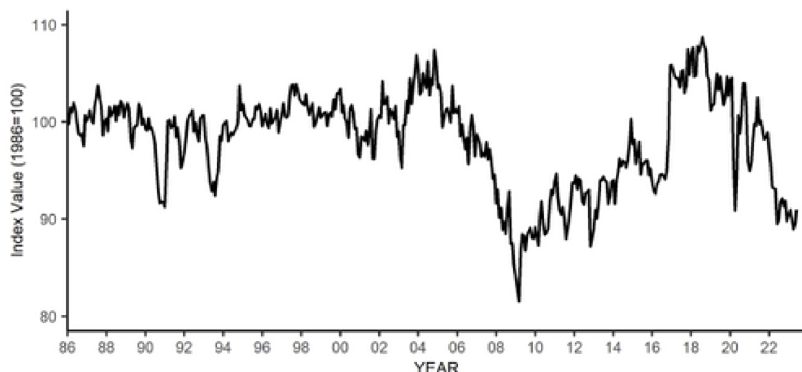
SMALL BUSINESS LANDSCAPE

The Small Business Administration (SBA) reports that as of 2022, there are 32.5 million small businesses in the United States, making up 99.9% of all American businesses. Small businesses are an essential part of the American economy and workforce because they create the majority of new jobs and generate billions of dollars in economic activity. According to the U.S. Chamber of Commerce, small businesses employ almost half (46%) of America's private sector workforce and represent 43.5% of gross domestic product.

The National Federation of Independent Business (NFIB) Small Business Optimism Index reported its highest reading since November 2022, signaling that small business pessimism may have bottomed out.

The NFIB Small Business Optimism Index is an indicator of the health of small businesses in the United States. A rising index suggests that small businesses are optimistic about the future and are likely to invest and hire more workers. A falling index suggests that small businesses are pessimistic about the future and are likely to cut back on investment and hiring.

The June 2023 index suggests that small business optimism may be starting to improve. With that being said, the index is still below its long-term average, which suggests that small businesses are still facing some challenges.



NFIB Chief Economist Bill Dunkelberg said, "Inflation and labor shortages continue to be great challenges for small businesses. Owners are still raising selling prices at an inflationary level to try to pass on higher inventory, labor, and energy costs." He added that most small business owners who were concerned about inflation cited labor supply as the greatest concern.

Twenty-four percent of owners reported paying a higher rate on their most recent loan. The average rate paid on short-term loans was 9.2%, 1.4 percentage points above May's reading and the highest since June 2007.

The Federal Reserve raised the federal funds rate to 5.25-5.50% in July, which will discourage borrowing to finance spending of all types, including capital spending. Capital spending and inventory investment will fall, and economic growth will slow, which will help put a damper on inflation, but at the cost of lower employment.

WILL CREDIT SPREADS WIDEN?

With the U.S. economy holding up better than expected, credit spreads remain narrow. Credit spreads refer to the interest rate premium investors demand to hold corporate debt over safer U.S. Treasury bonds. When credit spreads widen, typically when economic growth slows, it means that investors are more risk-averse and are demanding a higher risk premium for investing in riskier assets. When credit spreads narrow, it means that investors are more confident in the economy and are willing to accept a lower risk premium for investing in riskier assets.

Further added by Morningstar, credit spreads indicate the credit risk perceived by market participants/investors and are dynamic reflecting real-time market conditions, unlike credit ratings which are revised (upgraded or downgraded) with some lag.

We expect credit spreads to widen as slowing economic growth weighs on corporate profitability and tightening credit conditions impact refinancing risk. We also expect this will lead to more defaults. According to Moody's Investors Service, the U.S. trailing 12-month speculative-grade default rate rose to 3.1% in May 2023, up from just 1.4% in May 2022. That rate is expected to rise to 5.6% by May 2024. S&P Global Ratings also expects the U.S. trailing-12-month speculative-grade corporate default rate to reach 4.25% by March.

STATE OF CORPORATE CREDIT

The U.S. economy is proving resilient, but cracks are forming, and credit risks remain present.

Tightening Credit Conditions

In response to the banking fallout, credit conditions have continued to tighten, and banks are more selective on extending credit. According to S&P Global, as banks strive to fortify their balance sheets and tighten their lending standards, small and midsize businesses could face difficulties in gaining access to funding. For higher risk companies, this could cause a liquidity crunch as funding will be more difficult to obtain and, in some cases, unavailable. While some companies will be able to refinance their upcoming debt, many restructuring bankers and attorneys say companies will first need to reduce leverage through options such as raising preferred equity and buying back debt at a discount.

“We’re talking to lots and lots of companies that have 2024, 2025, 2026 maturities, and if they had to refinance their entire capital structures today, they couldn’t afford it,” said Bill Derrough, co-head of capital structure advisory at Moelis. Tighter lending standards are expected to remain as the economy cools off and banks prepare for higher default rates. During this period, it is vital to ensure that your customers can service their debt and have access to liquidity if needed.

Elevated Interest Rates

Rising interest rates pose another threat to the state of corporate credit. The federal funds rate currently sits at 5.25-5.50%, the highest level in 22 years, after the Federal Reserve raised rates a quarter percentage point in July. Fed Chair Powell is also “keeping the door open” for more hikes this year, however rates are expected to remain at that level until mid-2024. As financing is expected to remain costly for the foreseeable future, some companies may be unable to service their debt and could miss interest payments. S&P Global Ratings expects corporate defaults to rise above the long-term average rate, especially for high-risk companies. S&P added that the default risk in the U.S. and Canada continues to increase as the volume of debt rated 'CCC+' and below neared its highest level since May 2020. The percentage of issuers rated 'B-' with a negative outlook or on CreditWatch with negative implications has increased since the first quarter. This could indicate that downgrades to 'CCC+' and below will continue.

Inflation Remains a Concern

For many businesses, input prices—including wages—remain high despite easing somewhat, and they're finding it more difficult to pass along costs to consumers and customers. With tightening credit conditions and dwindling earnings, credit quality could weaken further.

On the bright side, the U.S. economy is expected to avoid a recession this year and instead experience a protracted slowdown, which is a period of economic stagnation that lasts longer than usual. Credit spreads also remain narrow. Nevertheless, a downturn of some degree is still possible since the Fed would rather overshoot the mark than fall short in battling inflation.

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