

Q4 update – October

# 2013 Equipment Leasing & Finance U.S. Economic Outlook





The Foundation is the only research organization dedicated solely to the equipment finance industry.

The Foundation accomplishes its mission through development of future-focused studies and reports identifying critical issues that could impact the industry.

The Foundation research is independent, predictive and peer-reviewed by industry experts. The Foundation is funded solely through contributions. Contributions to the Foundation are tax deductible.

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## ABOUT THIS OUTLOOK

The Equipment Leasing & Finance Foundation (the Foundation) recognizes that with the wide variety and increasing complexity of economic data available to the public, the best way to utilize key equipment investment data is to have it all in one place, where business leaders can access it easily and quickly, thus assisting them in making the best business decisions. This report highlights key trends in equipment investment and places them in the context of the broader economic climate in the United States (U.S.).

Industry-specific data within the report include quarterly “Key Signposts” and monthly “Equipment and Software Investment Momentum Monitors,” which are leading indicators for the direction of growth in equipment and software investment. The outlook report also includes an analysis of capital spending in the U.S. as well as an evaluation of how capital spending is affected by various related and exogenous factors, both currently and in the foreseeable future.

The Foundation partnered with Keybridge Research LLC to produce this economic outlook report specific to the equipment finance industry. This Q4 report is the final update to the 2013 Annual Outlook, and will be followed by the publishing of the 2014 Annual Outlook.

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## Q4 2013 Equipment Leasing & Finance U.S. Economic Outlook

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October 2013

### EXECUTIVE SUMMARY

The U.S. economy is largely in the same position it has been in for the past six months – improving fundamentals weighed down by a number of headwinds resulting in subpar growth. Among the positive drivers, the housing market is still in recovery mode, inexpensive natural gas continues to benefit households and the industrial sector, auto sales remain above 15 million units (annualized rate), rising household wealth is buoying consumer confidence, credit availability is steadily improving for households and businesses, and job gains have been steady. However, a number of nagging headwinds including fiscal consolidation, rising oil prices, and renewed fiscal policy tensions continue to constrain growth.

***Overall, we expect that the U.S. economy will generate positive but slow growth of 1.7% in 2013.***

Equipment and software investment slowed from 3.1% annualized growth in Q1 2013 to just 1.0% in Q2. Slower growth is a reflection of broader macroeconomic headwinds and uncertainty, but also categorical revisions to the Bureau of Economic Analysis's equipment investment accounts. Looking ahead, we expect a modest uptick in investment through the end of the year, with an overall forecast of 3.3% growth for 2013.

- Agriculture equipment investment is expected to remain weak on a quarter-to-quarter basis, but unusually poor performance in Q3 2012 could translate into positive annual growth in the second half of 2013.
- Computers & software investment is expected to grow at a slower pace than has been observed over the past several years. Annual growth should be in the 0% to 3% range during Q3 and Q4 of 2013.
- Construction equipment investment continued its rapid growth, up 38% year-over-year in the second quarter, as investment has continued to grow at what is likely an unsustainable rate. Leading indicators all decelerated recently, suggesting that a negative correction could occur within the next three to six months.
- Industrial equipment investment grew 1.4% year-over-year in Q2 and is expected to grow at a slightly faster rate in the second half of 2013.
- Medical equipment investment indicators look bleak, suggesting little to no growth going forward.
- Transportation equipment investment is expected to improve some and grow between 2% and 5% year-over-year moving forward.

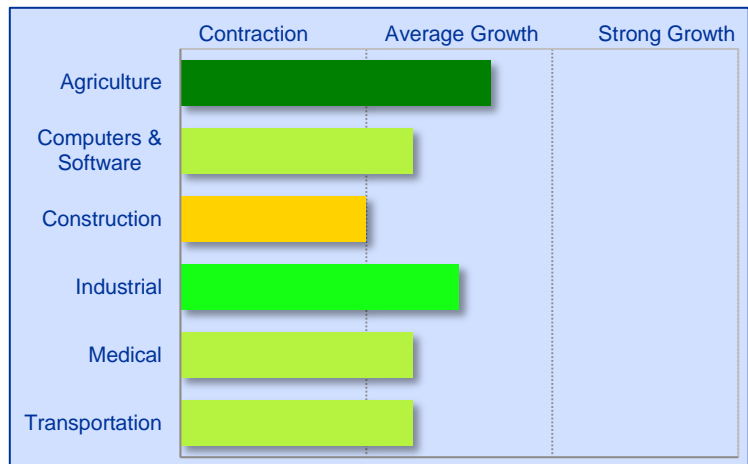
Credit market conditions are steadily improving, with a number of indicators continuing to recover to levels not seen since the onset of the recession. On September 18<sup>th</sup>, Fed Chairman Bernanke surprised financial markets by announcing that the current pace of quantitative easing would be maintained. Upon the news, stocks, bonds, commodities, and most all other asset classes rallied. Since then, there has been some unease in financial markets, as there is a perceived lack of clarity from the Fed regarding its timeframe for “tapering” bond purchases. Over the past few months, there has been a steady upward drift in long-term interest rates, which has flowed through to slightly higher mortgage rates. However, financial stress remains subdued and corporate and household balance sheets are relatively clean. Recent demand for business loans has been cautious, however, due to policy uncertainty and uneasy economic conditions, but credit supply remains relatively loose. Overall, our outlook for credit markets remains optimistic as investors continue to be risk-on, credit availability is steadily increasing, and the Fed is expected to maintain a near-zero short-term interest policy until economic conditions suggest otherwise.

## KEY SIGNPOSTS FOR EQUIPMENT INVESTMENT: THREE- TO SIX-MONTH OUTLOOK

### Summary

After the BEA's recent benchmark revisions, Equipment and Software investment grew 1.0% (quarter-to-quarter annualized) in Q2 2013, a slowdown from 3.1% in Q1. In the second quarter, Transportation and Construction equipment grew, but other major sectors – Computers & Software, Industrial equipment, Medical equipment, and Agricultural equipment – contracted. Overall, we expect the pace of growth to pick up slightly in the second half of the year, with a few exceptions at the sector level. In particular, in a reversal of recent trends, all signs are pointing to a slowdown of investment in construction machinery.

Key Signposts "Heat Map" Growth Chart



**Agriculture Equipment:** Investment in this vertical fell 6.6% year-over-year in Q2 after a sharp increase in Q1. On top of weak investment in Q2, monthly shipments of farm machinery are down 3.8% thus far in Q3. Overall, we expect investment to contract by up to 4% at an annualized rate in Q3 and Q4. However, due to a particularly weak Q3 2012, this would ironically result in 10% to 15% year-over-year growth.

**Computers & Software:** In July, the Bureau of Economic Analysis (BEA) performed a comprehensive revision to the National Accounts data, including a re-categorization of software investment as "Intellectual Property" and revisions to past data. After these revisions, investment in computers and software increased 1.9% year-over-year in Q2, a slowdown from 4.0% in Q1. Looking forward, two major indicators slightly contradict each other – the ISM Nonmanufacturing Composite Index points to above average growth, but the BRT CEO Economic Outlook Survey indicates slow to average growth. Together, the two indicators suggest average annual growth of around 1% to 5%.

**Construction Equipment:** As forecast, investment continued to surge, growing 38% year-over-year in Q2. Investment levels have doubled from normal levels (\$30 to \$35 billion per year) to an annualized rate of \$65.2 billion in Q2 2013. Evidence suggests that these record-level figures have not shown up in financing volumes, as rental companies may be playing a significantly larger role in the sector. Despite our faith in the housing recovery, all indicators point to a correction in construction equipment; meaning that equipment investment is likely to begin falling back down to normal levels. This may have a limited effect on financing volume.

**Industrial Equipment:** Investment grew 1.4% year-over-year, which was lower than forecast and slower than 4.2% growth in Q1. Three leading indicators are giving conflicting messages. Capacity Utilization indicates slow to average growth, Industrial Production indicates average growth, and Manufacturing New Orders points to above average growth. On balance, the key signposts suggest average growth (2% to 5% year-on-year) through the second half of the year.

**Medical Equipment:** In line with forecasts, investment increased 1.7% year-over-year in Q2, which was an improvement from no change in Q1. Looking forward, the outlook is bleak, with all three indicators currently underperforming. Hospital In-Patient Days and Medical & Diagnostic Lab Prices are both down year-over-year, and Revenue of Nursing & Residential Care Facilities grew at a slower than average rate. Additionally, the ultimate effects of sequester cuts on investment are unknown but continue to present downside risk. Overall, the signposts suggest little to no annual growth through the second half of 2013.

**Transportation Equipment:** Investment was noticeably weaker than expected in Q2, contracting 4.6% year-over-year after decreasing a revised 0.9% in Q1. The Philadelphia Fed Business Outlook Survey's Future Activity Index, a key leading indicator, has improved markedly this year but Personal Consumption Expenditures on Motor Vehicles & Parts have slowed. Taken together, the indicators suggest average annual growth between 2% and 5%.

**Key Signposts for Equipment Investment**
*(Estimated growth rate ranges are on a **year-over-year** basis)*

Leading Indicator	Most Recent Data Point	Recent Trend	3-6 Month Signal and Year-Over-Year Growth Rate Range
<b>Agriculture Equipment</b>			<b>Above Average Growth (10% to 15%)</b>
<i>Texas Index of Leading Indicators (SA)</i>	126.1 Jul-13	Up 0.6% in three months, and up 3.4% over the past year	Above average growth
<b>Computers &amp; Software</b>			<b>Slow to Average Growth (0% to 3%)</b>
<i>ISM Nonmanufacturing Composite Index (SA)</i>	58.6 Aug-13	Up 9.1% over the past three months, and at its highest level since December 2005	Above average growth
<i>Business Roundtable CEO Economic Outlook Survey</i>	79.1 Q3-13	Down 2.4% in two quarters, and almost equal to the long-term average	Slow to average growth
<b>Construction Equipment</b>			<b>Below Average Growth (-5% to 5%)</b>
<i>HMI: Sales of New Single-Family Detached Homes Index (SA), Next Six Months</i>	65 Sep-13	Down 4.4% over the past three months but up 27% over the past year	Above average growth
<i>New Private Housing Building Permits (SAAR, Thousand Units)</i>	918 Aug-13	Down 3.8% from last month and down 8.7% from April's four-year high	Slow to average growth
<b>Industrial Equipment</b>			<b>Average Growth (2% to 5%)</b>
<i>Capacity Utilization (SA)</i>	77.8% Aug-13	Unchanged from three months ago but down 0.5% from March's 4½ year high	Slow to average growth
<i>Industrial Machinery New Orders (SA, \$Mil)</i>	3,940 Jul-13	Up 1.6% in one month and up 20% in the past year	Above average growth
<i>Industrial Production Index (SA)</i>	99.4 Aug-13	Up 0.5% in past three months and up 2.7% year-year	Average growth
<b>Medical Equipment</b>			<b>Slow to Average Growth (0% to 2%)</b>
<i>Hospital In-patient Days (Thousands)</i>	55,876 Q2-13	Down 2.2% year-on-year, and the lowest reading on record	Contraction
<i>PPI: Medical &amp; Diagnostic Labs</i>	106.8 Aug-13	Flat this month, and down 1.6% year-over-year	Little to no growth
<i>Nursing &amp; Residential Care Facilities Total Revenue (\$Mil)</i>	52,235 Q2-13	Up 2.6% year-over-year, but up just 0.1% over the past two quarters	Slow to average growth
<b>Transportation Equipment</b>			<b>Slow to Average Growth (2% to 5%)</b>
<i>Philadelphia Fed Business Outlook Survey, Future Activity</i>	58.2 Sep-13	26 points above the 3-year average and up 17 points in a year	Above average growth
<i>Real PCE: Motor Vehicles &amp; Parts (SAAR, Bil.Chn.2005\$)</i>	379.8 Q2-13	Down 0.2% quarter-to-quarter from Q1's five-year high	Average growth

**How to Use the Key Signposts**

Key Signposts are leading indicators for turning points in the equipment investment cycle, and also the direction of growth in equipment investment. "Turning Points" are defined as any point where the annualized growth rate is at a two-year high or low. The signposts are designed to analyze the 6 largest verticals of equipment investment, as defined by the U.S. Department of Commerce's National Income & Product Accounts. These indicators have been chosen based on their ability to consistently and accurately identify future trends in equipment investment with a lead-time of 3 to 6 months. For each investment vertical, the signposts should be interpreted together – providing either reinforcing or counter-balancing signals. There are three components of the signpost analysis that can be used to identify the direction of growth in major verticals of the equipment financing industry:

- (1) The summary provides a narrative for each investment vertical.
- (2) The "heat map chart" shows which investment verticals are poised to contract, or grow at a normal or strong pace.
- (3) The data table lists the most recent sign post data, recent trends, and the investment growth signal provided by each indicator.

## OVERVIEW OF MACROECONOMY IN 2013

The U.S. economy is largely in the same position it has been in for the past six months – improving fundamentals weighed down by a number of headwinds resulting in subpar growth. Among the positive drivers, the housing market is still in recovery mode, inexpensive natural gas continues to benefit households and the industrial sector, auto sales remain above 15 million units (annualized rate), rising household wealth is buoying consumer confidence, credit availability is steadily improving for households and businesses, and job gains have been steady. However, a number of nagging headwinds including fiscal consolidation, rising oil prices, and renewed fiscal policy tensions continue to constrain growth.

The September average of the *Economist* Poll of Forecasters for 2013 GDP growth has declined to 1.6%, while the Federal Reserve’s most recent “central tendency” forecast for growth is in the range of 2.0% to 2.3% – a decline from the Fed’s June forecast. Both the *Economist* and the Fed forecasts assume some “fiscal drag,” yet the effect of increasing oil prices in the latter months of 2013 and budgetary uncertainty present further downside risks to growth. Both WTI and Brent oil prices have increased around \$11 per barrel over the past three months, as tensions in the Middle East have flared up. Sustained, elevated oil prices would be a drag on global economic growth and could hurt disposable income. Additionally, further fiscal policy uncertainty could subvert rebounds in confidence among businesses and households.

Indicator	Recent Activity
Consumption	Consumer spending grew in Q2 2013 but at a slower rate than in Q1. Higher taxes and oil prices appear to be reducing consumption.
Equipment & Software Investment	Equipment & Software Investment grew at a slower pace in Q2 than in Q1. It is possible that policy uncertainty is still weighing on businesses’ decisions to invest.
Residential Investment	Residential Investment continued to post a strong quarter in Q2, further evidence of the sustained housing recovery.
Government Expenditures	Government spending decreased for the third consecutive quarter in Q2. Both national defense and nondefense spending declined relative to the previous quarter.
Net Exports	Exports grew by the largest amount since Q4 2010, as demand for U.S. goods in Europe and Asia appears to be rebounding.
Inflation	Inflation has averaged only 1.6% from January through August.

### **Keybridge’s macro outlook remains in line with consensus forecasts – we expect growth of 1.7% in 2013.**

Headwinds from the “fiscal cliff” deal and sequestration will remain a drag on GDP growth through the rest of the year. Consumers are still internalizing higher taxes, government furloughs are expected to have a marginal negative impact on consumption, and overall government spending will continue to decline in real terms over the next few quarters. These contractionary effects will, however, continue to be counterbalanced by strength from the positive momentum of the private sector, most notably from autos and housing. In terms of prices, headline CPI inflation will remain subdued – below 2% – for the remainder of 2013. Notwithstanding any massive oil price shocks, energy prices will continue to add slight upward pressure on inflation. But, with limited real wage growth and easing food prices, inflation should remain subdued throughout the rest of the year.

### **SPOTLIGHT ON MONETARY AND FISCAL POLICY**

There have been two major developments in U.S. monetary and fiscal policy this past quarter that affect our economic outlook:

**Monetary Policy:** On September 18<sup>th</sup>, Fed Chairman Bernanke surprised financial markets by announcing that the Fed would continue its current rate of \$85 billion of bond purchases per month (“QE III”). Markets expected a slight reduction (so-called “tapering”) in the rate of asset purchases, beginning in September, but this turned out to be a misread of Bernanke’s comments in May. Chairman Bernanke pointed to several reasons for not tapering – two of the most important being financial instability and fiscal risks:

- **Financial Instability:** On this issue, the Fed is in a very tight position. QE is inflating asset prices, and the Fed’s eventual exit strategy will take a toll on stocks, bonds, commodities, home prices, and other real asset prices. The fact that so many asset classes are directly correlated with a single policy decision is a significant risk that the Fed must consider. All the more reason for the Fed to hold off on tapering until it feels that growth expectations are strong enough to outweigh the effects of rising interest rates.



- **Fiscal Risks:** Chairman Bernanke was surprisingly vocal in his press conference that Congress was taking large risks with the U.S. economy by engaging in political brinksmanship over the 2014 budget and the debt ceiling. He spoke at length about what the Fed would do if Congress' actions hurt consumer and investor confidence, suggesting that this is a major new area of concern for the Fed.

The Fed's messaging has become muddled, and some economists believe that the Fed's forward guidance, and by extension its credibility, have been compromised. The Fed clearly wants to see stronger economic conditions before tapering; but, they have not set clear goal posts. Even if there is improving economic data over the next 2-3 months, it would be disingenuous to call that "evidence" of a sustained recovery. Over the past three years there have certainly been three-month-long stretches of positive economic data, only to be followed by a slowdown. It appears as though changes to QE III will be on hold until 2014, when new leadership takes over at the FOMC and any positive economic trends will have had time to coalesce.

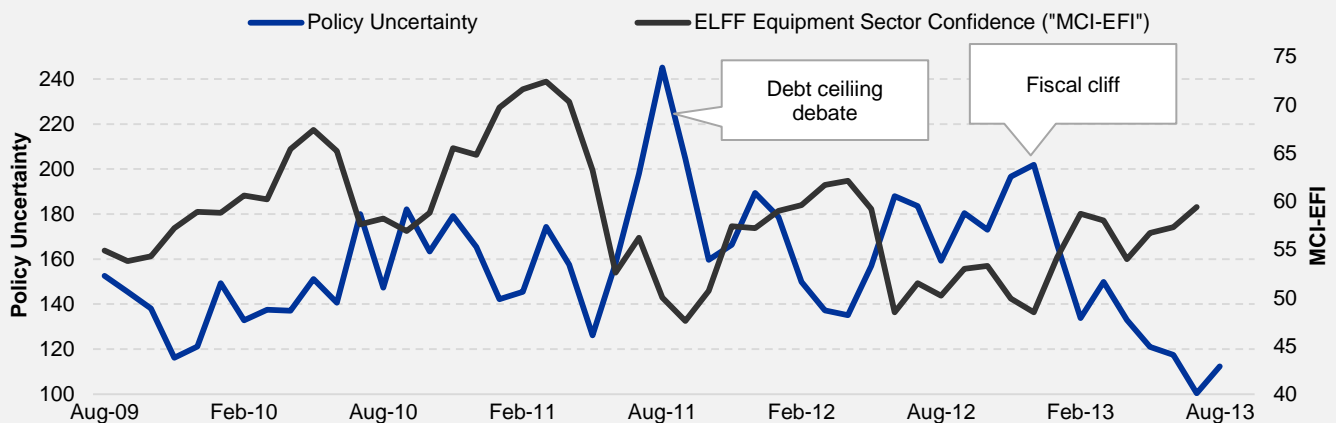
**Fiscal Policy:** At the time this report went into publication the federal government was shut down due to Congress' inability to compromise on a budget for the new fiscal year. The duration of the shutdown is uncertain, but most political analysts expect it to last a few days to several weeks when the federal government reaches its debt limit on or around October 17. If the debt ceiling is not raised, the federal government would first become delinquent on debt payments and risk a credit downgrade. In the worst-case scenario, the government risks outright default. While such an event is highly unlikely, the repercussions could be catastrophic.

This latest manufactured fiscal crisis has an "unstoppable force—immovable object" element. House Tea Party Republicans want to either de-fund or delay the Affordable Care Act, and the Senate Democrats and the Obama Administration are unwilling negotiate on the President's signature policy. As of October 1, the popular school of thought is that a showdown was inevitable, so better that it happened over the budget rather than the debt ceiling. We subscribe to this train of thought, but realize that raising the debt ceiling is not a given. The outcome depends on several factors – perhaps most importantly, will the government shutdown give members of Congress the political cover they need to reach a compromise? If so, both sides could find enough common ground on budget issues to fund the government and raise the debt ceiling. But, this is not your father's Congress. It is entirely possible that both (or either) sides become more entrenched and are unable or unwilling to compromise.

Whatever the case, there is a clear negative linkage between political uncertainty and business confidence. Two of the lowest readings of the ELFF Monthly Confidence Index for the Equipment Finance Industry ("MCI-EFI") occurred during or directly after Washington standoffs. We anticipate rising uncertainty and falling confidence as a result of the latest round of debates.

**Manufactured Crises Affect the Real Economy**

Policy Uncertainty and the "MCI-EFI"



Source: ELFF, Haver Analytics

## ADDITIONAL FACTORS TO WATCH

Our sector-level analysis repeats many of the same themes as in recent quarters, but the following trends continue to be a useful narrative for the U.S. outlook this year:

**Rebounding Housing Market:** The housing market continues to exhibit signs of a solid recovery. Among the key indicators, housing starts and sales are gradually rebounding, and home prices are up 12.3% over the past year. Although mortgage rates increased over the past six months, high affordability and increasing vacancies in some key markets should continue to drive housing activity, which should add half a percentage point to GDP growth this year.

**Oil & Gas Production:** Exports of petroleum products reached a record-high in July, a sign of a still-strengthening U.S. energy sector. As capacity comes online at production facilities, exports should continue along this strong trend. A recent study by IHS Global Insight showed that due to the increased production of oil and gas in the U.S., the average household saw an extra \$1,200 in disposable income.

**Rising Oil Prices:** Despite rising domestic production, the U.S. is still subject to global oil prices. Worries about further conflict in the Middle East have caused a jolt in oil prices, with crude oil now hovering well over \$100 a barrel. If oil price increases flow through to gasoline prices, it could take a substantial bite out of household income and consumption in the second half of 2013.

**Employment:** The private sector continues to slowly and steadily increase payrolls, and the unemployment rate ticked down to 7.3% in August – the lowest rate since December 2008. Improving conditions in the housing, energy, and retail sectors are spurring employment gains. However, many of the new jobs are part-time and average weekly hours worked are flat on a year-over-year basis.

**Auto Sales:** Total vehicle sales recently surpassed 16 million units, at an annualized rate in August, and it is clear that the vehicle replacement cycle is in full-effect. Pent-up demand and still-low rates for auto loans are driving demand back to long-term averages.

**Improving Global Economic Conditions:** Economic conditions in Europe and Japan are slowly improving. The euro-zone emerged from a six-quarter-long recession with 1.2% annualized GDP growth in the second quarter, driven by greater manufacturing output and higher retail sales. In Japan, factory orders are beginning to trend upwards – a sign that businesses are increasing capital expenditures.

## Projections for Key Economic Indicators

Indicator	2012	2013e	2013 Quarterly Estimates				2014e
			Q1	Q2	Q3e	Q4e	
Real GDP (SAAR %)	2.2%	1.7%	1.1%	2.5%	1.9%	3.1%	3.2%
Real Investment in Equipment & Software (SAAR %)	6.9%	3.3%	3.1%	1.0%	3.5%	3.7%	4.0%
Inflation (annualized rate)	2.1%	1.7%	1.7%	1.4%	1.7%	1.9%	2.5%
Federal funds (effective, end of period)	0.15%	0.15%	0.15%	0.15%	0.15%	0.15%	0.50%
10-year Treasury Rate (end of period)	1.72%	2.80%	1.95%	2.00%	2.70%	2.80%	3.25%
Total Payrolls (in thousands)	+2,193	+2,207	+645	+579	+433	+550	+3,000

Note: SAAR% refers to the annualized rate of change in seasonally adjusted data from one quarter to the next, which is the Bureau of Economic Analysis' standard method for reporting growth in the national accounts data.

## U.S. CAPITAL INVESTMENT AND CREDIT MARKETS

### Review of Recent Trends

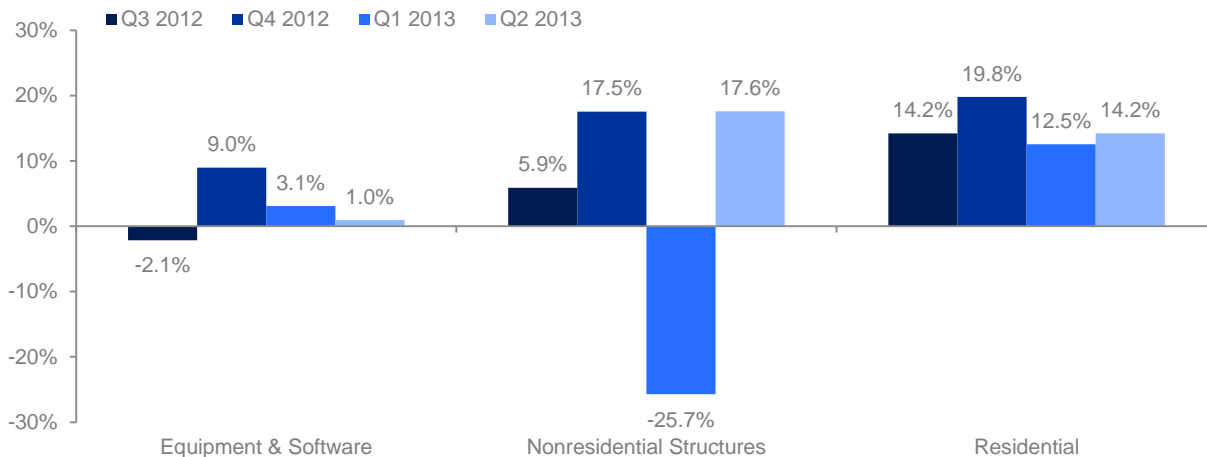
Equipment and Software investment grew at a 1.0% annualized rate in Q2, a slowdown from 3.1% growth in Q1 2013. Residential investment grew at a 14.2% annualized rate, a slight increase from 12.5% in the previous quarter. Investment in Nonresidential Structures increased at a 17.6% annualized rate after an unexpected decline of 25.7% in Q1.

Within the major equipment and software verticals, investment in Computers & Software decreased at an annualized rate of -4.7%, Transportation equipment increased by 4.9%, Medical equipment decreased by -1.9%, Construction equipment increased by 2.9%, Agriculture equipment decreased by -30.9%, and Industrial equipment decreased by -0.5%.

*The pace of equipment and software investment moderated in the second quarter, while residential investment picked up from the previous quarter, remaining in a strong growth phase. Equipment investment is expected to grow steadily over the next 6 months across most verticals, as underlying economic fundamentals continue to improve. Credit supply remains highly accommodative, but credit demand has eased slightly, especially from small businesses. Financial stress remains subdued.*

### Investment Growth Rates

Quarter-Quarter, Seasonally Adjusted Annualized Growth Rate



Conditions in the equipment leasing and finance industry exhibit slightly slower growth, but portfolio performance remains very strong. In August, the Equipment Leasing and Finance Association's Monthly Leasing and Finance Index (MFLI-25) reported new business volume of \$6.4 billion, which was down 7.7% from one year earlier and a decline of \$0.8 billion from the previous month. This was the second consecutive monthly decline in new business volume. Losses as a percentage of net receivables ticked up slightly to 0.4%, while the credit approval ratio increased again from 78.6% in July to 79.1% in August. The easing of the MFLI data over the past month is slightly at odds with the latest Equipment Leasing and Finance Foundation's Monthly Confidence Index for the Equipment Finance Industry ("MCI-EFI"), which increased in September from 61.0 in August to 61.3 – its highest level since April 2012. However, when asked about their assessment of business conditions over the next four months, only 30.3% of executives believe business conditions will improve, down from 32.4% in August. Moreover, 3% of respondents now believe business conditions will worsen, up from zero the prior month.

The Fed's quantitative easing program has pushed interest rates down, leaving some investors searching for higher yields. In particular, there has been an influx of higher-risk bond debt, as safer asset classes have not provided investors with attractive enough returns. According to Dealogic, in 2013, junk bonds have thus far made up 25% of all corporate bonds, up from 17% in 2007. There are other noticeable signs that financial market imbalances may be occurring throughout the economy. Debit balances on margin accounts are rising, corporate bond spreads are historically low, and the issuance of covenant-lite loans as a percentage of all loans continues to increase.

Our credit outlook continues to hinge on three primary factors that have already resulted in upward pressure on long-term interest rates:

- (1) “Risk-on” attitudes will prevail into 2014 as Europe has emerged from recession and the U.S. economy picks up momentum, notwithstanding any political flare-ups that reverse the recovery’s trajectory.
- (2) Lenders will continue to slowly loosen supply constraints.
- (3) The Fed will remain highly aggressive in its unconventional monetary policy – both in holding short-term interest rates at near-zero levels and in maintaining its current pace of large-scale asset purchases. The Fed will likely taper QE III in early 2014, but the expected rise in interest rates is unlikely to be rapid enough to affect business investment decisions in a material way. In fact, tapering may be a signal of stronger growth expectations and induce businesses to invest more.

Evidence suggests that the propensity to finance equipment investment rose in 2012, but it has since leveled off and even declined slightly in 2013. Businesses are weighing competing risks – lock in low rates while they last, or roll-over short-term rentals and leases until the economy picks up momentum. All else equal, an expected rise in interest rates should pull forward demand for equipment and financing.

- **Credit Supply & Pricing:** Credit availability remains mixed – financing is largely available for big businesses and strong credits, but smaller companies and marginal credits still find it difficult to access capital markets. The Q3 Federal Reserve survey of banks’ senior lending officers showed essentially unchanged standards on commercial & industrial (“C&I”) loans from the previous quarter. The benchmark 10-year Treasury rate has drifted to around 2.75% as of late, and given the improving position of the economy, many expect upward pressure on rates to continue. Short-term rates will likely remain near-zero through 2014.

**Summary of Credit Market Conditions**

Factor	Conditions Compared With Last Quarter
Supply	No Change
Demand	No Change
Financial Stress	Moderate Improvement

- **Credit Demand:** As policy uncertainty rises, businesses may hit the “pause button” on new capital expenditures. But, for the time being, there are multiple signs of slow growth in the demand for capital. The latest Fed survey showed acceleration in the demand for C&I loans over the past quarter, and C&I loans are closing in on their pre-crisis highs. Additionally, the Thomson Reuters/PayNet Small Business Lending Index increased from 105.7 in June to 117.7 in July. On the neutral-to-negative side, the 2013 Q3 Business Roundtable CEO Economic Outlook Survey showed a decline in the CEO’s expectations for capital spending over the next six months. Additionally, over 50% of Roundtable CEOs cited the tensions in Washington as having a negative effect on their outlook for employment over the next six months.
- **Financial Stress:** Steadily improving macroeconomic conditions and extremely accommodative monetary policy have continued to cause financial stress to abate across many sectors. The Kanas City Fed Financial Stress Index declined to -0.8 in August, which is its lowest level since February 2007. Specifically for businesses, the lease delinquency rate has ticked up in the past three quarters, but it remains below the typical non-recession average of 1.1%. The charge-off rate for all leases declined to 0.2% in Q2 2013, which is also well below its typical non-recession average. Meanwhile, nonfinancial sector debt as a percentage of GDP has increased slightly over the past five quarters and is around 78%, as of the latest data. Corporate bond yields have been increasing, but spreads have been compressed as Treasury yields have also increased.

## Keybridge Research Equipment & Software Momentum Monitors

Business investment in 2013 continues to look like a tale of two halves, as predicted in earlier versions of this outlook. Equipment and Software investment slowed in the second quarter, but signs continue to point to modest improvement in the second half of the year, notwithstanding a messy resolution of the current fiscal policy debates. Overall, we expect annual growth of around 3.3% in Equipment and Software Investment in 2013, with growth picking up towards the end of the year.

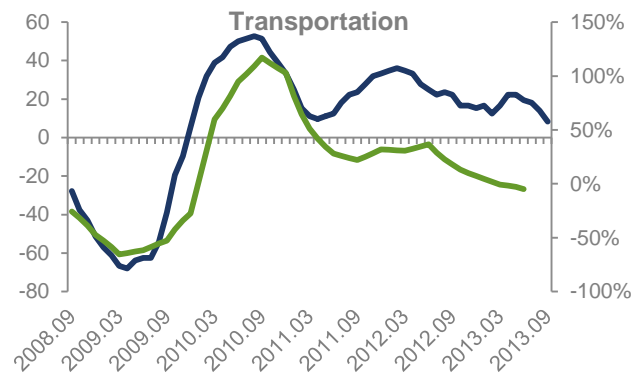
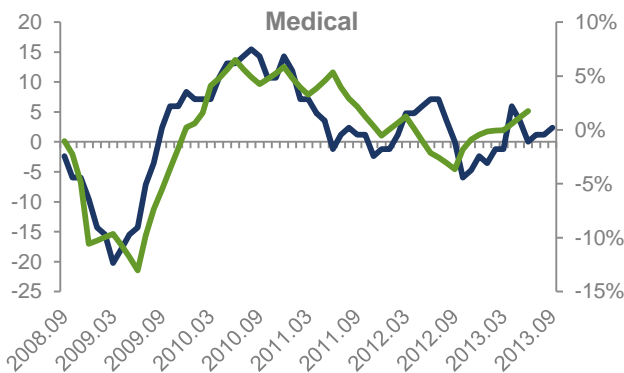
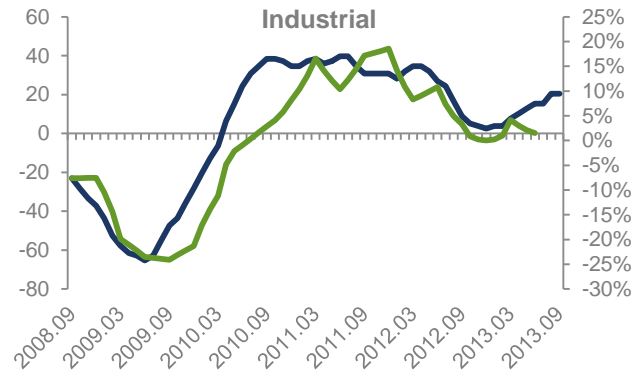
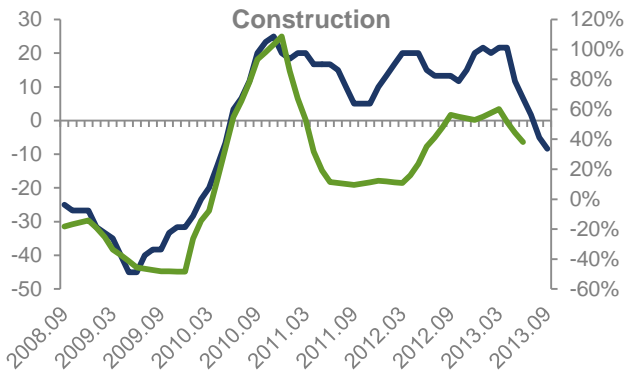
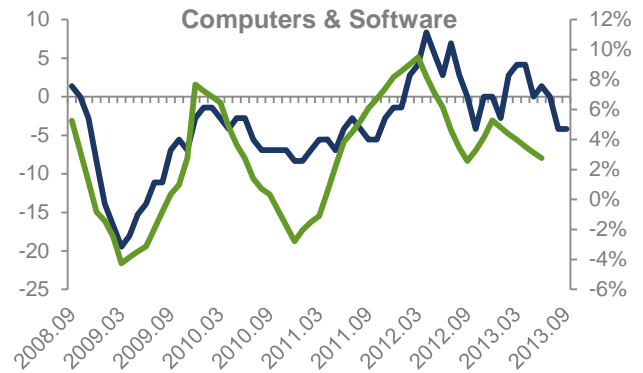
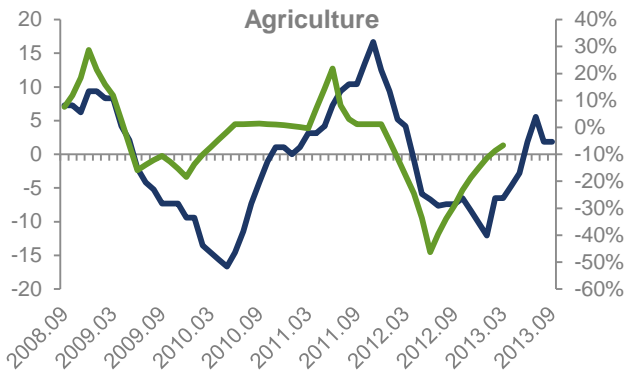
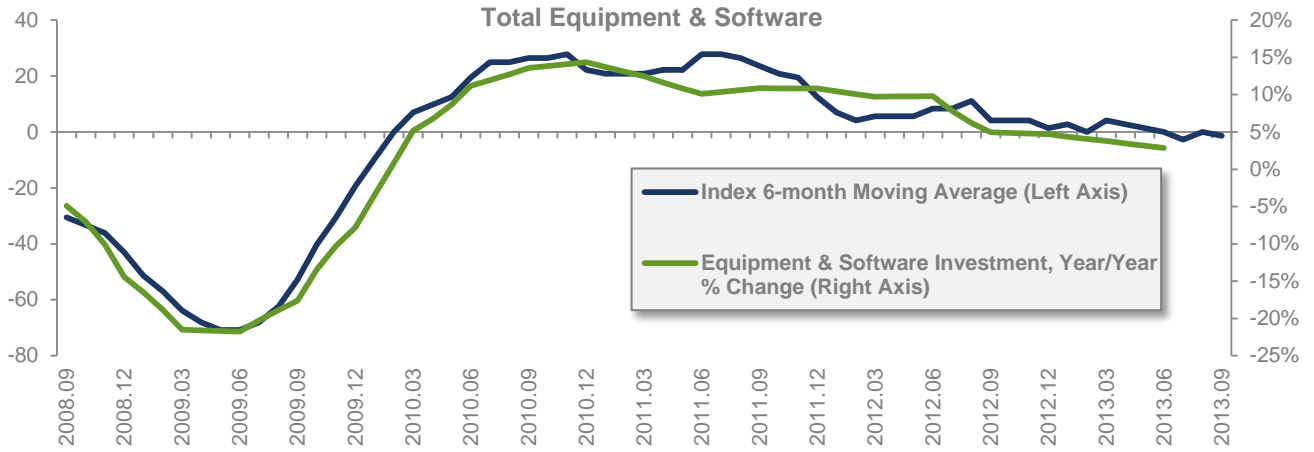
The *Keybridge Research Equipment & Software Momentum Monitor* – monthly leading Indices for equipment and software investment over the next 3 to 6 months – is predicting a slowdown in year-over-year investment growth in the third quarter, with some slight improvement closer to the end of the year.

Growth is expected to be mixed with some sectors outperforming others. Leading indicators point towards a possible stabilization in investment in agriculture equipment. Fairly average growth is expected for investment in computers & software, construction, industrial, medical, and transportation equipment. The monthly Momentum Indices for September are relatively consistent with the quarterly signposts:

- **Agriculture:** The Momentum Index's 6-month moving average remains weak but has picked up some slight momentum, increasing in each of the past three months. Indicative of this momentum, Red Meat and Poultry Production increased by 8.4% and Total Agriculture Leases increased by 13.0% from June to July. Additionally, the extended contraction in agriculture equipment investment continued to slow last quarter. The Index points to flat quarterly growth, which would translate to 10% to 15% year-over-year gains due to a very weak Q3 2012.
- **Computers & Software:** The Momentum Index's 6-month moving average remained weakly negative, at an almost two-year low. Leading indicators continue to remain muted – Manufacturers' Shipments of Electronic Computers decreased by over 10% in each of the past two months, while Consumer Expectations declined 3.7% over the past month. Overall, the Index suggests that growth will stabilize around its current slow rate.
- **Construction:** The Momentum Index's 6-month moving average has been in negative territory over the past three months, marking the first negative readings since mid-2010. For the past few quarters, construction equipment investment levels have been at remarkably high and likely unsustainable levels. The Momentum Index suggests a correction may begin as soon as this quarter or next. However, taking the froth out of the construction equipment market may not impact financing volume negatively.
- **Industrial:** The Momentum Index's 6-month moving average held steady at a 2013-high. Over the past month, the Index was strengthened by positive momentum in the Average Hourly Earnings for Goods-Producing Industries and in the ISM Manufacturing Employment Index. Continued moderate strength in the Index suggests continued slow growth through the end of the year.
- **Medical:** The Momentum Index and its 6-month moving average continued to fluctuate in September, remaining at near-neutral levels after a brief mid-year bump. With nine out of the fourteen leading indicators declining as of their most recent data, the Index points to little to no growth in the second half of the year.
- **Transportation:** The Momentum Index has been choppy over the past few months, while the Index's 6-month moving average declined to its lowest level since November 2009 – a clear signal that transportation equipment investment will be weak in the near term. Despite Motor Vehicle Assembly and Total Truck Production posting strong readings in August, the Index points to a slowdown in investment.

**Keybridge Equipment & Software Investment Momentum Indices**

Source: [www.keybridgeresearch.com](http://www.keybridgeresearch.com)



## QUARTERLY DATA

Indicator	2011				2012				2013	
	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	
<b>Real Gross Domestic Product (SAAR %)</b>										
GDP	3.2%	1.4%	4.9%	3.7%	1.2%	2.8%	0.1%	1.1%	2.5%	
Consumer Spending	1.5%	2.1%	2.4%	2.9%	1.9%	1.7%	1.7%	2.3%	1.8%	
Gross Private Fixed Investment	14.2%	2.5%	31.9%	10.5%	-1.6%	6.5%	-2.4%	4.7%	9.2%	
Inv: Equipment & Software	5.1%	17.3%	10.1%	6.7%	5.5%	-2.1%	9.0%	3.1%	1.0%	
Inv: Computers & Software	13.1%	7.6%	10.5%	6.8%	-0.1%	-6.2%	22.6%	1.7%	-7.8%	
Inv: Industrial Equipment	0.2%	32.6%	20.9%	-14.5%	10.1%	0.2%	6.2%	0.4%	-1.1%	
Inv: Transportation Equipment	4.2%	49.7%	48.0%	26.5%	24.2%	-16.8%	1.1%	-7.6%	6.5%	
Inv: Medical Equipment/Instruments	18.7%	0.1%	12.0%	-3.2%	8.9%	6.4%	1.4%	4.9%	-3.7%	
Inv: Construction Machinery	-38.1%	-21.8%	302.4%	195.2%	50.1%	6.4%	16.1%	-16.6%	39.6%	
Inv: Agricultural Machinery	-32.4%	-1.1%	-4.0%	14.5%	-3.6%	-0.2%	-6.0%	9.1%	115.0%	
<b>Credit Conditions</b>										
Nonfinancial Sector Debt (% of SAAR GDP)	75.6%	75.7%	75.6%	75.4%	75.7%	76.1%	77.5%	77.9%	78.7%	
Loan Delinquency Rate	2.1%	1.8%	1.6%	1.5%	1.4%	1.2%	1.2%	1.1%	1.0%	
Lease Delinquency Rate	1.1%	1.0%	0.9%	0.9%	0.8%	0.7%	0.8%	0.8%	0.9%	
Net Tightening of C&I Loan Standards	-16.4%	-21.8%	-5.9%	5.4%	-6.9%	-9.5%	-7.6%	-7.4%	-19.1%	

Note: SAAR% refers to the annualized rate of change in seasonally adjusted data from one quarter to the next, which is the Bureau of Economic Analysis' standard method for reporting growth in the national accounts data.

## MONTHLY DATA

Indicator	2012					2013							
	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug
<b>Employment</b>													
Change in Total Payrolls (thousands)	165	138	160	247	219	148	332	142	199	176	172	104	169
Change in Private Payrolls (thousands)	131	118	217	256	224	164	319	154	188	187	194	127	152
Unemployment Rate	8.1%	7.8%	7.9%	7.8%	7.8%	7.9%	7.7%	7.6%	7.5%	7.6%	7.6%	7.4%	7.3%
<b>Business Activity</b>													
Industrial Production	96.8	97.0	96.8	98.1	98.2	98.2	98.8	99.1	98.7	98.9	99.0	99.0	99.4
Capacity Utilization	77.2%	77.2%	77.0%	77.9%	77.8%	77.7%	78.1%	78.2%	77.8%	77.8%	77.8%	77.6%	77.8%
PMI Composite Index	51	52	52	50	50	53	54	51	51	49	51	55	56
NFIB Small Business Optimism Index	92.9	92.8	93.1	87.5	88.0	88.9	90.8	89.5	92.1	94.4	93.5	94.1	94.0
<b>Consumer Activity</b>													
Consumer Confidence	61	68	73	72	67	58	68	62	69	74	82	81	82
Real Personal Consumption (MM % Chg)	-0.1%	0.4%	-0.1%	0.3%	0.1%	0.1%	0.3%	0.3%	0.0%	0.1%	0.2%	0.0%	--
Retail Sales (M/M % Chg)	1.2%	1.1%	0.0%	0.4%	0.3%	0.1%	1.1%	-0.3%	0.2%	0.5%	0.7%	0.4%	0.2%
<b>Lending Activity</b>													
C&I Loans (M/M % Chg)	0.7%	0.2%	0.9%	0.1%	1.3%	1.0%	0.6%	0.5%	0.5%	0.0%	1.1%	0.9%	0.0%
MLFI-25 New Business Volume (Bil. \$)	6.9	8.2	7.6	6.4	11.5	5.9	4.7	6.8	7.5	7.5	8.6	7.2	--
MLFI-25 Avg Losses as a % of Net Rec.	1.9%	1.8%	1.7%	2.0%	1.6%	1.8%	2.0%	2.0%	2.0%	1.6%	1.4%	1.5%	--
MLFI-25 Credit Approval Ratio	77.0%	79.6%	79.5%	77.0%	78.5%	78.3%	77.4%	78.4%	77.2%	78.8%	78.5%	78.6%	--
<b>Interest Rates (% end of period)</b>													
Fed Funds Target Rate	0.1250	0.1250	0.1250	0.1250	0.1250	0.1250	0.1250	0.1250	0.1250	0.1250	0.1250	0.1250	0.1250
1-Year Treasury Rate	0.16	0.17	0.18	0.18	0.16	0.15	0.17	0.14	0.11	0.14	0.15	0.11	0.13
3-Year Treasury Rate	0.30	0.31	0.38	0.34	0.36	0.42	0.36	0.36	0.32	0.52	0.66	0.61	0.79
10-Year Treasury Rate	1.57	1.65	1.72	1.62	1.78	2.02	1.89	1.87	1.70	2.16	2.52	2.60	2.78
30-Year Treasury Rate	2.68	2.82	2.85	2.81	2.95	3.17	3.10	3.10	2.88	3.30	3.52	3.64	3.70
AAA Corporate Bond Yield	3.36	3.42	3.40	3.58	3.67	3.90	3.84	3.90	3.70	4.09	4.32	4.38	4.49
BAA Corporate Bond Yield	4.78	4.72	4.45	4.57	4.63	4.84	4.78	4.83	4.53	4.95	5.35	5.28	5.34
<b>Prices</b>													
Headline Inflation (Y/Y % Chg)	1.7%	2.0%	2.2%	1.8%	1.8%	1.6%	2.0%	1.5%	1.1%	1.4%	1.8%	2.0%	1.5%
Core Inflation (Y/Y % Chg)	1.9%	2.0%	2.0%	1.9%	1.9%	1.9%	2.0%	1.9%	1.7%	1.7%	1.6%	1.7%	1.8%
Oil Price (West Texas Intermediate, \$/barrel)	94.16	94.72	89.57	86.66	88.25	94.69	95.32	93.05	92.07	94.80	95.80	104.61	106.57



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