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Economics Group

Special Commentary

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V-Shape in Services Spending is Vital to Main Street

A Safe Re-opening is Vital for Service Businesses

It is generally well understood that the COVID-19 crisis and the efforts to contain it present a major threat to retailers, leisure & hospitality and the parts of the healthcare system not involved with the important work of fighting the virus. A factor that is slightly less widely followed is the forced change in the composition of consumer spending is a threat to Main Street.

The cratering in consumer spending on services is a threat to Main Street.

In this report, we examine how the cratering in consumer spending on services is nothing short of an existential threat to Main Street. The Commerce Department recently polled small businesses about the impact of the pandemic.[1] The largest share of businesses reporting a large negative effect were in sectors that have come to be synonymous with the challenges of this crisis like accommodations, entertainment and education (Figure 1). Some highly impacted business categories were less intuitive like healthcare (due to postponed non-life-threatening services) and mining (due to unprecedented low oil demand), but also "NAICS 81—other services." When you look into the subcomponents that comprise that "other" category, you see the same services and businesses you would see on a walk down Main Street in any town in America: churches & civic organizations, barber shops & beauty parlors, auto repair places & car washes, and laundromats & dry cleaners (Figure 2). In fact, the healthcare component also includes another familiar spot on Main Street: the dentist office.

Figure 1

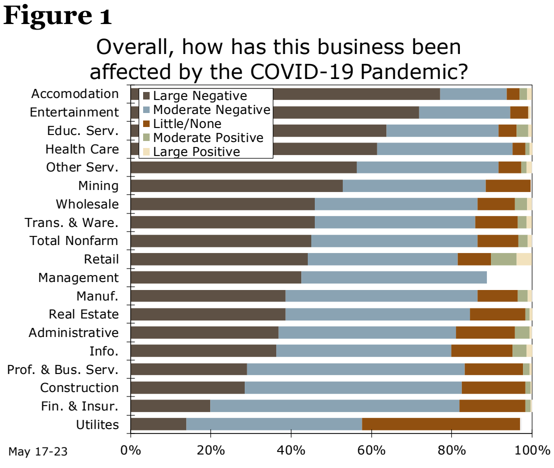
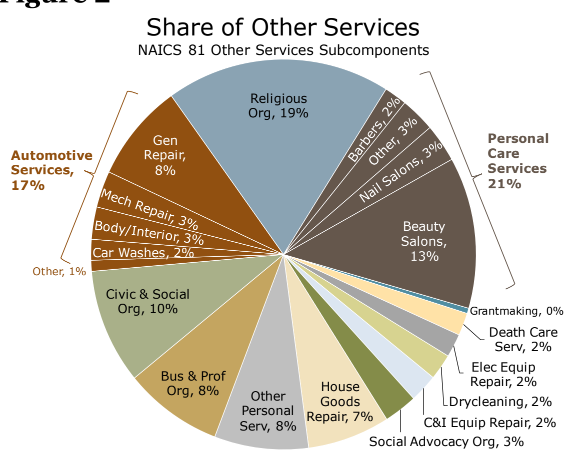


Figure 2



Source: U.S. Department of Commerce and Wells Fargo Securities

The shape of the recovery has been a key focus for Wall Street, but in the second half of 2020, a sharp rebound may matter more to Main Street. The federal government and Federal Reserve recognized this threat early on and have already deployed programs and facilities to ensure credit is widely available to these businesses. While policy solutions may bridge the gap, the most viable solution to ensure the long-term solvency is a rebound in service outlays. More plainly: a V-shaped recovery in local consumer services spending is vital to Main Street.

[1] "Small Business Pulse Survey," U.S. Department of Commerce.

Home Economics and Pent-Up Demand for Services

The crisis has dealt an unprecedented blow to services consumption.

In our recent report, Home Economics, we discussed how the various lockdown measures would shift the composition of spending to grocery stores, general merchandise retailers and to online merchants at the expense of virtually all other categories. Subsequent reports on retail sales have affirmed that guidance with record increases in these categories and record declines in just about everything else.

A follow-up publication looked at recessions over the past half century to see what typically happens to real consumer spending on goods and services. The takeaway there was that real spending on goods tends to decline sharply during recession, but spending on services does not typically fall below the pre-recession peak. This time is already different: in the first quarter alone services spending tumbled 2.7% (not annualized). That is already the largest decline in services on record and that is just the first quarter. We look for another 9.2% (not annualized) rate of decline in the second quarter, which will put the peak-to-trough decline in services spending at 11.6%, a drop that is simply without modern precedent.

Some Aspects of Re-opening Will Be Incremental

There may never be an "all clear" or sudden and immediate rollback of stay-at-home orders. Still, forcing everyone to stay home necessitates a sharp decline in spending and by the third quarter, after months of suppressed activity, there will be a coiled spring effect, which will likely translate into one of the strongest quarters on record for spending even if social distancing becomes a necessary part of life. Even with that surge in the third quarter however, it will not be until the end of 2021 or perhaps early 2022 before the level of personal consumption expenditures returns to the pre-recession peak.

Real consumer spending in general in the United States is on track to demonstrate the literal meaning of pent-up demand (Figure 3). We expect the Main Street businesses identified in Figure 2 on the first page to be a primary beneficiary particularly for services like haircuts and salon appointments that households have been denied for months due to shutdowns.

Consumption is on track to demonstrate the literal meaning of pent-up demand.

Figure 3

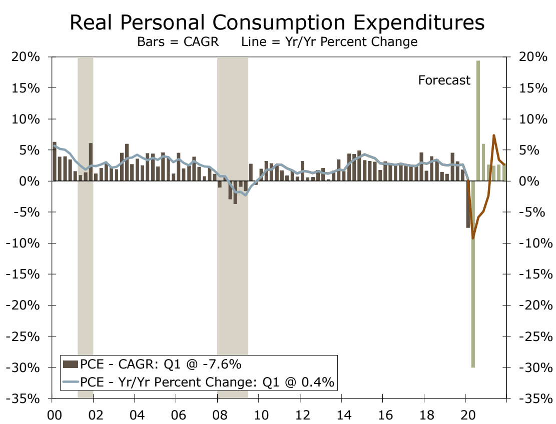
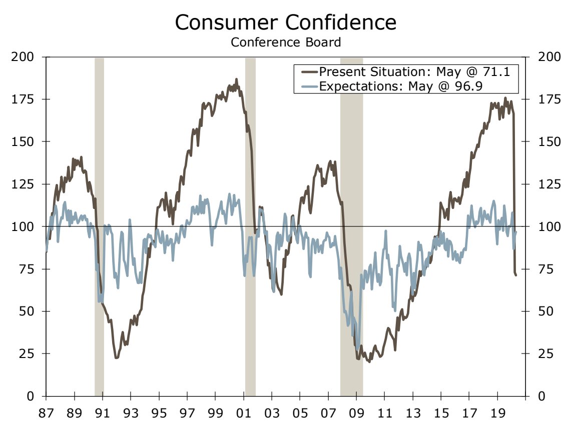


Figure 4



Source: U.S. Department of Commerce, The Conference Board and Wells Fargo Securities

Trends in the soft data support this argument for at least some positive turnaround in the coming months. Consumer confidence is still about a third lower from where it was before the pandemic, but the forward-looking expectations component rose to 96.9 in May, which is near pre-crisis levels and about where it was as recently as last September (Figure 4).

Down on Main Street

The expected rebound may not be soon enough. While the shutdowns and social-distancing guidelines were necessary for public health, to many small-town businesses they mostly resulted in widespread closures or operating at limited capacity. Whether or not those closures are temporary or permanent will depend upon how quickly these businesses can secure funding as many simply cannot afford to wait for a snapback in commerce and are in desperate need for a lifeline from the government. With sales having dried up, many businesses have faced difficulty even meeting basic operating expenses. As of May 23, 30% of small businesses reported they only have enough cash on hand to cover about one-to-two months of operation. Estimates from a recent National Bureau of Economic Research (NBER) paper were even lower, finding small businesses only have enough cash on hand to last two weeks.[2]

Programs have been introduced to make sure credit is widely available to small businesses.

With businesses suffering due to government mandated containment efforts, the federal government and the Federal Reserve have introduced programs to make sure credit is widely available. But, thus far the practical matter of facilitating that needed funding has proved more difficult than programs directed toward larger middle-market businesses that typically had relationships with commercial banks, which helped facilitate the government's lending programs.

PPP Brought Much-Needed Relief, but Not Everywhere

The most widely recognized small business program is the Paycheck Protection Program (PPP), which was created under the CARES Act, and was specifically meant to help keep employees on the payroll during the crisis. At a high level, small businesses with less than 500 employees are eligible for the PPP. Loan terms are favorable, with a 1% interest rate, deferment of interest payments for the first six months, and no participation or processing fees. Loan amounts will even be forgiven if employee and compensation levels are maintained, and at least 75% of the proceeds are used to cover payroll costs, while the remaining 25% can go toward operational costs such as mortgage interest, rent and/or utility costs over the eight-week period after the loan is made.

Most small businesses qualify for PPP loans, with roughly 80% of U.S. establishments having fewer than 500 employees, and demand for PPP funding has been high. In fact, demand was so high that the initial $350 billion allotted to the program was exhausted less than two-weeks after it was launched on April 3. A second round of funding ($321 billion) was authorized on April 27, and has not yet been exhausted. But, despite high demand, the initial phase of funding did not necessarily reach the hardest hit industries.

Figure 5

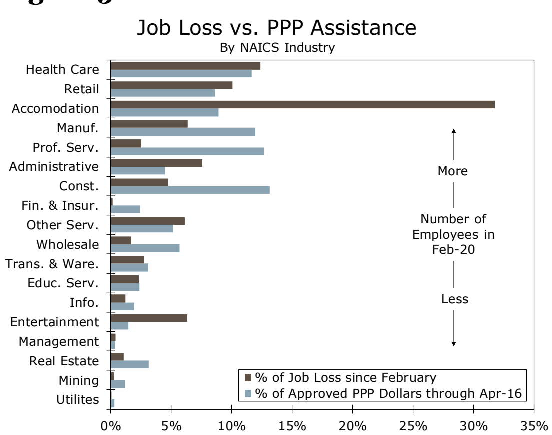
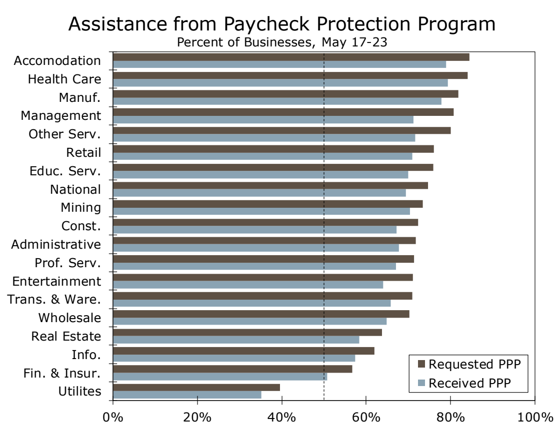


Figure 6



The initial phase of PPP funding did not necessarily hit the hardest hit industries.

Source: Small Business Administration, U.S. Department of Labor, U.S. Department of Commerce and Wells Fargo Securities

For example, while it is generally well understood that COVID-19 containment efforts have disproportionately hit the service sector, the largest share of initial PPP dollars actually went to the goods-producing sector (mining, construction & manufacturing), accounting for 26% of the dollars borrowed. Make no mistake, these industries are hurting and likely in need of financial support. But, consider that the leisure & hospitality sector (accommodation & entertainment), which has arguably been the hardest hit industry accounting for 38% of the jobs lost since February, only received about 10% of the dollars borrowed from the initial phase of funding. More plainly, the

[2] **Bartik, A., Bertrand, M., Cullen, Z., Glaeser, E., Luca, M., Stanton, C., "How Are Small Businesses Adjusting to COVID-19?," National Bureau of Economic Research, April 2020.**

leisure & hospitality sector lost more than three-times more jobs than the goods sector, but received less than half the amount of funding.

For Main Street businesses specifically, the "other services" industry received just 5% of the initial phase of PPP funding. While the industry accounted for only a small share of total jobs lost since February (6%), the industry has lost nearly a quarter of its total jobs over the past two months, which is the most of any major industry after leisure & hospitality. Thus, there appears to have been a mismatch between jobs lost and assistance received in the initial phase of the program (Figure 5).

It is too soon to say if this remains true of the second round of funding, as industry-specific data are not available from the Small Business Administration (SBA). Survey evidence from the Commerce Department, however, shows a majority of small businesses reported having tapped the PPP as of May 23. Nearly 75% of small businesses have requested financial assistance from the program and 69% of businesses have received a PPP loan (Figure 6). Main Street businesses were even more interested in securing access to these funds with 80% of "other services" seeking PPP funding and 72% of these businesses receiving the funds they need.

Other Relief Available, But "Shop Local" Has Never Been More Urgent

Businesses have also sought other forms of assistance, such as Economic Injury Disaster Loans (EIDL), which is an advance of up to $10,000 from the SBA to businesses experiencing a temporary loss of revenue from COVID-19, although due to limited availability eligibility has since been restricted to U.S. agricultural businesses. Additional sources include SBA loan forgiveness, other federal programs or even from business owners' own pockets or those of a family member or friend.

For businesses that are too large to meet the 500 employees or less requirement of the PPP, and too small to access credit markets, the Fed announced its Main Street Lending Facility (MSLF), which will be available to businesses with up to 10,000 employees or up to $2.5 billion in 2019 annual revenues. The programs are four-year loans aimed at getting firms through the pandemic-caused crisis and was expected to become available in May, although the exact timing remains uncertain. Earlier this week, Boston Fed President Rosengren said companies can expect to receive funding in the next couple of weeks.

The survival of many small businesses ultimately comes down to a quick bounce-back in activity.

These programs have provided much needed financial support to many businesses during the COVID-19 crisis. The Fed, to its credit, acted swiftly to create these programs and the coordination between the Fed and the Treasury and the eventual backing of Congress has been remarkably swift. Still, as the kinks in the system take time to be resolved, the survival for some of these small businesses may ultimately come down to a how quickly they see a bounce-back in local consumer activity.

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