



The Hexagon Briefing: A Global Perspective from HSBC

Episode 5: Small Business Recovery & Opportunities

June 9, 2021

Please refer to important disclosure at the end of this document.

Jose Rasco: Thank you for joining us today. Before we begin, you should be aware that relevant information relating to this podcast and the products and services we are about to discuss are available at the end of this recording and on our website at www.us.hsbc.com.

Welcome to the Hexagon Briefing: A Global Perspective from HSBC. Each episode, we'll bring you our insights on key financial topics. You can learn more about insights and research offered by HSBC on our website at www.us.hsbc.com.

I'm your host, Jose Rasco, and thanks for joining us today.

Today, we're going to discuss the topic of small business. Claudia Adamson, HSBC's U.S. Head of Commercial Business Banking, is here to help me unpack that concept.

This podcast was recorded on Wednesday, June 9th, 2021.

Thanks for joining me. And let's get going.

Today, we're going to talk about one of the myths that's out there, and that is that we have a bunch of issues, a bunch of headwinds that could derail this economic expansion as well as the financial market performance we've seen. So historically, the markets have looked at the Goldilocks scenario where it's things are not too hot. Things are not too cool. Everything is just right. And, you know, inflation is muted and interest rates are good. And the economy is growing at a good clip and unemployment is steady or falling.

Now, the new Goldilocks, from our perspective, Goldilocks and the three bears and the three bears are accelerating inflation, higher taxes and higher interest rates. Let's look a little in-depth at what's going on there in terms of higher inflation. We've talked about it a bunch over the last couple of months. And if you look, we knew we were going to get some higher inflation in the spring and into the second quarter, into the midsummer months, because last year inflation fell so dramatically. So you have this base effect where it's coming from a very low base over those six months, and then it's going to normalize as we go into the late summer and early fall. So that's number one.

Number two is the supply demand imbalance we've seen. And you'll hear business owners talking about it. You'll hear consumers talking about inflation. And all these pundits are out there saying inflation's going through the roof and it's going to derail. The feds going to have to raise rates more

quickly. And here's our take on that. We also have supply demand imbalances that are huge. During COVID, we didn't just shutter down or reduce performance in many facilities. We shut them down. We locked down entire segments of the economy for a prolonged period of time. As a result, if you look at most surveys, inventories are at historic lows. At the same time, the corporate sector is a wash in cash and consumers have a savings rate in excess of twenty seven percent. So as a result, we've got tremendous demand, tremendous pent up demand, tremendous cash. And we don't have the same goods. We have less goods. So of course, we're going to have some inflation in the short term because of the supply demand imbalance. But historically, when you see commodity prices rise like they have, when you see input prices rise like they have, as supply rises to meet demand, you see that inflation tends to normalize. It does not push the core CPI higher on a sustained basis. It'll push it up for a couple of months, no question. And we could see this last three year end. But we don't see a wage price spiral where we see inflationary numbers so high that the Fed has to step in and take away the proverbial punch bowl. So for now, look for higher inflation in the short term, short term being the next couple of months into the fall for sure. Maybe through year end. Going into next year, we think supply demand imbalances will normalize. That'll take care of that.

What about higher interest rates? We just said we don't think inflation is going to be pernicious and stay and accelerate and force the Fed to act more quickly. So we don't think the Fed is going to start raising policy rates at any point this year. At some point next year, yeah, they could begin to raise rates, but even then, they will do it very gradually because they want to make sure they don't derail the economy and they would rather err on the side of caution. Keep in mind, we're at the beginning of a multi-year rollout of technology that is deflationary in nature going to be reducing prices. So we think the Fed knows that they know these inflation spikes should be temporary, transitory, as they like to say, and therefore, we don't think it's going to be something that's going to force them to act more quickly.

In addition, when you talk about rates, you have to look not just at the policy rate at the short end of the curve. What's going on with the long end of the yield curve? And the Fed has been buying treasuries and mortgage backed securities, their quantitative easing program, keeping the yield curve lower and flatter. And for those of you who need to borrow to run your business, you've seen or if you want to borrow to buy a house or buy a car, you've seen the rates are lower than they've been in a long time. And they stay there. They're staying there. So that's good news.

As the Treasury curve steepens, as we see the economy growing in excess of 10%, if it does. You will see that fears of inflation or excess government borrowing could push the yield curve a little steeper. Does that mean it's the end of the business cycle? Not even close. Historically, when the yield curve steepens, it's because business is so strong that we see that need for credit pushes up inflation a little bit and therefore we see the yield curve steepen in response to the fact that the economy is stronger. And what happens historically is those cyclical sectors tend to do very well in markets. So it's not something that signals an immediate end to the business cycle or to financial markets performance. It means that we're getting healthy growth and the yield curve needs to respond and the cost of borrowing goes up because things are strong, not because things are weak or concerning.

Now on terms of tax rates, clearly we spent a lot of money for covid, clearly the Biden administration has an agenda focused on infrastructure, physical, digital and social. And there are many needs to beef up cybersecurity. In particular, tax rates are going to go up probably both on the corporate and the individual side. What does that mean for the business cycle? Well, if you look historically, what we've noticed is tax rates tend to go up, obviously, when the economy is expanding. You don't do it as you're going into recession or as you're just coming out of recession because you can kill the goose that laid the golden egg, proverbial goose that laid the golden egg. And as a result, we don't want to raise taxes when the economy's weak, we raise them when the economy is strong.

What does it do to consumer spending? Again, looking at the historical data, when tax rates go up, consumer spending tends to not really be affected all that much. Why? Because they're doing it when the economy is strong and consumer spending is going up, consumer saving looks strong and more importantly, job creation is good and the unemployment rate is low. So therefore, why you're going to tax a little more of my income in terms of marginal tax rates, I have more income or I have a job or I have a job that's paying better, consumers still tend to spend money.

Now on the corporate side, when corporate taxes go up, and we haven't seen a lot of data points of this historically, but the data points we do have suggest that it does not necessarily affect earnings as much as people think. What it does affect is the way companies invest. And that's another reason why we're optimistic about year end, because as we head toward a new tax regime going into next year, companies will probably pull forward some of those investment ideas or those investment programs into 2021 when they're comfortable knowing what the tax regime is, rather than being unsure of what it's going to be next year. So corporate taxes, when they go up, they don't really affect the business environment all that much dramatically from the top down. What they do, though, is they can affect investment decisions and those will get altered, lengthened or they'll be brought forward into 2021.

So as we talk about Goldilocks and the three bears and as I mentioned, those three bears for us going into this new budget as we head into September and October are accelerating inflation, higher taxes and higher interest rates. And the good news is we think Goldilocks is going to sleep just fine. We don't think we are at the beginning of the end here. We're at the beginning of a new business cycle that we think will sustain itself just with a new set of inputs and a new set of requirements. And we will adjust to that as we go forward. But we remain constructive in terms of the economy and financial markets, despite those three areas of concern.

The economy has gone through many shifts in the past year, we've been through the covid recession, we've been through COVID the pandemic, we've been through what I call the covid compression, where everything that was going to happen over 10 years happened over a period of 10 weeks. We have been through an awful lot, but one of the segments that has been hardest hit has been small business. And therefore, if we really want to get a gauge on what's going on in the US economy, what's going on with the US markets and what the future is, we need to get a handle on what's going on with small business. So thankfully, we brought along to discuss that concept with me is Claudia Adamson, HSBC's US Head of Commercial Business banking. Claudia, thanks for coming on the Hexagon Briefing.

Claudia Adamson Great. Thanks, Jose, great to be with you today.

Jose Rasco So, Claudia, we've known each other a long time. And I got to ask you, I don't think we've seen a more bizarre 18-month period where we had a very deep recession, but short. Right. And then the recovery, the response has been the proverbial bee shaped recovery. And they're looking at GDP growth in the second and third quarter of this year could be in excess of 10%. We're beginning to sound like an emerging market.

This is tremendous growth in terms of the projection, right? Earnings down 20% this year, could be up 50% this year. Claudia, you've got your finger on the pulse of what's going on in terms of our small business clients. Are we at a really unique moment in history here? Is this something that we're glossing over?

Claudia Adamson You know, you said a few things here, which I love, The Great COVID Compression. I actually like to think as COVID in some ways is the great equalizer and that we were all in the same boat. And as far as a point in time, this may be one of the most dynamic points in time as we look forward for small business and I don't mean that just in the US, I mean that from a global perspective. It's potentially a once in a lifetime opportunity.

Jose Rasco Now, when you say once in a lifetime opportunity, you mean for business owners as well as investors. Right? Because if you look at the markets this year, small caps have done pretty well.

Claudia Adamson Yeah, absolutely I believe it's a once in a lifetime opportunity for the business owners and for many, many different reasons. I'll give you a, for example, of this is that if you think about how small businesses get this and in the US has such a spirit of entrepreneurship and it's a land of I can I can do anything, is that these people, when they start their smaller businesses, they have an idea. But what often stands in their way is how do they get from their idea to actually implementing something? And because of what we've seen this past year, as far as people having to develop agility, understanding technology and maybe opening up to their minds about how they could actually achieve what they want to achieve.

So let's say you're starting a business today and you wanted to reach a broader market. You may have more capability as a small business today to attract a broader market share than you did a year ago at absolutely more than five years ago by leveraging technology. That's just one example of how an SMA could approach the market in a different way.

Jose Rasco And you bring up technology. And that's a very interesting byplay. Right, because if you look at where are we cyclically. We are at the beginning of a business cycle. We're into our third quarter of fourth quarter of growth in the second quarter. And it's supposed to be very expansive growth. Right? But we're also at the beginning of a multi-year secular buildout in next generation technologies, which really begins with 5G. And you talked about and we and we can talk about a bunch of issues around small business, whether it's minimum wages, whether it's closures and health issues and things like that. But one of the overriding issues you brought up, which is I think is crucial in the 90s, small business became global because of the Internet. And in this decade, you are absolutely right. With these next gen technologies, you can expand your global reach. Right. But you're going to need security. You're going to need AI. You're going to need fintech. You're going to need all these

other technologies that are being developed that can help you expand, not just reduce your costs, but expand your revenues and your geographic reach. Is that something you're hearing from our clients, Claudia?

Claudia Adamson

100%, And as you know Jose, we have a really strong connection globally with the other SMEs. I think we have between 1.3 and 1.4 million SMEs globally who bank at HSBC. So this is not just the US phenomenon. We're hearing it from across the globe. And you mentioned and you and I remember you and I have talked about this many times about the impact of Internet on retail in the 90s, how it did and how it didn't change. And I think the argument here might be not just about how the clients grow their revenue, but how they manage their employee base.

Let's say you're an SME now and you're in a market where it's difficult to attract talent. You might be able to go to a different state to attract that talent, now. You can think about this from a selling opportunity and from an expansion opportunity, but you can also think of it from a resource opportunity.

Jose Rasco

And when you say that, I'm assuming you're talking about a couple of different variables. Number one is right to work states, right. Where you don't have unionization rules and wages tend to be lower. And we saw a huge influx of businesses, not just from the US, to your point, in the last 10 years, I mean, we had European companies relocating in the southeast of the US because labor costs were competitive and they could reach the domestic market here in the US much more easily.

In addition, now, with this whole new emphasis on infrastructure, digital as well as physical infrastructure, with the Biden administration, we're spending a ton of money. We've got to pay back all the money we spent on COVID. Taxes are going up. Will we see a shift? Do you think that continued shift to states that don't have income tax at the state level or have minimal income tax at the state level?

Claudia Adamson

I think we can hypothesize on what's going to happen and it's going to be very difficult to do. And I think none of us know at this particular stage how people will embrace the opportunity if have us remote working. Will they gravitate towards low tax states? Potentially. I think that is a really hard question to answer. I think from what I'm seeing in the questions are being asked from SMEs, and we bank several thousand of them is the tone of agility. I think they're going to consider all options, but also know that they could potentially change their business very quickly if the state they're in doesn't seem to be the right site to be operating from.

Is there going to be a migration to low tax states? I would say probably, but then I think that the SMEs are not going to just pick up and move to those states. So I think it is probably more of I think that is probably more of a larger type organization that would be chasing tax return, chasing tax efficiency. You know, I think they're going to remain agile in how they leverage either technology or taxation havens.

Jose Rasco

You talked a lot about the internationalization of small businesses, right? Do you see opportunities in becoming more global? I remember, gosh, when I first started here, like 10 years ago, we started looking at small cap as an opportunity in the domestic market. And what I quickly realized was that the market had it wrong, that a lot of small cap was had become already very

global in nature. And so are we seeing more of that as we emerge from COVID? Do you think that will be a continuing trend, not just in terms of business and where they sell, but also financing flows? Will we see people coming in trying to get involved in small businesses here in the States?

Claudia Adamson 100%, absolutely. And it may have to do with, and you're the expert on this, Jose, is the evolution of COVID itself. So there are going to be certain markets that emerge more quickly than others. And you may see it and we are seeing it with the communication with our clients is that SMEs are searching for markets where they can be successful now. And what is the plan moving forward in this market? So absolutely, I think you're going to see SMEs expand more quickly into different markets.

Jose Rasco Claudia, in terms of SMEs. Do you see integration going on? Do you see them broadening out into new sectors? Because as you talked about, this new economy is really booming. Not just that, but with the Biden administration a desire to reach out to new pockets of the economy and to lift living standards in certain areas. Do you see small businesses trying to get involved in that and maybe even getting involved in new sectors where they may not be experts, but they may be willing to dip their toe or give it a go? Is this something that is it a trend that we're seeing?

Claudia Adamson I definitely think that people are exploring any sector that seems to have growth in the geography that they're in. But I will say this might be somewhat of a controversial statement, is SMEs that succeed tend to know exactly what their sweet spot is. They know their strategy. They know their focus. So in the early days of starting a business and that is also my advice is that you know who you are as a business, know what you're trying to achieve. Yes, I think that they will explore what they're selling opportunities are by looking at what sectors are changing, but I'm not sure they would change their actual business model or business opportunity that they're driving. In this space when you're starting a business, you should know what your sweet spot is.

Jose Rasco In terms of the business environment we're in. Obviously, we know interest rates are low. We know that the business community and the household sector has historic savings rates. If you look at the public markets, and if even if you look at private markets, cash levels are through the roof. We have a lot of money into circulation. What is the small business environment look like in terms of cash and financing? Is small business healthy? Do they have sufficient cash or are they looking for incremental cash in this low interest rate world?

Claudia Adamson Jose that is a great question. Absolutely, yes. The liquidity in the SME space is at an all time high from what we're seeing. In the conversations that we are having are a lot less about, "I need a financing solution today". What's happening is, is that people have significantly more liquidity than they had historically. This is across the entirety of our portfolio is way up. But the dialog that we're having with our clients is not about the challenge today. But what if their sales increase 2 and 3 times? So it's about how that client can scale. So the type of conversations that we're having are more around working capital, where they can touch capital if they're growing, who could they sell to or who could they acquire. But it's more strategic, mid and long term conversations, versus a need as of today.

Jose Rasco Now, when you say strategic, I mean, for example, there's a gentleman where I live on Long Island who started making these cookies that are healthy for you, believe it, sounds like an oxymoron, but it's true. His product took off so well during the COVID period that he's now selling it internationally. And he has, I've spoken to the guy, and he said that he has actually had people come to him and say, "We want you to bring this product to this country in Asia or this country in Europe". Are we seeing a lot of inflow of capital looking to expand some of these small business models and bring them to other countries?

Claudia Adamson You are, for example, that would be supply chain financing and how that actually can benefit a smaller organization with smaller SME if you're working with a larger global corporate. I think the individual companies are trying to manage how they can grow at scale, like the example that you just mentioned. But on the other side of this, clearly within HSBC, I'm talking to the people that run large corporate teams or global banking teams and they are trying to work with their clients about how their solutions can actually accommodate the SMEs they need to work with. So you know the supply chain right now, and you may want to touch on lumber prices or some of the other things that are happening right now. But I think everyone is learning that they need to be diverse in their supplier base. I'm seeing it from yes we need to have a strategic dialog, Claudia, about how we can plan for financing or something that will grow with me over time. Some type of working capital solution be a trade. And the other side is how are we working? How are we as an organization working with very large organizations so that they can help provide financing with our tools to SMEs?

Jose Rasco Interesting. So the supply chain issue is definitely a factor, right? We've seen commodity prices go up dramatically. There's a supply demand imbalance. Inventories are at historic lows due to the covid lockdown's, right? And demand is surging because of all the cash on hand. So you've got pent up demand, a lot of cash and nothing to buy. Right. It's like it's like the old Bruce Springsteen song, right? 57 channels and nothing's on. I've got tons of money and I don't know what to spend it on Claudia. That's, we hear that issue from the consumer side.

From the small business side, input costs are going up in terms of inputs. Right, as you mentioned. Wages are going up as higher minimum wages come into play and then they have to compete for workers now by raising wages. One of the things that we're thinking is happening in terms of the business landscape and I want to see if it's happening in small business, is higher cost structures are pushing them to invest even more rapidly, especially given the potential of a team changing tax regime next year even more rapidly in technologies that allow them to switch more quickly from labor to technological inputs and therefore trying to lower the cost of production. Is that something you're seeing in the small business side?

Claudia Adamson Because I'm a very optimistic person, I think SMEs are optimistic by nature. The biggest challenge is also going to be the biggest opportunity. And one of the benefits of being an SME today is that you may not have that weight on you of a large physical footprint. You may not have a workforce that you're having to contend with their desire to have a different way that they operate. You can be very nimble and you can be very agile. So I actually think SMEs are particularly well poised to benefit from the disruption that you just mentioned. And the smart ones will be thinking about that and having a plan

around how they can take advantage of the weakness of larger corporates that may not have quite the flexibility.

Jose Rasco Technology comes into play there right. Now one of the things that goes along with technology and this new economy we're going into, right, which is basically much more digital in terms of not just supply chain, the logistics. Look at the driverless car, autonomous vehicles, look at drones, shipping of goods through drones. And now this may not be something that affects small business immediately, but some of these technologies like AI and Big Data, definitely small business can take advantage of those things. So that's very interesting. And what do you see happening in terms of where they're going, in terms of use of their cash, do you see a lot of M&A opportunities? Do you see a lot of integration in the small business space? Is that something that we're seeing happening?

Claudia Adamson What I am seeing is a big uptick in larger businesses seeking to buy clients and SME space, more so than I've seen in the past decade. And I'm saying it because a lot of my clients are, a lot of our clients are being sold. And I think they're chasing opportunity and innovation. And as a result of that, there's a lot more opportunity for SME clients to sell.

Jose Rasco Interesting. So you are seeing that right.

Claudia Adamson I am seeing that.

Jose Rasco And that makes a lot of sense, we're going to be at this period of this or it could be a multi-year expansion, which could be very healthy. You need to expand those income generating opportunities, which means acquiring new products and services. Right. So yeah interesting.

Claudia Adamson Touching back on what you said on the tech issue Jose, is yes, our SMEs are embracing technology from AI to using their data more effectively. You know, how they use data to inform their decisions about how and what they sell and they service. But the unique benefit that SMEs have right now, and it's like that benefit you wish you had when you're ever starting a business. If you could have your company on a blank sheet of paper today, how would you design it? And the fact is, the SMEs have that capability more so than other businesses. Because if you're a really big organization, you're looking at your legacy architecture, data, cloud storage, cybersecurity, many of those different things. If you are a relatively new or small company, you can actually create from day 1 and embrace the technology that exists today. So you don't have that technology debt that you're carrying along with you.

Jose Rasco The parallel I've made with a lot of clients is if you think back at the end of World War II, the Marshall Plan in Europe, and European companies and Japanese companies, we're sort of starting from scratch in many ways. So they were able to deploy the latest and greatest technologies and become very productive very quickly. And it sounds like you're saying not that they were in a zero state, but if your business got shut and if you're seeing how the economy is getting revamped in this new digital format, yeah, it does give you that opportunity to rework the whole model, doesn't it?

Claudia Adamson 100%.

Jose Rasco What I'm taking away from this conversation, Claudia, is we're at the beginning of a new business cycle we're at the beginning of a secular rollout

of technology that's going to create a whole bunch of new industries. We have low interest rates. Inflation's a little higher than we like now. But when we get the supply demand issue straightened out in the next three to six months, that should begin to normalize as well. Are we at the beginning of a very good period of business formation and business expansion? And your answer is?

Claudia Adamson Yes, yes, yes, yes, yes. And I'm optimistic and I'm just excited to see what comes next.

Jose Rasco Excellent. Excellent. And look, it's technology, it's a new business cycle and it's this globalization that we continue to see. If you look at the trade deals that are being signed all over the place, US, China, the U.K., clearly we are at the beginning of a period of global expansion, which should be pretty healthy. So let's keep the conversation going. And Claudia, thank you for joining us. And hopefully you'll come back and talk to us soon about what you're seeing and how these trends continue to evolve.

Claudia Adamson Thanks so much, Jose it's always a pleasure talking to you.

Jose Rasco Thank you. Pleasure's all ours.

So if we think back to our conversation with Claudia Adamson, who is our Head of Commercial Business Banking here in the US, what are some of the highlights we take away from that? Number one, business looks good. She thinks we're at a historic point in terms of not only growth, but the ability to innovate and turn business models around and turn them toward this new economy. Number two, globalization continues. We're seeing inflows of capital and we're seeing small businesses look abroad to opportunities. Number three, we're seeing a lot of innovation and innovation in terms of the products and services being offered, as well as the use of technology to help adapt business models, lower costs, more importantly, expand the revenue opportunities. Finally, Claudia seems very enthused about small businesses and their ability to adapt to this work from home model and to incorporate these new inputs a new worker needs into the model. And therefore she's still very bullish, doesn't see a lot of financing needs, but more importantly sees potential for M&A, where larger companies are acquiring these creative small companies and therefore a lot of room for innovation.

So bottom line is, we see the small business space is healthy. Certainly there are pockets of weakness, but on balance, healthy and moving forward and innovating and creating new opportunities. So thanks to Claudia for her time and we thought it was really insightful conversation.

That's all for today. Thanks for listening to the Hexagon Briefing, I'm Jose Rasco, and we will see you next time.

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