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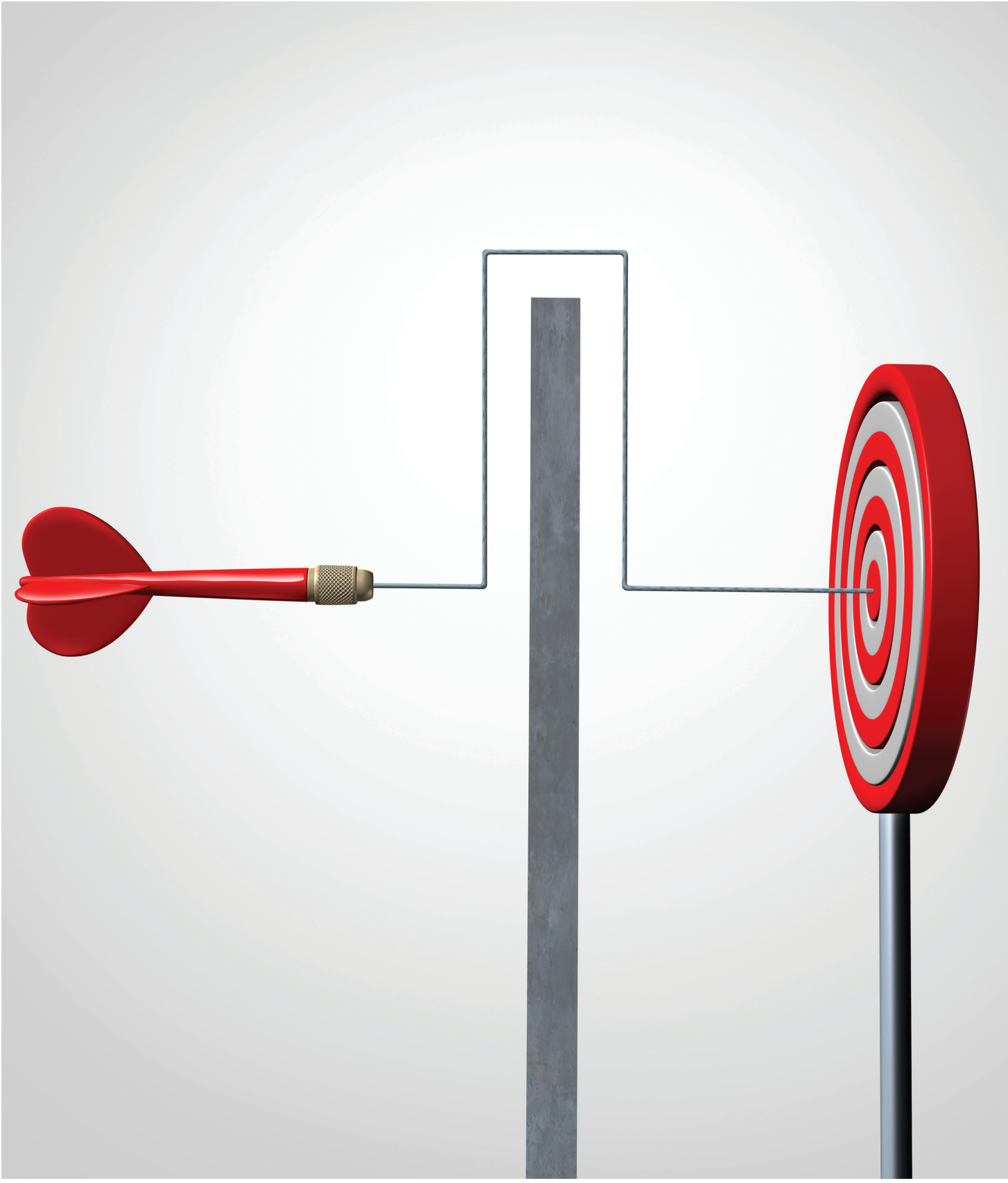


LOOKING BACK, LOOKING AHEAD

AN ECONOMIC STALL

BY WILLIAM PHELAN

Last year at this time, small businesses provided the one bright spot in a lackluster U.S. economy. GDP had grown just 0.6% in the first quarter of 2015 and, had small business not expanded, that growth likely would have been negative.

The magical 3% growth rate of GDP remains elusive. As of this writing, real investment by small businesses has fallen abruptly. Policy makers, politicians, and CEOs should look elsewhere for an engine to propel economic growth over the next few months.

The good news is that businesses remain financially viable with healthy balance sheets. But the sectors that are adding to GDP growth—and where bankers can find more C&I earning assets—are fewer, and geographic leaders are shifting as major parts of the country drive this trend.

The economy is changing for small businesses and they are doing what is sensible: settling in for the long haul and waiting for what they view as a difficult situation to pass. Once tax policy, interest rates, social policy, and other major drivers like health care are clearer, small business will get back in the game.

The Business Cycle

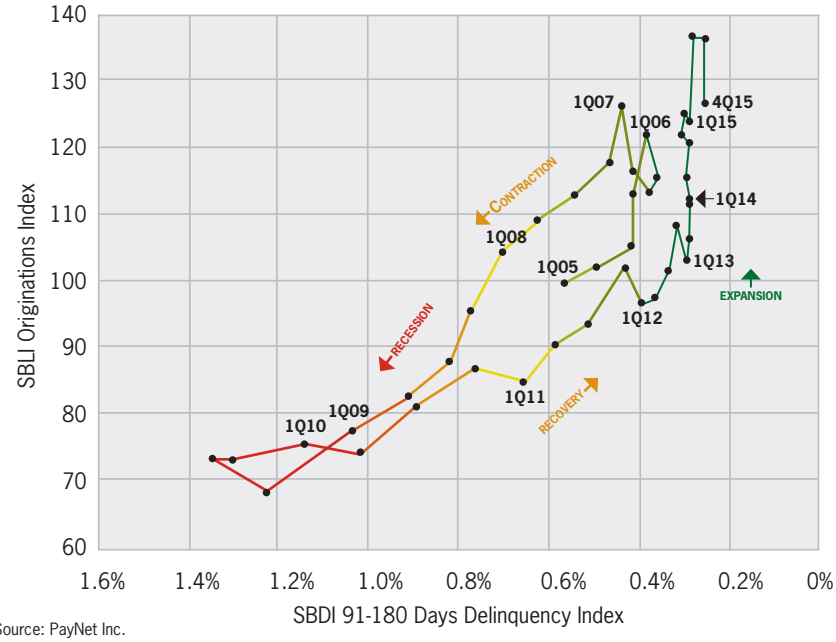
The reward part of the economic equation took a hard turn south in January 2016, which thankfully has not been coupled with deteriorating financial health. As a result, the business cycle has averted an inflection, but the odds of a change to the cycle have certainly shifted. Small businesses jammed on the investment brakes and declined to increase capacity to build more products, invent new products, or increase the efficiency of their plants and operations.

As Figure 1 shows, investment plunged while loans past due remained constant. A cautious reaction would be to stop lending to high-risk borrowers, limit concentrations to certain segments, and start pulling in lines of credit. But while caution can be a sound strategy, it can also be costly if growth opportunities are missed. Lower investments and continuously low loan delinquencies are keeping the business cycle in a moderate expansion phase with low risk.

National Investment Activity

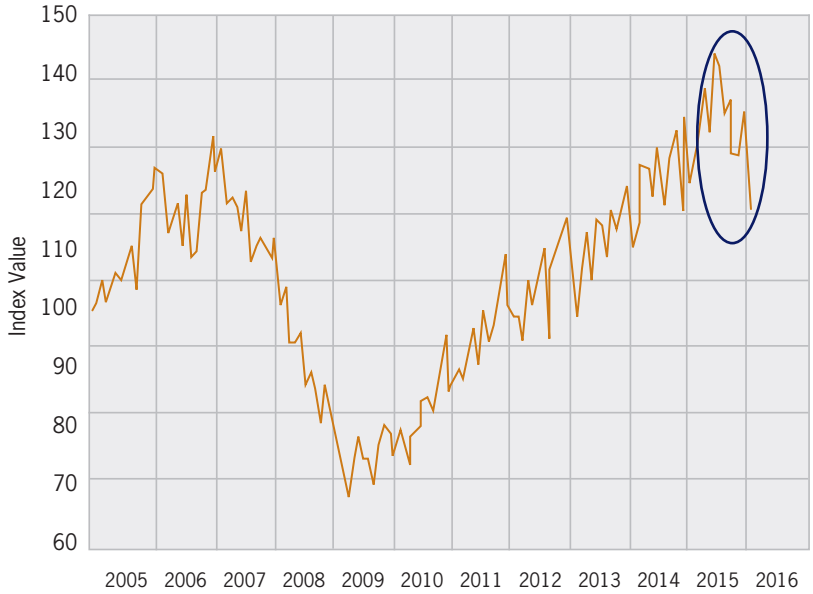
Alexander Hamilton, the first Secretary of the Treasury, once said, "Credit, private or public, is of greatest consequence to

FIGURE 1: PAYNET SMALL BUSINESS CYCLE



Source: PayNet Inc.

FIGURE 2: THOMSON REUTERS/PAYNET SMALL BUSINESS LENDING INDEX, JANUARY 2005 TO JANUARY 2016



Source: PayNet Inc.

every country." His idea, which has been proven right, is simple: Credit remains essential to provide innovators the capital needed to make the economy grow.

Availability of credit remains strong as banks, commercial finance, and online lenders all eagerly seek qualified borrowers. The Thomson Reuters/PayNet Small Business Lending Index (SBLI) declined 3% to 118.2 in January 2016 compared to the same month a year earlier. The January reading represented a sharp 13% decline from December, when the index stood at 135.4. Small businesses are declining to engage in new investment, owing in part to uncertainty.

The trend line has fallen dramatically over the past few months. From robust increases of 13% to 16% last summer, the three-month moving average of the SBLI now registers at less than 2%. Providing further evidence of the halt, three of the last four months have shown contractions and the one month of expansion was just 1%, as shown in the circled portion of Figure 2.

Sector Investment Activity

After decelerating late last year, the following sectors showed signs of momentum in January 2016 compared to January 2015: construction (+9.6%), retail (+5.1%), and administrative services (+6.5%). These three sectors account for about 18% of small-business GDP, so it is encouraging to see their loan activity improve in recent months. Interestingly, construction investment is accelerating while the sector is also exhibiting a material pickup in default rates, so the sustainability of this recent surge could be questionable.

Manufacturing remains a problem as it has slipped into outright contraction in the last three months (-0.6%). Meanwhile, sectors such as finance and transportation have started to decelerate. And investment in several sectors, such as real estate, information, mining, and wholesale, remains weak.

The worst appears to be over in accommodation and food services, where small investment declines in recent months have stabilized and the default rate has dropped increasingly over the last six months. By contrast, the day of reckoning has largely hit the transportation industry. While the year-over-year growth rate is still a healthy 6.4%, it is roughly half what it was three months ago. Wholesale trade's year-over-year investment has declined since April 2015 and was most recently -5.5%. Interestingly, the investment decline in mining appears to be finding a floor.

By contrast, conditions in the agricultural sector continue to deteriorate, as investments declined for 12 consecutive months and now stand at -18.6% compared to a year ago.

Credit Risk

The health of business financials remains strong. The Thomson Reuters/PayNet Small Business Delinquency Index (SBDI) 31-90 Days Past Due increased 2 basis points to 1.22% in January from December. Although flat compared with the same month the previous year, loans past due clearly appear to be on an upward path. The SBDI 91-180 Days Past Due, or loans severely past due, remained at 0.26% from December to January.

While it's true that financial health is near an all-time high for small business, it is also true that we are seeing the very early stages of erosion along the fringes of small business credit. Lenders with higher delinquencies are showing steeper loan delinquencies at the same time that lenders to the highest quality borrowers are seeing little increase in delinquencies. This means that the most financially sensitive business borrowers, those with a higher probability of default, are finding the prospects of loan repayment more challenging.

Further evidence of strong credit quality is found in consistently low loan defaults. Small businesses defaulted on loans at only a 1.6% rate for the full year of 2015. By comparison, larger non-investment-grade corporations defaulted on their debts at a 2.4% rate in 2015, according to Fitch Ratings.

Credit Risk by Sector

While looking good now, the underlying sectors most sensitive to economic inflections are starting to exhibit stress. Sectors showing higher loans past due are found in the most economically sensitive sectors. Loans 30-91 DPD show transportation delinquency was up 5 basis points to 1.21% in January, its 11th consecutive month of increase and its highest level since May 2013.

Every segment was up or flat, including construction, which was higher by 7 basis points. Loans 91-180 DPD show transportation delinquency increased 3 basis points to 0.31%, its highest level since May 2013. Retail and health care both decreased 1 basis point, the only segments to show a decline in delinquency.

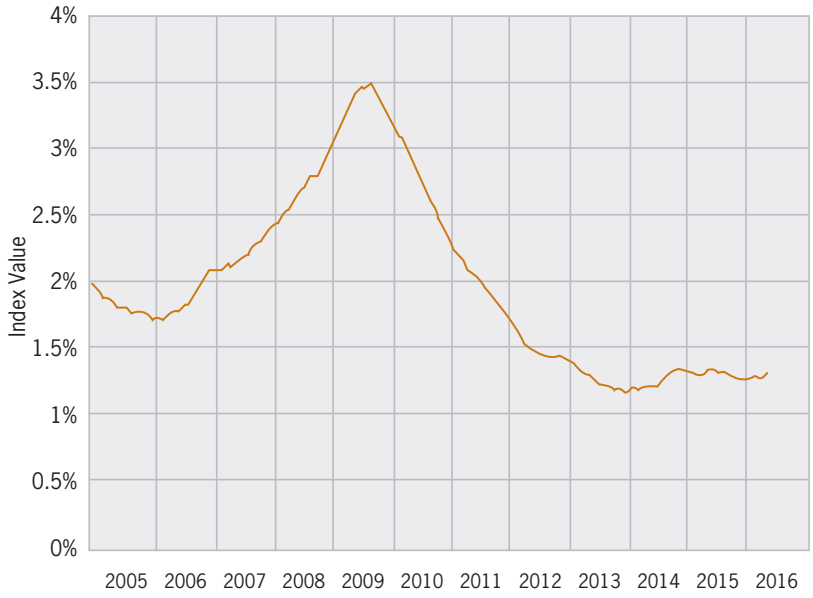
The states in Table 1 show rising or falling financial health for their small businesses, depending on local and industry conditions. Georgia and Florida have loans past due that are persistently above the national average and currently materially higher than the rest of the states. Texas businesses are also feeling rising stress with delinquencies at 1.67%, or 25 basis points higher than in the previous year. Undoubtedly, the crash in oil prices is spreading into the broader Texas economy. And even though businesses in Michigan show the largest year-over-year

TABLE 1: THOMSON REUTERS/PAYNET SBDI, VARIOUS STATES

31-90%	2009	2015	2016	YOY
New York SBDI	2.78%	1.52%	1.18%	-0.34%
California SBDI	3.44%	1.23%	1.07%	-0.16%
Illinois SBDI	3.11%	1.29%	1.16%	-0.13%
United States SBDI	3.37%	1.23%	1.22%	-0.01%
Florida SBDI	4.79%	1.71%	1.70%	-0.01%
Georgia SBDI	4.09%	1.66%	1.67%	0.01%
Ohio SBDI	2.32%	0.85%	0.96%	0.11%
North Carolina SBDI	3.36%	1.27%	1.41%	0.14%
Pennsylvania SBDI	2.84%	1.33%	1.47%	0.14%
Texas SBDI	3.39%	1.42%	1.67%	0.25%
Michigan SBDI	3.96%	0.83%	1.16%	0.33%

Source: PayNet Inc.

FIGURE 3: THOMSON REUTERS/PAYNET SBDI (31-90 DAYS PAST DUE), JANUARY 2005 TO JANUARY 2016



Source: PayNet Inc.

TABLE 2: HISTORICAL AND ABSOLUTEPD® FORECAST DEFAULT RATES, BY INDUSTRY

Industry Segment	Actual Historical Default Rates										Forecast Default Rates	
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Transportation	4.3%	6.4%	10.1%	12.4%	7.8%	4.2%	2.8%	2.7%	2.5%	2.6%	3.0%	2.5%
Information	3.5%	4.4%	4.9%	6.7%	3.6%	3.5%	2.9%	2.4%	2.2%	2.4%	2.2%	2.0%
Mining	1.0%	2.6%	3.5%	6.8%	4.8%	2.1%	1.8%	1.2%	1.3%	2.2%	2.4%	1.9%
Construction	2.7%	4.3%	6.7%	10.5%	7.5%	3.7%	2.2%	1.7%	1.6%	2.0%	2.3%	1.9%
Retail	2.5%	3.2%	4.4%	6.3%	4.3%	2.5%	1.9%	1.7%	2.1%	1.9%	2.0%	2.0%
Accommodation & Food	4.0%	5.1%	6.8%	7.7%	6.0%	3.2%	1.7%	2.0%	1.6%	1.8%	2.3%	2.5%
Health Care	2.5%	3.0%	3.7%	4.2%	3.5%	2.1%	2.0%	1.9%	1.8%	1.8%	2.0%	2.0%
Professional Services	2.7%	3.5%	4.3%	5.3%	3.5%	2.4%	1.9%	1.7%	1.6%	1.7%	1.8%	1.6%
Administrative Services	2.4%	3.1%	4.3%	6.1%	4.5%	2.7%	2.1%	1.9%	1.8%	1.7%	1.9%	1.7%
Manufacturing	2.1%	2.4%	3.3%	5.8%	4.1%	2.3%	1.6%	1.3%	1.5%	1.6%	1.7%	1.5%
Agriculture	2.0%	1.8%	1.8%	2.7%	2.3%	1.5%	0.9%	0.8%	0.9%	1.5%	1.6%	1.3%
Other Services	2.4%	2.7%	3.9%	4.8%	3.1%	2.1%	1.6%	1.3%	1.2%	1.3%	1.8%	1.7%
Wholesale	1.9%	2.1%	3.0%	4.2%	3.2%	1.9%	1.2%	1.1%	1.2%	1.3%	1.6%	1.6%
Finance	3.5%	7.5%	7.1%	5.8%	3.5%	2.0%	2.0%	1.4%	1.1%	1.2%	1.7%	1.5%
Entertainment	3.3%	3.7%	4.2%	4.2%	2.7%	2.3%	1.7%	1.3%	1.1%	1.1%	2.0%	2.1%
Education	2.4%	2.5%	2.8%	2.9%	2.0%	1.4%	1.4%	0.9%	1.1%	1.0%	2.0%	1.8%
Real Estate	2.1%	3.2%	5.0%	6.6%	4.1%	2.5%	1.4%	1.3%	1.2%	1.0%	1.8%	1.7%
Public Administration	2.5%	2.8%	1.9%	2.4%	1.6%	1.5%	2.0%	1.2%	0.9%	0.6%	2.0%	1.8%
ALL INDUSTRIES	**2.6%**	**3.6%**	**4.8%**	**6.2%**	**4.2%**	**2.5%**	**1.8%**	**1.6%**	**1.5%**	**1.6%**	**1.9%**	**1.8%**

Sources: PayNet Small Business Default Index; PayNet AbsolutePD® $1.0mm or Less in Total Lease/Loan Exposure

LAST FALL WE SAW THE BUSINESS CYCLE STRONG AND CONTINUOUSLY EXPANDING AMID LOW RISK. NOW WE SEE A HIGHER PROBABILITY OF THE BUSINESS CYCLE CHANGING, GIVEN DETERIORATING BUSINESS INVESTMENT BY SMALL COMPANIES.

increase, 33 basis points, financial stress among the state's small businesses stands near the national average.

States where financial health improved the most include New York (-34 basis points), California (-16 basis points), and Illinois (-13 basis points). Improvement is occurring most on the coasts at this time, particularly in the Northeast.

Defaults remain below their norm for all industry sectors. Actual default rates in 2015 rose slightly from 2014 as increases in key sectors indicated heightened stress. Economically sensitive sectors like transportation and construction showed very low defaults in 2015 relative to recessionary peaks.

Additionally, the transportation default index is increasing and stood the highest of any industry at 2.9% at the end of January. Mining, which includes the energy sector, shows default rates near the highest of all sectors and had the largest year-over-year increase. However, it is hard to believe that mining defaults fully reflect their ultimate level as the oil producers find ways to continue pumping despite low prices. PayNet's analytics reveal that the effects of low oil prices are spreading into the broader Texas economy, and rising defaults are expected for companies that are not directly related to oil but operate within the local oil market in Midland, Texas.[1]

Defaults of farms have jumped recently. Once the industry with the lowest defaults (the rate was 0.8% in 2013), farming is now near the median with a rate of 1.5%. While farms are experiencing a systemic change in their businesses, they are still finding ways to continue

producing cash grains. Many farmers are building storage bins to store grains until prices recover. Additionally, default momentum is increasing to 1.67% over the last three months.

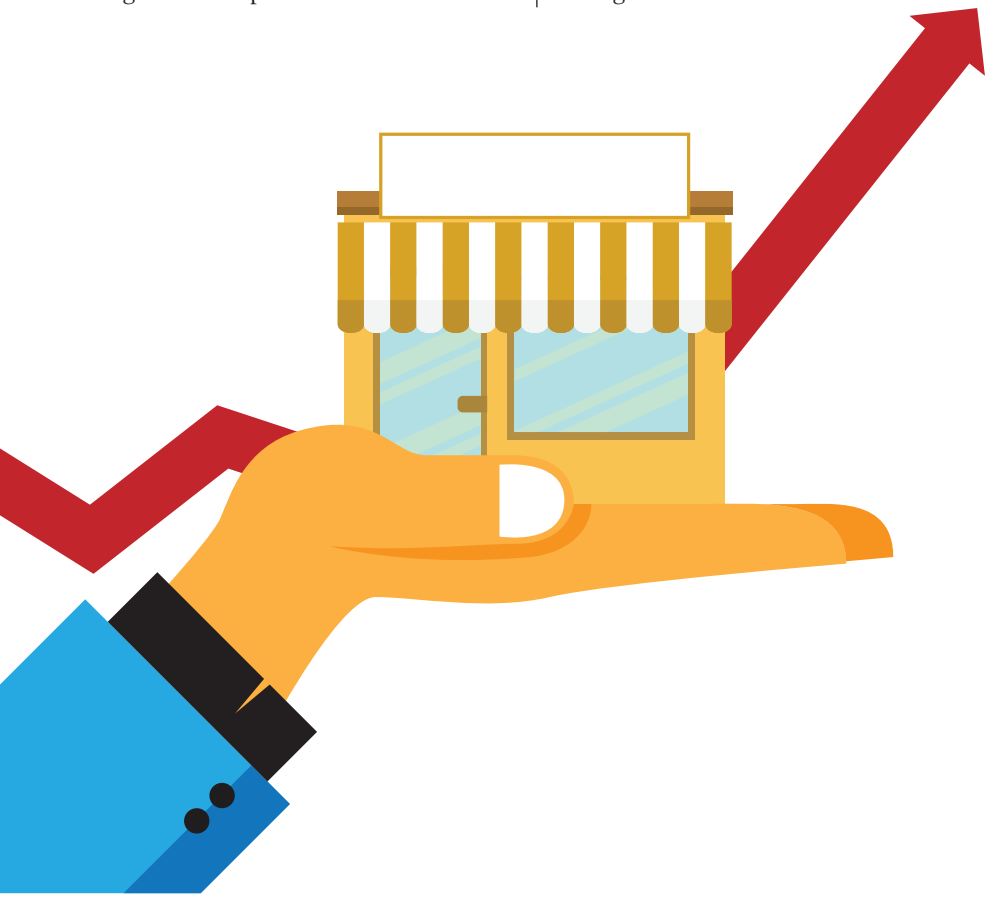
Default Outlook

Low business defaults mean low credit losses for banks, but they also reflect the continued economic malaise resulting from reduced risk taking. Overall, default rates are approximately 40% below pre-crisis rates, and mining is the only sector where current default rates are above pre-crisis rates.

Credit Risk Forecast

The projected default rates reflect industry issues, a forecast for continued slow GDP growth, low interest rates, and recent default trends:

- Agriculture is forecast to experience a moderate 0.1% rise in defaults as farmers pull back on investment and store grains until prices rise.
- Arts and entertainment defaults are projected to show one of the biggest jumps among all sectors, owing in part to removal of subsidies by state governments.
- Construction's 0.3% rise in defaults reflects the trend in 2015 toward higher defaults and a more volatile sector.
- Educational services show the second largest projected jump in defaults, 1.0%, owing to a reversion to the mean.
- The trend for higher defaults will likely cause increased rates for accommodation and food (0.5%) and finance and insurance (0.5%).
- Health care's forecast for higher defaults, up 0.2%, is due to uncertainty.
- Manufacturing's slight 0.1% rise in defaults reflects this sector's lower historical default experience.
- Mining's defaults are forecast to rise 0.2% as the oil rout takes effect.
- Retail's moderate 0.1% rise in defaults is due to recent trends toward stabilizing defaults.
- Transportation shows a trend toward 0.4% higher defaults.
- Wholesale's rate of defaults is still being impacted by the commodities crashes.



Conclusion

What a difference a few months can make. Last fall we saw the business cycle as strong and continuously expanding amid low risk. Now we see the business cycle changing, in line with deteriorating business investment by small companies.

Small businesses will not be in a position to contribute significantly to GDP over the next quarter as innovation, risk taking, and production are on hold for the present. The abrupt fall in January investment comes as a surprise after a relatively robust expansion in 2015. But although this halt in investment is concerning, it does not by itself signal a change in the business cycle, but rather a change in sentiment regarding future growth opportunities.

Financial health remains strong for small businesses. Loans past due are near all-time lows and recent defaults are below the long-term average for small business credit. However, some erosion in financial health is evident in certain economically sensitive sectors. Defaults are forecast to rise partly because of increases in interest rates and financial stress. This all adds up to above-average credit quality for 2016—with defaults rising to 1.9% in 2016, just below their long-term average. ®

William Phelan is president of PayNet Inc., a leading provider of credit data on small businesses in the United States. He serves on the Federal Reserve Bank of Chicago's Advisory Council on Agriculture, Small Business, and Labor, the board of directors of various industry associations, and the Research Committee for the Coalition for Responsible Business Finance, which he chairs.

Note

1. *Wall Street Journal*, "Oil Bust Forces West Texas to Adjust," March 2, 2016.