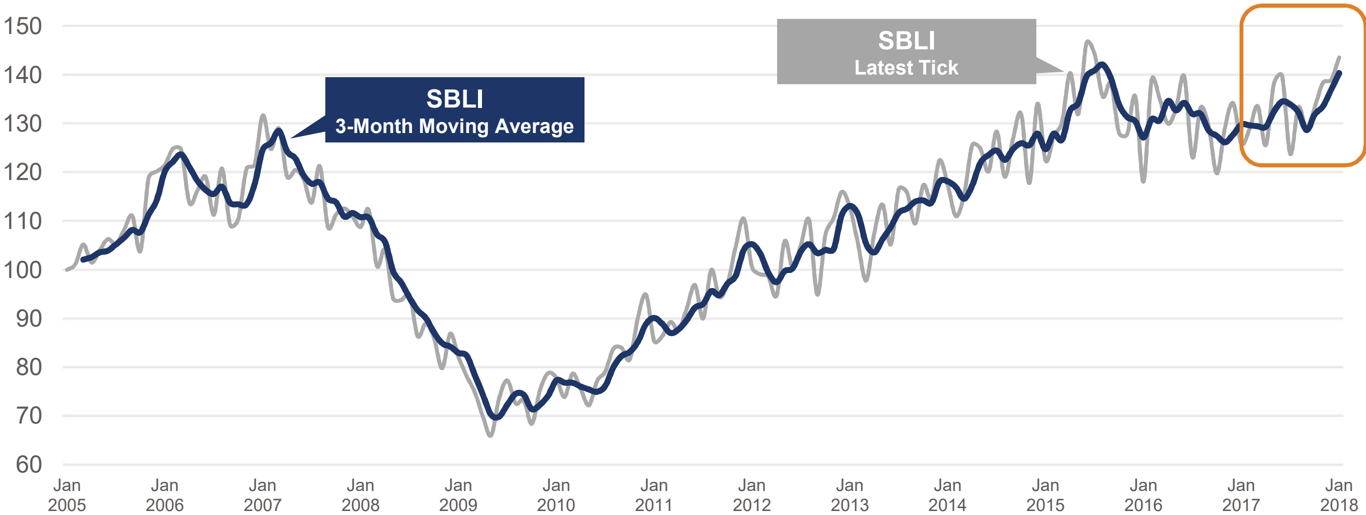
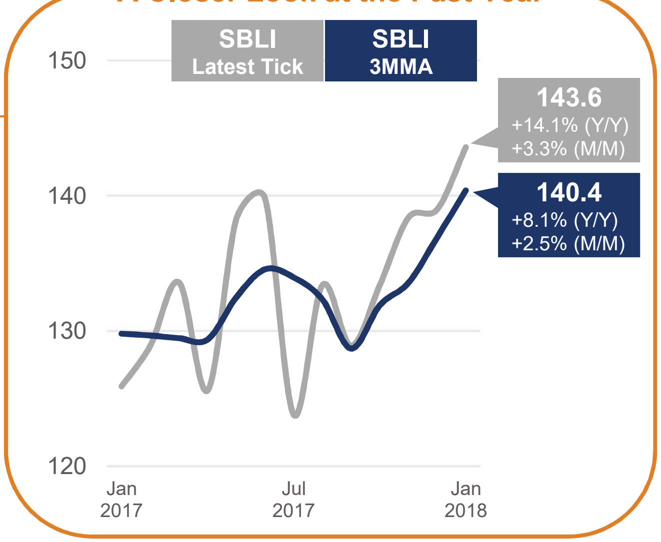
PayNet® Strategic Insights
March 2018

Main Street Lift-Off

Thomson Reuters / PayNet Small Business Lending Index (SBLI)*



A Closer Look at the Past Year



*Volume of New Commercial Loans & Leases to Small Businesses, Seasonally Adjusted Index (January 2005 = 100)

Index Analysis

The Thomson Reuters / PayNet Small Business Lending Index (SBLI) increased to 143.6 in January, its highest reading since July 2015. The SBLI is up 3.3% from 139.0 (revised) last month, and is now 14% above year-ago levels. The SBLI 3-month moving average also rose in January and is up more than 8% over the last 12 months.

Regional Story: Nine of the ten largest states saw their SBLI rise on a year-over-year basis in January, with the strongest growth occurring in North Carolina (+9.5% Y/Y) and Texas (+9.3% Y/Y). Notably, the SBLIs for both Michigan and North Carolina climbed to all-time highs in January. Of the top ten states, Georgia was the only one to experience a decline in small business lending activity, although its SBLI fell only slightly on both a monthly and annual basis and remains elevated.

Industry Story: Most industries saw growth in January, led by Construction (+7.6% Y/Y) and Public Administration (+6.3% Y/Y). Construction has risen consistently since late 2016 and is currently at its highest level since 2008, reflecting the sharp 13% expansion in residential investment in Q4 2017. Housing starts are more than 7% above year-ago levels, and most market watchers expect housing construction to continue to improve in light of economic conditions and rising home prices. As such, the Construction SBLI is likely to continue its steady upward march in 2018.

Economic Context

The U.S. economy expanded at a moderate 2.3% annual clip in 2017 and appears set for even stronger growth in 2018, and the resurgence of small businesses is a big reason why. Small business confidence is surging: according to the National Small Business Association, more than half of small business owners feel the national economy is improving (up from 22% in July 2016), and the National Federation of Independent Businesses reported in January that a record number of small businesses believe that “now is a good time to expand.” Not surprisingly, the Federal Reserve expects small business demand for C&I loans to strengthen throughout 2018, though it is worth noting that some economists believe that interest rates may rise more quickly than anticipated as a result, raising borrowing costs for small business owners. Overall, however, small businesses and the broader U.S. economy should maintain solid momentum in the next 3–6 months, and the SBLI will likely continue to rise.

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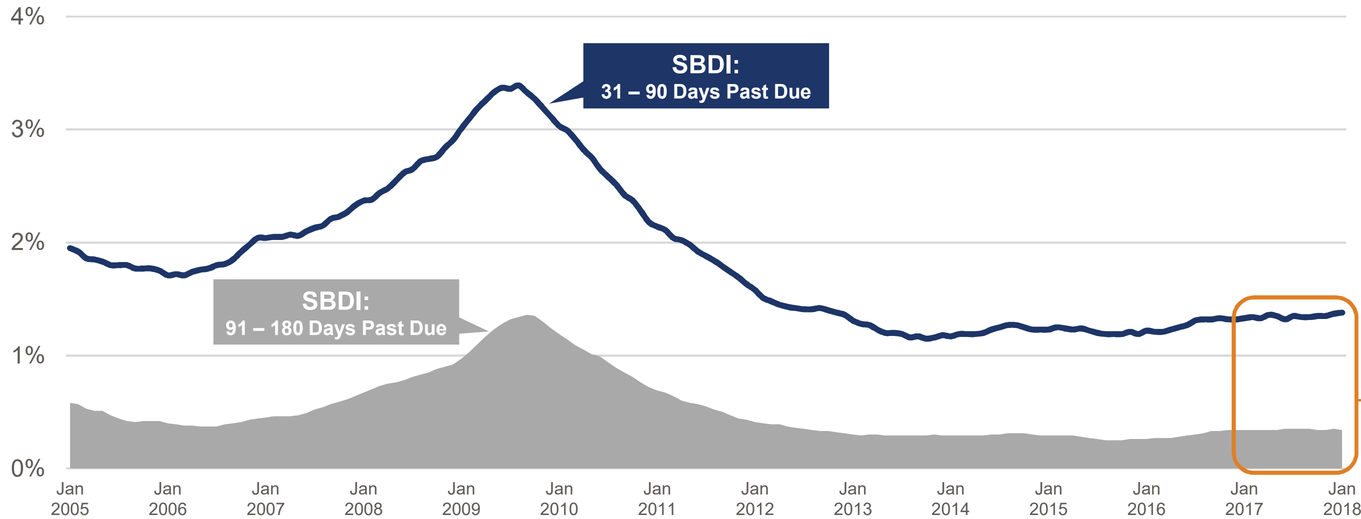
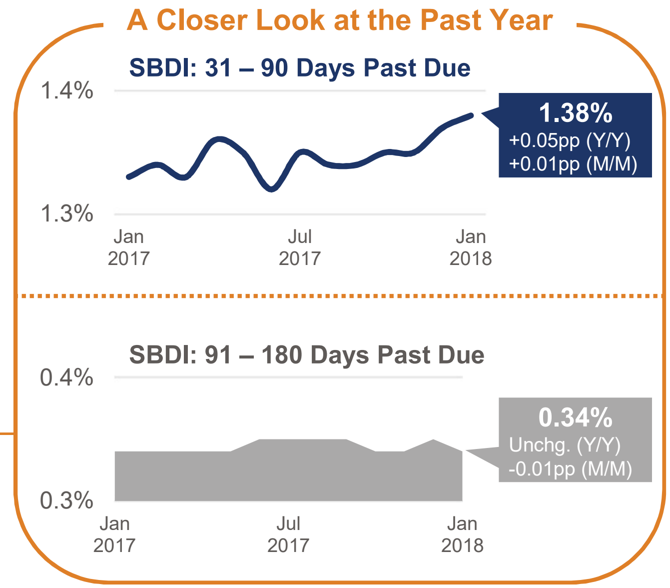
Shift Toward Higher Risk

Thomson Reuters / PayNet Small Business Delinquency Index (SBDI)*





*Delinquent Percentage of Small Business Loans, Seasonally Adjusted Index

Index Analysis

The Thomson Reuters / PayNet Small Business Delinquency Index (SBDI) 31–90 Days Past Due inched up to 1.38% in January, and is up five basis points over the last 12 months. The SBDI 91–180 Days Past Due edged down to 0.34% in January and is unchanged from year-ago levels.

Regional Story: Most large states saw delinquencies rise from year-ago levels, led by Florida (+22bp Y/Y) and Ohio (+12bp Y/Y). Since August, delinquencies are up in nine of the ten largest states by an average of 20bp. However, while recent movement points to a higher-risk lending environment, state delinquencies remain low historically. Regarding defaults, Texas has the highest default rate among large states (2.72%), but the rate has fallen 50bp since last January. Defaults climbed in New York (+25bp Y/Y) and Michigan (+24bp Y/Y) but remain relatively low.

Industry Story: Delinquencies rose in most large industries in January, led by Construction (+14bp Y/Y) — though Transportation delinquencies declined on an annual basis for the sixth consecutive month (-29bp Y/Y and -8bp M/M). Regarding defaults, the industry experience varied. The Information sector continued to lead default increases (+83bp Y/Y, though only +3bp M/M), while the Mining SBDFI fell to roughly half its year-ago level (-232bp Y/Y and -16bp M/M). Industry default rates are well below the 10-year average in nearly every industry except for Agriculture.

Economic Context

While financial stress remains muted by historical standards, small business delinquencies and defaults are beginning to creep up. Recent upticks in delinquencies and defaults suggest that small businesses are willing to take on more risk to take advantage of a strengthening U.S. economy. However, growing worries over inflation may lead the Fed to tighten monetary policy more quickly than anticipated in 2018, which could dampen small business lending. Furthermore, a tight labor market and rising wages may squeeze small businesses' margins, while proposed tariffs on steel and aluminum imports will likely raise costs for some small business owners (though tax cuts should offset some of these cost pressures). Lenders will need to carefully monitor credit losses going forward, as they are likely to rise in the months ahead.