The wrong kind of tightening

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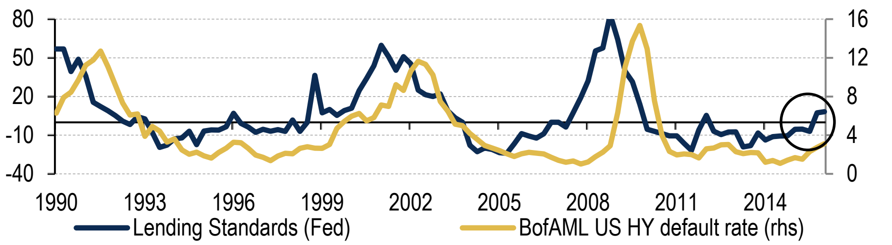
Banks tighten credit for a 2nd quarter

We have said in the past that companies don't default because of impending maturities- in fact in 2001 and 2007, the maturity wall was just as benign as it is today. Issuers default because at some point in the credit cycle their access to funding dries up; case in point, the two best leading indicators of future default rates are C&I lending (Chart 1) and CCC issuer access to the primary markets. Troubling, we've written about how CCC access to the HY primary market has been in a cyclical decline since 2013 and breached an ominous threshold last year. Perhaps even more worrisome is the data coming out of the C&I lending survey which polls regional banks on their lending standards to small and medium enterprises. The Q3 survey showed that for the first time since the recession, a net higher number of regional banks are tightening their lending standards vs loosening them. A fresh update released by the Fed on Monday confirmed our fears that we are in the throes of a trend, as regional banks yanked the leash tighter in what now amounts to be two quarters of tightening in a row. Never before have we had two consecutive quarters where banks increasingly tightened lending standards without it ultimately leading to a recession.

Chart 1: The net percent of banks tightened lending standards for the 2nd consecutive period



Source: BofA Merrill Lynch Global Research, Federal Reserve

There are several reasons for this turn of events, and why we think the trend is here to stay. Firstly, according to our bank analysts, C&I lending is in a cyclical decline because other segments look more attractive. Consumer lending, for example, is more in vogue as outlook for stable jobs and home prices, combined with low leverage in the segment drives loan growth. As such the risk-reward is now skewed against commercial borrowers and will continue to be so as the C&I survey suggests.

Secondly, mounting default losses in the Oil & Gas sector is likely forcing banks to increase loss provisions against their exposure. The amount of direct exposure US banks have to energy companies through bilateral loans currently stands at $80bn which on average represents 5% of total loans on banks' books. Indirect exposure is even more as there is a discernable spillover effect to banks' non-energy portfolios too (e.g. real estate and business loans in energy dependent markets). And if history is any indication, we are only in the early phases of loss provisioning for the sector. In the oil bust of the 1980s, net charge offs for banks peaked a year after the oil trough. In the same vein, reserves at banks against first and second order losses from the commodity fallout today stand at just about 1.3% of total loans vs the peak of 4% reached in the 80s. As such we can expect an increasing amount of funds to be diverted away from borrowers and into bank reserves as the commodity rout threatens to claim more corporate casualties.

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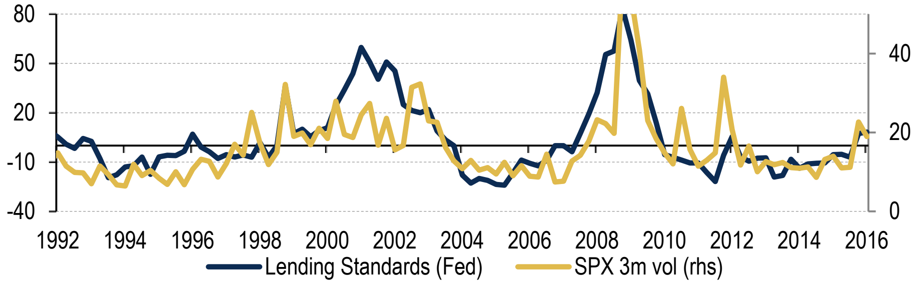
Finally, there is something to be said about market volatility. Stress in financial markets leads to general risk aversion. Just as capital markets temper down during volatile times, it's reasonable to assume banks responding the same way. Sure enough, C&I lending data show a very strong correlation to equity volatility. Since we expect to be living in a VUCA world for some time, there is no catalyst in sight that could flip this downward momentum. Combined with an already high regulatory hurdle for lending in the post-Volcker era, more and more banks could be forced to freeze credit going forward.

Chart 2: Lending standards are strongly correlated to equity volatility



Source: BofA Merrill Lynch Global Research, Bloomberg

HY primary markets are all but shut except for very high quality issuers. And if this trend continues for a while (the probability of which in our opinion is very high), we could envision a world where enterprises, big and small, find it harder to acquire financing across all industries, leading to widespread defaults, even outside of commodities

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