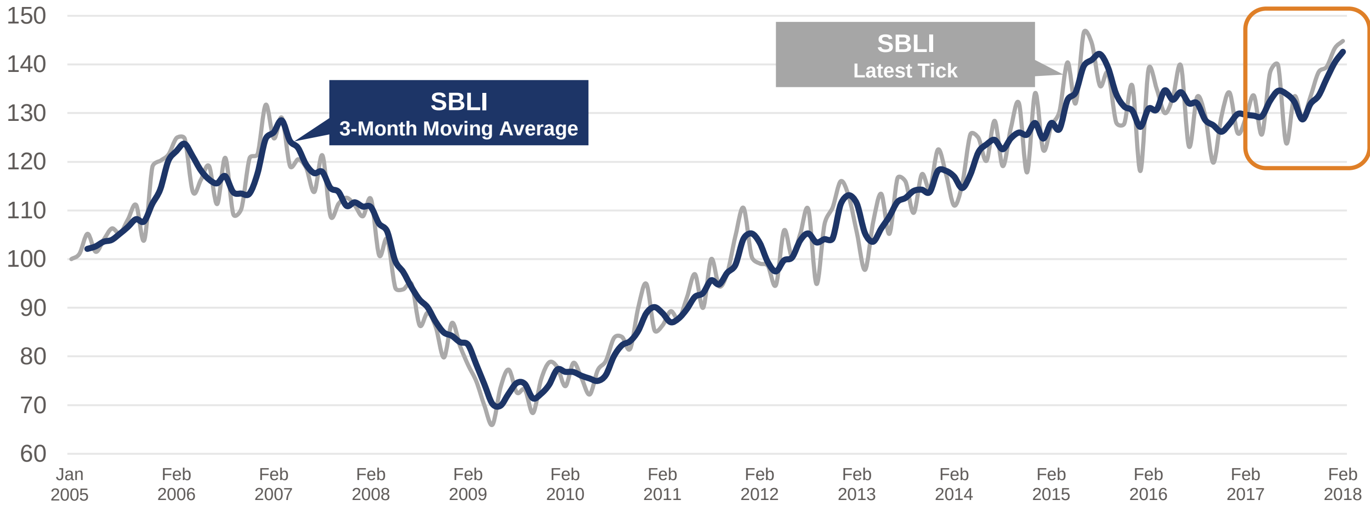
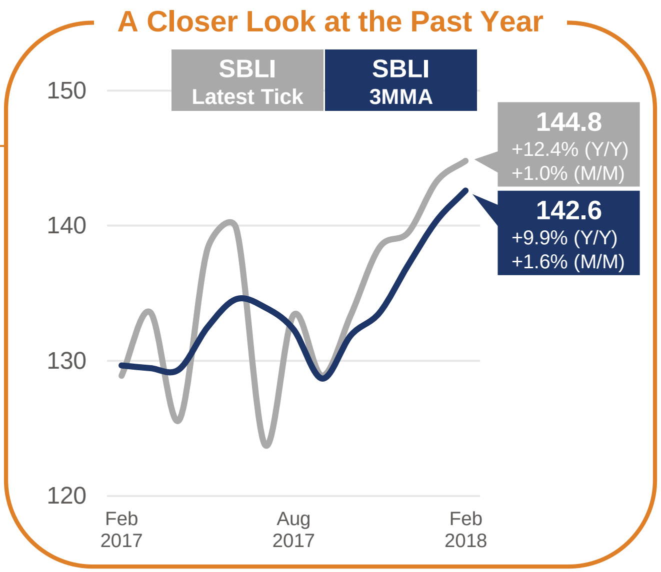
PayNet® Strategic Insights
April 2018

Shifting into High Gear

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





*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 144.8 in February, its second-highest reading ever and 5th consecutive monthly rise. The SBLI is up 1.0% from January and up more than 12% over the last 12 months. The SBLI 3-month moving average also rose and is now 10% above its year-ago level.

Regional Story: Lending in large states continued to rise on a year-over-year basis in February, led by North Carolina (+12.3%) and Texas (+10.6%), though Georgia's SBLI contracted slightly (-1.3%). Notably, California (+1.3%) experienced its first year-over-year SBLI increase since April 2016. The North Carolina SBLI reached an all-time high in February and has risen on a year-over-year basis for 33 consecutive months, while Michigan (+5.9% Y/Y) also set a new state record.

Industry Story: The majority of industries experienced year-over-year growth in February, including Construction (+7.4%) and Transportation & Warehousing (+7.2%). These two industries likely benefited from strong growth in residential and non-residential fixed investment in the fourth quarter. However, Manufacturing was mostly flat in February (+0.3% Y/Y) and Health Care and Social Assistance declined (-2.4% Y/Y). One industry to watch moving forward is Agriculture (+2.0% Y/Y), which rose for the fourth consecutive month after falling for the previous 42 months.

Economic Context

Business investment appears poised to drive economic growth in 2018, and the outlook for small businesses remains strong. The National Federation of Independent Business reported in February that small business optimism is at its highest level in 35 years, as the combination of reduced federal taxes, lighter-touch regulation, and low unemployment have created favorable conditions for growth. The strong labor market should lead to rising wages over the course of 2018, which should in turn boost consumer spending and promote business investment. Though recent friction with key trading partners and the threat of a trade war could negatively affect the business environment, the general economic outlook for 2018 remains positive and the SBLI appears likely to continue its upward march. Indeed, as Main Street businesses finally look to expand after years of cautiousness, one factor to watch is whether banks and other lenders are prepared to meet the increased demand for credit.

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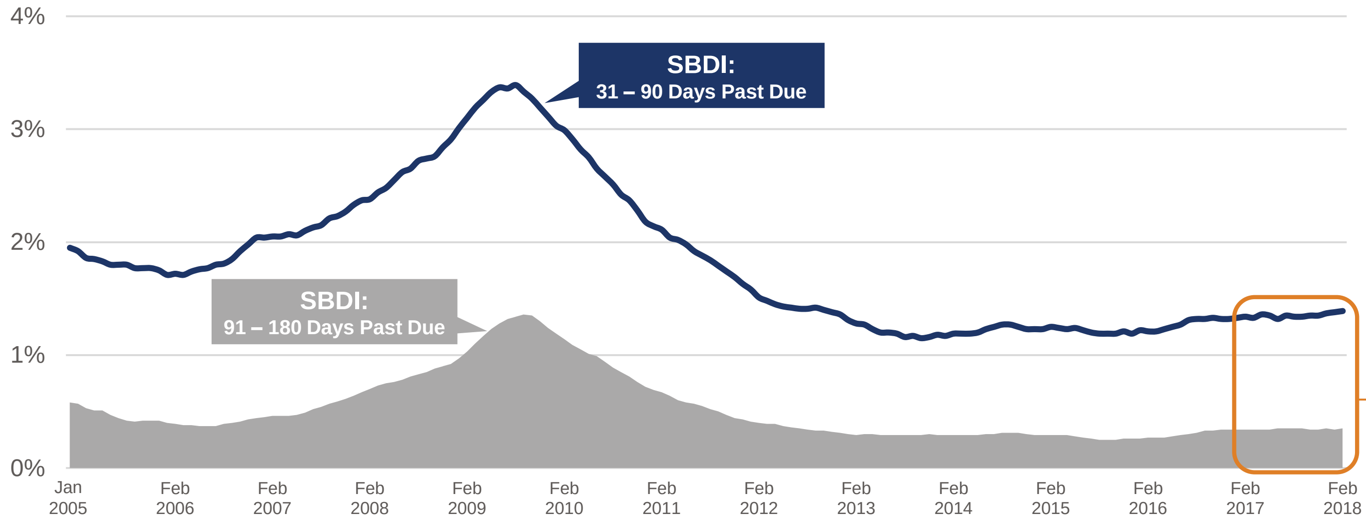
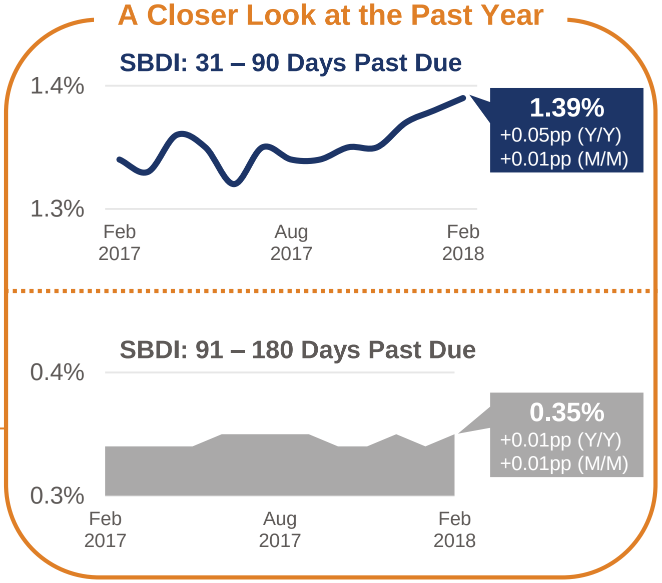
Financial Stress Edges Up

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 edged up to 1.39% in February and is up five basis points over the last 12 months. The SBDI 91–180 Days Past Due increased to 0.35% in February and is up one basis point compared to year-ago levels.

Regional Story: Delinquencies rose in seven of the ten largest states in February on a year-over-year basis, led by Florida (+21bp). Further, the three states that experienced a Y/Y decline in delinquencies (Pennsylvania, North Carolina, and Texas) nonetheless saw delinquency rates rise on a monthly basis, providing further evidence that credit quality appears to be slipping. Notably, Florida and Georgia delinquencies (2.11% and 1.97%, respectively) are at their highest level in six years. However, default levels remain near historical lows for all large states.

Industry Story: Most large industries saw delinquencies rise in February on a year-over-year basis, led by Construction (+16bp Y/Y) and Retail (+8bp Y/Y). Transportation was the only industry to see delinquencies fall (-8bp M/M and -35bp Y/Y), leading to this industry's lowest SBDI reading in nearly two years. Regarding defaults, roughly half of the major industries experienced increases, led by Information (+64bp Y/Y). Defaults in Health Care (+5bp Y/Y) and Construction (+4bp Y/Y) also ticked up. Meanwhile, Mining defaults continued to plummet (-242bp Y/Y), the seventh consecutive month in which Y/Y defaults fell by 50+ basis points.

Economic Context

Small business delinquencies are clearly on the rise, likely reflecting both rising interest rates and a maturing business cycle. Given that the Federal Reserve is expected to raise interest rates 2-3 more times this year, delinquency levels may continue to slowly rise in the months ahead — though strong economic conditions make it unlikely that we will see a sharp increase in small business delinquencies in the near term. Moreover, sustained economic growth could alleviate some of the strain on borrowers; according to the Federal Reserve, nearly 10% of lenders expect to see fewer delinquencies and charge-offs on C&I loans to small firms in 2018, compared to just 6% that expect to see more. As delinquencies rise, the ability of banks and other lenders to accurately assess credit risk will become even more important.