2019
Q4

SFNet Market Pulse

In this edition:

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Economic activity continues to hum along – with US consumers leading the way – but a manufacturing sector contraction threatens to take down the rest of the economy and reduce overall business demand for credit. Despite that risk, the probability that a recession will hit the US economy in the next several months remains relatively low; most signs point to recession onset in 1-2 years. The outlook for major economic sectors is mixed – while the US industrial and wholesale trade sectors are buckling under tariffs and flagging global demand, the retail and oil & gas sectors face cross currents with potential upsides. The global manufacturing slowdown is weighing far more heavily on the eurozone economy, pushing Germany to the brink of outright recession. Globally, large business demand for credit is likely to wane over the next two quarters, but an uncertain outlook could prompt a shift toward secured lending.

> **"Demand for credit is likely to wane, but an uncertain outlook may prompt a shift toward secured lending."**

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US ECONOMIC OUTLOOK

Key factors to watch

US gross domestic product (GDP) expanded at a decent 1.9% pace in the third quarter, driven by healthy consumer spending. Government spending and a surprise rebound in residential investment — the first quarterly expansion in two years — also contributed positively to growth. Meanwhile, contracting business investment and negative net exports continued to drag on the economy. Here are three key factors to watch in the fourth quarter of 2019:

Manufacturing recession. The US manufacturing sector officially entered contraction territory in July, after manufacturing output fell in both the first and second quarters of the year. Orders of non-defense capital goods (excluding aircraft) have fallen on an annual basis for three consecutive months, echoing the global manufacturing downturn that began in mid-2018 in response to the global trade war and weakening output in China. While manufacturing accounts for just 11% of the overall US economy today, manufacturing weakness could spill over into other sectors if it begins to weigh on consumer and investor confidence, in addition to direct job losses.

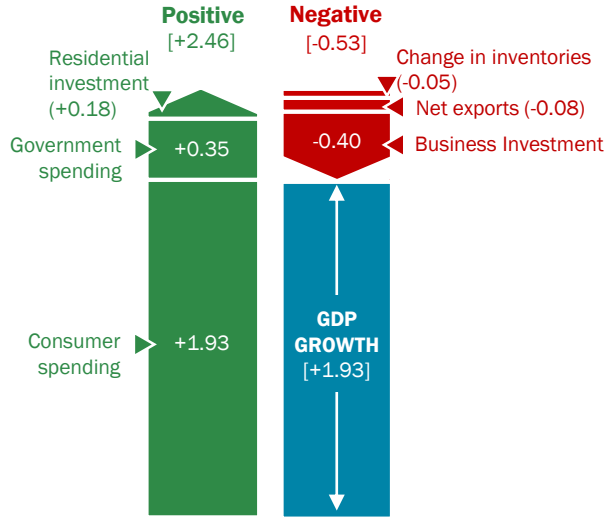
Labor market. At just 3.6% in October, the US unemployment rate is hovering near half-century lows. Average hourly earnings growth has outpaced inflation, suggesting that workers have made real wage gains (a boon for consumer spending) as employers compete for scarce labor. Recent developments, however, suggest that labor market conditions may begin to ease. Payroll growth has averaged 167,000 jobs per month in 2019, well below 223,000 per month in 2018. Job growth may ease further if weak business investment seeps into hiring plans.

Financial markets. US equity markets have reached new record highs several times in 2019 – but those highs have been punctuated by bouts of volatility, usually stemming from trade actions taken by the administration. Meanwhile, foreign investors have sought safe-haven assets in the US, sending Treasury yields to record lows. Though financial markets have remained relatively sanguine, if equity markets drop it is likely that consumer confidence will follow suit, which could imperil the outlook for consumer spending and the broader US economy.

A look back: US Q3 2019 economic activity

The US economy expanded by 1.9% in Q3 of 2019, a moderation compared to the first and second quarters but slightly above expectations.

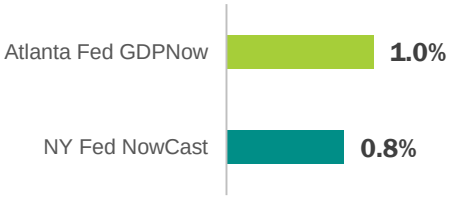
Contributions to GDP growth by sector



Source: Bureau of Economic Analysis (BEA)

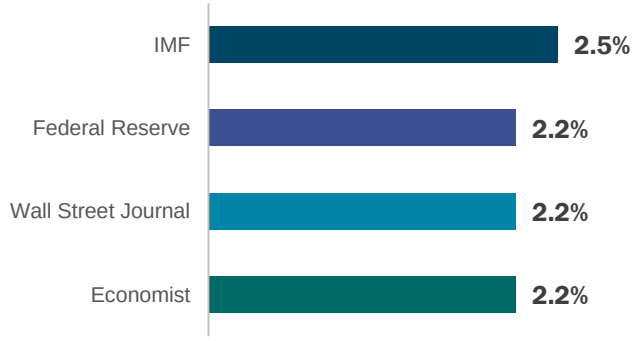
Looking forward: US Real GDP forecasts

Q4 2019 forecasts (annualized)



2019 annual forecasts

2018 GDP growth: **2.9%**



RECESSION MONITOR

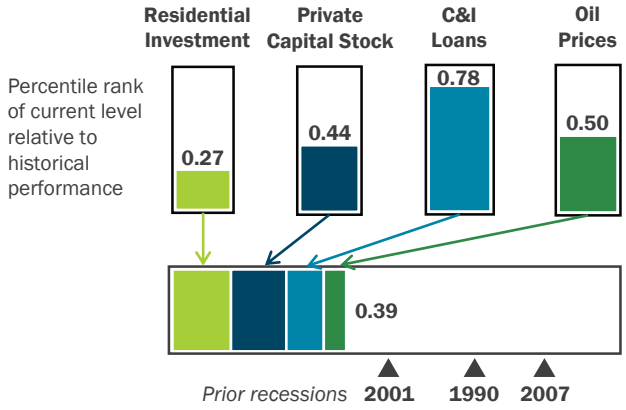
Recession risks subdued — but rising

Midway through the third quarter of 2019, the US economy appears to be at low risk of entering a general recession in the near term. Out of a set of 10 key indicators that tend to reliably lead recessions, three are in the "red zone" while half remain healthy and comfortably away from their historical thresholds. The current readings of the "green" indicators are consistent with the current strength of consumer spending, elevated consumer optimism, and a historically tight labor market. A couple of indicators have recently drifted into the "yellow zone," however, possibly signaling that the ongoing industrial recession may be beginning to spill over into the broader economy.

While a few leading indicators, including the infamous yield curve, are "flashing red," the typical lead times for these indicators suggest the next recession is still a year or so away. Regarding severity of the next recession, current measures are in line with what has historically been seen before a mild recession (e.g., 2001). Housing is not overbuilt, while private capital stock is likewise small relative to GDP. Although C&I loans are historically elevated relative to GDP, they alone are unlikely to cause a severe recession. Meanwhile, oil prices have been subdued, lessening the pressure that high prices could theoretically exert on the economy.

1 Critical mass
Number of recession indicators flashing red

3 Severity
Percentile rank of current reading



2 Indicator sequence
Indicator readings sorted by typical lead time

Indicator	Threshold	Lead	Value
Consumer Expectations – Present Situation Spread[1]	Spread < -30 for 3 months	12 – 36 months	**-77**
Yield Curve	10-year – 2-year spread < 0	12 – 24 months	**17 bp**
NAHB Housing Market Index	Y/Y change < -15% for 3 months	6 – 18 months	**4.4%**
Elkhart, Indiana Employment	Y/Y change < -3%	6 – 12 months	**0.1%**
Leading Economic Index[1]	Y/Y change < 0%	6 – 12 months	**0.4%**
Corporate Profits	Y/Y change < -15%	2 – 4 quarters	**-2.5%**
C&I Loan Delinquency Rate	Q/Q change > 0% for 2 quarters	2 - 4 quarters	**-8.0 pp**
Ratio of Consumer Confidence to Unemployment Rate	Y/Y change in 3MMA < -6%	1 – 6 months	**-0.9%**
Chemical Activity Barometer	Y/Y change < 0%	0 – 6 months	**-0.9%**
Household Durable Purchasing Sentiment Index[2]	Y/Y change in 3MMA < -10%	coincident	**-6.2%**

The color reading of each indicator is determined by whether it has crossed its threshold (entered the "red zone") within its lead time. "Yellow zone" readings are based on Keybridge's assessment of the indicator's recent movement and how close it is to crossing into the "red zone." For more information on the Recession Monitor, please refer to Page 9 (Appendix) of this report.

[1] Conference Board
[2] University of Michigan

SECTOR ACTIVTY

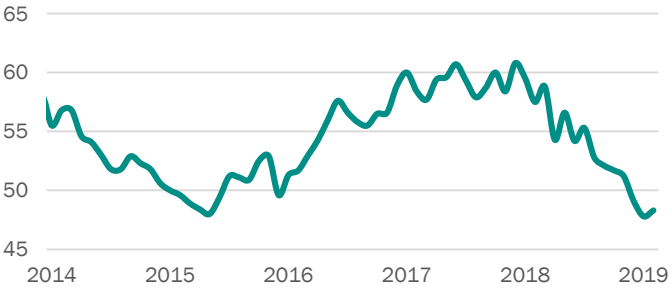
Retail trade. The US retail sector is currently confronting several cross-currents. Although American consumers are spending confidently, retailer indebtedness, structural demand shifts, and tariff uncertainty continue to take their toll on the sector's most vulnerable players.

Despite a slight dip in retail sales from August to September, US retail sales were up 4% on the year, supported by spending on motor vehicles, building materials, and hobbies. The weekly Johnson Redbook Index, up by more than 5% year-on-year in the last several weeks, corroborates that strong growth trend. Most consumer confidence measures remain healthy and portend solid spending activity for the rest of 2019.

Underlying demand remains strong, but retailers continue to struggle with excessive debt and overexpansion. More than twice as many retail storefronts closed in the first half of 2019 as in all of 2018. Although the pace of bankruptcies is slowing, any unexpected halt to consumer spending growth will likely sink the sector's most indebted firms.

Industrial sector. The doom-and-gloom outlook persists for the US industrial sector, which is in the middle of a contraction as bad as that seen in 2015-16. Industrial production and capacity utilization both inched up in August, but each measure is virtually flat on the year. Both shipments and new orders of durable goods now stand below year-ago levels.

ISM Manufacturing Purchasing Managers' Index



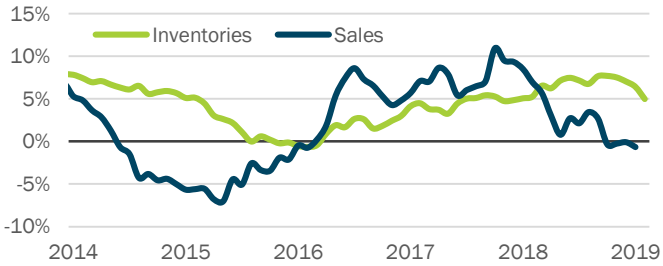
Source: Institute for Supply Management

Unfortunately, it is not yet clear if the decline has bottomed out. The ISM Manufacturing PMI recently fell to its lowest level since June 2009, and the apparent failure of China's economic stimulus does not bode well for near-term global manufacturing demand.

Wholesale trade. US wholesale trade is beginning to feel the bite of the broader downturn in the goods-producing economy and tariff uncertainty, with sales down significantly on the year and inventories set to follow. Sales growth for total merchant wholesalers has consistently decelerated on the year since peaking in mid-2018. Although inventories growth remains moderately strong, it has historically lagged sales growth by roughly 6-12 months. Since peaking in May, it looks set to decelerate further.

Wholesale inventory & sales growth

Year-over-year percent change



Source: US Census Bureau

Oil & gas. September's drone strike on Saudi processing facilities, which briefly took around 5% of total global oil production offline, has had a muted effect on prices. After briefly spiking to over $60 a barrel in mid-September, prices quickly returned to pre-strike levels. Record high oil production in the US has contributed to a global supply glut that has helped mitigate the impacts of the Saudi supply shock.

Although US oil production was at an all-time high at the beginning of November, the outlook for the domestic oil & gas sector has soured notably over the last quarter. The Dallas Fed's Energy Survey fell sharply into negative territory in the third quarter, indicating that oil & gas activity in the Texas region contracted. The US oil rig count has also fallen more than 20% from a year ago and is at its lowest point since April 2017.

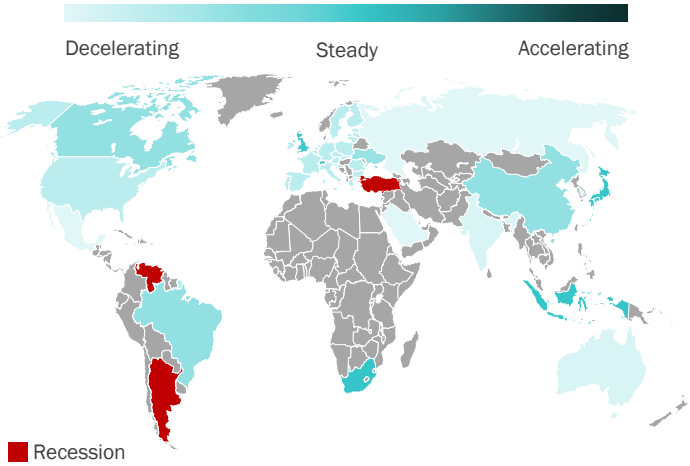
Amid lenders' souring attitude toward the sector, significant shares of respondents in the Dallas Fed Energy Survey indicated their strongest headwinds were "limited access to capital and credit" and "investor pressure to generate free cash flow" – factors that may provide a boost to secured lending demand.

GLOBAL ECONOMIC TRENDS

Slowing growth, mounting headwinds

At last month's annual meeting of the IMF and World Bank, financial leaders warned of the softening of investment and trade volumes in an environment of persistent trade tensions and policy uncertainty. The IMF's latest World Economic Outlook predicts overall global growth of just 3.0% for calendar year 2019 – the lowest rate of growth since the 2008-09 crisis -- with recovery in 2020 contingent on resolution of trade disputes and recovery in struggling emerging markets in Latin America and Asia. In the meantime, the global economy appears to be heading for a protracted period of subdued growth, with historically low interest rates leaving central banks little room to spur demand should conditions in certain countries deteriorate to the point of recession.

Growth of key global economies



Source: International Monetary Fund

Eurozone founders amid German slump

The eurozone economy expanded at an annualized pace of 1.1% in the third quarter as growth stalled across the bloc's key economies. France and Spain surprised to the upside with stronger-than-expected growth, while Germany's economy shrank 0.1% from the prior quarter. Germany's Purchasing Managers' Index (PMI) for manufacturing was at 42.1 in October, well below the 50-point expansionary threshold and bad news for an economy where manufacturing value added accounts for nearly 22% of GDP (double the US share of GDP). An important forward-looking barometer of Germany business activity, the IFO Business Climate Survey, offered a faint glimmer of hope, as the latest results suggest that the decline in incoming orders has begun to slow. Over the next couple of months, it should become apparent whether the German industrial slump bottomed out in the third quarter – or if the economy has formally gone into recession.

Brexit — Deal or no deal?

Three years after U.K. voters opted to leave the EU, a path to an orderly Brexit is still far from certain. Under Prime Minister Boris Johnson, the latest withdrawal agreement addresses several key sticking points, including a customs border with Northern Ireland and an outline for free trade with the EU. Parliament has until January 31, 2020 to pass the deal, which may be easier if Johnson succeeds in pushing for a general election to increase the number of Conservative MPs. If Parliament fails to approve a deal in time, Johnson could try to secure a fourth extensions, else the no-deal Brexit scenario will become reality. The consensus is that a hard Brexit would be overwhelmingly negative for the U.K. economy. Even if Johnson manages to achieve a timely, orderly exit, the unavoidable friction as the U.K. develops new unilateral customs agreements and trade policies mean near-term risks are all to the downside, regardless of how smoothly Brexit takes place.

Globalization in retreat

As the tit-for-tat trade conflict and disputes about IP theft and Chinese industrial policy push the US and China toward an economic and political decoupling, there are signs that the trend away from globalization is a much more pervasive phenomenon. From Brexit and the bitter Japan-South Korea trade war to the surge in protectionist policies in Indonesia and Mexico, there are more and more reasons to wonder — has globalization peaked? While the rise in nationalist political sentiment that has accompanied the increase in trade protectionism and unilateralism may be only temporary, rising labor costs in emerging markets and improved automation technologies in advanced economies are fundamentally changing the costs of producing goods abroad. Even if political attitudes shift back toward greater international engagement over the next election cycle or two, evolving production methods may mean that de-globalization is here to stay.

CREDIT DEMAND & GROWTH

Demand weakens in Q3 2019

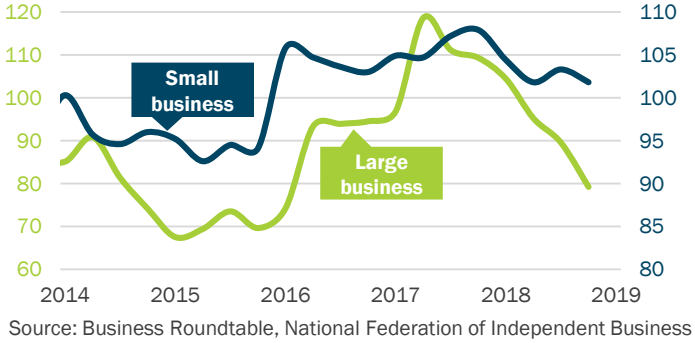
The Federal Reserve's Senior Loan Officer Opinion Survey on Bank Lending Practices – a survey of up to 80 domestic banks and 24 US branches of foreign banks – shows that demand for new commercial and industrial (C&I) loans weakened notably in the third quarter, particularly from large & middle market firms. Nearly all banks reporting weaker loan demand cited reduced client investment in plants or equipment as a reason for the decline. An uncertain global growth outlook and manufacturing contraction are likely weighing on business investment plans, reducing firms' financing needs. Although overall C&I loan growth eased in the first half of 2019, growth in committed credit by secured lenders accelerated according to SFNet data. While not a primary reason for reduced demand, a shift in customer borrowing to "other bank or nonbank sources" was cited by over half of senior loan officers reporting weaker loan demand in Q3, suggesting that firms are turning to nontraditional sources to meet their financing needs. The survey findings are consistent with the latest readings of the SFNet Confidence Index for new business demand, which saw expectations improve among nonbank secured lenders and ease among banks.

Uncertainty weighs on investment plans

Capital spending has eased substantially over the first three quarters of 2019, and a deepening industrial sector slowdown and heightened trade uncertainty pose additional downside risk to business investment in the fourth quarter and into 2020. Measures of business confidence for both goods-producing and service sector companies have eased, a sign that investment spending across sectors is likely to continue decelerating through the end of 2019.

Small & large business confidence

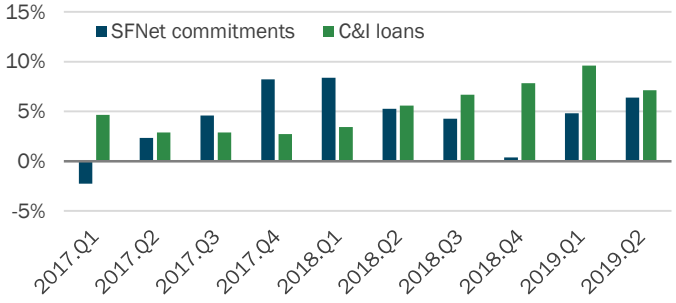
CEO Economic Outlook Index *Small Business Optimism Index*



Source: Business Roundtable, National Federation of Independent Business

SFNet ABL total committed credit lines vs. C&I loans

Year-over-year percent change



SFNet Confidence Index

Expectations for new business demand over the next 3 months

Bank lenders	Nonbank lenders
2.16	**2.33**
▼ -0.10	▲ 0.02

Note: Responses are on a 3-point scale where a "1" indicates a decrease/decline, a "2" indicates that things are expected to stay the same, and a "3" indicates an increase/improvement.

Senior Loan Officer Survey

*Top 3 reasons for **weaker** demand in Q3*

1. Decreased customer investment in plants or equipment
2. Decreased customer merger or acquisition financing needs
3. Increased customer internally generated funds

While 2017-18 was characterized by booming business confidence in the wake of tax reform and a global cyclical upturn, the surge has since ebbed. The Business Roundtable CEO Economic Outlook Index, a measure of large business confidence, has fallen for six consecutive quarters since peaking in Q1 2018. Small business confidence has mostly hung on: in September, the NFIB Small Business Optimism Index receded further from its April all-time high but still sits in the top 20% of all readings. The confidence gap largely comes down to trade, as large businesses feel greater impacts from tariffs and trade policy uncertainty while small businesses are more dependent on US consumers for sales growth. However, if tariff woes and industrial weakness spill into consumer confidence, small business confidence is set to decline quickly.

CREDIT SUPPLY

Q3 lending standards mostly unchanged

The Fed's Senior Loan Officer Opinion Survey shows that lending standards were essentially unchanged in the third quarter. While some categories of lending standards including spreads of loan rates over banks' cost of funds narrowed, collateralization requirements – an indication of standards in the secured lending space – tightened marginally. Most lenders reporting tighter standards pointed to a less favorable economic outlook as the primary reason.

Looking ahead, falling global interest rates and flagging demand for credit are likely to exert pressure on lenders to ease standards further in the coming months. For example, a 16% year-on-year decline in global M&A volume (per Refinitiv) in Q3 2019 points to a pricing mismatch between lenders and borrowers that is likely to be partially resolved through easing standards. Spreads are often the canary in the mineshaft for changes in other lending terms, since movements in short-term cost of funds are felt immediately whereas more complex channels for easing standards, such as loan covenants, take longer to take effect. As spreads continue to narrow, expect easing in other areas.

How did bank lending standards change in Q3?

Standards for large and middle-market firms:

Standards for small firms:

Source: Senior Loan Officer Survey **L** = Large Banks (>$50 bn in assets)
S = Small Banks (<$50 bn in assets)

Senior Loan Officer Survey

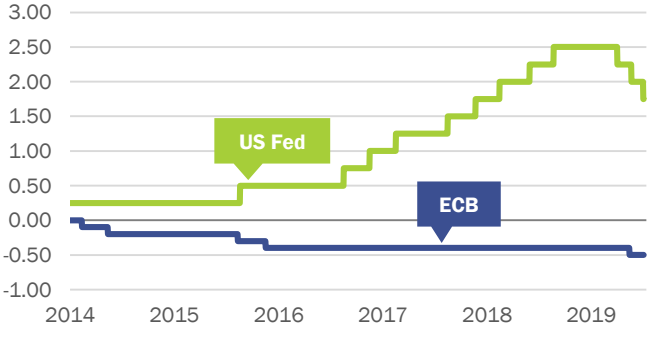
*Top 3 reasons for **tightening** standards in Q3*

1. Less favorable or more uncertain economic outlook
2. Reduced tolerance for risk
3. Worsening of industry-specific problems

Negative interest rates – new normal?

The European Central Bank's September 12 decision to lower its benchmark rate by 10 basis points to -0.50% has brought attention to the issue of negative interest rates. Once considered a temporary, emergency policy response for the struggling Euro Area economy when the ECB first dropped rates below zero in 2014, negative rates have since bled into the bond market and appear to be a widespread, global phenomenon. There is now an estimated $17 trillion in negative-yielding debt worldwide including $15 trillion in government bonds (accounting for 25% of all sovereign debt). With policy rates dropping further and credit supply continuing to expand, negative-yielding debt will likely continue to grow over the near term.

US Target Fed Funds Rate vs. ECB Target Rate



Source: Macrobond

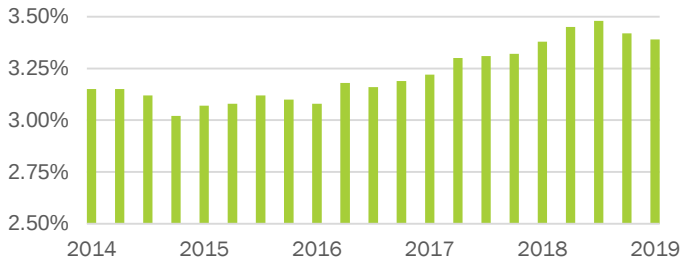
This state of affairs is uncharted territory for the global economy. A world dominated by negative-yielding debt, where lenders pay borrowers for the privilege of holding their money and banks face negative profitability, appears to violate the core laws of capitalism. For now, the phenomenon appears largely relegated to European sovereign bond markets, and affects just a fraction of all corporate debt. But negative rates may eventually make their way to the United States or to the household sector, particularly if the Fed ever pulls its policy rate into negative territory. Fed officials have dismissed such a possibility, but a US recession or continued political pressure from President Trump might change their calculus. For secured lenders, negative rates are likely to exert stronger upward pressure on asset prices and collateral values.

LENDER PROFITABILITY

Spreads set to narrow further

US bank profitability declined slightly in the second quarter of 2019. As the net interest margin for all commercial US banks fell three basis points to 3.39%. a moderate net fraction of banks reported easing lending standards by narrowing the spreads of loan rates over their bank's cost of funds. The narrowing effect was uniform across large banks, while small banks reported mixed trends in spread behavior. Looking ahead, lender profitability is likely to decline further over the next two quarters. Although the Fed's recent rate cuts should theoretically exert downward pressure on short-term yields and create space for wider spreads, in practice long-term yields have fallen faster than short-term yields since the Fed began easing in July.

Net interest margin for all US banks



Source: FDIC

Change in spreads in Q3

Source: Senior Loan Officer Survey

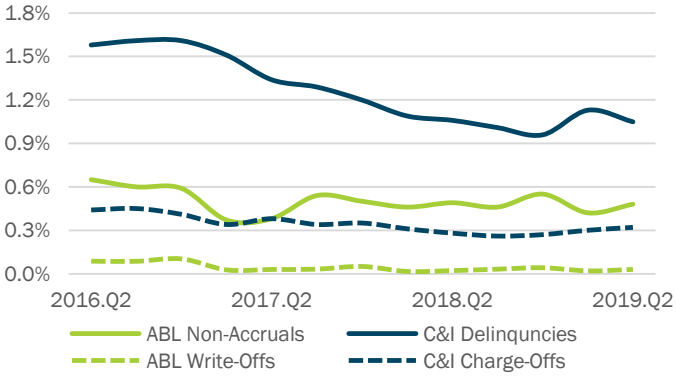
L = Large Banks (>$50 bn in assets)
S = Small Banks (<$50 bn in assets)

PORTFOLIO PERFORMANCE

Historically strong, but weakening

In Q2 2019, asset-based lending portfolio performance deteriorated slightly but remains historically strong. According to SFNet data on bank ABL, non-accruals as a percentage of total loans outstanding ticked up from 0.42% to 0.48%, and gross write-offs as a percentage of outstandings likewise inched up one basis point to 0.03%. ABL portfolio performance remains stronger than for overall commercial & industrial lending, where Q2 delinquencies and charge-offs stood at 1.05% and 0.32%, respectively. For both ABL and overall commercial & industrial lending, delinquency and default rates are almost as low as they've ever been. Looking ahead, however, portfolio performance is likely to deteriorate along with the overall US and global economic outlook. Delinquencies last surged in 2015-16 amid a global manufacturing contraction that stressed borrowers in the oil & gas and industrial sectors. Following a recovery in 2017-18, history appears to be repeating itself. Expect delinquencies and defaults to rise over the next few months, particularly for manufacturing borrowers.

Bank ABL non-accruals & gross write-offs

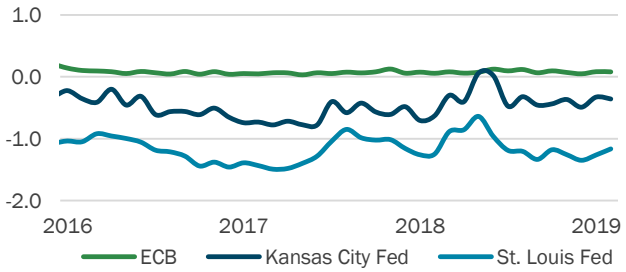


Source: SFNet, Federal Reserve

How stressed are financial markets?

Financial stress indices – which measure how well credit markets are functioning – remain at low, healthy levels. Underlying measures, including the Baa/Aaa and Aaa/10-year spreads, point to market confidence in the underlying values of assets and steady appetite for risk.

Indices of financial stress



Source: ECB, Federal Reserve

RECESSION MONITOR: METHODOLOGY

Indicator selection & severity assessment

Keybridge assessed hundreds of high-frequency indicators from a variety of sources covering all major segments of the US economy, and identified a set of 10 that have a good track record of independently anticipating a US economic recession without an excess of false signals. For each indicator, Keybridge identified a threshold that the indicator has historically crossed in the months prior to each of the last three US economic recessions (without false signals). Each indicator is assigned a color based on its recent behavior relative to its particular threshold: "green" for when the indicator is safely above (or, for the C&I loan delinquency rate, below) its threshold, "yellow" for when it nears its threshold, and "red" for when it has crossed its threshold at least once within its typical lead time.

For example, an indicator with a six-month typical lead time that crossed its threshold one month but rebounded the next month would remain "red" until six months had elapsed without re-crossing the threshold.

The assessment of the likely severity of the next recession is based on analysis of the extent of excess "buildup" in key sectors immediately preceding the past six US recessions. The percentile rank of the current level of residential investment, private capital stock, C&I loans, and oil prices are assigned weights based on their relative contributions to the severity of prior recessions, then summed to create a severity index ranging from 0 – 1, where readings closer to 0 indicate a milder recession and readings closer to 1 indicate a severe recession.

Early warning signs

Consumer Expectations – Present Situation Spread

The spread between the two major components of the Conference Board's Consumer Confidence Index. A wider spread between these components has been shown to reliably lead downturns with a long lead.

2-year – 10-year Yield Curve

The spread between short-and long-term government bond yields. Short-term yields rising above long-term yields indicates that investors are increasingly worried about the near-term health of the economy and a recession is likely close.

NAHB Housing Market Index (HMI)

An index that measures homebuilder sentiment. The housing sector has been shown to reliably lead broader downturns in the US economy.

Elkhart, Indiana Employment

Elkhart, Indiana is the US capital of recreational vehicle (RV) manufacturing. Since "big-ticket" items like RVs are among the first goods consumers pull back on, the RV industry is especially sensitive to downturns in consumer health.

Conference Board Leading Economic Index (LEI)

A composite index tracking the entire US economy. This index is a "catch-all" indicator that offers a broad assessment of national economic growth.

Closer signals

Corporate Profits

After-tax profits from non-financial US corporations. Profits historically always fall year-over-year in the quarters immediately prior to recession.

Commercial & Industrial (C&I) Loan Delinquencies

An indicator of business financial stress. When delinquencies rise, it signals that businesses are facing a broad deterioration in economic conditions that prevents them from meeting their financial obligations.

Consumer Confidence ÷ Unemployment Rate

Consumer Confidence is a coincident indicator while the unemployment rate is lagging. A coincident-lagging ratio acts as a leading indicator because as an expansion peaks the coincident indicator will be rising more slowly than the lagging.

Chemical Activity Barometer

A composite index of activity in a range of chemicals sectors. The index consists of indicators relating to hours worked in chemicals industries, stock-market data, chemical price information, end-user sales-to-inventory ratios, and more.

Univ. of Michigan Household Durable Purchasing Sentiment Index

An index measuring consumers' feelings about whether it is a good time to purchase large household durable goods. This is an area of spending that consumers tend to cut first when the economy sours.

About the SFNet Market Pulse

The *SFNet Market Pulse* is an economic report that highlights emerging macroeconomic trends likely to affect secured finance and asset-based lending over the near term. It is designed to help lenders stay up-to-date on the most important macro-level economic and policy trends driving commercial credit demand, credit supply, portfolio performance, and financial stress. The *SFNet Market Pulse* is produced by Keybridge, a boutique economic research consultancy comprised of economists and public policy experts based in Washington, D.C.