

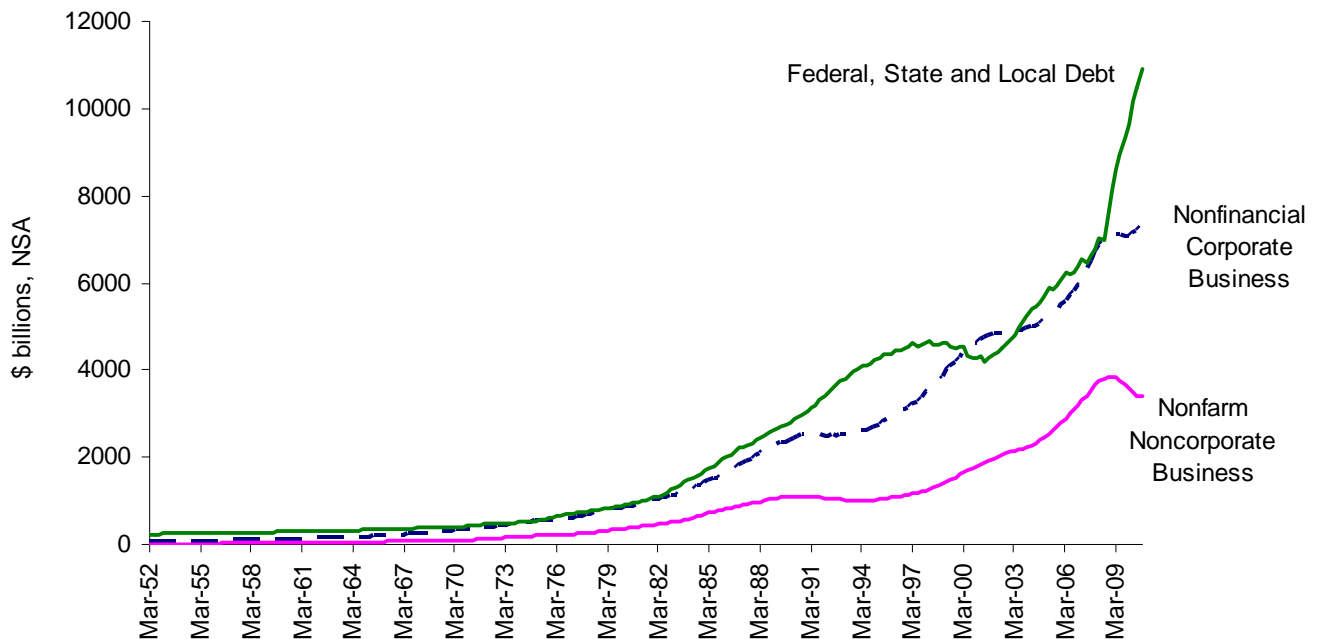
December 9, 2010

Credit Drain on Small Businesses and Households Lessening Somewhat

The Federal Reserve released its quarterly flow of funds report yesterday for the third quarter of 2010. **The Fed data showed a continued channeling of credit toward federal, state and local governments and bigger businesses. The shrinkage in the balance sheets of small businesses and households slowed.**

- Over the four quarters through September, federal debt grew 19.5%, state and local debt 3.3% and corporate debt 3.4%. Household debt fell 1.8%. Small-business debt shrank 7.5% (slowing to a 4.8% annual rate decline in the third quarter.)

Government, Corporate and Noncorporate Business Debt Outstanding (\$ billions, last obs. Q3 2010)



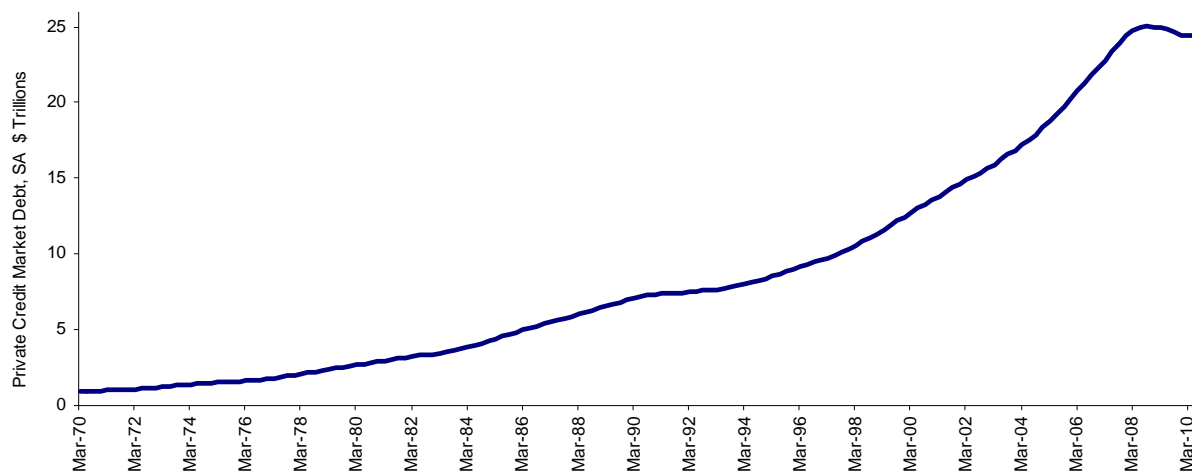
Source: Federal Reserve; Encima Global

- We note many forces in the regulatory environment pushing the private sector toward consolidation and bigness, including the bias in lending in favor of governments and big companies. Early in 2010, we discussed the implications of this debt consolidation process as part of a rolling debt crisis. In the long run, it increases and centralizes debt and makes credit allocation less market-oriented. In the short-run, it has been

stabilizing (e.g. Europe's bailout of Greece and Ireland, the U.S. pass-through of federal borrowing to states through the 2009 and August 2010 stimulus bills).

- U.S. private sector credit grew strongly in the 2000s, peaking at \$25 trillion in the third quarter of 2008. Since then, it has declined each quarter, with a cumulative reduction from the peak of \$660 billion through the third quarter of 2010.

Total Private Credit Market Debt (seasonally-adjusted, last obs. Q3 2010)



Source: Federal Reserve; Encima Global

- With the government included, the debt of the non-financial sector rose \$444 billion in the quarter -- to \$35.8 trillion at the end of the third quarter from \$35.3T at the end of the second. (In the table, the data is non-seasonally-adjusted. The financial sector is typically kept separate in this type of analysis because it borrows in order to lend and is therefore a net neutral through its financial intermediation.)

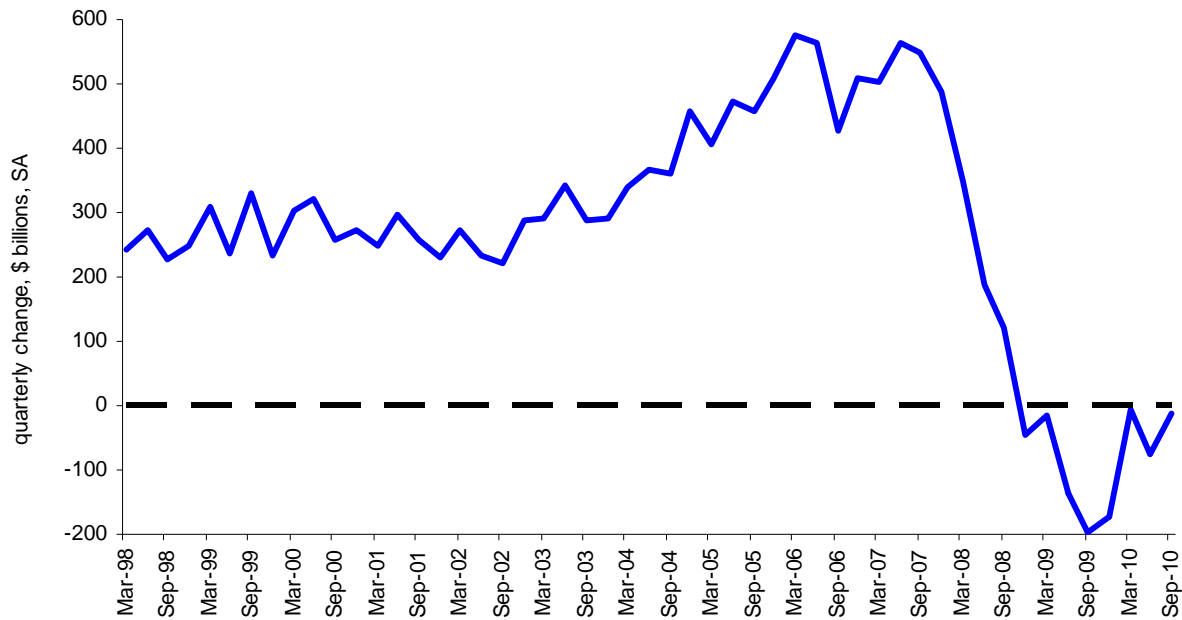
Credit Market Debt Outstanding (last obs. Q3 2010)

	2010 Q3 (\$ trill)	2010 Q2 (\$ trill)	Q3/Q2 % chg annualized	Yr/Yr % chg 2010 Q3	Yr/Yr % chg 2009 Q3	Yr/Yr % chg 2008 Q3
Domestic Nonfinancial Sectors	\$ 35.78	\$ 35.33	5.0%	3.7%	4.3%	6.5%
U.S. Government	\$ 9.02	\$ 8.63	18.1%	19.5%	30.1%	15.3%
State & Local Govt	\$ 2.40	\$ 2.39	2.3%	3.3%	3.7%	4.4%
Households	\$ 13.43	\$ 13.46	-0.8%	-1.8%	-1.7%	2.2%
Nonfin Corp Business	\$ 7.32	\$ 7.22	5.7%	3.4%	0.3%	8.3%
Noncorporate Business	\$ 3.38	\$ 3.43	-4.8%	-7.5%	-4.8%	8.7%
Farm Business	\$ 0.22	\$ 0.22	7.6%	0.3%	0.6%	2.2%
Foreign Sector	\$ 2.07	\$ 2.03	7.7%	11.3%	-8.1%	0.4%
Financial Sector	\$ 14.44	\$ 14.59	-4.3%	-9.6%	-6.0%	7.3%

Source: Federal Reserve; Encima Global

- Credit markets once provided \$300-\$550 billion net new credit per quarter to the non-financial private sector. This helped fund new investment, inventories and other working capital needs. This was accomplished by an increase in the net total for bonds, mortgages, commercial paper and bank loans. The third quarter reduction in net private sector credit was \$12 billion.

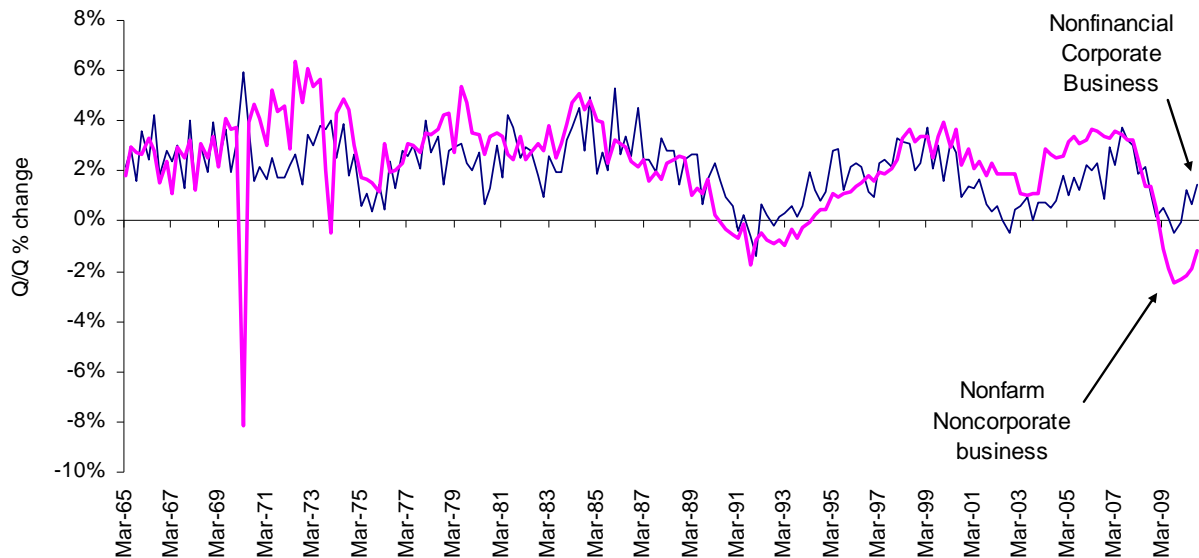
Credit Market Once Provided \$300-\$400B Quarterly to Non-Fincl Private Sector; Now Draining Funds Each Quarter (seasonally-adjusted, last obs. Q3 2010)



Source: Federal Reserve; Encima Global

- Federal government debt increased at an 18.1% annualized rate in the third quarter. Corporate businesses increased at a 5.7% rate. Household debt decreased at a 0.8% annualized rate. Non-corporate businesses decreased at a 4.8% rate.

Corporate and Noncorporate Businesses; Change in Credit Market Instruments (q/q % change, last obs. Q3 2010)



Source: Federal Reserve; Encima Global

In addition to the above discussion showing the sectors that got credit, the Fed flow of funds report breaks the data down into the credit instruments used – bank loans, bonds and mortgages. In most cases, there’s a bias toward bigness.

- On a seasonally adjusted annualized rate, bank loans in the third quarter fell for non-corporate businesses (by \$60.7 billion) and fell for incorporated businesses (by \$82.2 billion).
- Bonds for non-financial corporations increased by \$486.8 billion and commercial paper by \$47.6 billion. These instruments are largely unavailable to smaller businesses.
- In the quarter, mortgage balances outstanding fell less for corporate businesses (by \$88.6B) than for non-corporate businesses (fell \$118.8B), and households (fell \$255.8B.)
- Bottom line: Government debt is going up while private sector credit is going down, particularly for small businesses. Bank loans in particular were still in a severe squeeze in the third quarter for businesses. Corporations and governments used bonds to add to their debt and get around the decline in bank loans that hit small businesses.

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