

**June 11, 2010**

## **Small Business Credit Drain Continued Through Q1 2010**

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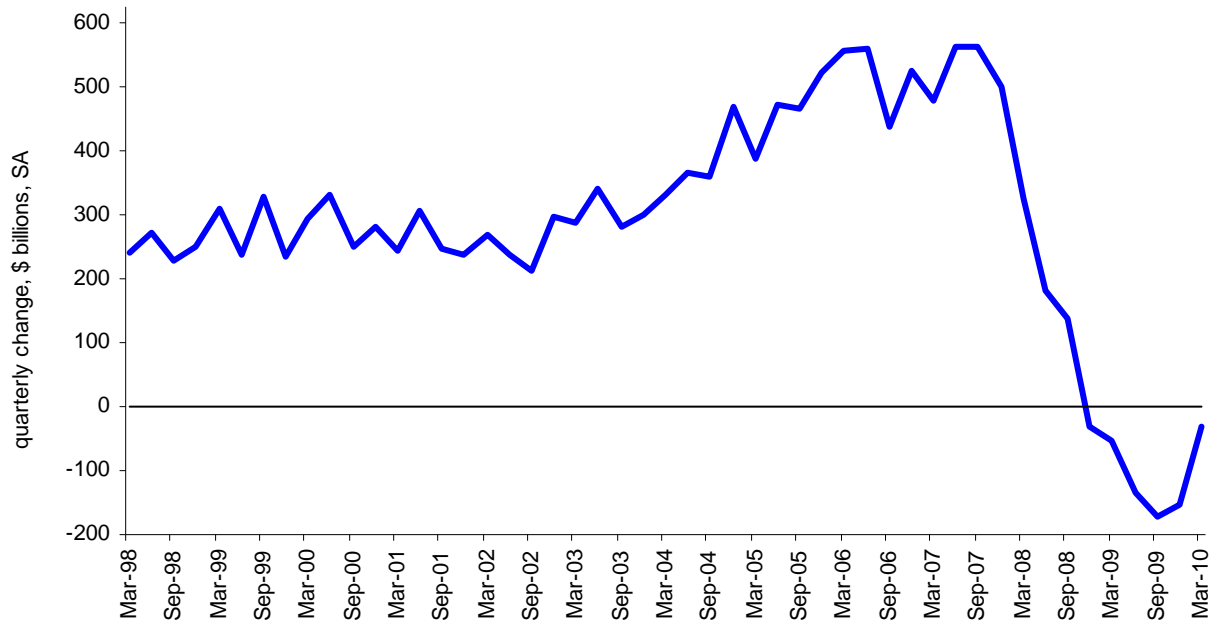
Yesterday's New York Times covered the squeeze in small-business credit conditions in its article "Tight Credit is Turning Franchisers Into Lenders." We think bank regulatory policy is causing a massive change in U.S. business structures, benefiting bigger companies and governments but harming small businesses. Per the Times article:

- "I went to several banks and they acted like they could do loans," Mr. Tessier said. "But when it came down to it, it was ridiculous. Ultimately, the terms and conditions were just outrageous."
- Chains are facing the worst credit squeeze since the franchise model boomed in the years after World War II. This year, the franchise industry is expected to seek \$10.1 billion in capital, but banks are expected to lend only \$6.7 billion, according to the International Franchise Association.
- "Banks have hit the reset button," said Reginald Heard. "Banks are defining who can play and who can't play," said Mr. Johnston.

The Fed released its quarterly flow of funds report on June 10 for the first quarter of 2010. **The Fed data showed a continued rechanneling of credit toward governments; and shrinkage in the balance sheet of small businesses.**

- Credit markets once provided \$300-\$550 billion net new credit per quarter to the non-financial private sector, funding 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. Private sector credit peaked at \$25 trillion in the third quarter of 2008. Since then, it has declined by \$576 billion through the first quarter, when credit markets drew a net \$31 billion from the non-financial sector, continuing the drain that started in 2008.

## Credit Market Once Provided \$300-\$400B Quarterly to Non-Fincl Private Sector, Now Draining Funds (seasonally-adjusted, last obs. Q1 2010)



Source: Federal Reserve; Encima Global

- Governments and corporations increased their debt in the first quarter while households and unincorporated businesses reduced their debts. Federal government debt increased at a 24% annualized rate in the first quarter. State and local debt increased at a 5% rate.
- In total, the debt of non-financial sectors (including governments) rose \$424 billion in the quarter -- to \$35.08 trillion at the end of the first quarter from \$34.7T at the end of the fourth (non-seasonally-adjusted).

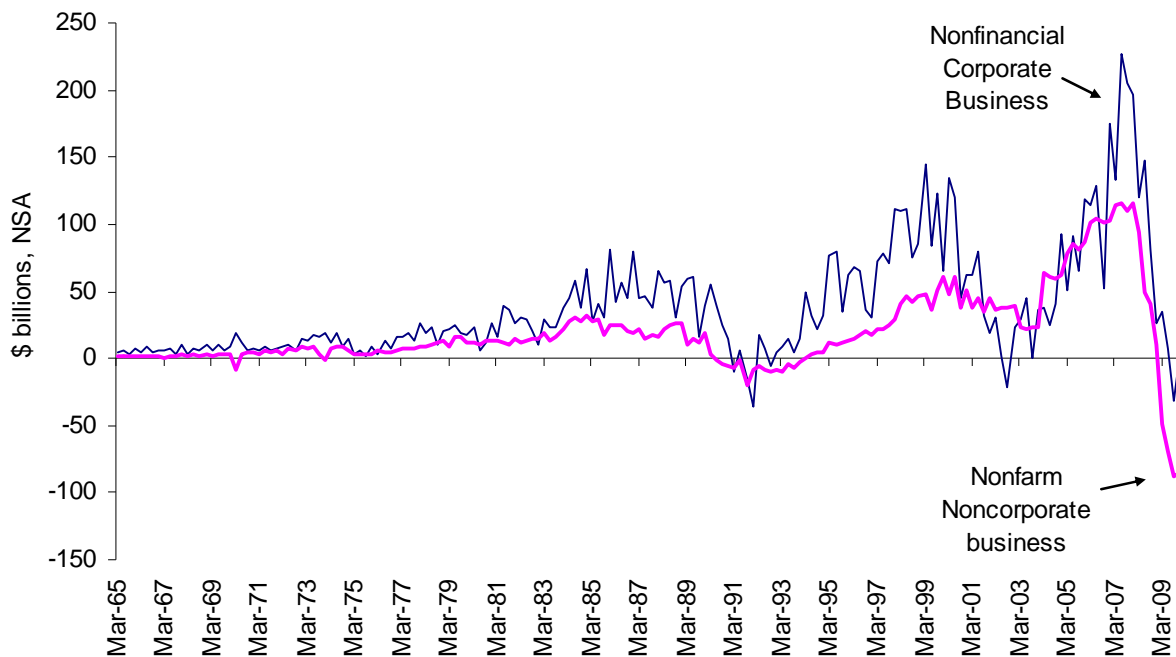
## Credit Market Debt Outstanding (last obs. Q1 2010)

	2010 Q1 (\$ trill)	2009 Q4 (\$ trill)	Q1/Q4 % chg annualized	Yr/Yr % chg 2010 Q1	Yr/Yr % chg 2009 Q1	Yr/Yr % chg 2008 Q1
Domestic Nonfinancial Sectors	\$ 35.08	\$ 34.65	4.9%	3.2%	5.6%	8.0%
U.S. Government	\$ 8.28	\$ 7.81	24.5%	21.3%	28.3%	5.7%
Nonfederal Sectors	\$ 26.80	\$ 26.85	-0.8%	-1.4%	1.1%	8.5%
Households	\$ 13.50	\$ 13.60	-2.9%	-1.8%	-0.8%	5.8%
Nonfarm Nonfin Corp Business	\$ 7.21	\$ 7.11	5.2%	1.0%	4.2%	12.3%
Nonfarm Noncorporate Business	\$ 3.48	\$ 3.55	-8.1%	-8.3%	1.4%	13.1%
Farm Business	\$ 0.22	\$ 0.22	-7.3%	1.0%	4.6%	1.7%
State & Local Govt	\$ 2.38	\$ 2.35	4.9%	4.7%	2.4%	7.6%
Foreign Sector	\$ 2.08	\$ 2.06	3.9%	9.9%	-13.9%	14.5%
Financial Sector	\$ 14.96	\$ 15.61	-16.6%	-12.0%	3.5%	11.1%

Source: Federal Reserve; Encima Global

- The biggest first-quarter decline in non-financial debt was a \$72 billion decrease (8% annualized rate) in the debt of non-corporate businesses. This reduction reflects the squeeze on working capital loans and other small-business credit and is contributing to the weakness in the labor environment. Corporate businesses saw an increase in credit of \$93.2B in the quarter (5% annualized rate).

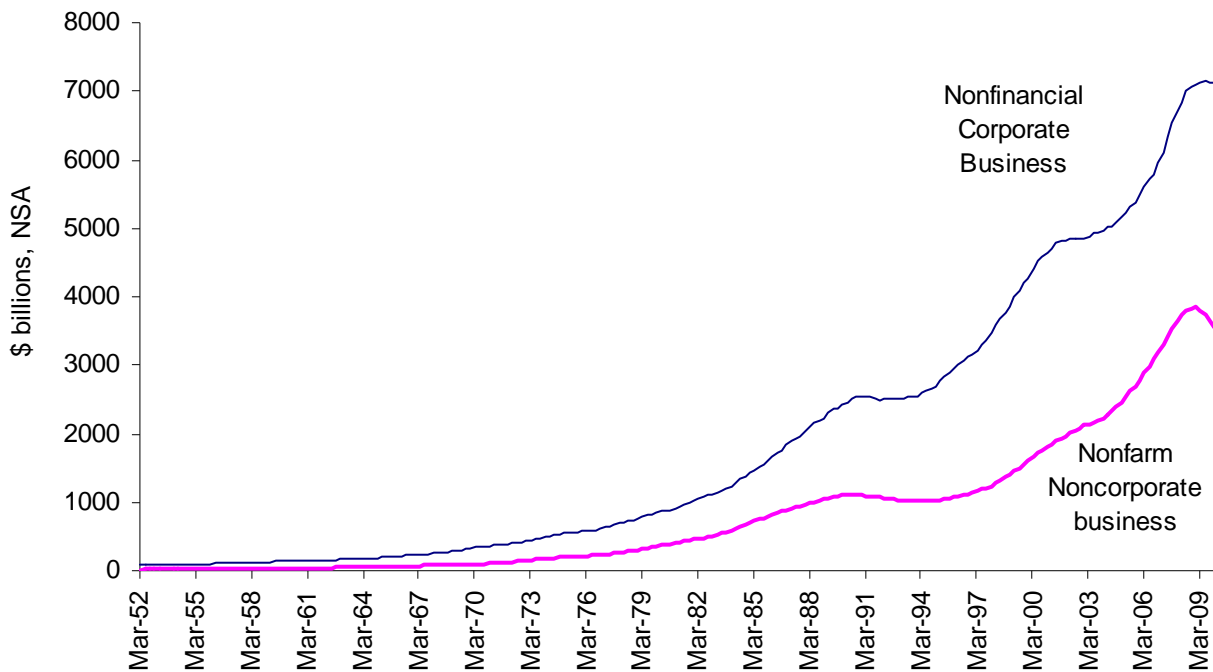
### Corporate and Noncorporate Businesses; Change in Credit Market Instruments (last obs. Q1 2010)



Source: Federal Reserve; Encima Global

- At the end of the first quarter, credit to non-corporate businesses (mostly small businesses) stood at \$3.48T (peak was \$3.85T). Credit to corporate businesses are reaching new highs at \$7.21T after only a small dip in Q3 2009.

## Corporate and Noncorporate Business Credit Market Debt Outstanding (last obs. Q1 2010)



Source: Federal Reserve; Encima Global

- The Fed flow of funds data breaks the credit instruments into the type of instrument – bank loans, bonds, mortgages. On a seasonally adjusted annualized rate basis, bank lending in the first quarter fell in both non-corporate businesses (by \$170.4 billion) and incorporated businesses (by \$108.1 billion). For corporations, this was more than offset by a net increase of \$413.0 billion in bonds outstanding. Mortgages also fell for both non-corporate (by \$109.6B) and corporate businesses (\$46.6B).
- Bottom line: Credit, especially bank loans, was still in a severe squeeze in the first quarter. 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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