Observation

TD Economics
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January 18, 2011

HIGHLIGHTS

- **Underlying the improvement in economic indicators over the last several months has been growing signs that the economy is also seeing a recovery in credit conditions.**
- **The mortgage market continues to act as the major constraint on growth, but outside of mortgages, credit availability, credit quality, and credit growth all appear to have turned a corner.**
- **Commercial banks' willingness to lend to households and businesses has moved from tightening to easing.**
- **Loan delinquencies for consumer loans and commercial and industrial loans fell consistently through 2010.**
- **Led by gains in non-revolving loans, consumer credit growth, which represents 18% of total household liabilities, has turned positive in recent months. Correcting for charge-offs, consumer credit growth is accelerating.**
- **Faster credit expansion means more money creation and reduced risk of deflation.**
- **While the recovery in credit is still in its early stages, a further acceleration of credit growth could signal a move to a much stronger pace of economic growth than currently expected by markets or forecasters.**

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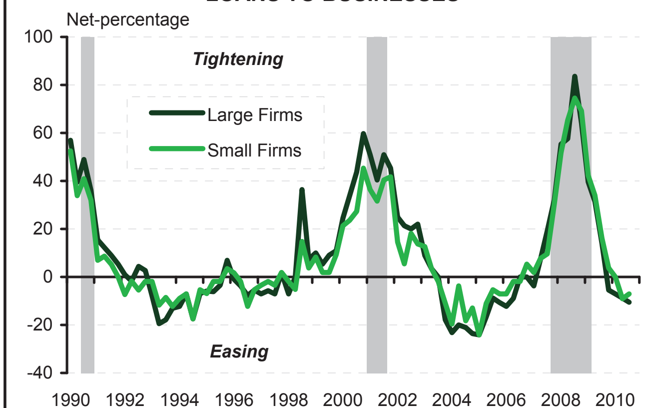
OUTSIDE OF MORTGAGES, U.S. CREDIT SHOWING BROAD IMPROVEMENT

The U.S. economic recovery has picked up steam over the last several months. The recent momentum in economic indicators, in combination with another round of fiscal stimulus, has led many forecasters – ourselves included – to upgrade the outlook for real GDP growth over the next year.

In a recovery punctuated by a credit crisis, unleashing economic potential will require an improvement in credit growth. While the credit crisis began in the U.S. housing market, the credit freeze that took place in its aftermath affected all sectors of the economy. In combination with broad losses in wealth, the increased cost of credit and reduced availability for businesses and households contributed to the depth and severity of the economic recession and the insufficient pace of recovery.

However, as we move further away from the financial crisis, there are growing signs that credit markets are on the mend. While residential and commercial real mortgage lending continues to be constrained, outside of mortgages, credit availability, credit quality, and credit growth are all showing broad improvement. This trend bears watching. As the minutes of the Federal Open Market Committee (FOMC) meeting in December noted: "an acceleration [in economic growth] would likely be accompanied by significantly more rapid growth in bank lending and in monetary aggregates." Given the type of recession and recovery we have experienced, an increase in credit may even lead the move to higher economic growth.

BANKS TIGHTENING C&I* LOANS TO BUSINESSES



*Commercial and industrial
Source: Federal Reserve Senior Loan Officer Survey

What is more, the current weakness in real estate is less a matter of continued deterioration of mortgage quality, and more a legacy of past credit excesses. Reducing uncertainty about the value of real estate assets and the eventual losses faced by lenders will depend on the pace of growth in the broader economy. Should the improved pace of credit growth outside of real-estate markets accelerate, it could signal a move to a much stronger economic growth trajectory.

Credit availability is improving

First on the list of encouraging signs is that the credit freeze is thawing and becoming more available. A key source of information with respect to the availability of credit is the Senior Loan Officer Survey conducted quarterly by the Federal

COMMERCIAL BANKS REPORTING INCREASED WILLINGNESS TO LEND TO CONSUMERS

Source: Federal Reserve Senior Loan Officer Survey, Haver Analytics

Reserve. The most recent survey for the fourth quarter of 2010 was conducted in October and revealed that outside of residential mortgages, willingness to lend to consumers and businesses continues to move in the right direction. On net, commercial banks are easing standards on consumer credit cards and other loans, as well as on commercial and industrial loans for both small and large firms. As shown in the chart above, willingness to lend to consumers is at its highest level in over five years.

Delinquency rates are falling

The trends taking place in credit standards are also mirrored in credit quality. Delinquency rates saw a meteoric rise for nearly all types of debt over the recession. The total commercial bank delinquency rate for all loans and leases peaked in the first quarter of 2010 and after remaining steady in the second quarter, fell in the third quarter. Nonetheless, even before the overall delinquency rate began showing improvement, there was a growing divergence in credit quality amongst different loan types. In particular, loans secured by real estate have seen delinquency rates remain high, while unsecured loans to consumers and businesses have been on a steady downward trend since 2009. The delinquency rate on consumer loans, including credit cards, peaked in the second quarter of 2009 at 4.9% and as of the third quarter of 2010 had fallen to 4.1%. Similarly, after peaking at 4.4% in the fourth quarter of 2009, the delinquency rate on commercial and industrial loans reached 3.3%.

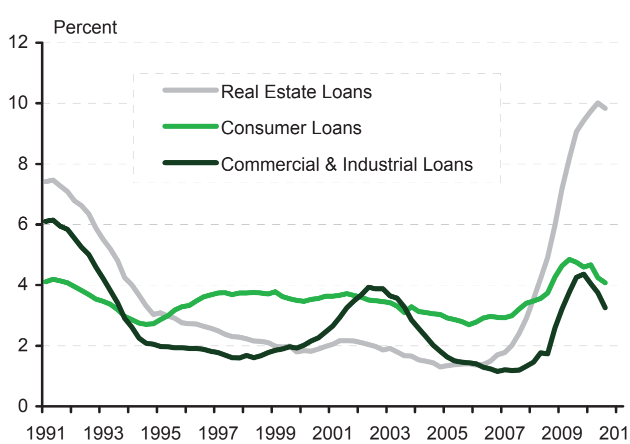
The improvement in credit quality is important because it could mark the beginning of a virtuous cycle where better credit quality leads to more credit growth and improved economic growth, which in turn feeds back into greater credit quality.

Consumer credit growth is accelerating

While understandably much of the focus over the recession has been on the decline in mortgage credit, unsecured consumer credit is an important component of household borrowing, representing close to 18% of total household liabilities. After decades of gains in consumer credit – fueled by strong growth in credit card debt – consumer credit plunged during the recession. From its peak, total consumer credit fell by 7.3%, led by a 17.2% decline in revolving credit (credit cards), and a 1.3% decline in non-revolving credit.

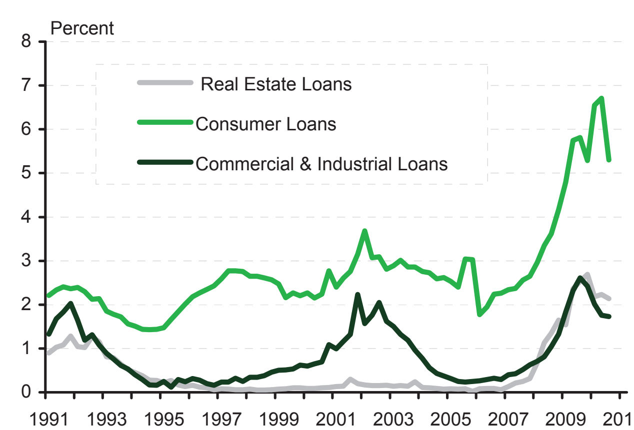
The change in consumer credit outstanding reflects both the write-down of non-performing loans as well as the change in credit due to consumer behavior – households taking on less debt or paying down debt. The main reason for the decline in consumer credit over the recession was due

COMMERCIAL BANK DELINQUENCY RATES

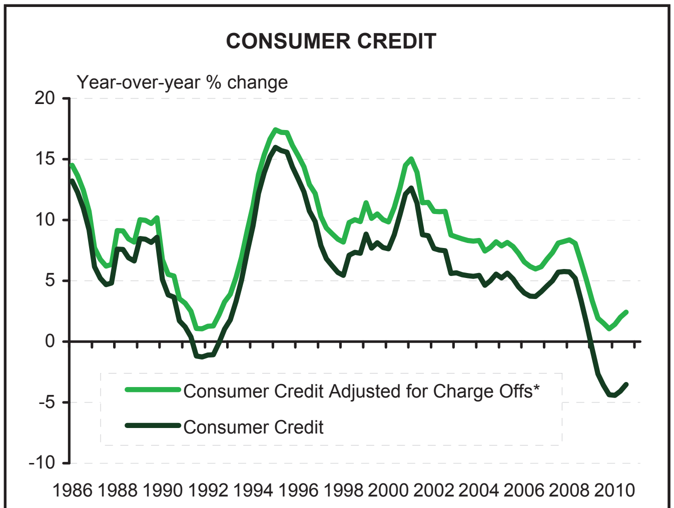


Source: Federal Reserve

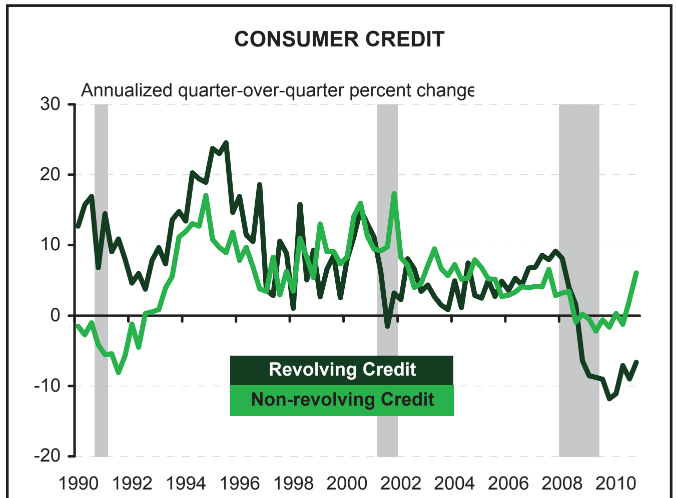
COMMERCIAL BANK CHARGE-OFF RATES



Source: Federal Reserve



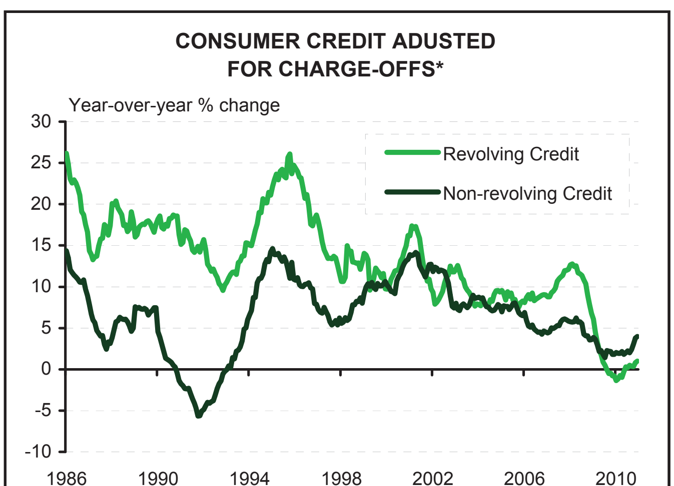
Source: Federal Reserve Board. *Calculation by TD Economics



Source: Federal Reserve

to the former – a large increase in the charge-off rate. While data on charge-offs for the entire economy is not available, data is available for commercial banks, which represent just under half of total consumer credit. Charge-offs on consumer credit rose to a peak of 6.7% in the second quarter of 2010, led by credit cards, which rose to 10.9% – the highest level for which data is available going back to 1985.

As shown in the chart below, by removing the decline in consumer credit due to charge-offs, we get a picture of the change in credit issuance. While this is only an estimate without data for the non-commercial bank sector, given the importance of commercial banks in consumer credit, it is likely a good representation of broader trends. Correcting for charge-offs shows that household deleveraging did lead to a slowdown in credit issuance. On a year-over-year



*Estimate by TD Economics based on commercial bank charge-off rate. Source: Federal Reserve, TD Economics

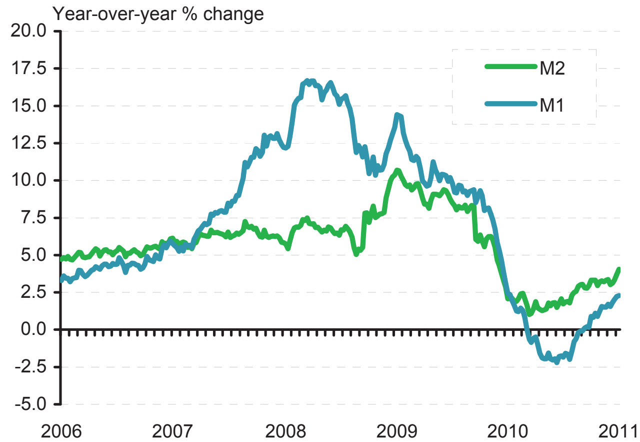
basis, revolving consumer credit was slightly negative in early 2010 – a new phenomenon for credit cards – while non-revolving net credit issuance slowed, but did not actually contract.

Importantly, over the last several months, there has been a considerable improvement in consumer credit growth. Even with the impact of charge-offs, total consumer credit rose in both October and November – the first two consecutive monthly gains since June and July of 2008. Moreover, the weakness in consumer credit growth is concentrated within credit cards. Non-revolving credit has seen fairly strong growth, rising by an average of 5.1% (annualized) over the past five months. This turn from negative to positive growth is particularly important for a variable like consumer credit, which exhibits a lot of momentum. Looking at the history of consumer credit, positive growth tends to be followed by more positive growth (and vice versa). The fact that consumer credit growth has moved back into positive territory is a good signal that it will continue to grow in the months and quarters ahead.

More credit means more money

An increase in the pace of credit growth is significant because it relates directly to the transmission of monetary policy to the broader economy – lower interest rates only stimulate growth if they result in an expansion of credit. But, it is also important because of what it means for the expansion of the money supply. With a fractional reserve banking system, money creation depends on the creation of new loans, which result in new deposits, which in turn result in new loans – a process called the multiplier effect. So, the fact that credit growth appears to be expanding should

MONEY SUPPLY

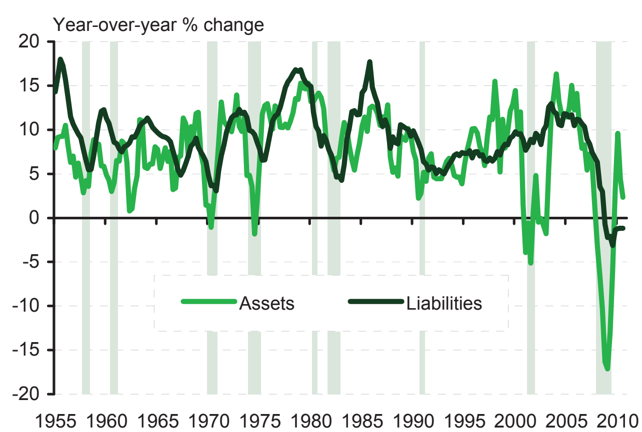


Source: Federal Reserve, Bureau of Economic Analysis

also show up in a faster pace of money supply growth. Looking at the aggregate money supply data – both M1, which includes just currency and checking deposits, and M2, which also includes saving and time deposits – this is exactly what we see. On a year-over-year basis, weekly data for M2 shows a growth rate of 4.0%, a steady acceleration from its trough (at 1.0%) in March.

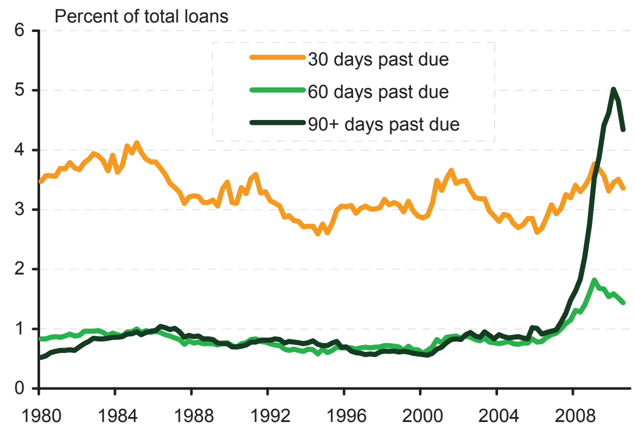
Given fears about deflation, the nascent rise in money supply growth is an important development. Inflation is essentially a monetary phenomenon – create enough (aggregate) money and prices will rise. While the significant amount of economic slack is likely to keep a lid on price pressures over the next year, the increase in money supply growth, which is only likely to accelerate further under the Federal Reserve's asset purchase program, eases significantly the risk of a deflationary spiral.

U.S. HOUSEHOLD ASSETS & LIABILITIES



Source: Federal Reserve Flow of Funds

RESIDENTIAL MORTGAGE DELINQUENCIES



Source: Mortgage Banker's Association, Moody's Economy.com

Problems in mortgage market reflect legacy of past bad loans

Perhaps the only mitigating factor in an otherwise good news story is the lack of traction within real estate secured lending. However, while the delinquency rate on residential and commercial mortgages has remained high, this does not mean that there has not been an improvement in the mortgage market. Indeed, for residential mortgages, the percent of mortgages entering delinquency (that is, falling behind 30 days on their payments) also peaked in mid-2009, as did the 60+ delinquency rate. Consequently, there is a much smaller pipeline for future seriously delinquent mortgages. The outstanding issue in residential mortgages is the backlog of mortgages that are 90 days or more past due on their payments, but have not made their way through the foreclosure process.

While data for commercial real estate is harder to come by, what is available for commercial mortgage backed securities, suggests the same phenomenon is also at play for non-residential mortgages. In both cases, problems moving seriously delinquent mortgages through the foreclosure pipeline and into liquidation are the main reasons for still heightened delinquency rates. Until there is more progress on resolving delinquent mortgages, secured lending is likely to remain impaired. As we discuss in our report, *Resolving U.S. Housing Problem Essential To Avoiding Japan Experience*, without a resolution in housing, improvement in other sectors of the economy can only push the gas pedal down so far. At the same time, the fact that credit quality is improving outside of mortgages illustrates that resolving issues in housing and commercial real estate could lead to a much faster pace of credit expansion and economic growth.

Bottom Line

The U.S. economic recovery is becoming more firmly entrenched. As the economy moves further away from the financial crisis, the balance of risks in terms of economic activity must also reflect the potential for growth to surprise to the upside. Perhaps the best early signal that upside economic risks may be gaining prevalance is the condition of credit markets. Given the importance of the supply and demand of credit to the Great Recession and recovery, an improvment credit growth could be the best sign that the economy has moved into a virtuous cycle based on higher expectations for future demand that lead to greater investment and production today.

With interest rates at record lows and pent-up demand still present, the further along that U.S. households move in terms of repairing their tattered balance sheets, the greater the potential for spending to rise. While the deleveraging process is likely not yet complete and the U.S. saving rate is likely to remain elevated, stronger income growth will allow consumer spending growth to match. Moreover, as expectations improve, greater wealth creation prospects will allow for upside to spending alongside further balance sheet repair. The improvement in credit conditions is still in its early stages and the housing market is still rife with uncertainty, but there is certainly cause for optimism in the direction of changes over the last several months.