Executive Summary
Credit is the lifeblood of the economy, therefore a substantial tightening in credit conditions could cut the current recovery short. The latest Senior Loan Officer Opinion Survey points to banks tightening credit across all major loan categories, and commercial and industrial (C&I) and non-mortgage consumer loans outstanding have fallen over the past few months. But loans at commercial banks account for only about 30% of the total credit extended to the U.S. private nonfinancial sector. Debt capital markets are more or less wide open again, which has helped keep credit flowing to larger businesses and to households indirectly. Meanwhile, mortgage lending, especially for residential properties, has been strong. At this point in time, we are not overly worried about credit conditions, but renewed, broad-based tightening would give us cause for concern given credit’s vital role in economic growth.

Economy and Credit Markets Distorted by the Pandemic
The pandemic and the measures that have been adopted to combat it have led to some marked distortions in the usually smooth operating of the economy. For example, real GDP contracted at an unprecedented rate in Q2-2020, but it likely will bounce back at the strongest rate on record in the current quarter. Similarly, the amount of outstanding commercial and industrial (C&I) loans that are held by the nation’s commercial banks surged by close to 30% between early March and early May. However, C&I loans have subsequently receded about 10% which, if sustained, is a bit disconcerting. Credit is the lifeblood of the economy, and the economic outlook would darken significantly if credit conditions tighten considerably. But the $2.8 trillion of C&I loans represent only a small part of the $33 trillion worth of total credit extended to the U.S. private nonfinancial sector. So before we start wringing our hands about the economic outlook, let’s first check in on how other parts of the credit markets are performing.

Credit to the Nonfinancial Business Sector: A Mixed Bag
Credit to the nonfinancial business sector totals about $17 trillion at present. Not only do businesses borrow via C&I lending at the nation’s commercial banks, but they also borrow from credit unions, foreign banks, and non-depository institutions such as insurance companies, pension funds and hedge funds. Businesses also borrow via mortgages, which we will discuss in more detail below, and there are roughly $6 trillion worth of corporate bonds outstanding at present.

The Paycheck Protection Program (PPP) that was authorized by the CARES Act accounted for a large part of the jump in C&I loans at the nation’s commercial banks that occurred a few months ago.

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1 We thank Ryan Brinkoetter and Lea Overby, fixed income analysts at Wells Fargo Securities, for helpful comments.
2 Real GDP contracted at an annualized rate of 31.7% in the second quarter, but we currently project that it will grow roughly 22% in Q3. See our Monthly Economic Outlook for details.
3 Not only do business loans include $2.8 trillion worth of C&I loans that are held at commercial banks, but banks also own $2.4 trillion worth of commercial mortgages.
Banks have tightened credit standards recently.

The corporate bond markets are wide open at present.

Corporate bond spreads have compressed significantly.

ago. But the amount of C&I loans outstanding has receded by nearly $300 billion since mid-May. Unfortunately, a time series on the amount of PPP loans outstanding is not readily available. Although some PPP loans may have rolled off of bank balance sheets recently, we suspect most of the decline in C&I loans reflects a pullback in other business lending among commercial banks.

Our suspicion is supported by recent data from the Fed’s Senior Loan Officer Opinion Survey (SLOOS), which shows that credit standards tightened considerably in the first and second quarters for every size of firm (Figure 1). Moreover, every major dimension of loan terms tightened, including wider spreads and increased cost of credit, premiums, loan covenants and collateral. So tighter credit standards likely have contributed to the recent weakness in C&I lending. But many businesses do not appear to be as willing to take on credit, as is often the case during periods of economic weakness. In that regard, the percentage of banks reporting stronger demand for loans fell between the first and second quarters (Figure 2).

Figure 1

Net Percentage of Banks Tightening Standards

C&I Loans

Standards for C&I Loans to Small Firms: Q2 @ 70.0%

Standards for C&I Loans to Large & Medium Firms: Q2 @ 71.2%

Figure 2

Net Percent of Banks Reporting Stronger Demand

Commercial & Industrial Loans

Demand for C&I Loans to Large & Medium Firms: Q2 @ -23.3%

Demand for C&I Loans to Small Firms: Q2 @ -28.6%

Source: Federal Reserve Board and Wells Fargo Securities

In contrast to the tightening that occurred in the C&I loan market in the first and second quarters, the corporate bond markets have been wide open in recent months. Year-to-date issuance in the investment grade (IG) market has totaled about $1.4 trillion, which through the first eight months of 2020 is already an annual record (Figure 3). Issuance in the high yield (HY) market through the first eight months of the year currently stands just shy of $300 billion. If the recent run rate in the HY market is maintained through the end of the year, then the all-time annual record of $368 billion that was set in 2013 will be easily eclipsed.

Moreover, the pricing of those bonds has been very favorable to the issuers. Spreads of IG and HY corporate bonds both blew out earlier this year when it became evident that the pandemic was spreading to the United States (Figure 4). However, the many programs that the Federal Reserve implemented in March and April to ease tensions in financial markets have contributed to a marked compression in spreads over the past few months. Spreads on IG corporate bonds have not generally returned yet to their pre-pandemic level, but the yield on the 10-year Treasury security is currently about 100 bps lower than it was in mid-February. Consequently, many IG companies can issue bonds at lower rates today than they did in February. The all-in cost of borrowing for HY companies today is generally not lower than it was earlier this year, but rates have come down sharply in recent months. In sum, credit is widely available for most companies that are large enough to issue in the corporate bond markets.

4 Banks extended more than $525 billion worth of PPP loans.
Tighter Credit Standards: Should We Be Worried?

WELLS FARGO SECURITIES
ECONOMICS GROUP

September 02, 2020

Figure 3

Gross Issuance of Corporate Bonds
Billions of Dollars

<table>
<thead>
<tr>
<th>Year</th>
<th>Investment Grade</th>
<th>High Yield</th>
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<td>2010</td>
<td>$100.3B</td>
<td>$51.9B</td>
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Source: Dealogic, Bloomberg LP and Wells Fargo Securities

Figure 4

Yield Spreads on Corporate Bonds
Over 10-year Treasury Note, Basis Points

<table>
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<tr>
<th>Year</th>
<th>Investment Grade Treasury Spread</th>
<th>High Yield Treasury Spread</th>
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</thead>
<tbody>
<tr>
<td>2018</td>
<td>164.8</td>
<td>481.0</td>
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Activity in the residential mortgage market has been strong.

Generally Supportive Conditions in the Mortgage Markets

Data from the Financial Accounts of the United States that are compiled by the Federal Reserve show that there were $16 trillion worth of mortgages at the end of Q1-2020 (latest available data), with the household sector owing nearly $10.7 trillion of this amount. Activity in the residential mortgage market weakened sharply as the economy went into lockdown mode in March and April, but it has subsequently bounced significantly. The number of mortgage applications for purchase is higher today than it was in February (Figure 5), and refi applications spiked to their highest level in seven years when mortgage rates started to tumble. In that regard, the rate on the benchmark 30-year fixed rate mortgage is down on balance by a half-point relative to February and currently stands at less than 3.00%, the lowest rate in at least 50 years (Figure 6). Standards have tightened up since the start of the year, but are near the middle of their historic ranges according the latest SLOOS.

Figure 5

Mortgage Applications for Purchase Index
Seasonally Adjusted Index, 1990=100, 4-Week Moving Average

Purchases: Aug-28 @ 308.8

Source: Mortgage Bankers Association, Bloomberg LP and Wells Fargo Securities

The residential mortgage market is more than three times larger than the commercial mortgage market, and conditions in the latter largely mirror the former at present. Specifically, the value of commercial mortgages held today at commercial banks is 2% higher than it was in late February. Data on commercial mortgage rates are not readily available, but spreads on corporate mortgage-backed securities (CMBS) over U.S. Treasury securities offer some clues to the current state of pricing. Similar to corporate bond spreads, CMBS spreads blew out in March and early April. However, CMBS spreads have compressed significantly in recent months, although they are not

CMBS spreads have narrowed.
quite back to the tights that prevailed at the beginning of the year. In short, credit conditions in both the residential and commercial mortgage markets at present generally appear to be supportive of continued activity in those sectors.

**Some Signs of Weakness in Consumer Credit**
Where credit conditions seem a bit more dicey is in the non-mortgage consumer segment. Consumer loans at banks—primarily auto loans and credit cards—are down about $90 billion (roughly 6%) since late February (Figure 7). Lending standards for consumer loans at banks have tightened significantly since the pandemic caused the jobs market to implode (Figure 8). At the same time, banks have reported weaker demand for consumer loans. Extensive fiscal support to households via supplemental unemployment benefits and stimulus checks likely helped reduce borrowing needs in recent months, but greater pessimism over income prospects may also have contributed to fewer households seeking debt.⁵

![Figure 7](image)

**Figure 7**
**Consumer Lending**

![Figure 8](image)

**Figure 8**
**Net Percent of Banks Tightening Standards**

Source: Federal Reserve Board and Wells Fargo Securities

Consumers obviously do not borrow directly in the capital markets as do large businesses, but many types of consumer loans are securitized and sold as bonds to investors. This securitization process helps support direct lending to consumers. Issuance in the asset-backed securities (ABS) market weakened considerably in March and April. Although issuance has picked up again in recent weeks, thanks in part to strength in prime auto loans, year-to-date issuance is down about 25% relative to the same period last year. Similar to corporate bonds and CMBS, ABS spreads have also narrowed significantly since April. The ABS market has been supported by the Fed’s Term Asset-Backed Securities Loan Facility (TALF), where like the corporate bond market, use of the program has been low, but has gone a long way in shoring up investor confidence and funding. ABS spreads on highly rated short-term securities have essentially retraced the entire widening that occurred earlier this year. But, spreads on lower rated and longer maturity bonds are still elevated relative to February.

**Could Tight Credit Lead to Another Downdraft in the Economy?**
Credit is integral to the economy’s growth, but the growth outlook is also integral to credit. Credit enables companies to expand and bridge gaps in revenue, but the extension of credit depends on the availability and demand for credit, which are heavily influenced by broader economic conditions. In other words, credit and GDP growth are dependent on each other. The two-way relationship is confirmed by a simple statistical analysis.⁶

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⁵ According to the Conference Board, the differential between consumers expecting income to increase and decrease over the next six months fell from +15.4 in Q4-2019 to -0.3 in Q2-2020.

⁶ A Grange Causality test with a two-quarter lag confirms that real GDP growth “Granger causes” nonfinancial private credit growth (significant at 1% level), while credit growth also “Granger causes” GDP growth (significant at the 5% level). We used year-over-year growth rates between 1995 and 2019 in our regressions.
In general, credit in the economy today continues to flow reasonably well. C&I loans at the nation’s commercial banks have receded somewhat in recent weeks from their PPP-induced jump, and non-mortgage consumer loans are also down relative to February. But mortgage lending, especially in the residential market, has been strong and debt capital markets are more or less wide open again. In sum, we are not overly worried at this time about tightness in credit markets choking off economic growth later this year. But we will be watching the evolution of the pandemic in coming weeks and months as well as developments in credit markets. Given the relationship between credit and economic growth, a re-tightening in the former would give us cause for concern. But as long as credit markets continue to perform reasonably well, then we likely will remain reasonably constructive on the economic outlook.
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