The Dramatic Tightening in Commercial Bank Lending Standards Portends Recession

Joe Lavorgna
Chief US Economist
SMBC Nikko, Inc.

(212) 893-1528
Joseph.Lavorgna@smbcnikko-si.com
February 7, 2023
The net percentage of banks that tightened lending standards on commercial and industrial loans (C&I), a leading indicator of the manufacturing sector, rose to 44.8% last month up from 39.1% previously. Every time C&I standards have been this tight, the economy was either in recession or on the cusp of one. This time is unlikely to be different, and these data probably explain why Chair Powell was so dovish last week.

Source: Bloomberg, Federal Reserve, SMBC Nikko
Tightening on CRE Loans Even More Dramatic

The situation is even worse for commercial real estate (CRE) loans where 61% of banks tightened standards. This, too, is a level consistent with recession. Within the CRE details, all three lending categories (construction & land development loans, nonfarm residential properties, and multifamily residential properties) experienced dramatically more stringent loan criteria. These figures point to an imminent pullback in construction payrolls.

Source: Bloomberg, Federal Reserve, SMBC Nikko
No Need to Tighten When No One Wants to Borrow

On the surface, it is surprising that standards on residential mortgages have tightened by only a little considering what has happened for C&I and CRE lending. But this reflects the fact that residential loan demand has collapsed because of a record large increase in mortgage rates. Look for banks to become more stringent only after mortgage rates decline in response to a Fed pivot.

Source: Bloomberg, Federal Reserve, SMBC Nikko
Less Lending Equals Less Demand

Lastly, Senior Loan Officers also have been less willing to extend credit to households. This is evident from a plunge in banks willingness to make consumer installment loans, which declined to -12.5% from -6.8% previously. This is a level that has always been consistent with recession. The bottom line: With bankers dramatically tightening lending standards on C&I, CRE and consumer loans, it is difficult to see how a 2023 economic downturn can be avoided.

Source: Bloomberg, Federal Reserve, SMBC Nikko
Disclaimer

This presentation is for discussion purposes only and is not intended to be an offer to sell or the solicitation of an offer to buy any securities, or any commitment to underwrite, subscribe for or place any securities, is not an offer or commitment to provide any financing or extension of credit or service, and does not contain any tax or legal advice. This presentation has been prepared by SMBC Group (which may include, collectively or individually, any of the following entities in the Americas Division: Sumitomo Mitsui Banking Corporation ("SMBC"), SMBC Nikko Securities America, Inc. ("SMBC Nikko"), SMBC Nikko Securities Canada, Ltd. ("Nikko Canada"), SMBC Capital Markets, Inc. ("SMBC-CM"), SMBC Leasing and Finance, Inc., JRI America, Inc., and SMBC Rail Services LLC) and is being furnished by SMBC Group solely for use by the client or potential client to whom such materials are directly addressed and delivered. This presentation is confidential, and is the property of SMBC Group subject to copyright. Any reproduction of this presentation, in whole or in part, is prohibited, and you may not release these materials to any person, except to your advisors and professionals to assist you in evaluating these materials, provided that they are obligated, by law or agreement, to keep the presentation confidential. These materials do not constitute research, a recommendation or an offer or solicitation to any person to enter into any transaction or adopt any hedging, trading or investment strategy. Prior to participating in any such transaction, you should consult your own independent, competent, legal, tax, accounting and other professional advisors.

In preparing this presentation, SMBC Group has relied upon information available from third parties, including public sources, and we have assumed, without independent verification, the accuracy and completeness of such information. Specific prices, indices or measures, including ranges, listed in this document were prepared at the time the document was prepared, and are subject to change without notice. SMBC Group makes no representations to and does not warrant this presentation’s accuracy or completeness. SMBC Group expressly disclaims any liability for any use of the information set forth herein, including, without limitation, any use of the information set forth herein in the preparation of financial statements or accounting material.

These materials may contain forward looking statements, which may include projections, forecasts, income estimates, yield or return, future performance targets or similar analysis. These forward looking statements are based upon certain assumptions. All forward looking statements are based upon currently available information and SMBC Group is not obligated to provide an update. Actual events may differ from those assumptions. Opinions, projections, price/yield information and estimates are subject to change without notice. There can be no assurance that estimated returns or projections will be realized, that forward looking statements will materialize or that actual results will not be materially lower than those presented. Past performance is not necessarily indicative of future results. Any transactions or strategies addressed may not be suitable for all parties. The value, price or income from transactions or strategies may fall as well as rise. SMBC Group or an affiliate may have a position in any of the underlying instruments, assets, indices or rates mentioned in this document. You should make your own independent judgment or seek independent financial and tax advice with respect to any matter contained herein.

SMBC is subject to Japanese firewall regulations and therefore absent client consent, non-public client information may not be shared with SMBC Nikko Securities Inc.

SMBC Nikko is a US registered broker-dealer of SMBC Group. Nikko Canada is a US and Canadian registered broker-dealer of SMBC Group. SMBC-CM is provisionally registered as a US swap dealer with the CFTC. Capital markets and other investment banking activities for SMBC Group are performed by a combination of SMBC Nikko, Nikko Canada, SMBC Nikko Securities Inc. and SMBC-CM. Lending and other commercial banking activities are performed by SMBC and its banking affiliates. Derivative activities may be performed by SMBC-CM or SMBC. SMBC Group deal team members may also be employees of any of the foregoing entities. SMBC Group does not provide tax advice. Accordingly, any discussion of U.S. tax matters contained herein (including any attachments) is not intended or written to be used, and cannot be used, in connection with the promotion, marketing or recommendation by anyone unaffiliated with SMBC Group or for the purpose of avoiding U.S. tax-related penalties. © 2020 SMBC Group. All rights reserved.