OBSERVATION

TD Economics

September 10, 2012

CONSUMER CREDIT – BUILDING THE BRIDGE OVER TROUBLED WATER

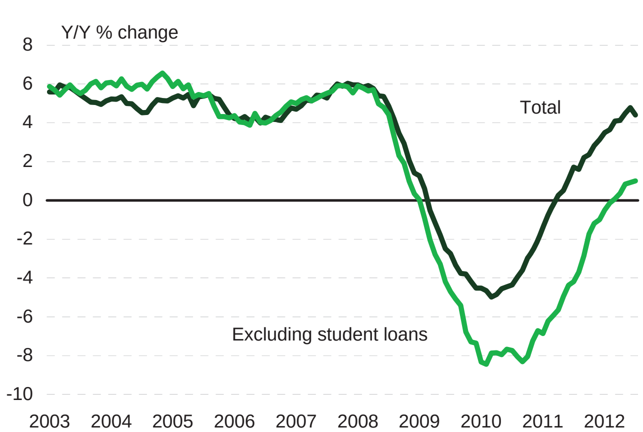
For this economic recovery to have any chance in gaining momentum there must be evidence that the consumer credit spigot is open and flowing. Recent years have been a stark reminder that if the ability to borrow money with ease is obstructed, the economy cannot function efficiently and growth is stunted. When it comes to household credit, there are two broad categories. There's the mortgage market and there's every day consumer financing needs, such as credit cards, auto loans and the like. Since the mortgage market was the epicenter of a financial crisis that is still being resolved, it is the latter credit category where a convincing improvement should first materialize. To this effect, monthly consumer credit statistics released this afternoon revealed a 4.4% y/y pace of growth in consumer credit for July. It was less than market expectations, but that's only part of the story. This Federal Reserve consumer credit measure includes student loans, which are not a useful gauge of private sector credit accessibility since the vast majority (roughly 90%) is dispersed by the government. Nor does it offer an ideal marker for broader consumer confidence and spending growth.

Stripping away student loans reveals an even softer picture. First, a mere 0.9% y/y pace of credit growth emerges. Second, the gain has persisted for only 5 months, while the aggregate measure was in the black throughout last year. Clearly, outsized strength in student loans has skewed the picture of consumer credit health.

However, this is where further investigation may offer some comfort. Part of the reason why credit growth appears weak is because the measure also incorporates the ongoing write-downs of defaulted loans by financial institutions. These write-downs are masking an upturn in new financing activity. While the Fed measure doesn't give us an indication of the magnitude of this charge-off behavior, data from Equifax does. Although the measures are not directly comparable due to different survey samples and methodologies, it still allows us to better understand underlying trends and developments.

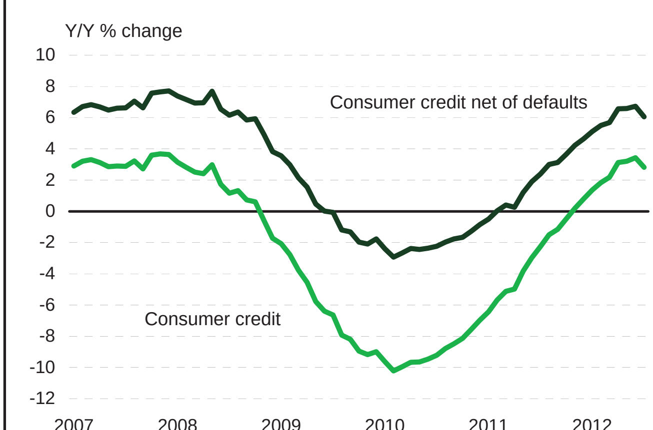
The Equifax data show a 2.8% y/y recovery in consumer credit for July, which we define as the combination of bank

TOTAL CONSUMER CREDIT



Source: Federal Reserve, TD Economics

CONSUMER CREDIT EX DEFAULTS



Includes auto loans, bankcard, retail credit
Source: Equifax, Moody's Analytics, TD Economics

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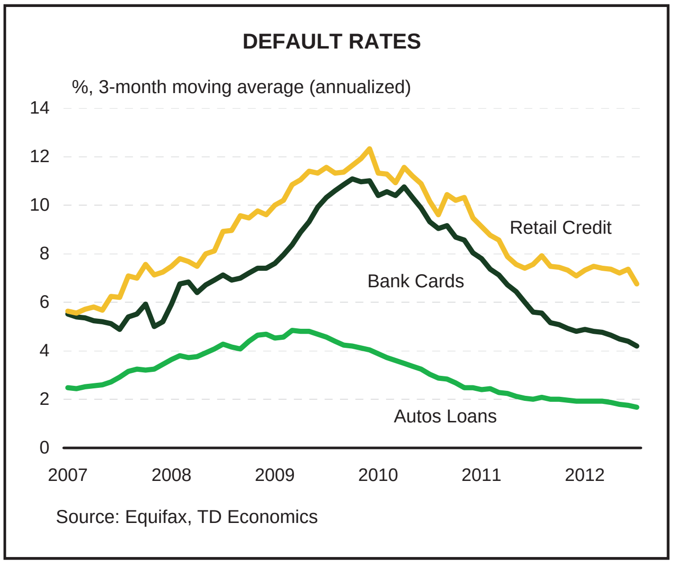

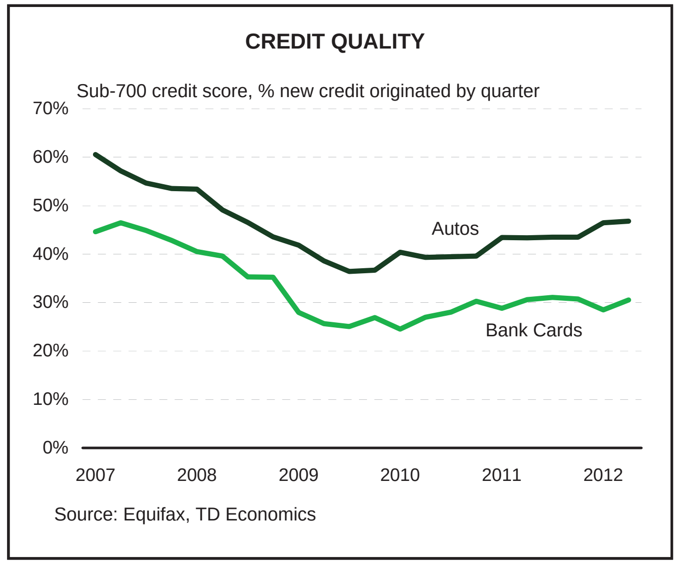

cards, retail credit and auto loans. Similar to the Fed data, the expansion in credit has only been occurring for a short period – 9 months – relative to year-ago levels. However, removing the drag stemming for charge-offs reveals a measure that is rising at a much quicker pace of 6% and has been in the black for 18 consecutive months. The impact from charge-offs is particularly large on bank cards and retail credit. For instance, bank-card credit is contracting prior to taking defaults into consideration, but shows a 4% expansion net of them. Obviously we can't completely ignore the influence of defaults, because it affects the willingness to extend credit. But, default rates are falling in all of the consumer credit categories mentioned above. This means that the reduction in credit stemming from charge-offs should be less and less with time, providing a truer snapshot of credit growth trends.

Does this mean that the recent expansion in credit is just a supply-side response related to a reduction in write-offs? It does not appear so. There is evidence that credit is expanding on the back of strengthening demand. For instance, Equifax data show that the number of new accounts is rising and credit is increasingly being extended to people of various credit quality – as opposed to just the crème de la crème. This is particularly true for auto loans, and there's a fledging trend taking hold within bank credit. There is also supporting evidence from the Federal Reserve's Senior Loans Officer Survey, which shows demand for consumer credit hovering at an 8-year high.

We certainly don't want to leave the impression that all is well in paradise, as credit growth is still soft, especially considering the degree to which it contracted during the financial crisis. But, we are encouraged to see that the credit spigot has been turned back on, and should remain so. As income and job growth continue to make headway, so too will credit demand. Meanwhile, as bad credit is expunged from lending institutions, improved loan portfolios provide a stronger incentive to loosen credit conditions. The water markings from an upturning consumer credit cycle are evident.

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