Changes to U.S. Economy Performance:

Lenders Reveal an Optimistic Outlook for Near Term and Increasing Pessimism for Long-Term Economic Strength

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For over 20 years, Phoenix Management Services has been collecting, tabulating and analyzing the results from its “Lending Climate in America” survey in order to evaluate national lending attitudes and trends. Here, the authors discuss the results of the latest survey.
Each quarter, Phoenix’s proprietary “Lending Climate in America” survey is distributed to over 5,000 lenders nationwide. In the Q2/17 survey results we saw a continuing trend of increasing pessimism by lenders with regard to the U.S. economy in the long term. (See Chart below.) In the Q2/17 survey, their long-term expectations (i.e., how will the U.S. economy perform beyond the next six months?) decreased 15 points to a GPA of 2.30, and their short-term expectations (i.e., how will the U.S. economy perform during the next six months) fell 8 points to a grade point average (GPA) of 2.50.

The near-term sentiments represent an overall ‘B’ grade while the long-term sentiments represents an overall ‘C’ grade. In our Q2/17 survey, lenders revealed a) a decrease in both the near- and long-term GPA, b) an increase in the diffusion indexes for interest rates, loan losses, and bankruptcies, and c) their belief that the stability of the stock market and unstable energy prices are the factors that have the greatest impact on the overall economy.

Positive Outlook for Near-Term Economy GPA
Each quarter we ask lenders, “How do you expect the U.S. economy to perform in the next six months on a scale of A through F?” The Q2/17 survey results exhibited a minor decrease of 8 points in the economic grade point average (GPA) to 2.50 from 2.58 in Q1/17. For the first time, lenders are equally split in their beliefs of the economy performing at a ‘B’ and ‘C’ level within the next six months. The results from the Q2 2017 survey continue the previous quarter’s results of a higher near-term GPA than long-term GPA.

In addition, we ask lenders, “How do you expect the U.S. economy to perform beyond the next six months on a scale of A through F?” Lenders continue to have an increasing pessimistic view about the U.S. economy in the long term. The long term GPA decreased 15 points from a 2.45 in Q1/17 to a 2.30 in Q2/17. In Q2/17 the percentage of lenders expecting the U.S. economy to perform at a ‘B’ level fell 12 percentage points from a 52% in Q1/17 to a 40% in Q2/17. We saw an increase in the percentage of lenders that expect the U.S. economy to perform at a ‘C’ level beyond the next six months. Although we are seeing a decrease in the long-term GPA, the Q2/17 GPA of 2.30 is still 41 points higher than the Q2/16 GPA of 1.89 at this time last year.

Interest Rates, Loan Losses and Bankruptcies to Increase
One of the questions posed to survey respondents is whether they expect economic indicators to be up, down, or remain at the same level over the next
six months. The question drills down even further into specific economic indicators including, but not limited to, interest rates, loan losses and bankruptcies. To measure lender sentiment, the survey utilizes a Diffusion Index. Our Diffusion Index is calculated by subtracting the percentage of negative expectations from the percentage of positive expectations. In the Q2/17 survey, lenders indicated a significant increase in these metrics. The interest rate diffusion index increased to 100%, a 9 percentage point increase, compared to 91% the previous quarter. This is the first time in the history of Phoenix’s “Lending Climate in America” survey that all lenders agree interest rates will be up rather than remain the same or decrease. Furthermore, we ask lenders on a quarterly basis in what direction they think the Fed will move interest rates and by how much in the coming six months. Of the lenders surveyed, 73% expect the Fed to raise interest rates by 50 basis points or more within the next six months. These answers were provided after the March Federal Reserve meeting when interest rates were raised by 25 basis points.

Echoing these sentiments, the survey shows an increase in lenders that expect loan losses and bankruptcies to increase over the next six months. The increase in these metrics correlates to the increase expected by lenders in regard to interest rates. With the expected increase in interest rates comes the increased possibility of a rise in loan defaults, causing loan losses and bankruptcies to increase. The bankruptcy diffusion index increased 47 percentage points from 18% in the previous quarter’s results to 65% in Q2/17. In addition, the loan losses diffusion index increased to 50% in Q2 2017 compared to 35% in Q1 2017. These results represent the highest negative sentiments since the Q2/16, which had diffusion indexes of 67% for loan losses and 81% for bankruptcies.

**Lenders Predict Interest Rate Spreads to Decline and Leverage Multiples to Increase**

The “Lending Climate in America” survey routinely asks lenders whether their financial institutions plan to reduce, maintain, or increase their interest rate spreads and fee structures. The question is then broken down further, based on average loan size. While a majority of lenders, 76% of the respondents, expect their financial institution to maintain its current interest rate spread and fee structure (a 12-percentage point increase from Q1/17), 16% of the respondents expect their financial institution to reduce its current interest rate spread and fee structure (a 12-percentage point increase from Q1/17). This would seem to indicate continued competitive pressure and the need to be sensitive to pricing in order to maintain and/or increase market share.

Echoing these competitive sentiments, lenders showed a marked shift in their expectation to increase leverage multiples. The survey asks lenders to indicate the highest senior debt-to-EBITDA leverage ratio that their banks would consider. Forty-one percent of lenders indicated the >3.5x range (the highest threshold in our survey) would be the highest EBITDA ratio they would consider, a 17 percentage point increase from the Q1/17 results.

**Stock Market and Unstable Energy Prices to Affect the Overall Economy**

Another question routinely asked to lenders is to select the two factors that they believe could have the strongest potential to affect the economy in the next six months. The top two factors selected by lenders in the Q2/17 survey were the stability of the stock market and unstable energy prices. The stability of the stock market garnered the highest amount of responses at 55%, while unstable energy prices garnered 36% of responses.

The sentiments for unstable energy prices is further supported by the fact that many economists expect gas prices to rise dramatically before the end of 2017. In the Q2/17 survey lenders were asked to identify which factor they think is most likely to cause gas prices to increase before the end of 2017. The majority of lenders, 63%, believe that geopolitical uncertainties will be the most likely factor to cause gas prices to increase dramatically before the end of 2017, while 29% believe gas prices will increase due to a decline in oil inventories. Of the lenders surveyed, only 8% believe the potential increase in gas prices will be from a reliance on foreign sources.

**Conclusion**

The results from the Q2/17 survey indicate a continuing trend in which lenders are increasingly pessimistic about the U.S. economy on a long-term basis. Despite lender expectation for interest rates, loan losses and bankruptcies to be up within the next six months, lenders remain relatively positive about the U.S. economy on a near-term basis.

The Phoenix Management “Lending Climate in America” Survey is conducted quarterly. To see the full survey results for Q2 2017 as well as to view previous quarter results, please visit www.phoenixmanagement.com/about-phoenix/lending-survey.

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