NATCAN WEEKLY MARKER

July 25, 2008

ON THE ECONOMIC IMPORTANCE OF CREDIT

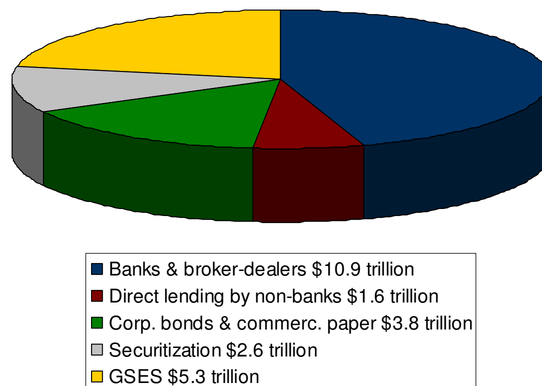
Proper availability and allocation of credit is the backbone of every free market economy. Credit is intermediated mainly by banks, but also by specialty intermediaries such as securitization markets and the now infamous “shadow banking system”. The current dislocation in U.S. credit markets may be the greatest challenge faced by the world’s largest economy. This week’s edition of the Marker examines the make up of the U.S. credit market in an effort to enhance our understanding of the present economic backdrop.

WHO LENDS, WHO BORROWS

To understand the importance of credit to economic activity, imagine for a moment a world where all long-term assets such as capital equipment, homes, and cars must be paid upfront in cash. Clearly, economic activity (measured by spending; the definition of GDP) would be a small fraction of its current total under such circumstances. Total borrowings by U.S. households and non-financial businesses are about $23 trillion or 176% of GDP. The impact of a drought of lending in an economy is thus clear. Investors fully appreciate these facts, knowing a contraction in credit availability is the number one cause of recessions.

For every dollar borrowed, there must be a dollar lent. Let’s examine who the lenders to the U.S. economy are. A recent report by Goldman Sachs Research indicates that lending by banks and broker-dealers ($10.9 trillion) and securitization ($2.6 trillion) account for over half of the country’s total borrowing needs. The next lenders by importance are the Government Sponsored Entities, which consist of Fannie Mae and Freddie Mac, as well as 12 regional Federal Home Loan Banks ($5.3 trillion). Borrowings via corporate bond and commercial paper markets ($3.8 trillion) are also an important source of financing, while direct lending by non-banks, vendor financing for instance, rounds out the total ($1.6 trillion).

Supply of Credit in the U.S.



Sources: Goldman Sachs Research and Natcan

WHY MAINTAINING THE CREDIT PIPELINE OPEN AND FLOWING IS CRITICAL

The Federal Reserve and Treasury departments are well aware of the risks of a drop in credit supply to the economy. That explains why the Fed has repeatedly stated since the start of the credit crisis in August 2007 that avoiding a systemic shock to the economy was its number one priority, and why it was prepared to underwrite a potential inflation spike to fight this risk. Lower interest rates and new measures to support broker-dealers following the implosion of Bear Stearns can be perceived as attempts to support and assist credit formation and distribution in the economy, but these efforts have yet to succeed. Total bank credit has been contracting for three consecutive months, and the securitization market has slowed to a standstill. As stated above, those two sources represent over half of total lending. Ironically enough, this brings regulators right back to the GSEs, which received their own support package just a week ago. As the provider of almost a quarter of total credit and over half of non-bank financing, their role today is of the greatest importance in their history. In fact, not only must the government keep Fannie Mae, Freddie Mac et al alive, it must ensure they grow their share of total lending aggressively in the short term if the U.S. economy is to extricate itself from its current malaise. Note that lending by Fannie and Freddie had recently increased 14% year over year, a pace that will need to be maintained or even perhaps accelerated. Fannie and Freddie - strongly popular with short sellers in recent months - may indeed be too important to fail in the current, or any other, context. Please see last week’s edition of the Marker for more specific details on those entities.

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Maintaining appropriate credit flow in the U.S. economy is potentially the number one priority of authorities. The need to do so explains several recent policy initiatives implemented to support lenders and intermediaries. It may also explain why inflation has been allowed to move up over the last eight or ten months. Economic growth and stability are at risk under current circumstances of constrained credit. Investors will need to consider the importance of credit before choosing to make investment allocations to economically sensitive sectors of the equity markets. The U.S. economy will face treacherous waters for several more months to come. Sticking to a long-term investment plan will likely be the most profitable strategy.

Michael Quigley, CFA
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FINANCIAL MARKETS

RETURNS AS AT JULY 18, 2008 (%)	MTD	QTD	YTD
S&P/TSX	-6.52	-6.52	-0.92
S&P 500	-2.76	-2.76	-12.12
S&P/TSX Small Cap	-7.19	-7.19	-7.55
Russell 2000	-0.84	-0.84	-7.80
MSCI EAFE	-4.36	-4.36	-12.46
MSCI World	-3.64	-3.64	-11.41
DEX Universe Bond	0.00	0.00	2.21

	RATES AS AT JULY 18, 2008
CAD/USD	1.01
CAD/Euro	1.59
US Treasuries yield 10-yr/30-yr	4.08/4.66
GOC bond yield 10-yr/30-yr	3.81/4.16
Fed Fund Rate (target)	2.00

Note: Returns in Canadian dollars, London 4h exchange rates. Source: Datastream, PC Bond, MSCI-Barra, and Bloomberg. PC-Bond, a business unit of TSX Inc. Copyright © TSX Inc. All rights reserved.

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