Loan Growth: A Canary in a Coal Mine

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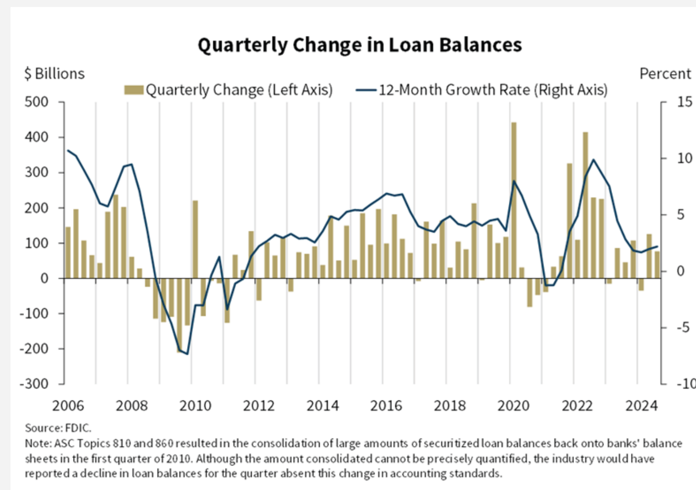
The banking industry has faced a notable slowdown in loan growth. This development has caught the attention of economists and investors alike, and it raises critical questions about the underlying health of the economy and the evolving investment landscape.

It makes sense to start with the basics. Banks play a pivotal role in economic expansion by extending credit, or loans, to businesses and consumers. Bank lending fuels business investment, supports consumer spending, and ultimately drives GDP growth. While many factors can impact loan growth, it can often serve as a proverbial canary in a coal mine, providing an important read on the state of the overall economy. Said another way, credit is the grease that makes the economy run smoothly.

As shown in the following chart, total bank loans have been growing at a low-single-digit annual rate over the past year, which is notably below the historical average of 5-6% during periods of economic expansion and well below the current rate of nominal GDP growth. Particularly troubling is that key categories like commercial & industrial (C&I) loans and consumer loans have been flat to down in recent quarters. Additionally, mortgage originations have declined by 20% year-over-year in the third quarter, reflecting the impact of elevated interest rates on housing affordability.



A slowdown in loan growth can signal broader economic shifts including reduced business investment and weaker consumer spending. In the corporate sector, this can indicate delayed or scaled back capital expenditures, which can, in turn, dampen productivity gains and employment. Business confidence plays a large role in loan demand as businesses are more likely to seek loans to invest in expansion, new projects, and operations when they believe future conditions support a positive return on their investment. The chart

below indicates confidence is trending below the long-term average, which supports the notion that the economy might be weaker than it appears. That said, we note the possibility that businesses were waiting for more clarity after the election to proceed with their investment plans.

For households, tighter credit conditions can curtail spending on non-essential goods and services. This can have ripple effects across real estate, manufacturing, retail, and various other areas.

Overall, the slowing loan growth presents a mixed bag of opportunities and challenges for investors, a few of which are discussed below.

Bank Earnings Pressure: Financial institutions derive significant revenue from interest income. Slower loan growth can weigh on earnings, particularly for regional banks, which are more reliant on traditional lending than larger, diversified institutions. We are closely monitoring loan volumes and net interest margins within banks we own across our portfolios at Crawford.

Balance Sheet Strength Becomes More Important: In addition to Financials, areas that are heavily dependent on borrowed capital like Real Estate, Construction, and big-ticket consumer purchases may also face headwinds due to constrained credit availability. Conversely, companies with strong balance sheets and minimal reliance on external financing may be better positioned to “weather the storm,” in turn attracting investor interest. At Crawford, we consistently invest in these types of businesses, and we expect that this approach will serve us well in the coming quarters.

In fairness, the slowdown in bank loan growth could have numerous other causes which are less related to potential economic weakness. Perhaps the most obvious of these is the Fed aggressively raising interest rates in 2022 and 2023 with a primary goal being to cool inflation via lower credit demand. With the Fed Funds rate up from near-zero to 4%+, their actions may be having the desired impact. Another potential reason could be the substantial pandemic-era fiscal stimulus that reduced the need for businesses and consumers to borrow. Additionally, non-bank lending is becoming more prominent with many alternative asset managers raising multi-billion dollar funds aimed at lending to small and mid-sized businesses. We

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have also seen slower merger and acquisition activity related to higher interest rates, increased uncertainty, and heighted regulatory scrutiny, which has created lower demand for financing. The reversal of some of these trends coupled with the potential for the incoming administration to increase business confidence could lead to stronger loan demand in the coming years.

While we certainly hope for stronger economic growth and improved loan demand this year, the current environment underscores the importance of fundamental, bottom up research and active risk management. Allocating capital to sectors and companies that can thrive despite tighter credit conditions is our primary focus at Crawford. While the current deceleration in loan growth can pose investment challenges, we have high conviction in our ability to navigate this evolving environment and continue to deliver value for our clients.

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CRA-2501-31