AURORA FUNDS MANAGEMENT — THE ALTERNATIVE VIEW

By Hugh Dive — 23rd September 2016

What to do with the Aussie Banks?

Aside from employing over 200,000 Australians and touching every sector of the Australian economy, the four major banks plus the two regionals comprise 25% of the ASX200 and are the four largest stocks listed on the ASX with a combined market value of A$380 billion. Assessing future prospects for the major banks is currently one of the biggest issues facing Australian equity fund managers and retail investors alike. Indeed over the past week the in the financial press there have been articles advocating a zero weighting to banks and another one on Tuesday morning recommending that bank shares are historically cheap and should be scooped up with abandon. We see that the current investment case for the banks lies between these two extremes.

After several years of delivering strong profit and dividend growth, primarily due to the tailwind of declining bad debt charges, in 2016 bank share prices have been sold off, with most of the pain falling on the two banks most heavily weighted to domestic housing, Westpac (-8%) and Commonwealth Bank (-10%). Paradoxically in the current yield-hungry environment, ANZ has been the best performer, despite cutting its dividend in May. In this piece we are going to look at the causes of this correction and some thoughts for the future.

CODE		MKT WHT (ASX 200)	Last Price	MCAP ($M)	6M Return	1YR TR Per annum	3YR TR Per Annum	5YR TR Per Annum	FWD PER	DIV Yield	Grossed Up Yield	Margin over 1 year TD (2.5%)
CBA	COMMONWEALTH BANK	8.4%	$ 72.89	125,017	-2.7%	1.3%	5.0%	16.6%	12.8	5.8%	8.3%	5.8%
WBC	WESTPAC BANKING	6.5%	$ 28.73	96,135	-9.5%	1.8%	2.2%	15.6%	12.0	6.5%	9.3%	6.8%
ANZ	AUST AND NZ BANK	4.7%	$ 27.24	79,744	8.8%	1.0%	0.9%	13.3%	11.6	5.9%	8.4%	5.9%
NAB	NATL AUST BANK	4.5%	$ 26.32	69,916	-2.4%	-2.4%	-0.4%	11.5%	11.0	7.1%	10.1%	7.6%
BEN	BENDIGO AND ADEL	0.3%	$ 10.42	4,833	11.7%	5.9%	6.1%	11.7%	12.0	6.6%	9.4%	6.9%
BOQ	BANK QUEENSLAND	0.3%	$ 11.01	4,195	-9.8%	-5.5%	6.8%	17.5%	11.3	6.9%	9.9%	7.4%
	Total Index Weight	**24.6%**									**9.2%**	**6.7%**

Unravelling of the Carry Trade

Since the start of August we have seen significant offshore selling of stocks in the higher yielding sectors of the market, namely banks, listed property trusts and utilities. A factor contributing to the fall in these companies' share prices has been the unravelling of the AUD "carry trade" caused by expectation of rising rates in the US towards the end of 2016.

The carry trade is an investment strategy, where an investor borrows in a country with a low interest rate like the US at 0.5%, then uses these funds to buy an asset in a different currency yielding a higher return such as Westpac shares at 6.5% or Australian government 3 year bonds yielding 2%. This strategy could give a profit of 6%, provided the AUD/USD does not change significantly and these profits are often magnified by the use of leverage. The risk inherent in this strategy occurs where sharp downward moves in the higher yielding currency wipes out the returns generated from the differences in interest rates.

Increasing Capital Requirements

Another factor weighing on the share prices of bank stocks in 2016 has been the uncertainty around the potential outcomes of the upcoming Basel 4 proposed standard on capital reserves for banks and whether the Australian banks will need to raise further capital in addition to the A$20 billion raised in 2015.

During the GFC, many banks globally were forced to seek direct financial support from governments (and ultimately taxpayers). For example, the US government injected US$45 billion into Citigroup at the height of the GFC. This proved to be quite profitable for US taxpayers, with the government later selling their Citigroup shares in 2011 for US$57 billion. Whilst the Australian banks did not require similar levels of government support, additional banking capital is designed to reduce the probability of Australian banks needing direct assistance from taxpayers during future crises.

More Capital?

We view that the potential for further capital raisings is not as high as many in the market believe and that the burden of additional capital will not fall on shareholders alone. Over the last 30 years the banks have proven to be effective at passing similar costs onto customers and we expect that profits will be maintained through a combination of reduced discounts for new mortgages, lower term deposit rates and wider spreads on some business loans. Effectively the consumer will bear their share of the cost for this "gold plating" of the banking system.

During 2012 Sweden introduced higher capital requirements on banks writing mortgages to rein in a very buoyant housing sector and provide greater bank capital requirements. These moves cooled down the Swedish housing sector, slowing housing credit growth from 10% to 5%. However this ended up being a positive development for shareholders in the Swedish banks (***Svenska Handelsbanken*** and ***Swedbank***); as the banks repriced their mortgage book upward to account for this additional capital and saw margins expand and earnings per share rise by approximately 15%! Whilst there has been speculation in the financial press that the Australian banks will engage in a further round of capital raising, we don't see that as a likely outcome given that their core capital ratios are amongst the strongest globally and it would be an admission that the 2015 capital raisings were insufficient.

The Australian banks are expected to deliver a combined $30 billion of cash profits in 2016. We sees that moderating lending growth (which requires less capital to set aside with reduced loan growth) will give the banking sector a few levers to bolster capital through underwritten dividend reinvestment plans, without resorting to massive new direct equity issues.

Valuations Attractive

Currently the banks trade at a 30% discount to the ASX 200, the biggest discount since 2007. Moreover the banking sector dividend yield is currently at 6.7% margin over the 1 year term deposit (TD) rate (see above table). As the banks report positive results in late October, we can see catalysts for buying support in these stocks as the banks report loan losses below expectations courtesy of falling interest rates, buoyant asset prices and benign unemployment. Additionally we view that the banks should continue to see support from retail investors dismayed at the subsistence-level deposit rates on offer.

Positives

Looking at the current positive investment case, we see that there are five key reasons to invest in major trading banks namely; 1) banks are very cheap in historic terms compared to the wider ASX, 2) banks appear to be winning back business debt market share with fewer corporates accessing the corporate bond market, 3) unemployment remains benign which has kept a lid on consumer bad debts, 4) falling rates improve debt serviceability for borrowers and 5) strong prices for the asset prices backing loans mitigate against losses.

Negatives

However balancing against the above positive factors are four dark clouds on the horizon for the Australian banks. These are 1) credit growth is slowing, 2) the banks naturally find it hard to hard to maintain net interest margins with falling rates 3) the falling bad debts tailwind that boosted profits as post GFC provisions have been released is over and 4) the banks face increasing political pressure and are seen to drag their heels in passing on rate cuts to residential borrowers. It is easy for politicians to create the impression that the banking sector has only one stakeholder, the residential borrower, whilst ignore other stakeholders such as shareholders and employees both of which are served by the improved profitability and stability of the organisation.

Our Take

The financial year for most of the banks (ANZ, NAB & Westpac) finishes next week and we expect that when they reveal their results in late October, they will exceed expectations. Whilst we see that the banks may be required to hold more capital backing the loans that they write, we believe this will be accomplished in a less dramatic form and more gradually than is currently being presented in the press.

Further whilst the sentiment towards the Australian banks is not strong, as an investor I would far prefer to own shares in Commonwealth Bank than European banks such as Deutsche Bank that have suspended dividends, recently reported a 98% decline in profit and also face a US$14 billion fine from the US Department of Justice!

Compared to this level of excitement, stable albeit limited growth and a 6% fully franked dividend looks pretty attractive.

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