

CIO MONTHLY NOTE

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TOUGH ROAD AHEAD FOR AUSSIE BANKS



Australian banks have benefited from structurally declining interest rates, a record breaking run of uninterrupted economic growth and a booming housing market.

However, there is increasing evidence that this golden run is over with the sector facing some serious challenges over the next 12 months. For the past 35 years, banks - and other interest rate sensitive sectors of the economy - benefited from a structural decline in interest rates. At its peak, the yield on the Aussie 10 year bond reached 16% in 1982, driven by the second OPEC oil crisis and rampant inflation.

But after central banks regained control of inflation, interest rates slowly began to decline. This trend decline, coupled with key financial market deregulation and low and stable inflation, spurred a structural leveraging-up of the Australian economy.

The banks benefited tremendously from this leveraging cycle. Despite a brief pause during the early 90s recession and GFC, credit growth has easily outpaced growth in GDP, leading to a significant increase in the economy's debt to GDP ratio. This boom in credit helped the banks make record profits and dividends. Long term shareholders are pleased.

But there is reason to believe this structural decline in global interest rates is coming to an end. Linked to the interest rate cycle is the bad and doubtful debt cycle. When interest rates decline, debt servicing costs fall, asset prices rise and the economy generally expands which makes servicing debt easy. We are currently in this phase of the cycle as evidenced by

NAB reporting its lowest bad and doubtful debt charge since at least 1980. Although this is great news for shareholders, the obvious question is where to from here?

My view is that the banks current bad and doubtful debt charge is unsustainably low. As the Aussie housing cycle matures, as the global interest rate cycle begins to normalise and as the fallout from the mining boom spreads through WA and Qld, bad debts will inevitably rise.

Also the Australian bank demerger cycle is well underway following decades of buying out their competitors. Non-core banking operations or capital intensive ones will continue to be sold in the years ahead, such as insurance, leasing, funds and wealth management operations.

Just to be clear, I am not foreshadowing a recession-like bad and doubtful debt cycle or a sharp correction in the banks. I believe the banks are high quality institutions by global standards that have been well regulated and have prudent mortgage books. Rather, I expect a period of sub-par earnings growth where the majority of the sector's return will come from dividends rather than capital appreciation.

Given this outlook, I would prefer to allocate to the sector from a structurally underweight position. When looking for growth to replace the banks, the ex-30 segment of the market represents a better risk-reward trade off than the top-30 stocks.

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