

Weathering the storm clouds around bank stocks

08 June 2018 | David Rosenbloom – Senior Investment Analyst, ARCO Investment Management

As investors, there's always plenty to worry about. In our view the reasons to be anxious just got bigger. You'd have to be living under a rock not to have heard or read excerpts from the Banking Royal Commission. Much of this has been unbelievably good theatre, but make no mistake, the underlying issues coming to light will have a very big bearing on the Australian economy.

Over the last 10 years there has been plenty written about house price bubbles and stretched consumer balance sheets. We won't rehash that here, other than to note that the Royal Commission has unearthed incredibly lax lending practices, some fraud, and multiple breaches of the Responsible Lending Act, all of which have implications on the process of credit creation.

As market practitioners we are concerned with risks and returns. So let's turn our attention to the first point: risk. As we may remember from Economics 101, credit creation, and thus banks, are an integral part of the economy. The "multiplier effect" whereby a dollar lent has several dollars of impact across the economy was rightfully drilled into our heads. Of course, it works both ways. For example, after the 2008 crisis, the US economy took quite a while to begin recovering due to, in part, the inability for the banks to lend. Every time the banks got their balance sheets in order they were hit with either multi-billion dollar fines, increased capital requirements or both.

In our view, the key questions are now: will the Royal Commission negatively impact credit availability or, in fact, produce a credit crunch? The answers, in our view, are: "of course" and "there's a very good chance."

The interesting part of this debate is that the impact on the economy garners nary a mention – although a recent meeting with a notable political insider indicated that Canberra is not only aware of this issue, but is worried about it, and on both sides of the aisle. Perhaps the absence of debate on the economics is notable only to those of us with a little grey hair, bearing in mind that the last recession in Australia was a full generation ago and when, for example, the new CEO of Commonwealth Bank was a teenager. We aren't necessarily forecasting a recession, nor do we have to, but we are interested in direction and in inflection points. So instead of hypothesising or forecasting, let's look at some facts:

1. House prices have stopped rising at best, and have begun falling at worst. According to Corelogic, prices in Sydney are already heading down, having jumped 75% in just six years.
2. Credit is already restricted. Banks are tightening terms both at the monetary and approval process levels. As one article in the financial press termed it "banks have slammed on the brakes."

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3. Mum and Dad are feeling the pinch: CBA disclosed in its latest result that “there has been an uptick in home loan arrears, influenced by a small number of customers experiencing difficulties with rising essential costs and limited income growth”.

Taken together, it is unfathomable to us that things get a lot better from here. With all this in mind, we’d make three further points: 1) our experience over decades is that asset bubbles are ALWAYS a result of loose credit; 2) asset bubbles ALWAYS burst when credit is withdrawn; and, 3) human beings tend to put more on their experiences of the most recent past. In other words, house prices can’t go down and we can’t have a recession because, well, we just can’t!

So as absolute return investors, what does this backdrop mean for us? Our aim is clear and simple: to grow, and, most importantly, *protect* investors’ wealth at all points in the market cycle. Unlike traditional managers, who are benchmarked against the index and will always have a large lick of the banks (currently over 25% of the index, after peaking above 30%), *if we don’t like them, we don’t have to own them!* In fact, we have been positioned for some time to take advantage of the current price falls. Furthermore, our ability to manage market risk enables us to profit, even if markets are falling and economies are stumbling.

Of course, capital preservation is only discussed when markets are going down, but the absolute return manager’s ability to hedge and manage market risk comes to the fore at just the right time: when you need it. This is something that all investors should consider in our view, with the equity market at elevated levels and as storm clouds appear on the credit horizon.

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