Banks post Covid-19

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Introduction

This document's purpose is to act as background for investment decisions in the midst of the COVID-19 pandemic. It represents a snapshot in time and is out-of-date pretty much as soon as it is written.

For some weeks I've been pondering about whether now is the time to buy into the banks. My initial thinking in early April was that the economic impacts of Covid would take some to play out and whilst that has been true, the market has also substantially savaged the banks.

This has left me with the old price/value conundrum and whilst I haven't reached any conclusions I have thought about it sufficiently that I think I can now write down some of my process and thought. Obviously, none of this is necessarily true or definitive, but an ongoing thought process.

I should start by saying I haven't attempted to make this suitable for the Mockingbird's BuyHoldSell series on the banks and I'm not trying to make any specific judgements on individual banks. Instead, I'm trying to look at the banking sector as a whole which includes more minor institutions than the big four and some investment banks such as Macquarie as well. I may touch a little on the international environment but my focus is on ASX homed banks.

I had thought about dividing this up into positives and negatives sections but decided against it. I think oscillating between these is a more accurate reflection of my thinking. This means it's a bit of a ramble.

Disclaimer

At the time of writing I am long VUK, ANZ, and KSL. My positions in VUK and ANZ pre-date Covid-19 and I've held on to them. I purchased KSL in late March 2020 after the market crash and during the initial bounce.

I have no form of financial qualification or expertise. Much of this document is half-considered opinion, based on dubious and conflicting experiences over a life of being interested in financial markets and being a private investor. Check your facts, I didn't.

Financial markets are notoriously fickle, and subject to emotion. In the unlikely event that some of my theses are correct, I am even more unlikely to predict financial market outcomes.

A snapshot of the economy

The labour force latest ABS data

(Figures are rounded)

Official Unemployment rose from 5.2% to 6.2% for 100K jobs

Employment fell 600K (unemployment +5% as the official number above is 1%)

There is apparently 1.3M people on jobseeker (13% extra unemployed)

So let's call it 25% unemployed.

Except there are millions more on jobkeeper; those currently not working is above 50%!

But, there is more stimulus cash (jobkeeper, jobseeker) from the government coming in than money going out for now. Also there was the collect your super which has added nearly $12B, and apparently 10% of people have taken a mortgage holiday.

The US would seem to be considerably worse, China took a hit but is recovering for now. Europe is in deep trouble too. Globally it's pretty damn bad out there and Australia is faring better than most and should recover faster if we remain relatively disease-free. Our mining sector has largely survived.

Crude Oil took a massive hit and has recovered a little but it'd be brave to suggest it's looking rosy now. Thermal coal and gas took sympathetic tumbles.

Gold has made a move after falling a little during the initial crash and is now at historic highs. Many people (myself included) expect it to move even higher as a result of low interest rates, increasing govt debt, money printing, and general fear.

Iron ore and Metallurgical coal have been (surprisingly) resilient.

Travel and tourism look dead for some time.

Predictions on the Oz housing market seem to range between 10% and 35% declines.

So lots of ups and downs, what about the banks?

ANZ, NAB and WBC have reported

The results were mixed in terms of delayed vs reduced dividends. NAB decided to capital raise. MQC got thrashed and recovered some. CBA has been a standout but is yet to report. VUK has been really bad. KSL is doing ok. SUN has been middling ameliorated by the insurance side. BOQ got hit hard. Essentially it's been a variable bloodbath.

They all put away significant provisions for losses but didn't seem to have realized much in the way of actual losses yet. The mortgage holidays in theory just looks like future lending if default rates don't go up. There was some early signs of mortgage stress but in the short term it's going to be all the small businesses. Later we'll see lots of capital raisings and bigger business collapses but it's not clear how bad things get in the underlying economy yet - it's still early.

My major concern is what happens starting in September. We're currently slated to unwind jobseeker, jobkeeper, and the mortgage repayment holiday around the same time. There will inevitably be some forced sales, esp amongst housing investors who don't have travel/tourism/airbnb activity. If they've moved back to the long-term rental market (which would normally be less income), they will find that

depressed too as rents are dropping, people moving back in with Mum and Dad etc. also, no foreign students or tourists for some time.

There is a lag in the construction business so new houses/units are still appearing. By September that will also stop which will add to real unemployment and compound the problem. I don't expect this to snowball all the way to a 60-70% housing price collapse but that possibility exists albeit tiny at this stage.

And then there is small business. Australia has a lot of people running single person endeavours as people quite like to have a hustle or two going on. Many of these survive only because people discount their own labour, but when there is no work, it doesn't work. Some of this is the cash-in-hand economy of informal work like massages/haircuts etc which is just shut down. You won't see this in the GDP figures but it's out there.

I expect a lot of small businesses to shut down and with them I think the banks will take more hits.

The question is then whether the domestic and small business damage in turn starts hitting big business and those large corporate loans. I expect a little bit of damage at the big end of town but on balance I think it'll be limited. We'll see some capital raisings and some very visible damage (e.g, VAH) but I think this one is not going to be the big business problem of the GFC. Balance sheets and profits were actually in pretty good shape coming into this.

Markets

The markets have punished the banks savagely. Damage is variable (30-66%) across the majors and wannabes with the banking index in total down about 40%.

What's not clear is how much damage the markets have factored in. There is a dramatic tension here as we all know it gets worse before it gets better but it's hard to find the price/value points. I think it's arguable that we're all making this up and we're a very long way from a perfect market as things lack clarity. The future is murky.

Final things about Banking in Australia

It's easy to lose sight of the fact that the Australian banks are an anomaly. They are stupidly reliable and profitable compared to their international peers. It's a strange Australian quirk propped up by history, regulatory policy, competition policy, the small market, and the unwillingness of Australian consumers to demand better. I have always expected this quirk to end but it never has. Perhaps it never will. If Australian banks were like the international ones profits would be **much** lower.

The rise of Fintech represents a new source of competition into the banking sector but ultimately I expect the banks to adjust to better business models and via reinvention and acquisition control this space. Capital will win but lower margins will be the result.

It's arguable that the banks simply represent a percentage of GDP and that this remains fairly constant over time. The implication of this is that if GDP falls 10% this year the banks should be 10% down and they're 40% down.

APRA (and the world via Basel) has been steadily decreasing the amount of leverage they are allowed to do but I think that's done now and worked through the system. This decreased profits.

The Australian banks have mostly been scrapping international expansion having lost money on it. This decreased potential profits but reduced risk. It limits growth stories though.

The royal commission was very bad for the banks. One of the growth drivers over the years has been the growth of the wealth management business and this is being unwound as the banks can't sustain the ethical position of screwing their customers. Whoever wrote into the legislation that super trustees have to work in the interests of their members was a genius. The banks are divesting these businesses now.

Much is made of Net Interest Margins (NIM) when it comes to the banks for good reason. It's basically the amount of profit they can take between their (highly leveraged) loans vs savings books. The leveraging here tends to amplify this by about 10x so a .2% change in NIM makes a 2% change in profitability. History has taught me two things here. Firstly that falling real interest rates tend to compress the NIM, and secondly financial crises tend to widen them as governments and regulators want fat banks in crises.

Much of the above is long term cyclic, In ten years the banks will expand overseas, start up wealth mgmt businesses, and take on more risk. That'll create a bull market for a while until … yeah, it's a cycle.

Conclusions

With my 'compared to three months ago at the market high' hat on the banks are spectacularly cheap.

With my worst case 'housing collapse and international economic meltdown' hat on the banks are spectacularly expensive.

The reality is likely to be that it is somewhere in the middle. Price vs Value. Sigh.

I think that if you buy the banks today, it's going to be a wild and exciting ride over the next two to five years and you'll end in the long-term in a very happy place having made money.

In 2008, (where we dodged a recession) household deleveraging was around 5% (of GDP) over 12-18 months. Business deleveraging was around 7.5% over three years. I expect it to be more than that as we will have a recession this time. Also GDP will go down to create a compounding effect.

I also think that the next 6-12 months are going to be dicey and have significant downside risk. It's for this reason, that I'm going to avoid banks for a little while and see if I can get a better market entry. Basically I'm expecting more economic bad news and whilst I think things are cheap and arguably good value I see the possibility of it being better.

The downside risk is I think low but not pretty. The upside risk is that I will miss the market bottom, but I don't think I'll miss the steep side of the recovery by waiting as I expect the steep climb not to happen for a year or two.

(But I'm not selling either)

Background and references

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