Research
Macquarie Wealth Management

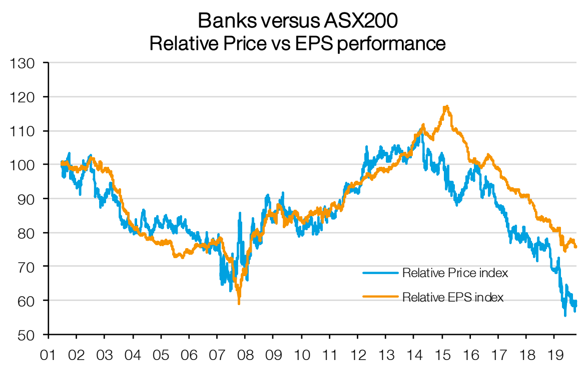
Investment Strategy Update #30

Australian Banks – the start of a new beginning

- After being negative on banks for much of the multi-year price and valuation de-rating, Macquarie has now turned more positive on the sector.
- Banks have been under pressure from a multitude of factors since peaking in 2015 including rising competition, regulation, slowing credit growth, unsustainable dividend payout ratios and falling margins. Many of these drags will be felt in the years ahead, but downside risks are well understood and captured in valuations.
- Banks are set to be a shadow of their former self. The 20-year consumer driven balance sheet expansion will not be repeated and so a more modest earnings and dividend outlook should be expected. Nevertheless, a stabilization and improvement in the earnings outlook should underpin share prices and ultimately allow a gradual re-build of dividend support.
- Banks are not the cleanest way to play a housing recovery, direct government fiscal support or an economic rebound. But they will benefit - albeit less directly – from all of these macroeconomic factors which are set to move in a more favourable direction. As long as investors now understand what banks offer, we see them as being part of a core stock holding.

Australian bank stocks have been perennial underperformers since 2015. Investing $100 in banks at the start of 2015 would have generated a loss of $13 versus a gain of $37 for the broader Industrial market. In other words, even a high dividend yield has not been able to shelter investors from substantial capital losses over the past 5 years.

Relative price performance matches decline in EPS



Source: Factset, MWM Research, October 2020

The 2015 peak in bank stock prices led the 2016 peak in earnings growth - which had been driven by a near 20-year consumer driven balance sheet expansion - and subsequently, an almost never-ending assortment of headwinds including:

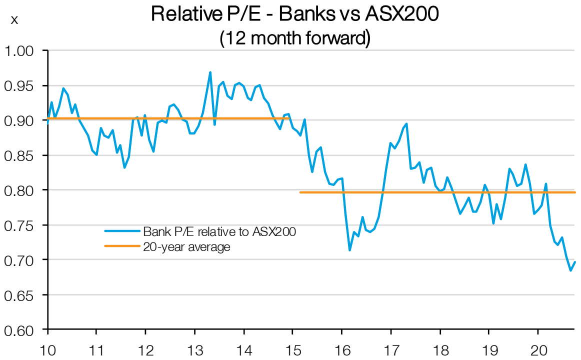
- **Capital dilution:** APRA's requirement for bank capital levels to be 'unquestionably strong' required substantial fresh capital.
- **Legal and regulatory headwinds:** The Royal Commission investigation into misconduct was damning for the banks leading to a substantial increase in compliance costs. In addition, banks have faced large-scale reparation/fines for misconduct.
- **Flattening yield curve:** Bank margins and interest income have been under pressure as lower interest rates and a flatter yield curve have crushed margins.

- **Slower credit growth / weaker collateral values:** A regulatory driven slowdown in house prices and credit creation has dragged on interest income and credit demand. These drags have been exacerbated by COVID-19 driving repayment holidays, regulator-imposed dividend cuts and higher provisioning for a rise in delinquencies.

- **Expensive valuations:** Australian banks have enjoyed a strong incumbency position and valuations have reflected this. Financial disintermediation/increased competition and an end to the structural earnings bull market have driven a re-assessment of future value.

This multi-year price and valuation de-rating has now left the bank sector trading at its lowest valuation in nearly two decades when compared with the Australian Industrial sector. It is possible that bank stock valuations could fall further should the outlook deteriorate relative to expectations - some even think Australian banks valuations still need to converge towards global peers which trade at a discount to book. However, we think downside risks are now well understood and that given the structure of the Australian market, current valuations have reached a point where they offer some cushion for negative surprises and a springboard should the outlook begin to improve.

Bank stocks are now outright cheap

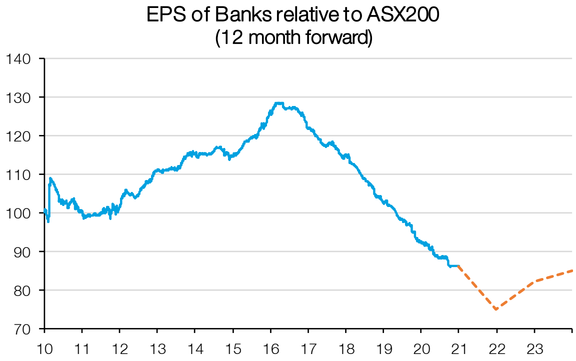


Source: Factset, MWM Research, October 2020

Positive on Australian Banks

We have avoided banks for some time (other than in an income portfolio where yield rather than total return has been the primary selection criteria). We now think it is time to get back into the sector. It is unlikely that banks are on the verge of a sustained or multi-year re-rating and structural differences mean they are unlikely to again reach their historic relative valuation levels.

Bank EPS near a bottom



Source: Factset, MWM Research, October 2020

While the sector still faces a number of headwinds, we think these drags are generally well understood and for the most part captured in current discounted valuations. In addition, given where valuations sit, we think the sector only requires ‘less bad’ news to support better performance. This is a low bar and we no longer think an outright bearish view is warranted.

What is looking better for banks?

Banks are not the cleanest way to play a recovery in housing, direct government fiscal support or a cyclical (economic) rebound, but they will benefit - albeit less directly - by all of these macroeconomic factors which we think are moving in a more favourable direction.

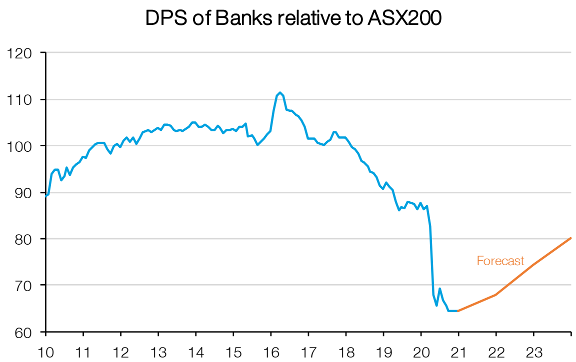
We know banks are still dealing with rising compliance and regulatory burdens, rising bad and doubtful debts (as well as loan forgiveness), a more competitive backdrop where there is disintermediation in a number of financial services, record low interest rates and yield curve control by the RBA which has flattened the outlook for interest income margins, falling dividends and they continue to aggressively cut costs as traditional models become more marginalized.

But the good news is that the market has had 5 years to discount banks for these risks. We do not expect banks to become high growth companies, but they are set to become leaner and valuations have been cut to levels that more accurately reflect what they have become and will remain rather than what they were.

We think 4 factors are now looking more encouraging for banks.

- Dividend cuts / restrictions have been factored into forecasts. In recent years bank sector payout ratios have sat at unsustainable levels. COVID-19 alongside regulatory guidance has combined to address this. However, dividend cuts appear to have abated and APRA's July guidance applies *"for the remainder of the calendar year"*, with any potential easing of guidance into 2021 likely to lift sentiment to the sector. Finally, even in the face of substantial cuts to dividends, banks still offer a yield premium on the broader market and once banks rebuild their capital buffer, we see a more sustainable yield for the sector at ~4-6%, albeit recognise it may take 2-3 years to get to that level.

Dividends are currently at trough levels

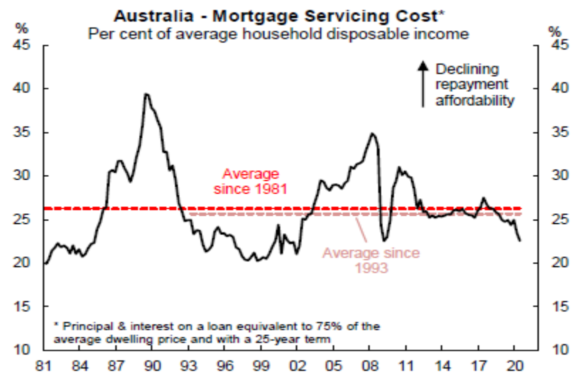


Source: Factset, MWM Research, October 2020

- Expansionary fiscal policy & regulatory tweaks: The removal of the Responsible Lending Obligations (RLO's) is a positive step in freeing up additional credit for housing and boosting credit growth even if it drives further competition pressures across mortgage lenders. Macquarie does expect it to have a positive impact on credit growth over the longer term as well as potentially reducing the downside risk to the property market as deferrals roll off and banks can better support their more vulnerable customers. In addition, the number of places in the First Home Loan Deposit Scheme was increased by 10,000 at the Federal Budget (on top of the 20,000 places already provided to date) with the cap on purchase value significantly increased e.g. Sydney now $950k, up from $750k.

- Improving Economic Growth: We think policy announcements coming from the government, regulators and central bank - taken together - are extremely positive for the economic outlook. On employment, we were encouraged by the Federal Budget's focus on jobs creation and Macquarie is upbeat on housing with increasing mortgage affordability to support an 8-10% recovery in house prices through the end of 2022.

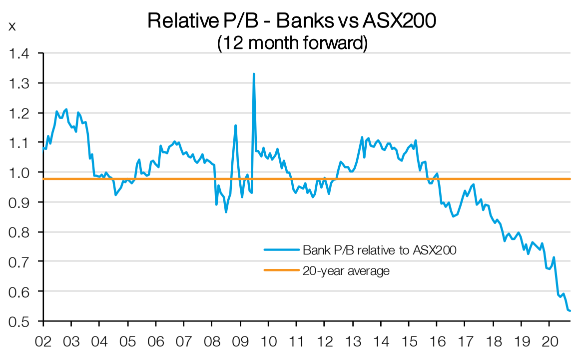
Mortgage servicing costs are at 20 year lows



Source: ABS, Core Logic, Macquarie Macro Strategy, Sep 2020

- Substantial valuation cushion for BDD's and downside risks: Expectations for rising delinquencies have now been accounted for by the major banks. We suspect, as has been the case since the start of COVID-19, that expectations around unemployment and BDD's prove to be overly pessimistic particularly given the support of *"Team Australian"* - government, central bank and regulators. A ~25% better impairments outcome lifts valuations by 4-7% for the majors.

Banks are now cheap on price to book value



Source: Factset, MWM Research, October 2020

Views on the major banks:

ANZ Bank (ANZ, Outperform) - While we continue to see underlying trends for ANZ as challenging, we believe its institutional book skew should result in better impairments experience in the short-term. ANZ offers the cheapest valuation in the sector.

Westpac (WBC, Outperform) - market share losses and management turnover leave us cautious on the near-term outlook for WBC, but these issues are well understood and captured in current discounted valuations. On a longer-term view, WBC's business mix (which is similar to CBA) appears to be undervalued.

National Australia Bank (NAB, Underperform) - in the short term, NAB is likely to have an elevated level of impairments relative to peers as a result of its SME portfolio and some higher-risk specialised businesses. NAB also appears relatively expensive (vs ANZ and WBC). Coupled with uncertainty relating to the impairments cycle, we see the risk-reward skewed to the downside at this point.

Commonwealth Bank (CBA, Underperform) - CBA's franchise is currently outperforming peers, but we see limited scope for CBA to sustain its returns superiority and see downside risk from current levels. CBA remains too expensive relative to the rest of the sector.

Major bank valuation metrics

	ANZ	CBA	NAB	WBC
Recommendation	Outperform	Underperform	Underperform	Outperform
Price ($)	18.61	67.71	18.69	18.21
Valuation (%)	18.62	58.90	17.48	18.16
12m target ($)	18.50	58.50	17.50	18.00
12m TSR (%)	2.85	3.01	3.09	2.52
P/E (x)	14.55	19.64	16.63	14.62
P/BV (x)	0.8	1.6	0.9	0.9
Dividend yield (%)	3.49	3.69	2.94	3.40
ROE (%)	6.08	8.70	6.00	6.82

Source: Macquarie, MWM Research, October 2020

Jason and the Investment Strategy Team

The report was finalised on 12 October 2020

Recommendation definitions (Macquarie Australia/New Zealand)

Outperform – return >3% in excess of benchmark return

Neutral – return within 3% of benchmark return

Underperform – return >3% below benchmark return

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