<u>The best way to be able to observe the Australian bank share price bubble.</u>

6/4/15 by Bruce Baker for clients of Puzzle Financial Advice

There is much debate over whether Australia has a bank share price bubble.

I think that probably Christopher Woods from CLSA may have summed it up correctly:

- *"The Australian banks are incredibly expensive but as long as they keep giving the dividend yield they will stay at that value,"* Mr Wood said.
    - http://puzzlefinancialadvice.com.au/130320_AFR_CLSAs_Christopher_Wood_says_Aussie_interest_rates_could_drop_to_zero.pdf 20/3/15

I suspect Chris Woods may well be correct in the current market …. Maybe. But whether (or when) he is correct, I think will come down to this:

- First let me refer you to the 2 charts from http://www.philipsoos.com/private-debt/ in Appendix A.
- If you look at the house-hold debt as percentage of GDP (chart 1 below) – I think this is one of the clearest charts of a bubble I have ever seen – at least as good as the Nasdaq bubble in 2000. See comparison in Appendix B.
- If you look at the chart of mortgage debt as a percentage of GDP (chart 2 below), while on a shorter time-frame, it was about 85%, and you will note from those charts that total household debt is about 95%. So overwhelmingly, personal debt is overwhelmingly mortgage debt – and by inference, we have the biggest mortgage debt in Australia's history by a very large margin.

If you want to clearly see the bank share price as a bubble, you simply need to look at the mortgage bubble as a percentage of GDP.

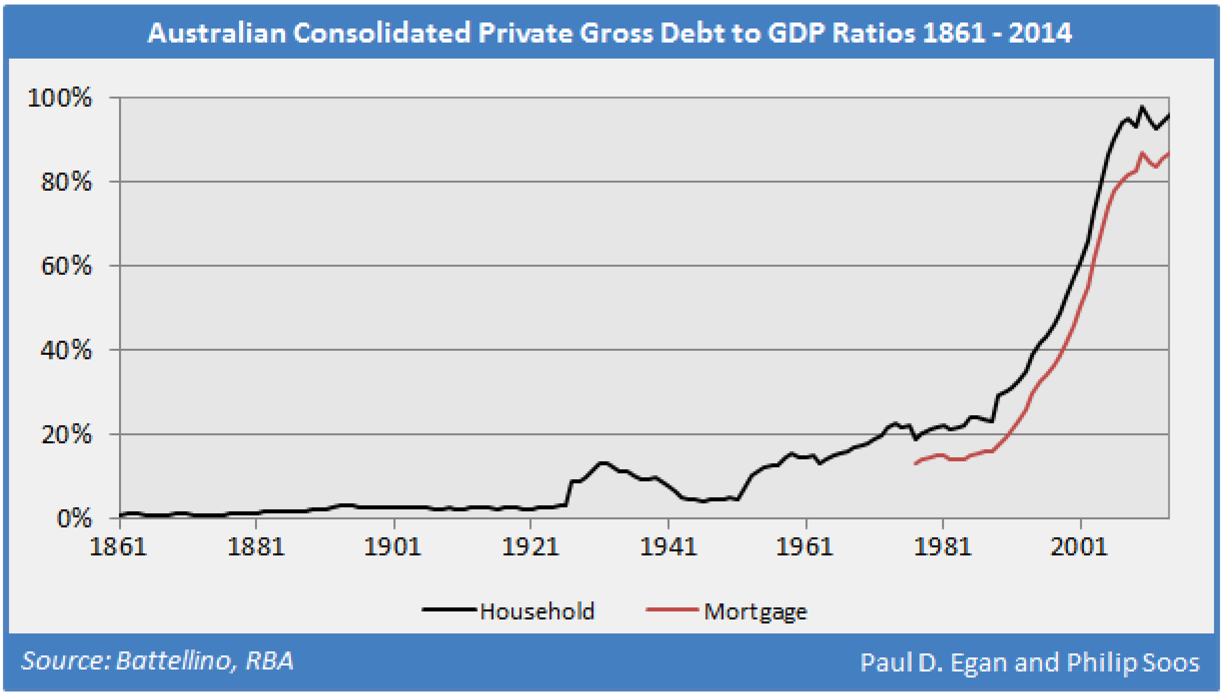
When the mortgage bubble bursts, so too will the bank share price bubble – they are integrally linked. That is when you will start to see mortgage defaults start to rise …… and bank provisions for bad debts (currently at historic lows) also start to rise … and hence you will be starting to see bank profits starting to fall at that point …… and then you hit the Christopher Wood "condition" that at the point bank dividend yields will start to fall ……. If regulatory requirements for higher capital ratios does not cause Aussie bank yields to start falling first.

Other references:

- http://www.abc.net.au/news/2014-09-02/moodys-warns-on-rising-bank-home-loan-risks/5712544
    - 'Ratings agency Moody's is warning that Australian banks are increasing the proportion of risky home loans they are making.'
    - 'However, Mr Serov says the report is a warning to the banking sector that continuing to issue a high and rising proportion of riskier loans would ultimately result in reduced creditworthiness.'

Appendix A. Personal debt and mortgage debt in Australia as percentage of GDP.

And most of the private debt is mortgage debt.



https://www.prosper.org.au/2014/12/18/soos-and-egan-australian-property-chart-pack/
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Chart 1. One of the most reliable guides in the financial world is reversion to the norm. This guide would suggest that at some point, the household debt to GDP will revert to something closer to what history says is more normal eg below 20%. As the mortgage debt bubble shrinks, so does a major source of profit for banks ….. and so does the major fuel for the house price bubble.

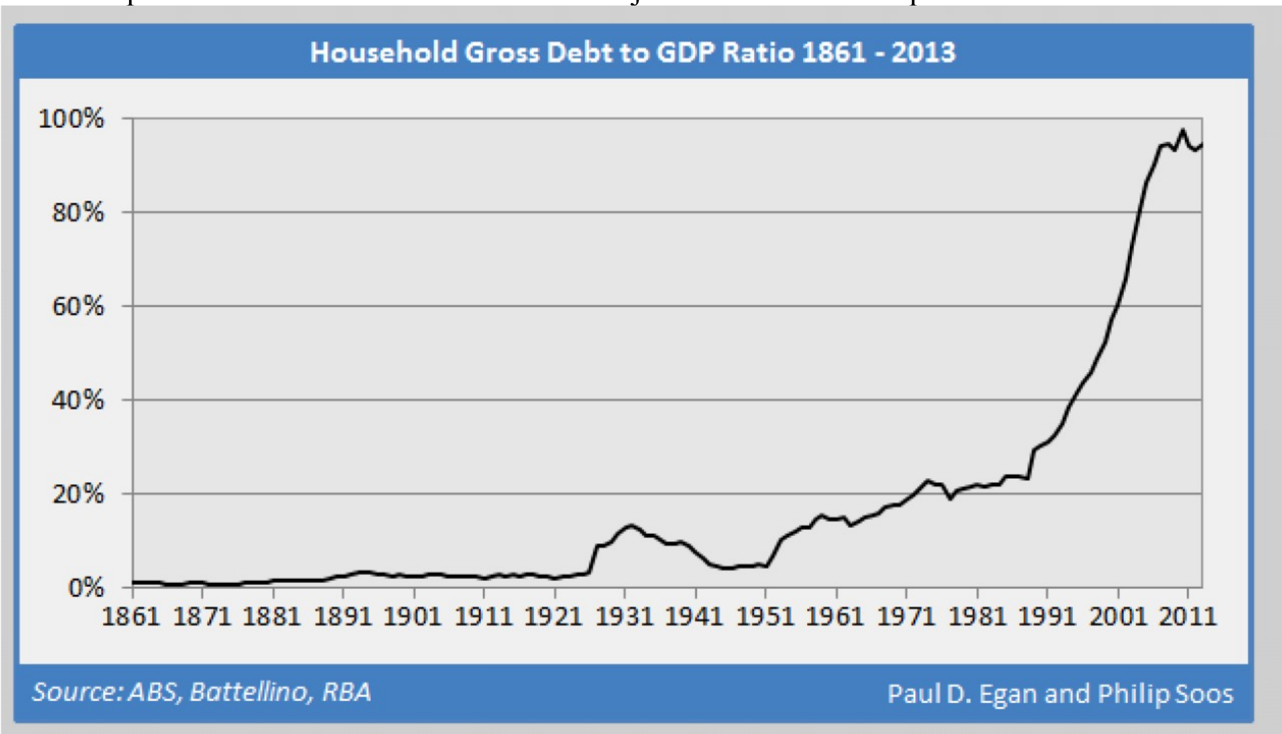
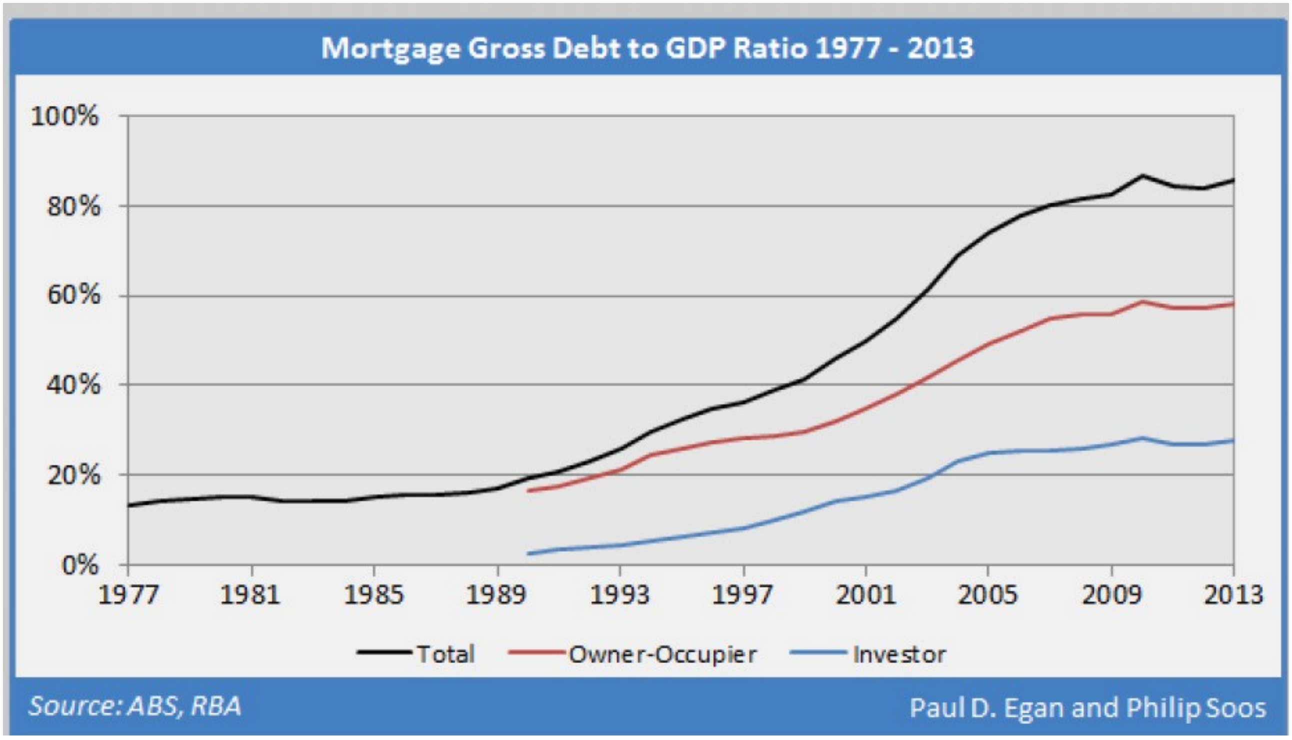
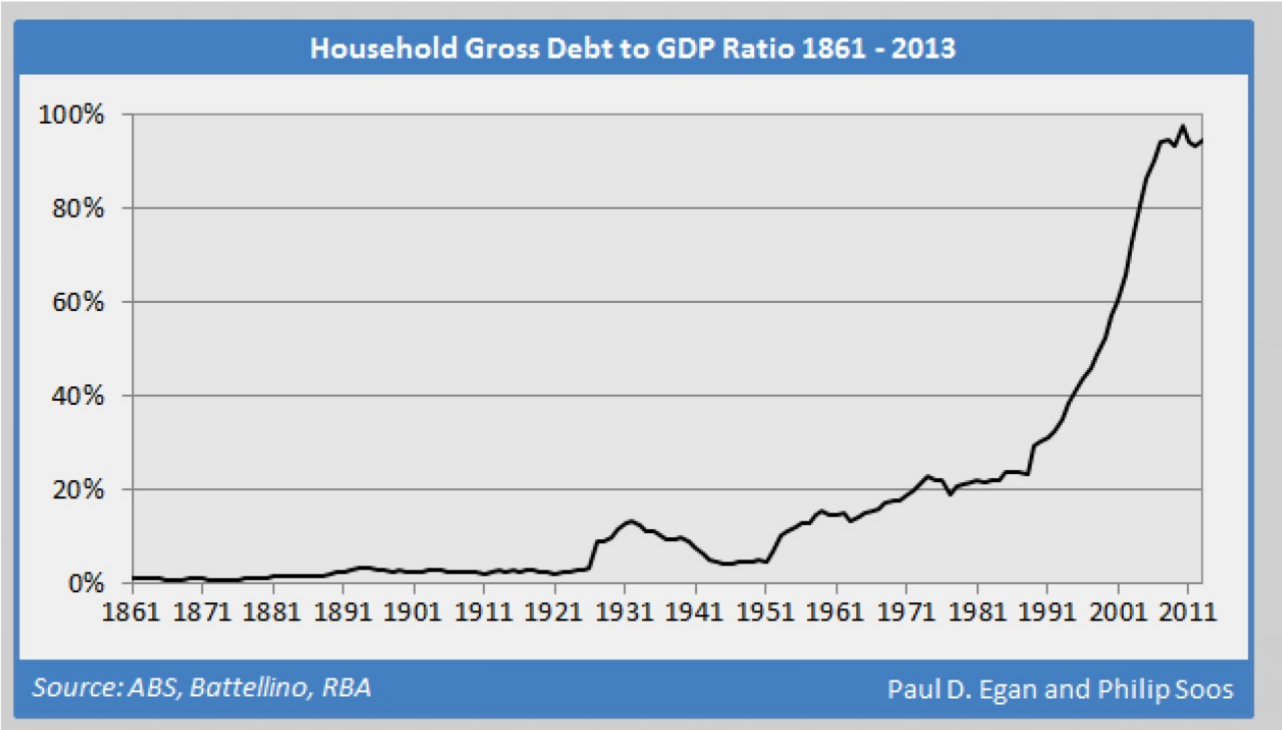
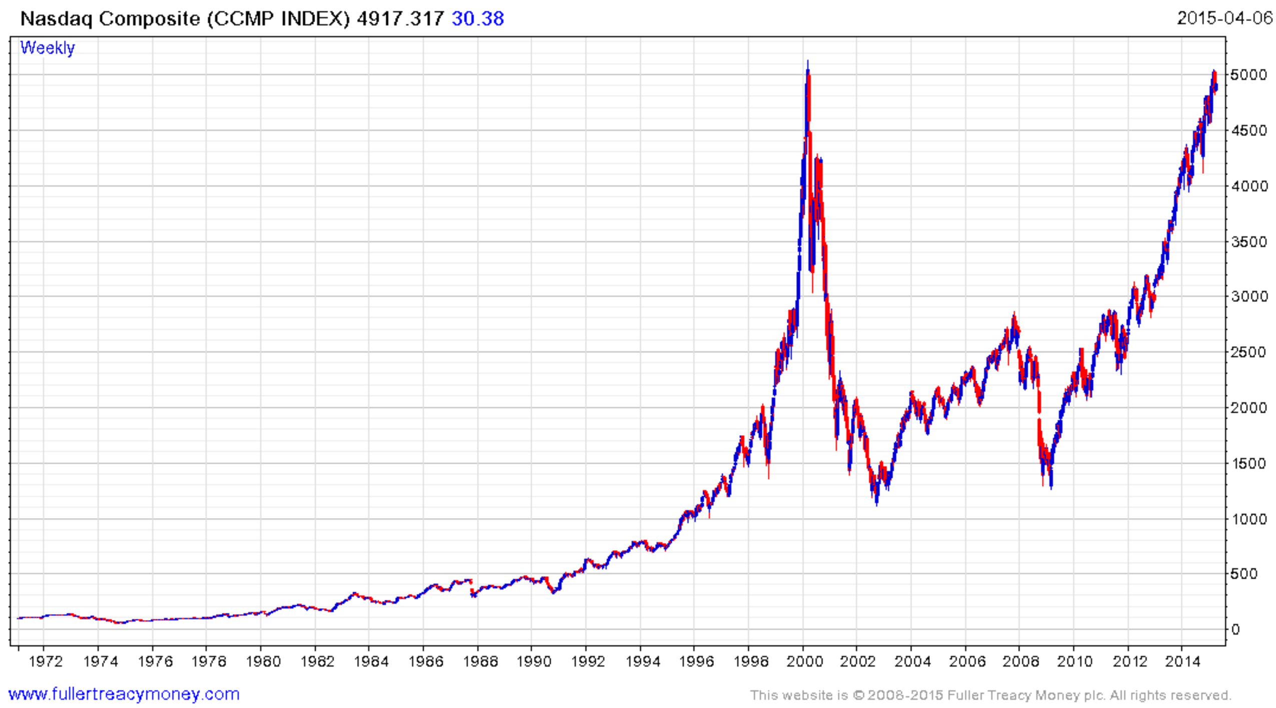


Chart 2.



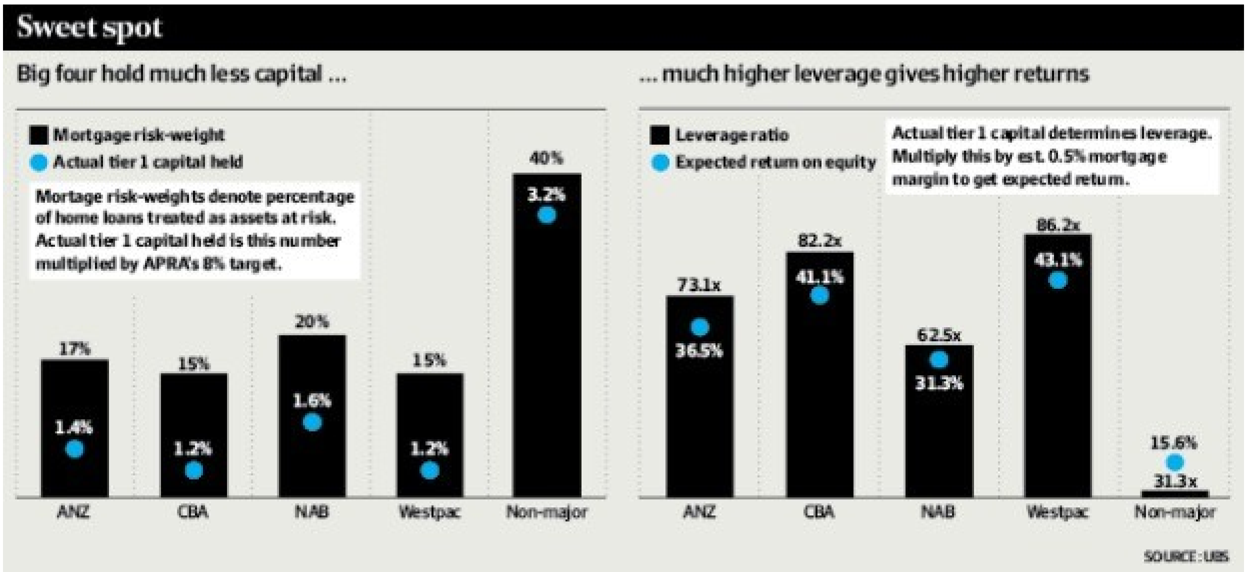
Appendix B. 2000 Nasdaq bubble vs Aussie mortgage bubble





Appendix 3. Big Aussie banks are highly geared.

The big banks a highly geared. As you know, gearing is good for the share price when profits are rising. But the more highly geared you are, the higher the gearing, the bigger the impact on share prices when profits start to shrink.



http://www.afr.com/markets/equity-markets/secret-to-big-bank-profits-20130419-ilt9b

Appendix 4. What happens to bank share prices when you have a house price crash?

Here is the US experience.

Citigroup – Citibank feel from US$550 down to US$10 in the middle of the GFC and has now recovered to be in the US$50s area.

The US broad bank share price index.