Will the Murray Inquiry improve financial advice? **Andrew Main** reports in **WEALTH on TUESDAY**

Tony Negline offers smart tax tips for dealing with losses in a DIY fund in **WEALTH on TUESDAY**

Lifting loan rates won't help banks

The move will slow credit demand and hurt their shares

ROGER MONTGOMERY

The fortunes of Australia's banks and its residential property market are inextricably intertwined and since David Murray's Financial System Inquiry, there have been a number of changes every investor needs to know.

The changes and their likely impact on property prices and bank profits were well flagged, yet investors clung tight to their bank stocks. The pressure on yield-hungry investors and retirees forced them to hold on — and that meant they were unable to avoid the subsequent capital losses, as bank shares declined.

With that summary in mind it is worth reflecting on bank stocks to determine what the outlook is, where the risks might be lurking and whether there are any implications for property prices in Australia.

Following observations that 90 per cent of house funding came from the major banks and that they are 60-70 per cent exposed to domestic lending, it was concluded that Australian banks need to be stronger than contemporaries elsewhere in the world. David Murray's inquiry produced two recommendations relevant to this discussion.

1. The first was to "set capital standards such that Australian authorised deposit taking institution capital ratios are unquestionably strong". This essentially increases the amount of capital the big banks are required to hold on their balance sheets.

2. The second was to "raise the average internal ratings-based mortgage risk weight to narrow the difference between average mortgage risk weights for authorised deposit-taking institutions using IRB risk-weight models and those using standardised risk weights". In other words, it reduces the amount of money they can lend for each dollar of capital they have.

BRITTA CAMPION

Westpac's Brian Hartzer trigger this week's round of rate rises

Shortly after the report was released, we saw the banks raise capital. Just in case the pool of demand for bank shares dried up, the NAB under new chief executive Andrew Thorburn went first and in July announced a rights issue, ostensibly to "absorb potential regulatory changes".

The rest of the banks followed fast. In August, ANZ raised $3 billion in equity capital "following the introduction of APRA's revised risk weightings" and CBA announced a $5bn raise.

Meanwhile Westpac had already sold a stake in its wealth management arm BT, raised $2bn earlier in the year, and more recently announced a further $3.5bn at a 36 per cent discount to the company's 2015 share price high.

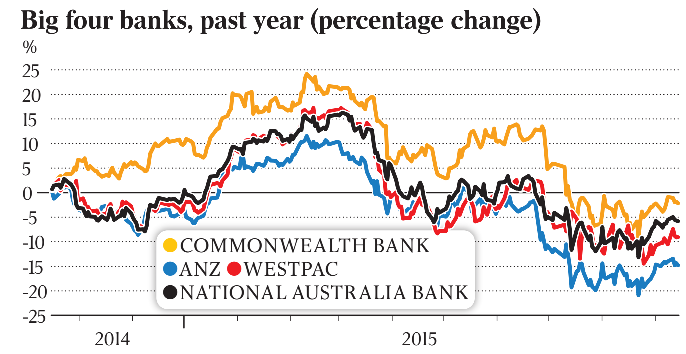
The combination of higher equity and reduced leverage is tantamount to a reduction in profitability as measured by return on equity because both the denominator and the numerator in the return on equity equation will be adversely impacted for the big four.

The importance of return on equity and buying companies with bright prospects cannot be understated. Return on equity drives intrinsic value, which over the long run determines share prices. The higher the profits for a given level of equity, or the lower the equity for a given level of profit, the more attractive and valuable the business is. When return on equity falls so does intrinsic value. So what's really happened is that bank stocks have had a double whammy from regulators:

- The Financial System Inquiry heralded pressure on their return on equity. Indeed, it presaged an actual decline in profitability on mortgages of about 40 per cent. As the Australian Prudential Regulation Authority noted: "The average risk weight on Australian residential mortgage exposures will increase from approximately 16 per cent to at least 25 per cent." In other words, the return on equity for major banks from Australian residential mortgages will fall by around 40 per cent.
- The FSI, however, wasn't the only issue for the big banks. The regulator already had designs on their growth. Amid a boom in residential property that risked a destabilising bubble, APRA sought in December 2014, to limit investment lending growth to 10 per cent per annum.

In response of course the banks could have simply increased interest rates on new investor mortgages to modify that growth. Raise the price of a product and demand for it will fall, usually. But what did the banks do? After waiting for the FSI report, and discovering the inevitable consequences for their returns on equity, Westpac led by Brian Hartzer decided to raise investor mortgage rates not only on new loans but on their entire existing book of investor mortgages too. Of course they all released statements explaining they were fulfilling their "regulatory obligations" and shifted blame to APRA, but what was really afoot was a mad scramble to recoup some of that lost return on equity imposed on them by the FSI's recommendations.

Big four banks, past year (percentage change)



Source: Bloomberg

Westpac has since been followed by CBA, NAB and ANZ Bank.

It's an admission by Dorothy to Toto, that when it comes to bank profitability and property prices, we might not be in Kansas anymore.

All of this suggests the boom in bank shares and property, and at least the rapid surges in prices, is over. If that were the end of the story however, your investment in property and bank shares might be safe, but perhaps they're not.

You see another regulator decided to perform a reconnaissance trip on 140 interest-only loans issued by Australian Authorised Deposit-Taking Institutions. They discovered lending practices were loose and in essence many investors had been lent more than they could comfortably manage under many likely scenarios.

A bursting bubble is not always bad, but history says it almost always has a negative impact on economic growth in the years following. The toxicity of a bubble bursting however is directly related to the level of debt associated with its inflation.

Given that a buyer of a median Sydney house, using 80 per cent leverage, would use 65-70 per cent of their disposable to service the first year of their loan on present low interest rates, and given the average NSW home loan jumped $78,000 in the last year, I would suggest that Kansas could be a long way down. And that's for both property prices and bank shares.

When credit becomes more expensive as it has, even in the absence of any RBA rate increase, demand for credit to fund property purchases falls. We can see this is already under way. Price growth has slowed and clearance rates have declined dramatically.

Meanwhile, the much longer construction cycle means that more apartments are still being constructed and these will be released into a slower period of demand. Economics 101 tells you that declining demand and increasing supply results in lower prices. Property will be no different. And if property prices fall, so does sentiment towards the intertwined banks. Boosting profits by raising mortgage rates reduces demand for the very credit on which the profits were based.

Roger Montgomery is founder and CIO of the Montgomery Fund.

Geodynamics: from 'hot rocks' to hot stock

RICHARD HEMMING
UNDER THE RADAR

You know Malcolm Turnbull has his work cut out to reboot the renewable energy sector in Australia when a big investor in the space dismisses it out of hand.

Andy Gracey manages the $400 million small-cap fund for Australian Ethical Investments, which he tells us has a "deep, green, ethical bias".

The small-cap fund invests in about 55 companies, but this doesn't include Australian renewable energy companies because there simply aren't enough to choose from.

Says Gracey: "We've got nothing in renewables here. (Wind farm operator) Infigen Energy has too much debt, while Energy Developments is being taken over by Duet. For green exposure, we look to New Zealand."

Fortunately, two New Zealand renewable companies are dual-listed on the Australian Securities Exchange. Gracey's fund owns the hydro and geothermal power companies Mighty River Power and Meridian Energy. It also owns Contact Energy in which Origin Energy recently sold its 50 per cent ownership.

One Australian renewable energy small cap that could find its way back into Gracey's portfolio one day is Geodynamics, which must be given marks for its technical achievements, not to mention its persistence.

Back in 2007 when it was positioned to solve Australia's energy needs through the power of deeply embedded "hot rocks", its share price was over $2.

These days those ambitions are gone and its share price is trading under 3c, although it has cash of $25.8m, which equates to 4.6c a share. That's right, this stock is trading at a 34 per cent discount to its cash valuation.

Moreover, its share price gives no value for its recent scrip based acquisition of Quantum Power, which has the largest portfolio of biogas projects in Australia, and has transformed Geodynamics, according to managing director Geoff Ward: "The most efficient way to run modern energy systems is to develop as much of your power as close to the consumers as you can." Quantum takes waste from abattoirs, piggeries, chicken and dairy farms and turns it into biogas, generates electricity and sells the power back to the farm or factory.

Geodynamics' geothermal projects involved over $45m in expenditure, whereas these biogas projects require about $5m and have an internal rate of return of 15 per cent over five years. The group has one operating biogas generator near Beaudesert, Queensland, which has two contracted projects: a piggery and an abattoir. Ward says the group has 10 proposals under consideration and expects an investment of between $25m and $50m.

He is confident because of the desire of small businesses not to be reliant solely on the grid for their energy needs.

The group has an approved $20m loan from the Clean Energy Finance Corporation and, as I keep saying, you can afford to be optimistic when you've got a strong balance sheet.

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New mirror to China: it pays to look at German economic health to gauge Asian prospects

STIRLING LARKIN
GLOBAL INVESTOR

For so many important reasons, Germany remains a central player in the global ultra-high-net-worth investment mix.

German banking, industrial complex and financial engineering leads at the front of the curve and can be seen directly in Australia via the footprint left by Deutsche Bank, Commerzbank and other German financial conglomerates.

These trends matter for two significant reasons: Germany, as represented in the graph, remains a dominant force itself, in individual UHNW wealth but secondly and as importantly, Germans continue to be China's best friend in Europe and arguably also the West and have been so since the Chinese Communist Party took control in 1949.

Anybody who has spent five minutes on the ground in China realises this undisputable fact — China and Germany have an unusual but unwavering alliance across commerce, finance and more broadly, their societies.

This dedicated bilateral relationship has been recently challenged by Britain's pursuit of China's external foreign exchange business, with the hope that London could be Beijing's international yuan foreign exchange hub in the near future.

When the yuan (or renminbi as it also called) achieves UN's reserve currency status, which is only a matter of time, then London can challenge Frankfurt and Berlin as China's financial ally in Europe.

Why this matters to Australians is that between Britain, Germany, France and also Switzerland — which acts as a wealth proxy on behalf of other European jurisdictions — four-fifths of the top UHNW industry leadership have allied themselves to the immediate fate of China and Emerging Asia.

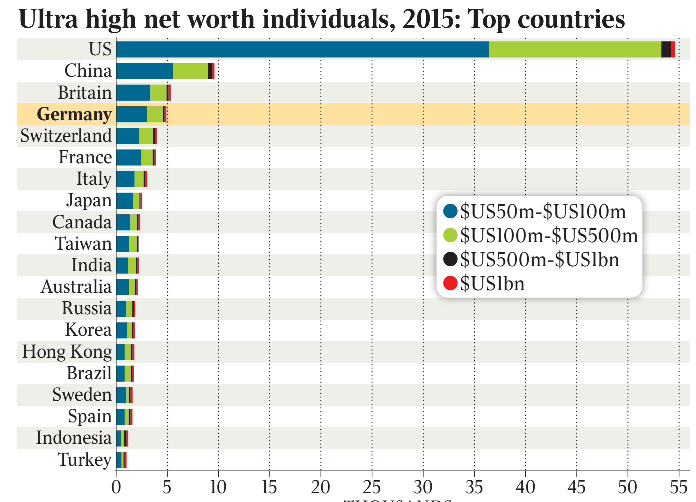
For the Australian economy and wealth sector, which has tied its cart to the same horse, these developments have ramifications that directly affect us in turn.

For these reasons, some are taking a deeper look at the health of the German economy, not only as both a reflection on the vibrancy of the eurozone but also as a proxy to trade and investment with China and Emerging Asia.

Commerzbank's leading indicator for the German economy — known as the "Early Bird" indicator — dropped again in September and, at 0.19 points, is now much lower than at the beginning of the year, when the indicators recorded a more stable 0.49 points.

As the global economic environment is still weakening and the euro is picking up again, Commerzbank believes this suggests that sentiment indicators will also turn downwards again and that the German economy will lose rather than gain momentum in the coming year.

Ultra high net worth individuals, 2015: Top countries



Source: James Davies, Rodrigo Lluberas and Anthony Shorrocks

As these warning signals become louder for the German economy, the pressure will mount on the ECB to support the bloc with an extended QE program. According to Commerzbank, a majority of German companies listed on the DAX index have this quarter released profit warnings and those who have account this to weaker demand from China and the strong depreciation of various emerging market currencies.

They believe this negative trend will continue and particularly for companies with a high share of sales in China and other emerging markets such as Brazil and Russia, which cannot compensate for this through US dollar gains versus the euro.

Examples include Volkswagen (VOW), Adidas (ADS) and Duerr (DUE). For Australian global investors wishing to identify DAX-listed companies that do not suffer these complications, companies such as Fresenius (FRE), Deutsche Telekom (DTE), Hochtief (HOT) and MTU Aero Engines (MTX) are likely to feel little or no pressure on this front.

But the realignments within the UHNW top 20 countries mix, as seen in the graph, matter as well.

Since 2014, China has moved up to second place with 9600 UHNW individuals (up 1800 on the year), followed by Britain (5400, up 400) which switched places with Germany (4900, down 1000). Switzerland (3800, down 200) moved up by overtaking France (3700, down 600).

More than simply musical chairs, these shifts reflect the wealth effects that a growing and then slowing China has on its closest trading partners.

For the Australian global investor who remains anxious about developments seen in the US, the German bond market, commonly referred to as the "bund" market, provides valuable insight into the market that sets the risk-free rate, from which all other markets are benchmarked.

Bund spreads have widened recently and are close to the highs seen earlier in the year, when the market believed that ECB QE would drive bund yields into negative territory and a shortage of bunds appeared imminent.

Some of the recent widening in bund spreads can be attributed to heightened risk aversion and increased anticipation of further ECB easing, in response to the deteriorating inflation outlook and weakening global growth prospects but as importantly, they provide the Australian global investor a barometer to gauge risk aversion linked to the trajectory of the Chinese economic machine.

As helpful as these gauges are, it remains important that the global investor not over rely on the proxy proponents of these spreads, as after all, the German manufacturing orders domestically fell 1.8 per cent month-on-month in August on their own volition.

As Deutsche Bank recently commented, "For the average German, a sack of rice falling over in China has long been considered none of his business", but as the importance of events in China for the German economy have come to be recognised, this indifference is changing and changing fast.

For the Australian UHNW and global investor, taking this deeper look at the German economy and relying on the cold fact that Germans are notorious for saying it as it is, becomes a dependable voice that is heard through all the Chinese whispers.

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Larkin Group is a wholesale wealth adviser focusing on high yielding global investments.