Cash is not so bad

by Roger Montgomery

If you are of a certain vintage, you may have enjoyed watching the antics of Wylie.E.Coyote and his attempts to catch and eat Road Runner. In almost every episode there was a moment, commonly referred to the W.E Coyote moment, where the disingenuous coyote found himself momentarily suspended in thin air, invariably above a canyon, held up only by an initial failure to realize there was nothing underneath him.

Yield hungry, bank share investors found themselves in just such a situation earlier this year. With term deposits yielding little and forced to move up the risk spectrum, investors purchased bank shares pushing them up while failing to realize that rising share prices need to be supported by earnings growth in order to be sustained. Without commensurate earnings growth, shares chased for yield would give up gains supported by nothing but thin air.

Banks need to retain profits in order to build capital against which they might lend. High dividend payout ratios must come at the expense of retained profits and when combined with the higher capital requirements and mortgage risk weighting ratios recommended by the Financial System Inquiry and imposed by APRA, growth for bank earnings was always going to be a little harder to come by in the future than in the past.

But while banks are part of, and related to, today's discussion, they aren't the primary objective.

Banks have extended significant credit to buyers of residential real estate in Australia such that housing lending now accounts for around 40% of banking industry assets and the proportion of total bank loans concentrated in mortgages is 60%. This is double the aggregate value for US banks and triple that of UK banks.

To be fair, it is possible that the worst of a real estate bubble may have been avoided through APRA's restriction of investor loan books to 10% per annum, a rise in mortgage rates and requirements for more substantial deposits. But mitigating the worst of the excesses does not mean excesses don't remain.

Lending for residential real estate investment has exploded higher in recent years. According to the ABS (Australia Bureau of Statistics), investor lending in 2015 grew by double digits over the previous year, surpassing $13 billion, to a record high.

Now, don't get me wrong, I do not think that any bursting of the property market will cause the economy to crash or that it will threaten the banking system. Nevertheless, a real estate correction, if it transpires, will see bank shares de-rated. In turn, that might provide an opportunity to establish positions to produce excellent long term returns.

SO, the question is whether the real estate market could be in any trouble. Anecdotal evidence and experience suggests the experience of 2015 is not sustainable. When full-page ads for apartment developments number 36 in the weekend real estate lift-out, one needs to pause and reflect. When 80,000 apartments are under construction – and a high concentration being completed mid 2016 – and another 117,000 in the pipeline, at the same time that population growth is slowing (and going backwards in Perth along with already high vacancy rates), investors need to be careful about how and when they deploy any low yielding cash.

The last time I saw excess supply over already rising vacancy rates and falling rents was in 2010's Chinese commercial property market. Fast-forward to 2015 and that market has fallen 50% in just the last twelve months.

I am not suggesting falls of that magnitude are likely but irrespective of whether you are a share market or property market investor you need to be mindful of the risks.

Cash seems like a terrible investment right now and I can understand the pain it must cause those who rely on investment returns for their living expenses or to supplement their social security. But a low positive return might not look so bad when compared to the negative returns that might ensue if the apartment market corrects.

And one final thought; if an apartment correction transpires, it is virtually impossible to imagine it could be contained to one dwelling type. For a significant proportion of home formers, they are indifferent to three bedroom houses or three bedroom apartments. If apartments are available at 10 or 15% lower than hitherto prices, there will be less demand for the equivalent houses that have not fallen. Houses would then have to fall too.

Cash in 2016 may not be so bad after all.