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US banks supreme in global turmoil

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The greatest fortunes have often been amassed during times of heightened concerns, periods of structural transition and especially during market structure corrections, just like the one we face today.

But as many have not seen the opportunities this presents nor recognise any clarion call that allows them to invest with reasonable confidence, Australian investment communities have transitioned to cash at one of the faster paces since the Great Recession.

Stoked by current fears over oil and China, magnified by anxiety stemming from existing European and potential (but unlikely) North American negative interest rates — coupled with the potential for systemic risks from banks globally — these fears created a surge in gold bullion that understandably rallied towards $US1300/toz at the beginning of February.

Remembering that gold is recognised as the barometer of fear or "currency of last resort", the significance of these events has deeper implications for the global investor, primarily because gold, in these circumstances, is a direct conduit for "risk off" (or risk aversion) across all asset classes.

In other words, when investors discuss gold in these ways they are really asking: Is it time to take risk out of all active market investment positions?

Australian Ultra High Net Worth investors are more attuned to the nuances of this debate (that is, those who hold more than $250 million in fungible wealth, which is the threshold between high and ultra-net wealth), and here diversification has been found across less-liquid asset classes.

Less depth of liquidity across a portfolio leads to the binary "risk on" or "risk off" decision process much quicker. Australian UHNW investors are currently focusing on the following three drivers of macroeconomic fear stemming from lower oil prices:

● The commodity capex cycle.

● Increased savings (from energy costs).

● What's referred to as the "Oil-Dollar" and "Oil-Renminbi" correlation

Recognising that each of these themes has already run their course, given the currently trendless oil market, the question becomes what's continuing to drive "risk off" and, by choosing to do so, are timely investment opportunities being missed?

On this, Goldman Sachs recently came out arguing these fears ignore the facts that systemic risks from oil, China and negative rates are very unlikely to spillover into crisis or recessionary territories.

It highlighted that OECD banks had ample liquidity to maintain funding against higher capitalisation, that the negative macroeconomic impacts from low oil prices have likely already played out and are not systemic while the spillovers from China are limited and the US is far from recession.

However, critics of these views are legion.

And that is because coming out in support of China or even the US economy at this time appears to become a poisoned-chalice position.

Australian UHNW global investors already know the following:

● An economic hard landing has already happened in the northeastern region of China.

● In that region, nominal GDP growth dropped to 1 per cent in 2015 from 5.4 per cent in 2014 and 14.9 per cent in the 10 years before that on average

● Growth of fixed-asset investment (FAI) tumbled to -11.6 per cent in 2015, compared with the 10-year average of 25.5 per cent previously seen

The significance of this region to Australian investors is that it directly accounts for about 8 per cent of total Chinese GDP, 8.1 per cent of their population, 7.2 per cent of bank loans in Greater China but, most importantly of all, is the recipient of much of Australia's exported iron ore and coking coal since 2005. Also, the northeastern region offers a natural experiment to gauge what would happen if tail-risks across Greater China materialise.

Across northeastern China in calender year 2015, growth of household income, household consumption and retail sales slowed more than the national average, but to a much lesser extent than other indicators such as investment and imports.

There are no reports of widespread unemployment or social unrest and in these contexts the social impact appears bearable.

For investors, there are clearly some complicated undercurrents at work right now, and with multiple factors already adversely impacting US, European and Australian corporate profits and valuations it is most reasonable to expect global investors to fear China's transition.

And, for global investors, this segues directly towards an equally impactful "fear conversation" regarding Chinese Banks.

Although national-level Chinese bank dividends present as comparable to the big four

Australian commercial comparisons, the state-owned Chinese banks' relationship with the government makes them more vulnerable to potential restructuring and dilution risk.

This debate has also circled around the reasons that led to the Chinese Banks' public listings in the first place:

● To subject the Chinese banks to market forces, leading to efficiencies

● To share future restructuring costs with minority shareholders, if and when the banks need to recapitalise balance sheets — akin to the current European experience with Contingent Convertible (CoCo) Bonds

● Chinese bank dividend payout ratio of 35 per cent is high compared with Chinese companies whose dividends tend to be low to nil. This approach is traditionally commensurate with fixed income, not equity positions.

With Chinese banks undercapitalised and their earnings deteriorating, the opportunity and risk question for Australian global investors is: where does that leave Australian iron ore exporters, consumer markets and the nascent but increasingly important Chinese tourism market?

Lastly, all the major Chinese offshore-listed banks are trading below their book values, however, as the denominator, being the "book value", needs to be re-evaluated based on more rigorously imposed loan classifications and strictly implemented Basel III, the banks would more likely be priced two to three times their net asset value.

Therefore, global investors would be wiser to invest in quality money-centre banks in the US, if they came to the view that the opportunity for a turnaround story existed within this "Fear & Gold" linked to "China & Iron Ore" tryst.

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