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1300 881 177

**The Banks**

09/08/2011 FAT-AUS-535

ANZ

AUD \$18.94

Core

**MED.****B****Overdrawn? No, just oversold.**

There's little doubt that the world as a whole is in a lower growth phase that will persist for some time. This is driven by the extent of public debt in the US and Europe, which will require some combination of lower levels of government spending and greater taxation to resolve. Such a situation is a significant headwind that will be with us for some time, but it is not a one-way street towards an inevitable double-dip recession for the countries concerned.

As we look at the Australian market we see stocks in many cases trading at values that assume a substantially worse outlook than where we see the present reality. The Australian banking sector is a case in point, with each of the four majors trading on single digit price to earnings ratios (PEs) and dividend yields of 7-8% fully franked.

The banks are in our view priced for fears that are unlikely to transpire. As such, we are re-iterating our previous buy recommendation for ANZ, upgrading Westpac to a buy and adding Commonwealth Bank of Australia as a new buy recommendation. Commonwealth is particularly interesting because it is due to go ex-dividend on the 15<sup>th</sup> of this month.

Buying the stock ahead of the 15<sup>th</sup> will capture 3 dividends over a 13 month period. This equates to a forecast dividend yield of around 10.5%, or almost 15% fully franked, over the next 13 months. The bank is unlikely to encounter difficulty in funding its dividends, while we would also expect the sector to have recovered from this latest rout over the next year or so.

	Next Report	Date	PE	PB	Div. Yield	Franking	Ex Date
<b>NAB</b>	Q3 trading update	9/08/2011	8.5	1.3	8.2%	100%	10/11/2011
<b>CBA</b>	Full Year	10/08/2011	10.8	2	6.9%	100%	15/08/2011
<b>WBC</b>	Q3 trading update	16/08/2011	9	1.4	8.2%	100%	7/11/2011
<b>ANZ</b>	Q3 trading update	19/08/2011	8.5	1.3	7.7%	100%	10/11/2011

To put the banks' current undervaluation in context, ANZ hit a low of \$12.02 in January 2009, before going on to deliver earnings of \$1.31 per share for the year to 30 September 2009. At its low point, ANZ was therefore effectively trading on a PE of 9.2 times its forthcoming full year earnings. At 8.5 times its consensus 2011 full year earnings, ANZ is comparatively cheaper than it was at its 2009 low.

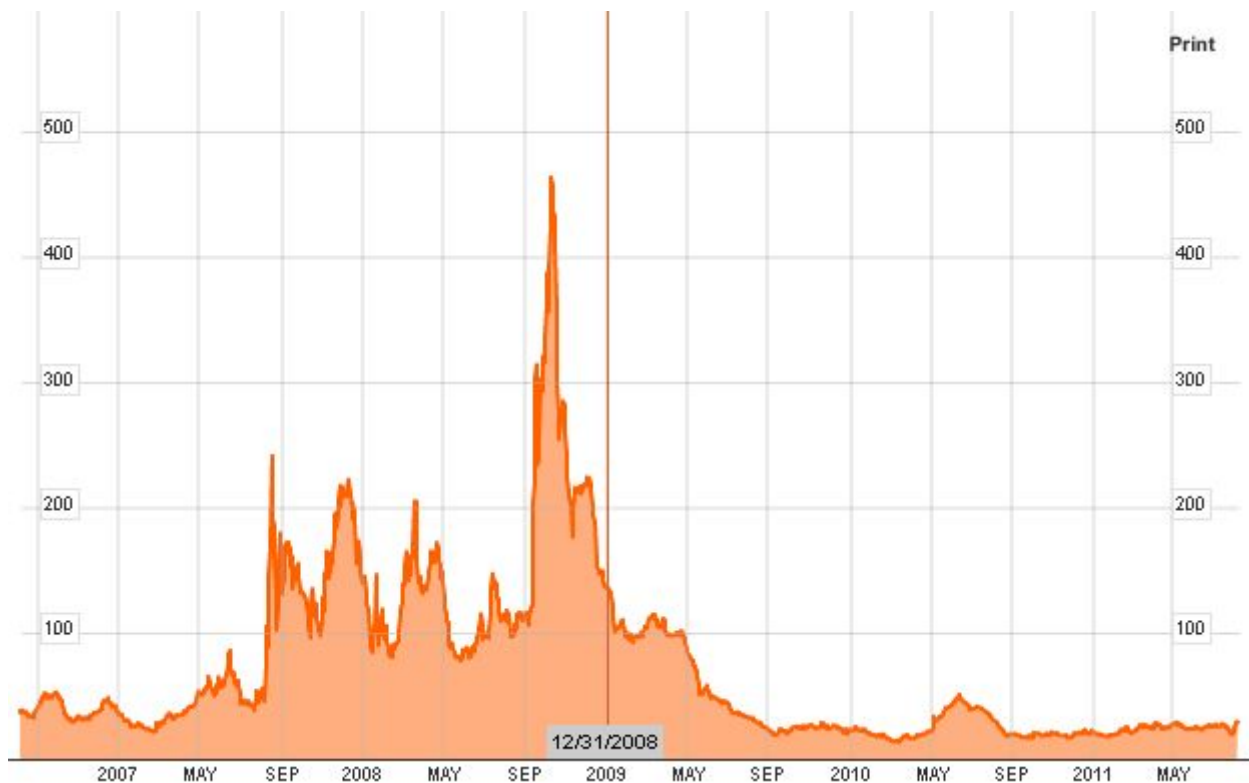
In Westpac's case, the stock hit a low of \$14.60 also in January 2009, before going on to report earnings per share of \$1.25 through to September 2009. This equates to a forward PE of 11.7 times at its 2009 low, which compares to just 9 times consensus 2011 earnings.

For the banks' current valuations to be justified the outlook for their operating environment would have to be commensurately worse than was the case in early 2009. This simply isn't the case.

Let's not forget that global credit markets were at that point in a deep freeze, which placed immense pressure on all of the banks' cost of funds. Move forward to today and the situation is considerably less serious. For one thing the banks have been busily reducing their reliance on wholesale credit markets since the GFC. ANZ for example has reduced its reliance on wholesale funding from 22% in 2008 to 11% as at March 2011. The change has been driven by ANZ's expansion of traditional deposit based funding from 50% to 60%.

It's a similar story for the other major banks. Westpac has moved from obtaining 20% of its short term funding through offshore wholesale credit markets in 2008 to 12% as at March 2011. Customer deposits have grown to represent 52% of the bank's funding over the same period, from 44% previously. Westpac does source 13% of its greater than 1 year maturity funds through offshore wholesale credit sources. But it's the debt maturing in less than one year that is most susceptible to short term dislocations in funding costs.

Getting back to our comparison with the state of play in early 2009, a good representation of the health of global credit markets is provided by the TED spread. The TED spread is simply the difference between the yield on 3-month US Treasury securities and the interbank lending rate.



As the chart above shows, the TED spread hit astronomical highs during the depths of the credit crisis in the second half of 2008. At this time no-one wanted to lend to anyone else because Lehman had just collapsed and fingers were pointing everywhere as to who might be next.

Although credit markets had thawed somewhat by the beginning of 2009, the TED spread was still at elevated GFC levels of around 100. This compares to less than 27 presently, which is well within the spread's historic norm. That's not to say that credit markets couldn't yet deteriorate, but they certainly haven't yet in any serious fashion and as we point out above, the banks are considerably less exposed to this threat than was previously the case.

The key point here is that the current issue is a public sector debt problem, rather than a private sector debt crisis as was the case during the GFC. There is far greater visibility to this with regards to where the risks lie and who is exposed. This is very different to the state of affairs through 2008 and 2009, when there was very little visibility.

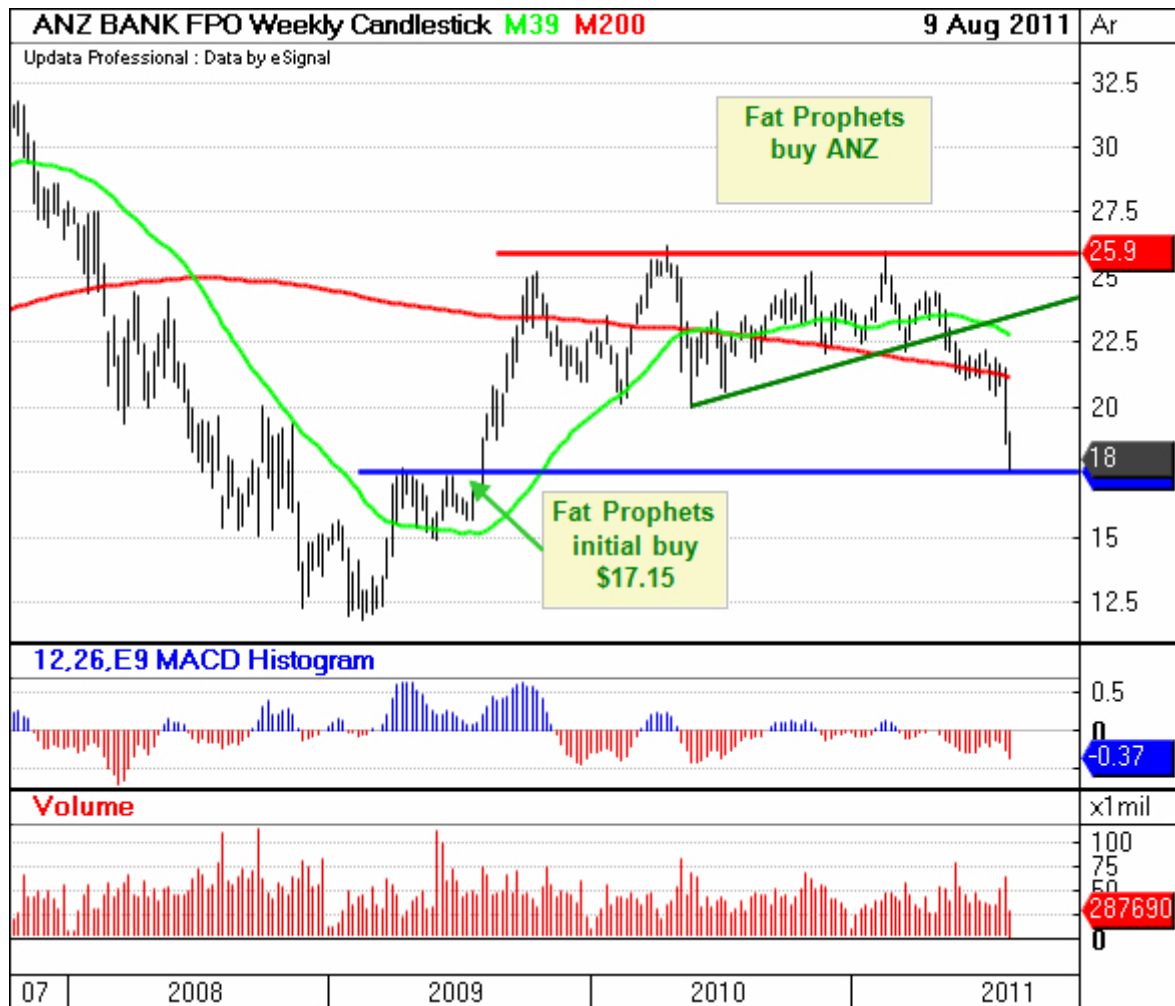
The two primary catalysts for a deterioration in wholesale credit markets are the US and European debt problems. We have already seen bond markets completely ignore S&P's downgrade of the US, as evidenced by falling rather than rising yields across the medium to longer dated sections of the US government yield curve. The downgrade is in our view a non-event and the concern that it will push up borrowing costs globally is not supported by the immediate evidence.

With regards to Europe, the ECB's decision to begin buying Spanish and Italian government debt provides a buffer against the threat of broader contagion from Europe's struggling PIIGS.

Probably the single most important indicator as to the outlook for the banks' funding costs is the actions of CBA and Westpac to cut their fixed rate mortgages today. CBA has cut its fixed rate offerings by up to 60bps while Westpac has carved up to 20bps from its equivalent product.

There are two major read throughs from the banks' action. Firstly, there is clearly an expectation that the RBA will soon move to cut its official cash rate. Secondly and more importantly as it relates to the banks, they clearly do not expect pressure on their funding costs from other sources such as wholesale credit markets. The banks are after all not in the business of wilfully contracting their margins.

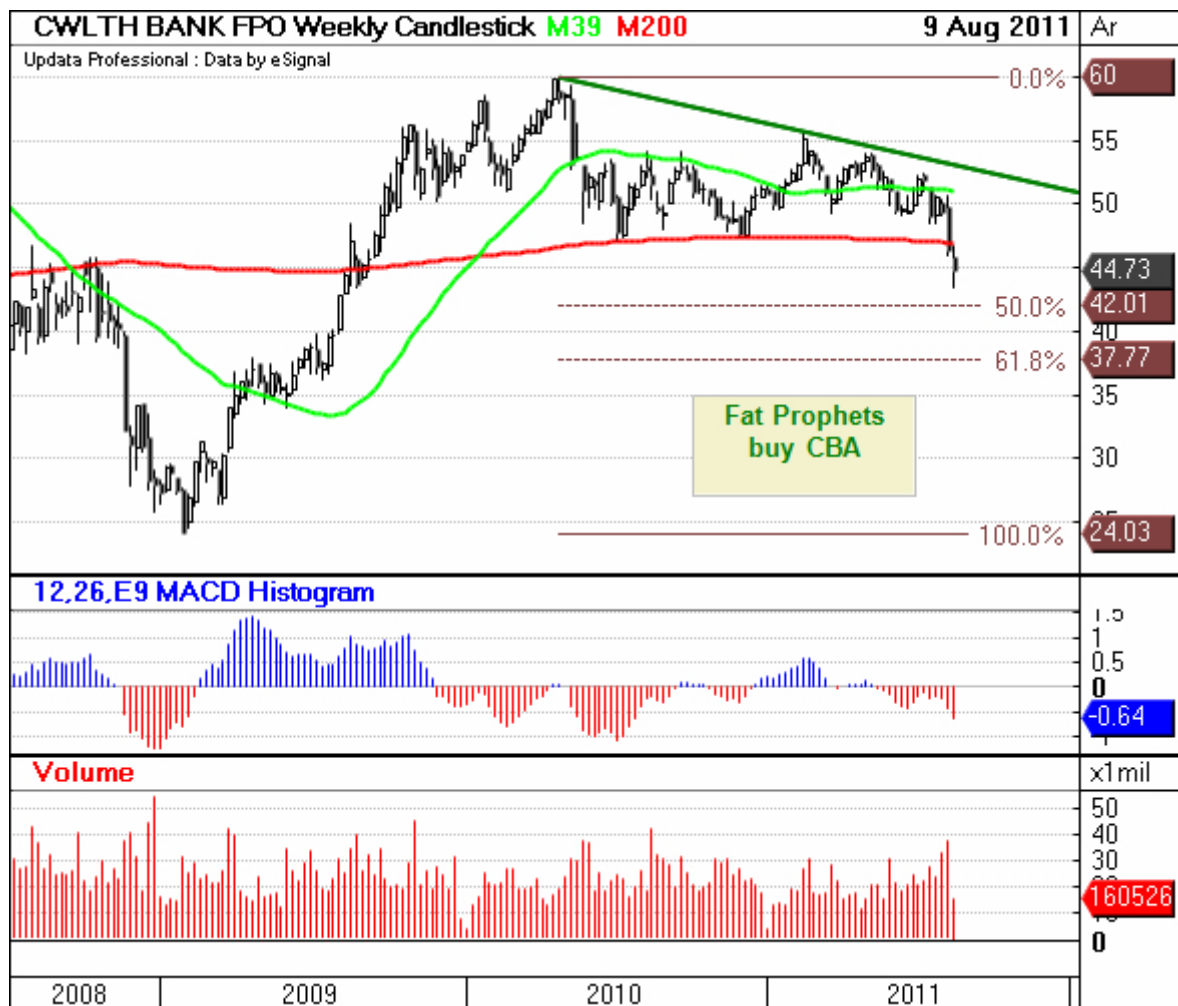
NAB's result today also provides reassuring insight to the current state of play within the Australian banking sector. NAB delivered third quarter cash earnings of \$1.4 billion, which was in line with expectations. The key elements of the result were a decline in bad debt costs and an improved net interest margin of 2.32%, compared to 2.23% previously. There is nothing in the result to suggest that the banks face a return to significant increases in bad debts or unmanageable funding costs.



The price action is below both the 39 and 200 week moving averages, indicating the strength of downward momentum at present. Support is being tested at \$17.50, thus we would expect prices to lift at this region. The downward decline certainly appears to be oversold.



The breach of support at the \$20.56 level saw prices decline sharply. Support is currently being tested at the May 2009 low at \$18.44. Should prices hold, we would expect prices to retest the previous support level, which is now acting as resistance at \$20.56. The next move on the upside would be towards the cluster of the 39 and 200 week moving averages at the \$22.55 region.



The breach of the technically important 200 week moving average is indicative of broader term momentum to favour the downside. Should the decline continue, we would expect prices to find solid support at the 50% Fibonacci retracement of \$42.01.

**In summary, we recognise that the sheer quantum of negative sentiment that is currently prevalent seemingly everywhere is not going to disappear overnight. As long term investors however, we must weigh this against our view of the world and the fundamentals of each business that we consider for investment. As we have discussed above, we believe that the banks and their outlook are in considerably better shape than their current valuations suggest. So although we cannot say that they will not go lower from here in the short term, we are very confident that they will reward investors over the next 12-18 months.**

**We recommend ANZ, Westpac and CBA as buys. CBA is most interesting from an income perspective due to the proximity of its next ex date on the 15<sup>th</sup>.**

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## Snapshot ANZ

### The Banks

ANZ Banking Group provides a range of consumer banking, business banking, institutional banking, insurance and funds management services, mainly within Australia, New Zealand and the Pacific Islands. It also has a small but growing presence in Asia. Following the acquisition of NBNZ in 2003, ANZ has a substantial presence in New Zealand. Through its funds management joint venture with ING, ANZ holds a 49% stake in a substantial Australian funds management business.

### Market Capitalisation:\$47.8bn

	FY1	FY2
Price to Earnings	8.5	8.2
Dividend Yield (%)	7.7	8.1
Price to Book	1.3	1.2
Return on Equity (%)	16.5	16.2

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