Time to switch banks?

INTELLIGENT INVESTOR
SHARE ADVISOR

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A letter from the author

Dear Member,

It's been 22 years since Australia's last recession, a time in which investors in local property and bank stocks have been blessed. Strong population growth, low personal debt levels, cheap property, low interest rates, easy credit and an unprecedented resources boom delivered extraordinary returns. Where once returns from banks and property were considered utility-like investments, now they're seen as growth stocks.

The big four banks typically form the backbone of most Share Advisor member portfolios. I'm going to assume that's been your experience and that you've been a beneficiary of this development, one which has led to Australia's Big Four being ranked among the safest, most profitable and valuable banks on the planet.

The success of the sector creates its own problems. Perhaps you purchased Commonwealth Bank – market capitalisation $132bn – during its 1991 privatisation at $5.40 a share. Since then it has returned about 15% annually, an incredible performance. Who can blame investors that are reluctant to dispose of, or even sell down, a stock with such a track record?

WINDS OF CHANGE

This special report makes the case for doing just that, albeit with a twist. We're going to recommend you diversify your banking exposure, first by selling down your stakes in the big four, and then by purchasing two giants of the global financial system.

Here's the nub of the argument: Successful investing is a mixture of preservation and opportunity. At one price a company is a buy, at another a sell. What made the banks attractive investment candidates over the past 20 years no longer applies at current valuations.

The Australian economy faces a decade that could look very different from the past 10 years. Rather than be over-exposed to Aussie banks and property, this report will recommend to you a simple approach that could help increase your returns and reduce your risk.

And the catch? You'll have to sacrifice some fully franked dividends in favour of potential capital gains. If this notion seems far-fetched, please stop reading now and divert your attention to our other special reports. But if you are in the fortunate position to be able to make this trade-off, I think you'll find what follows extremely interesting.

This report will first analyse the Australian big bank landscape. The regional banks have been excluded, simply because they don't offer enough potential return given the additional risks. The banking system is now heavily tilted in favour of the big banks, which, with an implied Government-backed guarantee, can fund their operations more cheaply than smaller banks. In all probability, the majors will be protected from failure at the expense of the competition in a crisis.

We'll then make the case for diversifying your bank exposure overseas, before nominating two US banks to help diversify your bank shareholdings and profit from a lower Aussie dollar. If the winds from a slowing China blow harder than most expect, those that take action today will have some protection while others are panicking.

I hope you enjoy the report and profit from its contents.

Yours sincerely,

Nathan Bell
Research Director

Analysing the big 4 banks: A six-point checklist

Before we think about analysing banks abroad, let's analyse the health of the banking industry at home.

> ***Collectively, the big banks now write more than 80% of loans in Australia.***

If there's one thing to understand about banks it's that they're a leveraged bet on the economy. Should the economy perform well, so will the banks. But without support in a crisis poorly managed banks can quickly sink. When confidence evaporates, so do deposits.

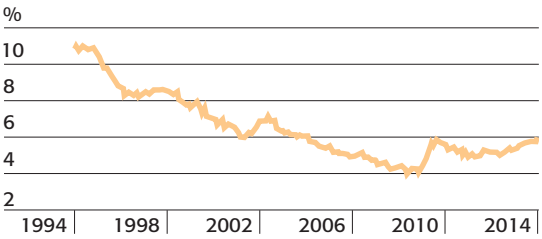
Banks are universally complex and individually intricate. No one bank looks exactly like another and banks in different countries face different challenges. During the GFC, mortgages-gone-bad and derivatives effectively rendered US banks insolvent. In Australia, the weak link was our reliance on flighty short-term wholesale debt provided by foreign banks.

So in analysing any bank, one first needs to consider the macroeconomic environment and then the particular issues facing each bank, before concentrating on valuation. The place to start, then, is at the top.

(1) ECONOMIC SNAPSHOT

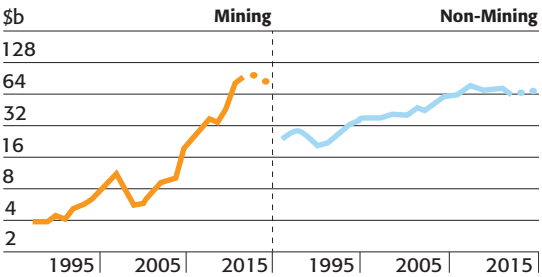
The goldilocks Australian economy is facing its biggest challenge in over two decades. Despite the resources boom, unemployment has reached a level not seen in a decade (see Chart 1). Jobs are being slashed in the media sector, the resources industry, the automobile and other manufacturing industries.

CHART 1: UNEMPLOYMENT RATE



Source: ABS

CHART 2: CAPITAL EXPENDITURE – MINING AND NON-MINING

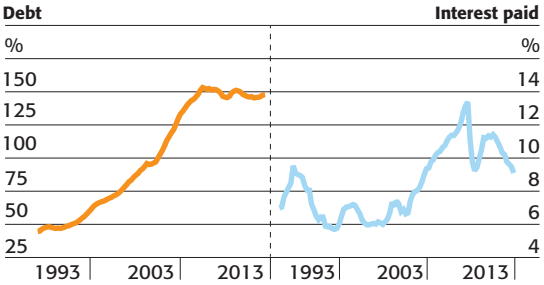


* Sample of firms' spending plans: dots represent the survey's most recent estimates for 2013/14 and 2014/15 adjusted for historical realised spending

Source: ABS; RBA

As China's growth slows and the current crop of massive resources and energy projects are completed (see Chart 2), it's unlikely other parts of the Australian economy will be able to fill the gap, even if the Aussie dollar falls significantly. With consumer debt levels ranking amongst the highest in the world (see Chart 3), if China's miracle economy sneezes then Australia could catch pneumonia.

CHART 3: HOUSEHOLD FINANCES*
(% OF HOUSEHOLD DISPOSABLE INCOME)



*Household sector excludes unincorporated enterprises; disposable income is after tax and before the deduction of interest payments

Source: ABS; RBA

Many miners and engineers earning two or three times more than they otherwise might have been without a resources boom won't be able to find similarly profitable work. And some families that are repaying mortgages with two incomes may have to make do with one.

Despite record low interest rates, current mortgage repayment schedules don't provide much wiggle room for these types of challenges. Ratings agency Fitch reported last year that Australians still spend a third of their income on mortgage repayments, compared to 16% and 17% in the US and UK respectively, down from a huge 44% in 2008.

Though we're cognisant of economist Paul Samuelson who once joked that Wall Street had predicted nine of the last five recessions, for the first time in over 20 years there's a genuine chance the economic glass could start looking half empty within a year or two.

(2) STRATEGY

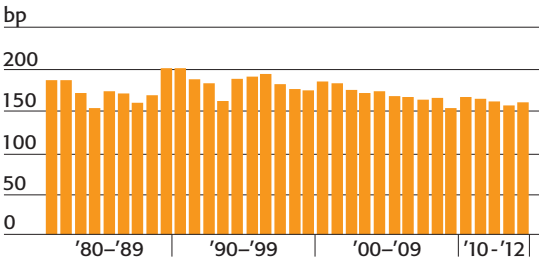
In contrast to the rest of the western world, the GFC was kind to Australia's major banks. Mergers, the withdrawal of foreign banks, the freezing of the mortgage backed securities market (see Securitisation pull out box), government support and investors looking for a safe place to park their money helped restore their oligopoly. Collectively, the big banks now write more than 80% of loans in Australia.

SECURITSATION

Securitisation is the ability to assemble a pool of loans and sell them to a third party. It allows smaller players to compete with large banks because they don't have to hold a large amount of capital on their balance sheets to protect against bad loans. When the securitisation markets shut during the GFC niche lenders were effectively unable to write loans because there were no buyers for the pools of mortgages.

Despite a raft of headwinds such as deregulation in the 80s, the recession in the early 90s, an influx of foreign banks, increased domestic competition from the likes of Aussie Homeloans and Rams, and a global financial crisis, return on assets (the true measure of a bank's profitability) before provisions has remained remarkably steady (see Chart 4).

CHART 4: PRE-PROVISION RETURN ON ASSETS (BP)



Source: Bank data

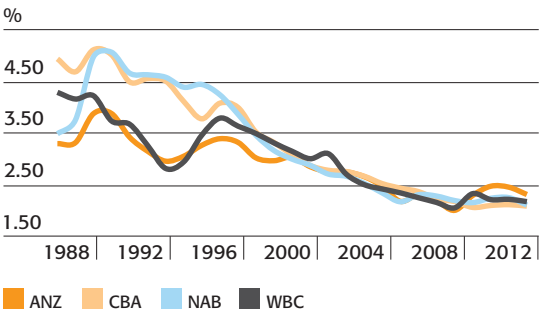
Despite recent efforts by **Macquarie Group** and thawing securities markets, which provide cheap finance to upstarts without large deposit bases, we expect the favourable industry structure to remain intact.

Despite enjoying a regulatory-sanctioned oligopoly at home, **ANZ** and **National Australia Bank** have expanded overseas. After suffering large losses NAB is winding down its problematic UK loan portfolios and we expect the company's UK banks to be offloaded at the first available opportunity.

ANZ's expansion into Asia has been relatively slow and steady, currently accounting for about 17% of total revenue, well below the company's aim of 25–30%. We suspect chief executive Mike Smith, due to move on in 2017, is under pressure from the board to move faster.

Interestingly, Smith recently sold $17m of his ANZ shares to buy an estimated $12m property in regional Victoria, suggesting he may hang around a little longer. But we'd hate to see his steady-as-she-goes approach tossed out in favour of a large, expensive acquisition just as China's economy is coming under more intense pressure.

CHART 5: AUSTRALIAN MAJOR BANKS' NET INTEREST MARGINS



Source: Company Data

In summary, we prefer **Commonwealth Bank**'s and **Westpac**'s strategy of milking their regulatory sanctioned advantages in Australia. And we prefer the big four to the regional banks that haven't been nearly as profitable or resilient and don't enjoy the advantages of the big four.

Unlike US banks, there's not much scope for net interest margins to increase.

MORTGAGE INSURANCE

Lenders' mortgage insurance protects your lender in the unfortunate event of you defaulting on your home loan. When lenders agree to lend a customer money, there is a small risk that they won't get the money back if the customer is not able to meet the repayments. Although they have the house as security, if property values decline that security may not be enough to cover the outstanding loan when the lender comes to sell it.

This insurance helps lenders broaden the net of who they are able to lend to by taking some of the risk out of lending the money. It means that more people are likely to get a loan and the home they want sooner.

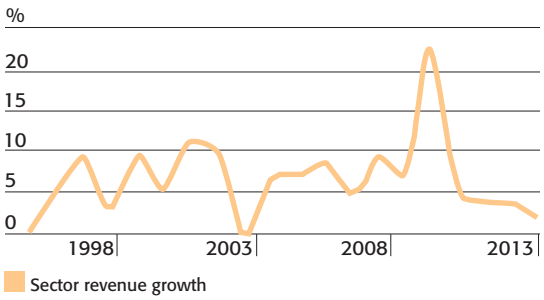
Source: QBE Lender's Mortgage Insurance

(3) NET INTEREST MARGINS

Net interest margin is the difference between what a bank charges when making loans (think mortgages and credit cards) and the rate it pays for funding (borrowings and deposits). Net interest margins have been declining since deregulation in the 80s (see Chart 5), but have more recently stabilised.

The reasons for this stabilisation are manifold. First, the GFC entrenched the big four's oligopoly as weaker competitors offering cheaper home loans were chopped off at the knees when securitisation markets froze.

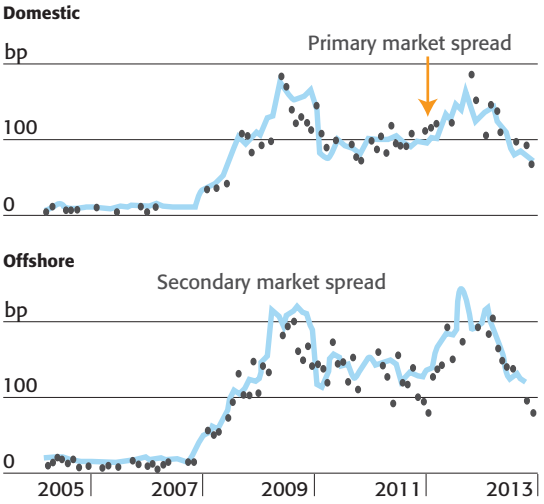
CHART 6: MAJOR BANK AGGREGATE REVENUE GROWTH (%)



Source: Bank Data

Second, the banks have been cutting costs and increasing fees to offset the impact of slow credit growth on their top line (see Chart 6). And lastly, wholesale funding costs have been falling as confidence returns to credit markets (see Chart 7). Foreign investors have been tripping over themselves to earn higher interest in Australia, the so-called 'carry trade'.

CHART 7: WHOLESALE FUNDING COSTS IMPROVING



Source: APRA, Bloomberg, RBA

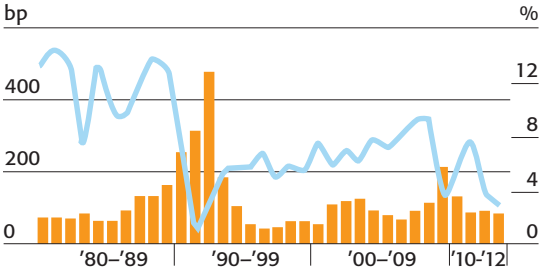
Unlike US banks, there's not much scope for net interest margins to increase. Cost cutting efforts are reaching their limit, borrowing costs are already low, and because of Australia's high consumer debt levels, high property prices and increasing unemployment, low interest rates aren't likely to produce another major upswing in credit growth. Revenue growth should therefore remain muted, at least by pre-GFC standards.

The banks are now facing increased competition at the margin as securitisation markets reopen. Macquarie Group is ramping up its home lending business with Yellow Brick Road, for example. But net interest margins aren't the only area where things may currently be as good as they get.

(4) BAD DEBTS AND PROVISIONING

Another key reason the major banks have been increasing profits and dividends, despite relatively weak revenue growth, is falling bad debts (see Chart 8). Although the current level of bad debts looks high by historical standards, in absolute dollar terms, as a percentage of loans they're very low. In 2013 bad debts totalled roughly $5bn, barely six months profit for Commonwealth Bank.

CHART 8: SECTOR BAD DEBT CHARGE (BP) VS GDP GROWTH (%, Y/Y)

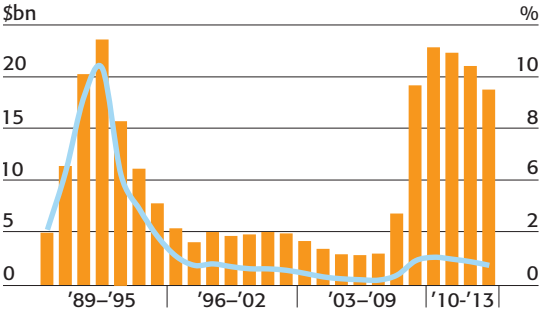


Sector BDD charge (bp of net loans) (LHS)
GDP growth (%, y/y) (RHS)
Source: Bank reports

The ability to accumulate capital quickly is one of the key advantages that the big four have over smaller regional banks. In combination with capital raisings, their huge profits should enable them to earn their way through virtually any downturn. If things got really bad we'd expect the government to step in, either offering direct financial assistance or financial guarantees as in the US. This might not save investors but the banks survive.

> ***If things got really bad we'd expect the government to step in, either offering direct financial assistance or financial guarantees as in the US. This might not save investors but the banks survive.***

CHART 9: AUSTRALIAN MAJOR BANKS' IMPAIRED ASSETS



Impaired Assets (LHS)
Impaired Assets % Total Loans (RHS)
Source: Credit Suisse

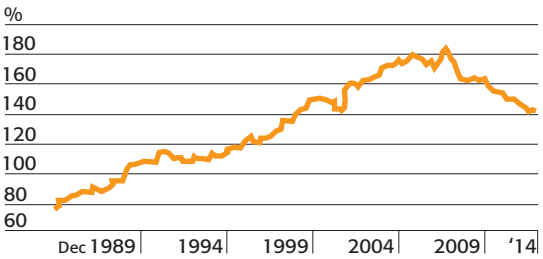
The level of impaired assets, currently around 2009 levels (Chart 9), is more troubling. A decent chunk relates to National Australia Bank's problem real estate loans in the UK, which is partly why we haven't upgraded the company since 2004. But it's surprising they haven't fallen further since the GFC given high employment levels and low interest rates.

The chart eloquently shows how things could turn ugly if there was an economic shock, although for the moment they remain under control. The current $18bn of impaired assets is falling and represents about nine months worth of profits for the major banks. But the threat is there, if not broadly recognised.

(5) BALANCE SHEET – FUNDING

It would be remiss not to acknowledge the great strides the major banks have made in reducing their reliance on flighty, overseas wholesale funding by increasing domestic deposits (see Chart 10).

CHART 10: SECTOR LOAN-TO-DEPOSIT RATIO (%)

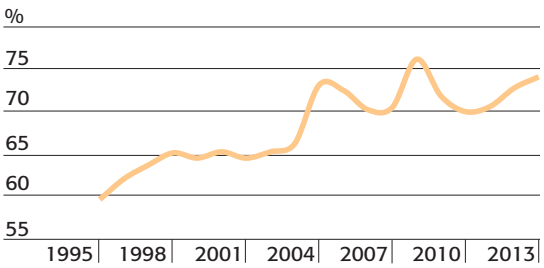


Bank Loan-to-Deposit Ratio (%)
Source: Bank data

Over the past five years the increase in deposits has funded credit growth, reducing the banks' need to increase debt. This is a healthy development that reduces investment risk.

Because Australia suffers from a savings deficit, the loan-to-deposit ratio of the major banks remains high by foreign standards. The ability to attract foreign capital is therefore vital, but the strong and stable property market and economy has meant the major banks remain far more leveraged than their foreign counterparts. We'll discuss this issue in more detail in the next section.

CHART 11: MAJOR BANKS' AVERAGE DIVIDEND PAYOUT RATIO



Source: Credit Suisse

Rather than build capital to protect against a downturn, the major banks have been increasing the proportion of profits paid as dividends (see Chart 11). Mike Smith rightly criticised the rules that prevent banks from holding more profit back to protect against future bad debts, but those hoping for more special dividends and share buybacks may be disappointed.

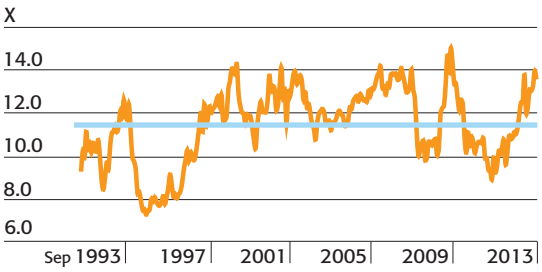
The uncertainty surrounding future capital requirements and the proposed inquiry into the financial system, led by ex-Commonwealth Bank CEO David Murray, is holding these capital initiatives back.

(6) VALUATION

So far we've concluded that the Australian economy is about to face its biggest challenge in over two decades and that credit growth is likely to stay low, along with interest rates. Meanwhile profit margins, bad debts and borrowing costs are about as good as they could be. The potential for shareholder friendly moves such as special dividends and share buy backs is also limited. The question is whether these factors are accounted for in the banks' share prices.

> ***Whilst the past 20 years gives the appearance of banks being defensive investments, they are in fact highly cyclical. The fact that Australia hasn't faced a recession in over 20 years merely disguises that fact.***

CHART 12: BANKS SECTOR 12MTH FWD PE



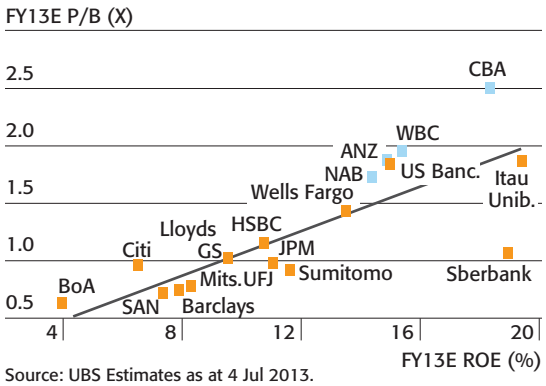
Source: IBES, Reuters

Price-to-book ratios for the big four are at the top end of their historical averages (see Chart 12 and 13). To add any big bank stocks to our buy list would require some hefty share price falls, despite the relatively attractive dividends.

The important fact to remember, though, is that whilst the past 20 years gives the appearance of banks being defensive investments, they are in fact highly cyclical. The fact that Australia hasn't faced a recession in over 20 years merely disguises that fact.

The structure of our model Income Portfolio embodies this thinking. With a combined 5% position, evenly split between Commonwealth Bank and Westpac, we're light on banks. Our recommended portfolio weighting to the sector is just 10% but, with plenty of opportunities elsewhere, our income portfolio is delivering nice returns without taking on the risks of over-exposure to the banks.

CHART 13: AUSTRALIA BANKS – VERY PROFITABLE AND EXPENSIVE



Source: UBS Estimates as at 4 Jul 2013.

But from feedback we know that many members still allocate far more of their portfolio to the big banks. Their reluctance to sell, though, isn't down to attractive yields or a reluctance to accept the inherent risks in the sector. No, the problem of finding suitable portfolio replacements for lower banking exposure is the big issue.

That's why, in the next section, we're going to compare the big four banks with some US banks. Then we'll introduce two stocks to help diversify your bank holdings and potentially increase your returns.

Five reasons to diversify overseas

Having analysed the Australian banking sector, let's test the case for diversifying overseas.

TABLE 1: THE CASE FOR INTERNATIONAL STOCK EXPOSURE

ARTICLE/PUBLICATION
A world of opportunity: Your overseas investing survival guide Part I and II – 6/10/09
The Coming China Crash – 31/12/11
Ripe for the picking: 8 overseas stocks to buy now – 28/6/12
Overseas Stock Opportunities 2012 Part I and II – 3/7/12
The China Crisis is here: What now? Part I and II – 19/9/12
Ripe for the picking: Overseas stocks to buy now – 17/10/12
Overseas Stock Opportunities 2013 Part I and II – 29/10/13
Stocks to profit from a lower Aussie dollar – 3/7/13

As a general strategy to take advantage of the strong Aussie dollar and to protect your portfolio from slowing Chinese growth, we've long recommended you diversify your portfolio overseas (see Table 1). That argument is even stronger when it comes to local banking exposure.

Our analysis will focus on the United States, but many of the arguments we'll make also apply to European, UK and Irish banks, all of which are still healing from the GFC. Let's start again at the top.

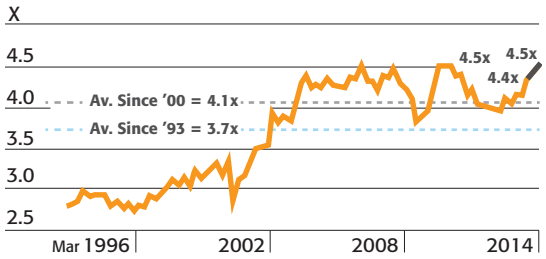
(1) US IN RECOVERY MODE, AUSTRALIA FACING CHALLENGES

In contrast to the Australian economy, which potentially faces a marked slowdown just as housing prices and consumer debt levels are approaching pre-GFC peaks (see Chart 1 and 2), the US economy is still in recovery mode.

After crashing to nearly 400,000 from a peak of over 2.2m, US housing starts are finally approaching the long term average of around 1.2m (see Chart 3 over the page).

Higher interest rates have recently slowed home loan demand, but if Smead Capital's contrarian call is correct, we're only at the beginning of a generational increase in housing starts (see *US Stocks for a Baby Boom*).

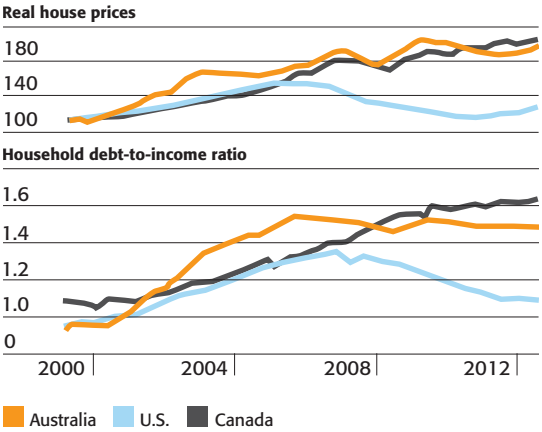
CHART 1: AUSSIE HOUSING IS CLEARLY OVERVALUED … AVERAGE DWELLING PRICE DIVIDED BY AV. DISPOSABLE INCOME PER FAMILY



Source: Rismark. ABS. RP Data. AFR

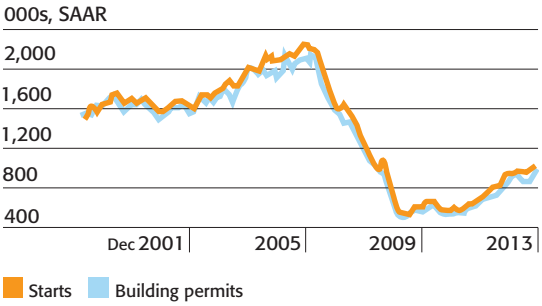
> ***Higher interest rates have recently slowed home loan demand, but if Smead Capital's contrarian call is correct, we're only at the beginning of a generational increase in housing starts.***

CHART 2: REAL HOUSE PRICES AND HOUSEHOLD DEBT-TO-INCOME RATIO



* Shown rebased to January 2000 = 100.
Source: OECD data

CHART 3: HOUSING STARTS AND BUILDING PERMITS 3-MONTH MOVING AVERAGE (US)



Source: Census Bureau; updated 1/17/14

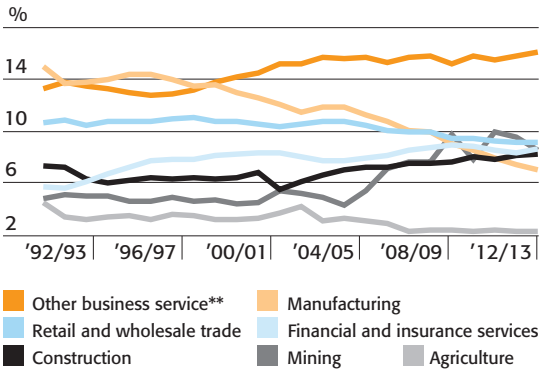
Smead Capital counts US banking giants Wells Fargo, Bank of America and JP Morgan among its largest positions, believing those aged 18-37, so called echo-boomers, are about to ignite a baby boom after delaying major life decisions during the GFC. This could spawn a wave of demand for cars, homes and all sorts of other products.

If interest rates and home prices remain relatively low and employment keeps increasing, strong demand for housing could create a virtuous circle where unemployed blue-collar workers rejoin the workforce, creating yet another wave of housing demand.

Shale gas is also reducing the cost of energy and production in the US, triggering a mini-manufacturing renaissance. Companies with production facilities abroad are increasingly closing them down to open factories in the US, creating new jobs and improved productivity. As the US economy has a much larger and more diversified services sector than Australia, and because we've become highly reliant on the highly cyclical mining industry since 2004 (see Chart 4), US banks should be less affected if China's economic miracle becomes a mirage.

The next question is how far the Aussie dollar might fall in the event of a China slowdown or crash. No one can really say but breaching the lows seen during the GFC (see Chart 5) is surely a possibility. As lenders to the major Australian banks demand their money back, or charge higher interest rates, who wouldn't want to own a few shares in some strong US banks?

CHART 4: INDUSTRY SHARE OF OUTPUT (AUS)

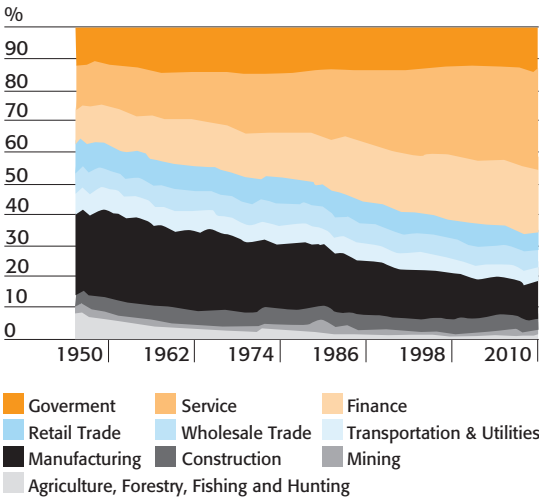


*Nominal gross value added

**Includes: information media and telecommunications; rental, hiring and real estate services; professional, scientific and technical services;

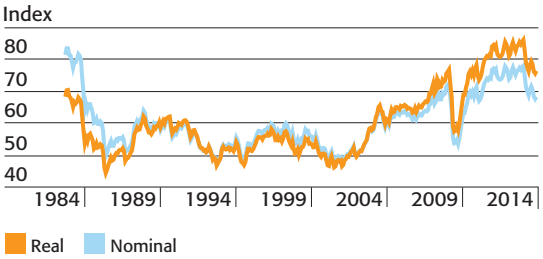
Source: ABS

PROPORTION OF US GDP BY SECTOR: 1947 TO 2011



Source: US BEA

CHART 5: AUSTRALIAN DOLLAR TWI*

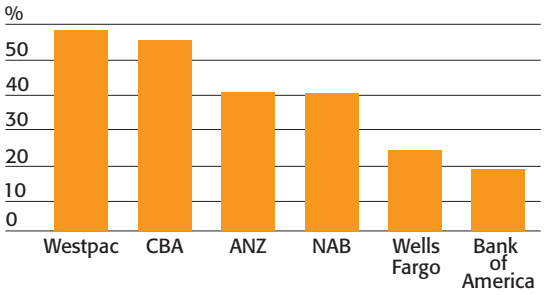


*May 1970 = 100 for nominal; real indexed to equate post-float avgs
Source: ABS; RBA; Thomson Reuters; WM/Reuters

(2) US BANKS LESS EXPOSED TO MORTGAGES

For all the talk of the dangerous role played by investment banks and derivatives in our financial system, it's good ol' fashion housing busts that generally do the most damage to banks and economies. Americans generally choke on their cronuts when they hear how exposed our major banks are to property (see Chart 6).

CHART 6: HOUSING LOANS AS A PROPORTION OF TOTAL ASSETS



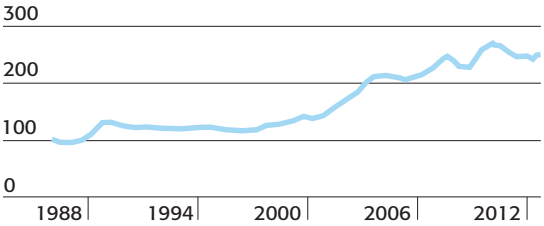
Source: Bank data

This is partly a response to the early 90s recession when **ANZ**, for example, suffered massive losses from its exposure to small and medium sized businesses (see *ANZ: It's different this time*). **Westpac** also needed bailing out. As these problems weren't steeped in the housing market, more aggressive lending to it was viewed by the banks as a safer course to increase profits and dividends.

> ***US banks Wells Fargo and Bank of America are much more diversified and less reliant on property than Australia's major banks. The US banks also aren't as reliant on flighty sources of funding that can vanish in a crisis.***

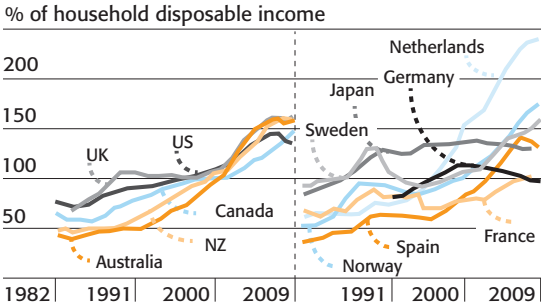
CHART 7: ABS REAL HOUSING PRICE INDEX

1986–2013 (1986 = 100)



Source: ABS

CHART 8: HOUSEHOLD DEBT



Source: National sources

And the banks have largely been proved correct in their thinking, as shareholders would claim. But there's a difference. In the 90s houses weren't dramatically overpriced and mortgage debt levels were low (see Chart 7 and 8). That argument isn't so easily mounted now. If house prices dropped significantly, the current level of mortgage debt would likely trigger dilutive capital raisings and widespread pain throughout the economy. Australians already spend a third of their earnings on mortgage repayments even though interest rates are plumbing record lows. That figure is twice what the average US and UK homeowner spends.

As for ANZ in particular, it has captured the hearts and minds of many investors because of its clearly laid out Asian expansion. But given Asia's economic woes will directly impact Australia, ANZ won't provide geographic diversification as might investing in US banks.

In summary, US banks Wells Fargo and Bank of America are much more diversified and less reliant on property than Australia's major banks. The US banks also aren't as reliant on flighty sources of funding that can vanish in a crisis.

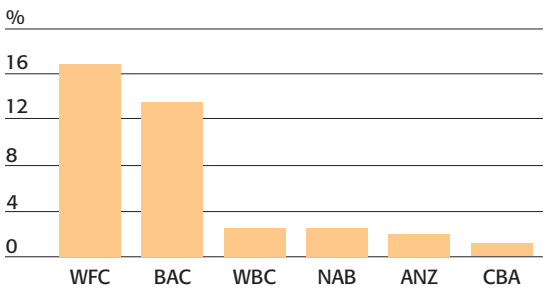
(3) HIGHER INTEREST RATES MIGHT HELP RATHER THAN HINDER US BANKS

Earlier, we explained how net interest margins were under pressure in Australia. While many fear the impact of tapering (an end to money printing) in the US, higher interest rates could actually be of benefit to US banks.

If interest rates normalise without suffocating the economy, it may signal that the economic recovery is sustainable. Confidence would likely increase, as would the demand for credit and homes. Revenue, margins and profits across the banking sector could increase significantly.

Even without this bullish scenario, US banks can benefit due to the huge pool of non-interest bearing deposits (see Chart 9). All things being equal, as interest rates on loans increase, margins fatten because money on deposit paying zero interest isn't increasing at the same time. Mark Curnin of White River Capital estimates Wells Fargo's earnings could increase 25% if net interest margins returned to normal, even after allowing for a 1% increase in bad loans.

CHART 9: NON-INTEREST-BEARING DEPOSITS AS A % OF TOTAL FINANCING



Source: Bank data

> ***Australia's major banks are also far more leveraged than their US brethren. Instead of retaining profits for a rainy day … they've been increasing the amount of profits paid as dividends.***

(4) BAD DEBTS, BALANCE SHEETS AND REGULATORY CAPITAL LEVEL CONCERNS OVERPLAYED

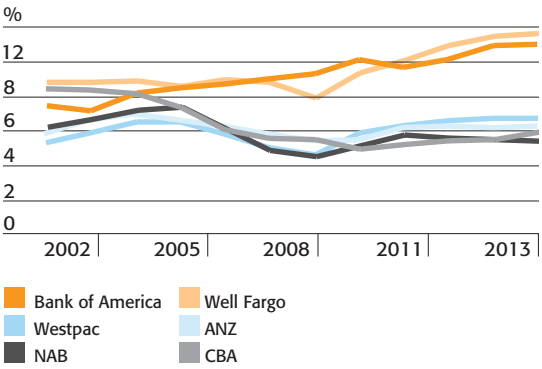
Many value investors have sworn off investing in banks since the GFC because of the uncertainty surrounding litigation and bad debts, or because they consider banks to be black boxes.

And yet, as they have in Australia, the big US banks have improved their market positions since the GFC. Market shares have increased, regulatory capital ratios have never been stronger and bad debts are falling rapidly. And we know that litigation payouts will eventually decline. Should that happen whilst interest rates, housing starts and employment are rising (a bullish scenario to be sure, but not impossible) then earnings, dividends and valuations across the banking sector should increase substantially.

This would be in stark contrast to the recent performance of Australia's major banks, which have been relying on unsustainable factors such as falling bad debts and cost cutting to increase earnings and dividends.

Australia's major banks are also far more leveraged than their US brethren (see Chart 10). Instead of retaining profits for a rainy day – a sensible approach given high consumer debt levels – they've been increasing the amount of profits paid as dividends, making the major banks more susceptible to an economic shock at this point in the cycle.

CHART 10: SHAREHOLDERS' EQUITY AS A % OF TOTAL ASSETS



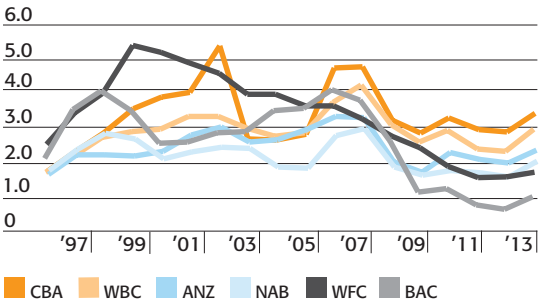
Source: Bank Special Report

(5) CHEAP VALUATIONS

If none of these factors entice you to consider sacrificing some fully franked dividends, by selling down Australian banks and directing the money to US banks, we have one very attractive card up our sleeve to convince you.

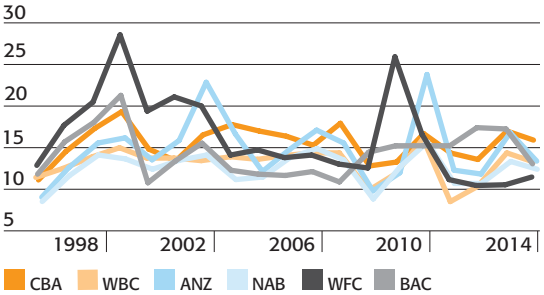
Since the GFC the return on equity ratios of Australia's major banks have been in a parallel universe, a fact better reflected in valuations that are high by international and historical standards (see Chart 11 and 12). Remember, US bank profits are depressed by low interest rates and high litigation costs, particularly in the case of Bank of America.

CHART 11: PRICE TO TANGIBLE BOOK



Source: Bank special report

CHART 12: PRICE TO EARNINGS RATIOS



Source: Bank special report

The large gap between Wells Fargo's and **Commonwealth Bank**'s respective price-to-earnings ratios of 12 and 16 is also hard to fathom. Wells Fargo is substantially more profitable dollar-for-dollar based on return on assets (1.5% v 1.1%). And its return on tangible equity of 17% is not that far behind Commonwealth's ratio of 22%, despite being half as leveraged measured by shareholders equity to total assets.

Given the additional potential benefit from a lower Aussie dollar, the ducks line up for Aussie bank investors to diversify into the US banking sector. But even if the disaster scenario of a China crash does not play out and the Australian economy keeps chugging along, current valuations suggest that, unless credit growth rises substantially, future returns for bank shareholders are unlikely to be anything like they have been in the past.

Given the high consumer debt levels, increasing unemployment and the coming massive fall in mining and energy expenditure beyond 2015, the 'looming problem' scenario seems more likely than 'business as usual', which is why in the next section we'll analyse two staples of the US banking sector, Wells Fargo and Bank of America.

Wells Fargo: the CBA of the USA

Unlike most large banks that suffered immensely from the GFC, Wells Fargo saw opportunity in the crisis, and used it to set new profit records.

**All values quoted in USD.*

'[I]n the wake of the financial crisis' says Mark Curnin of White River Capital, 'even the best banks were priced as if they would never fully recover. Investors tend to try to diffuse bombs after they've already gone off.'

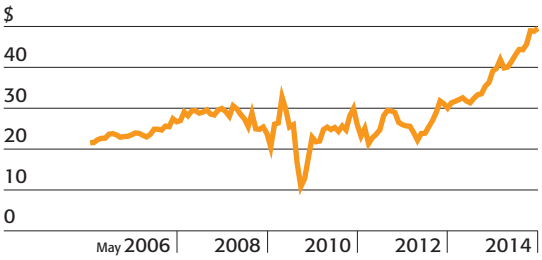
KEY POINTS

- Wells is a better business than it was pre-GFC
- By absolute and historical measures, it's cheap
- Appropriate for conservative investors, portfolio allocation up to 8%

Many value investors said 'never again' to investing in banks after the GFC. How else to explain why Wells Fargo – a vanilla US retail bank with minimal investment banking exposure – still trades on a price-to-earnings ratio (PER) of 12.

Many value investors said 'never again' to investing in banks after the GFC. How else to explain why Wells Fargo – a vanilla US retail bank with minimal investment banking exposure – still trades on a price-to-earnings ratio (PER) of 12.

CHART 1: WELLS FARGO SHARE PRICE



Source: Yahoo! Finance

The company's performance, however, tells a different story. Since the peak of the credit boom Wells Fargo has increased earnings per share (EPS) by 62%. Since 2009, the height of the GFC, EPS has grown four-fold. And despite distributing a lower proportion of its profits as dividends, dividends per share is at pre-GFC levels. Return on tangible equity stands at 17% and regulatory capital ratios are at record levels. No wonder the company is buying back shares.

REAR VIEW MIRROR

Investor disdain for Wells Fargo seems to be a classic case of recency bias, where investors extrapolate the recent past into the future. Placing more value on recent events at the expense of a longer, broader history is understandable, but it's also a prescription for short-term thinking and poor investment performance.

So, let's dispense with the recent past, one in which the bank dealt admirably, and move beyond the obvious recovery story to something more meaningful. The company's overall strategy, its secret sauce if you will, is explained thus:

"Going for gr-eight." Our average retail banking household has about six products with us. We want to get to eight … and beyond. One of every four already has eight or more. Four of every 10 have six or more. The average banking household, for example, has about 16 products. Our average wholesale bank relationship has six products with us and our average commercial bank relationship, eight. Our wealth management, brokerage and retirement customers lead the pack with an average of 10 products per customer.

Mark Curnin notes the bank's 'leading U.S. market positions in all their key businesses. They're #1 in the servicing and origination of mortgages. They're the #1 small-business lender. They're the #1 auto lender, commercial real estate lender and middle- market commercial lender. They have the largest bank-owned insurance brokerage, are very strong in corporate trust and treasury-management services, and operate the second-largest retail brokerage, Wells Fargo Advisors, with 15,000 advisors and $1.6 trillion under custody.'

Let's put that in perspective. **Commonwealth Bank** leads the Australian market selling, on average, 2.8 products to each customer. Why the difference? Wells Fargo's remarkable success rests on a simple and sustainable philosophy of satisfying its customers, a novel concept that Australia's banking cartel might one day consider. For investors fearful of investing in foreign banks, Wells Fargo's performance and philosophy should provide plenty of comfort.

GOLDEN OPPORTUNITY

In October 2008, Wells raised $20bn of new stock to acquire east-coast rival Wachovia for $15bn. The deal transformed Wells from a hometown hero on the US West Coast to a national champion. Because Wachovia didn't come with the subprime loan problems that besieged other merger partners during the GFC, it has recently been lauded as one of the best-ever acquisitions, helping Wells to recently report the largest ever US bank profit.

With a market value of $239bn, Wells Fargo is now the largest US bank. That fact appears not to have gone to management's head. Chief executive John Stumpf recently said, 'I've never met a customer yet who said, "I want to bank with you because you're so big I can just be a number."'

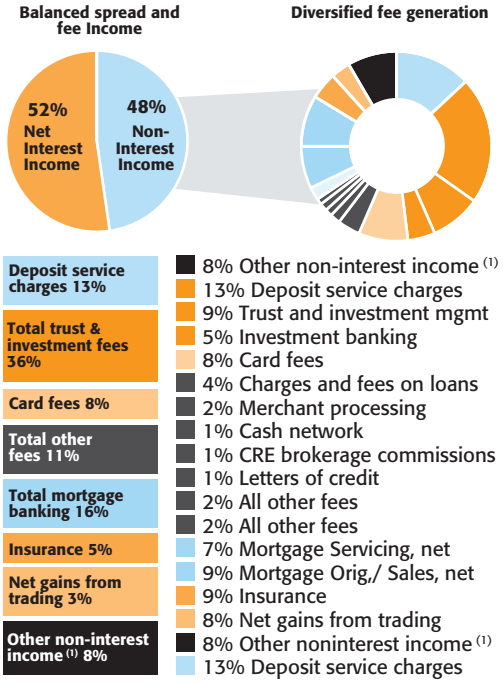
Wells' financial performance belies its formidable competitive advantages and cheap valuation. Revenue, earnings and dividends have been increasing steadily since the GFC (see Table 1).

TABLE 1: KEY FINANCIALS

YEAR TO 31 DEC	2010	2011	2012	2013	2014F
REVENUE ($M)	69,342	73,066	78,839	81,456	83,986
NET PROFIT ($M)	12,362	15,869	18,897	21,878	23,000
EPS ($)	2.21	2.82	3.36	3.89	4.04
PER (X)	22.6	17.7	14.8	12.9	12.4
DPS ($)	0.20	0.41	0.78	1.15	1.40
DIVIDEND YIELD (%)	0.4	0.8	1.6	2.3	2.8

Wells' return on assets, the best measure of a bank's profitability, at 1.5% trounces Commonwealth Bank's 1.1% in 2013. That's because Wells produces far higher net interest margins (3.5% versus Commonwealth's 2.1%) from a more diversified mix of products and services (see Chart 2).

CHART 2: STRONG REVENUE DIVERSIFICATION IS KEY



All data is for 4Q13.
(1) Other non-interest income includes net losses on debt securities, net gains from equity investments, lease income, life insurance, investment income and all other non-interest income.

Source: Financial Services Forum

The only reason Commonwealth Bank's return on tangible equity is higher (22% versus 17%) is because its equity is leveraged 20 times (measured by total assets divided by shareholders equity), more than twice Wells' ratio of nine.

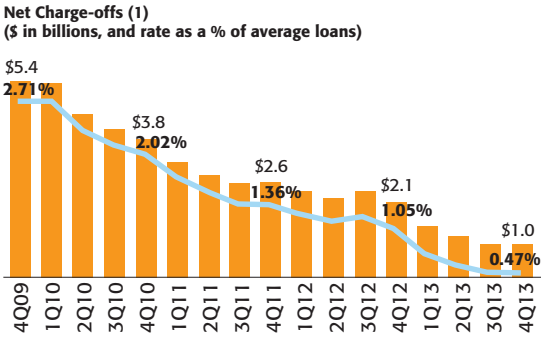
Let's put that in perspective. A 5% fall in the value of Commonwealth Bank's assets would wipe out its equity. For Wells, that figure is 11%. These facts, in combination with surviving a recent housing crash of biblical proportions, makes Wells Fargo the safer investment. Commonwealth is yet to contend with a large fall in property prices.

The only reason Commonwealth Bank's return on tangible equity is higher (22% versus 17%) is because its equity is leveraged 20 times (measured by total assets divided by shareholders equity), more than twice Wells; ratio of nine.

A WELL OF CAPITAL

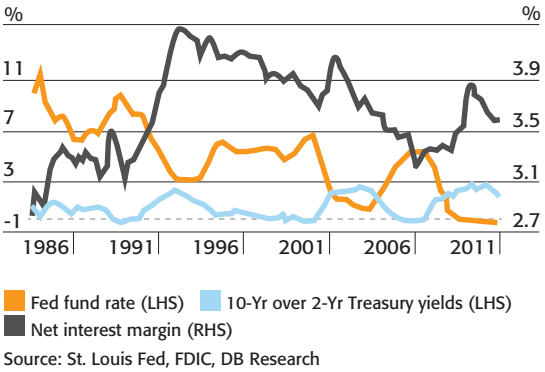
Wells' bad debts are also falling (see Chart 3). Plus the company isn't facing litigation costs in the same way as is Bank of America, for example. In fact, Wells Fargo is awash with capital.

CHART 3: CREDIT QUALITY TRENDS CONTINUED TO IMPROVE



Source: Financial Services Forum

CHART 4: INTEREST MARGIN FOLLOW THE YIELD CURVE



Source: St. Louis Fed, FDIC, DB Research

As a systemically important financial institution (the horrendous acronym is SIFI) with capital ratios at record highs, there are no major problems with annual stress tests. Unlike rival Citigroup, for example, Wells isn't being tightly restrained from returning capital to shareholders through dividends and share buybacks. In fact, Wells recently received approval to buy back 350m shares valued at around $17bn. At current prices, this move creates plenty of value for shareholders.

Wells also stands to benefit from higher interest rates, providing they don't choke the economy. Curnin estimates that if net interest margins return to normal (see Chart 4), even after allowing an extra percent of loan losses, it could add another dollar to earnings per share, reducing the PER further to 10.

REGULATION

The threat of increased regulation has kept many investors on the sidelines but if it needed to, Wells could easily top up its capital if regulations required it. In addition, the company's investment banking activities are quite limited.

Increased regulation is having a larger impact on smaller banks with short pockets because of the massive increase in compliance costs. Larger banks like Wells are thus at an advantage, offering more competitively priced products and services. This dynamic may also deliver acquisition opportunities, especially as bank earnings remain depressed and valuations based on price-to-book ratios are low by historical standards.

If this isn't enough to tempt you to look across the Atlantic for your next bank purchase, how about the prospect of joining Warren Buffett on the share register? Berkshire Hathaway owns a 9.3% stake in Wells that's been purchased over decades. Berkshire has been a regular buyer since the GFC and topped its holding up again last year.

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THE CBA OF THE US

Compared to most large banks in the US – think JP Morgan, Citigroup and Morgan Stanley – Wells is an old fashioned bank trying to sell as many regular products as possible to its army of satisfied customers. Were it an ordinary industrial company we'd expect its PER in the current environment to at least match its long term average of 14, not 12.

This is a bank that's been around for 162 years and we fully expect the well-known stagecoach logo to be around for decades more, earning more and more money as each year passes. For conservative investors looking to buy a best-of-breed financial franchise at a cheap price, they don't come any better than this.

Note: The 8% maximum portfolio limits we have for the major Australian banks are equally sensible for Wells Fargo, although more aggressive investors with a genuine long term view, assuming they understand the risks, might consider a higher limit.

Bank of America banks on Moynihan

Brian Moynihan copped a pasting in his first 18 months as chief executive of Bank of America. But the evidence suggests he was the right choice after all.

**All values quoted in USD.*

Being the sixth of eight children and co-captain of the Brown University rugby team may well have prepared Brian Moynihan for the challenges of becoming chief executive of what was then America's largest bank in January 2010.

KEY POINTS

- Riskier than Wells Fargo but with larger upside
- Recent share price fall is an opportunity
- Suitable for more aggressive investors

Moynihan had never run a major bank before and was criticised for lacking the charisma of someone like Jamie Dimon, the lauded chief of JP Morgan *[how this could be a bad thing seems hard to fathom – Ed]*. Few believed he could save Bank of America (stock ticker BAC) from a tidal wave of bad debts and GFC-related home loan litigation.

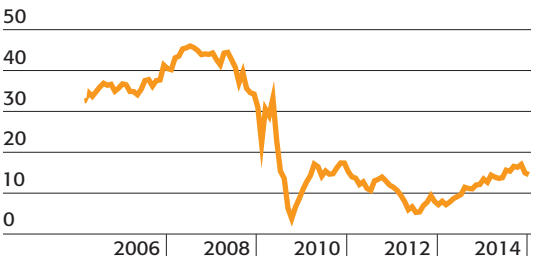
Then it got worse. Barely 18 months in the hot seat after declaring the bank had enough capital, two weeks later Moynihan issued $5bn of preference shares on highly favourable terms to Warren Buffett. It was a move that was rightly criticised.

Frustrations boiled over just weeks later when the company announced debit cardholders would be charged a $5 monthly fee. The decision was reversed after account closures reportedly increased 20% over the next three months. In the US apparently, competition still works.

To say that Moynihan endured an inauspicious beginning would be putting it mildly. The bank's share price plummeted from around $15 when Moynihan took over to just $4.92 on 19 Dec 2011 as investors feared an economic collapse in Europe (see Chart 1). The recovery since then reflects a mix of reduced fear surrounding the global economy and Moynihan's simple, sensible and successful approach. Let's count the ways.

To say that Moynihan endured an inauspicious beginning would be putting it mildly. The bank's share price plummeted from around $15 when Moynihan took over to just $4.92 on 19 Dec 2011 as investors feared an economic collapse in Europe.

CHART 1: BANK OF AMERICA SHARE PRICE



Source: Yahoo! Finance

First, he halted the acquisition binge. At $154bn BAC is America's second largest bank, a position it acquired through countless mergers and acquisitions over the past 100 years. The GFC purchases of sub-prime home lender Countrywide Financial and investment bank Merrill Lynch only served to add complexity, laced with a litigation cocktail nightmare.

Taking a leaf out of Wells Fargo's book, Moynihan has been prepared to shrink the financial giant to focus on what the company is good at – servicing the day-to-day financial needs of ordinary Americans. Since 2010 BAC has sold $70bn of 'non-core' businesses.

Taking a leaf out of Wells Fargo's book, Moynihan has been prepared to shrink the financial giant to focus on what the company is good at – servicing the day-to-day financial needs of ordinary Americans. Since 2010 BAC has sold $70bn of 'non-core' businesses.

TABLE 1: KEY FINANCIALS

YEAR TO 31 DEC	2010	2011	2012	2013	2014F
REVENUE ($M)	81,785	78,844	73,565	85,386	89,313
NET PROFIT ($M)	(2,238)	1,446	4,188	11,431	14,835
EPS ($)	(0.37)	0.01	0.26	0.94	1.22
PER (X)	N/A	N/A	26.2	15.5	12.0
DPS ($)	0.04	0.04	0.04	0.04	0.04
DIVIDEND YIELD (%)	0.3	0.3	0.3	0.3	0.3

BAC also sold its remaining shares in China Construction Bank late last year for over $20bn (the investment originally cost $17bn) showing the company's ambitions now sensibly lay at home where it's dominant.

This contrasts with the international ambitions of **ANZ** and **National Australia Bank** here at home. Even **Westpac** and **Commonwealth Bank** are getting in on the act now, expanding in Asia from a small base despite their complete lack of competitive advantages abroad.

LITIGATION

Second, Moynihan has dealt pragmatically with the litigation issue. Since 2010, BAC has paid or provisioned for $43bn in restitution, including an $8.5bn settlement for loans made by CountryWide Financial, which was twice what BAC paid for the company a year earlier. That eliminated a huge risk overshadowing the company. In retrospect, and perhaps Moynihan might have hoped at the time, it was a turning point.

Another leap forward occurred when management recently said 88% of the total cost of pending litigation had been resolved, the result of agreeing to pay $9.5bn to mortgage insurers Freddie Mac and Fannie Mae.

Where it maintains it behaved appropriately, BAC is still fighting in court. Management believes it could be on the hook for at least $9bn of further charges over and above its current provisions if this stance is unsuccessful, although it's impossible to estimate the final bill.

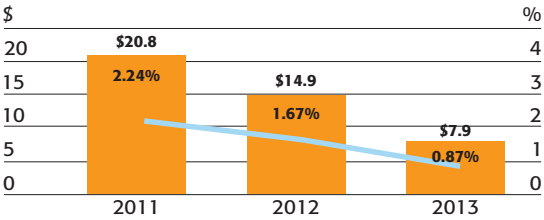
Should this discourage today's buyer? No, although given the share price it has clearly scared many investors away. Here's why: Last year, BAC's profit before litigation expenses and tax was $22.3bn. Additional settlements could take years, leaving the company plenty of time to earn its way out of any unfavourable verdicts.

REBUILDING THE SUPPORTS

Third, Moynihan has restored the capital base with BAC regularly passing the regulatory stress tests. The kerfuffle following the recent stress test is a storm in a teacup, as the company's capital ratios are now at record levels and long-term debt has almost been halved to $255bn over the past three years. That should provide the means to dramatically increase the dividend once its legal woes are resolved.

Problem loans are also falling rapidly (see Chart 2), showing how important the health of the economy in which a bank operates can be.

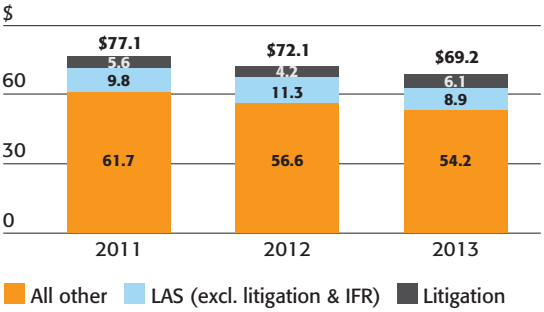
CHART 2: NET CHARGE-OFFS



Source: BAC Q4 Results

Fourth, Moynihan has been cutting costs. Non-interest expenses have fallen 10% over the past two years with cost reductions of $8bn targeted by 2015. Over 20% of non-interest expenses relate to the small army dealing with litigation and problem loans. Those costs too should shrink over time (see Chart 3).

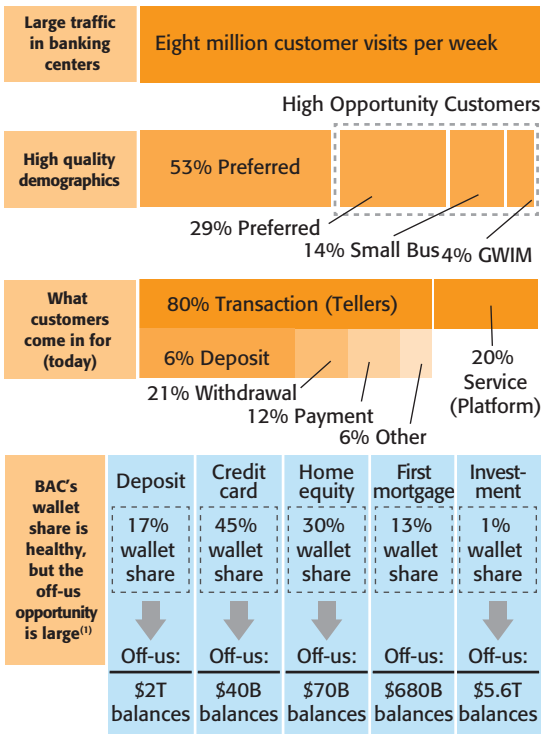
CHART 3: NON-INTEREST EXPENSE ($B)



Source: BAC Q4 Results

Lastly, BAC is following a similar strategy to Wells, aiming to increase the average number of products it sells to its legion of depositors (see Chart 4). Deposits have recently ticked up to $1.1tr bringing a constant flow of new customers. And because around a third of deposit accounts don't pay interest, BAC's net interest margins should improve when interest rates eventually increase, again assuming higher rates don't choke the recovery. BAC is also developing new services and technology as customers migrate online (see Chart 5).

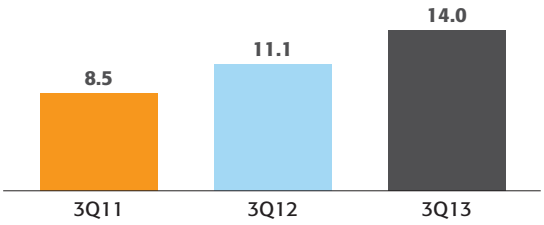
CHART 4: DEEPENING RELATIONSHIPS: LEVERAGING BANKING CENTER TRAFFIC



(1). Calculations based on population of BAC customers with a deposit relationship. Wallet share represents BAC's percent capture of these customers' overall balances held at all financial institutions(including BAC), while 'off-us' represents their total balances held at other financial institutions.

Source: BAC

CHART 5: INCREASING MOBILE BANKING USERS (MM)



Source: BAC

> ***At a current price-to-book ratio of 0.7 and with earnings depressed by many factors, all of which should fade as time passes, healthy returns are on offer in buying one of America's most valuable franchises.***

RESTORING HONOUR

Bank of America's complexity may keep conservative investors away, but that's partly why the stock is cheap. There's nothing magic about its strategy either. What is needed is time for it to bear fruit.

Should one or two things fall its way, BAC could produce earnings per share of around $2 in a couple of years, delivering a price-to-earnings ratio of seven. That would imply a return on equity of 10%, which should improve further over time.

The icing on the cake would be an end to the litigation (still years away), expanding net interest margins as interest rates increase, and a marked increase in dividends that truly reflect the company's underlying earnings power.

The ancient Roman poet Horace said, 'Many shall be restored that are now fallen and many shall fall that are now in honour.' Having fallen from grace during the GFC, the next decade should restore the fortunes of Bank of America and its shareholders.

At a current price-to-book ratio of 0.7 and with earnings depressed by many factors, all of which should fade as time passes, healthy returns are on offer in buying one of America's most valuable franchises.

Note: A 5–6% maximum portfolio limit would be recommended for most investors, but more risk tolerant investors might consider a higher weighting.

Disclosure: The author, Nathan Bell, owns shares in Bank of America.

Macro investing: A property price bubble?

Australia missed the US and European property market crashes. Has this left Aussie housing overpriced? Macro's Leith van Onselen investigates.

APPENDIX ARTICLE ▪ BY LEITH VAN ONSELEN ▪ FIRST PUBLISHED 19 MAR 2013

> ***Australia's population has grown well above average levels since the mid-2000s, whereas the rate of dwelling construction has hovered around average levels.***

The inexorable rise of Australian home prices over the past two decades has led to widespread debate about whether Australian housing is overvalued.

KEY POINTS

- The housing stock to GDP ratio suggests Australian housing is expensive
- Housing affordability has improved but risks are still high
- You can either pretend they're not, or do something about it

Surveys by *The Economist* and Demographia claim that Australian homes are amongst the most expensive in the English-speaking world—the former based on a price-to-rents methodology, the latter on house prices relative to incomes.

On the other hand, the Reserve Bank of Australia (RBA) acknowledges that Australian homes are far more expensive than they used to be, but considers them unexceptional by global standards. So who's right?

Cross-country comparisons of house prices against incomes and rents are inherently problematic. Country-to-country differences between the way incomes are calculated, the nature of house price data and a general absence of comparable and reliable rental data complicate matters.

All of these issues can be put aside by comparing the total value of a nation's housing stock against the size of its economy, or Gross Domestic Product (GDP). Most countries collect such data under the internationally agreed System of National Accounts. That makes it a far more accurate, but not perfect, tool for cross-country comparisons.

Australia's ratio of housing stock to GDP rose by over 50% from the mid-1990s, the result of strong house price appreciation that far exceeded growth in the wider economy, peaking at 3.3 times GDP in 2007 and 2010.

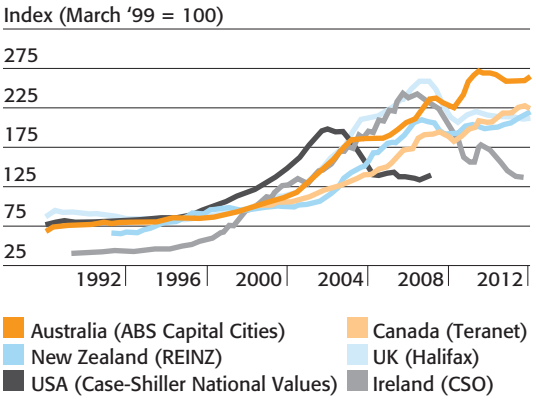
Australia's ratio has since fallen back to around 2.9 times GDP currently, similar to that of New Zealand's and the United Kingdom's. It is however considerably higher than ratios of the United States and Canada.

This simple measure of housing stock to GDP ratio confirms the view that Australian housing is relatively expensive by international standards. But it is by no means head and shoulders above everyone else's.

While Australian homes remain expensive, the combination of declining home prices, near record low mortgage rates and rising incomes has meant that housing affordability has improved significantly in recent years.

After peaking at around 11% in 2008, the share of aggregate (economy-wide) household disposable income eaten-up by mortgage interest payments declined to around 8% as at December 2012. Interest costs remain high by historical standards, however, as rising home prices over the past 20 years far outweighed the sharp reduction in mortgage rates.

CHART 1: HOUSE PRICE INDICES, 1988–2012



Source: www.macrobusiness.com.au

The situation is similar when initial principal and interest repayments on new mortgages are examined. Despite falling sharply since hitting an all-time high in 2008, repayments on a median priced house remain above their 40-year average.

DEMAND OUTSTRIPS SUPPLY

A common argument in support of Australian housing prices is that housing supply has failed to keep-up with population growth. There is some merit to this claim. Australia's population has grown well above average levels since the mid-2000s, whereas the rate of dwelling construction has hovered around average levels.

So how has the country managed to adapt? As Chart 2 shows, Australian households have adjusted to the lower rate of home construction by opting for group (share) housing.

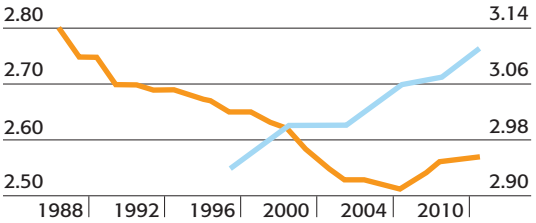
According to the 2011 census, the percentage of group households increased to 4.1% from 3.9% in

2006, whereas the percentage of single (lone person) households declined to 24.3% from 24.4%. ABS data confirms this trend, with the number of people per dwelling rising since 2006, while the number of bedrooms per dwelling has also been rising.

While the evidence confirms that housing supply *has* failed to keep up with population growth, it would be wrong to suggest that Australia's tight housing supply insulates homeowners against significant price falls.

Empirical evidence from abroad shows that housing markets facing restricted supply experience greater price volatility and have a higher propensity towards boom and bust price cycles than markets where supply is freely able to respond to changes in demand.

CHART 2: AUSTRALIAN HOUSING OCCUPANCY DATA, 1988–2010

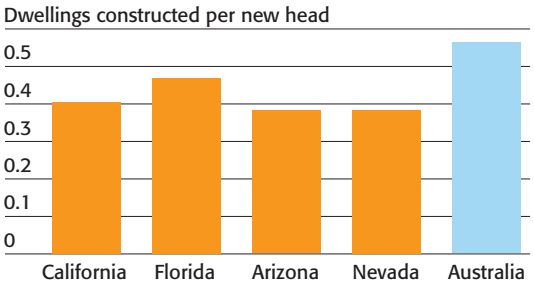


Source: www.macrobusiness.com.au

Chart 2 suggests there is significant latent capacity (excess bedrooms) in the pre-existing housing stock. Should economic conditions deteriorate, the number of Australians opting for group (share) accommodation would therefore likely increase, potentially turning a perceived housing shortage into a surplus.

This is not an outlandish proposition. Household formation rates in the United States fell to 65-year lows in the three years following the Global Financial Crisis, leading to a large oversupply of homes that exacerbated the downturn in both prices and rents.

CHART 3: AVERAGE DWELLING CONSTRUCTION RATE, 2000–2010



Source: www.macrobusiness.com.au

The United States is particularly instructive, given that over the period 2000 to 2010 the key 'bubble' states of California, Nevada, Arizona and Florida actually experienced lower rates of housing construction than did Australia.

Arguably, the Australian housing market was spared from experiencing a correction in 2004 by the sharp rise in commodity prices and the terms-of-trade.

> ***The Australian housing market was spared from experiencing a correction in 2004 by the sharp rise in commodity prices and the terms-of-trade.***

The extra disposable income generated from the commodity boom arrived just as the growth in mortgage debt was beginning to wane, enabling home prices to remain stronger for longer. While rising housing debt was the key driver of Australian home prices until 2004, strongly rising incomes from the commodity boom have played a greater role since.

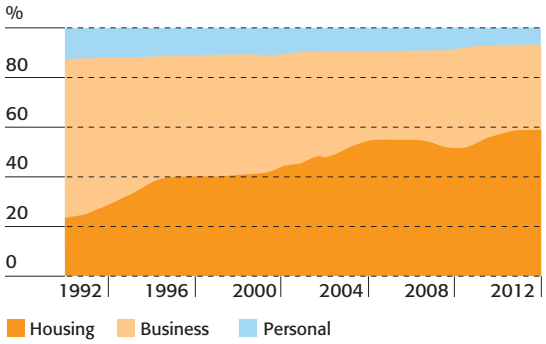
The flipside is that Australia could experience a severe housing correction in the event that commodity prices experienced a protracted downturn, brought about by the slowing Chinese economy or an increase in global commodity supplies.

That could quickly cause a sharp reduction in incomes, jobs and government revenues as the terms-of-trade deteriorates and planned mining investments are cancelled (a subject for another day).

So how should you protect your portfolio against this potential risk?

Under a prolonged commodity price correction, Australia's banks would be in the firing line. They're heavily exposed to the housing market, as Chart 4 shows. The proportion of total loans comprised of mortgages has grown from 24% in 1990 to 59% currently.

CHART 4: BANK LENDING BY CATEGORY, 1990–2012



Source: www.macrobusiness.com.au

Moreover, much of this lending has been financed from abroad, mostly via bond issuance, which has facilitated the rapid growth of bank assets (mostly loans) to nearly 200% of GDP currently. In 1994 that figure was less than 100%.

The key risk is in the banks' ability to refinance their borrowings. That rests on the willingness of foreign investors to continue to lend them money. In the event that commodity prices faced a protracted decline, overseas perceptions about the strength and safety of Australia's economy would likely worsen significantly. This is why the government stepped in and guaranteed deposits (amongst other measures) during the GFC.

Foreign lenders would probably increase the risk premium attached to lending to Australia's banks, significantly increasing their borrowing costs, and perhaps reducing their access to offshore funding.

With banks seeking to repay foreign creditors and restricting new lending to the domestic economy, that could lead to a liquidity shock. With credit rationed,

Australia's banks and housing sector would be very hard hit, especially without government support.

MIND YOUR ASSETS

If you own your home and have a significant chunk of your portfolio in banks or mortgage insurers like **QBE Insurance**, you are particularly exposed to a severe housing downturn.

Investors tend to not include their major asset—their house—in calculations regarding portfolio weightings. Because buying a home is often an emotional decision residential housing tends towards irrational pricing, which is a problem for rational assessment of the asset class—and why articles like this are so often quickly dismissed.

Then there's the fact that direct home ownership has significant tax benefits over renting that should be accounted for in any rent-versus-buy house price comparison. When you buy a house you receive 'imputed rent' which you don't receive as income and therefore don't pay tax on. A renter has to pay the same rent from after-tax dollars.

Yes, it's complicated. Suffice to say that if you own your own home or an investment property or two and have more than 10% of your portfolio in banks and another 5% in QBE Insurance, for example, you're very exposed to falling home prices.

If you work in financial markets, you're even more vulnerable. Same goes for resource sector workers. As Nathan Bell said recently, given their profession such people need very boring portfolios because resources employment is highly cyclical due to the volatility of commodity prices.

> ***None of this is to suggest there's an impending crash. But now is the time to make preparations as we find ourselves in a position where a slowdown in demand for our raw materials could have devastating, countrywide implications.***

You might not want to sell your home but you might consider following *Intelligent Investor Share Advisor's* suggestion to have no more than 10% of your portfolio allocated to the banking sector and no more than 25% allocated to highly leveraged finance-related businesses, which would include insurance companies and banks.

Finally, anything like the disaster described above would prompt a rapid fall in the local currency. That poses opportunities as well as risks and again, *Share Advisor* has regularly advocated the attractions of investing overseas as protection against them. *[See Ripe for the picking—Overseas stocks to buy now—Ed]*

None of this is to suggest there's an impending crash. But now is the time to make preparations as we find ourselves in a position where a slowdown in demand for our raw materials could have devastating, countrywide implications.

There are two basic responses; accept the possibility but carry on as if it won't happen and live with the consequences if it does; or try to guard against it by reducing your exposure to those businesses most exposed to the housing sector and allocate a higher percentage of your portfolio to international stocks, assuming that the yield you forgo will come back to you gift-wrapped in a falling currency. The choice is yours.

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