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ALL FEAR AND NO GREED

One of the most commonly used phrases in the investment world is to say that markets are driven by “fear and greed”. In the last few weeks nearly everyone I met wanted to talk about banks and the property market and this really brought home to me the extent to which at the moment it is all fear and no greed.
I thought that it might be interesting to share some of these anecdotes because they give a good sense of this fear. I also attempt to reflect on the implications of each anecdote.

Anecdote 1: At the opening of a friend’s art exhibition I was introduced to a relative of my artist friend. The subject of property prices and the banks came up in conversation. This man was blaming the banks for the mess. He told me that his son had been given a 100% mortgage on an investment property and of course he was now in negative equity. He said that he had advised his son not to do it but the son didn’t listen. He believed that the bank should have saved his son from his own desire to gamble on property prices!
I asked if the son had the property rented out. He said that at the moment it was rented out.
I also asked whether his son owned the property he lived in. He said that he did and at this stage it is difficult to tell whether his mortgage is higher than the value of the house because no houses have sold in the area in recent months.

This anecdote tells us some things we already know. It tells us that the banks relaxed their lending standards and they allowed people to become property investors / speculators at a young age. What it does not tell us is what it means for non performing loans / bad debts because this is probably the biggest issue for valuing bank shares in the current environment. It cannot tell us how difficult it will be to rent out the property into the future and it cannot tell us about the ability of the son to pay his mortgage on his personal property and / or any shortfall on the investment property.

To be honest my best guess is that the probability of a major bad debt in this particular situation is relatively low. I say this because I believe that even if the son loses his job, if he is anything like the father, he will probably find a new job and if he cannot find a job in Ireland he will move abroad. Of course the worst case scenario might happen but I would guess that there is a greater probability that the son will continue to work and continue to meet the mortgage payments. He will be in negative equity for many years and he will think twice about heavy borrowings in the future.

Anecdote 2: The subject of a local property developer came up at a recent dinner. This property developer has not sold even one unit in the latest phase of their property development but they got into the development side of things early in the boom and

must have made a lot of money from earlier phases of that development and other developments elsewhere.
They made a lot of money but they also spent a lot of money. They bought the obligatory helicopter and built a shed to house it. None of them can fly so they have to hire a pilot whenever they want to use it.
They also have a boat at a local marina and they have bought a few holiday homes in various locations!
Members of the family have started other businesses unrelated to property and it is not clear how successful these have been.

In a situation like this I cannot possibly attempt to say whether there is a potential bad debt. If they have kept their lifestyle spending within the limits created by the obvious historic success of their property business they should be fine but if they allowed success to go to their heads we might find a helicopter pilot looking for work!
Only the main bank to this developer knows just how good or how bad this particular situation is and the problem is that the bank will not tell us.
I have no doubt that some developers must be in trouble but in the absence of facts anecdotes can and do create fear.

Anecdote 3: A relation of mine that has an investment property mentioned that the Polish people that had been renting the house left recently and so far there seems to be far fewer Polish people now around to rent. There is a real fear that a new tenant is going to be difficult to find.

This is not a surprise. There will be fewer people around in the short term as the construction sector consolidates. Rents will probably have to drop. The question is by how much and in peripheral locations it might become increasingly difficult to rent at all.
Falling rents on their own need not lead to increased bad debts but at the margin there are bound to be some investors under pressure as a result.

Anecdote 4: A friend in the construction industry told me about a developer client that had a number of houses with booking deposits paid but the buyers were finding it hard to get final approval for their mortgages. If the buyers didn't get mortgage approval my friend's construction company would not get paid by the developer. Cash flow had become a real fear.
This is the only anecdote I heard that had any sort of positive aspect to it because the developer told the buyers to go off to his own bank manager and explain that it would be in the bank's interest to grant mortgage approval because without it the developer would not be able to repay his loans. Surprise, surprise some of the buyers did receive loan approval!
This story highlights how the banks have got themselves in a real mess because if they do not give loan approval they will end up shooting themselves in the foot because the developers will not be able to service all of their loans. (unless they are one of the lucky ones that made a fortune in the good times!)

IMPLICATIONS

When I think about all of these stories it brings me back to one critical issue, can the Irish economy create enough jobs to insure that there are people out there able to pay rent to all the property investors and ultimately turn renters into first time buyers that will allow developers to service their loans. If the jobs get created well then the current fear will subside and the banks will not have bad debts of such a scale that their current share prices suggest.

Irish demographics suggest that latent demand should remain strong for years to come as long as the jobs are created.

In the short term it is obvious to everyone that we are not creating enough jobs and it is more a question of how many jobs will be lost.

In the short term property prices will most likely fall further or at the very least we will hopefully see enough transactions taking place to establish the true extent of the fall that has already taken place.

In the medium term I believe that the job creation question is more difficult to answer. In fact this brings me all the way back to my second and third opinion pieces where I talk about “Competitiveness”. This is where my theory on Ireland as a location for multinationals is being put to a major test.

The announcement this week of expansion at EMC in Cork gives me some hope that quality jobs continue to be created. I have even read a newspaper article talking about vacant jobs in IBM, Microsoft and Google. Can these jobs be created fast enough to make this adjustment phase relatively mild or are we in for a very long and rocky road. I do not know for sure but as I said earlier I am not convinced that it has to be as bad as some people suggest.

We have moved from a world of little fear and plenty of greed to a world full of fear and no greed. This fact alone does not mean that property prices or bank share prices need necessarily have hit bottom. I am trying to be patient and prudent. I am trying to follow the philosophy that I have written about, the philosophy that acknowledged that there will always be a crisis, (I have seen plenty of them in the last 20 years) but eventually we come out the other side and share prices rebound.

I have no idea how long this crisis will last. The portfolio of shares I own has fallen in value by 17.1% year to date (up to July 25th) but I believe that this is a well diversified portfolio in terms of sectors and geography and I have taken consolation from the most recent results of companies that I have already written about like Linear Technology, Glaxo, Ascendas REIT and ASM Pacific. I believe that companies like these will survive even a deep recession. It is a question of not allowing fear drive me into selling these quality companies at prices that I believe do not reflect their long term potential.