4. Domestic Financial Markets

Conditions in Australian financial markets continue to support the financing of the business and household sectors. Yields on bonds issued by governments, banks and non-financial corporations are near historic lows. Spreads on corporate bonds remain relatively low and issuance has picked up over the year to date. The cash rate target was reduced at the May Board meeting. Interest rates on the stock of housing and business loans have declined in response to the February and May cash rate reductions and lower money market interest rates over the past three months. Growth in housing lending continues to be driven by lending to investors, while growth in business financing has picked up over the year. Australian equity prices have declined over recent months.

Money Markets and Bond Yields

The Reserve Bank Board reduced the cash rate target to 2 per cent at its May meeting. Yields on money market instruments imply some probability of a further reduction in the cash rate later in the year (Graph 4.1).

Rates on bank bills and certificates of deposit have steadily declined over recent months, reflecting both further monetary easing, and a narrowing of the spreads between bank bills and overnight indexed swaps (OIS) by around 15 basis points since their peak late last year.

Yields on 10-year Commonwealth Government securities (CGS) reached a historic low of 2.28 per cent in February, while the spread between CGS and US Treasuries declined to its lowest level since 2001 (Graph 4.2). More recently, better-than-expected domestic data and higher global yields have seen CGS yields increase by around 60 basis points from their lows.

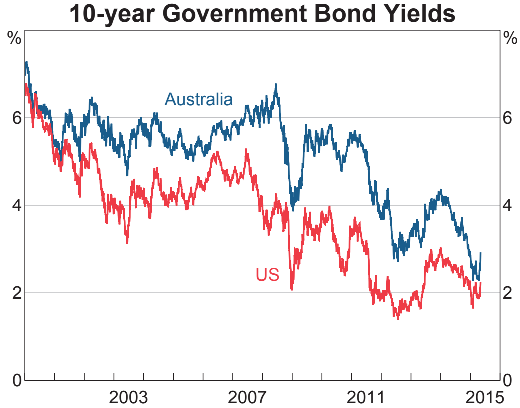
Demand for newly issued CGS has remained firm, with most bond tenders conducted by the

Graph 4.1
Cash Rate*

* Data from June 2015 onwards are expectations derived from interbank cash rate futures

Sources: ASX; Bloomberg

Graph 4.2
10-year Government Bond Yields

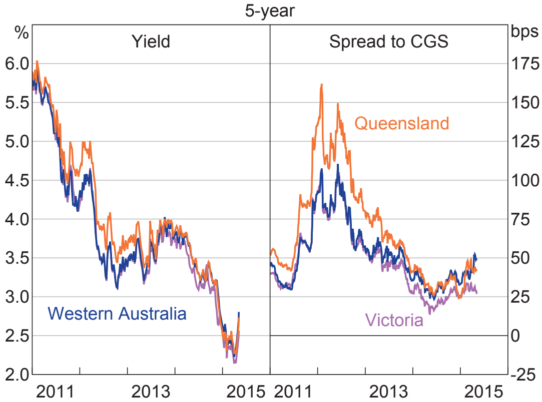


Source: RBA

Australian Office of Financial Management (AOFM) clearing below yields prevailing in the secondary market at the time of issuance. The AOFM issued a new 20-year bond in March at a yield of 2.86 per cent. Around one-third of the issue was purchased by non-residents, which was lower than for the April 2037 bond issued by the AOFM last October. Interest in Treasury notes has also improved, with several recent note tenders pricing at a premium to OIS.

Yields on debt issued by the state borrowing authorities ('semis') have increased after reaching historic lows in February, and spreads between semis and CGS have risen modestly over the past year (Graph 4.3). Gross issuance by the state borrowing authorities has totalled around $12½ billion since the February *Statement*, which is lower than the equivalent period last year. Continuing the trend seen over the past two years, around 30 per cent of the new issuance was in the form of floating-rate notes and the weighted-average residual maturity of outstanding semis declined further. This is consistent with the preferences of authorised deposit-taking institutions (ADIs) for shorter-tenor and floating-rate securities; ADIs have become the largest holders of semis as they constitute high-quality liquid assets, which are held to satisfy the Liquidity Coverage Ratio. After taking account of maturities, the total stock of semis outstanding has decreased slightly since the previous *Statement*.

Graph 4.3
State Government Debt
5-year



Sources: RBA; Yieldbroker

Standard & Poor's (S&P) placed Western Australia on negative credit watch based on expectations of a deterioration of the state's budgetary position following the falls in iron ore prices. Western Australia's current credit rating is AA+. Three other state or territory governments have a negative rating outlook from at least one of the major credit rating agencies.

Bond issuance by non-residents into the domestic market ('Kangaroo' issuance) has totalled around $10½ billion since the previous *Statement*. Almost two-thirds of the Kangaroo issuance was by banks, which is higher than typical of the past few years; sovereign and supranational issuance largely accounted for the other third. Kangaroo issuance by European-based entities has been somewhat higher than usual since the start of 2015 reflecting, in part, favourable movements in the cost of hedging Australian dollar proceeds into euros. Secondary market spreads on Kangaroo bonds have widened a little over the past year.

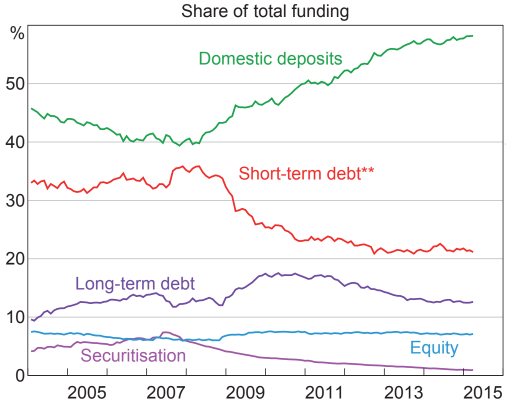
Financial Intermediaries

Bank balance sheets have continued to grow moderately following a pick-up in growth in 2014. The funding composition of bank balance sheets has remained broadly unchanged over the past year with deposits as a share of funding stable at around 58 per cent (Graph 4.4).

Banks' average funding costs have continued to decline, driven by reductions in wholesale funding costs and deposit rates following the February cash rate reduction. The reductions in deposit rates have been larger for term deposits with longer maturities, consistent with some lessening in appetite by banks for term deposits. Interest rates on term deposits with maturities greater than one year fell by around 60 basis points after the February cash rate reduction, reflecting the reduction in wholesale interest rates. Households have generally moved into other deposit products, such as bonus saver accounts which offer higher interest rates (Graph 4.5).

Graph 4.4
Funding Composition of Banks in Australia*

Share of total funding

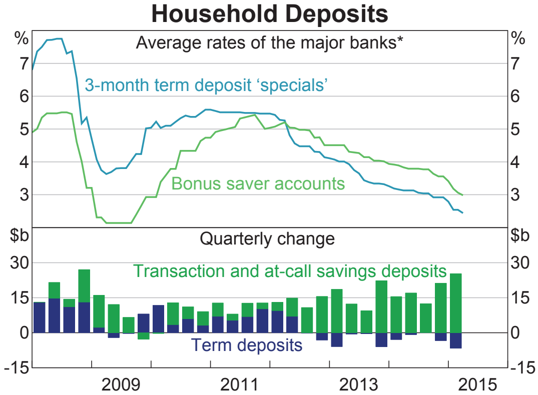


* Adjusted for movements in foreign exchange rates; tenor of debt is estimated on a residual maturity basis

** Includes deposits and intragroup funding from non-residents

Sources: APRA; RBA; Standard & Poor's

Graph 4.5
Household Deposits



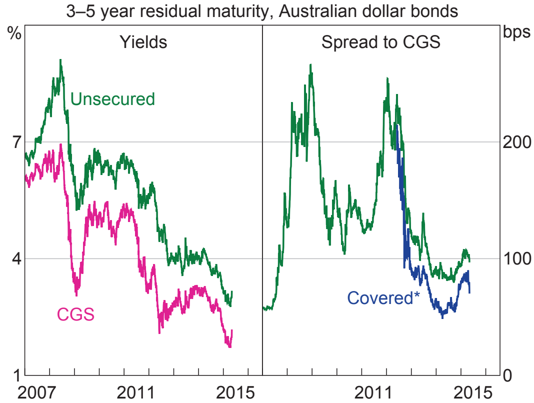
* Prior to the May cash rate reduction

Sources: APRA; CANSTAR; RBA

Conditions in wholesale funding markets remain favourable and continue to contribute to a decline in bank funding costs. Yields on the major banks' new long-term wholesale debt issuance have fallen over the past year; spreads on the major banks' unsecured bonds relative to CGS have also narrowed a little over the past few months (Graph 4.6). After having edged higher in 2014, the cost of short-term debt issuance declined notably following the February cash rate reduction. This funding is replacing debt previously issued at higher rates, leading to a sizeable decline in the average outstanding yield.

Graph 4.6
Major Banks' Bond Pricing

3–5 year residual maturity, Australian dollar bonds



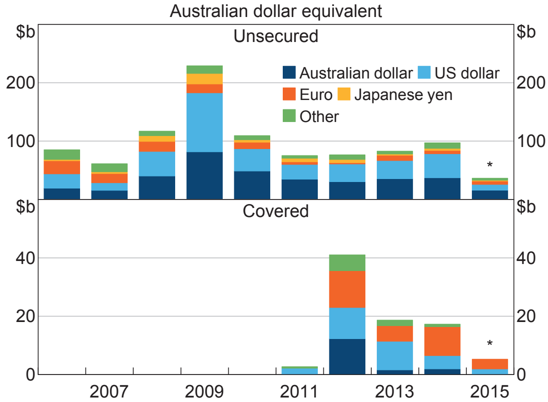
* Covered bond pricing interpolated to a target tenor of 4 years using bonds with a residual maturity between 2 and 10 years

Sources: Bloomberg; UBS AG, Australia Branch

Australian banks have issued around $40 billion in bonds since the start of the year, with around two-thirds issued into offshore markets. Over the past year, the stock of outstanding bonds has increased a little, with issuance outpacing maturities. Less than half of the banks' offshore bond issuance in 2015 has been denominated in US dollars, which is a lower share than that seen in recent years, while issuance of euro-denominated bonds has increased (Graph 4.7). Notwithstanding a pick-up in euro issuance hedging costs, the Australian dollar equivalent issuance costs achieved by the Australian banks have been broadly comparable across currencies. Australian banks have continued to explore new funding markets: a number of the large Australian banks issued bonds into the offshore renminbi market, with some of the banks accessing this market for the first time.

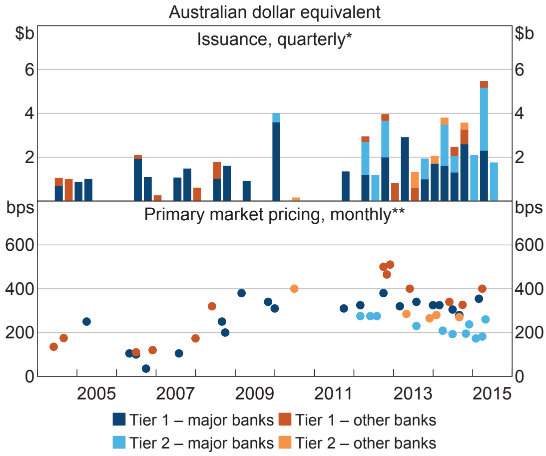
Australian banks have issued around $7½ billion in hybrid securities so far this year (Graph 4.8). Banks raised around $4.6 billion in Basel III compliant Tier 2 hybrids (a form of regulatory capital), with a significant share of this issued offshore in foreign currency-denominated securities. The remainder of the hybrid issuance was in the form of securities qualifying as Tier 1 capital, most of which were listed on the ASX. Primary market spreads on recent hybrid issuance have been wider than those seen in late

Graph 4.7
Resident Banks' Bond Issuance by Currency



* Year to date
Source: RBA

Graph 4.8
Hybrid Issuance by Australian Banks



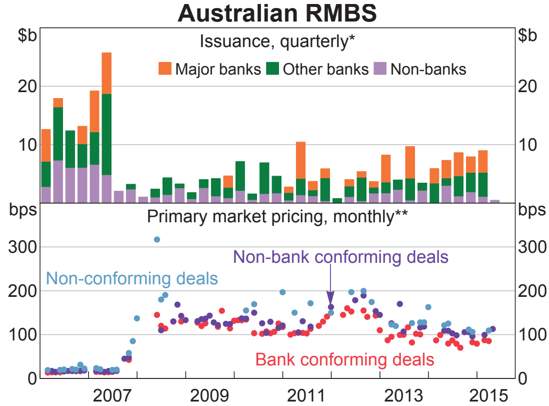
* Latest observation is quarter to date
** Face-value weighted monthly average of the primary market spread to bank bill swap rate; foreign currency hybrids hedged back to Australian dollars assuming redemption on the first call date
Source: RBA

2014, particularly for Tier 1 securities; this has been attributed to the increased supply.

Issuance of Australian asset-backed securities has continued at a robust pace, mainly in the form of residential mortgage-backed securities (RMBS) (Graph 4.9). Most of the RMBS issuance since the start of the year has been by banks, which have issued around $8 billion across five deals. As in 2014, RMBS backed by 'non-conforming mortgages', which typically involve borrowers with an impaired credit history, higher loan-to-valuation ratios or lower levels of income documentation, comprise only a very small proportion of the issuance. Four securitisations backed by assets other than residential mortgages have also been issued, raising around $2 billion in total. Issuance spreads on senior RMBS tranches have widened slightly since the start of the year, though they remain at low levels compared with most of the period since 2008.

S&P downgraded its rating on QBE Lenders' Mortgage Insurance (QBE LMI) Australia by one notch to A+ following the implementation of changes to S&P's criteria for rating mortgage insurers. Other Australian mortgage insurers had their ratings affirmed. Following the downgrade of QBE LMI and changes to S&P's ratings methodology, which reduces the credit given to lenders mortgage insurance when rating RMBS, S&P has placed 120, predominately subordinated, tranches of Australian and New Zealand RMBS on review for possible downgrade.

Graph 4.9
Australian RMBS



* Latest observation is quarter to date
** Face-value weighted monthly average of the primary market spread to bank bill swap rate
Source: RBA

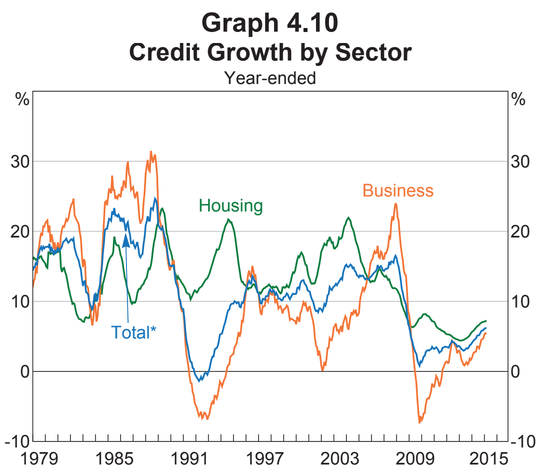
Financial Aggregates

Total credit is expanding at around 6 per cent on a year-ended basis (Graph 4.10). This reflects steadying growth in housing credit and a pick-up in business credit. Growth in credit remains below growth in broad money, which increased at a rate of around 8 per cent on a year-ended basis (Table 4.1).

Table 4.1: Financial Aggregates
Percentage change[(a)]

	Three-month-ended		Year-ended
	December 2014	March 2015	March 2015
Total credit	1.6	1.6	6.2
– Housing	1.8	1.8	7.3
– Owner-occupier	1.5	1.5	5.8
– Investor	2.6	2.4	10.4
– Personal	0.1	–0.2	0.9
– Business	1.5	1.6	5.3
Broad money	1.6	2.0	7.8

(a) Growth rates are break adjusted and seasonally adjusted
Sources: ABS; APRA; RBA



* Includes housing, personal and business credit
Sources: ABS; APRA; RBA

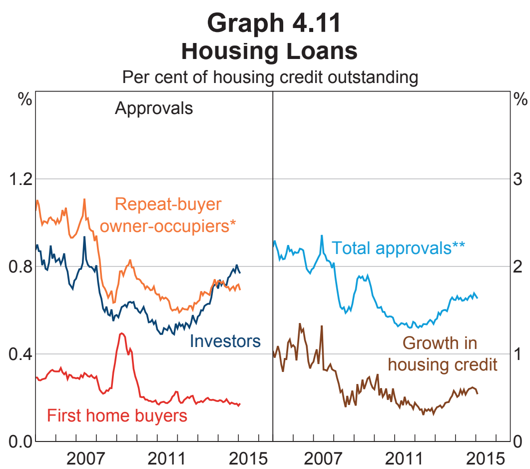
Household Financing

Housing credit growth continued at around 7 per cent on a year-ended basis. Credit extended to owner-occupiers increased by slightly less than 6 per cent over the year while the pace of investor credit growth increased slightly to be around 10½ per cent.

Growth in owner-occupier loan approvals (excluding refinancing) has been moderate and is consistent with credit growth remaining around its current pace (Graph 4.11). Loan approvals to investors have continued to grow, although the pace has slowed. Following an ABS review of the data there have been revisions to first home buyer loan approvals to adjust for under-reporting of these approvals. While first home buyer approvals have been revised up, they are a small share of total approvals relative to their historical average.

Personal credit has been growing at a year-ended rate of around 1 per cent. This reflects modest increases in fixed-term loans and credit card balances outstanding.

The February cash rate reduction was fully reflected across housing lending rates with most lenders reducing their standard housing variable rates by around 25 basis points (Table 4.2). Fixed rates were also reduced, most notably the 3- and 5-year fixed rates which declined by more than 25 basis points, reflecting the decline in comparable maturity



* Excluding refinancing
** Excluding refinancing of repeat-buyer owner-occupiers
Sources: ABS; RBA

Table 4.2: Intermediaries' Fixed and Variable Lending Rates
Prior to the May cash rate reduction

	Level at 4 May 2015	Change since end January 2015
	Per cent	Basis points
Housing loans		
– Standard variable rate[a]	5.67	–26
– Package variable rate[b]	4.82	–26
– Fixed rate[c]	4.74	–40
– Average outstanding rate[d]	5.04	–21
Personal loans		
– Variable rate[e]	11.36	–4
Small business		
– Term loans variable rate[f]	6.85	–25
– Overdraft variable rate[f]	7.72	–25
– Fixed rate[c],[f]	5.37	–37
– Average outstanding rate[d]	5.94	–24
Large business		
Average outstanding rate[d] (variable rate and bill funding)	4.11	–31

(a) Average of the major banks' standard variable rates
(b) Average of the major banks' discounted package rates on new, $250 000 full-doc loans
(c) Average of the major banks' 5-year fixed rates
(d) RBA estimates
(e) Weighted average of variable rate products
(f) Residentially secured; average of the major banks' advertised rates
Sources: ABS; APRA; CANSTAR; RBA

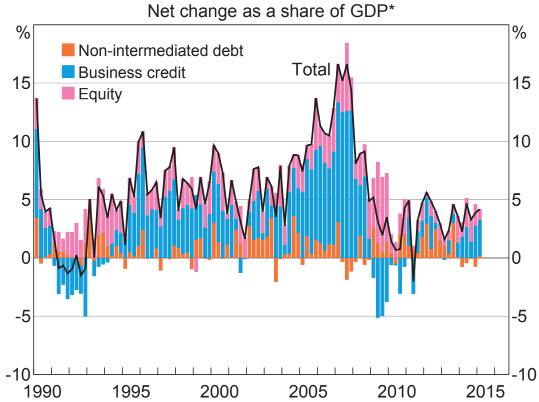
wholesale rates. Housing lending rate declines resulted in the estimated average interest rate on outstanding housing loans falling by about 20 basis points since the previous *Statement* (prior to the May cash rate reduction). The aggregate decline in outstanding rates has been less than the 25 basis points reduction to variable rates as it takes some time for fixed-rate loans to roll over. Following the May cash rate reduction, banks have lowered their standard variable rates on housing loans by 20–25 basis points.

Business Financing

Growth in external business funding remained steady in the March quarter at around 4 per cent of GDP (Graph 4.12). Equity raisings declined, but were offset by a pick-up in non-intermediated debt issuance.

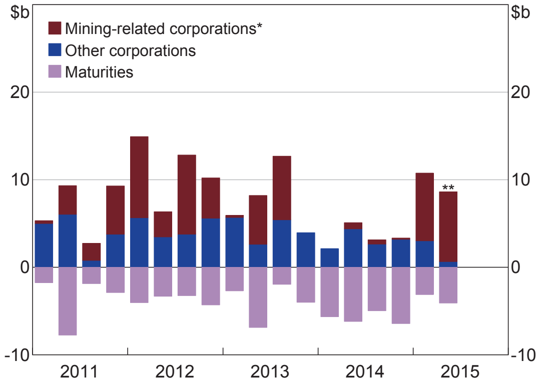
Bond issuance by Australian non-financial corporations has picked up, with around $20 billion raised over the year to date, predominantly in offshore markets (Graph 4.13). Mining-related companies were the main issuers with some companies returning to the market for the first time since 2013.

Graph 4.12
Business External Funding
Net change as a share of GDP*



* GDP data for the latest quarter are based on RBA forecasts
Sources: ABS; APRA; ASX; RBA

Graph 4.13
Australian Corporate Bond Issuance
Quarterly, Australian dollar equivalent

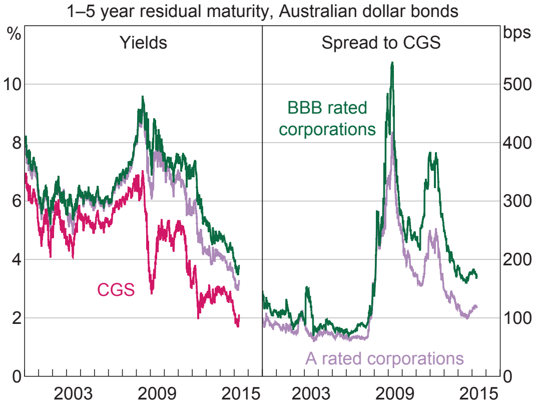


* Energy sector and mining-related materials sector companies
** Latest quarter issuance is quarter to date
Source: RBA

The pick-up in issuance is due at least in part to the low cost of issuance, with yields on corporate bonds around their lowest levels on record (Graph 4.14). Secondary market spreads over CGS for BBB rated corporate bonds have widened a little since mid last year, though they remain at around their lowest levels since 2008.

Business credit growth has strengthened over the past year, driven by lending to both private non-financial corporations and unincorporated (typically smaller) businesses. Credit provided by the major and foreign-owned banks has driven the growth, with Asian banks making a notable

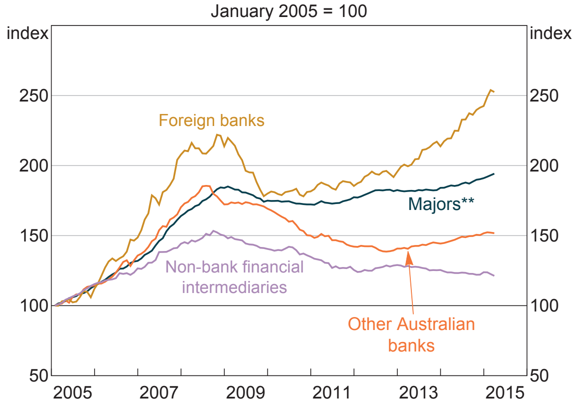
Graph 4.14
Australian Corporate Bond Pricing
1–5 year residual maturity, Australian dollar bonds



Sources: RBA; UBS AG, Australia Branch

contribution and increasing their market share (Graph 4.15). The Australian dollar value of foreign currency-denominated business credit has been boosted by the depreciation of the Australian dollar. In trend terms, commercial loan approvals have been at a relatively high level, consistent with the strengthening in business credit growth.

Graph 4.15
Business Credit by Source*
January 2005 = 100

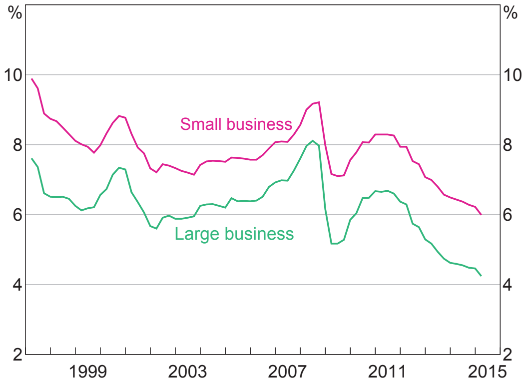


* Break and seasonally adjusted; includes securitisation
** Majors include St. George and Bankwest
Sources: ABS; APRA; RBA

Credit ratings of Australian corporations have been affected by the declines in commodity prices. Since the beginning of February, six resource sector companies have been downgraded by the major ratings agencies, with negative outlooks remaining in place for most of these companies' ratings.

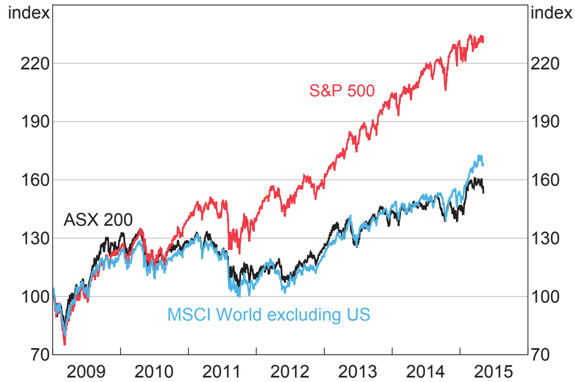
The cost of intermediated business borrowing for both small and large businesses declined in the March quarter, mainly reflecting the repricing of loans following February's cash rate reduction (Graph 4.16). Prior to the May cash rate reduction, average rates on outstanding small business loans had fallen by around 25 basis points since the end of January, with banks' advertised variable rates on small business loans having fully reflected February's cash rate reduction. Lending rates on large business loans have also been reduced, with the average rate falling by more than 25 basis points, reflecting the reduction in yields in wholesale markets. Following the May cash rate reduction, banks have generally

Graph 4.16
Australian Business Lending Rates*
Average interest rate on outstanding lending



* RBA estimates; prior to the May cash rate reduction
Sources: APRA; RBA

Graph 4.17
Share Price Indices
End December 2008 = 100



Sources: Bloomberg; Thomson Reuters

lowered their variable rates on business loans by 25 basis points.

In contrast to the second half of last year, there has been little activity in the IPO market so far this year. Already listed corporations continue to raise around $4 billion in equity per quarter, driven by non-resource corporations, particularly in the infrastructure sector.

Mergers and acquisitions (M&A) activity has picked up over the past 18 months, with around $21 billion in deals announced by listed companies so far this year. M&A activity has been concentrated in the industrial sector and has included Japan Post's $6.5 billion proposed acquisition of Toll Holdings and Macquarie Group's acquisition of a $5 billion aircraft leasing portfolio.

Equity Markets

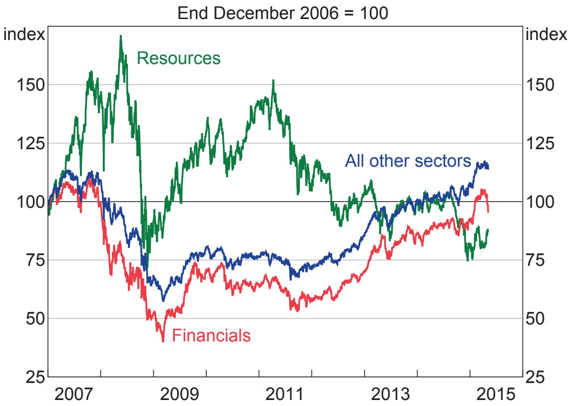
After falling in late 2014 in response to lower commodity prices, Australian equity prices rebounded in January but have declined since then (Graph 4.17). Over this period, the Australian equity market has underperformed other developed markets.

Equity prices in the resources sector remain well below their levels in mid 2014 owing to lower commodity prices, particularly for iron ore (Graph 4.18). However, better-than-expected profit results for the major miners and a slight slowing in the expected pace of expansion of iron ore production have supported materials sector equity prices since the beginning of the year. Energy sector share prices have increased over recent months, alongside a rebound in oil prices.

Financial sector equity prices have declined over recent months, affected by mixed earnings updates across the banks and diversified financial companies. Outside the financial and resources sectors, share prices have generally risen. The prices of industrial stocks have increased substantially, supported by increased M&A activity in the sector. Equity prices were mixed across the consumer sectors: consumer staples share prices have underperformed while share prices of the consumer discretionary sector have increased following a pick-up in sales growth across companies exposed to the residential real estate sector.

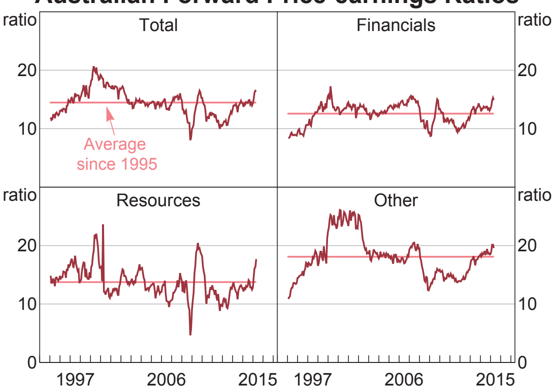
Valuations of Australian equities, as measured by forward price-earnings (PE) ratios, have increased. Equity price rises have outpaced increases in earnings expectations (Graph 4.19). Forward PE ratios remain above the 20-year averages of all broad sectors, with the PE ratio of the ASX 200 remaining at around its highest level over the past 10 years. However, the aggregate forward PE ratio of

Graph 4.18
Australian Share Price Indices



Source: Bloomberg

Graph 4.19
Australian Forward Price-earnings Ratios



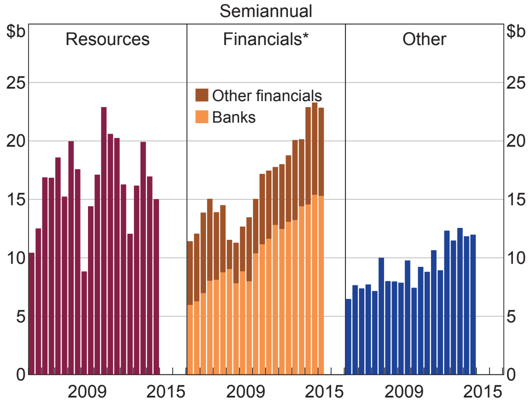
Sources: MSCI Australia; Thomson Reuters

the Australian equity market is well below the level reached in the late 1990s.

ASX 200 companies reported their December half 2014 results in February. Aggregate underlying profits, which exclude the impact of non-recurring items, fell slightly from the same period in 2013, driven by lower profits of resource companies. In aggregate, profits were slightly better than consensus analysts' expectations; this was due in large part to the better-than-expected results of the resources sector. Among resource companies, however, performance was mixed: the major miners' profit results exceeded analysts' expectations, while energy companies generally underperformed.

Notwithstanding the better-than-expected results, resource sector profits declined by 22 per cent from the same period in 2013, owing to lower commodity prices (Graph 4.20). The decline in profits has been accompanied by significant cost-cutting efforts and further increases in production volumes across the major miners. Many of the smaller resource companies reported substantial falls in profit, with a number of these companies also recording asset writedowns.

Graph 4.20
ASX 200 Underlying Profits



* The June 2015 half observation for financial companies is based on reported results during the half and consensus expectations for companies that have not yet reported

Sources: Bloomberg; Morningstar; RBA

Underlying profits of financial companies rose by 15 per cent from the same period in 2013, primarily reflecting substantial increases in profit at insurance and real estate companies. The increase in profits at real estate companies partly reflected heightened activity in the residential property market.

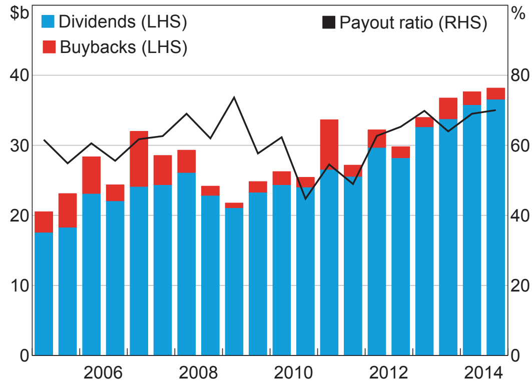
Banks generally reported smaller increases in underlying profit compared with the same period in the previous year. Net interest income was supported by strong growth in interest earning assets, partially offset by a decline in net interest margins for the major banks as a result of strong competition in lending markets and increased holdings of liquid assets. Declines in bad and doubtful debt charges owing to improved asset quality also contributed to profit growth. Banks generally increased their dividend payments compared with the same period in the previous financial year.

Underlying profits for companies outside the resources and financial sectors have been broadly flat over the past couple of years. Profits in the industrial sector, which includes a number of mining services companies, declined in the most recent reporting season alongside lower capital expenditure at resource companies.

Company shareholder distributions grew modestly in the December half 2014 compared with the previous year, driven by an increase in dividend payments, particularly in the resources sector (Graph 4.21). The increase in dividends exceeded earnings growth, resulting in the aggregate payout ratio rising further to its highest level since 2009.

Listed corporations' balance sheets expanded by 6½ per cent over the December half 2014, with the expansion largely due to the depreciation of the Australian dollar against the US dollar, which increased the value of offshore assets (Graph 4.22). The depreciation of the Australian dollar also led to a revaluation of foreign currency-denominated debt, resulting in a shift in the reported funding mix towards debt; however, this was partly offset by reductions in US dollar-denominated debt among the mining companies. Equity rose over the period, also partly due to exchange rate effects, despite a number of asset writedowns across resource companies. As a result, the gross book value gearing ratio – the ratio of debt to equity – rose a little to 54 per cent, but remains well below its historical average. ✠

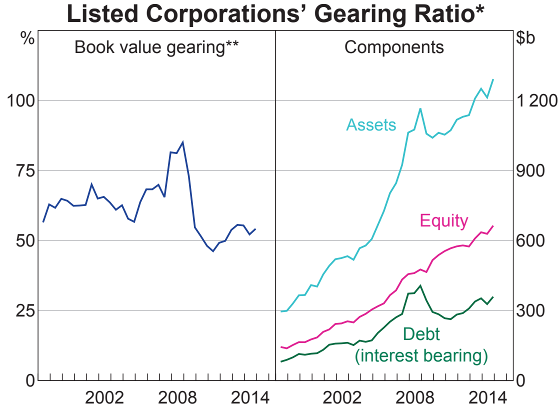
Graph 4.21
ASX 200 Shareholder Distributions*



* Shareholder dividends are attributed to the reporting period in which they are accounted for rather than the period in which they are paid

Sources: ASX; Morningstar; RBA

Graph 4.22
Listed Corporations' Gearing Ratio*



* The gross gearing ratio is defined as the ratio of the book value of gross debt to the book value of equity; excludes foreign-domiciled companies

** Data from 1997 includes real estate companies

Sources: Morningstar; RBA; Statex