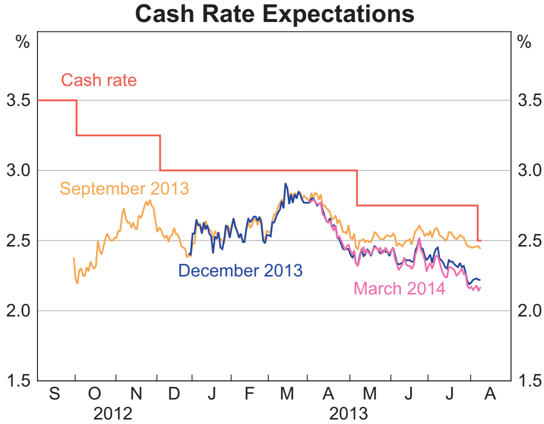
4. Domestic Financial Markets

Money Markets and Bond Yields

The Reserve Bank Board reduced the target for the cash rate from 2.75 per cent to 2.50 per cent at its August meeting. Prior to this, the pricing of money market instruments had pointed to some expectation within financial markets of a further easing in monetary policy during 2013, although the depreciation of the Australian dollar, at times, acted to temper these expectations. Rates on overnight indexed swaps (OIS) currently imply an expectation that the cash rate will be lowered to 2.25 per cent early in 2014 (Graph 4.1).

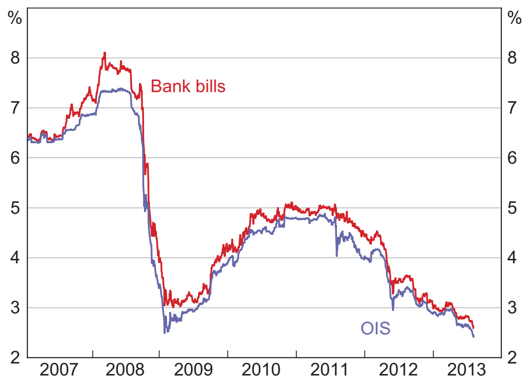
Graph 4.1
Cash Rate Expectations



Sources: RBA; Tullett Prebon (Australia) Pty Ltd

Rates on bank bills and certificates of deposit (CDs) are lower than at the time of the previous *Statement*, with the yield on 3-month bills reaching a historical low of 2.59 per cent in early August. The spread between 3-month bills and OIS rates has remained broadly stable at around 15 basis points in recent months (Graph 4.2).

Graph 4.2
Yields of 3-month Bank Bills and OIS



Sources: RBA; Tullett Prebon (Australia) Pty Ltd

In contrast, yields on long-term Commonwealth Government securities (CGS) have increased significantly since the previous *Statement,* reflecting the rise in bond yields observed globally (Graph 4.3). In more volatile trading conditions, 10-year CGS yields briefly reached an 18-month high of 4.04 per cent in late June as speculation grew that the US Federal Reserve may taper its asset purchase program earlier than anticipated. Yields subsequently declined as this speculation abated and following the release of weaker-than-expected Chinese and domestic economic data. Reflecting the reassessment of the economic outlooks in Australia and the United States, the spread to 10-year US Treasuries has declined to around 100 basis points, its narrowest level since 2007 (Graph 4.4).

With the 10-year CGS yield 60 basis points above its levels of three months ago and the prices of shorter-term CGS supported by expectations of further monetary policy easing, the spread between 3-year

Graph 4.3
Australian Government Bond Yields

Source: RBA

Graph 4.4
Australia/US 10-year Bond Differential

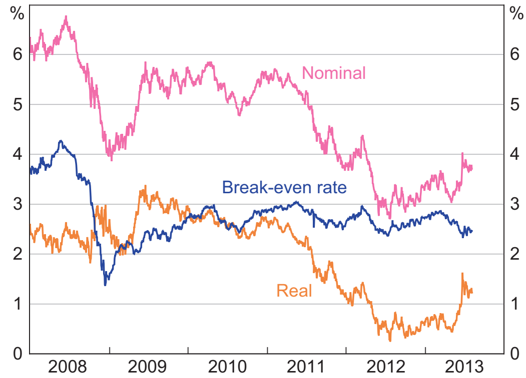
Source: RBA

and 10-year CGS is now around 120 basis points, its widest level in around four years.

Consistent with trends observed in offshore bond markets during recent months, yields on Treasury Indexed Bonds (TIBs) have increased by more than yields on nominal CGS of comparable maturity. The implied break-even inflation rate on 10-year CGS is now around 2.4 per cent, down around 50 basis points from its recent peak at the beginning of the year (Graph 4.5).

In August, the Australian Office of Financial Management (AOFM) outlined its planned issuance of CGS for the 2013/14 financial year following the release of the Australian Government's Economic Statement. The AOFM expects to issue around

Graph 4.5
Australian 10-year Government Bond Yields



Source: RBA

$4 billion of TIBs and around $60 billion of nominal CGS during 2013/14, with the total CGS on issue expected to peak at around $300 billion.

Trading of Australian Government bonds commenced on the Australian Securities Exchange (ASX) on 21 May with both nominal bonds and TIBs becoming available as exchange-traded Australian Government bonds. These instruments represent investments in CGS, but will be held as depositary interests within CHESS, a securities settlement system operated by the ASX. With the launch of exchange trading, the Reserve Bank has discontinued its facility for selling CGS to retail investors; for the time being, however, investors may continue to sell small parcels of CGS to the Bank.

The amount of state government bonds ('semis') outstanding has declined a little since the previous *Statement*, as new issuance has been less than maturities. The size of the semi-government bond market is expected to increase only modestly during the 2013/14 financial year. Although Western Australia's funding plan was not available at the time of writing, the states' overall funding requirements in the coming year are likely to be much lower than in the previous year, with gross bond issuance expected to decline significantly from $42 billion in 2012/13 (Table 4.1). The prospect of reduced issuance contributed to spreads between semi-government debt and CGS remaining stable during the recent periods of market volatility.

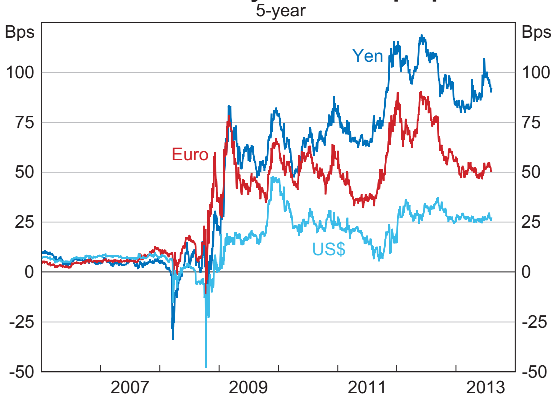
Table 4.1: Long-term Debt Issuance by State Borrowing Authorities[(a)]

		2013/14		2012/13
	Outstanding as at end May 2013	Budget position	Gross issuance	Gross issuance
	$ billion	$ billion	$ billion	$ billion
New South Wales	62	–1.9	5.3	6.9
Queensland	84	–7.7	7.1	13.7
South Australia	15	–0.9	3.0	4.4
Tasmania	4	–0.4	0.4	1.0
Victoria	33	0.2	6.7	7.2
Western Australia[(b)]	26	na	na	8.6

(a) Securities with an original term to maturity of greater than one year
(b) The Western Australian 2013/14 budget was not available at the time of writing
Sources: RBA; state treasury corporations

Issuance of domestic bonds by non-resident entities ('Kangaroos') has been around $6 billion since the previous *Statement*. The difference in yields between Kangaroo bonds and CGS has widened in recent months, particularly for European issuers. Nonetheless, these spreads remain around their post-2007 lows. The cost of hedging Australian dollar issuance into US dollars and euros, the main currencies for foreign issuance, has increased only marginally since the previous *Statement*, with cross-currency basis swap spreads for these currencies remaining around their lowest level since late 2011 (Graph 4.6).

Graph 4.6
A$ Cross-currency Basis Swap Spreads
5-year

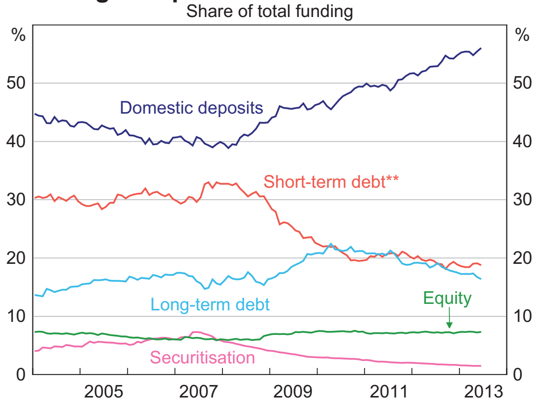


Source: Bloomberg

Financial Intermediaries

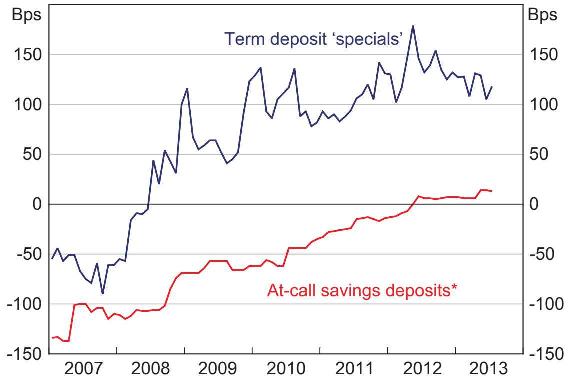
Competition for deposits remains vigorous, with deposits now accounting for 56 per cent of total bank funding (Graph 4.7). The relatively attractive pricing of at-call savings accounts has continued to drive a reallocation of deposits away from term deposits towards at-call deposits. Spreads on term deposit 'specials' have eased from their 2012 highs, although they still remain at elevated levels (Graph 4.8). At-call deposits are yet to be repriced following the latest reduction in the cash rate.

Graph 4.7
Funding Composition of Banks in Australia*
Share of total funding



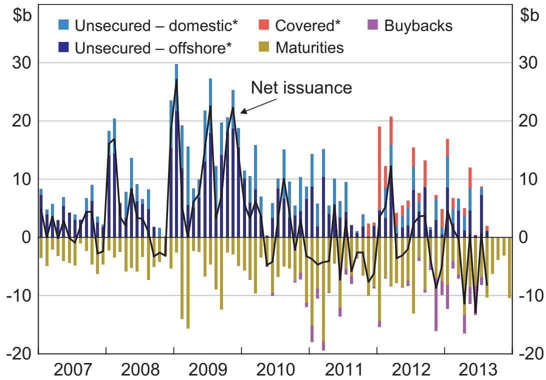
* Adjusted for movements in foreign exchange rates
** Includes deposits and intragroup funding from non-residents
Sources: APRA; RBA; Standard & Poor's

Graph 4.8
Major Banks' Deposit Rates
Spreads over money market rates of equivalent maturity



* Spread to cash rate; existing customers only; excludes temporary bonus rates
Sources: Bloomberg; RBA

Graph 4.9
Banks' Bond Issuance and Maturities
A$ equivalent



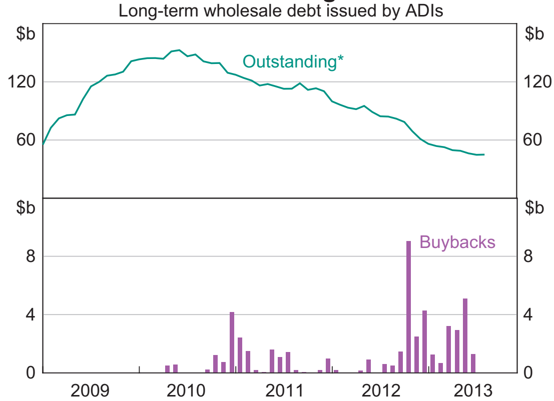
* Latest month issuance to date
Source: RBA

Bond issuance by Australian banks of around $17 billion since the May *Statement* has been somewhat less than maturities. Almost no long-term debt was issued during June as speculation surrounding the future course of US monetary policy created volatility within global debt markets (Graph 4.9). Banks have continued to buy back their government-guaranteed debt. A total of $9 billion has been repurchased over the past three months, with the stock of guaranteed debt declining to $45 billion (Graph 4.10). The lower level of issuance together with sizable maturities and buybacks has meant that the stock of outstanding bank bonds has fallen by around $20 billion over the past three months.

Secondary market spreads to CGS on the major banks' unsecured bonds widened in June as bond yields rose globally. Much of this widening of spreads was subsequently reversed, with spreads on unsecured bank bonds now only around 6 basis points wider than at the time of the previous *Statement* and broadly unchanged since the start of the year (Graph 4.11). Spreads on covered bonds have been less volatile.

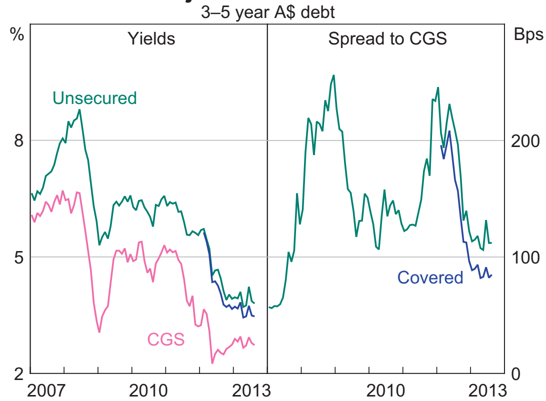
Overall, the average cost of banks' outstanding unsecured long-term wholesale funding has been little changed over the past three months. This reflects both the low level of new bond issuance

Graph 4.10
Australian Government-guaranteed Debt
Long-term wholesale debt issued by ADIs



* Adjusted for monthly exchange rate movements
Source: RBA

Graph 4.11
Major Banks' Bonds
3–5 year A$ debt



Sources: Bloomberg; RBA; UBS AG, Australia Branch and the slower repricing of outstanding long-term wholesale debt compared with other funding liabilities of banks.

Since the previous *Statement,* $2.5 billion of hybrid notes have been issued by banks. Of this issuance, nearly two-thirds will qualify as additional Tier I capital, and the remainder as Tier II capital. Following Moody's revision to its global rating methodology for banks, the subordinated debt ratings of eight Australian banks have been placed on review for possible downgrade. This was in response to government policy in many national jurisdictions, which now requires junior debt holders to suffer a loss before any public support is provided to banks' senior debt holders. The total value of outstanding Australian bank debt under review is around $20 billion.

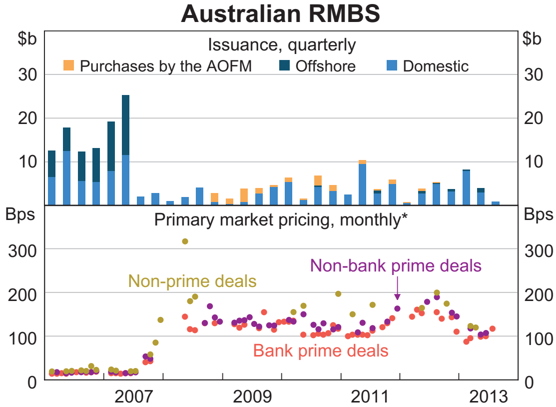
In contrast to other forms of long-term wholesale funding, securitisation activity has been relatively strong since the previous *Statement* with just under $4 billion of residential mortgage-backed securities (RMBS) issued (Graph 4.12). RMBS pricing has also been steady, with spreads around their lowest level since the beginning of the financial crisis in 2007. Following an absence of issuance between February and mid May, $2.6 billion has subsequently been issued in other asset-backed securities, including the first commercial mortgage-backed security (CMBS) issue since 2011. The CMBS deal is backed by commercial loans and self-managed super fund mortgages secured by a mix of residential and commercial properties.

Moody's has finalised a new methodology for assessing tail risk for some Australian RMBS. (This is the risk of a disproportionately large loss emerging on the securitised pool at the end of a transaction's term.) As a result, 41 senior and mezzanine tranches of Australian RMBS from five issuers with an outstanding value of $4.2 billion (equivalent to around 4 per cent of outstanding RMBS in the market) have been put on review for a possible downgrade. The tranches that are affected relate to RMBS issued before the global financial crisis, which provide less protection to senior note holders and have smaller liquidity reserves.

Financial Aggregates

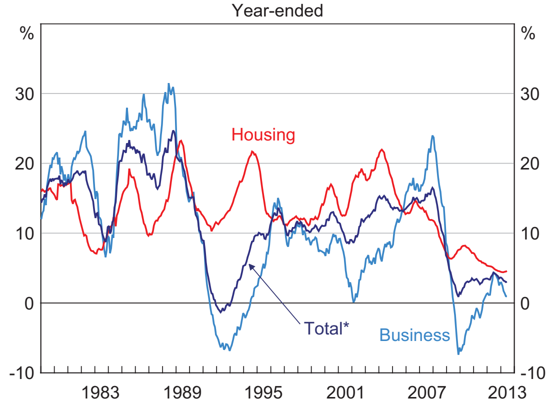
Total credit grew modestly over the June quarter, reflecting small increases in both household and business credit (Graph 4.13, Table 4.2). Growth in broad money has remained strong, largely reflecting ongoing inflows into saving and transaction deposit accounts.

Graph 4.12
Australian RMBS



* Primary market spreads are face-value weighted monthly averages of AAA-rated RMBS
Source: RBA

Graph 4.13
Credit Growth
Year-ended



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

Table 4.2: Financial Aggregates

Percentage change[(a)]

	Three-month-ended		Year-ended
	March 2013	June 2013	June 2013
Total credit	0.6	1.0	3.1
– Owner-occupier housing	1.1	1.0	4.1
– Investor housing	1.4	1.6	5.7
– Personal	0.2	–0.1	0.2
– Business	–0.2	0.9	0.9
Broad money	1.2	1.8	5.4

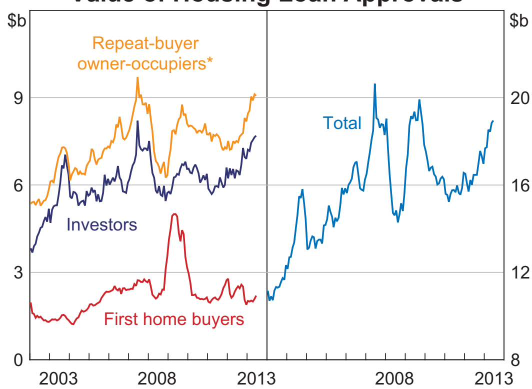
(a) Growth rates are break adjusted and seasonally adjusted
Sources: APRA; RBA

Household Financing

Growth in housing credit continued at a measured pace over the June quarter. Investor credit, the smaller component of housing credit, has continued to grow at a slightly faster rate than owner-occupier credit. The value of total housing loan approvals has increased in recent months to be around 15 per cent higher over the year (Graph 4.14). The increase in approvals has been underpinned by loans to repeat-buyer owner-occupiers and investors. In contrast, first home buyer approvals remain subdued following a number of changes to first home buyer incentives offered by state governments last year, which have refocused government assistance towards purchases of newly built homes. With households maintaining their higher pace of mortgage prepayments, and much of the growth in loan approvals being to repeat buyers and investors, growth in the level of housing credit has been relatively modest.

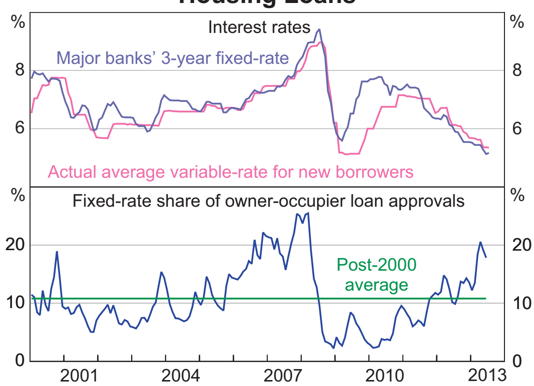
Competitive pressures in the fixed-rate mortgage market have intensified. The low level of interest rates and the favourable pricing differential between many advertised fixed-rates and discounted variable-rates have increased the number of existing borrowers choosing to fix some portion of their loan. These factors have also contributed to the increase in the proportion of owner-occupier loans approved at fixed-rates, which has remained around its highest level since early 2008 (Graph 4.15).

Graph 4.14
Value of Housing Loan Approvals



* Net of refinancing
Sources: ABS; RBA

Graph 4.15
Housing Loans



Sources: ABS; RBA

In contrast to fixed-rate loans, most lenders have not adjusted their standard variable rate discounts offered to new customers in recent months. However, competition remains strong with most lenders reducing their standard variable housing loan rates by an amount equal to the 25 basis point reduction in the cash rate in May (Table 4.3). At the time this *Statement* was finalised, a number of lenders had also announced that they will reduce their standard variable housing loan rates by at least a further 25 basis points.

Personal credit, which is a small component of total credit, was little changed over the June quarter. Decreases in the total value of credit card balances outstanding and other revolving credit facilities were largely offset by an increase in the value of personal fixed-term loans. A large portion of these fixed-term loans were extended by car finance companies, with personal motor vehicle sales remaining elevated in the June quarter. Preliminary data suggest that the value of outstanding margin lending fell over the June quarter. Although there was an increase in equity market volatility during the quarter, the overall number of margin calls remained at a very low level.

While advertised rates on most credit cards and unsecured personal loans are little changed, average variable rates on home equity loans and margin loans have fallen broadly in line with the change in the cash rate since the end of April.

Business Financing

Australian corporate bond issuance has remained relatively subdued since the previous *Statement,* with around $6 billion issued (Graph 4.16). Most of this issuance was in offshore markets, with Rio Tinto accounting for more than half of the total.

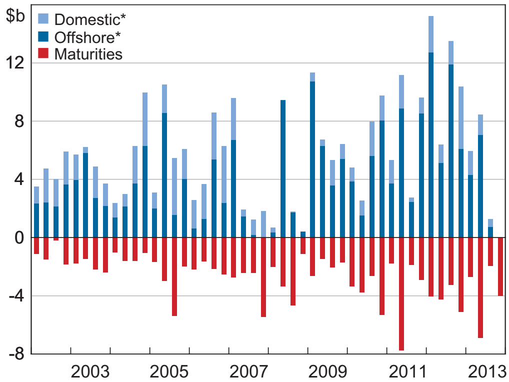
Secondary market spreads to CGS on corporate bonds have widened since the previous *Statement,* although they remain near their lowest levels since the onset of the financial crisis in 2007 (Graph 4.17).

Table 4.3: Intermediaries' Variable and Fixed Lending Rates
Prior to the August cash rate reduction

	Level at 30 July 2013 Per cent	Change since 30 April 2013 Basis points	Change since end October 2011 Basis points
Housing loans			
– Standard variable rate[(a)]	6.18	–25	–161
– Package variable rate[(b)]	5.35	–26	–168
– Fixed rate[(c)]	5.17	–27	–134
Personal loans			
– Variable rate	11.75	–6	–81
Small business (variable rates)			
Residentially secured, advertised			
– Term loans	7.35	–25	–165
– Overdraft	8.22	–25	–163
Average rate[(d)]	6.95	–25	–168
Large business			
Average rate[(d)] (variable rate and bill funding)	4.92	–24	–211

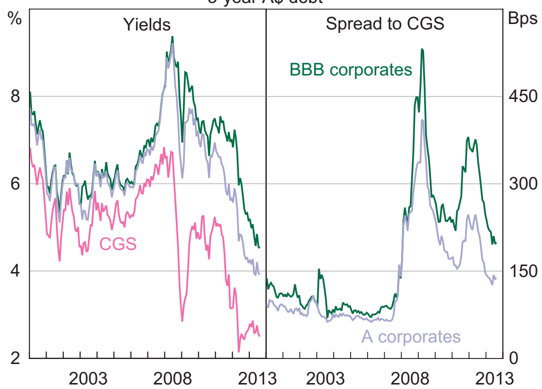
(a) Average of the major banks' standard variable rates
(b) Average of the major banks' discounted package variable rates on new, $250 000 full-doc loans
(c) Average of the major banks' three-year fixed rates
(d) Rates on outstanding business lending (includes discount)
Sources: ABS; APRA; RBA

Graph 4.16
Australian Corporates' Bond Issuance
A$ equivalent



* Latest quarter issuance to date
Source: RBA

Graph 4.17
Australian Corporates' Bond Pricing
3-year A$ debt

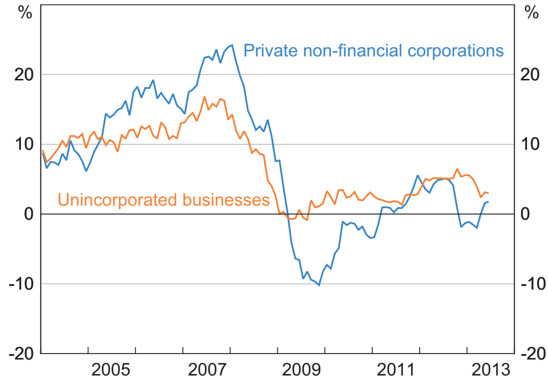


Sources: RBA; UBS AG, Australia Branch

As with bank bonds, the widening of spreads was consistent with global trends and was largely prompted by market speculation surrounding the US Federal Reserve's future asset purchases.

Intermediated business credit increased by 0.9 per cent over the June quarter, with lending to both private trading corporations and unincorporated businesses increasing modestly (Graph 4.18). A sizeable share of the growth in business credit over the period was a result of foreign currency valuation effects stemming from the depreciation of the Australian dollar. Overall, growth in business credit has remained subdued during the past year, consistent with the slow pace of business investment outside the mining sector.

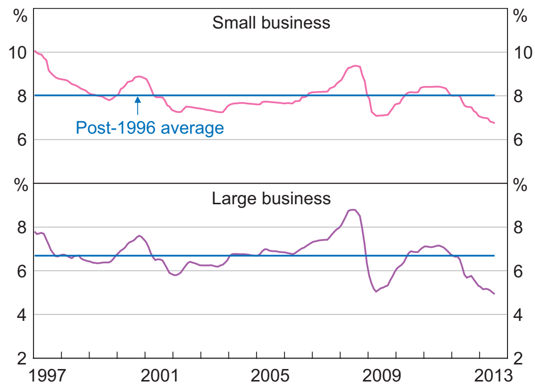
Graph 4.18
Business Credit*
Six-month annualised growth



* Excludes securitised loans
Sources: APRA; RBA

The cost of intermediated business borrowing has continued to decline since the previous *Statement*, with average interest rates on outstanding small and large business lending below their previous troughs in April 2009 (Graph 4.19). These reductions largely reflected movements in wholesale benchmark rates and the reduction in the cash rate.

Graph 4.19
Average Business Borrowing Rates



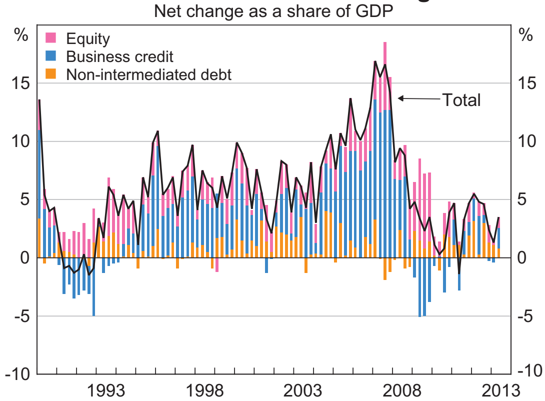
Sources: APRA; RBA

In line with seasonal patterns, the value of domestic syndicated loan approvals – of which around two-thirds are included in domestic business credit – picked up in the June quarter. The increase in activity was broad based and driven by a large number of refinancing loan approvals, although capital expenditure by the mining sector has continued to decline. Similar to the general trend in business credit, the value of outstanding syndicated lending by Asian banks has continued to expand.

Equity raisings by listed corporations remain moderate, with just under $4 billion in net equity raised during the June quarter. Merger and acquisition activity was subdued, with $8 billion in transactions announced by listed corporations since the May *Statement*. Consolidation in the utilities sector accounted for much of the activity.

Overall, external funding of businesses rose by the equivalent of 3.5 per cent of GDP in the June quarter (Graph 4.20). The pick-up in growth was mainly driven by the increase in credit provided by financial institutions, which, as discussed above, was boosted by the valuation effects of a lower Australian dollar on the stock of foreign currency loans.

Graph 4.20
Business External Funding
Net change as a share of GDP



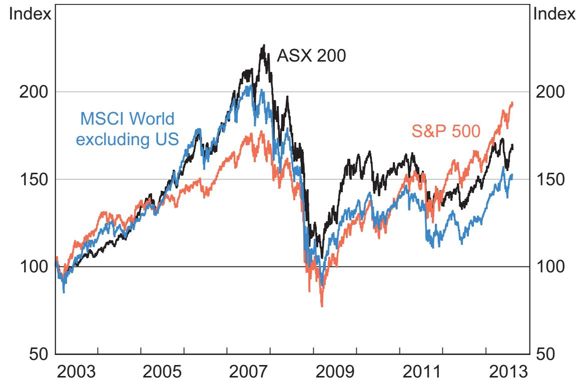
Sources: ABS; APRA; ASX; RBA

Equity Markets

Australian equity prices have declined by 4 per cent since the previous *Statement*, weighed by uncertainty about the outlook for economic growth in China and uncertainty over the path of monetary policy in the US (Graph 4.21).

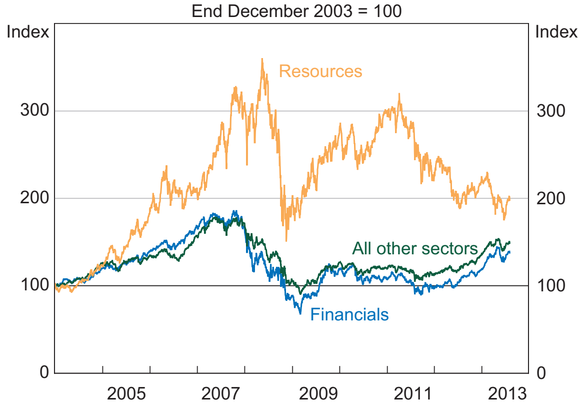
Resources sector share prices fell by 3 per cent since the previous *Statement*, despite declining almost 14 per cent at one stage (Graph 4.22). Movements

Graph 4.21
Share Price Indices
End December 2002 = 100



Sources: Bloomberg; Thomson Reuters

Graph 4.22
Australian Share Price Indices
End December 2003 = 100



Sources: Bloomberg; RBA

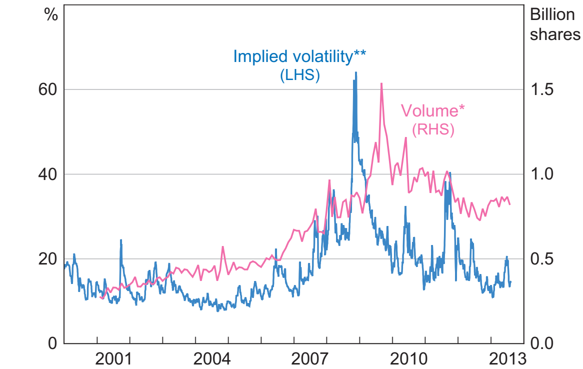
in mining company share prices have tended to track movements in iron ore, coal and other base metal prices. The decline in the gold price prompted Australia's largest listed gold mining company, Newcrest, to announce asset writedowns of up to $6 billion. In contrast, share prices of energy companies have been broadly unchanged since the previous *Statement* due to support from higher oil prices.

Financial sector share prices declined by 5 per cent, largely due to declines in the prices of high-yielding bank stocks. Notwithstanding this decline, financial sector share prices remain 16 per cent higher over the year to date. Equities in other sectors have been mixed, with the utilities and consumer staples sectors falling by 5 per cent since the previous *Statement*. The depreciation of the Australian dollar has generally supported sectors with large foreign revenue streams.

Measures of volatility, such as those derived from options, are little changed from the previous *Statement*, despite briefly rising in June as prices in international markets declined (Graph 4.23). Trading volumes have remained broadly stable over 2013.

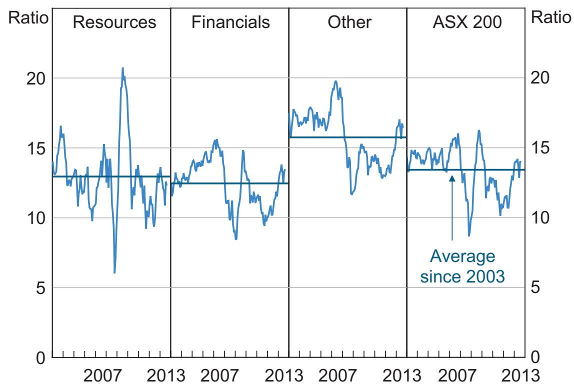
Forward price earnings (PE) ratios for Australian equities are slightly above their long-run averages in aggregate (Graph 4.24). With earnings expectations only slightly higher, PE ratios have largely tracked movements in prices. ✠

Graph 4.23
Equity Volatility and Trading Activity



* ASX 200 average daily volume per month traded on the ASX and Chi-X exchanges, seasonally adjusted
** 5-day moving average, ASX VIX from 2008, implied volatility from ASX SPI options prior to 2008
Sources: ASX; Bloomberg; RBA; Thomson Reuters

Graph 4.24
Australian Forward Price Earnings Ratios
ASX 200



Sources: RBA; Thomson Reuters