4. Domestic Financial Markets

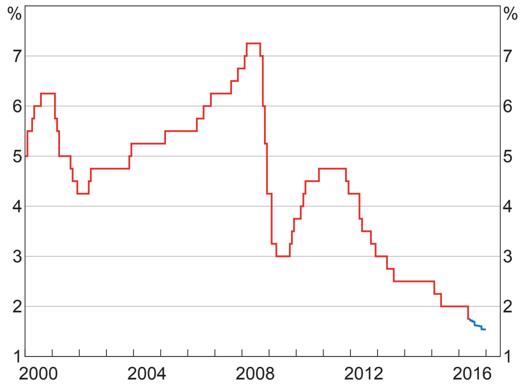
After a period of volatility at the start of the year, driven mainly by concerns about the outlook for the Chinese economy and declines in oil prices, conditions in domestic financial markets have been more stable. The cash rate was reduced at the May Board Meeting, and interest rates on the stock of housing and business loans have declined in response. Yields on paper issued by banks and non-financial corporations remain low. The increase in wholesale funding costs for banks earlier in the year has translated into only a modest pick-up in their average funding costs. Banks have been readily sourcing funding from wholesale markets, while deposit growth has slowed. Housing lending growth eased following the increases in lending rates in 2015 and the measures taken to strengthen lending standards. Business lending rates are at historic lows and business lending has continued to grow strongly. Australian equity prices have risen in recent months from their lows in February, particularly in the resource sector following increases in commodity prices.

Money Markets and Bond Yields

The Reserve Bank Board reduced the cash rate target to 1.75 per cent at its May meeting. Rates on overnight indexed swaps (OIS) suggest an expectation of a further reduction in the cash rate (Graph 4.1). Bank bill rates have also declined, with spreads between these rates and OIS remaining relatively stable.

Yields on long-term Australian Government securities (AGS) remain near historic lows.

Graph 4.1
Cash Rate*



* Data from June 2016 onwards are expectations derived from interbank cash rate futures

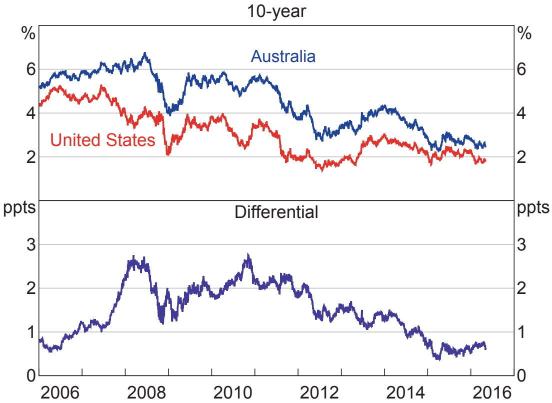
Sources: ASX; Bloomberg

Movements in AGS yields have continued to be largely influenced by movements in US Treasury yields, with the spread between the two remaining broadly steady over the past year or so (Graph 4.2).

The Australian Office of Financial Management has announced plans to issue around $70 billion of AGS in the 2016/17 financial year in net terms, which would see total AGS rise to around $500 billion (30 per cent of GDP) at the end of June 2017.

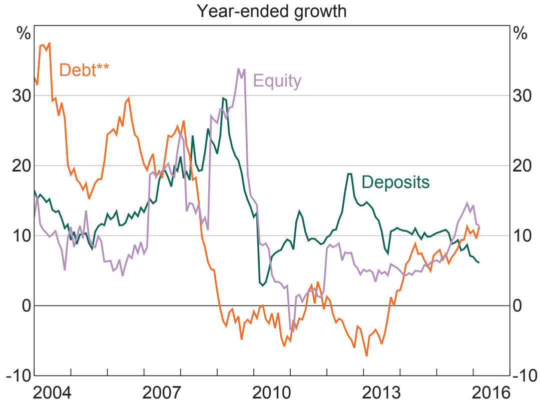
State and territory governments ('semis') have raised around $30 billion in bonds in the current financial year. After taking account of maturities, the total stock of bonds outstanding has declined to $239 billion. An increase in net borrowing by Western Australia was offset by reduced borrowing elsewhere. In early February, Moody's downgraded Western Australia's long-term credit rating by one notch to AA (Standard & Poor's equivalent) with a stable outlook.

Graph 4.2
Government Bond Yields
10-year



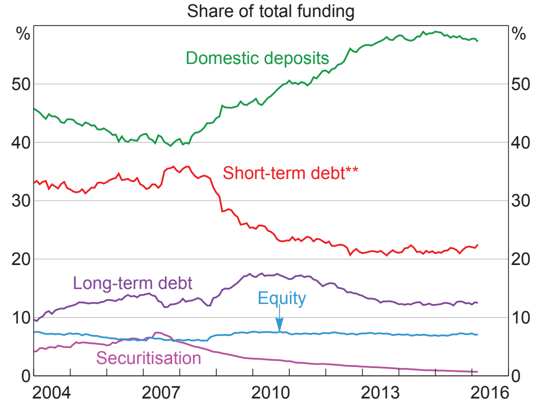
Sources: Bloomberg; RBA

Graph 4.3
Banks' Funding Liabilities*
Year-ended growth



* Adjusted for movements in foreign exchange rates
** Includes long-term debt, short-term debt and securitisation
Sources: APRA; RBA

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

Bond issuance by non-residents into the domestic market ('Kangaroo' issuance) has totalled around $10 billion since the start of 2016. There has been a modest reduction in issuance over the past year, although a broad range of issuers remain active in the market. Secondary market spreads to AGS on Kangaroo bonds have widened over the past year, consistent with pricing trends in other markets.

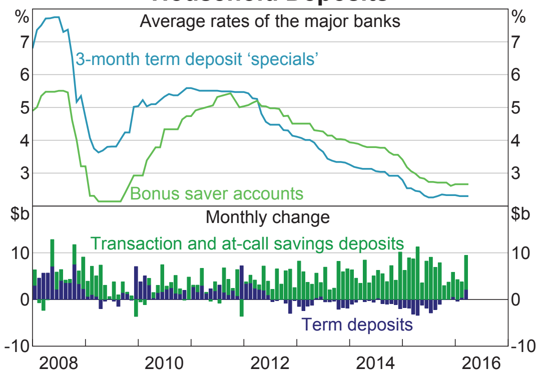
Financial Intermediaries

Banks' balance sheets have continued to grow at a moderate pace. Over the past year, growth in deposits has slowed, while growth in both wholesale and equity funding has picked up noticeably (Graph 4.3). Consistent with this, deposits as a share of total bank funding has declined a little, to around 57 per cent of total funding (Graph 4.4).

Prior to the May cash rate reduction, major banks' average debt funding costs were little changed since November 2015, notwithstanding increases in the cost of new wholesale debt. Funding costs on outstanding short-term wholesale debt are estimated to have risen by around 10 basis points over this period. The cost of new long-term issuance also rose, although it remains below the cost of outstanding issuance. Banks reported that higher wholesale funding costs had also begun to feed through to higher deposit rates, particularly wholesale term deposits. However, there was little pass-through of higher wholesale costs to overall deposit costs, which are estimated to have been little changed in recent months. Over this period, deposit growth slowed, and the business sector switched towards investing in banks' wholesale debt instruments. Household deposit growth remained strong, driven by growth in 'at-call' deposit products, such as offset accounts (Graph 4.5).

Australian bank bond issuance has been relatively high, with $53 billion in bonds issued since the start of the year (Graph 4.6). After accounting

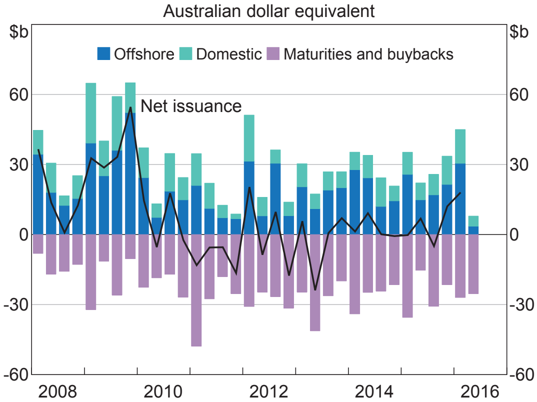
Graph 4.5
Household Deposits



Sources: APRA; Canstar Cannex; RBA

Graph 4.6
Australian Banks' Bond Issuance*

Australian dollar equivalent



* Latest quarter issuance to date

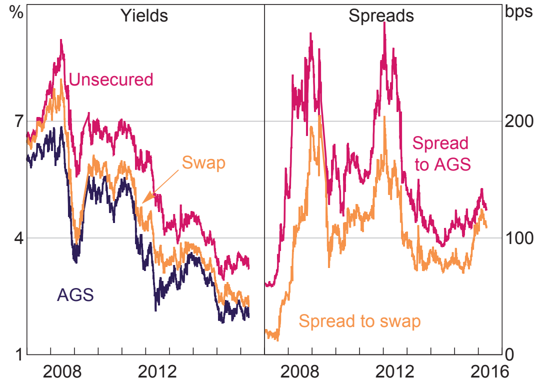
Source: RBA

for maturities, net bond issuance was around $21 billion and the stock of bank bonds outstanding has increased to $514 billion. Secondary market yields on major banks' bonds have declined since the start of the year; spreads to benchmark rates increased in February amid concerns around banks globally, though the move has since moderated (Graph 4.7).

Australian banks have issued $2.6 billion in Basel III-compliant hybrid securities in 2016, the largest of which was Commonwealth Bank's $1.5 billion Additional Tier 1 hybrid note. The pace of issuance so far this year has been slower than in previous years. Hybrid issues in the secondary

Graph 4.7
Major Banks' Bond Pricing

5-year residual maturity, Australian dollar bonds

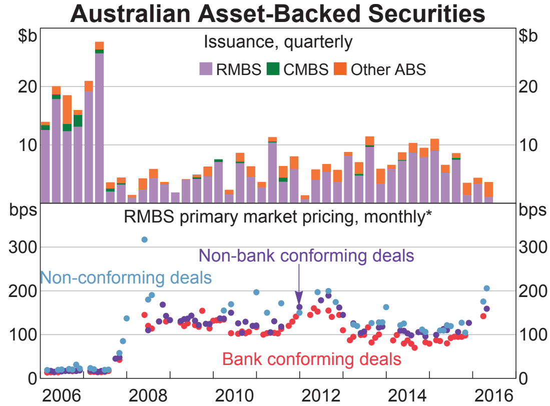


Sources: Bloomberg; UBS AG, Australia Branch

market are generally trading at a spread above the bank bill rate of around 475 basis points, an increase of around 100 basis points over the past year.

After a period of inactivity around the turn of the year, issuers of asset-backed securities have raised around $8 billion in recent months. Deals were backed by a broad range of collateral including conforming mortgages, non-conforming mortgages, automotive loans and equipment leases (Graph 4.8). Consistent with other wholesale funding markets, primary issuance spreads to the bank bill rate have widened compared to similar deals issued late last year.

Graph 4.8
Australian Asset-Backed Securities



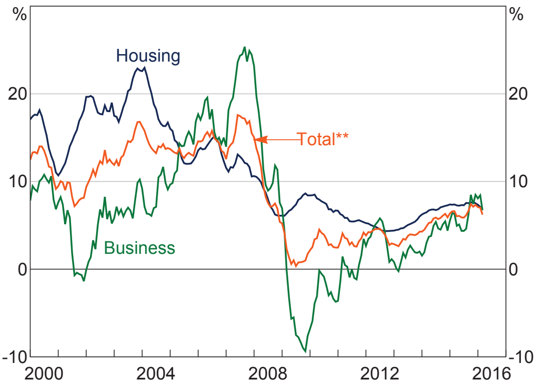
* Face-value weighted monthly average of the primary market spread to bank bill swap rate for AAA rated notes

Source: RBA

Financial Aggregates

Total credit growth has been steady in recent months at around 6 per cent in six-month annualised terms (Graph 4.9). Growth in housing credit has eased a little; business credit growth has continued to grow at a robust pace, notwithstanding some monthly volatility. Credit has been growing at around the same pace as broad money (Table 4.1).

Graph 4.9
Credit Growth by Sector*
Six-month-ended annualised

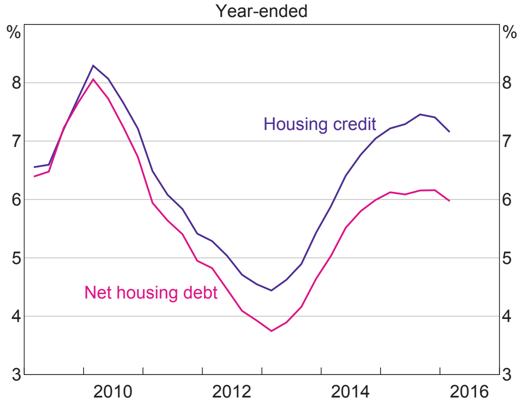


* Seasonally-adjusted and break-adjusted; including securitisation
** Includes housing, personal and business credit
Sources: ABS; APRA; RBA

Household Financing

The pace of housing credit growth has eased in recent months, to around 7 per cent. This follows increases in variable lending rates by most lenders in late 2015 and measures introduced by the Australian Prudential Regulation Authority (APRA) to strengthen lending standards. In particular, loan serviceability criteria have been tightened by lenders, which reduce the amount that some households can borrow. Consistent with these developments, there has been a decline in turnover in the housing market, along with slower growth in the average size of loans. Net housing debt has continued to grow around 1¼ percentage points slower than housing credit due to ongoing rapid growth in deposits in mortgage offset accounts (Graph 4.10). Recent housing loan approvals data suggest that housing credit will continue to grow at about its current pace.

Graph 4.10
Housing Credit Growth*
Year-ended



* Seasonally and break adjusted
Sources: ABS; APRA; RBA

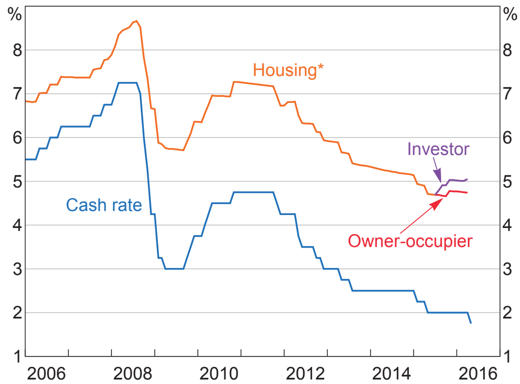
Table 4.1: Financial Aggregates
Percentage change(a)

	Three-month ended		Year-ended
	December 2015	March 2016	March 2016
Total credit	1.6	1.4	6.4
– Housing	1.8	1.5	7.2
– Owner-occupier	2.2	1.7	7.2
– Investor	1.1	1.3	7.0
– Personal	–0.4	–0.7	–1.0
– Business	1.6	1.7	6.5
Broad money	1.3	1.8	6.3

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

Prior to the May cash rate reduction, the estimated average outstanding housing interest rate had been little changed since lenders increased interest rates in the second half of 2015 (Graph 4.11). Following the May rate reduction, banks have lowered their standard variable rates by 19–25 basis points.

Graph 4.11
Interest Rates



* Estimated outstanding rate prior to the May cash rate reduction.
Sources: ABS; APRA; Perpetual; RBA

More broadly, there are signs that competition for both owner-occupier and investor loans is intensifying. New loans are typically benchmarked to standard variable rates, with lenders then offering discounts below these rates. Over recent months, interest rate discounts for new owner-occupier loans have increased and may be offsetting some of the increase in standard variable rates last year. Discounts for investors on variable-rate housing loans were reduced substantially last year but have increased in recent months. Fixed interest rates for housing loans continue to be priced competitively and, consistent with this, a higher share of mortgages has been taken out with fixed interest rates (Table 4.2).

Since the introduction of differential pricing for investor and owner-occupier lending by most major banks in the second half of 2015, growth in investor lending has slowed considerably, while growth in owner-occupier lending has accelerated. As noted previously, a large number of borrowers have contacted their existing lender to change the purpose of their loan, while there has also been a surge in owner-occupier refinancing and a drop in investor refinancing with different lenders.

Business Financing

Business credit has continued to grow strongly over recent months. This partly reflects a re-intermediation of business debt, with businesses engaging in less bond issuance. There has also been a slow-down in equity raisings.

The strength in business credit has been broad based across lending to both private non-financial corporations and unincorporated (typically smaller) businesses. The recent pace of business credit growth is consistent with business loan approvals which remain at a relatively high level. Foreign banks have increased their market share to around 15 per cent over the past year. The local operations of Japanese, Chinese and Singaporean institutions have driven the increase in business lending by foreign banks.

Prior to the May cash rate reduction, the estimated average outstanding cost of business borrowing had risen slightly in recent months, reflecting higher variable rates, alongside increases in rates for products linked to market interest rates (Graph 4.12). Lenders, including the major banks, raised average advertised variable rates on small business loans by around 15 basis points. Competition for large business lending has contributed to a narrowing of bank margins on these loans in recent years although this appears to have stabilised recently.

Australian corporate bond issuance for the year to date has totalled $5 billion, which is low compared to recent years. While secondary market corporate bond yields remain low for issuers outside the resource sector, spreads have risen over the past couple of years. For resource-related issuers, yields increased sharply in February, but have eased back as commodity prices have recovered (Graph 4.13).

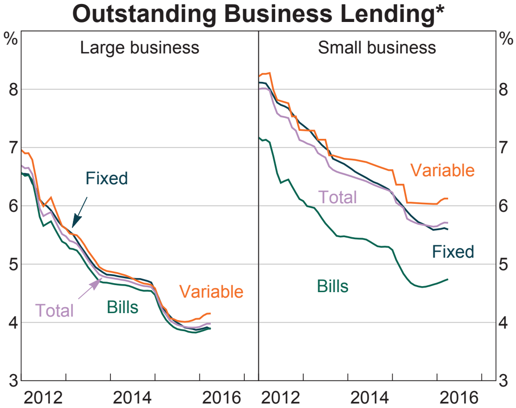
Table 4.2: Intermediaries' Fixed and Variable Lending Rates

Prior to the May Cash Rate Reduction

	Interest rate	Change since January 2016	Change since July 2015
	Per cent	Basis points	Basis points
Housing loans			
– Standard variable rate[(a)(d)]			
– Owner-occupier	5.63	0	17
– Investor	5.87	–3	41
– Package variable rate[(b)(d)]			
– Owner-occupier	4.83	0	16
– Investor	5.07	–4	40
– Fixed rate[(c)(d)]			
– Owner-occupier	4.43	0	–23
– Investor	4.66	–4	–43
– Average outstanding rate[(d)]	4.85	–1	16
Personal loans			
– Variable rate[(e)]	11.40	9	19
Small business			
– Term loans variable rate[(f)]	6.75	15	15
– Overdraft variable rate[(f)]	7.63	15	15
– Fixed rate[(c)(f)]	5.42	–1	4
– Average outstanding rate[(d)]	5.71	6	–1
Large business			
Average outstanding rate[(d)]	3.98	5	2

(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' 3-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 Cannex; RBA

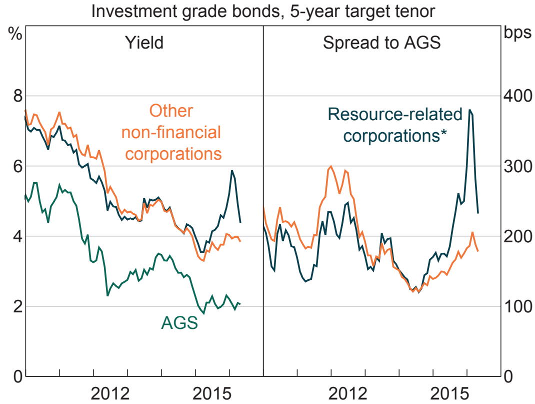
Graph 4.12
Average Interest Rates on Outstanding Business Lending*



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

Graph 4.13
Australian Corporate Bond Pricing

Investment grade bonds, 5-year target tenor



* Includes Origin Energy
Sources: Bloomberg; RBA; S&P Capital IQ

The relatively weak conditions in the resource sector have led to ratings downgrades for several Australian firms. Since the start of the year, 19 resource-related firms, including BHP Billiton and Rio Tinto, have had their credit ratings downgraded or been placed on review for downgrade by the major ratings agencies.

Equity raisings by non-financial corporations (including real estate companies) have been relatively small so far this year. Raisings by corporations that are already listed have been low, though this follows a number of large equity raisings in the second half of last year. There have been only a limited number of initial public offerings.

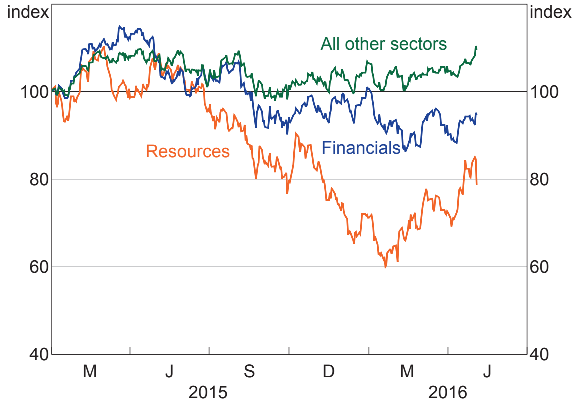
Mergers and acquisitions (M&A) activity in recent months has included the $9 billion takeover bid for Asciano by a consortium of investors including Qube Holdings and Brookfield, which was accepted in March. Excluding this deal, other M&A activity has totalled around $7 billion since the start of the year, which is below the average seen in recent years.

Equity Markets

The Australian equity market has risen from its lows in February, supported by large increases in resource sector share prices and a more recent recovery in financial sector share prices (Graph 4.14). Nevertheless, financials have underperformed the broader Australian market, which is slightly lower than at the start of the year.

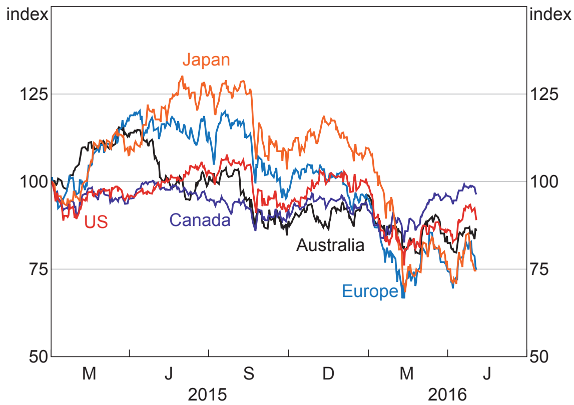
Financial sector share prices have traded in a wide range since the start of the year; bank share prices have fallen by 11 per cent over this period. Falls in global banking stocks amid increased concerns about bank profitability have been a factor, as has been the evidence of a levelling out in housing activity in Australia and signs of financial vulnerability in the resource sector (Graph 4.15). The latter has raised concern about the potential for a rise in bad debts. Against this backdrop, short selling of the major banks and their credit default swap (CDS) premia have increased.

Graph 4.14
Australian Share Price Indices
End December 2014 = 100



Source: Bloomberg

Graph 4.15
Banks' Share Prices
End December 2014 = 100

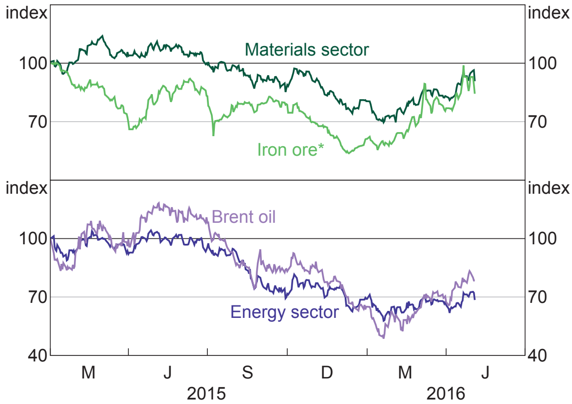


Sources: Bloomberg; RBA

Materials sector share prices have risen alongside a substantial increase in iron ore prices over recent months; energy sector share prices have also risen, albeit by less than oil prices (Graph 4.16). Equity prices for companies outside the financial and resource sectors have been mixed: share prices for consumer staples have fallen while industrials stocks have increased substantially.

Analyst earnings expectations for 2015/16 and 2016/17 have been revised lower since the start of the year, particularly for the resource sector. Analysts expect no earnings growth in the other sectors this financial year.

Graph 4.16
Resources Share Prices and Commodity Prices
End December 2014 = 100



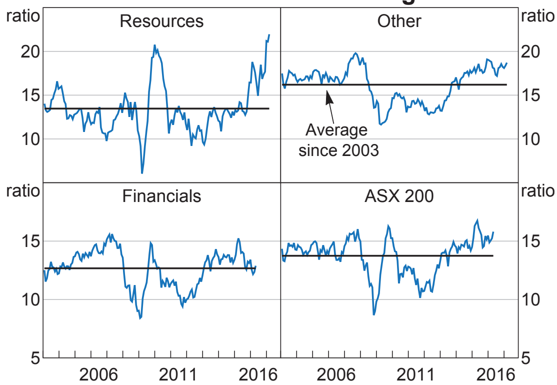
* Qingdao import iron ore spot price
Sources: Bloomberg; RBA

Valuations of Australian equities, as measured by forward price-earnings ratios, remain around or above their long-term averages across all broad sectors (Graph 4.17). Financial sector valuations have declined amid lower bank share prices. The sharp rise in resource sector valuations reflects the combination of higher equity prices and lower earnings expectations; the range of analysts' earnings expectations for the resource sector has been unusually wide recently.

ASX 200 companies reported their December half 2015 results in February. Aggregate underlying profits declined by 8 per cent from the same period last year, reflecting a sharp fall in resource sector profits (Graph 4.18).

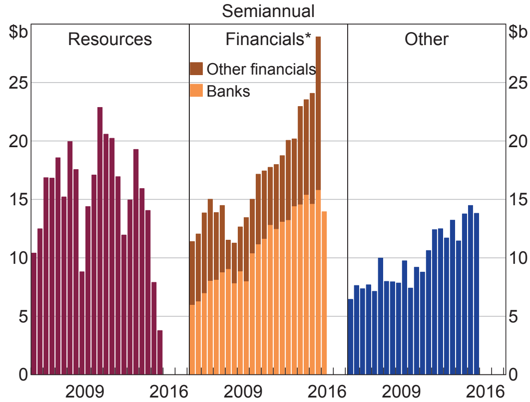
Resource sector profits were around 70 per cent lower than the same period last year, largely tracking lower commodity prices. The decline in profits was partly offset by extensive cost-cutting (including further capital expenditure reductions) and the depreciation of the Australian dollar, which lowered production costs for the major miners that report in US dollars. Many resource companies also recorded sizeable asset impairments as commodity price assumptions were revised downward.

Graph 4.17
ASX 200 Forward Price-earnings Ratios



Source: Thomson Reuters

Graph 4.18
ASX 200 Underlying Profits
Semiannual



* The June 2016 half observation for banks is based on reported results during the half and consensus expectations for companies that have not yet reported

Sources: Bloomberg; Morningstar; RBA

Financial companies reported a large increase in underlying profits in the December half driven by real estate and diversified financial companies. Profits of real estate companies were supported by sizeable revaluation gains, as well as heightened activity in the residential property market.

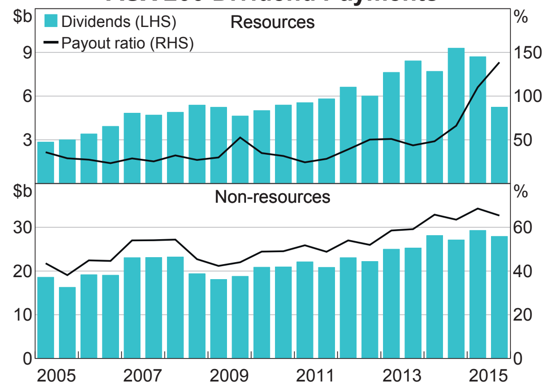
Banks reported lower underlying profit in the half year to March compared with the same period in the previous year. Net interest income was supported by growth in interest-earning assets. Net interest margins for the major banks were little changed, with higher interest rates on housing lending offset by competition in business lending markets. Bad and doubtful debt charges increased, primarily driven by a relatively small number of exposures including to businesses in the resources sector and in Asia.

Underlying profits for companies outside the resource and financial sectors were generally higher in the December half. Industrial sector profits increased substantially, supported by transportation companies which benefited from lower oil prices. In contrast, companies in the consumer staples and discretionary sectors reported lower profits in aggregate, weighed by mixed performance across the major supermarkets and lower earnings from consumer service companies.

Reflecting the decline in profits, aggregate shareholder distributions fell by almost 10 per cent in the December half 2015 from the same period last year, and the payout ratio – the ratio of dividends to earnings – remained unchanged. Much of the decline in dividends was attributable to resource companies, which substantially reduced their dividend payments in order to preserve cash and reduce leverage (Graph 4.19). In particular, the major diversified miners both shifted from progressive dividend policies to more flexible regimes. Nonetheless, the payout ratio for the resource sector increased to over 100 per cent reflecting the sharp fall in earnings.

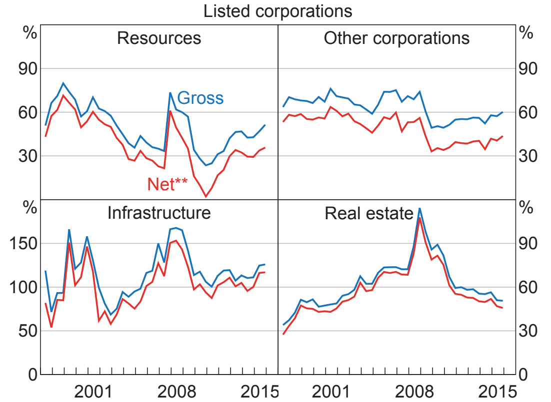
Listed corporations balance sheets expanded by 1 per cent over the December half 2015, largely driven by acquisitions outside the resource sector (Graph 4.20). The increase in assets was largely funded by debt, while aggregate equity declined slightly. As a result, the gross book value gearing ratio (the ratio of debt to equity) rose by 3 percentage points to 59 per cent.

Graph 4.19
ASX 200 Dividend Payments



Sources: ASX; Morningstar; RBA

Graph 4.20
Gearing Ratios by Sector*
Listed corporations



* Excludes foreign-domiciled companies listed on the ASX
** The net gearing ratio is total debt less cash divided by total equity
Sources: Bloomberg; Morningstar; RBA