

Domestic Financial Markets

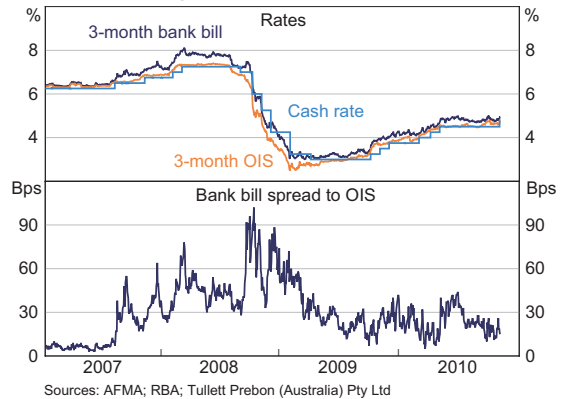
Money Markets and Bond Yields

In November, the Reserve Bank Board increased the target for the cash rate from 4.50 per cent to 4.75 per cent, the first change to the target in six months. Money market yields suggest markets currently expect a further increase in the cash rate in the first half of 2011.

Bank bill rates have largely moved in line with cash rate expectations, although spreads to overnight indexed swaps (OIS) have narrowed over recent months. Short-term bill spreads are now close to their tightest levels of the past three years and are only slightly above their pre-crisis level (Graph 57). Through its market operations, the Reserve Bank has generally maintained exchange settlement (ES) balances around \$1¼ billion, and the cash rate has traded at target on all days.

In line with moves seen in global markets, long-term bond yields declined during August, with the yield on 10-year Commonwealth Government Securities (CGS) falling to around 4¾ per cent, its lowest in more than a year. The subsequent strength in economic data has seen the 10-year yield rise above 5 per cent again (Graph 58). Spreads between other highly-rated securities and CGS – including state government and supranational debt – have narrowed slightly in recent months. The stock of state government debt guaranteed by the Australian Government has continued to decline with Queensland buying back \$3 billion in October against issuance of new unguaranteed lines. This follows similar actions by Queensland and NSW earlier in the year.

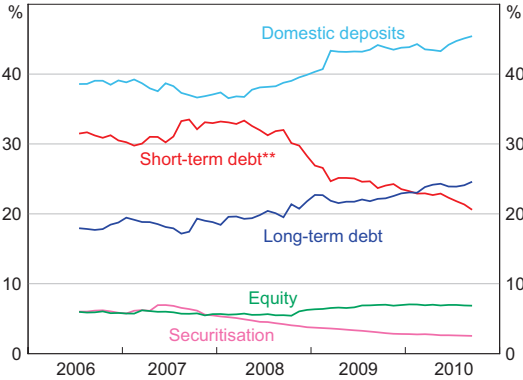
Graph 57
Money Market Interest Rates



Graph 58
Australian Government Bond Yields

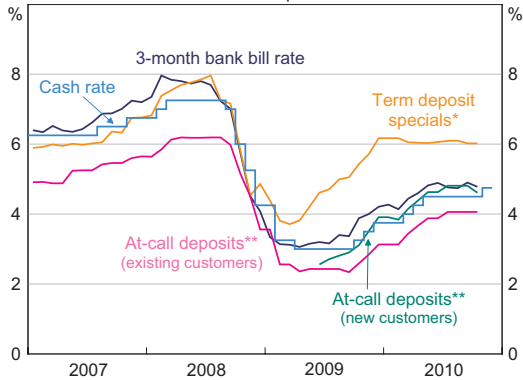


Graph 59
Funding Composition of Banks in Australia*
 Per cent of funding



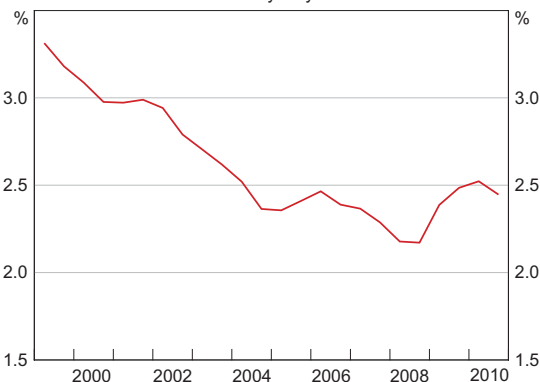
* Adjusted for movements in foreign exchange rates
 ** Includes deposits and intragroup funding from non-residents
 Sources: APRA; RBA

Graph 60
Deposit Rates
 \$10 000 deposits



* Average of 1–12, 24-, 36- and 60-month terms at the major banks
 ** Average of online, bonus and cash management accounts at the major banks
 Source: RBA

Graph 61
Major Banks' Net Interest Margin*
 Half-yearly



* From 2006 data are on an IFRS basis; prior years are on an AGAAP basis;
 Excludes St. George Bank and Bankwest prior to the first half of 2009
 Sources: Banks' financial reports; RBA

Financial Intermediaries

The composition of banks' funding in the September quarter has continued to evolve in the same manner as it has done over the past couple of years. Notably, there was a further increase in the share of relatively high cost funds, such as deposits and long-term debt, while the share of short-term capital market liabilities continued to decline (Graph 59). These shifts reflect regulatory and market pressures.

While pressures for retaining deposit funding remain strong, in recent months there has been little movement in interest rates on new or existing at-call deposits, including online saving, bonus saver and cash management accounts (Graph 60). The average rate on the major banks' term deposit 'specials', the most relevant rate for term deposit pricing, has been little changed since the previous *Statement* at just over 6 per cent. This is around 230 basis points higher than in early 2009, a considerably larger increase than that in the cash rate over the same period. The interest rate on these deposits is currently almost 100 basis points above the cost of funds of equivalent duration in the wholesale money market. On average, 'special' term deposit rates of the smaller Australian-owned banks are at similar levels to those offered by the major banks.

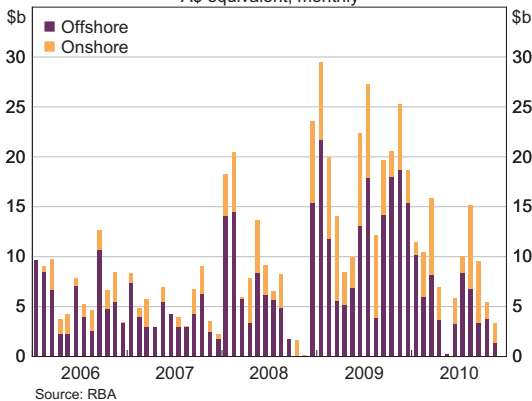
The average cost of the major banks' long-term funding continues to rise as maturities are rolled over at higher spreads. However, in recent months, this has been largely offset by the narrowing in the spread between bank bills and OIS rates. Overall, this suggests that, in aggregate, the major banks' funding costs are likely to have been little changed over recent months, though trends differ for individual banks depending on their mix of funding.

In terms of net interest margins, banks have recently reported mixed results; most have experienced a small decrease in margins, though some have experienced a small increase. In aggregate, the net interest margin of the major banks has fluctuated in a relatively narrow range since 2004, between 2¼ and 2½ percentage points (Graph 61).

Since the previous *Statement*, Australian banks have issued a total of \$33.5 billion of bonds and have continued to access a wide range of markets and currencies. Issuance was particularly strong in August following the broad improvement in global market conditions (Graph 62). Just over one-half of issuance in recent months has occurred in the domestic market, with Australian branches of overseas banks being particularly active. The cost of recent issuance has remained broadly stable since the previous *Statement*, with spreads remaining well below their peaks in late 2008 (Graph 63).

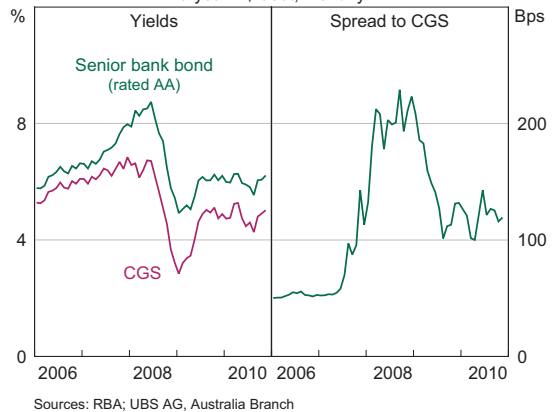
The cross-currency basis swap spread – which represents an additional funding cost for banks hedging foreign currency bond issuance into Australian dollars – has declined since the previous *Statement*, particularly for swapping euro into Australian dollars, and remains below its level early this year. This downward pressure on the basis is consistent with an increase in the volume of Kangaroo bond issuance relative to foreign currency issuance that Australian issuers hedge into Australian dollars (Graph 64). Issuance of Kangaroo bonds picked up substantially in the September quarter to total \$10 billion, compared with \$6 billion in the June quarter. So far this year, Kangaroo issuance has totalled \$35 billion, close to the previous annual record in 2006.

Graph 62
Australian Banks' Bond Issuance
 A\$ equivalent, monthly

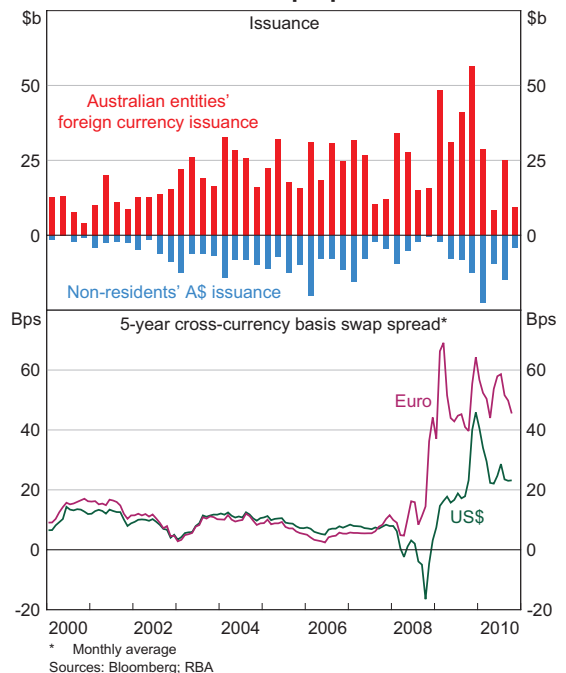


Activity in the Australian securitisation market has picked up over recent months, with issuance in the September quarter totalling \$8.6 billion, compared with issuance of \$2.3 billion in the June quarter. The Australian Office of Financial Management (AOFM) has continued to be a key participant in

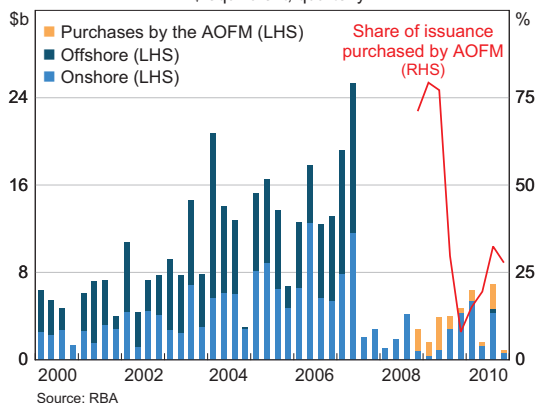
Graph 63
Major Banks' Bond Pricing
 3-year A\$ debt, monthly



Graph 64
Bond Issuance and the Cross-currency Basis Swap Spread



Graph 65
Australian RMBS Issuance
A\$ equivalent, quarterly



the Australian residential mortgage-backed security (RMBS) market, purchasing up to one-third of new RMBS issuance (Graph 65). In recent months, the AOFM has purchased most of the longer-dated tranches of RMBS issues and has tended to invest at lower spreads than other participants in the market. Spreads on AAA-rated tranches trading in the secondary market have widened slightly during recent months, to around 155 basis points above the bank bill swap rate.

Credit rating agency Standard & Poor's has proposed changes to its methodology for Australian RMBS designed to reduce the dependence of the AAA-rating of Australian RMBS on lenders' mortgage insurance and to make ratings more resilient to periods of severe economic stress. Compliance with the proposed new methodology would require Australian issuers of RMBS to provide more subordination in their issues, with the headline level of subordination rising from 3.8 per cent to 5.0 per cent under the proposals. Most recent RMBS issues have been structured to include more subordination.

Household Financing

The major lenders left their variable housing interest rates unchanged over the three months to the end of October (Table 9). A couple of institutions began offering new borrowers larger discounts on housing loans, and several have raised their maximum loan-to-valuation ratios. At the time of writing, only one major lender has announced an increase in its variable housing interest rates following the increase in the cash rate in November.

Table 9: Intermediaries' Variable Lending Rates
Per cent

	Level at 31 Oct 2010	Change since:	
		August Statement	Mid 2009
Housing loans			
Prime full-doc	6.82	0	1.63
Prime low-doc	7.48	0	1.68
Personal loans	12.64	0	1.70
Small business			
Term loans			
– Residentially secured	8.59	0	1.51
– Other security	9.35	0	1.45
Overdraft			
– Residentially secured	9.45	0	1.56
– Other security	10.31	0	1.50
Average actual rate	8.61	0	1.49
Large business			
Average actual rate, variable and bill funding	6.72	-0.08	1.70

Sources: ABS; APRA; Canstar Cannex; Perpetual; RBA

The major banks' interest rates on new 3-year and 5-year fixed-rate housing loans have fallen slightly in recent months. These rates have also decreased relative to their corresponding swap rates (a common pricing benchmark), although the level of these spreads is still around the average of the past couple of years. Fixed-rate lending has remained at a very low share of owner-occupier approvals, with fixed rates still above variable rates.

Overall, the average interest rate on all outstanding housing loans (fixed and variable) is likely to increase to marginally above its post-1996 average, following the increase in the cash rate in November (Graph 66).

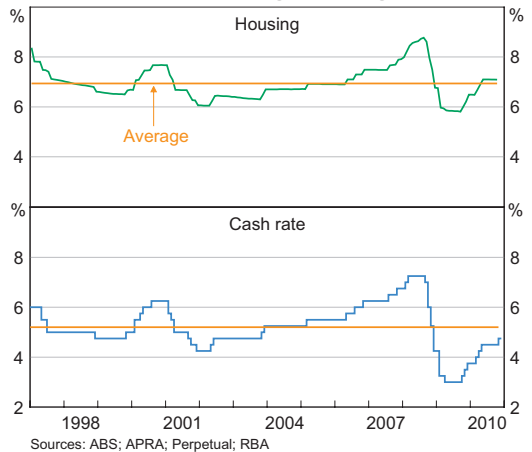
The total value of housing loan approvals has declined in recent months, reflecting a fall in investor activity. Loan approvals to owner occupiers, including first-home buyers, have remained steady in recent months (Graph 67).

The five largest banks' share of gross owner-occupier loan approvals has declined to around 6 percentage points below its peak in early 2009 but remains well above its pre-crisis level (Graph 68). Most of this decline in market share has been picked up by other Australian-owned banks.

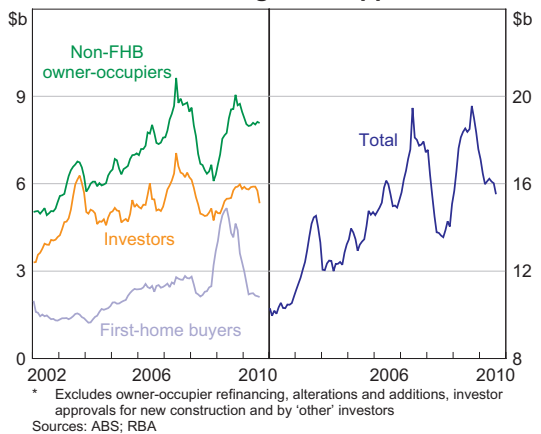
Housing credit growth has been steady at an annualised pace of around 7 per cent in the September quarter (Graph 69). Despite the recent decline in approvals, investor housing credit has picked up during the year, while lending to owner-occupiers has eased.

With one exception, financial institutions are yet to announce changes to variable personal loan rates following the increase to the cash rate in November. Personal credit, which is a small component of household credit, was broadly stable over the September quarter as weakness in margin lending has been offset by a pick-up in other personal lending. Credit card debt has been broadly unchanged over 2010. The weakness in margin lending, as well as an increase in the value of collateral (mainly equities) backing these margin loans has resulted in average gearing levels declining in the September quarter

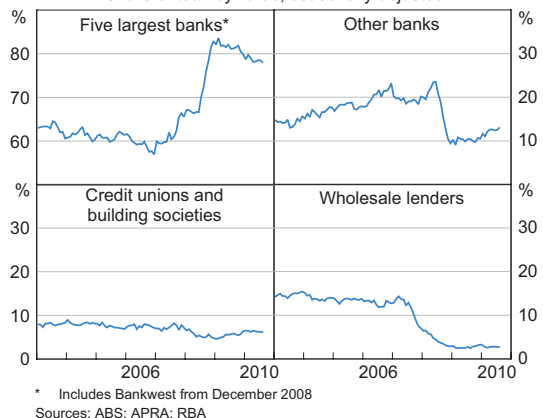
Graph 66
Average Interest Rates on Outstanding Lending



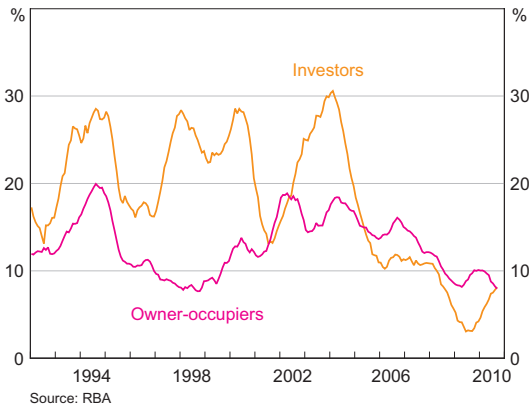
Graph 67
Value of Housing Loan Approvals*



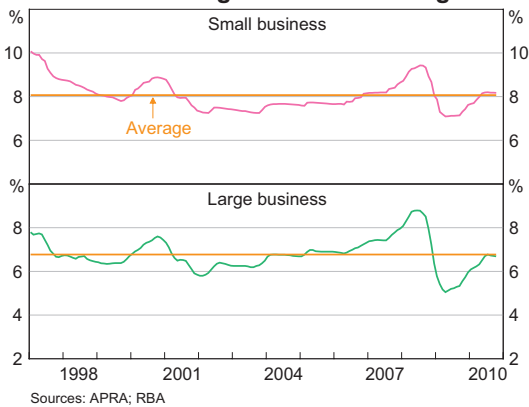
Graph 68
Owner-occupier Loan Approvals
Share of total by value, seasonally adjusted



Graph 69
Housing Credit Growth
 Year-ended



Graph 70
Average Interest Rates on Outstanding Business Lending



and has meant that the number of margin calls also remained very low (at less than one margin call per day per 1 000 clients).

Business Financing

At the time of writing, no major lender has announced an increase to their variable indicator rates on small business lending following the increase in the cash rate in November. Indicator rates on 1-year to 5-year fixed-rate facilities have generally increased in line with corresponding swap rates, which have risen by around 30 basis points over recent months. The average rate on outstanding small business loans remains around its post-1996 average (Graph 70).

The average interest rate on banks' outstanding variable-rate lending to large business (bill and term facilities of \$2 million or more) is estimated to have decreased by almost 10 basis points since the end of July, to 6.72 per cent. These loans are repriced at regular intervals off money market benchmark rates (such as the 3-month bank bill yield), which have been slightly lower on average in the past few months. Furthermore, the risk margins that banks charge above these benchmark rates for new customers have tended to decline a little over 2010, having risen substantially over the past few years. The recent reduction in margins is flowing through to lower average margins on some facilities (especially bill facilities). While margins on variable-rate term loan facilities for some new borrowers have also fallen, the average margin on outstanding facilities has continued to rise slowly as margins on new loans are still above those on existing loans.

Syndicated loan approvals declined in the September quarter, with deals totalling around \$14 billion, compared with around \$20 billion in the June quarter. The decline reflected a fall in lending for the refinancing of existing facilities, while approvals for capital expenditure and general corporate purposes have picked up slightly.

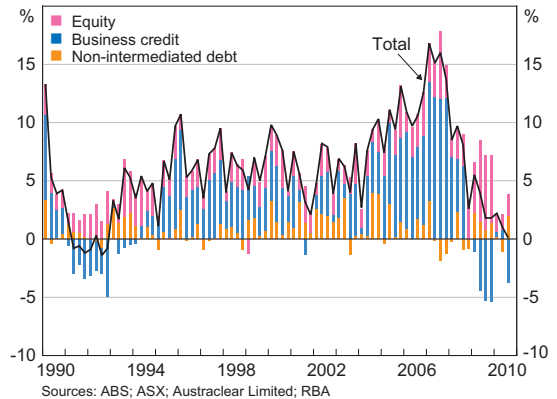
Corporate bond issuance totalled \$8 billion in the September quarter, a significant pick up from volumes in the previous two quarters. Improvements in market conditions are also reflected in secondary market corporate bond spreads, which have tightened by around 50 basis points since June to around 205 basis points over CGS.

Net corporate external funding was broadly flat as a share of GDP in the September quarter (Graph 71). The decline in intermediated business credit in the September quarter was offset by equity raisings and an increase in the stock of non-intermediated debt.

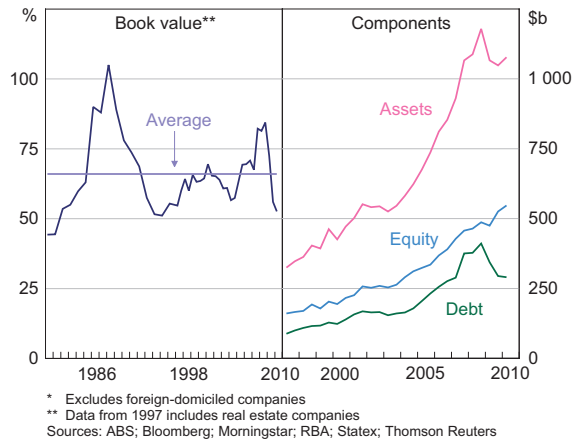
Following a significant contraction over 2009, listed corporates' balance sheets expanded over the first half of 2010 and gearing ratios continued to decline. Book value gearing – the ratio of debt to the book value of shareholders' equity – declined to 53 per cent, its lowest level since the mid 1990s and around 30 percentage points lower than its peak in December 2008 (Graph 72).

Unlike last year when gearing declined sharply as corporates raised equity to retire debt, the recent decline in gearing reflected higher retained earnings following the strong recovery in profitability. Along with higher earnings, more stable asset values meant that total asset values of Australian listed corporates rose for the first time since the December half 2008. The decline in gearing was largely driven by the resources sector, which has enjoyed a significant increase in headline profits and retained earnings (Graph 73). Gearing in other sectors was mostly unchanged.

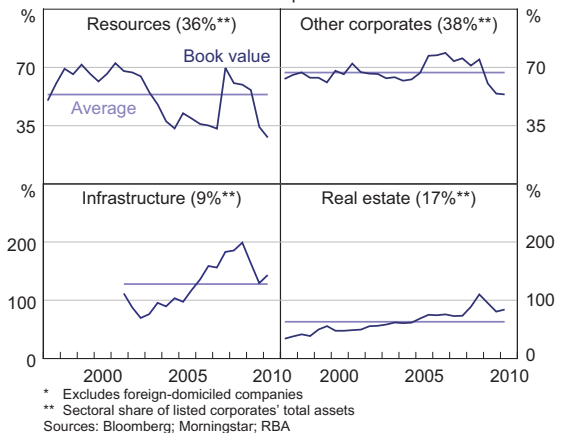
Graph 71
Business External Funding
Net change as a share of GDP, quarterly



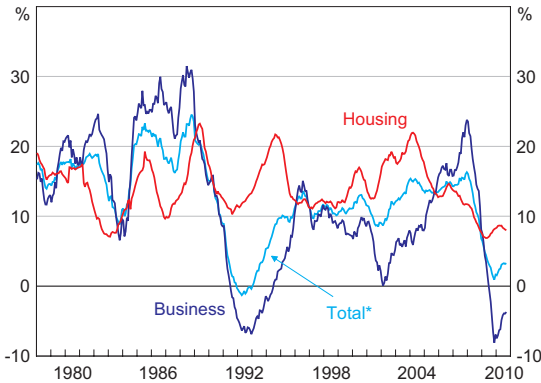
Graph 72
Listed Corporates' Gearing*



Graph 73
Gearing Ratios by Sector*
Listed corporates



Graph 74
Credit Growth
Year-ended



* Includes housing, personal and business credit
Source: RBA

Aggregate Credit

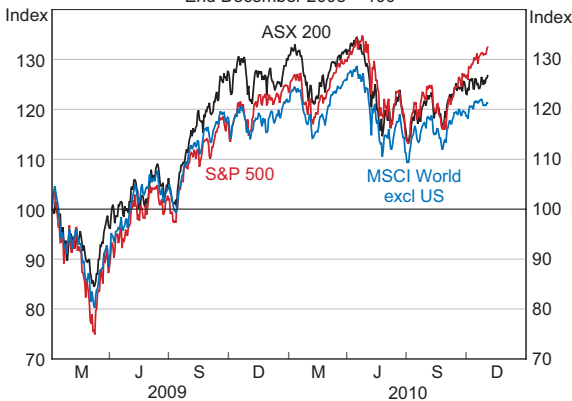
Total outstanding credit grew at an annualised rate of 1.5 per cent over the September quarter, reflecting moderate growth in household credit and weakness in lending to businesses. Business credit has declined in recent months, following six months where it remained broadly unchanged (Table 10; Graph 74). Growth in broad money has remained solid in recent months, partly reflecting a preference to hold assets in deposits. Reflecting this increase in deposits, the growth of broad money has outpaced credit since the latter half of 2007.

Table 10: Financial Aggregates
Percentage change

	Average monthly growth		Year to September 2010
	June quarter 2010	September quarter 2010	
Total credit	0.3	0.1	3.3
– Owner-occupier housing	0.5	0.6	7.9
– Investor housing	0.7	0.7	8.1
– Personal	–0.2	0.0	2.8
– Business	0.1	–0.6	–3.7
Broad money	0.6	0.6	5.4

Source: RBA

Graph 75
Share Price Indices
End December 2008 = 100



Source: Bloomberg

Equity Markets

Since the previous *Statement*, the ASX 200 has risen by 3½ per cent compared with an average increase of around 4½ per cent in major overseas markets (Graph 75). On a sectoral basis, gains in resources led the broader market, while financials underperformed (Table 11).

Table 11: Sectoral Movements in the ASX 200

	Per cent change since:		
	August Statement	Trough (March 2009)	Peak (November 2007)
Resources	7.7	56	-14
Financials	1.0	63	-40
Other	2.3	33	-32
ASX 200	3.4	50	-31

Sources: Bloomberg; RBA

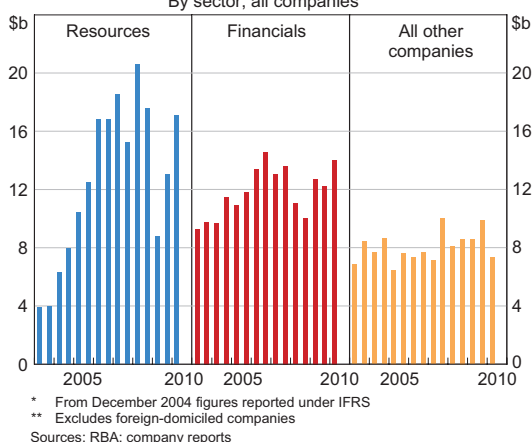
Profits announced by ASX 200 companies during the recent reporting season were substantially higher over the year, broadly in line with expectations. Headline profits rebounded strongly as the phase of large asset write downs by real estate and resource companies came to an end. Write downs in the first half of 2010 amounted to just \$0.1 billion, following a total of \$44 billion over the three previous half years.

Underlying profits – which exclude significant items and asset revaluations/sales – were 30 per cent higher in the first half of 2010 compared with the corresponding period last year (Graph 76). The rise in aggregate underlying profits was largely driven by resource companies, which reported a 94 per cent increase compared with the corresponding period of 2009. The rise reflected both higher commodity prices and stronger production volumes. Financials' profits rose by 10 per cent, largely as a result of lower bad and doubtful debt charges and an increase in net interest income. Profits at insurance and real estate companies declined, although these declines were driven by a few of the sectors' largest companies. The profits of other companies declined by 9 per cent.

Aggregate dividends increased by 11 per cent, reflecting not only the significant increase in profits but also a recovery in dividend payout ratios, which had previously declined as firms acted to strengthen their balance sheets during the financial crisis. For the first time since June 2008, there were more dividend increases than cuts; 37 per cent of companies increased dividends compared with 20 per cent announcing cuts.

Graph 76

Underlying Profits of ASX 200 Companies*
By sector, all companies**



Merger and acquisition activity has been substantial over recent months, with around \$70 billion of deals announced by listed companies since the previous *Statement*. BHP's bid for Canadian group PotashCorp of around \$43 billion and Singapore Exchange's \$8.4 billion offer to merge with the Australian Stock Exchange account for a large share of this amount. In addition, there were other sizeable bids in the resources and energy sectors, while private equity groups placed bids for Foster's wine division and for wealth manager Perpetual. Around \$100 billion of deals are pending, although recent developments suggest BHP's bid for PotashCorp will not go ahead in its current form. ↗

