4. Domestic Financial Markets

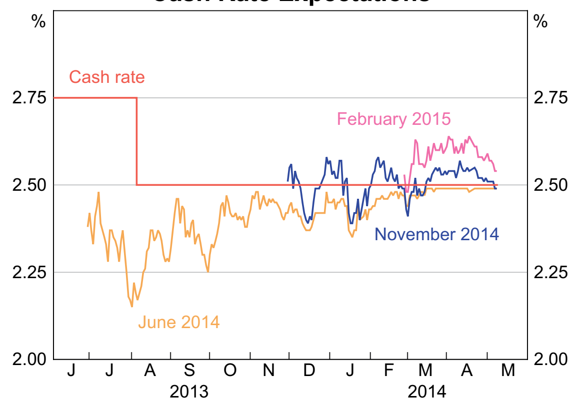
Australian financial markets have been relatively quiet over recent months. Money market rates imply that the cash rate is expected to remain unchanged over the remainder of the year. Longer-term government bond yields are lower than at the time of the previous *Statement* and demand for Commonwealth Government securities (CGS) has been very strong. Corporate bond spreads have remained around their lowest levels since 2007 and issuance has been readily absorbed by the market, including issuance by lower-rated corporations and at longer maturities. Intermediated lending has grown at a moderate pace, with housing credit growth steadying over recent months, while growth in business credit has picked up. Australian equity prices have risen over the period, broadly in line with global markets.

Money Markets and Bond Yields

The cash rate target has been at 2.50 per cent since August last year (Graph 4.1). The pricing of money market instruments implies little likelihood of a change in monetary policy this year, although there is an expectation that the cash rate will be increased around the middle of 2015.

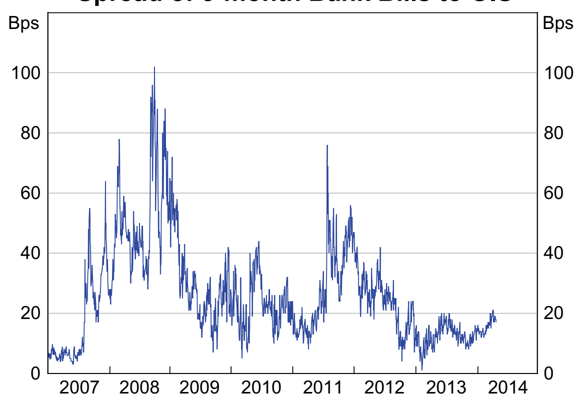
Rates on 3-month bank bills and certificates of deposit (CDs) are little changed since the previous *Statement*. Increased issuance of bills and CDs has contributed to a widening of the spread between these instruments and overnight indexed swaps (OIS) of around 5 basis points since the previous *Statement*. Nevertheless, the spread on 3-month bills remains low compared with levels experienced over recent years (Graph 4.2).

Graph 4.1
Cash Rate Expectations



Sources: RBA; Tullett Prebon (Australia) Pty Ltd

Graph 4.2
Spread of 3-month Bank Bills to OIS

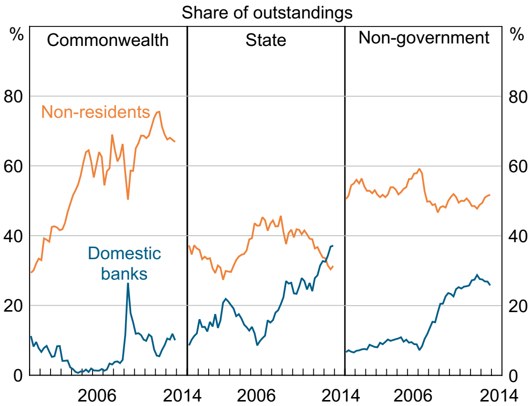


Sources: AFMA; Tullett Prebon (Australia) Pty Ltd

Yields on long-term CGS are lower than at the time of the previous *Statement,* mainly reflecting global developments as well as lower-than-expected domestic inflation. As a result, the spread between 10-year CGS and US Treasuries has narrowed by around 15 basis points since the previous *Statement*.

Demand for newly issued CGS has been very strong in 2014 to date. The Australian Office of Financial Management (AOFM) issued $7 billion of a new April 2026 bond in March, which was the largest initial Australian government bond issue on record. Much of the issue was initially purchased by domestic investors, though 30 per cent went to Asian accounts (excluding Japan). More generally, AOFM bond tenders have been clearing below yields prevailing in the secondary market at the time of the auction. The share of CGS held by non-residents was little changed in the December quarter at around two-thirds, though it is well below its peak in late 2012 (Graph 4.3).

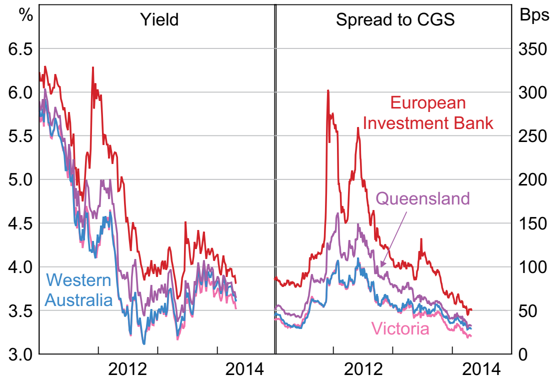
Graph 4.3
Holders of Australian Bonds



Sources: ABS; RBA

Net issuance of state government bonds ('semis') has totalled $7.8 billion since the previous *Statement*. Over half of this net issuance was comprised of floating-rate bonds, facilitating investment by Australian banks, which are increasing their holdings of high-quality liquid assets ahead of the implementation of the Australian Prudential Regulation Authority's (APRA's) Basel III liquidity reforms in 2015. Spreads between 5-year CGS and semis have generally narrowed by around 10 basis points since the previous *Statement*, and for some state issuers, spreads are at their lowest levels since 2006/07 (Graph 4.4).

Graph 4.4
5-year State Government and Supranational Debt



Sources: RBA; Yieldbroker

Domestic bond issuance by non-resident entities ('Kangaroos') has totalled $9.4 billion since the previous *Statement*, and has been raised primarily by banks. Secondary market spreads for Kangaroo bonds have contracted by around 15 basis points, and are close to their lowest levels since late 2007. The cost of hedging Australian dollar issuance into US dollars remained mostly unchanged, while the cost of hedging into euro and yen has increased, mainly reflecting a narrowing in the US dollar/euro and US dollar/yen cross-currency basis swap rates.

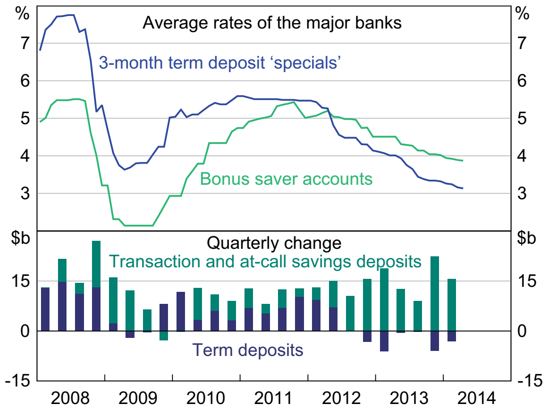
Financial Intermediaries

Bank funding costs have been stable since the previous *Statement*, as the effects of a decline in deposit rates and favourable wholesale funding conditions have been offset by a change in the deposit mix towards transaction and at-call accounts.[1] This has been driven by banks reducing rates on term deposits relative to comparable at-call 'bonus saver' accounts, which have higher advertised rates (Graph 4.5).

The aggregate share of deposits in banks' funding has remained broadly stable over recent months. The share of long-term debt has been little changed as banks have tended to only replace maturing debt (Graph 4.6).

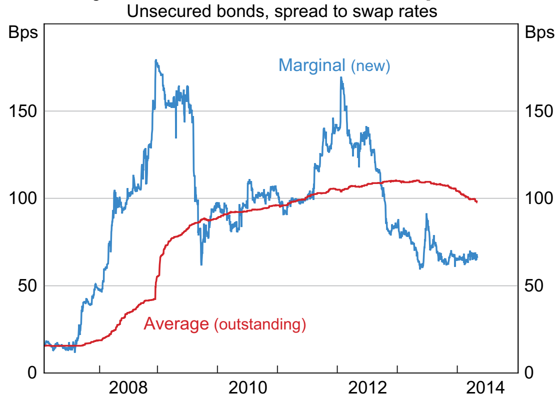
1 For more details on bank funding costs, see Berkelmans L and A Duong (2014), 'Developments in Banks' Funding Costs and Lending Rates', RBA *Bulletin*, March, pp 69–75.

Graph 4.5
Household Deposits



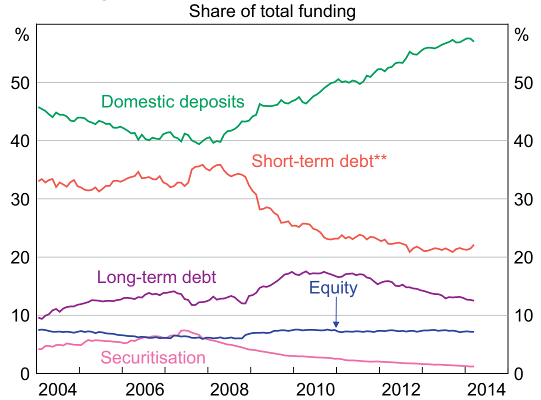
Sources: APRA; CANSTAR; RBA

Graph 4.7
Major Banks' Domestic Bond Spreads
Unsecured bonds, spread to swap rates



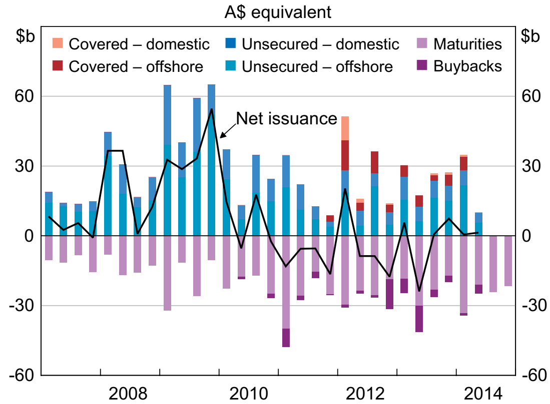
Sources: Bloomberg; RBA; UBS AG, Australia Branch

Graph 4.6
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 4.8
Banks' Bond Issuance and Maturities*
A$ equivalent



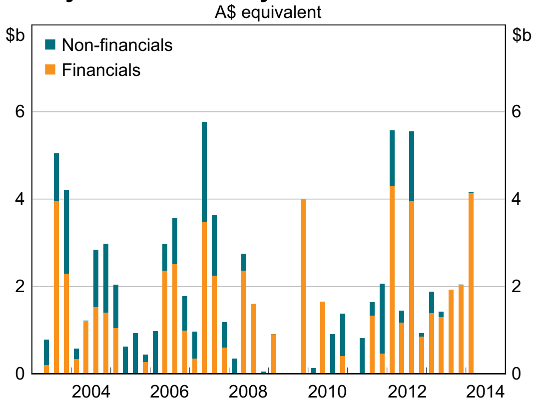
* Last quarter gross issuance and net issuance are quarter to date
Source: RBA

The cost of issuing unsecured long-term wholesale debt remains at relatively low levels for banks (Graph 4.7). This, together with the maturing of debt issued in 2008 and 2009 at high spreads, has meant that the outstanding cost of wholesale debt has continued to decline over the past few months. This decrease in long-term wholesale funding costs has made only a small contribution to the decline in banks' overall funding costs, reflecting its small share of banks' total funding of around 12 per cent.

Australian banks have issued around $31 billion in senior unsecured and covered bonds since the previous *Statement*, around two-thirds of which was issued offshore (Graph 4.8). The stock of outstanding bonds has remained broadly unchanged, reflecting bond maturities and a small amount of government-guaranteed bond buybacks.

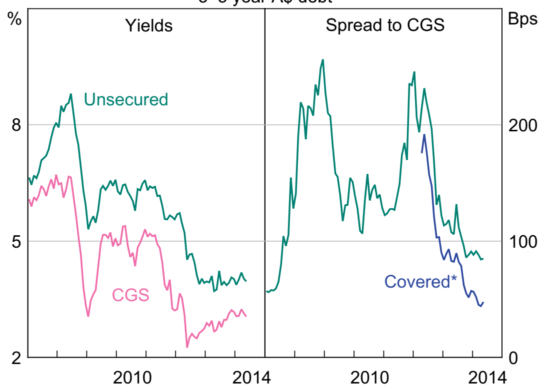
Hybrid issuance has picked up this year, with banks and other financial institutions raising more than $4 billion of Basel III compliant hybrid securities, including securities marketed solely to institutional investors (Graph 4.9). This was a departure from the retail-focused issuance of 2012 and 2013. Institutional demand has focused on Tier 2 capital compliant notes. These notes include an option for the security to be converted to equity or written off if APRA determines that the issuer has reached a point of non-viability.

Graph 4.9
Hybrid Issuance by Australian Entities
A$ equivalent



Source: RBA

Graph 4.10
Major Banks' Bonds
3–5 year A$ debt

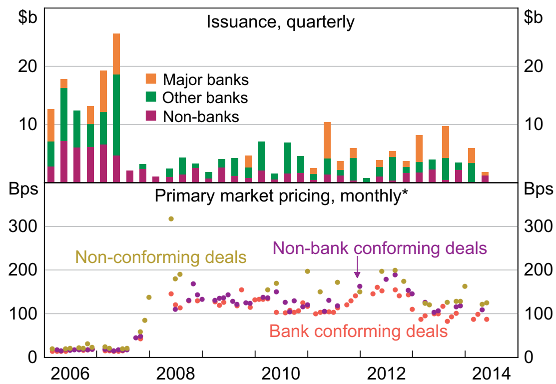


* Covered bond pricing interpolated to a target tenor of 4 years using bonds with a residual maturity between 2 and 10 years
Sources: Bloomberg; RBA; UBS AG, Australia Branch

Relative to CGS, spreads on the major banks' bonds have declined since the previous *Statement* (Graph 4.10). Credit ratings activity over the period was generally positive, with Bank of Queensland's rating upgraded by one notch by one of the major credit rating agencies.

Banks have generally reported increases in underlying profit, reflecting ongoing declines in bad debt charges owing to improved asset quality, and increases in income due to balance sheet growth. For the major banks, net interest margins have narrowed, with banks attributing this to the ongoing effects of lower interest rates and strong competition in lending markets; this has been offset, in part, by reduced competition for term deposits. The banks generally increased their dividends compared with the same period in the previous financial year.

Graph 4.11
Australian RMBS



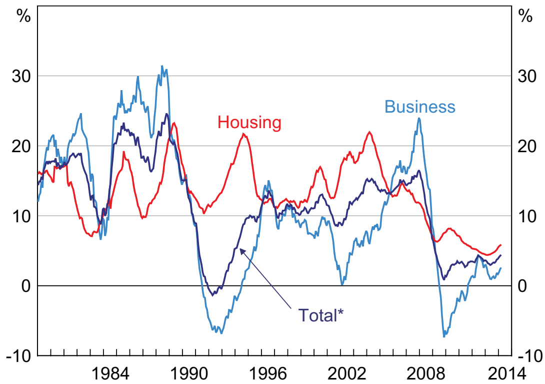
* Face-value weighted monthly average of the primary market spread to bank bill rate
Source: RBA

Issuance of residential mortgage-backed securities (RMBS) has been around $6.6 billion since the previous *Statement* (Graph 4.11). Mortgage originators accounted for around one-quarter of this, including three new deals involving 'non-conforming' mortgages. These mortgages typically involve borrowers with a history of credit impairment, higher loan-to-value ratios and/or reduced documentation. Issuance spreads on senior RMBS tranches have remained around their lowest levels since 2007/08. In response to the improved conditions in the RMBS market, the AOFM completed a full divestment of its mezzanine note holdings. Demand for these mezzanine notes from private investors has been strong, partly reflecting expectations that APRA's reform of securitisation standards will limit the future supply of mezzanine and other more junior notes.

Financial Aggregates

Total credit increased at an annualised rate of around 5 per cent over the March quarter (Graph 4.12). This reflected a decline in personal credit and a pick-up in business credit growth, with housing credit growth little changed (Table 4.1). Growth in credit remains below growth in broad money, which increased at an annualised rate of around 7.8 per cent over the quarter.

Graph 4.12
Credit Growth by Sector
Year-ended

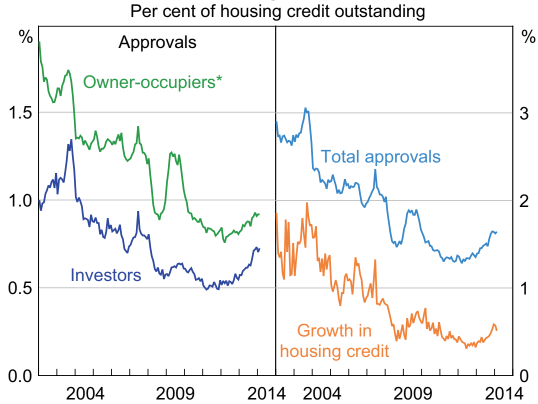


* Includes housing, personal and business credit
Sources: APRA; RBA

Household Financing

Housing credit continued to grow at an annualised pace of around 6.5 per cent over the March quarter, with growth in investor housing credit outpacing growth in owner-occupier housing credit. The value of housing loan approvals is little changed since November 2013, although it has increased by around 24 per cent over the past year (Graph 4.13). Consistent with this, housing credit growth for both investors and owner-occupiers has steadied in recent months following a pick-up during the second half of 2013. Higher levels of mortgage prepayments and a relatively low level of approvals to first home buyers are likely to be affecting housing credit growth.

Graph 4.13
Housing Loans
Per cent of housing credit outstanding



* Net of refinancing
Sources: ABS; RBA

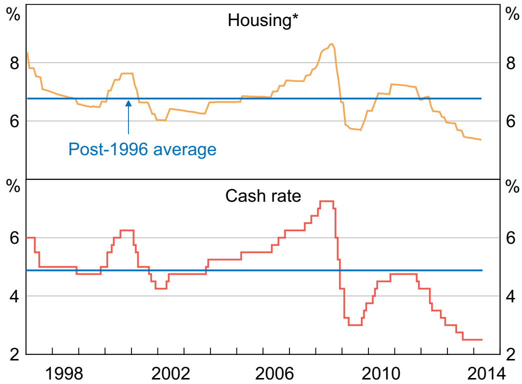
The average interest rate on outstanding housing loans has continued to fall as borrowers have refinanced at lower rates (Graph 4.14). The average interest rate on housing loans is now around 34 basis points below its previous trough in September 2009.

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

	Three-month ended December 2013	Three-month ended March 2014	Year-ended March 2014
Total credit	1.2	1.2	4.4
– Owner-occupier housing	1.3	1.3	4.9
– Investor housing	2.2	2.1	7.9
– Personal	0.1	–0.3	0.4
– Business	0.6	0.9	2.6
Broad money	1.7	1.9	6.5

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

Graph 4.14
Housing Interest Rates and the Cash Rate



* On outstanding loans
Sources: ABS; APRA; Perpetual; RBA

Lenders' standard variable rates have remained largely unchanged since the previous reduction in the cash rate target in August, although some lenders have increased the interest rate discounts they offer on loans with low loan-to-valuation ratios (Table 4.2). In addition, some lenders have reduced their fixed rates this year, despite equivalent term swap rates being little changed. Lenders continue to advertise limited term special offers to new customers, including fee waivers and rebates for refinancing from another institution.

The value of outstanding personal credit fell slightly over the quarter, mainly driven by decreases in revolving credit.

Business Financing

External business funding has risen by the equivalent of around 2 per cent of GDP in the March quarter, which was smaller than in recent quarters. Lower equity raisings and a fall in non-intermediated debt funding partly offset an increase in business credit (Graph 4.15).

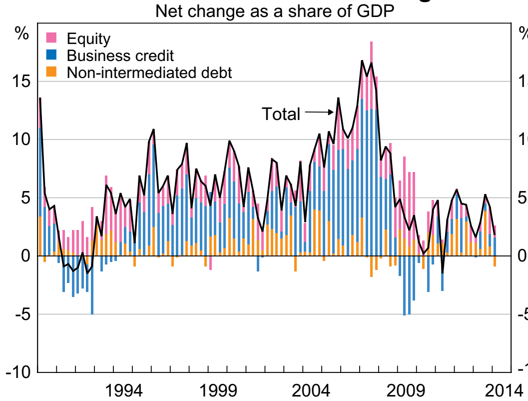
Corporate bond issuance has totalled around $3 billion since the previous *Statement* (Graph 4.16). The bulk of the issuance occurred in offshore markets; however, around one-quarter of the total was comprised of domestic bonds issued by lower-rated corporations (around BBB) at relatively longer tenors (around 7 years) than is usual for the domestic market.

Table 4.2: Intermediaries' Fixed and Variable Lending Rates

	Level at 7 May 2014 Per cent	Change since January 2014 Basis points	Change since end October 2011 Basis points
Housing loans			
– Standard variable rate[(a)]	5.93	0	–186
– Package variable rate[(b)]	5.08	0	–195
– Fixed rate[(c)]	5.20	–9	–131
Personal loans			
– Standard variable rate	11.56	0	–85
Small business (variable rates)			
– Term loans	7.10	0	–190
– Overdraft	7.97	0	–188
Average rate[(d)]	6.71	–2	–192
Large business			
Average rate[(d)] (variable rate and bill funding)	4.58	–2	–245

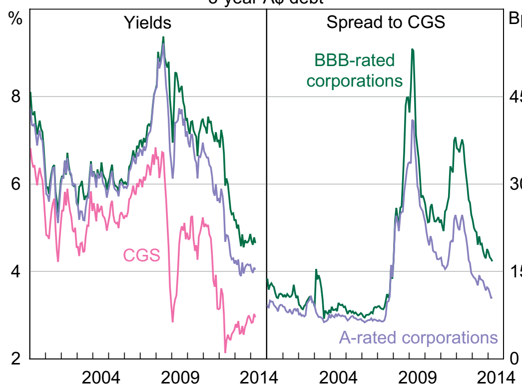
(a) Average of the major banks' standard variable rates
(b) Average of the major banks' discounted package variable rates on new, $250 000 full-doc loans
(c) Average of the major banks' 3-year fixed rates
(d) Rates on outstanding business lending (includes discount)
Sources: ABS; APRA; RBA

Graph 4.15
Business External Funding
Net change as a share of GDP



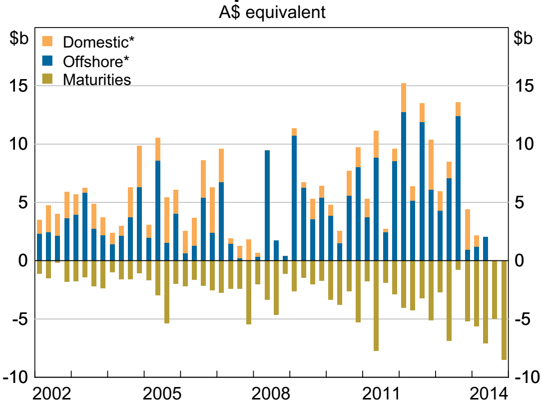
Sources: ABS; APRA; ASX; RBA

Graph 4.17
Australian Corporate Bond Pricing
3-year A$ debt



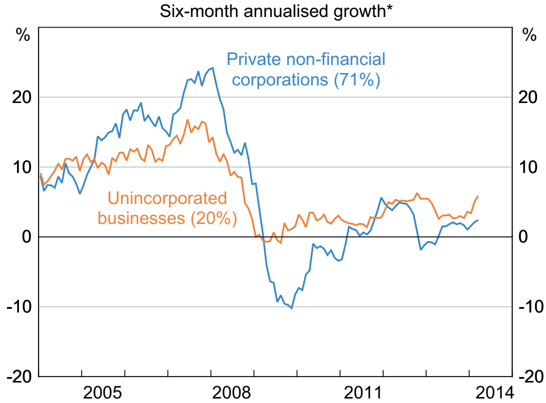
Sources: RBA; UBS AG, Australia Branch

Graph 4.16
Australian Corporate Bond Issuance
A$ equivalent



* Latest quarter issuance to date
Source: RBA

Graph 4.18
Business Credit by Borrower
Six-month annualised growth*



* Excludes securitised loans
Sources: APRA; RBA

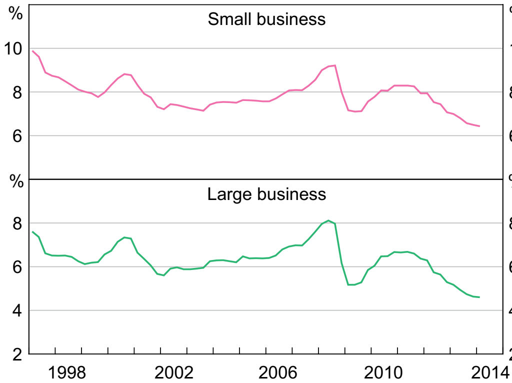
Secondary market spreads for Australian dollar corporate bonds over CGS have narrowed by around 15 basis points since the previous *Statement* for both the broad A-rated and BBB-rated entities. Spreads are at their lowest levels since 2007 (Graph 4.17).

Growth in business credit picked up in the March quarter reflecting an increase in lending to both private non-financial corporations and unincorporated businesses (Graph 4.18). The latter is likely to reflect an increase in lending to small businesses. The major banks accounted for a large share of the increase in business credit over the quarter, while credit extended by the Asian banks continued to rise. Most of the increase in business credit was driven by lending denominated in domestic currency.

The cost of intermediated business borrowing for both small and large businesses has been little changed over the past three months (Graph 4.19). Average rates on small and large business loans outstanding remain well below the previous trough in April 2009.

After a large increase in syndicated loan approvals in the December quarter, activity fell back in the March quarter, partly reflecting reduced refinancing activity, while financing for acquisitions remains at a very low level. This is consistent with the typical seasonal pattern of weak activity in the March quarter.

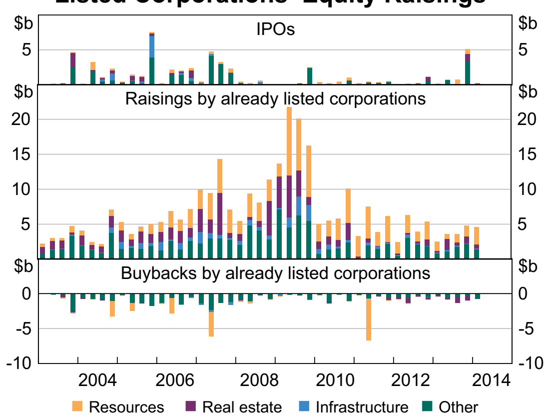
Graph 4.19
Australian Business Lending Rates
Average interest rate on outstanding lending



Sources: APRA; RBA

Equity raisings by non-financial corporations (including real estate companies) declined in the March quarter to $4 billion (Graph 4.20). This was mainly driven by a slowdown in initial public offerings (IPOs), following a sharp pick-up in the December quarter. Equity raisings are typically weak in the March quarter, and a number of large IPOs are expected later in the year. Equity raisings by already listed companies remained stable, with issuance totalling $4½ billion, as an increase in resource sector private placements offset a fall in real estate sector placements and rights issues. There were $760 million in share buybacks during the quarter.

Graph 4.20
Listed Corporations' Equity Raisings*



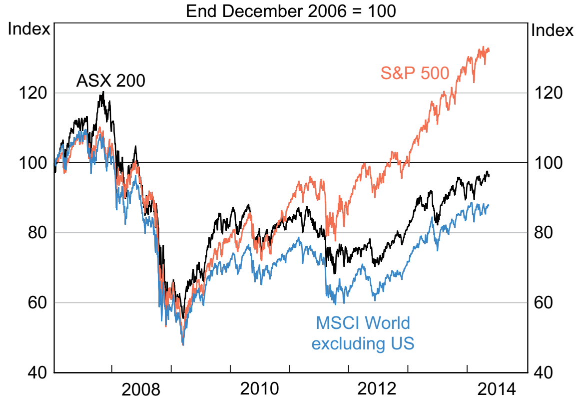
* Excludes financial corporations other than real estate; excludes privatisations and hybrid conversions
Sources: ASX; RBA

Merger and acquisition (M&A) activity has increased, with around $21 billion in deals announced by listed companies since the previous *Statement*. The largest deal was Transurban Group's $7 billion acquisition of a Brisbane-based portfolio of toll road assets. In addition, around $4 billion in deals were announced in the energy sector, mostly relating to oil and gas.

Equity Markets

Australian equity prices have risen by 6½ per cent since the previous *Statement*, broadly in line with global equity markets (Graph 4.21). This partly reflected domestic economic data that was generally stronger than market expectations and positive company profit results.

Graph 4.21
Share Price Indices
End December 2006 = 100

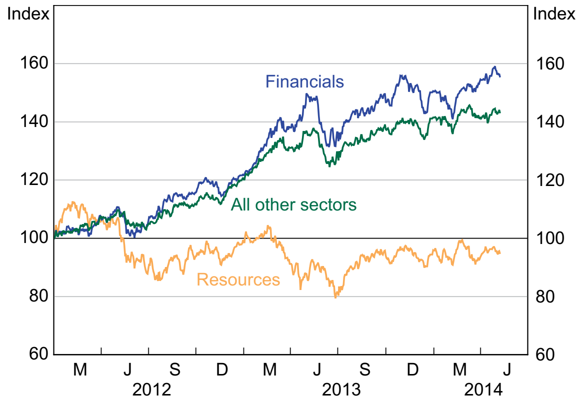


Sources: Bloomberg; Thomson Reuters

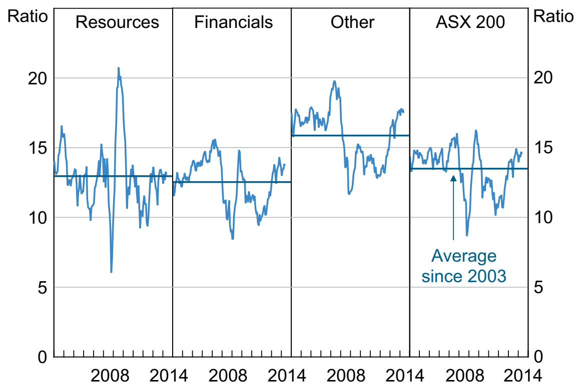
Resource sector share prices rose by 3 per cent, with a recovery in the reported profits of the major diversified miners for the December half partially offset by concerns about the outlook for Chinese economic growth and lower prices for iron ore and coal (Graph 4.22).

Financial sector share prices rose by 9 per cent, supported by strong bank profit results. Despite significant declines in the reported profits of some insurance companies, insurance sector share prices increased by 11 per cent as investors focused on the

Graph 4.22
Australian Share Price Indices
End December 2011 = 100



Graph 4.23
Australian Forward Price-earnings Ratios
ASX 200



more forward-looking aspects of the December half profit announcements, particularly among insurers' banking business units. Real estate companies lagged other financial companies but their share prices still increased by 7 per cent reflecting the improvement in residential real estate market conditions.

Shares prices in other sectors rose by 4 per cent, with cyclical sectors generally outperforming the broader market following positive profit results, some M&A activity and domestic economic data that was generally stronger than market expectations. In contrast, defensive sectors, such as consumer staples and healthcare companies, underperformed the broader market amid concerns about the outlook for their earnings.

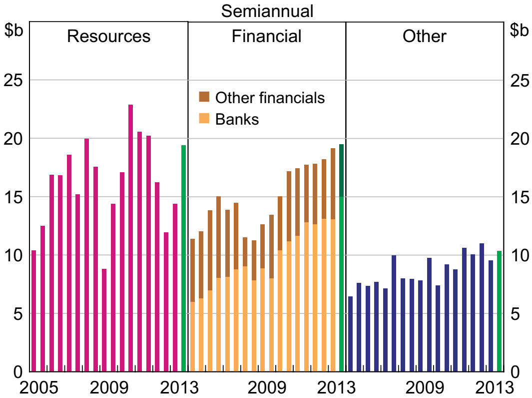
Valuations of Australian equities, as measured by forward price-earnings (PE) ratios, have increased since the previous *Statement* and remain close to, or above, their decade averages for all of the broad sectors (Graph 4.23). The PE ratio of the resources sector rose alongside higher equity prices and lower consensus earnings forecasts for the sector based on concerns about the economic outlook for China. The PE ratio of the financial sector increased as the rise in equity prices outpaced the increase in expected earnings. For other sectors, PE ratios generally rose amid higher equity prices and as analysts scaled back earnings expectations, particularly for defensive firms.

ASX 200 companies reported their December half 2013 results during February and March. Aggregate underlying earnings, which exclude the impact of non-recurring items, increased by 22 per cent compared with the same period last year.

The main driver of the rise in aggregate profits was a large increase in resource sector profits, as the major diversified miners began to transition from the investment phase towards increasing production volumes (Graph 4.24). There was also a recovery in iron ore prices over that period. Underlying profits in the financial sector rose by 7 per cent from the same period in 2013, primarily reflecting the strength of banks' earnings. Profits for real estate companies also grew, partly reflecting stronger activity in the residential housing market. Underlying earnings outside the resources and financial sectors declined by 6 per cent from the same period in 2013.

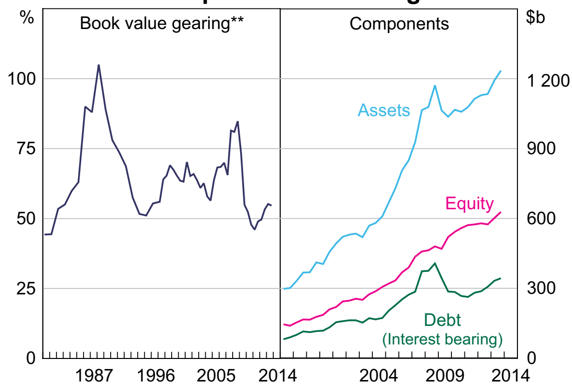
Listed corporations' balance sheets expanded by 4 per cent in aggregate over the second half of 2013 (Graph 4.25). The growth was funded in roughly equal parts by debt and equity, with both rising by around 5 per cent. The book value gearing ratio of listed corporations declined marginally to 55 per cent and remains well below its historical average. By sector, the net debt of the major diversified miners declined, driven by a substantial accumulation in cash balances as higher sales volumes supported revenues and profits. In contrast, energy companies increased their use of debt to fund their high levels of capital investment over the period. The gearing of firms across the other sectors was generally little changed. ✠

Graph 4.24
ASX 200 Underlying Profits*



* Figures are based on actual data for companies which have reported in the December half 2013. For companies which have not yet reported, current period earnings are based on company-level consensus expectations.
Sources: Bloomberg; Morningstar; RBA

Graph 4.25
Listed Corporations' Gearing Ratio*



* Excludes foreign-domiciled companies
** Data from 1997 includes real estate companies
Sources: Morningstar; RBA; Statex