4. Domestic Financial Markets

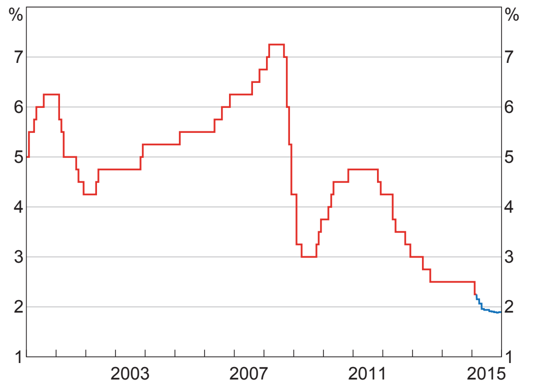
Following a reduction in the cash rate target at the February Board Meeting, money market rates imply that the cash rate is expected to be lowered further over the year ahead. Yields on Australian and state government bonds have fallen to historic lows. While spreads on corporate bonds remain relatively low, bond issuance has been subdued, mainly reflecting very low issuance by resource companies. Interest rates on the stock of housing and business loans are continuing to edge down, reflecting both the refinancing of existing loans at lower interest rates and, more recently, the pass-through of the cash rate reduction. Growth in housing lending has continued to rise, driven by lending to investors, and lending to businesses has picked up over the year. Australian equity prices have been affected by weakness in the resources sector.

Money Markets and Bond Yields

The Reserve Bank Board reduced the target for the cash rate from 2.50 per cent to 2.25 per cent at its February meeting. Yields on money market instruments indicate expectations of a further easing in monetary policy, with rates on overnight indexed swaps (OIS) implying that the cash rate will be lowered to 2 per cent in the months ahead (Graph 4.1).

After rising over most of 2014, rates on bank bills and certificates of deposit have declined since the previous *Statement* (Graph 4.2). The earlier widening in the spread between 3-month bills and OIS in part reflects the introduction of the Liquidity Coverage

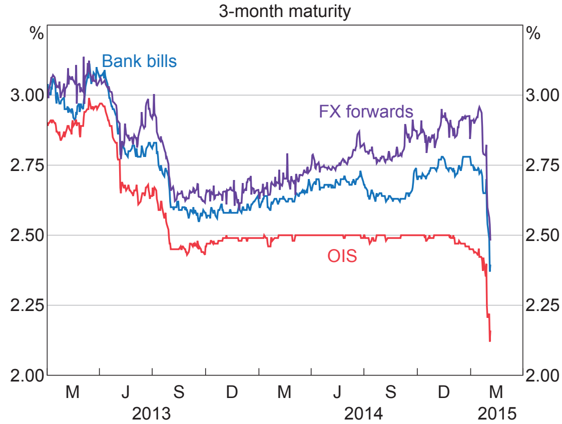
Graph 4.1
Cash Rate*



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

Sources: ASX; Bloomberg

Graph 4.2
Australian Dollar Interest Rates
3-month maturity



Source: RBA

Ratio (LCR), as well as the increased cost of Australian dollars in the forward foreign exchange market, and does not reflect rising concerns over the credit quality of the Australian banks.[1] The LCR generates an incentive for banks to issue securities with longer maturities, so spreads on bank bills at the longer terms have widened following increased issuance of these tenors. In addition, the higher cost of Australian dollars in the forward foreign exchange market has encouraged domestic banks to raise more of their short-term funding in the domestic bank bill market.

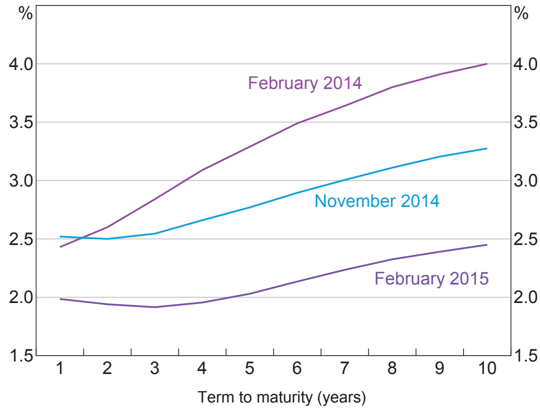
Yields on long-term Commonwealth Government securities (CGS) have steadily declined over the past year, with the yield curve flattening considerably (Graph 4.3). Since the previous *Statement*, 10-year yields have fallen by around 80 basis points, following the decline in global bond yields and the cut in the cash rate, recently reaching an historic low of around 2.3 per cent (Graph 4.4). Reflecting the rally in global bond markets, the spread between 10-year CGS and US Treasuries has declined by 35 basis points since the previous *Statement* to be around 60 basis points.

Inflation-linked bond yields have declined by less than nominal bond yields, resulting in break-even inflation rates falling to their lowest levels since 2009. Ten year break-even inflation rates are now around 2 per cent; inflation swaps (an indicator of inflation expectations that is less affected by fluctuations in market liquidity than index-linked securities) currently imply that inflation over the next 10 years will average around 2½ per cent.

The Australian Office of Financial Management (AOFM) announced a revised CGS issuance program for the 2014/15 financial year following the Mid-Year Economic and Fiscal Outlook (MYEFO). Net issuance is projected to be $68 billion over the year, an increase of $5 billion compared with the forecast in the 2014/15 budget. The total amount of CGS on issue is expected to reach almost $370 billion by the end of June 2015.

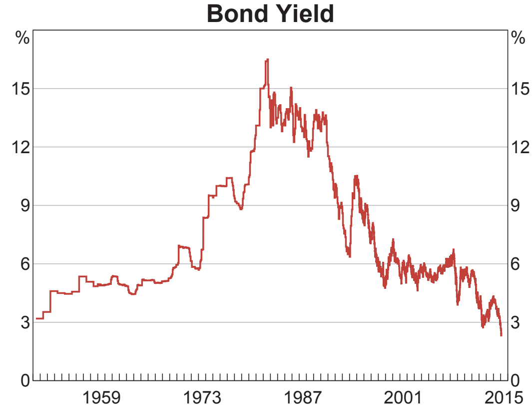
1 For more details, see Debelle G (2014), 'Liquidity', Speech at the 27th Australasian Finance and Banking Conference, Sydney, 16 December.

Graph 4.3
Commonwealth Government Bond Yields



Source: RBA

Graph 4.4
Australian 10-year Government Bond Yield

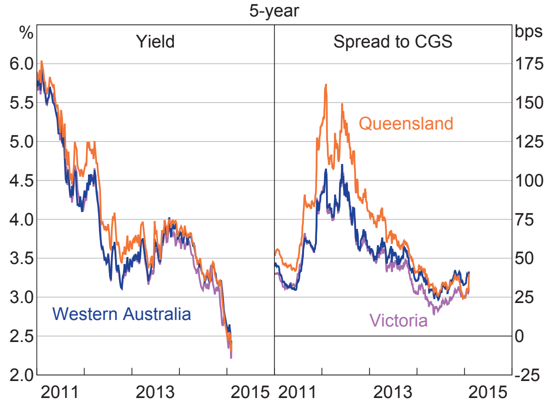


Source: RBA

Spreads between debt issued by the state borrowing authorities ('semis') and CGS have been little changed since the previous *Statement*, and yields on semis are around their lowest levels on record (Graph 4.5). New South Wales Treasury Corporation issued a small one-year RMB-denominated bond, the first issue of RMB-denominated government bonds in Australia.

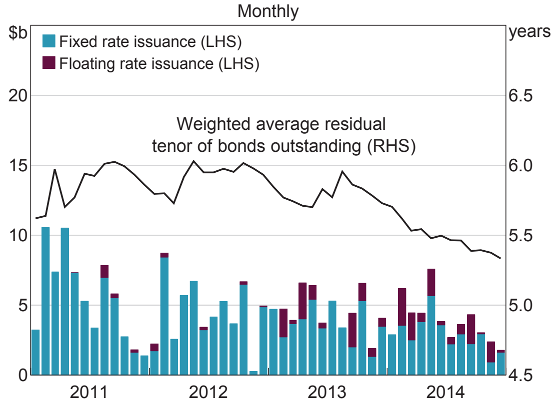
The states have issued $5½ billion of semis since the previous *Statement* which, after taking account of maturities, has left the outstanding stock of semis largely unchanged. In a continuation of the trend towards floating rate issuance, 40 per cent of new issuance since the previous *Statement* has been in

Graph 4.5
State Government Debt
5-year



Sources: RBA; Yieldbroker

Graph 4.6
Bond Issuance by States and Territories
Monthly



Sources: RBA; State Treasury Corporations

the form of floating rate notes (Graph 4.6). The share of floating rate notes in the outstanding stock of semis is now 10 per cent, significantly higher than the 2 per cent share at the end of 2012. This is partly in response to the introduction of the LCR, which requires banks to hold high-quality liquid assets such as semis, and the preference of banks for floating rate debt. The weighted average residual maturity of semis outstanding has continued to decline, consistent with the preference of banks to hold shorter-tenor debt.

The states and territories have raised a total of $19 billion in term funding since the beginning of the 2014/15 financial year, which is around 70 per cent of their aggregate target for the financial year (Table 4.1). Mid year borrowing updates indicate that planned issuance for New South Wales and Queensland has been revised down.

Domestic bond issuance by non-resident entities ('Kangaroo' issuance) has totalled around $11 billion since the previous *Statement*, taking issuance over 2014 to its highest level on record. Consistent with prior years, around half of all Kangaroo issuance in 2014 was raised by banks; sovereigns and supranationals accounted for another 40 per cent, while the remaining 10 per cent was issued by non-bank financials and corporations. The share of issuance by non-AAA rated entities increased

Table 4.1: Long-term Bond Issuance by the State Treasury Corporations[(a)]

Issuer	Outstanding as at December 2014 $ billion	2013/14 issuance $ billion	2014/15 issuance to January 2015 $ billion	2014/15 indicative target $ billion
New South Wales	64	14	5	6
Queensland	83	15	6	7
South Australia	16	4	3	4
Tasmania	4	0	1	1
Victoria	34	9	1	3
Western Australia	32	11	4	9
Total[(b)]	**240**	**55**	**19**	**29**

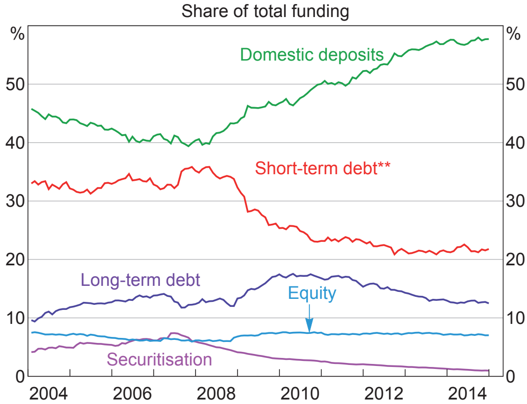
(a) Securities with an original term to maturity of greater than one year; figures are rounded to the nearest whole number; projections are based on the latest funding program forecasts for gross term issuance less prior year surplus funding
(b) Includes ACT and NT bonds
Sources: RBA; State Treasury Corporations

from around 30 per cent in 2013 to around 40 per cent in 2014. Secondary market spreads for Kangaroo bonds have narrowed by 13 basis points for European issuers and by 3 basis points for non-European issuers since the previous *Statement* and remain around the lowest levels seen since mid 2007.

Financial Intermediaries

The funding composition of banks was little changed over 2014, after several years of an increasing deposit share and decreasing wholesale funding share (Graph 4.7). With the rate of growth in bank balance sheets rising a little and conditions in wholesale funding markets improving, average wholesale funding grew by 8 per cent over the year, having declined by 5 per cent over the preceding few years.

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

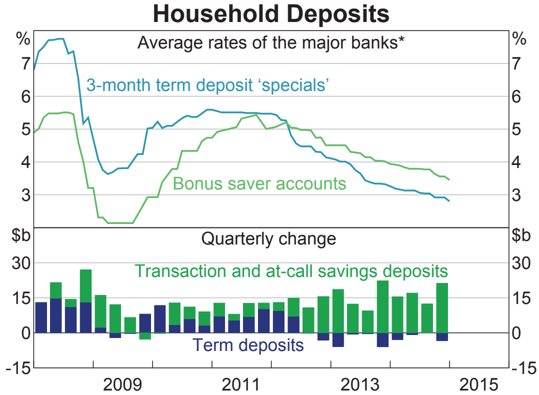


* Adjusted for movements in foreign exchange rates; tenor of debt is estimated on a residual maturity basis
** Includes deposits and intragroup funding from non-residents
Sources: APRA; RBA; Standard & Poor's

The major banks' average funding costs declined over the year, largely driven by banks reducing their term and at-call deposit rates as competition for deposits has eased. Over the past three months, some of the major banks have reduced interest rates on bonus saver accounts by up to 25 basis points (prior to the February cash rate reduction). Despite these reductions in at-call deposit rates, households' at-call deposits have continued to grow faster than term deposits as the interest rates on term deposits continue to be less attractive than those on bonus saver accounts (Graph 4.8).

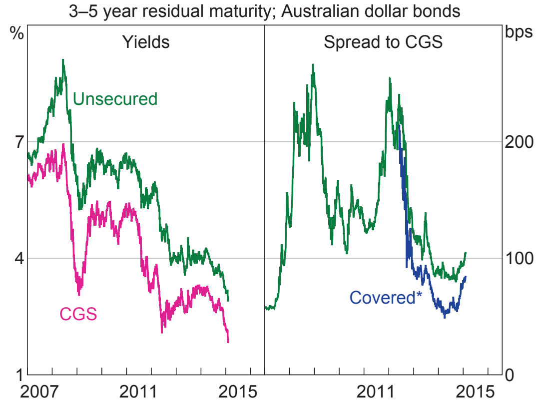
Spreads on the major banks' bonds relative to CGS were little changed for most of 2014 before picking up later in the year. Nevertheless, spreads remain around their lowest levels since late 2007, and yields are at historically low levels (Graph 4.9). Spreads on unsecured bonds have increased by around 10 basis points since the previous *Statement*, while spreads on covered bonds have risen by 18 basis points. Once the cost of hedging foreign currency issuance back into Australian dollars is taken into account, the

Graph 4.8
Household Deposits



* Prior to the February cash rate reduction
Sources: APRA; Canstar; RBA

Graph 4.9
Major Banks' Bond Pricing
3–5 year residual maturity; Australian dollar bonds



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

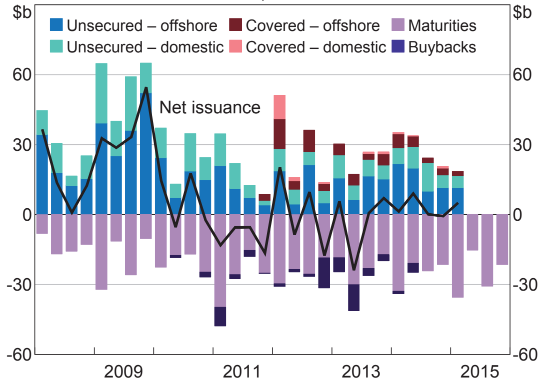
pricing of recent issuance across major currencies is broadly consistent with the cost of domestic issuance.

Net bond issuance by the Australian banks was $10 billion in 2014, compared with the $10 billion decline in outstanding bank debt in 2013. Australian banks raised around 40 per cent of their funds in US dollars, while the share of bank bonds issued in Australian dollars fell slightly to one-third. Covered bond issuance totalled $17 billion in 2014, down slightly from the $19 billion issued in 2013.

Australian banks have issued around $28 billion in bonds since the previous *Statement*, mostly in the form of senior unsecured bonds. Around 75 per cent of the issuance has been in the offshore market, with a higher-than-typical proportion of euro-denominated issuance (Graph 4.10). The stock of outstanding bonds has decreased by around $1 billion since the previous *Statement*.

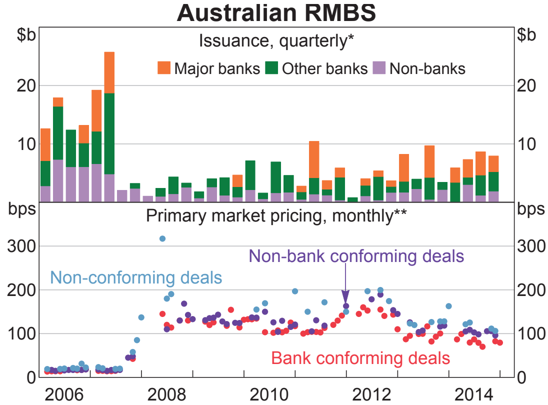
Australian securitised issuance reached $35 billion in 2014, an increase of $2 billion from 2013 and the highest level since 2007. Around $9 billion in securitisations have been issued since the previous *Statement*, with around 80 per cent in the form of residential mortgage-backed securities (RMBS) (Graph 4.11). One major bank issued a $2.5 billion RMBS, while smaller banks accounted for about $3 billion of RMBS issuance. Mortgage originators have raised around $1 billion in securitisations, with around half of that backed by 'non-conforming' mortgages. These typically involve borrowers with a history of credit impairment, higher loan-to-valuation ratios or less income documentation. Two securitisations backed by assets other than residential mortgages (mainly vehicle and equipment leases) have also been issued, raising a total of $1.5 billion; issuance of such securities has remained low in 2014. Issuance spreads on senior RMBS tranches have been little changed over 2014, remaining at their lowest levels since late 2007, but still well above their pre-crisis levels.

Graph 4.10
Australian Banks' Bond Issuance*
A$ equivalent



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

Graph 4.11
Australian RMBS



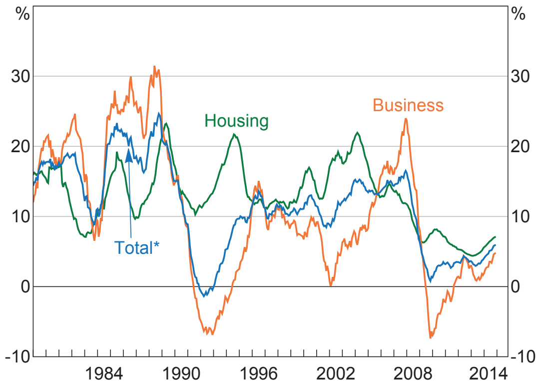
* Latest observation is quarter to date
** Face-value weighted monthly average of the primary market spread to bank bill rate
Source: RBA

S&P downgraded 61 AA- rated mezzanine tranches of Australian and New Zealand RMBS that are dependent on lenders mortgage insurance from Genworth Financial Mortgage Insurance, following a rating downgrade of the insurer. No AAA rated tranches were downgraded. S&P also announced changes to its ratings methodology that will reduce the credit it gives to lenders mortgage insurance when rating RMBS. The changes will become effective from February and are expected to result in downgrades to 18 per cent of the number of rated Australian RMBS tranches, though this will predominantly affect mezzanine tranches. Moody's made similar changes to its rating methodology in 2013.

Financial Aggregates

Total credit grew by 6 per cent over 2014, reflecting faster growth in both housing and business credit (Graph 4.12). Growth in credit remained below growth in broad money, which was 7½ per cent over the year (Table 4.2).

Graph 4.12
Credit Growth by Sector
Year-ended



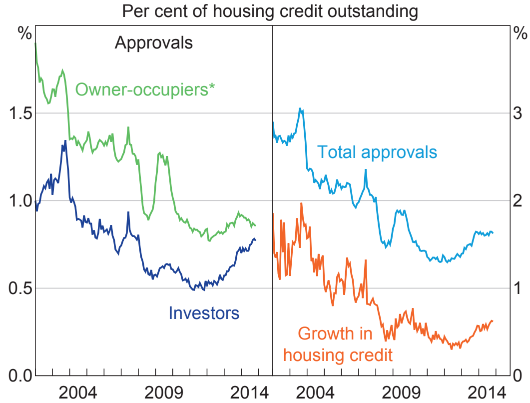
* Includes housing, personal and business credit
Sources: ABS; APRA; RBA

Household Financing

Housing credit grew by 7 per cent over the year, with growth in credit extended to investors increasing to 10 per cent, while owner-occupier credit growth remained more moderate at around 5½ per cent.

Housing credit growth is likely to remain around its current rate in coming months, reflecting continued solid growth in housing loan approvals over the second half of 2014 (Graph 4.13). The increase in housing loan approvals has been driven by investor approvals and should contribute to continued strong investor credit growth. Owner-occupier housing loan approvals have been steady, consistent

Graph 4.13
Housing Loans
Per cent of housing credit outstanding



* Net of refinancing
Sources: ABS; RBA

Table 4.2: Financial Aggregates
Percentage change(a)

	Three-month ended		Year-ended
	September 2014	December 2014	December 2014
Total credit	1.3	1.6	5.9
– Housing	1.7	1.9	7.1
– Owner-occupier	1.3	1.5	5.6
– Investor	2.5	2.7	10.1
– Personal	0.6	0.1	0.9
– Business	0.8	1.4	4.8
Broad money	2.0	1.5	7.7

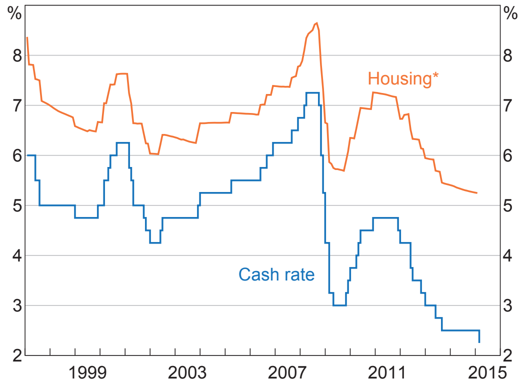
(a) Growth rates are break adjusted and seasonally adjusted
Sources: ABS; APRA; RBA

with credit growth remaining around its current pace. Some borrowers are using low interest rates to pay down their mortgages at a faster rate, with mortgage prepayments remaining at a high level.

Growth in personal credit has remained relatively subdued in recent months, with growth largely reflecting an increase in credit card balances outstanding.

The average interest rate on outstanding housing loans has continued to edge down over recent months (prior to the February cash rate reduction; Table 4.3 and Graph 4.14). The decline has been driven by the replacement of more expensive fixed-rate loans from previous years, particularly loans written prior to 2013. Over the year, there have been reductions in advertised interest rates on fixed- and variable-rate loans; most notable has been the decrease in the major banks' five-year fixed rates. Competition for lending remains strong, with interest rate discounting and broker commissions rising over the past year.

Graph 4.14
Interest Rates



* RBA estimate; outstanding rate; prior to the February cash rate reduction

Sources: ABS; APRA; Perpetual; RBA

Table 4.3: Intermediaries' Fixed and Variable Lending Rates

Prior to the February cash rate reduction

	Level at 2 February 2015	Change over 2014
	Per cent	Basis points
Housing loans		
– Standard variable rate[a]	5.93	0
– Package variable rate[b]	5.08	–2
– Fixed rate[c]	5.08	–20
– Average outstanding rate[d]	5.25	–15
Personal loans		
– Variable rate[d],[e]	11.76	5
Small business		
– Term loans variable rate[f]	7.10	0
– Overdraft variable rate[f]	7.97	0
– Fixed rate[c],[f]	5.78	–45
– Average outstanding rate[d]	6.18	–28
Large business		
Average outstanding rate[d] (variable rate and bill funding)	4.39	–17

(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 estimate
(e) Weighted average of variable rate products
(f) Residentially secured, average of the major banks' advertised rates
Sources: ABS; APRA; Canstar; RBA

Business Financing

Growth in external business funding steadied in the December quarter, to 3 per cent of GDP (Graph 4.15). Equity raisings and business credit both rose in the quarter, while non-intermediated debt fell.

Total issuance of Australian non-financial corporate bonds in 2014 was $14 billion, which was the lowest since 2008. This was partly due to the absence of issuance by the large diversified mining companies that dominated corporate issuance in prior years (Graph 4.16). Around $2½ billion of corporate bonds have been issued since the previous *Statement*, mainly in the domestic market.

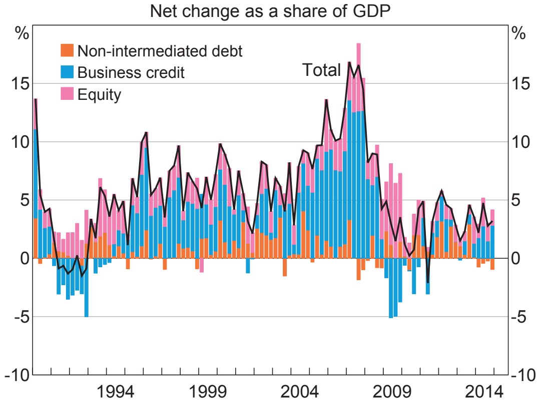
Secondary market spreads over CGS for Australian dollar A and BBB rated corporate bonds remain around their lowest levels since 2007, despite increasing a little in the second half of 2014, while yields are at historically low levels (Graph 4.17). Spreads have increased by 6–8 basis points since the previous *Statement*.

Hybrid issuance over 2014 was particularly strong with a record $14.5 billion raised, mainly by the larger banks. Since the previous *Statement*, six financial entities have raised a total of around $2.6 billion of hybrid debt. This included the first two RMB-denominated Tier 2 hybrid debt issues by Australian banks.

Australian corporate entities' credit ratings were relatively stable throughout 2014. More recently, however, a number of financial sector entities were placed on positive credit watch, while two non-diversified resource companies were downgraded owing to commodity price declines.

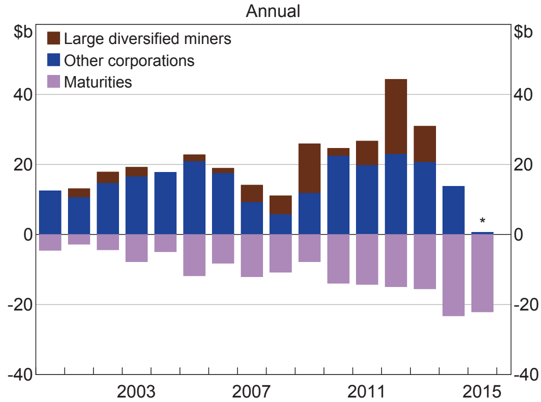
Business credit growth picked up over 2014, driven by lending to private non-financial corporations and unincorporated (typically smaller) businesses (Graph 4.18). In recent months, growth in foreign-currency denominated business credit has been boosted by valuation effects associated with the depreciation of the Australian dollar. While commercial loan approvals increased strongly over 2014 compared with 2013, they have fallen back in

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



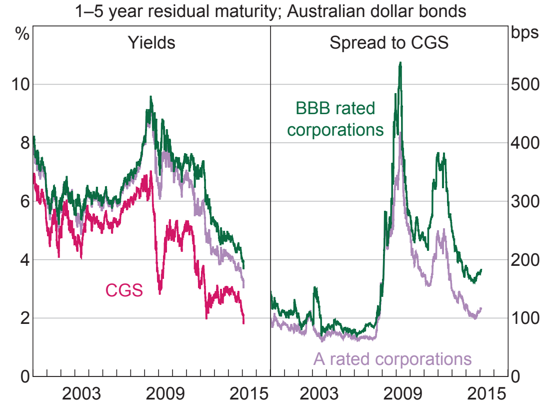
Sources: ABS; APRA; ASX; RBA

Graph 4.16
Australian Corporate Bond Issuance
Annual

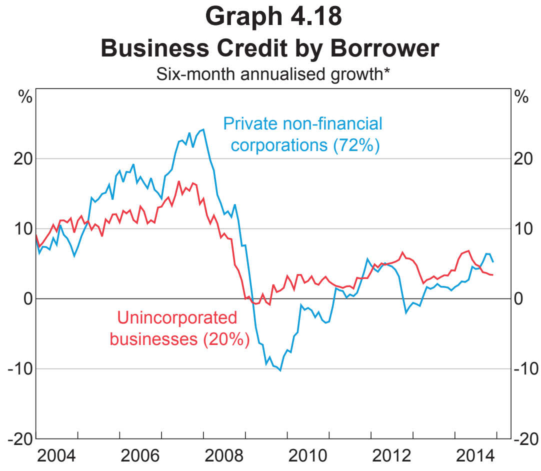


* Year to date
Source: RBA

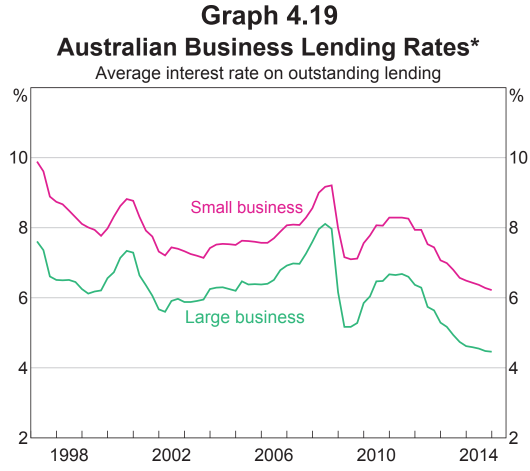
Graph 4.17
Australian Corporate Bond Pricing
1–5 year residual maturity; Australian dollar bonds



Sources: RBA; UBS AG, Australia Branch



* Excludes securitised loans
Sources: APRA; RBA



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

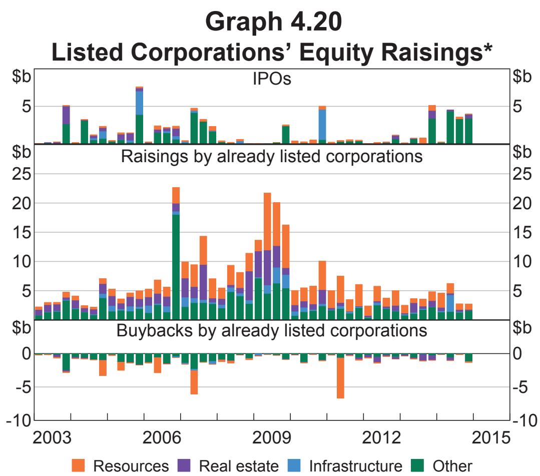
recent months, partly reflecting lower loan approvals for mining and related transport industries.

Activity in the syndicated lending market was stronger over 2014, with the total value of approvals over one-third higher than in the previous year. After a large increase in syndicated loan approvals in the September quarter, activity fell back slightly in the December quarter, although it remains at a high level. Falls in loan approvals for acquisitions, and capital and general corporate expenditure, were partly offset by a strong increase in refinancing-related approvals.

Average interest rates on outstanding bank loans to both small and large businesses have declined since the previous *Statement*, largely driven by the replacement of fixed rate loans at lower interest rates (prior to the February cash rate reduction; Graph 4.19).

Net equity raisings by listed non-financial corporations (including real estate companies) rose to $26 billion in 2014. The increase was primarily driven by initial public offerings (IPOs), which were at their highest level since 1997. The healthcare and consumer sectors accounted for a large portion of the IPOs. In the December quarter, net equity raisings by listed non-financial corporations decreased slightly to $5 billion. The high volume of equity raisings from new listings was partly offset by lower net raisings by already listed companies, most notably Telstra engaging in a $1 billion share buyback (Graph 4.20). The financial sector also experienced a significant pick-up in new listing activity through the privatisation of Medibank Private, which raised $5.7 billion in the largest Australian equity market IPO since the 1997 Telstra float.

Over 2014, mergers and acquisitions (M&A) activity increased to $63 billion, which was the highest level since 2011. M&A activity has picked up considerably since the previous *Statement*, with around $26 billion in deals announced by listed companies. The pick-up



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

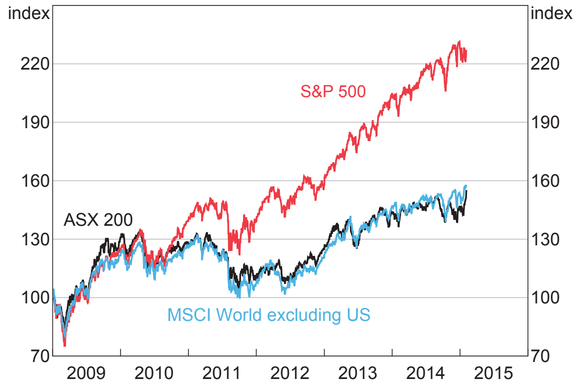
in activity was concentrated in the energy sector and included large LNG-related deals by Woodside Petroleum and APA Group.

Equity Markets

In aggregate, Australian equity prices were little changed over 2014, driven by substantial declines in the resources sector. The market underperformed global equity markets, although this was offset to some extent by the generally higher dividends paid by Australian companies (Table 4.4; Graph 4.21). Since the start of 2015, Australian equity prices have increased by 7 per cent, with resource sector equity prices partially recovering and financials' equity prices increasing strongly.

Resource sector share prices fell by 19 per cent over 2014 in response to lower commodity prices, with most of this fall occurring since the previous *Statement* (Graph 4.22). The share prices of the major diversified miners broadly tracked iron ore price movements over the second half of 2014, while share price declines among the smaller producers – who tend to have higher production costs – were larger. Energy sector share prices fell sharply alongside lower oil prices, particularly following the November OPEC meeting. The share prices of companies developing large liquefied natural gas (LNG) projects came under the most pressure due to concerns that the contract prices for LNG, which tend to be linked to oil prices, may be lower than previously expected, resulting in a reduction in expected earnings (see 'Box D: The Impact of Recent Commodity Price Movements on Resource Companies').

Graph 4.21
Share Price Indices
End December 2008 = 100



Sources: Bloomberg; Thomson Reuters

Graph 4.22
Australian Share Prices Indices
End December 2006 = 100

Sources: Bloomberg; RBA

Over 2014, financial sector share prices rose by 6 per cent, with banking stocks gaining 3 per cent and real estate sector share prices rising substantially. Since the start of 2015, financials' share prices have increased by 8 per cent.

Table 4.4: Equity Markets
Percentage change

	2013	2014	2015 to date
Australia (ASX 200)	15.1	1.1	6.8
– Resources	–2.9	–19.0	6.3
– Financials	23.6	6.5	8.0
– Other	17.7	6.1	5.5
United States (S&P 500)	29.6	11.4	–0.6

Sources: Bloomberg; Thomson Reuters

Share prices outside the resources and financial sectors increased by 6 per cent over 2014. Defensive sectors, such as healthcare and telecommunications, tended to outperform the broader market. On the other hand, share prices in the consumer sector underperformed amid continued market concerns about weak retail sales growth.

Similar to other international markets, Australian equity market volatility has remained relatively low since the previous *Statement*, albeit above the levels observed in mid 2014. Volatility in commodities prices and continued uncertainty around global economic growth and the future path of monetary policy in the larger economies has contributed to the pick-up in volatility in recent months, especially in the resources sector.

In aggregate, analysts' earnings expectations for 2014/15 and 2015/16 have been revised lower since the previous *Statement*. Reflecting the decline in commodities prices, expected earnings in the resources sector have been revised down significantly, although the fall has been limited by a number of recently announced cost reduction measures. Outside the resources sector, expected earnings in the financial sector have been upwardly revised.

Valuations of Australian equities, as measured by forward price-earnings ratios, have increased since the previous *Statement* to be above their decade averages for all sectors (Graph 4.23). Valuations have increased in the resources sector as the downward revisions to earnings expectations were larger than the share price declines. Valuations also increased in the other sectors. ✠

Graph 4.23
Australian Forward Price-earnings Ratios