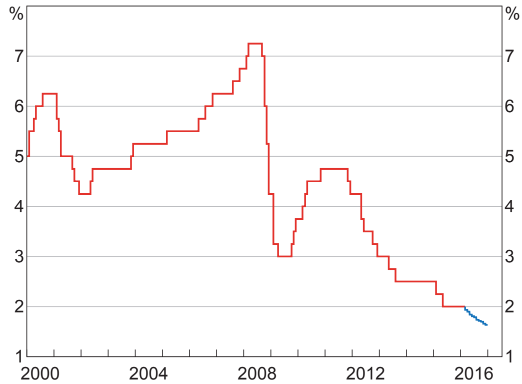
4. Domestic Financial Markets

The cost of wholesale funding has increased in recent months with yields on paper issued by banks and non-financial corporations having risen relative to benchmark rates; nonetheless, they remain low compared to history. In the second half of 2015, most housing lenders increased their standard variable lending rates. Overall, housing loan rates for owner-occupiers have risen to their levels prior to the easing of monetary policy in May, while those for investors have risen by more, to be back to their levels of around a year ago. Partly in response to this, growth in lending to housing investors has slowed, while growth in lending to owner-occupiers has picked up. Business lending rates remain close to historic lows for both small and large businesses, consistent with strong competition in the banking sector. Business lending has grown strongly in recent months, although there has been relatively little corporate bond issuance. Australian equity prices have fallen recently in response to further declines in commodity prices and concerns about the global economic outlook.

Money Markets and Bond Yields

After lowering the cash rate target in two 25 basis point steps in the first half of 2015, the Reserve Bank has maintained the cash rate target at 2 per cent since May 2015. Rates on overnight indexed swaps (OIS) imply an expectation of a further reduction in the cash rate to 1.75 per cent in the second half of this year (Graph 4.1). Interest rates on bank bills and negotiable certificates of deposit increased at the end of last year, with the three-month spread to OIS reaching its highest level in four years, although

Graph 4.1
Cash Rate*



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

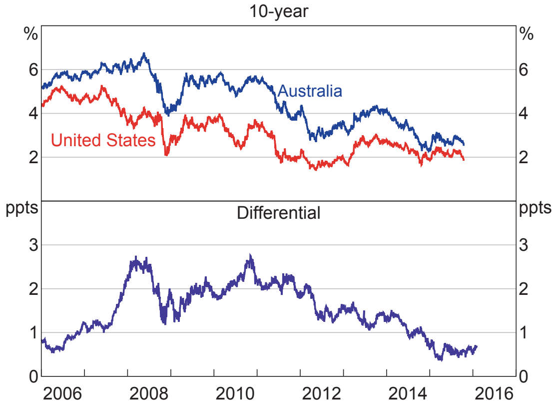
Sources: ASX; Bloomberg

it remains well below the levels reached in 2008. This is consistent with a generalised increase in the cost of wholesale funding in offshore markets, and the higher cost of Australian dollar funding in the forward foreign exchange market. Secured funding rates in the repurchase agreement (repo) market have also risen relative to OIS rates in recent months.

Yields on long-term Australian Government securities (AGS) have traded in relatively narrow ranges in recent months. AGS yields have continued to follow offshore bond markets, as evidenced by the spread between AGS and US Treasuries remaining broadly steady over the past year or so (Graph 4.2).

The Australian Office of Financial Management (AOFM) revised its planned issuance of AGS in the 2015/16 financial year in response to updated economic and budget forecasts in the Mid-Year Economic and Fiscal Outlook (MYEFO). Net issuance

Graph 4.2
Government Bond Yields

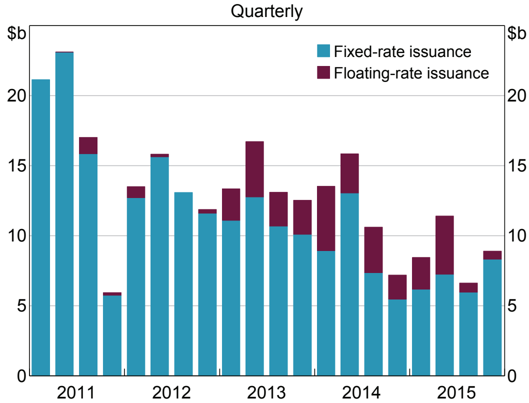


Sources: Bloomberg; RBA

during 2015/16 is expected to be around $56 billion, $15 billion higher than at the time of the 2015/16 budget, taking total AGS on issue to around $430 billion at the end of the financial year.

State and territory governments ('semis') have raised around $17 billion since the beginning of the 2015/16 financial year, which is lower than in preceding years (Graph 4.3). After taking account of maturities, the total stock of bonds outstanding increased only slightly to $243 billion. Planned issuance under long-term borrowing programs was revised down by a number of states (particularly by New South Wales) in their recent mid-year updates. This has resulted in an aggregate indicative

Graph 4.3
Bond Issuance by States and Territories



Sources: RBA; State Treasury Corporations

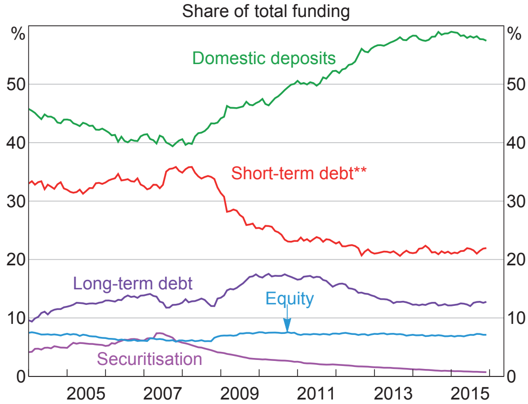
funding requirement of $22 billion for the 2015/16 financial year. Abstracting from refinancing needs, net issuance for the financial year is expected to be subdued, at around $3 billion; this primarily reflects the funding requirement of Western Australia. The states have issued around 75 per cent of their gross funding target for the financial year thus far.

Bond issuance by non-residents into the domestic market ('Kangaroo' issuance) was $32 billion in 2015, which was around the average of recent years. A comparatively higher proportion of Kangaroo issuance in late 2015 was by non AAA rated issuers, which is consistent with a higher level of Kangaroo issuance by corporate issuers (see 'Business Financing' section for further details). Around $4 billion in Kangaroo bonds have been issued since the start of this year. Secondary market spreads to AGS on AAA rated Kangaroo bonds are broadly unchanged since November, remaining around historically low levels.

Financial Intermediaries

The funding composition of bank balance sheets was little changed over 2015, with the deposit share of funding edging lower as the wholesale debt and equity shares increased slightly (Graph 4.4).

Graph 4.4
Funding Composition of Banks in Australia*



* Adjusted for movements in foreign exchange rates; tenor of debt is estimated on a residual maturity basis

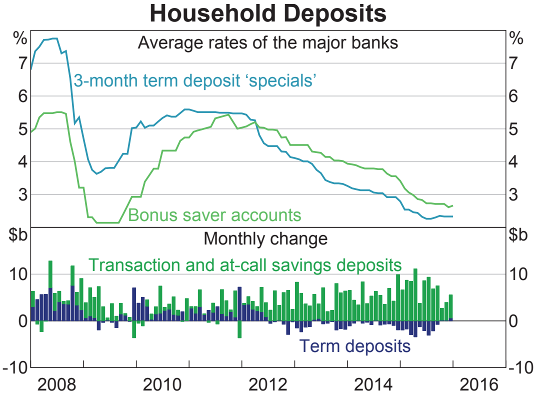
** Includes deposits and intragroup funding from non-residents

Sources: APRA; RBA; Standard & Poor's

Conditions in wholesale funding markets remain accommodative, although spreads on bank paper have widened relative to benchmark rates. The major banks also raised equity in the second half of the year to meet upcoming changes to prudential regulation.

Over 2015, debt funding costs declined by around 20 basis points more than the cash rate, reflecting lower wholesale funding costs and reduced deposit rates. Deposit rates have been little changed in recent months; households have continued to invest more in 'at-call' deposit savings products, such as bonus saver accounts, consistent with the higher rates for these products relative to term deposits (Graph 4.5).

Graph 4.5
Household Deposits

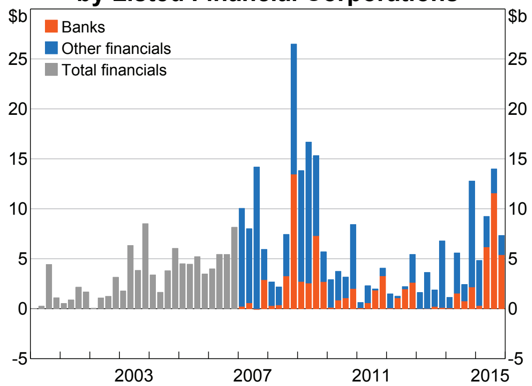


Sources: APRA; Canstar Cannex; RBA

Net equity raisings by financial corporations was around $35 billion in 2015, which is the largest amount raised since 2009, with the bulk of this raised by the major banks to increase their common equity in preparation for changes to prudential regulation (Graph 4.6). In the December quarter, Westpac raised $3.9 billion and total financial corporations' net equity raisings was $7.3 billion. Westpac's issuance followed sizeable raisings by each of the other major banks in earlier quarters.

Bond issuance by Australian banks in 2015 was strong relative to the post-crisis period (Graph 4.7). Australian banks have raised around $41 billion

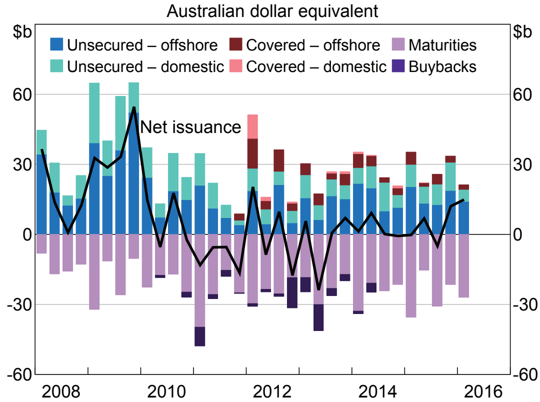
Graph 4.6
Net Equity Raisings by Listed Financial Corporations



Sources: ASX; RBA

Graph 4.7
Australian Banks' Bond Issuance*

Australian dollar equivalent

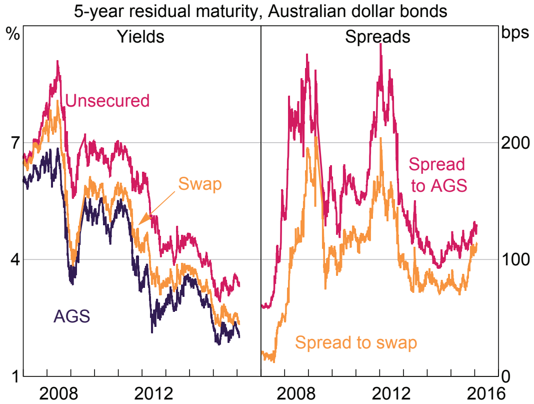


* Latest quarter gross issuance and net issuance are quarter to date

Source: RBA

since the start of November, predominantly in offshore markets; after accounting for maturities, the stock of bank bonds has increased by $19 billion to $508 billion. Secondary market yields on the major banks' bonds have increased over recent months while spreads to AGS and interest rate swap rates have generally widened (Graph 4.8). The increased spread between yields on bank bonds and interest rate swaps suggests higher costs for new issuance. The widening in spreads on bank paper, which is evident elsewhere, reflects an increase in the cost of liquidity as well as some widening in credit premia.

Graph 4.8
Major Banks' Bond Pricing
5-year residual maturity, Australian dollar bonds

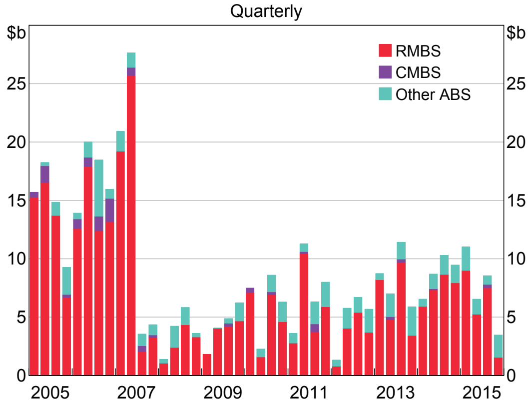


Sources: Bloomberg; UBS AG, Australia Branch

Hybrid issuance by Australian financials continued at a moderate pace, with around $3.5 billion issued since October, primarily in the form of Tier 2 securities issued by the major banks and insurers. Primary market spreads on recently issued hybrid securities were generally wider than on securities issued earlier in 2015.

Australian asset-backed issuance totalled $30 billion in 2015, which was around the average since 2009. As in previous years, this was mainly RMBS issuance. The pace of issuance has slowed in recent months, with just three deals totalling $1.6 billion issued since November, two of which were backed by assets other than residential mortgages (Graph 4.9).

Graph 4.9
Issuance of Australian ABS
Quarterly



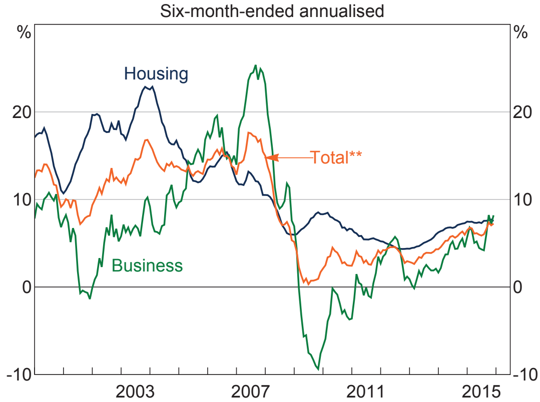
Source: RBA

Primary issuance spreads on senior RMBS tranches were wider than those issued earlier in 2015, though they remain at relatively low levels.

Financial Aggregates

Total credit has grown by around 7 per cent in six-month annualised terms (Graph 4.10). Housing credit growth has been steady at around 7½ per cent, although the composition of this growth has shifted markedly away from investor lending and towards owner-occupier lending. Business credit growth picked up over the year. Growth in credit has been a little faster than that in broad money, which grew by around 6 per cent over the year (Table 4.1).

Graph 4.10
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 been steady over the past year. Net housing debt has continued to grow around 1 percentage point slower than housing credit due to ongoing rapid growth in deposits in mortgage offset accounts (Graph 4.11). Housing loan approvals are consistent with housing credit continuing to grow at about its current pace.

In the second half of 2015, most lenders increased their standard variable housing interest rates by 15–20 basis points, after raising rates for housing

Table 4.1: Financial Aggregates

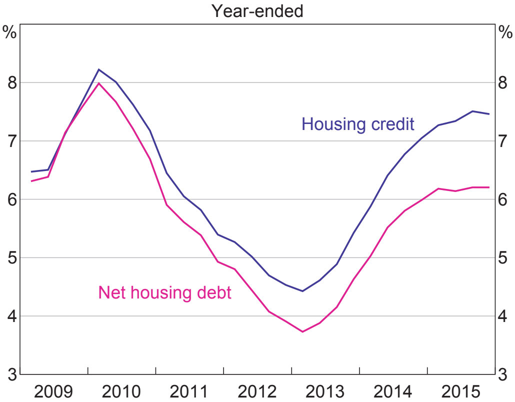
Percentage change[(a)]

	Three-month ended		Year-ended
	September 2015	December 2015	December 2015
Total credit	1.9	1.6	6.6
– Housing	1.9	1.8	7.5
– Owner-occupier	1.8	2.2	6.8
– Investor	2.0	1.0	8.5
– Personal	0.2	–0.4	0.0
– Business	2.4	1.6	6.3
Broad money	1.5	1.3	6.1

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

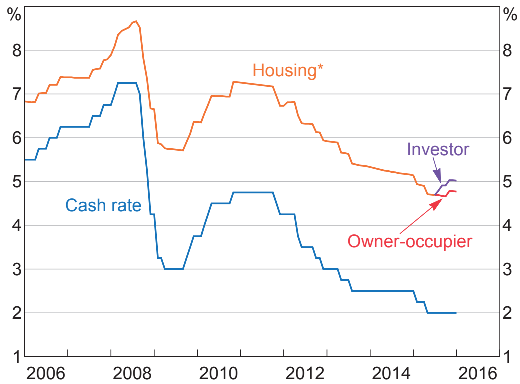
Graph 4.11
Housing Credit Growth*

Year-ended



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

Graph 4.12
Interest Rates



* Estimated outstanding rate
Sources: ABS; APRA; Perpetual; RBA

investors in the middle of the year. These increases lifted average outstanding housing interest rates by nearly 20 basis points (Graph 4.12). Taking into account the reductions in interest rates in the first half of 2015, advertised standard variable housing interest rates are around 30 basis points lower for owner-occupiers compared to a year ago and are little changed for investors (Table 4.2). Lenders have not raised their advertised fixed rates to the same extent as standard variable housing rates, with fixed rates around 40 and 60 basis points lower over the year for investors and owner-occupiers respectively. Consistent with this, a higher share of mortgages has been taken out with fixed interest rates.

There has been an increase in the dispersion of housing interest rates across lenders over recent months, with the major banks raising housing interest rates by more than the mid-size lenders and smaller lenders.

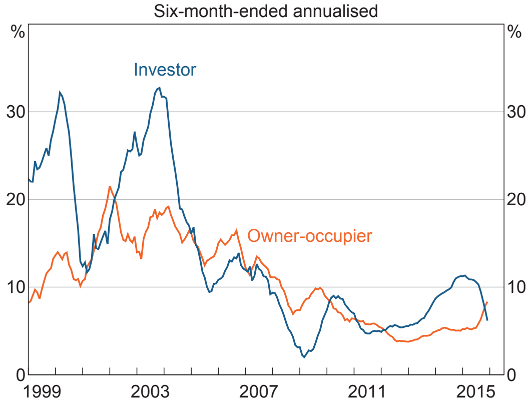
Following the introduction of differential pricing for owner-occupier and investor loans in mid 2015, the composition of housing credit growth has shifted towards owner-occupier lending and away from investor lending (Graph 4.13). Six-month annualised owner-occupier credit growth increased from around 5 per cent in June 2015 to around 8½ per cent in December. Conversely, investor credit growth decreased from around

Table 4.2: Intermediaries' Fixed and Variable Lending Rates

	Interest rate Per cent	Change over 2015 Basis points	Change since July 2015 Basis points
Housing loans			
– Standard variable rate[(a)(d)]			
– Owner-occupier	5.63	–30	17
– Investor	5.90	–3	44
– Package variable rate[(b)(d)]			
– Owner-occupier	4.83	–25	16
– Investor	5.11	3	44
– Fixed rate[(c)(d)]			
– Owner-occupier	4.43	–65	–23
– Investor	4.70	–38	4
– Average outstanding rate[(d)]	4.86	–29	17
Personal loans			
– Variable rate[(e)]	11.35	10	11
Small business			
– Term loans variable rate[(f)]	6.60	–50	0
– Overdraft variable rate[(f)]	7.47	–50	0
– Fixed rate[(c)(f)]	5.43	–35	5
– Average outstanding rate[(d)]	5.62	–63	–10
Large business			
Average outstanding rate[(d)]	3.92	–69	–4

(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 4.13
Housing Credit Growth*
Six-month-ended annualised



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

11 per cent in June 2015 to around 6 per cent in December. The introduction of differential pricing also resulted in borrowers and lenders updating the reported purpose of a large number of loans to owner-occupier from investor; the RBA adjusts for this when measuring investor and owner-occupier credit growth. The net value of loan purpose switching has amounted to $34 billion since July.

In response to lower housing interest rates over recent years, borrowers have had the opportunity to either reduce the principal on their loan by making additional payments above what is required, or to reduce their loan repayments in line with reductions in the required repayment and use the cash for other purposes. Household survey data indicate that the share of households ahead on their mortgage repayments has increased over recent years for both owner-occupiers and investors to its highest level since the early 2000s. These excess repayments form a buffer for households in the event that housing interest rates increase, as they did in the second half of 2015.

Business Financing

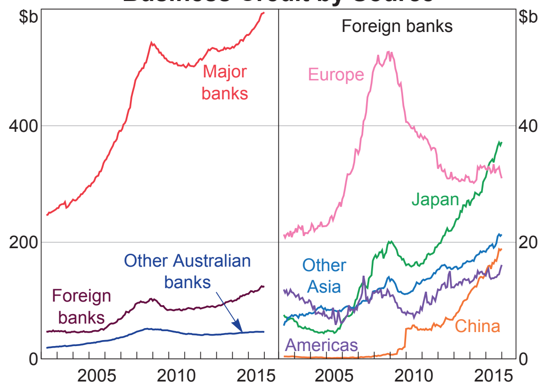
Growth in external funding for businesses picked up over recent months, driven by a faster pace of growth in business credit and an increase in equity raisings, while non-intermediated debt issuance has been subdued.

Business credit growth has accelerated over recent months, with growth over 2015 at its highest rate since 2009. Part of the growth in 2015 is due to the depreciation of the currency, which has increased the Australian dollar value of foreign-currency denominated business credit. Nevertheless, growth has been robust even abstracting from valuation effects. Part of the recent increase reflects greater use of intermediated credit by businesses rather than non-intermediated debt issuance. Business credit growth continues to be driven by the major banks and the foreign banks. In particular, the local operations of Japanese and Chinese institutions have significantly increased their business lending over 2015 (Graph 4.14). Lending to private non-financial corporations has been responsible for the majority of growth in business credit, while growth in lending to unincorporated (typically smaller) businesses has remained relatively steady. Business loan approvals have increased over 2015 and remain at a relatively high level, consistent with the faster pace of business credit growth seen in recent months.

The average outstanding interest rate on intermediated business borrowing has been little changed over recent months (Graph 4.15). Since the start of 2015, average rates on outstanding small and large business loans have declined by over 60 basis points. Strong competition among lenders has returned interest margins for lending to large businesses back to the levels of the mid 2000s (Graph 4.16). However, the recent increase in bank bill rates is expected to flow through to a modest increase in business borrowing rates, particularly for those businesses with loans directly priced off bank bill rates.

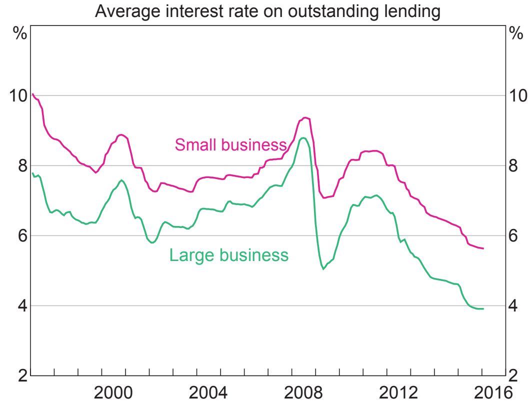
Gross bond issuance by Australian non-financial corporations in 2015 totalled $27 billion, which was well above 2014 levels, as a number of large issuers returned to debt markets in the first half of the year. However, issuance by Australian corporations was modest in recent months, with seven issuers raising

Graph 4.14
Business Credit by Source



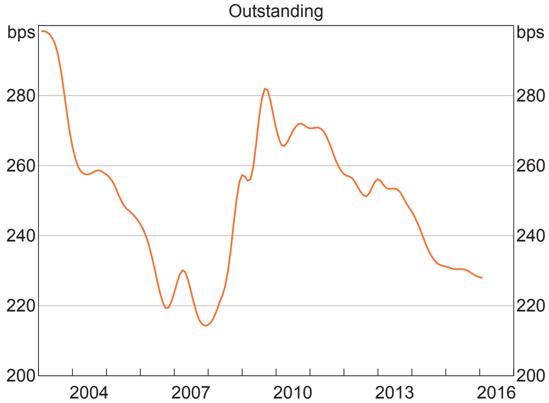
Sources: APRA; RBA

Graph 4.15
Australian Business Lending Rates*
Average interest rate on outstanding lending



* RBA estimates
Sources: APRA; RBA

Graph 4.16
Implied Spread on Business Lending*
Outstanding



* Weighted-average interest rates on lending less funding costs; 13-term Henderson trend

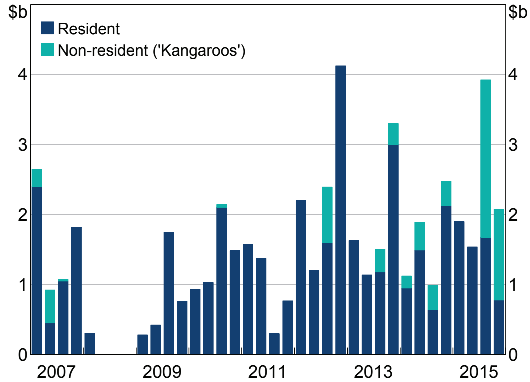
Sources: APRA; Bloomberg; Financial Reports; RBA; UBS AG, Australian Branch

around $1 billion. Kangaroo issuance by (non-resident) non-financial companies made a sizeable contribution to domestic corporate bond market activity with two issuers raising around $1 billion (Graph 4.17).

Australian corporate bond yields have risen in recent months, leading to a significant widening in corporate bond spreads relative to benchmark rates; this widening has been more pronounced for bonds issued by resource-related corporations and for bonds issued offshore (Graph 4.18). While resource companies' bond spreads have typically been marginally narrower than spreads for non-resource companies in recent years, they are currently around 75 basis points wider, as these companies face weaker conditions in commodities markets.

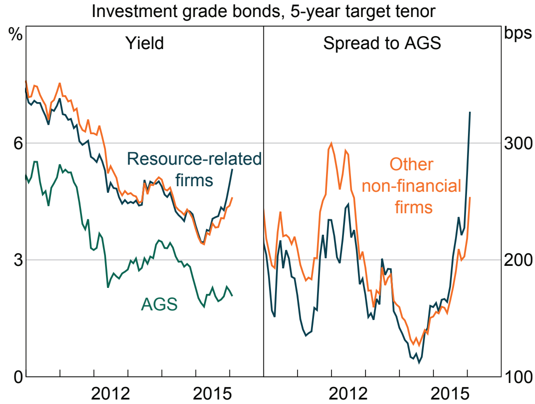
The credit ratings agencies have made downward revisions to their price assumptions on a number of commodities for the next couple of years, which has affected the credit ratings of some Australian non-financial corporations. Since the start of November, 23 (mostly resource-related) companies have experienced downgrades to their credit ratings or outlooks, or been placed on review for a downgrade.

Graph 4.17
Domestic Market Corporate Bond Issuance
Quarterly, Australian dollar



Source: RBA

Graph 4.18
Australian Corporate Bond Pricing
Investment grade bonds, 5-year target tenor

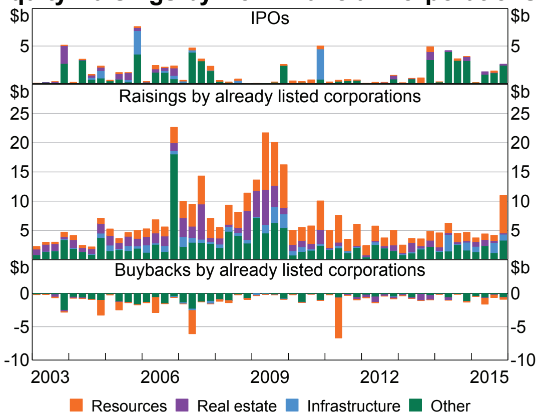


Sources: Bloomberg; RBA; S&P Capital IQ

Non-financial corporations (including real estate companies) raised $26 billion in net equity in 2015, which was slightly lower than in 2014 (Graph 4.19). IPO activity proceeded at a moderate pace in 2015 following a large number of new listings in 2014. There was a strong pick-up in equity raisings in the December quarter, with $13 billion raised predominantly by already listed corporations; this included capital raisings by energy companies seeking to pay down debt and strengthen their balance sheets following falls in oil prices.

Graph 4.19

Equity Raisings by Non-financial Corporations*



* Excludes financial corporations other than real estate; excludes hybrid conversions

Sources: ASX; RBA

Merger and acquisition (M&A) activity increased in 2015 with $85 billion in deals announced by listed companies. Activity was supported by the lower Australian dollar and interest from foreign buyers. M&A activity picked up in the December quarter with around $39 billion announced. This was concentrated in the financials and industrials sectors, and partly reflected takeover interest in Asciano, including a restructured offer from Brookfield Infrastructure Partners and rival interest from a consortium led by Qube.

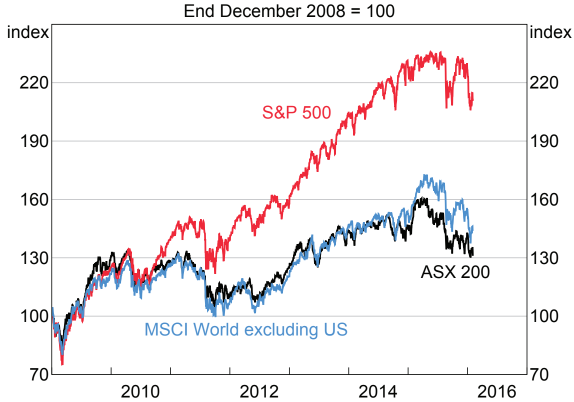
Equity Markets

Australian equity prices fell by 2 per cent over 2015, with sharp falls in commodity prices weighing on the resources sector (Graph 4.20; Table 4.3). Since the start of 2016, equity prices have fallen by 8 per cent alongside an increase in global share market volatility and further falls in oil prices. The Australian market generally underperformed global equity markets over 2015; however, this underperformance can be partly attributed to the higher dividends that are paid by Australian companies. On a total return basis, Australian equities rose by 3 per cent over 2015, outperforming the US but underperforming European markets.

Graph 4.20

Share Price Indices

End December 2008 = 100



Sources: Bloomberg; Thomson Reuters

Table 4.3: Equity Markets

Percentage change

	2014	2015	2016 to date
Australia (ASX 200)	1.1	–2.1	–7.9
– Resources	–19.0	–28.8	–14.2
– Financials	6.5	0.7	–10.3
– Other	6.1	6.5	–3.7
Europe (Eurostoxx)	1.7	8.0	–10.3
United States (S&P 500)	11.4	–0.7	–6.8
World (MSCI)	7.2	–0.7	–7.5

Source: Bloomberg

Resources sector share prices fell by 29 per cent over 2015, and have fallen a further 14 per cent since the start of this year (Graph 4.21). Share prices for this sector are now at their lowest level in over 10 years; at the end of 2015, the sector accounted for 16 per cent of the ASX 200 by market capitalisation, down from 24 per cent around two years ago.

The materials sector has declined by around 28 per cent since mid October alongside the fall in the iron ore price (Graph 4.22). Energy sector share prices have declined by 20 per cent, with oil prices falling by roughly 30 per cent over this period. Partially offsetting the negative effect of lower commodity prices has been continued cost cutting, particularly by the major diversified miners.

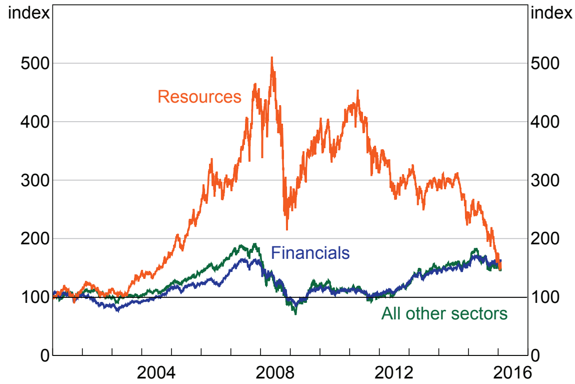
After being little changed over 2015, financial sector share prices have fallen by around 10 per cent since the start of this year driven by banks and diversified financials, and has occurred alongside falls in financial share prices globally.

Equity prices for companies outside the resources and financial sectors rose by 7 per cent over 2015. These companies have continued to outperform the broader index in aggregate since the start of this year, with a number reporting an improved outlook for earnings.

Analyst earnings expectations for 2015/16 and 2016/17 have been revised lower in recent months, with resources sector earnings expectations having fallen alongside further commodity price declines.

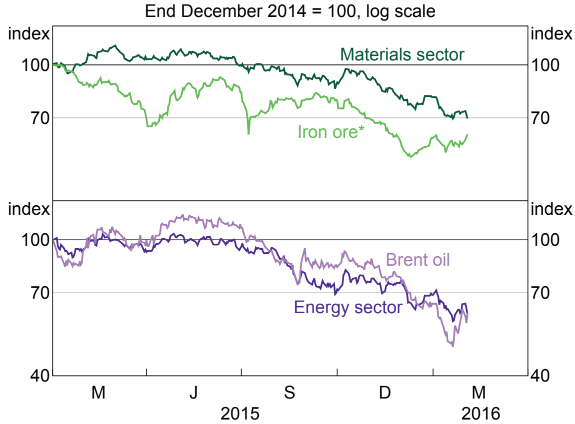
Valuations of Australian equities, as measured by forward price-earnings ratios, have declined in recent months reflecting lower share prices. Valuations remain above or around their long-term averages across all the broad sectors (Graph 4.23). ✠

Graph 4.21
Australian Share Price Indices
End December 2000 = 100



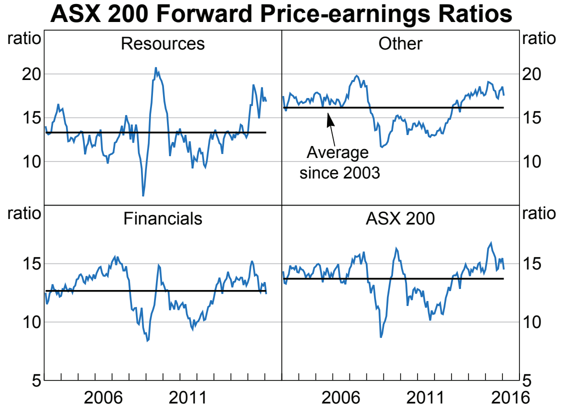
Source: Bloomberg

Graph 4.22
Resources Share Prices and Commodity Prices
End December 2014 = 100, log scale



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

Graph 4.23
ASX 200 Forward Price-earnings Ratios



Source: Thomson Reuters