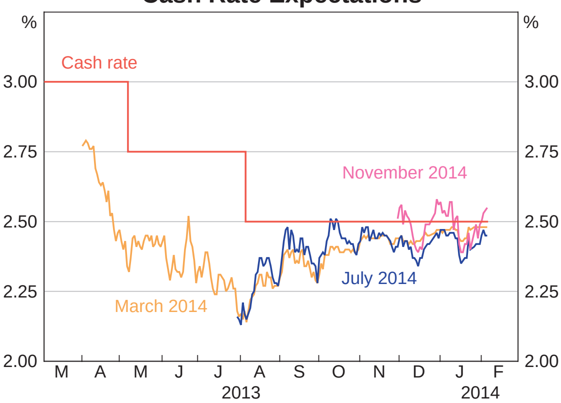
4. Domestic Financial Markets

Money Markets and Bond Yields

The Reserve Bank has maintained the cash rate target at 2.50 per cent since the previous *Statement*. Yields on money market instruments imply an expectation that there is little chance of an easing in monetary policy in 2014 (Graph 4.1).

Graph 4.1
Cash Rate Expectations



Sources: RBA; Tullett Prebon (Australia) Pty Ltd

Rates on bank bills and certificates of deposit have been stable over the past few months, and remain close to historically low levels of around 2.60 per cent. Spreads between bank bill and OIS rates have risen by around 5 basis points, reflecting a modest increase in issuance activity, but remain narrow.

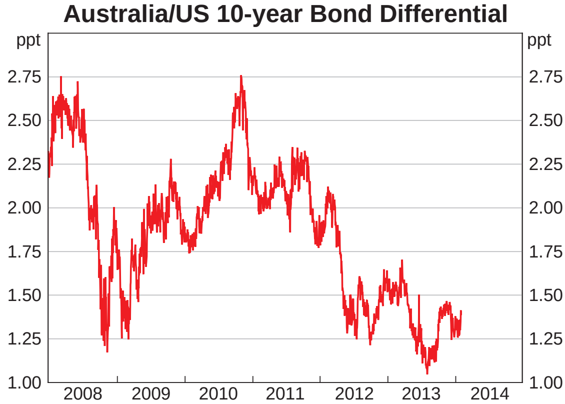
Yields on long-term Commonwealth Government securities (CGS) have moved in a wide range during the past few months, but in net terms are around 20 basis points lower than at the time of the previous *Statement* (Graph 4.2). Yields on 10-year CGS reached a 20-month high of 4.38 per cent in January in response to stronger-than-expected economic data in the United States, before declining to around 4 per cent.

The spread between 10-year CGS and US Treasuries is little changed since the previous *Statement*. (Graph 4.3).

Graph 4.2
Australian Government Bond Yields

Source: RBA

Graph 4.3
Australia/US 10-year Bond Differential

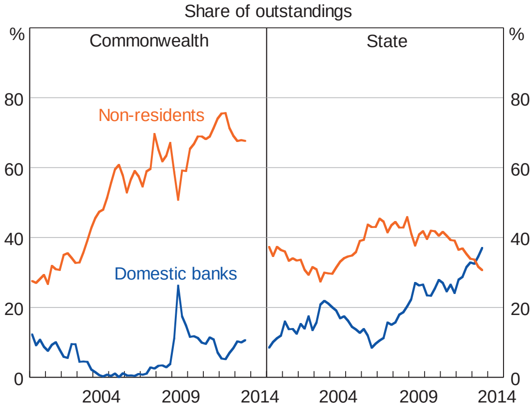


Source: RBA

The Australian Office of Financial Management (AOFM) announced a revised CGS issuance program for the 2013/14 financial year in response to the Mid-Year Economic and Fiscal Outlook (MYEFO). Net issuance is projected to be $52 billion over the year, an increase of $15 billion from the Pre-Election Economic and Fiscal Outlook (PEFO). The total amount of CGS on issue is expected to reach $310 billion by the end of the financial year.

The share of CGS held by non-residents remained broadly unchanged in the September quarter at around 68 per cent (Graph 4.4). Non-residents' holdings of state government bonds declined further to 31 per cent, while the share held by Australian banks increased further as they continued to increase their liquid asset holdings ahead of implementation of the Australian Prudential Regulation Authority's (APRA's) Basel III liquidity reforms in 2015. The share of non-government bonds held by non-residents was broadly unchanged in the September quarter.

Graph 4.4
Ownership of Australian Government Debt
Share of outstandings



Sources: ABS; RBA

State government bonds (semis) outstanding have increased slightly since the previous *Statement*, with a total of $2.5 billion in new lines issued via fixed- and floating-rate bonds. The states raised a total of $15.3 billion of term funding in the first half of the 2013/14 financial year, which is around 60 per cent of their aggregate funding target for the financial year (Table 4.1). Planned term borrowing by the states for the current financial year is significantly lower than their bond issuance in the 2012/13 financial year. In December, Queensland, Victoria and Western Australia revised down their planned issuance for this financial year by a total of $3.2 billion, mainly reflecting lower-than-anticipated government expenditure. Spreads between 5-year CGS and semis declined by as much as 10 basis points, reaching their lowest levels since mid 2011 (Graph 4.5).

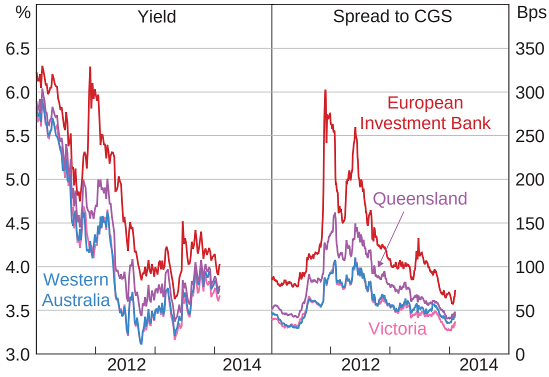
Domestic bond issuance by non-resident entities ('Kangaroos') was around $30 billion in 2013, similar to the amount raised in the previous year. Around $7 billion has been raised since the previous *Statement*, mostly by supranational and financial entities. Secondary market spreads for Kangaroo bonds have declined slightly and remain around

Table 4.1: Term Borrowing by State Authorities

Issuer	2012/13 Issuance $ billion	2013/14 Issuance as at end December 2013 $ billion	 Indicative target $ billion
New South Wales	6.9	2.8	5.3
Queensland	13.7	3.0	6.1
South Australia	~4	~2	~3
Tasmania	1.0	0	0.4
Victoria	7.2	3.5	6.1
Western Australia	8.6	~4	6.1
Total	**41**	**15**	**27**

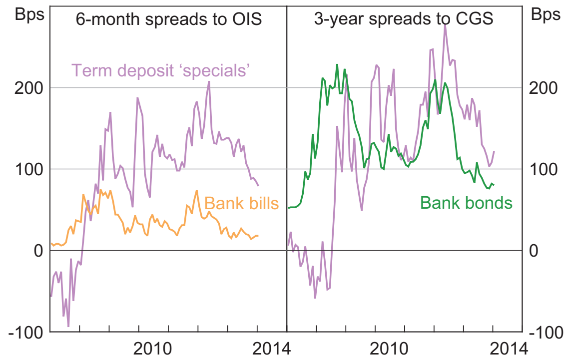
~ Indicates an approximation
Sources: state borrowing authorities

Graph 4.5
5-year Semi-government Debt



Sources: RBA; Yieldbroker

Graph 4.6
Major Banks' Pricing of Term Deposits



Sources: Bloomberg; RBA; Thomson Reuters; UBS AG, Australia Branch

their lowest levels since late 2007. Australian dollar cross-currency basis swap spreads have been broadly unchanged against the US dollar but have narrowed against the euro and the yen, reducing the attractiveness of issuance in Australian dollars for euro- and yen-based issuers.

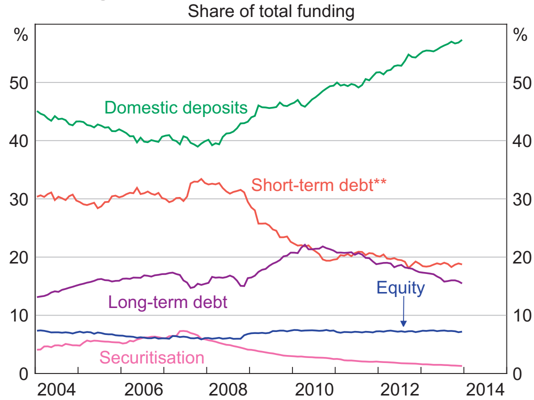
Financial Intermediaries

Since the previous *Statement*, bank funding costs have declined a little relative to the cash rate. As conditions in wholesale funding markets have improved, interest rates on some term deposit 'specials' have been reduced, leading to a further narrowing in spreads relative to comparable term wholesale market rates (Graph 4.6). With average interest rates on at-call deposits little changed, term deposits have become less attractive to savers than at-call deposits, which has resulted in a continued inflow of household savings into at-call deposit accounts. The aggregate share of funding from domestic deposits has remained broadly stable over this period (Graph 4.7).

Over the past three months, the cost of banks' new issuance of unsecured long-term wholesale debt has been little changed, and remains at around its lowest level since mid 2009 (Graph 4.8). The outstanding cost of wholesale debt has started to decline over the past few months as some of the debt issued in 2008 and 2009 at high spreads has matured. This has had a limited effect on banks' overall funding

Graph 4.7
Funding Composition of Banks in Australia*

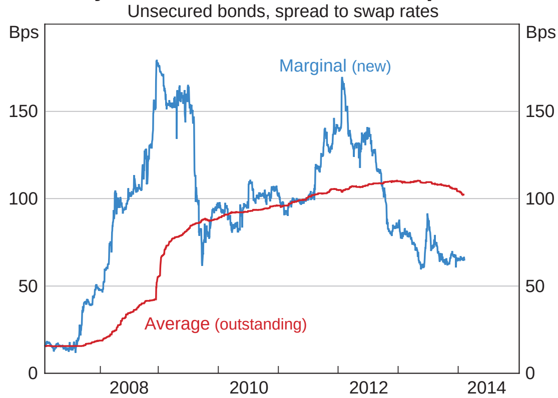
Share of total funding



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

Graph 4.8
Major Banks' Domestic Bond Spreads

Unsecured bonds, spread to swap rates



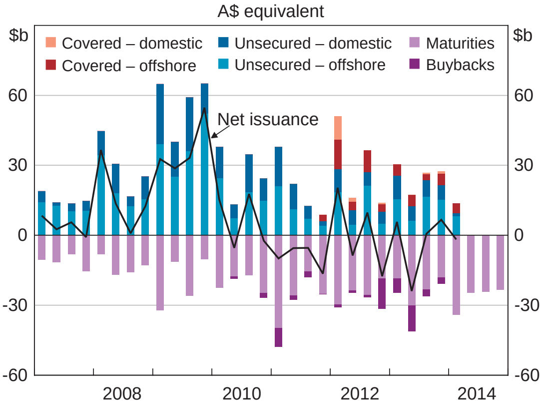
Sources: Bloomberg; RBA; UBS AG, Australia Branch costs to date as long-term wholesale debt currently represents only 15 per cent of banks' total funding.

Relative to CGS, spreads on the major banks' bonds have remained broadly unchanged since the previous *Statement*. Spreads over CGS on the unsecured bonds of the major banks are near their lowest level since the onset of the global financial crisis, while spreads on covered bonds are at their lowest since the banks started issuing these securities.

Around $29 billion of bonds have been issued by Australian banks since the previous *Statement* (Graph 4.9). Over 85 per cent of these bonds were issued offshore, including $9 billion of covered bonds. US dollar issuance comprised half of the total, with the remainder split equally between the Australian dollar, euro and yen. Notwithstanding the pick-up in gross issuance late in the year, net bank bond issuance in 2013 was lower than in 2012 reflecting a combination of subdued asset growth and the ongoing shift towards deposit funding by the Australian banks. The stock of outstanding government guaranteed bonds has declined to around $30 billion reflecting maturities and buybacks.

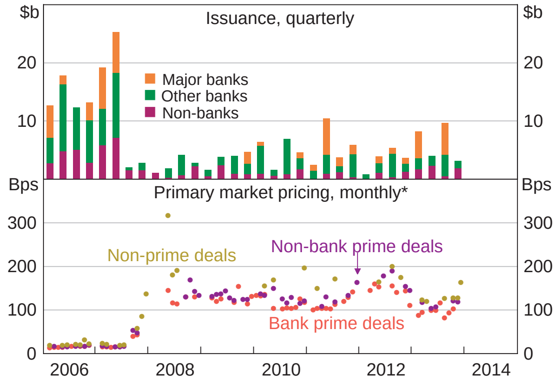
Issuance in the Australian securitisation market of $32 billion in 2013 was the highest it has been since the start of the global financial crisis (Graph 4.10). Most of the issuance was in the form of residential mortgage-backed securities (RMBS), although issuance of other asset-backed securities was also

Graph 4.9
Banks' Bond Issuance and Maturities
A$ equivalent



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

Graph 4.10
Australian RMBS



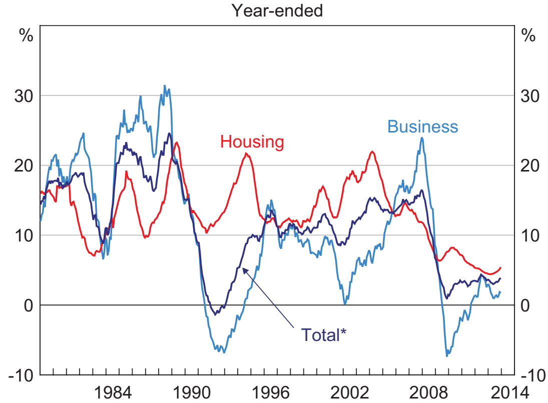
* Face-value weighted monthly average of the primary market spread to bank bill rate
Source: RBA

robust, including the first issuance of commercial mortgage-backed securities since 2010. Around $2.5 billion of these securities have been issued since the previous *Statement*, with most of that in the domestic market. RMBS issuance spreads have remained broadly unchanged since March 2013.

Financial Aggregates

Total credit grew modestly in the December quarter, increasing at an annualised rate of around 4¾ per cent (Graph 4.11; Table 4.2). This is still below growth in broad money, which increased at an annualised rate of 7 per cent over the quarter. The growth in broad money mainly reflected continued inflows into saving and transaction deposit accounts.

Graph 4.11
Credit Growth
Year-ended



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

Table 4.2: Financial Aggregates
Percentage change[(a)]

	Three-month ended		Year-ended
	Sep 2013	Dec 2013	Dec 2013
Total credit	0.9	1.2	3.9
– Owner-occupier housing	1.1	1.4	4.6
– Investor housing	1.7	2.2	7.1
– Personal	0.4	0.1	0.9
– Business	0.4	0.5	1.7
Broad money	1.1	1.7	5.8

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

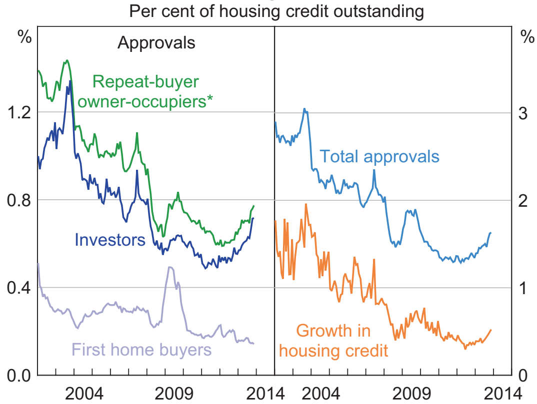
Household Financing

Growth in housing credit edged higher over the December quarter, consistent with the pick-up in prices and activity in the housing market over the past year (Graph 4.12). The value of housing loan approvals is around 5 per cent higher than its previous peak in June 2007. The increase in both the value and number of loan approvals has been underpinned by loans to investors and repeat-buyer owner-occupiers. Loan approvals for purchases of dwellings in New South Wales by investors continue to be particularly strong. With the value of first home buyer loan approvals at historically low levels, the small share of first home buyer approvals is likely to have held down housing credit growth. This reflects the fact that approvals to first home buyers typically translate into larger increases in housing credit than loans to investors and repeat-buyer owner-occupiers. In addition, households continue to maintain a high pace of mortgage prepayments.

The average interest rate on outstanding housing loans continued to fall as borrowers refinanced at lower rates (Graph 4.13). The average interest rate on housing loans is now around 30 basis points below its previous trough in September 2009.

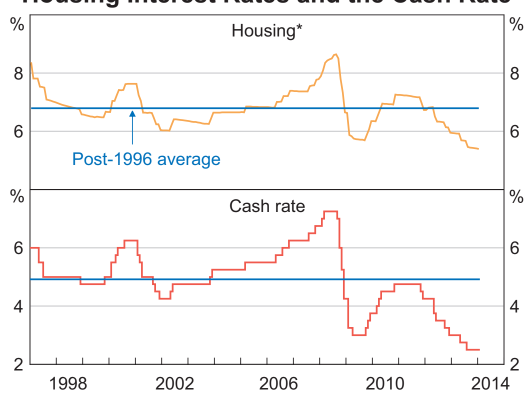
Lenders' standard variable rates have remained largely unchanged since the last reduction in the cash rate target in August, although some lenders have altered their advertised package discount rates amid ongoing mortgage competition (Table 4.3).

Graph 4.12
Housing Loans
Per cent of housing credit outstanding



* Net of refinancing
Sources: ABS; RBA

Graph 4.13
Housing Interest Rates and the Cash Rate



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

Table 4.3: Intermediaries' Fixed and Variable Lending Rates

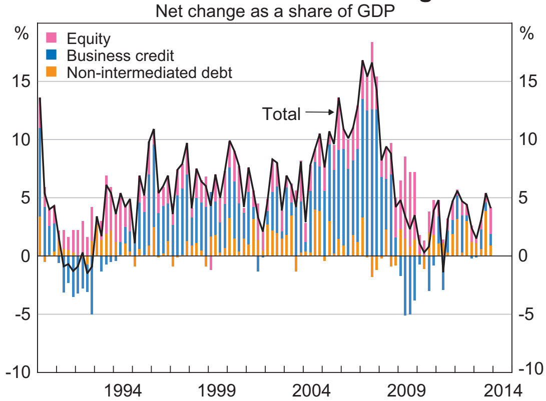
	Level at 31 January 2014	Change since October 2013	Change since end October 2011
	Per cent	Basis points	Basis points
Housing loans			
– Standard variable rate[(a)]	5.93	0	–186
– Package variable rate[(b)]	5.10	2	–195
– Fixed rate[(c)]	5.29	5	–123
Personal loans			
– Standard variable rate	11.58	2	–96
Small business (variable rates)			
Residentially secured, advertised			
– Term loans	7.10	0	–190
– Overdraft	7.97	0	–188
Average rate[(d)]	6.80	0	–183
Large business			
Average rate[(d)] (variable rate and bill funding)	4.67	1	–236

(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

Many lenders continued to advertise special offers to new customers, including fee waivers and additional discounts on rates for a limited time.

The value of outstanding personal credit increased slightly over the December quarter. The stock of fixed-term loans continued to increase, supported by ongoing strength in credit extended by car finance companies. Notwithstanding the rise in equity prices over the second half of 2013, preliminary data from the RBA's December quarter margin lending survey suggest that the value of margin loans outstanding remains less than one-third of its pre-crisis peak.

Graph 4.14
Business External Funding
Net change as a share of GDP



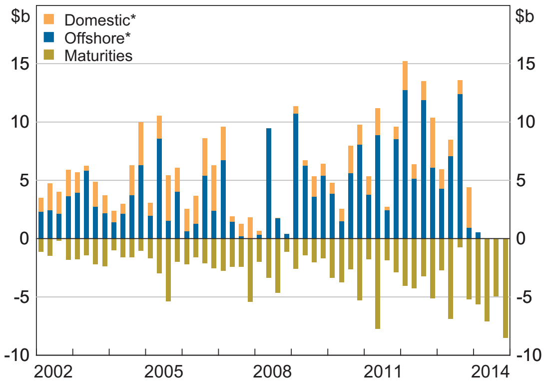
Sources: ABS; APRA; ASX; RBA

Business Financing

External business funding has risen by the equivalent of around 4 per cent of GDP in the December quarter. The main contribution was from equity raisings (Graph 4.14).

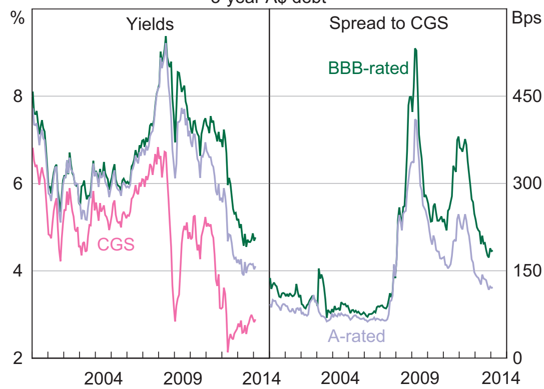
Corporate bond issuance totalled $2 billion since the previous *Statement* (Graph 4.15). Issuance was mostly confined to the domestic market with around half at the 5-year tenor. Issuance in 2013 was slightly below the record issuance volume in 2012, mostly due to

Graph 4.15
Australian Corporates' Bond Issuance
A$ equivalent



* Latest quarter issuance to date
Source: RBA

Graph 4.16
Australian Corporates' Bond Pricing
3-year A$ debt



Sources: RBA; UBS AG, Australia Branch

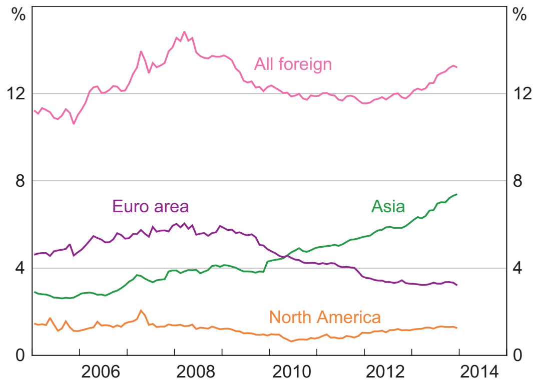
reduced activity by the large diversified miners. Corporate bond issuance by other companies was very strong in mid 2013, with significant issuance in the domestic market and at longer-than-usual tenors for the lower-rated issuers.

Secondary market spreads for Australian dollar corporate bonds over CGS have increased since the previous *Statement* for BBB-rated entities, and have remained unchanged for A-rated entities. Spreads remain near their lowest levels since the onset of the global financial crisis (Graph 4.16).

The value of outstanding business credit rose modestly over the December quarter, reflecting an increase in lending to both private trading corporations and unincorporated businesses. Much of the growth in business credit over the past year was driven by lending by Asian banks operating in Australia which have increased their share of total business credit from around 4 per cent in December 2008, to almost 7½ per cent in December 2013 (Graph 4.17). However, the overall rate of growth in business credit remains low, consistent with subdued investment intentions despite some surveys indicating improved business conditions.

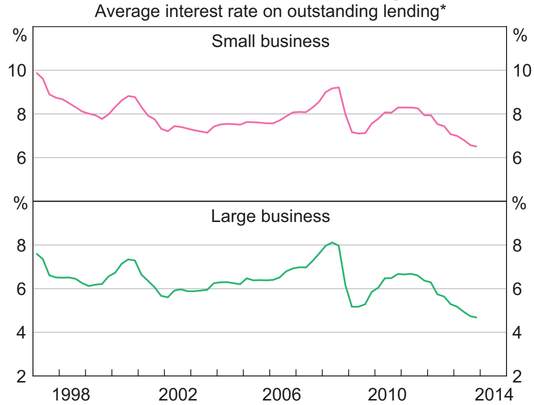
Since the previous *Statement*, the cost of intermediated business borrowing for both small and large businesses has continued to decline (Graph 4.18). Rates on small and large business loans outstanding remain well below their post-1996 averages.

Graph 4.17
Business Credit*
Share of total business credit provided by foreign banks



* Non-seasonally adjusted, non-break adjusted; includes securitisation
Sources: APRA; RBA

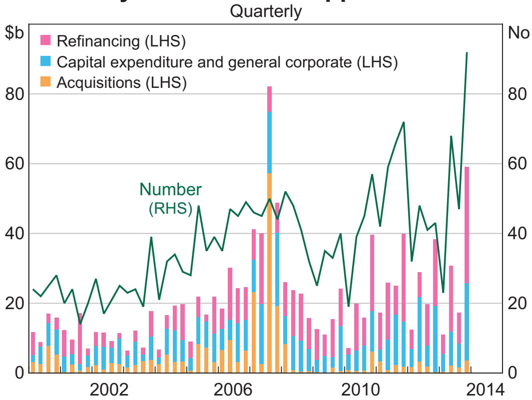
Graph 4.18
Australian Business Lending Rates
Average interest rate on outstanding lending*



* RBA estimate for December quarter 2013
Sources: APRA; RBA

Activity in the Australian syndicated lending market picked up over the December quarter (Graph 4.19). Loan approvals for refinancing, capital and general corporate expenditure increased strongly even after accounting for seasonality. Acquisition-related financing increased a little in the quarter but remains at a low level.

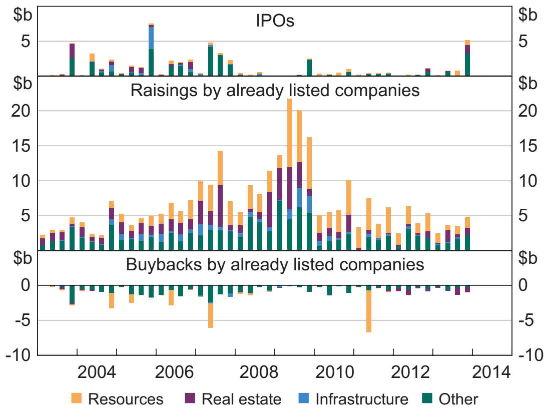
Graph 4.19
Syndicated Loan Approvals



Sources: RBA; Thomson Reuters

Equity raisings by non-financial corporations (but including real estate companies) rose sharply in the December quarter to $9 billion (Graph 4.20). The increase was mainly driven by $5 billion in initial public offerings (IPOs), which was the highest level of quarterly IPO activity since 2005 and a number of these transactions involved private equity interests. The pick-up in activity is expected to continue into 2014, reflecting a build-up of supply in recent years. Several large deals accounted for most of the IPO activity, including a $1 billion deal by a New Zealand based renewable energy developer – the largest IPO since November 2009 – as well as listings of around $650 million each from two other companies. Real estate companies raised a further $1 billion across four IPOs. Equity raisings by already listed companies also increased in the December quarter, with issuance totalling $5 billion and driven by private placements across a number of sectors. There were $1 billion in share buybacks during the quarter, mainly by real estate companies. With the pick-up in

Graph 4.20
Listed Corporates' Equity Raisings*



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

issuance late in the year – especially IPOs – total net equity raisings in 2013 were the highest since 2010.

In contrast, merger and acquisition (M&A) activity has remained subdued with around $9 billion in deals announced by listed companies since the previous *Statement*. The level of M&A activity in 2013 was the lowest in over a decade, with only $30 billion in deals announced.

Equity Markets

Australian equity prices have declined by 6½ per cent since the previous *Statement*, broadly following overseas market developments (Graph 4.21). Over 2013, Australian equity prices rose by 15 per cent, underperforming global equity markets, particularly Japan and the United States.

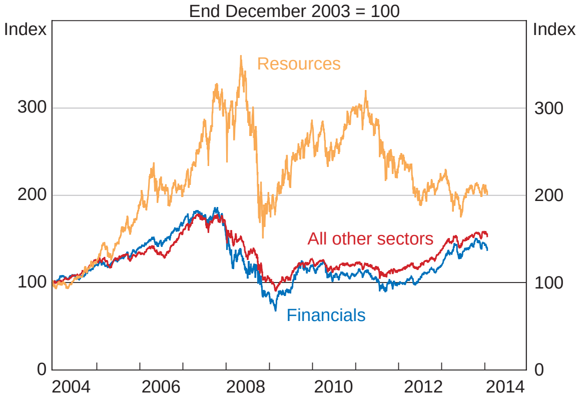
Resource sector share prices have declined by 6½ per cent since the previous *Statement* (Graph 4.22). The share prices of major diversified mining companies have generally tracked movements in the price of iron ore.

Financial sector share prices have declined by 9 per cent since the previous *Statement*, with the dividend payments by three of the major banks adding to the general equity market trend. Prices in the insurance subsector have declined by 16½ per cent, following

Graph 4.21
Share Price Indices
End December 2006 = 100

Sources: Bloomberg; MSCI; Thomson Reuters

Graph 4.22
Australian Share Price Indices
End December 2003 = 100



Sources: Bloomberg; RBA

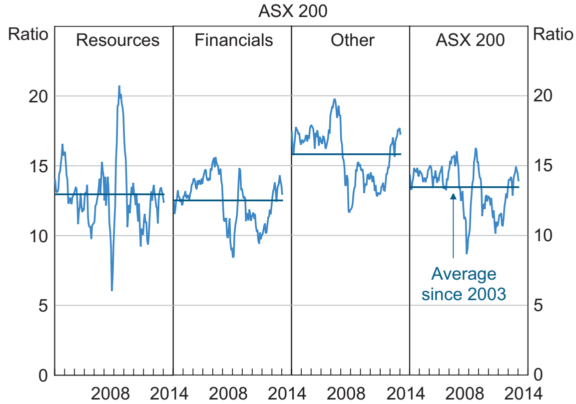
QBE's announcement of an expected $275 million loss for this financial year related to weakness in its North American business, including asset writedowns and higher–than-expected insurance claims.

Share prices in other sectors have declined by 3 per cent since the previous *Statement*, although defensive stocks, in particular the healthcare and telecommunications sectors, have outperformed. In contrast, industrial companies' share prices have declined by 5 per cent since the previous *Statement*.

In line with international markets, the option-implied volatility of Australian equities has increased since the previous *Statement*. Trading activity has remained subdued.

Equity analysts' consensus earnings forecasts have increased for the resources sector by around 7 per cent since the previous *Statement*. This is largely due to the translation impact on the sector's US dollar generated earnings following the depreciation of the Australian dollar, rather than an upward revision of expected underlying performance. Earnings expectations for the other sectors have been broadly unchanged over this period. Valuations of Australian equities, as measured by forward price-earnings (PE) ratios, have declined since the previous *Statement* but remain close to or above their decade averages across all of the broad sectors (Graph 4.23). The PE ratio of the resources sector declined alongside lower share prices and an increase in expected Australian dollar earnings in the sector, while PE ratios for financials and other companies followed developments in these sectors' share prices. ✠

Graph 4.23
Australian Forward Price-earnings Ratios
ASX 200



Sources: RBA; Thomson Reuters