

4. Domestic Financial Markets

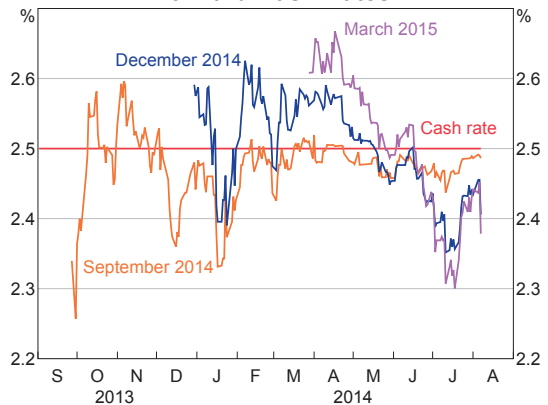
In line with conditions globally, volatility in Australian financial markets has been at particularly low levels over recent months. Money market rates imply that the cash rate is expected to remain unchanged over the remainder of the year. Government bond yields have declined since the time of the previous *Statement*, and borrowing costs for state governments are near historic lows. Corporate bond spreads have declined to their lowest levels since 2007 and issuance by lower-rated corporations and at longer maturities has been readily absorbed by the market. Growth in intermediated lending has picked up, with both housing and business credit growth increasing over recent months. Australian equity prices have risen slightly over the period, underperforming those in other developed markets.

Money Markets and Bond Yields

The Reserve Bank has maintained the cash rate target at 2.50 per cent since August 2013. Rates on overnight indexed swaps (OIS) suggest that the cash rate is expected to remain unchanged over the remainder of the year (Graph 4.1).

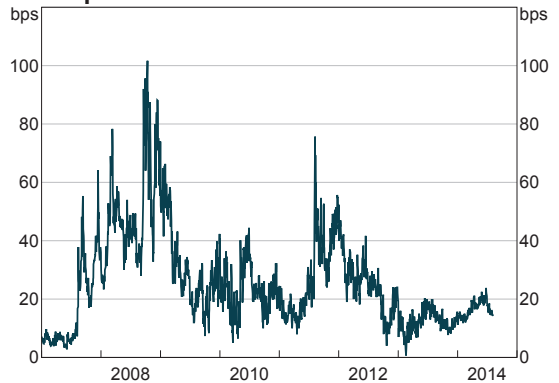
Rates on bank bills and certificates of deposit (CDs) have declined by around 5 basis points since the previous *Statement* and the 3-month bank bill rate is currently around 2.65 per cent. Spreads between bank bill and OIS rates have declined somewhat recently, after having increased over the first half of the year in line with increased issuance of bank bills and CDs (Graph 4.2).

Graph 4.1
Forward Cash Rates



Sources: RBA; Tullet Prebon (Australia) Pty Ltd

Graph 4.2
Spread of 3-month Bank Bills to OIS



Sources: AFMA; Tullet Prebon (Australia) Pty Ltd

Yields on long-term Commonwealth Government securities (CGS) have declined by around 30 basis points since the previous *Statement* (Graph 4.3). Global developments, including tensions in the Middle East and Ukraine, have contributed to the decline in CGS yields over recent months, as have market expectations that the cash rate will stay at its current level for longer. Consistent with this, the spread between 10-year CGS and US Treasuries has narrowed by around 20 basis points since the previous *Statement*, to reach its lowest level since 2006 (Graph 4.4).

Graph 4.3
Australian Government Bond Yields



Source: RBA

Graph 4.4
Australia/US 10-year Bond Differential

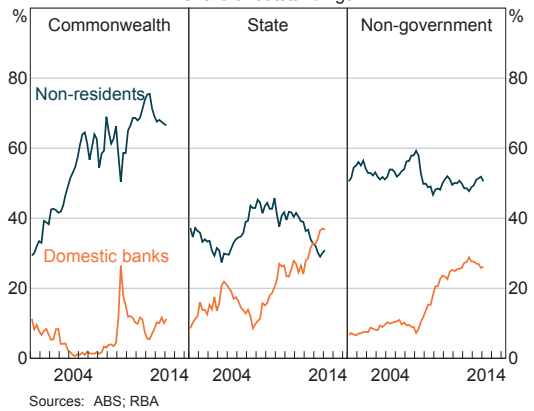


Source: RBA

Following the release of the Australian Government Budget in May, the Australian Office of Financial Management (AOFM) announced its updated

financing requirement for 2014/15. The AOFM expects to issue around \$63 billion of nominal CGS and \$4 billion in Treasury Indexed Bonds, with total CGS on issue expected to reach around \$360 billion by June 2015. While buying of CGS by non-residents has picked up in recent quarters, it has only kept pace with new issuance. Accordingly, the share of CGS held by non-residents remains around two-thirds of the outstanding stock (Graph 4.5).

Graph 4.5
Selected Holders of Australian Bonds
Share of outstandings



Sources: ABS; RBA

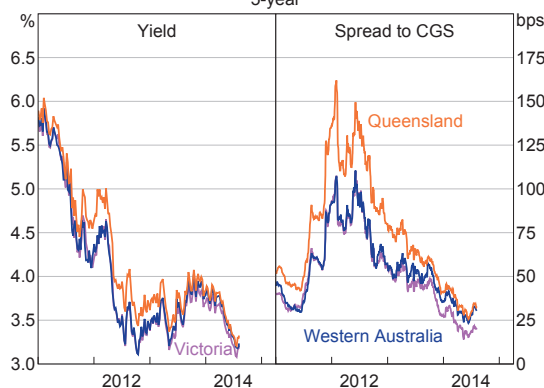
The states have announced their 2014/15 budgets and updated their borrowing programs. Gross long-term bond issuance (less pre-funding) by the states is expected to increase by about \$31 billion in the current financial year (Table 4.1). Taking into account scheduled maturities, the stock of state bonds on issue is expected to increase by around \$10 billion during the financial year, compared with an average increase of around \$20 billion in each of the previous three financial years. While a number of states have announced plans to privatise assets, these have not yet been legislated and therefore have not been reflected in the states' borrowing programs. Should these plans eventuate, issuance in the near term would be lower than currently projected. Spreads between securities issued by state governments ('semis') and CGS remain close to their historic lows (Graph 4.6).

Table 4.1: Long-term Bond Issuance by State Treasury Corporations^(a)

Issuer	Outstanding as at June 2014 \$ billion	2013/14 issuance \$ billion	2014/15 indicative target \$ billion
New South Wales	64	5	6
Queensland	81	6	8
South Australia	14	3	4
Tasmania	3	0	1
Victoria	36	6	3
Western Australia	30	6	9
Total	230	27	31

(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
Sources: State Treasury Corporations; RBA

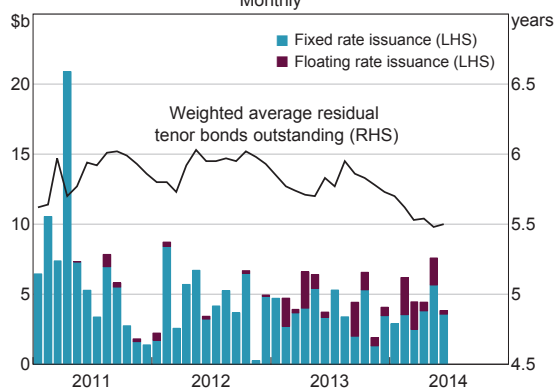
Graph 4.6
State Government Debt
5-year



Sources: RBA; Yieldbroker

Bond issuance by the state borrowing authorities in recent years has featured increased issuance of floating-rate notes (FRNs) and a shortening of the issuance tenor (Graph 4.7). Since early 2013, around one-quarter of the issuance has been FRNs. The increased issuance of FRNs reflects, among other things, strong demand for such securities from banks, which have increased their holdings of state government securities to meet the soon to be implemented prudential liquidity requirements. Banks have a preference for holding FRNs and shorter-term fixed-income assets as they match the predominantly floating rate nature of their liabilities.

Graph 4.7
Bond Issuance by States and Territories
Monthly



Sources: RBA; State Treasury Corporations

Domestic bond issuance by non-resident entities ('Kangaroo' issuance) has totalled \$12 billion since the previous *Statement*, about half of which was raised by supnationals largely refinancing previous issuance. Non-supnational issuance has largely been driven by European banks returning to the Kangaroo market, although there has been some small first-time issuance by Middle Eastern entities adding further to the issuance from this region earlier in the year.

Since the previous *Statement*, the cost of hedging Australian dollar issuance into major currencies has remained mostly unchanged. The general trend over

the past year has been towards increased cost of hedging Australian dollar issuance into yen and euros as the cross-currency basis swap spreads of these currencies against the Australian dollar have declined. Despite the increased cost of hedging Australian dollar issuance, Kangaroo bond issuance has remained attractive owing to the general decline in credit spreads, particularly for European-based issuers.

Financial Intermediaries

Major banks' average funding costs have declined slightly since the previous *Statement*. Conditions for issuers in long-term wholesale debt markets have continued to improve, with the cost of new issuance remaining at low levels. At the same time, wholesale debt issued previously at higher spreads has continued to mature, reducing the cost of outstanding debt (Graph 4.8). To date, this has only had a modest effect on banks' average funding costs as long-term wholesale debt currently represents about 12 per cent of banks' total funding.

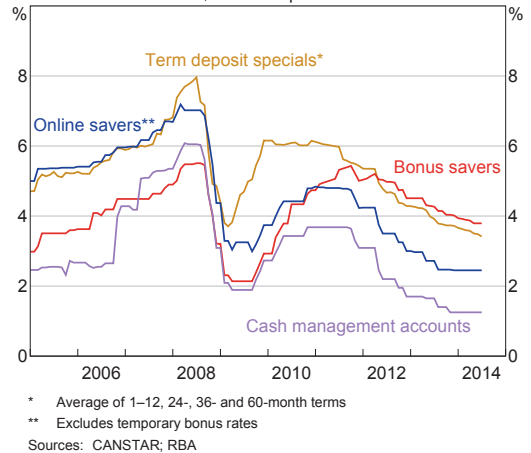
Graph 4.8
Major Banks' Domestic Bond Spreads
Unsecured bonds, spread to swap rates



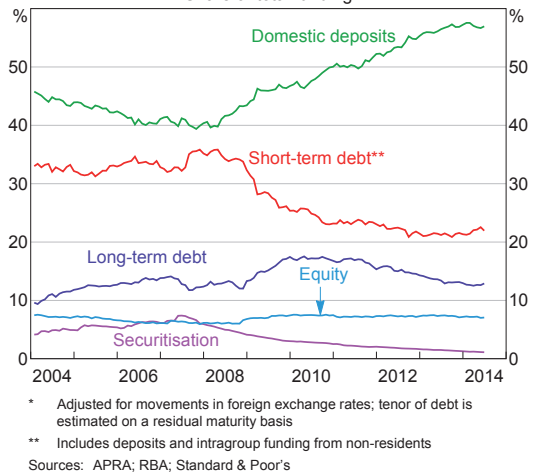
The favourable conditions in wholesale markets, together with some easing in competition for deposits, have led banks to reduce their term deposit rates (Graph 4.9). In addition, the spread between term deposit rates and wholesale market rates has narrowed over the past year. Consistent with these

developments, the aggregate share of deposits in banks' funding has been broadly unchanged over the past few months at around 57 per cent (Graph 4.10).

Graph 4.9
Major Banks' Deposit Rates
\$10 000 deposits

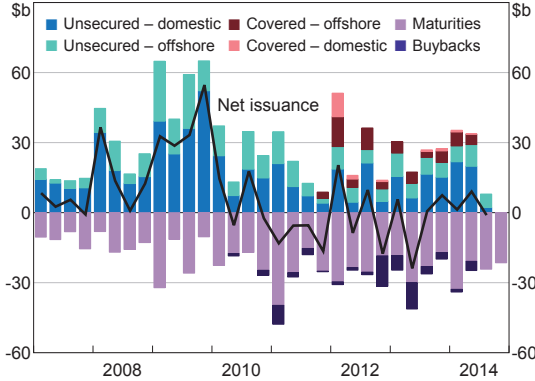


Graph 4.10
Funding Composition of Banks in Australia*
Share of total funding



Australian banks have issued around \$33 billion in senior unsecured and covered bonds since the previous *Statement* (Graph 4.11), with two-thirds of this issued offshore, primarily in the US market. Nonetheless, the stock of outstanding bank bonds continues to grow only modestly, increasing by

Graph 4.11
Banks' Bond Issuance and Maturities*
A\$ equivalent



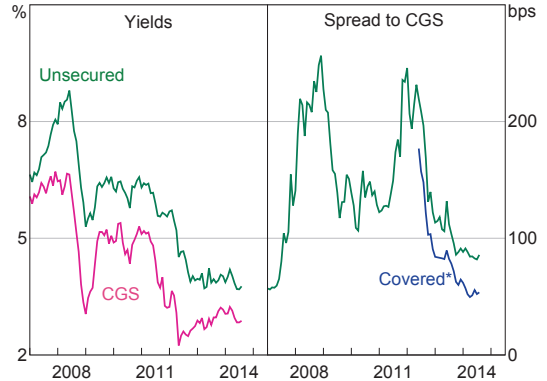
* Last quarter gross issuance and net issuance are quarter to date
Source: RBA

\$9 billion over the most recent quarter. Debt maturities have averaged around \$20 billion a quarter over the past three years, while the weighted average residual maturity of outstanding bank bonds is currently around 3½ years. The volume of hybrid issuance was lower than during the three month period before the previous *Statement*, with two bank issues of Basel III compliant securities raising \$2 billion.

Secondary market spreads to CGS on the major banks' bonds have been little changed since the previous *Statement*, with senior unsecured bond spreads remaining around their lowest levels since 2007 (Graph 4.12).

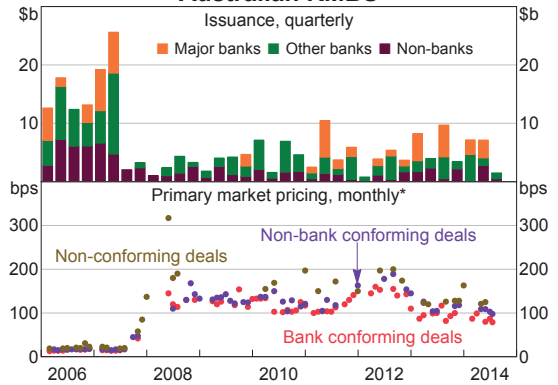
Australian securitised issuance has totalled around \$10 billion since the previous *Statement* (Graph 4.13). Around 85 per cent of the issuance has been in the form of residential mortgage-backed securities (RMBS). Most of the RMBS were originated by banks, although non-banks raised \$3 billion in RMBS. Primary market issuance spreads for banks and mortgage originators on senior RMBS tranches tightened further to their lowest levels since 2007. A small commercial mortgage-backed security and two securities backed by assets other than real estate were also issued since the previous *Statement*.

Graph 4.12
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
Source: Bloomberg; RBA; UBS AG, Australia Branch

Graph 4.13
Australian RMBS



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

Financial Aggregates

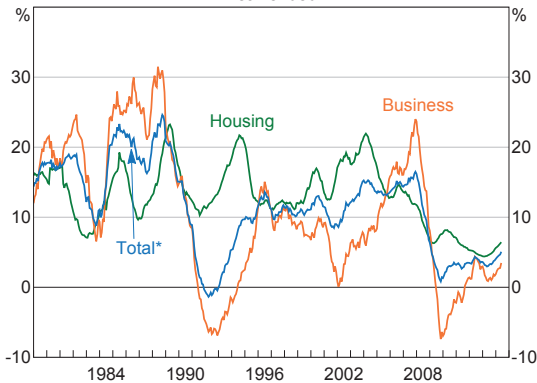
Total annualised credit growth picked up to around 6½ per cent over the June quarter. This reflected an increase in growth in both housing and business credit (Graph 4.14). Growth in credit remains below growth in broad money, which increased at an annualised rate of around 8 per cent over the quarter (Table 4.2).

Table 4.2: Financial Aggregates
Percentage change^(a)

	Three months ended March 2014	Three months ended June 2014	Year ended June 2014
Total credit	1.2	1.6	5.1
– Owner-occupier housing	1.3	1.4	5.3
– Investor housing	2.1	2.5	8.7
– Personal	-0.2	0.4	0.7
– Business	0.8	1.5	3.5
Broad money	1.9	1.9	7.0

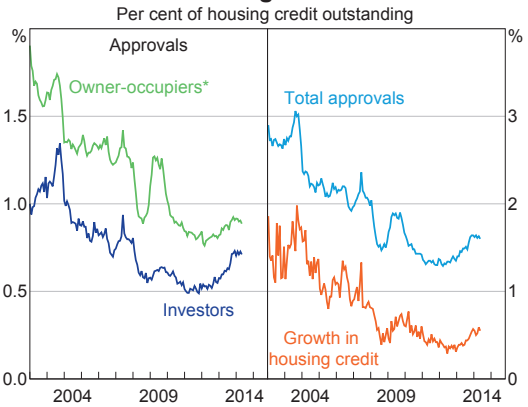
(a) Growth rates are break adjusted and seasonally adjusted
Sources: APRA; RBA

Graph 4.14
Credit Growth by Sector
Year-ended



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

Graph 4.15
Housing Loans



* Net of refinancing
Sources: ABS; RBA

Household Financing

Housing credit growth steadied in the first half of 2014, after increasing in the second half of last year. This is consistent with growth in housing loan approvals, which have stabilised at a high level (Graph 4.15). Credit extended to investors has continued to grow at a faster pace than for owner-occupiers. Mortgage prepayments remain at a high level and continue to restrain credit growth.

There has been a reduction in advertised rates on fixed-rate loans, mainly reflecting a reduction in fixed-rate funding costs for banks (Table 4.3).

Lenders continue to advertise special offers to new customers, including fee waivers and additional discounts on rates for a limited time. Consistent with this, the average interest rate on outstanding housing loans has continued to gradually decline as borrowers have refinanced at lower rates (Graph 4.16). The average interest rate on housing loans is now around 15 basis points lower than it was after the reduction in the cash rate target in August 2013. Liaison with financial institutions indicates that competition for lending remains strong, with interest rate discounting and broker commissions increasing over the past year.

Table 4.3: Intermediaries' Fixed and Variable Lending Rates

	Level at 6 August 2014 Per cent	Change since end April 2014 Basis points	Change since end August 2013 Basis points	Change since end October 2011 Basis points
Housing loans				
– Standard variable rate ^(a)	5.93	0	0	–186
– Package variable rate ^(b)	5.08	0	–2	–195
– Fixed rate ^(c)	5.12	–8	1	–140
– Average outstanding rate	5.30	–5	–16	–187
Personal loans				
– Standard variable rate	11.63	1	–7	–86
Small business (variable rates)				
– Term loans	7.10	0	0	–190
– Overdraft	7.97	0	0	–188
Average rate ^(d)	6.69	–2	–11	–194
Large business				
Average rate ^(d) (variable rate and bill funding)	4.50	–7	–29	–253

(a) Average of the major banks' standard variable rates

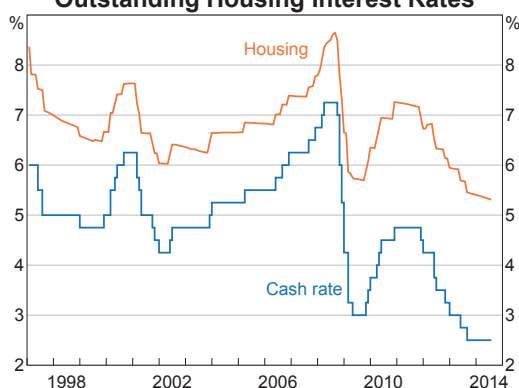
(b) Average of the major banks' discounted package rates on new, \$250 000 full-doc loans

(c) Average of the major banks' 3-year fixed rates

(d) Rates on outstanding business lending (includes discounts)

Sources: ABS; APRA; RBA

**Graph 4.16
Outstanding Housing Interest Rates**



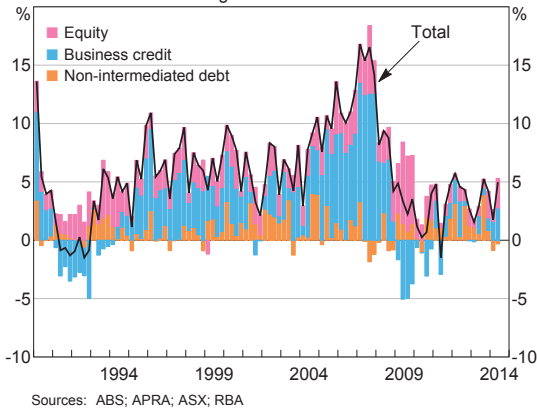
Sources: ABS; APRA; Perpetual; RBA

Business Financing

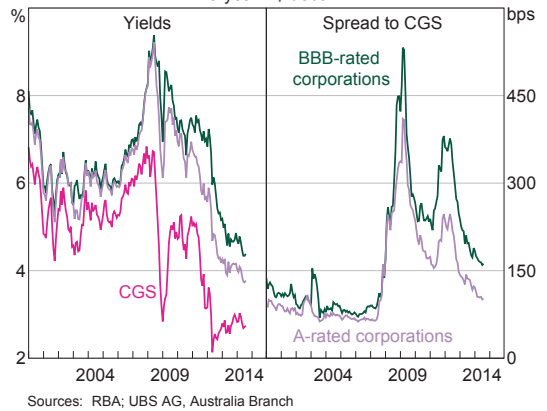
Growth in external business funding picked up in the June quarter to 5 per cent of GDP. Equity raisings and business credit both increased while non-intermediated debt was broadly unchanged (Graph 4.17).

Australian non-financial corporate bond issuance has totalled around \$3 billion since the previous *Statement*. Issuance has been relatively low over the past 9 months, as the large resource companies have been absent from the market (Graph 4.18). As is typical for Australian corporate issuance, most bonds were placed offshore, although the domestic market saw the first sub-investment grade (rated below BBB-) bond issuance with Qantas raising \$700 million through two bonds with relatively long maturities.

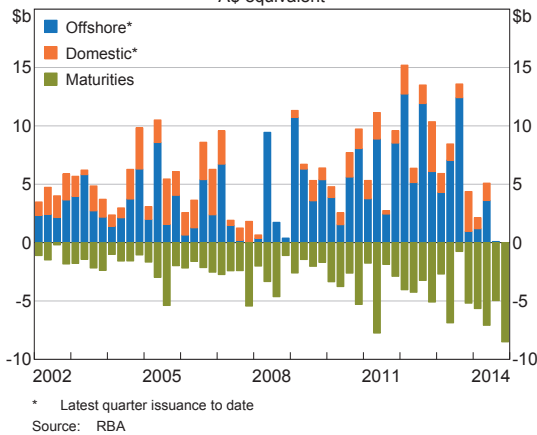
Graph 4.17
Business External Funding
Net change as a share of GDP



Graph 4.19
Australian Corporates' Bond Pricing
3-year A\$ debt



Graph 4.18
Australian Corporates' Bond Issuance
A\$ equivalent



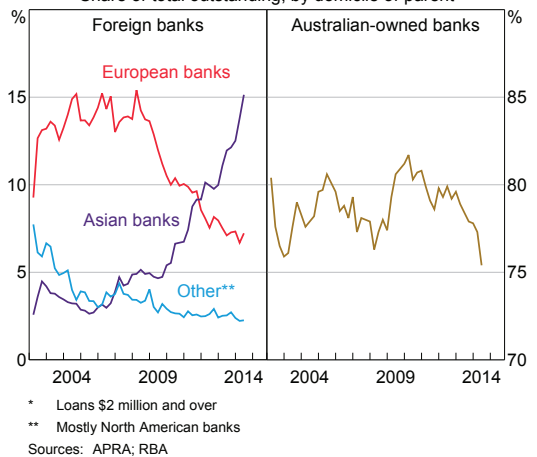
Secondary market spreads over CGS for Australian dollar corporate bonds have declined slightly since the previous *Statement* across all credit ratings. Spreads are at their lowest levels since 2007 (Graph 4.19).

Non-bank financial bond issuance has picked up since the previous *Statement*. Scentre Group, a newly formed company from the restructuring of Westfield, issued \$3 billion across four offshore bonds with maturities ranging from 4 to 12 years. Credit ratings for Australian issuers have remained stable since the previous *Statement*.

Business credit growth picked up in the June quarter, with part of the increase due to a number of banks providing bridging finance for the restructure of Westfield. The major banks and foreign-owned banks accounted for the bulk of the increase in business credit over the quarter. Lending to unincorporated (typically smaller) businesses has generally grown at a faster pace than lending to private non-financial corporations over recent months.

Asian-owned banks continue to increase their share of lending to large businesses (Graph 4.20). Over the past couple of years, these banks have

Graph 4.20
Banks' Large Business Lending*
Share of total outstanding, by domicile of parent

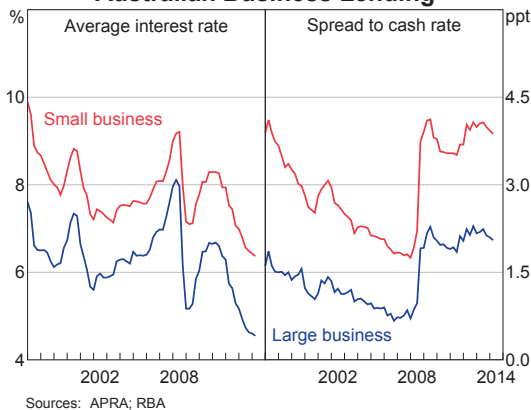


provided a significant share of intermediated lending to the mining sector and, more recently, to the manufacturing sector. This increase in market share reflects, among other things, very competitive pricing and terms, particularly in the syndicated loan market.

Overall activity in the syndicated loan market picked up in the June quarter, consistent with seasonal patterns, with stronger approvals for capital and corporate expenditures. Despite some merger and acquisition (M&A) activity by listed Australian entities, syndicated loan approvals for acquisitions remain at very low levels. The maturity of most syndicated loans at origination is around 3½ years, slightly below its long-term average.

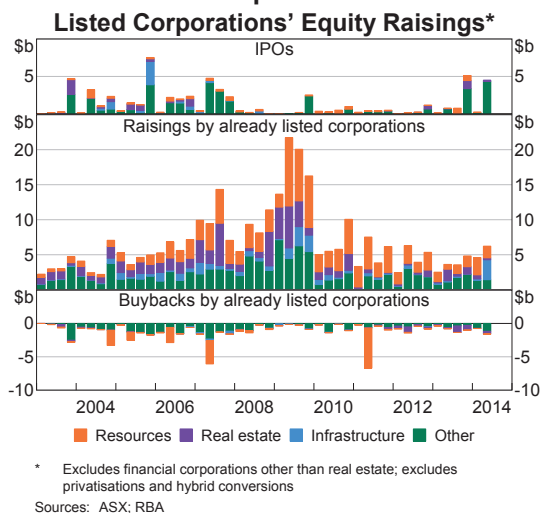
The cost of intermediated business borrowing for both small and large businesses has declined over recent months and average rates on loans outstanding are at historic lows (Graph 4.21).

**Graph 4.21
Australian Business Lending**



Equity raisings by non-financial corporations (including real estate companies) increased in the June quarter to \$9 billion, with initial public offerings (IPOs) picking up to \$4½ billion (Graph 4.22). Equity raisings by corporations that are already listed increased to \$6 billion, driven by infrastructure sector rights issues. There were \$1½ billion in share buybacks during the quarter.

Graph 4.22



M&A activity has slowed since the previous *Statement*, with around \$8½ billion in deals announced by listed companies. Around \$3 billion in deals were announced in each of the materials and consumer discretionary sectors.

Equity Markets

Australian equity prices have increased slightly since the previous *Statement*, reaching a post-crisis high, amid continuing low volatility (Graph 4.23). Resource and financial sector share prices increased since the

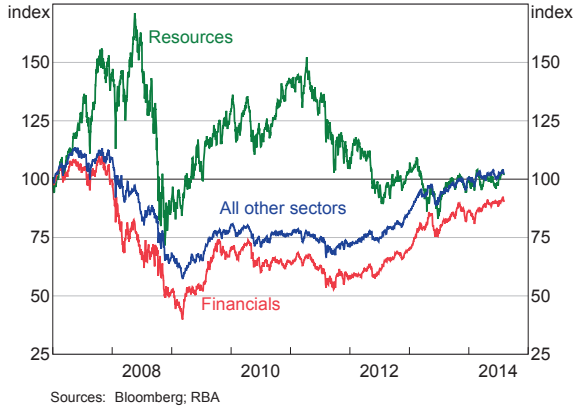
**Graph 4.23
Share Price Indices**
End December 2006 = 100



previous *Statement*, with financial sector share prices supported by positive trading updates by the banks and diversified financials. Equity prices in other sectors have increased a little (Graph 4.24).

Graph 4.24
Australian Share Prices Indices

End December 2006 = 100



Valuations of Australian equities, as measured by forward price-earning (PE) ratios, have increased since the previous *Statement*, and are above their decade averages for all broad sectors (Graph 4.25). The PE ratio of the resources sector increased as equity prices rose and analysts' consensus earnings estimates declined. ↘

Graph 4.25
Australian Forward Price-earnings Ratios

ASX 200

