4. Domestic Financial Markets

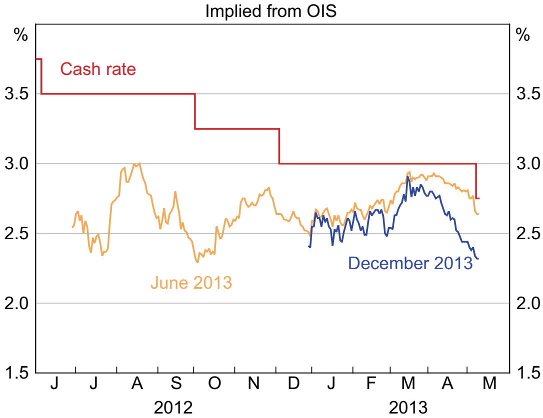
Money Markets and Bond Yields

The Reserve Bank Board reduced the target for the cash rate from 3 per cent to 2.75 per cent at its May meeting. Within financial markets, the expectation of a further easing in monetary policy had varied over the preceding months with the release of domestic and offshore economic data. Rates on overnight indexed swaps (OIS) currently imply an expectation of a reduction in the cash rate target to 2.5 per cent in the second half of the year (Graph 4.1).

Rates on 3-month bank bills and certificates of deposit (CDs), which had been largely unchanged since the previous *Statement*, declined by about 10 basis points on the easing announcement. In general, issuance of bills and CDs into the interbank market remains low, contributing to the narrow spread between these instruments and OIS rates (Graph 4.2).

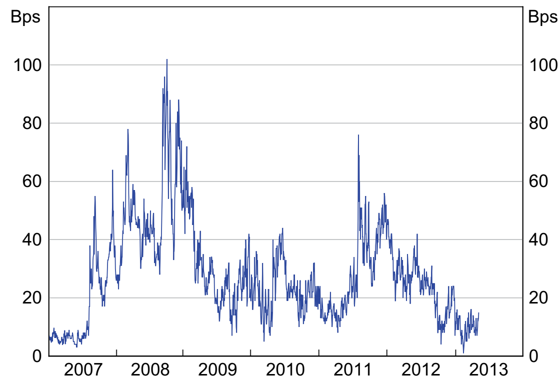
A range of positive global and domestic economic data saw long-term bond yields rise during March, with rates on 10-year Commonwealth Government securities (CGS) reaching a high of 3.70 per cent. Since that time, however, bond yields have tended to fall globally as economic data, particularly for the United States and China, have been a bit weaker than expected (Graph 4.3).

Graph 4.1
Cash Rate Expectations
Implied from OIS



Sources: RBA; Tullett Prebon (Australia) Pty Ltd

Graph 4.2
Spread of 3-month Bank Bills to OIS



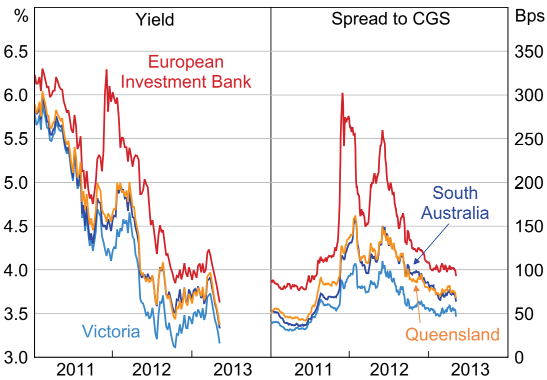
Sources: AFMA; Tullett Prebon (Australia) Pty Ltd

Graph 4.3
Australian Government Bond Yields

Source: RBA

Yields on state and territory government securities ('semis') have largely followed movements in CGS yields, with spreads little changed as a result. Issuance on behalf of the state and territory governments has remained robust since the previous *Statement*. Unlike earlier periods of heightened sovereign risk within the euro area, the events in Cyprus during March and April had little impact on spreads between CGS and other debt instruments, including semis (Graph 4.4).

Graph 4.4
5-year State Government and Supranational Debt

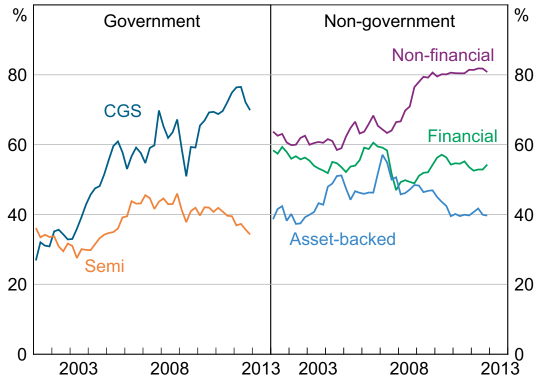


Sources: RBA; Yieldbroker

The December quarter Financial Accounts showed that foreign holdings of CGS and semis were little changed during the second half of 2012, with the bulk of the increase in government debt during that period absorbed by the domestic banks. With the stock of CGS outstanding rising over the second half of 2012, the share of CGS held by foreigners declined from a peak of 77 per cent in mid 2012, to 70 per cent in December (Graph 4.5).

Following strong activity at the start of the year, issuance of domestic bonds by non-resident entities ('Kangaroos') has totalled around $5 billion since the previous *Statement*. Secondary market spreads of these bonds to CGS have been relatively stable, while the cost of hedging Australian dollar issuance into foreign currencies has been broadly unchanged.

Graph 4.5
Foreign Ownership of Australian Bonds
Share of outstandings

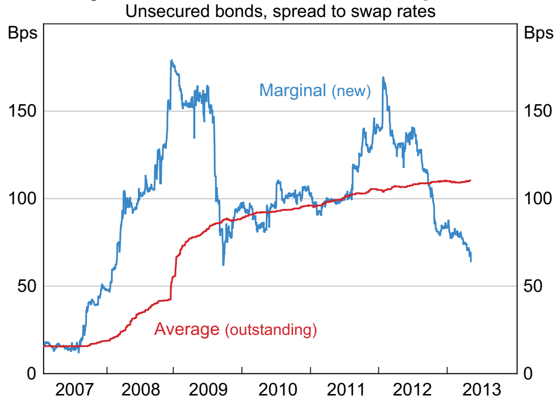


Sources: ABS; RBA

Financial Intermediaries

Average funding costs on banks' outstanding liabilities are estimated to have been broadly unchanged since early February, despite a further reduction in wholesale market spreads. To date, the fall in the cost of issuing long-term bonds has had only a limited impact on banks' outstanding long-term wholesale funding costs (Graph 4.6). This reflects the long time to maturity of the bonds, reduced issuance and the fact that a portion of the outstanding stock of debt was issued prior to the financial crisis at much lower spreads.

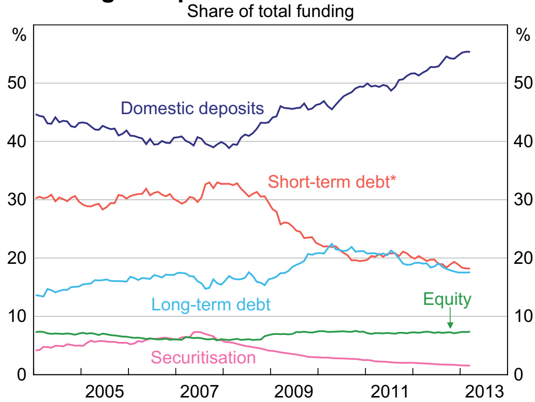
Graph 4.6
Major Banks' Domestic Bond Spreads
Unsecured bonds, spread to swap rates



Sources: Bloomberg; RBA; UBS AG, Australia Branch

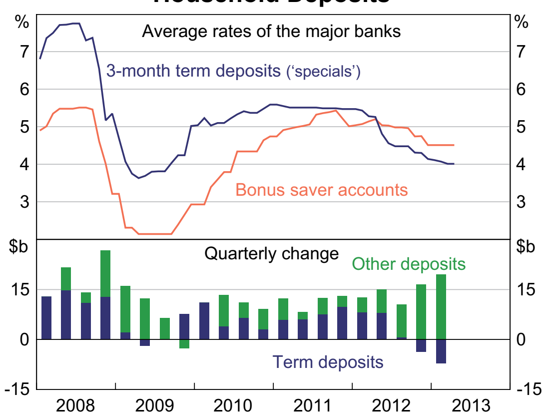
Strong competition for deposit funding has continued over the past quarter, although a number of banks have reduced the premium offered on some term deposit 'specials'. With the banks funding new lending with deposits, the share of deposit funding has continued to increase, and deposits now account for 55 per cent of total bank funding liabilities (Graph 4.7). Since the middle of 2012, however, there has been a noticeable reallocation away from term deposits and towards at-call savings deposits (Graph 4.8). This predominantly reflects the relatively higher interest rates offered on some at-call savings accounts, particularly bonus saver accounts, compared with term deposits. Given the relatively fast repricing of these products, developments in the deposit market have a more immediate effect on overall funding costs than developments in wholesale funding markets.

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



* Includes deposits and intragroup funding from non-residents
Sources: APRA; RBA; Standard & Poor's

Graph 4.8
Household Deposits

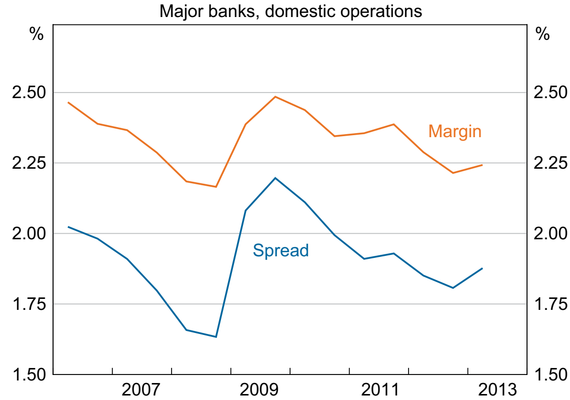


Sources: APRA; RBA

A number of banks have reported an increase in underlying profit over the past few months. Although deposit costs continued to weigh on margins, most banks reported an increase in their domestic net interest margins reflecting the effects of loan repricing (Graph 4.9). Owing to the strength of their results, most banks also reported an increase in interim dividends compared with the first half of 2012. In particular, Westpac announced a one-off special dividend of 10 cents due to its strong capital position, while a number of other banks also increased the ratio of dividends to cash earnings.

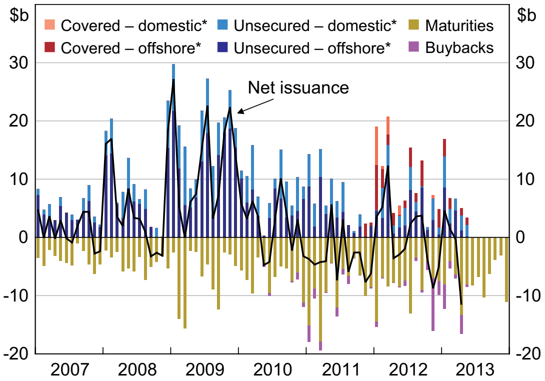
As noted previously, bond issuance by Australian banks has remained relatively subdued, reflecting their preference for deposit funding. While around $18 billion of bank bonds has been issued since the previous *Statement*, the stock of outstanding bonds has declined by $11 billion (Graph 4.10). Around two-thirds of recent bank issuance has been in offshore markets and around 75 per cent in unsecured form. Hybrid issuance by financial institutions has totalled $3.5 billion since the previous *Statement*. This includes $2.8 billion in securities that qualify as Tier 1 capital under Basel III, and $700 million in Tier 2 compliant securities.

Graph 4.9
Net Interest Margin and Spread*
Major banks, domestic operations



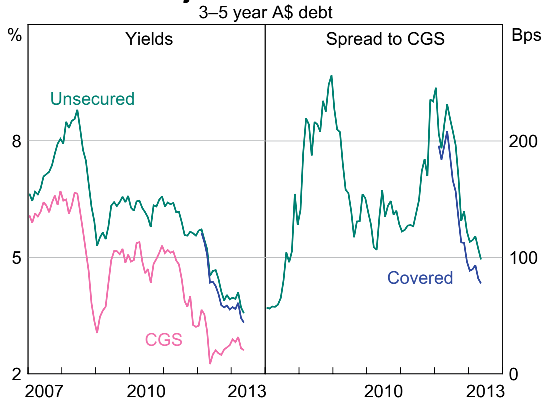
* From 2006 data are under AIFRS; margin and spread estimates based on group figures where domestic data are unavailable
Sources: RBA; banks' financial reports

Graph 4.10
Banks' Bond Issuance and Maturities
A$ equivalent



* Latest month issuance to date
Source: RBA

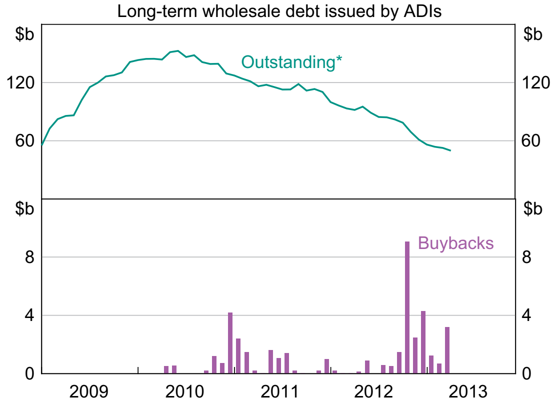
Graph 4.11
Major Banks' Bonds
3–5 year A$ debt



Sources: Bloomberg; RBA; UBS AG, Australia Branch

The major banks' unsecured and covered bond spreads relative to CGS have declined by 10 to 20 basis points since the previous *Statement* (Graph 4.11). Secondary market spreads are 140 basis points lower than at the peak of concerns about European sovereign debt in the middle of 2012. Unsecured spreads are now close to their lowest level since the start of the global financial crisis.

Graph 4.12
Australian Government Guaranteed Debt
Long-term wholesale debt issued by ADIs



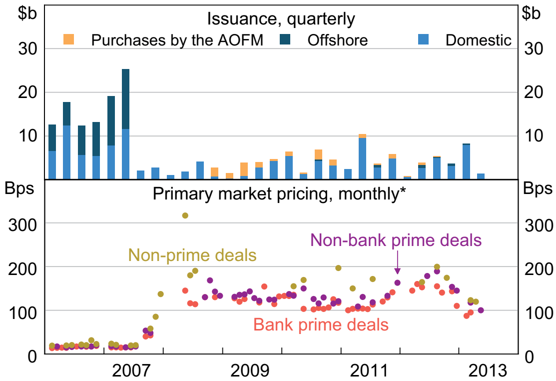
* Adjusted for monthly exchange rate movements
Source: RBA

With bank spreads narrowing further, buybacks of government-guaranteed bank debt have continued in recent months, totalling $5 billion since the previous *Statement* (Graph 4.12). Suncorp-Metway, ING Direct and Macquarie Bank each recently repurchased around one-quarter to one-third of their outstanding securities. The stock of outstanding debt securities issued by banks that is guaranteed by the Australian Government has declined to below $50 billion.

There has also been a significant improvement in the market for residential mortgage-backed securities (RMBS) over recent months, with around $9 billion in new debt issued since the previous *Statement*. Around two-thirds of this issuance has been by banks, including large deals by Westpac and the Commonwealth Bank, each in excess of $2 billion. Non-bank issuers have also been active, with seven deals issued over this period, including three non-conforming RMBS. Issuance spreads on the senior RMBS tranches have declined by around 30 basis points since late last year, with the recent deals priced at the lowest spreads since the early stages of the global financial crisis (Graph 4.13). While RMBS issuance spreads have declined, the interest rate on the mortgages in the collateral pool relative to market reference rates has remained broadly unchanged. As a result, the residual income stream, net of fees, has increased to some of the highest levels on record and hence issuers, who receive this income, are finding RMBS to be a profitable source of funding.

In response to the improvement in market conditions, in April the Australian Government announced that it will make no further purchases of RMBS through

Graph 4.13
Australian RMBS

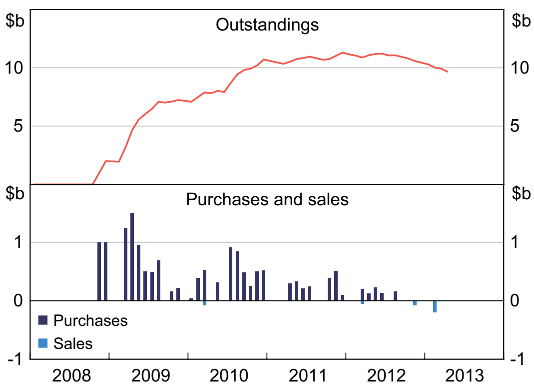


* Primary market spreads are face-value weighted monthly averages of AAA-rated RMBS

Source: RBA

the Australian Office of Financial Management (AOFM). Since the inception of its program in 2008, the AOFM has purchased a total of $15.5 billion in RMBS securities, although no purchases have been made since August 2012 owing to the improved demand from private investors (Graph 4.14). The AOFM does not intend to sell its existing stock of RMBS (currently worth $10 billion) in the near future, although it has said that it may engage in periodic sales to assist in the price discovery process. To date, the AOFM has sold $400 million of its holdings in six separate transactions.

Graph 4.14
AOFM Investment in RMBS



Sources: AOFM; RBA

In February, Moody's concluded its ratings review of 95 Australian RMBS tranches, downgrading a number of mainly non-senior tranches with a combined outstanding value of $2.3 billion (around 3 per cent of the total market). The downgrades followed the publication of Moody's revised methodology for evaluating credit support provided by lenders mortgage insurers (LMI) to Australian RMBS and the downgrade by Moody's of QBE's and Genworth's Australian LMI operations.

Household Financing

At the time this *Statement* was finalised, a significant number of lenders had announced that they will reduce their standard variable housing loan rates by 25 basis points. Interest rates on new three-year fixed-rate loans have fallen by around 10 basis points over recent months and are now at their lowest level in over two decades (Table 4.1). However, this has had little effect on the average interest rate on housing loans as variable-rate loans constitute by far the largest share of the Australian mortgage market. The average housing loan rate will be around its 2009 low when the reductions in standard variable housing loan rates become effective (Graph 4.15).

Other indicators suggest that competition for housing loan customers has increased a little. In particular, a number of banks have increased the discounts offered on certain variable-rate mortgage products by up to 30 basis points. Some lenders have either introduced or extended other measures to attract customers, including application fee waivers and cash-back offers.

The value of total housing loan approvals has increased in recent months to be around 10 per cent higher over the year (Graph 4.16). The increase in approvals over the past year has been underpinned by loans to repeat-buyer owner-occupiers and investors. In contrast, first home buyer approvals have decreased further and are yet to show signs of recovery following a number of changes to first home buyer incentives by some state governments last year, which has refocused assistance on purchases of new homes.

Despite the recent lift in loan approvals, the stock of housing credit has continued to grow at around

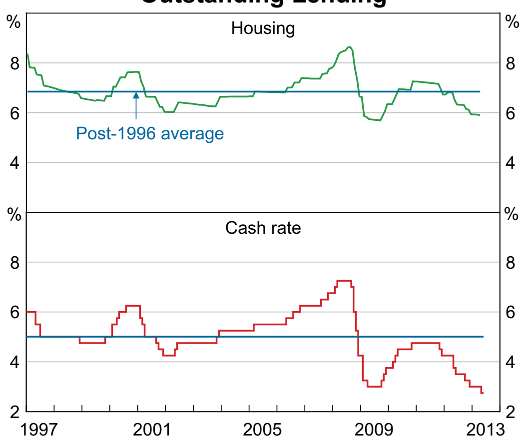
4½ per cent over the year to March. Investor credit, the smaller component of housing credit, has grown at a faster rate than owner-occupier credit. While there has been a pick-up in owner-occupier loan approvals in recent months, this increase has been driven by repeat-buyer owner-occupiers who generally need to repay an existing mortgage and therefore do not contribute as much to credit growth compared with first home buyers. In addition, households have accelerated their mortgage prepayments, which has reduced credit growth.

Table 4.1: Intermediaries' Lending Rates
Prior to the May cash rate reduction

	Level at 30 April 2013 Per cent	Change since end October 2011 Basis points
Housing loans		
– Standard variable rate(a)	6.44	–135
– Package variable rate(b)	5.63	–140
– Fixed rate(c)	5.44	–108
Personal loans		
– Variable rate	11.88	–68
Small business (variable rates)		
Residentially secured, advertised		
– Term loans	7.60	–140
– Overdraft	8.47	–138
Average rate(d)	7.20	–143
Large business		
Average rate(d) (variable rate and bill funding)	5.12	–191

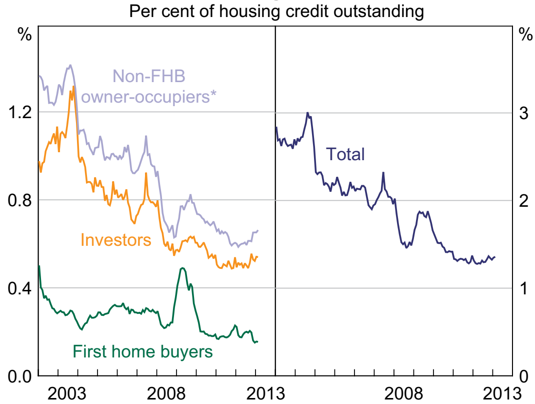
(a) Average of the major banks' standard variable rates
(b) Average of the major banks' discounted package variable rates on new, $250 000 full-doc loans
(c) Average of the major banks' three-year fixed rates
(d) Rates on outstanding business lending (including discounts)
Sources: ABS; APRA; RBA

Graph 4.15
Average Interest Rates on Outstanding Lending



Sources: ABS; APRA; Perpetual; RBA

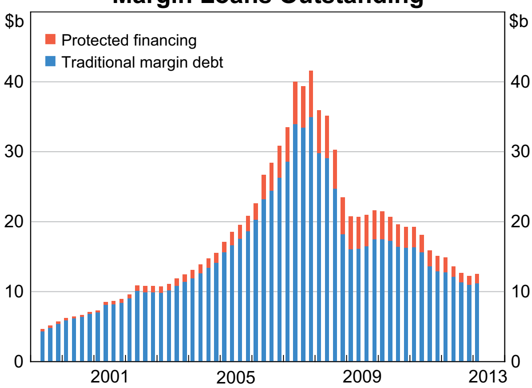
Graph 4.16
Value of Housing Loan Approvals
Per cent of housing credit outstanding



* Net of refinancing
Sources: ABS; RBA

Personal credit grew modestly over the March quarter, driven by an increase in the value of fixed-term loans and total credit card balances. Although motor vehicle sales were softer in the March quarter, some of the recent increase in the value of fixed-term loans has been due to growth in lending by car finance companies. Consistent with the improvement in equity markets over the latter part of 2012 and early 2013, preliminary data suggest that the value of margin loans outstanding increased by about 2 per cent over the March quarter, the first quarterly increase since 2009 (Graph 4.17). However, the level of margin loans outstanding remains less than one-third of its pre-crisis peak and is a very small share of the overall stock of household credit.

Graph 4.17
Margin Loans Outstanding



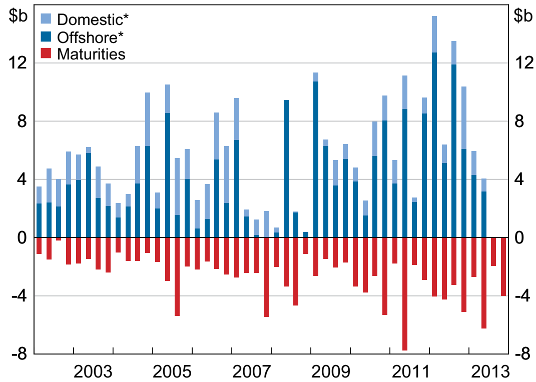
Source: RBA

Business Financing

Activity in the corporate bond market has increased, with corporates issuing $9 billion in bonds since the previous *Statement* (Graph 4.18). Around three-quarters of this issuance has been in offshore markets.

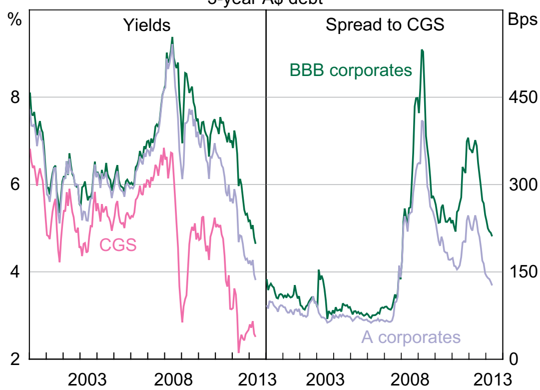
Secondary market spreads between corporate bonds and CGS have contracted by a further 20 to 30 basis points over the past three months, and are around their lowest levels since the early stages of the global financial crisis (Graph 4.19). Given the modest decline in CGS yields, corporate bond yields are at their lowest levels since at least the early 2000s.

Graph 4.18
Australian Corporates' Bond Issuance
A$ equivalent



* Latest quarter issuance to date
Source: RBA

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

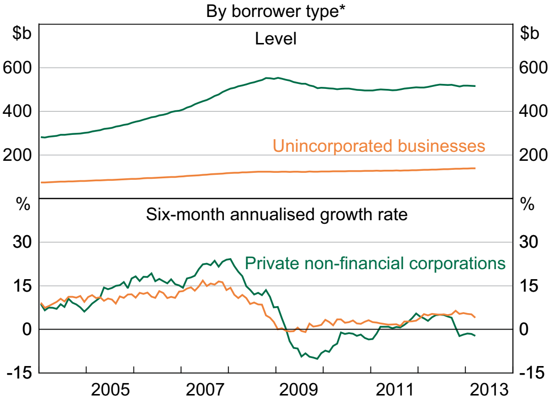


Sources: RBA; UBS AG, Australia Branch

Hybrid issuance by corporations has been subdued in recent months, totalling $600 million since the previous *Statement*. Standard & Poor's has revised its criteria for assessing the equity content of hybrid securities issued by corporates, making it more difficult for a hybrid security, particularly one with a maturity date, to be assessed as having a high level of equity.

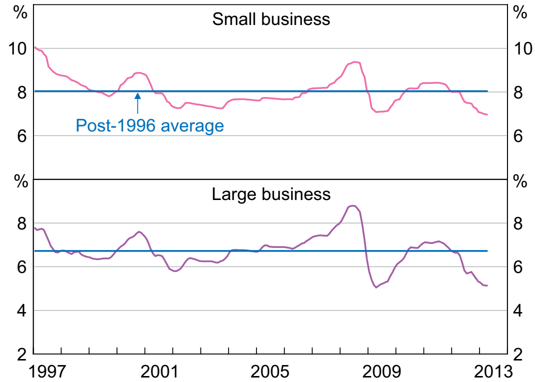
Intermediated business credit declined by 0.2 per cent over the March quarter, in part due to reduced lending to private non-financial corporations (Graph 4.20). The softness in business credit growth since mid 2012 partly reflects some substitution towards non-intermediated debt, which remains

Graph 4.20
Business Credit
By borrower type*



* Excludes securitised loans
Sources: APRA; RBA

Graph 4.21
Average Interest Rates on Outstanding Business Lending



Sources: APRA; RBA

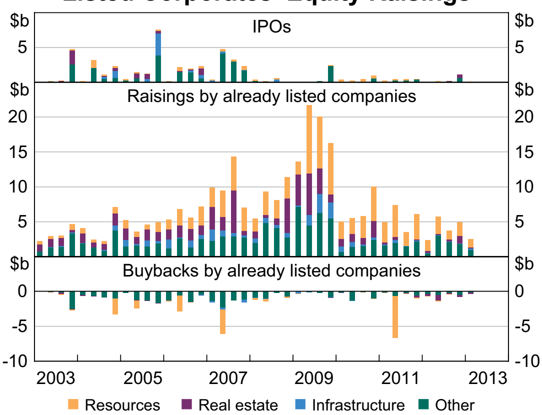
a relatively cheap source of funding for many corporations. In contrast, lending to unincorporated businesses – which tend to be smaller businesses that have limited direct access to debt markets – continued to grow modestly over the March quarter.

The value of syndicated loan approvals, which tend to be volatile and seasonal, fell significantly in the March quarter and was at its lowest level in three years. While the decline in lending was broad based, Asian banks continued to increase their share of the market, whereas lending by European banks contracted further.

The cost of intermediated business borrowing continued to decline prior to the cash rate reduction, with average interest rates on outstanding bank loans to small and large businesses falling by about 10 and 20 basis points, respectively (Graph 4.21). This largely reflected the ongoing repricing of fixed-rate and bill-financed lending. The average rates for small and large business lending remain around their April 2009 troughs.

Net equity raisings totalled $2.3 billion in the March quarter, with resource sector companies continuing to account for a reasonably large share (Graph 4.22). Initial public offerings (IPOs) accounted for less

Graph 4.22
Listed Corporates' Equity Raisings*

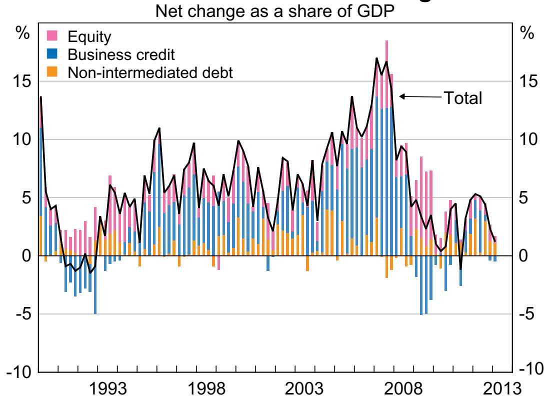


* Excludes privatisations and hybrid conversions, which are very small
Sources: ASX; RBA

than $100 million during the quarter. Merger and acquisition activity has also been limited, declining to its lowest level since the 1990s, with only $4.9 billion in transactions announced by listed corporates since the last *Statement*.

Overall, total business external funding increased by the equivalent of 1.2 per cent of GDP in the March quarter (Graph 4.23). Growth in external finance was primarily through non-intermediated debt. Intermediated debt funding contracted for the second consecutive quarter.

Graph 4.23
Business External Funding
Net change as a share of GDP

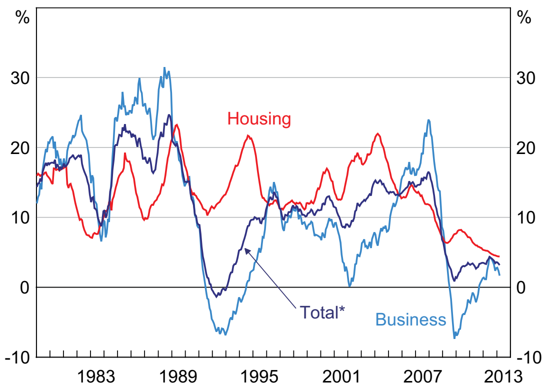


Sources: ABS; APRA; ASX; RBA

Financial Aggregates

Growth in outstanding credit slowed to an annualised rate of around 2½ per cent in the March quarter (Graph 4.24). Broad money continued to grow at a faster rate than credit. Strong inflows into saving and transaction deposit accounts were behind much of the growth in broad money, although there were modest declines in household term deposits and CDs held by non-bank institutions.

Graph 4.24
Credit Growth
Year-ended

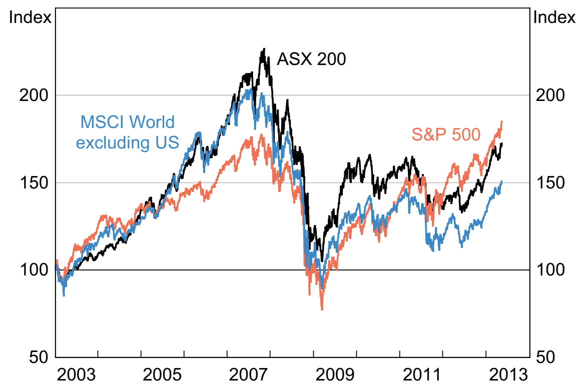


* Includes housing, personal and business credit
Source: RBA

Equity Markets

Australian equity prices have risen by around 5 per cent since the previous *Statement*, with much of the increase due to strong growth in share prices of companies in the financial sector. Bank share prices have risen by around 15 per cent over the past three months, owing to positive earnings reports, increased dividends and ongoing investor support for high-yielding equities. The Australian equity market overall has generally matched movements in developed equity markets, notwithstanding ongoing share price declines in the resources sector, which accounts for a larger share of the local market than is the case generally elsewhere (Graph 4.25).

Graph 4.25
Share Price Indices
End December 2002 = 100

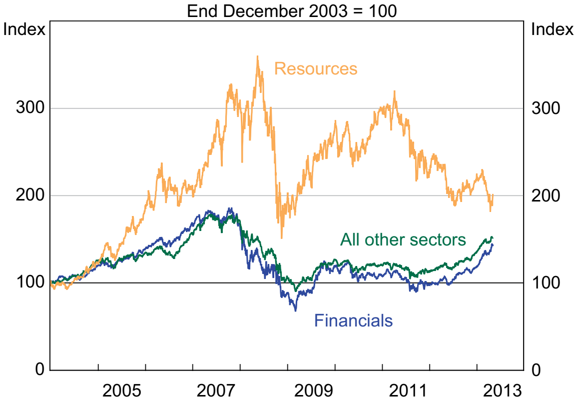


Sources: Bloomberg; Thomson Reuters

Largely reflecting declines in commodity prices, resource sector share prices have fallen by 9 per cent since the last *Statement* and are around their lowest level since early 2009 (Graph 4.26). Gold miners have significantly underperformed the rest of the market, with share prices for these companies declining by 31 per cent since the last *Statement* alongside sharp falls in precious metals prices.

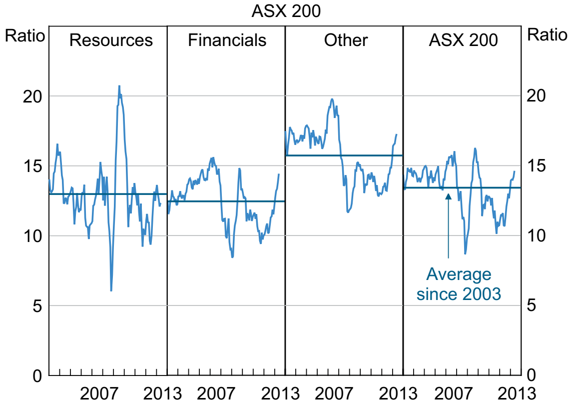
Outside of the resources sector, earnings expectations and valuations, as measured by forward price earnings (PE) ratios, have risen modestly and are slightly above their long-run averages (Graph 4.27). The forward PE ratio of the resource

Graph 4.26
Australian Share Price Indices
End December 2003 = 100



Sources: Bloomberg; RBA

Graph 4.27
Australian Forward Price-earnings Ratios
ASX 200



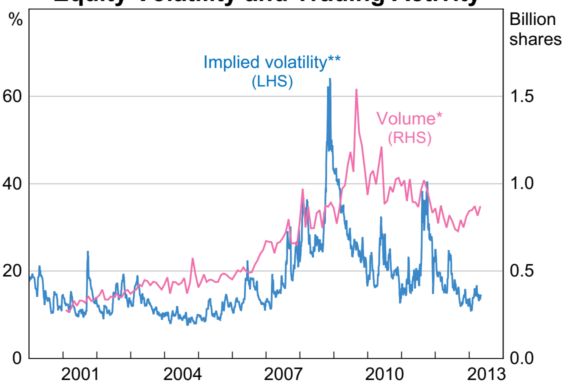
Sources: RBA; Thomson Reuters

sector has declined as the fall in share prices since January has outpaced downwardly revised earnings expectations.

The volatility of Australian equity prices has been broadly unchanged since the previous *Statement* (Graph 4.28). Trading volume in the market has continued to increase from its trough in late 2012.

Listed companies with June and December balance dates reported their December 2012 half earnings during February. Headline earnings fell by 34 per cent from the previous comparable period, mainly because of large impairment charges recorded by Rio Tinto and, to a lesser extent, BHP Billiton.

Graph 4.28
Equity Volatility and Trading Activity



* ASX 200 average daily volume per month traded on the ASX and Chi-X exchanges, seasonally adjusted

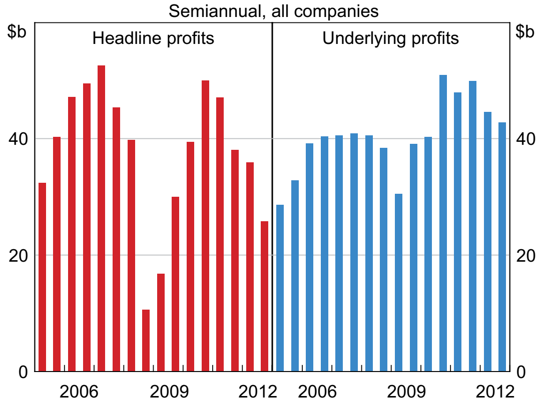
** 5-day moving average, ASX VIX from 2008, implied volatility from ASX SPI options prior to 2008

Sources: ASX; Bloomberg; RBA; Thomson Reuters

These impairments were largely in line with earlier guidance. More generally, earnings were supported by cost containment initiatives.

Aggregate underlying earnings declined by 15 per cent from the previous comparable half in December 2011 (Graph 4.29). The resources sector, whose underlying earnings fell by 38 per cent, accounted for a large share of the decline as the lower commodity prices in the second half of 2012, particularly for iron ore, weighed on revenue. Financial sector underlying earnings were stable in the December half, although more recent profit

Graph 4.29
ASX 200 Company Profits
Semiannual, all companies

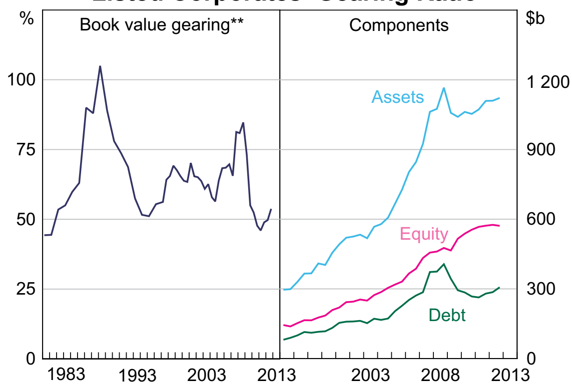


Sources: Morningstar; RBA; company reports

reports from banks have generally shown improved earnings. Diversified financial corporations and insurers also reported higher profits, although QBE was adversely affected by its exposure to natural disasters in the United States. Underlying earnings of other non-financial companies increased by 8 per cent from the previous comparable period. This was driven by the healthcare sector and the consumer staples sector where earnings rose by 18 per cent and 6 per cent, respectively. The industrial sector reported underlying profit growth of 21 per cent from the previous comparable period, driven by the completion of construction projects which had suffered earlier cost overruns. In contrast, earnings of consumer discretionary stocks fell 24 per cent as the sector contends with structural challenges.

Listed corporates' balance sheets expanded by 1 per cent in the December half 2012 (Graph 4.30). The funding mix shifted towards a higher share of debt, with total debt increasing by 8 per cent over the half. This was predominantly due to resources companies financing more of their committed capital expenditure with debt, especially bond issuance. Equity declined by 1 per cent as lower commodity prices reduced retained earnings in the resources sector and was exacerbated by Rio Tinto's asset writedowns. As a result, gross book value gearing increased by 5 percentage points to 54 per cent. Despite this increase, gross leverage remains well below its historical average.

Graph 4.30
Listed Corporates' Gearing Ratio*



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