INTERNATIONAL DEPARTMENT MONTHLY REVIEW – SEPTEMBER 2023

Financial Markets

In China, property developers remain under considerable financial stress, although their bond and equity prices increased in September following stronger-than-expected economic data and the announcement of further support measures. The renminbi has continued to depreciate against the US dollar reaching multi-decade lows and authorities have stepped up efforts to lean against the pace of depreciation. Spillovers to emerging markets from weakness in China have been limited so far.

Developments in advanced economy financial markets have been driven primarily by the outlook for monetary policy and its anticipated effect on economic activity. Policymakers at some advanced economy central banks have signalled that policy rates may have peaked and are likely to remain around current levels for some time. Market-based policy rate expectations are consistent with an extended period of restrictive policy rates, which has also kept government bond yields in most advanced economies near their highest levels in more than a decade. Despite this, equity prices in most major markets remain within 10 per cent of record highs and corporate bond spreads are around or below their long-run averages. This pricing is consistent with market expectations of a ‘soft landing’ in the United States and Europe.

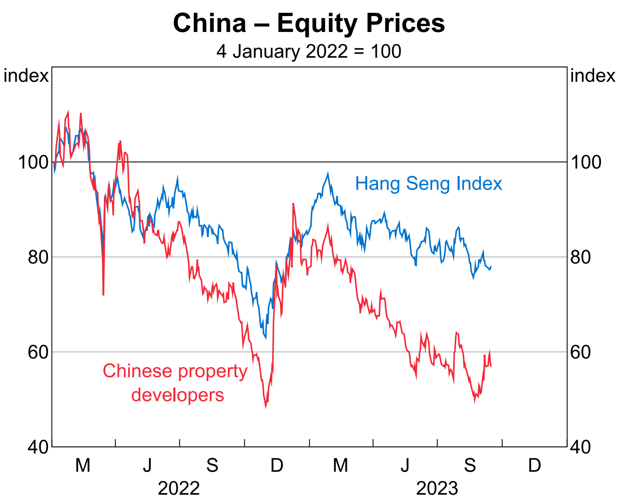
The Australian dollar has depreciated in recent months amid a broad-based US dollar appreciation and concern over the outlook for China’s economic growth.

Chinese property developers remain under stress leading authorities to introduce further support measures

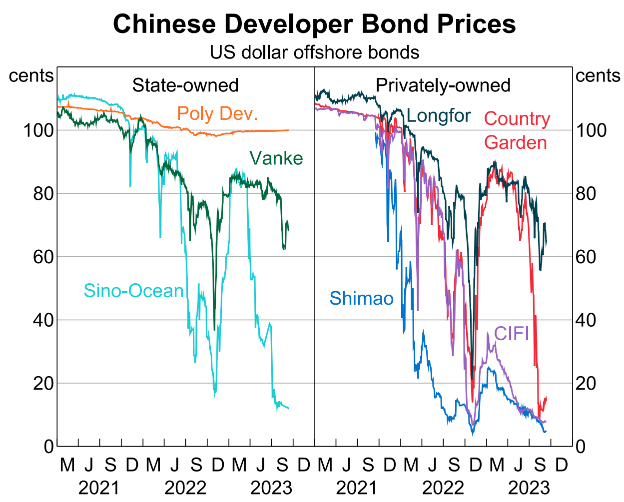
Chinese property developers’ bond and equity prices remain at severely distressed levels, though they increased in September following the release of stronger-than-expected economic data and the announcement of further support measures aimed at stabilising property sales (see Economic Conditions paper). Weak demand for new properties has weighed on developer earnings, such that interest payments now exceed earnings (before interest and tax) for around one-third of all property developers. Private developers’ financing conditions are especially challenging. Their access to capital markets has become more difficult as defaults have risen, and state-banks are reportedly holding back from providing loans as part of a special program designed to support the completion of stalled construction projects.

Overall, around half of all private developers (weighted by assets) have defaulted and a significant amount of upcoming debt repayments have raised the prospect of further defaults. One example of this is Country Garden – one of the largest private developers in China – which failed to make interest payments on two offshore US dollar bonds in August. The developer eventually made these payments before a 30-day grace period expired. Its creditors also approved a maturity extension on several onshore bonds by three years. However, the developer faces several upcoming payments, including two large maturity payments before the end of this year.

Weak property sector conditions have increased concerns that stress could spill over to other parts of China’s financial sector (see Financial Stability paper). Authorities have responded by extending existing property support measures, directing state-owned banks to lower interest rates on outstanding mortgages, and further reducing home purchase restrictions. However, the impact of existing support remains modest, and an absence of direct assistance to troubled developers suggests authorities are continuing to balance short-term growth against longer-term efforts to reduce vulnerabilities in the sector.



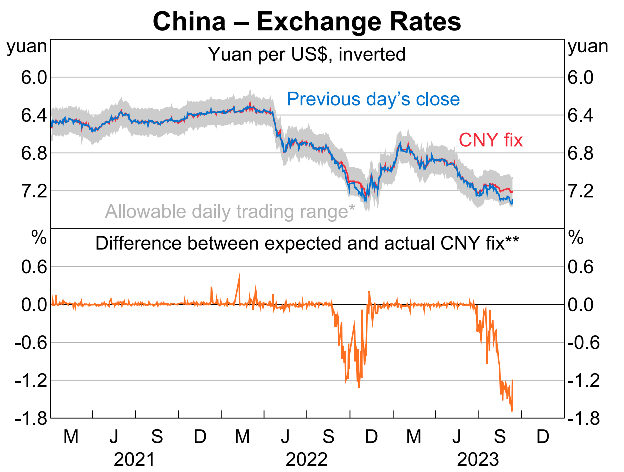
Sources: Bloomberg; RBA.



Source: Bloomberg.

The renminbi has depreciated to multi-decade lows and authorities have continued to implement measures to lean against the pace of depreciation

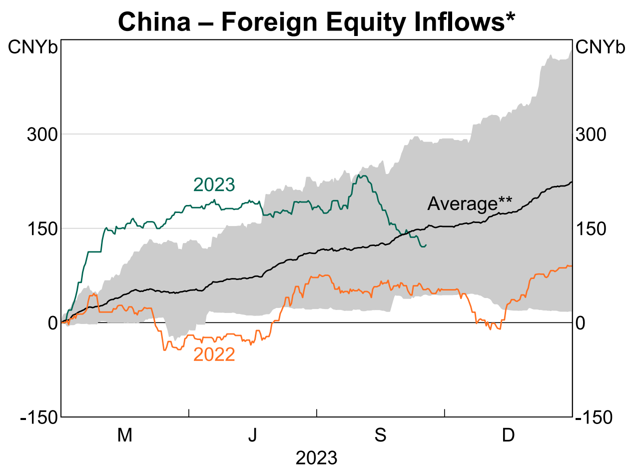
The Chinese renminbi depreciated to its lowest level since 2007 against the US dollar alongside subdued growth in the Chinese economy and a widening interest rate differential between US and Chinese government bonds. Authorities have responded by stepping up their efforts to reduce the pace of depreciation of the renminbi. The PBC has set a consistently stronger 'CNY fix' – the midpoint of the permitted daily trading range of +/-2 per cent – than expected by a survey of market participants. Even so, the renminbi has regularly traded near the weaker end of the daily trading range leading the PBC to issue a warning to speculators, cut a reserve requirement ratio on foreign exchange deposits and issue central bank bonds in the offshore market. These measures are aimed at reducing depreciation pressures on the renminbi by increasing the (relative) amount of foreign currency available onshore and making it more expensive to short the renminbi. Timely data suggest portfolio investment outflows increased further over September; this has reflected outflows from both domestic and foreign equity investors.



* Since early 2014 the CNY has been allowed to trade in a daily range of +/- 2 per cent from the CNY fix.

** Negative value indicates official fix was stronger then expected by market economists, supporting the yuan against the US dollar.

Sources: Bloomberg; CEIC; RBA.



* Cumulative northbound Stockconnect flows since 1 January.

** Average line reflects the annual average of flows to that point in the calendar year for each year from 2015 to 2020; shaded area indicates the minimum and maximum.

Source: CEIC Data, RBA.

The PBC eased monetary policy further in September by lowering the reserve requirement ratio by 25 basis points for most financial institutions. The additional liquidity will enable banks to absorb the issuance of a large volume of local government special bonds typically used to support infrastructure investment (see

Economic Conditions paper) and help to ease tighter short-term funding conditions that have seen 1-year Chinese government bond yields increase.

Most advanced economy central banks view their monetary policy settings as restrictive and are expected to keep rates near current levels until around mid-2024

Most advanced economy central banks judge policy rates to be restrictive. Their recent commentary has continued to emphasise that future policy rate decisions will be data dependent, although several have noted that the risks to the economic outlook have become more evenly balanced. This has prompted policymakers at some central banks to signal that policy rates may have peaked and are likely to remain around these levels for some time. Central banks' central forecasts show inflation returning to be around their inflation targets by end of 2024 in Canada and New Zealand, in 2025 in the United States, euro area, United Kingdom and Sweden; and beyond the 2026 forecast horizon in Norway.

Policy Rates at Advanced Economy Central Banks

	Change in September (Basis points)	Current level (Per cent)	Expected peak (Per cent)**
United States*	0	5.25-5.5	5.25–5.5
Euro area	+25	4	4
Canada	0	5	5
Japan*	0	-0.1	NA
New Zealand	NA	5.5	5.5
Norway*	+25	4	4.25
Sweden*	+25	3.75	4
Switzerland *	+25	1.75	2
United Kingdom*	+25	5.25	5.5

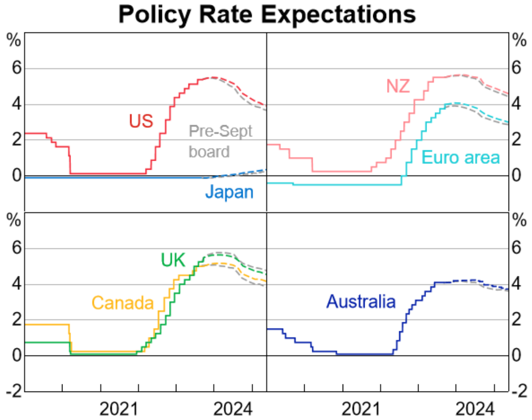
* Decision forthcoming in September. Reflects current market expectations.

** Values represent the peak policy rate that is fully priced in.

Sources: Bloomberg, central banks

Market participants expect most central banks' policy rates will have peaked by the end of the month. Market participants expect most central banks will hold their policy rates at or near current levels until around mid-2024.

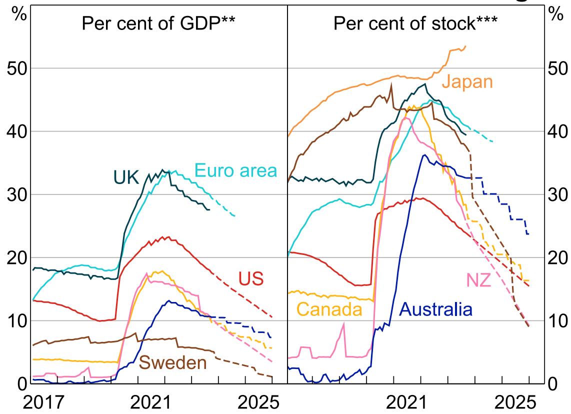
Policy Rate Expectations



Sources: Bloomberg; RBA.

The Bank of Japan (BoJ) has continued to increase its asset holdings as part of its general quantitative easing programs, adding nearly ¥7 trillion to its holdings since the end of July. It has made no further purchase to support yield curve control since relaxing its strict cap on 10-year Japanese Government Bond yields to 1 per cent in July. All other central banks are continuing to run down their holdings of assets purchased under quantitative easing programs.

Central Bank Government Bond Holdings*



* Central government debt only for all countries except the euro area. Holdings data for euro area only include bonds held as part of asset purchase programs; holdings data for the United Kingdom does not include purchases for financial stability purposes; holdings for other central banks also include bonds held for operational or liquidity purposes.

** Four quarter rolling sum. Japan (not shown) is currently 103% of GDP.

*** Per cent of eligible outstanding stock. Projections use current stock of government debt.

Sources: Central banks; debt management offices; IMF; RBA; Refinitiv.

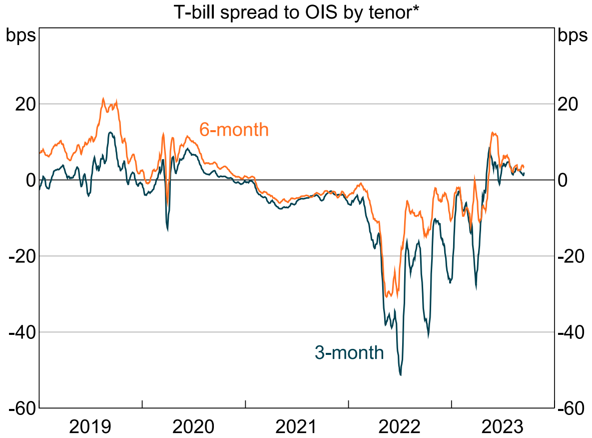
Government bond yields in most advanced economies remain near recent highs, consistent with market expectations that policy rates will remain restrictive for some time

Government bond yields remain near their highest levels in more than a decade in most advanced economies. Consistent with this, longer-term real yields remain near their recent high levels, with most longer-term market-implied inflation expectations remaining between 2 and 3 per cent. The increase in real yields over recent months in part reflects greater optimism about the sustainable level of real policy rates, while in the United States an increase in expected issuance of longer-term US Treasury securities may also have contributed.

The US Treasury continues to rebuild its cash balance following the suspension of the US debt ceiling. It expects the balance to increase from $US630 billion to $US750 billion by the end of 2023. Bill issuance has been absorbed comfortably by investors to date, reflected in the continued narrowing in spreads between bills and equivalent OIS rates. However, progress has stalled in the US Congress passing appropriations bills, which allocate funding to government agencies for the upcoming fiscal year. If appropriations bills are not passed by end-September, affected non-essential government functions will temporarily shut down, although Congress may pass a continuing resolution to temporarily maintain current funding levels. Yields on US government bonds have typically declined during previous US government shutdowns but have not yet responded in a meaningful way to the current episode.

US Treasury Bill Spreads

T-bill spread to OIS by tenor*

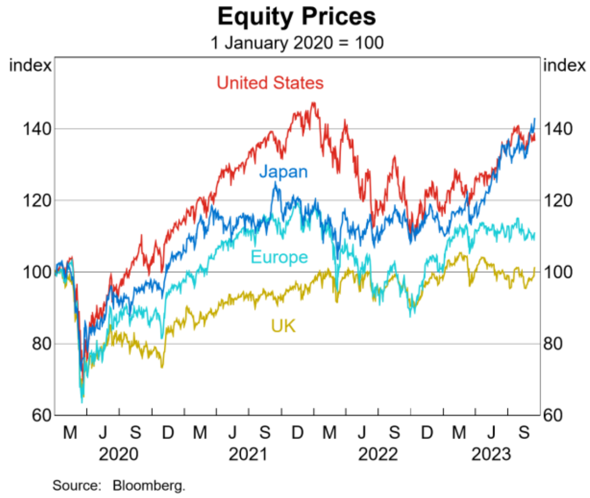


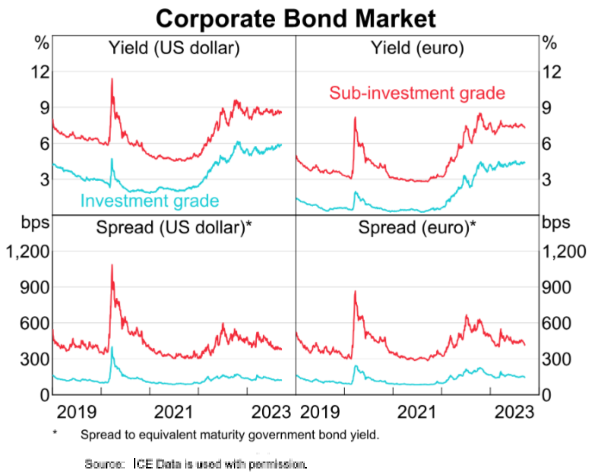
* 10-day moving average. Positive value indicates T-bill yield is trading above the equivalent OIS rate, vice versa.

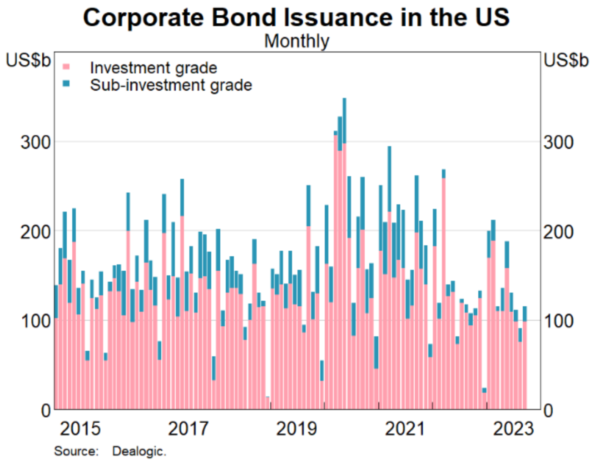
Source: Bloomberg.

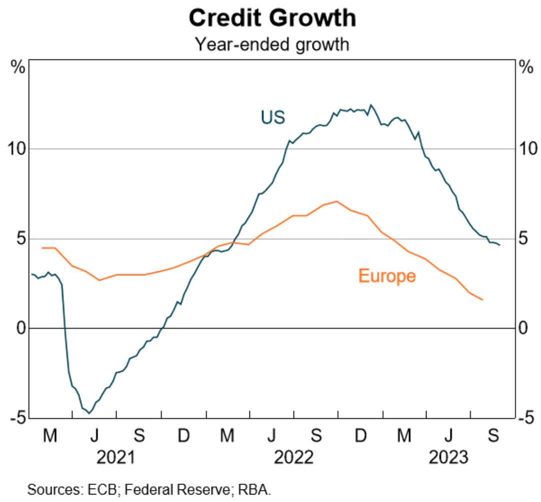
Risk asset prices in advanced economies have remained steady despite restrictive policy rates, at levels consistent with market expectations of a 'soft landing' in advanced economies

Equity prices in most major markets remain within 10 per cent of record highs while corporate bond spreads remain around their long run averages in Europe and narrower than long-run averages in the United States. This is despite rapid increases in policy rates to restrictive levels and associated increases in longer-term risk-free rates, and is consistent with market expectations of a 'soft landing'. Meanwhile, corporate bond issuance has picked up in the United States and Europe. In the United States, the increase in issuance has been driven by financial firms and non-US firms. Market commentary has attributed some of the increase in issuance to firms seeking to issue at current yields and so guard against the risk that central banks increase policy rates further than expected. Primary activity has also picked up in US equity markets, with an increase in IPOs following a long period of inactivity.





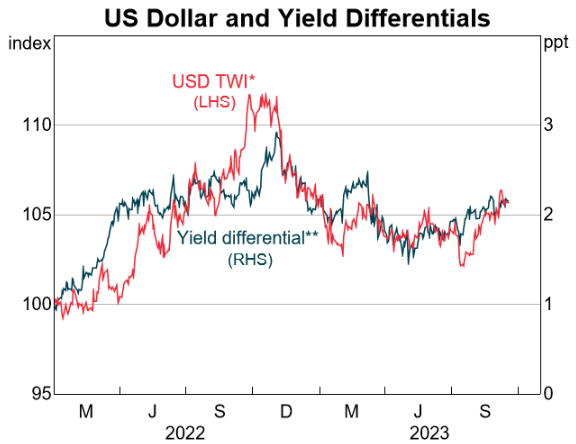




In contrast to equity and corporate bond markets, central bank surveys have shown a broad-based tightening in lending standards and weakening in demand for credit this year. Credit growth has slowed sharply this year in the United States and Europe, although has started to stabilise in the United States in recent months.

The US dollar has appreciated over recent months to return to its level at the beginning of the year

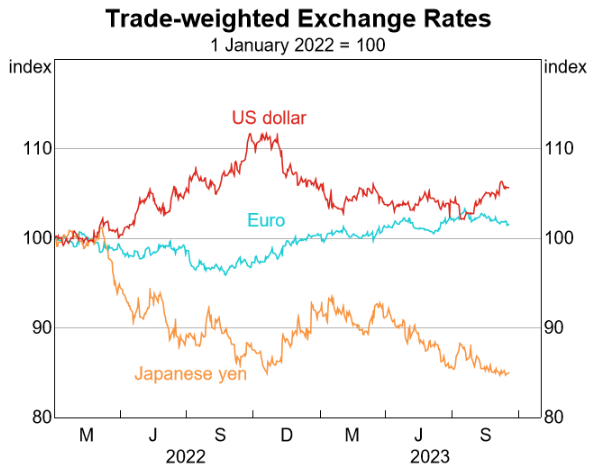
The US dollar has appreciated on a trade-weighted (TWI) basis since July to be around the level observed in early 2023. This appreciation has occurred alongside an increase in US Government bond yields relative to those of other major advanced economies. The Japanese yen has continued to depreciate in recent months and is around 7 per cent lower on a TWI basis since the start of the year, owing in large part to a widening in yield differentials between Japanese and other major market government bonds. The euro is little changed on a TWI basis over recent months.



* 1 January 2022 = 100.

** Three-year US sovereign yield less simple average of yields of Germany, Japan and the United Kingdom.

Sources: Bloomberg; Board of Governors of the Federal Reserve System.



Sources: Bloomberg; Board of Governors of the Federal Reserve System.

The Australian dollar has depreciated over recent months against a backdrop of broader US dollar appreciation and concerns around the outlook for the Chinese economy

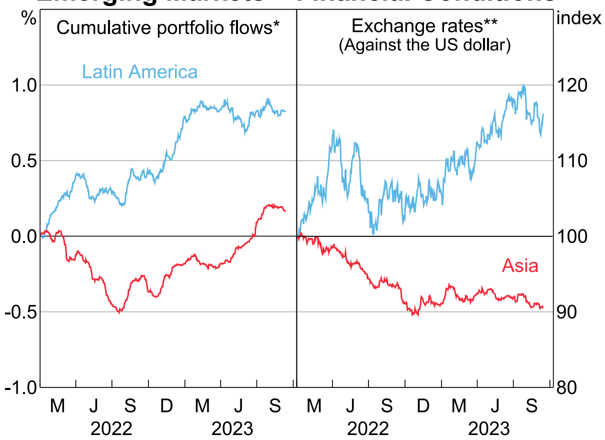
The Australian dollar is little changed over the month but has depreciated by 1½ per cent on a TWI basis and by 4 per cent bilaterally against the US dollar since the beginning of August. The depreciation has occurred alongside a broad-based US dollar appreciation and as yields on US government bonds have increased by more than those on Australian government bonds.

Concerns about the outlook for China's economic growth have also continued to weigh on the Australian dollar. Despite a recent increase in the RBA's Index of Commodity Prices (ICP) due to strength in bulk commodity prices, the index remains well below levels observed earlier in the year.

Spill overs to financial conditions in emerging markets from increased financial pressures in China and the appreciation of the US dollar have been limited

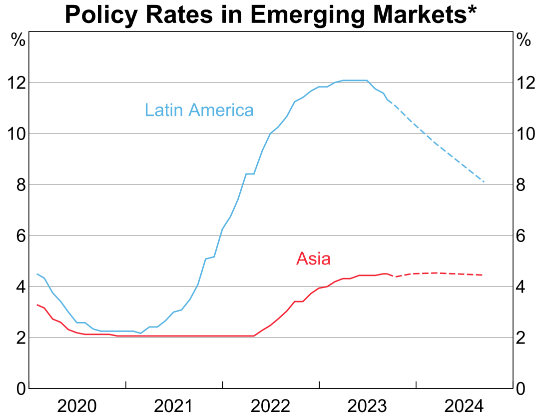
Emerging market financial conditions have been little changed over recent months. Portfolio flows have been stable and spreads between emerging market sovereign debt and US Treasuries have risen by only a small margin. This suggests financial spillovers from weakness in China have been limited so far, which is also consistent with modest financial linkages between China and many large emerging market economies (for instance, China accounts for less than 5 per cent of foreign direct investment for many large emerging market economies). Even so, growth in emerging Asia would be most exposed to a material slowing in China's economy via strong trade linkages (see Economic Conditions paper). Indeed, a modest depreciation in emerging Asian exchange rates against the US dollar over recent months is likely to reflect, in part, weaker growth in China. In Latin America, most central banks have commenced easing policy rates and are expected to continue to do so at a measured pace. Exchange rates in Latin America have depreciated over recent months, consistent with expectations of narrowing interest rate differentials.

Emerging Markets – Financial Conditions



* As a share of GDP.
** 1 Jan 2022 = 100.
Sources: Bloomberg; IIF; IMF: RBA.

Policy Rates in Emerging Markets*



* Solid lines show actual policy rates; dashed lines show market-implied policy rate expectations. Latin America is an average of Brazil, Chile and Mexico; Asia is an average of India, Malaysia, Philippines and Thailand.
Sources: Bloomberg; RBA; Refinitiv.

International Department
19 September 2023

INTERNATIONAL DEPARTMENT MONTHLY REVIEW – OCTOBER 2023

Financial Markets

Government bond yields in advanced economies have risen further, particularly at longer maturities. Most of the increase in longer-term yields over recent months has come from higher real yields. The increase may reflect a number of factors, including: increased uncertainty around the economic and policy outlook, expectations of a larger supply of government bonds from debt issuance while central banks are reducing their asset holdings, and market participants upgrading their estimates of the level of interest rates required to achieve central bank inflation targets. Policymakers at several central banks have suggested that this increase in yields could reduce the need for policy rate increases if they result in a sustained tightening of financial conditions. Higher risk-free rates have contributed to a recent decline in equity prices and a modest widening of credit spreads; however, both remain at levels that imply expectations of resilient corporate earnings and only a limited increase in corporate defaults. The Australian dollar has depreciated slightly on a trade-weighted basis and against the US dollar over the month, to trade at year-to-date lows.

In China, property developer bond and equity prices have fallen further in October amid extreme financial stress. The authorities have continued to lean against the depreciation of the renminbi, which has stabilised around multi-decade lows against the US dollar.

Most advanced economy central banks have increased policy rates to levels they consider restrictive, and are expected to maintain these settings for some time

Most advanced economy central banks judge policy rates to be restrictive. Central banks' recent statements have continued to emphasise that future policy rate decisions will be data dependent. Central bank commentary has increasingly focussed on balancing upside risks to inflation and downside risks to economic growth, while many have noted that the conflict in the Middle East is a new and significant source of uncertainty. Nevertheless, policymakers at some central banks have emphasised the need to keep policy rates around their current restrictive levels for as long as necessary to bring inflation back to target. Officials from several central banks have indicated that recent increases in sovereign bond yields could reduce the need for policy rate increases if they result in a sustained tightening of financial conditions. Market participants expect most central banks' policy rates have peaked and will be held at or near current levels until around mid-2024.

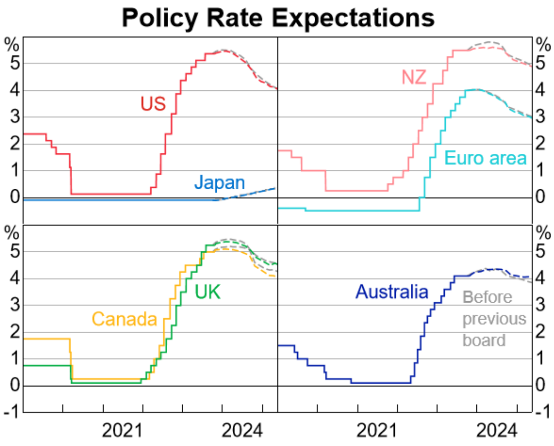
Policy Rates at Advanced Economy Central Banks

	Change in October (basis points)	Current level (per cent)	Expected peak (per cent)**
Australia	0	4.1	4.35
United States*	0	5.25–5.5	5.25–5.5
Euro area*	0	4	4
Canada*	0	5	5
Japan*	0	-0.1	NA
New Zealand	0	5.5	5.5
Norway	NA	4.25	4.25
Sweden	NA	4	4
Switzerland	NA	1.75	1.75
United Kingdom*	0	5.25	5.25

* Decision due before November RBA board meeting. Reflects current market expectations.

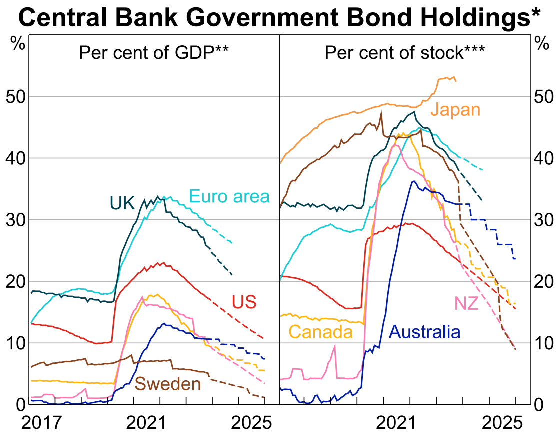
** Values represent the peak policy rate that is fully priced in by markets.

Sources: Bloomberg, central banks



Sources: Bloomberg; RBA.

Most central banks have continued to reduce their holdings of assets purchased under quantitative easing programs. The Bank of Japan (BoJ) has continued to purchase assets through its general quantitative easing programs. It also purchased ¥675bn of Japanese government bonds (JGB) to support yield curve control (YCC). Those purchases were undertaken amid a rise in JGB yields alongside an increase in other government bond yields and speculation that the BoJ may further loosen YCC settings, although the yield on 10-year JGBs has remained somewhat below the BoJ's strict cap of 1 per cent.



* Central government debt only, except the euro area. Holdings for euro area only include asset purchase programs; holdings for UK do not include financial stability purchases; other central banks include bonds held for operational or liquidity purposes.

** Four quarter rolling sum. Japan (not shown) is currently 99% of GDP.

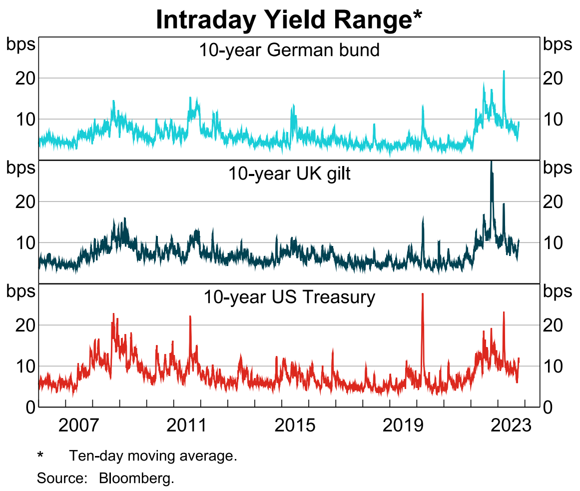
*** Per cent of eligible outstanding stock. Projections use current stock of government debt.

Sources: Central banks; debt management offices; IMF; RBA; Refinitiv.

Government bond yields have risen further, particularly at longer maturities, amid elevated volatility

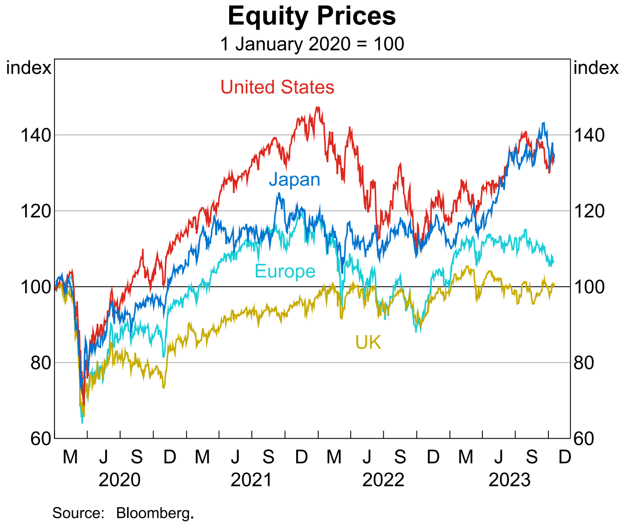
Government bond yields have increased substantially over recent months, particularly at longer maturities, and in most advanced economies are near their highest levels in more than a decade. Most of the increase in longer-term yields has come from higher real yields. There has been a small increase in longer-term market-implied inflation expectations in recent months, but these generally remain between 2 and 3 per cent. Short-term bond yields have not increased as much as longer-term yields, reflecting market expectations that most central banks will leave their policy rates around current levels for an extended period.

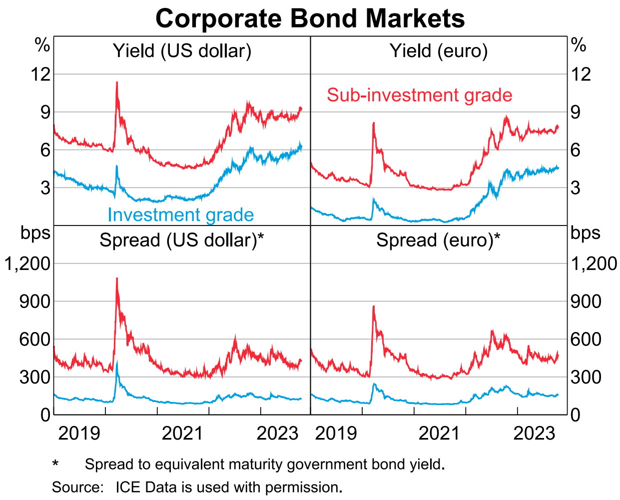
The increase in real yields over recent months appears to partly reflect an increase in the term premium, which is the return investors require to hold longer-term bonds over and above what is explained by expectations of inflation and shorter-term real interest rates. The apparent increase in the term premium may reflect a number of factors, such as increased uncertainty around the economic and policy outlook and expectations of a larger supply of government bonds from debt issuance while central banks are reducing their asset holdings. Increased real yields could also partly reflect some investors upgrading their estimates of the level of interest rates required to achieve central bank inflation targets, in light of stronger than expected indicators of economic activity. Volatility of longer term government bond yields has increased alongside the recent increase in yields. This is likely to reflect elevated uncertainty over the future path of inflation and interest rates, including as a result of conflict in the Middle East.



Private sector financial conditions have tightened in advanced economies but compensation for credit risk remains low

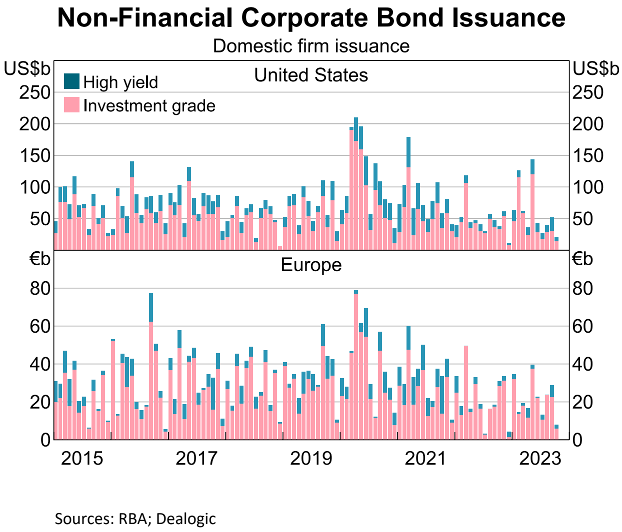
Equity prices in the United States and Europe declined over recent months, in part due to higher interest rates, which decrease the present valuation of future company earnings. Corporate bonds yields have increased alongside the rise in government bond yields and a modest widening of credit spreads. Nevertheless, equity prices in most major markets are still noticeably higher than a year ago while corporate bond spreads are only slightly above their average over the past 10 years in Europe and the United States. This is despite the significant increases in policy rates to restrictive levels and increases in longer-term risk-free rates. Levels of these asset prices signal market participants do not anticipate significant declines in corporate profits or a large rise in corporate defaults.

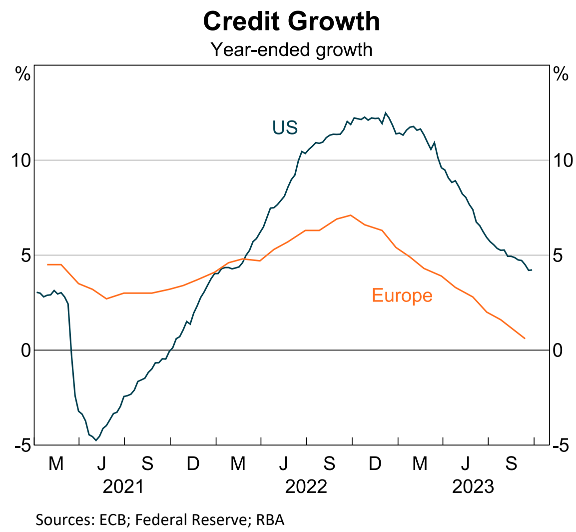




Corporate bond issuance in the United States and Europe has picked up in recent months. This may in part reflect that some firms have brought forward their issuance to guard against the risk that yields rise even further. Initial public offerings have also picked up in US equity markets following a long period of inactivity.

Central bank surveys have shown a broad-based tightening in lending standards and weakening in demand for credit this year. Credit growth has slowed sharply this year in the United States and Europe, although the rate of deceleration has moderated in the United States in recent months.

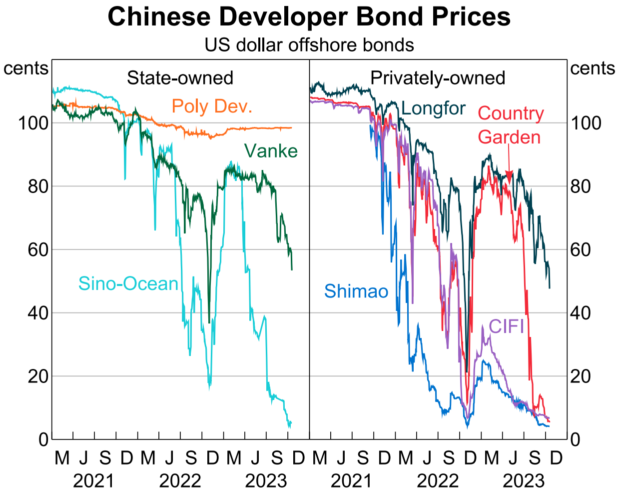




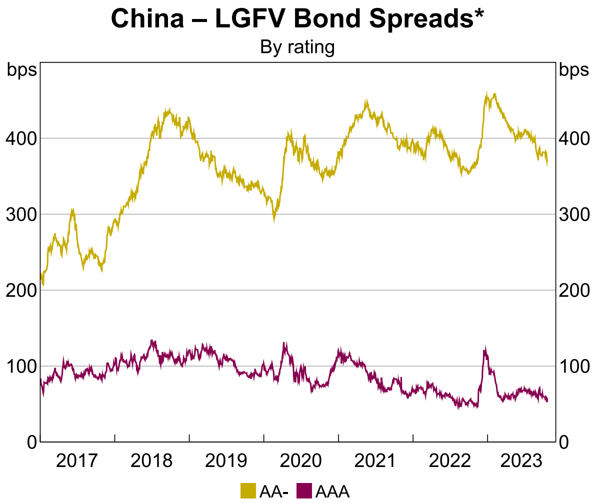
Chinese property developers remain under extreme stress

Chinese property developers' bond and equity prices have declined further over the month as weak demand for new housing continued to weigh on developers' earnings. Private developers' financing conditions are especially challenging. Their access to funding from capital markets has largely been cut off and banks have been hesitant to extend loans as defaults have risen. Overall, around half of large private developers (weighted by assets) have defaulted, and many may find it difficult to meet upcoming debt repayments. A prominent example is Country Garden – one of the largest private developers in China – which is widely expected to have defaulted in October after missing an interest payment on a US dollar bond. Country Garden had previously warned it would be unable to meet upcoming payments and will seek to restructure its debt.

There are some concerns that stress in the property sector could spill over to other parts of China's financial sector. Defaults on shadow banking products, including trust loans and wealth management products, have increased further, and smaller regional banks with weaker capital adequacy positions remain particularly exposed to weak conditions in the property sector. Notably, local governments have been drawing down on special bond quotas that are made available for recapitalising small regional banks.



Source: Bloomberg.



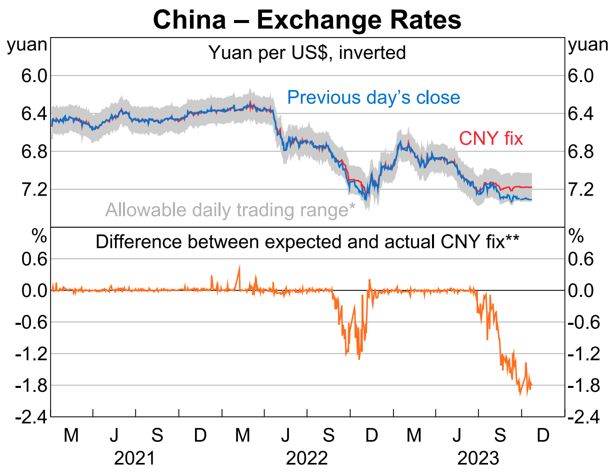
* Spread to 5-year Chinese government bonds.
Sources: CEIC Data; RBA; WIND.

To address local government debts risks that have been exacerbated by weak land sales revenue, several local governments have reportedly been allocated refinancing bond quotas which can be used to pay off loans from local government financing vehicles (LGFVs). Though quotas are modest relative to total outstanding LGFV debt, the refinancing program has raised expectations of further support, and the spread on LGFV bonds to Chinese government bonds has narrowed. Authorities have also reportedly instructed state-owned banks to roll over existing loans to LGFVs at longer-terms and with lower interest rates.

The renminbi has remained around multi-decade lows and authorities have continued to lean against the pace of depreciation

The renminbi has stabilised around multi-decade lows after depreciating by 6 per cent against the US dollar since March alongside efforts by authorities to lean against the pace of depreciation. This has included the PBC setting a consistently stronger 'CNY fix' – the midpoint of the permitted daily trading range of +/- 2 per cent – than expected by a survey of market participants.

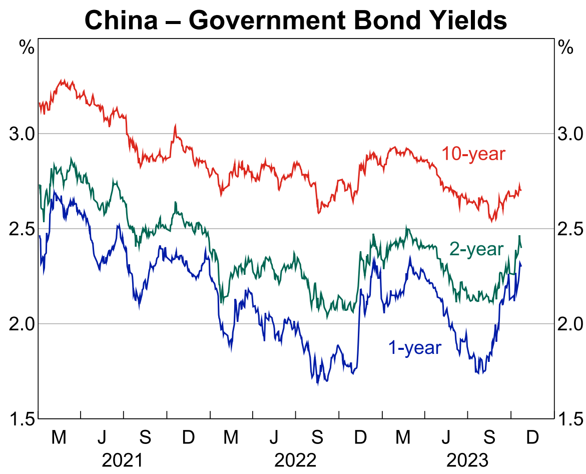
Chinese government bond yields rose further in October reflecting expectations that authorities may provide further stimulus by allowing local governments to bring forward next year's special bond issuance quotas. The recent acceleration of local government special bond issuance has contributed to an increase in total social financing growth. Growth in household lending remains subdued but also increased modestly following the release of several measures by authorities to support housing demand in August.



* Since early 2014 the CNY has been allowed to trade in a daily range of +/- 2 per cent from the CNY fix.

** Negative value indicates official fix was stronger then expected by market economists, supporting the yuan against the US dollar.

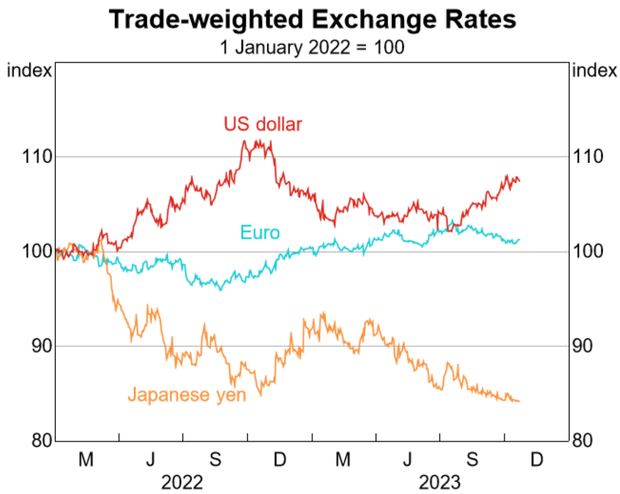
Sources: Bloomberg; CEIC Data; RBA.



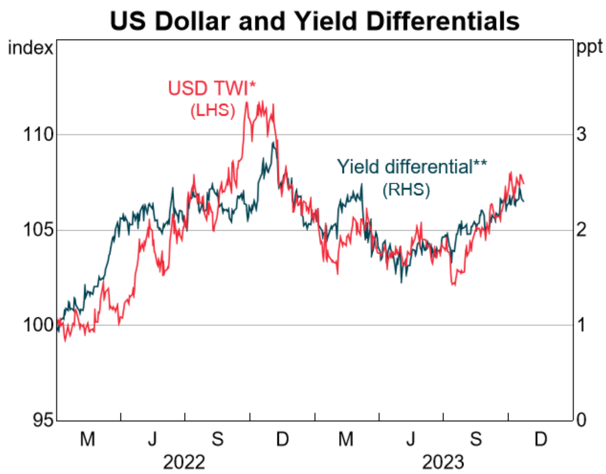
Sources: CEIC Data; RBA.

The US dollar is little changed over the month, after having appreciated in recent months alongside widening US yield differentials

The US dollar is little changed on a trade-weighted (TWI) basis over the month but is around 2 per cent higher since the beginning of the year. The appreciation of the US dollar since mid July has been broad-based and consistent with the widening in the yield differential between US Treasury bonds and other advanced economy government bonds over this period. The Japanese yen has continued to depreciate over recent months and is over 8 per cent lower on a TWI basis since the beginning of the year. Weakness in the yen has reflected the BoJ maintaining very accommodative policy settings in an environment of rising global yields.



Sources: Bloomberg; Board of Governors of the Federal Reserve System.



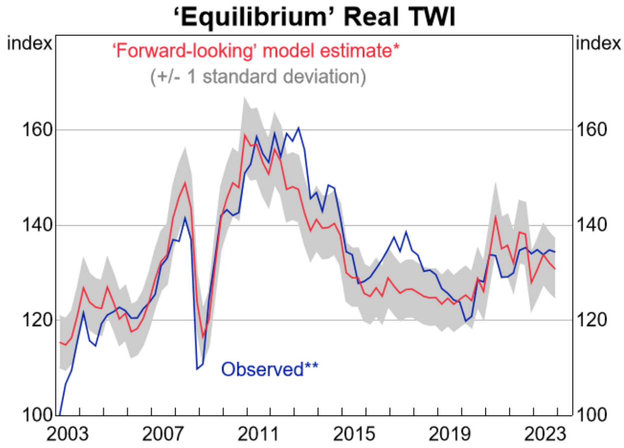
* 1 January 2022 = 100.

** Three-year US sovereign yield less simple average of yields of Germany, Japan and the United Kingdom.

Sources: Bloomberg; Board of Governors of the Federal Reserve System.

The Australian dollar continues to trade near year-to-date lows

The Australian dollar has depreciated by around 1 per cent on a TWI basis and by over 3 per cent against the US dollar since early August. The recent depreciation of the Australian dollar has reflected broad-based US dollar strength and ongoing concerns about the outlook for the Chinese economy. The slight depreciation against the US dollar since the October Board meeting has seen the Australian dollar trade near its year-to-date low of US$0.63.

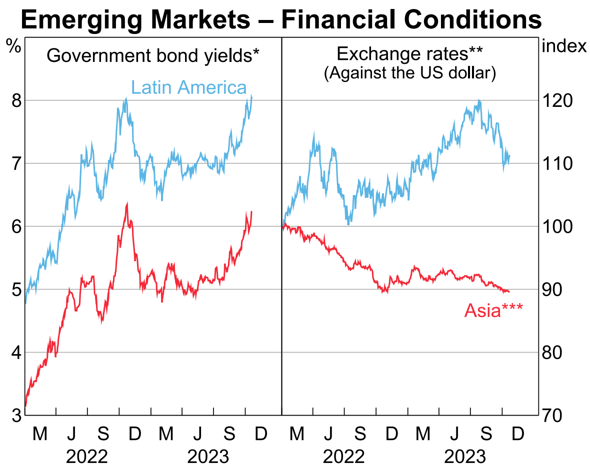


* Using terms of trade forecast and real Australian Government bond yield curve factors relative to the G3; standard deviation based on model errors.
** Indexed to March 2003 = 100; quarterly average real TWI.
Sources: Bloomberg; RBA.

On a longer-term basis, the Australian dollar TWI is trading slightly below its early 2022 levels, when global central banks began raising their policy rates. Yield differentials between Australian government bonds and those of major advanced economies are little changed, while the Bank's Index of Commodity Prices (ICP) is slightly weaker after traversing a wide range over this period. The level of the Australian dollar (in real TWI terms) has remained broadly consistent with model estimates implied by historical relationships with forecasts of the terms of trade and real yield differentials.

Emerging markets are facing tighter external funding conditions

External funding conditions in emerging markets tightened in October, driven by the rise in longer-term yields and a further depreciation in exchange rates against the US dollar. Yields on US dollar denominated sovereign debt increased to be near their recent peak in late 2022, while spreads between US-dollar-denominated bonds and US Treasuries have only widened by a small margin. Net portfolio outflows have been most pronounced in Asia and many Asian central banks have intervened in response to exchange rate depreciation. Notably, Bank Indonesia increased its policy rate by 25 basis points in October to stabilise the currency and mitigate the impact of imported inflation risks. Some central banks in Latin America – which started raising policy rates earlier and by more than advanced economies – have continued to reduce policy rates as core inflation has eased.



* US-dollar-denominated bond yields, weighted by market value.
** 1 Jan 2020 = 100.
*** Excluding China.
Sources: Bloomberg; JP Morgan; RBA.

International Department
24 October 2023

INTERNATIONAL DEPARTMENT MONTHLY REVIEW – NOVEMBER 2023

Financial Markets

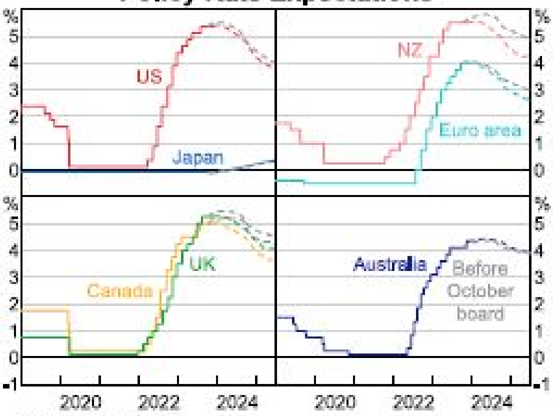
Most central banks judge their policy rates to be restrictive, although they have reduced the emphasis placed on the likelihood of further policy rate increases, while indicating that they remain data dependent and emphasising that it is too early to consider the timing of future rate cuts. Weaker-than-expected inflation and economic data, particularly in the United States, and more balanced messaging from central banks that policy is data dependent, have led market participants to price in larger decreases in policy rates over 2024 and bring forward expectations of when decreases will start. Consistent with this, government bond yields have decreased of late, reversing some of the substantial increase over recent months, while equity prices have increased and corporate bond spreads have narrowed. Broad-based US dollar weakness has seen the Australian dollar appreciate against the US dollar over the past month, although it is little changed on a TWI basis.

In China, financial conditions have tightened modestly alongside better-than-expected economic data and the announcement of further government bond issuance to support investment. Property developer asset prices remain at severely distressed levels as many private developers continue to face challenges in meeting upcoming debt repayments.

Most advanced economy central banks expect policy rates to remain at or near current levels for some time, while market expectations of the timing of rate cuts have been brought forward

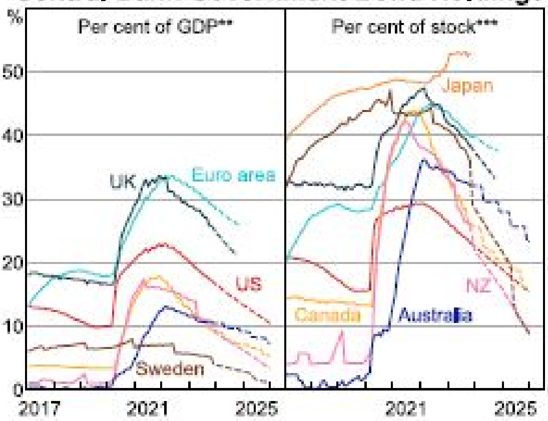
Almost all advanced economy central banks have left their policy rate unchanged since September, with most judging their policy rates to be restrictive. Central banks have reduced the emphasis placed on the likelihood of further policy rate increases, while indicating that they remain data dependent and emphasising that it is too early to consider the timing of future rate cuts. The US Federal Reserve (Fed) has indicated that it will proceed carefully as it considers further policy rate increases, while the European Central Bank has indicated it is unlikely to change its policy rate for the next few quarters, absent a major shock. In response to recent weaker-than-expected inflation and economic data, particularly in the United States, as well as the more balanced and data-dependent messaging from central banks, market participants have priced in larger decreases in policy rates over 2024 and brought forward expectations of when decreases will start.

Policy Rate Expectations



Source: Bloomberg; RBA.

Central Bank Government Bond Holdings*



* Central government debt only, except euro area. Holdings for euro area only include asset purchase programs; holdings for UK do not include financial stability purchases; other central banks include bonds held for operational or liquidity purposes.

** Four quarter rolling sum. Japan (not shown) is currently 100 per cent of GDP.

*** Per cent of eligible stock. Projections use current stock.

Sources: Central banks; debt management offices; IMF; RBA; Refinitiv.

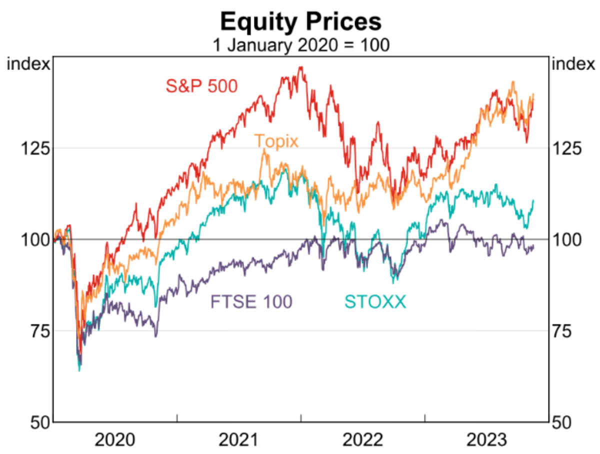
Government bond yields have declined from recent high levels, amid elevated volatility

Government bond yields have decreased of late, reversing some of the substantial increase over recent months. Nevertheless 10-year government bond yields remain close to recent decade-highs. Most of the decline has been driven by lower real yields in response to weaker-than-expected inflation and economic activity data, primarily in the United States, which has brought forward market expectations of the timing of policy rate cuts. Longer-term market-implied inflation expectations in most advanced economies have declined a little and remain consistent with central bank inflation targets. Meanwhile, volatility of longer-term government bond yields remains elevated as uncertainty over the future path of inflation and interest rates remains high.

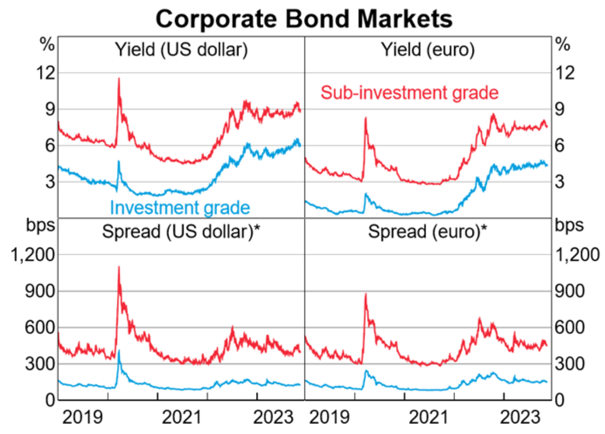
Most central banks have continued to reduce their holdings of assets purchased under quantitative easing (QE) programs. The Bank of Japan (BoJ) continues to add to its asset holdings through its regular QE program but has not made any unscheduled purchases to support yield curve control since shortly after removing strict 10-year yield limits in late October. Over this period 10-year Japanese government bond yields have remained somewhat below 1 per cent.

Private sector financial conditions have loosened a little in advanced economies

Equity prices in most advanced economies have risen over the past month, in part due to lower interest rates, which increase the present value of future company earnings. In addition, third quarter reported earnings by companies in the United States have been mostly better-than-expected, in particular for banks and large technology companies. Corporate bond yields have declined alongside decreases in government bond yields and a narrowing of credit spreads. Consequently, equity prices in most major markets are still noticeably higher than a year ago while corporate bond spreads are around their long-term average in Europe and the United States. This is despite the increases in policy rates to levels judged to be restrictive and longer-term risk-free rates that remain near decade-highs. Levels of these asset prices suggest that market participants do not anticipate significant declines in corporate profits or a large rise in corporate defaults.

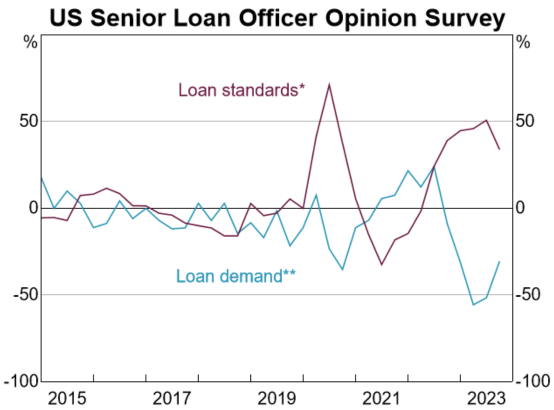


Source: Bloomberg



* Spread to equivalent maturity government bond yield.
Source: ICE Data is used with permission.

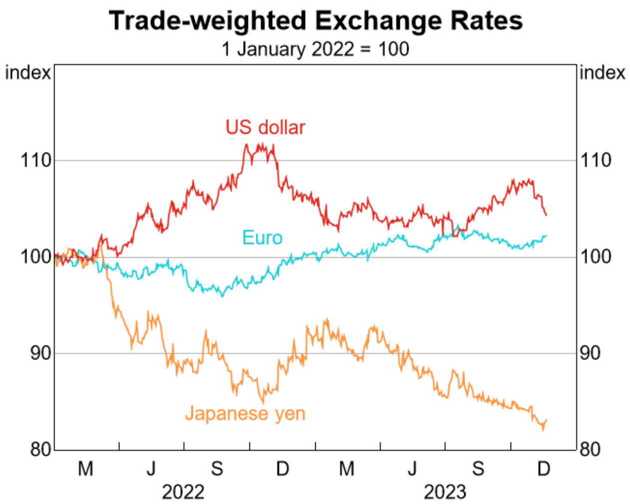
Central bank surveys have shown a broad-based tightening in lending standards and weakening in demand for credit this year, although this trend has moderated in the United States over recent months. The Fed's recent senior loan officer opinion survey (SLOOS) showed that the net proportion of banks reporting a tightening in lending standards has declined while the net proportion reporting an increase in loan demand rose from strongly negative levels. The rate of tightening of lending standards in Europe has similarly slowed. This suggests a moderation of banks' concerns about the economic outlook, consistent with the relatively benign outlook implied by the modest widening in corporate bond spreads in the United States and Europe this year.



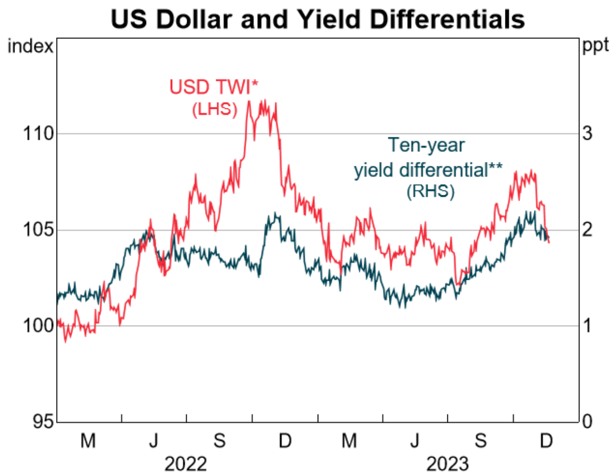
* Net percentage of domestic banks tightening standards for commercial and industrial loans to large and middle-market firms.
** Net percentage of domestic banks reporting stronger demand for commercial and industrial loans from large and middle-market firms.
Source: FRED.

The US dollar has depreciated alongside lower US Treasury yields

The US dollar has depreciated on a trade-weighted (TWI) basis over the month amid softer-than-expected US economic data and declines in longer-term US Treasury yields. Despite the decline, the US dollar remains 4 per cent stronger than its early 2022 level. The Japanese yen is little changed over the month at multi-decade lows as the BoJ has maintained very accommodative monetary policy settings. Meanwhile, the euro is slightly stronger.



Sources: Bloomberg; Board of Governors of the Federal Reserve System.



* 1 January 2022 = 100.
** Ten-year US sovereign yield less simple average of yields of Germany, Japan and the United Kingdom.
Sources: Bloomberg; Board of Governors of the Federal Reserve System.

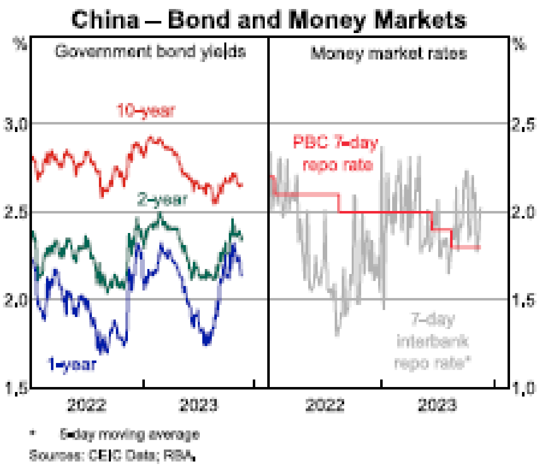
The Australian dollar TWI is little changed over recent months despite widening yield differentials

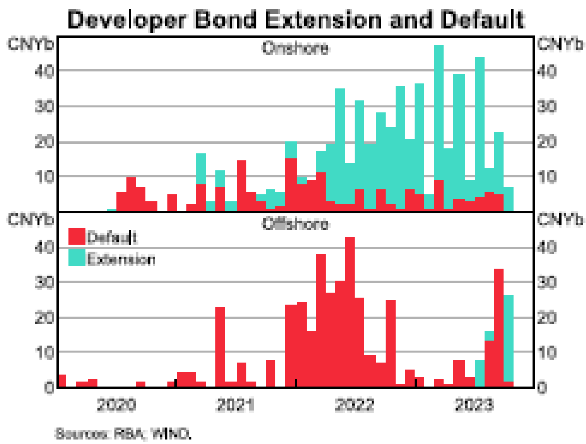
The Australian dollar has appreciated by around 2 ½ per cent against the US dollar but is little changed on a TWI basis over the past month. Stability in the Australian dollar TWI over recent months has occurred despite a widening in yield differentials between Australian government bonds and those of the major advanced economies. The Bank's Index of Commodity Prices has been little changed over this period. On a longer-term basis, the Australian dollar TWI is trading near its early 2022 levels.

Increased government bond issuance has contributed to a modest tightening in Chinese financial conditions

Chinese government bond yields have increased over recent months alongside better-than-expected economic data and the announcement of further government bond issuance to support investment (see Economic Conditions paper). As a result, interbank funding conditions have tightened as domestic banks – which hold around 70 per cent of outstanding government bonds – have increased demand for funds to finance upcoming bond purchases. This is despite the PBC making an additional CNY600 billion of liquidity available through the medium-term-lending facility in November.

The rise in government bond issuance has supported total social financing growth over recent months, while household credit growth has stayed subdued as demand for property remains very weak. Property developer asset prices remain at severely distressed levels reflecting the ongoing challenges by many developers in meeting upcoming debt repayments. This has led many property developers to restructure their onshore debt repayments; however, stronger creditor rights and weaker official influence in offshore credit markets have made offshore debt restructures far less common. As a result, offshore bond defaults have increased further over recent months – most notably by Country Garden in October.

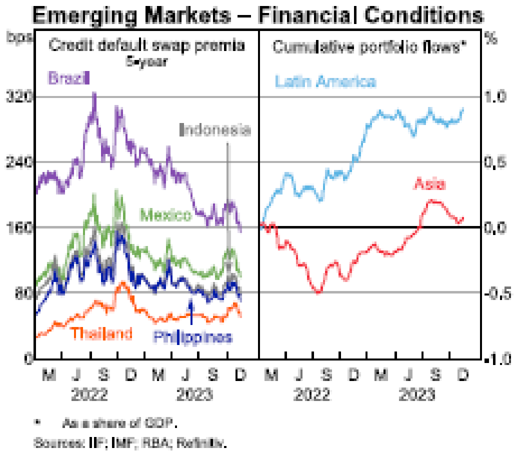




The renminbi has remained around multi-decade lows against the US dollar. Authorities have continued to set a stronger CNY fix – the midpoint of the permitted daily trading range of +/– 2 per cent – than expected by surveyed market participants alongside ongoing depreciation pressure from sustained capital outflows.

Financial conditions in emerging markets have eased a little amid the decline in global bond yields

Financial conditions in emerging markets eased modestly in November as bond yields and credit default swap premia on emerging market sovereign bonds declined. Improved funding conditions have contributed to an increase in emerging market sovereign bond issuance in November which have helped to stabilise net portfolio flows in Asia following earlier outflows. Exchange rates have appreciated in Latin America in November but have remained broadly steady in Asia. Market participants' expectations for the paths of policy rates have also decreased as inflation has continued to ease.



International Department
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