

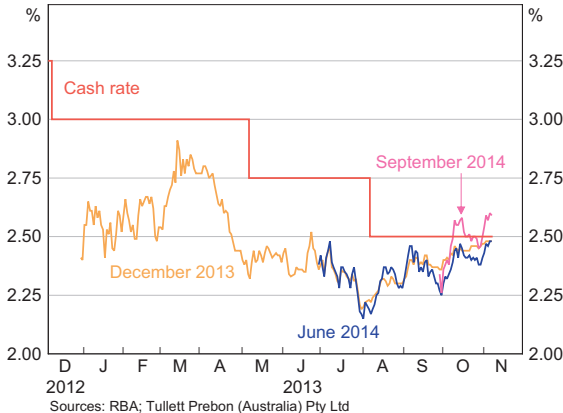
4. Domestic Financial Markets

Money Markets and Bond Yields

The Reserve Bank Board has maintained its target for the cash rate at 2.50 per cent since August. Over recent months, the pricing of money market instruments has pointed to reduced expectations of a further easing in monetary policy, as domestic and offshore economic data have generally been stronger than expected. Rates on overnight indexed swaps (OIS) currently imply that the cash rate is likely to remain at 2.50 per cent over the next year (Graph 4.1).

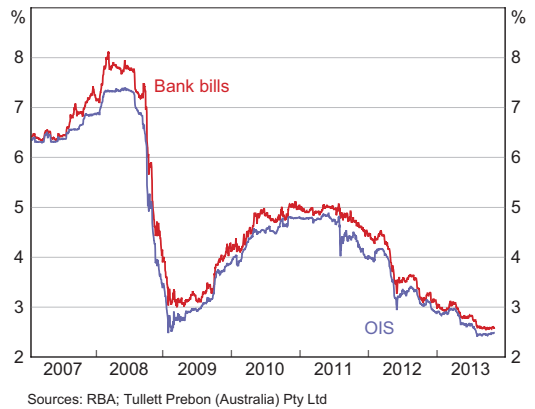
Yields on long-term Commonwealth Government securities (CGS) have fluctuated in a relatively wide range during recent months (Graph 4.3). Yields on 10-year CGS are currently 4.1 per cent, having briefly reached an 18-month high of 4.2 per cent in September. Uncertainty about fiscal and monetary policy in the United States has

Graph 4.1
Cash Rate Expectations



Rates on bank bills and certificates of deposit (CDs) are mostly unchanged from the time of the previous *Statement*, with the yield on 3-month bank bills remaining at historical lows of around 2.6 per cent (Graph 4.2). Spreads between comparable bill and OIS rates have been stable at low levels, with liquidity in the interbank market for bills and CDs benefiting from more active price making from the major participants (see 'Box D: Bank Bill Swap Benchmark Rates').

Graph 4.2
Yields of 3-month Bank Bills and OIS



Graph 4.3
Australian Government Bond Yields



been an influence, as has diminished expectations for a lower cash rate. The latter has resulted in the spread between 10-year CGS yields and those on US Treasuries widening by around 40 basis points since August (Graph 4.4).

Graph 4.4
Australia/US 10-year Bond Differential

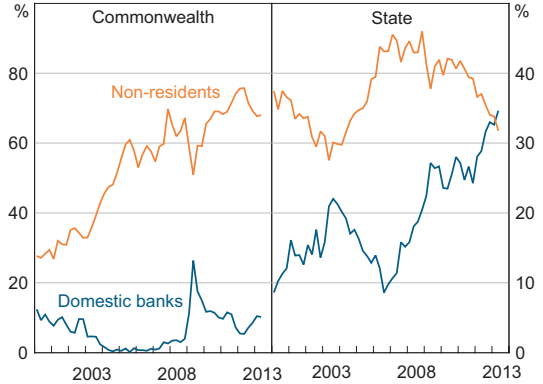


Source: RBA

The Australian Government announced in October that it would seek to raise the legislative ceiling on the amount of CGS outstanding from \$300 billion to \$500 billion. In August, the Treasury had projected that the current limit would be reached before the end of the calendar year, with CGS outstanding peaking at \$370 billion in 2016. The Australian Office of Financial Management (AOFM) expects gross issuance of Treasury Bonds to be \$70 billion this financial year, with issuance net of maturities of \$47 billion; up to \$5 billion of Treasury Indexed Bonds will also be issued this financial year.

The share of CGS held by non-residents was unchanged at 68 per cent in the June quarter, while the share of the state and territory ('semi-government') market held by non-residents fell further, to 32 per cent. The amount of semi-government debt held by the domestic banks now exceeds that held by non-residents as banks have been increasing their liquid asset holdings in advance of new prudential requirements being implemented in January 2015 (Graph 4.5).

Graph 4.5
Ownership of Australian Government Debt
Share of outstandings

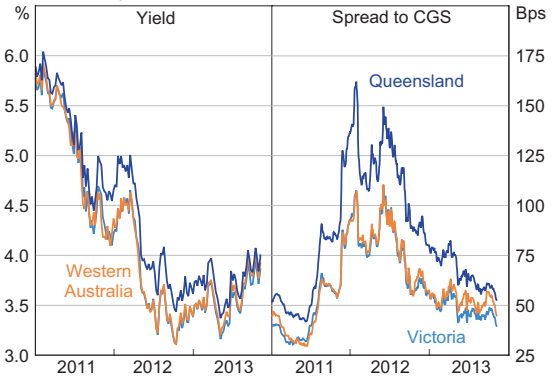


Sources: ABS; RBA

Spreads between semis and CGS have narrowed since the previous *Statement* (Graph 4.6). Standard & Poor's downgrade of Western Australia's credit rating from AAA to AA+ resulted in spreads on that state's debt decreasing by less than other semi-government issuers.

Issuance of bonds in the domestic market by non-resident ('Kangaroo') entities since the previous *Statement* has been around \$9 billion. Secondary market spreads of Kangaroo bonds remain close to their post-2007 lows. While Australian dollar cross-currency basis swap spreads against the US dollar have been broadly unchanged, spreads have narrowed against the euro and the yen, reducing the attractiveness of issuance in Australia for some offshore entities.

Graph 4.6
5-year Semi-Government Debt

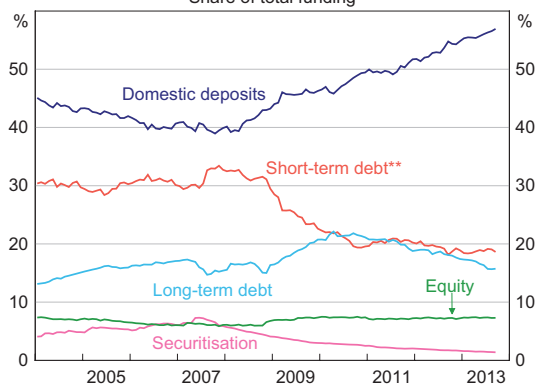


Sources: RBA; Yieldbroker

Financial Intermediaries

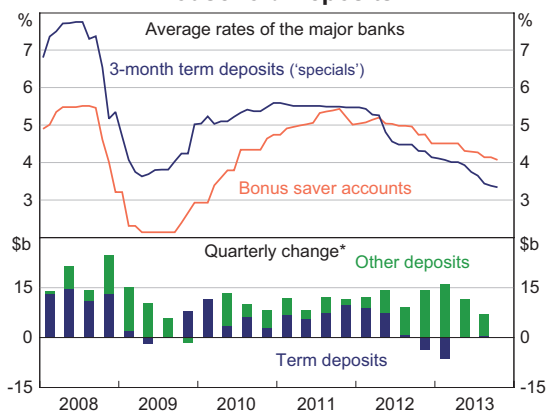
The share of funding from domestic deposits has increased slightly as banks continue to fund new lending with deposits (Graph 4.7). The cost of banks' outstanding funding liabilities relative to the cash rate has changed little in recent months. Notwithstanding the repricing of advertised rates on most banks' at-call savings accounts in line with the reduction in the cash rate in August, spreads on these accounts remain at elevated levels. The widening interest rate differential between at-call deposits and short-term deposits has been a factor in the further inflow of household deposits into at-call savings products (Graph 4.8).

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



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

Graph 4.8
Household Deposits



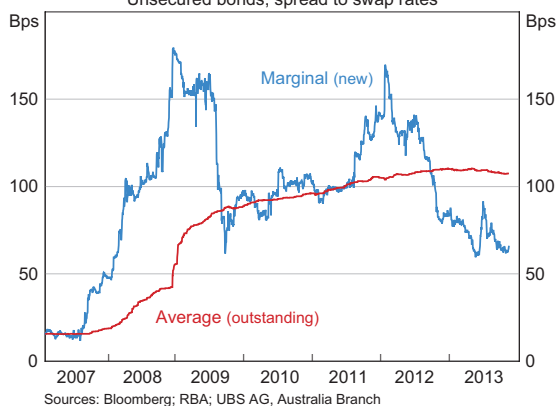
* Deposits with banks; seasonally adjusted
Sources: APRA; RBA

Movements in the rates offered on term deposit 'specials' have tended to coincide with changes in the cash rate during 2013, rather than move with wholesale rates of comparable terms. Consequently, as term interest rates in the wholesale market have risen, the spreads between term deposit 'specials' and wholesale interest rates have narrowed, particularly for long-term deposits. This has also made term deposits relatively less attractive.

Since the previous *Statement*, the marginal cost of new long-term wholesale funding, as measured by the spread to equivalent swap rates, has declined further (Graph 4.9). Relative to CGS, spreads on the major banks' unsecured bonds declined by around 25 basis points, while spreads on covered bonds fell by 20 basis points (Graph 4.10). This contraction in spreads was supported by the US Federal Reserve's unexpected decision in September to delay the tapering of its asset purchase program.

Notwithstanding these trends, there has been little change in the average cost of banks' outstanding wholesale debt funding costs recently, reflecting both the low levels of bond issuance in recent times and the generally long term to maturity of outstanding wholesale funding. Nevertheless, if the marginal cost of new debt remains around current levels, the average cost of banks' outstanding wholesale debt relative to the cash rate is expected to gradually decline over the coming year, particularly

Graph 4.9
Major Banks' Domestic Bond Spreads
Unsecured bonds, spread to swap rates



Sources: Bloomberg; RBA; UBS AG, Australia Branch

as bonds that were issued during 2008 and 2009 at higher spreads mature.

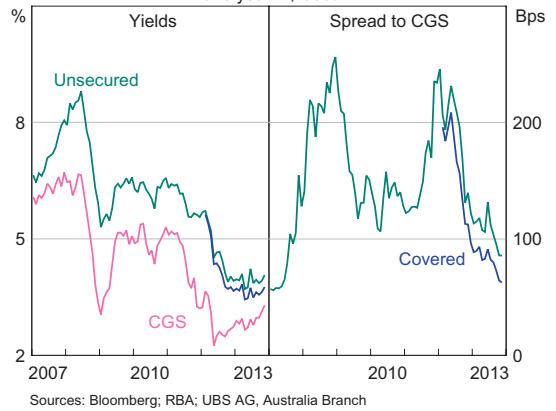
Around \$20 billion of bonds have been issued by Australian banks since the previous *Statement*. About two-thirds of this debt has been issued in offshore markets, while around \$2 billion was raised through covered bonds. Around \$4 billion of government-guaranteed debt has been repurchased over the past three months, which together with maturities has reduced the stock of outstanding government-guaranteed debt to \$39 billion, compared with a peak of \$150 billion. Taking into account these buybacks and maturities, net bond issuance by banks in 2013 has been negative, reflecting their greater use of deposit funding and the modest growth in bank assets (Graph 4.11).

Several banks have reported increases in underlying profit over the past few months. Overall, these results were characterised by a reduction in bad debt charges as asset quality has improved, and a modest increase in net interest income. The major banks have generally increased their dividends in the most recent half-year compared with the same period in 2012.

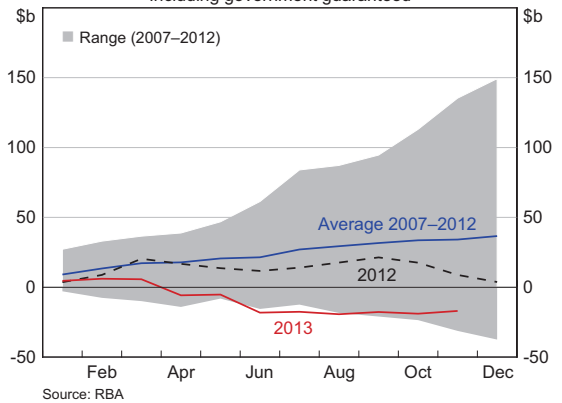
Around \$11 billion of residential mortgage-backed securities (RMBS) have been issued since the previous *Statement* (Graph 4.12). Almost all recent RMBS have been issued in the domestic market with a number of issuers returning to the market after an absence of at least two years. The securities have exhibited a greater variation in loan pool characteristics, with a number of recent deals having a relatively high share of new loans and a small number having a higher-than-usual share of low-documentation loans. These features have generally been offset by higher-than-average credit support for the AAA rated tranches. Pricing on RMBS has been little changed since early in the year, with issuance spreads remaining around their lowest level since the beginning of the financial crisis.

Issuance of other asset-backed securities has totalled \$2 billion since the previous *Statement*, with a mix of auto-, equipment- and consumer loan-backed securitisations. Two particularly bespoke

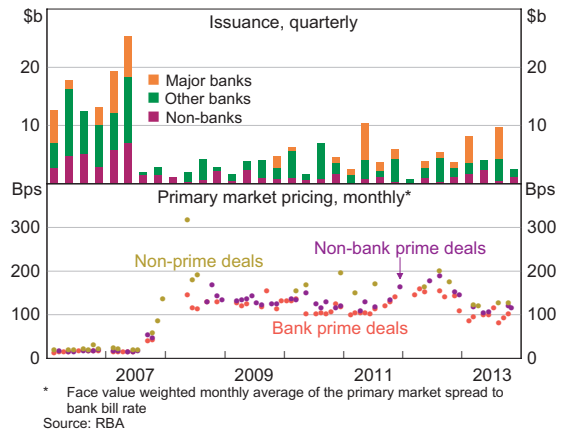
Graph 4.10
Major Banks' Bonds
3–5 year A\$ debt



Graph 4.11
Cumulative Net Bank Bond Issuance
Including government guaranteed



Graph 4.12
Australian RMBS

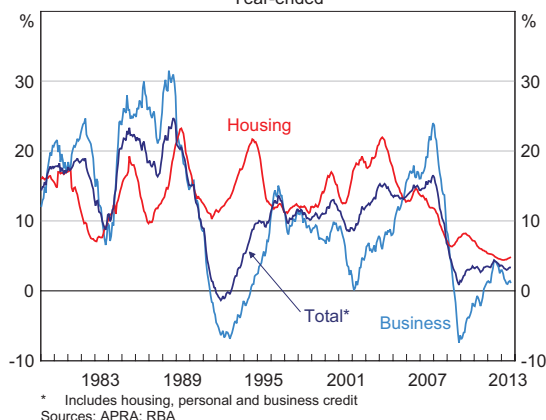


asset-backed securities were issued during the period: a commercial mortgage-backed security backed by leases on a number of home improvement stores; and an Australian airline issue into the US asset-backed security market, the first such aircraft-backed deal by an Asia-Pacific airline.

Financial Aggregates

Total credit grew modestly in the September quarter (Graph 4.13, Table 4.1). Growth in broad money slowed over the quarter although, as discussed above, inflows into saving and transaction deposit accounts have remained strong.

Graph 4.13
Credit Growth
Year-ended



Household Financing

Consistent with the pick-up in prices and activity in the housing market over the past year, the value of new housing loan approvals has increased to be around its highest level in four years, although it remains low as a share of total housing credit outstanding (Graph 4.14). The increase in both the value and number of loan approvals has been underpinned by loans to repeat-buyer owner-occupiers and investors. Loan approvals for purchases of dwellings in New South Wales by investors were particularly strong. In contrast, the value of first home buyer loan approvals remains subdued following changes to first home buyer grants in most states over the past year.

Graph 4.14
Value of Housing Loan Approvals
Per cent of housing credit outstanding

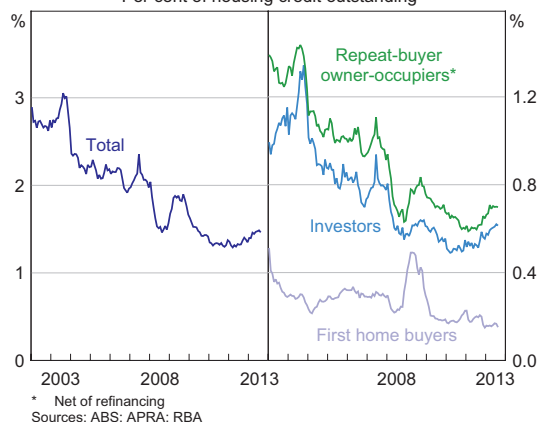


Table 4.1: Financial Aggregates
Percentage change^(a)

	Quarterly		Year-ended
	Jun 2013	Sep 2013	Sep 2013
Total credit	1.0	1.0	3.3
– Owner-occupier housing	1.0	1.1	4.2
– Investor housing	1.6	1.7	6.1
– Personal	0.1	0.5	1.0
– Business	0.9	0.4	1.1
Broad money	1.8	0.8	5.2

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

Following the cut in the cash rate in August, most lenders passed on the reduction to their mortgage customers. This reduced advertised rates on package variable-rate home loans to below the average advertised rate on 3-year fixed-rate loans (Table 4.2). As a consequence, the share of new loans approved at fixed rates has fallen in recent months, although it remains elevated because of many borrowers' desire to lock in the historically low level of interest rates (Graph 4.15). Competition for new variable-rate loans has seen several lenders increase their advertised discounts on new loans. Lenders have also begun competing more aggressively for customers via the broker channel, with a number of lenders increasing the commissions paid to mortgage brokers who meet volume targets.

Notwithstanding the pick-up in approvals, housing credit continued to grow at a modest pace over the September quarter. In part, this reflects households maintaining their higher pace of mortgage

prepayments and a decreasing share of approvals to first home buyers, where the value of approvals typically translates into a larger increase in housing credit. Growth in investor credit has picked-up over the past two quarters, while growth in owner-occupier credit has remained steady (Graph 4.16).

**Graph 4.15
Housing Loans**

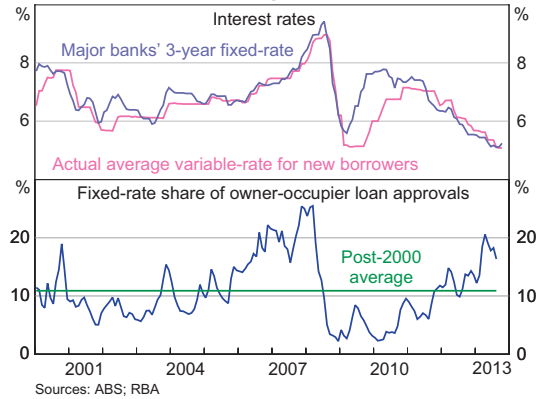


Table 4.2: Intermediaries' Fixed and Variable Lending Rates

	Level at 6 November 2013 Per cent	Change since July 2013 Basis points	Change since end October 2011 Basis points
Housing loans			
– Standard variable rate ^(a)	5.93	–26	–186
– Package variable rate ^(b)	5.08	–28	–195
– Fixed rate ^(c)	5.24	7	–127
Personal loans			
– Variable rate	11.59	–4	–95
Small business (variable rates)			
Residentially secured, advertised			
– Term loans	7.10	–25	–190
– Overdraft	7.97	–25	–188
Average rate ^(d)	6.80	–26	–183
Large business			
Average rate ^(d) (variable rate and bill funding)	4.66	–21	–238

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

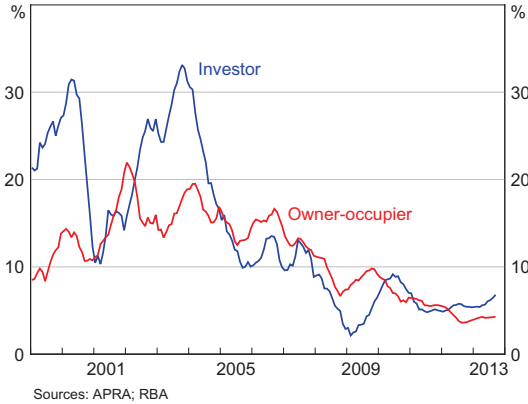
(b) Average of the major banks' discounted package variable rates on new, \$250 000 full-doc loans

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

(d) Rates on outstanding, business lending (includes discount)

Sources: ABS; APRA; RBA

Graph 4.16
Housing Credit Growth
Six-month-ended annualised



The value of outstanding personal credit grew modestly over the September quarter as the stock of fixed-term loans continued to increase. This has been supported by ongoing strength in credit extended by car finance companies. Preliminary data suggest that there was a small decline in the value of outstanding margin lending over the September quarter.

Rates on some variable-rate personal loans including margin loans and home equity loans were largely reduced in line with the cut in the cash rate in August. Advertised rates on most credit cards and unsecured personal loans, which are generally less sensitive to changes in the cash rate, have changed little over the past couple of years.

Business Financing

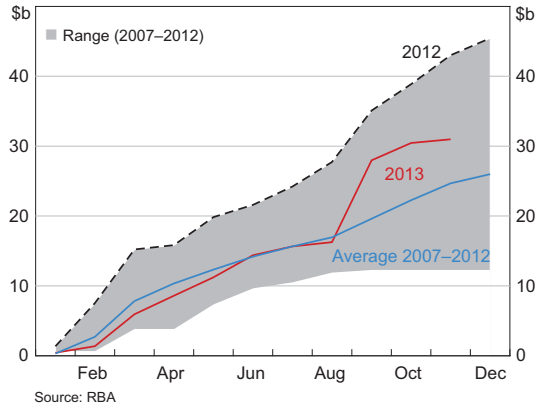
Australian corporate bond issuance has picked up in recent months, with around \$15 billion issued since the previous *Statement* (Graph 4.17). The majority of this issuance was in offshore markets, with one \$5 billion US dollar-denominated deal (which included a 30-year bond) accounting for one-third of the total. Most of the remaining offshore issuance was placed into the euro market by a range of Australian companies. Issuance into the domestic market was around average at \$2.3 billion, but four BBB rated bonds were issued at a tenor of seven years, which is relatively long for the domestic market. This follows five BBB rated bonds of comparable tenors

issued earlier in the year and represents a significant pick-up in longer-term domestic issuance, given that only six bonds with such maturities were issued from 2007 to 2012.

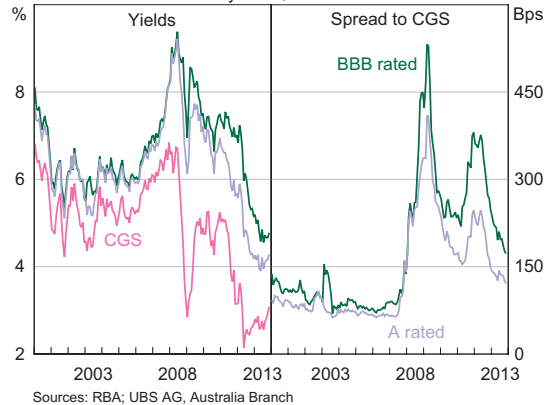
Secondary market spreads of 3-year corporate bonds over CGS have narrowed by around 25 basis points since the previous *Statement*, and remain near their lowest level since the onset of the financial crisis (Graph 4.18).

There was a slight increase in intermediated business credit over the September quarter, although the overall rate of growth remains subdued. The rise in business credit has been driven by an increased demand for loans by other financial corporations.

Graph 4.17
Cumulative Corporate Bond Issuance
Australian resident entities



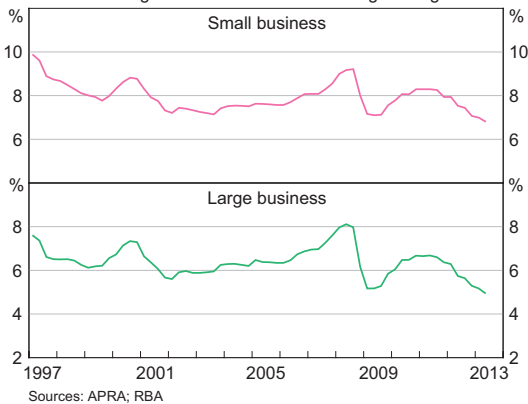
Graph 4.18
Australian Corporates' Bond Pricing
3-year A\$ debt



In contrast, growth in credit extended to private trading corporations and unincorporated businesses was little changed, which largely reflects ongoing weakness in business conditions and investment intentions.

The cost of intermediated business borrowing has continued to decline since the previous *Statement*; the average interest rates on outstanding small and large business loans have both fallen (Graph 4.19). This has largely reflected the ongoing repricing of fixed-rate and bill-financed lending. Rates on small and large business loans outstanding are now around 150 and 200 basis points below their post-1996 averages, respectively.

**Graph 4.19
Business Lending Rates**
Average interest rate on outstanding lending



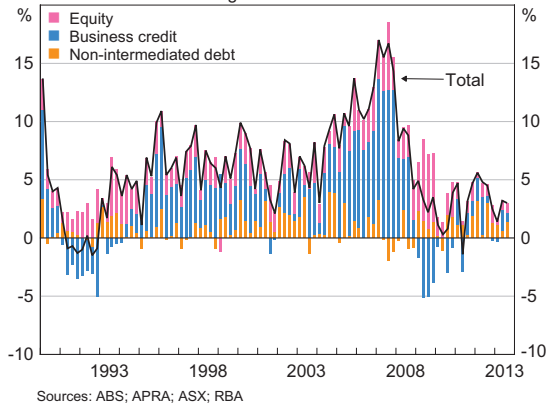
Activity in the Australian syndicated lending market softened in the September quarter, although this was partly seasonal. Over the past few years, the value of outstanding syndicated loans has been little changed, largely reflecting a general decline in acquisition activity since the financial crisis. While there has been an increase in lending by Asian institutions, this has mostly offset a decline in lending by European institutions.

Equity raisings by listed corporations totalled \$3 billion during the September quarter, well below their historical average. Initial public offerings (IPOs) amounted to \$770 million during the quarter, with the majority of this the result of one new listing.

Around \$6 billion in merger and acquisition deals have been announced by listed corporations since the previous *Statement*. The largest two transactions were Westpac's \$1½ billion acquisition of Lloyds Banking Group's Australian finance business and corporate loan portfolio and a \$1½ billion joint venture between Boral and a US industrial firm.

Overall, external business funding is estimated to have risen by the equivalent of 3 per cent of GDP in the September quarter (Graph 4.20). A slowing of business credit provided by financial institutions was partly offset by an increase in non-intermediated debt issuance; equity raisings were stable during the quarter.

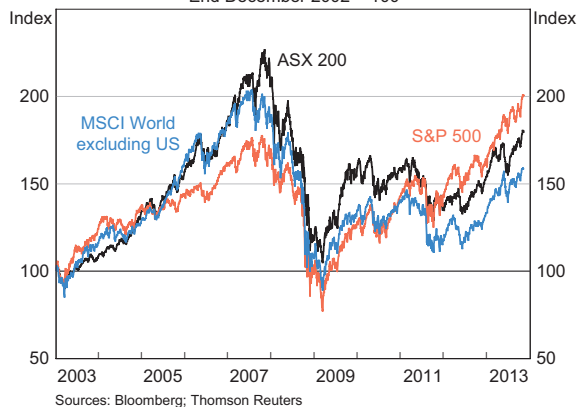
**Graph 4.20
Business External Funding**
Net change as a share of GDP



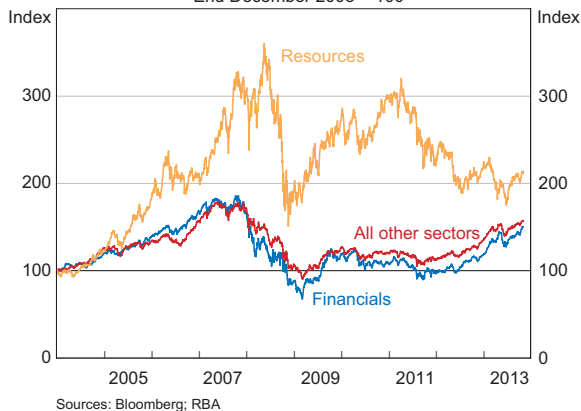
Equity Markets

Australian equity prices have increased by around 7 per cent since the last *Statement*, reaching a 5½-year high in October (Graph 4.21). Domestic equity prices have been supported by a broadly positive reaction to the local profit reporting season in August and better-than-expected Chinese economic data. Market sentiment responded positively to the US Federal Reserve's decision in September not to commence the tapering of its asset purchase program. Australian equities generally outperformed US equities over the past three months.

Graph 4.21
Share Price Indices
End December 2002 = 100



Graph 4.22
Australian Share Price Indices
End December 2003 = 100



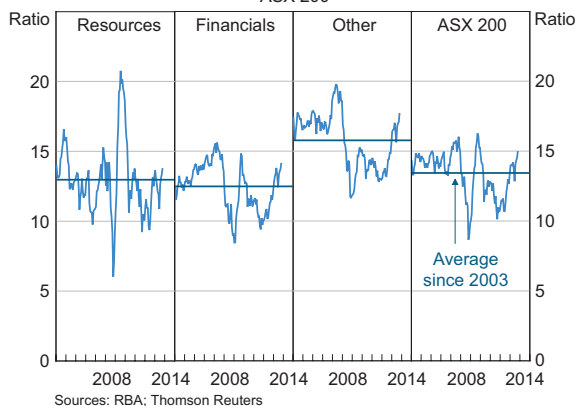
Resource sector share prices have risen by 8 per cent since the previous *Statement* and by around 23 per cent since the equity market trough in late June. They have been supported by positive September quarter production reports as new capacity has come on line, and the recovery in the prices of base metals (Graph 4.22).

Financial sector share prices have increased by 9 per cent since the previous *Statement*, with domestic bank valuations benefiting from a rise in bank share prices globally. Share prices in other sectors have risen by 4 per cent, largely due to strength in the more cyclical sectors.

Similar to international markets, the option-implied volatility of Australian equities has been little changed in recent months despite the market's reassessment of the future path of US monetary policy and the political disagreement over US fiscal policy.

The valuation of Australian equities, as measured by forward price-earnings (PE) ratios, has risen since the last *Statement* and these measures are now above their averages of the past decade across all three broad sectors (Graph 4.23). Valuations have increased as a result of both the increase in equity prices and small downward revisions to earnings expectations in some sectors.

Graph 4.23
Australian Forward Price-earnings Ratios
ASX 200



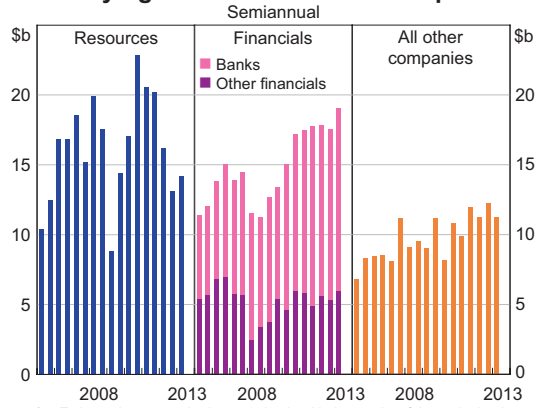
ASX 200 companies reported their June half 2013 earnings results during August. In aggregate, underlying earnings, which exclude the impact of non-recurring items, were marginally lower than in the same period last year, but rose by 3½ per cent over the December 2012 half.

Resource sector profits increased by 8 per cent in the first half of 2013 as companies continued to bolster revenues by containing costs and increasing production and sales volumes (Graph 4.24). However, underlying earnings are 12½ per cent below the same period in 2012 owing to the impact of lower commodity prices, particularly for iron ore.

Underlying profits in the financial sector rose by 11½ per cent in the half year to June 2013. As noted previously, this mainly reflected the improvement in operating conditions for banks. Underlying earnings of corporations outside the resources and financial sectors declined by 8½ per cent from the December half, to be around their levels of a year ago.

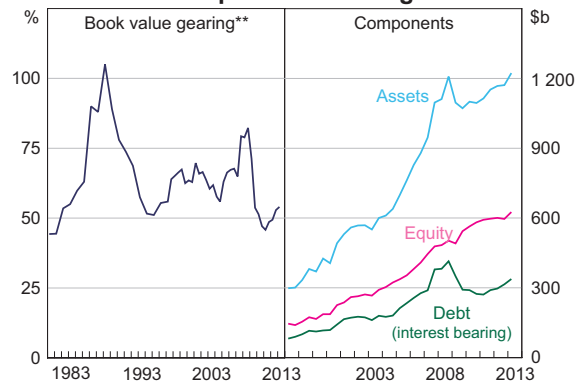
Listed corporations' balance sheets expanded by 4½ per cent over the first half of 2013, partly due to the depreciation of the Australian dollar increasing the value of assets held offshore (Graph 4.25). At the same time, the depreciation of the currency contributed to a shift in the reported funding mix towards debt, as foreign currency-denominated debt was revalued. Bond issuance by resources companies, that can currently access debt markets on relatively favourable terms, also resulted in higher aggregate corporate debt. Balance sheet equity rose by 4 per cent over the half year as an increase in profits boosted retained earnings, though this was partially offset by large asset writedowns in a small number of resources companies. As a result of these developments, and largely reflecting the impact of the depreciation of the Australian dollar, gross book value gearing of Australian corporations increased by 1½ percentage points to 57 per cent.

Graph 4.24
Underlying Profits of ASX 200 Companies*



* Estimated on a matched sample basis with the results of the major banks and Macquarie Group rolled forward
Sources: Morningstar; RBA; company reports

Graph 4.25
Listed Corporates' Gearing Ratio*



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