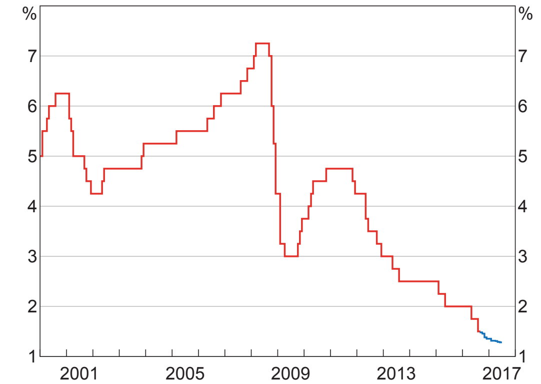
4. Domestic Financial Markets

Conditions in domestic financial markets continue to support the financing of the household and business sectors. The cash rate target was reduced at the August Board meeting, and housing and business lending rates have declined. Australian government bond yields have fallen to historic lows in line with global developments. Yields on bonds issued by domestic banks and non-financial corporations have also declined, and banks have been able to raise ample funding in wholesale debt markets. In contrast, non-financial corporate bond issuance has remained subdued, particularly in the resources sector. Despite historically low interest rates, growth in credit extended to households and businesses has slowed in recent months. Equity prices have picked up from their lows earlier in the year, with resources sector share prices rising in response to higher commodity prices.

Graph 4.1
Cash Rate*



* Data from September 2016 onwards are expectations derived from interbank cash rate futures

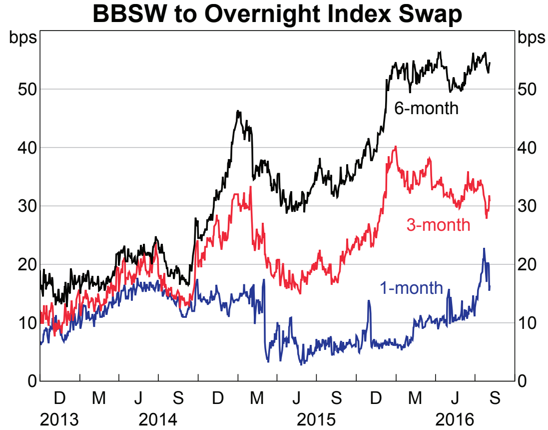
Sources: ASX; Bloomberg

Money Markets and Bond Yields

The Reserve Bank Board lowered its target for the cash rate to 1.50 per cent at its August meeting. Rates on overnight indexed swaps (OIS) suggest that the cash rate is expected to be reduced again in the year ahead (Graph 4.1).

Since the start of the year, 3- and 6-month bank bill rates (BBSW) have moved broadly in line with OIS rates (Graph 4.2). In contrast, the spread between 1-month bank bill rates and OIS rates has risen. However, the 1-month bank bill market has become a less significant source of bank funding since the introduction of the Liquidity Coverage Ratio in 2015, which reduces the attractiveness to banks of very short-term wholesale funding.

Graph 4.2
BBSW to Overnight Index Swap



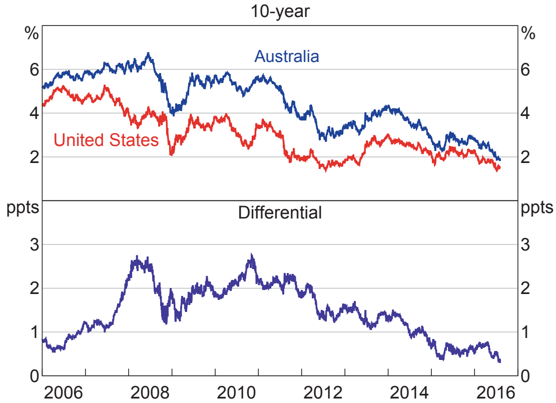
Sources: AFMA; Tullett Prebon (Australia)

Secured rates in the repurchase agreement (repo) market have also risen relative to OIS rates in recent months. This widening appears to reflect heightened demand for secured funding from market participants responding to arbitrage opportunities in the bond futures and foreign exchange (FX) swap markets. Bond futures have been trading at higher implied prices than the basket of bonds that underlie the futures and, in response, some investors have sold the futures and bought the bonds using repo funding. In the FX swap market, Australian dollars can be lent against yen at a relatively high implied Australian dollar interest rate; in response, some investors have been borrowing Australian dollars under repo to lend against yen in the swap market at a higher interest rate.

Yields on 10-year Australian Government Securities (AGS) reached a historic low of 1.82 per cent in early August alongside the decline in global bond yields. AGS yields have continued to be largely influenced by movements in US Treasuries, although the spread between the two has narrowed in recent months (Graph 4.3). Despite large intraday movements in prices on the day of the UK referendum result, and much greater than normal volumes, market functioning was very orderly (see Box C: 'Australian Financial Markets and the UK Referendum').

Standard & Poor's (S&P) revised its outlook on Australia's AAA sovereign credit rating from stable to negative, reflecting its view that prospects for fiscal consolidation have weakened. There was minimal market reaction to S&P's announcement.

Graph 4.3
Government Bond Yields
10-year



Sources: Bloomberg; RBA

In line with the negative outlook S&P placed on Australia's sovereign credit rating, the AAA ratings of New South Wales, Victoria and the Australian Capital Territory were revised to a negative outlook. S&P also announced that the major banks' credit ratings would be lowered by one notch in the event that Australia's sovereign rating was downgraded, since the banks benefit from S&P's assumption of implicit government support.

The Australian Office of Financial Management (AOFM) has announced plans to issue around $60 billion of AGS in the 2016/17 financial year in net terms, which would see total AGS rise to around $430 billion (25 per cent of GDP) at the end of June 2017. Recent AGS auctions have been well received and there appears to be considerable offshore demand for Australian bonds. State and territory governments ('semis') issued around $35 billion in bonds in the 2015/16 financial year. Taking into account the $40 billion in maturities over the same period, the stock of semis bonds outstanding fell to $237 billion at the end of June. Funding requirements for the 2016/17 financial year are expected to be modest compared to recent years, although this depends on the timing and realised prices of planned asset sales.

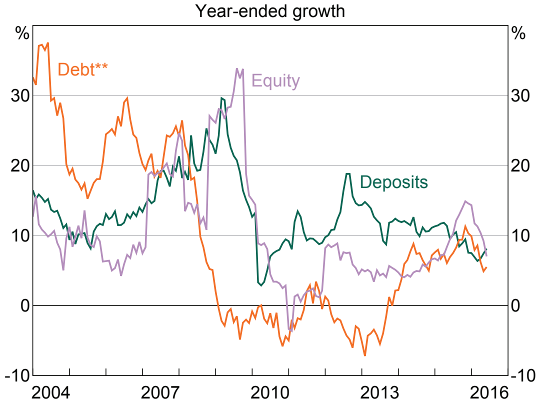
Bond issuance by non-residents in the domestic market ('Kangaroo' issuance) has totalled $20 billion in the year to date. In addition to ongoing issuance by supranational institutions, foreign sovereigns and agencies, US corporations have been able to issue large deals, with Apple and Coca Cola raising a combined $2.4 billion this year. Secondary market spreads to AGS for AAA rated issuers are slightly wider than in late 2015.

Financial Intermediaries

Growth in banks' balance sheets has slowed over the past 6 months, mainly reflecting a slowing in deposit growth. Growth in wholesale debt and equity also declined following a pick-up in these funding sources last year (Graph 4.4). Deposits have remained close to 60 per cent of total funding (Graph 4.5).

Graph 4.4
Banks' Funding Liabilities*

Year-ended growth



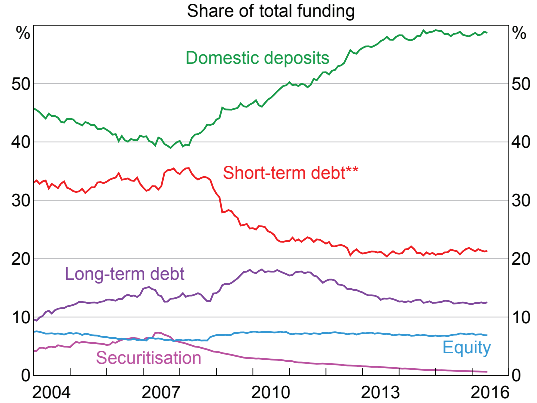
* Adjusted for movements in foreign exchange rates

** Includes long-term debt, short-term debt and securitisation

Sources: APRA; RBA

Graph 4.5
Funding Composition of Banks in Australia*

Share of total funding



* Adjusted for movements in foreign exchange rates; tenor of debt is estimated on a residual maturity basis

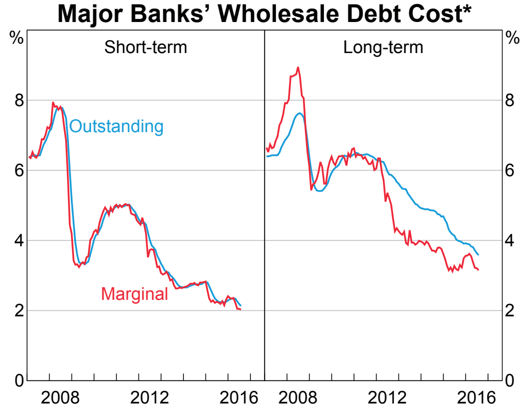
** Includes deposits and intragroup funding from non-residents

Sources: APRA; RBA; Standard & Poor's

A factor that is likely to influence the composition of banks' balance sheets over the period ahead is the introduction in January 2018 of the Net Stable Funding Ratio (NSFR) as part of the Basel III liquidity reforms. The NSFR is designed to encourage banks to maintain a stable funding profile in relation to the composition of their assets and off-balance sheet activities. This may encourage banks to utilise more stable sources of funding such as retail deposits and long-term debt and encourage less use of short-term wholesale debt. Consistent with this, some banks recently announced increases in term deposit rates for terms over 12 months. The NSFR may also influence the composition of banks' assets, given that unsecured lending to businesses and households generally requires more stable funding than housing-secured lending.

Estimates of the major banks' average debt funding costs declined following the May cash rate reduction, but by a little less than the cash rate, mainly reflecting upward pressure on wholesale funding costs. There had also been some upward pressure on the cost of term deposits. Nevertheless, the cost of new issuance by banks of both short- and long-term debt has recently been below the cost of outstanding debt (Graph 4.6).

Graph 4.6
Major Banks' Wholesale Debt Cost*

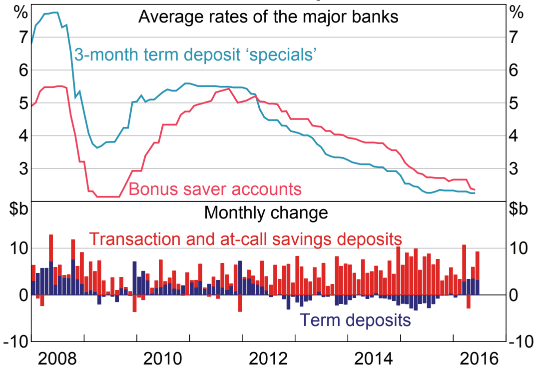


* Funding costs model estimates; rates do not include interest rate hedges

Source: RBA

Competition for term deposits has increased a little in the past few months. The May cash rate reduction was largely reflected in lower advertised deposit rates, but term deposit rates remained little changed. Following the August cash rate reduction, the average interest rate banks will be offering on term deposit 'specials' for terms of 12–36 months will increase to around 3 per cent. Deposits of this maturity currently account for less than 2 per cent of total funding. With the interest rates on term deposits not declining in line with other deposit rates, strong growth has been recorded in term deposits more recently (Graph 4.7).

Graph 4.7
Household Deposits

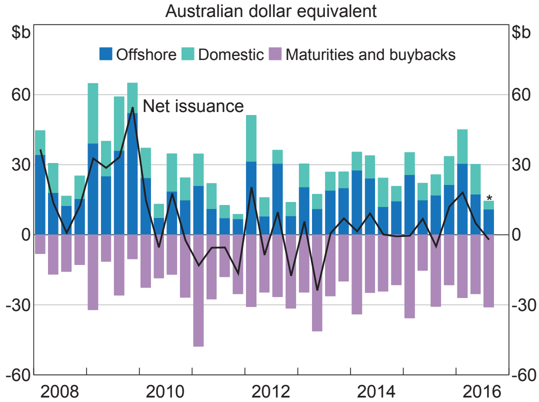


Sources: APRA; Canstar Cannex; RBA

Australian banks have issued a relatively large amount of debt this year (Graph 4.8). In the year to date, $90 billion of bank bonds have been issued; taking bond maturities into account, net bank bond issuance has been $21 billion. Bank bond yields in the secondary market are around historical lows, while spreads to benchmark rates are a little wider than at the start of the year (Graph 4.9).

Graph 4.8
Australian Banks' Bond Issuance

Australian dollar equivalent



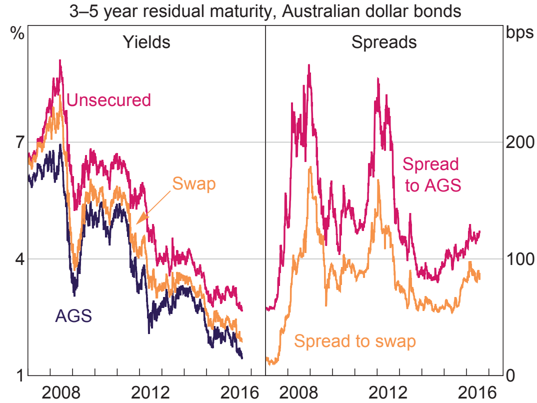
* Latest quarter issuance to date

Source: RBA

Hybrid issuance by Australian financial companies was large in the June quarter, driven by issuance by the major banks (Graph 4.10). The four major banks have each issued Basel III-compliant Additional Tier 1 (AT1) hybrids in 2016. This included the issuance by a major bank of an AT1 hybrid into the offshore market for the first time since 2009. The AT1 hybrid issuance

Graph 4.9
Major Banks' Bond Pricing

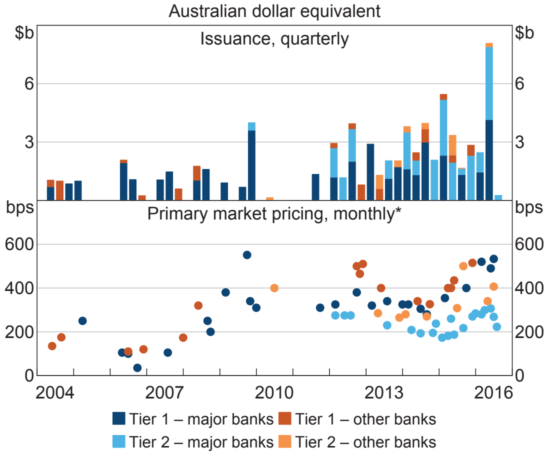
3–5 year residual maturity, Australian dollar bonds



Sources: Bloomberg; UBS AG, Australia Branch

Graph 4.10
Hybrid Issuance by Australian Banks

Australian dollar equivalent

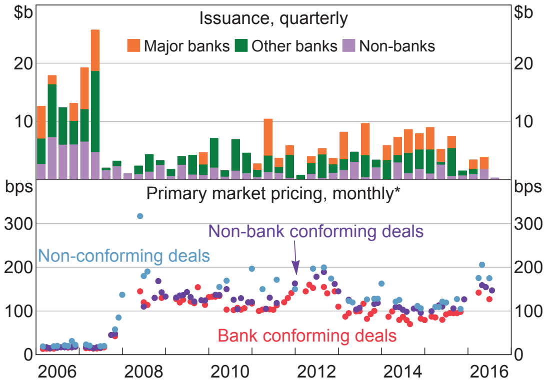


* Face-value weighted monthly average of the primary market spread to bank bill swap rate; foreign currency hybrids hedged back to Australian dollars assuming redemption on the first call date

Source: RBA

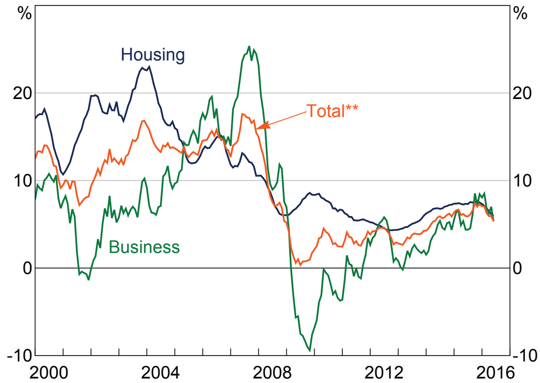
has been used by the major banks to replace existing hybrids. Tier 2 hybrids have been issued by a wide range of banks and insurance companies.

Activity in the asset-backed securities market remains low and primary market spreads to bank bills continue to be elevated (Graph 4.11). Recent issuance has included a large residential mortgage-backed securities (RMBS) deal from a major bank, and several deals from non-bank originators. There has been no issuance of other asset-backed securities since April.



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

Source: RBA



* Seasonally adjusted and break-adjusted; including securitisation

** Includes housing, personal and business credit

Sources: ABS; APRA; RBA

Financial Aggregates

Total credit growth has eased a little in recent months (Graph 4.12). Growth in housing credit has been below the pace seen in 2015, while business credit growth has moderated following strong growth earlier in the year. Credit has been growing at around the same pace as broad money (Table 4.1).

Household Financing

Housing credit growth has been steady at an annualised pace of around 6 per cent over the first six months of the year, which is a little slower than in 2015. Growth in credit to investors has remained around 4 per cent, while growth in credit to owner-occupiers has slowed a little. Net housing debt has continued to grow around 1¼ percentage points slower than housing credit due to ongoing rapid growth in deposits in mortgage offset accounts (Graph 4.13).

After falling through late 2015 and early 2016, the flow of new housing loan approvals has stabilised in recent months and is consistent with housing credit growth continuing at around its current pace (Graph 4.14). Some lenders have placed restrictions on lending to non-residents or borrowers reliant on foreign income, while some state governments have increased taxes and duties for foreign buyers. These changes will likely have only a small impact

Table 4.1: Financial Aggregates

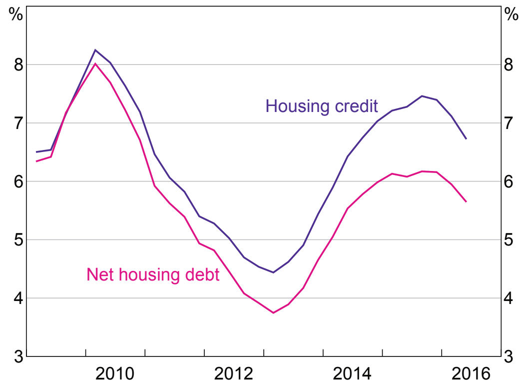
Percentage change[(a)]

	Three-month ended		Year-ended
	March 2016	June 2016	June 2016
Total credit	1.5	1.1	6.2
– Housing	1.5	1.4	6.7
– Owner-occupier	1.8	1.6	7.7
– Investor	1.1	1.1	5.0
– Personal	–0.3	–0.3	–0.8
– Business	1.7	0.8	6.6
Broad money	2.1	1.1	6.0

(a) Growth rates are break adjusted and seasonally adjusted

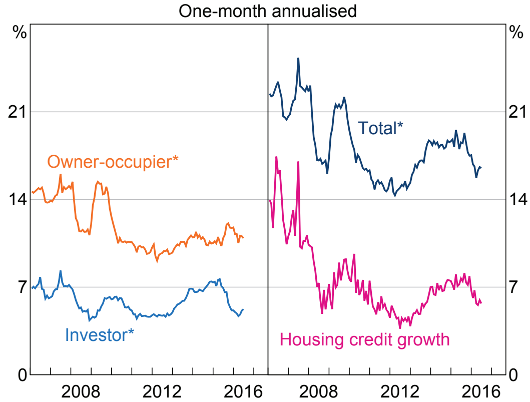
Sources: APRA; RBA

Graph 4.13
Housing Credit Growth*
Year-ended



* Seasonally and break-adjusted
Sources: ABS; APRA; RBA

Graph 4.14
Housing Loan Approvals and Credit
One-month annualised



* Seasonally adjusted and break-adjusted; net of refinancing; as a share of housing credit
Sources: APRA; RBA

on housing credit growth, as lending to this cohort represents a small share of total housing lending.

The slowing in housing loan approvals over the past year is consistent with the decline in turnover in the housing market. It also reflects slower growth in the average size of new loans and a decrease in the average loan-to-valuation ratio. This follows various measures introduced by the Australian Prudential Regulation Authority (APRA) to strengthen lending standards.

Some of the recent decline in the value of housing loan approvals may also reflect an increase in off-the-plan purchases. These transactions do not involve a mortgage at the time the dwelling is purchased off the plan, but add to the stock of housing credit when a mortgage is taken out by the purchaser upon the completion of the dwelling. Loans for the purpose of constructing new dwellings may be taken out by both households and businesses, although loans for the purpose of constructing large apartment blocks are typically undertaken by businesses. Loans drawn down by businesses for the purpose of constructing residential dwellings have grown very rapidly in recent years, consistent with the strong growth in building approvals for apartments.

The May cash rate reduction was passed through to most advertised housing lending rates. A number of lenders reduced fixed rates by more than variable rates, and some fixed rates have been lower than variable rates since the middle of last year (Table 4.2). Consistent with this, the share of loans being taken out at fixed interest rates has been elevated. The average outstanding housing interest rate declined by around 20 basis points and will decrease further following the August cash rate reduction and as fixed rate loans roll over to lower interest rates. The major banks have announced that they will pass through around half of the August cash rate reduction to their standard variable housing lending rates.

Business Financing

Over recent months, business credit growth has moderated and the issuance of debt securities by Australian companies has remained low, as reflected in the slowing in a broad measure of business debt growth (Graph 4.15). The easing in business credit growth is consistent with the decline in business loan approvals (Graph 4.16). This has been driven by slower growth in lending to some larger businesses and follows some lenders reporting an increase in non-performing large business loans. The reduction in business loan approvals has been apparent across

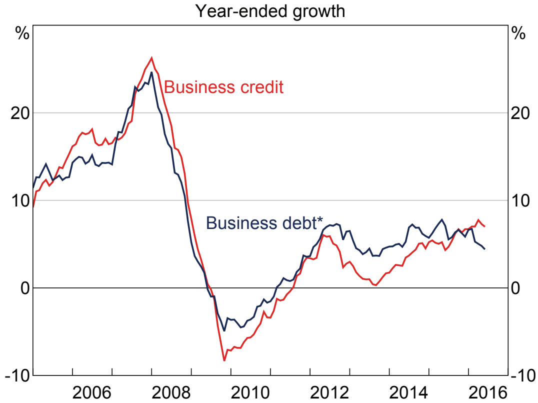
Table 4.2: Intermediaries' Fixed and Variable Lending Rates

Prior to the August cash rate reduction

	Interest rate Per cent	Change since April 2016 Basis points	Change since July 2015 Basis points
Housing loans			
– Standard variable rate[(a)(d)]			
– Owner-occupier	5.39	–24	–7
– Investor	5.63	–24	17
– Package variable rate[(b)(d)]			
– Owner-occupier	4.59	–24	–8
– Investor	4.83	–24	16
– Fixed rate[(c)(d)]			
– Owner-occupier	4.27	–16	–39
– Investor	4.48	–18	–18
– Average outstanding rate[(d)]	4.64	–22	–6
Personal loans			
– Variable rate[(e)]	11.32	–5	0
Small business			
– Term loans variable rate[(f)]	6.50	–25	–10
– Overdraft variable rate[(f)]	7.38	–25	–10
– Fixed rate[(c)(f)]	5.38	–6	0
– Average outstanding rate[(d)]	5.51	–19	–20
Large business			
Average outstanding rate[(d)]	3.76	–21	–20

(a) Average of the major banks' standard variable rates
(b) Average of the major banks' discounted package rates on new, $250 000 full-doc loans
(c) Average of the major banks' 3-year fixed rates
(d) RBA estimates
(e) Weighted average of variable rate products
(f) Residentially secured, average of the major banks' advertised rates
Sources: ABS; APRA; Canstar Cannex; RBA

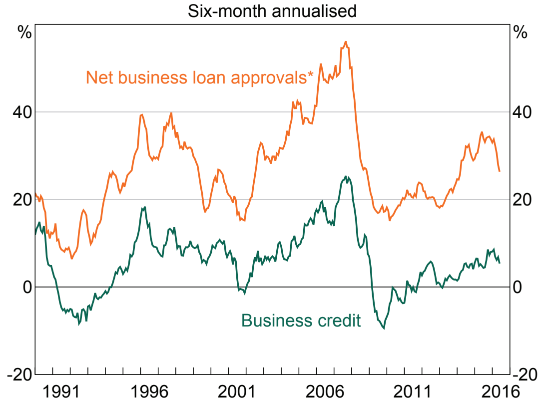
Graph 4.15
Business Debt
Year-ended growth



* Non-seasonally adjusted and non-break adjusted; includes RFI business credit, non-intermediated debt and an estimate of cross-border syndicated lending

Sources: ABS; APRA; Bloomberg; RBA; Thomson Reuters

Graph 4.16
Business Credit Growth and Approvals
Six-month annualised



* As a share of business credit

Sources: ABS; APRA; RBA

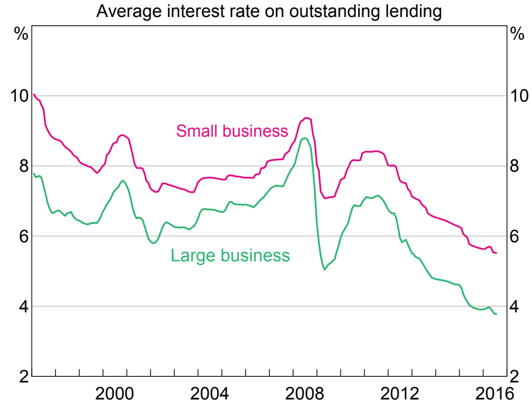
most industries, although it has been more prevalent in sectors in which lending grew more quickly in 2015, such as finance and insurance, manufacturing, and utilities and telecommunications. Some segments of lending remain strong, particularly fixed-term loan approvals for property and construction purposes. Both foreign and domestic banks have contributed to the easing in business credit growth, with the foreign bank share of business credit remaining steady in recent months.

Prior to the August cash rate reduction, business lending rates had declined by less than the cash rate. For large businesses, the pass-through of the cash rate reduction in May followed increases in business lending rates earlier in the year in response to higher spreads in non-intermediated credit markets (Graph 4.17). The average outstanding small business lending rate declined by around 15 basis points over the first half of the year; advertised small business lending rates were generally reduced by 25 basis points in May, partly offsetting increases in small business lending rates earlier in the year.

Bond issuance by Australian corporations remains relatively low with $11 billion issued in the year to date (Graph 4.18). This mostly reflects the continued absence of issuance by resource-related corporations. Spreads to AGS for resource-related corporations increased significantly through 2015 and early 2016; while spreads have eased in recent months, they remain elevated compared to the first half of 2015, when these corporations last engaged in substantial issuance (Graph 4.19). Spreads for other non-financial corporations have reversed the widening seen earlier in the year.

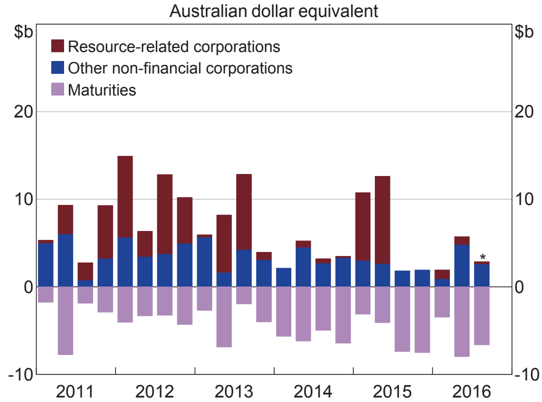
Equity raisings by non-financial corporations (including real estate companies) increased in the June quarter following limited activity earlier in the year. Mergers and acquisitions (M&A) activity has been elevated over the past 18 months, with around $27 billion in deals announced by listed companies so far this year.

Graph 4.17
Australian Business Lending Rates*
Average interest rate on outstanding lending



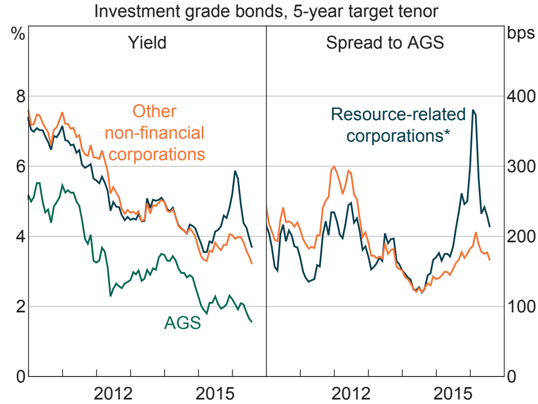
* RBA estimates
Sources: APRA; RBA

Graph 4.18
Australian Corporate Bond Issuance
Australian dollar equivalent



* Latest quarter issuance to date
Source: RBA

Graph 4.19
Australian Corporate Bond Pricing
Investment grade bonds, 5-year target tenor

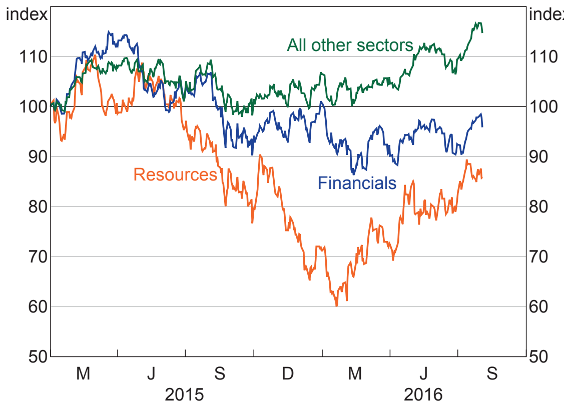


* Includes Origin Energy
Sources: Bloomberg; RBA; S&P Capital IQ

Equity Markets

Australian equity prices have largely followed movements in global share prices in recent months, falling following the UK referendum vote before recovering to be 3 per cent higher than at the start of the year. The rise in equity prices was broad based across sectors, although financials continue to underperform (Graph 4.20).

Graph 4.20
Australian Share Price Indices
End December 2014 = 100



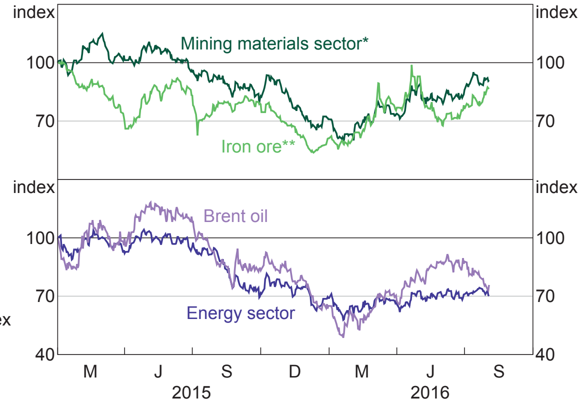
Source: Bloomberg

The resources sector has outperformed throughout the year to date as commodity prices have traded at higher levels compared with late 2015 (Graph 4.21). More recently, gold miners have been buoyed by higher gold prices amid heightened demand for safe haven assets.

Share prices for companies outside the financial and resources sectors are generally higher; utilities, healthcare, industrials and consumer discretionary have outperformed the broader market, while consumer staples were affected by earning downgrades and impairments.

Analysts' earnings expectations for the 2016/17 financial year have generally been revised lower over the past few months. However, resources sector earnings expectations have been revised higher alongside a sustained recovery in commodity prices.

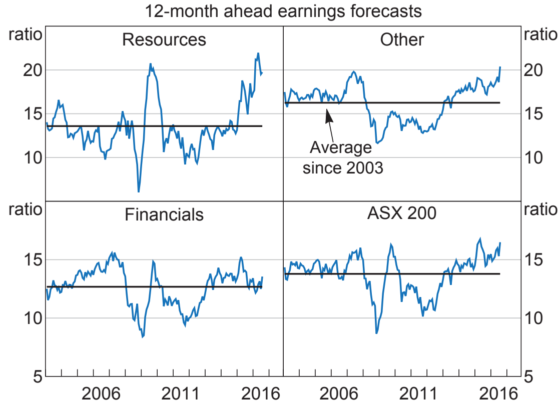
Graph 4.21
Resources Share Prices and Commodity Prices
End December 2014 = 100



* Derived from resources sector share prices
** Qingdao import iron ore spot price
Sources: Bloomberg; RBA

Valuations of Australian equities, as measured by forward price-earnings ratios, remain at or above their long-term averages across all broad sectors (Graph 4.22). Resources sector valuations remain well above long-term averages, reflecting low analysts' earnings expectations over the next 12 months. However, analysts are expecting an improvement in resources sector earnings over the coming years. ✠

Graph 4.22
ASX 200 Forward Price-earnings Ratios
12-month ahead earnings forecasts



Source: Thomson Reuters