Home Loan Rates

Fixing short terms for the long term.

- **Future OCR cuts are possible, but the impact on mortgage rates will be minimal.**
- **Short-term mortgage rates will remain low over 2009, but long-term rates have lifted significantly.**
- **Low floating and short-term rates are more appealing than higher long-term rates.**

We noted in the past couple of Home Loan Reports that it was around the point at which rolling into long-term rates was a good option ensure the dramatic plunge in rates got locked in for a considerable period. Financial market developments and the sheer volume of shifts into fixed-rate mortgages have driven long-term wholesale rates dramatically higher in a short space of time, closing the window on attractively-priced long-term rates very abruptly.

The trade-offs amongst mortgage rates have become more apparent: at the time of writing there is a 2.5 percentage-point difference between the 5.5% 6-month rate and 8% 5-year rate. Long-term fixed rates still offer a high degree of security, though at a high cost relative to very low short-term rates. Instead of the clearer option to fix for long terms at low rates borrowers now have to think through several possible options:

- *remain floating in case long-term rates subside to a degree;*
- *fix for a short term (e.g. 6 months or 1 year) to take advantage of the cheapest rates on offer;*
- *fix for the medium term (e.g. 2-3 years) at a relatively low rate to gain some certainty; or*
- *take the certainty of a long-term rate even if the rate is no longer as advantageous as it was recently.*

These options have different levels of risk, certainty, and cashflow benefits. Borrowers need to think about where their individual circumstances fit best against these three criteria.

OCR outlook: RBNZ holds and hopes for the best.

The Reserve Bank (RBNZ) held the cash rate steady at its June Official Cash Rate (OCR) Review. We are at or near the end of an amazing easing cycle in which the RBNZ has slashed the cash rate from 8.25% to today's 2.5%. The OCR is at its lowest rate since it was introduced in 1999.

In June, there were few surprises from the Bank. Financial market pricing had only a 1-in-3 chance of a rate cut built in. At the review the RBNZ acknowledged signs of so-called green shoots, noting international economic activity is stabilising and international financial conditions are improving. The RBNZ also noted the recovery in the housing market and net migration. Nonetheless, the RBNZ continued to emphasise the weak economic outlook and see risks remain weighted to the downside.

The RBNZ acknowledged the tightening in monetary conditions over recent months via the higher NZ dollar and long-term interest rates. The RBNZ notes that much of the drivers are from overseas. Critically, the RBNZ seems resigned to these developments – there is little evidence of any desire to directly combat them.

We see two key influences on the OCR outlook: downside risk to the RBNZ's economic outlook, but some acceptance that there is little the RBNZ can do about tighter monetary conditions except hope that they abate. We still judge there is some chance of further OCR cuts, but increasingly that likelihood rests on when the RBNZ changes its view on the longer-term outlook for the NZ dollar. That won't happen immediately. We expect another pause in July, and have pencilled in two 25bp cuts in for September and October, although these are heavily dependent on the NZ dollar. Further cuts would help reinforce the message interest rates will remain low for an extended period of time, though will do little to push mortgage rates lower.

Implications.

With the OCR now very low, its effectiveness on lending rates depends on the extent to which bank funding costs fall. Retail deposit rates are sticky: regardless of the OCR level, deposit rates have to be high enough to continue to keep money flowing into banks - and ultimately depositors determine that through their actions. For this reason the impact of the April OCR cut on mortgage has been blunted. Short-term rates are low, but did not dip further after the 30 April cut, and long-term mortgage rates have risen over the past 2 months.

The RBNZ have removed some panic from the market by stating in both April and June it expects "to keep the OCR at or below the current level through until the latter part of 2010." Short-term rates are unlikely to lift any time soon if this statement holds true.

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Although short-term mortgages could get a little lower than today's levels, we expect they may have bottomed. For longer-term rates, the upward drift has already started. We are most likely past the low point for mortgages such as the 5-year term. There might be some scope in the future for lower long-term rates over time, depending on the lasting impact of the RBNZ's current and future actions and whether the recent lift in global long-term rates also abates. However, longer-term rates are more at the mercy of the huge amount of government debt that is going to be issued both here and abroad. The risk is these rates keep rising. The choice of fixing vs. floating will remain a trade-off between the certainty of fixed rates and the low debt-servicing costs in the immediate future of floating rates. In April, and again in June the RBNZ provided a little more certainty over how long the benefits of floating rate debt will be sustained.

What next?

For borrowers it is certainly time to sort out your loan strategy for the next few years. We expect little movement for short-term rates. Floating rates are likely to remain around the low 6-6.5% range over the coming months. For longer-term rates, the picture is more complicated. Fixed term mortgage rates have been rising for the long terms - particularly the 5-year rate.

In early 2009, rolling floating loans into longer terms was a good strategy to ensure that the dramatic plunge in rates got locked in for a considerable period. But long-term rates have risen noticeably since March. As rates stand at the end of June, the decision on what mortgage term to choose is not clear cut. Borrowers now have to think through several possible options:

- remain floating in case long-term rates subside to a degree;
- fix for 6-12 months to get low debt servicing costs for a period;
- fix for a medium term (e.g. 2-3 years) to get some certainty at a relatively low rate; or
- take the certainty of a long-term 4-5 year rate even if it the rate isn't particularly low.

These options have different levels of risk, certainty, and cash flow benefits. Borrowers need to think about where their individual circumstances fit best against these three criteria.

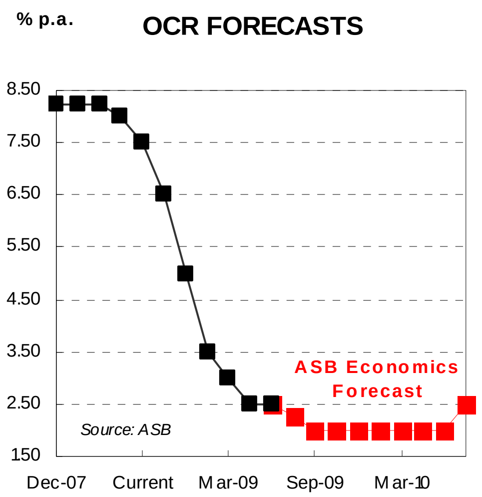
Based on our mortgage rate forecasts, rolling 6-month or 1-year mortgages for sequential terms looks like the cheapest strategy for the next few years (e.g. our forecast for the interest rate on four sequential 6-month terms is lower than the current 2-year mortgage rate, and the forecast for 5 sequential 1-year mortgages is cheaper than the current 5-year mortgage rate). However, the strategy comes with one key risk; if short-term mortgage rates rise faster and/or sooner than we are forecasting, the strategy may not pay off. Given the rapid, and somewhat unexpected mortgage rate rises lately, we cannot dismiss this risk.

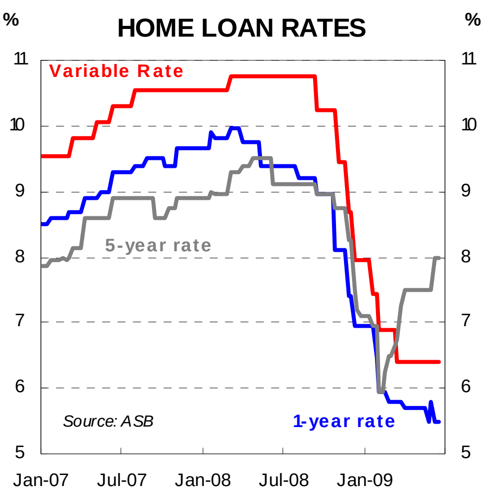
Splitting borrowing across terms is one way to hedge your bets to get a sampling of low debt servicing, some flexibility, and certainty over a portion of debt. The RBNZ's last two statements suggest there is no rush to fix, as floating rates will remain low for some time. Furthermore, it is quite possible long-term fixed rates remain substantially higher than short-term rates for a sustained period. This is another consideration to keep in mind.

The rates for all terms out to 4 years are low compared to long-run averages – particularly for the shorter terms. The 5-year mortgage, at 8% sits right on its long-term average. But choosing a term for fixing a mortgage is an important decision, not only influenced by the interest rate, but also future personal circumstances.

Which mortgage rate turns out to be the 'best' will only really be known with hindsight.

As it always is the case, the only certainty about the future is that it is uncertain. Which mortgage rate turns out to be the 'best' will only really be known with hindsight. We are certainly in a difficult time for many businesses and households, and the outlook for early 2009 remains challenging. However, easier monetary conditions are one of the factors providing some buffer from the global slowdown, as well as a seed of eventual recovery.





Outlook for long-term rates

We expect long-term rates are unlikely to revisit their lows of early 2009. Moreover, long-term rates are likely to be more expensive than short-term rates for a period of time, a change from the state of play in prior years. The greater certainty of long-term rates now comes with a cost. That is the more normal state of affairs and, in the midst of the uncertainty of a global credit crisis, paying others to bear your uncertainty carries a much higher cost around the world than it used to.

Potential downward influences on long-term interest rates are:

- In the short term, possible subsidence of the pressures in wholesale markets as fixing flows slow up;
- The RBNZ judges the economy will be weaker for longer and cuts the OCR below 2.5%, which would have a muted but downward effect on long-term rates;
- A renewal of concern over the state of the global economy after the recent burst of relative optimism;
- Strong downward impact on long-term rates if central banks step up buying of long-term securities in an explicit attempt to reduce interest rates.

Potential upward influences on long-term interest rates are:

- The NZ economy recovers over the remainder of 2009, in which case speculation of further interest rate cuts would dry up and focus would swing towards when the RBNZ would lift rates;
- Risk appetites strengthen further once investors anticipate that the global economy is past the worst, with funds flowing from safe havens (e.g. interest rate products) back into risk assets (e.g. equities);
- The flood of government bond issuance globally, particularly in the US but also in NZ.

Other considerations and ideas.

The sharply-sloped positive mortgage rate curve (where long-term rates are higher than short-term rates) at the moment means fixing a mortgage requires the more normal trade-off between shorter terms providing a very low interest rate in the here and now against long-term rates providing greater certainty – but at a higher price.

Borrowers now have to think through several possible options and scenarios outlined in this article. Choosing a term for fixing a mortgage is an important decision, not only influenced by the interest rate, but also future personal circumstances. Breaking fixed mortgages can be an expensive exercise for borrowers and banks alike, so choosing the correct term before fixing is very important.

We are certainly in a difficult time for many businesses and households, and the outlook for early 2009 remains challenging. We stress that life is highly uncertain at present and can literally change overnight. It would pay to keep an eye on our Economic Weekly to keep up with events, particularly thoughts on the OCR outlook. There is no one 'right answer' for selecting a mortgage term, or choosing whether or not to keep floating.

The following sections take you through some advantages and disadvantages of various fixed rate terms.

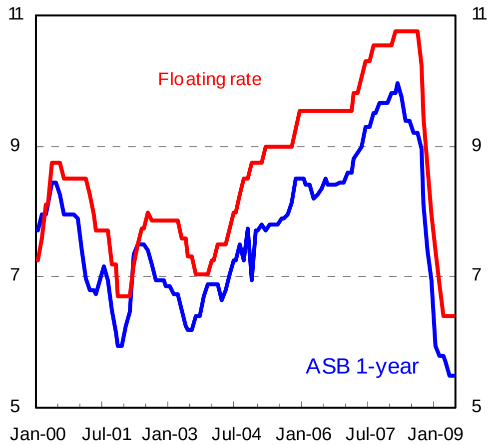
The main **advantages** of the 1-year rate are:

- An immediate saving compared to a floating mortgage, as a 1-year mortgage is typically lower than the floating rate.
- Along with the 6-month rate it is the lowest rate on offer at present.
- Our forecast for sequential 1-year mortgages is cheaper than the current 2-year through to 5-year mortgage rates. Forecasts aside, in fixing for 1 year at 5.5%, you will only do worse than fixing for 5 years if the borrowing cost for the following 4 years averages above 8.6%. Our forecast is for future mortgage rates to remain below this level.

The major **disadvantages**:

- Slightly longer terms will provide the benefit of low rates for longer, on the assumption the RBNZ will look to raise the OCR at some point in 2010. If the RBNZ raises interest rates faster than we are forecasting, longer-term mortgages may prove cheaper than sequential 1-year mortgages.
- Conversely, should rates drop further than the RBNZ's latest outlook suggests, you are locked into a higher rate than otherwise for 12 months. However, we see only a small possibility to borrow at an even lower rate over the coming months. If the economic outlook pans out worse than expected, and the RBNZ takes the OCR below 2.5%, lower short-term rates *may* become available.

1-YEAR HOME LOAN RATE



The 1-year fixed rate would suit those who prefer some interest rate certainty, but place some priority on low debt servicing costs, or those who will be repaying their debt over the 12-month timeframe.

The 2-year fixed rate currently offers the **advantages**:

- It is around the average Variable Home Loan rate forecast by ASB for the next 24 months, with the added advantage of surety for a longer period than the shorter-term fixed rates.
- At 6.25%, the two year rate is not the cheapest available rate, but it is significantly cheaper than longer terms, and is well below the average 2-year mortgage over the past 10 years (7.8%).

The **disadvantages**:

- The current 2-year rate, at 6.25% is higher than our current 1-year rate, of 5.5%, combined with our expectation of the 1-year rate available in 12 month's time (6.3%). A 2-year rate would only prove cheaper than rolling a 1-year rate if the 1-year rate in a year's time exceeded 7.7%.
- Missed opportunity for lower rates should rates decline over the coming months.
- The risk of higher rates after the fixed term, assuming global economic conditions stabilise in line with expectations. By June 2011 we expect the RBNZ will be well into a tightening cycle, and floating rates will be around 8%, and all term mortgages will be over 7%.

The 2-year fixed rate would again suit those who prefer a degree of interest rate certainty in the near-term at a relatively low rate, or those who will be repaying their debt over the 24-month timeframe.

The 3-year fixed rates currently offer the **advantages:**

- Providing interest rate surety for longer.
- The opportunity to lock in rates which are below average or typical during normal economic conditions.
- The rates available now are well below what we would expect over the next 5 to 10 years.

The **disadvantages**:

- Missed opportunity for lower rates should rates decline over the coming months.
- The risk of higher rates after the fixed term, assuming global economic conditions stabilise in line with expectations.
- Not necessarily providing lower interest costs over its lifespan than shorter terms might.

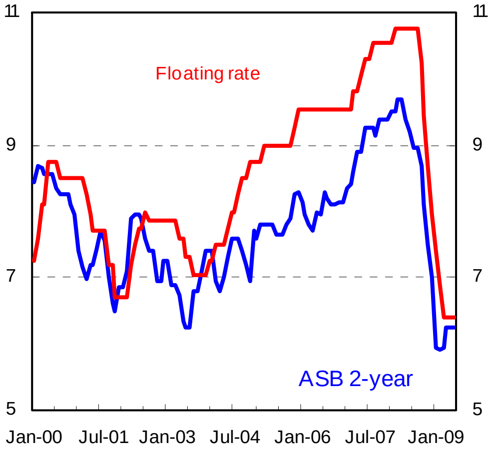
The 5-year fixed rate currently offers this **advantage**:

- It around the average level for the 5-year term rate available over the last 10 years, so in this sense, remains relatively reasonable. The rate offers certainty for a much longer period than the shorter-term fixed rates.

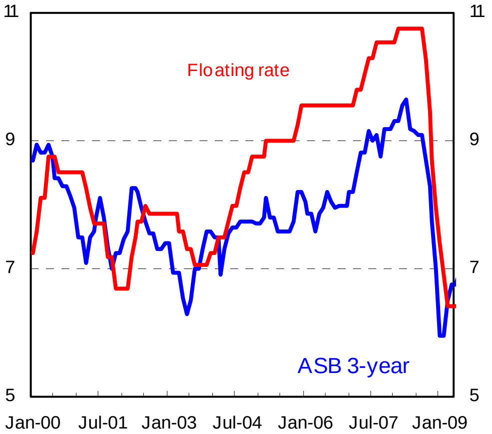
The **disadvantages**:

- It is above the average Variable Home Loan rate forecast by ASB for the next 60 months.
- Missed opportunity for lower rates should rates decline over the coming months.
- It is now significantly higher than the shorter-term rates on offer, and higher than the variable rate.

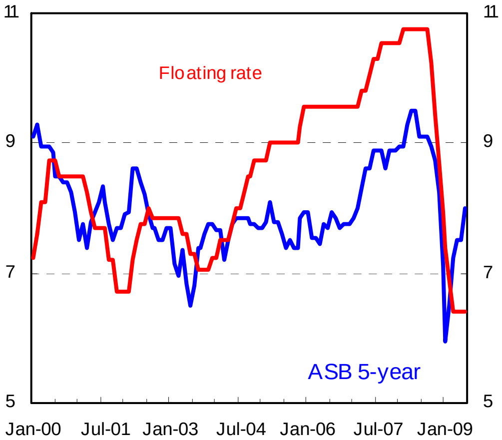
2-YEAR HOME LOAN RATE



3-YEAR HOME LOAN RATE



5-YEAR HOME LOAN RATE



At around 8% it may no longer be the cheapest option over the next 5 years to shorter terms, in contrast to the case when the 5-year rate was still in the 6+% region a few months' ago

We emphasise that there is an explicit trade-off if choosing the current 5-year fixed rate.

The 5-year rate is higher than our forecasts for sequential 6-month or 1-year terms, and slightly higher than our forecasts for sequential longer-term mortgages. As an example of the tolerances, fixing for 5 years at 8% would give roughly the same outcome over time as fixing now for 2 years at 6.25% then re-fixing for 3 years at around 9%. We do not expect the 3-year mortgage rate will be as high as 9% in 2 years time. What the 5-year term provides is *certainty*, particularly if interest rates rise quicker, or to higher levels, than our current forecasts suggest. This certainty now comes at a higher cost than it did.

The term for fixing a mortgage is not only influenced by the interest rate, but also future personal circumstances. Breaking fixed mortgages can be an expensive exercise for borrowers and banks alike, so choosing the correct term before fixing is very important. Longer-term rates would suit those who foresee interest rates returning to normal levels within the next few years, and want to lock in below-average rates now. Longer terms also suit those who do not see a need to restructure their finances over the loan term.

Just remember the only certainty about the future is it is uncertain. Which mortgage rate turns out to be the 'best' will only really be known with hindsight. But with the above pros and cons for the various mortgage rates on offer we hope to give you a good platform from which to consider what interest rate option appears most suitable for your personal circumstances.

Feel free to phone the ASB Home Loan Line at 0800-100-600 to talk through these issues with ASB staff.

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