

Home Loan Rates

Upward creep likely to continue.

- The RBNZ has signalled its intention to keep the OCR low well into 2010.
- In contrast, there has been a steady upward march in long-term fixed mortgages.
- Borrowers face a trade off: certainty of fixing long-term vs. the benefit of lower short-term rates.

Despite the RBNZ's signalled intention to keep the OCR low well into next year, there has been a sustained upward creep in long-term fixed mortgage rates. Talk from the RBNZ is no match for global interest rate dynamics. The lift in fixed-term rates is likely to continue over time, compounded by the impact of the RBNZ's liquidity policy. Although short-term rates are likely to remain low into 2010, the cost of fixing for 1 year or more will progressively creep higher.

For borrowers the trade-off between the certainties of fixing vs. benefiting in the interim from low short-term rates is becoming more polarised. For borrowers wanting some degree of certainty the better options appear around the 2 year mark (3 years at a stretch): these rates are still below average, in contrast to the longer-term rates. Borrowers who place a high priority on keeping their debt-servicing costs low in the short-term, while accepting that future debt-servicing costs will rise sharply, would find a term of around 1 year more suitable to their needs. Given the uncertainties about the economic and interest rate environment some borrowers might consider spreading their maturities out. Each borrower's situation is unique, so it comes down to the individual weighing up their own requirements.

Making sense of interest rates

RBNZ keeps the OCR low...

...but long-term rates surge.

The RBNZ implied OCR will remain low for roughly another year.

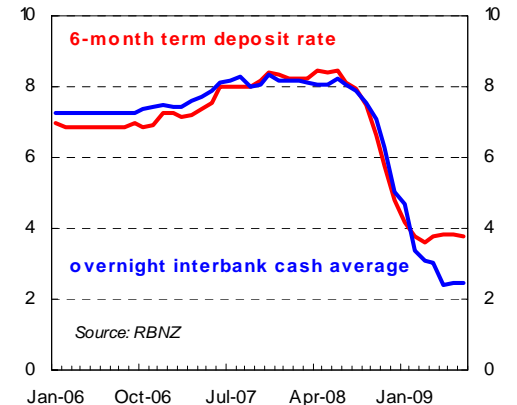
The RBNZ repeatedly says it expects to keep interest rates low until 'the latter part of 2010'. Nevertheless, long-term interest rates have surged dramatically over the past 6 months. There are a number of domestic and global influences acting like a tug of war.

Short-term rates only weakly anchored down

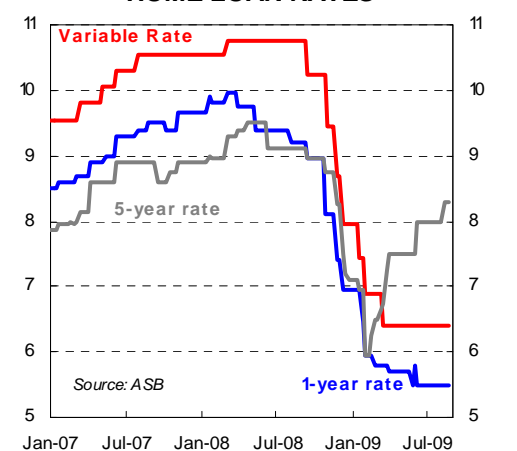
The RBNZ has implied it will keep the OCR low for roughly another year. That will provide some anchor for short-term mortgage rates. However, the RBNZ has lost its ability to push short-term mortgage rates down. Short-term rates are being dictated by depositors: deposit rates will be as high as is required to provide banks with sufficient funding to maintain lending. Rather than following the OCR down, deposit rates are now significantly higher than the OCR. Consequently, short-term mortgage rates have hit a barrier that further OCR cuts would struggle to push through.

A further challenge the RBNZ faces is that financial markets are pricing in an earlier start to OCR increases than the RBNZ's words imply. Market pricing in part reflects the improved global sentiment, including signs that economies are starting to stabilise.

NZ TERM DEPOSIT AND OVERNIGHT CASH RATES



HOME LOAN RATES



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General Advice Warning

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In Australia, for example, there is a growing expectation that the Reserve Bank of Australia will lift interest rates later this year or early next year given how well the economy there has held up. Shifts in Australian wholesale interest rates have affected NZ short-term rates.

Despite these influences, by holding the OCR low for a period the RBNZ will still have some ability to contain short-term interest rates.

Long-term rates on global express

However, the RBNZ has limited control over global trends that affect NZ, highlighted by the rapid lift in long-term mortgages over the past 6 months. Globally long-term interest rates have risen for several reasons. First, risk appetites have been recovering, so money has started to flow out of safe havens such as government bonds, pushing their yields up. The expectation that low policy rates will eventually be lifted is contributing to higher interest rates. In addition, the sheer amount of government term debt issuance looming around the globe has contributed to the upward pressure as investors focused on the possibility of yields being pushed up in the future if the debt issuance becomes difficult to digest.

All these factors have dominated attempts by the US Federal Reserve and Bank of England to contain long-term interest rates by purchasing long-term debt securities. NZ long-term interest rates, paid by the Government and banks alike, have been driven up. NZ is competing to get its share of a hotly-contested pool of global savings.

The influences above mean it is very likely that short-term rates remain lower than long-term rates even after the RBNZ eventually lifts the OCR back to a more normal level.

RBNZ liquidity policy

The RBNZ's new liquidity policy is not helping its desire to hold interest rates down. The policy will encourage banks to put great weight on retail deposits and long-term wholesale funding, at the expense of more fickle short-term wholesale funding.

The irony is that, at present, offshore short-term funding is very cheap now that the impact of the financial crisis has moderated. Banks will increasingly rely on the more expensive sources of funds, which will add further pressure to banks' funding costs.

The focus on reducing exposure to short-term wholesale funding is entirely appropriate, and also what banks have been steadily doing since the financial crisis began 2 years ago. However, with the RBNZ expecting the first stage of the liquidity policy to be met from the end of September, this prudential policy is not making the job of monetary policy any easier. Depositors, however, will continue to benefit from the very vigorous "deposit war".

Implications

The battle of global forces on interest rate trends is being dominated by improved perceptions of the global economy, huge volumes of ongoing government and private-sector term debt issuance, and a whiff of inflation fears. Even attempts by the US Federal Reserve and Bank of England to counter the trend have at best blunted rather than prevented it. Over the next year term rates are likely to continue trending up, though more noticeably around the 1- and 2-year mark as the day of eventual OCR increases moves closer.

There is still some chance RBNZ cuts further, though we are in a distinct minority in even raising the possibility. However, the impact of an OCR cut on borrowing rates would likely be modest – we see a cut being more about slowing the upward creep in the NZD and interest rates than about dragging borrowing rates down.

The September OCR decision will be a watershed. If the RBNZ does in fact cut, it might provide a (probably brief) opportunity to fix. But no action from the RBNZ will be a strong signal that, despite the RBNZ's repeated concerns about the rising NZD and interest rates, it is not prepared to take any action to stem the trend.

For anybody who is considering fixing their debt but has yet to do so, the next month is a time to think hard about your requirements. The opportunity to fix at relatively low rates has been gradually disappearing month by month. It is hard to envisage a scenario in which term rates will become significantly more attractive. But whether it is appropriate to lock in a long-term fixed rate or stick to the cheap rates (i.e. 12 months or less) will depend on your individual priorities. Key amongst those is how much you value the certainty of term rates against the ability in the short term to benefit from very low debt-servicing costs and some degree of flexibility.

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 9%. 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 little chance for borrowing 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.

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 12 months, with the added advantage of surety for a longer period than the shorter-term fixed rates.
- At 6.55%, the two year rate is not the cheapest available rate, but it is significantly cheaper than longer terms, and is below the average 2-year mortgage over the past 10 years (7.8%).

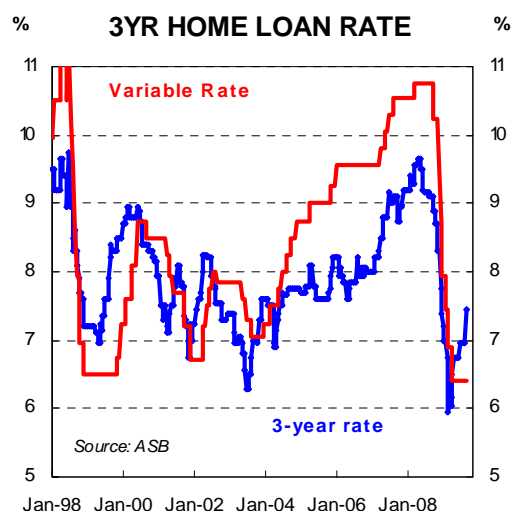
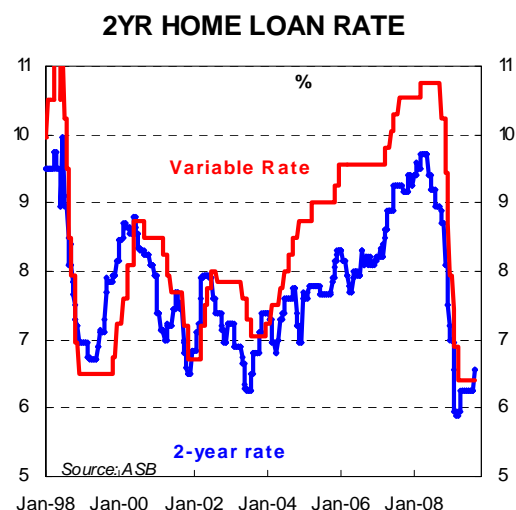
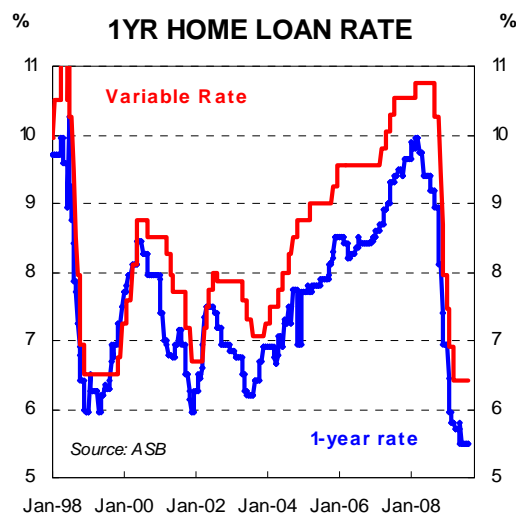
The **disadvantages**:

- The current 2-year rate, at 6.55% 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 (6.4%). 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 7.8%.
- 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 September 2011 we expect the RBNZ will be well into a tightening cycle, and floating rates will be around 8.5%, and all term mortgages will be over 7.4%.

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 still below what we would expect over the next 5 to 10 years.



The **disadvantages**:

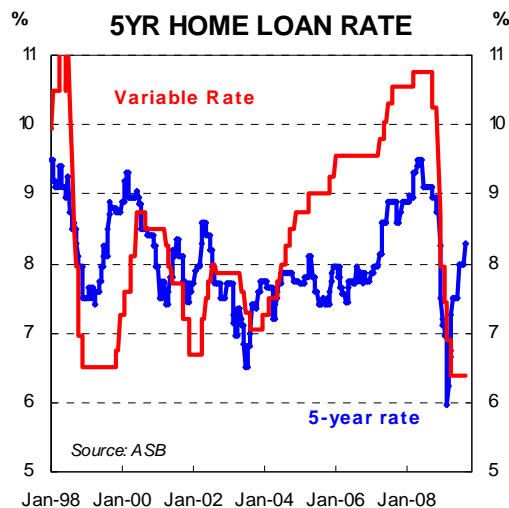
- Missed opportunity for lower rates should rates decline over the coming months.
- The risk of higher rates after the fixed term, assuming global economic conditions stabilise in line with expectations.
- Not necessarily providing lower interest costs over its lifespan than shorter terms might.

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

- 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.
- It is above the average level for the 5-year term rate available over the last 10 years (the long-term average is 8%), so in this sense, is looking slightly expensive.



At around 8.3% 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 earlier in 2009.

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 8.3% would give roughly the same outcome over time as fixing now for 2 years at 6.55% then re-fixing for 3 years at around 9.3%. We do not expect the 3-year mortgage rate will be as high as 9.3% 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 much higher cost than it did earlier this year.

Final thoughts

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.

<http://www1.asbbank.co.nz/reports>

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