

Home Loan Rates

Approaching a cyclical peak

- Home loan rates are high and were still rising in early March.
- But a peak to this interest rate cycle is likely this year.
- Fixing for 1-2 years appeals but that depends on your ability to cope with higher rates should current forces unexpectedly persist.

There are no easy choices when it comes to deciding how long to fix your loan rate at present. All rates are high; the recent trend is upward and even higher mortgage rates cannot be dismissed in the short-term. But, also, sharply lower interest rates are probable over the next few years. As always, it comes down to your own financial situation, your own tolerance of risk – including how you sleep at night – and your opinion about the future. The difference between fixed home loan rates is primarily due to differences in the wholesale interest rates, in turn influenced by the policy stance of the Reserve Bank of New Zealand (RBNZ) and the rates determined in global debt markets. The following notes take you through these influences, and also outline the advantages and disadvantages of various fixed home loan rate terms. As a general guide, longer-term fixed rates are likely to suit those with little risk tolerance but shorter-term fixed rates are likely at present, in our opinion, to provide the lower interest cost over the course of the next 4-5 years.

The major reason for the high interest rates at present is the high Official Cash Rate (OCR) that has been set by the Reserve Bank. The OCR is the major influence on short-term interest rates, and hence in turn on the Variable Home Loan Rate. It is also expectations about the OCR that is a major determinant of the wholesale fixed rates that lie behind the ASB Home Loan Rates currently quoted.

The RBNZ set the OCR, a target for overnight interbank interest rates, at 8.25% p.a. in July 2007 and reiterated this policy stance on March 6th. The Governor went further and stated “the OCR will need to remain at current levels for a significant time yet”. And that is in spite of the current OCR being the highest level since the present monetary policy regime was introduced in 1999, the current OCR being above the 6.2% average and well above the 4.5% minimum since then. The RBNZ have set the target rate high in their efforts to counter the pressures driving the inflation rate above 3% p.a.

Just because the RBNZ have indicated their expectation of no change to the OCR, this need not be the case. The future is unknown and it may be that the RBNZ, unexpectedly, adds to the four 0.25% rate hikes of 2007 (though the chances of this are reducing). Alternatively, the OCR may have to be dropped by 1-2% over 2-3 quarters. These outcomes depend on how inflation rates unfold and whether housing and credit problems force economic growth rates down or not, here and abroad. The Reserve Bank sees the alternatives as “we are faced with high probability but modest upside risks to inflation, offset by lower probability but potentially severe downside risks to activity”. Re-phrased in terms of interest rates, there remains a high probability of stable-to-slightly higher interest rates and a low probability of sharp interest rate falls in the near future. The first risk implies fixed home loan rates are preferable to variable home loan rates, already favourable due to the lower fixed home loan rates. The second risk implies not fixing interest rates for too long.

However local monetary policy is not the sole determinant of interest rates. Offshore rates can also have a large influence, especially on longer-term fixed rates but also occasionally on shorter-term rates. Now is one of those times. NZ longer-term fixed rates are rising due to a similar trend in Australia (where inflation has seen the cash rate rise) while short-term rates are also rising due to the extra premium charged in international markets these days for loans to banks, even banks with high credit ratings (NZ banks are highly rated and borrow heavily offshore). Both offshore interest rate trends are still upwards.

It may be several months before the global financial markets return to a higher level of trust, and hence lower risk premiums. Markets will take some time to settle after the recent rescue of US investment bank Bear Stearns. It may be several months before the forces driving up Australian fixed interest rates have also worked their way through the system. These upside risks to external influences on local rates are further reasons to favour a fixed home loan rate at present, but are factors to take into account when determining your fixed term.

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In essence, the choice of fixed term comes down to when you believe the current upward interest rate trend will end, and how much extra are you willing or able to pay if you call the turnaround too early (as many have discovered in recent months).

The most likely timing for a cyclical interest rate peak, in our opinion, is within the next six months. ASB forecasts are for fixed home loan rates to be around 0.5-1.0% p.a. lower across the board in twelve months, and around 0.5-1.0% lower in twenty four months. We are assuming that the RBNZ will cut the OCR in early 2009 *and* that current funding premiums will abate.

Thus it *might* be possible to minimise your interest cost by choosing a 6-month fixed rate now, in the expectation of re-fixing at a lower fixed rate in six months time.

But this is a risky strategy which does not leave much margin for forecast error within this six-month period. The risk is that you may be paying a rate above 10% in six months if the current upward interest rate momentum is sustained a little longer.

The more conservative approach would be to choose a 1-year or 2-year fixed rate, allowing more time for the interest rate peak to emerge, with the 2-year being the more conservative option.

The lowest rate at present is the 5-year rate. That may have added appeal to those who simply cannot or do not want to risk having to pay higher interest rates in the next few years. But locking in that certainty will come at a high price – and may be something you repent at leisure in coming years.

The following sections note the advantages and disadvantages of various fixed rate terms.

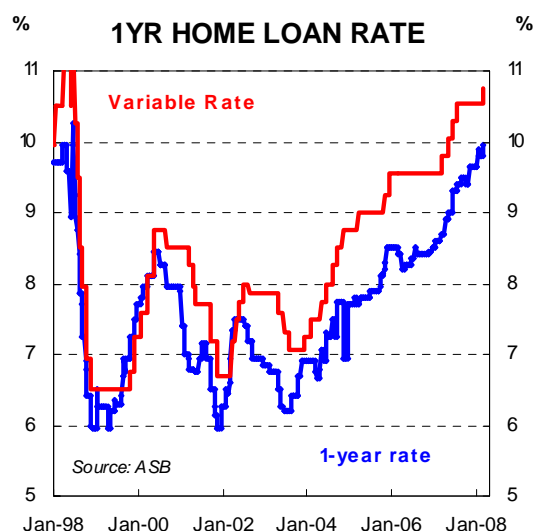
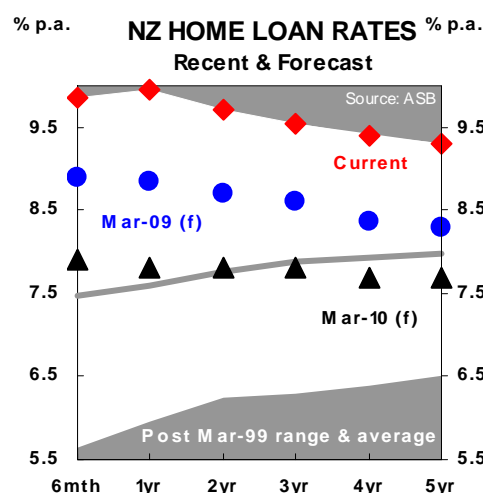
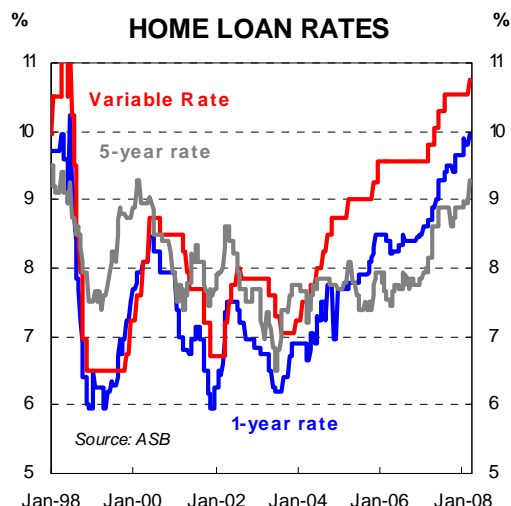
The main **advantages** of the 1-year rate are:

- it is below the average Variable Home Loan rate forecast by ASB for the next 12 months;
- there is also the potential to borrow at a lower rate in 12 months should the economic situation worsen rapidly, either here or abroad, enabling interest rates to decline quickly.

The major **disadvantages**:

- should interest rates actually rise further than expected then high rates will apply when coming off the fixed term next year.

The 1-year fixed rate would suit those who prefer interest rate certainty during the period when rate rises are still a risk (i.e. inflation and global anxiety still high) but who either will be repaying debt soon or who foresee the period of high interest rates passing quickly.



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

- it is below 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;
- there is a very reasonable chance that fixed rates drop by the time the term matures.

The **disadvantages**:

- missed opportunity for lower rates should the economy worsen rapidly and rates declines quickly;
- but also still some risk of higher rates after the fixed term if, instead, inflation risks become much greater.

The 2-year fixed rate would again suit those who prefer interest rate certainty in the near term but were willing to take the risk that interest rates will return to lower levels during the next 24 months.

The 3-year fixed rate currently offers the **advantages**:

- providing interest rate surety for longer;
- it is lower than the current 6-month, 1 & 2-year rates.

The **disadvantages**:

- likelihood of missed opportunity should global and local inflation pressures ease and rates fall within the next 3 years;
- the current rate is high by historical standards, and also relative to where we expect shorter-term fixed rates to average over the next 3 years.

A 3-year fixed rate would again suit those who foresee interest rates returning to lower levels within the next few years but either prefer less risk or foresee the inflation and/or global debt adjustment process as lengthy (and interest rates slow to fall as a result).

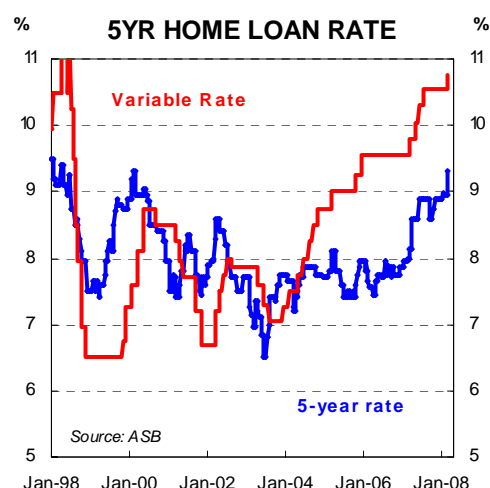
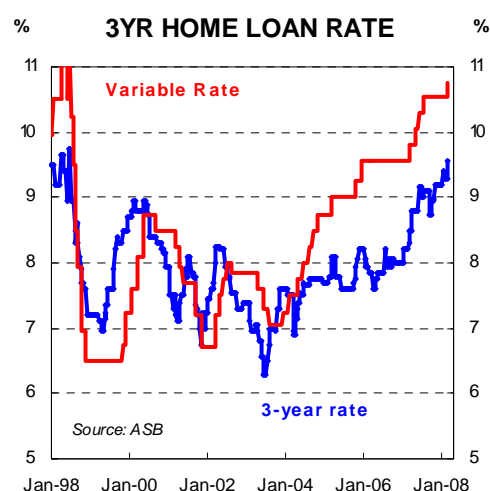
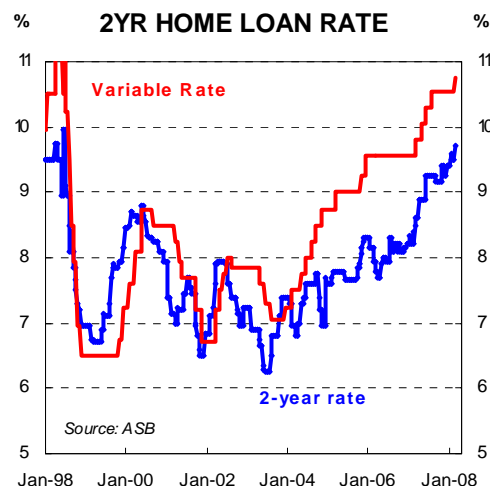
The **advantages** of the 5-year rate are:

- surety for the next 5 years;
- being the lowest fixed rate at present.

The major **disadvantages** of the 5-year rate are:

- it is well above the average 1-year Home Loan rate forecast by ASB for the next 60 months;
- and, therefore, there is strong likelihood of missing out on the opportunity to benefit if fixed rates do decline within the next 1-3 years.

A 5-year fixed rate would suit those who strongly prefer interest rate certainty or who foresee a period of persistent inflation. But after recent sharp increases in this rate we view it as the least likely choice to minimise long-term debt-servicing costs.



Just remember that the only certainty about the future is that it is uncertain – and this is very true at present. 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. The current environment is also one in which it is prudent to avoid over-committing yourself financially.

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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