



# Home Loan Rates

## Rates on their way down

- The Official Cash Rate is now falling, with more cuts expected in 2008 and into early 2009.
- However, global funding costs remain high as financial conditions remain challenging.
- Mortgage rates have fallen substantially since May, and will continue to edge down.

*Mortgage rates have been declining ever since it became clear that the RBNZ would move to cut the OCR as the economy weakened noticeably. Fixed mortgage rates were the first to fall as wholesale rates progressively priced in the expectation of earlier and greater interest rate cuts from the RBNZ. With the OCR itself now falling, floating mortgage rates have started to follow. We expect the OCR to continue to decline to 5.5% in the early parts of next year. As the OCR falls, mortgage rates will continue to decline. However, financial markets have already factored in continued declines in the OCR, so any falls in longer-term fixed rates are now likely to be more muted. Short-term fixed rates and floating rates will tend to be the main movers.*

*A large fly in the ointment is the state of global credit markets, which became increasingly gummed up over September and into early October. A return to more normal risk premiums is a considerable time off: the US financial system still has considerable problems to work through and Europe has also been beset by issues. As a consequence, global funding costs will remain elevated for some time and dampen the impact of OCR cuts. The state of global credit markets is the main reason the RBNZ decided to cut the OCR by 100bp in October, an unusual step, and why it is likely to cut the OCR further in the coming months. For borrowers, a strategy at present would be to fix for only a short time to tide you over until mortgage rates fall further and offer a broader range of (lower) fixed-term options. This strategy is not without risk given the current global uncertainties. If you place a high weight on certainty, a 1-year rate would give more peace of mind in the short term.*

The outlook for mortgage rates faces two very distinct and opposing forces – both quite powerful. The state of global credit markets has become increasingly parlous – as so abruptly illustrated by the bankruptcy filing of investment bank Lehman Brothers and the effective nationalisation of mortgage securitisers Fannie Mae and Freddie Mac and the world's biggest insurer American Insurance Group. Meanwhile, New Zealand's Official Cash Rate has been cut swiftly in response to the mild local economic recession and the disinflationary impact the weak economy will bring.

Global financial markets, including the all-important credit markets, started to seize up towards the end of September. In October markets moved into panic mode, with global equity markets taking a hammering. Governments in the US and Europe hurriedly devised rescue packages to try and restore the functioning of credit markets. To date some calm has started to return, though it is likely to be some time off until some semblance of normality starts to return. Ahead is a long period of recapitalisation of the US and European banking systems, during which credit will be far less freely available than it was over the 2001-2006 period.

NZ's main banks (and their Australian parents) have some of the best credit ratings in the world and have been blessed with being 'vanilla'. Lending has been relatively prudent by international standards, with loans made to NZ households and businesses rather than to high-risk US households. Even so, NZ has paid (and will continue to pay) higher risk premiums for borrowing money offshore. This adds to the overall cost of funds. Moreover, in highly uncertain times investors want much greater compensation for the uncertainty they are exposed to. Accordingly, the longer the term investors will lend at the higher is the premium charged. This impact on funding costs will also influence mortgage rates: high long-term rates are likely to be sticky.

The other influence is what the RBNZ does with the Official Cash Rate. The inflation outlook will be more muted, in part as global growth will be weak. A weak growth outlook has seen commodity prices retreat from record highs. Ongoing weakness in local consumer spending and the housing market will curtail persistent underlying inflation pressures. For these reasons alone the RBNZ has scope to reduce the OCR further. The RBNZ has already lowered the OCR aggressively to counter the higher cost of offshore funding: ultimately it will focus on what it sees as the appropriate level of 'Main Street' lending rates, as these are what matter for the economy. As the OCR is an overnight interest rate, its influence is greatest on short-term wholesale rates as opposed to long-term rates. Therefore, as the OCR falls, it will drag down short-term lending rates most noticeably.

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### General Advice Warning

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We expect the OCR will drop to 5.5% by early 2009, with scope for more aggressive cuts if needed to counter the impact of global turmoil.

What are the likely outcomes for mortgage rates? These days the crystal ball is so cloudy it resembles a bowling ball, with global financial markets still in disarray.

Assuming some degree of order returns globally, we expect to see floating and short-term fixed mortgage rates to decline over the next 6 months. However, there is no guarantee that the long-term fixed rates will fall, and even if they do they are likely to remain at above average levels.

Our view is that the overall tug of war will be won by the RBNZ, but the impact will be felt mainly on the shorter term rates.

Where does this leave prospective borrowers? If the RBNZ wins the tug of war then fixing for short terms (possibly even floating) would enable you to benefit once rates have fallen further.

That strategy has its risks. If certainty is important, fixing for longer than 6 months may be a better compromise between cost and security.

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.

Unfortunately there is no one 'right answer'. The following sections take you through the advantages and disadvantages of various fixed rate terms.

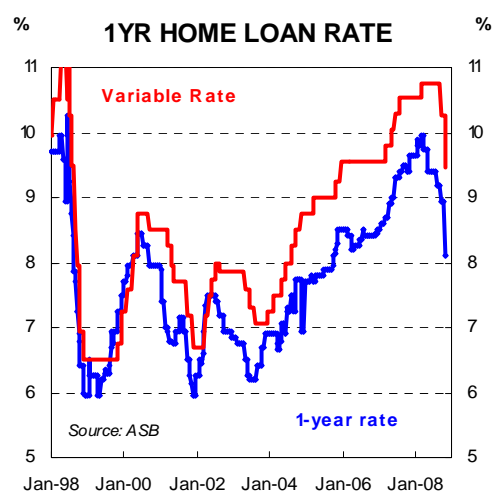
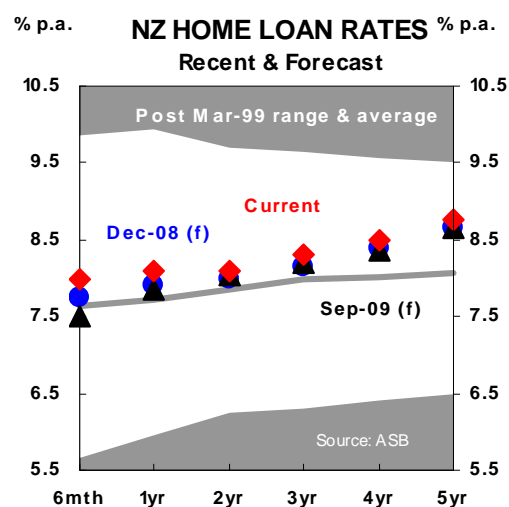
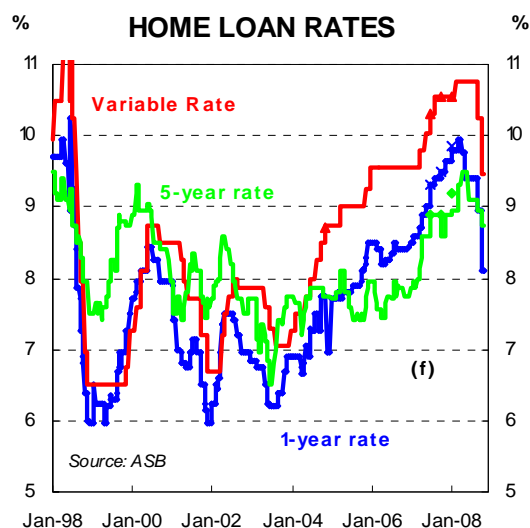
The main **advantages** of the 1-year rate are:

- 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 outlook pan out in line with our expectations.

The major **disadvantages**:

- should interest rates actually rise further than expected then high rates will apply when coming off the fixed term next year;
- conversely should rates drop sharply you are locked into a higher rate for 12 months.

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), or those who will be repaying their debt over the 12-month timeframe.



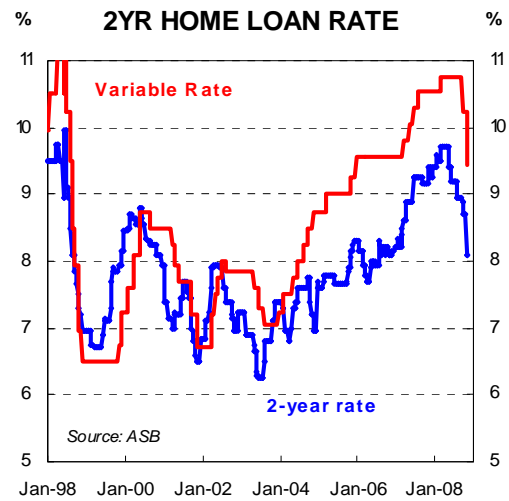
The 2-year fixed rate currently offers the **advantages**:

- 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 rates decline over the next 6 to 12 months.
- but also still some risk of higher rates after the fixed term if, instead, inflation risks become much greater.
- The two-year rate is higher than our expectation of what you would pay by fixing for two consecutive one-year terms.

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.

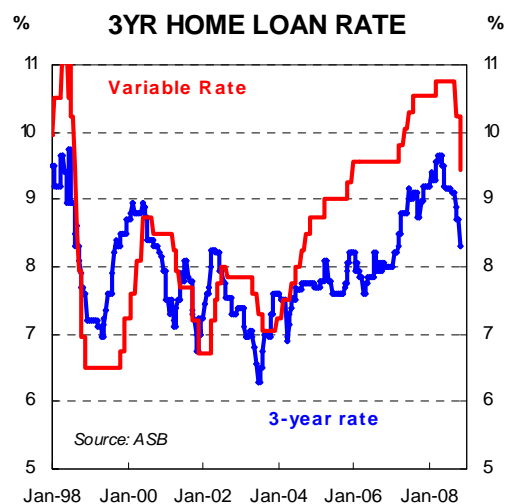


The 3-year fixed rate currently offers the **advantage** of providing interest rate surety for longer;

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).



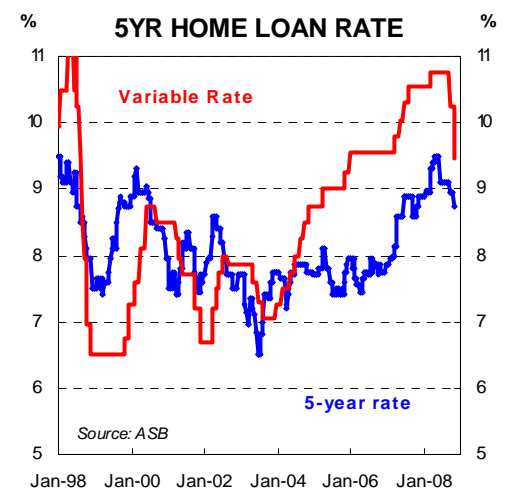
The **advantages** of the 5-year rate are:

- surety for the next 5 years;

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

- it is the highest of the fixed rates advertised at present;
- it is 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 return to a period of persistent inflation. For the reasons discussed, we view it as the least likely choice to minimise long-term debt-servicing costs.



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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