

# Home Loan Rates

## Floater get set.

- The Official Cash Rate has been cut drastically in 2008, and early 2009.
- Future cuts are expected, but they will be more modest in size.
- Mortgage rates have fallen substantially, and borrowers need to have a strategy to benefit.

### Economic snapshot...a bleak picture

The Reserve Bank (RBNZ) did it again, cutting the cash rate by 1.5% to 3.5% at their January 2009 Official Cash Rate (OCR) Review. The OCR is now at its lowest rate since it was introduced in 1999. The outsized cuts delivered over the last few months are bigger than we expected this time a year ago, but now can't be labelled as that surprising given the run of bad economic news lately.

Households struggled with a number of challenges in 2008. Although the pressure on many household budgets has reduced as petrol prices and mortgage rates have declined from 2008's record highs, the pressure is still on the broader NZ economy. NZ business confidence is dismal, reflecting an environment of falling activity, profitability, employment and investment.

The news from offshore is also gloomy. The economic outlook for New Zealand's trading partner growth is the weakest in many years. Indeed, the RBNZ pointed to the deterioration in the world economic outlook, export outlook and the terms of trade for its decision to slash the OCR in January.

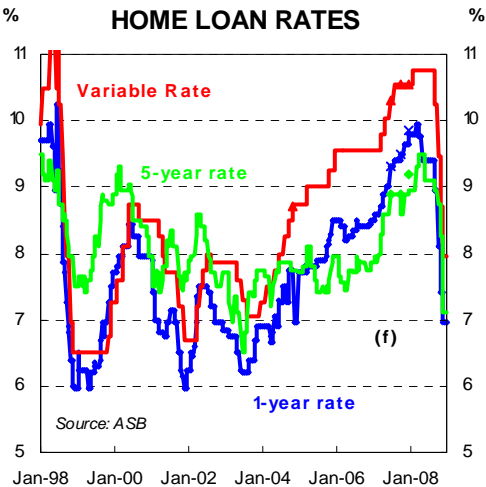
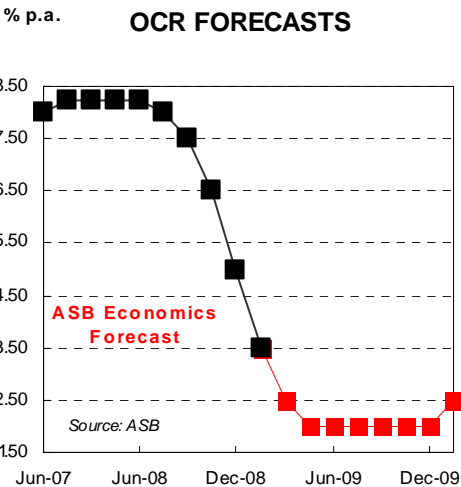
Aggressive action from the RBNZ pre-empt a lot of the downside risks to the economic outlook. Nonetheless, we think there are more challenges to come, for both the NZ and global economic outlook. Businesses show clear signs of pressure and, given the current uncertainty and unemployment on the rise, households are going to watch their spending habits very closely.

### Expectations: More cuts on the way

We expect the RBNZ will keep cutting the OCR in the coming months. Even though the RBNZ has factored in a lot of bad news, unfortunately, we think there is still more to come. In our judgement the RBNZ has little to lose by getting the cash rate even lower: the extent of the slowdown means high inflation is not going to be an issue in the near future, and monetary policy is the swiftest buffer available for the economy.

One thing to keep in mind is that we are getting close to the end point for interest rate cuts. Theoretically there is nothing to stop the RBNZ cutting all the way to zero if it views that as necessary. However, there may be practical limitations to the effectiveness at the OCR at low levels that limit the extent to which the OCR eventually falls.

If such a limit is reached and the RBNZ still wants to add more monetary stimulus, it will have other options it can turn to. Neither the RBNZ, nor the Government can completely buffer NZ from global events. But, the RBNZ will clearly take further action in 2009.



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### General Advice Warning

As this report was prepared without taking into account your objectives, financial situation or particular needs, you should not take any action in reliance of this report without considering your particular circumstances and, if necessary, obtaining professional advice.

## Implications for borrowers

The market is pricing in a terminal OCR of 2.5%, which would imply very little further downward movement for long-term wholesale rates though still some room for short-term rates to drop. We see the risk of the OCR dropping even further, which would put some more downward pressure on interest rates.

For borrowers it is time to start thinking about a loan strategy for the next few years. A likely 'worst case' scenario for early 2009 is term rates remain steady and floating rates fall slightly further. Our expectation is there are more likely to be further – albeit modest – falls in term rates.

We are at or close to the point at which rolling loans into long terms becomes a good option to ensure the dramatic plunge in rates gets locked in for a considerable period. On balance we see the prospect for slightly better fixed rates in the near future, assuming the RBNZ cuts the OCR further. However, more conservative borrowers may want to consider the low long-term fixed rates available now. Timing the bottom will be difficult, and the risk of hanging on too long is the very long-term rates could actually rise.

Staying floating will allow participation in any further interest rate declines. But the trade offs are: paying a higher interest rate than the fixed terms on offer at present; further rate declines will tend to be for shorter terms; and the risk long-term rates could rise rather than fall if the flood of bond issuance becomes a significant influence.

On that matter, the risk of long-term interest rates actually lifting in early 2009 is worth considering. A significant development in global interest rate markets recently is an assessment of the huge bond issuance required to fund the various Government bailouts and stimulus plans being proposed. This concern is noticeably influencing the US bond market in early 2009, and long-term Government Bond yields there have risen dramatically off 2008's record lows. A continuation of this development, combined with increased Government Bond issuance in New Zealand, could cause an upward influence on local long-term interest rates, including mortgage rates.

In general, choosing a long-term rate will allow borrowers to benefit from low interest rates for a considerable period. But 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 consideration needs to go into what an appropriate term would be.

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.

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 the advantages and disadvantages of various fixed rate terms.

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

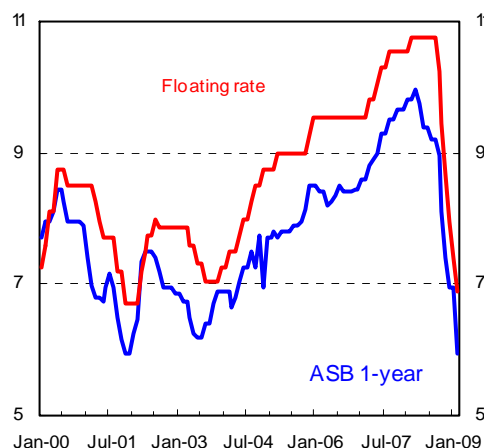
- An immediate saving compared to a floating mortgage, as a 1-year mortgage is typically around 1-1.5% lower than the floating rate.

The major **disadvantages**:

- There is the potential to borrow at an even lower rate over the coming months should the economic outlook pan out in line with our expectations.
- Longer terms will provide the benefit of lower rates for much longer, on the assumption the RBNZ will look to raise the OCR at some point in 2010.
- 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, or those who will be repaying their debt over the 12-month timeframe.

1-YEAR HOME LOAN RATE



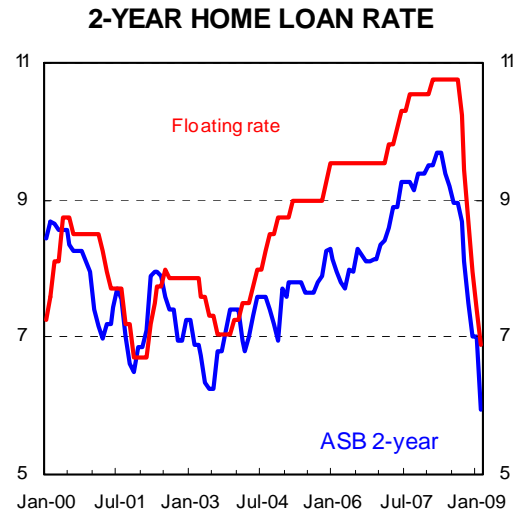
The 2-year fixed rate currently offers the **advantages:**

- 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.

The **disadvantages:**

- Missed opportunity for lower rates should rates decline over the coming months.
- The strong risk of higher rates after the fixed term, assuming global economic conditions stabilise in line with expectations.

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



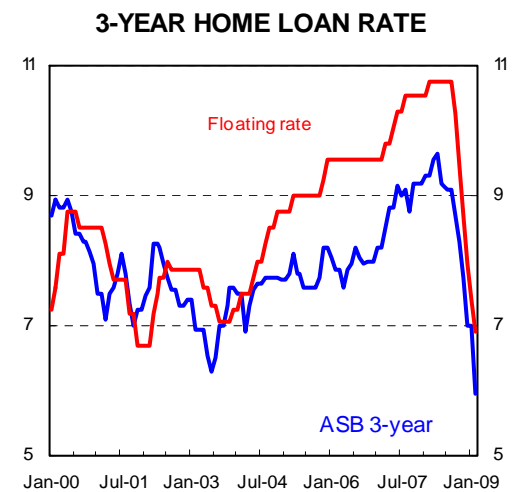
The 3 to 5 year fixed rate currently offers the **advantages:**

- Providing interest rate surety for longer.
- The opportunity to lock in rates which are well 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 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 rate would again 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 term of the loan.

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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