

# Home Loan Rates

## Fixing time.

- 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: the end of the RBNZ rate cut cycle is near.**

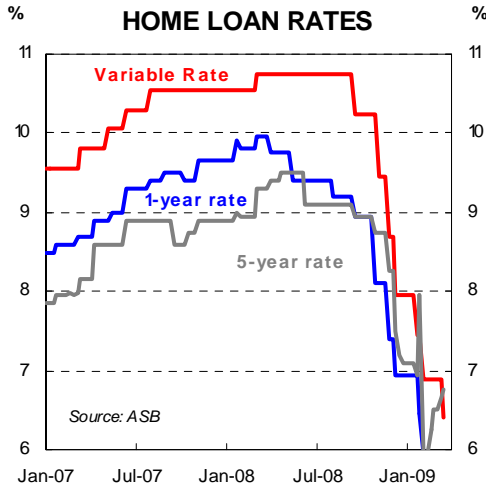
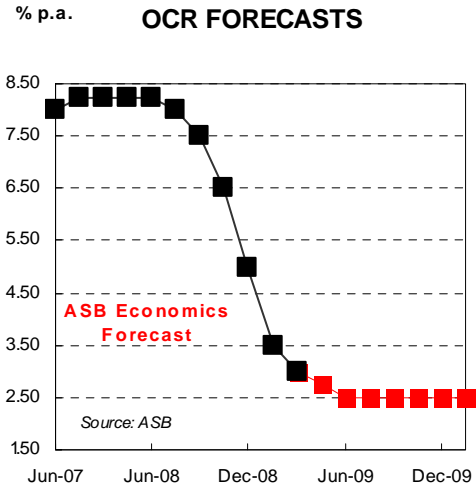
The Reserve Bank (RBNZ) cut the cash rate by 0.5% at its March Official Cash Rate (OCR) Review. The cut was small compared to the series of outsized 1.5% cuts the RBNZ has delivered over the past 8 months as they slashed the cash rate from 8.25% to today's 3%. The OCR is at its lowest rate since it was introduced in 1999.

The big surprise in the latest assessment from the RBNZ is the change in the Bank's tone. The RBNZ is now sending a strong signal that it is slowing down the pace of cuts, and is reasonably reluctant to cut by too much more. At the latest OCR Review, the RBNZ provided their latest assessment of the economy, and its prospects over the coming years. In our view, the RBNZ's medium-term economic growth forecasts are optimistic, with the economy exiting the recession by mid-2009 (we think early 2010 more likely). However, the RBNZ acknowledged the risk that the recovery may occur later and be more protracted than it anticipates. Given the RBNZ's apparent reluctance to cut the OCR much further, an end point of 2.5% now seems likely. However, as we think the RBNZ will have to revise down future growth forecasts there remains a possibility of the cash rate still going to 2%. Either way, we are close to an end-point for the interest rate easing cycle. Accordingly, mortgages are unlikely to get much lower than today's levels, and for longer-term rates, an upward drift has been underway.

**Implications for borrowers.**

For borrowers it is time to sort out your loan strategy for the next few years. If the Reserve Bank does end up with a terminal Official Cash Rate of 2.5%, we would expect some further downward movement for short-term rates. Floating rates would likely trough out in the high 5 to low 6% range over the coming months under this scenario. For longer term rates, the picture is more complicated. Longer-term fixed term mortgage rates have recently lifted - particularly the 5-year rate.

Previously we had expected modest falls term rates, largely because we expected a lower Official Cash Rate than the Central Bank is currently signalling. In addition, we have a weaker outlook for the economy over the next two years, compared with the RBNZ's outlook. However, based on the RBNZ's latest assessment, the OCR is not likely to fall as far as we have been forecasting for the last few months, and long-term interest rates may well have seen their low point already.



Nick Tuffley – ASB Chief Economist – 649 374 8604 – [nick.tuffley@asbank.co.nz](mailto:nick.tuffley@asbank.co.nz)  
 Chris Tennent-Brown – CBA NZ Economist – 649 374 8819 – [chris.tennent-brown@asb.co.nz](mailto:chris.tennent-brown@asb.co.nz)

**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.

Over the coming months we see the prospect for slightly better fixed rates only for very short terms up to one year over the coming months. The RBNZ sees the economy starting to recover by mid-2009. It would be a great outcome if the economy recovers in line with the RBNZ forecast. But this recovery scenario also implies interest rates won't stay low forever – the RBNZ would want to return interest rates to less stimulatory levels as the economy picks up. The risk of fixing for 6 months or 1 year is rates are higher when the term matures in late 2009/early 2010.

Anything seems plausible these days, and it is possible events transpire which see long-term rates press lower again. Huge efforts by the US Federal Reserve to drive down bond yields are one example of the possibilities. However, on balance we think longer long-term fixed rates for terms of three to five years are unlikely to move lower than the rates we see today, particularly if the next few months pan out along the lines of the RBNZ's latest assessment.

We are at the point at which rolling floating loans into long terms is a good option to ensure that the dramatic plunge in rates gets locked in for a considerable period.

The rates for all terms are now very low compared to long-run averages. 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 choosing the correct term before fixing is very important.

### **Why are long-term interest rates rising?**

Long-term interest having been rising for a number of reasons, some domestic and some global. The recent catalyst was the Reserve Bank's 0.5% rate cut, combined with its signalled reluctance to lower the Official Cash Rate much further. In contrast, financial markets had built in some probability of a bigger cut, and expected further cuts would happen more swiftly than the RBNZ has now signalled. As a consequence, wholesale interest rates rose noticeably after the RBNZ meeting on 12 March.

For every dollar borrowed, a lender must be found, and long-term interest rates reflect the supply and demand balance between global savers and global borrowers. Official cash rates are only one part of the overall mix. Long-term wholesale interest rates are now rising due to increased borrowing pressure as borrowers start to lock in these historically low rates. The increased long-term borrowing from households and businesses causes wholesale rates and in turn mortgage rates to lift. On the saving side of this equation, a degree of optimism has recently returned to financial markets. Money has flowed back into global equity markets and out of safer securities such as bonds further pressuring interest rates higher.

Another significant factor in recent months relates to the huge stimulus plans being announced by governments around the world. Governments are going to be issuing huge amounts of debt to finance their respective stimulus packages, with the US alone likely to issue upwards of 2 trillion US dollars worth of Government Bonds over the next year. Markets have become concerned about the ability for these amounts of debt to be absorbed without providing investors with higher returns (yields), and long-term interest rates have risen in response to these concerns.

### **Considerations**

The outlook for interest rates in coming months looks mixed, and is subject to a number of opposing forces. Very short-term rates, particularly floating, are likely to fall further as the RBNZ cuts the OCR. However, long-term fixed rates are likely to be relatively resistant to move lower. For noticeable falls in long-term interest rates we would need to see one or more of the following: the RBNZ cut the OCR further than the 2.5% now widely anticipated (which implies a considerably worse outlook for the NZ/global economy); another bout of global risk aversion to drive money out of sharemarkets back into fixed-interest securities; a sizable impact on long-term rates from efforts by the Federal Reserve and Bank of England to push down long-term interest rates in their markets. On the other side of the coin, global bond issuance will remain a source of upward pressure, particularly once issuance starts to step up. And, if the worst is truly past, long-term rates will increasingly anticipate a lift in interest rates back to more normal levels.

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

Our core expectation is short-term interest rates are likely to fall further in coming months, but it is unlikely long-term rates will fall (and they are more likely to rise further). For much, if not all, of 2009 short-term rates will remain lower than long-term rates. This is the more usual state of affairs but one that has not been present in NZ for several years. Implicitly, 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 slightly higher price. Splitting borrowing across terms is one way to hedge your bets.

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. 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 lower than the floating rate.

The major **disadvantages**:

- Longer terms will provide the benefit of low rates for much longer, on the assumption the RBNZ will look to raise the OCR at some point in 2010.
- Conversely should rates drop further than the RBNZ's latest outlook suggests, you are locked into a higher rate for 12 months. There is the potential to borrow at an even lower rate over the coming months if the RBNZ aggressively cuts, particularly if the economic outlook pans out worse than current expectations, and the RBNZ takes the OCR below the current expectation of 2.5%.

The 1-year fixed rate would suit those who prefer some interest rate certainty, 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.

The **disadvantages**:

- Missed opportunity for lower rates should rates decline over the coming months (not our core expectation for 2-year rates).
- 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 rates currently offer 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 loan term.

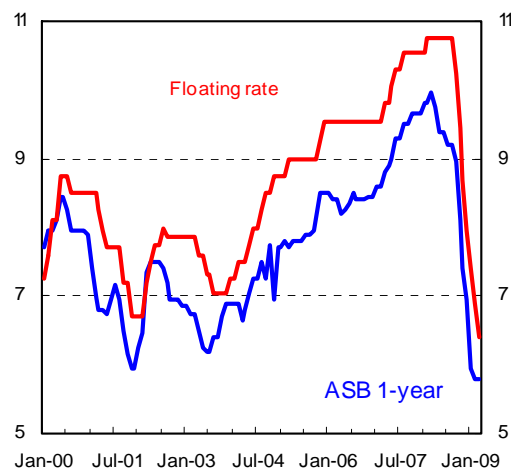
Just remember the only certainty about the future is it is uncertain. Which mortgage rate turns out to be the 'best' will only really be known with hindsight. But with the above pros and cons for the various mortgage rates on offer we hope to give you a good platform from which to consider what interest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

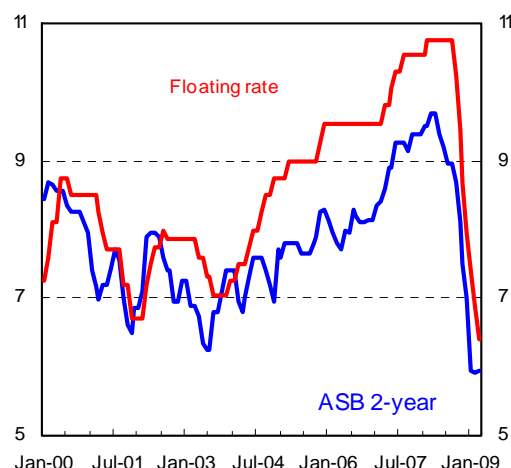
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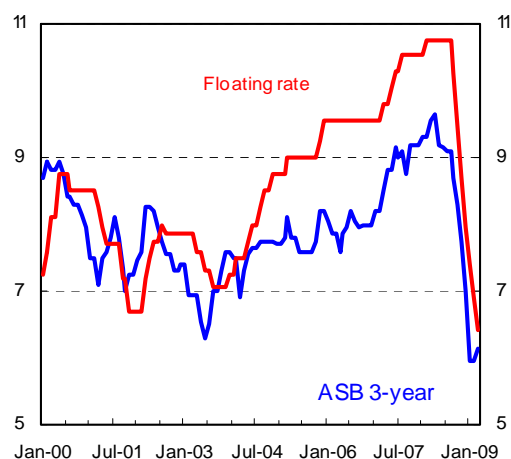
### 1-YEAR HOME LOAN RATE



### 2-YEAR HOME LOAN RATE



### 3-YEAR HOME LOAN RATE



ASB ECONOMICS  
Level 9, 135 Albert Street, Auckland

ASB ECONOMICS			PHONE	FAX
<b>Economics</b>				
Chief Economist	Nick Tuffley	<a href="mailto:nick.tuffley@asb.co.nz">nick.tuffley@asb.co.nz</a>	(649) 374 8604	(649) 302 0992
CBA NZ Economist	Chris Tennent-Brown	<a href="mailto:chris.tennent-brown@asb.co.nz">chris.tennent-brown@asb.co.nz</a>	(649) 374 8819	
ASB Treasury Economist	Jane Turner	<a href="mailto:jane.turner@asb.co.nz">jane.turner@asb.co.nz</a>	(649) 374 8185	

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