

Home Loan Rates

Fixing trade-offs.

- Future OCR cuts are expected, but they will be more modest in size.
- Short-term mortgage rates will remain low over 2009, but long-term rates have lifted recently.
- Trade-off: low floating and short-term rates vs. paying up for certainty of long-term rates.

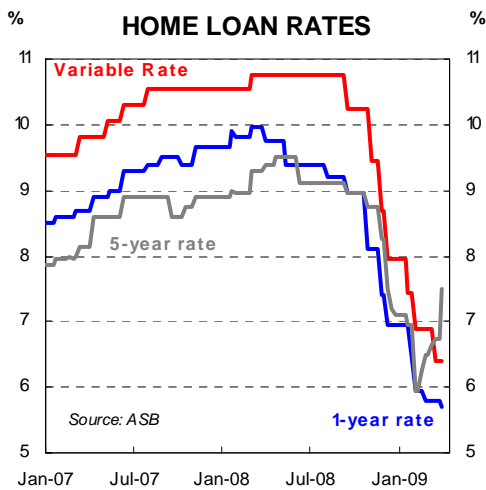
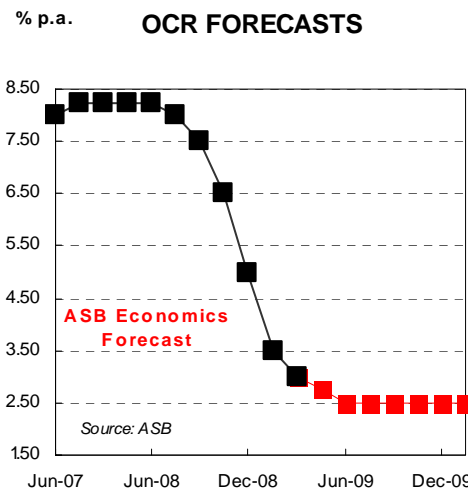
We noted in the past couple of Home Loan Reports that it was around the point at which rolling into long-term rates was a good option ensure the dramatic plunge in rates got locked in for a considerable period. Financial market developments and the sheer volume of shifts into fixed-rate mortgages have driven long-term wholesale rates dramatically higher in a short space of time, closing the window on attractively-priced long-term rates very abruptly. Whether or not the lifts are sustained, in the here and now the trade-offs amongst mortgage rates have become more apparent: at the time of writing there is a 2 percentage-point difference between the 5.5% 6-month rate and 7.5% 5-year rate. Long-term fixed rates still offer a high degree of security, though at a cost relative to very low short-term rates. Instead of the clearer option to fix for long terms at low rates borrowers now have to think through several possible options: remain floating in case long-term rates subside to a degree; fix for a medium term (e.g. 2-3 years) at a relatively low rate; take the certainty of a long-term rate even if the rate is no longer as advantageous as it was recently. These options have different levels of risk, certainty, and cashflow benefits. Borrowers need to think about where their individual circumstances fit best against these three criteria.

OCR outlook: RBNZ reluctant to cut much further

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 cuts the RBNZ delivered over the past 8 months as it slashed the cash rate from 8.25% to today's 3%. The main surprise in the March Statement was 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. Given the RBNZ's apparent reluctance to cut the OCR much further, an end point of 2.5% now seems likely. But, 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 though, we are close to an end-point for the interest rate easing cycle after a string of dramatic falls.

Outlook for short-term rates

With the OCR likely to fall further, short-term mortgages have scope for further modest falls. And, even as long-term rates rose in late March, the 6 and 12-month rates were nudged down. Any future moves down will be larger for the floating rate, more modest for the 6-month rate, and very muted on the 1-year rate. If the RBNZ kept the OCR low through to mid-2010 then the floating rate would remain at a very low level for the next year or more. The short-term fixed rates will eventually rise in anticipation of the RBNZ restoring the OCR to a less stimulatory level. But over the next few months the risks are down not up.



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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.

Why have long-term interest rates been rising?

Before looking at probable future influences on long-term mortgages, it would be helpful to have some idea of why these rates have been rising. There are a number of reasons, some domestic and some global.

One 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 signalled. As a consequence, wholesale interest rates rose noticeably after the RBNZ meeting on 12 March. In Australia, the RBA Governor cast some doubt over the likelihood of near-term interest rate cuts there, with higher Australian rates influencing NZ's.

Another significant factor 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. The announcement by the Federal Reserve that it would buy up \$300bn of Treasuries over the next 6 months did dampen US rates for a period but had little impact in NZ. On the saving side of the equation, a degree of optimism returned to financial markets in March. Money flowed back into global equity markets and out of safer securities such as bonds, further pressuring interest rates higher.

The increases in long-term rates prompted borrowers to start locking in these historically low rates. A trickle turned into a river, which turned into a torrent. The flows became so large that extreme pressure was exerted on long-term wholesale interest rates as banks rebalance their balance sheets to match the shift in customer preference. The increased demand for long-term borrowing from households and businesses caused wholesale rates to leap, causing a feedback loop to long-term mortgage rates.

Outlook for long-term rates

In the short term there is the possibility that long-term rates subside to some extent from their late March peaks: the flood to long-term fixing is likely to abate, particularly as higher rates have changed the relative trade-offs. However, looking at a longer time horizon suggests long-term rates will struggle to revisit their lows. Moreover, long-term rates are likely to be more expensive than short-term rates for a period of time, a change from the state of play in prior years. The greater certainty of long-term rates now comes with a cost. That is the more normal state of affairs and, in the midst of the uncertainty of a global credit crisis, paying others to bear your uncertainty carries a much higher cost around the world than it used to.

Potential downward influences on long-term interest rates are:

- In the short term possible subsidence of the extreme pressures in wholesale markets as fixing flows slow up;
- The RBNZ judges the economy will be weaker for longer and cuts the OCR below 2.5%, which would have a muted but downward effect on long-term rates;
- A renewal of concern over the state of the global economy after the recent burst of relative optimism;
- Strong downward impact on long-term rates as central banks step up buying of long-term securities in an explicit attempt to reduce interest rates.

Potential upward influences on long-term interest rates are:

- The NZ economy does indeed recover as quickly as the RBNZ forecasts, in which case speculation of further interest rate cuts would dry up and focus would swing towards when the RBNZ would lift rates;
- Risk appetites strengthen further once investors anticipate that the global economy is past the worst, with funds flowing from safe havens (e.g. interest rate products) back into risk assets (e.g. equities);
- The flood of government bond issuance globally, particularly in the US but also in NZ.

Considerations

Our core expectation is short-term interest rates are likely to fall further in coming months. Long-term rates might reverse some of their recent surge, but there are no guarantees. The sharply-sloped positive curve at the moment means 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 higher price.

As rates stand at the end of March the decision on what mortgage term to choose is no longer clear cut. Borrowers now have to think through several possible options: remain floating in case long-term rates subside to a degree; fix for a medium term (e.g. 2-3 years) to get some certainty at a relatively low rate; take the certainty of a long-term rate even if it isn't as low as it was recently and is only modestly below its long-term average. These options have different levels of risk, certainty, and cashflow benefits. Borrowers need to think about where their individual circumstances fit best against these three criteria. Splitting borrowing across terms is one way to hedge your bets to get a sampling of low debt servicing, some flexibility, and certainty over a portion of your debt.

The rates for all terms are below 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.

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.
- Aside from the 6-month rate it is the lowest rate on offer at present.

The major **disadvantages**:

- Slightly 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 than otherwise 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 around 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 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 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.

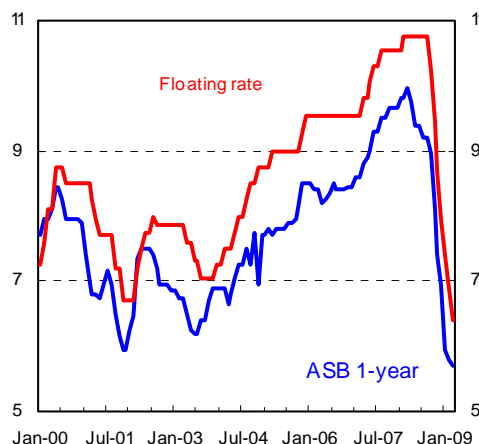
The 3-year fixed rates currently offer the **advantages**:

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

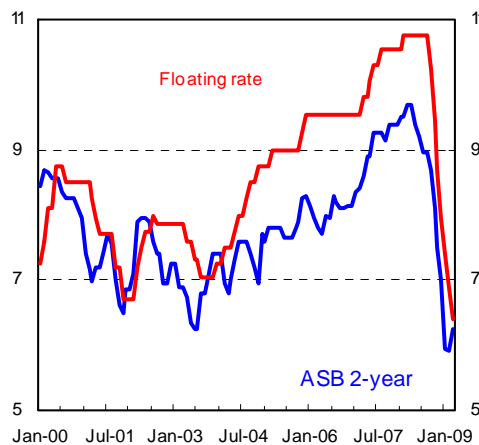
The **disadvantages**:

- Missed opportunity for lower rates should rates decline over the coming months.
- The 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.

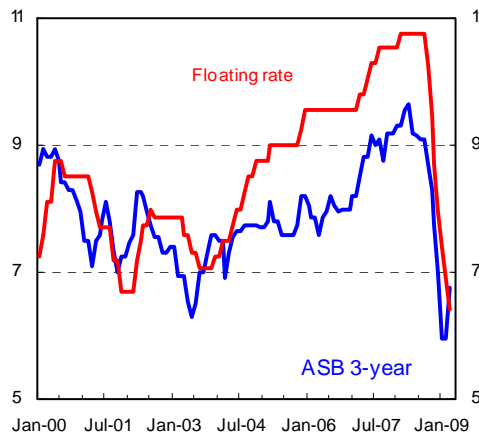
1-YEAR HOME LOAN RATE



2-YEAR HOME LOAN RATE



3-YEAR HOME LOAN RATE

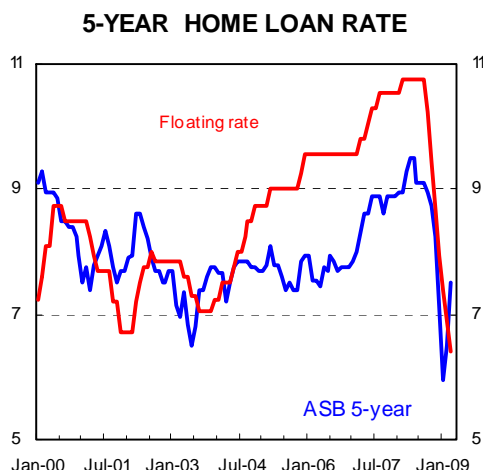


The 5-year fixed rate currently offers the **advantages**:

- It is around the average Variable Home Loan rate forecast by ASB for the next 60 months, with the added advantage of surety for a much longer period than the shorter-term fixed rates.
- It is also below the average term rate available over the last 10 years, so in this sense, remains relatively reasonable.

The **disadvantages**:

- 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.
- At around 7.5% 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.



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 7.5% would give roughly the same outcome over time as fixing now for 2 years at 6.25% then re-fixing for 3 years at roughly 8.3%.

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 higher cost than it did.

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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