

Home Loan Rates

Short-term rates to join the climb

- RBNZ removes easing bias as economic backdrop improves and housing picks up.
- Shorter-term interest now rising as markets factor in future OCR increases by RBNZ.
- No clear cost advantage in fixing vs. floating, although fixing provides certainty for borrowers.

The landscape of the mortgage market since March has been that of a steadily steepening slope. Long-term mortgage rates have climbed a long way as risk aversion died away and expectations of global recovery became firmer. But increasingly the short-term fixed rates will lift over the 6 months as it becomes more likely that the RBNZ will start lifting the Official Cash Rate at some stage over the next year. In October the RBNZ said it will keep the OCR unchanged until “the second half of 2010”, however, the risk is an earlier lift in rates. In recent weeks the NZ economic environment is looking healthier and inflation pressures less likely to weaken as much as banked on. In particular, house prices are starting to lift sharply due to a dearth of listings.

The challenge for borrowers is that wholesale rates (and hence mortgage rates) are already factoring in a substantial increase in interest rates over the next year. That means the potential cost savings from fixing have steadily been eroded over time. Given little likely cost advantage between floating and fixed terms, preference will be more dependent on factors such as desire for certainty over flexibility. The 1- and 2-year fixed mortgage rates still provide some certainty, though no likely cost advantage over remaining floating or fixing for 6 months. However, they do provide some protection should the RBNZ lift interest rates even earlier than is generally expected. Floating would likely pay off if NZ’s economic recovery is patchier than is widely expected. We see very little benefit in fixing beyond a 2-year term: yes those rates provide certainty but at a very high cost. Each borrower’s situation is unique, so it comes down to the individual weighing up their own requirements.

RBNZ removes easing bias

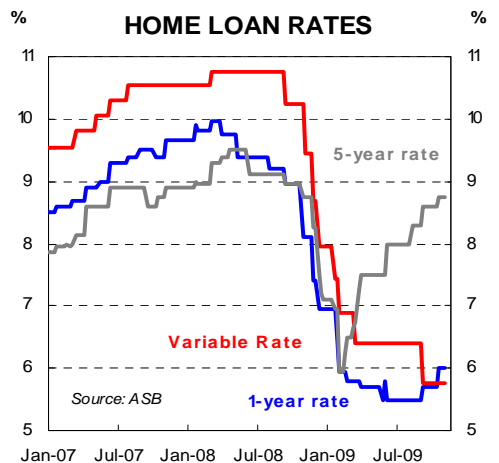
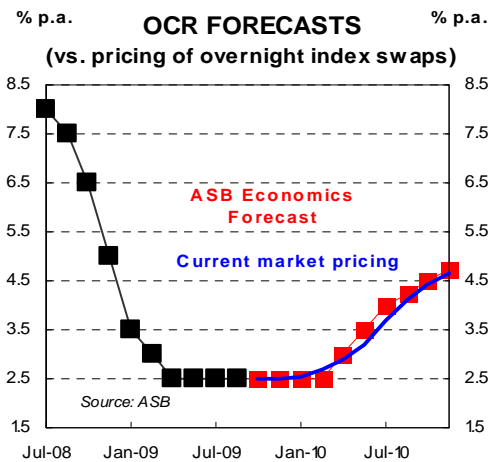
Housing led recovery concerns RBNZ

Economic backdrop improves over recent months

Changing environment

Back in the September the RBNZ backed away from any suggestion it might lower the OCR to try and clip the wings of the ever-higher NZ dollar. Instead, the recovering housing market was of increasing concern to the RBNZ, risking returns to both renewed housing-related inflation and an unbalanced economy. In its late October statement the RBNZ repeated its concerns that the recovery is being led by domestic spending (households). The catch is that if household demand doesn’t taper off of its own accord the main way to rein it in is higher interest rates.

Furthermore, both the local and global economies are looking in slightly better shape than they were even a couple of months ago. In NZ the list of positive economic developments include: the economy stabilised in Q2; business and consumer confidence have recovered substantially; the housing market has picked up. Inflation hasn’t fallen as far as expected, and the disinflationary impact of the recession will wear off by 2011. The RBNZ has to look that far ahead as the decisions it makes now will take up to two years to fully impact on inflation.



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.

In Australia the Reserve Bank has been confident enough to believe that interest rates at 'emergency settings' are no longer appropriate for an economy that avoided falling into recession. NZ was worse hit by recession so needs support from monetary policy for longer – something the RBNZ has made clear. But eventually the RBNZ will also get uncomfortable about leaving interest rates very low, particularly in light of the evident froth appearing in the housing market.

We expect the RBNZ to lift the OCR from April, initially in 50bp amounts until the OCR is back to 4%, then move in 25bp amounts. One other strategy for the RBNZ would be to start slightly earlier but move in more modest amounts. Either way it would still take a year or more until the OCR got back to a more neutral level. The early phases of the tightening cycle would still leave short-term lending rates at stimulatory levels, just increasingly less so.

Interest rate dynamics

Globally long-term interest rates have risen substantially since the peak of the crisis, a time during which safe-haven floods of money into government bonds (particularly US Treasury bonds) pushed bond yields down to extraordinarily low levels. Money has flowed from bond markets as risk aversion subsided, pushing yields up. Recognition that official interest rates would not stay at extraordinary levels indefinitely has also contributed to higher long-term rates.

Now the shorter-term fixed rates are rising as markets anticipate that the RBNZ will start lifting interest rates in the early parts of next year. Markets have priced in a 25bp hike for March. Economists' expectations of eventual OCR increases have also moved, from roughly mid-2010 to March/April (one economist predicts a January OCR increase, though that looks unlikely to occur).

The RBNZ is the loose anchor for the short-term interest rates via the OCR. The level of the OCR has a very direct influence on short-term interest rates. But if widespread expectations are that the OCR will shift before too much longer then the RBNZ's ability to anchor short-term rates starts to diminish. That is the case now: markets discount the probability the RBNZ will wait until the second half of 2010. Consequently, 6-month and 1-year mortgage rates are starting to get pushed up as the underlying wholesale rates (cost of funds for those terms) starts to lift.

Increasingly the 6-month to 2-year rates will lift as the anticipated start of the tightening cycle draws even closer. The floating rate is usually the last to start increasing.

Value harder to find

For borrowers the choices of what to do – when looking purely from a cost point of view – are steadily narrowing. The lift in the long-term rates has put those rates at high levels that are less likely to provide good value over time.

The extent to which the 1- and 2-year rates have lifted also reduces much of their price advantage. Wholesale rates imply the OCR will reach 4.75% by the end of 2010 and 5.25% - 5.5% around mid-2011. That pricing is not too different from our own view of the OCR path. Our calculations suggest that any option from floating through to the 2-year fixed rate will give roughly the same average cost of funds over the next 2 years.

Consequently it is now a tough call whether remaining floating or opting for the shorter fixed terms will give the lowest cost of funds over the next 2 years. Other considerations are likely to carry more weight now. Floating will continue to give the greatest flexibility and a low interest rate until the RBNZ starts lifting rates – at which point debt-servicing costs will pick up sharply. A 6-month fixed rate also gives low interest rates in the here and now but at a loss of flexibility. Both of these choices are more suitable for borrowers who place a lot of weight on low debt-servicing costs now, and are either prepared tolerate sharp lifts in future interest rates or believe the RBNZ will be a lot slower lifting rates than is generally expected. At the other extreme, the 2-year rate gives protection from rapid rate increases as well as certain, stable and below-average debt-servicing costs. As such it may suit more conservative borrowers.

Other considerations for borrowers

There is still a fair amount of uncertainty over the interest rate outlook – though less than there was over the last year! Often you won't know until well after the fact what the "best" choice would have been. What you can do is weigh up your priorities: importance of certainty vs. flexibility; the trade-off between benefiting from very low interest rates in the near term at the expense of more rapid lifts in debt-servicing costs in the future.

Borrowers should also take into account that in the future interest rates will be higher than what they have been over the past year. It is important for borrowers to leave a buffer in their finances so that they will be able to meet those higher debt-servicing costs in the future. Fixed-term rates have averaged between 7.5% - 8% in the past and also exceeded 9% for long enough to cause pain. Mortgage rates of around 6% are very rare. One thing borrowers can be certain about is that future interest rates will continue to average higher than the cheap rates still currently available.

We stress that life is 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 some advantages and disadvantages of various fixed rate terms.

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

- A very low mortgage rate by historical standards, and beaten at present only by the floating and 6-month terms.
- Repeatedly rolling a 1-year term is likely to produce a lower average cost of funds than fixing at current rates for 3 to 5 years.

The major **disadvantages**:

- Should the RBNZ lift rates in the first half of 2010 then rates available in a year's time will be substantially higher than those currently available (this is also a disadvantage of the floating and 6-month terms). The 1-year term provides less of a hedge than the 2-year rate against sharp lifts in interest rates.
- Conversely, if the RBNZ lifts interest rates later than expected then borrowers would forego the very slight pricing advantage afforded by floating and 6-month rates.

The 1-year fixed rate would suit those who prefer some interest rate certainty, but place some priority on low debt servicing costs, or those who will be repaying debt over the 12-month timeframe.

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

- Greater certainty than that available through shorter terms, potentially at no or only moderate cost.
- A hedge against an earlier or more aggressive lift in interest rates relative to current market pricing.

The **disadvantage**:

- Foregone savings if the RBNZ started hiking later e.g. if the RBNZ waited until October, 6 months longer than we expect, to lift rates then floating could work out 50bp lower on average over the next 2 years.

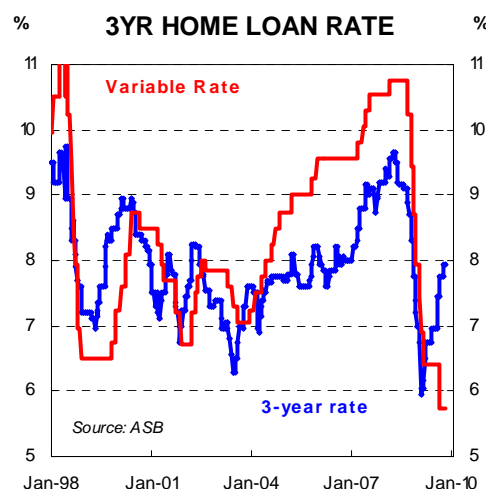
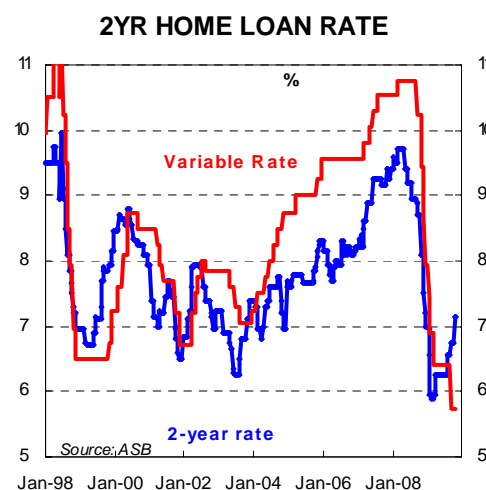
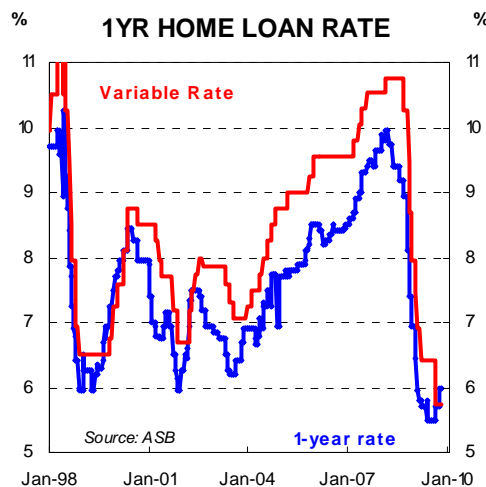
The 2-year fixed rate would again suit those who prefer a degree of interest rate certainty in the near-term at a relatively low rate, or those who will be repaying their debt over the 24-month timeframe.

The 3-year fixed rates currently offer the following **advantage**:

- Providing interest rate surety for longer, including some insulation against an aggressive lift in interest rates over the next few years.

The **disadvantages**:

- The risk of higher rates after the fixed term, if future inflation is substantially higher than expected or global government bond issuance puts considerable upward pressure on future interest rates.
- The current 3-year rate is a fraction above its 10-year average and higher than the long-run average for the shorter terms, so provides no clear-cut savings.
- Shorter-term rates are likely to provide a lower cost of funds over the next 3 years.



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

- The rate offers certainty for a much longer period than the shorter-term fixed rates.
- A hedge should future interest rates sustain substantially higher levels than we envisage e.g. through high inflation or pressures from global government debt issuance.

The **disadvantages**:

- The current 5-year rate is 75bp higher than it has averaged over the past 10 years.
- Other rates are highly likely to provide a lower cost of funds over the next 5 years – particularly rolling the shorter terms. The certainty of the 5-year rate is likely to come at a considerable price.

As an example, rolling a 1-year term for 5 years could yield an average interest rate of under 8% over the period, a distinct saving. Alternatively, fixing for 5 years would only work out cheaper than fixing for, say, 2 years if interest rates for the subsequent 3-year period averaged more than around 9.8%. Although one should never say never, the probability of that happening appears low. Fixed rates did exceed 9% for about a year over 2007-08, but only in order to rein in the strong housing market boom in decades.

Final thoughts

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.

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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