

Home Loan Rates

Rate rises on the radar.

- A mixture of forces influenced mortgage rates over the latter part of 2009.
- Mortgage rates are expected to rise further over 2010, with short-term rates moving the most.
- The choices of what borrowers can do to minimise interest costs are steadily narrowing.

A mixture of forces influenced mortgages over the latter part of 2009, primarily pushing term rates up. Over 2010 we expect mortgage rates will continue to rise. Whereas the increases of the past 6 months have been concentrated in the longer-term rates, during 2010 we expect the shorter-term rates will be moving the most.

Floating rates have stayed at or near their 2009 lows, held down by the RBNZ's record low 2.5% Official Cash Rate. Short-term fixed rates (6 months to 1 year) have lifted off their 2009 lows, and will lift further over the next 3 to 6 months as it becomes more likely that the RBNZ will start lifting the OCR. In January 2010 the RBNZ said it will keep the OCR unchanged until "around the middle of 2010", repeating the view stated in December. The NZ economic environment is looking healthier and inflation pressures are less likely to weaken as much as was expected when a deeper recession was looking likely both here and abroad. As the economic recovery continues to gradually gather momentum, the RBNZ will want to begin the process of returning interest rates to more normal levels.

Mortgage rates for 2-year terms and longer were actually at their low point back in January 2009, before the OCR reached its low point. Long-term mortgage rates have climbed a long way since then as expectations of global recovery became firmer, and interest rate markets have priced in a return to more normal (higher) interest rates. Over the past 10 years, mortgages rates have averaged between 7.5% (6-month fixed) and 8% (5-year fixed). Now only the rates available for up to two years are below their long-term averages. The lift in long-term rates means the potential cost savings from fixing have steadily been eroded over time. The trend over 2010 will be for those shorter-term rates also to start lifting back to average, or slightly above-average rates. With long-term fixed rates so high, it is really only the floating or short-term fixed rates that offer value. Priority will be dictated by borrowers' preference for maximising the chance of low debt servicing costs or smoothing the inevitable increase in mortgage rates.

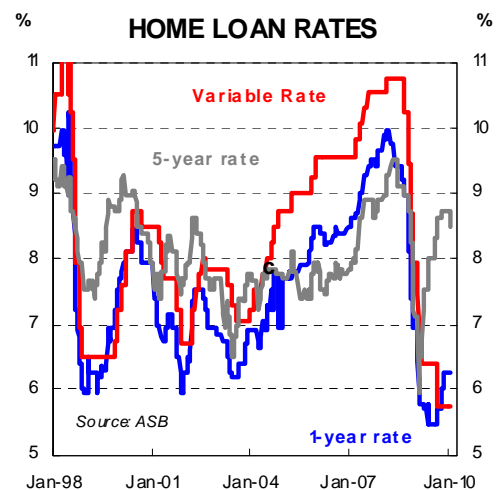
RBNZ move "around the middle of 2010"

Rate hikes are coming, although some urgency has dissipated.

In January the RBNZ toed a very similar line to its December statement, and remained comfortable with its assessment that "around the middle of 2010" is the appropriate timing to start lifting the Official Cash Rate. The RBNZ noted the NZ economy continues to recover, and is 'comfortable' with the inflation outlook.

We expect the RBNZ to start lifting the OCR at their June Monetary Policy Statement. We expect the pace of OCR increases to be in 0.25% steps. Some of the urgency for the rapid tightening we expected as the economy recovered in 2009 has dissipated with signs that the housing market's rise is ending.

Another key factor behind our view change is the relationship between the OCR and lending rates. We think this relationship is likely to be a lot firmer than we previously assessed.



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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.

Higher bank finding costs change the OCR outlook.

High funding costs for banks (particularly for longer terms) has driven a wedge between the Official Cash Rate and mortgage rates. This wedge means the RBNZ can be more confident they can lift borrowing costs up to an appropriate level with a lower OCR than before the financial crisis.

Legislative changes that would reduce the incentive to invest in property could also help the RBNZ if they are worried about another housing boom. Tax changes could do some of the work to rein in housing-driven inflation pressures. The current Government appears to have a sympathetic ear for the suggestions of the recent Tax Working Group on the issues surrounding property tax. For any policy shifts, it is worth keeping an eye on the May 2010 Budget.

Short-term rates remain at stimulatory levels.

Regardless of the exact timing of RBNZ rate hikes, the early phases of the tightening cycle would still leave short-term lending rates at stimulatory levels.

Some key factors to watch over the coming months for the exact timing of interest rate increases will be: the durability of housing market strength; household credit growth; the sustainability of the global economic recovery; and signs of how well-behaved NZ inflation is likely to be.

Short-term rates to rise over 2010

OCR has direct influence on floating and very short-term rates.

The level of the OCR has a direct influence on floating and very short-term interest rates. Shorter-term fixed rates have been rising off their lows as markets anticipate the RBNZ will start lifting interest rates. Markets have rate hikes priced in from June onwards, and expect the Official Cash Rate to be around 4.0% by early 2011.

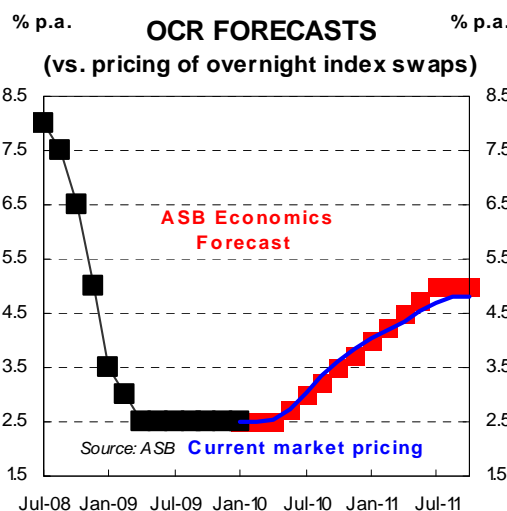
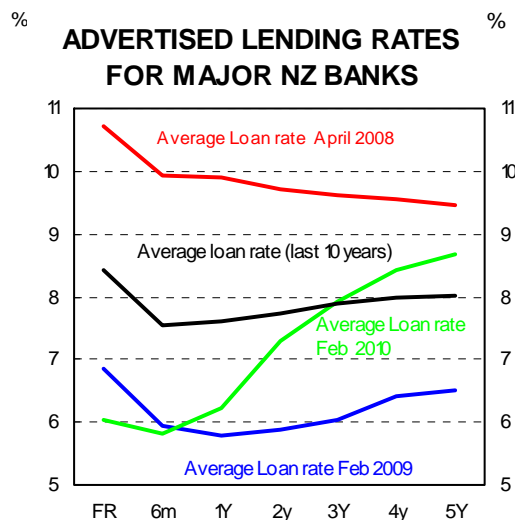
As the market has begun pricing in rate hikes from the RBNZ, 6-month and 1-year mortgage rates have lifted in line with the lift in the underlying wholesale rates. Increasingly the 6-month to 2-year rates will lift as the anticipated start of the tightening cycle draws even closer. The floating rate will be the last to start increasing, likely moving in reasonably close step with increases in the OCR.

Long-term rates remain high in 2010

Long-term rates are already high, reflecting several influences.

At the other end of the borrowing curve, 5-year mortgages reflect both a return to a more normal OCR level over the coming years, and the high cost of long-term funding banks have been paying since the financial crisis. Long-term rates such as the 4 and 5 year terms are not expected to rise to the same degree over 2010 as we observed in 2009. But there is likely to be some modest pressure as the RBNZ tightens and brings into sharper focus exactly how far (and fast) the Bank will lift the OCR.

A wildcard for long-term rates over the next few years will be global government bond issuance. In order to reinvigorate economies, many governments are taking on huge amounts of debt. The expected debt for the governments of major economies (particularly the UK, US and Japan) is concerning. Other governments, including our own, are also borrowing. At present global bond markets are absorbing the flow of bonds quite comfortably. However, in time investors may become wary of lending money to indebted governments without a little extra compensation – in other words without being paid progressively higher bond yields. If this happens on a uniform basis it will lift global costs of borrowing, particularly at the longer terms at which governments tend to issue bonds. This will cause long-term mortgages to lift as well. Recent developments in Greece are a good example of this.



Rate less of an influence on term choice

Taking into account our expectations the OCR will start rising from June and current market pricing, there are no longer any clear-cut advantages of one term over another out to the 2-year mark. There are several potential benefits from a floating rate. Debt-servicing costs will remain low until the RBNZ lifts rates, and the floating rate is currently either the lowest or nearly the lowest rate on offer, depending on the provider. Floating would bring a slightly longer period of low debt-servicing costs if the RBNZ did wait until the second half of 2010 before lifting rates. The trade-off of trying to maximise the period of very low debt-servicing costs is that once the RBNZ does tighten the floating rate will jump quite quickly and fixed rates on offer then would be even less of a bargain. Floating also provides no insulation should the RBNZ hike more aggressively than the market has currently factored in. Floating rates do offer the flexibility to make lump-sum repayments.

The advantage of the fixed rates is that they bring varying degrees of security, even if they don't necessarily provide an obvious pricing advantage any more.

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 a similar view of the OCR path to our own forecasts of steady increases in the OCR from 2.5% up to around 5% at the end of 2011. Based on this forecast, our calculations suggest that any option from floating through to the 2-year fixed rate will give a similar average cost of funds over the next 2 years – with likely costs in the 6.8% to 7.5% p.a. range.

The longer the RBNZ holds the more likely floating will be the cheapest option. But it is 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 some 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 to tolerate sharp lifts in future interest rates or believe the RBNZ will be a lot slower lifting rates than is generally expected. The 2-year rate gives protection from rapid rate increases as well as certain, stable and below-average debt-servicing costs. The current 3-year term interest rate is very near its long-term average. By that measure, the 3-year rate could therefore be seen as providing some longer-term certainty at a reasonable cost (although the shorter terms are a better bet from a purely a cost perspective). Beyond the 3-year mark, terms look expensive (though do provide more certainty if that is an important factor). A good question for borrowers to ask themselves is: which of the following options am I more comfortable with: one. Floating/six-month fixed to maximise the chance of low debt-servicing costs with the trade-off debt servicing costs will in time rise rapidly; or two, fix for a year (maybe two) to provide smoother and more certain debt servicing costs for a period, with the trade-off that this option may not be the cheapest. If choosing is difficult, then splitting debt between the two options is a strategy with “a dollar each way”.

Other things to bear in mind

Given the hugely unusual global events of the past year or more there is still a lot of uncertainty as to how central banks will extract themselves from the huge provision of liquidity and low interest rates. This means making the perfect rate decision right now is something that could happen more by accident than design. Faced with uncertainty the best strategy is to weigh up what your priorities are and make the choice that looks the best aligned with them.

The final factor, particularly for first home buyers or anyone increasing their borrowings is to take into account the inevitability that interest rates will be higher in the future. It is very important to make sure that your finances will have ample headroom to absorb the impact of higher debt-servicing costs than what you pay now. The vast majority of borrowers came through the 2007/08 period of eye-watering rates and the housing market downturn in one piece, but it was traumatic for those that didn't.

Over the last year or two we have stressed that life in the financial world is very 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 floating rate are:

- The floating rate is the lowest rate on offer at present.
- Based on our forecasts of steady 0.25% OCR increases from mid 2010 and accompanying lifts in the floating rate, this strategy still provides the lowest estimated interest cost over the next two years.
- If the RBNZ lifts interest rates later than expected then borrowers will maximise the pricing advantage afforded by floating rates.
- Borrowers can lock in term rates at any time, and have also flexibility in terms of principal repayments.

The major **disadvantages**:

- Should the RBNZ lift rates more aggressively than our forecasts, the interest rate costs could turn out to be higher over the next two years compared with locking in a fixed term now.

The floating rate suits borrowers that want to minimise borrowing costs, and are comfortable with the likelihood of increasing interest costs as the floating rate rises over the near future.

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 around mid 2010, 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.

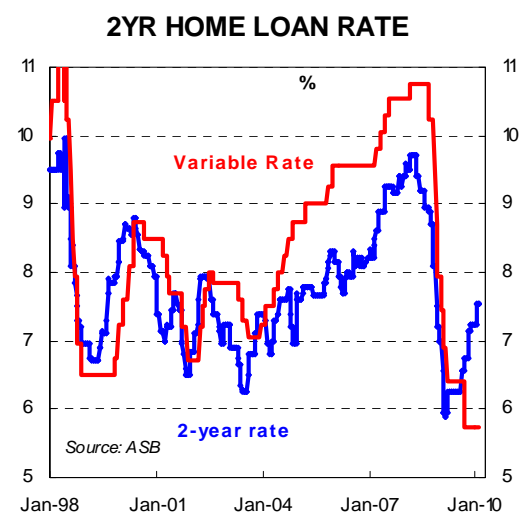
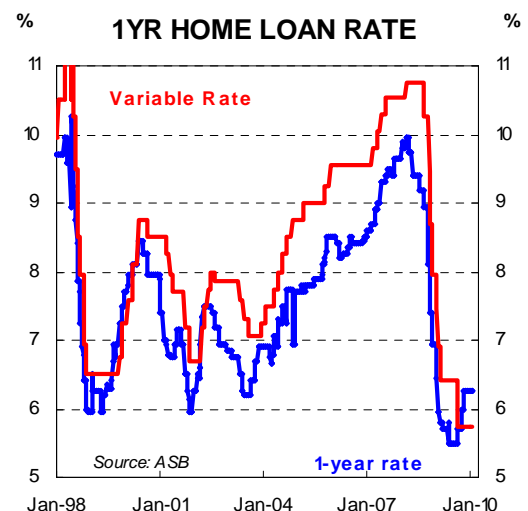
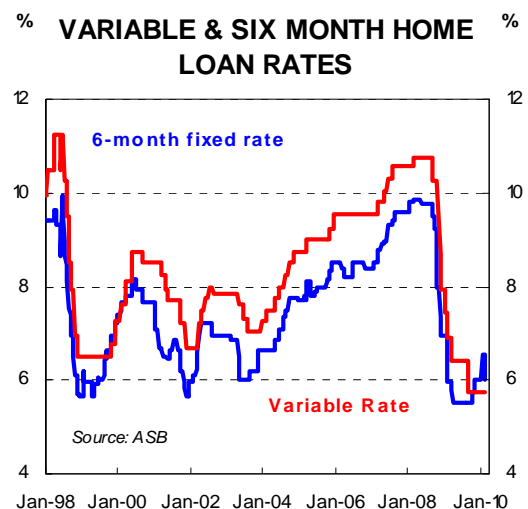
The 2-year fixed rate currently offers the **advantages**:

- 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, or more gradually than expected e.g. if the RBNZ waited until October, 3 months longer than we expect, to lift rates then floating could work out around 0.5% 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 0.5% 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.

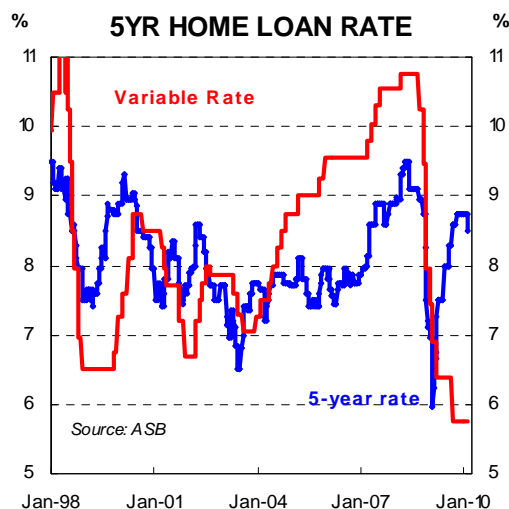
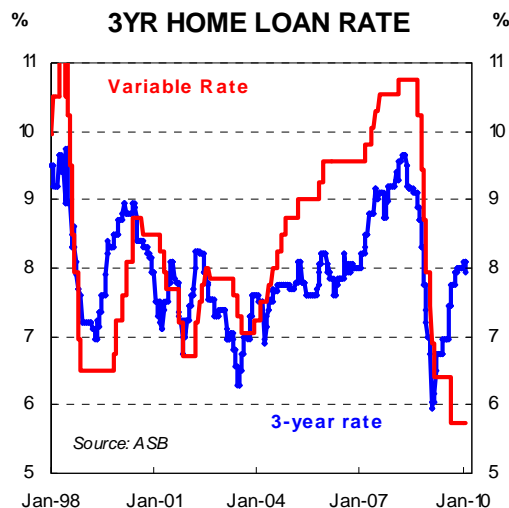
As an example, based on our current forecasts for mortgage rates, rolling a 1-year term for 5 years could yield an average interest rate of under 8% over the period, a distinct saving. Alternatively, fixing for 5 years would only work out cheaper than fixing for, say, 2 years if interest rates for the subsequent 3-year period averaged more than around 9.2%.

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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