

Home Loan Rates

Housing a 'likely' trigger for higher interest rates

- Higher interest rates in the here and now look 'likely'.
- But interest rates are likely to decline in 2008.
- Meanwhile, a 2-year fixed rate remains a reasonable trade-off for borrowers.

On January 25 the Reserve Bank of NZ (RBNZ) stated that it needs to see clear evidence that the domestic economy is cooling to avert a lift in the Official Cash Rate, deeming the need for higher rates as 'likely'. We are doubtful that the momentum in the housing market will show sufficient – or any sign – of cooling by the time the March MPS is released. That means a strong likelihood that mortgage rates get nudged up in the first half of 2007. As has been the case for some time, borrowing at a fixed rate is prudent. Fixing provides some protection against any future lift in floating funding costs – and fixed rates remain substantially lower than floating rates. The main consideration is the trade-off between fixing for short terms and retaining some flexibility against fixing for a long period at rates that are the lowest-cost option at present but will deny the opportunity to benefit once rates eventually fall. The more risk-tolerant borrowers will probably prefer a 2-year fixed term, anticipating that rates will have dropped substantially by the time the term matures. For the risk averse, the 5-year fixed rate, the lowest of the terms, will be attractive. It is a personal choice – there is no blanket right answer for everyone.

Over the past 6 months we have seen the RBNZ creep ever closer to lifting interest rates once again. **We expect the Official Cash Rate (OCR) will increase in March.** Though 2007 will see temporary inflation reprieve courtesy of lower petrol prices, resource pressures in the economy have been slow to dissipate even as the economy lost momentum over the past two years. The RBNZ has been banking on markedly slower consumer spending growth and a softening housing market to further reduce those inflation pressures. However, in recent months the housing market has once more started to gather a head of steam: prices have jumped, turnover has lifted, and borrowing has been strong. Consumer spending has also shown some signs of lifting now that petrol prices have fallen. How durable that pick-up is will depend on how much fuel consumer get through factors such as ongoing paper wealth gains (again, housing rears its head) or resilience in wage and employment growth.

The RBNZ will continue leaning hard on the economy – via interest rates and the exchange rate – to rein in those inflation pressures. But it won't lean indefinitely. At some point it will judge it has squeezed the economy hard enough to trigger a drop in inflation back to a level that no longer threatens the mandated inflation target. That relaxation should start to occur over 2008.

With all this in mind there are two key factors to take into account when deciding what to do with your mortgage: the threat of higher interest rates in the here and now and the longer-term issue of when interest rates will eventually start falling. **Fixing remains the prudent course of action, and the 2-year rate appears a good balance between protecting from higher rates now against enabling you to benefit once interest rates eventually fall.**

Threat of higher interest rates in early 2007

The likelihood of a further lift in interest rates firmly suggests that fixing the bulk of borrowing will pay off. Even fixing for 6 months brings substantial cost savings relative to floating debt, with flexibility only sacrificed for a relatively short period.

Eventual easing of rates from high levels

This consideration has implications for just how long you might want to fix. Once the RBNZ cuts the OCR, fixed rates will fall – substantially out to the 2-year mark, for example, but less so at the 5-year mark. Ideally, the rate you choose now should mature after fixed rates have fallen substantially, giving plenty of choice of low fixed rates. But the future is uncertain: fix for too short a term and you may roll off and face still-high rates. Conversely, if you fix for a long term and the RBNZ suddenly cuts the OCR then you will be left paying a high rate of interest for longer than necessary. Our suggestion of fixing for 2 years stems from our view that the RBNZ should have dragged mortgage rates down by early 2009. But if you are risk averse or value certainty then a longer term may suit your personal circumstances.

Nick Tuffley – ASB Chief Economist – 649 374 8604 – nick.tuffley@asbbank.co.nz

General Advice Warning

As this advice has been prepared without considering your objectives, financial situation or needs, and before acting on the advice, you should consider its appropriateness to your circumstances. The Bank as a provider of investment, borrowing and other financial services undertakes financial transactions with many local corporate entities. This may include any corporate issuer referred to in this report.

Financial markets react continually to news as it comes out, constantly re-evaluating the likelihood and timing of when the RBNZ will move the OCR up or down.

The wholesale interest rate market is currently factoring in a 2 in 3 chance of the OCR lifting in early March, and has a full 25 basis point increase built in by the April OCR Review.

In other words, lending rates currently already have built in a strong likelihood of a higher OCR. That means fixing at present won't insulate you completely from a rise in the OCR should it occur, as funding costs have already risen to a degree. But if the OCR rises markets will build in some risk of a follow-up increase, so fixed rates could rise further yet.

Eventually, markets will get to the stage when they begin anticipating a lower OCR, and fixed-term rates will begin to decline. But there can be many false dawns before the RBNZ actually acts: borrowing rates plunged in the second quarter of 2006 when it looked like the economy was nose diving, only to rebound in the second half of the year as the RBNZ's inflation concerns were reignited by soaring petrol prices and, more recently, the resilience of domestic spending.

Our pick of the 2-year mortgage rate is based on the RBNZ cutting the OCR by early 2009 or at the least markets strongly anticipating imminent action by then.

The following sections note the advantages and disadvantages of various fixed rate terms.

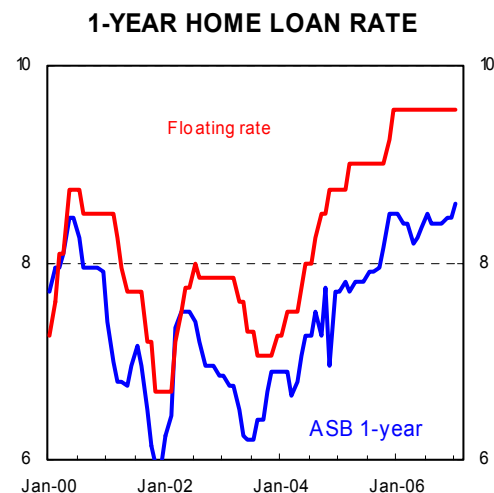
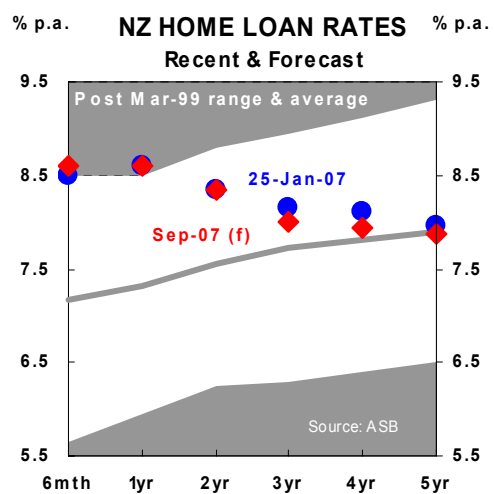
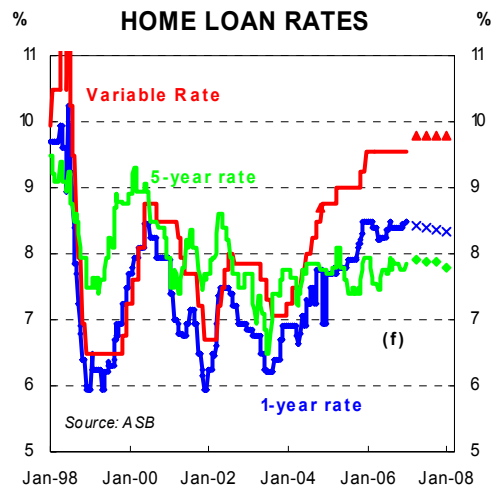
The main **advantages** of the 1-year rate are:

- it is below the average Variable Home Loan rate forecast by ASB for the next 12 months;
- there is also the potential to borrow at a lower rate in 12 months should the economic situation worsen rapidly, either here or abroad, enabling interest rates to decline quickly.

The major **disadvantages**:

- should interest rates actually rise further than expected – still a big risk – then high rates will apply when coming off the fixed term next year.

The 1-year fixed rate would suit those who prefer interest rate certainty during the period when rate rises are still a risk (inflation still high) but who either will be repaying debt soon or who foresee the period of high interest rates passing quickly.



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;
- it is below shorter-term fixed rates;
- with the added advantage of surety for a longer period than the shorter-term fixed rates

The **disadvantages**:

- missed opportunity for lower rates should the economy worsen rapidly and rates declines quickly;
- but also still the risk of higher rates after the fixed term if, instead, inflation risks become much greater.

The 2-year fixed rate would again suit those who prefer interest rate certainty in the near-term but were willing to take the risk that interest rates will return to lower levels during the next 24 months.

The 3-year fixed rate currently offers the **advantages**:

- providing interest rate surety for longer;
- and enables an even lower fixed rate at present.

The **disadvantages**:

- missed opportunity should global and local economies worsen and rates fall;
- the current rate is now above the average 3-year Home Loan rate (average 7.7% since Mar-99).

A 3-year fixed rate would again suit those who foresee interest rates returning to lower levels within the next few years but either prefer less risk or foresee the inflation adjustment process as lengthy.

The **advantages** of the 5-year rate:

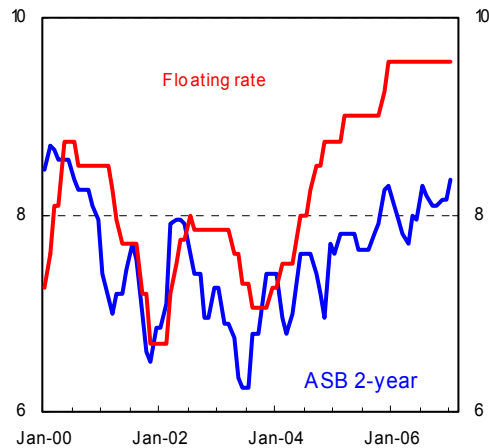
- surety for the next 5 years and protection against very high interest rates;
- plus the lowest fixed rate at present.

The major **disadvantages** of the 5-year rate are:

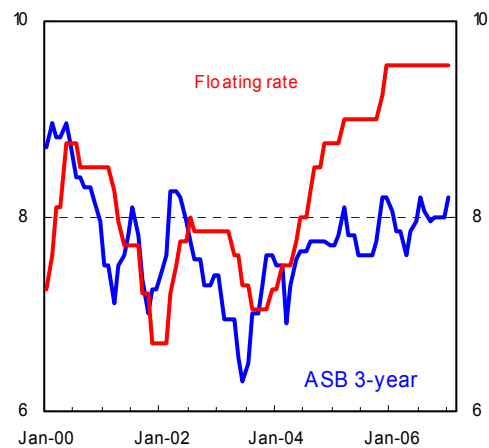
- it is above the average 1-year Home Loan rate forecast by ASB for the next 60 months;
- and there is the missed opportunity if fixed rates do decline within the next 1-3 years.

A 5-year fixed rate would suit those who strongly prefer interest rate certainty or who foresee a period of persistent inflation.

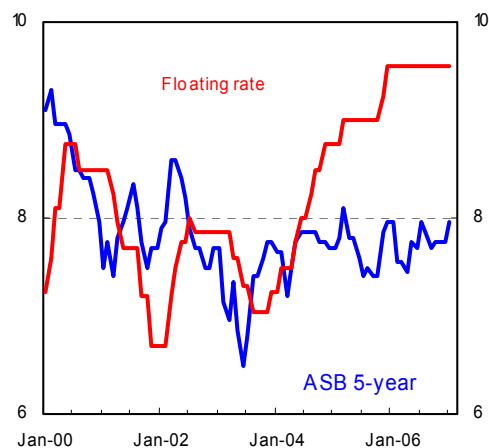
2-YEAR HOME LOAN RATE



3-YEAR HOME LOAN RATE



5-YEAR HOME LOAN RATE



The last word remains the same: nobody knows the future. The above notes hopefully provide some perspective to current trends and help with the decision about fixing loan rates. They do not, unfortunately, describe what will happen. You need to weigh up your own situation against possible rate changes – expected and unexpected – to find the term best suited to your needs. 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>

<http://www.research.comsec.com.au>

ASB ECONOMICS

Level 9, 135 Albert Street, Auckland

ASB ECONOMICS			PHONE	FAX
Economics				
Chief Economist	Nick Tuffley	nick.tuffley@asb.co.nz	(649) 374 8604	(649) 302 0992
Treasury Economist	Daniel Wills	daniel.wills@asb.co.nz	(649) 374 8185	
CBA NZ Economist	Chris Tennent-Brown	chris.tennent-brown@asb.co.nz	(649) 374 8819	

DISCLAIMER

The views expressed herein are those of the authors and are based on information believed but not warranted to be correct. Any views or information, whilst given in good faith, are not necessarily the views of the bank and are given without responsibility and no right of action shall arise against any of the authors, the bank or its employees either directly or indirectly out of any views, advice or information.