

# Home Loan Rates

## Interest rates will stay high in 2007

- Interest rates are likely to remain high over 2007.
- But interest rates decreases remain on the cards for 2008.
- Fixing for no more than 2 years seems the better course of action.

Recent months have seen the Reserve Bank (RBNZ) push the Official Cash Rate (OCR) up three times to an eye-watering 8%. Consequently, floating mortgage rates are exceeding 10% for the first time since 1998. Fixed-term mortgage rates have risen by 80-100 basis points since the start of the year, a considerable amount in a short period of time. Importantly, the 5-year rate is now nearly 9% and no longer offering much of a hiding place from the RBNZ's efforts to make mortgage borrowing more expensive. But those very increases make further OCR lifts less likely, and the odds presently favour the OCR remaining where it is for the rest of the year. Even so, the relative balance of risks is to higher, rather than lower, interest rates. With that in mind, fixing the bulk of any borrowing remains the best risk management option – in addition to the fact that fixed rates are still considerably lower than floating rates. However, as interest rates are unlikely to drop until sometime in 2008, it makes sense to fix for around 2 years to tide you over until interest rates have dropped back. Though the 5-year rate may still have some appeal due to the fact that it is still the lowest on offer, we suggest steering clear of that term now if the level of the rate is your primary consideration.

The housing market has been firmly in the RBNZ's gun sights in recent months, along with a pick-up in consumer spending and the prospect of strong dairying incomes adding further fuel to the spending bonfire. The RBNZ's inflation forecasts hit 2.8% for 2009, which implies very little headroom to tolerate any further news pointing to stronger inflation pressures than are presently factored into that outlook.

**Our assessment is that the RBNZ has done enough to rein in inflation pressures.** In particular, there are early – but consistent – signs that the rapid lift in mortgage rates is starting to impact on the housing market. Provided those signs continue to emerge the RBNZ will be prepared to hold off hiking again. **However, that prediction also comes with the assumption that the RBNZ gets no more unpleasant (from its perspective) shocks.** For example, the news that Fonterra's next milk solid payout will jump was a significant factor behind the June OCR increase given the potential for added spending to boost inflation.

Although we are not expecting a further interest rate increase this year (we place around a 30% chance on a further lift happening), we don't see an OCR fall before mid-2008.

Picking an interest rate at present means taking two key considerations into account:

### Threat of higher interest rates remains

The RBNZ's assessment of inflation risks is skewed very much in one direction: up. Ditto the risk for interest rates. For that reason, fixing makes a lot of sense as it offers some protection from any further OCR increases.

### Eventual easing of rates from high levels

Ideally, you want to fix for just long enough to tide you over until the RBNZ has started dropping interest rates. Any easing from the RBNZ remains a considerable way off. Floating and short-term mortgage rates will remain elevated into 2008, and look set to remain high until there is a firm expectation of when the RBNZ will begin to ease the OCR. Given the still-strong domestic inflation pressure within the economy, our view is an OCR easing will be unlikely until mid-2008 – and any further signs of inflation pressure could mean an even longer wait. Financial markets need to build expectations of a significant easing of the OCR before we will see a big step down in mortgage rates.

**Fixing for 2 years will carry you through until mid-2009, by which time the odds are favourable that RBNZ will have well and truly changed tack.** In contrast, one year might not be long enough, given the degree of uncertainty that is par for the course when looking out into the future.

The 5-year mortgage rate does remain the lowest on offer, and is 35 bps lower than the 2-year rate. However, we see it as ultimately the most expensive. For the 5-year rate to come out ahead means the OCR has to spend the next 5 years at or above its current level, and we are sceptical that will happen.

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### General Advice Warning

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The RBNZ is still indicating further risk of an OCR increase, and we see a one-in-three chance of a further rate increase this year. Financial markets have factored that prospect into wholesale interest rates.

Presently market pricing implies upwards of a 50% chance of a further OCR increase this year.

As a result current mortgage rates also reflect the risk of a higher OCR, so fixing provides some protection from a further OCR increase but not 100% protection.

Nevertheless, that risk premium is modest, and also likely to linger on until the risk of a yet-higher OCR diminishes.

Mortgage rates will begin to edge down once financial markets eventually start to anticipate that the RBNZ will swing towards cutting interest rates. Concerted falls in mortgage rates will follow actual OCR cuts.

The RBNZ will not relax until it is positive it has got the housing market and wider spending pressures firmly reined in. Even then, the RBNZ will still have a weather eye out for any boosts to fiscal spending that could get announced next year.

By year-end interest rates could well be a fraction lower than they are now, provided the RBNZ keeps the OCR at 8% and the current risk of a further hike gets unwound from wholesale rates. But the benefits to borrowers of low rates aren't likely to materialise in substantial fashion until we are into 2008.

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

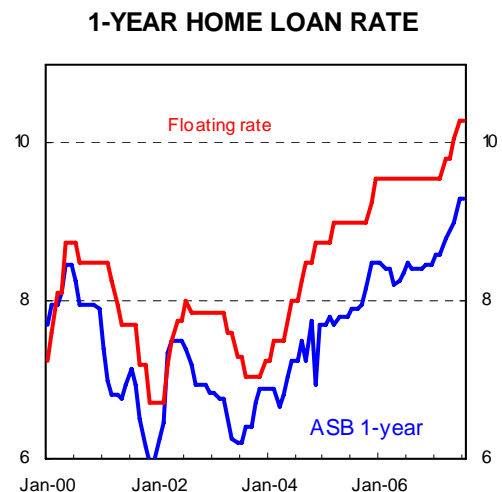
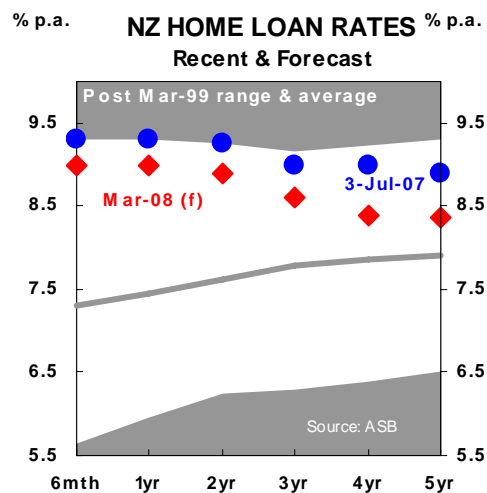
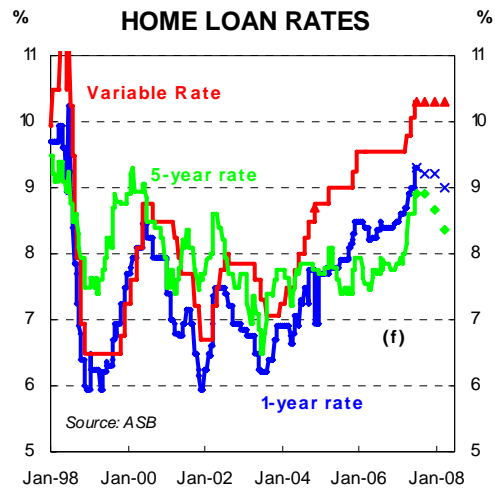
The main **advantages** of the 1-year rate are:

- 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;
- with the added advantage of surety for a longer period than the shorter-term fixed rates;
- there is a very reasonable chance that fixed rates drop by the time the term matures.

The **disadvantages:**

- missed opportunity for lower rates should the economy worsen rapidly and rates declines quickly;
- but also still some 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;
- it is lower than the 6-month, 1 & 2-year rates.

The **disadvantages:**

- likelihood of missed opportunity should global and local inflation pressures ease and rates fall over the next 3 years;
- the current rate is high by historical standards, and also relative to where we expect shorter-term fixed rates to average over the next 3 years.

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 (and interest rates slow to fall as a result).

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

- surety for the next 5 years;
- being the lowest fixed rate at present.

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

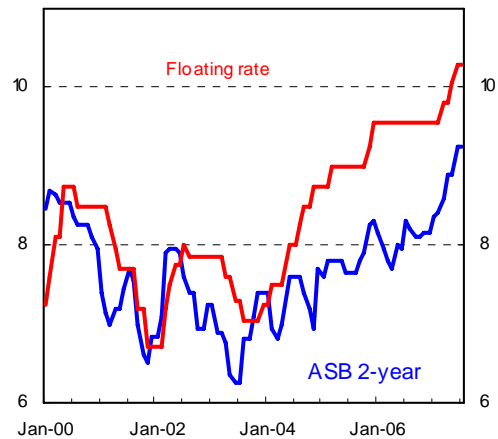
- it is well above the average 1-year Home Loan rate forecast by ASB for the next 60 months;
- and, therefore, there is strong likelihood of missing out on the opportunity to benefit if fixed rates do decline within the next 1-3 years.

A 5-year fixed rate would suit those who strongly prefer interest rate certainty or who foresee a period of persistent inflation. But after recent sharp increases in this rate we view it as the least likely choice to minimise long-term debt-servicing costs.

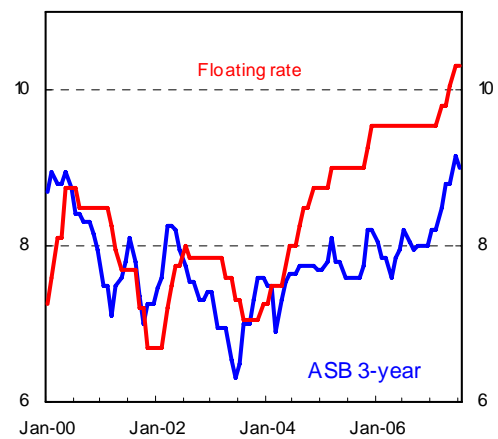
Just remember that only certainty about the future is that it is uncertain. Which mortgage rate turns out to be the 'best' will only really be known with hindsight. But with the above pros and cons for the various mortgage rates on offer we hope to give you a good platform from which to consider what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

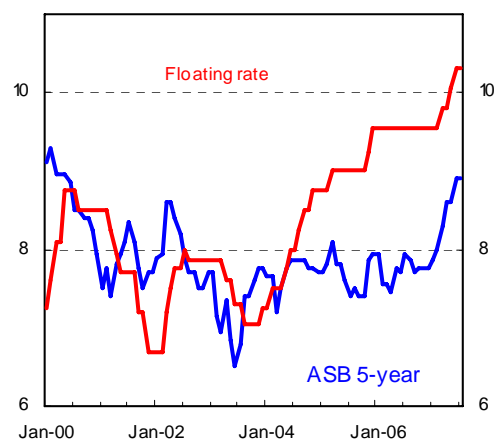
2-YEAR HOME LOAN RATE



3-YEAR HOME LOAN RATE



5-YEAR HOME LOAN RATE



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