

# Home Loan Rates

## Long wait for lower rates.



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

In September the Reserve Bank of New Zealand (RBNZ) held the Official Cash Rate (OCR) at 8.25%, having hiked four times in 2007. The 2007 rate hikes boosted the upward pressure on wholesale rates, and in turn have sent home loan rates up dramatically this year. The recent on-hold decision combined with a balanced inflation outlook mean that high home loan rates will remain in place for the time being. Home loan rates for all terms remain expensive when compared to the rates available over the last few years. Floating mortgages are very expensive, with rates around 10.5 percent. Fixed mortgages for 1 to 5 years are largely over 9% at the time of writing. Only the 5 year rate has been consistently under 9% over the last few months.

RBNZ Governor Bollard has stated "New Zealanders have been showing early signs of moderating their borrowing. Provided they keep this up, and the pressure on resources continues to ease, we think the four successive OCR increases we have delivered will be sufficient to contain inflation." Thus, the RBNZ has indicated this should be the top of the interest rate cycle.

In September the RBNZ had to balance greater than normal uncertainties surrounding upside and downside risks to the NZ inflation outlook. The extent of the global growth fallout from a tightening US credit market and slowing US housing market has emerged as the key downside risk to NZ growth via its impact on global commodity prices and export trading partner activity. Domestic spending appears to be responding to the RBNZ rate hikes, but the RBNZ was quick to underline the fact that it believes "inflation pressures remain intense".

We are seeing a tentative sign of moderation in ASB's housing confidence survey and a decline in confidence in several consumer confidence surveys. House sales data are similarly showing a lower level of turnover. Things appear to be moving in the right direction for the RBNZ. But if domestic demand and the related inflation pressures do not continue to ease, the possibility remains RBNZ could hike further.

Given the still-strong domestic inflation pressures within the economy, our view is the OCR will remain at 8.25 percent until mid-2008 at least, with an easing possible in the second half of 2008. Financial markets need to build expectations of a significant easing of the OCR before we will see a big step down in mortgage rates for terms up to two years. Floating and short-term mortgage rates will remain elevated through the coming months, and look set to remain high until there is a firm expectation of when the RBNZ will begin to ease.

Beyond the two-year period, offshore interest rates are the dominant influence on local long-term rates. The pressures are mixed at present. Jittery global investors have been sheltering in the relative safety of US Government Bonds, sending yields lower. But yields on riskier investments have stayed relatively high. New Zealand long-term wholesale rates have been choppy over the last three months, but have declined from their peaks. This has led to some slight reductions in some home loan rates on offer, but overall, loan rates remain high relative to recent years, and are unlikely to decline significantly in the months ahead.

In summary, New Zealand home loan rates are expensive now, and are likely to remain so for a while. The advice for those borrowing money at present remains the same: fix the interest rate and/or have some strategy in mind to manage any unforeseen interest rate rise. Borrowers should also carefully consider the timeframe for their loan. Lower rates should be available in the years ahead. 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.

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### 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.

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

Threat of higher interest rates remains

The RBNZ's assessment of inflation risks remains skewed in one direction: up. Accordingly, upside risks remain 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 late 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.

Current Financial Market uncertainties

The extent of the global growth fallout from a tightening US credit market and slowing US housing market has emerged as the key downside risk to NZ growth.

Should the current financial market turmoil significantly affect growth in our major trading partners, New Zealand economic growth and in turn domestic inflation could fall faster than expected. This scenario is not our core expectation, but would likely lead to mortgage rates falling quicker than we currently forecast.

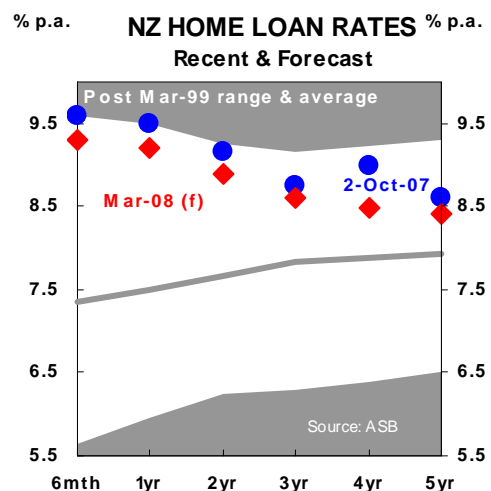
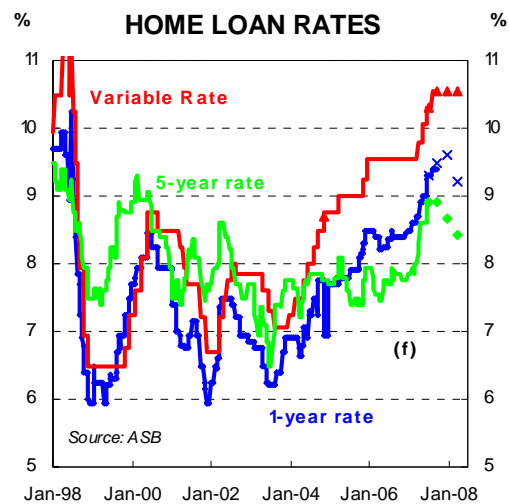
**Fixing for 18 to 24 months years will carry you through until a time when the odds are favourable that RBNZ will have well and truly changed tack.** In contrast, one year might not be quite long enough, given the degree of uncertainty that is par for the course when looking out into the future.

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 early 2008 mortgage rates could well be a fraction lower than they are now, provided the RBNZ keeps the OCR at 8.25%. But the benefits to borrowers of low rates aren't likely to materialise in substantial fashion until we are well 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 – not our core view, but still a 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 these **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**:

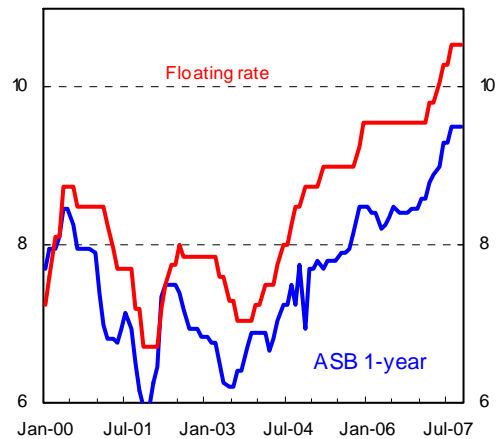
- providing interest rate surety for longer;
- it is lower than the 6-month, 1 & 2-year rates.

The **disadvantages**:

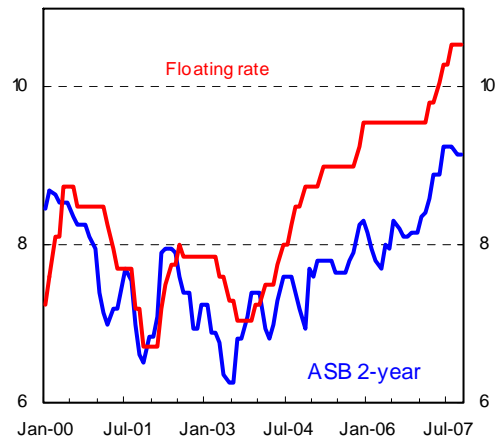
- likelihood of missed opportunity should global and local inflation pressures ease and rates fall over the next 3 years;
- the current rate is high by historical standards, and also relative to where we expect shorter-term fixed rates to average over the next 3 years.

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).

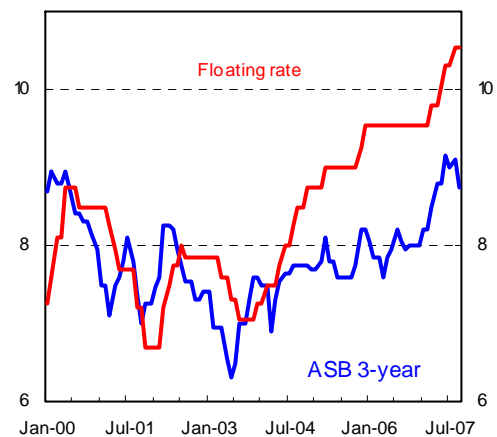
### 1-YEAR HOME LOAN RATE



### 2-YEAR HOME LOAN RATE



### 3-YEAR HOME LOAN RATE



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

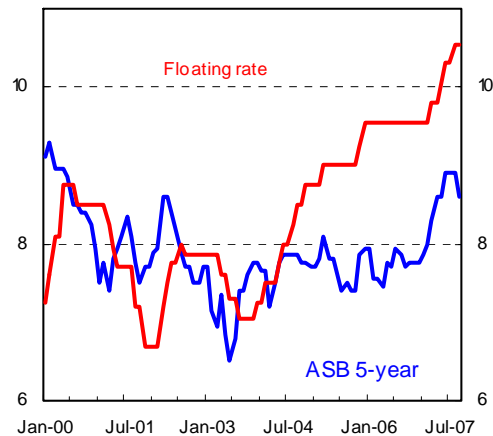
- surety for the next 5 years;
- being the lowest fixed rate at present.

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. Despite the recent dip in the 5-year rate, and the fact it is the lowest rate on offer, sharp increases earlier this year mean we view it as the least likely choice to minimise long-term debt-servicing costs.

5-YEAR HOME LOAN RATE



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.

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