Home Loan Rates

2 February 2015

ASB

RBNZ's neutral stance and low global rates provide opportunities

- **RBNZ leaves OCR unchanged at 3.5% as expected and moves quickly to a neutral bias.**
- **Low inflation removes the need for rate hikes, and we expect the RBNZ will remain on hold for the foreseeable future.**
- **Borrowers wanting some certainty can lock in reasonable length fixed-terms at rates lower than the floating rate.**

RBNZ moves to an explicit neutral stance

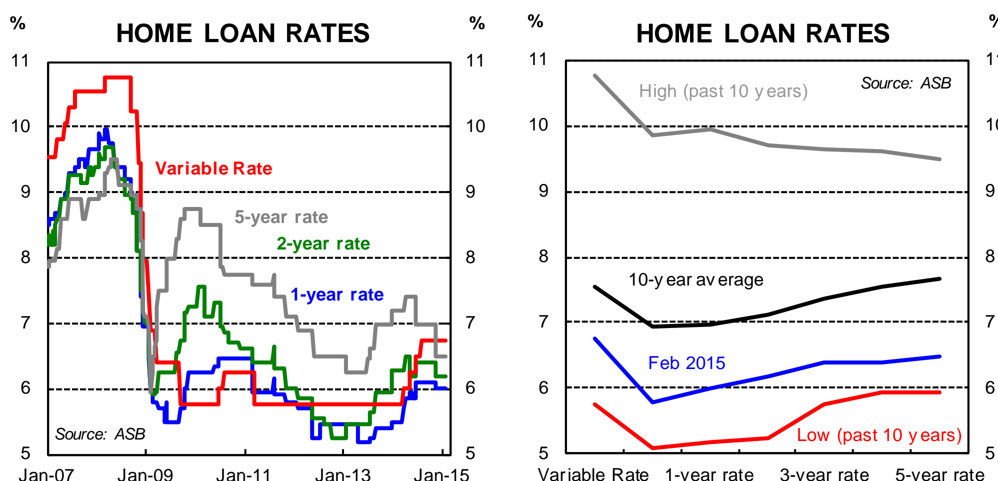
At the January 2015 Review, the Reserve Bank (RBNZ) left the Official Cash Rate (OCR) unchanged at 3.5%. This was widely expected, and the focus was more on the RBNZ's assessment for future OCR moves. On the outlook for the OCR, the RBNZ was explicit: *"future interest rate adjustments, either up or down, will depend on the emerging flow of economic data".* This is a shift from the RBNZ's earlier bias for higher rates being expected at some stage in the future.

To cut to the chase, we no longer expect the RBNZ to increase the Official Cash Rate (OCR) in the foreseeable future and this has implications for our expectations for mortgage rates over the coming months and years. Headline inflation is going to remain very subdued over 2015 courtesy of the plunge in oil prices and a backdrop of mild inflation. Given how long inflation has already remained low, we expect the RBNZ will be increasingly wary about putting up the OCR until reported inflation demonstrates some distance from the 1% floor of the inflation target. By the time that happens, we expect key leading indicators of capacity pressures will be giving the RBNZ signals that future inflation will be sufficiently contained.

Saying that, we still see the long-term risks to this view as skewed to a higher OCR. One risk is the economy could grow more strongly than our respectable forecast. A more immediate threat is the recent rebound in the Auckland property market. But, any sustained pick-up seems more likely to be addressed by prudential tools. On the other side of the coin, an OCR cut would need a significant overseas catalyst. That is not our base case, but the risk can't be ruled out given the recent global wobbles. These wobbles mean that over the next few months the OCR is more likely to fall than rise.

Local interest rates (particularly longer-term rates) can also change because of offshore developments regardless of what the RBNZ does with the OCR. And right now global interest rates are incredibly low, and having a significant influence on local term rates. For example, the German 10-year Government Bund yield has been less than 0.4%, trading around its all-time lowest level. Despite the impressive run of US data over 2014, the US 10-year Government bond yield continues to trade under 2.0%, which is very low by historical standards, and when considering the economy is now expanding at a respectable growth rate. New Zealand's equivalent 10-year Government bond now yields under 3.2%, a higher return, although very low by our own historical standards, and over 1% lower than the yield a year ago. As well as influencing New Zealand's Government bond yields, these low global rates are putting downward pressure on local term mortgage rates.

We have tended to have a below-consensus view of where the OCR, and in turn mortgages, will peak in this tightening cycle. This latest view change puts us even more at odds with the consensus. In contrast, we are not far off the current interest rate pricing in wholesale financial markets which, due to the weight of global events, is effectively pricing no lift in the OCR for the next 2 years, and some risk of a rate cut.



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RBNZ's high LVR lending restrictions remain in place

Within the RBNZ's November Financial Stability Report the RBNZ noted the housing market remains very stretched, pointing to the continued high level of house prices relative to fundamental metrics such as incomes and rents, particularly in the two hotspots of Auckland and Christchurch. In addition, the RBNZ points to the increase in indebtedness among house buyers, with Auckland again highlighted as a concern.

The RBNZ has highlighted 3 main criteria for removing the restrictions:

- whether house price inflation and housing credit growth have returned to more sustainable levels;
- the risk of a resurgence in housing market pressures after the removal of the restrictions; and,
- whether the policy is creating significant market distortions.

The criteria aren't met at present, and the risk of a continued resurgence in prices is still very real – particularly in Auckland. A key risk we and the RBNZ see is housing demand from strong net migration, which has yet to peak. In recent months the net inflow has been very strong, and the annual net migration inflow is at a record level. Weighing up the mix of conditions, we think that the LVR restrictions will remain in place for at least the next six months and quite possibly longer. Added prudential measures are also a growing risk.

What does it mean for borrowers?

The maintenance of the high LVR lending restrictions means the challenge of a higher deposit requirement will remain for some borrowers. And for banks, it probably means the practice of offering "specials" or lower rates on lending with equity over 20% will likely remain in place.

Floating mortgage rates move fairly much in lock-step with each RBNZ move, and lifted 100bps, or 1% over 2014. If we are correct in our view that the RBNZ is on hold for the foreseeable future, it should mean a period of stability for floating mortgage rates. We expect the six-month rate to also remain fairly steady near the current level, given it is also very heavily influenced by where the OCR is sitting.

In contrast, the longer-term rates are subject to a number of influences that could cause them fall or rise this year.

Since March 2014, despite the RBNZ's OCR hikes, fixed-term mortgage rates have been held down and at times dipped, as global interest rates declined. Bank competition has also been fierce and margins have been tightened and further pushed down some of the fixed rates on offer. The combination has meant it has been possible for borrowers to access fixed-term rates that are lower than when the RBNZ began raising rates a little less than a year ago.

Longer-term mortgage rates will most likely change over the year ahead, even if the RBNZ holds the OCR steady at 3.5%. Developments in the economies and financial markets of the US and Europe will be a key influence on where New Zealand term mortgage rates settle. The US Federal Reserve is expected to lift interest rates over the next year. But the current bout of dis-inflationary forces stemming in part from tumbling oil prices is clouding the outlook for US interest rates. The weak European economy and related low inflation have triggered more monetary policy stimulus from the European Central Bank.

These global influences look set to keep term rates low in the immediate future, while global growth concerns are high. However, we expect the global backdrop to improve over the course of the year. And that improvement should in turn eventually lead to higher offshore interest rates, and higher NZ term mortgage rates.

It is impossible to predict the exact mix and timing of bank competition, and pressure on local wholesale rates stemming from offshore interest rate market developments. But right now the RBNZ's signal to pause, and the low global rates are helping keep the six-month and one-year rates and some targeted 'specials' on offer under 6%, significantly below the floating rates. Borrowers should monitor these developments, and discuss the options with their mortgage providers when deciding what to do with their mortgage.

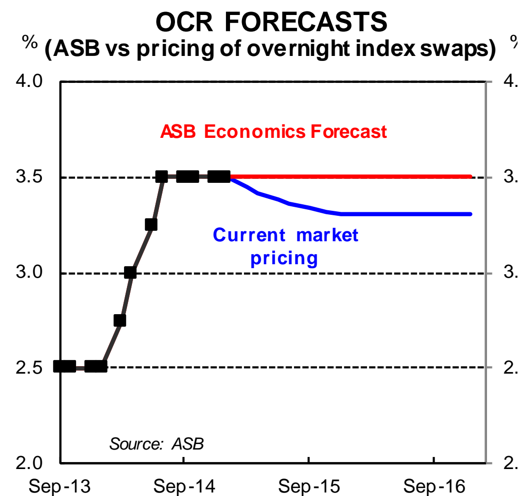
Identifying the best strategy

The best choice to make as a borrower involves assessing the likely path for interest rates, the various risks to that outlook, and personal preferences for certainty and flexibility. That's a lot to consider, but despite all the variables, there are still a number of things that we can identify.

Firstly, the six-month rate is the cheapest rate right now, nearly 1% below the floating rate. So borrowers can create some certainty, and obtain a lower rate than floating by fixing for short terms. In fact, almost all of the carded rates at the main banks are lower than floating rates at the time of writing, effectively meaning borrowers can create interest rate certainty and at the same time save on interest rate costs (provided of course the OCR doesn'tdrop).

Secondly, all fixed rates are well below their long-run (10-year) average. So by this simple measure, the fixed terms are reasonable value, as shown in the charts on page 1. We can also use our forecasts to calculate the expected cost of strategies such as rolling six-month or 1-year terms for the next 5 years, and compare the interest rate expense to the interest rate of the fixed terms available today for longer terms.

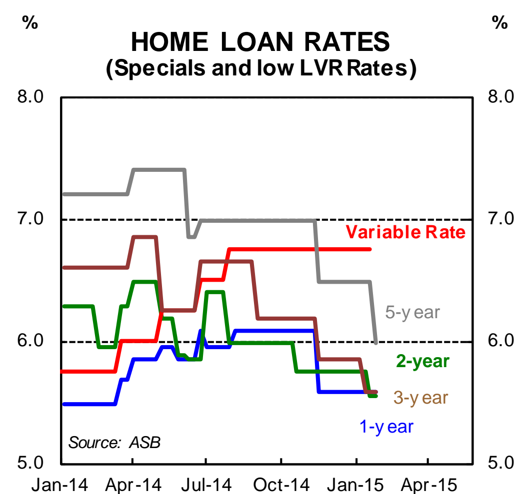
Based on our forecasts, rolling these shorter terms is still a cheaper strategy than locking in the longer terms such as the 4-year to 5-year rates. This hinges on our view that the RBNZ's tightening cycle is complete. If the RBNZ delivers more rate hikes over the coming years, some of the longer terms may prove to be better value. With that risk in mind, term rates such as the 3-year rate are not much higher than the 1-year rate. That means a long period of interest rate certainty can be achieved at a relatively low cost. It's also important to note these calculations are based on carded rates – the periodic availability of special rate offers skews the calculations, and are important for borrowers to consider.



When choosing a mortgage, of course it's not just about finding the cheapest rate. One of the characteristics of floating mortgages that borrowers have enjoyed has been the flexibility of repayments that floating offers. Splitting the mortgage into different terms, or a mix of fixed and floating mortgages can be a good strategy for keeping a bit of flexibility while locking in some interest rate certainty. The following section goes through some general advantages and disadvantages of the various mortgage rates on offer:

The main **advantages** of the floating rate are:

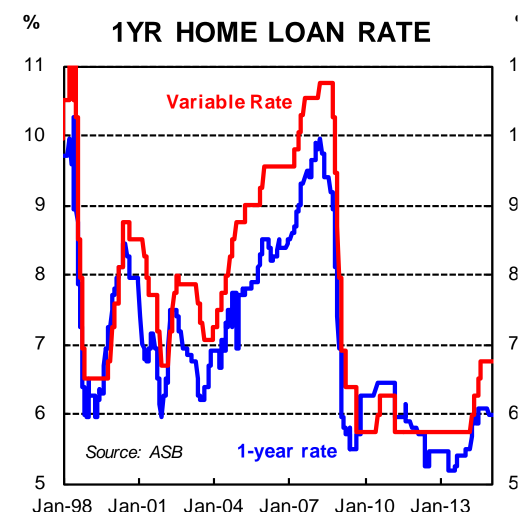
- Despite the four OCR increases, the floating rate remains around 75 basis points below its 10-year average of 7.5%. Borrowers retain the freedom to lock in term rates at any time, and have flexibility with principal repayments. If the RBNZ were to actually cut the OCR, then borrowers would benefit soon afterwards.



The major **disadvantage**:

- Even with the RBNZ on hold for the foreseeable future, the interest rate costs are likely to be higher on average over the coming years compared with locking in a fixed term now.
- Fixing for six months obtains a cheaper rate than the floating rate, and the short term of the loan means the opportunity to adjust principal payments is never too far away.

The floating rate particularly suits borrowers that need or value repayment flexibility. If the RBNZ unexpectedly cuts the OCR, the floating rate may provide a very cost-effective and flexible option.



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

- Lowest rate on offer at several of the major financial institutions (with the exception of some 6-month rates).
- Provides some certainty for the borrower.
- We expect the 1-year fixed mortgage rate will only rise a fraction from current levels, unless the RBNZ resumes lifting the OCR. Being the lowest rate on offer (along with the 6-month rate), rolling sequential six-month or one-year mortgages could prove cheaper than longer terms, based on our forecasts.

The major **disadvantages**:

- The 1-year term provides less of a hedge than the 2- and 3-year against lifts in mortgage rates that could be caused by rising global interest rates, or the RBNZ resuming OCR increases in the coming years.

The 1-year fixed rate would suit those who prefer some interest rate certainty, but place some priority on low debt-servicing costs, or the ability to review their mortgage structure reasonably frequently.

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

- Greater certainty than available through shorter terms at a relatively low rate.

The **disadvantage**:

The 2-year term provides less of a hedge than the medium- and longer-term rates against increases in interest rates, particularly if global interest rates lift more than expected, or the RBNZ resumes raising the OCR again.

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 debt in the 2-year timeframe.

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

- Providing interest rate certainty for longer at a relatively low cost.

The **disadvantage**:

- More expensive than shorter terms if the RBNZ remains on hold over the next three years, as we currently expect.

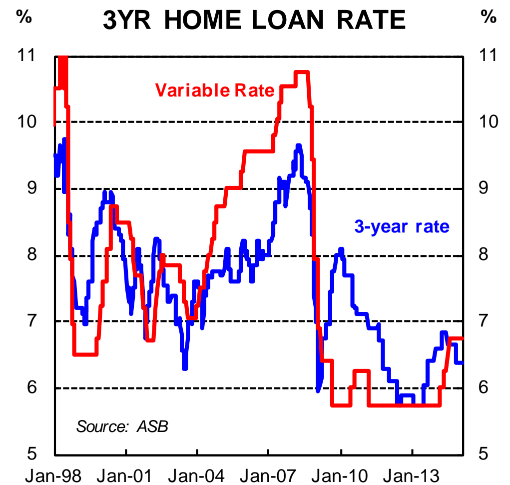
Last year's dip below 7% has taken the 5-year fixed rate significantly lower than the average level over the past 10 years (7.7%). The 5-year fixed rate currently offers these **advantages**:

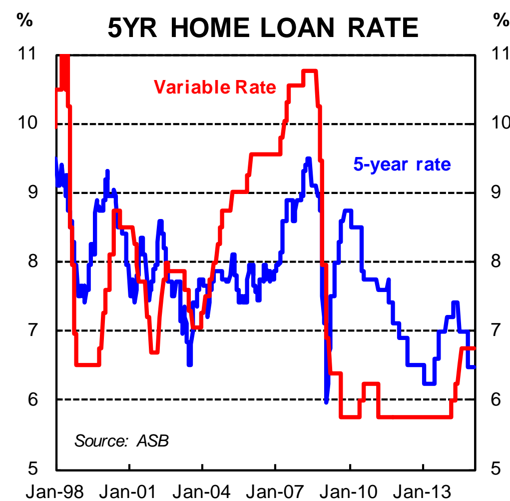
- The rate offers certainty for a much longer period than the shorter-term fixed rates. Accordingly, the 5-year term offers a long-term hedge in case future interest rates rise to substantially higher levels than we envisage e.g. through high inflation, more RBNZ OCR increases or pressures from funding costs.

- The 5-year rate is only 0.5% above the one-year rate, and lower than the floating rate, meaning borrowers can obtain certainty about their interest rate expenses for an extended period at a relatively low cost.

The **disadvantage**:

- Although it is below average levels, based on our forecasts, other rates are likely to provide a lower cost of funds over the next 5 years – particularly the option of rolling shorter fixed terms.





Final thoughts

There are always risks to the assumptions behind our forecasts, and New Zealand interest rates could be higher or lower than our current view. But with the economy still growing well, and influential global rates expected to eventually rise, we continue to think it is prudent to plan for more mortgage rate increases from today's level over the years ahead. Ultimately the best mortgage strategy is one that also takes into account an individual borrower's cash flows, tolerance for uncertainty, and ability to deal with changes in future mortgage payments as interest rates change. It is always important for borrowers to weigh up their own priorities and make the mortgage choice that looks the best aligned with them.

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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