Home Loan Rates

1 July 2011

Fixing creeping back on the radar

- **RBNZ leaves the OCR at 2.5%, but hints at possibility of an interest rate increase as early as December.**
- **We expect interest rates will remain low over 2011, before lifting over 2012.**
- **Floating remains the cheaper option for now, but relative cost will depend on exact timing of interest rate increase.**

The Reserve Bank of New Zealand (RBNZ) held the Official Cash Rate (OCR) at 2.50% in the June Monetary Policy Statement (MPS). However, there has been a shift in the RBNZ's perceived risks to its previous outlook. The RBNZ has become more comfortable that the wider economy is starting to pick up but less comfortable about the inflation outlook. Both of these factors suggest the risk of an earlier increase in interest rates than we previously thought. As a result, we have shifted our view of the first tightening to January, from March.

The RBNZ's forecasts imply an OCR increase in December. However, we still judge that the RBNZ has time to wait until early 2012, despite the discomfort over less favourable inflation developments. Even December could be too early to be fully confident a recovery is firmly embedded. There is still far too much uncertainty about Christchurch's reconstruction for the RBNZ to have a clear picture of when inflation from that source will appear.

A large proportion of borrowers now have floating rate mortgages, and are benefitting from the lowest interest rates available. RBNZ data show that in April 2011, 52.5% of mortgages were floating, and a further 28% were fixed for less than 12 months. This contrasts to 33% of mortgages floating in April 2010, and 23% in April 2009. This mortgage market trend gives the RBNZ some leeway should it need to act against stronger than expected inflation pressures. When rate increases occur a significant proportion of borrowers will be affected very quickly, meaning monetary policy's bite will be swifter than it has been for some time once rates start increasing.

Exactly when the RBNZ resumes its tightening cycle will be heavily influenced by economic developments over the coming year. Borrowers need to be aware of the range of risks to the interest rate outlook. The 0.5 percentage point cut to the OCR in March has meant that floating rates are cheaper for longer than we were expecting a year ago. However, with OCR increases almost certain over the coming years, mortgage rates will eventually rise from today's levels.

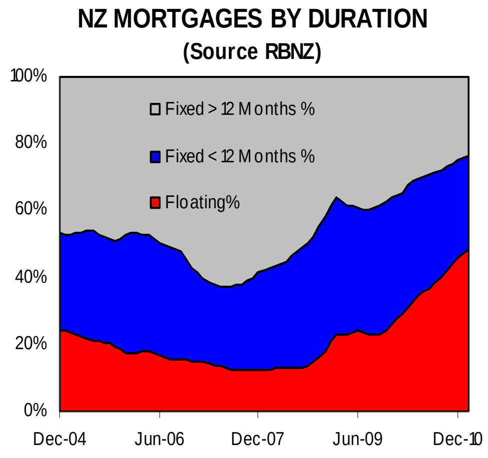
Floating pays off in the short term

The floating rates remain the cheapest on offer for shorter terms.

The floating rates remain the cheapest on offer. However, the difference between the expected interest costs of floating versus fixing is reducing as we near the time we expect a series of floating rate increases. We expect the floating mortgage rate will lift from the current level in early 2012 in line with the expected OCR rate increases. By the end of next year, we expect the floating mortgage rate will be about 2% higher than the current rate.

However, for longer terms fixing may turn out to be cheaper.

Assuming the RBNZ lifts the OCR in January next year, our calculations suggest floating could prove to be slightly cheaper than fixing for a year, due to the lower floating rate being paid over the coming eight months. However, for horizons beyond the one-year mark, fixing may turn out to prove a cheaper strategy.



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Timing of interest rate increases key to which strategy proves cheapest overall.

Which mortgage strategy proves to be the cheapest is heavily dependent on exactly when the RBNZ resumes lifting rates, and also how quickly rates are returned to more normal levels. If the RBNZ is on hold for longer than we expect, floating will continue to be the cheapest strategy. In contrast, if the RBNZ resumes its tightening cycle sooner or raises the OCR more aggressively than we are currently forecasting, today's fixed term rates will likely turn out to be a cheaper strategy than floating over the years ahead. While timing is the key uncertainty, what borrowers need to be aware of is that mortgage rates will definitely resume lifting back towards average rates over the coming years.

Long-term rates give certainty at some cost.

Premium for the certainty of fixing is currently low.

Whilst floating will continue to appeal to borrowers who want the cheapest mortgage rate, looming interest rate rises will make the benefit of certainty appealing for others. If certainty is something a borrower is willing to pay for, then now may be an opportune time to fix: the premiums for fixing around the 18-24 month terms are low at present.

Fixing may be slightly cheaper over two years.

The 6.4% two-year fixed term rate is 0.65% higher than the current floating rate. However, we expect the floating rate will be around 6.5% by mid-2012, and 7.8% by December 2012. The expected cost difference between floating for two years and fixing for two years is small, but is now tipped slightly in favour of fixing based on our forecasts.

Fixing looks to be cheaper over the longer term.

Over three years, there is very little difference between our forecast for the interest expense from floating or fixing at the current three-year term rate. Beyond the three-year mark, fixed rates look less appealing than the shorter-term rates.

All longer-term rates look attractive from historical perspective.

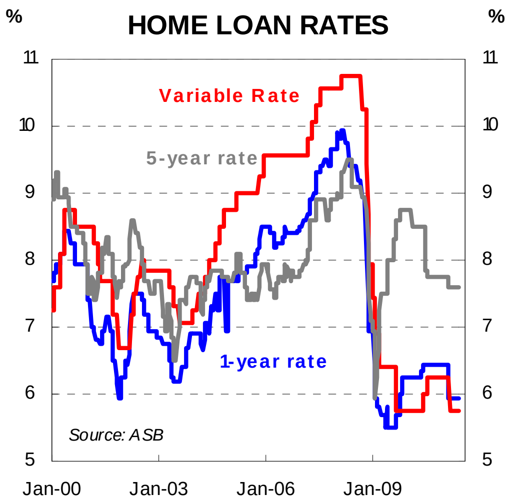
However, for those that value certainty over a long timeframe, there are several further factors to consider. Firstly, all terms on offer now are below their average level over the past 10 years. By this measure, the longer-term rates are reasonable at present.

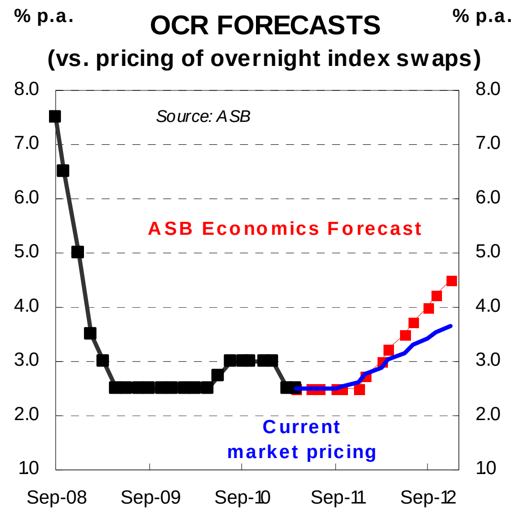
Improvement in global outlook should place upward pressure on longer-term rates.

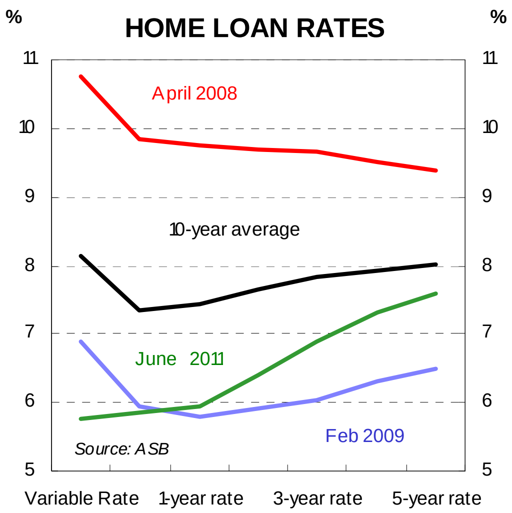
Secondly, although the biggest lift in the years ahead is expected for the floating and short-term fixed rates, there is also likely to be some modest upward pressure on long-term mortgage rates when the RBNZ lifts the OCR. Longer-term fixed rates are also likely to lift as confidence in the global economic recovery returns. We expect these influences will lift the four and five-year rates to around 8 to 8.5%.

Cost difference between floating and fixing has reduced.

Given the extent to which the cost difference between floating and fixing have reduced, there are no longer any clear-cut mortgage choices based on our forecasts. Factors such as how important it is to minimise debt-servicing costs in the short term against the certainty that fixed rates bring will also be influential for decision-making. Priority will be dictated by borrowers' preference for maximising the chance of low debt servicing costs against smoothing the inevitable increase in mortgage rates. It is always important for borrowers to weigh up their own priorities and make the choice that looks the best aligned with them – it is not all about picking the lowest interest rate.







Future uncertainties

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. Investors may become wary of lending money to indebted governments without 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 would cause long-term mortgage rates to lift as well, even if the RBNZ kept the OCR low. Another uncertainty is how far the OCR will eventually rise. Our 4.5% view is based on the RBNZ steering short-term borrowing rates back to around their historical average, but no higher. Given the current risks, it is equally conceivable borrowing rates could end up either lower or higher than average.

Other things to bear in mind

The perfect rate decision is something that will probably only be known with the benefit of hindsight. Faced with uncertainty the best strategy for borrowers is to weigh up what their priorities are and make the choice that looks the best aligned with them.

The final factor to take into account is the inevitability that interest rates will be higher in the future. It is very important to make sure that finances have headroom to absorb the impact of higher debt-servicing costs than what are being paid now.

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

- The floating rate is the lowest rate on offer at present.
- If the RBNZ lifts interest rates more gradually than currently expected, floating would provide the most cost-effective option.
- 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 as expected, the interest rate costs are likely to be marginally higher over the next two years compared with locking in a fixed term now.

The floating rate suits borrowers that want to take advantage of lower debt servicing costs for the time being and are comfortable with the likelihood of increasing interest costs as the floating rate rises over the near future.

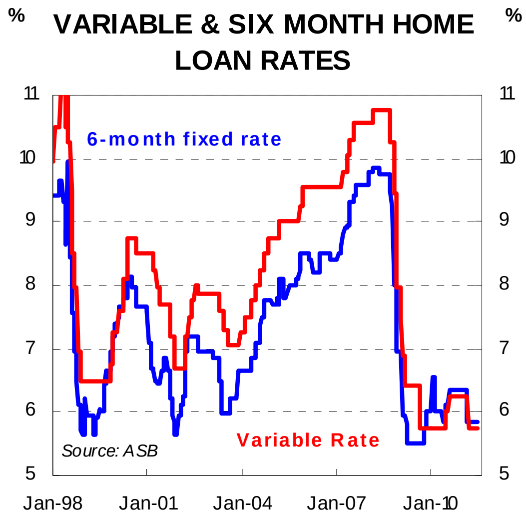
The main **advantages** of the 1-year rate are:

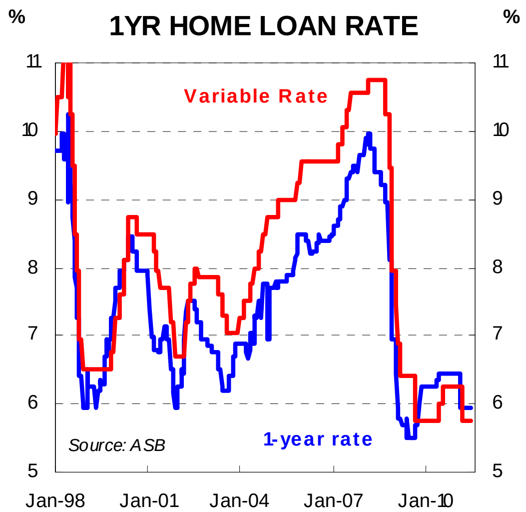
- A very low mortgage rate by historical standards, and beaten at present only by the floating and 6-month terms.

The major **disadvantages**:

- The 1-year term provides less of a hedge than the 2-year rate against sharp lifts in interest rates, particularly if the RBNZ lifts interest rates more aggressively than currently expected.
- Conversely, if the RBNZ lifts interest rates more gradually 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.





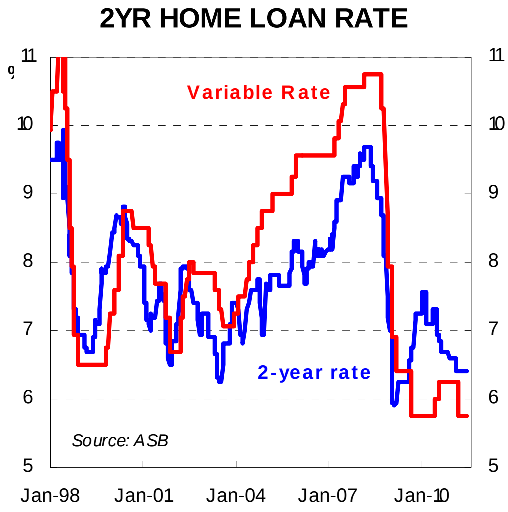
The 2-year fixed rate currently offers this **advantage**:

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

The **disadvantage**:

- Foregone savings if the RBNZ increases the OCR more gradually than expected (i.e. pauses earlier or for longer than expected).

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.



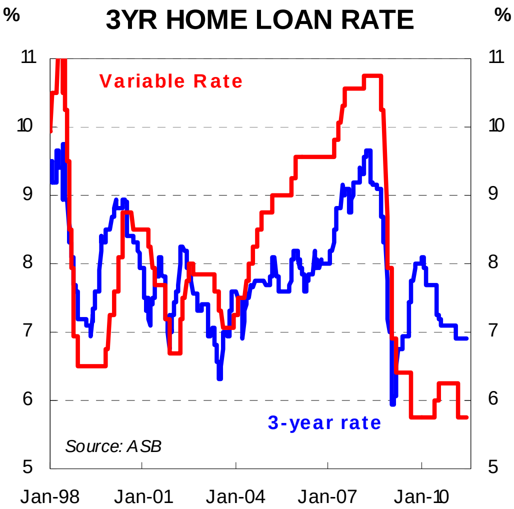
The 3-year fixed rates currently offer the following **advantage:**

- Providing interest rate certainty for longer, including some protection should the OCR be hiked considerably more aggressively than currently expected.

- The 3-year rate is unlikely to remain at current low levels for long and create a window of opportunity for those who strongly value certainty, and are willing to pay a small premium for it.

The **disadvantages**:

- Foregone savings if the RBNZ increases the OCR more gradually than expected (i.e. pauses earlier or for longer than expected).



The 5-year fixed rate currently offers these **advantages**:

- The rate offers certainty for a much longer period than the shorter-term fixed rates.

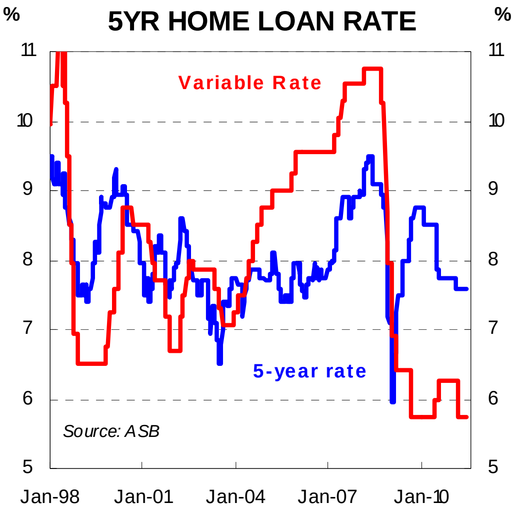
- A hedge in case future interest rates rise to substantially higher levels than we envisage e.g. through high inflation or pressures from global government debt issuance.

- Recent declines in the 5-year rate are not likely to last and create a window of opportunity for those who strongly value certainty, and are willing to pay a premium for it.

The **disadvantages**:

- Although around average levels, other rates are likely to provide a lower cost of funds over the next 5 years – particularly the option of rolling the shorter terms.

- Foregone savings if the RBNZ increases the OCR more gradually than expected.



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 in 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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