Home Loan Rates

7 October 2014

ASB

Mixed forces on the mortgage market

- **RBNZ intends to pause for a period to assess the impact of the four OCR increases made to date.**
- **Nonetheless, mortgage rate increases should still be expected over the next two years.**
- **Borrowers wanting some certainty can lock in reasonable length fixed-terms at rates lower than the floating rate.**

Economic backdrop for interest rates.
While the Reserve Bank of New Zealand (RBNZ) put through four rapid-fire Official Cash Rate (OCR) increases earlier this year, other major central banks have been generally steering along a steady monetary policy course, or in the case of the European Central Bank (ECB), easing policy settings. This in part reflects the fact that most developed economies have not enjoyed the strong economic growth we have seen in New Zealand over the past year or so.

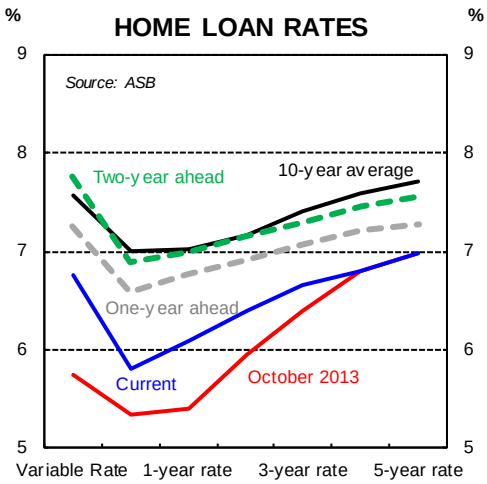
Europe has been particularly weak. In July the ECB took the unprecedented step of cutting its deposit rate to negative territory. In September, Europe's central bank cut the deposit rate even deeper into negative territory, and launched other measures to try and simulate the economy.

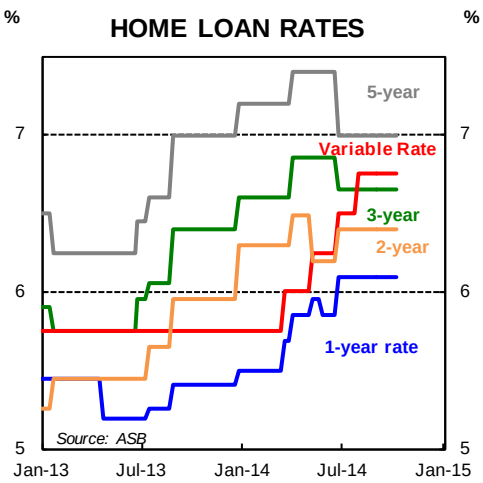
In contrast to the weakness in Europe, the US economic recovery continues to impress. The US unemployment rate has now fallen to 5.9%. The last time it was this low was back in July 2008, before the Lehman Brothers bankruptcy and the global financial crisis. More US jobs have now been created in the US recovery than were lost in the downturn - payroll employment in May 2014 finally exceeded the previous peak in January 2008. The Federal Reserve's monetary policy objective is "to foster maximum employment and price stability." The Fed is still some way off that objective, but each month of decent US data reinforces the view that the Fed will begin the process of normalising interest rates within a year.

Global interest rates remain incredibly low. For example, the German 10-year government bund yield is less than 1%, and set an all-time low recently. New Zealand's equivalent 10-year Government bond yields over 4%, a much higher return, although low by our own historical standards.

New Zealand's economic growth has been strong over the past year. But recently there has been a softening in the tone of some domestic data. In particular, the sharp decline in global dairy prices means dairy farmer's incomes will be much lower this season than the record level reached in the season just gone. We have also seen a continued easing in business confidence. The particularly sharp decline in confidence in the agriculture sector reflects the drop in global dairy prices. While the level of business confidence is still consistent with healthy levels of expansion, the downward trend warrants monitoring. We may see some stability or even a pick-up in confidence now that the uncertainty of the General Election is behind us. The recent decline in the NZD should also boost the confidence of exporters.

The RBNZ has indicated it will now take time out to assess the effects of the 100bps of OCR increases it has put through this year, as well as other developments here and abroad. We expect the RBNZ will hold the OCR at 3.5% until March next year.





Nick Tuffley | Chief Economist | 649 301 5659 | nick.tuffley@asb.co.nz
Chris Tennent-Brown | Senior Economist | 649 301 5660 | chris.tennent-brown@asb.co.nz

What does it mean for future mortgage rates?

So why does all this matter for local borrowers? Firstly, floating rate mortgages move fairly much in lock-step with each RBNZ move, and have lifted 100bps, or 1% so far over 2014. Accordingly, the RBNZ's signal to pause likely means a period of stability for floating mortgage rates. But secondly, for fixed-term mortgages, particularly the 2-5 year terms, global developments have been an important influence (on top of the RBNZ's influence via the Official Cash Rate). Over the year ahead we expect that 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.

Despite the signs of local growth starting to slow to a more sustainable pace, and the RBNZ's signal to pause, we still expect the RBNZ will lift the OCR to 4.5% by March 2016. That's another 1% or four 0.25% hikes above the current level. We expect other central banks will join the RBNZ in lifting rates next year too, adding to the upward pressure on term rates.

Mortgage rate increases will be greatest for rates of up to 2 years maturity: these terms will steadily reflect the effect of the rising OCR. In contrast, longer-term rates have less to move as their time periods mean that for some time they have been factoring in the tightening cycle.

Our peak OCR forecast of 4.5% implies the variable mortgage rate will reach around 7.75% (reflecting a fairly direct transmission of the next 1% of expected OCR hikes). We expect short-term fixed rates to eventually settle near 7% and the 5-year rate to settle around 0.5% higher, near 7.5% - 7.8%.

Since March, despite the RBNZ's rate hikes, fixed-term mortgage rates have been held down (and have at times dipped), as global interest rates declined. Bank competition has also been fierce and margins have been tightened to lower some of the fixed rates on offer. Both of these influences contributed to relatively low 1- to 3-year fixed rate specials over recent months. It has actually been possible for borrowers to sometimes access fixed-term rates that were lower than when the RBNZ began raising rates back in March.

It is impossible to predict the exact mix and timing of bank competition, and strong downward pressure on local wholesale rates stemming from offshore interest rate markets. But the RBNZ's signal to pause, and the low global rates are helping keep the six-month rate and some targeted 'specials' on offer under 6%, significantly below the carded floating rates at the time of writing. Borrowers should monitor these developments, and discuss the options with their mortgage providers if they are looking to fix.

Identifying the best strategy

The best choice to make as a borrower right now will involve 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 6-month rate is the cheapest rate right now, and is below the floating rates. Borrowers can create some certainty, and obtain a lower rate than floating by fixing for short terms. In fact, many of the carded rates at the main banks out to around 36 months are lower than floating rates at the time of writing.

Secondly, all fixed rates are still below their long-run (10-year) average. So by this simple measure, the fixed terms are reasonable value, as shown in the charts.

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. But this really hinges on our view that the RBNZ's next phase of its tightening cycle will be far more drawn out than the phase just completed, and the OCR will peak at 4.5%. It's also important to note these calculations are based on carded rates – the availability of specials skews the calculations, and are important for borrowers to consider.

We stress that if the RBNZ hikes more aggressively than we expect (i.e. more hikes early on in the next part of the cycle and/or lifts the OCR higher than 4.5%), then these shorter-term rates will lift more than we are forecasting, making the strategy of fixing for short terms more expensive than the longer-term rates on offer today.

To illustrate, we can estimate what would happen to mortgages if the RBNZ lifts the OCR to 5% (in line with its June forecasts, rather than our 4.5% peak, or the RBNZ's more recent forecasts). With a 5% OCR, we would expect the variable rate to eventually lift to around 8.25%, and fixed-term rates to be up around 8% too, rather than the 7-7.6% peak levels we are currently forecasting.

With this in mind, a key thought is that fixing for longer terms now does give extra insurance against stronger OCR increases than we are expecting. Depending on borrowers' risk appetite, that insurance may be worth taking. And the cost of some added certainty is actually not high, based on current mortgage rates: The carded floating rate is between 6.59% - 6.75% at the main banks at the time of writing. A borrower can fix for out to three years for under 6.7%. Borrowers can lock in a fixed-term rate that is lower than the floating rate now, and even lower than the floating rates we expect in a year's time.

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 low when compared with historical levels. And even after several more OCR hikes, the floating rate will still only just approach its 10-year average of 7.6%. Borrowers retain the freedom to lock in term rates at any time, and have flexibility with principal repayments.
- If the RBNZ lifts interest rates more gradually than currently expected, the floating rate may provide a very cost-effective and flexible option.

The major **disadvantage**:

- Should the RBNZ lift rates as expected, the interest rate costs are likely to be marginally 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 suits borrowers that need or value repayment flexibility. The floating rate also 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:

- Lowest rate on offer at several of the major financial institutions, with the exception of the 6-month rate.
- Provides some certainty for the borrower.
- Our forecast is for the 1-year fixed mortgage to gradually rise to around 7% - the same level of the current 5-year term, and only fractionally higher than the 4-year term. Accordingly, rolling sequential one-year mortgages could prove cheaper than those 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 sharp lifts in interest rates, particularly if the RBNZ lifts interest rates more aggressively than currently expected over 2015.

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.

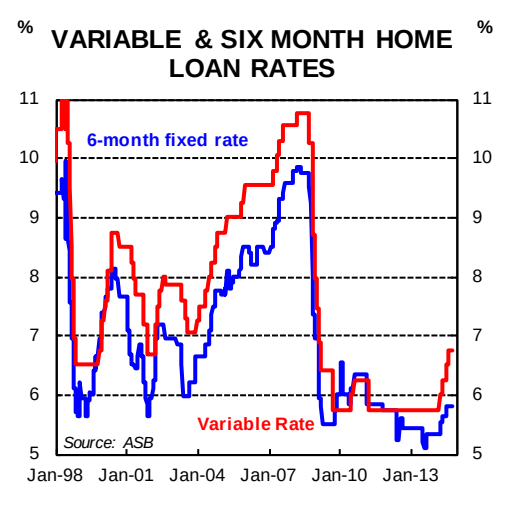
The 2-year fixed rate currently offers these **advantages**:

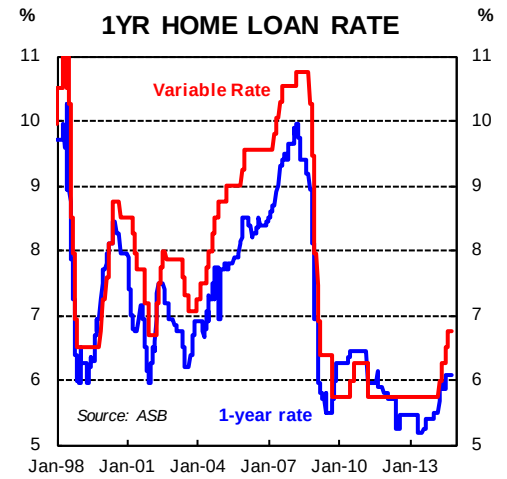
- Greater certainty than available through shorter terms at a relatively low rate.

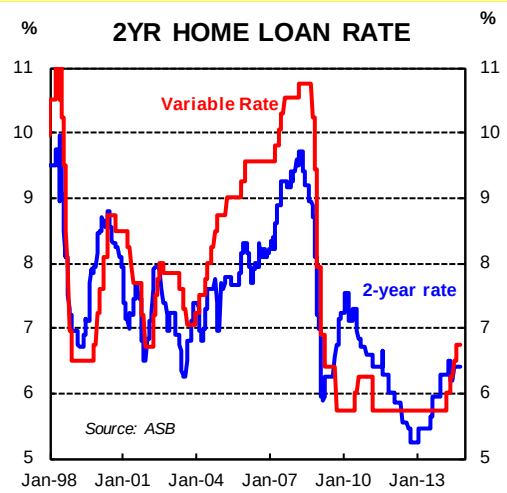
The **disadvantage**:

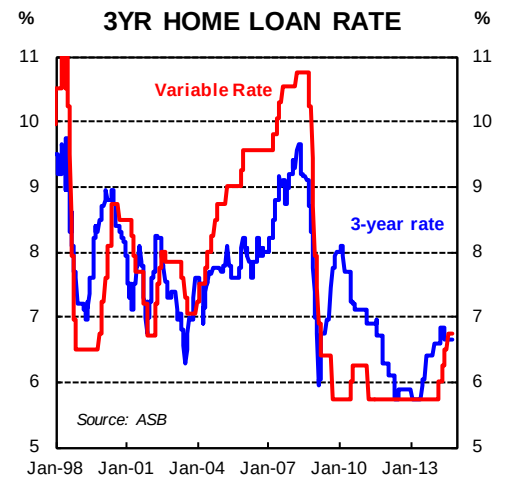
- The 2-year term provides less of a hedge than the medium- and longer-term rates against increases in interest rates, particularly if the RBNZ lifts interest rates more aggressively than currently expected.

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 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**:

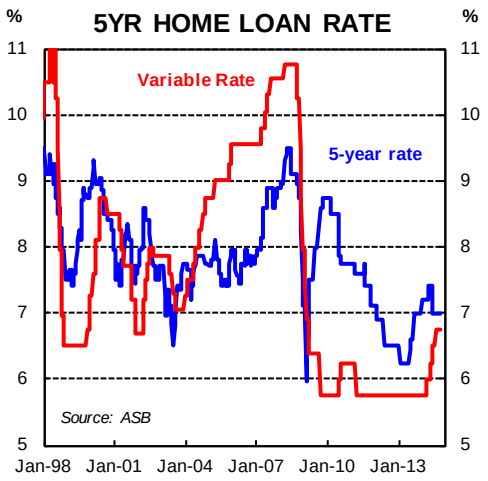
- More expensive if the RBNZ lifts interest rates more gradually than expected.

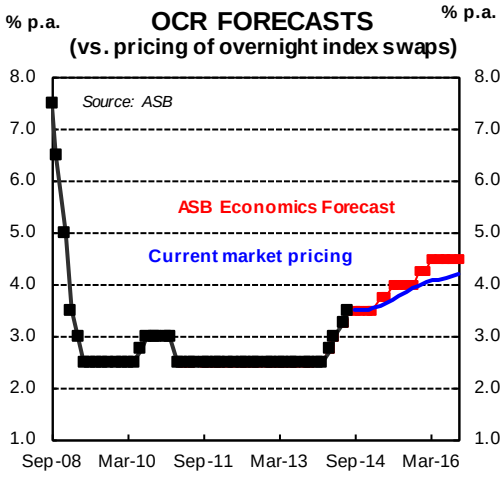
The recent dip below 7% has taken the 5-year fixed rate significantly lower than the average level over the past 10 years (7.7%). The 5-year fixed rate currently offers these **advantages**:

- 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 or pressures from funding costs.

The **disadvantage**:

- Although it is back below 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 fixed terms.





Final thoughts

More mortgage rate increases should be expected over the next two years. Floating rates should be fairly steady while the RBNZ remains on hold, but are still set to lift the most out of all the mortgage rates over the next year or so. Borrowers can lock in some certainty and pay a lower rate than current floating rates. 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.

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: there is more to it than just picking the lowest interest rate.

Feel free to phone the ASB Home Loan Line at 0800-100-600 to talk through these issues with ASB staff.

https://reports.asb.co.nz/index.html
ASB Economics
Level 9, 135 Albert Street, Auckland

ASB Economics & Research			Phone	Fax
Chief Economist	Nick Tuffley	nick.tuffley@asb.co.nz	(649) 301 5659	(649) 302 0992
Senior Economist	Chris Tennent-Brown	chris.tennent-brown@asb.co.nz	(649) 301 5660	
Economist	Christina Leung	christina.leung@asb.co.nz	(649) 301 5661	
Rural Economist	Nathan Penny	nathan.penny@asb.co.nz	(649) 448 8778	