Home Loan Rates

14 November 2014

ASB

RBNZ re-assessment influences mortgage rate outlook

- **RBNZ intends to pause for a period to assess the impact of the four OCR increases made to date.**
- **The central bank has opened the door to the possibility that it won't need to raise the OCR any further.**
- **Borrowers wanting some certainty can lock in reasonable length fixed-terms at rates lower than the floating rate.**

RBNZ re-assessment

Although the RBNZ's decision to hold the Official Cash Rate (OCR) at 3.5% in October was widely expected, the tone of the OCR Review statement was more of a surprise. A very subdued inflation environment has seen the RBNZ step away from its earlier view that significantly more interest rate increases were likely in the future. The central bank is still considering further policy adjustment (OCR increases) this cycle, but has opened the door to the possibility that it won't need to raise the OCR any further.

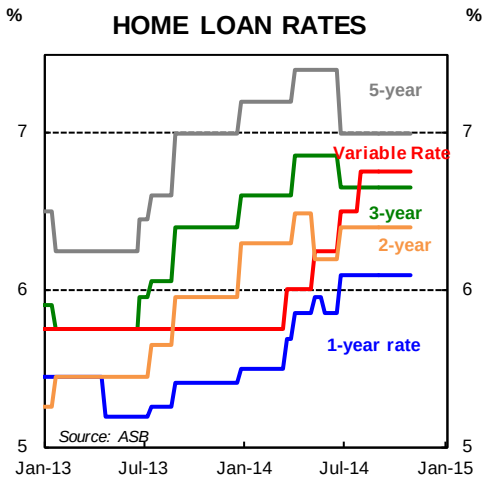
The benign inflation environment was highlighted in the 1%p.a. September quarter CPI inflation reading. This contributed to us changing our OCR forecast over the past month. Within our forecasts, we have delayed the timing of the next RBNZ rate hike from March to September 2015. And beyond that, we have another OCR increase pencilled in for March 2016 for an OCR peak of 4% - lower than our earlier forecast of a 4.5% OCR peak. These changes impact our mortgage rate forecasts.

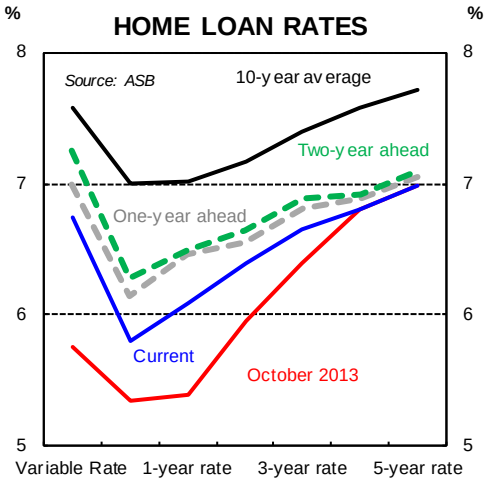
We see the risks to our forecast of further OCR increases and, in turn our short-term mortgage forecasts, as balanced. Inflation could yet pick up materially for a variety of reasons. But the longer the RBNZ remains on hold the greater will become the conviction that growth, migration and the housing market are past their peak, and the less likely future OCR increases would become.

The global influence on local interest rates is also important: local interest rates (particularly longer-term rates) change because of offshore developments regardless of what the RBNZ is doing, or not doing, with the OCR. And right now global interest rates are still incredibly low. For example, the German 10-year Government Bund yield is less than 1%, trading around its all-time lowest level. Despite the impressive run of US data recently, the US 10-year Government bond yield continues to trade under 2.5%, 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 yields just over 4%, a much higher return, although very low by our own historical standards. As well as influencing New Zealand's Government bond yields, these low global rates are influencing longer-term local mortgage rates.

RBNZ's high LVR lending restrictions remain in place

Within the RBNZ's November Financial Stability Report the RBNZ highlighted the sharp slowing in housing market activity, particularly amongst first-home buyers, in the wake of the high-LVR restrictions taking effect in October 2013. Nonetheless, the RBNZ notes 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.





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The high loan-value ratio lending restrictions were always designed to be temporary, so the logical question is when might they be removed? 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.

Everything is moving in the right direction for easing the restrictions, but the criteria aren't met at present, and the risk of resurgence in prices is still very real. A key risk we and the RBNZ see is housing demand from strong net migration, which has yet to peak. Although it could start to show signs of peaking by early 2015, in recent months the net inflow has been very strong. We see the second or third quarter of next year as the likely timing for the RBNZ to ease the restrictions.

What does it mean for borrowers?

Firstly, the maintenance of the high LVR lending restrictions means the challenge of a higher deposit 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 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 until the RBNZ moves again next year.

But 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 OCR). 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. Longer-term mortgage rates can still move over the year ahead, even if the RBNZ holds the OCR steady at 3.5%. Underlying wholesale rates and in turn fixed-term mortgage rate movements will likely lift in anticipation of central bank hikes, rather than after the actual interest rate adjustments from the RBNZ or offshore central banks.

Our peak OCR forecast of 4.0% implies the variable mortgage rate will reach around 7.25% (reflecting a fairly direct transmission of the remaining 0.5% of expected OCR hikes). We expect short-term fixed rates to eventually settle between 6.5% and 7% and the 5-year rate to settle around 0.5% higher, just above 7%.

Since March, despite the RBNZ's OCR 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 at times 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 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 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 6-month and 1-year rates are the cheapest rate right now, significantly below the floating rates. So 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, effectively meaning borrowers can create interest rate certainty and at the same time save on interest rate costs.

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 4.0%. It's also important to note these calculations are based on carded rates – the periodic availability of special rate offers skew 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 4.0%), 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.

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.

As always, there are risks to the assumptions behind our forecasts. New Zealand interest rates could be higher or lower than our forecasts. But with the economy growing well, and influential global rates expected to rise, we continue to think it is prudent to plan for more mortgage rate increases from today's level over the year ahead.

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. If the RBNZ only delivers two more OCR hikes, the floating rate should end up around 7.25%, below 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 even 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.

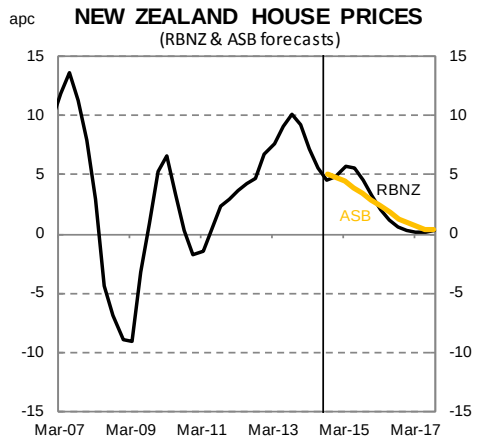
The floating rate suits borrowers that need or value repayment flexibility. The floating rate also suits borrowers that want to take advantage of lower debt servicing costs for the time being and are comfortable with the likelihood of increasing interest costs as the floating rate rises over the near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

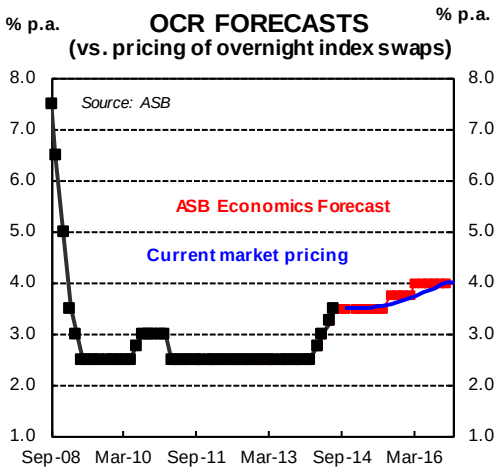
The main **advantages** of the 1-year rate are:

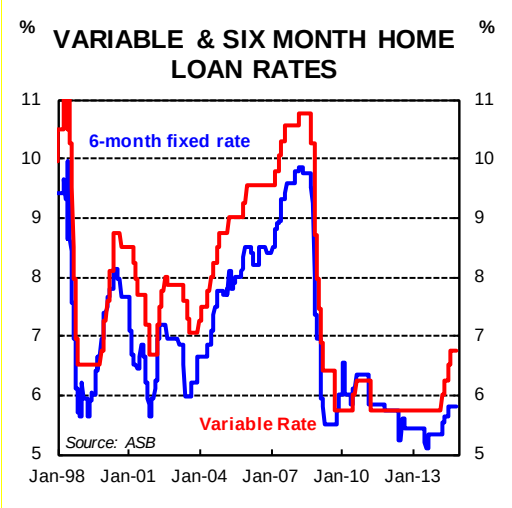
- Lowest rate on offer at several of the major financial institutions, with the exception of the 6-month rate.
- Provides some certainty for the borrower.
- Our forecast is for the 1-year fixed mortgage to gradually rise to around 6.5% - lower than the current 5-year term, and close to the current 2-3 year terms. Accordingly, rolling sequential one-year mortgages could prove cheaper than those longer terms, based on our forecasts.

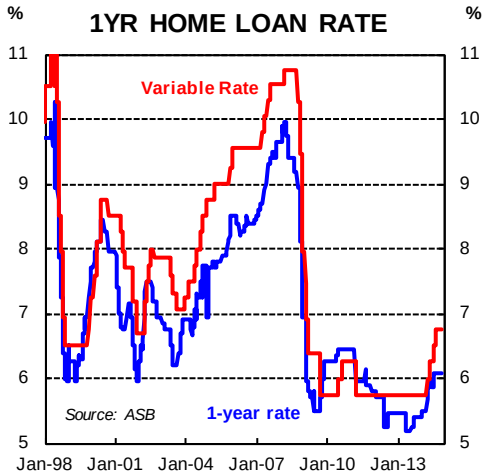
The major **disadvantages**:

- 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 as gradually, or 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.

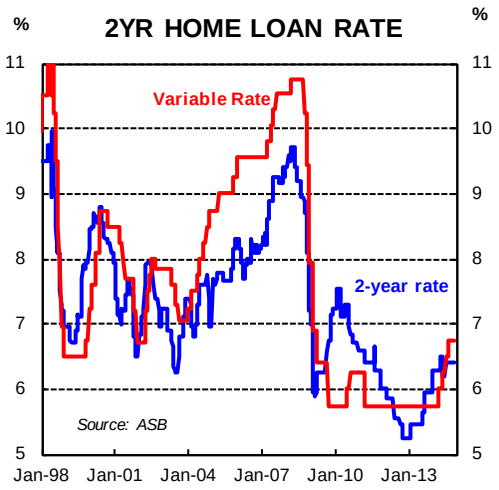
The **disadvantage**:

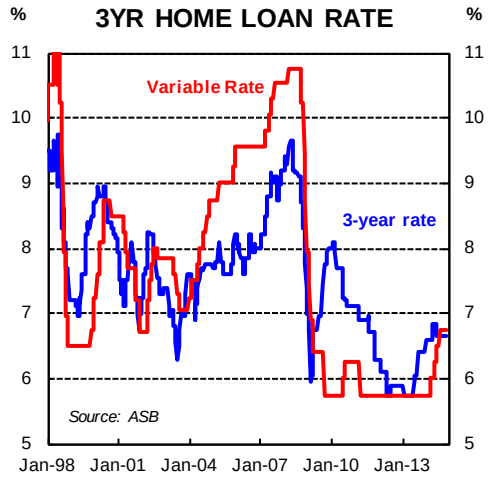
- Although it is below average levels, based on our forecasts, other rates are likely to provide a lower cost of funds over the next 5 years – particularly the option of rolling shorter fixed terms.

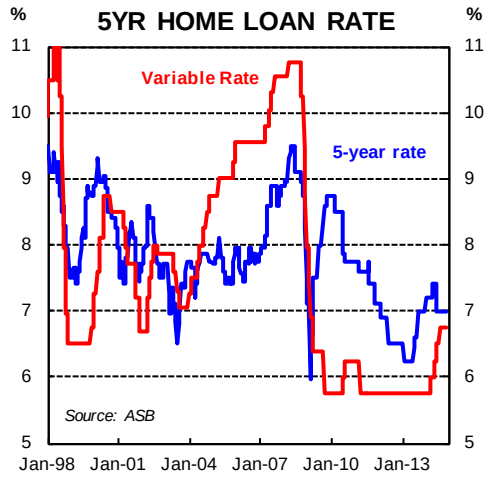
Final thoughts

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







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