Home Loan Rates

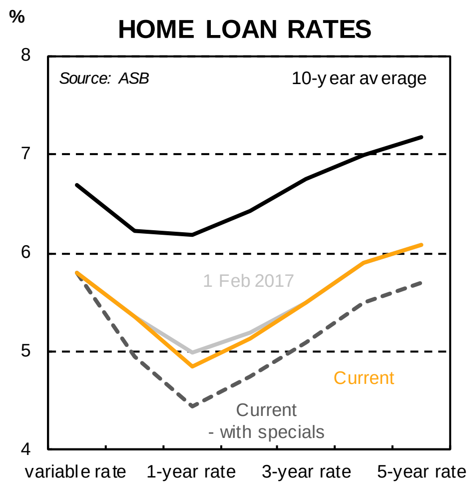
3 July 2017

Still waiting for US tax reforms

- **Markets are in limbo waiting for Trump's pro-growth tax policy reform.**
- **In the meantime, the US Federal Reserve has raised interest rates twice in 2017.**
- **Further, bank funding remains squeezed, keeping pressure on interest rates despite the OCR remaining on hold.**

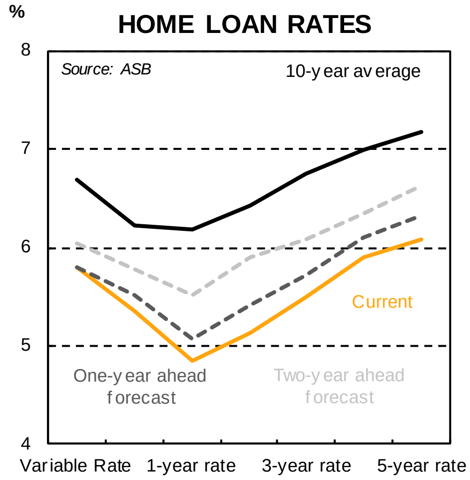
Mortgage Rate Outlook

Mortgage rates have largley been flat since February's Home Loan Rate Report. NZ interest rates are generally affected by a combination of the RBNZ's Official Cash Rate (OCR), offshore interest rates and banks' funding environments.



Since February, the **OCR has remained at record lows**. However, **domestic banks' funding environments remain constrained.** As a result, the practice of attracting deposits through higher term deposit rates is continuing, keeping a floor under mortgage rates. Interestingly, while the US Federal Reserve has lifted interest rates by 50bp over 2017, US long-term interest rates have dipped recently. The lower interest rates reflect concern surrounding the timing of Donald Trump's tax policies. Overall, while there are a number of opposing forces impacting interest rates at the moment, **mortgage rates remain low relative to historical averages, with "specials" even lower for most term rates.**

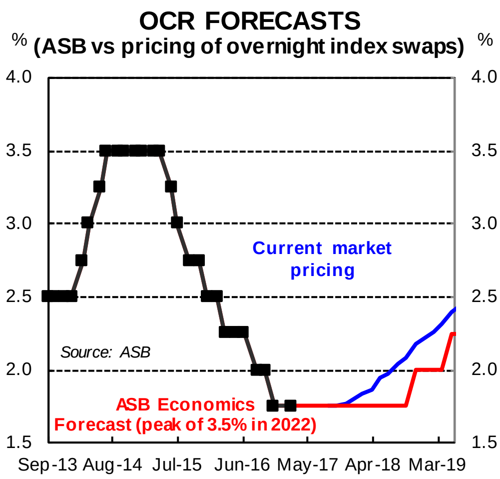
Looking forward, we continue to expect the RBNZ to leave the OCR on hold until late 2018. As the OCR is one factor influencing floating and shorter-term fixed mortgage rates, **we are not likely to see the floating mortgage rate and short-term fixed rates decline any further this year.** Further, higher funding costs could see further (but modest) upward pressure on shorter-term interest rates.



Upward pressure on longer-term mortgage rates is likely to be slightly more pronounced. While US interest rates have eased from their post-election highs given the tax reform delays, the US Federal Reserve is expected to continue to lift US interest rates. As a result, we expect US interest rates to generally trend higher, and as a result, anticipate further upward movement over time in NZ's 3- to 5-year fixed mortgage rates.

The RBNZ's LVR lending restrictions and borrowers

The RBNZ introduced further LVR restrictions on 1 October 2016. Investors are now required to have a 40% deposit and owner-occupiers (O-Os) are required to have a 20% deposit. Only 10% of O-Os loans can be permitted with a deposit of less than 20%. As a result, the practice of offering "specials" or lower rates on lending with equity in excess of the LVR restrictions is likely to remain in place. Borrowers should monitor these "specials", and discuss the options with their mortgage providers when deciding what to do with their mortgage.



Identifying the best strategy

Personal preferences for certainty and flexibility are also important when choosing a mortgage. On the following page we summarise some pros and cons of different mortgage term options. But here are some general points when considering short-term rates vs longer-term rates:

The **1- to 2-year fixed rates remain the cheapest rates at most main banks,** roughly 0.8% below the floating rate. So borrowers can create some certainty and obtain a lower rate, by fixing for short terms. Further, all

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fixed rates remain well below their long-run (10-year) average. So by this simple measure, the fixed terms are reasonable value. However, 4- and 5-year fixed rates are now higher than the floating rate. Splitting the mortgage into different terms, or a mix of fixed and floating mortgages, are strategies for keeping some flexibility while locking in some interest rate certainty.

Some advantages and disadvantages of the various mortgage rates

The main **advantage** of the **floating rate** is:

- The floating rate currently sits around 90bp below its 10-year average of 6.7%. Borrowers retain the freedom to lock in term rates at any time, and have flexibility with principal repayments. If mortgage rates lift further, borrowers could choose to fix at any time.

The major **disadvantage**:

- Short-term fixed rates are currently a cheaper option. For example, fixing for 6 months or a year obtains a cheaper 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.**

The main **advantages** of the **six-month** rate are:

- Typically one of the lowest carded rates on offer at the major financial institutions (although other terms were lower at the time of writing).
- Provides some certainty for the borrower in the immediate term.
- If mortgage rates move higher, the ability to re-fix is never too far away.

The major **disadvantage**:

- The 6-month term provides less of a hedge than floating against lifts in mortgage rates that could be caused by funding challenges or the RBNZ resuming OCR increases earlier than we expect.

Given we are not expecting any more OCR cuts, the 6-month rate is unlikely to fall further. Over the next year, the 6-month rate could lift slightly due to ongoing funding pressures or if the RBNZ starts lifting the OCR earlier than we are expecting.

The 6-month fixed rate would suit those who **prefer some interest rate certainty** (but place **priority on low debt-servicing costs)** and the ability to **review their mortgage structure frequently**.

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

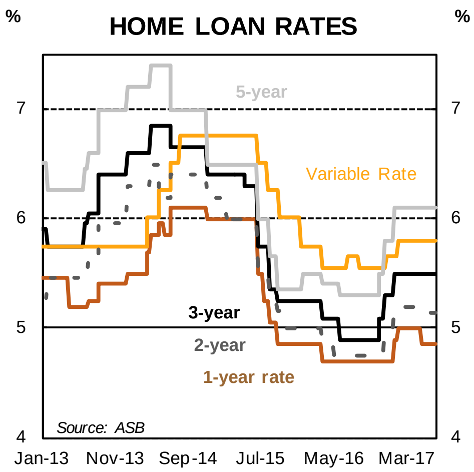
- The lowest carded rate on offer at several major financial institutions.
- Provides some interest rate certainty for the borrower.

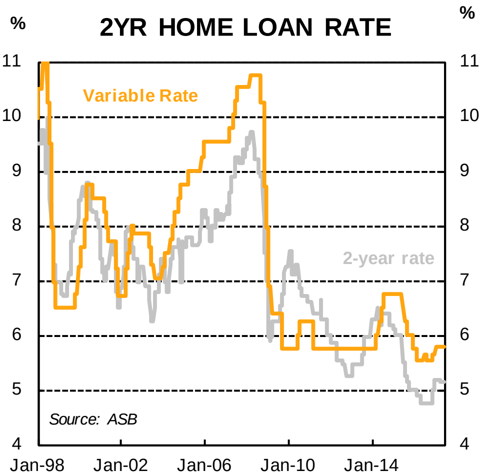
The major **disadvantage**:

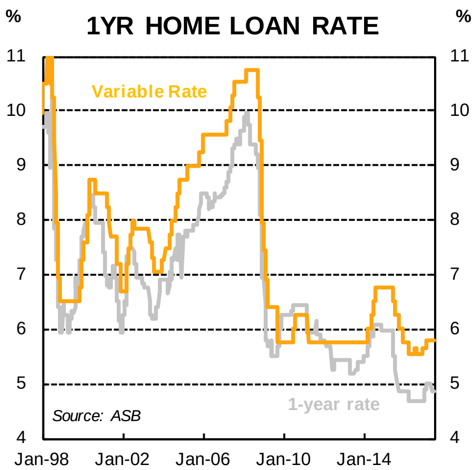
- The 1-year term provides less of a hedge than the longer terms against lifts in mortgage rates that could be caused by rising global interest rates, bank funding challenges, volatility or the RBNZ resuming OCR increases earlier than expected.

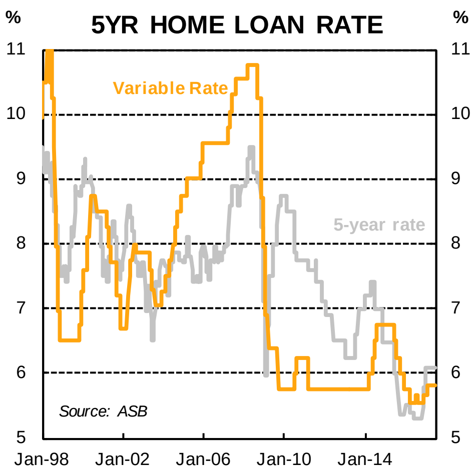
Over the next year we expect the 1-year fixed mortgage rate could lift slightly as a result of funding pressures. Further, given we expect mortgage rates to continue to lift and the RBNZ to raise the OCR within two years' time, fixing for 2 or 3 years' time could prove cheaper than rolling shorter terms, based on our current forecasts.

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









<u>The main **advantage** of the **2-year fixed rate** is:</u>

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

The **disadvantage**:

- The 2-year term provides less of a hedge than the longer-term rates against interest rate increases. For example, if global interest rates lift more than expected, or the RBNZ resumes raising the OCR within two years' time (as we expect).

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**.

<u>The main **advantage** of the **3-year fixed rate** is:</u>

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

The **disadvantage**:

- More expensive than our forecast of sequential shorter terms over the next three years.

<u>The main **advantage** of the **5-year** fixed rate is:</u>

- The rate offers certainty for a long period. It offers a long-term hedge in case future interest rates rise substantially higher either through RBNZ OCR increases, funding cost pressures or higher global interest rates.

The **disadvantage:**

- The 5-year rate is roughly 120bp higher than the one-year rate and almost 30bp higher than the floating rate. Based on our forecasts, fixing for shorter terms (e.g. 3 - 4-year terms) are likely to provide a lower cost of funds over the next 5 years.

However, the current 5-year fixed carded rate of 6.09% is significantly lower than the average level over the past 10 years (7.20%), and may **suit those who prefer a high degree of interest rate certainty.**

Final thoughts

Just remember the only certainty about the future is its uncertainty**. The 'best' mortgage rate is only 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 the interest rates options that appear most suitable for your personal circumstances.**

On top of trying to minimise interest payments, a good mortgage strategy also needs to **take into account an individual borrower's cash flows, tolerance for uncertainty, and the ability to deal with changes** in future mortgage payments as interest rates change. Borrowers' financial circumstances can change too, and this needs to be taken into account. Overall, it is important for borrowers to **weigh up their own priorities and make the mortgage choice that looks best aligned with their needs.**

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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