Home Loan Rate Report

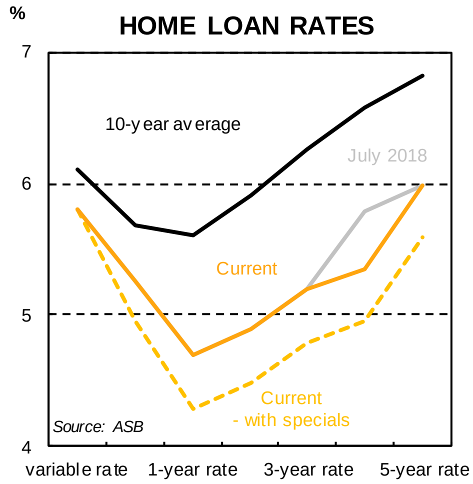
30 August 2018

Holding steady

- We expect floating and short-term fixed mortgage interest rates to remain around current levels well into 2019.
- The tick-shaped curve and our expectations of a mild RBNZ tightening cycle suggest shorter-term fixed rates should continue to offer good value.
- There is the risk that mortgage interest rates increase faster and more significantly than what our forecasts currently assume. Borrowers should think about their appetite for risk and ability to absorb higher interest rate costs should this occur.

Mortgage Rate Outlook

Mortgage rates are little changed since we published our last Home Loan Rate Report in July. Mortgage rates are influenced by a number of factors, but bank competition and easing funding costs appear to be the catalyst for the most recent mortgage rates moves.



Outside of these movements, the main themes largely remain intact. We continue to expect the RBNZ to leave the OCR on hold for a considerable period of time. However, we are now expecting the next OCR move (upwards) to occur in February 2020, in contrast to our previous November 2019 OCR view. A cautious RBNZ and heightened downside risks to the medium-term inflation outlook suggest that the OCR will remain on hold for even longer. Note that our forecasts suggest an earlier move than the RBNZ's central view. The RBNZ is now signalling it does not expect to lift the OCR until late 2020/early 2021. The ultimate consequence of these changes is that **floating and shorter-term fixed mortgage rates should now remain relatively stable well into 2019**. Further, when the RBNZ does start lifting the OCR, any increases are expected to be only modest in relation to historical norms and this should limit the uplift in local short-term rates. We now expect the OCR to peak at only 2.75%, previously we expected a 3.50% peak.

Our bias also remains for longer-term mortgage rates to drift up, given gradual increases to the OCR and the drift higher in global longer-term interest rates. US longer-term interest rates remain elevated (but off recent highs), increasing the chance we see these pressures flow through into NZ mortgage rates. Higher offshore rates tend to influence domestic tenors longer than the 2- to 3-year fixed rate.

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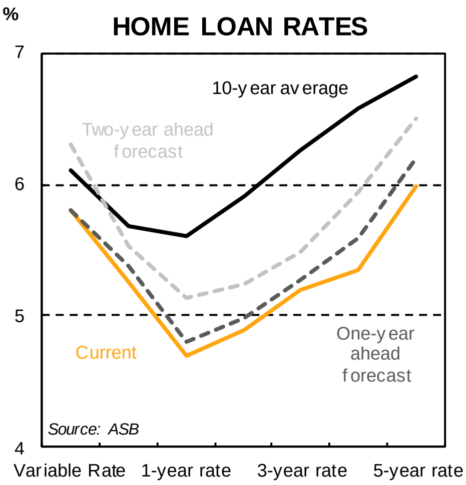
There is a risk that mortgage interest rates move up sooner (and by more) than what we expect. The catalyst could be the OCR moving up earlier and faster that what our forecasts assume, or the lift in global rates feeding though into higher local longer-term yields sooner than expected.

The RBNZ's LVR lending restrictions and borrowers

The RBNZ eased its LVR restrictions at the start of 2018. Investors are now required to have a 35% deposit (was 40%) but the 'speed limit' remained unchanged at 5% for new investor loans. Owner-occupiers' deposit requirements remain fixed at 20%, while the 'speed limit' has eased to 15% from 10% of new lending. At this stage, we are not expecting to see any further tweaks made to the LVRs in the near future, with the RBNZ signalling it was unlikely to revist the topic until November. As a result, offering "specials" 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.**

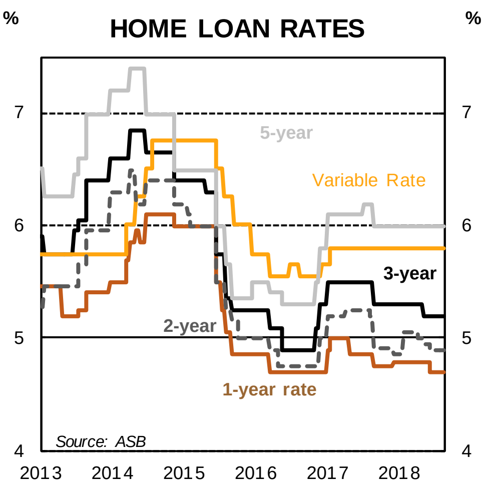


Identifying the best strategy

Kiwi's love a bargain and would like to always secure the best deal for their mortgage. This is easier said than done given the number of domestic and global influences impacting on domestic mortgage interest rates - sometimes the crystall ball gets a little cloudy! The lowest carded rate on offer may initially appear cheaper, but this can quickly change. Personal preferences for certainty and flexibility are also important considerations when choosing a mortgage rate, rather than simply opting for the lowest rate.

One of the characteristics of the mortgage borowing curve is that it is "tick-shaped", with 1- to 2-year fixed rates lower than both the variable and 5-year rate. The 1-year carded rate on offer by most main banks, is roughly 100+ basis points (bps) below both the floating rate and the 5-year fixed rate (and for some institutions, the 1-year fixed rate is currently at record lows); the gap is around 150bps for borrowers with more than a 20% deposit.

As a result, borrowers can currently obtain some certainty and a lower rate, by fixing for short terms. While the future is inherently uncertain, our forecasts suggest carded 1- to 2-year fixed rates are unlikely to approach the current floating rate until about 2021/2022. As such, splitting the mortgage into different terms, or a mix of floating and short-term fixed mortgages, is a strategy for keeping some flexibility while locking in some interest rate certainty**.**



The caveat to this view would be if mortgage interest rates move up more aggressively than what we assume. Borrowers who place a high premium on certainty and stability should consider locking in part of their mortgage for longer terms. For example, the current carded 3-year rate is about 60bps below the floating rate (specials are about 100bps lower).

On the following pages we summarise some pros and cons of different mortgage term options.

Some advantages and disadvantages of the various mortgage rates:

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

- The floating rate currently sits around 30bps below its 10-year average of 6.10%. Borrowers retain the

freedom to lock in term rates at any time, and have flexibility to make additional principal repayments.
- The floating rate particularly suits borrowers that need or value repayment flexibility.

The **major disadvantage**:

- Short-term fixed rates are currently a cheaper option. For example, fixing for 6 months or a year is considerably cheaper, with the flexibility of being able to adjust principal payments not too far away.

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

- Typically cheaper than the variable rate for major financial institutions.
- 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 disadvantages**:

- Offers considerably lower flexibility than a variable rate.
- The 6-month term provides less of a hedge than longer terms against larger than expected climbs in mortgage interest rates.

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 on a frequent basis.

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.
- Sequentially rolling a 1-year rate may be the cheapest option over 4/5 years, according to our forecasts.

The **major disadvantage**:

- The 1-year term provides less protection to borrowers from large increases to mortgage interest rates than for longer-term fixed rates.

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, or those repaying their debt within a year's time. There is the risk that mortgage rates over the next year could lift more than currently expected.

The **main advantage of the 2-year fixed rate** is:

- 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, if interest rates move up sharply. Catalysts for the latter could be sizeable increases in global interest rates or the RBNZ rising the OCR by considerably more than expected over the next 2 years.

The 2-year fixed rate would again suit those who prefer a degree of interest rate certainty at a relatively low rate, or those who intend to repay debt in around 2 years time.

The **main advantage of the 3-year fixed rate** is:

- Providing interest rate certainty at a relatively low cost and for a longer period than short-term rates. Would provide more protection if mortgage interest rates move up by more than we assume.

The **disadvantage:**

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

The **main advantage of the 5-year fixed rate** is:

- Provides certainty for a longer period. It offers a long-term hedge in case interest rates rise substantially.

The **disadvantage**:

- The carded 5-year rate is roughly 130bp higher than the one-year rate (also round 130bp higher for specials), and close to 20bps higher than the existing floating rate (only 20bps lower for specials). Based on our forecasts, fixing for shorter terms is likely to provide a lower cost of funds over the next 5 years.

The current 5-year fixed carded rate of 5.99% (5.59% for specials) is lower than the average level over the past 10 years (6.82%), 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

Online mortgage calculators are available here

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