Home Loan Rate Report

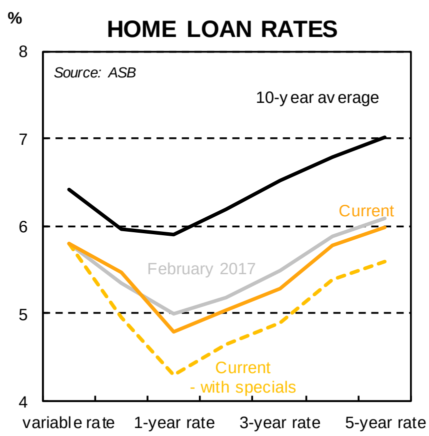
01 March 2018

A balanced approach

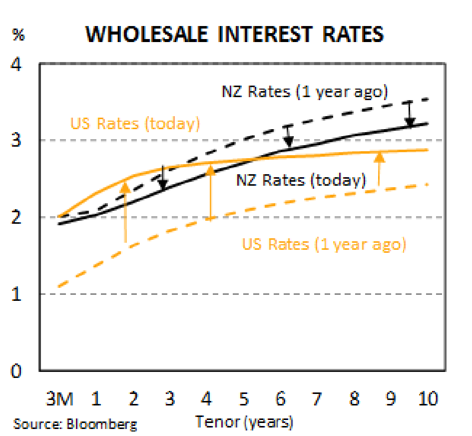
- We expect floating and short-term fixed mortgage interest rates to remain around current levels for the rest of 2018, with rates to drift up prior to RBNZ hikes from August 2019.
- The tick-shaped mortgage borrowing curve and our expectations of a mild RBNZ tightening cycle suggest that the 1 to 2-year part of the mortgage curve should continue to offer good value.
- There is the risk that mortgage interest rates move up more quickly and significantly than what our forecasts currently assume. Borrowers who place a high premium on certainty and stability may want to consider fixing a portion of their loan for longer terms.

Year in Review

About this time last year we were of the view that mortgage interest rates were biased to move higher from historically-low levels. We saw no immediate need for the Official Cash Rate (OCR) to go up, but had expected pressures in obtaining bank funding and firming offshore global (i.e. US) yields would push up in local longer-term yields. **This has not happened, with ASB's current carded mortgage interest rates for most fixed tenors marginally lower than what they were a year ago.**



Why is this? Like we had envisaged, the OCR has not moved up. **In fact, we now expect the OCR to remain on hold till August 2019, about six months later than previously anticipated.** Market expectations of OCR hikes have been pared back, helping to flatten the local interest rate curve**. The tightening in bank lending standards** has also resulted in a slowing in credit growth, which along with solid deposit growth **has enabled banks to reduce reliance on offshore mortgage funding**. This, combined with a fall in local wholesale interest rates has seen local carded mortgage interest rates fall despite the rise in US interest rates.



Mortgage Rate Outlook

As the OCR is a major factor influencing floating and shorter-term fixed mortgage rates, our on hold until August 2019 OCR view suggests a period of stability for these mortgage interest rates. We expect forthcoming monetary tightening in NZ to be modest in relation to historical norms, which should cap the degree of uplift in local short-term rates.

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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. This will eventually flow through into higher NZ wholesale and mortgage rates, particularly for tenors longer than the 2-year fixed rate.

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

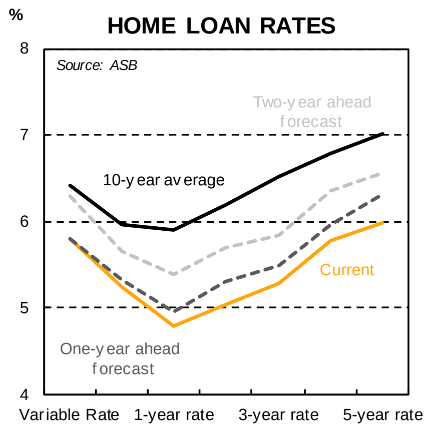
The RBNZ's LVR lending restrictions and borrowers

The RBNZ eased its LVR restrictions at the start of 2018. Investors are now required to have a 35% deposit (was 40%) but the 'speedlimit' remained unchanged at 5% for new investor loans. Owner-occupiers deposit requirements remain fixed at 20%, while the 'speedlimit' has eased to 15% from 10% of new lending. Although LVR restrictions may ease further over 2018, this is likely to be a gradual process. 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 can be a little cloudy! The lowest carded rate on offer usually attracts the headlines and may initially appear cheaper, but this can quickly change. Personal preferences for certainty and flexibility can also be important consideration when choosing a mortgage rather than 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 below both the floating rate and the 5-year fixed rate; the gap is about 120-130bps for borrowers with more than a 20% deposit.



Borrowers can 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 2020. 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. We currently place a low probability on this eventuating, but cannot rule out the possibility entirely. **Borrowers who place a high premium on certainty and stability should consider locking in part of their mortgage for longer terms.** The current 3-year rate looks particularly atractive, with the carded rates about 75bps below the floating rate (specials are about 90bps lower).

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

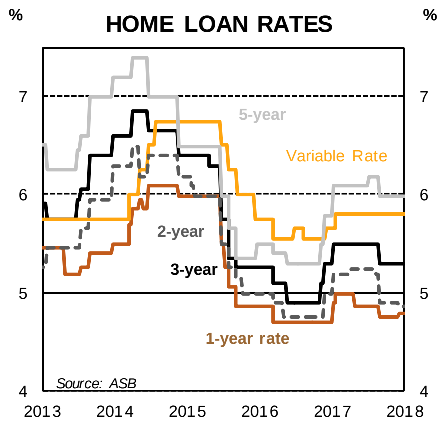
Some advantages and disadvantages of the various mortgage rates:

<u>The **main advantages of the floating rate** are:</u>

- The floating rate currently sits around 55bps below its 10-year average of 6.35%. 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 disadvantage**:

- 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.

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 or so could lift more aggressively. Borrowers re-fixing in early 2019 could face a somewhat higher rate than they face at present.

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

- Greater interest rate certainty than available through shorter terms at a relatively low rate.
- Sequentially rolling a 2-year rate may be the cheapest option over 4/5 years according to our forecasts.

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. This could prove an important consideration in a period of fluidity for mortgage interest rates.

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:

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

The **disadvantage**:

- The carded 5-year rate is roughly 120bp higher than the one-year rate (close to 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.

Tthe current 5-year fixed carded rate of 5.99% (5.59% for specials) is lower than the average level over the past 10 years (7.00%), 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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