Home Loan Rates

8 April 2016

March OCR cut sees mortgage rates move lower

- **The RBNZ cut the OCR by 25bp in March and we expect two further 25bp OCR cuts this year.**
- **Another OCR cut is likely to put further downward pressure on floating and short-term fixed mortgage rates.**
- **There is a risk of long-term mortgage rates increasing if influential offshore rates increase this year.**

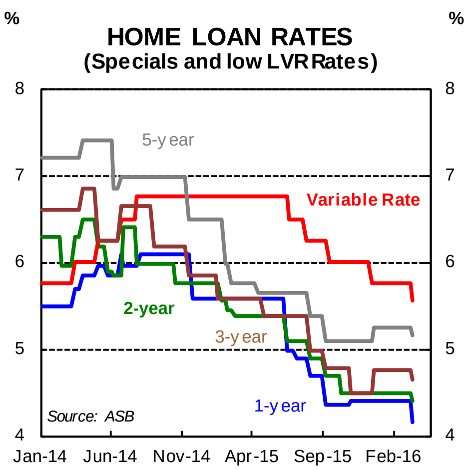
Mortgage rate outlook

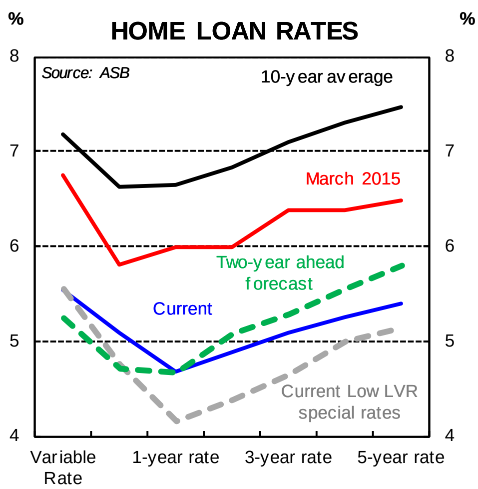
The Reserve Bank of New Zealand (RBNZ) has been cutting the Official Cash Rate (OCR) since June 2015 and mortgage rates have been falling alongside this. Despite the OCR cuts, inflation remains incredibly low and in fact the downside risks to an already benign inflation outlook have been growing. As a result, w**e expect an additional 50bp of cuts over the remainder of 2016, which would take the OCR to a new record low of 1.75%.**

If the OCR is reduced to 1.75% as we are expecting, we are likely to see the floating mortgage rate and short-term fixed rates decline slightly further. While the floating and shorter-term fixed mortgage rates generally move closely in line with each RBNZ move, this relationship can break down during periods of increased market volatility. We have seen this recently with only 10-20bp of the most recent OCR cut passed through to floating mortgage rates as higher bank risk premia partially offset the OCR cut. If the RBNZ reduces the OCR two more times, it means we could see floating and shorter-term fixed mortgage rates move lower within the next 6 months, but the reduction may be less pronounced than seen with earlier OCR cuts.

Pressures on longer-term mortgage rates are slightly more complex. While we expect longer-term mortgages to also dip slightly over 2016, these rates are also influenced by offshore developments, particularly in the US. In our last Home Loan Rate Report we discussed how rising US interest rates could put upward pressure on longer-term mortgage rates. However, developments since then have seen the likelihood of further US interest rate hikes diminish and, therefore, the upward pressure on longer-term rates lessen. But when US interest rate hikes do resume we will likely see this flow through to higher longer-term mortgage rates.

But right now, the combination of the RBNZ's recent rate cuts, expectations of more easing and relatively low global interest rates are helping keep **all fixed carded and "special" offers below the floating rates**. For example, at the time of writing, the 1-year fixed special rate of 4.15% is the lowest recorded since 1998 and roughly 140bp lower than the floating rate.





Identifying the best strategy

As a borrower it is important to assess the likely path for interest rates, the 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. At the end of this document 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 **one- to two-year fixed rates are the cheapest rates at most main banks right now**, around 1% below the floating rate. So borrowers can create some certainty, and obtain a lower rate by fixing for short terms rather than floating. Based off our

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assumption the RBNZ will cut rates further this year, **there is some scope for floating and some short-term rates to be even lower later this year.** However, if the RBNZ does not cut interest rates further, short-term rates may rise from these levels.

All **fixed rates are well below their long-run (10-year) average** and are well below the floating rate. So by this simple measure, the fixed terms are reasonable value. Longer-term rates are influenced by the RBNZ, but are also at the mercy of global interest rates. As discussed on the front page, we expect longer-term rates will dip slightly before rising again.

When choosing a mortgage, it's not just about finding the cheapest rate. One characteristic of floating mortgages borrowers enjoy is flexibility of repayments. **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.**

The RBNZ's LVR lending restrictions and borrowers

The RBNZ introduced tighter loan-to-value (LVR) lending restrictions for Auckland property investors on 1 November 2015. LVRs were left unchanged for Auckland owner-occupiers, and were eased outside of Auckland. The practice of offering "specials" or lower rates on lending with equity in excess of the LVR restriction 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**.

Some advantages and disadvantages of the various mortgage rates

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

- The floating rate currently sits around 160bp below its 10-year average of 7.2%. Borrowers retain the freedom to lock in term rates at any time, and have flexibility with principal repayments. If the RBNZ does cut the OCR again soon, then borrowers could benefit soon afterwards.

The major **disadvantage**:

- While we expect the RBNZ to cut the OCR by another 50bp later this year, short-term fixed rates are currently a cheaper option. For example, fixing for 6 months 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 are lower at the time of writing).
- Provides some certainty for the borrower in the immediate term.
- If the RBNZ cuts the OCR further, a 6-month term will roll off in a period when we would expect other rates to be low.

Over the next few months we expect the 6-month mortgage rate could dip further if the RBNZ cuts the OCR twice more this year, although some of this is "priced in" to the current rate. And over the next year the 6-month rate should fall further, before rising modestly, unless the RBNZ declines to cut the OCR further or lifts the OCR more aggressively than we are expecting.

The major **disadvantage**:

- The 6-month term provides less of a hedge than the longer terms against lifts in mortgage rates that could be caused by rising global interest rates or the RBNZ resuming OCR increases sooner, or by more, than we expect.

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.

Over the next year we expect the 1-year fixed mortgage could dip as the RBNZ cuts the OCR by another 50bp (again, some is "priced in" to the current rate). And over the next few years based on our current forecasts, the 1-year rate should only rise 1% or so from current levels, unless the RBNZ lifts the OCR above 3.5%. Being the lowest rate on offer, rolling 1-year mortgages could prove cheaper than longer terms based on our current forecasts.

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, volatility or the RBNZ resuming OCR increases earlier than expected.

The 1-year fixed rate would suit those who prefer some **interest rate certainty**, but also place some **priority on low debt-**

servicing costs, or the ability to **review their mortgage structure reasonably frequently**.

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 **disadvantages**:

- Committing to the 2-year term means borrowers may not be able to access lower rates if the RBNZ cuts the OCR further and shorter-term mortgage rates dip from current levels.
- However, the 2-year term also 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 unexpectedly resumes raising the OCR within two years' time.

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

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

The **disadvantage**:

- More expensive than our forecast of sequential shorter terms, particularly if the RBNZ delivers more OCR cuts.

The main **advantages** of the **5-year** fixed rate are:

- The rate offers certainty for a long period. It offers a long-term hedge in case future interest rates rise substantially higher than we envisage. For example through high inflation, more RBNZ OCR increases, or funding cost pressures.
- The 5-year rate is only 0.5% above the carded one-year rate, and lower than the floating rate, meaning borrowers can obtain certainty about their interest rate expenses for an extended period at a relatively low cost.

The **disadvantage:**

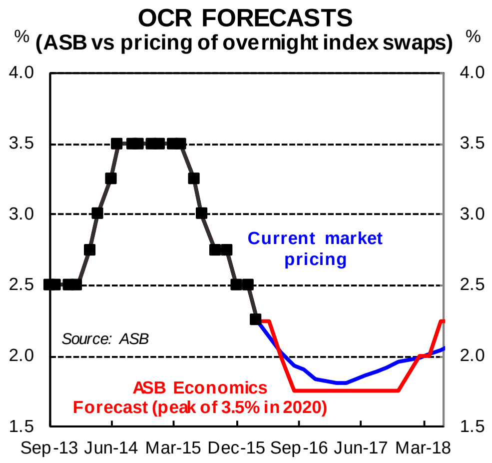
- Although below average levels, rolling shorter fixed terms is expected to provide lower funding costs over the next 5 years, according to our forecasts.

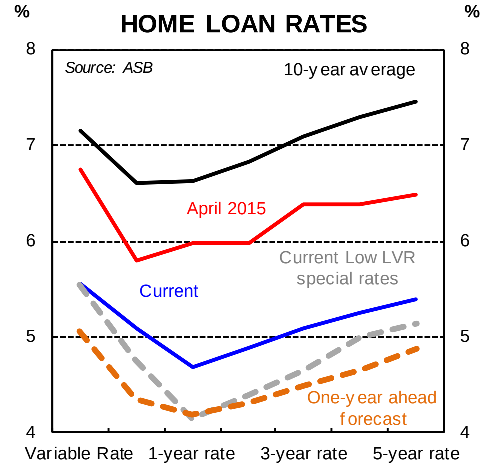
The current 5-year fixed carded rate of 5.40% is significantly lower than the average level over the past 10 years (7.5%), and may **suit those who prefer a high degree of interest rate certainty.**

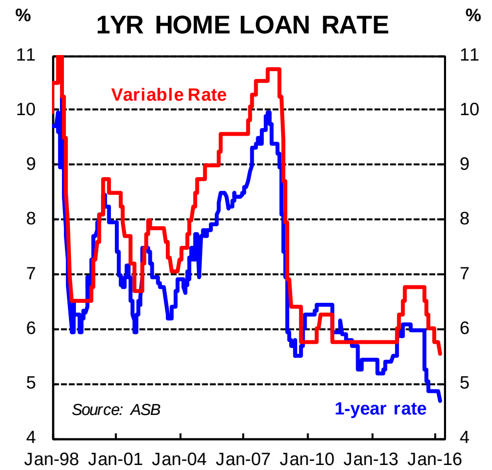
Final thoughts

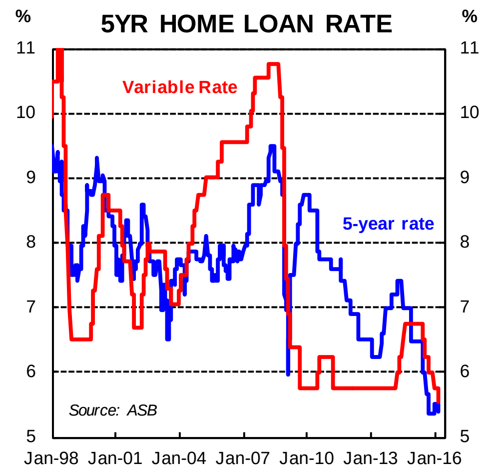
Just remember the only certainty about the future is its uncertainty**. The 'best' mortgage rate is only known in hindsight.** But, with the above pros and cons for the various mortgage rates on offer we **hope to give you a good platform from which to consider what interest rate option appears most 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 ability to deal with changes** in future mortgage payments as interest rates change. Borrower's financial circumstances can changes 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 them.**









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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