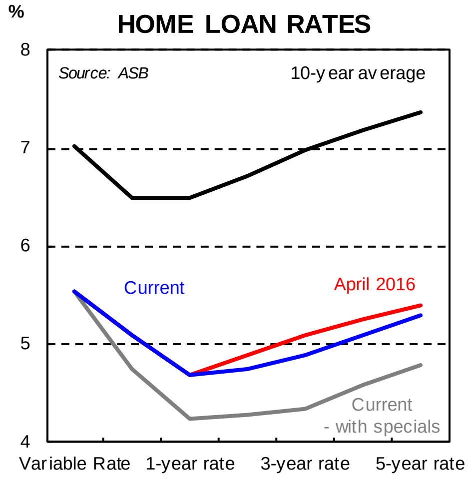
Mixed pressures on mortgage rates muddy outlook

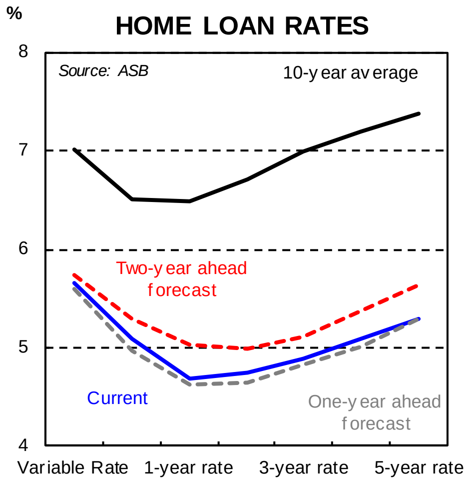
- **Mortgage rates have remained largely steady since April's Home Loan Rate Report.**
- **Increases in funding costs have limited mortgage rate declines following the RBNZ cutting the OCR in August.**
- **We are expecting another 25bp cut in November, which may put some downward pressure on mortgage rates.**

Mortgage Rate Outlook

Since April's Home Loan Rate Report, longer-term fixed mortgage rates have moved slightly lower. Inter-bank competition and the 25bp OCR cut the RBNZ delivered in August have weighed on interest rates. However, increased wholesale funding costs during this period limited the extent of the mortgage rate falls. Despite this, mortgage rates remain incredibly low relative to historical averages and current "specials" are even lower.



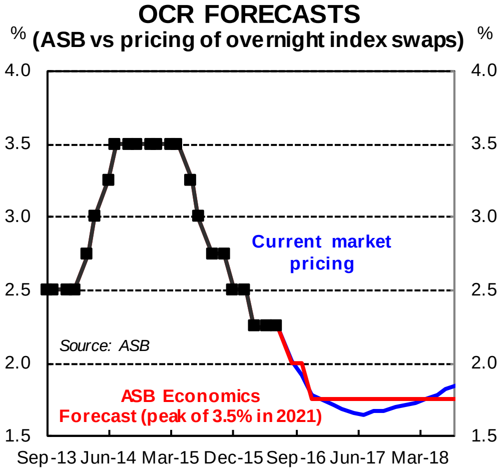
We are expecting one more 25bp OCR cut by the RBNZ this year in November. As floating and shorter-term fixed mortgage rates generally move closely in line with each RBNZ move, **we are likely to see the floating mortgage rate and short-term fixed rates decline slightly further this year.** However, wholesale funding costs, due to increased market volatility, are expected to remain higher than normal. Ongoing Brexit-related concerns as well as the impending US election are two reasons why volatility may remain elevated for some time. As a result, further floating and short-term interest rate falls may be limited.



Pressures on longer-term mortgage rates are slightly more complex. We expect longer-term mortgages to also dip slightly over the remainder of 2016. However, these rates are also influenced by offshore developments, particularly in the US. As the US Federal Reserve resumes interest rate hikes (likely by the end of the year) longer-term mortgage rates could lift to reflect this. However, the pace of US interest rate hikes is expected to be slow. 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.

The RBNZ's LVR lending restrictions and borrowers

The RBNZ is in the process of introducing another round of LVR restrictions, due on 1 October. Nationwide, 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 for LVRs of less than 20%. As a result, 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.



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 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. Based on our assumption the RBNZ will cut rates further this year, **there is some scope for floating and a few short-term rates to be slightly lower later this year.** However, if the RBNZ does not cut interest rates further, short-

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term rates may rise from these levels.

All **fixed rates are well below their long-run (10-year) average** and the floating rate. So by this simple measure, the fixed terms are reasonable value. And as discussed above, we expect longer-term rates will dip slightly over the year ahead. One characteristic of floating mortgages is that borrowers enjoy 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.

Some advantages and disadvantages of the various mortgage rates

<u>The main **advantage** of the **floating rate** is:</u>

- The floating rate currently sits around 160bp below its 10-year average of 7%. 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**:

- 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.**

<u>The main **advantages** of the **six-month** rate are:</u>

- 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 the RBNZ cuts the OCR further, a 6-month term will roll off in a period when we would expect other rates to be slightly lower.

We expect the 6-month mortgage rate could dip more if the RBNZ cuts the OCR further. Hoever, as some of this is “priced in” to the current rate, falls may be limited. Over the next year, the 6-month rate could fall further unless the RBNZ declines to cut the OCR any more or lifts the OCR more aggressively than we are expecting.

The major **disadvantage**:

- The 6-month term provides less of a hedge against lifts in mortgage rates that could be caused by rising global interest rates or the RBNZ resuming OCR increases earlier 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**.

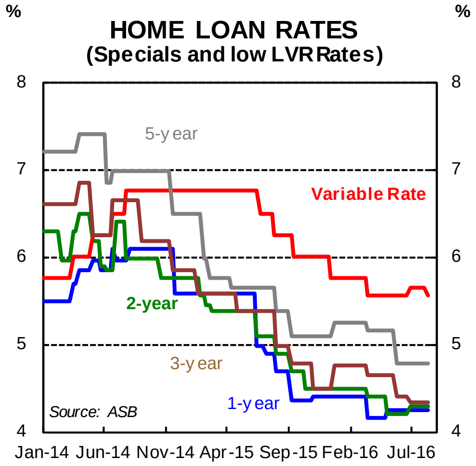
<u>The main **advantages** of the **1-year** rate are:</u>

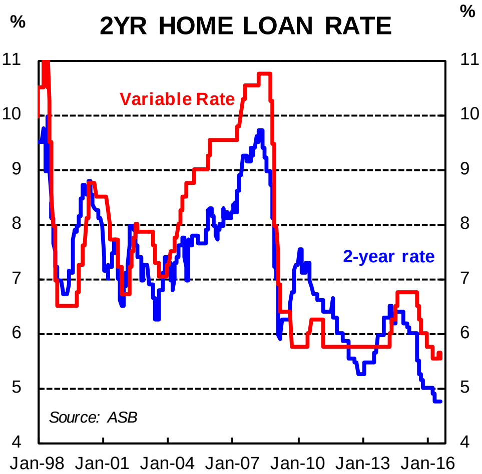
- The lowest carded rate on offer at several major financial institutions.
- Provides some interest rate certainty for the borrower.

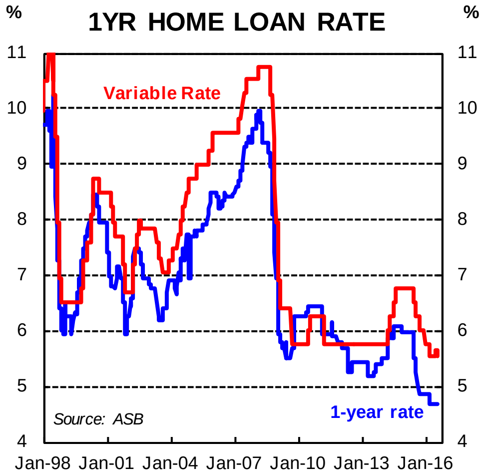
Over the next year we expect the 1-year fixed mortgage could dip slightly as the RBNZ cuts the OCR further. Over the next few years, the 1-year rate should only rise 1% or so from current levels, based on our forecasts. Being the lowest rate on offer, rolling 1-year mortgages could prove cheaper than longer terms based on our current forecasts.

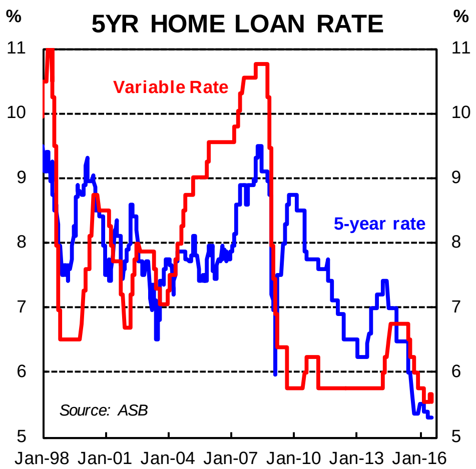
The major **disadvantage**:

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 either 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 5.29% is significantly lower than the average level over the past 10 years (7.4%), 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. 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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