# Home Loan Rate Report

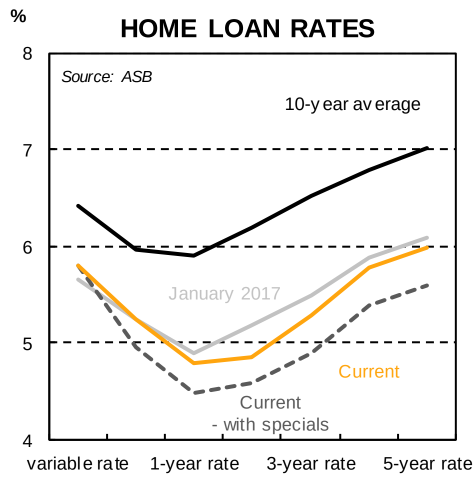
08 January 2018

## Where to from here?

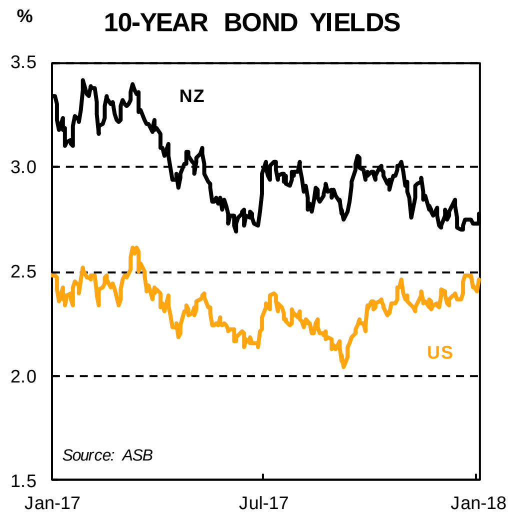
- NZ interest rates largely unchanged from this time last year.
- However, we expect longer-term interest rates to move higher this year as US interest rates lift.
- Floating and short-term fixed rates may rise in late 2018 with expectations of an early 2019 RBNZ OCR hike.

### Year in Review

Heading into 2017, our expectation had been for slightly higher mortgage rates by year-end. Key to this was expectations of higher offshore (US) interest rates and ongoing bank funding challenges. However, the chart opposite shows current mortgage rates are close to where they were in January 2017 (and some fixed-terms are even lower than they were then!).




So what happened? Firstly, bank funding challenges were already exerting pressure on mortgage rates at the end of 2016/early 2017. However, increasing domestic deposit growth rates later in 2017 saw some of these pressures ease. Secondly, the lift in US interest rates was less straightforward than we had anticipated. Despite the US Federal Reserve lifting the Fed funds rate 3 times in 2017, interest rates actually softened as concern over the pace of US tax reform progress grew.




### Mortgage Rate Outlook

Now as we face 2018 we are, once again, expecting interest rates to lift over the year. US interest rates are expected to continue lifting (particularly now that the US tax bill has passed). US interest rates tend to impact NZ's longer-term interest rates and, as a result, we are likely to see this pressure flow through to the 3-year plus fixed rates.

The RBNZ is also likely to have a bigger impact on rates in late 2018. After leaving the Official Cash Rate (OCR) on hold since November 2016, we are expecting the RBNZ to lift the OCR in February 2019. And, as the OCR is one factor influencing floating and shorter-term fixed mortgage rates, **there is a risk that NZ's shorter-term interest rates start to lift ahead of any OCR increases**.

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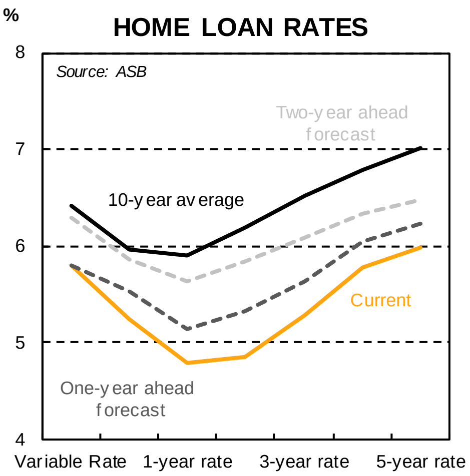
## The RBNZ's LVR lending restrictions and borrowers

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' remains unchanged at 5%. On the other hand, owner-occupiers deposit requirements remain fixed at 20%, while the 'speedlimit' has eased to 15% from 10% of all lending. Although LVR restrictions will potentially 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

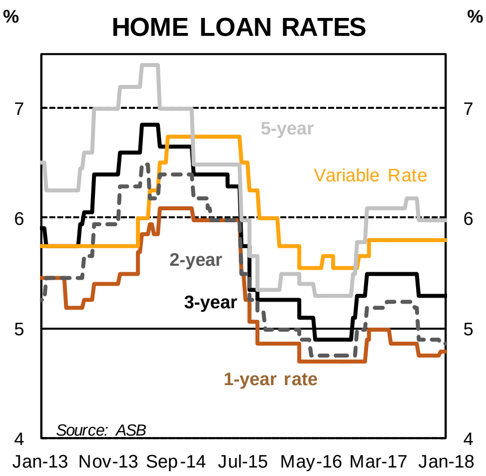
Personal preferences for certainty and flexibility are also important when choosing a mortgage. On the following pages we summarise some pros and cons of different mortgage term options. But here are some general points when considering short-term rates vs longer-term rates:

The 1- to 2-year fixed rates remain the cheapest rates at most main banks, roughly 1.0% below the floating rate. So borrowers can create some certainty and obtain a lower rate, by fixing for short terms. Further, all fixed rates remain well below their long-run (10-year) average. So by this simple measure, the fixed terms are reasonable value, though the 5-year fixed rate is now higher than the floating rate. Splitting the mortgage into different terms, or a mix of fixed and floating mortgages, are also strategies for keeping some flexibility while locking in some interest rate certainty.

## Some advantages and disadvantages of the various mortgage rates:

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

- The floating rate currently sits around 60bp below its 10-year average of 6.40%. 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 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 obtains a cheaper rate and the short term of the loan means the opportunity to adjust principal payments is never too far away.

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 longer terms against lifts in mortgage rates that could be caused by 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 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, volatility or the RBNZ resuming OCR increases.

Given we are expecting the RBNZ to resume OCR hikes in roughly a year's time, the 1-year fixed rate could lift slightly over the next year in anticipation of this. As a result, our current forecasts suggest a strategy of sequentially rolling 2-year rates could prove cheaper over a five-year horizon.

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.

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 two-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 against interest rate increases. For example, if global interest rates lift more than expected, or the RBNZ lifts the OCR more times than expected over the next 2 years.

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 intend to repay debt in around 2 years time.

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 over the next three years.

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

- 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 or higher global interest rates.

The **disadvantage**:

- The 5-year rate is roughly 120bp higher than the one-year rate and almost 20bp higher than the floating rate. Based on our forecasts, fixing for shorter terms is likely to provide a lower cost of funds over the next 5 years.

However, the current 5-year fixed carded rate of 5.99% is significantly 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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