Home Loan Rate Report

06 October 2017

Signs pointing to slightly higher interest rates ahead

- NZ interest rates are down a touch from July, reflecting a period of tax reform uncertainty in the US.
- However, we expect this to be short-lived as US interest rates have begun to grind higher again.
- Locally, bank funding costs remain a constraining factor despite the RBNZ sitting on the sideline.

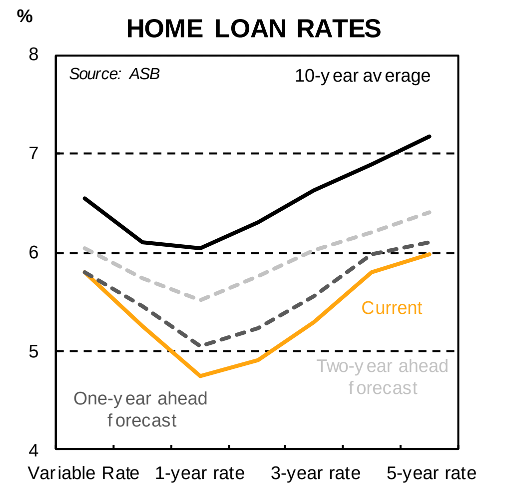
Mortgage Rate Outlook

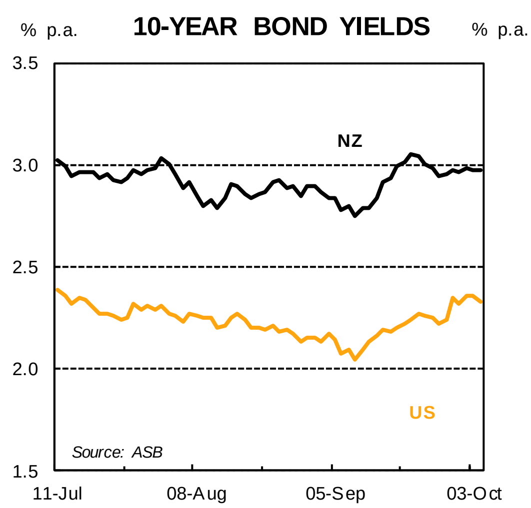
Fixed mortgage rates have fallen slightly following July's Home Loan Rate Report. Movements in offshore rates continue to be the dominant force behind NZ interest rates at the moment, especially as the Official Cash Rate (OCR) has been on hold since November 2016.

NZ longer-term fixed rates are particularly sensitive to movements in US interest rates. Since July's Home Loan Rate Report, a period of uncertainty in the US regarding tax reform and Federal Reserve rate hikes weighed on US interest rates. The flow-on effect has been marginally lower interest rates here in NZ.

However, we think this unexpected period of lower interest rates will be short lived. For one, US interest rates have started increasing again (although remain lower than they were in July). The Fed has strongly signalled that a rate hike is likely in December and markets have also taken notice of the renewed tax talk. This is likely to see upward pressure shortly return to NZ's longer-term interest rates.

Here in NZ, we are not expecting any Official Cash Rate (OCR) increase until February 2019. As the OCR is one factor influencing floating and shorter-term fixed mortgage rates, **this suggests minimal movement over these terms over the remainder of the year.** However, there is a risk that NZ's shorter-term interest rates lift ahead of any OCR increases. In particular, any further increases to bank funding costs or earlier than expected progress with US tax reform could see modest upward pressure on shorter-term interest rates.





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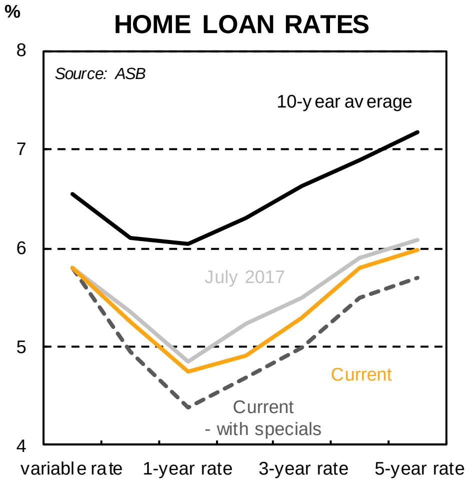
The RBNZ's LVR lending restrictions and borrowers

The RBNZ introduced further LVR restrictions on 1 October 2016 and these look set to remain in the market for some time yet. As a result, the practice of offering "specials" or lower rates 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



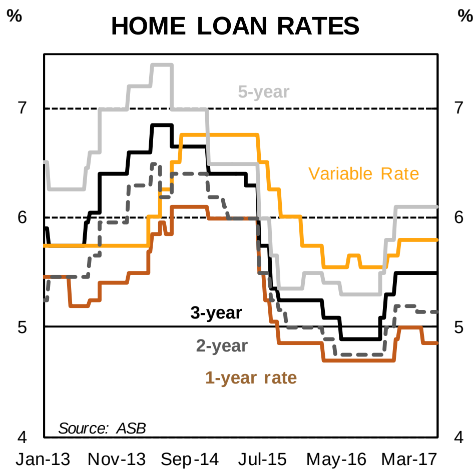
Personal preferences for certainty and flexibility are also important when choosing a mortgage. On the following pages we summarise some pros and cons of different mortgage term options. But here are some general points when considering short-term rates vs longer-term rates:

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:

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

- The floating rate currently sits around 75bp below its 10-year average of 6.55%. 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.

<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 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 funding challenges or 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 due to ongoing funding pressures or 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.
- Sequentially rolling a 1-year rate may be the cheapest option over a 5-year period.

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

Over the next year we expect the 1-year fixed mortgage rate could lift slightly as a result of funding pressures. Even though we expect mortgage rates to continue to lift and the RBNZ to raise the OCR within two years' time, fixing now for one year and then re-fixing for short terms in likely to prove better than fixing for longer (and more expensive) terms, based off our current forecasts.

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.

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 against interest rate increases. For example, if global interest rates lift more than expected, or the RBNZ resumes raising the OCR within two years' time (as we expect).

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 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, funding cost pressures or higher global interest rates.

The **disadvantage**:

- The 5-year rate is roughly 125bp 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 (7.20%), 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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