Home Loan Rates

23 September 2015

More downward pressure on interest rates

- **We expect the RBNZ to cut the OCR by an additional 25bp this year – taking the OCR to 2.5% by year-end.**
- **Influential global interest rates have been choppy recently, but could come under upward pressure later this year.**
- **Another OCR cut will put downward pressure on mortgage rates. Rising global rates could become an opposing force.**

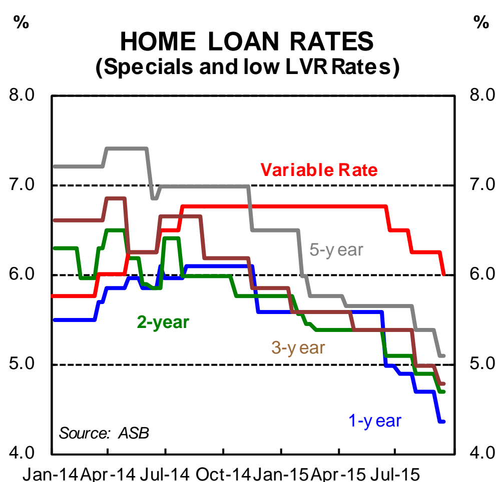
The RBNZ has cut the Official Cash Rate by 75bp since June, taking it back to 2.75%. We now expect an additional 25bp cut later this year 2015 – taking the OCR to 2.5% by year-end. Inflation remains incredibly low, and recent developments are pointing to weaker economic growth over the remainder of 2015 than our earlier forecasts. Related to these developments, confidence levels of both businesses and consumers remain subdued, especially in dairy-intensive regions.

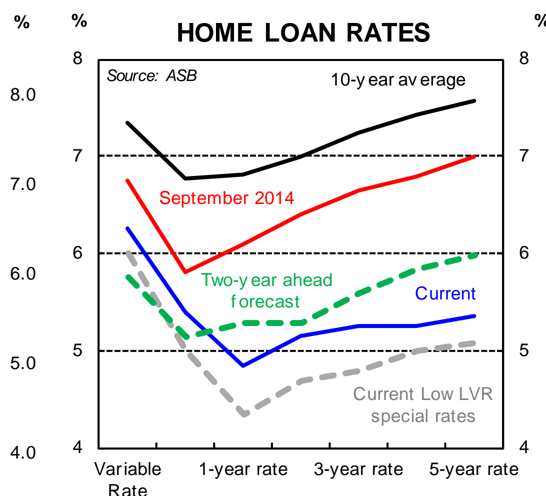
If the OCR is reduced to 2.5% as we are expecting, we are likely to see floating mortgage rates and short-term fixed rates decline further. Floating mortgage rates move fairly much in lock-step with each RBNZ move. If we are correct in our view that the RBNZ will cut once more over 2015, it should mean we see floating mortgage rates move roughly 25bp lower by the end of the year. The six-month rate is also very heavily influenced by where the OCR is sitting. While the 6-month rate has already reduced slightly, it should reduce further if the OCR is cut as we are expecting.

OCR cuts might seem strange given the current housing market. Especially as lower interest rates risk stoking that market further. However, the RBNZ's primary focus is price stability and it targets the Consumer Price Index inflation rate. The RBNZ's concerns with housing at the moment are about financial stability foremost, particularly within Auckland's housing market. The RBNZ's additional macro-prudential policies are aimed at reducing the risk of financial instability stemming from the housing market, and are due to be introduced in November 2015. The Government is also introducing measures in October to help tackle some housing market issues. These developments appear to have made the RBNZ more comfortable about responding to low inflation by lowering the OCR this year.

Longer-term mortgage rates (particularly the 5-year rate) are likely to be influenced by offshore developments, particularly in the US over the rest of 2015. It's looking increasingly likely that the US Federal Reserve will raise rates later this year. Growing expectations of US rate hikes should put upward pressure on longer-term rates in the US and this should flow through to NZ rates.

The US 10-year Government bond yield is trading near 2.1%, which is very low by historical standards, but around 0.5% higher than earlier this year. Currently, NZ's equivalent 10-year bond yield is around 3.3%, very low by our own historical standards, but around 20bp higher than the year's lows. If US rates lift over the course of the year and long-term bond yields keep rising, we would expect to see some upward pressure to flow through to longer-term fixed mortgages here.





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RBNZ's high-LVR lending restrictions tighten in Auckland

In November, the RBNZ will introduce tighter lending restrictions for Auckland property investors, while simultaneously easing them outside of Auckland. The existing loan-to-value ratio (LVR) restrictions will only apply to owner-occupiers in the Auckland Council Area. Property investors within Auckland now require a LVR of no more than 70% (i.e. investors must have 30% equity in a house purchase). Residential mortgages outside the Auckland area will continue to be restricted by a maximum LVR of 80%. But, the proportion of higher-LVR loans banks can lend will lift from 10% to 15% (i.e. outside of Auckland banks will be able to write more loans for home buyers with low deposits). The RBNZ is also establishing a new asset class for bank loans to residential property investors. These loans will attract a higher risk weighting than similar loans to owner-occupiers. This means banks will need to put aside more capital against these loans, which could lead to slightly higher borrowing costs (read more in the Financial Stability Review).

What does it mean for borrowers?

The new lending restrictions mean the challenge of a higher deposit requirement will remain for many. But the need for a higher deposit will be felt most strongly by Auckland property investors. For banks, it probably means the practice of offering "specials" or lower rates on lending with equity in excess of the LVR restrictions remains in place.

Floating mortgage rates move fairly much in lock-step with each RBNZ move. Following the three OCR cuts so far this year, the floating rate moved 75bp lower to around 6%. If we are correct in our view that the RBNZ will cut the OCR once more in 2015, it should mean we see floating mortgage rates move below 6% by the end of the year. The six-month rate is also very heavily influenced by where the OCR is sitting. While the 6-month rate has already reduced slightly, it could reduce further if the OCR is cut again.

In contrast, the longer-term rates are subject to a number of influences that could cause them to fall or rise this year.

Recently, the RBNZ's rate cuts, and expectations of more easing has lowered mortgage rates. The combination has meant it has been possible for borrowers to access fixed-term rates this year that are lower than when the RBNZ began raising rates last year. For example, at the time of writing the 5-year fixed carded rate is 5.35% whereas it was 7.40% last year.

However, longer-term mortgage rates will most likely change over the year ahead, even if the RBNZ doesn't cut the OCR further. Developments in the economies and financial markets of the US and Europe will be a key influence on where New Zealand long-term mortgage rates settle. The US Federal Reserve is expected to lift interest rates in the coming months. In contrast, the weak European economy and low inflation has seen ongoing monetary policy stimulus from the European Central Bank this year. The combination of influences from the US and Europe mean pressures on long-term interest rates will be mixed, and difficult to predict. We expect the global backdrop to improve over the year ahead. And that improvement should eventually lead to higher offshore interest rates and, in turn, upward pressure on long-term NZ rates.

Right now, the combination of the RBNZ's stance and the low global rates are helping keep all fixed carded and "special" offers significantly below the floating rates. For example, at the time of writing, the 1-year fixed special rate has dropped to 4.35%, the lowest rate we have on our charts (which date back to 1998). High-equity borrowers should monitor these developments, and discuss the options with their mortgage providers when deciding what to do with their mortgage. For other borrowers, the RBNZ's lending changes are intended to take place from 1 November, but are influencing lending practices already.

Identifying the best strategy

The best choice to make as a borrower involves assessing the likely path for interest rates, the various 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.

Firstly, the 6-month to two-year fixed rates are the cheapest rates at most of the main banks right now, around 1% below the floating rate. So borrowers can create some certainty, and obtain a lower rate than floating by fixing for short terms. In fact, all carded rates at the main banks are significantly lower than floating rates at the time of writing. This means borrowers can create interest rate certainty and at the same time save on interest rate costs.

Secondly, all fixed rates are well below their long-run (10-year) average. So by this simple measure, the fixed terms are reasonable value, as shown in the charts on Page 1. We can also use our forecasts to calculate the expected cost of strategies such as rolling six-month or 1-year terms for the next 5 years, and compare the interest rate expense to the interest rate of the fixed terms available today for longer terms.

Thirdly, high equity borrowers need to check out the targeted "specials" on offer as they are often the lowest rates available. Chart two on page one shows how low some of the special rates are relative to carded rates.

Based on our forecasts for carded rates, rolling shorter terms remains a cheaper strategy than longer terms such as the 4-year or 5-year rates. And if the RBNZ cuts the OCR further, then the shortest six-month term will roll off into a period where we would expect the floating rate and other short-term rates to be lower.

Beyond the next year, our view that rolling short-term mortgages should be a reasonable strategy is based on the RBNZ not lifting the OCR for a while. Further, when the RBNZ does lift the OCR, we don't expect it to lift beyond 3.5% for the foreseeable future.

However, if the RBNZ delivers more rate hikes over the coming years, some of the longer terms available today may prove to be better value. With that risk in mind, historically-low term rates mean a long period of interest rate certainty can be achieved at a relatively low cost. That story is even better for loans with a loan-to-value ratio of less than 80%, where the "special" rates are lower for most terms.

If the RBNZ cuts the OCR again as we are forecasting, we would expect the floating rate and short-term (six month and one year) fixed rates to come down further.

The longer-term rates will be influenced by the RBNZ, but also be at the mercy of global interest rates. Longer-term rates may, but won't necessarily, decline further. Remember the five-year rate fell last year when the RBNZ raised the OCR; it's possible the opposite could occur over the year ahead.

When choosing a mortgage, it's not just about finding the cheapest rate. One characteristic of floating mortgages borrowers have enjoyed has been the flexibility of repayments that floating offers. 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 following section goes through some general advantages and disadvantages of the various mortgage rates on offer:

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

- The floating rate currently sits more than 125 basis points below its 10-year average of 7.35%. 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 should benefit soon afterwards.

The major **disadvantage**:

- While we expect the RBNZ to cut the OCR again this year, the interest rate costs of rolling floating mortgages are likely to be higher on average over the coming years compared with locking in a fixed-term rate.

- Fixing for six months obtains a cheaper rate than the floating 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).

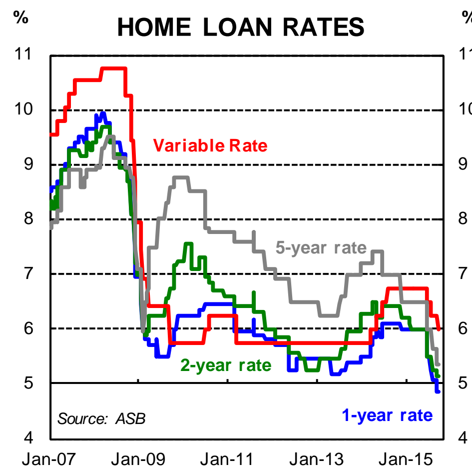
- Provides some certainty for the borrower in the immediate term.

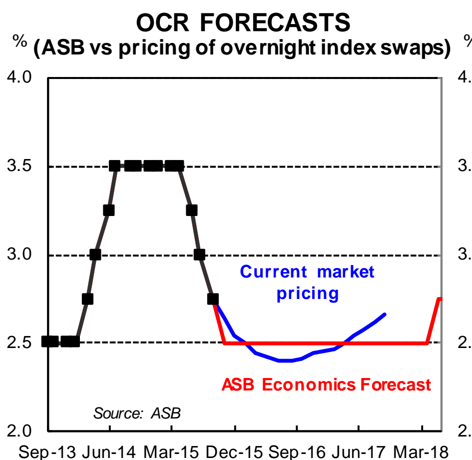
- If the RBNZ cuts the OCR by another 25bp this year, a 6-month term will roll off in a period when we would expect other rates to be low.

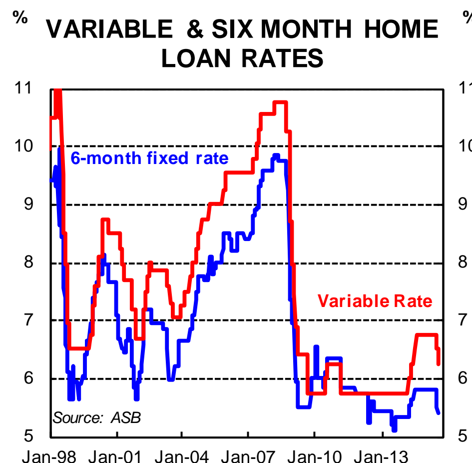
Over the next few months we expect the six-month mortgage rate could dip further if the RBNZ cuts the OCR again, although some of this is "priced in" to the current rate. And over the next few years the six-month rate should only rise modestly from current levels, unless the RBNZ lifts the OCR more aggressively than we are expecting.

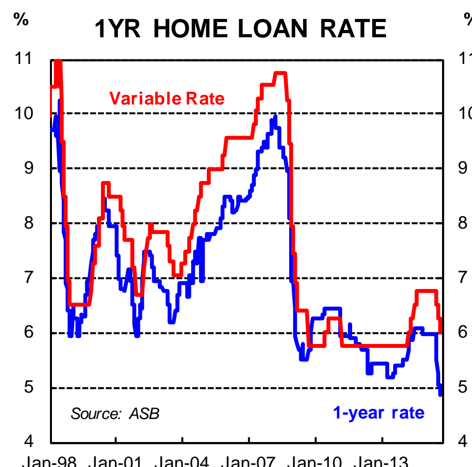
The major **disadvantages**:

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

Over the next few years we expect the 1-year fixed mortgage could dip further if the RBNZ cuts the OCR again (again, some is "priced in" to the current rate). And over the next few years 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 one-year mortgages could prove cheaper than longer terms based on our forecasts.

The major **disadvantages**:

- 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, or the RBNZ resuming OCR increases next year.

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 2-year fixed rate currently offers these **advantages**:

- Greater interest rate certainty than available through shorter terms at a relatively low rate.

The **disadvantage**:

- Committing to the 2-year term means borrowers cannot access lower rates if the RBNZ cuts the OCR further, and mortgage rates dip from current levels.
- And at the other end of the list of concerns, the 2-year term provides less of a hedge than the longer-term rates against interest rate increases. E.g. if global interest rates lift more than expected, or the RBNZ unexpectedly resumes raising the OCR within two years' time.

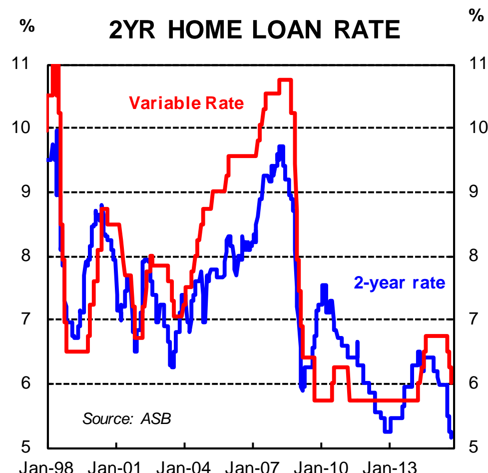
The 2-year fixed rate would again suit those who prefer a degree of interest rate certainty in the near term at a relatively low rate, or those who will be repaying debt in the 2-year timeframe.

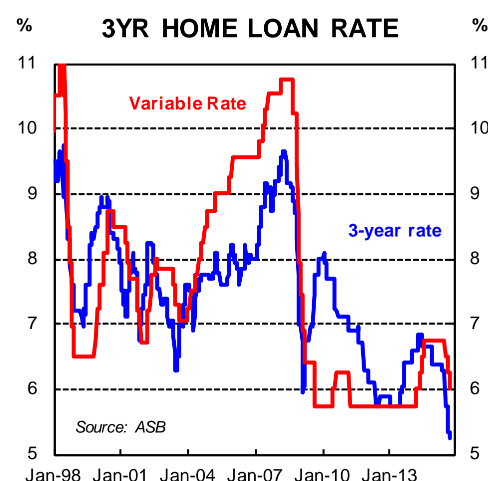
The 3-year fixed rates currently offer the following **advantages:**

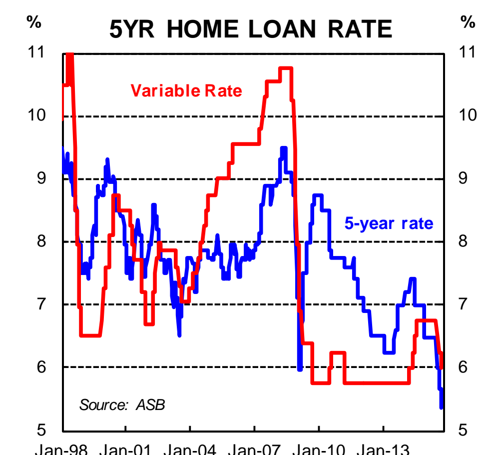
- Providing interest rate certainty for longer at a relatively low cost.

The **disadvantage**:

- More expensive than sequential shorter terms, particularly if the RBNZ cuts the OCR again, as we expect.







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 it is below average levels, rolling shorter fixed terms is expected to provide a lower cost of funds over the next 5 years according to our forecasts.

The current 5-year fixed carded rate of 5.35% is significantly lower than the average level over the past 10 years (7.6%), and may suit those who prefer a high degree of interest rate certainty.

Final thoughts

A weaker growth outlook than anticipated at the start of the year is likely to result in the RBNZ cutting the OCR by an additional 25bp this year, to a low of 2.5%. This rate cutting cycle was something we did not expect a year ago. One more 25bp cut to the OCR this year should add to the downward pressure on mortgage rates for shorter terms at least. Longer-term rates have the additional influence of global interest rates – particularly US interest rates, which are expected to start to lift soon.

On top of trying to pick a strategy that minimises 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.

It is always important for borrowers to weigh up their own priorities and make the mortgage choice that looks the 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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