Home Loan Rates

Taking advantage of easier monetary policy

- **Local interest rates are likely to decline in the next couple of years.**
- **But the Reserve Bank has called for stable rates in the next few months.**
- **The short-term and long-term fixed rates have varying positive factors.**

ECONOMICS

4 May. 06

The Reserve Bank has called for a pause in the emerging downward interest rate trend. But the market is anticipating a resumption of this trend this year. This creates a difficult choice: take the lower 5-year rate now and enjoy the certainty; or pay a higher rate and face the risk of even higher rates, in anticipation of locking into a lower fixed rate next year (the more likely scenario). As always, it is a personal thing.

The trend for fixed home loan rates has been down this year although there have been ups and downs along the way. And the trend for the next couple of years to also likely to be down given the relatively high level of interest rates in New Zealand now, possibly not high by historical standards but certainly high by international standards and our recent history.

The challenge for borrowers at present is to judge (a) the period that the down-trend stalls while the Reserve Bank of New Zealand (RBNZ) calls for restraint and (b) the extent that lower interest rates have already been anticipated and hence built into current fixed rates.

How long does the RBNZ remain on-hold?

The RBNZ sets the Official Cash Rate (OCR), a rate that in turn heavily influences other short-term interest rates and, to a lesser degree, medium- and long-term fixed rates as well. The RBNZ stated last week: "we still do not expect to raise the interest rates again in this cycle"; and "we … see no scope for a cut in the OCR this year" [more on OCR Review]. In other words, the RBNZ does not anticipate changing the OCR this year but does expect the next move to be a rate cut in 2007. The RBNZ is well aware of the slower economy at present – and the slower housing market – but is also concerned about the strong inflation pressure that exists, pressure added to by rising oil prices and a falling NZ dollar.

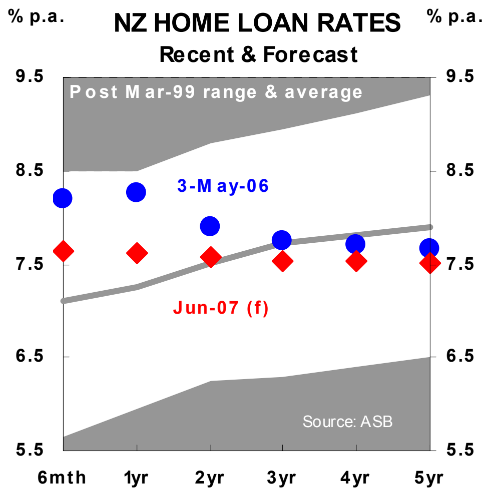
As always, the future is unknown and risks can look quite different in six months time. Furthermore, the very comments of the RBNZ – in part prompting a small upward interest rate movement – are likely to increase the degree to which cost increases are absorbed rather than passed on as higher product/service prices. ASB economists expect that the RBNZ will be in a position to review the "on-hold" stance in the December quarter of this year, in spite of their recent comments, and will reduce the OCR once or twice by year end.

Will interest rates decline more than already anticipated?

Market pricing is already based on the assumption that the RBNZ does change its mind. Current fixed rates are priced on the implicit assumption that the RBNZ reduces the OCR by 1% over the next 18 months, including by 0.5% around December-March. This means that borrowers can already take advantage of any potential easing in monetary policy now by choosing current fixed rates.

For example, the 5-year rate at 7.65% p.a. (today) is priced on this assumption. It is also below the average 5-year rate in recent years and below the average Variable Home Loan of recent years. Plus it is the lowest home loan rate at present and offers certainty for a long time (e.g. it does not matter whether the RBNZ cuts the OCR or not – the rate is fixed). So it has many advantages at present.

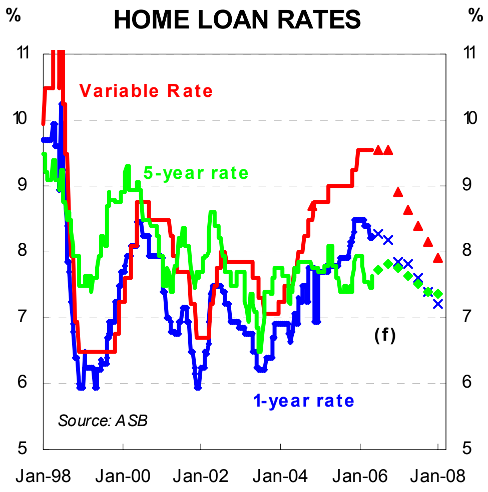
But should the RBNZ lower the OCR more, or faster, than expected then an even lower interest rate could be achieved. ASB economists believe more rate cuts than assumed are likely during 2007 and hence see some advantage – albeit with more risk – to fixing for 6-18 months, allowing the possibility of re-fixing at home loan rates around 7-7.5% by second half 2007.



Anthony Byett – ASB Chief Economist – 649 374 8604 – anthony.byett@asbbank.co.nz

Envisaged by ASB is a return toward average over the next 2-3 years for short- to medium-term rates, a process that will invariably be less regular than suggested opposite, but one that should take the OCR back to around 6% by late 2007, early 2008 and hence the 1-year home loan rate to near 7% (the average since Mar-99 being 7.3%).

The decline in longer-term fixed rates is expected to be moderate since these rates have not risen so much in recent years and there is the likely opposing force of rising offshore fixed interest rates (rising offshore fixed rates typically provide upward pressure on local fixed interest rates).



As always, there is the risk that this outlook proves wrong. In particular, rates may stay high or even rise further. These are risks that should also be factored into which fixed term is the most appropriate for you, along with your ability to cope with unforeseen events.

The following sections note the advantages and disadvantages of various fixed rate terms.

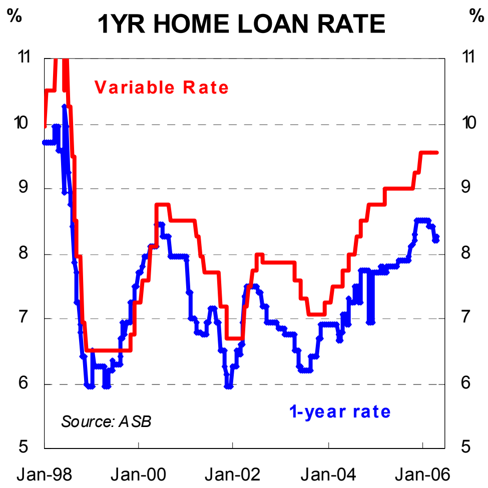
The main **advantages** of the 1-year rate are:

- it is below the average Variable Home Loan rate forecast by ASB for the next 12 months;
- there is also the potential to borrow at a lower rate in 12 months should the economic situation worsen rapidly, either here or abroad, enabling interest rates to decline quickly.

The major **disadvantages**:

- should interest rates actually rise further than expected – always a risk – then high rates will apply when coming off the fixed term next year.

A 1-year fixed rate would suit those who prefer interest rate certainty during the period when rate rises are still a risk (inflation still high) but who either will be repaying debt soon or who foresee the period of high interest rates passing quickly.



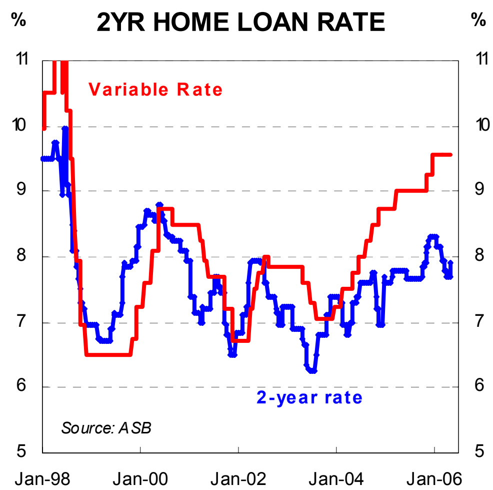
The 2-year fixed rate currently offers the **advantages**:

- it is below the average Variable Home Loan rate forecast by ASB for the next 24 months;
- it is below shorter-term fixed rates;
- with the added advantage of surety for a longer period than the shorter-term fixed rates

The **disadvantages**:

- missed opportunity for lower rates should the economy worsen rapidly and rates declines quickly;
- but also still the risk of higher rates after the fixed term if, instead, inflation risks become much greater.

A 2-year fixed rate would again suit those who prefer interest rate certainty in the near-term but were willing to take the risk that interest rates will return to lower levels during the next 24 months.



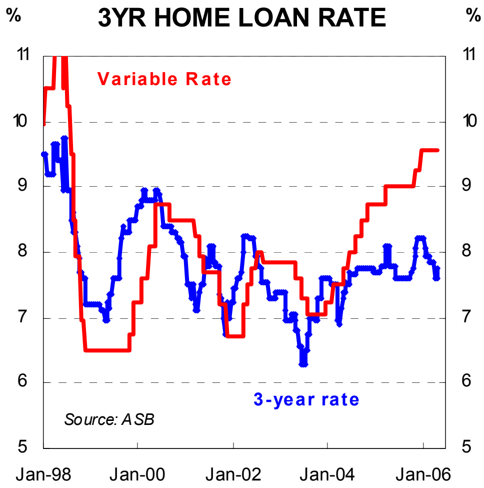
The 3-year fixed rate currently offers the **advantages**:

- providing interest rate surety for longer;
- and enables an even lower fixed rate at present.

The **disadvantages**:

- missed opportunity should global and local economies worsen and rates fall;
- the current rate is now above the average 3-year Home Loan rate (average 7.7% since Mar-99).

A 3-year fixed rate would again suit those who foresee interest rates returning to lower levels within the next few years but either prefer less risk or foresee the inflation adjustment process as lengthy.



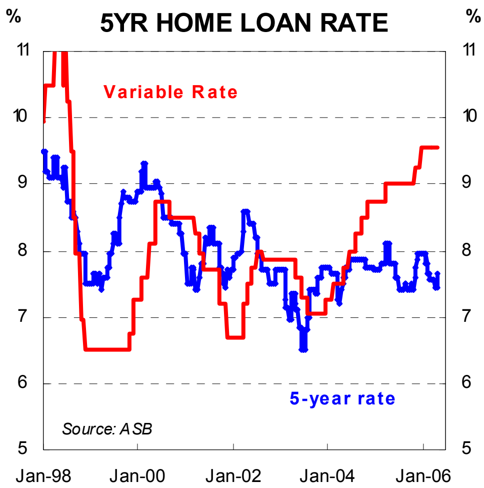
The **advantages** of the 5-year rate:

- surety for the next 5 years and protection against very high interest rates;
- plus the lowest fixed rate at present.

The major **disadvantages** of the 5-year rate are:

- it is above the average 1-year Home Loan rate forecast by ASB for the next 60 months;
- and there is the missed opportunity if fixed rates do decline within the next 1-3 years.

A 5-year fixed rate would suit those who prefer interest rate certainty or who foresee a period of persistent inflation.



The last word remains the same: nobody knows the future. The above notes hopefully provide some perspective to current trends and help with the decision about fixing loan rates. They do not, unfortunately, describe what will happen. You need to weigh up your own situation against possible rate changes – expected and unexpected – to find the term best suited to your needs. Feel free to phone the ASB Home Loan Line at 0800-100-600 to talk through these issues with ASB staff.

http://www1.asbbank.co.nz/reports   http://www.research.comsec.com.au

ASB ECONOMICS
Level 9, 135 Albert Street, Auckland

ASB GROUP STRATEGY & ECONOMICS			PHONE	FAX
Economics				
Chief Economist	Anthony Byett	anthony.byett@asb.co.nz	(649) 374 8604	(649) 302 0992
Treasury Economist	Daniel Wills	daniel.wills@asb.co.nz	(649) 374 8185	
CBA NZ Economist	Chris Tennent-Brown	chris.tennent-brown@asb.co.nz	(649) 374 8819	
Research				
Head of Research	Rodney Dickens	rodney.dickens@asb.co.nz	(649) 374 8300	