Home Loan Rates

22 June 2015

RBNZ OCR cut triggers a mortgage rate drop

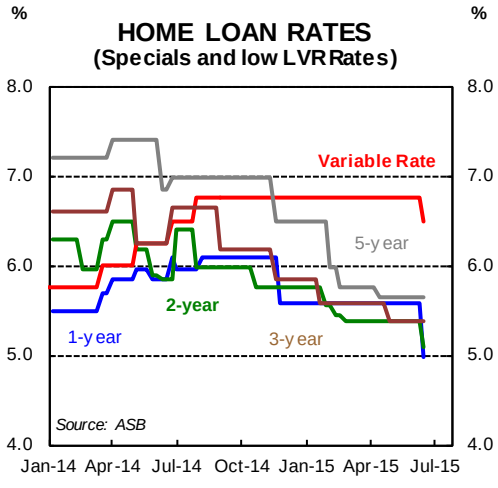
- **The RBNZ cut the OCR by 25bp in June, and we expect another cut will soon follow.**
- **Influential global interest rates remain low, but have started to lift recently.**
- **The OCR cut has put downward pressure on local mortgages, but rising global rates could become an opposing force.**

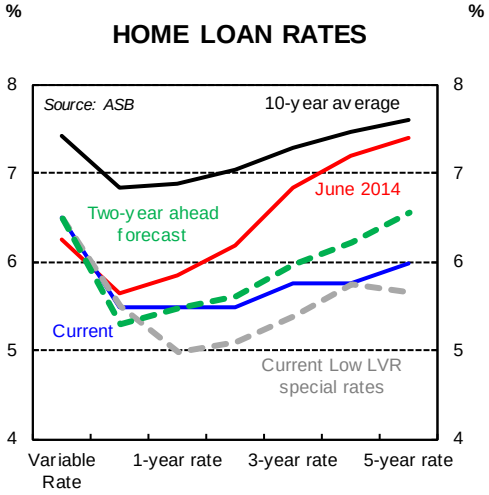
One year ago the RBNZ was lifting the OCR from the record low level of 2.5% and expected to lift it by up to 2%. What a difference a year makes. Having hiked the OCR to 3.5% by July 2014, the RBNZ remained on hold for nearly a year, and has now cut the OCR by 25bp at its June Review. Furthermore, the RBNZ acknowledged the chance of more cuts, stating that "further easing ***may*** be appropriate".

The inflation environment has proved to be very different to what the RBNZ envisaged when it started lifting the OCR last year; the RBNZ is now responding to that. Annual CPI inflation was only 0.1% in Q1 2015. Dairy price weakness and strong growth in the labour supply have also been important drivers of the RBNZ's shift in stance. From here, we expect one further 25bp cut this year. It will be a tight call between July and September and some of the key upcoming data will shed a little more light on the urgency (or otherwise) for another cut. We favour a rate cut at the RBNZ's 23 July meeting.

It might seem strange to be cutting the OCR cuts considering what's going on in the housing market. It's hard to read the newspaper or watch TV for too long without coming across a story about New Zealand house prices, and in particular the price gains in Auckland. Lower interest rates risk stoking that market further. 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, with the Auckland market the area of concern. This concern about financial stability was made explicit in the RBNZ's May Financial Stability Report. The RBNZ proposed additional macro-prudential policies aimed at reducing the risk of financial instability stemming from the housing market. The Government's May 2015 Budget also included measures to help tackle some of the housing market issues. These developments appear to have made the RBNZ more comfortable about responding to low inflation by lowering the OCR.

Local interest rates (particularly longer-term rates) are likely to be heavily 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 this year, with current market pricing suggesting a lift-off in the fourth quarter. 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 2.3%, which is very low by historical standards, but around 0.5% higher than earlier this year. New Zealand's equivalent long-dated Government bonds are trading with a similar pattern. Currently, NZ's equivalent 10-year bond yield is around 3.5%, very low by our own historical standards, but around 30bp 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

Within the RBNZ's May 2015 Financial Stability Report the RBNZ highlighted 3 main areas of risk to the financial system:

- Housing market imbalances, especially within Auckland;
- Dairy sector prices and high debt levels; and,
- Global financial conditions and their impacts on asset choices.

As a result of these concerns, the RBNZ is proposing tighter lending restrictions in Auckland for investors, but an easing of the current restrictions elsewhere. The existing loan-value ratio (LVR) restrictions now only apply to owner-occupiers in the Auckland Council Area. Property investors within Auckland will soon 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 on the FSR).

What does it mean for borrowers?

The additional high-LVR 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 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, and lifted 100bps, or 1% over 2014. However, following the OCR cut in June, the floating rate has since moved 25bp lower to around 6.50%. If we are correct in our view that the RBNZ will cut again soon, it should mean we see floating mortgage rates move a 25bp step lower. 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 may 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 fall or rise this year.

Despite the RBNZ's OCR hikes over 2014, fixed-term mortgage rates have been held down, and at times dipped, as global interest rates declined. Bank competition has also pushed down some of the fixed rates on offer. The combination has meant it has been possible for borrowers to access fixed-term rates 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 5.99% whereas it was 7.40% this time last year.

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 term mortgage rates settle. The US Federal Reserve is expected to lift interest rates over the next year. In contrast, the weak European economy and related low inflation triggered more monetary policy stimulus from the European Central Bank in March 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 course of the year. And that improvement should in turn eventually lead to higher offshore interest rates, and in turn, upward pressure on long-term NZ rates. At this stage it's hard to say if this process is clearly underway, but the key long-term government bond yields in Germany and the US have lifted significantly off their 2015 lows.

It is impossible to predict the exact mix and timing of RBNZ moves, bank competition, and pressure on local wholesale rates stemming from offshore interest rate market developments. But 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 below 5%, which is the lowest rate we have on our charts which go back to 1998. Borrowers should monitor these developments, and discuss the options with their mortgage providers when deciding what to do with their mortgage. The RBNZ's lending changes are intended to take place from 1 October, but are influencing lending patterns 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 six month and one-year rates are the cheapest rates at most of the main banks right now, over 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 of the carded rates at the main banks are significantly lower than floating rates at the time of writing, meaning 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, borrowers need to check out the targeted "specials" on offer as they are often the lowest rates available. The first chart to the right shows how low some of the special rates are relative to carded rates.

Based on our forecasts for carded rates, rolling shorter terms is still a cheaper strategy than locking in the longer terms such as the 4-year or 5-year rates. And if the RBNZ cuts the OCR again, 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 hinges on our view that the RBNZ will not need to lift the OCR for a while, and when it does, it won't lift it 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 rates are lower for most terms.

If the RBNZ cuts the OCR again, we would expect the floating rate and very short-term fixed rates to come down further. The longer-term rates will be more at the mercy of global interest rates, and may, but won't necessarily, decline further. We think it would likely require a series of OCR cuts, combined with flat or lower offshore rates to see a significant dip in long-term rates (which is not what we are currently forecasting).

When choosing a mortgage, of course it's not just about finding the cheapest rate. One of the characteristics of floating mortgages that 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 can be a good strategy for keeping a bit of 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 around 125 basis points below its 10-year average of 7.5%. 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 once more 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.

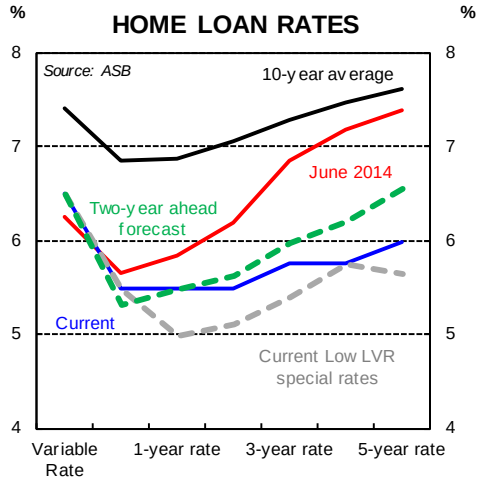
The floating rate particularly suits borrowers that need or value repayment flexibility. And if the RBNZ cuts the OCR again, the floating rate may provide a very flexible option.

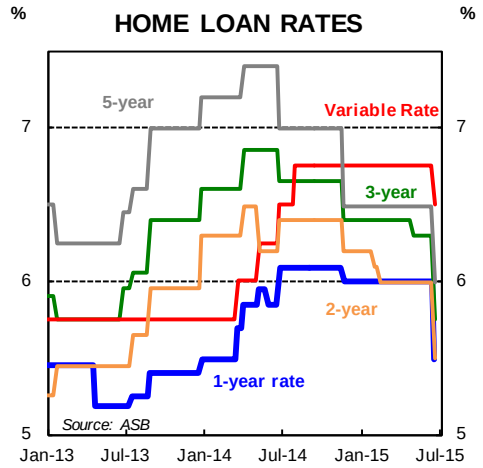
The main **advantages** of the six-month rate are:

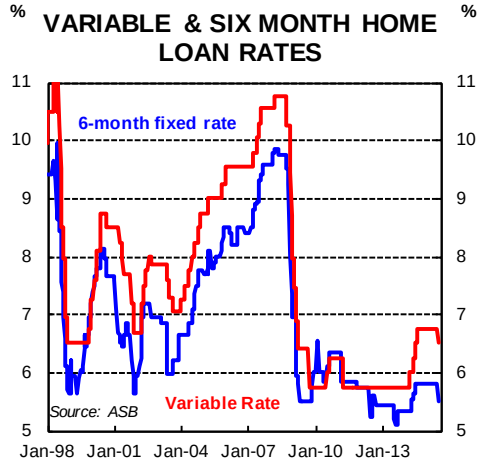
- Lowest carded rate on offer at several of the major financial institutions.

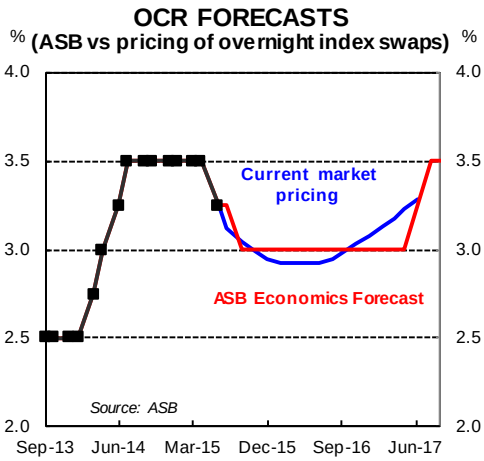
- Provides some certainty for the borrower in the immediate term.

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









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" the current rate). And over the next few years the six-month rate will only rise modestly from current levels, unless the RBNZ lifts the OCR above 3.5%. Being the lowest rate on offer, rolling sequential six-month mortgages could prove cheaper than longer terms, based on our forecasts.

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 than expected.

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 very frequently.

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

- One of the lowest carded rate on offer at several of the major financial institutions (with the exception of some 6-month rates).
- 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 (although some of this 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 (second to the 6-month rate), rolling one-year mortgages could prove cheaper than longer terms, but not cheaper than sequential 6-month 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 in the coming years.

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.

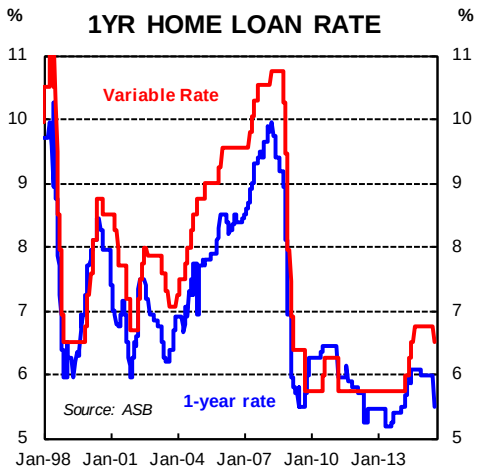
The **disadvantage**:

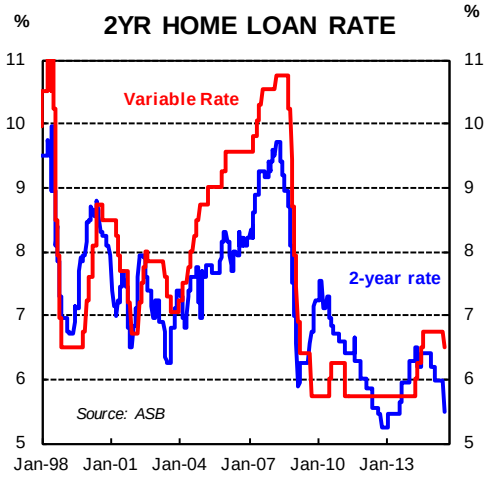
- Committing to the 2-year term means borrowers cannot access lower rates if the RBNZ cuts the OCR further, and mortgage rates dip from current levels.
- And at the other end of the list of concerns, the 2-year term provides less of a hedge than the longer-term rates against increases in interest rates,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

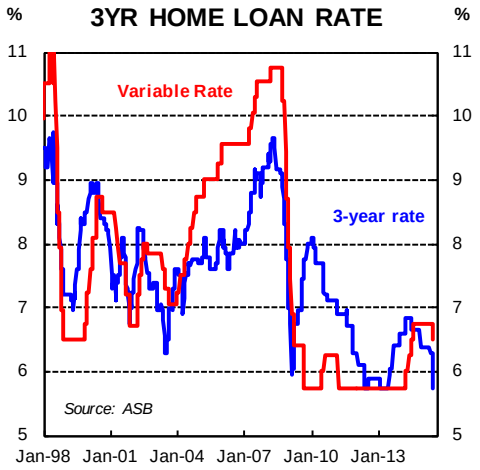
The 2-year fixed rate would again suit those who prefer a degree of interest rate certainty in the near term at a relatively low rate, or those who will be repaying debt in the 2-year timeframe.

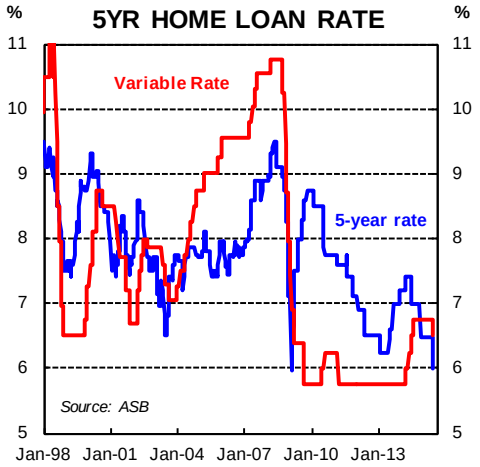
The 3-year fixed rates currently offer the following **advantages:**

- 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 5-year fixed rate, which at the current carded rate of 5.99% is significantly lower than the average level over the past 10 years (7.7%), currently offers these **advantages:**

- The rate offers certainty for a long period. Accordingly, the 5-year term offers a long-term hedge in case future interest rates rise to substantially higher levels than we envisage e.g. through high inflation, more RBNZ OCR increases or pressures from funding costs.
- 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, based on our forecasts, the option of rolling shorter fixed terms is expected to provide a lower cost of funds over the next 5 years.

Final thoughts

The inflation environment has proved to be very different to what the RBNZ envisaged when it started lifting the OCR last year. The RBNZ has responded by cutting the OCR, something we did not expect earlier this year. A follow-up cut to the OCR over the coming months 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 have started to lift.

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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