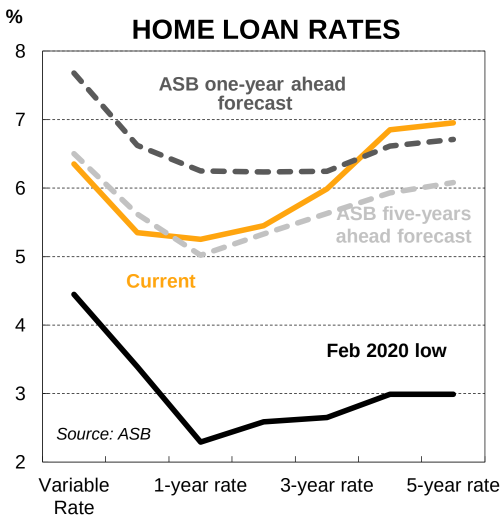
Home Loan Rate Report

28 July 2022

Looking for the peak

The RBNZ has lifted the Official Cash Rate significantly off the record low level set during the pandemic, and continues to signal more increases over the year ahead. Similarly, mortgage rates have lifted significantly off the lows set during the pandemic. Long-term mortgage rates have risen the most over the past year but could be near the peak. Short term rates still have a way to go and are expected to lift the most over 2022, as the RBNZ keeps lifting the OCR.

Fixed-term mortgage rates have been lifting since early 2021, and we predict more increases over the rest of the year for the popular fixed rates (1-2 year terms). The resilience of the local economy since the initial shock of the pandemic, confidence in the longer-term outlook, and most importantly significant inflation pressures are why we continue to forecast higher interest rates, including mortgages.



The RBNZ lifted the OCR back to its pre-pandemic level of 1% over three meetings between October 2021 and February 2022. The RBNZ stepped up the pace of increases by lifting the OCR by 0.5% at subsequent meetings, rather than the usual 0.25% change that it had used at earlier meetings. We expect 0.5% lifts to be repeated, and have a forecast OCR peak of 3.75%. Our forecasts have mortgages lifting faster, and to a slightly higher peak than reports written at the start of the year.

Fixing for the lowest-cost shorter terms and subsequently rolling fixed-term mortgages has been a good strategy. However, for those running this strategy, the prospect of higher future rates should be budgeted for.

Fixing for some of the longer terms provides interest rate certainty for the next few years, but at a significantly higher cost than the cheaper short-term rates. For those who want this longer-term interest rate certainty now, the cost of fixing for two years is still low compared to the average rates over the past twenty years, the longer 4- and 5-year terms are sitting close to their respective 20-year averages, and aren't expect to lift much further.

We are reluctant to start predicting when interest rates will eventually start coming down, when all the near term signals are pointing to the RBNZ continuing to lift the OCR, and in turn mortgage rates. Nonetheless, our forecasts and comments are based around our expectation that the RBNZ's strategy of tackling the inflation challenge with swift OCR increases means mortgage rates will peak higher and earlier (2022/2023) than our earlier forecasts, then potentially ease to rates similar to today's levels over the longer term, as shown in the chart above.

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Please refer to the important disclosures at the end of this document.

RBNZ snapshot

The RBNZ's 2020 response to the COVID-19 pandemic had the desired effect of pushing interest rates within the economy significantly lower, including mortgage rates (which dropped to their lowest level on record going back to the 1960s). Extremely low interest rates, combined with other monetary policy measures combined with the Government's response were key to the economic recovery and housing market strength last year.

Now the RBNZ is unwinding the huge amount of stimulus it put in place during the pandemic. The RBNZ has lifted the OCR from a record low of 0.25% to 2.5% at the time of writing in late July. The OCR is now much higher than the pre-pandemic setting of 1%, but low compared to its typical settings over the past 20 years. More increases are expected – and we are currently picking a 3.75% OCR peak over the year ahead. Our forecast OCR peak is slightly lower than the RBNZ's forecasts and current market pricing.

During the pandemic, the RBNZ temporarily removed the loan-to-value ratio (LVR) restrictions that were impacting borrowers and borrowing costs. The RBNZ put LVR restrictions back in place last year as the economic recovery gained momentum. You can find out more from the RBNZ here in a FAQ page and here regarding the developments with LVR restrictions. Debt servicing restrictions were also discussed in its Financial Stability Report.

What's the outlook for the rest of 2022?

Clear risks remain to the outlook, particularly with COVID-19 continuing to throw up new challenges, and global risks including the war in Ukraine adding to the clouded outlook. But our core view is the RBNZ will lift the OCR to around 3.75% by late 2022. Our view is every RBNZ meeting from now on should be considered "live" for an OCR increase.

If the NZ and global economic outlook continues along the path we expect, interest rates are expected to keep lifting as the world gets past the worst of the pandemic. To be sure, if the economic situation changes for the worse, the RBNZ has options to maintain current settings for longer or even lower borrowing costs to support the economy. In addition, fiscal (Government) support will continue.

Continue to budget on higher interest rates

Fixed term mortgage rates are between 2.4 to 4.0% above the lows available during the pandemic. ASB forecasts suggest rates will continue to lift from current levels over the year ahead for the shorter terms, but we may be near or at the peak for longer fixed-term (4- and 5-year) rates Shorter fixed terms are still available at levels below the long term (20-year) averages but have risen incredibly quickly from last year's lows. The expected Official Cash Rate increases over the rest of the year will lead to further increases in wholesale and retail funding costs for banks, in turn pushing NZ borrowing rates (including mortgages) higher.

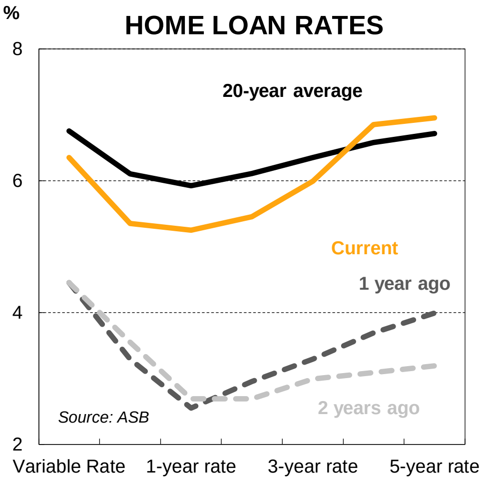
Prior to the pandemic, the RBNZ had proposed a new regime for bank capital requirements which would have put upward pressure on mortgage rates. The changes were delayed during the pandemic as part of the suite of changes the RBNZ made to support the economy. The RBNZ plans to phase in higher capital requirements for banks over the coming years, and that will lead to increases in bank funding costs and, in turn, mortgages. Technical details and the timeline of the changes can be found here, and are considered within our mortgage rate forecasts.

In summary, we think it is prudent for borrowers to budget on mortgage interest rates being higher than they are now over the coming years. Lenders will likely do budget calculations for loan eligibility using interest rates that are higher than those currently available to borrowers (i.e., budgeting with rates significantly above 6%, even though rates below 6% are still available).

How high could mortgage rates get?

This depends on a host of factors including the RBNZ's Official Cash Rate settings, inflation, and bank funding costs, many of which are difficult to forecast with a high degree of accuracy. Based on the ASB Economics team's expectation that the OCR will peak at 3.75%, and our assumptions about bank funding costs and inflation forecasts, we expect most fixed-term mortgage interest rates will peak within a 6-7% range over the year ahead. However, as is often the case, the outlook is far from certain.

Our base expectation is mortgage interest rates over the next decade ahead will be around or below the long-run averages of the past 20 years, rather than press to the higher levels seen prior to the global financial crisis. ASB's latest rates are here.



Is it worth breaking to re-set?

ASB can calculate the break costs of a mortgage to help with these decisions. There is no shortcut to lower mortgage interest rates without incurring a break cost. But breaking a mortgage and resetting for a longer term can still be a reasonable strategy for getting interest rate certainty over a longer term at a known rate. There are many moving parts in this equation, so take time to work through the numbers, and the pros and cons.

The RBNZ's loan-to-value ratio (LVR) restrictions are back

The RBNZ first put its LVR restrictions in place back in 2013, and has tweaked them over the subsequent years. During the pandemic the RBNZ temporarily removed the LVR restrictions. This was to avoid any undesired impact on borrowers or lenders from the mortgage deferral scheme implemented in response to the pandemic. The LVR restrictions are back now, and impact lending practices. Borrowers should discuss their circumstances with their mortgage providers when deciding what to do with their mortgage. Differing levels of equity and risk can have a bearing on credit availability and overall borrowing costs.

Identifying the best strategy

The table on the following page summarises some advantages and disadvantages of the different mortgage terms on offer. Floating and short-term fixed rates tend to suit those who prefer the ability to review their mortgage structures frequently (or those who are due to pay off debt shortly). As fixed terms get longer, they are typically preferred for their interest rate certainty, but also carry a higher interest rate.

Everyone wants to secure the "best" deal for their mortgage. Working out what strategy is best is easier said than done given the number of influences impacting on mortgage interest rates, and individual borrower's differing requirements for flexibility and certainty. It is often not as simple as opting for the lowest rate.

Historically the mortgage curve has been "tick-shaped", with short-term fixed rates lower than both the variable and the longer-term rates. The fixed rates out to the three-year term are below the floating rates at present. The lowest fixed rates are at the 1-year term at the time of writing, 1.1% below the floating rate. The longer-term rates (4-5 years) are typically higher than the shorter-term rates (1-2 years), and that is the case now. The longer-term rates are also now above the floating rates on offer, which reflects the expectation of generally higher interest rates over the years ahead.

Borrowers can obtain certainty and a lower rate simply by fixing their mortgages for terms out to 2 years rather than having a floating rate mortgage. There is a significant cost of the higher floating interest rate, but some borrowers still prefer the flexibility that comes with floating mortgages. Borrowers could also consider splitting the mortgage into different terms to better suit their preferences for interest rate certainty versus retaining flexibility.

While the future is inherently uncertain, fixing for the longer terms are prudent strategies to avoid the expected interest rate increases, and the risk rates get higher than we are currently forecasting. It is a trade off of the cost of the higher rate (vs. rolling the cheaper 1-year rate), and interest rate certainty over a longer period.

It's always the case that mortgage rates could dip lower, due to anything from RBNZ actions through to renewed threats to the economic outlook. But right now the risks are strongly skewed to higher mortgage rates over the year ahead. We suggest all borrowers pick a strategy that suits personal budgets (including a tolerance for changing interest rates) and need for flexibility, as well as the goal of minimising interest rate costs.

Term	Advantages	Disadvantages	Rate*	Short-term bias	Longer-term bias
Floating	Below 10-year average. Fix at any time. Additional principal repayments are easy.	All fixed term rates are cheaper.	6.35	↑	↑
6-month fixed	Cheaper than floating rate. Short-term certainty. Can pay down, alter, or re-fix fairly quickly.	Less flexibility than floating. Exposed quickly to any unexpected near-term rate increases.	5.35	↗	↗
1-year fixed	Lowest rate currently. Short-term certainty. Can re-fix fairly quickly.	Less protection from near-term interest rate increases.	5.25	↗	↗
18-month fixed	Provides interest rate certainty for a reasonable period.	Less of a hedge against interest rate increases if rates go up more than expected over the next few years. Two year rate is lower.	5.65	↗	↗
2-year fixed	Provides interest rate certainty for a reasonable period.	Less of a hedge against interest rate increases if rates go up more than expected over the next few years.	5.45	↗	↗
3-year fixed	Certainty for a relatively low cost. Protection if rates rise quicker than expected.	Potentially more expensive than rolling shorter terms.	5.99	↗	→
5-year fixed	Interest rate certainty for a long time.	Fixing for short terms expected to be cheaper over next 5 years.	6.95	→	↘

*** ASB carded rate at time of publishing**

Final thoughts for borrowers

The 'best' mortgage rate is only known in hindsight. Still, with the discussed pros and cons for the various mortgage rates on offer we hope to give you some thoughts to consider the interest rate options that appear most suitable for your personal circumstances.

On top of trying to minimise your interest payments, a good mortgage strategy also needs to take into account your personal cash flows, tolerance for uncertainty, and your ability to deal with changes in future mortgage payments as interest rates change. Everyone's financial circumstances can change, and you need to take this into account too.

It is important to weigh up your own priorities and make the mortgage choice that looks best aligned with your needs. Feel free to phone the ASB Home Loan Line at 0800-100-600 to talk through these issues with the ASB team. Online mortgage calculators are available here. The latest ASB mortgage rates are available here.

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