1 April 2009

If it ain't broke, don't fix it

An update on the mortgage market

- **Wholesale interest rates were driven higher by a shift in the RBNZ's stance at the March *Monetary Policy Statement*, and a flurry of activity to fix long-term mortgage rates.**
- **Long-term mortgage rates have risen, but the RBNZ has emphasised that short-term rates will be low for a long time.**
- **Borrowers should focus on managing the interest costs over the life of their loan, not simply trying to pick the bottom in long-term rates.**

New Zealand's wholesale interest rates increased dramatically in March. The five-year swap rate rose from around 4.0% in late February to as high as 5.4% last week. RBNZ Governor Bollard's comments this morning have helped to soothe the market, and the five-year rate has since fallen back to 4.8%. Some of the rise in wholesale rates was passed on to retail rates, with five-year mortgage rates now in the range of 7.5-7.6%, compared to around 6.5% a month ago. Here we elaborate on what's behind this move, and what it means for borrowers. We remain of the view that there is no urgency to fix for long terms – short-term rates are not going higher any time soon.

Causes

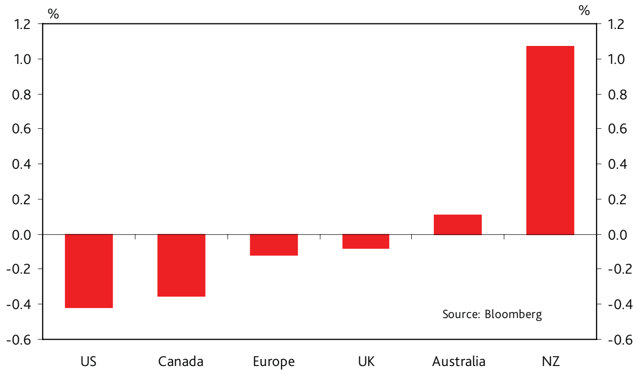
Table 1 provides a list of the main influences on fixed-term mortgage rates at the moment. We examine four of these in more detail: global trends, central bank policy, mortgage activity, and market positioning.

Table 1: Influences on fixed mortgage rates

Factors driving fixed rates up	Factors driving fixed rates down
Bank mortgage flows all one way	OCR to remain low for an extended period
No natural counterparties	Wave of fixing activity will abate
Margins squeezed by higher cost of international funding	Global central banks engineering lower long-term rates
Banks extending duration of funding over time, as per RBNZ's liquidity policy	Global bank funding premiums will ease as risk sentiment improves
Very thin and illiquid market	Very thin and illiquid market

Global trends: Some commentators have pointed to upward pressure on long-term rates around the world, due to concerns about an impending glut of government bond issuance, and central bank easing measures that may create inflation further down the road. That hasn't been the experience though: five-year swap rates in most major economies actually *fell* in March *(Figure 1)*. This is not surprising when you consider that many central banks have been actively trying to drive down longer-term rates – for example, the US Federal Reserve has begun printing money to buy government and mortgage-backed bonds. So the anomalous rise in New Zealand's rates suggests that we are doing something differently.

Figure 1: Change in five-year swap rates in March



Central bank policy: At the 12 March *Monetary Policy Statement*, the RBNZ cut the cash rate by 50 basis points to 3.0%, a smaller move than the market was anticipating, and indicated that any further rate cuts would be significantly smaller than in recent months. Governor Bollard suggested that he expected to cut the OCR further to 2.5%, and possibly 2.0% if the economy failed to recover as quickly as hoped, but that the need to remain competitive with global interest rates was a constraining factor.

The shift in the RBNZ's stance was integral in kicking off the rise in long-term rates. Notably, the only other major central bank that has slowed the pace of easing is the Reserve Bank of Australia – not coincidentally, the only other country where long-term rates have risen in the last month. However, the most dramatic rise in rates has been in the last two weeks, well after the RBNZ statement. So we must look to other factors.

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Mortgage activity: The initial rise in interest rates after the *MPS* convinced many borrowers that long-term rates have reached the bottom, and that they need to move quickly to lock in at these low rates for as long as possible. The result has been a surge in demand for fixed-rate loans (or at least the expectation of such a surge). This flow is potentially huge: the RBNZ's figures show that between September 2008 and February 2009, nearly $15bn of loans were switched to floating rates, and it's likely that these borrowers have been waiting to see how low fixed rates go.

Note that this doesn't mean an increase in net loan demand – rather, it consists of existing borrowers looking to lengthen the terms of their loans. Banks manage this by using interest rate swaps to lengthen the terms of their own funding. The impact on the price (i.e. the interest rate) depends on the swap market's ability to absorb these flows, which leads us to the last factor.

Market positioning: Until the March *MPS*, New Zealand interest rate markets were one-way traffic, as the RBNZ cut the cash rate from a record high of 8.25% to a low so far of 3.00%. But with the RBNZ signalling the beginning of the end of the easing cycle, many traders have exited from their bets that interest rates would fall, and in some cases are now betting on rates going higher. On top of this, mortgage lenders, who have largely been absent from the swap market in recent months due to the lack of fixed-rate loans to hedge, have re-entered in force, pushing long-term rates higher. And demand for uridashi bonds, which would provide downward pressure on swap rates, has dried up in recent months. The swap market is relatively large, but no market in the world can handle it when all of the major players try to head in the same direction at once.

Note that we haven't listed the 'credit crunch' as a factor. While this is a significant ongoing issue for long-term borrowing costs, it doesn't explain the most recent moves. For one, the New Zealand dollar has risen in lockstep with interest rates, suggesting that the market views the rise in rates as an improved rate of return, not as compensation for higher risk.

Implications

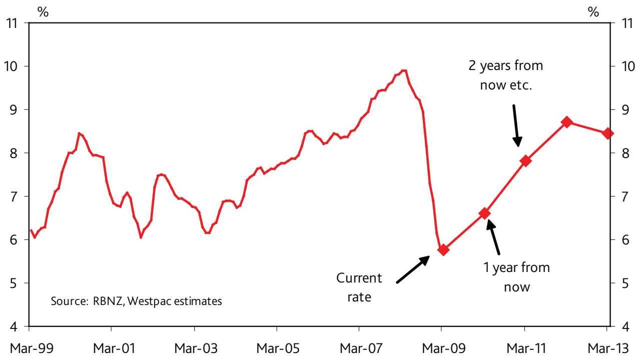
So what should borrowers do, now that the horse has seemingly bolted on long-term mortgage rates? Our view remains that there is no urgency to fix for long terms right now. This is not to say that floating is necessarily better than fixed – rather, it means that the trade-off between fixed and floating rates in three or six months' time will likely be similar to what it is today. Hence, there is no penalty for waiting.

Longer-term rates have risen, but short-term rates are not going higher any time soon. The RBNZ has stated that the cash rate is still expected to go lower in this cycle, and rate hikes are some way off. That was clear enough from the March *MPS* – and this morning the RBNZ even took the unusual step of reinforcing that message.

Moreover, the RBNZ's interest rate projections rely on a significant rebound in the economy from the second half of this year, in defiance of a weak global economy. We believe they will be disappointed on this front – recent data and surveys suggest that neither consumers nor businesses are in any position to launch themselves into a quick recovery. On top of this, the jump in long-term interest rates and the NZ dollar in the last month have led to tighter monetary conditions than the RBNZ was hoping for. This raises the risk that the RBNZ will have to back up its words with action – that is, lower interest rates for longer. We continue to expect a low in the OCR of 2.0% by mid-year.

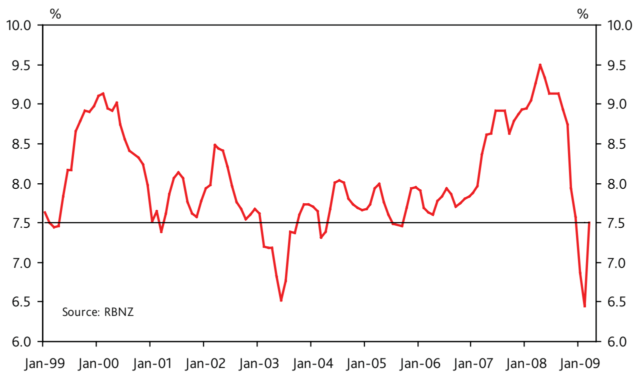
Borrowers face the usual trade-off: fix long, fix short, or stay floating. Shorter terms carry more risk, but borrowers are compensated through a lower rate today. To evaluate this trade-off, we can work out what current mortgage rates imply for a strategy of fixing for one year and resetting every year, versus fixing for five years. Figure 2 shows that, for these strategies to be equivalent, the one-year rate would have to rise fairly sharply – around 100bp in the next year, and another 100bp in the following year. To put this in terms of monetary policy, it implies that the RBNZ will start raising the OCR within the next year, and by 2012 could be nearing the peak of the previous tightening cycle. If you feel confident that rates aren't going to rise that quickly or that far, then floating or fixing for shorter terms is the way to go.

Figure 2: Implied track for one-year mortgage rates



On the other hand, those who need the certainty of a fixed rate shouldn't be dissuaded from fixing for a longer term, as current rates are still favourable relative to history. Figure 3 shows that five-year mortgage rates, which have risen the most in recent weeks, are still around the bottom end of their historical ranges, setting aside the recent lows and a downward spike in the short-lived 2003 easing cycle.

Figure 3: Five-year mortgage rates



The decision of when or where to fix ultimately comes down to personal circumstances, and there is no one right answer. Some people require certainty in their outgoings for budgeting purposes; others have the temperament to take a bit more of a calculated risk, or require more flexibility in their repayments.

One way to address this is a "regrets" analysis: how irritating would it be to fix at today's rates and potentially miss the bottom by 0.5% or so, versus how problematic would it be to not fix yet and see rates climb? Borrowers also can (and many do) diffuse both of these risks by splitting the loan over several terms.

Our final comment is that borrowers need to focus on managing the total interest costs over the life of the loan. Simply picking the bottom in long-term rates may prove to be a victory only in a very relative sense, if there are better options at the shorter end of the interest rate spectrum.

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