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Westpac

Institutional Bank

Time to fix

- **Two- to four-year fixed mortgage rates are currently the best value for borrowers, given where we think floating rates are heading.**
- **We doubt there is much to be gained by waiting any longer before fixing.**

Since mid-November last year the *Fixed versus floating* section of our Weekly Economic Commentary has consistently said "fixed rates are currently good value, given where we think floating rates are heading." But we've also been saying "there is no immediate pressure on fixed rates to rise, so borrowers can afford to wait a little longer." In other words fixing was a good idea, but waiting a while and then fixing was probably even better.

As it turns out floating mortgage rates have remained low and fixed rates have fallen, so floating was indeed the best strategy. But the balance of risks has changed over the past few weeks. Swap rates have risen sharply in February. Swap rates are akin to a "wholesale" fixed interest rate, and when they rise retail rates tend to follow. If these higher swap rates are sustained – and we think they will be – fixed mortgage rates will at least stop falling, and could even begin to rise. That makes now a very good time to fix.

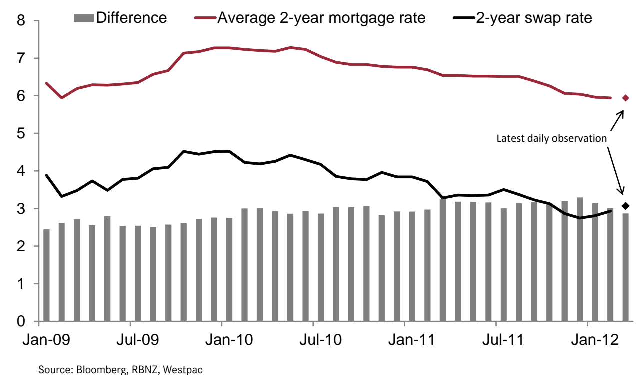
End of an era

We regard terms from two to four years as the best value. Our long-held view has been that the Canterbury rebuild (among other things) will strain New Zealand's limited economic resources and generate inflation pressure. The Reserve Bank will eventually have to respond to that pressure by increasing the OCR. And that, in turn, will push floating mortgage rates higher. The cycle in floating mortgage rates that we envisage is significant, but more muted than the 2000s cycle.

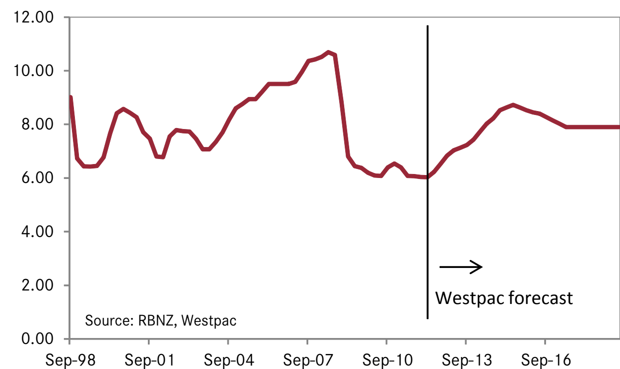
Financial markets have long seemed blissfully unaware of the looming pressures on our economy. Long-term swap rates have been priced as though the OCR will be nudged only slightly higher over the next few years. This means only a few OCR hikes are required to make a strategy of fixing for two to four years worthwhile.

The second possible cause of higher mortgage rates is the European sovereign debt crisis. The cost to New Zealand banks of raising funds overseas is now substantially higher than it was

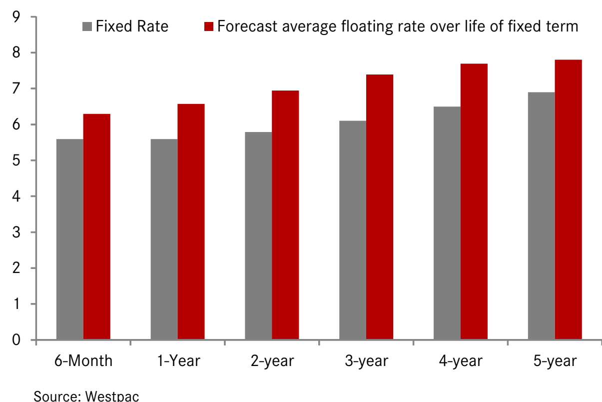
2-year swap rate compared to 2-year mortgage rate



Floating mortgage rate forecast



Fixed rates versus average expected floating rate



Source: Westpac

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in mid-2011. In Australia, higher bank funding costs have already been partially passed on to borrowers and savers. Interest rates there have risen independent of the Reserve Bank's official rate. We have long warned that the same thing could happen in New Zealand – retail interest rates could rise without any change in the OCR. The Reserve Bank has sounded a similar warning.

The only certainty is uncertainty

So we expect mortgage rates to rise a little this year. But by definition forecasts can be wrong. What about the balance of risks? There is a risk that mortgage rates could stay low for longer than we expect. But there is less risk of mortgage rates actually falling materially from here. First of all, the Reserve Bank has flatly indicated that it does not intend to lower the OCR, even if the global economy deteriorates quite seriously. The main scenario in which the Reserve Bank could relent and cut the OCR is a full-blown banking crisis in Europe. But in that scenario, mortgage rates would not necessarily follow the OCR lower. Global capital markets would probably freeze, making it even more difficult and expensive for New Zealand banks to procure overseas funds. The spread between the OCR and mortgage rates would widen further. Depending on the severity of the crisis, mortgage rates could actually rise rather than fall.

Why do today that which can be put off until tomorrow?

Given that there are risks, and floating rates are low, why not wait a while longer before fixing? The trouble with that strategy is that others are thinking the same thing. If a rush of borrowers all try to fix at the same time, interest rates will be forced up by the surge in demand. Exactly that happened in March and April 2009. There was a rush of borrowers seeking to take advantage of low fixed rates, and only a limited pool of savers/investors willing to commit their savings at such low rates. Market forces quickly saw fixed mortgage rates rise. Waiting for the ding-dong low before fixing might make you part of a large crowd all hoping to exit through a small door at the last possible moment. The nimblest few will make it, but most will wish they had exited earlier.

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