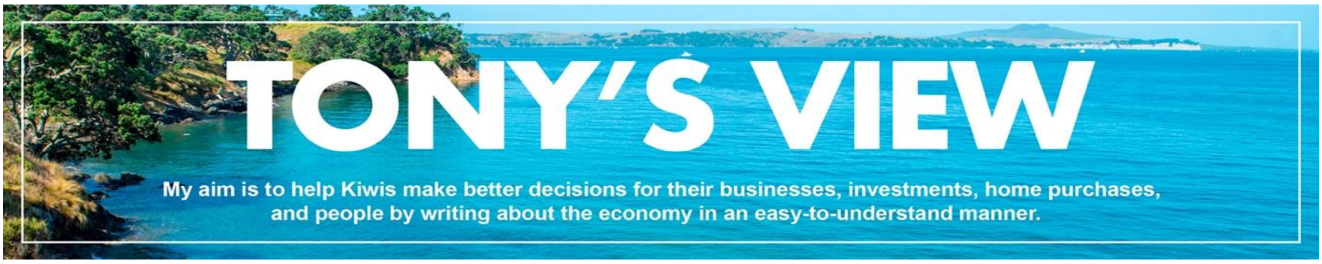

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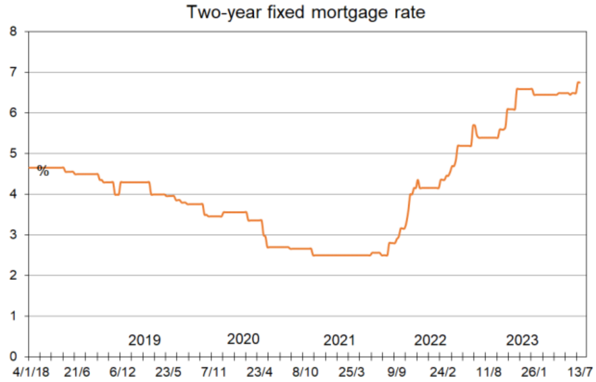
Why fixed mortgage rates have gone up

In Australia on the Gold Coast a house exploded last week. Prior to the explosion social media posts by the occupant indicated great concern about rising interest rates. The presence of four gas cylinders on the scene and the provision of details on seeking help for those concerned by the media item tells us what happened.

Rising interest rates always cause pain for many people, outright distress for some, and loss of home for a number. The intention of a central bank when raising interest rates is that worries about being able to service one's debt cause people to pull back on their spending and in this way, inflation is reduced as businesses lose their ability to raise prices to pass on cost increases. So, they suffer as well.

Tightening monetary policy brings pain. It also brings confusion and as I have noted before, people only ever come up with what they think are good ideas for alternatives to high interest rates to fight inflation when those interest rates are rising. When rates are low or falling such ideas don't see the light of day.

At the moment there is an extra element of confusion afoot and it revolves around the way banks here have raised their fixed mortgage rates recently despite the Reserve Bank stating in May that they didn't feel rates needed to go any higher. In fact they have stopped increasing the official cash rate. But in spite of their no change position which was completely factored into financial market pricing of fixed rate debt ahead of last week's cash rate review, banks raised their fixed rates again.



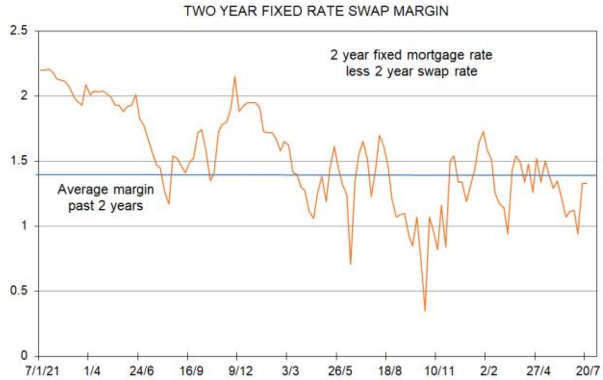
Why have fixed mortgage rates gone up in spite of the Reserve Bank not seeking such increases? Here are the main reasons.

When a bank lends at a two year fixed rate to you and I they do not fund that loan by borrowing at a floating rate. That is very dangerous because if floating rates should rise because of new inflation concerns their profit will be slashed. If rates fall profit will be boosted. But if a bank wishes to take a view on what short-term interest rates are going to do then that view is implemented in their Treasury division where exposure to risk is monitored and tightly controlled on a minute to minute basis.

The bank will fund the loan by borrowing at a two year fixed rate in the wholesale market. This is called the swap rate – though the name doesn't matter. If the two year wholesale interest rate goes up, then a bank will eventually raise their two year fixed lending rate. But this does not happen immediately.

It can cause problems for staff processing loans when fixed rates change quickly and there is a risk of reputational damage if fixed rates chop and change quickly up and down. So, when the cost to a bank of lending fixed changes the bank will want to be reasonably sure that the change will be sustained before they change their lending rate.

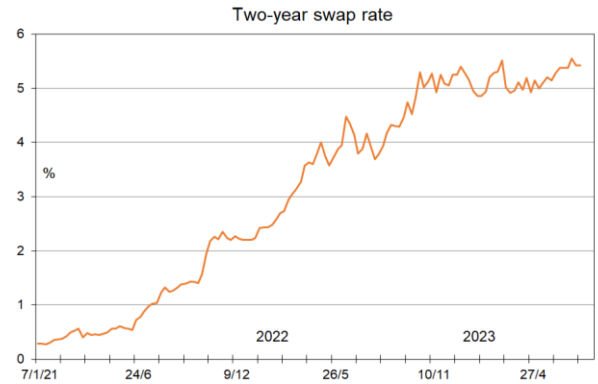
This means the margin between what a bank pays and the rate it lends at can change and I attempt to show such margin shifts each week in my Tview Premium publication with a set of graphs including this one for the two year term.



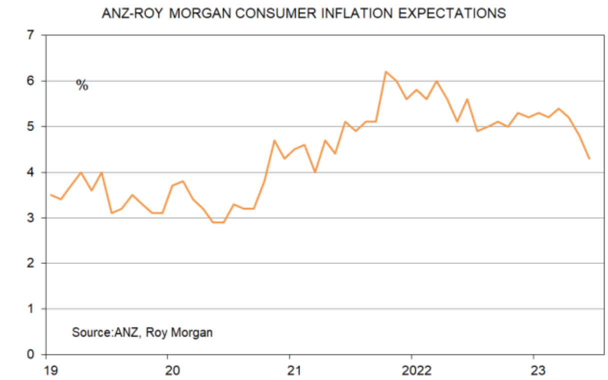
The orange line measuring the margin goes all over the place. The blue straight line is the average margin for the past two years. Note how the margin fell below average between May and early-July as banks did not respond to rising wholesale interest rates. They have now responded. But the margin is still below average.

We don't know what margin they are targeting. But the graph can give insight into where bank mortgage rates may or may not go and the signal recently has been that they would probably go up.

The question now becomes why did bank wholesale funding costs go up despite the Reserve Bank's expression of happiness about where inflation is heading? This next graph shows that the two year swap rate rose from 5% in the second week of May to almost 5.6% in the first week of July.



This 0.6% rise was not driven by new inflation worries in New Zealand. We have in fact seen good declines in local gauges of inflation expectations and capacity pressures.



Instead, the rise in local borrowing costs has been driven by higher interest rates in the United States.

US wholesale borrowing costs increased through June into July in response to surprisingly strong data on the labour market mainly. The markets moved to pricing in more increases in the Fed's funds rate than had been the case before. The US two-year Treasury note yield rose from 4.14% at the start of May to a peak of 5% on July 6. It is now near 4.75%.
https://www.cnbc.com/quotes/US2Y

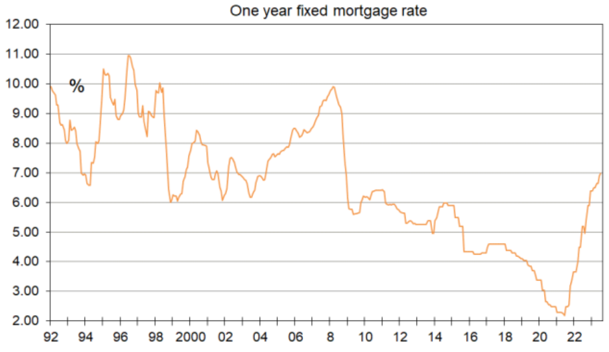
So, the short-term fixed mortgage rates which most people are interested in and borrow at in our tiny economy are influenced mainly by changes in the official cash rate, developments in the United States, and changes in bank margin goals.

There is another factor which I have spent considerable time explaining to people over the past three decades during which fixed rates for borrowers have been an option. Sticking with the two-year period the important point to note with regard to the influence of the Reserve Bank's official cash rate is this.

Changes in the two year mortgage rate are driven by changes in the two-year wholesale cost to a bank of borrowing money. That two-year swap rate is driven not just by where the official cash rate sits now, but where it is expected to sit on average over the entire two-year period.

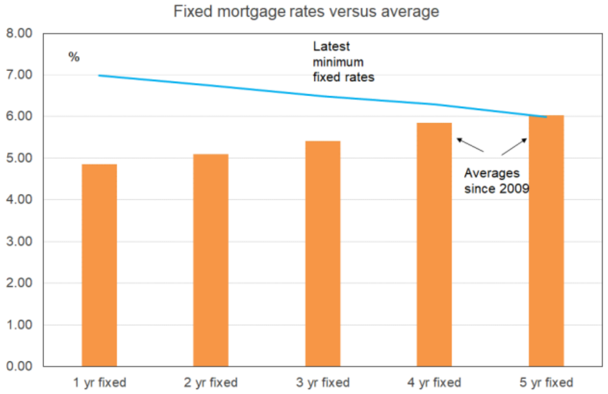
This means that if inflation is looking like it will rise, and investors begin to anticipate tighter monetary policy they will want extra compensation for locking their money in with a borrower for two years rather than riding floating deposit rates upward. Floating deposit rates (let's say for 90-days and less) are hugely influenced by the current level of the official cash rate.

Swap rates rise before monetary policy tightens. That is why in 2021 during the period between January and early-October when the cash rate was 0.25% the one-year fixed mortgage rate rose from 2.29% to 3.19%. The two year rate rose from 2.49% to 3.59%.



This becomes important now. Current fixed interest rates reflect expectations for what the official cash rate will do over the next 1-5 years. For the moment the markets are pricing in no easing of monetary policy until late next year. The chances are this expectation will shift in coming months towards expecting an easing of monetary policy well before then.

When that happens, even though the Reserve Bank will still be many months way from cutting the cash rate, fixed rates will fall. These falls look likely before the end of the year.



One silly thing worth noting for no purpose whatsoever. I started my career in the Reserve Bank of Australia in their Economics Department in Sydney in 1985 alongside the new RBA Governor Michelle Bullock. I lasted five months, she has lasted 38 years and counting. Well done Michelle and good luck for your new very challenging role.

In case you missed it

This week I released results from my monthly survey of mortgage advisers alongside mortgages.co.nz The main insights offered by the brokers include these.

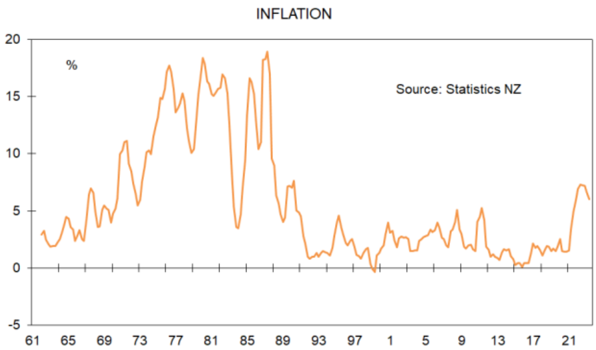
- First home buyers remain active in the mortgage market, but most investors are on the sidelines waiting for the election outcome.
- There has been a lift in borrower preference for fixing two years.
- High stress test mortgage rates are keeping a lot of buyers on the sidelines, frustrated

perhaps as they see signs of the market turning but are unable to make a purchase until interest rates fall.

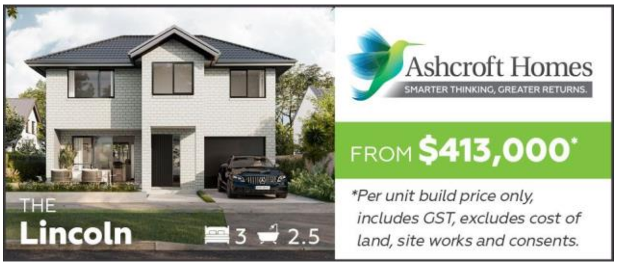
[mortgages.co.nz & Tony Alexander Mortgage Advisers Survey - July 2023 - mortgages.co.nz]

If I were a borrower, what would I do?

The Reserve Bank are firmly of the view no further rises in the official cash rate beyond the 5.5% they took it to late in May will be necessary and yesterday's inflation data will not have altered their view. The 6% outcome was slightly above market expectations of 5.9% but below the RB's pick of 6.1%. There was little sustained impact in the wholesale market from the number and this morning bank borrowing costs were little changed from a week ago.



In Australia one more rate rise is considered likely then after that cuts are predicted from sometime next year. In the United States one further rate rise is locked in with the lingering possibility of one more after that. Then cuts are expected from the first half of the year.



Personally, I still favour fixing 12-18 months. I discuss rates a lot more in Tview Premium with lots of useful graphs to help your decision-making process.

Nothing I write here or anywhere else in this publication is intended to be personal advice. You should discuss your financing options with a professional.