

July 1st, 2009

Is it time to fix or is it a false dawn on fixing rates?

Have the bank's already moved too high?

Everybody get your crystal balls out please.....as predicting money movements over the next 3 – 5 years is going to be very difficult indeed. So before we state the pros & cons for each argument we at least need to get a better understanding of the big picture.

HOW ARE FIXED RATES FUNDED?

Refresher from my comment in our May newsletter on fixed rates:

Funding Fixed Mortgages - Lenders tend to outsource funding on money markets, via other banks/lenders – swap rates, through government bonds or via fixed savings deposits of similar duration which they collect from their own retail deposits, locking in their spread or profit margin for similar timeframes, as they plan to lend out this money. Bill Evan's – Westpac Chief Economist noted in his April 20th comment in Westpac weekly economic report called Australian Weekly "Around 40% of banks' funding costs are affected by the bank bill rate but the remainder are determined by retail deposit rates (40%) while around 20% of funding costs are independent of market rates (capital; non interest bearing deposits)."

HOW HAVE FIXED RATES PERFORMED AGAINST 'COMPETITIVE' VARIABLE RATE MORTGAGES?

The chart below shows the historical 'margin' between fixed rates and variable rates since it has been tracked by the RBA.

Month	Cash Rate	Discount Var.	3 Yr Fixed	Margin b/w Discount Var. & 3 Yr Fixed Rates
Jun-2004	5.25	6.60	6.95	-0.35
Jul-2004	5.25	6.60	6.95	-0.35
Aug-2004	5.25	6.60	6.95	-0.35
Sep-2004	5.25	6.60	6.85	-0.25
Oct-2004	5.25	6.60	6.70	-0.10
Nov-2004	5.25	6.60	6.65	-0.05
Dec-2004	5.25	6.60	6.60	0.00
Jan-2005	5.25	6.60	6.60	0.00
Feb-2005	5.25	6.60	6.75	-0.15
Mar-2005	5.50	6.80	6.90	-0.10
Apr-2005	5.50	6.80	6.90	-0.10
May-2005	5.50	6.80	6.85	-0.05
Jun-2005	5.50	6.80	6.85	-0.05
Jul-2005	5.50	6.70	6.85	-0.15
Aug-2005	5.50	6.70	6.85	-0.15
Sep-2005	5.50	6.70	6.55	0.15
Oct-2005	5.50	6.70	6.55	0.15
Nov-2005	5.50	6.70	6.65	0.05
Dec-2005	5.50	6.70	6.70	0.00
Jan-2006	5.50	6.70	6.70	0.00
Feb-2006	5.50	6.65	6.70	-0.05
Mar-2006	5.50	6.65	6.65	0.00
Apr-2006	5.50	6.70	6.85	-0.15
May-2006	5.75	6.95	7.00	-0.05
Jun-2006	5.75	6.95	7.05	-0.10
Jul-2006	5.75	6.95	7.20	-0.25
Aug-2006	6.00	7.20	7.30	-0.10
Sep-2006	6.00	7.20	7.25	-0.05

Oct-2006	6.00	7.20	7.25	-0.05
Nov-2006	6.25	7.45	7.25	0.20
Dec-2006	6.25	7.45	7.25	0.20
Jan-2007	6.25	7.45	7.30	0.15
Feb-2007	6.25	7.45	7.30	0.15
Mar-2007	6.25	7.45	7.30	0.15
Apr-2007	6.25	7.45	7.45	0.00
May-2007	6.25	7.45	7.45	0.00
Jun-2007	6.25	7.45	7.50	-0.05
Jul-2007	6.25	7.45	7.70	-0.25
Aug-2007	6.50	7.70	7.80	-0.10
Sep-2007	6.50	7.70	7.75	-0.05
Oct-2007	6.50	7.70	7.85	-0.15
Nov-2007	6.75	7.95	8.20	-0.25
Dec-2007	6.75	7.95	8.35	-0.40
Jan-2008	6.75	8.10	8.45	-0.35
Feb-2008	7.00	8.35	8.70	-0.35
Mar-2008	7.25	8.70	8.95	-0.25
Apr-2008	7.25	8.80	8.95	-0.15
May-2008	7.25	8.85	8.95	-0.10
Jun-2008	7.25	8.85	9.30	-0.45
Jul-2008	7.25	8.95	9.40	-0.45
Aug-2008	7.25	8.95	8.90	0.05
Sep-2008	7.00	8.75	8.50	0.25
Oct-2008	6.00	7.70	7.30	0.40
Nov-2008	5.25	7.10	6.90	0.20
Dec-2008	4.25	6.20	6.25	-0.05
Jan-2009	3.25	6.20	5.85	0.35
Feb-2009	3.25	5.20	5.65	-0.45
Mar-2009	3.00	5.20	5.60	-0.40
Apr-2009	3.00	5.10	5.85	-0.65
May-2009	3.00	5.10	6.05	-0.95
AVERAGE	5.78	7.17	7.26	-0.11

- Interestingly the average margin between the average 3 year fixed rates and the discounted variable rate, has only been 0.11% since Jun 2004 in favour of the variable rate
- In studying the numbers above, there was a window to fix rates for 3 years around the Sept 05 to around the June 06 mark, those who fixed for longer, may and most likely still have lost all or even more of the interest saved given the dramatic decline in rates. (Count me in that group with one of my loans)
- What's interesting to note, is the margin gap between variable and fixed in Apr 09 is the highest gap since the RBA tracked the average between Discount Variable rates and 3 year fixed rates – June 04. Unfortunately this gap is even larger with 'real time rates', which I will highlight later in this report (Current Rate Comparison section below)

INTEREST RATE FORECASTS:

It would be ideal if we could obtain longer term forecasting to allow you, our client/s, a more informed set of data to make your decision as to whether now is the time to lock in or not. I have collated what some lenders are publishing as their forecast for the next year, and in uncertain times, even these forecasts can actually fluctuate considerably as the global markets perform a balancing act between stabilisation and upside or falling further.

Westpac Forecast – Week Beginning 29 June

Interest rate forecasts

	Latest (Jun 26)	Sep 09	Dec 09	Mar 10	Jun 10	Sep 10
Cash	3.00	2.75	2.50	2.50	2.50	2.50
90 Day Bill	3.24	3.00	2.75	2.75	2.75	2.75
3 Year Swap	4.90	4.50	4.25	4.25	4.50	5.00
10 Year Bond	5.59	5.00	4.75	5.00	5.50	5.75
10 Year Spread to US (bps)	203	150	150	125	125	100
International						
Fed Funds	0.125	0.125	0.125	0.125	0.125	0.125
US 10 Year Bond	3.55	3.50	3.25	3.75	4.25	4.75
ECB Repo Rate	1.00	1.00	1.00	1.00	1.00	1.00

We have revised our forecast for the employment profile and accordingly slightly adjusted our interest rate view. While we still expect that the RBA will keep rates on hold through 2010 we no longer expect that 2% will be the low point in the cycle for the cash rate. We have raised that low point to 2.5%, now expecting the RBA to limit its rate cuts to 2 x 25 bp's cuts over the course of the remainder of 2009. These cuts are likely to be spaced with 2/3 month gaps.
– Bill Evans Chief Economist WBC.

ANZ Forecast – 18th June 2009

Australian interest rates	Current	Jun 09f	Sep 09f	Dec 09f	Mar 10f	Jun 10f
RBA cash rate	3.00	3.00	2.50	2.00	2.00	2.00
90 day bill	3.26	3.20	2.30	2.30	2.30	2.35
3 year bond	4.53	4.15	4.10	4.00	4.20	4.30
10 year bond	5.59	5.65	5.50	5.20	5.30	5.30
3s10s yield curve	1.06	1.50	1.40	1.20	1.10	1.00
3 year swap	4.91	4.50	4.40	4.30	4.50	4.60
10 year swap	6.07	6.15	5.90	5.55	5.60	5.60
International interest rates						
RBNZ cash rate	2.50	2.50	2.25	2.00	2.00	2.00
NZ 90 day bill	2.82	2.85	2.43	2.35	2.35	2.35
US Fed funds note	0.25	0.25	0.25	0.25	0.25	0.25
US 2 year note	1.35	1.35	1.10	1.00	1.25	1.50
US 10 year note	3.93	4.76	3.85	3.70	3.75	3.90
Japan call rate	0.10	0.10	0.10	0.10	0.10	0.10
ECB refinance rate	1.00	1.00	0.75	0.75	0.75	0.75
UK repo rate	0.50	0.50	0.50	0.50	0.50	0.50

For additional information on interest rates please refer to ANZ's *Interest Rate Strategy Weekly*.

St George Bank

St George Forecast as at 16th June 09

End Period:	2008		2009				2010	
	Q3	Q4	Q1	Q2 (f)	Q3 (f)	Q4 (f)	Q1 (f)	Q2 (f)
RBA Cash, %	7.00	4.25	3.25	3.00	2.50	2.50	2.50	3.00
3 Year Bond, %	5.09	3.90	3.40	3.80	3.90	4.10	4.30	4.50
10 Year Bond, %	5.40	3.99	4.42	5.10	5.40	5.90	6.10	6.20

Comment on forecasts:

The observation I am making from this and also the report for the World Bank last week, reporting that global growth will take a long time to return to a positive position, is that the cash rate still has downside forecast into it. This means that the cash rate is still expected to decline further to around the 2.50% level (currently at 3.0%), given fears of increased unemployment and our overall economy slowing further, maybe taking us into a technical 'recessions' by the end of 2009.

Furthermore we are seeing the bank holding position regarding when the cash rate will increase, and this is at least a year off according to these forecasts (St George on only bank stating that rates will be back at current day levels by Q2 2010).

Current Interest Rate Comparisons: Professional Package Variable vs. 3 & 5 Year Fixed Rates

Lender	Date	Discount Var.	3 Yr Fixed	5 Yr Fixed	Margin b/w Dis. Var. & 3 Yr Fixed	Margin b/w Dis. Var. & 5 Yr Fixed	Mthly Int. Savings Dis. Var. to 3 Yr Fixed	Mthly Int. Savings Dis. Var. to 5 Yr Fixed
CBA - Pro Pack	04-Jun-09	5.14%	6.04%	6.69%	-0.90%	-1.55%	\$187.50	\$322.92
	01-Jul-09	5.24%	6.54%	7.19%	-1.30%	-1.95%	\$270.83	\$406.25
NAB - Pro Pack	04-Jun-09	5.04%	5.74%	6.39%	-0.70%	-1.35%	\$145.83	\$281.25
	01-Jul-09	5.04%	6.39%	7.09%	-1.35%	-2.05%	\$281.25	\$427.08
WBC - Pro Pack	04-Jun-09	5.11%	5.89%	6.49%	-0.78%	-1.38%	\$162.50	\$287.50
	01-Jul-09	5.11%	6.39%	6.99%	-1.28%	-1.88%	\$266.67	\$391.67
ANZ - Pro Pack	04-Jun-09	5.21%	6.34%	7.19%	-1.13%	-1.98%	\$235.42	\$412.50
	01-Jul-09	5.21%	6.34%	7.19%	-1.13%	-1.98%	\$235.42	\$412.50
St G - Pro Pack	04-Jun-09	5.09%	5.99%	6.64%	-0.90%	-1.55%	\$187.50	\$322.92
	01-Jul-09	5.09%	6.49%	7.14%	-1.40%	-2.05%	\$291.67	\$427.08
ING	04-Jun-09	5.09%	5.89%	6.69%	-0.80%	-1.60%	\$166.67	\$333.33
	01-Jul-09	5.09%	6.69%	7.39%	-1.60%	-2.30%	\$333.33	\$479.17

Note: Other costs / fees may alter the savings or expenses in the table above, but we are simply looking to get an idea of the monthly interest payable / savings in this example

Findings: The above comparison clearly demonstrates that current variable rates are offering considerable savings on the current fixed rate price. Comparison between the best 3 year fixed rate and the discount variable is a saving of \$235 per month and against 5 year fixed is \$391 per month.

The difficult question is how quickly variable rates will increase to the level of fixed rates, or will fixed rates come off their current highs and move back to their long term average variance of around .1% of one per cent.???

Summary:

History shows us that the margin between historical 3 year fixed rates and Discount Variable has been a lot smaller than it currently is now (and growing). If financial markets return to further normality, then will this margin return to more historical levels with less difference between them? – One hopes so! If it is the case, then I suspect fixed rates won't keep going too much higher and variable rate will catch up, but that means variable rates will then give you a saving on interest paid.

Furthermore if you are wise, these interest savings should be focused on paying down your current mortgage, by keeping your repayments as high as you can possibly afford. This could save you tens of thousands on interest over the full term of the loan and also build a buffer for you, which will be available as 'redraw' in the event of an emergency.

So why would you fix?

It would be very wise to start looking at what your household can afford in regards to repayments. If your circumstances are such that if rates went over 7.5%, would you be able to manage meeting the family's financial commitments. If not, then fixing just might be an option or fixing a portion of your loan, anywhere between 30% to 70% may ease the budget. Just remember the higher repayments start from the month you fix. On the flip side, guessing to save \$500 to a couple of thousand of dollars in picking how high rates are going to go, verses risking losing your property, because you cannot meet your potential higher repayments in the future, then you are better to lock in and play a conservative 'hedging your bets approach'.

Those who are in a position to meet the repayments even if they got to 8% or more, well history has shown that variable rates have been the cheapest over the long term. And given no one really knows how quickly we will recover

both domestically and globally, if it's a more gradual rebuilding and improvement in the economy, then variable rates, will more than likely be the cheaper outcome and also offer far more flexibility than fixed rate loans.

Ben Kingsley
Director
Empower Wealth.

Please feel free to contact me or one of the team for us to review your own circumstances, so you can make a more informed decision on your current options.

Tel: (03) 9326 8900 - Ask to speak with one of our Finance Strategists.