

No fixed solutions

By John Kavanagh
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Few people took the chance to lock in low interest rates.

Home buyers and others with large debts took two big gambles during the past year when the Reserve Bank of Australia cut rates to levels that might only be seen once in a lifetime. They didn't fix their mortgage rates and they didn't reduce their overall borrowing.

Now we are about to find out if they made the right calls.

The RBA move last week to put up interest rates by a quarter of a percentage point is likely to be the first of a number of rises. Economists forecast that the official cash rate, which sat at 3 per cent for five months, could rise to 4 per cent, 5 per cent or even 6 per cent before this new round of tightening is finished.

Borrowers will have to take a look at how their budgets would be affected if their rates went up by that much.

Savers who might have been tempted by two- and three-year term deposit rates of 5 per cent or 6 per cent might consider keeping their money in shorter-term accounts so they can take advantage of increases in deposit rates.

A banking analyst with J.P. Morgan, Scott Manning, says the behaviour of borrowers in the past year has surprised him. Despite the very low rates there has been almost no overall reduction in household gearing. He has also been surprised so few borrowers have taken the opportunity to lock in low rates.

"There was a slowing of the growth in housing outstandings as a percentage of disposable income at the onset of the crisis but this percentage has subsequently rebounded to an all-time high at around 150 per cent," Manning says. "Household interest payments as a percentage of disposable income, while falling dramatically following initial rate cuts, hold the potential to return to around 11 per cent of total disposable income if interest rates increase by 2 percentage points."

He says borrowers preferred to bet that sticking with variable rates would be a better option than fixing. "It may be a case of once bitten, twice shy. Over 20 per cent of households locked in fixed-mortgage rates of between 8 per cent and 9 per cent over the course of 2007/08 and paid substantial exit fees to break those contracts."

About 8 per cent of home-loan borrowers are now taking out fixed rates and it is not hard to see why fixed rates have not been more popular.

The average three-year fixed rate of the big four banks was 7.12 per cent and the average five-year fixed rate is 7.77 per cent before last week's official rate rise, according to banking industry research group Infochoice.

With most borrowers able to get some form of discount on the standard variable rate, people were paying about 5.1 per cent for their variable-rate mortgage. Infochoice says the gap between fixed and variable rates is wider than it has been for many years.

The joint head of lending at Centric Lending Services, Sheyne Walsh, advises his clients to look at the fixed versus variable question this way: "If you are paying a little over 5 per cent on a discounted standard variable rate now and rates go up to 10 per cent over the next five years, your average rate over that period will be a little over 7 per cent. Five-year fixed rates are higher than that now. But if you think rates will get to 10 per cent and you can't afford the repayments at that level, then you should work out the point at which you have to move out of variable and into fixed."

For a \$250,000 loan at 5.78 per cent (the average standard variable rate of the big four banks before the latest rise) the monthly payment is \$1577.30 and will go up \$38.04 with a rate increase of 0.25 of a percentage point.

Cashed-up investors with their money in high-yield savings accounts and term deposits will have to review the changing mix of short- and long-term rates on offer to see what's best for them.

A director of fixed-interest broker Curve Securities, Andrew Murray, says one-year rates are the best in the market now. "Some financial institutions are paying more than 5 per cent for one-year terms. You would have to say that is very attractive. A 2 per cent yield over the cash rate with money tied up for only a year is very competitive."

The Infochoice online database shows Suncorp, Heritage Building Society, Macquarie Bank and ME Bank offer 5 per cent or more

for one-year term deposits. Among the big banks, St George was offering 4.85 per cent for one year; Commonwealth, Westpac and National Australia Bank 4.5 per cent; and ANZ 4.25 per cent.

Whether having your money tied up for a year is a safe bet depends on how far and how quickly rates move up. Markets economists disagree about how far rates might climb in this cycle but they all agree that the rise will be slow and steady.

Where to for rates?

Westpac chief economist Bill Evans says: "We expect the peak in rates in mid-2010 to be around 4 per cent, with the bank likely to be pausing over the second half of the year."

ANZ's economics department predicts the official cash rate will reach 4 per cent by the end of 2010.

CBA says another rate rise is likely before the end of year but "there are enough uncertainties to mean that the withdrawal of stimulus should be gradual".

Macquarie Group commented last week: "If the Australian economy continues to strengthen, we can expect the RBA over an extended period to move through its various policy settings, from emergency (3 per cent) towards easy (4 per cent) and then neutral (5 per cent or so)."

Rising repayments

Monthly repayments on 25 year loan terms

LOAN

AMOUNT	5%	5.25%	5.50%	5.75%	6%	6.25%	6.50%	6.75%	7%	
\$100,000	584.59		599.25	614.09	629.11	644.3	659.67	675.21	690.91	706.78
\$200,000	1169.18		1198.50		1228.17		1258.21		1288.60	1319.34
	1350.41	1381.82		1413.56						
\$300,000	1753.57		1797.74		1842.26		1887.32		1932.90	1979.01
	2025.62	2072.73		2120.34						
\$400,000	2338.36		2396.99		2456.35		2516.43		2577.21	2638.68
	2700.83	2763.65	2827.12							
\$500,000	2922.95		2996.24		3070.44		3145.53		3221.51	3298.35
	3376.04	3454.56		3533.90						

SOURCE: INFOCHOICE

This story was found at: <http://www.smh.com.au/articles/2009/10/13/1255195773046.html>