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LONSDALE

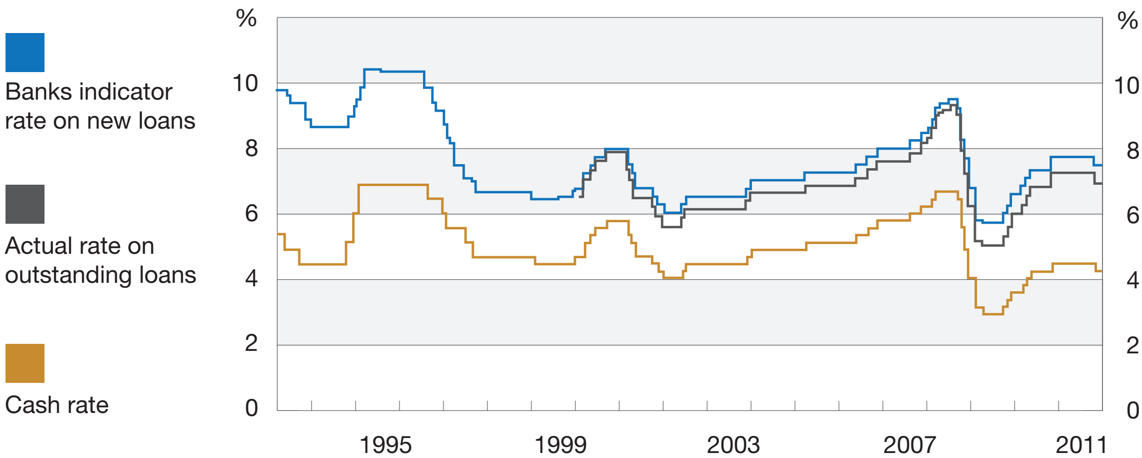
Belmores Wealth Management

Cutting rates — a welcome relief?

Lower interest rates might provide some welcome relief for home buyers and existing home loan customers in 2012, but they are not such good news for people dependent on income from their investments nor an indicator of a confident, growing economy.

The Reserve Bank (RBA) cut interest rates by 25 basis points, or one quarter of a per cent, in both November and December last year, taking the official cash rate to 4.25 per cent. The majority of mortgage lenders followed suit, bringing home loan interest rates down to their lowest level in more than two years.

Australian Housing Lending Rates
Average interest rate on variable-rate loans



Source: ABS; APRA; Perpetual; RBA

The graph shows the comparison over the past 20 years between the RBA's official cash rate, the bank indicator rate on new loans (which is higher than the average variable rate), and the actual rate on existing outstanding home loans. And remember that small businesses typically pay one to two per cent above mortgage rates on their loans.

According to financial comparison website, RateCity, the biggest cuts were among 3-year fixed rate home loans which fell to an average of 6.29 per cent by the end of 2011, with some as low as 5.75 per cent.

Snapshot

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By comparison, the average variable rate is 6.89 per cent, the lowest point since May 2010. Home buyers and anyone refinancing an existing loan can attempt to negotiate a lower rate if they shop around.

Bond yields and rate cuts

One of the best indicators of the future direction of interest rates is the yield on government bonds, and by this traditional measure the market clearly thinks rates have further to fall.

In 2011, 10-year government bond yields fell to 3.8 per cent, the lowest for 60 years. Normally, investors would expect to receive a higher rate of interest on long-term bonds than short-term cash as compensation for locking their money away for longer, but these are not normal times.

Interest rates in the US, Japan and other major economies are close to zero and this, coupled with Australia's relative economic stability and prosperity, has caused a flood of foreign money into Australian government bonds, pushing up bond prices and reducing yields.

Expectations in 2011 were that local interest rates would rise to keep the lid on inflation caused by the mining boom. But with domestic inflation in check and the depth of Europe's debt crisis even clearer, in November the RBA finally decided to loosen the reins on local interest rates. Europe's woes may take years to remedy, hampering global recovery and the relatively strong Australian economy.

Australia's economy may be the envy of many countries, but it is chugging along, not powering ahead. It grew by 2.5 per cent in the year to September, well short of the long-term average of 3.25 per cent. Inflation hovered around 3.5 per cent last year, above the RBA's target range of 2–3 per cent, but most economists forecast inflation will fall slightly this year.

Future moves

Falling interest rates reduce the cost of borrowing for business so they are potentially good news for company profits and share prices. But the share market has also been spooked by the debt crisis in Europe and the lack of a clear political strategy to fix it. In this uncertain climate, Australian shares fell 12.7 per cent last year.

CommSec chief economist, Craig James, expects at least one more rate cut by the Reserve Bank in 2012. "Clearly with inflation under control and significant risks abroad, the Reserve Bank stands ready to cut rates and shore up Australia's economy", he says.

However, home buyers should not celebrate too quickly as the banks look like moving the goalposts to cope with global pressure on their funding costs. ANZ chairman, Mike Smith, announced in mid-December that borrowers should no longer expect the ANZ to match official moves in interest rates.

Other banks are likely to follow his lead. This will break the strong link that has grown up between movements in the RBA's official rate and bank mortgage rates. Whether it leads to more competition or more conformity among the major lenders is tomorrow's question. For now it is a case of "watch this space".

If you want to discuss this or any other aspect of your investments, please don't hesitate to contact us.

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