

Our Advice

The Reserve Bank of Australia (RBA) commenced its interest rate easing cycle on 2 September 2008 with a 0.25% reduction in its official cash rate. We haven't seen an interest rate reduction since December 2001. With signs that inflation has peaked and is starting to fall, significant reduction in demand for corporate and household borrowings, lower retail sales, a flat property market and an ugly share market, the RBA would be concerned about the economy slowing too much, too quickly. A leading bank economist predicted that the market would need an interest rate reduction of 1.0% to 1.5% for property market growth to pick up again. Our view is that good quality locations will start to appreciate in value sooner rather than later. In regards to rates, our concern is focused on when the banks will reverse the independent rate increases they have made since January 2008. Major banks' have increased rates by 0.50% to 0.60% independent of RBA. The banks' short term funding costs have reduced over the past month or so (although deposit and longer term funding is still alleviated). We think it's fair that the banks should eventually hand back some of these independent rate hikes. Most economists are forecasting significant reductions in the RBA's cash rate over the next 12 months. The consensus is that interest rates will fall by a further 0.75% to 1.00% over the next 12 months. Over the last few weeks, we have seen fixed rates cut significantly by most of the major banks – something we haven't seen for a while. There is one additional risk to consider – lenders not passing on all RBA interest rate reductions. This is a very difficult risk to assess.

Given the current variable (professional package) rate is now 8.53% to 8.72% and the lowest fixed rates are around 8.20%, we do not see any value in fixing interest rates at this stage given forecast interest rate reductions of 0.75% to 1.0% over the next 12 months. In fact, we would expect to see fixed rates reduce further over the coming months.

Banks forecasts that rates are going to decline steeply

Whilst it is very difficult to predict the future (even for so called experts), let's look at what the major banks have forecast in relation to the RBA cash rate (which is currently 7.00%) over the next 12 to 15 months.

Bank (forecast date)	Oct to Dec 2008	Jan to Mar 2009	Beyond Mar 2009
CBA (01/09/08)	Down 0.25%	Steady	Steady
ANZ (29/08/08)	Down 0.25%	Steady	Down 0.50%
Westpac (29/08/08)	Down 0.50%	Down 0.25%	Steady
NAB (22/08/08)	Down 0.25%	Down 0.50%	Down 0.25%
St George (22/08/08)	Down 0.25%	Down 0.50%	Steady

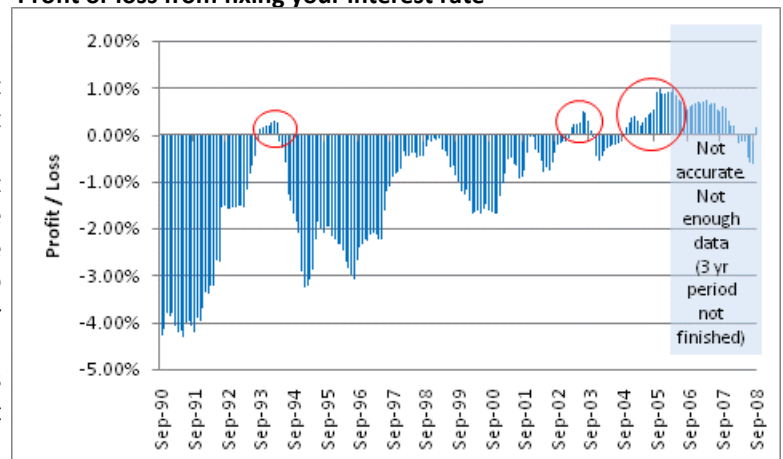
Source: Bank websites and economic reports.

The RBA elected to reduce the cash rate by 0.25% at its most recent meeting on 2 September 2008. The consensus is that the RBA will reduce rates by 0.75% to 1.00% over the next 12 months.

Benefit of hindsight

The graph to the right calculates the profit or loss arising from fixing your interest rate in the past. The data is sourced from the RBA and starts in September 1990. It compares the average 3 year fixed rate with the average professional package variable rate for the subsequent 3 years to determine if the borrower makes a loss or profit. You will note that there are only 3 periods during this time that borrowers were better off fixing – circled in red (but not by a huge margin).

Profit or loss from fixing your interest rate



Source: RBA

02-09-08: Interest Rate Advisory Note

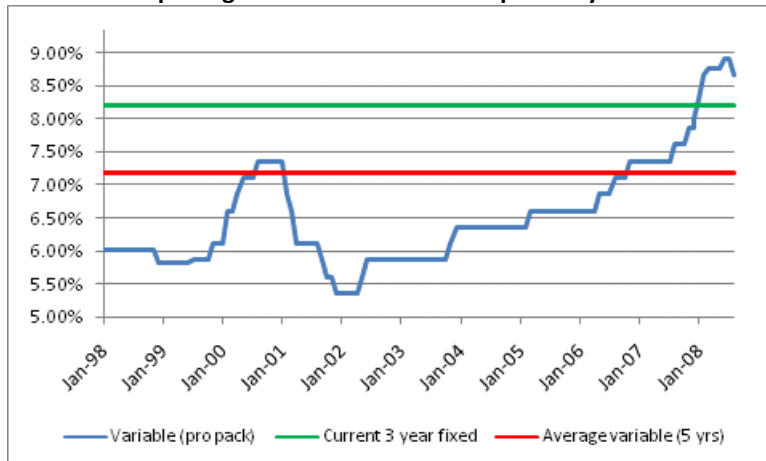
It is important to note that the average loss from fixing your rate has reduced over time. The likely reason for this is that lenders often use fixed rate loans to compete with other lenders as they have more certainty over their 'cost of funds' and that the customer is not likely to refinance during the fixed rate period. As such, lenders profit margins from fixed rate products have been in decline.

This data tells us that since 2001, borrowers have a greater chance of being better off if they fix their rate. However, on average, variable rate borrowers have still been better off by just over 0.25% since 2001.

What does history tell us?

The chart on the right sets out the variable professional package interest rate (i.e. 0.70% discount off average standard variable rate) over the past 10 years. I have also included the lowest 3 year fixed rate (which is 8.19%) and the average professional package variable rate over the last 5 years (which is 7.19%). Given that most market commentators expect rates to decline over the next 12 months, there is no value in fixing at the moment.

Professional package variable rate over the past 10 years



Source: RBA

Non financial & personal considerations

Non-financial considerations can be more important than the financial ones, at times. It may be appropriate to consider other factors such as:

- Some people feel emotionally comfortable if their financial commitments are 'locked in'. These people may therefore prefer a fixed rate.
- You may already have a significant interest rate exposure, so it may be prudent to limit or reduce this exposure by fixing your rate.
- Most fixed rate products limit the amount of extra repayments that can be made which might make these products inappropriate.

There are many personal considerations to take into account so it may not be appropriate to be influenced solely by the abovementioned financial and economic considerations.

Current Best Rates (as at 01/09/08)

- Variable professional package rate (i.e. 0.70% to 0.80% discount): 8.53% to 8.72%
- Fixed rates: 2 years = 8.39%, 3 years = 8.19%, 4 years = 8.19%, 5 years = 8.19%

(Note: these rates are the lowest rates offered by our lenders)

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