PROPERTY BAROMETER – WEEKLY COMMENT - TO FIX OR NOT TO FIX INTEREST RATES

With multi-year Rand depreciation continuing, and food price inflation rising, upside risk to interest rates remains significant, and at such times the question around whether to fix interest rates or not gets more frequently asked. Here are some key considerations around Fixed interest rates.

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In the last week of this month, the Reserve Bank's (SARB) Monetary Policy Committee (MPC) once again meets to deliberate on interest rates. The outcome will be announced on 28 January, and we expect that it will raise its policy Repo Rate by 25 basis points to 6.5% , in turn leading to a Prime Rate increase to 10%. Consumer Price Inflation to date has been benign, at 4.8% year-on-year for November, but drought-driven food price inflation pressures along with a sharply weaker rand lifting imported inflation pressures has raised concern of a near term rise in the overall CPI inflation rate.

As of late, recent events including the renewed Rand deprecation have even led to some speculation about the possibility of a more significant 50 basis point interest rate hike, and a more rapid rise in interest rates thereafter.

And of course, the interest rate hiking cycle, or even speculation around possible hiking, normally brings about a heightened level of queries from individuals regarding whether they should fix their interest rates on their home loan(s) or not, so at this time it is probably useful to re-iterate some of the pros and cons around fixing interest rates.

Sadly, the general line of questioning normally centres around what we expect interest rates to do, with individuals trying to base their "fix vs float" decision on whether they think they can "beat the market" or not.

This approach, I believe, misses the very reason why the fixed interest rate offering exists. It exists precisely because economists, try as they may, along with anyone else from accountants with their budgeting to weather forecasters, don't always get future predictions right. That's right, the only certainty about the future is that it is an uncertain place (apart from the obvious death, taxes……and yes, that interest rates will go up at some point but we just don't know when and by how much).

Fixed interest rates are a tool offered precisely because of future uncertainty.

Indeed, a number of the MPC Meetings of the SARB in recent years, the Governor has warned of key "upside risks" to inflation forecasts that we should not ignore, emanating from high wage demands in our economy, while the Rand remains volatile, and sharp unpredictable periodic weakening in the currency can increase imported price inflation. As for the all-important food price component of the CPI, this is subject to local and global weather conditions amongst other factors, which can greatly influence supply and thus the somewhat volatile food price component of the CPI.

Given the SARB's 3-6% CPI inflation targeting mandate, it could be forced to act more extremely than expected at some stage (as happened in the 2006-2008 interest rate hiking cycle), should upward inflationary pressures become too severe.

In short, people can and often need to attempt to make educated predictions, but the future remains an uncertain place.

So how then, should one think about interest rates and manage risk going forward?

THE PURPOSE OF FIXING RATES – GREATER CASH FLOW CERTAINTY, NOT BEATING THE MARKET

Typically, in periods of low and "declining-to-sideways" interest rates, it is natural for many people to lose interest in the option of fixing interest rates, but the idea typically becomes very popular when interest rates are rising.

Now there is no right or wrong when it comes to fixing rates. But it is perhaps important to consider some important factors when deciding whether or not to fix rates, as well as to point out that the usual times when people normally rush to fix rates (i.e. when interest rates are beginning to rise) are not always when one gets the "best deals".

Firstly, fixed interest rates exist precisely because of the fact that future moves in interest rates are uncertain. Fixed rates should be viewed as a service provided by banks which enables the client to, for a certain period, shift the cash-flow risk involved with fluctuating interest rates onto the bank. The bank assumes and manages the interest rate risk, and the client obtains certainty over the interest rate payment portion of their cash flows. In return for this benefit, the customer can expect to pay some price.

Should floating rates over the period in question average a rate lower than the level of the fixed interest rate for the period, then the client would have been better off (but only with hindsight of course) leaving his/her interest rate to float. Conversely, if the SARB were to "shock us" with significant interest rate hiking, and the average floating rate over the period is significantly higher

than the client's average fixed rate, then the client will thank his lucky stars should he have fixed his interest rate at the beginning of the period.

While some people may want to use fixed rates to try to "beat the market", my view is that the decision to fix or float should rest on how much certainty one would like over one's cash flow. *For the person that is more keen to avoid risk, even should floating rates average a lower rate over a specific period than the average fixed rate that he/she fixed at, the value for this person is that he/she has cash flow certainty under a fixed rate arrangement for a defined period, be it 1 or 2 years or even perhaps 5 years. This can allow such people to sleep more peacefully at night, and thus be worth its weight in gold for that particular period regardless of which way interest rates move.*

Conversely for the more risk-taking individuals, some of whom may feel there is a good chance of very little interest rate hiking due to an underperforming local economy for some years to come, they may feel that they are losing out on an opportunity by fixing rates.

Each to their own. It is a personal decision, but when considering whether to fix or not, think about the following:

- *What is your appetite for risk? Does the risk of interest rate hiking cause you major stress? If so, perhaps you lean naturally towards fixing.*
- *How "close to the edge" are you financially? If your overall financial situation gives you very little leeway to absorb any nasty shocks, you may also lean towards fixing rates.*

WHEN IS THE BEST TIME TO FIX INTEREST RATES?

For those to whom the fixed rate option has some appeal, the next question should be at what stage of the interest rate cycle should one fix rates?

Timing the interest rate cycle to perfection is always going to be tough. Traditionally, as mentioned, we find a considerable increase in fixing of interest rates as the SARB starts to hike its repo rate (and prime rate starts to rise). Simplistically, this would seem to many to be the logical time to fix one's interest rates, as history tells us that when the SARB hikes the repo rate for the first time there's usually more hiking to come.

There's a catch, though. When a client fixes her interest rates, a bank takes over the risk of interest rate fluctuations from its client. The bank in turn will then hedge out its own risk by offloading the client's floating rate debt in exchange for a fixed rate debt instrument in what is called a swap, for the duration of the fixed rate term that the bank has offered its client (In practice this gets done in bulk deals by the bank's treasury division). The price and interest rates at which banks can obtain such fixed interest debt instruments (and thus the fixed rate which they can offer their clients) is determined by future interest rate expectations of the market.

Like the individual, the money market also often expects more rate hiking to come when interest rates first start rising (and for a major part of the hiking phase).If the market expects more interest rate hikes during a SARB hiking phase, then the rate which the banks can pass on to their client can appear somewhat unattractive.

The converse also holds true, i.e. that fixed rates on offer start becoming more attractive when market expectation of future interest rates has moved lower, and can remain fairly attractive during periods where interest rates have reached the bottom of a cycle (always impossible to know for sure if that stage has been reached) but the market doesn't yet expect interest rate hiking for a significant time period.

Therefore, the decision to fix interest rates or not depends on considerations such as an individuals' appetite for risk or their own financial position. But if one does find the fixed rate option appealing, while the human instinct is to look for fixed rates during phases when the SARB has already started hiking interest rates, those may not be the times when one obtains the most attractive fixed interest rates. Rather, it is often in times of interest rate cutting or in periods of low sideways movement in interest rates, prior to widespread expectation of imminent rate hikes, that the better fixed rate deals are probably going to be found.

OTHER WAYS OF OBTAINING GREATER CERTAINTY OVER CASH FLOWS – SETTING MONTHLY PAYMENTS WELL-ABOVE REQUIRED PAYMENT

- ***Setting one's monthly instalment well-above the required amount, and then adjusting one's lifestyle accordingly***

For those entering the residential property market as buyers now, a great way to increase certainty regarding repayment cash flows is by "living well within one's means" by buying significantly cheaper than one's financial limits allow. These days, many bonds allow the client to "pay down" ahead of schedule. One would then be able to set the monthly repayment significantly above the required monthly payment, which would imply that up until a certain magnitude of rate hikes one's monthly payments would not change, thereby improving cash flow certainty (though obviously not eliminating it entirely).

For example, the table below indicates that, if one has a bond to the value of R700,000 at prime rate (currently 9.75%), setting the monthly instalment value at R9,218 (which is what would only be required should Prime Rate get to 15%), instead of the required R6,640, would mean that one's instalment value would not be required to change unless prime rate rose to above 15%. That should provide one with very significant cash flow stability with regard to one's bond repayments. On top of that, one would be paying down the bond ahead of schedule (should interest rates remain lower than 15%), enabling the person to build up a "buffer" in the form of an amount in the bond account that she could access, possibly for any unexpected expenditure "shocks".

Bond Value (20 years)	Monthly instalment value according to interest rate charged on a 20-year bond											
	15.00%	14.00%	13.00%	12.00%	11.50%	11.00%	10.75%	10.50%	10.25%	10.00%	9.75%	9.50%
R 300 000	R 3 950	R 3 731	R 3 515	R 3 303	R 3 199	R 3 097	R 3 046	R 2 995	R 2 945	R 2 895	R 2 846	R 2 796
R 400 000	R 5 267	R 4 974	R 4 686	R 4 404	R 4 266	R 4 129	R 4 061	R 3 994	R 3 927	R 3 860	R 3 794	R 3 729
R 500 000	R 6 584	R 6 218	R 5 858	R 5 505	R 5 332	R 5 161	R 5 076	R 4 992	R 4 908	R 4 825	R 4 743	R 4 661
R 600 000	R 7 901	R 7 461	R 7 029	R 6 607	R 6 399	R 6 193	R 6 091	R 5 990	R 5 890	R 5 790	R 5 691	R 5 593
R 700 000	R 9 218	R 8 705	R 8 201	R 7 708	R 7 465	R 7 225	R 7 107	R 6 989	R 6 872	R 6 755	R 6 640	R 6 525
R 800 000	R 10 534	R 9 948	R 9 373	R 8 809	R 8 531	R 8 258	R 8 122	R 7 987	R 7 853	R 7 720	R 7 588	R 7 457
R 900 000	R 11 851	R 11 192	R 10 544	R 9 910	R 9 598	R 9 290	R 9 137	R 8 985	R 8 835	R 8 685	R 8 537	R 8 389
R 1 000 000	R 13 168	R 12 435	R 11 716	R 11 011	R 10 664	R 10 322	R 10 152	R 9 984	R 9 816	R 9 650	R 9 485	R 9 321
R 1 100 000	R 14 485	R 13 679	R 12 887	R 12 112	R 11 731	R 11 354	R 11 168	R 10 982	R 10 798	R 10 615	R 10 434	R 10 253
R 1 200 000	R 15 801	R 14 922	R 14 059	R 13 213	R 12 797	R 12 386	R 12 183	R 11 981	R 11 780	R 11 580	R 11 382	R 11 186
R 1 300 000	R 17 118	R 16 166	R 15 230	R 14 314	R 13 864	R 13 418	R 13 198	R 12 979	R 12 761	R 12 545	R 12 331	R 12 118
R 1 400 000	R 18 435	R 17 409	R 16 402	R 15 415	R 14 930	R 14 451	R 14 213	R 13 977	R 13 743	R 13 510	R 13 279	R 13 050
R 1 500 000	R 19 752	R 18 653	R 17 574	R 16 516	R 15 996	R 15 483	R 15 228	R 14 976	R 14 725	R 14 475	R 14 228	R 13 982
R 1 750 000	R 23 044	R 21 762	R 20 503	R 19 269	R 18 663	R 18 063	R 17 767	R 17 472	R 17 179	R 16 888	R 16 599	R 16 312
R 2 000 000	R 26 336	R 24 870	R 23 432	R 22 022	R 21 329	R 20 644	R 20 305	R 19 968	R 19 633	R 19 300	R 18 970	R 18 643
R 2 100 000	R 27 653	R 26 114	R 24 603	R 23 123	R 22 395	R 21 676	R 21 320	R 20 966	R 20 615	R 20 265	R 19 919	R 19 575
R 2 200 000	R 28 969	R 27 357	R 25 775	R 24 224	R 23 461	R 22 708	R 22 335	R 21 964	R 21 596	R 21 230	R 20 867	R 20 507
R 2 300 000	R 30 286	R 28 601	R 26 946	R 25 325	R 24 528	R 23 740	R 23 350	R 22 963	R 22 578	R 22 195	R 21 816	R 21 439
R 2 400 000	R 31 603	R 29 844	R 28 118	R 26 426	R 25 594	R 24 773	R 24 365	R 23 961	R 23 559	R 23 161	R 22 764	R 22 371
R 2 500 000	R 32 920	R 31 088	R 29 289	R 27 527	R 26 661	R 25 805	R 25 381	R 24 959	R 24 541	R 24 126	R 23 713	R 23 303
R 2 600 000	R 34 237	R 32 332	R 30 461	R 28 628	R 27 727	R 26 837	R 26 396	R 25 958	R 25 523	R 25 091	R 24 661	R 24 235
R 2 700 000	R 35 553	R 33 575	R 31 633	R 29 729	R 28 794	R 27 869	R 27 411	R 26 956	R 26 504	R 26 056	R 25 610	R 25 168
R 2 800 000	R 36 870	R 34 819	R 32 804	R 30 830	R 29 860	R 28 901	R 28 426	R 27 955	R 27 486	R 27 021	R 26 558	R 26 100
R 2 900 000	R 38 187	R 36 062	R 33 976	R 31 931	R 30 926	R 29 933	R 29 442	R 28 953	R 28 468	R 27 986	R 27 507	R 27 032
R 3 000 000	R 39 504	R 37 306	R 35 147	R 33 033	R 31 993	R 30 966	R 30 457	R 29 951	R 29 449	R 28 951	R 28 456	R 27 964

**Note: The above rates are indicative only. Actual instalment values can differ mildly depending on the method of calculation applied by a lending instituion*

If I follow this approach, how much in the way of interest rate hiking should I make provision for? That is impossible to say for sure, but if one uses the previous 2 interest rate hiking cycles as a benchmark, Prime Rate rose by 4 percentage points to 17% in 2002, and by 5 percentage points to 15.5% in 2008.

- ***Raising one's instalment annually in line with one's annual wage inflation***

The 2nd alternative is to start one's instalment at the required rate, and raise it annually by a certain percentage, for instance by one's annual wage increase percentage or by the CPI (Consumer Price Index) inflation rate. This would mean that, as the years go by, one would gradually adjust one's lifestyle to a higher bond repayment, and hopefully also gradually reduce one's exposure to unwanted cash flow "shocks" created by interest rate hiking.

The key point, though, is that building one's financial "buffers" should be an ongoing process, not merely ignored until such time as it appears that a financial "shock" may be on its way, or only when interest rates start to rise. By then it is usually too late, and one has missed out on the ideal period in which to build one's "defences". Such "ideal periods" for building the "defences are usually periods of low interest rates.

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