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## Interest rate game plan

By John Kavanagh  
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The economic recovery will determine whether locking your cash away in a term deposit is a good move.

The good news for investors in term deposits is rates have gone back over 6 per cent after languishing at about 4 per cent earlier in the year. The bad news is they will have to lock their money away for three years or more to get those rates.

Banks and fixed-interest brokers report cash is still coming out of equity funds and being reinvested in savings accounts and term deposits, continuing the trend of the past 18 months. Australians invested a record \$100 billion in term deposits in 2008.

This time last year investors could put their money into a 12-month TD and earn 8 per cent. But then TD rates fell in line with the Reserve Bank's aggressive reduction in the official cash rate.

The accompanying table shows short-term rates are still about 4 per cent to 4.5 per cent. But long-term rates (three to five years) are as high as 6.5 per cent.

Banks report the bulk of TD money is invested for 12 months or less. It is a tough decision to go long for the higher yields. While short-term rates reflect movements in the official cash rates, long-term rates tend to move in response to changes in the wholesale markets, such government bond rates.

AMP Capital Investors chief economist Shane Oliver says long bond yields were low earlier this year, reflecting the gloom about the economy, but have picked up in the past couple of months as the flow of economic data has suggested the economic downturn in Australia will not be prolonged or severe.

"We have gone from thinking about an endless recession to focusing on green shoots and recovery and what we are seeing in bond markets now is an expectation that there may be some renewal of inflationary pressure as the economy recovers," Oliver says.

"In the space of about six months we saw the 10-year Commonwealth bond yield move from 4 per cent to 6 per cent.

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The movement in the longer-dated term deposit rates reflects that."

This creates a dilemma for investors. Most like to keep their money in for 12 months or less. But they have to go longer to get 6.5 per cent.

Oliver says that decision depends on why the money is in a TD in the first place. "If it has come out of shares or equity funds and is going to be reinvested in shares when the market settles down, then you have to expect that recovery to come in the next year or two. Locking the money up for three to five years might mean missing out on good growth in shares or even property.

"But if we are talking about the fixed-interest part of your portfolio, 6 per cent is a good deal. Inflation is falling and is forecast to be about 2.5 per cent for the next couple of years, so the real return on 6 per cent is good. There is some risk rates will rise from where they are now if the people who are bearish about inflation are proved correct. Term rates could go higher and you might be locked in on a rate that is no longer so attractive."

Fixed-interest broker Andrew Murray, who is a director of Curve Securities, says he has been recommending two- and three-year terms to clients and thinks five years is too long when the economy is so uncertain.

He says if investors want 6 per cent or more they should not wait: "A few weeks ago I was able to put clients into three-year terms at 6.5 per cent. Things have come back from there and they may come back a little more. What we have seen in the market is rates moving from a very gloomy scenario early in the year to a recovery scenario in the past couple of months. Now things are settling down and people are saying the recovery will still be slow. If anything, longer-term rates may start to move back down a little."

Investors will have to consider the likely movement in the official cash rate. On July 10, Westpac chief economist Bill Evans issued a report saying: "The prospects for further rate cuts in Australia have diminished to the point where we have revised our forecasts to eliminate rate cuts from our view."

ANZ's forecast for the cash rate is for no change before September 2010 (beyond which time it offers no view). The bank's inflation forecast is 1.8 per cent for 2009, 2.4 per cent for 2010 and 2 per cent for 2011.

When considering a two- or three-year term deposit to secure 5.5 per cent or 6 per cent, investors need to bear in mind that the cash rate and inflation are likely to remain pretty stable over that period.

#### Importance of compounding

The interest rate you are paid on a term deposit is important but so is the frequency of interest payments.

\* The effective rate of interest will vary according to the frequency of interest payments and, assuming those payments are rolled over until the deposit reaches maturity, can have a significant impact.

\* A TD with a rate of 5 per cent and interest paid quarterly (and rolled over) has an effective rate of 5.095 per cent over 12 months.

\* A TD offering more frequent interest payments is a better deal than one paying interest annually or at maturity, assuming the nominal rates are the same.

*This story was found at: <http://www.theage.com.au/articles/2009/07/20/1247941872590.html>*