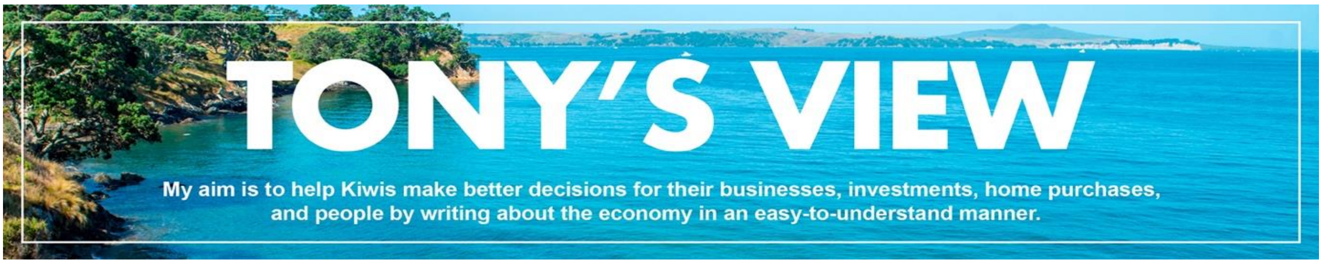

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Monetary policy shifts

Yesterday afternoon the Reserve Bank conducted their semi-regular review of the official cash rate and updated their forecasts for where they see the economy and inflation going over the next three or so years.

As was expected by the markets but not all of us economists they cut the 5.5% cash rate but only by a mild 0.25% to 5.25%. (I thought they'd hang out to October – c'est la vie).

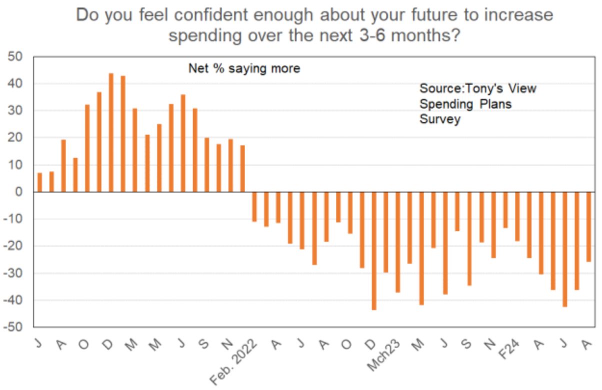
Only three months ago in May the Reserve Bank said there would be no cut until August next year. So, in the space of three months they have changed their prediction by a full year.

This is a sad indictment of the deterioration in the performance of the Reserve Bank with regard to forecasting inflation. But it is consistent with the errors they made in 2022. It backs up the view I've been expressing this past year that after loosening too much during and after the pandemic they had tightened too much.

In that regard the markets are right to factor in some sizeable cuts over the coming 12 months because if the Reserve Bank can change this much in three months they are likely to power ahead once they feel the credibility loss is smoothed over by rate cut happiness.

The central bank is picking that come this time next year the cash rate will be near 4.1% and not their previous pick of 5.5%.

Since early this year my monthly surveys have been showing surprising weakness in the housing market, consumer willingness to spend, and business sentiment. Hiring intentions have declined, plans for investment have edged down, and feelings of job security have worsened.

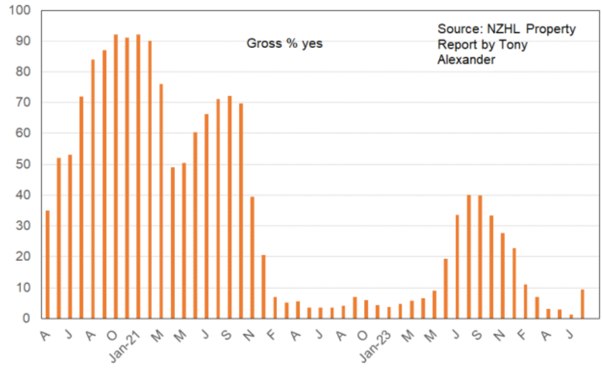


It has been a matter of guesswork regarding when the Reserve Bank would admit that the economy was tanking. Many of us thought they would do so in May, but they retained their forecast of no rate cut until 2025 and even warned that they may need to take the cash rate higher than 5.5%. That looks like a very silly statement not just in hindsight but at the time also.

But enough gratuitous sticking the boot in. No-one's infallible. What happens now? Basically, more of what I have already observed in my real estate agent and mortgage broker surveys when it comes to the housing market.

Buyers will feel more confident to return to the market. Property enquiries will pick up, FOMO will recover more than it has, and vendors will feel more emboldened to hold out for the price they dream they can get rather than the one which will allow them to move on with their lives straight away.

DO YOU THINK FOMO IS IN PLAY FOR BUYERS?



But we are not talking about a boom. Net migration is dropping away fairly sharply, and young Kiwis (potential home buyers) are leaving the country.

Job security feelings will remain weak well into 2025 and it will take quite some time for the business community to feel the effects of lower household debt servicing costs. Which brings us to the economy overall.

The Reserve Bank have lifted their forecasts for growth over 2025 from an average gain in GDP of 0.6% a quarter to 0.8%. That seems optimistic but looks to be in response to their now predicting the economy will shrink by 0.2% this quarter after having fallen 0.5% last quarter.

The big change in the Reserve Bank's assessment of the economy is for calendar 2024 and not 2025 or 2026. They have finally embraced the view that they have applied too much restraint to the economy and generated three extra quarters of GDP shrinkage which they were not predicting just three months ago.

Our economy will get worse before it gets better. Downside risks exist regarding developments in the Middle East, and new weakness in China and the United States.

The Reserve Bank forecasters see the unemployment rate hitting 5.3% at the end of this year from 5% previously, with the peak at 5.4% rather than 5.1%. This is not a particularly high rate in the historical context of New Zealand's labour market experience. But it will help to keep consumer spending supressed through into 2025.

The immediate upturn in the residential real estate market is not likely to lead to an immediate similar uptick in the economy overall. There is still a lot of weeding out to be done across all business sectors and it looks like the Reserve Bank expects this will continue to happen even though pessimism regarding interest rates will now clearly ease.

How quickly will interest rates fall? It doesn't matter with regard to the term one opts to fix at currently. The direction is downward and almost everyone will fix for about six months. This won't change if rates fall another 0.75% in the next 12 months or 1.5%.

The view I've been expressing since early this year is that come the middle of 2025 mortgage rates would be 1% lower than in the first half of this year. I then shifted that to 1% at least. Now I'd say maybe 1.5% when we allow for the markets pricing in the cash rate falling through to the latter part of 2026.

So, from around 7.24% earlier this year the one-year fixed mortgage rates are likely to be near 5.75% come the middle of 2025. Currently it is near 6.85%.

Can we reasonably pick when it will be optimal for people to switch from fixing six months to locking in for 3-5 years? No. And even if we could, 95% of people won't go beyond two years fixing anyway.

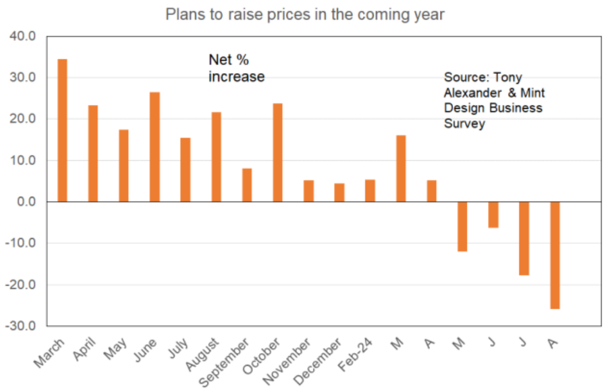
Also, it pays to keep in mind that the Reserve Bank have noted a number of times in their Monetary Policy Statement that the pace of rate cuts will depend on business pricing practices. This is the key point I have highlighted when discussing the clear negative economic signals coming through my surveys.

The ANZ Business Outlook Survey shows that a net 38% of businesses still plan raising their selling prices in the coming year. This is well

above the 25% average and well away from what would be consistent with recession in the economy rather than the 2.7% average growth rate.

Clearly the Reserve Bank expects that these pricing intentions will decline, and I can see further change is showing up in my monthly Business Survey undertaken with Mint Design.

Whereas a month ago a net 18% of respondents said they intend not raising their prices in the next 12 months, now a net 26% are saying that. A year ago a net 22% said they would raise their selling prices.



The Reserve Bank outlined their intentions to closely watch pricing plans with comments such as this.

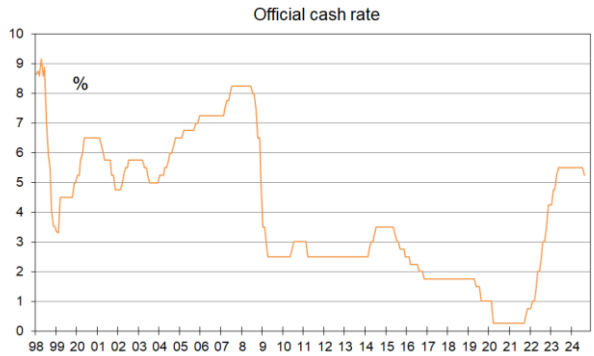
"…the pace at which price-setting behaviour will adjust to a low-inflation environment remain uncertain."

"The pace of further easing will thus be conditional on the Committee's confidence that pricing behaviour is continuing to adapt to a low inflation environment and that inflation expectations remain anchored around the 2 percent target."

The next cash rate review will occur on October 9 and at least a 0.25% cash rate cut is likely, possibly 0.5%. It would take an exceptionally bad run of data for the central bank to ease 0.75%.

If I were a borrower, what would I do?

As discussed above, I would fix six months and look to ride rates down with the hope of best guessing when 3-5 year rates bottom out and locking in then. That's a story for some time in probably 2026 when the cash rate approaches 3% - well away from the current 5.25%.



For your guide, at the moment there is quite a wide range of picks for the level at which the cash rate will bottom out – namely 2.75% to 3.5%.

This week 90-day bank bill yields which heavily influence floating mortgage rates and the cost of funds for most businesses eased to near 5.3% from 5.7% at the start of the year. The change is fairly small and debt servicing interest expenses for businesses will take some time to shift away from punishing levels.

The one year swap rate is now near 4.45% from 5.25% at the start of this year. As this graph shows there is a long way to go yet before one can consider rates to be at "good" levels for borrowers.

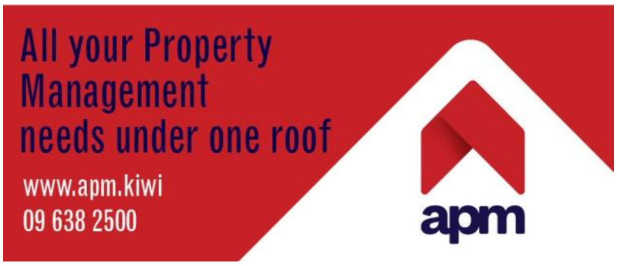
What about investors in term deposits? Your good run is over. What you've got to do now is avoid rushing into other assets in search of yield right at the same time as some of those investments could be under strain not yet apparent to the average investor.

For instance, I have yet to be paid for a presentation I gave on behalf of an Auckland developer of sections over one and a half months ago. Promises of payment have yet to be acted on and they explicitly noted that they are having some cash flow challenges at the moment with some settlements apparently not going ahead as expected. It's not Du Val.

Across many sectors there is still a lot of weeding out to be done and as any banker who has been around a while will tell you, the sector which has the greatest tendency to cost banks and investors a lot of money is not retailing or hospitality, but property development. Dairying can feature large at times because of the sizeable amounts involved. Not so much sheep and beef.

And it is not just in property development that problems arise as the cycle slips and the Reserve Bank enters panic mode.

I've had a kitchen company tell a mistruth to me about the reason they could not install what I paid for and so far have not come forward with any compensation. I might do a special survey on the issue of whether businesses at the moment when handling the economic downturn (set to get worse) are displaying more dishonest behaviour.



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