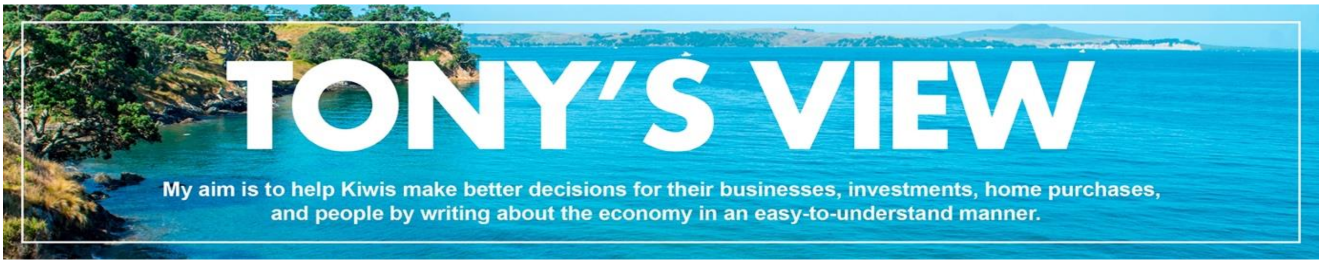

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Interest rates won't fall quickly

A key point which I have been making in commentaries for some time now has been that bank wholesale borrowing costs peaked in mid-June as world worries about high inflation and tightening monetary policy were at their greatest levels. But since then, the speed with which interest rates have been raised has restored credibility to central banks which in turn has led analysts to predict that there will eventually be good success at suppressing inflation to the point that monetary policies will probably be able to be eased before the end of 2023.

The worsening forecasts for the likes of the UK economy and China only add to this view of inflation falling. So too does the evidence of some things falling in price such as oil, food, minerals etc. At some stage inflation may turn to deflation in some countries.

For the moment inflation rates and risks remain high and it will be some time before central banks express confidence about inflation. But eventually they will and when they do this is likely to cause some additional decline in wholesale borrowing costs which will feed through to some more cuts in fixed mortgage rates.

Already banks in New Zealand have cut their fixed rates by between 0.2% and 0.4% from where they were a couple of months ago.

But people should not get optimistic about interest rates either falling away quickly or settling at new extraordinarily low levels come 2024 – 25.

One reason is that central banks are going to keep a close eye on labour market measures to gauge the extent to which upward pressures on wages growth will be easing. The trouble is, the labour market is a lagging indicator of the state of the economy. It will be one of the last things to change. That might not matter much if the economic outlook were to suddenly deteriorate a lot.

However, there is a structural shortage of labour in New Zealand which is only going to be temporarily alleviated in the coming two years by the slowing of the pace of economic growth. Plus, there are good reasons for believing that New Zealand will avoid recession – reasons which will likely stay the hands of firms who would otherwise be laying off some of their staff as a precautionary response to weaker economic activity.

Or to put it another way – we're only going to see a decent inflation-suppressing hike in the unemployment rate in New Zealand if businesses not only feel pain from reduced demand but also believe the pain will be sustained for some time.

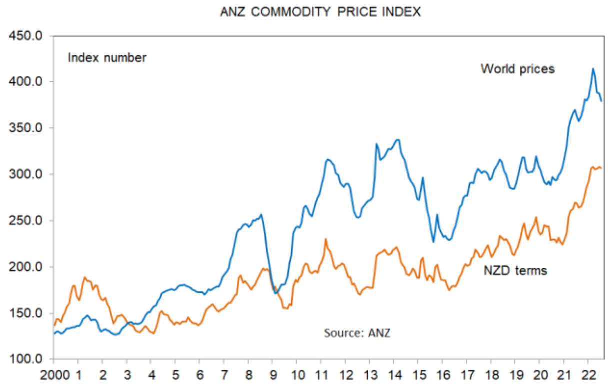
But there are plenty of reasons for expecting our economy not to go into recession, or for believing if we do it will be shallow and fairly meaningless for the majority of the business sector. Here are some of the factors which suggest an outlook of deep economic weakness is not justified.

Low NZ dollar

The NZ dollar is tracking at below average levels. In the past a recession in New Zealand has typically been preceded by the currency reaching very high levels on the back of high interest rates compared with those offshore. No such effect is in play this time around.

High export commodity prices

Prices are falling for the moment but by and large remain well above levels before the pandemic.



Returning foreign visitors

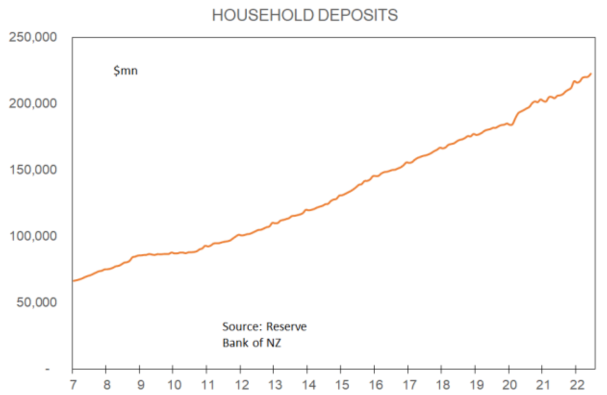
It looks like numbers visiting Australia have so far recovered to between 40% and 50% of pre-pandemic levels. We can reasonably anticipate similar growth in the coming year especially as the numbers of Australians coming to ski are reported to be strong down south.

Returning foreign students

Reopening of the borders has already seen some students return for the second half of this year. Many more are expected for 2023 and this will be of special assistance to Auckland CBD where there are emerging reports of investors showing renewed interest in apartments.

High household deposits

Deposits in banks by NZ households are about $30bn higher than levels before the pandemic. This will provide an important buffer against spending reductions set to come from other factors such as the hike in living costs and higher interest rates.

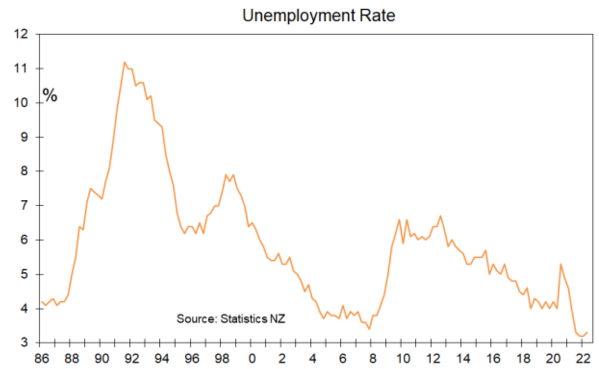


Visa changes

Some 200,000 people in the families of migrant workers are going to be able to legally buy a house as their visas are switched to permanent residency.

High job security

During an economic downturn worries about job loss occupy the minds of hundreds of thousands of people and cause them to rein in their spending. Some precautionary spending reduction is unlikely this time around with high awareness amongst the employed of the demand for their valuable labour. This is a key way in which this period of challenge for the NZ economy will be less severe than in the past.



A rise in the unemployment rate towards 4.5% is likely this time around as opposed to 6.5% in 2009.

Staff shortages

Because the shortage of staff has been around for so long there will not be many businesses which need to layoff large numbers of people. The excess fat to trim will be minor and concentrated in just a few areas such as residential real estate and crypto exchanges.

Backlog of work

Many people have refrained from getting work done on their houses or businesses because of concerns about delays, cost, and quality of work done by hurried less-skilled staff. As things free up slightly these people will step forward.

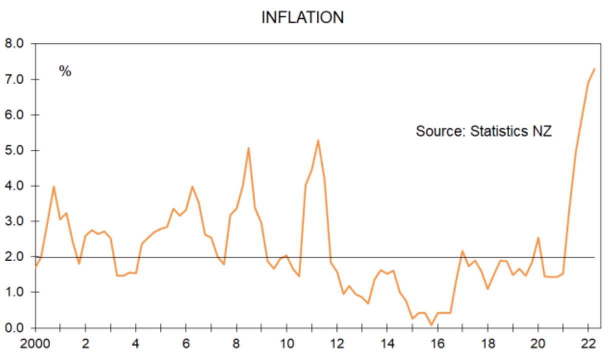
In addition, while new order flows in the likes of housing are drying up for a year or so out, there are plenty of projects waiting to start or be finished as resources allow.

Fiscal stimulus

This is a key uncertain element for 2023 and the Reserve Bank have already fired a shot across the Finance Minister's bow warning about the interest rate implications of loosening fiscal policy. Nonetheless, history tells us clearly what Labour governments do if they enter election year with a view that the election will see them ousted – they open the spending spigots. That is a possibility for next year's Budget.

Higher average inflation

The absence of a deep downturn in the NZ economy despite obvious woe in the UK, Europe, and China, is one reason not to think that our central bank will soon be back to fighting the low average 1.2% inflation rate which prevailed from 2012 to 2019.



There are plenty of other reasons for not expecting heightened deflation risks once the current inflation surge passes and here are a few of them.

Dangerous supply chains

Business have learnt that their assumptions about the reliability of materials supply chains have been wrong. This is leading to a number of changes. One is running higher inventories of inputs and that adds to higher costs via hiring of the storage facilities and financing the higher stock levels.

Another is the shifting of supply sources from predominantly the cheapest supplier to a more geographically diversified range of suppliers. This comes at a higher cost.

Geo-political diversification and reshoring

Concern about the actions of authoritarian states - predominantly China - is leading businesses and governments to shift where they get goods from towards more stable, democratic regimes which are not always the cheapest.

Aging baby boomers

As this large cohort of people leaves the workforce and enters retirement the available supply of labour is being constrained – actively falling in some cases. This is adding to upward pressure on wage rates around the world.

China's economic development

China's success at raising some 800 million people out of poverty is necessarily bringing higher remuneration for employees. The ability of China to keep supplying goods at the same low prices as before is reducing every year.

Climate change costs

Businesses are having to boost expenditure on methods of mitigating the impact of their activities on global warming. This addition to costs will be passed on in higher prices charged to consumers.

End of plentiful liquidity

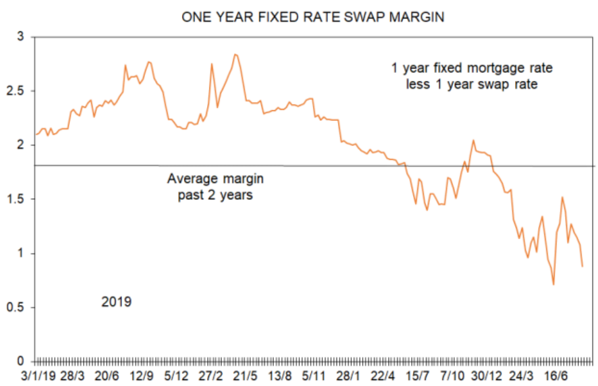
This factor will take some time to feed through, but as central banks start taking printed money out of their financial systems the quantity of money willing to back loss-making ventures will shrink. This is already leading to less money being made available for potentially productivity-boosting and inflation-suppressing new enterprises. It is also making life less comfortable for businesses which in the past have focussed largely on rapidly growing user/subscriber numbers rather than turning a profit.

The willingness of investors to back these perpetually loss-making firms has declined substantially and pricing changes upward by the likes of Netflix for instance are already underway.

Bank margins

There are also some factors quite specific to the interest rates charged by banks as opposed to the general pace of economic growth and the average rate of inflation.

Margins on bank fixed mortgage rate lending are well below average for some terms. Competition between lenders is currently very strong. Eventually this will fade, and margins will be restored.



It is impossible to know when this will happen, but the implication is that when wholesale interest rates start falling for the likes of the one and two year fixed mortgage terms in particular, the feed-through into the rates charged to customers will be less than the wholesale rate drops would imply.

The upshot of these and other factors is that when interest rates next reach their cyclical lows, unless we have a new big shock it is unlikely that they will go close to the levels caused recently by the global pandemic coming along when worries about deflation were already the highest in decades. Such a unique situation may not be repeated for a very long time – hopefully.

So where might rates settle? We don't know. The Reserve Bank is busy trying to create a new estimate of the level of the official cash rate which can be considered neutral. That is the rate where monetary policy is neither stimulating nor restraining growth.

In their recent Monetary Policy Statement, the Reserve Bank indicated that the rate could be a bit higher than they were thinking previously.

My best guess would be that the next time rates bottom out, putting aside an extraordinary shock scenario, the one year fixed mortgage rate might be near 4% and the three year perhaps near 4.5%. But seriously, you can't place any reliance on such a view. After all, while I have argued the case for higher inflation on average than between 2012-19 when it averaged 1.2% a year, we can't rule out reversion to that deflation risk environment once again.

So, when you are considering how to manage your interest rate risk for the next few years, allow for high uncertainty continuing and give positive thought to spreading your risk over more than just the one time period – unless we go back to 2.99% for five years fixed again! That was a no-brainer, but the fixation people have on minimising costs now rather than taking a long view of their expenses meant very few people actually locked in at that rate. Instead, they opted for the candy of a one year rate at 2.19%.

If I were a borrower, what would I do?

Nothing I write here or anywhere else in this publication is intended to be personal advice. You should discuss your financing options with a professional.

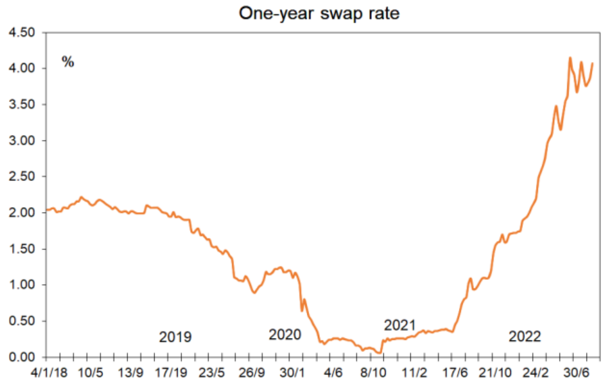
Rates rise this week

Wholesale interest rates have risen this week as around the world the bout of optimism regarding central banks cutting their cash rates before the end of 2023 has backed off a bit.

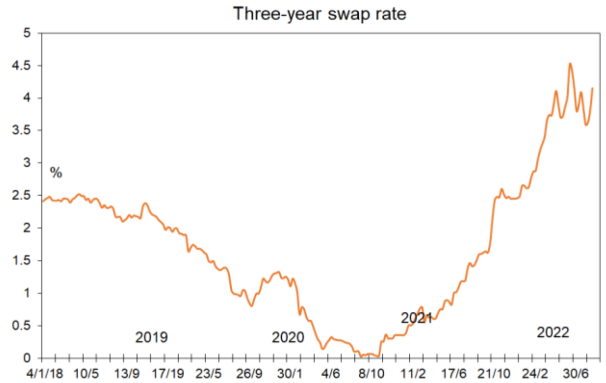
This backing off has been mainly driven by comments from senior people on the Federal Reserve Board in the United States warning the markets that they may be getting ahead of themselves with their optimism not just about inflation but about the Fed. easing in 2023.

In particular the selloff has been promoted by hawkish comments along the same line anticipated to be made by the Fed. Chairman at the annual Jackson's Hole central banker meeting our time Friday night.

The cost to NZ banks of borrowing money at a fixed rate for one year to lend to you and I has risen to near 4.1% from near 3.9% last week and 3.75% three weeks ago.



The three year bank borrowing rate has risen to near 4.15% from 3.8% last week and 3.6% three weeks ago.



These rate moves serve to remind us that things do not move in straight lines in the financial world. Bouts of extreme pessimism get followed eventually by bouts of extreme optimism. Skilled traders make a living gauging these emotions in the asset markets of interest to them. I'm not a trader with such skills and instead aim to identify the broader underlying trends around which the fluffy emotions and reef fish swirl.

In that regard the track for very short-term interest rates remains upward as central banks including our own still have some policy tightening to do. But for rates longer than a few months the signs of worsening world growth imply falling inflation and one day easing policies again.

Here's something to watch for. At some stage inflation forecasts will change to deflation predictions. When? No idea. How big a switch around? Ditto.

If I were a borrower, what would I do?

I'd probably just fix one year, looking to take advantage of the easing of monetary policy I expect from late-2023. But I'd hopefully recognise the poor record we all have predicting interest rates since 2008 and look for opportunities to fix some of my debt longer sometime down the track. For the moment banks are competing for business with heavily discounted one year rates.

To see the interest rates currently charged by major lenders go to www.mortgages.co.nz