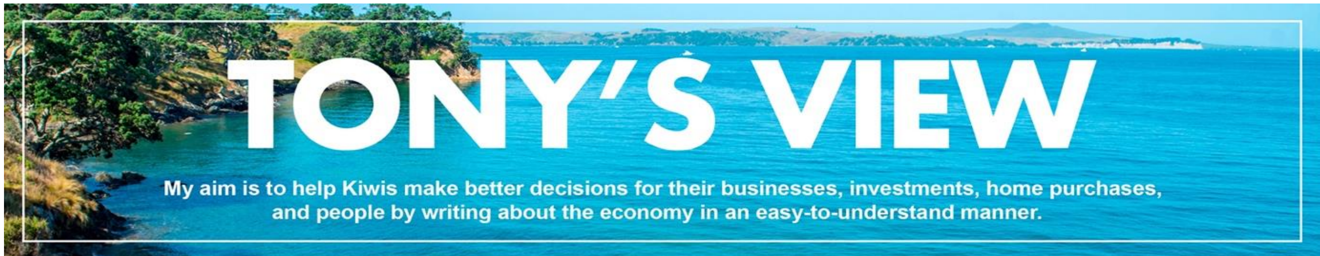

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ISSN: 2703-2825 Thursday 29 September 2022
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Interest rate uncertainty

I don't know about other economists, but when I make a forecast I do so reluctantly and don't expect to be right. Having been in this game for three and a half decades I know how much outright guesswork is involved and how out of date models are as soon as they are squished and massaged to fit past relationships.

Some economists have to produce numbers because they have clients who are actively taking positions in quickly traded financial assets on the basis of what they say. So, a high degree of care is needed when making the forecast and justifying its difference with those of other forecasters and current market pricing is very important.

I try to avoid giving numbers and you might think that the best thing to do would be to instead pick a range. Not so. People will choose whichever end of the range suits them most for their particular purposes – as I found with a prediction of the dairy payout a couple of decades ago. I almost had it right for the top end of my prediction, but all focus was immediately on the potential low end outcome. It didn't go too well for me for a while there with the farmers and agribusiness lenders.

Hence, don't expect to see forecasts put out in terms of ranges in which the outcome is likely to occur. You greatly magnify your chances of being slammed and will be seen as a bit wishy washy by those who desperately want a single number to work with.

My preference is to give a general indication for where things are likely to go and then concentrate on two things.

1. Make people aware of the risks surrounding the future and encourage them to not overly rely on one set of predictions proving correct. Hedge your bets and allow for things turning out differently – because they will.
2. Get the most up to date information as possible in order to be able to spot divergences in the real world from earlier expectations, then convey the changing risks to people.

Interest rate outlook changes

So, let's do this exercise with interest rates. This is the area where the swirling mass of

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uncertainties in the world we live in are manifesting themselves and causing alterations in what we think likely to happen. The trend over the past couple of months has been away from a prevalent view that inflation will comfortably go back towards 2% in most countries by early-2024 and central banks probably won't have to screw their economies into the ground in order to make that happen.

Opps. What we are learning is increasingly telling us that inflation is going to be harder to beat offshore than previously thought and we can no longer rule out recession being created in the United States in order to get inflation back safely down – at which point worries about deflation will probably return and we'll be talking and writing about interest rates falling much further than we are predicting down and will do so for next year.

But that is an item of interest for quite a few quarters down the track and not now. I just wanted to remind people that in the world of economics and financial markets things can easily switch from up and up to down and down.

UK troubles

The key development regarding inflation over the past week has been the loosening of fiscal policy in the United Kingdom aimed at boosting the pace of economic growth. This makes no sense in the short-term given the already binding capacity constraints on the UK economy's ability to grow and the ongoing fight by the Bank of England against high inflation.

Expectations for inflation in the UK have lifted and markets are prising up to a 6% cash rate being imposed by the Bank of England next year. For the moment the BOE is saying things are okay and they will stick with their planned next review of monetary policy in November. That seems irresponsible in light of the fiscal stimulus, the rout in bond markets, and the falling of the British pound to a record low against the US dollar.

Last night the Bank of England backed away from their hands-off approach and intervened to buy bonds to stabilise that market. This has caused some easing of yields around the world but the central problem remains – and now the UK government's deficit is being monetised for the next fortnight.

Recession is all but guaranteed for the rest of this year into 2023 for Europe and the UK now that new financial market shocks including weak share prices are adding to the energy shock coming from Russia's appalling actions. Should a nuclear weapon be used by Russia then it seems hard for even an optimist like myself to conclude we will still get by without a recession down here.

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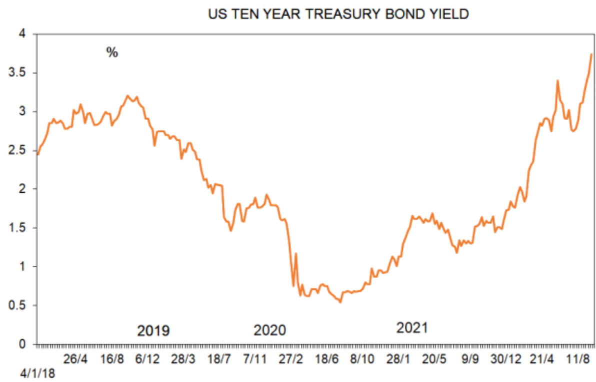
Rate changes

Three months ago in the middle of June the development of optimism about monetary policy successes saw wholesale interest rates start falling from multi-year peaks. The likes of the United States ten year government bond yield hit 3.5% mid-June then fell away to 2.6% early in August. But the yield hit 3.5% again at the end of this week then rose to 3.9% following the UK ructions and global bond market selloff. It has now retreated to near 3.75%.



What changed from the start of August apart from the policy conflict in the UK? A number of things. First, the monthly inflation number in the United States came out higher than expected and that raised concerns about the speed with which rising interest rates would hit consumer spending, business pricing, and annual inflation. Note – at some stage we will definitely get lower than expected inflation outcomes and you'll see some sudden moves down in wholesale interest rates. Don't expect local banks to quickly alter their fixed mortgage rates in response to these sometimes sudden changes in wholesale borrowing costs here – influenced as they are by developments in the United States. But a round of NZ rate rises looks quite likely now given local borrowing costs rises – discussed in the Interest Rates section.

In the United States the labour market is holding up a lot better than expected and you might have noticed the reports last Friday regarding how much unemployment needs to rise here in New Zealand before the Reserve Bank will presumably be comfortable with the inflation outlook.

Perhaps a further factor in play in the United States is the concern recently expressed by the central bankers that people were being over-optimistic about the inflation outlook. Their comments led to a number of articles noting how back in the 1970s-80s excessive optimism about the inflation fight being won led the US central bank to ease monetary policy too soon and inflation shot back up again.

The New Zealand situation

No-one wants to make that mistake again, which brings us to New Zealand where our own central bank made a similar mistake of easing too soon in

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the late-1980s. They also tightened much too slowly from 2004 to 2007 and allowed inflation to become cemented in at too high a level. The outcome was that they had to throw the economy into recession over 2008 and as bad luck would have it when we were climbing out the Global Financial Crisis got rolling with the collapse of Lehman Brothers investment bank and the length of our recession got roughly doubled.

With regard to the current shifting sands of inflation and interest rate prospects here we have evidence being factored into rate expectations which includes the following.

The coalface surveys I run of people in the residential real estate sector tells us that first home buyers are returning to the market and the investors have perked their ears up and are paying attention.

The extent to which consumers are pessimistic about the future has eased recently. Business pessimism has also eased a tad. But note that pessimism does overall still reign.

There are no mass layoffs related to the state of the economy and businesses continue to actively seek whatever staff they can get their hands on. This sounds great from an economic and income growth point of view. But it is not at all what the Reserve Bank wants to see.

They have focussed much too strongly in recent years on making sure only a small a number of people are unemployed and have over-cooked the labour market to the point where businesses are struggling to stay afloat. They let wage and growth-related inflationary pressures develop to a dangerous degree before we got the extra inflationary shock from supply chain disruptions, capacity constraints in other economies, the European energy crisis caused by Russia's appalling actions, and pressure on food prices from weather events.

The upshot of things turning out to be better economically and worse inflation-wise is that the interest rates outlook has changed. The chances have now increased fairly strongly that the Reserve Bank will need to take the official cash rate above 4%. Rates are going higher than expected overseas, and for now the general view also is that rates will stay higher for longer than previously thought. That is where things get interesting.

History tells us something about successful tightenings of monetary policy. When the rate rises work and one's economy is thrown into recession, you usually don't realise you are in recession until it is well under way, and then the speed with which interest rates fall can be quite surprising.

Will that happen this time around? Probably? When? Haven't the foggiest. Best guess? Late next year. Still – if you fixed your mortgage rate for five years in 2021 at 2.99% rather than grabbing the 2.19% candy, none of this really matters, does it?

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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 up again – surprise!

I could have kept the same headline regarding NZ wholesale rates rising for the past seven or so weeks. The story for rates here as offshore since the start of August has been rises on the back of deepening worries about inflation.

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Optimism about how quickly the fast pace of cost of living increases will ease has reduced in the face of strong labour market data and some higher than expected inflation outcomes in a few locations. The extreme easing of fiscal policy in the United Kingdom is the last thing the Bank of England would have wanted to see as it fights inflation and the new concerns there have only added to concerns elsewhere.

The upshot for us here has been as follows. The one year interest rate at which banks in New Zealand must borrow in order to lend to you and I at a fixed rate for one year has climbed this week to around 4.6%. Last week the rate was 4.4%, the week before 4.25%, and in early-August 3.75%.

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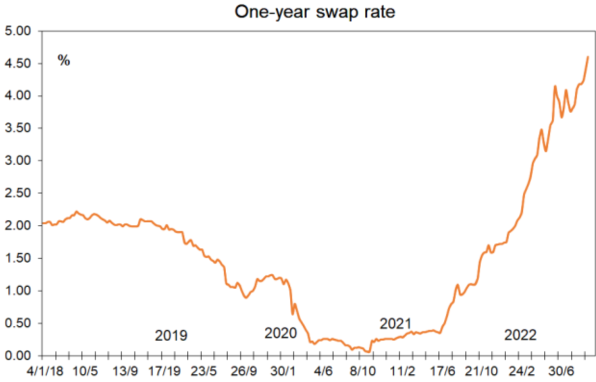
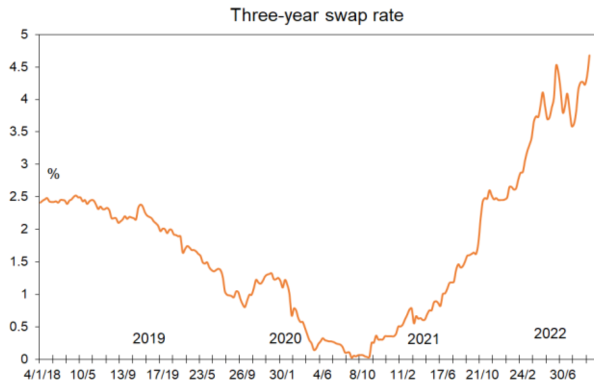


The three year bank wholesale borrowing cost has risen to 4.65% from 4.4% last week and 3.6% early in August.



So, now you know why I dropped my long-running table of interest rate forecasts a few weeks back. I could see that with so many large and unpredictable factors in play there is just no way I'd be willing to lay money down to back any particular view of where rates are headed.

Even before we learnt about the higher than expected inflation in the US, stronger than expected labour markets, and the loosening of UK fiscal policy, we had severe things such as the following.

A complete lack of knowledge of how economic growth, inflation, and interest rates track coming out of a global pandemic, matching our already revealed lack of insight when the pandemic started.

The plethora of changes in underlying relationships between interest rates and inflation which have happened since the last time monetary policies around the world were on a sustained tightening cycle ahead of the 2008-09 Global Financial Crisis.

The usual uncertainty surrounding central bank competence and attitudes towards inflation risks associated with every loosening and tightening phase of the monetary policy cycle.

You cannot base your interest rate risk management decisions strongly upon a particular set of interest rate forecasts and the belief that they will prove accurate. They will be wrong – virtually every time. That is why most economics publications are weekly. Every week we receive new information which needs to be analysed and put in the context of what we already know and what we have been expecting to happen.

The flow of information and new developments these days is so overwhelming that a monthly publication is usually pointless apart from digging into really deep nitty gritty. A daily publication is too much for 99% of people. Weekly is about right.

I recall when I started work at the BNZ in 1993 that the main economics publication was quarterly.

Anyway, what about the interest rates outlook in NZ? Is it as dire as in the UK? No. Much as we should expect a Labour government falling behind in the polls and associated with a pandemic period people want to forget all about opening up the fiscal spigots in the May 2023 Budget, it is unlikely Mr Robertson will truly abandon fiscal restraint.

But some fiscal easing is likely. The Reserve Bank have already warned that if this happens there will be interest rate consequences (upward pre-election). There are also upward interest rate implications from the weakness in the NZ dollar.

A lower NZ currency transfers inflation and higher offshore interest rates into New Zealand via higher import costs and the need to react against them by the Reserve Bank.

The labour market is also, as noted elsewhere, holding up much better than expected and that suggests that as the Reserve Bank loses confidence in the unemployment rate comfortably tracking up to 5% early in 2025 it will be inclined toward more monetary policy tightening.

Upside risks for monetary policy here have intensified but at this stage the Reserve Bank is giving no hint that it feels a need to deviate from the rate indications given in their August Monetary Policy Statement.

Specifically, in a speech this week the embattled Reserve Bank Governor said the following.

"We believe we still have some work to do. But the good news is because we've done so much already, the tightening cycle is very mature. It's well advanced,"

The RBNZ was not the first central bank to tighten monetary policy last year. But it moved well in advance of the big ones which held onto an obviously incorrect assessment of inflation risks until early this year.

If I were a borrower, what would I do?

Central banks are planting boot on their monetary brakes. That changes the interest rates profile. It means higher rates in the short-term, but lower ones further out because of the much increased inflation risk.

The implication for borrowers is that sticking with the one year and maybe two year term for fixing likely is probably optimal. But keep in mind the uncertainties stressed above.

If I were borrowing currently I'd probably fix one year but wouldn't turn my nose up at a good two year rate.

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

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