

Input to your Strategy for Adapting to Challenges

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Interest rate pressures – mainly for 2027

Back in August 2024 when the Reserve Bank started easing the official cash rate from 5.5% there was a surge in optimism about what lay ahead for the NZ economy. I issued two warnings.

The first one which I concentrated 90% of my energy and writing on was a warning that just because interest rates were now falling a period of really good growth did not beckon for 2025. There were plenty of other restraining factors still in play and it was wise to remember that when a central bank cuts interest rates from their cyclical peak it is not because things look good. It is because they look like crap and they need to act fast to prevent really deep woe and weakness.

Come the middle of last year when it was clear that the economy was not yet thriving and surviving to '25 was not enough, I switched to concentrating on my second warning. This one was about inflation.

I warned that the pace of price increase would likely not fall away strongly and that when the customers did eventually return in good numbers businesses would take advantage of the situation to rebuild their margins.

I've been hammering that message harder and harder these recent months but also reminding everyone about the behavioural pattern of our central bank.

They loosen too late (waited until August 2024) then loosen too much (cut an extra 0.75% over October and November 2025 when our economy was already showing some good growth).

After that they tighten too late and then they tighten too much. We are in the tightening too late part of their behavioural pattern now and that was shown last week when despite only weeks earlier warning about upside risks the cash rate was left unchanged at the still stimulatory level of 2.75%.

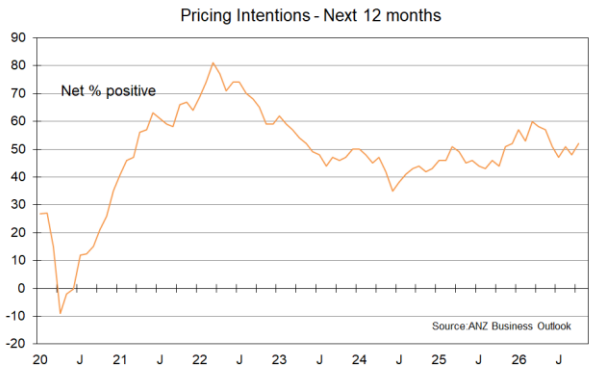
The Australian cash rate has just been raised to 4.85%. Their inflation rate is 4.3%, ours is 3.7% set to rise above 4.5% shortly. The US funds rate is targeted between 3.75% and 4.0% and their inflation is 3.7%.

We are an outlier and as highlighted here, prospects for inflation through 2027 do not look good for a variety of reasons I won't list yet again. Except for this one which I track closely and which formed the basis of the warning I issued but kept on the back burner initially from August 2024.

In their long-lasting monthly Business Outlook survey, the ANZ ask a range of questions including whether businesses plan raising their selling prices over the coming 12 months. The long-term average since 1992 has been a net 27% saying yes. Inflation has averaged 2.4% over the same time period.

The pricing measure peaked at a net 81% positive early in 2022 then eased off to 35% come June 2024. But it then rose back to peak at 60% in March before easing to 48% in September.

The latest reading which was released last Thursday is 52%.



I do not read that as pricing intentions trending back up again because this result is easily within the range in place for the past year. But it is almost twice the rate consistent with inflation averaging 2.4% let alone the target of 2%.

It is also relatively high considering that cost pressures on businesses from falling capacity availability in New Zealand associated with good economic growth have yet to appear. That is, once the unemployment rate starts tracking below 5% we can expect faster wages growth.

Not that we are close to that yet. Yesterday we learnt that the unemployment rate rose to 5.7% in the September quarter from 5.6% in the June quarter and 5.3% a year earlier. The lagged labour market response to previously tight monetary policy is continuing – but probably near an end.

Job numbers fell almost 0.2% in the latest quarter and although these numbers lag the economic cycle, they are likely to be looked on by the Reserve Bank as good reason to delay further the next rise in the official cash rate.

Inflation risks for New Zealand lie on the upside and there is something important to consider when you perhaps look at forecasts for the economy produced by the Reserve Bank to see where things might be headed. They predict that inflation will fall away to 2.1% come the end of next year and then sit there.

The problem is that they are charged with achieving inflation of 2% and keeping the rate there, so they are never going to forecast anything other than inflation getting to about 2% some 12 - 18 months out from when they make their predictions.

The 2% is not a forecast. It is a goal.

In August 2025 the RB "predicted" inflation currently would be 2.2%. It is 3.7% - or 3.2% excluding the petrol surge according to Statistics New Zealand. Their forecast was out by 1%.

In August 2024 they predicted inflation come October 2025 would be 2.4%. It was 3%. Only a 0.6% error.

In August 2023 they predicted inflation come October 2024 would be 2.7%. It was 2.2%. So, their errors can go both ways. But the tendency is to under-estimate inflation.

In August 2022 they predicted inflation would be 4.1% come October 2023. It was 5.6%.

Their inflation forecasts are not reliable unfortunately.

What does this mean for Kiwis? For borrowers you need to be aware of upside risks for short to medium term interest rates come the latter part of next year. At some point probably in the second half of 2027 but conceivably later the Reserve Bank will again realise they have tightened too slowly. Then they will move to the next phase of their behavioural pattern. They will tighten too much.

Getting oneself some protection again these interest rate risks from late-2027 through 2028 would probably be a good idea.

For investors – better fixed interest returns will eventually return.

For exporters – be aware that at some point the exchange rate is going to shoot back up again, especially against the Aussie dollar. They are more advanced in the tightening cycle than our central bank and will see their rates peak out before ours do. Then, while they are holding steady or cutting, we will still be raising rates.

At some point anticipation of a reversal of the current unusual situation of our cash rate sitting well below theirs will arise. The currency will react. But that won't likely happen until our Reserve

Bank again say “opps” and play the catch-up game. We do not seem close to that point.

For importers – as evidenced by downward currency movements last week following the surprise decision to leave the cash rate unchanged - things will possibly get worse for you before they get better.

If I were a borrower, what would I do?

After falling a bit last week because of the absence of an expected tightening of monetary policy, wholesale interest rates have again edged slightly lower this week. These latest moves partly reflect the weaker than expected employment data released yesterday. The markets had been ready for jobs growth to be reported as high as 0.3% for the September quarter. The actual outcome was a fall of almost 0.2%.

However, one thing which people like myself have learnt to do over the decades since the Household Labour Force Survey data started to be compiled and released in 1986 is to be on the lookout for rogue results.

Every now and then the numbers will move strongly with no obvious reason in play. That might have happened this time because the seasonally adjusted number of hours worked fell by an unusually large 1.6%. This is the biggest change in either direction since 2021.

Nevertheless, because the Reserve Bank are showing a cyclical bas towards not tightening monetary policy much, they are likely to seize onto the data as evidence that the time when capacity in our economy gets used up and then fosters inflationary pressures is further out than thought.

The chances of a third rise in the cash rate this cycle at the next review on December 9 have weakened.

The one year swap rate at which banks borrow fixed in the wholesale markets to lend to you and I at a fixed rate for the likes of our mortgage now sits near 3.46% from 3.66% last week and 3.68% a month ago. The three year swap rate is now near 3.87% from 4.11% last week and 4.2% a month back.

Is there scope for banks to cut their fixed lending rates because of these slight borrowing cost declines? Not really unless they are feeling very hungry for market share.

The basically calculated margin on one year fixed mortgage rate lending is running about 0.3% below average for the past two years. The two year margin is about 0.2% below average.

If I were borrowing at the moment, I would fix for two years but give thought to fixing for three years if I were offered a rate better than the 5.59% now commonly charged.

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