TONY'S VIEW

Input to your Strategy for Adapting to Challenges

Feel free to pass on to friends and clients wanting independent economic commentary

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My Aim

To help Kiwis make better decisions for their businesses, investments, home purchases, and people by writing about the economy in an easy-to-understand manner.

Why raise interest rates?

A message to young, fresh-faced borrowers wondering what's going on

The Reserve Bank is going to raise interest rates within the next 12 months and some people may struggle to understand why. In particular, because we have not had a sustained monetary policy tightening cycle since 2004-08 when the official cash rate rose by 3.25% to 8.25%, a whole generation of borrowers know nothing about interest rates restraint.

So, this is an article for those who are soon going to feel that the Reserve Bank is really mean to them.

The Great Depression of the 1930s taught us that when something hits your economy and things spiral downward, a government can help stem the decline and set the scene for recovery by boosting spending. Since then, the implementation of such policies has prevented another Depression.

High inflation is very damaging to those without pricing power be it for wages of products

The 1970s taught us that high inflation destroys the wealth of those without enough power to keep raising their incomes, and crushes output per capita. The latter happens as people and businesses focus more on protecting themselves against cost increases than developing new products and boosting productivity.

Since the 1970s-90s central banks have gained substantial independence from politicians and been allowed to enact policies which prevent inflation from rising to high levels and staying there. Their actions have contributed to greater growth in wealth and household incomes.

When an economy looks weak, and inflation looks like turning into deflation (falling prices) central banks will do things which cause mortgage rates and bank deposit rates to go down. They want to reduce cash outflow pressures on businesses and households holding debt in the hope they spend more.

To fight low inflation or the risk of deflation, sometimes drastic loosening action is needed

They also hope low borrowing costs will encourage businesses to invest in new machinery etc., and you and I to borrow and buy couches, cars, and houses. Our actions can boost retailers, manufacturers, building firms etc., and our feelings of happiness and confidence if our house prices rise. We feel richer, more clever, and spend even more.

These actions have played out to a degree no-one ever expected or even intended these past 15 months.

When it looks like the rate of inflation as measured by the Consumers Price Index might go above 3%, or at least no longer threaten going below 1% and staying low, a central bank will raise interest rates. Their intention in raising rates is to reverse some of the stimulus applied when interest rates were cut. They will seek to reduce the ability of businesses to raise selling prices and encounter limited customer resistance by causing people to think twice before spending money.

They want businesses to ease off on their borrowing and spending growth. Plus, they want the pace of increase in prices for assets like houses to slow down and deliver less spending stimulus from the rising paper wealth effect.

The Reserve Bank has two bouts of looser monetary policy to unwind

Last year the Reserve Bank cut its official cash rate from 1% to 0.25% in order to fight the effects of the global pandemic. Their actions stimulated our spending and caused house prices and house construction to soar. Now, our economy is growing firmly, employment growth is high, and there is no need for interest rates to be at levels which risk inflation getting out of control.

So, at a minimum the Reserve Bank will soon look to take away last year's sugar. Borrowers should comfortably expect a 0.75% rise in floating and short-term interest rates.

But they should also expect the interest rate cuts of 2019 (another 0.75%) to be taken away as well. Back then, business and consumer confidence levels were very bad, and the outlook was for falling inflation.

This 0.75% + 0.75% is probably why the Reserve Bank is projecting that from the September quarter of next year they will raise their cash rate by 1.5% over a two-year period. Note that they cut the official cash rate by 1.5% in a ten-month period from May 2019 to March 2020 so do be aware that big interest rate changes can happen quickly.

Their instrument is blunt and rate changes can disproportionately affect some groups

Does the Reserve Bank deliberately want to make life difficult for young buyers of houses? No more than they wanted to make life difficult for farmers pre-GFC when their interest rate increases would unfortunately cause the NZ dollar to rise sharply and badly affect export receipts.

The problem with monetary policy is that as a tool for influencing the economy and therefore eventually the rate of inflation (it can take 18 months to do so) it is very blunt. Stuff gets mashed up rather than finely cut into a better shape.

Monetary policy changes always involve some group being disproportionately affected when they are not the prime cause of the inflation problem or deflation risk. This time around it is not likely that farmers will be worst affected because their export prices are good and because at the same time as interest rates rise in New Zealand, they are likely to be rising offshore. That means the rise in the NZ dollar is likely to be less than in the past.

The pain this tightening cycle will be strongly felt not just by recent highly leveraged buyers, but young people seeking their first home

This cycle it is likely to be young house buyers who are most negatively affected. Why? Because history tells us that house prices won’t fall given the growth in our economy but rising interest rates will cause many borrowers to no longer be able to meet debt-servicing criteria set by banks.

The results of a new survey I have up and running and which will be coming out shortly, show that the banks are placing an increasing emphasis on debt servicing ability. This is through means such as implementation of debt-to-income limitations well in advance of the Reserve Bank one day making them mandatory.

Young prospective buyers of houses and those who have bought recently, will likely feel that they are not the cause of inflation worries. They will note comments about supply chain disruptions and shortages of labour. They will come up with ideas for them to be excluded from interest rate rises (fixing five years at 2.99% would have achieved that dear reader).

But just as farmers made no impact on the Reserve Bank when expressing their concerns in previous cycles, so too this time will buyers locked out of a purchase by tightening bank debt servicing criteria get little comfort from the RB.

If I were a borrower, what would I do?

Now that there is finally something interesting happening in the interest rates space, I shall reintroduce this section into my weekly TV publication. Nothing I write here or anywhere else in this publication is intended to be personal advice and you should discuss your financing options with a professional. But, for me personally, this is what I would be doing at the moment if managing a big mortgage again.

If I were not already fixed five years at 2.99%, as a conservative borrower I would look to spread my risk by having a mix of one, three, and five year rates. As an optimist, whatever happens I can feel I got some of my strategy right. For pessimists – unfortunately part of what you do would be wrong and that is what you’ll focus on.

NZHL Tony’s Thoughts Video

Each week I record a three-minute video for NZ Home Loans and in the most recent one I discussed where fixed mortgage rates have averaged since 2009, where rates look like going, and what an average borrower might optimally do facing major uncertainties over where rates go and how fast they get there.

The landing page for these videos is here.

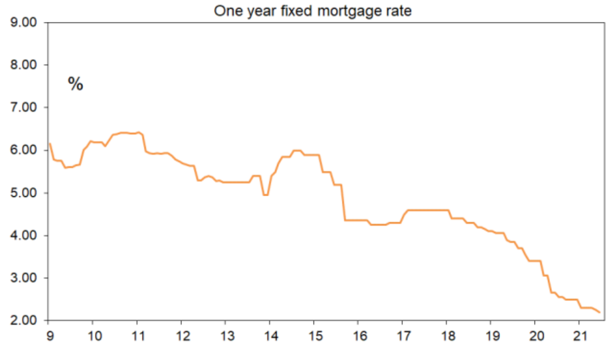
TONY'S VIEW

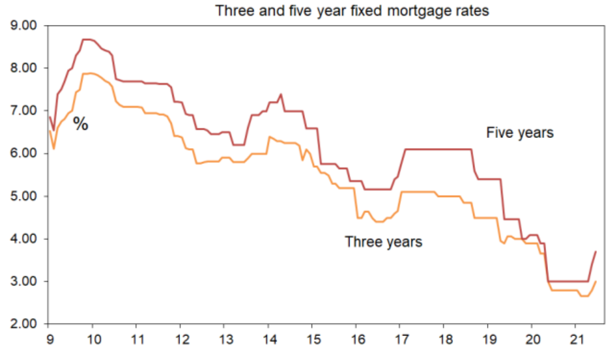
New Zealand's Housing Markets

What rates strategy has worked best since 2009?

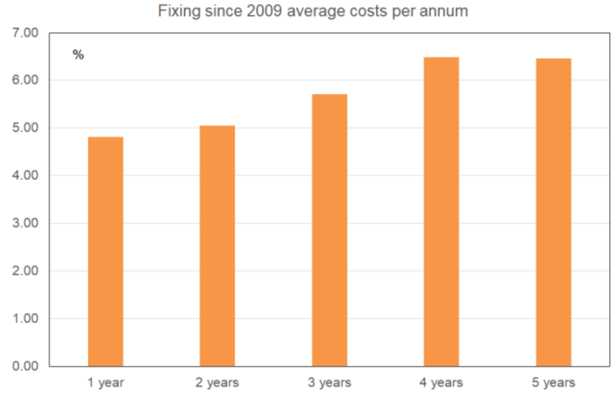
Let's run the numbers and see what the cost of having a mortgage would have been since the end of the Global Financial Crisis in 2009 if you had done a number of things. For each option I'll calculate the average interest rate for someone running a mortgage from mid-2009 and someone from mid-2014.

These first two graphs show how fixed rates have changed since 2009. Note the upward kick for the three and five-year terms recently.



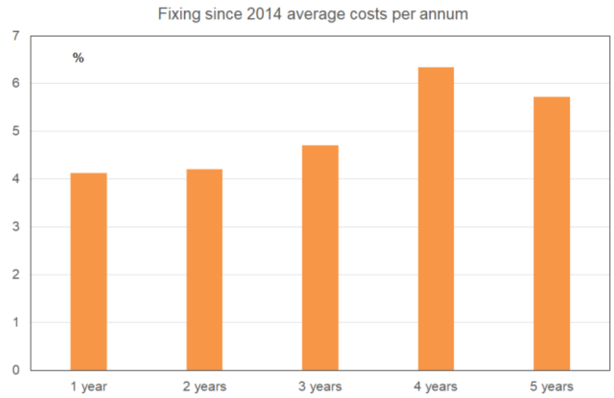


This next graph contains five bars, each showing the average interest rate since 2009 for five fixing alternatives. The first shows that if you simply rolled over one-year rates every 12 months your average rate was 4.8%. If you rolled over two years fixed every 24 months the cost was 5.05%. If you rolled over three years 5.7%, four years 6.5%, and five years also 6.5%.



The best option for borrowers in the post-GFC environment has been to roll at a one-year fixed rate.

This next graph shows the average cost for the same terms regularly re-rolled, but since 2014.



Again, fixing one-year has been the cheapest option at 4.1% versus two years 4.2%, three years 4.7%, four years 6.3%, and five years 5.7%.

The best option has been to roll religiously for a one-year term.

So, now your brain is working quickly and you're thinking this is simple. The best option has been to roll religiously for a one-year term. This is what most people have been doing. So, why have I up until recently shown such a strong preference to fix five years?

Because the five-year rate at 2.99% was not just a record low for that term, it was lower than the averages for all terms since 2009 and since 2014. Only for a period of 14 months out of the last 12 years has the one-year rate been below 2.99%.

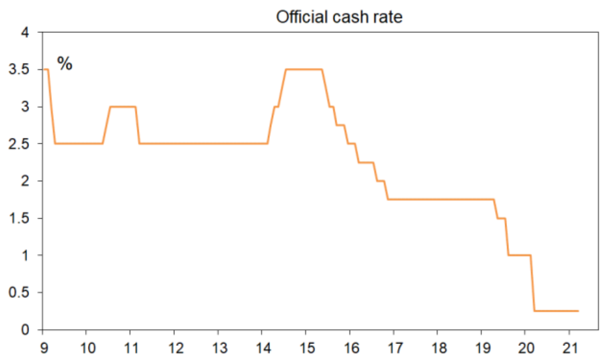
The one-year rate has only been below the recent five-year fixed rate of 2.99% because of the global pandemic. Now, we can see economies booming around the world under the power of large stimulatory policies including extraordinarily low interest rates which central banks have put in place to discourage saving, encourage borrowing, and to push asset prices higher.

But consider the future we now face. Inflation rates are rising around the world. Since 2009 when the one-year fixed mortgage rate in New Zealand has averaged 4.8%, inflation averaged only 1.6%. It is currently 1.5% and set to rise quite a bit.

The unemployment rate since 2009 has averaged 5.3%. It is now 4.7% and set to fall.

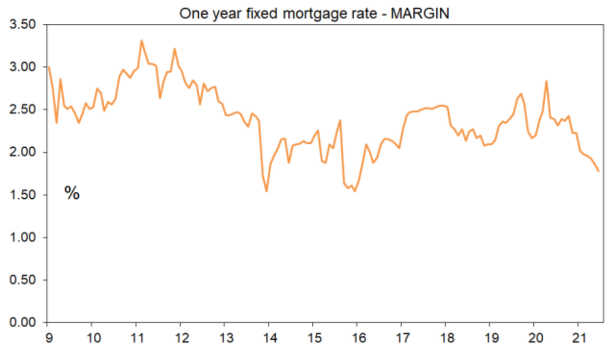
There is no longer any justification for the official cash rate staying at a record low of 0.25% compared with an average of 2.2% since 2009.

Is it reasonable to expect that the one-year fixed rate will go back above 5% as it was from almost all of 2009 to 2014? One might say yes on the basis of the official cash rate from 2009 to 2014 being at 2.5% almost the entire time and that being where we are probably headed back to.



But the average margin on bank one-year fixed rate lending back then was about 2.7% from 2009 – 2013 versus 2.2% from 2014 – 2019. So, if we use 2.2%, then we're probably talking about the one-year fixed rate going from the unusually low-margin 2.19% at the moment to a peak of 5% if the cash rate goes to 2.5% as I believe it will.

Tony's View



For the moment, giving the benefit of the doubt to many inflation pressures proving temporary, and allowing for banks continuing to compete most strongly in the one-year term, I am running with a 4.5% peak for the one-year fixed mortgage rate come 2024. Further discussion of this is contained in the Interest Rates section further on in TVP.

Links to publications

Tony's View Spending Plans Survey

Tony's View Business Survey

Tony's Thoughts Vlog

NZHL HOME LOANS | INSURANCE

REINZ & Tony Alexander Real Estate Survey

REINZ REAL ESTATE INSTITUTE OF NEW ZEALAND

Oneroof weekly column

OneRoof

mortgages.co.nz & Tony Alexander Mortgage Advisors Survey

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Tony Alexander Regional Property Report

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Valocity Valuer Survey

VALOCITY

One-off issue of Tview Premium

To receive a one-off copy of Tview Premium for $15.00 incl. GST, being this week's issue only, there are two payment options offered in order to keep admin simple at my end. Be sure to enter your email address correctly as that is where the issue will be sent. All payments received up until next Wednesday night will elicit a TVP of the same date as this TV. All from next Thursday morning will receive the next TVP issue. Any problems, just email me.

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