TONY'S VIEW

My aim is 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.

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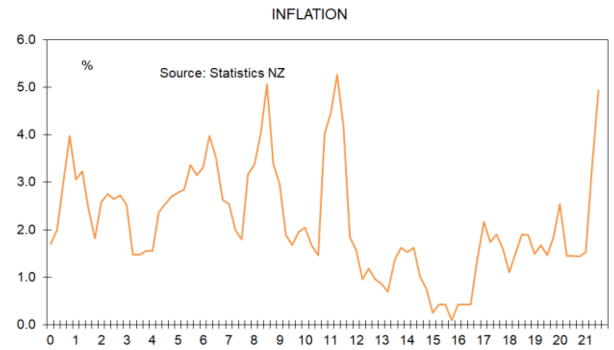
The candy turns sour

I am receiving an increasing number of emails from people all of a sudden awakened to the risks of high interest rates which I have been highlighting for a long time now. They want to know what to do when the candy they have taken as recently as July in one case expires - the candy being a cheap one-year fixed term interest rate.

If you've not already got your mortgage rate fixed for five years at the likes of the 2.99% I was so strongly in favour of, your options to get some decent cover against the Reserve Bank eventually remembering what its job is and hiking rates strongly, are diminishing by the day.

This past week we have seen all the major lenders lift their lending rates in response to recent sharp increases in wholesale borrowing costs. Those wholesale interest rates have gone up to reflect rising rates offshore as worries about inflation grow, and sharply higher inflation worries here in New Zealand.



Our inflation rate is now 4.9%, and when numbers come out for the next two quarters inflation above 5% is widely expected. One forecasting group is picking a 6% peak. That makes for a lot of inflation – and it pays to keep in mind that inflation is another way of saying change in the cost of living for the average household.

The following table shows what the best fixed rates are for each term now, what the rates were four weeks ago, and where those rates sat six months back.

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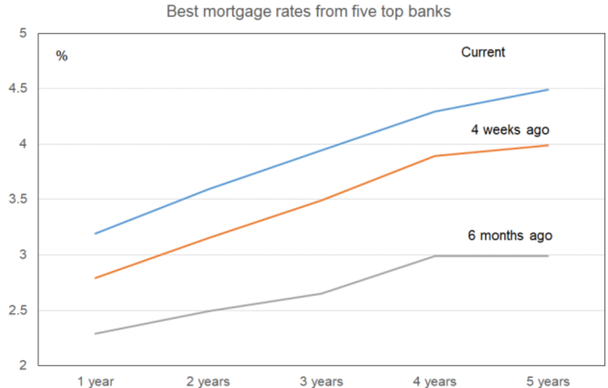
	Now	4 weeks ago	6 months ago
1 year	3.19	2.79	2.29
2 years	3.59	3.15	2.49
3 years	3.94	3.49	2.65
4 years	4.29	3.89	2.99
5 years	4.49	3.99	2.99

Here is the same thing as a picture.



Are interest rates going to keep rising?

Yes, for a number of reasons.

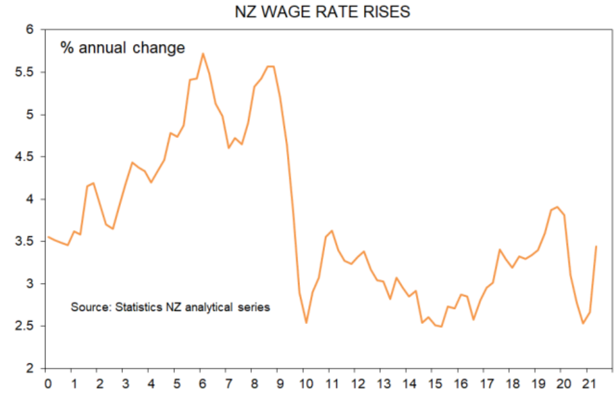
Inflation not solely temporary

First, the temporary factors which have caused a spike in inflation around the world look like dragging on through to the end of 2022. That makes for a long period of time during which the higher costs get cemented in and only partly reversed when supply chain issues are resolved.

Labour shortages

Second, labour is in short supply here and overseas. In fact, the situation here is likely to get worse as Kiwis shift to at least Australia in order to earn far higher incomes from a country with actual elements of a plan for economic growth and development, as compared with the absence of anything like that here.

Labour shortages have delivered employees there best bargaining power in over four decades. The chances are very high that wages growth will rise firmly and business costs from this source, plus things like recruitment and training, will soar. This will place pressure on businesses to raise their selling prices.



Pricing power

Third, businesses find themselves in a position many will be unfamiliar with. Increasingly, they can raise their selling prices and not suffer a large loss of customers. Why? Because going online to make a purchase and wait six months for it to be delivered rather than the normal few weeks or days is removing buying power from consumers.

Higher inflation expectations

Fourth, inflation expectations are rising. It is our expectations for things which drive our behaviour and if we expect prices to rise we will be prepared to pay higher prices when they appear. Our response then will be to raise our own selling prices and wage demands.

Households healthy

Fifth, household balance sheets are in very good shape. Housing wealth on paper has gone up about $400bn over the past year and a half and we have an extra $10bn or so in our bank accounts beyond what would have been there without Covid-19.

Energy costs

Sixth, energy prices have soared and history tells us this is a factor which tends to push up global inflation.

Reserve Bank credibility loss

Seventh, our central bank has suffered a dent to its credibility. The top people have been so focussed on rebranding the institution, full employment, weaving flora and fauna into their commentaries, and (in their minds) saving the economy from Covid with press releases patting themselves on the back, that they have lost sight of their key objective. That being to keep inflation in check.

Credibility, once lost, is hard to regain. The cost of regaining it is not going to be borne by the Reserve Bank with their active PR department, but by average Kiwis. This is what happened when the Reserve Bank put the economy into recession in 2008 because of tardy policy

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tightening (that they eventually admitted to) over 2004-06.

No fiscal restraint

Eighth, the government is unlikely to help the Reserve Bank restrain household spending by imposing fiscal austerity. There will be extra work required of monetary policy because of a left-wing government with an eye towards the 2023 general election and big goals on social policy.

Good export income prospects

Nineth, the export sector faces a good outlook with people enjoying freedoms overseas and buying more of our primary products – dairy in particular. Higher export incomes will make the Reserve Bank's job of reducing inflation just that bit harder. So too will the underlying strong activity in the broadly defined construction sector.

What this long list adds up to is my current view that the official cash rate will get pushed from the 0.25% of a few weeks ago to 3% come the middle of 2023.

When we allow for banks rebuilding their fixed rate lending margins, that means the likes of one-year fixed rates between 5% and 5.5%. The rate currently is about 3.19%, just ahead 1% so far from the candy lows of four months back.

What should borrowers do?

Don't email me asking what you should do. I'm an economist, not a mortgage or financial advisor. You need to speak with a mortgage broker or banker regarding your options and they can discuss your specific circumstances. I can't.

All you'll get from me depends upon my mood. If I'm having a bad day I'll think you've mucked up by staying fixed one-year and not heeding my warnings, and I'll (politely) tell you so. If I'm having a good day I'll still think you stuffed up, but I just won't mention it.

At the moment, if I personally were a borrower, I'd probably fix three years. Simple as that. Some people might like to fix a portion of their loan for three years, some for two, maybe some for four years. But much as I have spoken in support of such a strategy, I never did it when I was a borrower and still probably wouldn't if I put myself back in that situation again.

But it does pay to recognize the extremely uncertain environment which we have been facing for some time now and will continue to face for the next few years. I do, by noting after the forecast table I publish in my interest rates section, that I'd give the rate forecasts a 10% chance of proving correct.

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I write that because I know new information will appear and the forecasts will have to be changed. At some stage the new information will argue for less inflation and less monetary policy tightening than previously thought, rather than the one-way street it's been for practically all of this year and from late-2020.

If you fix three years at the moment you'll be paying just under 4%. That means you'll be paying what most people were paying when they were successfully rolling over one-year rates repeatedly as recently as May 2019.

Having rates go back to where they were just over two years ago doesn't feel like it would be sufficient to cause much of a dent in the housing market. But we are talking about a period just before the Reserve Bank made a panicked 0.75% cut in interest rates through 2019, which they repeated in March last year.

Basically, at a minimum, the stimulus applied to our housing market from rate cuts over 2019-20 is in the process of disappearing. After that will come actual restraint aimed deliberately at forcing the pace of growth in our economy below the long-term average.

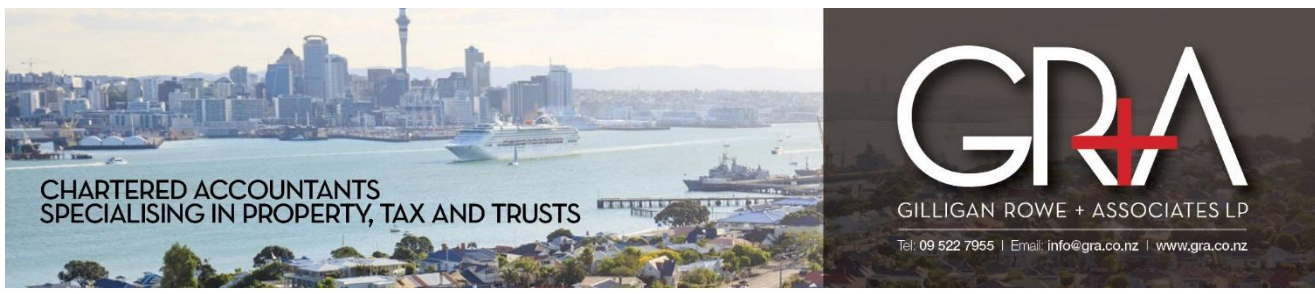
Will the housing market be badly hit?

Average prices growth will stall when we take into consideration rising supply (but watch for collapsing builders because of falling bank credit availability, materials and staffing problems, and orders being cancelled). There will be restraint also from

- banks curtailing credit availability,
- the slow burn of the next tax rules affecting investors,
- diversion of spending to offshore travel,
- erosion of shortage fears and resulting ending of the FOMO boom, and
- impact of recently announced intensification rules.

As a rule, in New Zealand, house prices on average fall largely only when we are in a recession. Which therefore raises this question. Will the Reserve Bank have to throw the economy into recession in order to get inflation back under control?

For the moment I don't believe they have the culture to do such a job if it were again necessary. A change in top personnel would probably be needed for that staunch effort. The chances are recessionary restraint will not be necessary. But we've been down this track before and failed to pick recession. So, we'll see.



Selling housing to buy other assets?

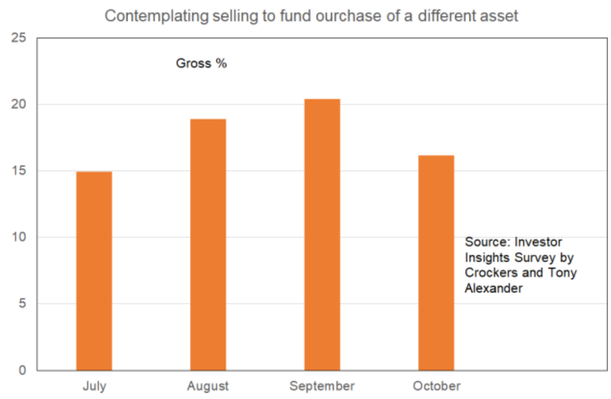
Tomorrow morning I will release results from my monthly Investor Insight survey run with Crockers Property Management. The main outcomes are these.

- Lockdown has not brought about a sustained deterioration in investor plans to purchase property.
- Rising interest rates have yet to incentivise selling by investors.
- Planned resource consent changes on intensification have yet to shift intentions more towards purchasing new builds.
- No trend changes in rents growth are apparent.

One thing I thought it might be useful to examine in a bit more depth here is the reasoning investors reveal for selling a property. First, we have to note that as yet there is no upward trend in the net proportion of investors planning to offload their property asset or assets.

Results from my other surveys tell us that if we had been running this survey for months before the March 23 tax announcement then net purchase intentions probably would have fallen in this survey after then.

I ask people why they are thinking about selling a property and one of the options is "Want to fund another investment". As the following graph shows, there is no upward trend in this measure.



Therefore, much as my Portfolio Investment Survey last month showed a net 58% of respondents planning to buy shares versus a net 15% residential property, one cannot claim that property owners are making a big switch.

This underpins my view that it is probably new investment money which will be showing inclination towards non-property assets, rather than money already invested in residences.

If I were a borrower, what would I do?

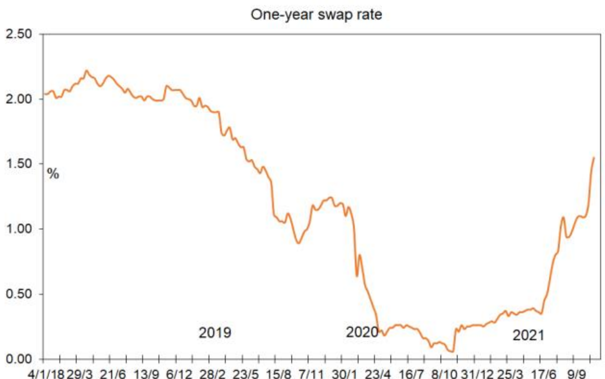
Nothing I write here or anywhere else in this publication is intended to be personal advice. You should discuss your financing options with a professional.

Last week NZ wholesale interest rates which banks must pay to fund fixed rate lending shot higher in response to the 4.9% inflation rate revealed on Monday. This week rates have gone higher yet again in response to Australia's core inflation rate printing well above expectations.

The headline rate which everyone sees came in at the expected 3% (compare that with our 4.9% and you'll see why Kiwis will be leaving here for cheaper living in Australia next year). But the core inflation rate which strips out one-offs came in at 2.1% and not the expected 1.8%.

This has led to markets over there pricing in an even higher probability that the Reserve Bank of Australia will have to tighten monetary policy well ahead of the 2024 timeline they keep stating.

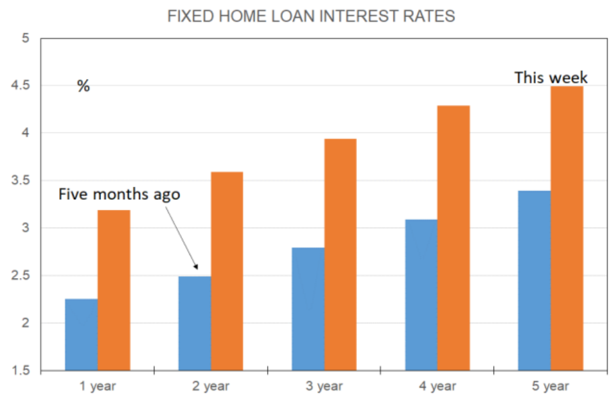
Of relevance to borrowers here, the one-year swap rate which influences one-year mortgage rates has risen to 1.55% from 1.44% last week, 1.19% two weeks ago, and 0.35% in June.



The two-year swap rate now sits at 2.18% from 1.95% last week, 1.57% two weeks ago, and 0.55% in June. That is, the rate has risen over 1.5% in four months. Has the two-year fixed mortgage rate done the same?

In June the best two-year rate from the main lenders was 2.49%. Now it is 3.59%. Margins have compressed and banks have catch-up increases to do.

Borrowers should anticipate further increases in fixed rates. I discuss potential further rate upside in Tview Premium, using the graphs showing how far bank margins need to be rebuilt to get back to average levels as a guide.



My expectation for the one-year rate in October each year is shown in the first column of the table below. The second column shows what the one-year rate will average over the next 2-, 3-, 4, and 5-year periods. The last column shows the current minimum 2 – 5-year fixed rates charged by the lenders I track.

	Forecast 1 year rate	Rolling average rates	Current fixed	
2021	3.19		3.19	1 yr
2022	4.5	3.85	3.59	2 yr
2023	5.25	4.31	3.94	3 yr
2024	4.65	4.40	4.29	4 yr
2025	4.25	4.37	4.49	5 yr

If these forecasts prove correct (I'd give that a 10% probability), rolling one-year fixed will deliver an average rate for the next two years of 3.85%, three years 4.31%, four years 4.40%, and five years 4.37%.

The last column shows what the current minimum fixed rates are for those time periods. Given that there is a rate premium one should be prepared for rate certainty, rolling one-year fixed will easily deliver a cost higher than one could get by fixing at the moment – if the forecasts are right.

If I were a borrower, what would I do?

Personally, I would fix three years where rates currently are near 4%.

Links to publications

Tony's View Spending Plans Survey

Spending Plans Survey

Tony's View Business Survey

Business Survey

Tony's Thoughts Vlog

REINZ & Tony Alexander Real Estate Survey

Oneroof weekly column

mortgages.co.nz & Tony Alexander Mortgage Advisors Survey

Tony Alexander Regional Property Report

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[Tony's View Portfolio Investment Survey]

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