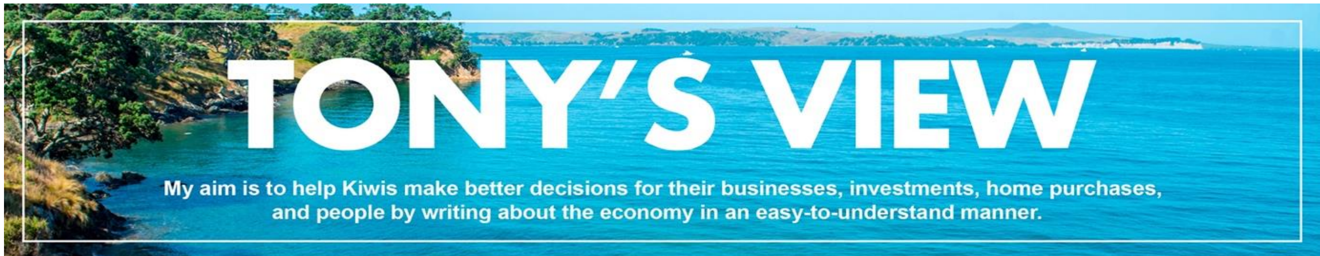

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ISSN: 2703-2825 Thursday 7 October 2021
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The tightening cycle begins

Yesterday afternoon at 2.00pm the Reserve Bank met expectations by raising their official cash rate from the record low of 0.25% it was taken to following an emergency meeting in March last year. The OCR now sits at 0.5%.

They want to reduce the extent of stimulus being applied to the economy by low interest rates and noted explicitly that as vaccination rates rise the extent of disruption from Covid-19 will fade over time.

They see good balance sheets for the household and business sectors, fiscal stimulus, high export prices, and a recovering global economy. But as discussed here many times before, there are worsening capacity issues in our economy, especially in the labour market. These issues are raising costs for businesses and the Reserve Bank have explicitly noted that recent disturbances such as higher energy and transport costs risk getting passed on into generalised price rises.

With inflation currently at 3.5% and expected by our central bank to exceed 4% soon, these risks are not to be under-estimated.

However, the Reserve Bank has made it clear that it plans to raise the cash rate at a gradual pace. This slow pace reflects their concerns about the ongoing negative effects of Covid-19 including the risk of additional disruption down the track should new variants appear, or the speed of spread overwhelm our health facilities.

There are also other things to worry about internationally such as the growing energy crisis offshore involving oil prices at a seven-year high, soaring gas prices, and record thermal coal prices. Uncertainty surrounds Evergrande in China and the broader effect on an economy laden with debt and becoming increasingly regulated.

Let's add in the worsening supply chain issues all around the world leading to warnings of shortages of turkeys, toys and so on for Christmas.

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But all these issues don't change the fact that around the world inflation is rising and central banks are saying they need to act. The central bank in Norway has tightened monetary policy and it is only a matter of time before other countries join in.

This brings a special risk in the United States related to tapering of the Fed.'s bond buying. Their tapering attempt of a few years ago post-GFC backfired in the form of slowing economic growth.

Tightening risks mean that much as I have expressed major concerns about rising inflation here and overseas, there are reasons why people can legitimately accept a view that the extent of rate rises this cycle in New Zealand will be limited. The Reserve Bank has projected a gradual rise in rates adding up to 1.75%. Others talk of just 1.5% and less.

Personally, if I were a borrower, I would be conservative and work out my ability to pay an interest rate in two years time 2.5% ahead of whatever I was paying about six months ago. In doing my workings I would allow for my revenue falling back because if rates do have to rise a lot more than the Reserve Bank have projected then we are looking at a scenario where they are looking to crunch the pace of growth below its long-term average for a while in order to get the inflation genie back in the bottle.

We are some way away from that however, so for those who have done very well by repeatedly rolling a one-year fixed rate these past few years, the option of doing so will still look attractive next year. But come 2023 deeper worries are likely. Then, when people look to switch to a long-term rate, they will be too late. Many already are with the five-year rate 1% above its level of a few months ago.

For your guide, seven weeks ago I was all set to release the results of my special survey regarding how people have handled high interest rates in the past. But the Reserve Bank delayed the rise, so I have held it back.

But for those young people who have not trodden the rate rise path before, there may be some value in reading the insights of the old hands. You can find the document at the following link.

How to Handle High Interest Rates Survey October 2021.pdf (tonyalexander.nz)

The suggestions include these.

- Make your own lunch and stop buying it.
- Cut café coffees and make your own.
- Get in a boarder or flatmates. Shortages of accommodation mean there should be no shortage of potential takers.
- With widespread labour shortages, consider taking on some part-time work.

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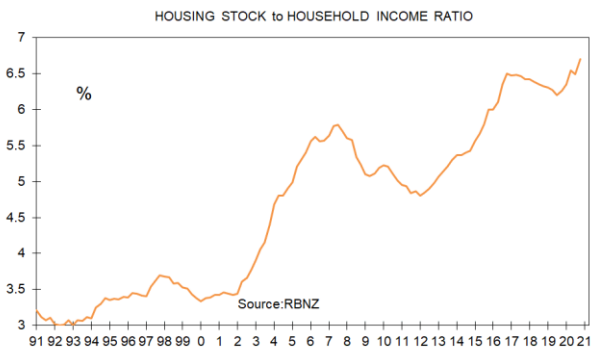
Long-term causes of high house prices

Why has the ratio of the average house price in New Zealand to average income soared over the past three decades? Back in the early-1990s the ratio of the value of our housing stock to total household income was just over three. Now it is approaching 7 and is much higher in some locations.



Over the past 1-2 decades when concern about housing affordability has been greatest, too often people including politicians, analysts, and the public have believed that simple interventions would solve the problem.

There will have been some restraining effect on price growth from the likes of introduction of LVRs, ban on foreign buying, and attempts to free up more land. But at the same time as these things have appeared governments have been actively pushing up house prices through legislating higher building standards and that process is still ongoing.

Mainly however, people have vastly under-estimated the sheer magnitude and durability of the factors causing a structural shift in average house prices. Interventions have been tiny in comparison with these key driving forces, many of which have contributed to the ultimate key driver of our high house prices – the development of housing as an asset class for people looking to build their retirement wealth.

Decades back the people in an auction room would have been almost entirely potential owner occupiers. Now, these people are competing with investors who want the house as an asset to assist with their income and wealth growth goals.

Only if governments over the past three decades had taken measures to prevent average Kiwis from preparing for retirement by investing in houses alongside or as a replacement for the likes of shares, would house price growth have been contained.

We can't blame politicians for failing to take the necessary steps because almost everyone has

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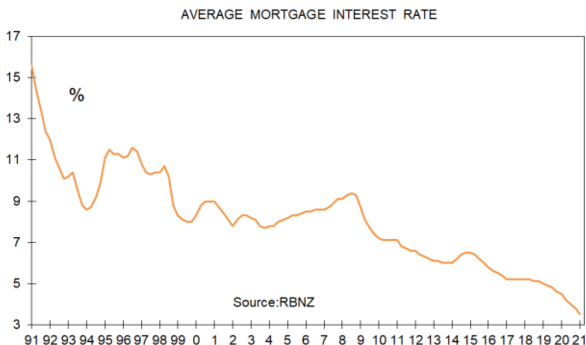
had a belief that no matter what prices had just done, they would soon flatten out for many years if not fall for a while.

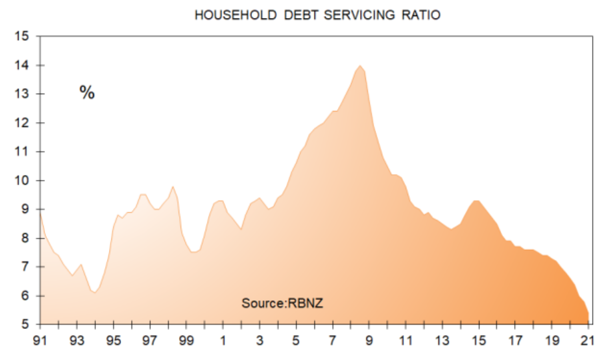
Following are the key large magnitude factors which have smashed policy interventions of the past 1-2 decades onto the rocks. The first one is the biggest, not just because it has made home ownership more accessible for people, it has also generated a desire to find returns better than banks can any longer offer.

Lower mortgage interest rates

The average interest rate paid on household debt (mostly mortgages) was above 15% in 1991 and averaged 11% from 1991-95. The graph here shows how the rate has trended down over time and has averaged 4.9% in the past year with a 3.5% average rate for the March quarter.



Lower mortgage rates have made a home purchase more affordable for buyers, and this is best seen in the debt servicing ratio of interest costs to income falling. House prices may be high relative to the incomes of young buyers these days. But they enjoy interest rates never before seen in our modern times.



Lower bank deposit rates

We normally talk about housing in terms of mortgage rates. But rates of return on the most basic alternative asset of cash in the bank are relevant as a driver of willingness to invest.

The six-month bank term deposit rate has fallen from peaks near 18% in the late-1980s to 8% pre-GFC and less than 1% more recently. Allowing for inflation currently at 3.5%, the real after tax return from leaving one's money in the bank is about -2.9%.

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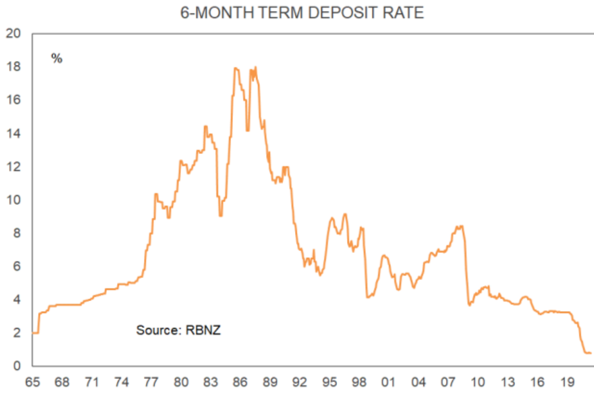
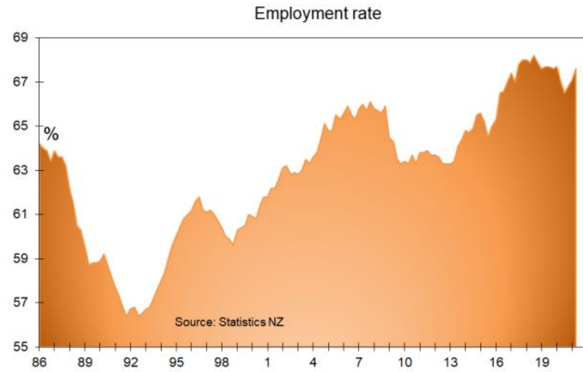


More people working

Technically, this factor shouldn't much affect the ratio above of the value of the housing stock to total household incomes. But we'll include it here because greater security of income for two-income households and shifting of people onto an income level allowing house purchase rather than renting probably has lifted the ratio slightly.

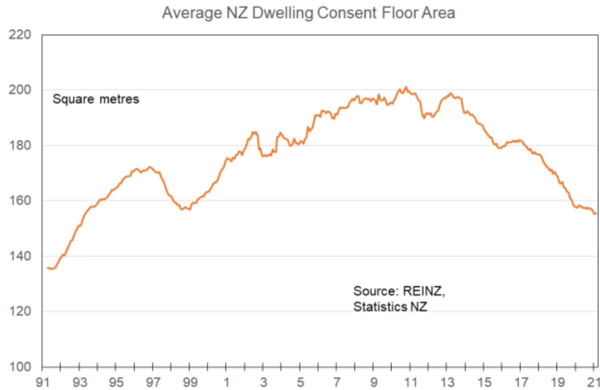
In 1990 the proportion of the working age population in employment was 58%. It is now 68%. The employment rate has risen.



Note the fall in the employment rate during the reform period of 1986 into 1992 as people in sectors previously subsidised by other people's taxes and protected from imports (keeping the cost of living high) lost their jobs.

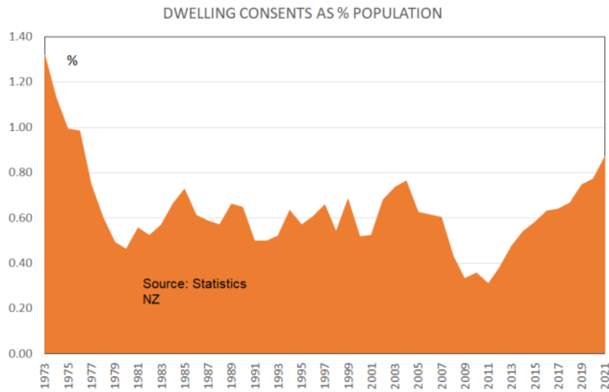
Larger dwellings

On average, the size of the average new dwelling being built was just under 140 square meters in 1991. The size peaked at over 200 square meters in 2010, and now the average new dwelling size is 156 from a still high 180 four years ago. It will take a long time for newly constructed smaller dwellings to have much impact on the average size of the overall dwelling stock.



Post-GFC construction collapse

New Zealand did not go into the GFC of 2008-09 with excess construction of houses. But because the sector fell so strongly offshore, we saw a retreat of willingness to build here and of the willingness of lenders to fund construction. So, as the following graph shows, there was a sharp fall in consent numbers relative to our population after 2008 and levels remained unusually low until 2015.



Save for retirement

For over three decades governments in New Zealand have been warning people of the coming fiscal strains as Baby Boomers retire. We have been told we need to save and invest to help fund our own retirement. These campaigns of encouraging investment have driven a larger number of people to become property investors than would otherwise have been the case.

Foreign buyers

Our houses have become an international investment asset as more migrants have come to New Zealand, and people offshore generally have sought investments outside their country – outside of mainland China in particular.

Miscellaneous

The surge in international tourism and development of apps like Airbnb has seen a portion of our housing stock taken out of the ownership and long-term rental market. However, with international tourism currently non-existent and perhaps set for some extended years before full recovery, reversal of this factor may have already occurred.

The average dwelling built these days has to be constructed to a far tougher and more expensive set of criteria than in the past. Houses have to meet enhanced standards regarding earthquake strength, energy efficiency etc.

Council fees for construction are much higher than before with regard to developers' contributions, consent fees, inspection fees etc.

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.

The Reserve Bank met market expectations by raising the official cash rate 0.25% to 0.5% yesterday. They also met expectations in expressing a view that rates will need to go higher but that they don't plan doing so at a hurried pace.

We've heard this music before at the start of a monetary policy tightening cycle and it did not end well for borrowers who took the Reserve Bank's comments at face value over 2004-06.

Around the world inflationary pressures are growing and while it still looks like a low possibility, more people are talking about stagflation. This is the situation seen back in the 1970s when inflation was high but the pace of economic growth slow.

This can happen when the main cause of a lift in inflation comes from supply shortages rather than a strong shift up in demand. There would probably not be so much talk about stagflation were it not for the shortages of labour worldwide which are causing wages growth to accelerate in a manner not seen since the GFC of 2008-09.

The growth in wages will help support household incomes, and that combined with high job security, higher wealth, and higher bank deposits, will tend to underpin good growth in household spending over the next couple of years.

But because of supply chain problems the ability of consumers to shop around for alternative products when the one they want has just been lifted in price, is the most constrained also since before the GFC.

This means businesses have regained a lot of the pricing power which they lost some years back to the internet and search engines.

The key components of some version of the wage-price spirals of the 1970s – 80s are falling into place. People will need to give thought to what it means for their levels of debt, their degree of interest rate fixing, and the portfolio assets they are exposed to as inflation and interest rates rise.

My expectation for the one-year rate in October each year is shown in the first column of the table below. I focus on that rate because there are many people who have fixed one-year repeatedly since 2009 and the strategy has worked very well.

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 six biggest lenders I track. Note, usually the Australian-owned banks have rates above the minimums shown here offered usually by KiwiBank and TSB.

	Forecast 1 year rate	Rolling average rates	Current fixed	
2021	2.79		2.79	1 yr
2022	4	3.40	3.15	2 yr
2023	4.5	3.76	3.49	3 yr
2024	4.4	3.92	3.89	4 yr
2025	4	3.94	3.99	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 3.40%, three years 3.76%, four years 3.92%, and five years 3.94%.

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.

This week, wholesale interest rates in New Zealand have ended basically where they were last week. Meh.

If I were a borrower, what would I do?

Personally, I have concerns about inflation over 2022 and 2023 and the Reserve Bank eventually having to play policy catch-up after initially downplaying the need for higher rates.

Therefore, I would like to hedge my rate rest risk for at least the next three years and would probably fix for that term at the current 3.49% rate. The five-year rate of 3.99% might attract some people – but not in any great numbers until inflation worries are a lot stronger. But by then these people will be too late as the five-year rate will be much higher than it is now.

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