RODNEY'S RAVINGS take an open-minded and at times irreverent look at topical economic and housing issues. Unlike our pay-to-view reports that are for the eyes of subscribers only, the **RAVINGS** are free and you may forward them to other people. You can signup to the **RAVINGS** on our website – http://www.sra.co.nz/lists/. This distribution list will occasionally be used to make people aware of new services we have to offer and educational seminars.

RODNEY'S RAVING

How to minimise mortgage interest costs - a new service

EXECUTIVE SUMMARY

"Don't borrow so much" probably isn't the answer you are looking for. Rule No. 1 is to ask your current lender for discounts on the listed rates and Rule No. 2 is to shop around for a better deal. Setting aside these every-relevant rules, this Raving presents a range of insights relevant to minimising interest costs and is an introduction to a new service we will be offering (i.e. providing accessible, quality and eminently affordable advice for mortgage borrowers). For information about the new service use the following link to our website - http://www.sra.co.nz/pdf/MortgageStrategyService.pdf - but not until earlyish February).

For many borrowers the objective will be to minimising interest costs over the life of the mortgage. A consideration for some will be minimising the risk of paying significantly higher interest costs than currently because to do so would be unbearably painful. For some the timeframe for minimising interest costs could be only the next 1-2 years. In the new service all these factors will be taken into account, but in this Raving I discuss this issue in the context of borrowers who want to minimise average interest costs over at least the next five years. The key considerations are: (1) the current relativities between the range of fixed rates and the floating rate; and (2) the odds that these rates will be higher or lower in the future.

Things would be straight forward if you could rely on the economic forecasters' interest rate predictions in deciding whether to fix, float or adopt a mixed strategy (e.g. having some fixed for 6-months and some for 2-3 years). But history says you can't. Consequently, Rule No. 3 is to be wary of what the economic forecasters are predicting for interest rates.

What the Reserve Bank (RB) does with the OCR plays a major part in driving the floating and short-term fixed rates but also plays a part in driving all fixed mortgage rates. Unfortunately, past experience shows you shouldn't take much notice of what the RB has signalled it plans to do with the OCR over the next few years. Consequently, Rule No. 4 is to seek the best available advice on the game the RB is playing and what this implies for interest rates over the next few years.

Even before the financial crisis had a major impact on interest rates global developments at times played a part in determining especially medium-term and longer-term fixed mortgage rates. Consequently, Rule No. 5 is to be opportunistic when global developments deliver the opportunity to lock in cheap fixed rates.

Finally, I would like to thank a blogger for promoting our housing reports (see page 7).

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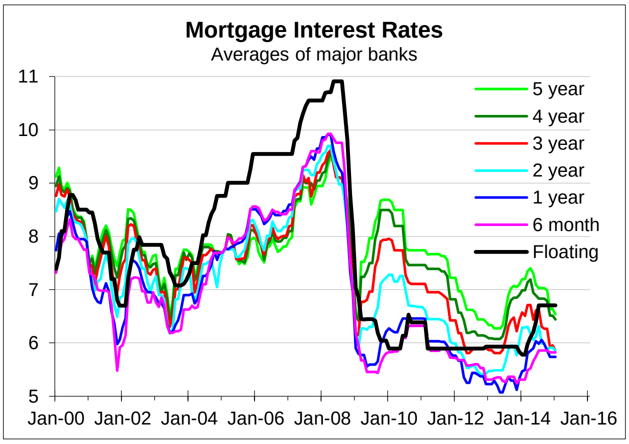
 January 2015

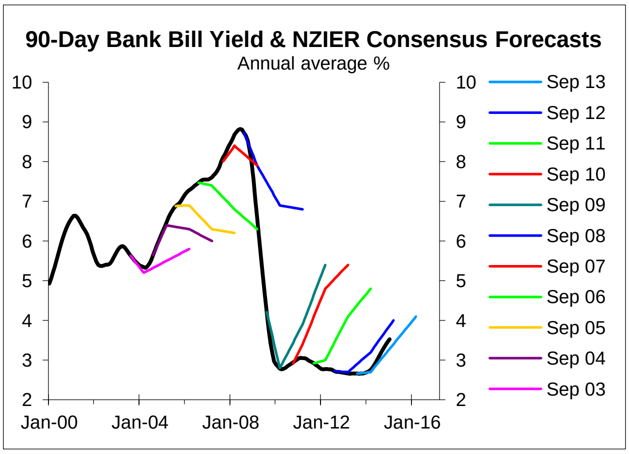
Rule No. 3 - Be wary of what the economic forecasters are predicting



Things would be straight forward if you could check out what the economic forecasters like the Reserve Bank (RB) and bank economists were predicting and use that as an input into your decisions about fixing, floating or adopting a mixed strategy to borrowing (i.e. diversifying your borrowing between different maturities, like having some fixed for 6-months and some for 2-3 years). Unfortunately, doing so could be the worst thing you did.

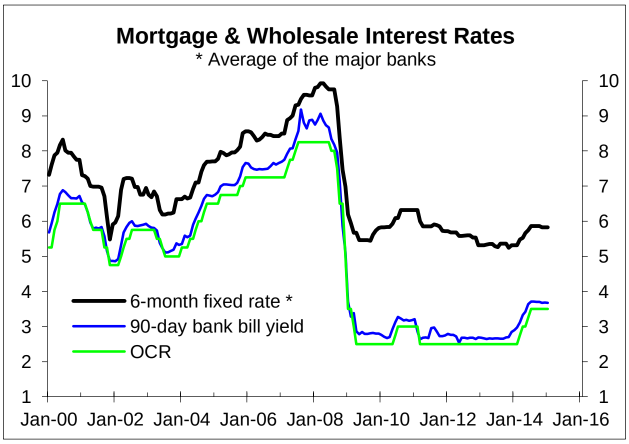
Before interest rates increased dramatically between late-2003 and early-2008 it would have been a great idea to fix rates for a reasonably long period (see the adjacent chart for mortgage rates). But if you took notice of what the economic forecasters were predicting for interest rates over this period you wouldn't have locked in medium-term and longer-term fixed rates and as a result you would have been burnt by higher interest rates.

Each quarter NZIER surveys around 10 of the economic forecasters, including the RB and the bank economists and produces the consensus forecasts (i.e. the average predictions of the forecasters). In September 2003 the average prediction for the key short-term wholesale interest rate relevant to mortgage interest rates - the 90-day bank bill yield - was for it to increase only slightly over the next two years (see the bright pink-purple line in the chart below labelled "Sep 03"). While mortgage interest rates marched ever higher over the subsequent five years, the economic forecasters on average predicted that the 90-day bank bill yield would fall (see the Sep 04, Sep 05 and Sep 06 lines in the chart below). Only the September consensus forecasts are shown in the chart below so it isn't too cluttered.



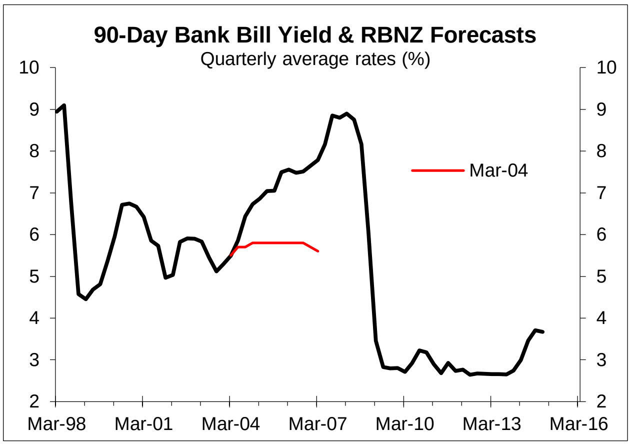
When it was most opportune to lock in longer-term or medium-term fixed rates the interest rate forecasts by the economic forecasters provided no warning that this was a good idea. Even worse, by predicting that the 90-day bank bill yield would fall during much of this period the implication was that you shouldn't have locked in medium-term or longer-term fixed rates at all. Eventually rates fell, but for quite some time locking in at least medium-term fixed rates was the best option.

The 90-day bank bill yield largely moves with the OCR and is the key wholesale interest rate of relevance to especially the floating and shorter-term fixed rates like the average 6-month fixed rate offered by the major banks (see the bottom chart).



For most of the period since 2009 the smart thing to do was to fix for short-term periods (e.g. 6-month or 1-year fixed rates in the case of mortgage borrowers), with these rates generally having been the lowest (see the top chart). However, the economic forecasters have persistently predicted sizeable upside in the 90-day bank bill yield since 2009 (see the Sep 09, Sep 10, Sep 11, Sep 12 and Sep 13 lines in the middle chart). Having not predicted the substantial upside in interest rates between 2003 and 2008 the economic forecasters were determined not to make the same mistake again, which meant they made an equally bad mistake. If you had acted on what the economic forecasters were predicting for interest rates since 2009 you would have often opted to lock in medium-term if not at times longer-term fixed rates, which proved to be the wrong thing to do again.

Rule No. 4 - Seek the best available advice on the game the RB is playing

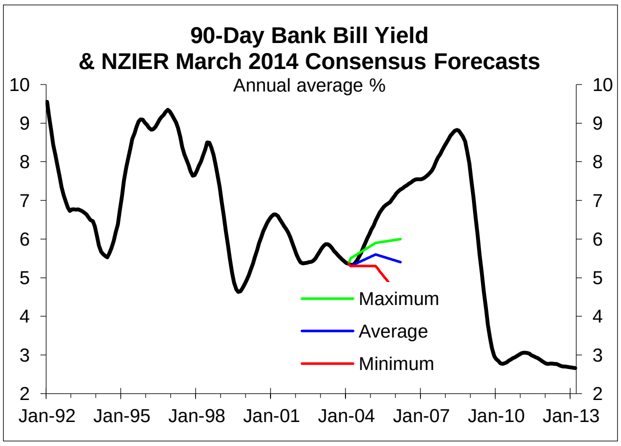


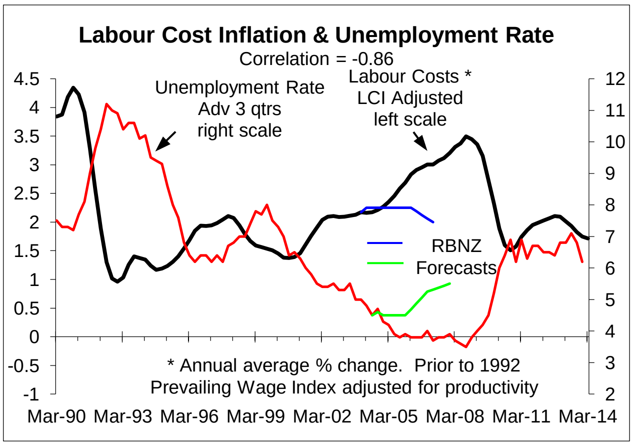
It is critical to understand what game the RB is playing because of the risk the central bank is making a major mistake that will burn uninformed borrowers. The mid-2000s is one good case study.

In January 2004 the RB delivered the first of 13 OCR hikes that contributed to the 90-day bank bill yield increasing from not much above 5% in early-2004 to a peak of around 9% in early-2008 (adjacent chart). This drove the large increase in mortgage interest rates shown in the top chart on page 3 that meant locking in fixed debt early in this period would have been a great idea.

In the March 2004 Monetary Policy Statement the RB left the OCR unchanged and signalled the risk of "a small further increase in interest rates". This was reflected in the RB predicting virtually no further upside in the 90-day bank bill yield over the subsequent three years (see the red line in the chart above).

Similarly, the average prediction for the 90-day bank bill yield in March 2004 by the 12 economic forecasts surveyed by NZIER was for little change (see the blue line, left chart below). The green line in the left chart below shows the highest predictions for the 90-day bank bill yield by any of the 12 forecasters and the red line shows the lowest predictions. None of the 12 forecasters warned of the risk of major upside in interest rates that would warrant borrowers locking in longer-term fixed debt. The 12 forecasters NZIER surveyed in March 2004 were: ANZ, ASB, Berl, BNZ, Deutsche Bank, First NZ Capital, NBNZ, NZIER, Reserve Bank, Treasury and UBS Warburg. It was about 18 months before this I stopped attending the regular gathering of the economic forecasters in Wellington because they were so out of touch with reality. By contrast, at this time I was warning ASB Corporate clients of the risk of major upside in interest rates.





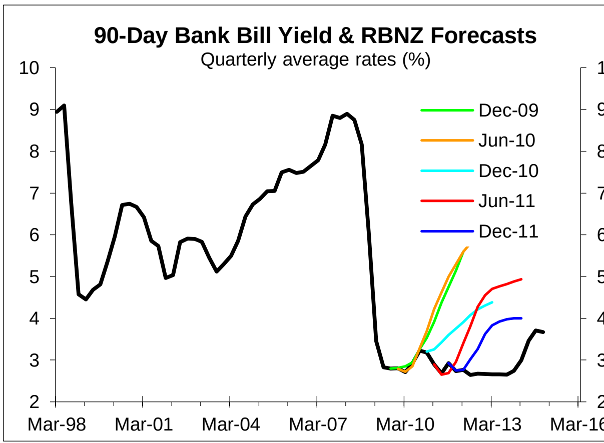
The game being played by the RB in March 2004 is illuminated by the right chart above that goes to the heart of the medium-term inflation risk the RB is supposed to focus on most. The black line shows annual inflation in the productivity-adjusted measure of labour cost inflation the RB focuses on most for good reason (left hand scale). It measures how much labour costs have increased relative to the rate of productivity growth, with increases above the level justified by productivity growth pushing up production costs per unit produced. Increases in unit production costs result in producers putting up selling prices. Effectively, if this measure of labour cost inflation is allowed to increase above 1.5-2% it will be self-defeating because the temporary increase in wage-salary income will be undermined by price increases, while the resulting higher inflation will spur the RB to eventually hike the OCR.

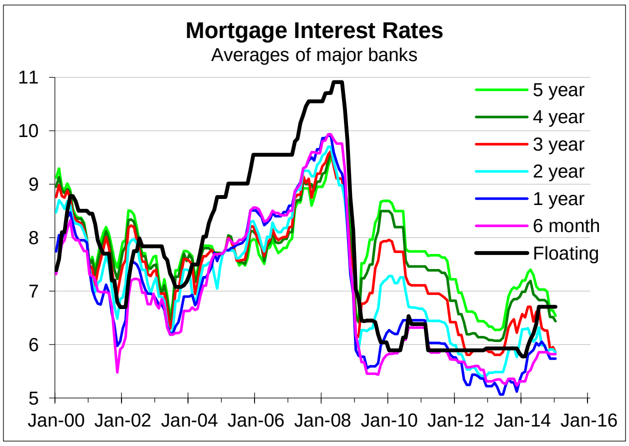
The chart shows a strong inverse relationship between productivity-adjusted labour cost inflation and the unemployment rate. The best fit is with the unemployment rate advanced or leading by three quarters. The chart also shows the RB's March 2004 predictions for the unemployment rate (the green line) and productivity-adjusted labour cost inflation (the blue line). The RB was incorrectly predicting that the unemployment rate would increase when it subsequently fell to a level that gave too much bargaining power to employees vis-à-vis employers, leading to higher labour cost inflation and, in time, higher CPI inflation. The RB was at least consistently wrong in that it was also predicting that labour cost inflation would fall back below 2% when instead it headed well above the level that is consistent with keeping CPI inflation within the RB's 1-3% medium-term target range. The RB was assuming away the inflation threat.

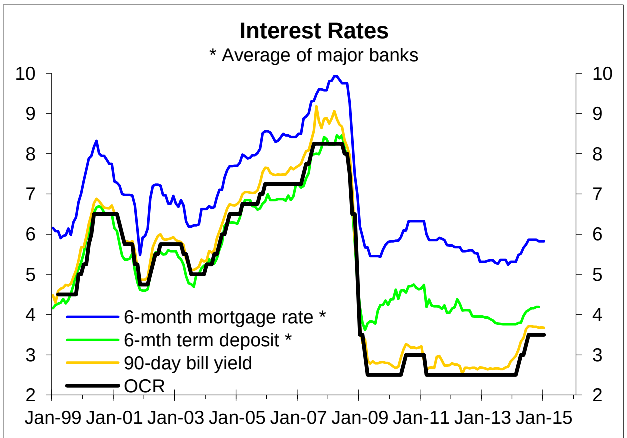
The bank economists and other economic forecasters went along for the ride. By contrast, I warned Governor Bollard in person of the risks of the game he was playing and the result of this and subsequent warnings was my being removed from the RB's Christmas card list despite having once been a member of the Monetary Policy Committee. For some strange reason central bank governors don't seem to like being told they are making a major mistake. They would rather try some misguided experiment and, if put under lots of pressure down the track, acknowledge having made a mistake.

The period in the first three years after the financial crisis stuck in late-2008 provides another useful case study. The economy started to recover from the crisis in 2009 and by December 2009 the RB was predicting imminent and major upside in the 90-day bank bill yield (lime green line, left chart below). If you took notice of the December 2009 predictions you would have locked in at least 2-3 year fixed rates even though they were above the floating and short-term fixed rates at the time (right chart below). For a relatively short period I also made the mistake of assuming interest rates could rebound quickly, but the RB continued to predict upside in the 90-day bank bill yield that didn't eventuate over the next two years (see the various predictions in the left chart below), while I started to warn that interest rates wouldn't increase anywhere near as much as the RB and economic forecasters more generally were predicting.

During 2010 and 2011 the RB continued to predict sufficient upside in the 90-day bank bill yield to justify borrowers locking in medium-term if not at times long-term fixed rates while the best thing to do was to take advantage of the low short-term fixed rates. Again, taking notice of what the RB was predicting for interest rates would have resulted in higher than necessary interest costs.

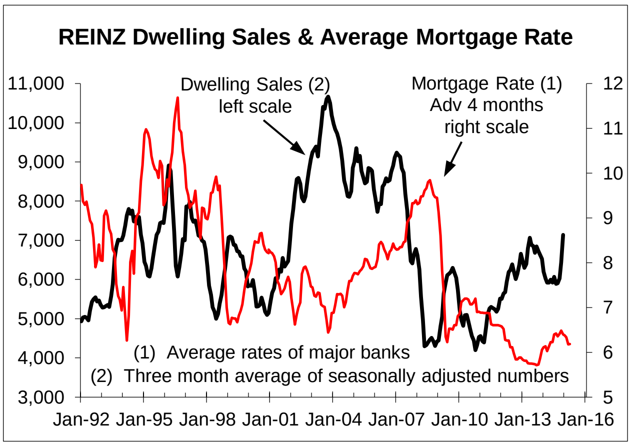


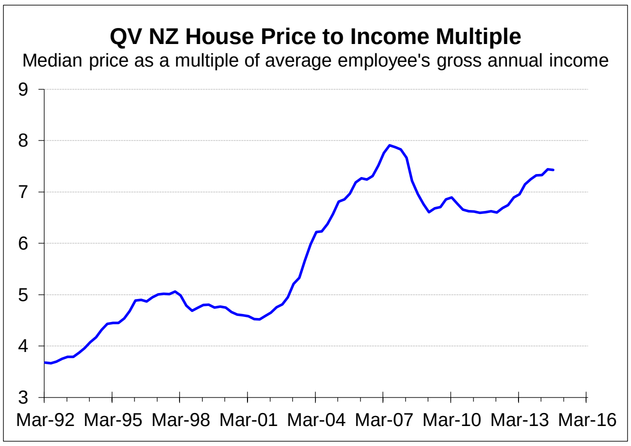


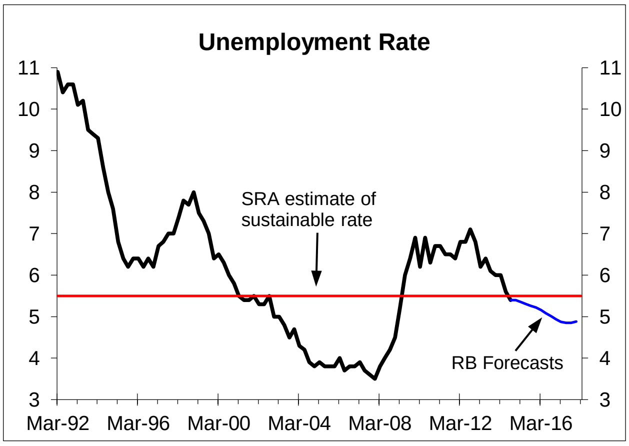


The RB and economic forecasters were much too slow to take on board that the financial crisis had resulted in some structural changes that meant the OCR and 90-day bank bill yield could remain much lower than was the case prior to the financial crisis without fuelling an inflation problem. The adjacent chart tells part of the story. Prior to the crisis the average 6-month fixed mortgage rate offered by the major banks averaged 1.5% (150 basis points) above the 90-day bank bill yield, but this gap more than doubled after the financial crisis, although it has started to narrow again. This occurred partly because the RB forced banks to focus more on borrowing from local retail depositors, which resulted in banks offering higher term deposit rates relative to the 90-day bank bill yield and OCR (see the chart above). This significantly undermined the need to the 90-day bank bill yield to increase significantly.

Secondly, despite the average mortgage rate offered by the major banks heading well below historical average levels between 2010 and 2013, the housing market didn't experience a mega-boom of the sort experienced in the mid-2000s (left chart below). Dwelling sales reported by REINZ did respond to the fall in interest rates, but the super low interest rates didn't fuel a mega-boom that required many OCR hikes to tame. A range of factors were behind this but one factor was unaffordable housing. Even after the fall in house prices in 2008-09 the national average house price remained elevated compared to the national average employee's income (right chart below). This somewhat reduced the need for OCR hikes.







Most importantly in the context of OCR decisions, the 2008-09 recession that was partly a result of the financial crisis resulted in a large increase in the unemployment rate (adjacent chart). In 2010, 2011, 2012 and even 2013 the unemployment rate remained above our estimate of the "sustainable" rate (i.e. the rate consistent with CPI inflation remaining around the mid-point of the RB's 1-3% medium-term target range). This meant there was spare capacity in the labour market so there wasn't the need for either imminent or significant OCR hikes of the sort justified to tame a medium-term inflation threat. So there wasn't a case from a monetary policy perspective for locking in medium-term or longer-term fixed rates in 2010 and 2011.

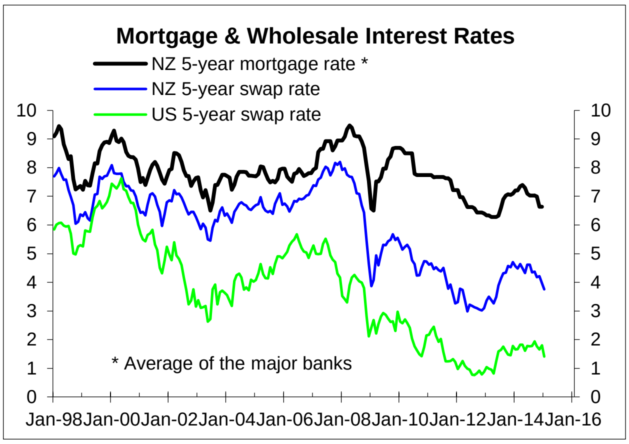
However, things are starting to change on this front with the unemployment rate having fallen a little below our estimate of the sustainable rate in the 2014 September quarter, while we expect it to fall more than the RB is predicting over the next couple of years. So while there hasn't been a strong case for locking in medium-term fixed rate debt from the context of the game the RB is playing for most of the last six years things are changing on this front as discussed in our monthly economic reports (use the following link for info about these reports - http://sra.co.nz/index.php/interesting-times) and in our six-weekly monetary policy reports (visit http://sra.co.nz/index.php/monetary-policy for info about these reports). As part of the launch of the new mortgage service we are offering discount pricing on these reports or three-month free trials.

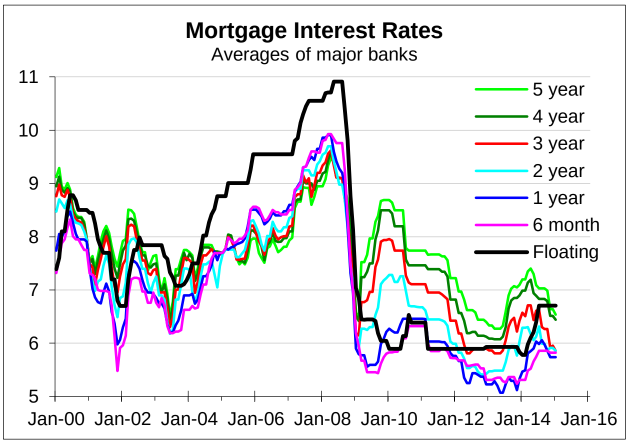
The bank economists are good at advising what the RB will do at the next OCR decision and do some other useful things. But understanding what the RB will do at the next OCR decision is of little relevance when deciding if it is a good idea to lock in medium-term and longer-term fixed rates. Equally, taking notice of what the RB or economic forecasters more generally are predicting for interest rates is of little use given the poor forecasting track record. What is required is quality analysis of whether the RB is right or wrong about medium-term inflation prospects (i.e. the analysis contained in our monthly economic and six-weekly monetary policy reports). The same analysis will be behind our recommendations to mortgage borrowers in the new **Mortgage Strategy** reports. For more info about the new reports use the following link to our website - http://www.sra.co.nz/pdf/MortgageStrategyService.pdf - but not until earlish February 2015.

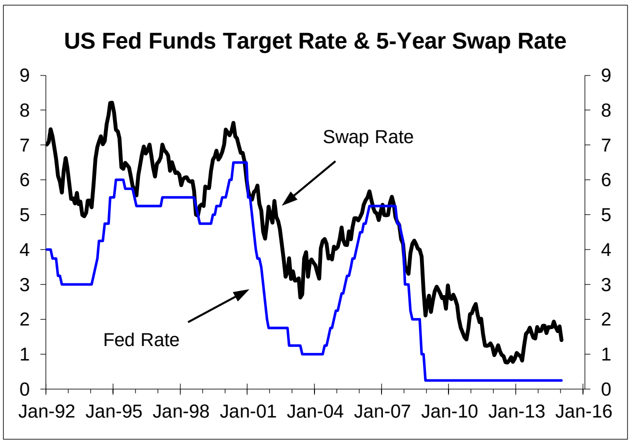
Rule No. 5 - Be opportunistic when global developments deliver cheap fixed rates

While the gap between the two widened after the financial crisis, the average 5-year fixed mortgage rate offered by the major banks still moves in synchrony with the 5-year swap rate (i.e. the benchmark 5-year wholesale interest rate), as shown in the left chart below. The chart also shows a link between the NZ and US 5-year swap rates, although the gap between these two has changed quite a bit at times. This means global developments that impact on especially US interest rates like the 5-year swap rate have a bearing on NZ fixed mortgage interest rates. Theoretically the link is via the impact global developments have on expectations about the future level of the OCR, with the NZ 5-year swap rate linked to this.

A major fall in US interest rates in 2002-03 played a part in driving down NZ fixed mortgage interest rates to the extent that in mid-2003 4-5 year fixed rates were both low by historical standards and not much above the cheapest available rates that at the time were the 6 month and 1-year fixed rates (see the right chart below). The risk of upside in the OCR and in mortgage interest rates as a result of the RB's misguided experiment discussed on page 3 combined with the adverse US/global developments to create one of the best ever opportunities to lock in cheap longer-term fixed mortgage interest rates.







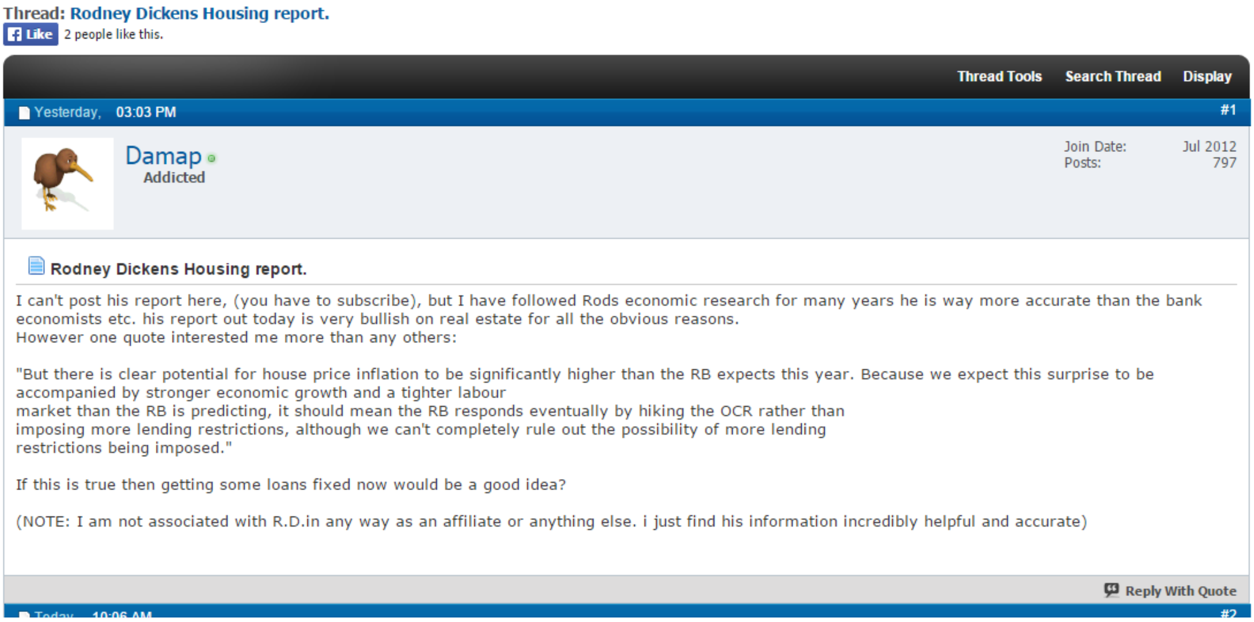
Key to the fall in the US 5-year swap rate in 2002-03 was the Fed cutting the Fed Funds Rate dramatically (adjacent chart), with the fall in US interest rates playing a key part in driving a US and global housing boom and a subsequent large interest in US interest rates. Understanding the at times mad games played by the likes of the Fed is also important in deciding whether to fix or float.

Fear about the escalating crisis in the Eurozone played an important part in the fall in US wholesale interest rates in 2011 and 2012 that contributed to lower fixed mortgage interest rates in NZ. The result was the NZ 2-year fixed rate falling to around the levels of the 6-month and 1-year fixed rates as shown in the right chart above. This was another example of adverse global developments creating an opportunity to lock in reasonably favourable fixed rates. Equally, when global developments improve it will generally contribute to higher NZ medium-term and longer-term fixed rates and at times to higher short-term fixed rates. Reflecting the importance of global developments to interest rate prospects, our monthly economic reports focus almost as much on economic growth prospects in the major economies as on NZ economic prospects and these insights will be incorporated in the **Mortgage Strategy** reports.

The recommendations in the new reports will be based on the rules presented in this Raving and any other relevant insights I have at the time. For clients of our other pay-to-view reports access to the **Mortgage Strategy** reports will be free in 2015. For people not currently subscribing to any of our reports the new reports will cost $25+GST per report (visit http://www.sra.co.nz/pdf/MortgageStrategyOrderForm.pdf for an order form and payment details, but not until earlish February 2015).

An anonymous recommendation of our services

The following was posted as a blog on www.propertytalk.com last week:


Thread: Rodney Dickens Housing report.
Like 2 people like this.

Thread Tools Search Thread Display

Yesterday, 03:03 PM #1

Damap
Addicted

Join Date: Jul 2012
Posts: 797

Rodney Dickens Housing report.

I can't post his report here, (you have to subscribe), but I have followed Rods economic research for many years he is way more accurate than the bank economists etc. his report out today is very bullish on real estate for all the obvious reasons.
However one quote interested me more than any others:

"But there is clear potential for house price inflation to be significantly higher than the RB expects this year. Because we expect this surprise to be accompanied by stronger economic growth and a tighter labour
market than the RB is predicting, it should mean the RB responds eventually by hiking the OCR rather than
imposing more lending restrictions, although we can't completely rule out the possibility of more lending
restrictions being imposed."

If this is true then getting some loans fixed now would be a good idea?

(NOTE: I am not associated with R.D.in any way as an affiliate or anything else. i just find his information incredibly helpful and accurate)

Reply With Quote

The blogger is clearly subscribing to our **Housing Prospects** reports (use the following link to our website for info on these reports - http://sra.co.nz/index.php/housing-prospects) and it would be nice if he/she contacted me. The **Housing Prospects** reports provide the best available advice on house price prospects at the national level, how housing in general stacks up as an investment option and near-term house price prospects for 24 cities/districts. To find out whether I concur with the bloggers comments about locking in fixed mortgage rates now I recommend you buy one of the **Mortgage Strategy** reports when they become available in February or sign up for any of or other pay-to-view reports and receive the **Mortgage Strategy** reports on a complimentary basis in 2015. Predicting interest rates isn't easy and these reports will come with the normal disclaimer (i.e. we provide our advice in good faith but can't guarantee that unexpected events or strange behaviours by the likes of central banks won't undermine our recommendations).