REFERRER NEWS

with Tony Alexander

Credit squeeze improves rates outlook

The outlook for interest rates here and overseas has become interesting over the past four weeks since I wrote my last column. In the second week of March a medium sized regional bank in the United states, Silicon Valley Bank, required a bailout from the US government because of the quickest run on a bank's deposits ever seen.

The problem for the bank was not one of bad lending but of having a depositor base very focused on the tech sector. The deposits were very lumpy and the people doing the depositing have a high degree of connectivity. This meant that as soon as one or two got concerned about the ability of the bank to quickly payout their deposit, communications with others led to a very large withdrawal of funds.

All of a sudden the bank found itself unable to quickly process the deposit requests and they closed down. Their assets have now been taken over by another bank and the big question around the world following issues for Credit Suisse in Switzerland and two other banks in the United states is whether this represents the start of a new global financial crisis.

The chances are it does not because of the very specific nature of problems affecting SVB and the other two United States banks. Nonetheless, this is where it gets interesting. There is evidence that with banks newly focusing on making sure their depositor bases are more stable there has been a decrease in willingness to lend to people looking to borrow. A reduction in credit availability of unknown magnitude in coming months will sap some economic growth in the United States predominantly but also to lesser degrees in other economies.

This reluctance to lend is in effect a tightening of monetary policy and in that regard reduces the pressure on central banks to keep raising their interest rates. This is why we have seen wholesale interest rates fall quite substantially in the United States with the markets pricing in only one further increase in the Federal Reserve's cash rate and expecting that rates will in fact start to be cut by the end of this year.

That seems too optimistic and we have to acknowledge that the bias in financial markets is towards believing that inflation is under control and central banks will be able to ease quite comfortably not too far down the track. And that is the bigger picture we need to focus on. Inflation rates remain much too high around the world and we cannot at all as yet be confident that interest rate increases so far will completely do the job of getting inflation back towards 2% here and overseas.

This high level of uncertainty means that we could continue to see high volatility in bank wholesale funding costs and that means we need to be cautious with any expectation of cuts in bank lending rates here in the near future.

No bank wants to cut its fixed interest rates across the board to then experience a jump in the wholesale cost of funds because of some disturbance overseas and have to increase those rates again very quickly. There is reputational damage in such moves and for that reason we shouldn't expect a repeat of the general cuts in bank fixed mortgage rates of two months ago for a while.

In particular, here in New Zealand inflation expectations are still too high and the key factor to keep in mind is that the Reserve Bank will be losing all hope that the unemployment rate will comfortably head towards almost 6% over the next two years. Their forecast of such an extreme easing of pressures in the labour market always looked too optimistic from their point of view, and pessimistic from the point of view of the household sector, and the degree of wages pressure is likely to be more than they have assumed in their economic modelling.

This means that we are unlikely to see our Reserve Bank sending any soothing signals regarding inflation being comfortably on the track towards 2% for a few more months. But, as noted above, the financial markets have a bias towards believing things are either under control or very close to being under control and for that reason the potential for further increases in bank fixed wholesale funding costs is not necessarily that high.

When might we see fixed mortgage rates falling on a generalised basis? Possibly before the middle of the year which coincidentally is likely to be roughly the time the housing market is close to bottoming out. At the moment I can see from my monthly surveys of real estate agents and mortgage advisors in particular that while first home buyers are back in the market looking to make a purchase the investors are still standing well back and owner occupiers are also reluctant to move.

In both January and February the level of turnover in the real estate sector in New Zealand was the lowest on record since records started in 1992. Consumer confidence is weak, especially since the Reserve Bank talked about recession on November 23, and the media continue to highlight negative elements in the economy.

But we have to remember that there are many positive trends such as strong inbound tourism, soaring net migration inflows, high job security, strong underlying growth in some sectors such as healthcare and aged care not to mention the space industry, plus the government is likely to increase spending ahead of a general election which looks like the toss of a coin.

Borrowers should keep an eye out for banks offering some short lived special deals as around half of all fixed rate mortgages come up for rate re-fixing in the coming 12 months. But as mentioned last month, while the majority of people are quite happy fixing for just one year there remains a lot of uncertainty regarding inflation here and overseas. And in the absence of a new financial crisis it is unreasonable to expect that interest rates will fall as quickly as they did after the 1997 - 98 Asian Financial Crisis and the 2008 to 2009 Global Financial Crisis.

Borrowers should curb their enthusiasm regarding interest rate declines but can reasonably believe that we have already seen the peaks for fixed mortgage rates in New Zealand.

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By Tony Alexander