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SMARTER BETTER BUSINESS

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ARTICLE OVERVIEW

When will we see interest rate relief? It's a common question. What if they were to rise? If you are reliant on interest rates coming down a long way, you might have problems across your business or investment strategy that need addressed. There is nothing wrong with hoping lower interest rates are around the corner, and they might be. Hope is not a sound strategy though.

Immaculate disinflation, that combination of receding inflation and limited economic damage (i.e. the unemployment rate not moving up too far) captured market sentiment in late 2023 and early 2024. Interest rate relief was around the corner. Markets were anticipating in mid-January the Official Cah Rate (OCR) could fall 150 basis points by mid-2025.

"We've got this" sentiment was rife when it comes to getting rid of inflation.

The inflation thief, who robs consumers of purchasing power, and steals business margin as cost increases get harder to pass on, is far from being put back in jail.

Non-tradable inflation is New Zealand – the domestic pulse of inflation, and the one the Reserve Bank exerts most influence over stands at 5.9%. The headline inflation rate is 4.7%, still more than 2.5 times the target. Commentators and pundits have differing views.

Those calling for lower interest rates, and sooner, point to China, who is exporting deflation and experiencing financial pressures across housing and financial assets. Monetary policy works with a lag of around 18 months and central banks need to be mindful of keeping rates high for too long. There are $200 billion of mortgages to refinance in New Zealand over 2024 so more pain is coming. The NZ economy is already in recession. The earnings reports out of listed companies are becoming glummer.

Some believe interest rates might need to be higher. Inflation is proving to be sticky. The economic environment is less disinflationary that we have been used to as globalisation unravels, geopolitical tension puts pressure (and costs) on supply chains, demographics (population ageing) encourage spending over saving, climate change carries higher costs, and governments continue to borrow and spend. Unemployment rates are still incredibly low around the globe, and wage growth (a cost that adds to inflation) is not consistent with 2% inflation. Countries experiencing weak productivity growth face higher cost pressures.

Then there is the middle ground, where central banks keep rates where they are for the next year or so, and maybe rates come down in 2025.Spin the interest-rate roulette wheel, which is hardly helpful.

So, can we agree on anything?

There is widespread agreement we need to remain focused on inflation, which includes lowering business cost inflation too and eventually easing pressure on margins. Unfortunately, we do not like the medicine to achieve it as it involves consumers tightening the belt and sub-par growth. Interest rates higher than normal is the mechanism to achieve it.

There is a consensus interest rates are above their neutral or equilibrium level. Think of this as the average rate across the business cycle or where a central bank neither has the foot on the accelerator or the brake. The foot is on the brake at present. So, it seems reasonable to assume a few years out interest rates will be lower as the foot is taken off the brake. We are now seeing neutral interest rate estimates rise though due to numerous factors including shifts in savings behaviour, a less globally connected world, and greater government spending/borrowing.

A rising neutral rate limits have far actual rates can be expected to normalise to. A defining feature of the past 20 years was falling neutral interest rates, which allowed actual interest rates to trend down and fluctuate around lower levels. That helped propel asset prices higher over a long period. The Reserve Bank of New Zealand has now started to lift their estimate of the neutral OCR. So, while we can anticipate lower interest rates, they are likely to be higher than seen over the past decade.

Without that trending interest rate tailwind we saw over 20 years, the cashflow, fundamentals and ability to add value become defining features of wealth creation. The trend lower in interest rates diverted attention from some good old basics. The lack of an interest rate trend might help refocus on some of those basics.

Maybe we focus and talk about interest rates too much. Financial markets hang off every central bank world looking for hints on direction.

If the next 100 basis point movement in the OCR is going to have a major impact on a business, I'd be questioning the business model.

That does not mean we should ignore interest rates. Apply the sleep test. If any pending interest rate decision keeps you awake at night, I'd be inclined to take more certainty, even if it costs more. But do not under-estimate the power of getting the basics right and letting interest rates just do what they need to do.