MacKay ON MONEY (AND OTHER THINGS)

BY AUTHORISED FINANCIAL ADVISER CHRIS MACKAY

Interest. Got your attention?

"Interest" means lots of things, but when it relates to money, here's what the Collins dictionary guys say: "a charge for the use of credit or borrowed money – such a charge expressed as a percentage per time unit of the sum borrowed or used".

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Disclosure statements are available on request and free of charge.

We can choose to be dismissive and not – well you know – interested in interest and its association with mammon and all this conjures up. Worshipping mammon as the New Testament teaches isn't very cool. Just to remind you, according to one definition "mammon is the personification of riches and greed in the form of a false god and is a source of evil and corruption".

And of course even though money isn't bad in itself Saint Paul told Timothy: "For the love of money is a root of all kinds of evil. Some people in their eagerness to get rich, have wandered away from the faith and caused themselves a lot of pain". The oft misquoted and incorrect version is money is the root of all evil. Not right. Loving it's the problem!

But the truth is, whether we like talking about it or not and as long as we don't love it, we are all very influenced by money and one of its consequences, which tends to be….you guessed it, interest.

Wikipedia defines interest as "a payment from a borrower to a lender of an amount above repayment of the principal sum

(i.e. the amount borrowed). For example, a customer would usually pay interest to borrow from a bank, so they pay the bank an amount which is more than the amount they borrowed; or a customer may earn interest on their savings, and so they may withdraw more than they originally deposited."

John Buchanan Robinson put it this way. "Money is often hired, and the hire paid for the use of it is called interest".

Ok. Get the idea? You all know how it works.

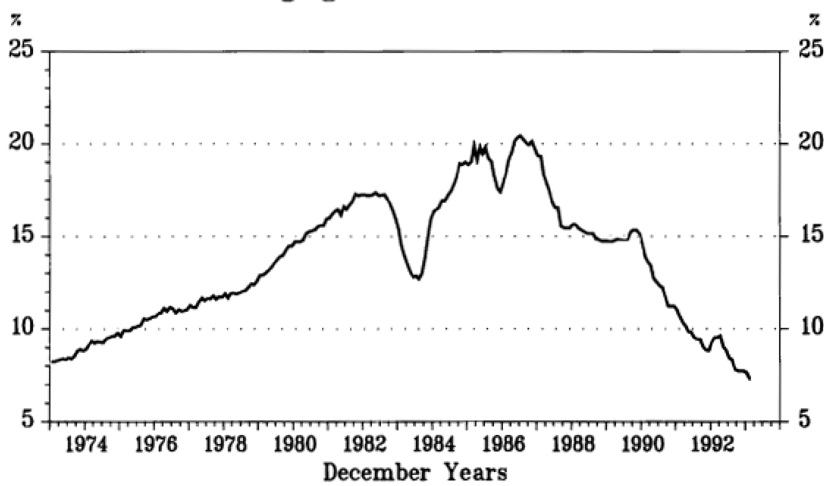
For us boomers, we remember paying interest of 20 per cent for our mortgages in 1987 (see graph below).

And if we had some dough back then, we could invest it at 15 per cent pa or higher.

I remember Gerald Bond, a long time and well respected City Councillor and Branch Manager of Marac Finance in the Hutt, ringing me around the time Muldoon had lost the election to Lange in 1984. Short term (daily or weekly) interest rates spiked to stupid levels when we had the currency speculators correctly betting Roger Douglas would depreciate the NZ dollar when they could kick Muldoon out of Vogel House (another article?). He asked if I had a few spare shekels to invest for a week or two. I don't recall I did but it leads me back to what's going on at the moment although at the other end of the spectrum.

Today in case you hadn't picked up on it, interest rates are extremely low for borrowers and lenders alike.

And according to most commentators most likely they are going to stay that way for some time.



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What does this mean?

It's great for borrowers especially those with a mortgage.

But if you are a retiree, it's not so much fun.

People requiring income to top up their NZ Superannuation are struggling. Whereas a few years ago they could invest their capital and get a before tax 6 or 7 or 8 per cent return, nowadays the banks are offering **an average** of 3 percent for 12 months, around 3.3 per cent for three years and about 3.5 per cent for five years. And that's before the taxman has had a crack at you.

This has a run on effect to how much life insurance Kiwis require too.

Way back when 10 per cent was the norm, in order to generate $50K ongoing annual income for the surviving family, $500K of capital (life insurance) was needed. Today $50K ongoing annual income requires well over a million dollars. And this assumes the mortgage is paid off and other expenses have been paid or allowed for.

Now you may feel nervous about the banks and instead prefer to invest in Government Bonds backed by the New Zealand government. According to the next chart, you can buy a two year Bond at just over 2 per cent per annum or a 10 year Bond which will give you a mind blowing 2.5 per cent per annum. And in 10 years, you'll get your capital back too.

Why are interest rates so low?

Well Reserve Bank Governor Wheeler is charged with keeping inflation in a 1 to 3 per cent range. And inflation remains lower than this. For the March 2016 year, it was 0.4 per cent so the Gov is worried. The traditional solution to controlling inflation is by increasing or lowering the Official Cash Rate (OCR) which is the rate of interest which the central bank (the Reserve Bank) charges on overnight loans to commercial banks.

When inflation goes outside that range, the Reserve Bank increases the OCR and the theory is we all taihoa with spending and inflation comes down.

When inflation is low, like now, they decrease the OCR and so if we are behaving ourselves, we all go out and spend lots of dough because credit is cheap and because we get such a pathetic return from the banks and from Government Bonds. As a result of all this spending, inflation goes up and the good Governor gets all his KPIs ticked off and keeps his job.

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> *"For us boomers, we remember paying interest of 20 per cent for our mortgages in 1987."*

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Let's have a look at the international picture. Basically Graeme Wheeler's counterparts around the world have similar instructions. "Encourage spending and kick-start the economy!"

And they are trying to do this by a weird and off the wall vehicle. They use negative bond yields in an attempt to get people to spend money and buy stuff.

Imagine this. You live in Switzerland and you invest 100,000 Swiss Francs in a 20 year government bond. According to the Wikipedia definition of interest given earlier, you would expect to "withdraw more than you originally deposited". That's only fair isn't it?

However, in Switzerland, if you invested 100,000 Francs for 20 years, at maturity you would receive about 99,000 back. Not bad eh?

Here's a matrix sourced from Harbour Asset Management and Bloomberg which shows a number of countries and their bond yields. The red squares are the ones with the negative bond yields. The green squares are positive bond yields. Apparently, as at July, there is a total of US $13 trillion* worth of global negative – yielding debt!

You can see why Property and Shares are being purchased as alternative assets. Lockable mattresses have also been popular buys as Europeans horde their cash instead of investing it in Bonds to get less back than they started with.

The Matrix: Race to Negative Bond Yields

Country	1-Year	2-Year	3-Year	4-Year	5-Year	6-Year	7-Year	8-Year	9-Year	10-Year	15-Year	20-Year	30-Year
Switzerland	-0.86	-0.89	-0.94	-0.89	-0.85	-0.77	-0.71	-0.60	-0.51	-0.44	-0.18	-0.05	0.10
Japan	-0.26	-0.24	-0.24	-0.25	-0.24	-0.24	-0.24	-0.22	-0.18	-0.13	0.01	0.22	0.30
Germany	-0.54	-0.55	-0.56	-0.51	-0.43	-0.38	-0.31	-0.23	-0.11	0.03	0.12	0.35	0.62
Austria	-0.50	-0.50	-0.44	-0.42	-0.39	-0.22	-0.17	-0.08	0.08	0.22	0.30	0.80	1.06
Netherlands		-0.49	-0.46	-0.43	-0.26	-0.24	-0.12	-0.01	0.12	0.24			0.74
Belgium	-0.51	-0.50	-0.46	-0.41	-0.36	-0.25	-0.15	0.11	0.27	0.42	0.80	0.89	1.33
Finland	-0.53	-0.49	-0.45	-0.33	-0.28	-0.12	-0.07	0.02	0.16	0.33	0.57		0.77
France	-0.49	-0.44	-0.41	-0.33	-0.21	-0.15	-0.04	0.08	0.24	0.38	0.73	1.02	1.21
Sweden	-0.50	-0.63		-0.52	-0.33		-0.06			0.30		1.06	
Denmark		-0.40			-0.17	0.31				0.28			0.73
Ireland	-0.18		-0.31	-0.15	-0.07	0.12	0.29	0.50	0.65	0.72	1.08		1.58
Italy	-0.14	-0.06	-0.02	0.18	0.39	0.58	0.78	0.99	1.20	1.37	1.70	2.02	2.41
Spain	-0.16	-0.11	-0.01	0.22	0.44	0.48	0.71	1.07	1.22	1.41	1.80		2.56
United States	0.57	0.76	0.91		1.20		1.47			1.66			2.46
Australia	1.64	1.63	1.58	1.60	1.72	1.83	1.91	2.00	2.06	2.10	2.34	2.69	
New Zealand		2.09	2.08	2.10	2.11		2.17			2.50			

May 2016
Source: Bloomberg

There are some commentators who reckon NZ is in a great position to use these low bond rates as a way of financing a whole lot of new infrastructure. The government only owes about $75 billion, which is around 30 per cent of GDP.

As a percentage of GDP, 30 per cent is low compared to other developed countries. And in this case, low means better. Australia is over 40 per cent. The US about 75 per cent. The UK 90. Canada 95. Italy 140. Greece 175. And Japan a whopping 225 per cent. By way of comparison, NZ household debt (that's you and me) is around $400 billion or 160 per cent of GDP. This is not so good.

There would be local and international appetite for long term NZ Bonds which are still yielding positive and comparatively high returns.

If we could lock in some long term (say 20 or 30 year) bonds at less than 3 per cent per annum to provide ongoing finance to fund our infrastructure, wouldn't that be smart? The $100 million the Wellington region want government to kick in as their contribution towards our $300 million runway extension effectively would cost a maximum of $3 million a year. Peanuts! A bit less than what our top five public servants collectively earn. And in 30 years, the government could pay back the $100 million principal. It will be a pittance then. At 2 per cent pa inflation, $100 million will have the same purchasing power as $55 million in today's dollars. We would kick ourselves if the Wellington region missed out on a true international airport for just over double the cost the taxpayer is spending on the Haywards Interchange ($43 million).

Anyway, I digress.

Low interest rates are here for some time. Get used to them.

It makes it even more essential for retirees to have diversification (growth assets such as New Zealand, Australian and International Shares, and Property) in their investment portfolios. As a general rule having all one's money in the bank or in Government Bonds isn't going to generate the cash flow superannuitants want and need.

*How much is a trillion? It's a million million (a one followed by 12 zeros) or a thousand billion. In Britain, in former times (possibly when they ran the world and needed big numbers to count their collective wealth) it was one followed by 18 zeros.

These are generalised comments only and should not be taken as personalised advice. Disclosure Statements are available on request and free of charge.

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