The Treasury Hub

THE TREASURY HUB

BANKING AND TREASURY MARKETS

FEBRUARY 2019 REPORT

RBK

1. Executive Summary

1.1 Introduction

This is the first Banking and Treasury Report of 2019 which we bring to you as part of THE TREASURY HUB. It was an active start to the year on many fronts: Brexit continues to dominate matters in Ireland and the UK while the US looks at a possible stalling/slowdown of the economy.

1.2 Markets in a Table: what's up and what's down?

This is a new feature of the report for 2019 to allow a swift view of key indicators

Table 1. Key Metric Movements: 2019 to date

Heading	Metric	YTD move	From	To
Interest	3-m euribor	0.0020%	-0.3100%	-0.3080%
Interest	EUR 3-year	0.0300%	-0.1200%	-0.0900%
Interest	GBP 3-year	-0.0064%	1.1564%	1.1500%
Interest	USD 3-year	0.0620%	2.5580%	2.6200%
FX	EUR/GBP	-2.7410%	0.8996	0.8756
FX	EUR/USD	0.9778%	1.1342	1.1454
Equities	ISEQ	6.3%	5490	5834
Equities	FTSE 100	4.6%	6734	7042
Equities	Dow Industrial	7.4%	23346	25064
Gilts	IE 10-yr	0.0190%	0.875%	0.894%
Gilts	GB 10-yr	0.0000%	1.249%	1.249%
Gilts	US 10-yr	0.0050%	2.686%	2.691%

Please note that the % moves are in green if the metric has moved upwards and in red if it has moved downwards. It is NOT a statement as to whether this is a positive or negative move as one could be a borrower or depositor, a seller or buyer of currency, etc.

1.3 Monthly Feature

Section 5 is our Monthly feature section and this month we focus on the impact of various Brexit scenarios on the Irish and UK economies as forecast by a leading, independent economic consultancy.

1.4 Conclusion

We hope that this report continues to be of both interest and benefit to you. Please let us know if you have a requirement arising from any of the topics discussed herein.

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2. Interest Rate Review

THE BIG TREND IN THE INTEREST RATE MARKETS IN 2019 SO FAR HAS BEEN THE EASING OF RATES, ESPECIALLY IN THE US BUT ALSO, TO A LESSER EXTENT, IN THE EUROZONE (EZ).

While this may be seen as positive for those with debt, in a macroeconomic sense it is likely to be negative as it suggests that economic growth is slowing and, in some countries, faster than others and faster than expected.

We suggest that borrowers ascertain if they can fix rates if they request the bank to do so but that the upward pressure is off for now. From a Eurozone perspective, the gap between fixed rates out to 3 years and floating rates is now marginal. So, current fixed rates may merit consideration as being good value. A hard Brexit would drive them lower again on the markets but whether the banks pass on such dips remains to be seen - contact us if you are considering such a move before you do so.

2.1 EUR short-term rates

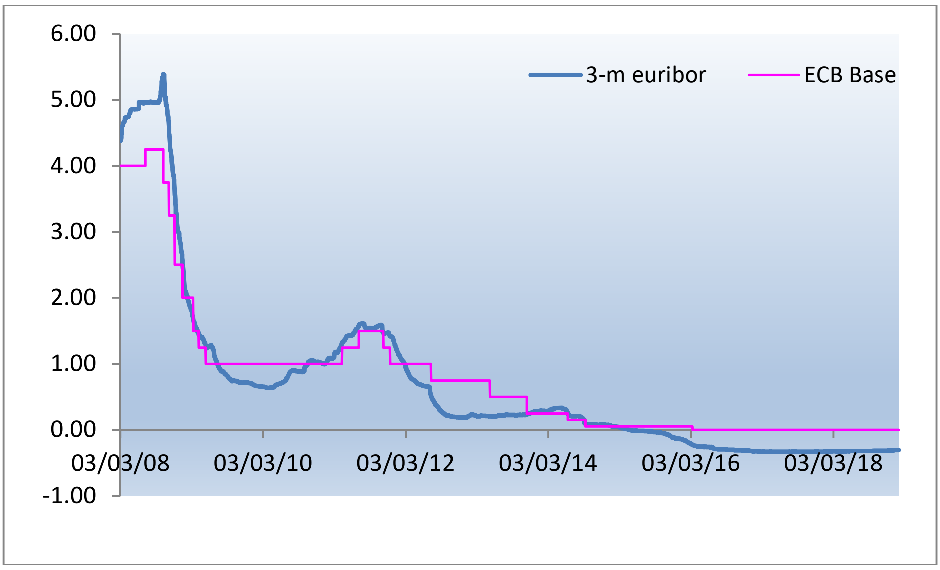
Background

The possibility of the ECB Base Rate increasing in Q3/Q4 2019 is beginning to look more unlikely now. The key trend in 2019 to date is that the EUR 3-year swap rate has been negative for all of January. The slow reversal of Quantitative Easing ("QE") moved 3-month euribor up a little since the start of November 2018 but this too has stalled in the past week.

However, as previously mentioned here, these slight movements in 3-month Euribor have no bearing on variable interest rates charged by Irish banks who continue to use a floor of 0% in all loan agreements where the margin is added to a Euribor rate.

The Euribor rate that we monitor for the purposes of this bulletin (as it is the most relevant one for variable rate debt) is the 3-month rate.

Graph 1. 3-m Euribor versus ECB Base Rate: ten-year trend



German inflation eased back again to +1.4% from 10-year peak at +2.5% in October 2018. The broader Euro area readings are showing similar trends. Irish inflation rose slightly to +0.7% in December and hasn't been above +1.0% in over five years.

Static EZ and falling German inflation figures remove potential upward pressure on interest rates arising from inflation.

German unemployment remained static at 3.3% for the fourth month in a row in December while the Eurozone equivalent sat at 7.9% in December. Irish unemployment held at 5.3% in December for the second month in a row.

However, youth unemployment remains stubbornly high - in the Eurozone it at 16.6% (actually lower in the EU28 at 14.9%) and, worryingly, still at 32.7% and 31.9% in Spain and Italy respectively. You have a bubbling social problem with these levels when one considers that the general unemployment rates are hitting a floor in this cycle.

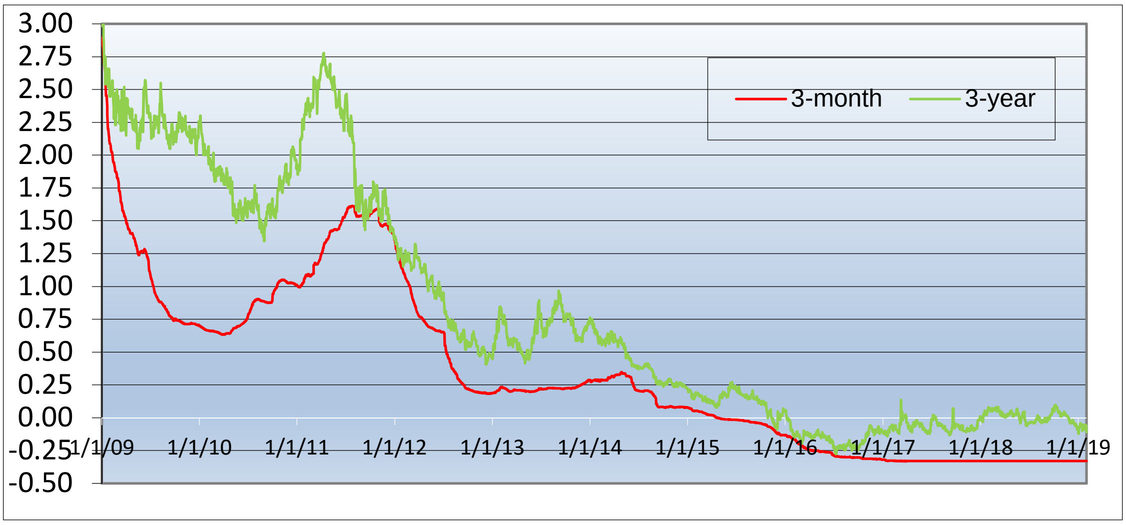
Finally, German GDP fell by -0.2% in Q3 while Italy is officially in recession having had two consecutive quarters of negative growth in Q3 and Q4 2018. As unemployment is often referred to as a lagging indicator (i.e. it is one of the last to move both positively and negatively), the signs increasingly point to a slowdown.

2.2 EUR medium-term rates

Background

As indicated in previous bulletins, we track the 3-year swap rate as a good proxy for medium-term rate trends. Please note that fixings are available for both shorter and longer periods as required under your risk management strategy.

Graph 2. EUR 3-year swaps versus 3-month euribor: ten-year trend



Key Observations

The graph of the 3-year swap rate for the past 24 months follows. The key takeaway from this graph is that the 3-year rate is now back at (or close to) the lows seen in Q3 2017 with an increasingly pessimistic view of the Global economic outlook. As reiterated in prior bulletins, the difference between this fixed rate and Euribor floating rates is small due to the imposition of a floor of 0% by banks on the latter rate in loan agreements. **We would suggest you push the management of your debt up the agenda again based on recent trends in fixed rates and get in contact with us prior to taking any such action as there are a few pitfalls to be aware of.**

Graph 3. EUR 3-year swap rates for past two years

2.3 UK and US interest rates

Interest rates in the UK and US remain in different parts of the cycle compared to Eurozone rates with the US much farther into the cycle. The table below highlights the difference between both short-term and long-term rates of the various geographies. The narrower the gap between 2-year and 10-year rates, the closer the cycle to the top (or bottom).

Table 2. Comparative Interest Rates

	EUR	GBP	USD
3-m	-0.003	0.009	2.730
2-year	-0.150	1.110	2.660
3-year	-0.090	1.150	2.620
5-year	0.150	1.250	2.600
7-year	0.380	1.490	2.620
10-year	0.800	1.430	2.700
2v10 spread	0.950	0.320	0.040

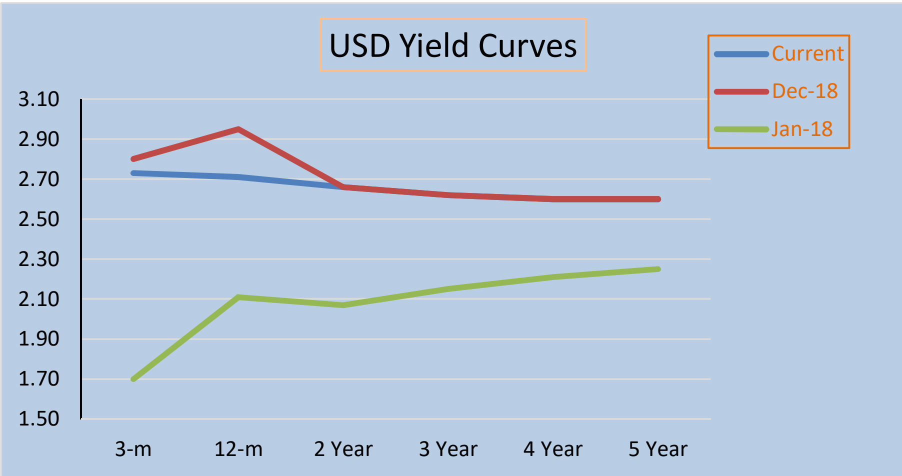
In the UK, the interest rate markets remains somewhat worried about a hard Brexit resulting in lower UK interest rates since the start of October 2018. The 3-year swap rate has given up 40% of the increase that arose between Q2 2018 and mid-Q4 2018.

Graph 4. GBP 3-year swap rates over past 12 months

In the US, the US yield curve is now firmly negatively sloped i.e. short-term rates are higher than long-term rates. Graph 5 below is for 3-year swaps over the past 24 months to show where rates have come from since they starting climbing while Graph 6 highlights the change in the shape of the yield curve over the past 12 months.

Graph 5. USD 3-year swap rates over the past 24 months

Graph 6. USD Yield curve over past twelve months



Talk of 2-3 rate hikes by the Fed in 2019 now looks very unlikely based on the shape of the curve currently.

2.4 Summary

- Eurozone longer-term rates up to 3-years were negative for all of January – the outlook is for a slowdown to emerge. Hard Brexit will make it worse
- Despite the FX markets acting as it a hard Brexit is less likely, the interest rate markets seem less convinced. The outcome of the Brexit negotiations will have a major impact on UK interest rates over the coming months
- The inversion of the US interest rate curve looks significant in what it signals for the US economic outlook. Positive outcomes from trade talks with China would help, negative will make it worse.

3. Foreign Exchange Review

Brexit continues to influence the fate of GBP against other currencies and is ebbing and flowing with sentiment towards and away from a hard Brexit scenario. The high-low range in EUR/GBP for the year-to-date is already higher than for all of 2018.

USD is currently treading water, but the average high-low move in EUR/USD has been close to 1% over the past decade and a half so don't expect this calm to remain.

3.1 EUR/GBP

Background

Brexit continues to dominate EUR/GBP.

Key Observations

While we still stick to our view that the UK is likely to push back the trigger date of Article 50 (March 29th) to buy more time, the closer we get to the end of March, the higher the probability of No Deal. This is dealt with in more detail in Section 5.

Graph 7 highlights the extent of EUR/GBP movements since Brexit while Graph 8 demonstrates the movements since the start of 2018. From a charting perspective, the long-term range remains quite wide – EUR/GBP0.8500 to EUR/GBP9050 and we have seen it bounce back off (or close to) this level over the past 6 weeks on more than one occasion.

Looking at more recent trends, the high/low range in the 2018 exchange rate was 5.58% - **the high/low range for 2019 to date has already exceeded that (5.73%). The strengthening of GBP in the first few weeks of January represented a growing view that a deal could be done (or, at least, No Deal avoided). However, the past 2 weeks has seen a reversal in this trend as Mrs. May did a U-turn and voted against her own deal. Sunday papers carried a story of a possible June election as Labour "labours" in the polls! Today's paper suggests an Article 50 extension to May 24 even in event of a deal as parliament will need that time to pass the appropriate bills.**

Those who hedge forward please note that EUR/GBP 6 months forward points are +0.0060 and 12-months forward points are +0.0125 (which favours importers). The equivalent EUR/USD figures are +0.0180 and +0.0370 respectively.

Graph 7. EUR/GBP since Brexit Referendum

Graph 8. EUR/GBP: 01/01/18 to date

Summary

The pressure could grow on the Irish government now….Europe could take the view that it will support whatever we want…but we are the weak link in the European chain and the UK looks like it is exploiting that fact now (nothing personal, just business!)

We still think that FX options are worth considering to cover the period to the end of March, especially for exporters as a No Deal will weaken GBP significantly and immediately**. If someone was considering selling GBP now for 2019, run through the scenarios: Deal done will most probably strengthen GBP so any cost of an option (rather than covering forward at current levels) should be quickly offfset by strong GBP. In the case of No Deal, the option would be expected to be in the money very quickly with a hedge in place at that level. No hedging means taking a punt. We ask you is that really a strategy?**

3.2 EUR/USD

Background

Exposure to USD tends to be of an indirect nature for many Irish companies e.g. energy and fuel prices. EUR/USD is traditionally more volatile than EUR/GBP.

Graph 9. EUR/USD: 12-month trend

Looking at Graph 9, the exchange rate range is narrowing. As previously mentioned, a sustained break up through EUR/USD1.1500 would be significant.

Key Observations

The gradual strengthening since April against EUR has reversed over Q4 2018, but not at any aggressive pace. As highlighted in the Interest rate section, trends on that front indicate a slowing economy and the lack of progress of discussions with China has reinforced this view. However, the Eurozone outlook is not very rosy either (and is arguably behind the US in how far out of recession it is) meaning that the key question could be: which will deteriorate faster; the US or Eurozone. Crystallization of a market view on that could influence EUR/USD in the coming months.

US economic data is broadly positive although January unemployment saw a rise from 3.9% to 4.0%. However, we can't get away from the poor state of government finances with a budget deficit despite strong economic data and a growing debt:GDP ratio.

Summary

The economic outlook for the US has definitely softened over the past 2 months and this is the most likely factor to weigh on the US dollar. But, similar to the point made on EUR/GBP, the Eurozone outlook is also deteriorating. The market view on which is likely to deteriorate first and/or more quickly could have quite a significant bearing on 2019 trends in EUR/USD.

4. Oil and Financial Markets

- *Oil price rebound has been strong*
- *Equity markets have also reversed in January after weak finish to 2018*
- *But bond yields are bouncing around a little.*

4.1 Oil Price Trends

Graph 10. Oil prices: 12-month trend

OI price has bounced back quite quickly since the end of December. It takes about 6 weeks for this to feed through to retail markets so if you need a top up in your home heating, order without delay!

4.2 US

4.2.1 US Bond Yields

Graph 11. US 10-year Bond Yields: 12-month trend

The swift Q4 decline has partially reversed since year-end although the easing of swap rates is also reflected here - easing bond yields indicating a softer economic outlook.

4.2.3 US Equity Markets

Graph 12. Dow Jones Industrial Average: 12-month trend

The losses of December have been largely regained. Results from the big players has been broadly acceptable.

4.3 Ireland

Graph 13. ISEQ 100: 12-month trend

Similar equity market story in Ireland.

Graph 14. Irish 10-year bond yields: 12-month trend

This rate is a lot more volatile and could continue to be as the impact of a hard Brexit on Ireland will be greater than for other EU countries. Ireland has almost EUR30 billion of debt to refinance in 2019 and 2020 at coupons in the 4% to 5% range. Given that 10-year rates are currently close to 1%, the annual interest savings on refinancing at this level would be EUR1billion per annum for the next 10 years.

4.4 UK

Graph 15. FTSE 100: 12-month trend

The 2019 bounce is even higher than the late 2018 decline. A hard Brexit doesn't hit a lot of the FTSE 100 companies as they have international operations, but they could be hit based on a decline in sentiment.

Graph 16. UK 10-year bonds: 12-month trend

4.5. Summary

- Equity markets have had a positive start
- Bond yields have declined but stabilized for now
- General economic outlook is deteriorating
- Are we stuck in a long-term low interest rate environment like Japan?
- And, if so, what does this mean for returns on the various asset classes?

5. Brexit and the potential impact

There has been a lot of talk of potential outcomes and what might happen.

Capital Economics, an independent UK-based economic consultancy, issued a paper in the past few days assessing the potential impact of various Brexit scenarios on Ireland. We like their commentary as it is, like us, independent. You tend to get an unbiased view as a result.

The key points are as follows:

- They see three possible outcomes at this stage: Hard Brexit, extension of Article 50 with a subsequent deal ("Fudge and Delay") or leave with the current Withdrawal Agreement (or something closely approximating it)
- Their estimated probabilities are:
  - Deal=15%
  - Fudge and Delay=55%
  - Hard Brexit=30%
- Obviously, the impact of the various outcomes varies materially

Table 3. Forecast impact of Brexit Outcomes on UK

	Deal	Deal	Fudge and Delay	Fudge and Delay	No Deal	No Deal
	2019	2020	2019	2020	2019	2020
GDP (yoy%)	1.8%	2.0%	1.5%	2.2%	0.5%	1.5%
UK Base Rate	1.5%	2.0%	1.25%	1.75%	0.25%	0.50%
UK 10-year Govt Yield	2.00%	2.25%	1.75%	2.00%	0.75%	1.25%
GBP/USD	1.40	1.45	1.35	1.40	1.15	1.20

Table 4. Forecast impact of Brexit Outcomes

	2019	2020
Deal	3.3%	1.8%
Fudge and Delay	3.0%	2.0%
No deal	1.5%	1.5%

- They estimate that the effect of higher tariffs (assuming WTO kicks in) and a weaker GBP could increase the cost of Irish goods in the UK by about 25% in a hard Brexit scenario
- The impact would not just be restricted to this effect as over half of Ireland's exports to countries other than the UK pass through the UK - the cost of delays could materially impact on their competitiveness
- They also make the point that apart from the much larger exposure to the UK of Ireland compared to any other EU country, a lot of the agri-foods exported are more homogenous than other goods and services and, therefore, more price sensitive. They see a 1:1 correlation between price increases and volume decrease implying that a 25% PRICE INCREASE (DUE TO TARIFFS AND WEAKER GBP) WOULD REDUCE EXPORTS BY 25%
- UK imports to Ireland would not suffer as much as a large percentage of such imports are intermediate goods

- Ireland would benefit from some UK investment as UK companies move some activity out of UK into Ireland, but this would be outweighed by the lower investment caused by falling exports
- ON THE GOOD NEWS FRONT
    - Any deal should lead to increased investment in Ireland (suppressed to date by Brexit uncertainty)
    - UK investment in Ireland is likely to continue
    - In general, some form of deal should be slightly positive for Ireland
    - GDP slowdown is probably inevitable as a result of a global slowdown and possible capacity constraints emerging after a strong period of economic growth
- THEY SEE THE LONG-TERM RISK AS THE QUESTIONING OF IRELAND'S LOW-TAX, EXPORT-ORIENTED MODEL
- HOWEVER, THEIR LONG RUN VIEW FOR THE UK IS BROADLY POSITIVE….WHICH SHOULD ALSO BE POSITIVE FOR IRELAND.

We need to get through the next few weeks avoiding a Hard Brexit (which is NOT off the table right now). If that outcome is avoided, there is still a long road ahead for the UK to do a trade deal.

WE REITERATE THAT THE NEED FOR LONG-TERM STRATEGIC (COMMERCIAL AND FINANCIAL) PLANNING IS NOT GOING TO GO AWAY AND EARLY ACTION IN THIS SPACE WILL REAP REWARDS. GET IN TOUCH FOR ANY ASSISTANCE IN THIS SPACE OR IN YOUR BREXIT PLANNING WHERE WE HAVE A TEAM READY TO HELP.