THE TREASURY HUB
Banking and Treasury Markets

July 2019 Report

Introduction

While we appreciate that we are now in the summer holiday period, the indicators are worrying for the second half of the year.

We have urged proactivity from both strategic and financial planning perspectives as a result over the course of the year to date. We reiterate this view now and suggest that you get in touch if you are concerned about any aspects highlighted in this bulletin.

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1. Executive Summary

1.1 Introduction

This is the sixth Banking and Treasury Report of 2019 which we bring to you as part of THE TREASURY HUB.

Lot of talk domestically about government debt and general economic performance in the past month. We covered this in detail 2 months ago, so we were ahead of the posse!

GBP has weakened as we had forecast and has been hovering around EUR/GBP0.8950 for the past few weeks and pushing EUR/GBP0.9000 this morning. Interest rates have been remarkably soft also in recent weeks. The appointment of Christine Lagarde as ECB President is currently being assessed by the markets.

Our Section 5 this month is a half-year review. Please read it as we believe that we have been ahead of the curve in our observations to date and have concerns about the threats to the economy in the second half of the year.

In this section, we also introduce what we call our Risk Monitor. We plan to include this every 6 months unless something emerges that we think requires immediate attention.

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

Table 1. Key Metric Movements: 2019 to date

Heading	Metric	YTD move	From	To
Interest	3-m euribor	-0.0350%	-0.3100%	-0.3450%
Interest	EUR 3-year	-0.2500%	-0.1200%	-0.3700%
Interest	GBP 3-year	-0.4114%	1.1564%	0.7450%
Interest	USD 3-year	-0.8180%	2.5580%	1.7400%
FX	EUR/GBP	-0.4803%	0.8996	0.8953
FX	EUR/USD	0.2287%	1.1342	1.1368
Equities	ISEQ	11.2%	5490	6107
Equities	FTSE 100	10.3%	6734	7425
Equities	Dow Industrial	13.9%	23346	26599
Gilts	IE 10-yr	-0.6950%	0.875%	0.180%
Gilts	GB 10-yr	-0.4170%	1.249%	0.832%
Gilts	US 10-yr	-0.6860%	2.686%	2.000%

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. Also, the % move for interest rates is in absolute terms while for interest rates is in absolute terms while for currency and equities it is expressed in relative terms.

1.3 Monthly Feature

This month's feature is a general markets review half-way through the year.

1.4 Brexit

The Tory leadership contest is moving into the home strait between Boris and Jeremy. Both seem to be trying to "out-Brexit" each other. Meanwhile a chorus of warnings about the potential impact of a hard Brexit from Mark Carney to Philip Hammond (Chancellor of the Exchequer) appears to be falling on deaf ears for now. UK markets currently expect an interest rate cut in response to hard Brexit. **The interest rate section (Section 2) highlights the rapid fall off in interest rates in the main economic areas over the past two months and it is quite concerning for the macroeconomic outlook.** Difficult to see anything other than GBP remaining weak for now.

1.5 Risk Monitor

As part of our semi-annual reviews we are introducing our risk monitor. This is to highlight what we consider to be possible priorities for business based on macro trends and current forecasts. We appreciate that different businesses have different risk profiles, exposures and culture. However, the table below is worth considering, if only because action taken prior to any adverse moves is a lot cheaper than repairing subsequent damage. So, this is to be seen as a general view with each client needing to assess in the context pf their own business.

Table 2. The Treasury Hub Risk Monitor

Area	Monitor	Assess	Action
EUR/GBP		X	
EUR/USD	X		
EUR Debt Management		X	
Financing/re financing			X
Equities	X		
Bonds	X		
Brexit			X

Monitor = Maintain a watchful eye (No need to act yet)

Assess = Establish plan to be implemented if outlook deteriorates (Be ready to act)

Action = Implement plan (Act)

2. Interest Rate Review

RAPID EASING OF INTEREST RATES MEANS THAT THIS AREA NOW REQUIRES ATTENTION.

June has seen Euribor rates back to record low levels again, EUR swap rates are actually negative out to 7 years while bond yields have also retreated, and curves are becoming inverted (long-term rates lower than short-term rates). We now strongly urge consideration of what fixed rates are available to you.

2.1 EUR short-term rates

Background

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

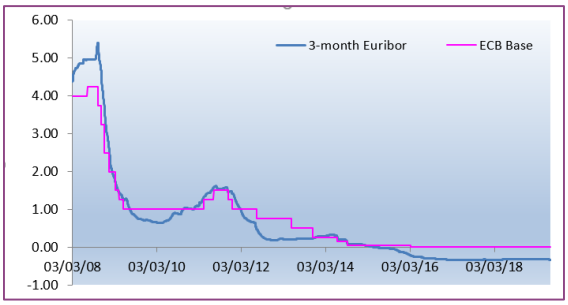
Key Observations

German inflation rebounded slightly in June to +1.6% having slipped back to 1.4% in May. The Euro area reading was static at 1.2% in June.

The Irish inflation increase from +0.6% in February to 1.7% in April (7-year high), reversed to +1.0% in May. So, the spike looks like a little bit **of an aberration which is what we predicted last month. It is also possible that the increasing economic uncertainty is influencing consumer confidence and that is stalling the ability to pass on higher prices. In fact, Irish Retail Sales in May were up only 1.1% year-on-year compared to +4.5% the previous month (See Section 5).**

The interest rate outlook is very benign as will be apparent when you look at longer-term rates in Section 2.2 and gilt rates in Section 5.

Graph 1. 3-m Euribor versus ECB Base Rate: 2008 to date

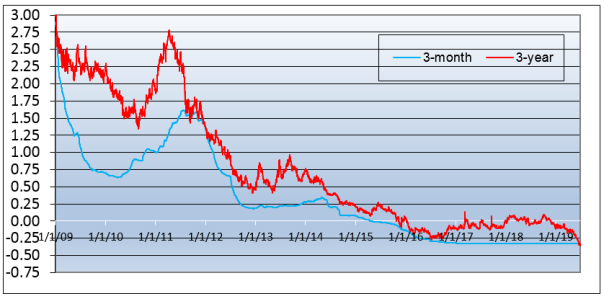


2.2 EUR medium-term rates

Background

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 2 years follows. **The most notable trend here is the rapid decline in this rate in the past few weeks as we are now at historic lows. Normally 3-year rates would be below 3-month rates (as is the case now) at the top of an interest rate cycle. The current level is both strange and somewhat unsettling. Would be good news for borrowers but bad news for depositors and for economic outlook.**

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

2.3 UK and US interest rates

3 months ago the markets were of a firm view that interest rate cycles in the UK and US were different (the US being well ahead). That has changed dramatically in the past weeks as evidenced by the table below. US rates in particular have eased considerably with the fall only being arrested last Friday as a result of some stronger than expected unemployment numbers.

Please note that the rates below are before borrowing margins and would also be subject to credit spreads if fixed rates were being quoted by banks.

Table 3. Comparative Interest Rates as at June 30th, 2019

	EUR	GBP	USD
3-m	-0.345	0.774	2.319
2-year	-0.390	0.750	1.809
3-year	-0.370	0.745	1.740
5-year	-0.260	0.790	1.726
7-year	-0.100	0.850	1.819
10-year	0.170	1.036	1.935
2v10 spread	0.560	0.286	0.126

In the UK, Brexit and politics continue to heavily influence the economic outlook and, as a result, interest rates. With both Jeremy Hunt and Boris Johnson promising to take the UK out of Europe by October 31st (with varying degrees of "commitment"), the resultant uncertainty is having an adverse effect on key indicators and variables. Hence the recent decrease in longer-term UK interest rates.

Graph 4. GBP 3-year swap rates over past 24 months

In the US, the yield curve shape continues to evolve with the gap between 3-month and longer-term rates now even more substantial in a negative sense.

Graph 5 below is for US 3-year swaps over the past 24 months to show where US rates have come from since they started to climb in 2017.

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

Donald Trump is now putting pressure on the Fed to cut rates (as he knows that it could give the economy a boost in the election year of 2020). But his own handling of tariffs on trade with China continues to have the largest potential (negative) impact on the US outlook. The economy is now officially in the longest period of growth in its history and started the 11th such year recently. And with the addition of (an unexpected) 224,000 jobs last month, the interest rate decline is being viewed as overdone by some.

2.4 Summary

- This decline in interest rates was not anticipated by the markets at the start of the year
- We had encouraged vigilance in this space (but no action yet) in anticipation of rates possibly rising in Q3 2019
- We are now suggesting possible pricing of fixing for the opposite reason: rates are so low
- This is also worth considering as Irish banks have NOT passed on the benefits of negative euribor rates but have inserted clauses in loan agreements that the lowest such rates can go is 0%
- Section 5 contains further views on the economic outlook and possible impact on interest rates.

3. Foreign Exchange Review

The strengthening of GBP against EUR at the start of the year was a welcome relief for exporters. However, we predicted in the May bulletin that GBP would weaken to at least EUR/GBP0.88 and possibly EUR/GBP0.90 as a result of uncertainty associated with the Tory leadership race and the fallout of likely poor showing by the Tories in the local and European elections. And so, it came to pass.

USD has been treading water for most of H1 2019. The high/low difference for 2019 is only 4.18% while the 2019 average is actually 4.53% stronger than the 2018 average due to the strengthening of USD in the second half of last year, benefitting exporters to USD-denominated or USD-linked countries. Looking back at the trends since the inception of the Euro, the narrowest annual high/low range in EUR/USD has been 8% in 2013 with the average high/low range being 17% over the period 2000-2018. History tells us that the H1 narrow trending is unlikely to continue.

3.1 EUR/GBP

Background

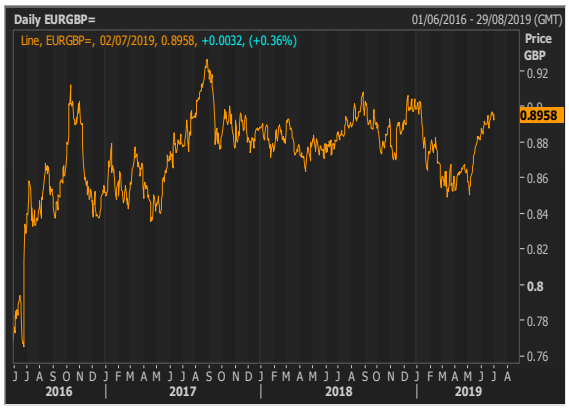
Brexit continues to dominate EUR/GBP but largely linked to political developments. The race to replace Mrs. May as Tory party is down to the final two with the significance being the efforts to "out Brexit" the Brexit party on taking a hard line on leaving the EU without a deal if necessary. But it is beginning to take its toll on the economy.

Key Observations

As stated in previous bulletins the sudden weakening of GBP against EUR caught out a lot of exporters as the currency pair had traded below 86p for much of March and April (and into May) The result of the Tory election race will be announced around July 23rd and the expectation pending a faux pas on his part (which is quite possible) is that Boris Johnson will succeed. Reading whether or not his threat to leave on October 31st, deal or no deal, is a real possibility is difficult. On one hand, he appears to be very much of the mind of "We won two world wars, we can win this" which appeals to many of his party faithful. However, he is ultimately a politician. And he certainly doesn't want to be the shortest ever reigning Prime Minister which is a distinct possibility if he gets his tactics wrong. So, our view is that his decision on a hard or soft Brexit will be driven by (a) the possibility of a general election and (b) the possibility of winning same.

On the economic front, UK data IS softening, and this could put pressure on him by October. Investment is falling and some believe that a recession is already where they are heading to. But Eurozone data is not a lot better with a report yesterday that the German economy could be experiencing negative growth already. Whichever weakens faster will impact on the currency pair. We still see a real chance of breaching EUR/GBP0.9000 in July or August. Graph 6 demonstrates the trend in EUR/GBP since Brexit while Graph 7 highlights the trend since January 2018.

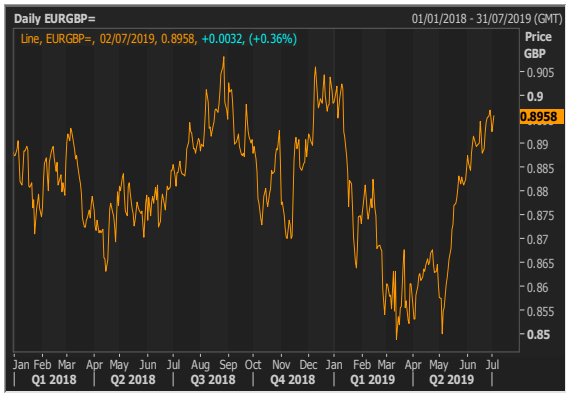
Graph 6. EUR/GBP since Brexit Referendum



The long-term range above remains intact: EUR/GBP0.8500 to EUR/GBP0.9050 and, as we pointed out in prior bulletins, our focus (worry) for now is a breach of the upper end of that range. Strategies should consider same.

6 and 12-month forward points remain unchanged at 0.60p and 1.20p respectively (added to the spot rate).

Graph 7. EUR/GBP: 01/01/18 to date



Summary

High probability that next move is up through EUR/GBP0.9000 due to ongoing UK political uncertainty. EUR/GBP0.9050 is a critical level if breached.

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.

Looking at Graph 8, the exchange rate range continues to narrow - currently from EUR/USD1.0900 to EUR/USD1.1400. The upper end was briefly tested recently but it bounced back off it.

Graph 8. EUR/USD: 1/1/16 to date

Key Observations

The EUR/USD holding pattern continues for now. The temporary weakening to the top of the range was attributed to a growing view of a July interest rate cut by the Fed but last week's strong employment data halted that for now at least. We mentioned last month that we had a sneaking suspicion that the Chinese outlook is worse than official figures suggest. Australia, an economy that is heavily dependent on Chinese demand for its commodities, has cut its interest rate since the start of the month reconfirming our view. Their currency (Australian Dollar or AUD) has also weakened this year with the average for the year to date 8% weaker than the 2017 average.

EUR/USD forward points for 6 and 12 months are +0.0170 and +0.0315 respectively.

Summary

Still very difficult to call direction in this currency pairing with all of the political and economic uncertainty. If there is a global slowdown approaching, one of the key factors may be if the markets see USD as a safe haven (usually along with Swiss Franc and Japanese Yen). If that is the case, then a break back below EUR/USD1.1000 could be fairly swift. Watch and wait for now.

4. Oil and Gold Markets

- ***Oil price continues to bounce around***
- ***We will monitor the price of gold for the second half of the year as it tends to increase in price when financial markets become more volatile.***

4.1 Oil Price Trends

Graph 9. Oil prices: 2-year trend

The price continues to be impacted upon by the threat of falling demand due to slowing economic output (pushing the price down) and reactions from OPEC cutting back production to boost the price again. If falling interest rates are a predictor of economic slowdown, then one would expect oil prices to ease. The continuing push towards renewables and developments in shale extraction (the US is now a bigger oil producer than either Russia or Saudi Arabia), etc. might also impact negatively in the medium term but this commodity is prone to short-term volatility. Similar to the USD, need to monitor this for short-term directional moves.

4.2 Gold Price Trends

Graph 10. Gold prices: 10-year trend

We have added this chart in to monitor it for the second half of the year as a possible further indicator of a slowdown. Gold prices tend to rise in periods of uncertainty as a safe haven asset.

5. Half-year Markets Review

5.1 Banking Market Review

As part of The Treasury Hub collaboration, we have met several funders (both bank and non-bank) in order to establish a database of funders for varying needs of our clients. These represent a broad church providing working capital, senior debt, mezzanine debt and equity with varying levels of appetite for leverage and sectors (including construction). The purpose of this effort is to be able to direct clients to the most relevant lenders for their needs thereby focusing on those most likely to lend and/or invest.

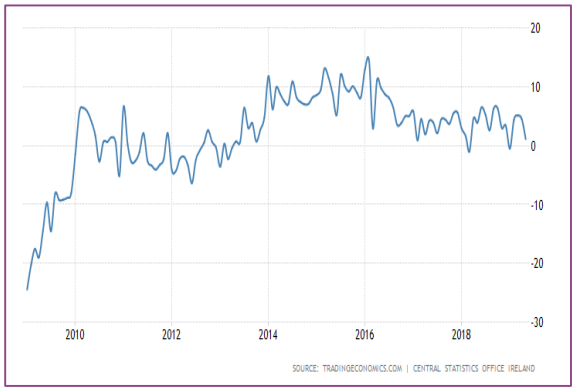
The pillar banks are very much open for business as they have lending targets to hit and while the experience of the members of The Treasury Hub around the country has been similar in that identification of good people within each bank appears to be as relevant as the bank itself, we have access to the highest senior management levels in Business Banking across all the main providers and are in a position to use this access to the benefit of our clients where the need arises.

From the start of the year we advocated consideration of early refinancings where loan agreements are due to mature in the next 18-24 months due to a favourable lending environment. This advice has become more pertinent in the event that the economy begins to slow as adequate headroom and borrower-friendly terms and conditions become more valuable in such circumstances but also more difficult to attain. Timing is everything…hence the suggested proactivity.

5.2 Irish Economy

We covered this in detail last month and since then bond yields have fallen further while the equity market has risen again. The former is now at an incredible 0.18% for 10-year bonds which from a government financing perspective is great (German 10-year gilt yields are -0.35%). We highlighted the risks to the public finances in May and, as a small open economy, we are exposed to global trends more than most. Brexit would also have a materially negative effect in the event of no deal. Retail sales are already slowing here (see Graph 11).

Graph 11. Irish Retail Sales (source: trading economics.com)



Graph 12. ISEQ: 12-month trend (source: Reuters)

Graph 13. Irish 10-year bond yields: 12-month trend (source: Reuters)

In summary, the macro indicators for the most part are at odds with the slowing growth across the major economies. The risk would appear to be on the downside.

5.3 US

The US is even more of an enigma. It is currently experiencing the longest period of economic growth in its history, unemployment is very low, recent jobs data has been better than expected and the stock market is riding high. This is despite the trade war with China, growing political tensions with Russia, China and Iran and an impending Presidential campaign which has the potential to be very divisive.

Graph 14. US 10-year Bond Yields: 12-month trend

This rate has fallen "off a cliff" since November from 3.2% to the month-end level under 2.00%. The rate hit a low of 1.955% on July 3rd but has bounced back just above 2.00% again in the past couple of days.

Remember the impact on bond prices of this fall is huge as this is a 1.2% drop every year for 10 years. The speed and extent of this fall is worrying if it indicates a slowdown in the world economic outlook.

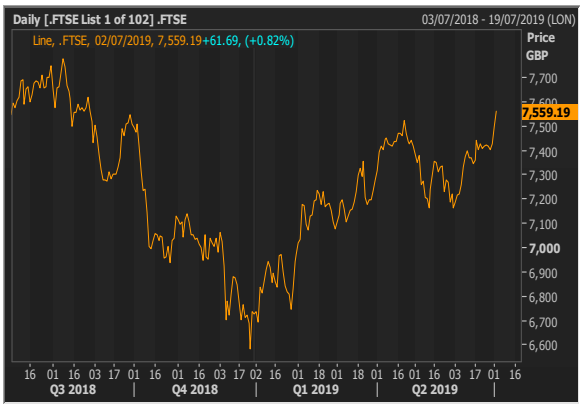
Graph 15. Dow Jones Industrial Average: 12-month trend

The Dow has had a rocky May/June: having breached 26,500 at the start of May, it was 24,820 last week but is back over 26,000 again. What to make of this? A bit perplexed to be honest… tech drives a lot of the US market capitalization so there is a view that low interest rates boost the performance/profitability of larger companies.

5.4 UK

The UK is following somewhat similar trends to the US in that the equity market has held strong but gilt rates are falling and economic indicators are beginning to falter. By way of example, PMI indices are forward-looking surveys of purchasing managers. They cover manufacturing, services and construction. Readings above 50 signal expansion while sub-50 indicate contraction. The most recent UK readings were 43.1 for construction, 48.0 for manufacturing and 50.2 for services. The composite reading (of all three) was 49.2 and apart from a dip in the immediate aftermath of the Brexit of the Brexit referendum, this was the lowest such reading since 2009.

Graph 16. FTSE 100: 12-month trend



Similar to the US, the UK equity market recovery has been strong over the past few weeks as evidenced above. However gilt rates (see below) fell as low as 0.676% in the past few days before recovering to 0.71%.

Graph 17. UK 10-year bonds: 12-month trend

Summary

In our first report of the year in early January we stated that "The outlook from an investment perspective is probably the most uncertain in a decade". Nothing in the intervening period has changed our view. We also stated in that publication that "having toughed it out after the recession, don't be a casualty of the next one".

Liquidity (or lack thereof) has been mentioned in previous bulletins and we recently saw two instances of this in the UK with investment guru, Neil Woodford, closing withdrawals from one of his funds and another investment fund having similar issues.

The biggest concern from a "signaling" perspective is the rapid decrease in interest rates and inverted yield curves (short-term rates being higher than long-term rates). History shows that in every instance since the 1960's where the curve was inverted in the US for one continuous 3-month period, a recession has followed. We will watch this with interest.