THE TREASURY HUB
Banking and Treasury Markets

September 2019 Report

Contents

1.	Executive Summary	2
2.	Interest Rate Review	3
3.	Foreign Exchange Review	6
4.	Oil and Gold Markets	7
5.	Brexit	8

1. Executive Summary

1.1 Introduction

We continue to bring you our regular Banking and Treasury Report as part of THE TREASURY HUB.

As we head into the Autumn, the focus is firmly on Brexit and how it may play out. Over the Summer the main casualty was the EUR/GBP exchange rate.

Our Section 5 this month focuses on the Brexit issue.

The Market Metrics table below is all in red apart from the trend in EUR/GBP and equities (EUR/GBP would be viewed as red if one is an exporter).

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	-0.1230%	-0.3100%	-0.4330%
Interest	EUR 3-year	-0.4400%	-0.1200%	-0.5600%
Interest	GBP 3-year	-0.5464%	1.1564%	0.6100%
Interest	USD 3-year	-1.1680%	2.5580%	1.3900%
FX	EUR/GBP	0.5%	0.8996	0.9038
FX	EUR/USD	-3.2123%	1.1342	1.0989
Equities	ISEQ	7.0856%	5490	5879
Equities	FTSE 100	7.0241%	6734	7207
Equities	Dow Industrial	13.0943%	23346	26403
Gilts	IE 10-yr	-0.9580%	0.875%	-0.083%
Gilts	GB 10-yr	-0.7700%	1.249%	0.479%
Gilts	US 10-yr	-1.1800%	2.686%	1.506%

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 Brexit

This week has been a crucial week and it looks like a Hard Brexit on October 31st has been avoided but a general election now looks inevitable.

1.4 Conclusion

If your company hasn't undertaken a Brexit impact assessment, then you are running out of time. Companies will commence work on their 2020 budgets soon and the backdrop to such preparation is largely negative at this point in time.

Chris Ball
Corporate Finance Partner

T: +353 (0)90 6480607
M: +353 (0)86 6075012
E: cball@rbk.ie
W: www.rbk.ie

2. Interest Rate Review

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

Euribor rates continue to fall back to record low levels again, EUR swap rates are now negative out to 15 years! Bond yields have also retreated and curves are increasingly inverted (long-term rates lower than short-term rates).

One quarter of all bonds (government and corporate) are now at negative yields meaning that over USD15 trillion of debt is costing investors to hold it.

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

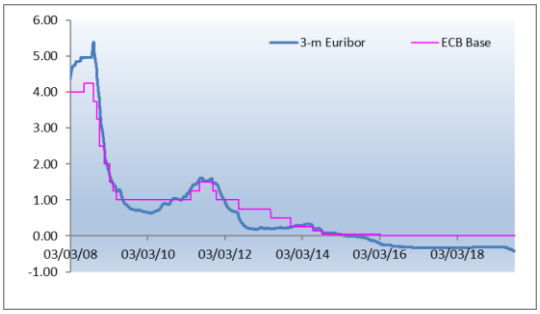
THE KEY OBSERVATION IS THAT 3-M EURIBOR IS NOW AT A NEW ALL-TIME LOW AND ANY HOPE OF THE ECB BEING IN A POSITION TO RAISE INTEREST RATES AS A MONETARY POLICY TOOL HAS RAPIDLY DISAPPEARED.

German inflation retreated to 1.4% in August having hit +1.7% in July. The Euro area reading was static at 1.0% in August.

Irish inflation at +0.5% is at its lowest level in 14 months. This would be consistent with a poorer consumer outlook. Retail sales dropped by a huge (-4.4%) in July although this was attributable to Motor Trade (-13.0%) and Other Retail Sales (-11.5%).

The interest rate outlook is now negative as will be apparent when you look at longer-term rates in Section 2.2.

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

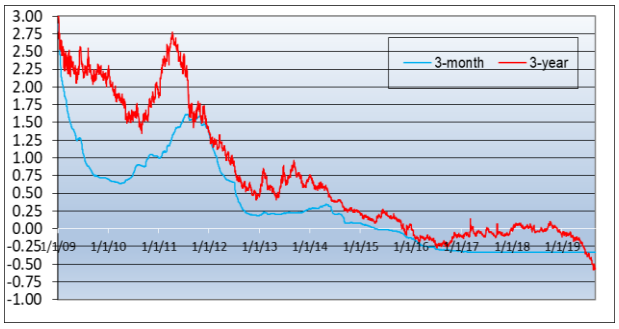


2.2 EUR medium-term rates

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 above graph of 3-month Euribor versus 3-year swap shows the latter below the former which is a worrying development as in the past it has been consistent as an early indicator of an approaching economic slowdown.

The graph of the 3-year swap rate for the past 2 years follows. **The key trends here are the negative rates that have prevailed for most of the period in question and the more recent and rapid decline in this rate in 2019. The fact that this rate is lower than the (short-term) 3-month Euribor rate at this point in an interest rate cycle is not a good sign.**

Increasingly, the outlook is for a sustained period (years?) of low/negative official interest rates.

GRAPH 3: EUR 3-year swap (fixed) rates for past two years

GRAPH 4: GBP 3-year swap rates over past two years

2.3 UK and US interest rates

The interest rate cycle in the US has been completely turned on its head over the past 5 months as rather than the expected rate hikes in 2019 we have already seen a rate cut by the Fed. UK interest rates have also eased back but due to the anticipated negative impact on UK economic performance of a hard Brexit. The gap between 2-year and 10-year rates is also monitored in this context.

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 2: Comparative Interest Rates as at August 30th, 2019

	EUR	GBP	USD
3-m	-0.433	0.774	2.138
2-year	-0.550	0.640	1.510
3-year	-0.560	0.610	1.390
5-year	-0.550	0.580	1.320
7-year	-0.428	0.570	1.320
10-year	-0.240	0.600	1.380
2v10 spread	0.310	-0.040	-0.130

In the UK, Brexit and Brexit-related politics are having a major impact on the economic outlook and, as a result, interest rates. The rate has more than halved since Q1 and the curve is flat/slightly inverted as evidenced above.

Please note that if you have GBP debt, LIBOR will be discontinued by 2021 as a valid basis for short-term interest rates to be replaced by SONIA. More again about this but you will have to start thinking about this and one of the consequnces is that the rate to be charged on SONIA-based loans will only be known at the end of the interest period.

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 two years to show where US rates have come from since they started to climb in 2017. It's probably fair to say that this must be one of the shortest ever rate hike cycles in the US.

GRAPH 5: USD 3-year swap rates over the past two years

Donald Trump had put pressure on the Fed to cut rates (as he knows that it could give the economy a boost in the election year of 2020) and it duly obliged (although they will say it was not as a result of his interjection) in July. However, the ongoing trade war with China has escalated in recent weeks and this is now holding back the US economy. The Chinese have also allowed their currency to start weakening again as a result of the trade war. Finally, China's trade with Europe and other areas is increasing, all of which is bad for the US.

The unemployment rate is very low at 3.7% but this is what is known as a lagging indictor. Forward-looking indices such as PMI readings are moving downwards indicating worsening market expectations. Readings above 50 indicate expansion and although the composite figure is at 50.9 in August, the manufacturing reading is now below 50 (at 49.9) indicating contraction in that part of the economy.

2.4 Summary

- This decline in interest rates was not anticipated by the markets at the start of the year
- With current levels at record lows, 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%
- The benefit of such a move to borrowers could be offset by a poorer business outlook
- OUR BIGGER CONCERN IS THE IMPACT OF QUANTITATIVE EASING (PRINTING OF MONEY) ON ALL OF THIS AND WHETHER WE ARE HEADING TOWARDS A MAJOR FINANCIAL MARKETS CORRECTION (IMPACT ON INVESTMENTS AND PENSIONS).

3. Foreign Exchange Review

We have consistently forecast (and focused on) GBP weakening as a result of uncertainty associated with UK politics and, by extension, Brexit.

USD has tread water for most of H1 2019. However it has started to strengthen in the past few weeks. We continue to hold the view that the EUR/USD range has been very narrow for a long time and past experience suggests this is unlikely to continue.

3.1 EUR/GBP

Background

Brexit continues to dominate EUR/GBP linked to political developments. This week in the UK parliament has already been tumultuous, and it is likely to remain so as the parliament seeks to avoid leaving the EU without a deal.

Key Observations

In the case of EUR/GBP, the problem with the increasingly fragile situation is that the possible range in the currency range could be +/-5p: a hard Brexit would easily see the rate move to EUR/GBP0.96 (some say parity) while a soft Brexit should see the rate trade back to EUR/GBP0.86 or thereabouts (one international bank has called EUR/GBP0.80 by year end).

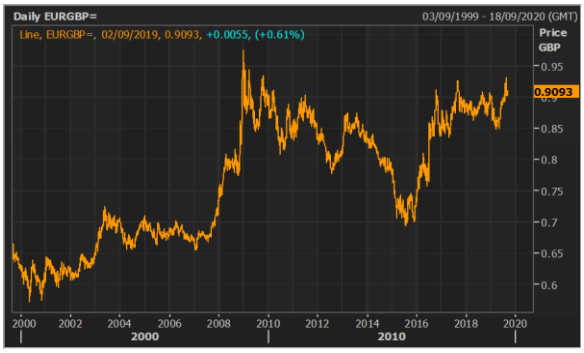
UK economic data will start to worsen as the longer the drama drags on, the more that investment will either be postponed or cancelled altogether. Graph 6 demonstrates the trend in EUR/GBP since Brexit while Graph 7 highlights the 20-year trend to put current rates in a historic context.

GRAPH 6: EUR/GBP since Brexit Referendum

The long-term range based on hard versus soft Brexit is now closer to EUR / GBP0.8600 to EUR / GBP0.9600. Strategies should consider same.

6 and 12-month forward points remain unchanged at 0.60p and 1.25p respectively (added to the spot rate).

GRAPH 7: EUR/GBP: 20-year trend



Summary

We are now approaching high probability of a large (positive or negative) move in the short-term. If, as looks likely, an election is called, then the uncertainty increases and if a Tory/Brexit Party alliance wins a majority, then hard Brexit will move to its highest probability. The next two months will be volatile as a result.

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 and ease downwards - currently from EUR/USD1.0800 to EUR/USD1.1300.

GRAPH 8: EUR/USD: 1/1/16 to date

Key Observations

The EUR/USD holding pattern has held for over 12 months now. And while we believe that the current trade war with China is damaging for the US economy, the increasing view of a slowing global economy tends to push investors towards cash, gold (see Section 4) and safe haven currencies which are mainly JPY and CHF but also, potentially, USD.

EUR/USD forward points for 6 and 12 months are +0.0150 and +0.0280 respectively. These have narrowed over the Summer but are still a drag on hedging costs for exporters.

Summary

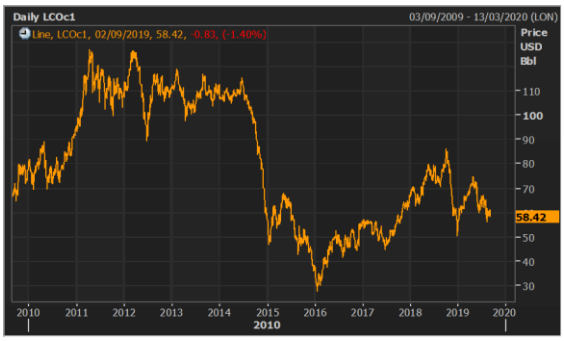
Still very difficult to call direction despite our concern that this currency range has been too narrow for too long. If there is a global slowdown approaching, one of the key factors may be if the markets see USD as a safe haven (usually along with Swiss Franc and Japanese Yen). If that is the case, then a sustained break back below EUR/USD1.1000 could gather momentum. Watch and wait for now.

4. Oil and Gold Markets

- *Oil price continues to bounce around*
- *We will continue 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 as has already happened since we started monitoring it.*

4.1 Oil Price Trends

GRAPH 9: Oil prices: 10-year trend



Researching the subject over the past few weeks, there is a suggestion that the price may have topped out for now. Slowing economic output reduces demand and the green agenda seems to be getting some real momentum now. Add in US shale production and there doesn't appear to be a lot that OPEC can do in the short-term.

Similar to the USD, need to monitor this for short-term directional moves.

4.2 Gold Price Trends

GRAPH 10: Gold Prices: 20-year trend

We have added this chart 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. The rise in this asset price has coincided with the recent fall-off in interest rates.

GRAPH 11: Gold Prices: 2019 trend

5. Brexit

This section is brief but getting ready for Brexit has now reached a critical juncture. Both anecdotal evidence and recent experience suggest that most SMEs have no plan or basic level of preparedness.

We are looking at the consequences of a hard Brexit for some clients and have run sensitivity analyses assuming a 5p weakening of GBP (with a 5p strengthening in the event of a soft Brexit). The following is a list of questions that may be worth asking:

- Are you aware of the tariffs on your UK sales?
- Are you aware of tariffs on your purchases from the UK, including raw materials/parts, etc.?
- What is your breakeven exchange rate and how does that relate to the +/-5p moves identified above i.e. would such a move breach the breakeven rate?
- A hard Brexit will have adverse consequences on both the UK and Irish economies. What would be the impact on your cashflows of a 10% reduction in sales and a corresponding increase of 7 days extra credit taken by customers?
- Do you have enough working capital lines to fund the above adverse cashflow movement?
- Have you started to examine possible alternative (to the UK) export markets?
- Have you examined non-UK sources of your inputs?
- Have you considered if your sector could be exposed to increased UK competition (including UK companies entering into the Irish market due to weak Sterling)?

The impact of a hard Brexit will be sudden and sharp. That is for certain. The hope is that it is avoided and that the economy “dodges the bullet”. But for now, it remains a very material possibility. Its not too late to undertake some action (especially if there is a delay to end January 2020 in the decision to exit as appears likely at this point in time) but it is getting tight.