THE TREASURY HUB
Banking and Treasury Markets

November 2019 Report

1. Executive Summary

1	Executive Summary	2
2	Interest Rate Review	3
3	Foreign Exchange Review	6
4	Oil and Gold Markets	8
5	2020 Budget Considerations	9

1.1 Introduction

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

The deadline date for the UK to trigger its exit from the EU came and went….again. The next date is January 31st (or sooner if agreed by parliament) but with an election now called, there remains a risk that "no deal" could still arise (Tory/Brexit Party coalition).

On a separate issue, one of the main banks recently wrote to some clients stating that they will be charging negative deposit rates on BOTH deposit and (positive) current account balances. This is a consequence of both negative market interest rates in general and regulations (as they are now obliged to keep a reasonable level of their assets in cash/near cash to protect against a sudden "run" on deposits). As they incur negative returns on such assets, they are starting to pass on this cost to smaller customers (they have been charging negative deposit rates on larger deposits since end 2017/early 2018).

Our Section 5 this month focuses on the economic outlook and how it may impact on your company budgets for 2020. Our general thinking is that while the broad outlook remains positive, the risk of a hard Brexit has not completely abated and there is the added risk that if that disappears off the agenda, the government will promise to spend more before an election here. Would be a short-term benefit but at a likely subsequent cost.

The Market Metrics table below is all in red apart from the trend in equities.

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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	-0.0840%	-0.3100%	-0.3940%
Interest	EUR 3-year	-0.2160%	-0.1200%	-0.3360%
Interest	GBP 3-year	-0.3605%	1.1564%	0.7959%
Interest	USD 3-year	-0.9780%	2.5580%	1.5800%
FX	EUR/GBP	-4.4225%	0.8996	0.8615
FX	EUR/USD	-1.7220%	1.1342	1.115
Equities	ISEQ	19.1257%	5490	6540
Equities	FTSE 100	7.6329%	6734	7248
Equities	Dow Industrial	15.8485%	23346	27046
Gilts	IE 10-yr	-0.8650%	0.875%	0.010%
Gilts	GB 10-yr	-0.6190%	1.249%	0.630%
Gilts	US 10-yr	-0.9950%	2.686%	1.691%

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

1.3 Forward-looking Indices

Last month we introduced forward-looking indictors known as Purchasing Manager Indices or PMIs to be monitored in the context of the economic outlook in Ireland and the UK. We will continue to include these for the foreseeable future. Please note that readings above 50 indicate expansion while below 50 denotes contraction.

Table 2. Irish and UK PMI readings

Variable	Ireland	UK
Manufacturing PMI	50.7	49.6
Services PMI	53.1	50.0
Construction PMI	48.3	44.2

1.4 Brexit

With an election now called, there remains a risk that "no deal" could still arise (Tory/Brexit Party coalition). The EUR/GBP exchange rate has held steady around EUR/GBP0.8600, a level that broadly reflects a deal (we called EUR/GBP0.8500 in the event of a deal a number of months back, a level that we still stand over) but the risk right now is very much on GBP weakening again for the simple reason that "no deal" is seen as off the table by the markets. We still think it has a much higher probability than the markets are forecasting at this point in time… and so encourage exporters to remain cautious in their GBP hedging over the next 4-5 weeks.

1.5 Treasury Hub Activities

One of the advantages of our collaboration under The Treasury Hub is that we now have access to 7 other firms across the country who have good clients similar to you. It has come to our attention that all firms have a mix of clients that are expanding and some that are thinking of selling, usually due to succession issues.

If you have an interest in either expanding or disposing of your business, please get in touch with us as we have a large network now that could facilitate the best possible outcome for you in your business requirements in this regard. Even if you are unsure but are considering either of the above situations, please feel free to have a chat with us to provide you with appropriate guidance.

1.6 Conclusion

Regardless of Brexit fatigue, it will dominate the business landscape in 2020. Even if they meet the transition exit date of January 31st, the current scheduled date for leaving the EU is December 31st 2020, with a possible 2-year extension if requested. The 2020 Budget of your company will have to reflect this continuing uncertainty.

2. Interest Rate Review

NO MATERIAL CHANGE IN EUROZONE INTEREST RATES. BIGGEST EMERGING TREND IN THAT SPACE IS NEGATIVE DEPOSIT RATES FOR SMALLER BALANCES.
EUR swap rates having been negative out to 13 years at the start of last month, are now negative to 8 years. Bond yields have also increased slightly.
Fixing interest rates remains a serious consideration.

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. Please note that there are plans to replace euribor as a refence rate in due course. More about this at a later date.

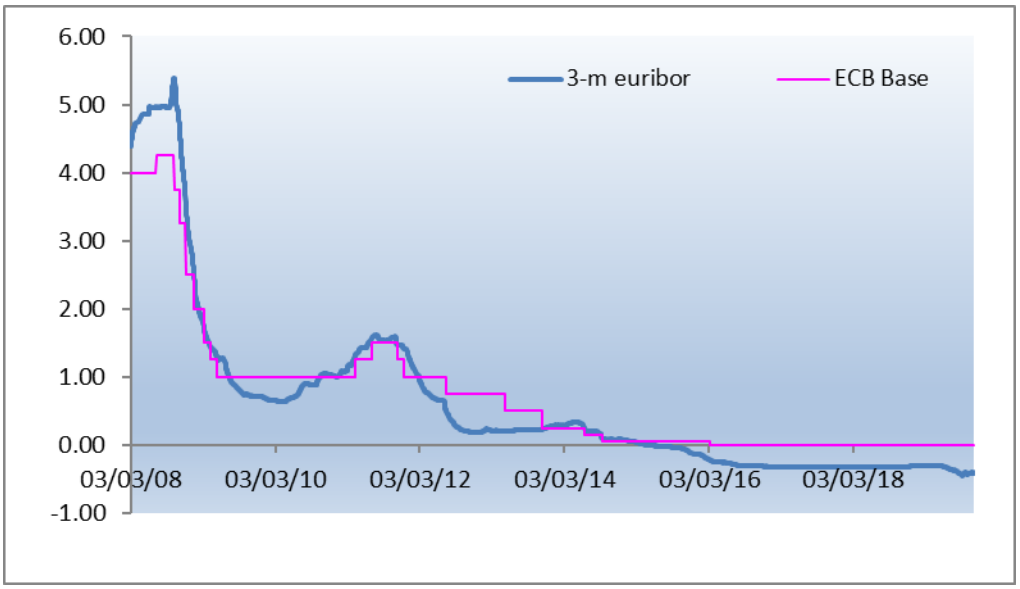
Key Observations

We could "cut and paste" the commentary in this section from one month to the next. 3-month euribor has remained around -0.40% for most of October. The main development, as referenced in 1.1 above, has been the signaling of negative interest rates to flow through to current and deposit account balances. This does not look like it will reverse any time soon, once established, as the outlook for interest rates continues to be very benign.

German inflation continued to ease last month, for the 4th month in a row, sitting at +1.1% in October. The Irish equivalent was +0.9% in September while the October reading for the Eurozone was +0.7%.

The ECB cut its deposit rates (commercial banks are the main depositors with the ECB) to -0.50% making it more expensive for banks to place such deposits. This is part of the reason why negative deposit rates are starting to be charged by Irish banks on retail deposits. However, the ECB has also said that these rate cuts are likely to have a marginal effect on stimulating economic growth at best and that fiscal policy (government spending) is the required stimulus now. That could be a challenge in Ireland where the Government debt is above €200bn as a result of the financial crisis, and still rising (see Section 5).

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

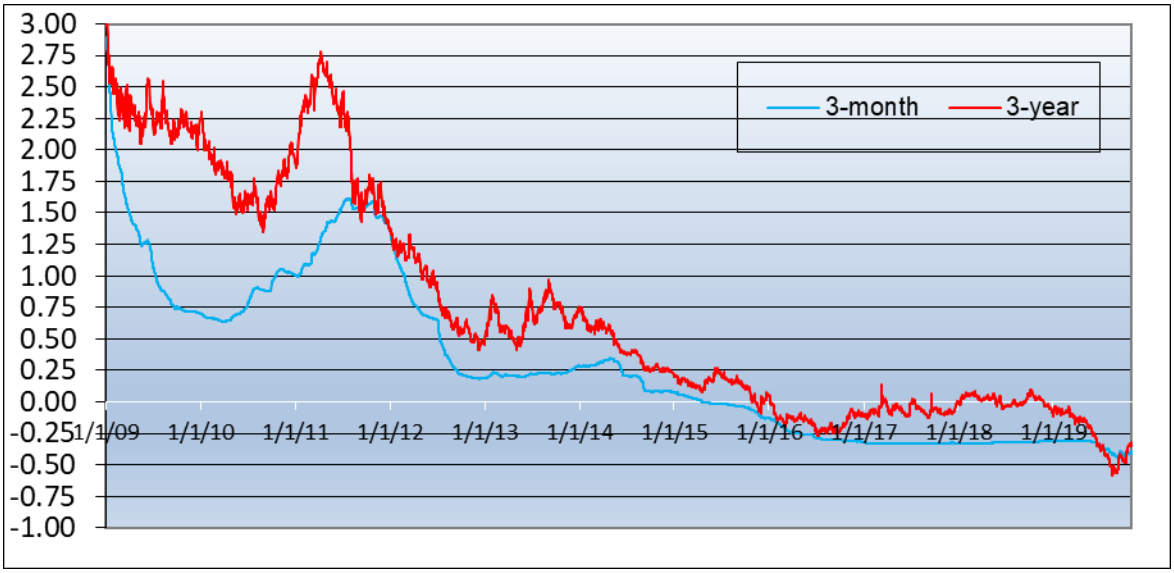


2.2 EUR medium-term rates

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 above graph of 3-month Euribor versus 3-year swap shows that there is still little difference between both although fixed rates have risen off recent all-time lows in the past month and are now marginally above the 3-month rate again.

Th graph of the 3-year swap rate for the past two years follows. Given that (pre-margin) variable rates have been "floored" at 0% in most loan agreements, the gap between fixed and floating rates is now close to if not zero. In summary, it should now be possible to fix interest rates at an all-in cost that reflects the margin only.

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

2.3 UK and US interest rates

The rapid change in UK and US interest rates expectations since Q2 2019 has tailed off with US fixed rates increasing slightly in October. The Fed cut official US (short-term) rates again last week and while the general consensus is for significant economic softening if not outright recession in the US in 2020, we believe that this may prove too pessimistic

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

	EUR	GBP	USD
3-m	-0.394	0.809	1.903
2-year	-0.350	0.800	1.620
3-year	-0.336	0.796	1.580
5-year	-0.240	0.805	1.573
7-year	-0.120	0.830	1.606
10-year	-0.140	0.640	1.610
2v10 spread	0.210	-0.160	-0.010

In the UK, the negative yield continues mainly due to Brexit uncertainty and the forthcoming general election will not help matters in the short-term due to its resultant continuing uncertainty. The outcome of that election may also impact on UK rates, especially on gilt yields, if Labour wins and launches an investment initiative through higher borrowing.

Graph 4. GBP 3-year swap rates over past two years

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. So if borrowing Sterling for a period past 2021, ensure that the documentation caters for this eventuality.

In the US, the yield curve shape continues to be negative out to 8 years (the 3-month rate is higher than longer-term fixed rates to 8 years).

Graph 5 below is for US 3-year swaps over the past 24 months to show how quickly US rates have declined since Q4 2018. If the trade war with China is averted, this correction may prove to be overdone with longer-term US rates possibly increasing, albeit slowly, again in 2020.

The unemployment rate fell to 3.6% in October but forward-looking indices such as PMI readings and business confidence are, if positive, are barely so. October Manufacturing and Services readings are 51.3 and 50.6 respectively while business confidence was 48.3.

We believe that the US/China trade war may see some element of compromise soon as President Trump cannot afford a slowing economy in an election year. If, as we expect, some sort of compromise is reached, then interest rates (and the dollar) could rebound. The one other Chinese-related risk is possible military intervention on the streets of Hong Kong – this risk, we believe, is increasing). How the world would react is not certain although there is probably little other countries can do. Watch this space.

Graph 5. USD 3-year swap rates over the past two years

2.4 Summary

- This decline in interest rates not anticipated by the markets at the start of the year looks like it has bottomed out for now. However, there is little likelihood of any upswing in Eurozone or UK rates in the foreseeable future. US rates may bounce back a little in the event of a resolution to the trade war with China

- We are now suggesting possible pricing of fixing of the cost of debt because fixed rates are so low

- We previously noted that Irish banks had NOT passed on the benefits of negative euribor rates to borrowers having inserted clauses in loan agreements that the lowest such rates can go is 0%. This appears to be changing which is good news for borrowers but bad news for depositors with negative interest rates on positive current account balances and deposit rates looking inevitable next year

- OUR BIGGER CONCERN REMAINS THE IMPACT OF QUANTITATIVE EASING (PRINTING OF MONEY) ON ALL OF THIS AND WHETHER WE ARE HEADING TOWARDS A MAJOR FINANCIAL MARKETS CORRECTION.

3. Foreign Exchange Review

While GBP weakened as a result of political uncertainty at the start of the Summer, it strengthened in line with views that a Hard Brexit was less likely and has held firm in a narrow range around EUR/GBP0.8600 in the past few weeks.

USD continues to trade within a narrow range. There was a brief bit of USD strength over the past month with the rate dropping below EUR/USD1.0900. We continue to hold the view that the range has been very narrow for a long time and past experience suggests this is unlikely to continue.

3.1 EUR/GBP

Background

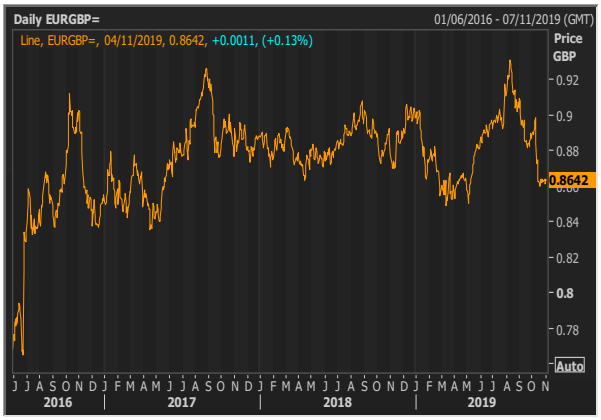
Brexit and related political developments continue to weigh on EUR/GBP. However, the uncertainty is taking its toll on the UK economy with unemployment appearing to have bottomed out over the Summer, retail sales have fallen on a month-on-month basis in three of the past five months, manufacturing PMI remaining below 50 at 49.6 while Services PMI is at 50. Business and consumer confidence are both negative and have been in eight of the nine months for the former and for every month of 2019 for the latter.

Key Observations

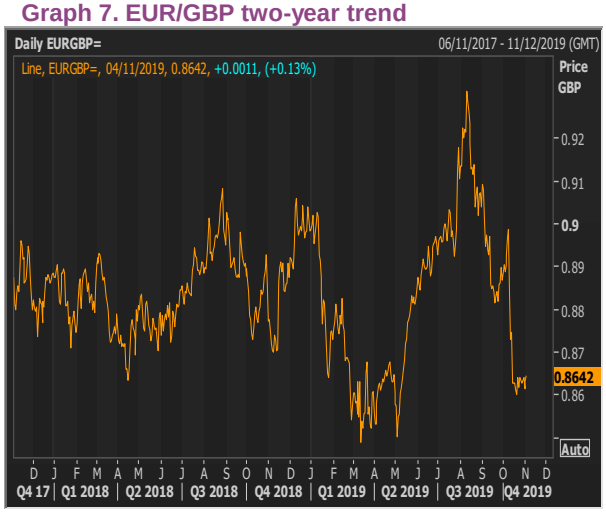
The view expressed in this bulletin since the end of Q2 has been that the possible currency range could be +/-5p around the 90p level: a hard Brexit would easily see the rate move to EUR/GBP0.95 (some say parity) while a soft Brexit should see the rate trade back to EUR/GBP0.85 or thereabouts.

The market took the view that a “no (transition) deal” outcome was ruled out due to a parliamentary vote and, as a result, the rate has traded in a tight range of EUR/GBP0.8600 to EUR/GBP0.8650 since the middle of October. The announcement of a general election was as expected (and as predicted here also). The markets will watch the polls carefully over the coming weeks as the current expectation is that some sort of coalition will be required. We believe that a Tory/Brexit Party alliance or a Labour-led coalition would be bad news for Sterling, for different reasons. Therefore, exporters need to avoid complacency (that caught them out in Q2 of this year). Graph 6 demonstrates the trend in EUR/GBP since Brexit while Graph 7 highlights the trend over the past two years.

Graph 6. EUR/GBP since Brexit Referendum



Graph 7. EUR/GBP two-year trend



Summary

The wide range of EUR/GBP0.8500 to EUR/GBP0.9500 depending on soft/hard Brexit remains intact for now. With the election outcome having the most likely impact between now and Christmas on EUR/GBP, we see the risk towards weaker sterling.

6 and 12-month forward points are 0.55p and 1.10p respectively (added to the spot rate).

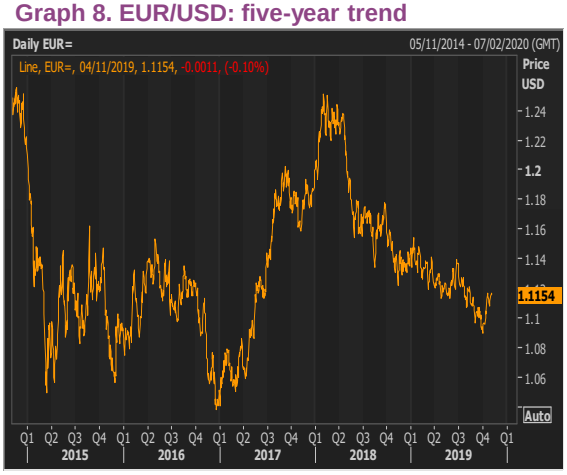
3.2 EUR/USD

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/USD1.0750 to EUR/USD1.1200. Dollar has been slowly but steadily strengthening over the course of the year against EUR (as evidenced in Graph 8).

Graph 8. EUR/USD: five-year trend



Key Observations

The EUR/USD holding pattern has held for 18 months now. Any signs of a resolution to the trade war with China would support it in the short-term. The Democrats appear intent on pushing impeachment proceedings against President Trump and this would probably be negative for the dollar. And with the Dow recently hitting new record highs, this is also dollar-supportive….for now!

EUR/USD forward points for 6 and 12 months continue to narrow and are +0.0130 and +0.0255 respectively. This plus gradually strengthening of the US currency has been positive for exporters in recent months.

Summary

Still very difficult to call direction in this currency pairing with all of the political and economic uncertainty. At this point in time, the downside risk appears to be more in the Eurozone. And, as previously mentioned, if there is a global slowdown, one of the key factors may be if the markets see USD as a safe haven. Continue to watch and wait for now.

4. Oil and Gold Markets

- ***Oil price continues to bounce around***
- ***Our decision to monitor the price of gold as it tends to increase in price when financial markets become more volatile has seen a sharp increase in the price.***

4.1 Oil Price Trends

Graph 9. Oil prices: two-year trend

While this commodity has been less volatile in 2019 than in the previous year, we are still looking at a trading range of $55/bl to $75/bl over the year to date. It's a very difficult commodity to call from either a price or directional perspective. What is sure is that it is volatile and can move material amounts in a short space of time.

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

4.2 Gold Price Trends

Graph 10. Gold prices: ten-year trend

Having climbed from $1275/oz at the start of June to over $1550/oz at the beginning of September, the price has eased back a bit over the past few weeks trading in a range of US$1470 to US$1513/oz. As an asset class, it's still showing a very positive return since the end of Q2 (when we first started tracking it). As we mentioned, it tends to increase in price as a hedge against a slowing economy. The recent stabilisation probably reflects a similar "pause" position on the US economic outlook.

Graph 11. Gold prices: 2019 trend

5. 2020 Budget Considerations

5.1 Background

As most companies are about to if not already started their annual budgetary process, we thought it would be worthwhile to look at some key variables worth considering.

The 2020 Budget recently produced by the Department of Finance ("DOF") contains a significant amount of data and we highlight what we believe are key points below. We also planned to look at forecasts by certain banks and we conclude with our own thoughts.

- **Hard Brexit scenario forecasts**
    - Slightly negative GDP growth
    - Fall in personal consumption of -0.1%
    - Significant deterioration in fixed investment of -27.9%
    - Deflation of –0.1%
    - Growth still driven by exports – offsetting material fall off in domestic demand.

- **Impact of 'No Deal' versus 'No Brexit"**
    - GDP 3.8% worse
    - Employment rate 2.1% worse
    - Unemployment rate to rise to 5.9% in 2021/22 before improving again.
    - Still talking about wages growth of 3.0% to 3.2% in 2020 and 2021.
    - Inflation a mix of rising prices for services and falling prices for goods.
    - DOF also sees oil price supply shock potential.

5.2 Macroeconomic Indicators

Key points from the recent presentation by DOF are:

- Global economic policy uncertainty (monitored since 1999) is at an all-time high
- Emerging markets especially are facing a material and sudden drop in fixed investment
- Most PMI readings point to a manufacturing recession
- Irish households also increasingly cautious: household savings ratio has increased over the past few years (which tends to indicate lower spending). In fact, the savings ratio will be higher than the long-run average in the period 2017 to 2019 inclusive. Household debt levels remain high by European standards (see Graph 12 below).

5.3 Bank Forecasts

The availability of forecasts from commercial banks is very poor at the minute. Data available is out of date and so accordingly we will form our views below based on Central Bank, DOF and our own observations.

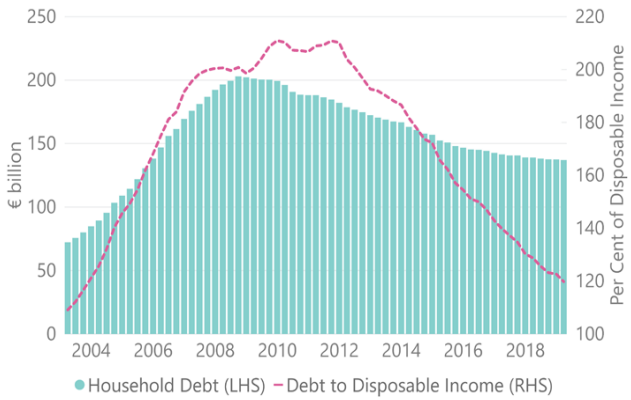
5.4 Observations

1. The difference in impact on the economy between soft and hard Brexit scenarios is very material, especially for those sectors that are more exposed to disposable income trends. These would include non-food retail, hotels, hospitality (pubs, restaurants).
2. Brexit is more likely to hit the regions much harder than the East Coast. A lot of food companies exporting to the UK are regionally based and are more likely to be SME's.
3. Government spending is forecast to remain strong on the investment side (although probably driven by some very large projects) but private sector investment will suffer. However this is against a backdrop of still rising debt despite several years of strong economic growth (see Graph 13).
4. A hard Brexit will present acquisition opportunities in the UK as their SME base is very poorly prepared and one would expect their banking sector to retrench in the event of economic slowdown. Bottom line is good UK companies could run out of money quickly.
5. Irish Banks are also taking a conservative view of lending to exporters, especially SME's until Brexit uncertainty is resolved. So if you don't have spare financial capacity yet and export to the UK, applications for funding (other than SBCI) will need to be put together very carefully and comprehensively in 2020.
6. Level of preparedness on FX hedging despite all of the education and grants available, was poor to date for Irish SME Sector. This would be expected to have negative consequences for future banking of such SMEs as higher risk (no hedging) inevitably leads to higher pricing of loans. Thus companies could potentially lose out on the double (higher borrowing margins, lower receipts for GBP Sales).
7. Negative interest rates on current account balances will be an extra cost in 2020. The focus now needs to be on processes (lower transaction costs, less time spent on processes in the area of daily cash management).

In summary, 2020 will be a big challenge in the event of "No Deal". When the transition deal is done, the next question is do they leave in December 2020 or December 2022?

Strategically focusing on non-UK sales could become a short-term priority as will be sourcing from non-UK sources within supply chains. Plenty of work of a strategic nature to be done next year by all businesses.

Graph 12. Irish Household Debt (Source: Central Bank)



Graph 13. Government Debt)Source: Central Bank)

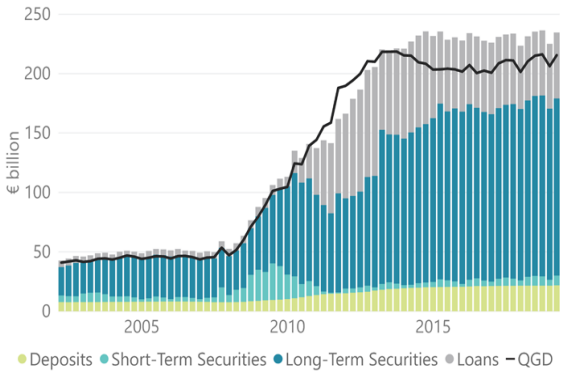


Table 4. DOF Forecasts under disorderly Brexit

	2019	2020	2021	2022	2023	2024
GDP	5.5%	0.7%	2.5%	2.8%	2.7%	2.6%
GNP	4.3%	-0.1%	2.4%	2.5%	2.4%	2.3%
Personal Consumption	2.7%	1.4%	1.9%	2.1%	2.3%	2.4%
Investment	50.4%	-24%	-3.6%	3.9%	3.9%	3.9%
Inflation	0.9%	1.1%	1.4%	1.8%	2.0%	2.1%
Unemployment	5.2%	5.7%	5.95	5.9%	5.7%	5.55