THE TREASURY HUB
Banking and Treasury Markets

December 2019 Report

1. Executive Summary

1.1 Introduction

We bring you the final Banking and Treasury Report of 2019 as part of THE TREASURY HUB.

The focus appears to be on politics worldwide. The UK election is now in full swing, the US presidential election is also gearing up while the current Irish government is moving into its last months.

As the table across highlights, it was a good year for equity investors, a bad year for bank deposits, a good year for borrowers and a reasonably stable year for currencies, especially USD.

Brexit news was negligible in the past month as the outcome of the UK election will dictate a lot of what is to come in 2020 on that topic. We still remain uncomfortable about the prospect of a hard Brexit if, as the polls suggest, the Tories win a majority.

Our Section 5 this month focuses on the banking sector and prospects for 2020.

We urged clients to refinance bank facilities in 2019 as it was a good time to do so, especially in light of Brexit uncertainty. We have noticed quite a lot of such activity in Q4 and, more importantly, the type of companies doing it is quite telling as it is the ones that we would normally consider to be the "early adopters". We believe that this opportunity should prevail for H1 2020 but if Brexit negotiations do not proceed well by June, then the increasing prospects of a hard Brexit will have a negative effect on banking (and broader economic prospects). An economic slowdown is probably due based on past cyclical trends and borrowing/refinancing in such an environment will, in all probability, be more challenging (and expensive).

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	-0.0910%	-0.3100%	-0.4010%
Interest	EUR 3-year	-0.1500%	-0.1200%	-0.2700%
Interest	GBP 3-year	-0.3464%	1.1564%	0.8100%
Interest	USD 3-year	-0.9680%	2.5580%	1.5900%
FX	EUR/GBP	-5.5869%	0.8996	0.852
FX	EUR/USD	-2.9687%	1.1342	1.1015
Equities	ISEQ	27.4681%	5490	6998
Equities	FTSE 100	9.0882%	6734	7346
Equities	Dow Industrial	20.1533%	23346	28051
Gilts	IE 10-yr	-0.8100%	0.875%	0.065%
Gilts	GB 10-yr	-0.5500%	1.249%	0.699%
Gilts	US 10-yr	-0.9100%	2.686%	1.776%

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.

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1.3 Forward-looking Indices

In October 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. The Irish readings worsened across the board in October with two of them in contraction territory now while all three UK indicators are below 50.

Table 2. Irish and UK PMI readings

Variable	Ireland	UK
Manufacturing PMI	49.7	48.9
Services PMI	50.6	48.6
Construction PMI	46.2	45.3

1.4 Brexit

GBP has acted as we expected in a scenario of No Deal being taken off the table and has traded close to the 85p level as we called during the year. The election result will the next driver of the currency although a Tory majority will probably see the currency hold around EUR/GBP0.8500 for the remainder of the year. The risk will be to the downside in the New Year in that scenario.

1.5 Treasury Hub Activities

As 2019 closes we look forward to our 2020 planning meeting as part of The Treasury Hub where we will seek to broaden and deepen the quality of the service provided to you in the area of banking and treasury. We will keep you informed of further developments as they arise during the course of the coming year.

1.6 Conclusion

As referenced in last month's bulletin, Brexit will still dominate the business landscape in 2020 with the current scheduled date for leaving the EU being December 31st 2020. We also believe that 2020 will see further changes in the banking environment as non-banks continue to increase their market share in their areas of expertise such as payments, foreign exchange and lending. Finally, we believe that green and environmental issues will begin to impact on mainstream lending from 2020.

2. Interest Rate Review

ALTHOUGH THERE IS NO MATERIAL CHANGE IN EUROZONE INTEREST RATES, SWAP RATES CONTINUE TO EASE BACK UPWARDS, ADMITTEDLY FROM VERY LOW LEVELS. The restart of QE by ECB has led to 3-month Euribor slipping back towards -0.40%. If considering fixing, be careful in the rates being quoted by banks.

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.

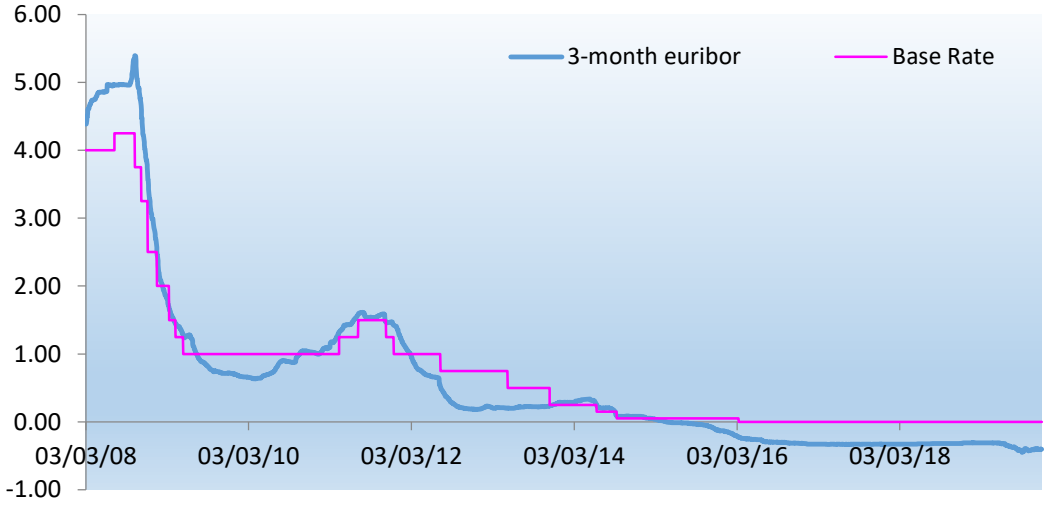
Key Observations

Very little change to report over the course of November. Swap rates are easing back upwards from historic lows seen in August/September.

German inflation held at the prior month rate of 1.1% in November having eased for 4 consecutive months. The Irish equivalent was +0.7% in October, back from +0.9% the previous month while the November reading for the Eurozone was up 0.3% to +1.0%.

The last ECB meeting of the year will be on December 12th but all the indications are that the Bank is running out of effective monetary tools in that further rate cuts are unlikely to have a material effect on stimulating economic growth leaving fiscal policy (government spending) as the required stimulus now. The focus in Europe is on Germany as it has run a government Budget surplus since 2014 and the surplus has been growing with the 2018 reading at 1.90% of GDP. Germany, of course, has been a major beneficiary of the Euro as the currency is weaker than a German currency would be thereby boosting its exports. In fact, Germany has run a positive balance of trade in every year since the inception of the Euro. We will watch this space with interest in 2020.

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

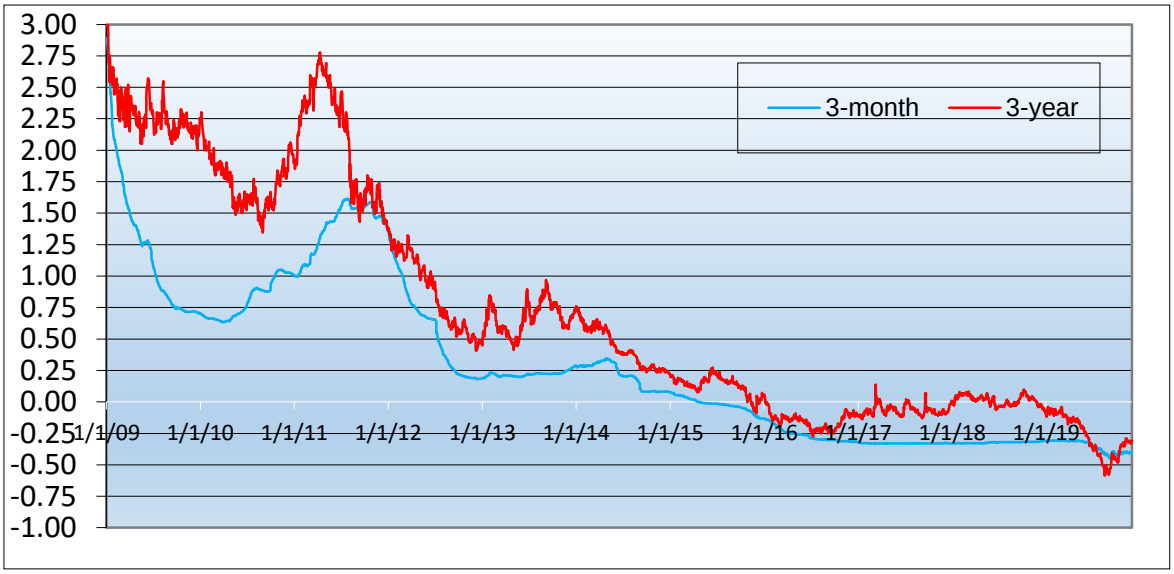


2.2 EUR medium-term rates

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 the swap rate is now back above the Euribor rate again although the gap remains quite narrow.

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. Based on recent conversations with one of the main banks, they will only offer fixed rates at zero at best (pre-margin).

Graph 3. EUR 3-year swap (fixed): two-year trend

2.3 UK and US interest rates

Although both UK and US interest rates have fallen dramatically over 2019, they have recently bottomed out and increased in November. The key trend in November is that both UK and US yield curves are no longer inverted in the 2 to 10-year range. We continue to hold the view that the world economic outlook is not as bad as previously envisaged but that may change should there be a sudden fall in equity markets, especially in the US.

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

	EUR	GBP	USD
3-m	-0.401	0.793	1.906
2-year	-0.320	0.790	1.600
3-year	-0.270	0.810	1.590
5-year	-0.180	0.850	1.590
7-year	-0.070	0.890	1.640
10-year	0.100	0.950	1.705
2v10 spread	0.420	0.160	0.105

In the UK, swap rates have been in a "holding pattern" of +/- 5 basis points around 0.75% since mid-October mainly due to markets waiting to see what will materialize out of the forthcoming general election. The outcome of that election would be most likely to impact on UK rates, especially on gilt yields, if Labour wins as higher Government borrowing would be inevitable.

Graph 4. GBP 3-year swap rates: two-year trends

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, whilst the yield curve shape is still negative (the 3-month rate is higher than longer-term fixed rates to 10 years), the 2 vs 10-year spread is now positive again.

Graph 5 below is for US 3-year swaps over the past 24 months. Longer-term US rates have stabilised over the past few weeks as fears surrounding the economic outlook for 2020 have abated somewhat.

The unemployment rate was at 3.6% in October and has been hovering around this level for the past 7 months. Forward-looking indices such as PMI readings remain positive (i.e. above 50) and are in better shape than in either Ireland or the UK. November Manufacturing and Services readings are 52.6 and 51.6 respectively while business confidence was 48.1.

Talk about some element of settling of the US/China trade war ebbs and flows. China has recently halted US permission to undertake some military manoeuvers in Hong Kong. The US need to reach some sort of compromise in the short-term given the 2020 election. However, we still hold the view that military intervention on the streets of Hong Kong is possible so watch developments this space.

Graph 5. USD 3-year swap rates: two-year trends

2.4 Summary

- This decline in interest rates which has prevailed over the course of the year to varying degrees has halted over the past six weeks. However, the prospect of a meaningful rise in Eurozone rates in 2020 is almost zero at this point in time future.
- Governments remain the biggest beneficiary of the negative rates with 57% of all Eurozone government bonds (or €4.52 trillion!) still yielding negative returns.
- It would appear that fixed rates of zero (pre margin) may the best that people can achieve in the short-term…..but variable rates do not appear to be moving below zero either.
- We reiterate the point made last month that depositors are likely to have to contend with negative interest rates on positive current account balances and deposit rates 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

The EUR/GBP currency pair has been weighed upon by Brexit and related political developments all year and has traded in a tight range in the past few weeks because of a markets “wait and see” approach to the general election result. UK retail sales have been flat or negative for the past three months while the three PMI categories have readings below 50 signaling contraction. Business and consumer confidence are both negative and have been consistently in 2019.

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 continues to take the view that “no (transition) deal” is off the table and we have broken through the EUR/GBP0.8500 rate this morning (December 4th). The markets continue to watch the polls carefully as to the likely election outcome. Current polls put a Tory majority the most likely outcome and bookies have such a result as odds on (4/11). Therefore, exporters remain in a good place for now but we continue to urge them 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. Technical analysis suggest that we are approaching a key level around EUR/GBP0.8450.

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 has just been breached on the downside. With the election outcome having the most likely impact between now and Christmas on EUR/GBP, we see the risk towards weaker sterling but in H2 2020 assuming a Tory majority in parliament. EUR/GBP should finish the year around the EUR/GBP0.8500 level.

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. The gradual strengthening of USD against EUR continues.

Graph 8. EUR/USD: two-year trend

Key Observations

The EUR/USD holding pattern which has held for 18 months shows no sign of being altered for now. Any resolution to the trade war with China would further support it in the short-term. Impeachment proceedings against President Trump continue but it has yet to have an affect on the dollar. Meanwhile the Dow hit another new record high at the end of November.

EUR/USD forward points for 6 and 12 months continue to narrow and are +0.0130 and +0.0250 respectively. This plus gradual strengthening of the US currency has been positive for exporters in recent months.

Summary

Given that the downward trend (strengthening of USD) remains intact, the short-term expectation can only be for further gradual USD strength. The long-term direction in this currency remains more difficult to call although as we have previously pointed out the downside risk appears to be more in the Eurozone. Stock market corrections are probably a material risk but we (and others) have been saying this for a while now. Continue to watch and wait.

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 in the period of observation.***

4.1 Oil Price Trends

The 2019 trading range of $55/bl to $75/bl remains intact as the OPE cartel continues to try to counteract negative consequences of both a slowing global economy and the rising green agenda. It's a commodity that is prone to speculative activity and this increases the price volatility of it as a result.

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

4.2 Gold Price Trends

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$1455/oz. The easing in the price probably reflects the recent scaling back of a negative global economic outlook. We commenced watching this asset class as it tends to increase in price as a hedge against a slowing economy. The recent stabilisation is not unexpected as a result.

Graph 11. Gold prices: 2019 trend

5. 2020 Banking Outlook

5.1 Background

The banks have made a full recovery since the financial crisis and their capital and liquidity metrics are both in line with market norms (or thereabouts). Net interest margin (the difference between their cost of funds and the average margins that they charge on loans) is significantly higher than their international peers and, as a result, could be both questioned (as it puts Irish firms at a cost disadvantage to their European competitors) and could come under pressure in 2020. However, they have been somewhat cushioned from competitive pressures in that foreign banks have so far avoided acquiring one of the market participants. Competition will, however, increase in those sectors where there are non-bank participants.

5.2 Credit Ratings

All banks have credit ratings as these ratings are an indicator of the relative financial health of the banks. It is of particular relevance to those that invest in or lend to the banks including depositors (as a deposit from a company or individual is, in fact, a loan to a bank).

Many may be familiar with the term “AAA-rated” as this implies the best (long-term) rating possible. No commercial bank in the world is AAA-rated (banks controlled by AAA-rated countries such as Germany may be but, as State Banks, they are seen as the same credit risk as the country.) There are 10 levels of investment grade credit ratings with AAA being 1 (best) to BBB- being 10 (worst). Anything below this is deemed to be sub-investment grade.

After the financial crisis, all three Irish banks (AIB, Bank of Ireland and Permanent TSB) were sub-investment grade. At the end of September, both AIB and Bank of Ireland are rated BBB+ (or 8) while PTSB was BB=+ (or 11). Ulster Bank has an A- (7) rating in the Republic of Ireland.

As a country, Ireland was upgraded to a credit rating of AA- (4) having fallen to BBB+ (8) at the height of the crisis.

5.3 Share Prices

Up to the end of Q3 2019, the Irish banks share prices had taken a bit of a battering. AIB at €2.72 was down 35% in the year while Bank of Ireland at €3.64 was down just over 33%. Both shares have recovered somewhat to €2.97 and €4.56 respectively at the end of November 2019. PTSB is down from €1.66 at the start of the year to €1.04.

5.4 Observations

Key observations of the current state of play for the Irish banks in general are as follows:

- Their cost bases are still too big for the current loan books. If they don’t grow loan volumes soon, they will have to start another round of significant job cuts. The latter is almost 100% the likely outcome and the Irish banks as matters stand today will be a lot smaller than they currently are in 5 years time
- They have lost quite a lot of market share in the foreign exchange (“FX”) area over the past 5-10 years as FX is seen as a commodity by most companies and, as a result, choice of provider comes down to pricing for the most part. Technically there is potential credit risk in using non-bank providers of such services but companies may get comfortable in this respect either totally or by using non-bank providers for spot and short-dated forward contracts whilst using banks for longer-dated forward contracts
- Negative interest rates have prevailed on larger deposits (€10m+) for nearly two years now but it looks like negative rates will prevail across deposits of all sizes over the course of 2020 and, probably, on positive current account balances
- This will leave companies paying interest on both loans and deposits
- This has both cost and liquidity consequences. In the case of the latter, companies had been keeping cash as a source of liquidity in case banks provide lower facilities when they go to refinance. The cost of holding cash and debt simultaneously will rise as a result. **(We can help you to structure your debt facilities to reduce this cost with a little creativity)**
- From a technological perspective, they are spending money on systems but are playing catch-up. Already they are losing out, especially in the younger market segment to the likes of Revolut for clearing accounts and this trend looks likely to continue unless their system developments are both brilliant and rapid

- On the lending front, there is a lot of competition in the €10m+ borrowing range and even more in the €25m+ range
- Non-Irish banks such as Barclays and HSBC tend to focus on the Top 300 companies in the country and large exporters/multinationals respectively
- Rabobank remains a strong market participant in the food and Agri sector but doesn't stray outside of it. It also has a preference for loans in the €10m+ category
- The main Irish Banks are keen to lend to hit their budgets but are still taking a conservative view of lending to certain sectors including exporters especially SME's exposed to Brexit
- Property development is not part of what they will fund so that part of the market is very much the domain of the non-bank lenders and new "State" bodies
- The number of non-bank lenders has also grown. Some lend directly like a bank while others participate in certain markets such as leasing or invoice discounting. Bespoke solutions are also available from some
- All of these charge more than the main banks but that is a function of both their higher cost of funds and the potential higher risk profile of some of the loans made
- Turnaround times are also very slow…in fact too slow for what is supposed to be a service sector
- However, money remains available for a wide range of activities including equity release and acquisitions.

5.5. Summary and Action Points

We have adopted a proactive approach to borrowing with our clients in 2019. Preparation and presentation are crucial aspects of any borrowing process as they can result in both better commercial deals and lower pricing. We can see margins under pressure in the upper end of the market and this ought to begin to trickle to the mid-corporate market in 2020.

One of the key advantages of The Treasury Hub is that we can now compare prices charged by banks across different sectors around the country as we have collaborating firms operating in 10 counties already. No other accounting firm will be able to match this ability for price checking (and also obtaining best terms and conditions). The ultimate beneficiary of this is you as a borrower. It also means that our service pays for itself, often many time over.

The first half of 2020 should remain positive for borrowers. If you would like to seek some equity release if you are an older shareholder, then come and talk to us. If you are thinking of selling then early 2020 would be a good time as funding will be available to those that are seeking to borrow to acquire. If, we as fear, hard Brexit starts to emerge as a real possibility over 2020, this will likely have a dampening effect on the availability of credit and this, in turn, could adversely effect the price payable on acquisitions (as they have to be funded). So it would not only impact on acquirors but also on sellers.

We are uniquely positioned to provide a top-quality service which will address best pricing, terms and conditions by benchmarking these against comparable deals nationwide from a local base. We aim to be the #1 firm in this locality to talk to when dealing with your bank. Please give us a call if you are considering buying or selling your business or simply financing or refinancing activities.