THE TREASURY HUB
Banking and Treasury Markets

January 2020 Report

1. Executive Summary

1.1 Introduction

We bring you the first Banking and Treasury Report of 2020 as part of THE TREASURY HUB. The publication both looks back at 2019 trends and looks forward at possible 2020 developments.

Brexit dominated for a lot of the year while politics dictated worldwide events in general. The UK elected a new Prime Minister while the US presidential election started to gear up. Ireland will also see a new government elected in 2020.

From an investment perspective it was a good year for equity investors, a bad year for bank deposits, a good year for bond investors while on the currency front EUR/GBP bounced around quite a bit but EUR/USD remained very stable again.

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

As noted in the previous bulletin, we noticed quite a lot of refinancing activity in Q4 particularly amongst companies that did not have to do so from the perspective of maturity current facilities – it was a strategic decision for most to refinance now in order to get 5 to 7 year facilities established against a backdrop of both favourable borrowing conditions again and the prospect of a slowing economy over that time period. We continue to hold the view that this opportunity should prevail for H1 2020 but if Brexit negotiations do not proceed well by June, then the increasing probability 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 (although we also thought that last year) 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

Heading	Metric	YTD move	From	To
Interest	3-m euribor	-0.0730%	-0.3100%	-0.3830%
Interest	EUR 3-year	-0.1600%	-0.1200%	-0.2800%
Interest	GBP 3-year	-0.3364%	1.1564%	0.8200%
Interest	USD 3-year	-0.9780%	2.5580%	1.5800%
FX	EUR/GBP	-6.4112%	0.8996	0.8454
FX	EUR/USD	-1.1775%	1.1342	1.1210
Equities	ISEQ	30.8379%	5490	7183
Equities	FTSE 100	11.9988%	6734	7542
Equities	Dow Industrial	22.2394%	23346	28538
Gilts	IE 10-yr	-0.7550%	0.875%	0.120%
Gilts	GB 10-yr	-0.4240%	1.249%	0.825%
Gilts	US 10-yr	-0.7760%	2.686%	1.910%

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.

Basically the year was a good year for investors with the main equity markets and bond prices also up (as interest rates were down). We also started to monitor the price of gold in the middle of the year and that commodity has also increased in price. Brexit fatigue hit in Q1 and with GBP recovering, currency management took a back seat…until the Summer when some panic took place with weaker GBP. The year ended with stronger Sterling and equally high levels of complacency on the foreign exchange management front. The risk of hard Brexit increased with the Tory election majority. This story has more to play out in 2020.

The outlook for 2020 is a mixed one. Longest US equity market bull run must end at some pint. But we have never had Quantitative Easing (printing of money) on the current scale before which is feeding asset values. Vigilance will be required. See Section 5 for our predictions.

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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 improved somewhat towards the end of the year but UK construction was worse again while UK Manufacturing output fell at the quickest rate in 7 ½ years.

Table 2. Irish and UK PMI readings

Variable	Ireland	UK
Manufacturing PMI	49.5	47.5
Services PMI	55.9	50.0
Construction PMI	48.2	44.4

1.4 Brexit

GBP reacted favourably to the Tory majority in the election as it gave certainty to them controlling the parliament and EUR/GBP briefly broke through 83p level. Last month we stated that "a Tory majority will probably see the currency hold around EUR/GBP0.8500 for the remainder of the year". The year-end rate was EUR/GBP0.8454 but the risk in the New Year remains to the downside i.e. weaker Sterling.

1.5 Treasury Hub Activities

We met with senior management of the main banks in December as we look to establish ourselves as the "go to" advisors for all the banking needs of the SME and mid-corporate market in 2020. There are no other advisors in the market that can provide the full range of debt sourcing and negotiation, interest and foreign exchange risk and cash management services. The banks (and non-bank service providers) are very interested in both what we are doing at individual firm level and also collectively under the banner of The Treasury Hub (as the eight firms involved employ over 550 staff across 13 offices in 10 counties). Our contacts at the highest levels in all of these bank and non-bank service providers will ensure you of the best solutions to your banking and funding needs in 2020.

1.6 Conclusion

Brexit will remain to the fore in 2020 – the UK either leaves by December 31st 2020 or requests an extension by June 30th 2020. This year will also see further competitive pressure on the Irish banks who are faced with the prospect of large-scale redundancies if their competitive positions do not improve. Finally, we believe that green and environmental issues will begin to impact on mainstream lending from 2020, a topic we will return to in the coming weeks.

2. Interest Rate Review

EURIBOR AND OFFICIAL (ECB) RATES REMAINED IN A TIGHT RANGE IN 2019. THE FORMER RANGED FROM -0.306% TO -0.4480%. THE LATTER HAS BEEN 0% SINCE MARCH 2016.

SWAP (FIXED) RATES OPERATED IN A WIDER RANGE OVER THE COURSE OF 2019: FROM -0.026% TO -0.602%. HOWEVER, BANKS HAVE FAILED TO PASS THROUGH THE BENEFIT OF THESE NEGATIVE RATES TO ALL EXCEPT THE LARGER BORROWERS.

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.

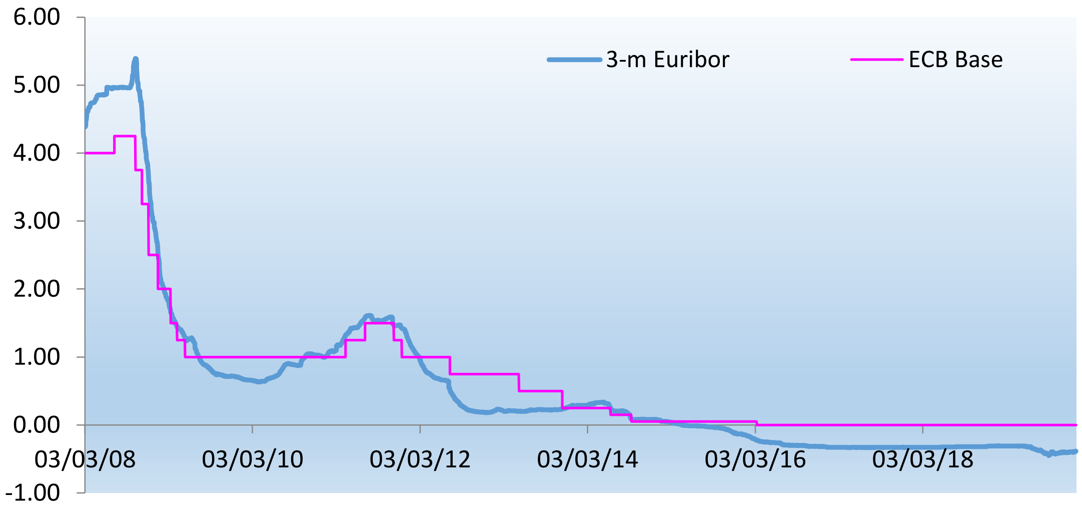
Key Observations

Very little change in short-term rates over the course of the year, mainly attributable to Quantitative Easing by the ECB. Swap rates gradually fell between March and September – Q3 swap rates being 20bp BELOW short-term rates – before increasing by 30bp to -0.28% at the end of the year. So we start 2020 with 3-month and 3-year rates, broadly speaking, at the same level.

On the inflation front (ECB has a target to maintain the rate at no higher than 2.0%), in general the outlook is benign. German inflation ranged from +1.1% to +2.0% over the course of the year, ending the year at +1.5%. In the wider Eurozone area, the 2019 range was +0.7% to +1.7% with a year-end rate of +1.3%. The Irish equivalent figures were 0.5% (July) to 1.7% (April) while the last reading was +1.1% (November), up 0.4% on October.

2019 saw the end of Mario Draghi's reign at the helm of the ECB and his replacement with Christine Legarde. As previously indicated, 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. One possible choice for it is to implement a dual rates policy (higher rates for deposits, lower rates for borrowers). A second would be to target their long-term funding to banks on specific areas such as sustainable energy and environmentally-friendly projects. However, its difficult not to see the bank pressurising Eurozone governments to increase their spending, especially on infrastructure. We will watch this space with interest in 2020.

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

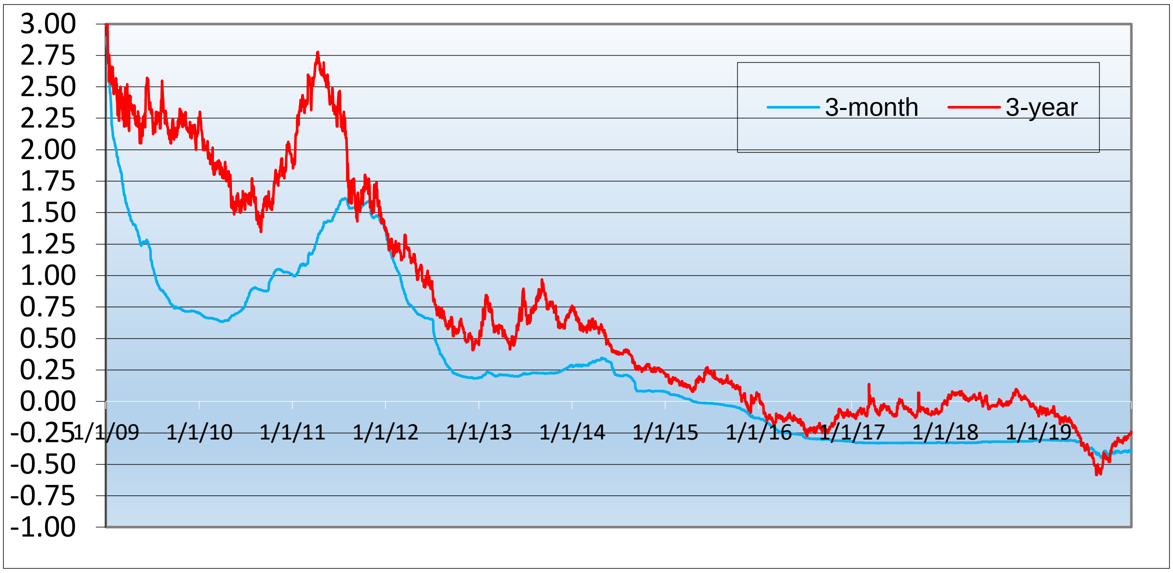


2.2 EUR medium-term rates

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 if you so require.

Graph 2. EUR 3-year swaps versus 3-month euribor: 2009 to date



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 and highlights the significant (and unexpected) fall-off in 3-year rates over quarters 2 and 3 of 2019. Increasingly, banks that have employed a "floor" of 0% for variable rates in most loan agreements are now doing the same for fixed rates. Therefore the choice facing borrowers is do they want to secure a fixed market rate of 0% for 3 years or so if they believe that variable rates are unlikely to be cut below this level over that time period?

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

2.3 UK and US interest rates

UK and US interest rates also followed a trend similar to Euro interest rates in 2019, falling until Q3, bottoming out and then creeping upwards again. Both yield curves are flat if not inverted at the end of the year. We put forward the view in Q4 that the world economic outlook is not as bad as previously envisaged and we continue to hold that view for now with the largest risks being of a geo-political nature and/or financial markets correction.

Table 3. Comparative Interest Rates as at December 31st 2019

	EUR	GBP	USD
3-m	-0.383	0.794	1.870
2-year	-0.310	0.820	1.600
3-year	-0.280	0.820	1.580
5-year	-0.190	0.880	1.590
7-year	-0.080	0.890	1.650
10-year	0.100	0.950	1.705
2v10 spread	0.410	0.130	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 awaiting the outcome of the general election. The possible trend for 2020 depends very much on the Brexit negotiations and their knock-on effect on UK economic prospects. Fulfillment of pre-election promises would also require a significant increase in UK government borrowing. Finally, LIBOR will be discontinued by 2021 as a valid basis for GBP short-term interest rates to be replaced by SONIA.

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

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. Although the shape of the curve is not dissimilar to the equivalent UK curve, the scale of the decrease in US rates is far more pronounced: this rate peaked at 2.70% in January 2019 but fell as far as 1.26% by early September before recovering somewhat in Q4 2019.

The US unemployment rate was at 3.5% in November (compared to an average rate of 5.74% between 1948 and 2019) and has been hovering around this level for the past 8 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. December Manufacturing and Services readings are 52.4 and 52.8 respectively although business confidence has steadily worsened over 2019 and stood at 47.2 in December.

US/China trade war exchanges abated towards the end of the year but the US military "intervention" in Iran/Iraq and how the Chinese government deals with the street protests in Hong Kong will have to be watched closely in 2020.

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

2.4 Summary

- This decline in interest rates which prevailed over the first three quarters of 2019 halted and reversed over Q4. The prospect of a meaningful rise in Eurozone rates in 2020 is almost zero at this point in time.
- Negative interest rates are expected to be applied by Irish banks to SME and retail deposit and current account balances in 2020.
- 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.
- The world economic outlook improved slightly at the end of 2019 which would imply that interest rates internationally may creep up again in those jurisdictions where the outlook has improved.

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/GBP0.8500 in the past few weeks.

USD continues to trade within a narrow range. 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 since the Brexit vote in June 2016. Volatility (measured as the % difference between highest and lowest rates of the year) was 12.7% in 2019, the highest in three years and marginally above the average of such annual ranges since the launch of the Euro of 12.2%.

However, since the Brexit vote in 2016 when the average rate for the year was EUR/GBP0.8192, the average rate has been in or around EUR/GBP0.88 with the 2019 figure being EUR/GBP0.8775.

Given that the current UK Prime Minister now has a House of Commons majority but that he has also restricted his negotiation stance by committing to leave the EU by December 31st 2020, the currency will be hostage to Brexit negotiation trends again in 2020. And the possibility of a hard Brexit is NOT priced into the current rate.

Key Observations

We held a consistent view since Q2 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 (or up to parity) while a soft Brexit should see the rate trade back to EUR/GBP0.85 or thereabouts.

With the Tory election majority, “no (transition) deal” was off the table and the rate finished the year at EUR/GBP0.8454, marginally below the 85p level. 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

We called 90p in May/June when the rate was at EUR/GBP0.86. It broke through that level in July touching EUR/GBP0.9310 at one stage. The key takeaway from this year (which we believe will persist into 2020) was that the range between Deal/No Deal was at least 10p. And given that the widely held view is that no full deal is possible by December 2020 but that Mr. Johnson has vowed to leave the EU by then, the Deal/No Deal scenario will remain valid for at least the first half of the year with the associated 10p+ range risk.

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 heading into 2020 and, as a result, the risk is currently on the downside (weaker Sterling).

6 and 12-month forward points are 0.53p 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 for now.

Graph 8. EUR/USD: two-year trend

Key Observations

EUR/USD has been in a narrow range for over 18 months. The 2019 high/low spread was only 6.37% which is the tightest since the EUR was launched – the next tightest year was 8.01% in 2013. The average high/low spread since the launch of the Euro is 16.70% but this has narrowed over time with the average for the decade 2010-2019 being 13.8%. Either way, the 2019 range looks too narrow and so one would expect a breakout in 2020.

But which way?

EUR/USD forward points for 6 and 12 months are +0.0125 and +0.0250 respectively.

Summary

The downward trend (strengthening of USD) has remained intact for some time but, in all probability, is unlikely to continue to do so for much longer. Political developments are most likely to influence matters, especially in an election year in the US. So the long-term direction in this currency pair remains difficult to call - downside risk in the Eurozone also exists. Stock market corrections are probably a material risk. We will watch this closely in 2020 for signs of a directional shift either way.

4. Oil and Gold Markets

- ***Oil price continues to bounce around***

- ***Our decision to monitor the price of gold over the course of 2019 was a good one given the manner in which it has increased in price.***

4.1 Oil Price Trends

Graph 9. Oil prices: 2019 trend

The 2019 trading range was $55/bl to $75/bl. OPEC still influences pricing to a certain degree although the emergence of the US as a net producer as a result of shale oil and gas has changed the dynamic somewhat over the past 10 years. The price reacted quickly (upwards) after the US assassination of the Iranian General in anticipation of a possible escalation of Middle Eastern tensions and that is an ongoing risk. The largest medium-term risk is the rising green agenda which now looks like it has momentum that won't be stopped. As this is a commodity that is prone to speculative activity, price volatility will remain a fact of life with it.

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 eased back over Q4 but has spiked again post year-end as a result of the US attack in the Middle East (hit $1610/oz on January 8th). We started to monitor this as a "hedge" against a slowing economy. It is also a safe haven asset (along with Japanese Yen and Swiss Franc) in times of trouble.

So 2020 price trends in this commodity will most likely continue to be driven by political and macroeconomic concerns - price will ease back if global economic outlook improves. Given our view that economic outlook looks a little better (for now) than it did two months ago, this could fall again in Q1.

Graph 11. Gold prices: 2019 trend

5. 2020 Forecasts

5.1 Summary

Table 3. Key Risk Factors 2020

	High Risk	Medium Risk	Low Risk
EUR/GBP	Weak GBP in case of hard Brexit. 90p at some point before June		
EUR/USD		Narrow range in ‘18 and ‘19 but history is against continuation of this trend	
3-m Euribor			Going nowhere. No change in ECB Base rate in 2020
3-y € Swap			Benefit of negative rates not feeding through. 0% floor implies little practical impact of any moderate rate rise
UK Interest Rates		Hard Brexit would have major economic impact. Bank lending margins would increase	
US Interest Rates		Possible bounce back if economy holds up	
Equities	Correction overdue		
Bonds		Rates will rise (prices fall) if economy holds up. How long can governments continue to borrow at top of economic cycle?	
Oil	Geo-political risk to weigh on it. Wider range than 2019		
Gold		Price to retreat as economic outlook stabilises/improves?	
Irish Bank lending		Hard Brexit would make borrowing more challenging	

5.2 Other Key Points

5.2.1 Borrowers

- Environment remains positive for borrowers for now given need for banks to hit lending targets
- Hard Brexit (or prospect of it) would change that
- As Hard Brexit would also have immediate and material negative effect on the economy, financial capability of corporates to borrow would be adversely affected
- Non-bank debt providers much faster at approving credit and advancing loans. Also more expensive
- High level of leverage in US corporate market, especially sub-investment grade market, could become problematic and have an adverse ripple effect on financial markets in 2020.

5.2.2 Depositors

- Negative interest rates on deposit and current accounts to become widespread
- Catalyst for investors to look at alternative investments? Is this the right time to do this?
- Trend in Germany (where negative deposit rates have prevailed for some time) was that savers deposit balances rose by 8.5% in 2019 (equivalent to 11% of their disposable income) i.e. it didn't discourage savers.

5.2.3 Investing

- Move from active to passive funds over the course of the last decade has been huge
- They are cheaper and have also outperformed most active stock picking funds
- QE and general printing of money has led to asset price inflation….any correction in such pricing (which has to arise eventually) is likely to be 10%+
- Possible opportunity to look at purchasing floors on stock market indices?

5.2.4 Banking

- Irish banks are rapidly coming to an inflexion point in their challenges
- Saving grace for them would be the failure of a non-bank provider of some financial services. Unsure of likelihood of that as lots of such providers across lending, foreign exchange, payments. Failure of a challenger bank could be significant
- Move to online and mobile payments gathering pace – negative interest rates on current accounts could accelerate this process
- And move to online/mobile, one could argue, reduces the value of the banks' brands
- ELG (Environment, Social, Governance) factors already having an impact on investing norms. Will impact on borrowing from 2020 (for large corporates initially). So measurement of such variables will become a core reporting requirement from 2020 onwards
- This, in turn, will drive the issuance of green loans and green bonds
- Governments and other bodies e.g. ECB, EIB may increase their focus on preferential lending for green initiatives
- Trading of carbon credits and/or the pricing of carbon costs into goods and services provided will be normalized in the near term.

5.2.5 Politics/Others

- Irish governmental election likely to lead to coalition/minority government again. Challenging outlook given large-scale capital projects that are exceeding costs forecasts, “artificially high” Corporation Tax returns and ongoing borrowing necessity
- UK government stable from a majority perspective. Key issue will be whether Boris Johnson sticks to his Brexit by December 31st mantra or agrees to an extension in order to facilitate the completion of trade discussions. We currently veer towards the former view
- US election to result in the re-election “The Donald”? Second term Presidents tend to be less effective as they can’t be elected for a third term…..but they are also unanswerable to an electorate for a third time…..
- Our main concern about the US is the huge annual borrowing requirement that persists despite the long run of positive economic data. Will investors buy US (and other government debt) at low/negative interest rates indefinitely when they would never lend to corporates with the same recurring negative cashflows?
- New people at the top in Europe and the ECB – will they have a different attitude to their predecessors?
- How China deals with the Hong Kong street protests will be widely watched. It is a potential problem as China doesn’t take challenges to the State well and fears that the same could happen on the mainland in due course if not handled correctly. But a heavy-handed approach will not be well received internationally. The trade war with the US has weighed on economic performance and the government has reacted by pumping more liquidity into the banking system. Is the level of leverage in China likely to be a serious risk? Working population has now peaked in China.
- The treatment of minorities in India is also becoming an issue (as in other countries). Modi has growing internal challenges as a result
- Demographic trends have a significant impact on economies in the medium-term. In Europe, more people died than were born in Italy. In Croatia it was worse with their population shrinking by 15,000 (out of 4 million people). At current rates, it will lose 17% of its 2017 population by 2050. The reverse is true in Africa where Nigeria is projected to have a larger population than the US by 2050. These trends will have material social and economic impacts over the coming decade.

In summary, the coming decade will continue to bring significant change to the wealth and constitution of nations with a shift in wealth towards the East and real challenges for Europe’s (and Japan’s) ageing populations. Understanding what these trends mean, especially demographic trends, will be an important part of strategic and financial planning in the coming years.