



THE TREASURY HUB

Banking and Treasury Markets

February 2020 Report



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1.1 Introduction

We bring you the second Banking and Treasury Report of 2020 as part of THE TREASURY HUB.

The publication continues with the formats adopted last year. This month's focus in Section 5 is on the area of ESG (Environment, Social and Governance).

Brexit came back onto the agenda at the very end of January as the UK officially entered into the transition period. The general election kicked into gear here in Ireland with a lot of spending promises being made, all of which appear to be predicated on an orderly exit deal for the UK.... an assumption which may yet prove to be flawed.

From an investment perspective the year got off to a negative start with the three equity indices that we track (ISEQ, FTSE and DOW) all deteriorating in January and a lot of the blame being attributed to the outbreak of the coronavirus in China.

EUR/GBP held around EUR/GBP0.8450, especially as the UK exited the EU but with the "hard line" opening negotiation position being taken by PM Johnson last week, we have seen GBP lose 1p against EUR in a single day and move back to EUR/GBP0.8500. We expect further GBP weakness in the weeks ahead.

We have noted since the start of the year that the banks are focusing as much on holding current business as generating new business so far in 2020. This, in turn, has taken some of the "heat" out of the market and we also have some concern that the focus will be on standardizing documentation to keep bank costs down. But this means operating with bank-friendly loan facilities. As we still see an economic slowdown as a possibility, 2020 refinancing would be wise.

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

Table 1. Key Metric Movements: 2020

Heading	Metric	YTD move	From	To
<u>Interest</u>	3-m euribor	-0.0190%	-0.3790%	-0.3980%
<u>Interest</u>	EUR 3-year	-0.0900%	-0.2600%	-0.3500%
<u>Interest</u>	GBP 3-year	-0.1440%	0.8140%	0.6700%
<u>Interest</u>	USD 3-year	-0.2660%	1.6560%	1.3900%
<u>FX</u>	EUR/GBP	-0.7024%	0.8459	0.8400
<u>FX</u>	EUR/USD	-1.0547%	1.121	1.1093
<u>Equities</u>	ISEQ	-4.3336%	7315	6998
<u>Equities</u>	FTSE 100	-4.1820%	7604	7286
<u>Equities</u>	ow Industri	-2.1234%	28869	28256
<u>Gilts</u>	IE 10-yr	-0.2490%	0.098%	-0.151%
<u>Gilts</u>	GB 10-yr	-0.2670%	0.794%	0.527%
<u>Gilts</u>	US 10-yr	-0.3630%	1.882%	1.519%

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.

You may recall that the only "green" last year was on the equity market indices. While 2020 also saw a positive start to these markets, concern over the scale of the recent flu outbreak in China has pushed these indices downwards on the back of the likelihood of a material negative impact on Chinese economic growth which, in turn, has an impact on global growth prospects.

Bond prices are up again (as interest rates have fallen) with Irish 10-year rates now negative. We will continue to monitor the price of gold as a hedge against adverse economic trends.

Brexit disappeared from the front pages for a few weeks with all the other political and health issues gaining momentum but that won't last for long. It's worrying that the first official meeting on the trade talks is at the start of March as our understanding is that any extension to the transition end date of December 31st 2020 must be applied for by the UK no later than June 30th which leaves only 4 months for meaningful discussions. The risk of a hard/harder Brexit has increased this week and GBP doesn't have a lot of downside priced into yet. We continue to strongly advocate heightened vigilance on the investment and refinancing fronts in 2020.

1.3 Forward-looking Indices

Forward-looking indicators known as Purchasing Manager Indices or PMIs are useful to monitor in the context of the economic outlook in Ireland and the UK. Readings above 50 indicate expansion while below 50 denotes contraction. The Irish readings are all above 50 again, most probably due to the UK finally being in a position to leave the EU. The UK also experienced a similar trend with the exception of the construction sector. For now, we would have concerns that this is more a post-election bounce than a sustained period of growth given our view on Brexit risks and the coronavirus impact.

Table 2. Irish and UK PMI readings

Variable	Ireland	UK
Manufacturing PMI	51.4	50.0
Services PMI	55.9	52.9
Construction PMI	52.0	44.4

1.4 Brexit

Our bulletin last month stated that “the risk in the New Year remains to the downside i.e. weaker Sterling”.

We have made our first call of the year on EUR/GBP in the past week: we do not see the risks of a hard/harder Brexit priced into GBP and called EUR/GBP0.8800 to EUR/GBP0.9000 by June as a result. It has traded through EUR/GBP0.8500 already this week. Exporters had an opportunity to get some cover in around 84p for a few weeks. These levels continue to look attractive when they arise.

1.5 Treasury Hub Activities

The focus of The Treasury Hub in 2020 will be on growing the offer and making the market aware of our specialist skills. This month our advisory team commences a programme which upskills our team in treasury risk management so that we can continue to offer you a premium, all-inclusive service that our competitors cannot match. If you have any interest in buying or selling companies, please get in touch as we have a wide range of sources of funding and countrywide contacts available.

1.6 Conclusion

Regardless of any fatigue on the matter, Brexit will remain to the fore in 2020. Could this be the year that equity markets suffer a material correction? We'll see. We also have a very strong view that 2020 will be a tough year for the Irish banks and have seen some early signs that negotiation of new loan agreements will require specialist and focused advice. Section 5 looks at green and environmental issues in that context.

2. Interest Rate Review

EURIBOR AND SWAP RATES HAVE EASED AGAIN IN THE FIRST MONTH OF 2020. THE TREND HAS ALSO APPLIED TO GILT YIELDS AND IS REPLICATED IN THE EU, UK AND US.

BANKS, HAVING FAILED TO PASS THROUGH THE BENEFIT OF SHORT-TERM NEGATIVE RATES TO BORROWERS ARE INCREASINGLY DOING THE SAME ON LONGER-TERM FIXED RATES. DEPOSIT RATES WHICH ARE ALREADY NEGATIVE FOR LARGE DEPOSITS WILL FOLLOW THAT TREND FOR SMALLER AMOUNTS AND FOR CURRENT ACCOUNTS SOON.

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

Having eased quite dramatically over the course of Q4 2019, 3-month Euribor rates recovered slightly in January 2020. The easing coincided with increased liquidity from the ECB again as economic growth prospects softened.

On the inflation front, the ECB has a target to maintain the rate at no higher than 2.0% but this, in turn, is likely to be reviewed by the ECB as a guiding principle in the near future.

German inflation has picked up a little to +1.7% in January. In the wider Eurozone area, the January reading was +1.4% which is the 4th month in a row that the figure has increased. The Irish equivalent figure is +1.3%.

Christine Lagarde has announced the first strategic review of the ECB in 16 years to be completed by December 2020. A review of the 2% inflation target is on the agenda. As part of QE, it holds €200bn of corporate bonds and it is also considering the possible alteration of this portfolio to take climate change into account. While the outcome of the review won't have a direct impact in 2020, it highlights the potential impact that ethical investing can have and why we are focusing on the area in Section 5. Graph 1 below shows the ECB Base Rate in green with the y-axis on the left-hand side (in green) and the 3-month Euribor rate in orange (y-axis on right-hand side).

Graph 1. 3-m Euribor versus ECB Base Rate: ten-year trend



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. Table 3 below highlights the fixed rates for various time periods.

Graph 2. EUR 3-year swaps versus 3-month euribor: two-year trend



Key Observations

The above graph compares the 3-month Euribor (purple, left-hand side axis) rate to the 3-year (orange, right-hand side axis). They remain broadly in line which tends to signal no expected rate changes for quite some time, possibly measured in years.

Banks are now actively employing a “floor” of 0% for fixed rates in most loan agreements now. The flipside of this argument is that one could seek to secure a fixed (pre-margin) rate of 0% for as long a period as possible and seek to reduce borrowing margins through refinancing of facilities.

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



2.3 UK and US interest rates

UK and US interest rates have notably eased in January 2020. This has resulted in a flattening of both yield curves. Our previous view that the world economic outlook is not as bad as previously envisaged with the largest correction risks being of a geo-political nature and/or financial markets correction has been upturned by the Chinese coronavirus (on both fronts). It is currently forecast to cut Chinese economic growth by 1.6% in Q1. And with a high degree of probability that the extent of its reach is underreported, we haven't seen the peak impact of this outbreak yet.

Table 3. Comparative Interest Rates as at January 31st 2020

	EUR	GBP	USD
3-m	-0.398	0.765	1.751
2-year	-0.360	0.680	1.440
3-year	-0.350	0.670	1.390
5-year	-0.280	0.680	1.390
7-year	-0.187	0.710	1.430
10-year	-0.045	0.755	1.520
2v10 spread	0.315	0.075	0.080

In the UK, 3-year swap rates have been in a channel of 0.55% to 0.85% since the start of August with a lot of this trend attributed to political uncertainty (Brexit, general election, leadership contests). The rate has eased off by 0.20% or thereabouts since the start of the year reflecting concerns about GDP growth prospects. Following through on pre-election promises may also pose a challenge yet, especially if the post-Brexit trade deal proves to be problematic. The current rate is well off the 2018 highs.

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



In the US, the yield curve shape remains negative (the 3-month rate is higher than longer-term fixed rates to 10 years) and “dips” out to 5 years.

Graph 5 below is for US 3-year swaps over the past 24 months. As previously noted, while the two-year trend is not dissimilar to the equivalent UK curve, the scale of the decrease in US rates is far more pronounced: this rate was as high as 3.15% in November 2018 so current rates are less than half of those levels.

The US unemployment rate has been 3.5% for three of the last four months of 2019 and under 4% since January of that year. Forward-looking indices such as PMI readings remain positive (i.e. above 50) although Services readings have been improving while Manufacturing readings have been reversing.

The overall picture (measured by GDP growth) was +2.3% for 2019, below the target of 3%. The annual figure was supported by a stronger Q1 reading as the Q2 to Q4 figures were 2%, 2.1% and 2.1% respectively. Within the Q4 figures, consumer spending slowed sharply which could be worrying as the consumer drives the US and other economies.

Some progress has been made on the US/China trade war which we predicted as President Trump doesn't need it in an election year. Some speculation that the EU could be next in his line of sight!

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



2.4 Summary

- Interest rates have started the year on a negative (i.e. falling) trend. The prospect of a rate rise by the ECB in 2020 is, effectively, non-existent at this point in time. We see a similar trend in the UK for now.
- 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 be the best that people can achieve in the short-term.....but variable rates do not appear to be moving below zero either.
- In summary, the ongoing low/negative interest rate environment globally is proving to be a challenge for investments and pensions...with asset prices still high in so many asset classes and probably distorting the risk/return trade-off largely due to Quantitative Easing.
- How this plays out remains difficult to predict. It is disappointing that the benefit of negative interest rates has not flowed down to the SME sector as Irish banks have put a floor at 0% in loan agreements. This creates a disadvantage for Irish companies vis-a-vis their international competitors and this, in turn, could be more pronounced as exporters veer away from the UK and start to target European markets competing against European SMEs who can access cheaper funding.
- **Therefore, we are recommending that interest costs are best managed in 2020 through lowering of margins via refinancing and through better structuring of loans and related cash management.**

3. Foreign Exchange Review

GBP had a strong end to 2019 and an even better start to 2020 as a result of the general election result and confirmation (finally) of the UK exit from the EU.

Narrow range-trading in EUR/USD that has prevailed since 2018 has continued into 2020 although the downward (strengthening) trend has stalled with the rate moving in a lateral manner in more recent time.

3.1 EUR/GBP

Background

The EUR/GBP currency pair has been almost totally driven by Brexit since June 2016. However, against that backdrop, the annual average rate has not varied hugely over that period. Volatility (measured as the % difference between highest and lowest rates of the year) was 12.7% in 2019. 2019 average rate was EUR/GBP0.8775

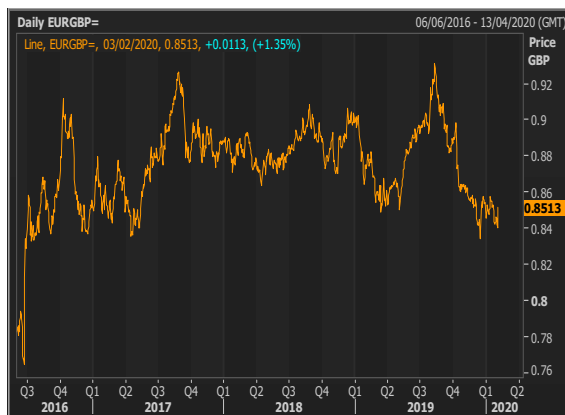
Given that the date for a new trade deal is December 31st 2020 but that any extension request to this date has to be submitted by the end of June 2020, the risk of heightened volatility in the first half of 2020 is high. Equally this risk is NOT priced into the exchange rate at this point in time. And the initial salvo from the UK side on trade negotiations was quite aggressive and unrealistic – getting friction-free trade whilst not committing to EU standards will never be a runner.

Key Observations

Current EUR/GBP rate looks attractive when put in the context of exchange rate averages since the Brexit vote. 2017, 2018 and 2019 average rates were EUR/GBP0.8765, EUR/GBP0.8849 and EUR/GBP0.8775 respectively. **The 2020 average rate to date is EUR/GBP0.8494.**

Our 2019 calls on this currency pair were quite accurate and those that followed them ought to have benefitted.

Our first call in 2020 is that GBP looks too strong given the uncertainty surrounding the trade negotiations and, in particular, the brevity of available time to negotiate. Our opinion is that No Deal would see it back towards EUR/GBP0.95. A comprehensive deal looks unlikely so uncertainty would tend to weaken any currency and, accordingly, we see it as being quite possible that the rate will trade back to EUR/GBP0.88 to EUR/GBP0.90 in the coming weeks and months.

Graph 6. EUR/GBP since Brexit Referendum

This is the last time that we will include the above graph as Brexit has officially started from January 31st 2020. It is, however, a reminder of how exporters to the UK had a “golden era” up to 2016 on the FX front but, equally, they have managed to survive over the past few years as the average rate has remained below 90p.

It has equally been our experience that firms have been slow to engage in formal currency hedging despite the volatility, mainly because the 85p-90p range has prevailed for much of the time since the end of 2016. We do not expect these ranges to continue into 2021.

Graph 7. EUR/GBP: two-year trend

Summary

Risk is weighted towards a weakening GBP over the coming months.

6 and 12-month forward points are 0.53p and 1.05p 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, while the narrow exchange rate range continues to exist, the trend is no longer downwards.

Graph 8. EUR/USD: two-year trend

Key Observations

EUR/USD has been quite stable on average over the past five years. **With the exception of 2018 when the average was EUR/USD1.1811, the average rate since 2015 varied from EUR/USD1.1066 to EUR/USD1.1299.** 2020 has seen no change to this (YTD average of EUR/USD1.1108).

We await the long-anticipated breakout from these narrow ranges and average rate trends.....but also watched and waited in 2019 for it!

EUR/USD forward points for 6 and 12 months are +0.0120 and +0.0240 respectively.

Summary

Economic activity in the western world for the past number of years has been slowing with world growth being driven by the Far East and India. One could argue that the relative stability in the FX rate reflects this benign situation between the two largest trading blocs in the West. However, the future doesn't look a lot different for either bloc and both (but especially the US) have very high debt:GDP ratios and, in most countries, current account deficits prevail despite stable, positive economic growth. So, it is possible that “steady as she goes” will continue for the currency pair reflecting the economic outlook for both. But we just can't get our thoughts away from the large amount of cheap money and government debt driving asset values and perceived wealth in these blocs. Remain vigilant as a result.

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: five-year trend



The 2019 trading range was \$55/bbl to \$75/bbl but this was recently briefly breached on the bottom of the range due to the coronavirus as China is a large consumer of oil and with economic growth expected to fall by 1.6% in Q1 2020 as a result of the virus, their demand for oil will fall. There is talk of OPEC (Saudi Arabia in particular) seeking production cuts in order to prop up the price but we are not convinced that other countries will want to follow given the negative implications for revenues. Continue to monitor but risk is probably on the downside for now.

4.2 Gold Price Trends

Graph 10. Gold prices: ten-year trend



We have included Gold prices since the middle of 2019 as a possible hedge against an economic slowdown (prices tend to rise as economies slow and/or as a reaction to adverse political events).

It was priced at \$1275/oz when we started monitoring it, spiked after the US attack in the Middle East to \$1610/oz on January 8th but has eased back again since.

Given the continuing economic and political uncertainties that are likely to prevail in 2020, we feel it is worthwhile to continue including it in our metrics to watch.

Graph 11. Gold prices: 2019 trend



5. What is ESG?

5.1 What is ESG?

ESG stands for Environmental, Social and Governance.

It is a set of standards for businesses to apply within their company under these headings.

Examples : Environmental - energy use of a company, Social - the business relationships with shareholders and Governance - clear and concise methods of running a business.

5.2 Why has it emerged as a trend?

There are various reasons being put forward but some of it at least is a consequence of the financial crisis. While the economic recovery has been strong from the perspective of economic indicators, there would appear to be a disproportionate redistribution of wealth/recovery towards larger/richer companies and individuals and away from middle income individuals and smaller companies. Demographics are also at play as younger people become active in putting forward their environmental views while, finally, the role of large corporates and capitalism is being questioned with less emphasis on shareholders benefits and more on stakeholders benefits.

5.3 How is it manifesting itself?

Initially, the drive has come from the investor community. They have started to define what constitutes “ethical investing” but this has been based more on what they exclude rather than what ought to be included in a company’s activities or profile. Thus, gambling and oil have suffered on this basis of exclusion.

ESG issues have also been focused on by credit rating agencies when they assess companies in those industries that they believe are more prone to adverse ESG events. By way of example, how carbon emissions, labour relations and corruption may impact on credit ratings. However, banks are also beginning to include ESG factors in the credit appraisal process. It would be fair to say that the international banks are further up the curve in this area compared to the domestic banks. However, this will change in the coming months and years.

5.4 What are the challenges in this area?

Variables can be measured but it can be difficult to assign them with a monetary value. And in many cases, the metrics have never been formally measured. From a financial perspective, understanding which variables are to be measured and what subsequent costs or benefits derive from improving performance (or commencing to measure the performance) of some of these measures are the starting points. This will require an initial evaluation of what to measure before then deciding on how to measure and to “translate” these measurements. This, in turn, may require the establishment of reporting mechanisms in order to measure the identified metrics.

5.5 Sample variables under each heading.

Table 4. Possible Metrics to measure

Environmental	Social	Governance
Climate change and carbon emissions	Customer satisfaction	Board composition
Air and water pollution	Data protection and privacy	Audit committee structure
Biodiversity	Gender and diversity	Bribery and corruption
Deforestation	Employee engagement	Executive compensation
Energy Efficiency	Community relations	Lobbying
Waste management	Human rights	Political contributions
Water scarcity	Labour standards	Whistleblower schemes

5.6 Summary

Larger, public interest companies with greater than 500 employees will be subject to new EU provisions in this space from 2021. Therefore it will start to migrate from theoretical to practical over the next 12-24 months.

Sustainability issues will, of course, flow both ways: borrowers may also evaluate their finance providers and advisors based on sustainability principles.

The of adoption of ESG and sustainability principles by companies will be gradual: from limited to moderate and then gradual consideration of such factors.

From a financing perspective, banks will make more funding available for projects that are “green” projects. Therefore borrowers will seek to both incorporate green aspects into projects to qualify for such funding (care will be required here as there will be resistance to and rules around the “greenwashing” of projects whereby green elements are introduced to meet criteria rather than being an intrinsic part of a project). However, such availability is also designed to encourage investment in green projects.

Banks will also consider the green credentials of borrowers where they are borrowing for non-green purposes so it will become a core rather than a peripheral issue over the coming months and years.

We will revisit this area throughout 2020 as it will become a new but core area of focus for all companies, big and small, in this decade.

5.7 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