THE TREASURY HUB
Banking and Treasury Markets

March 2020 Report

1. Executive Summary

1.1 Introduction

Welcome to the latest version of THE TREASURY HUB Banking and Treasury Markets Bulletin. This is probably the most volatile environment in which we have drafted this bulletin since its inception in 2018. A lot of the matters that we have been flagging for the past weeks/months are now beginning to converge in something of a "perfect storm".

From an investment perspective the coronavirus has started to have a material effect on sentiment and economic outlooks. Not surprisingly the equity markets bear the brunt of the initial negative sentiment (given their forward-looking perspective) with the three equity indices that we track (ISEQ, FTSE and DOW) all in significant negative return territory.

On the topic of Brexit and EUR/GBP, last month we stated that "with the hardline 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". This has already proven to be a good call with the rate touching EUR/GBP0.8840 this morning (March 11th).

We also noted last month that banks were tightening up on the lending front and there was a danger of loan documentation veering towards bank-friendly loan facilities. The coronavirus is going to make credit availability tighter and, as a result, we will visit this topic in more detail in Section 5. Please read it as it is pertinent for all businesses.

Finally we highlighted ESG as an emerging trend in last month's bulletin. Last week we saw our first lending term sheet (loan in the €10m-€20m category) which has the margin moving upwards and downwards depending on whether or not ESG metrics have been met.

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
Interest	3-m euribor	-0.0940%	-0.3790%	-0.4730%
Interest	EUR 3-year	-0.2300%	-0.2600%	-0.4900%
Interest	GBP 3-year	-0.3640%	0.8140%	0.4500%
Interest	USD 3-year	-1.1760%	1.6560%	0.4800%
FX	EUR/GBP	3.1042%	0.8459	0.8730
FX	EUR/USD	1.7528%	1.121	1.141
Equities	ISEQ	-18.715%	7315	5946
Equities	FTSE 100	-20.239%	7604	6065
Equities	Dow Industrial	-10.409%	28869	25864
Gilts	IE 10-yr	-0.2490%	0.098%	-0.151%
Gilts	GB 10-yr	-0.2670%	0.794%	0.527%
Gilts	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.

Red says it all. Equity market correction has been severe and rapid. ISEQ down nearly 20% although these levels were last seen in September 2019. FTSE is in a worse situation. Current levels were last experienced in Q3 2016.

Bond prices are up again (as interest rates have fallen) with Irish 10-year rates now negative -0.15% which is an all-time low. Oil prices have also fallen off a cliff. This is covered in more detail in Section 4.

The short-term effect of all of the above will be a fall in consumer confidence, real impact on economic output, disruption of supply chains from the Far East (hasn't worked its way through the system yet) and a highly probable "wait and see" approach to lending by banks. Whether this is a temporary or long-term issue remains to be seen.

Either way, our advice that we have advocated since last year to refinance to make the business resilient against a possible downturn is reiterated again. It will require a little more application and expertise against the current backdrop but better late than never!

1.3 Forward-looking Indices

Forward-looking indictors 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 readings below are for February. They have also been improving, especially in the UK (continuation of the post-election and some (temporary) Brexit certainty. Expect these to change materially for March readings.

Table 2. Irish and UK PMI readings

Variable	Ireland	UK
Manufacturing PMI	51.2	51.7
Services PMI	59.9	53.2
Construction PMI	50.6	52.6

1.4 Brexit

Last month we made our first call of the year on EUR/GBP: "we do not see the risks of a hard/harder Brexit priced into GBP and call EUR/GBP0.8800 to EUR/GBP0.9000 by June as a result". It traded through EUR/GBP0.8800 this morning touching EUR/GBP0.8840 (March 11th). Good article in the FT last week which suggested that the UK may indeed trigger a WTO exit by December but that both UK and EU will lose, the damage will become apparent and they will then sign a proper deal within 2 years of that. Plausible? Yes. Wise to exit without a deal while coronavirus remains a threat (it will go away for the Summer but return next Autumn according to some medical experts)? No. Might the coronavirus knock some sense into both sides? Possibly. With all countries now focusing internally due to the virus, it will, if anything, likely lead to slowdown in trade talks.

1.5 Treasury Hub Activities

The corporate finance teams of all The Treasury Hub members met in late February to review markets and swap market intelligence **(this is a key advantage of The Hub as we benchmark what banks are doing around the country from a lending perspective giving us market knowledge that is unmatched by any other accounting firm).** We also see a lot of opportunity to match business sellers with buyers so please get in touch if you fall into either of those categories

1.6 Conclusion

Last month's summary flagged a possible equity market correction and a tough year for the Irish banks. View has been reaffirmed in the interim. Section 5 looks at the latter in detail. **Strongly advocate a strategic review/audit of your loan documents. Weak documents are a liability.**

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 but dropped again since. The easing coincided with increased liquidity from the ECB again as economic growth prospects softened.

While inflation remains the key target KPI for many central banks, we see it of little consequence in the short-term.
Key driver now is the economic outlook as there will be a material "shock" to the global economy in Q1 (with China expected to register negative growth of -2.5% against annual growth rates of between 6% and 12% over the past decade).

3-month Euribor is at an all-time low (almost -0.50%) but it will have little impact on growth as (i) the negative rates are NOT flowing to borrowers in the Irish economy, (ii) depositors are achieving negative returns but don't want to invest in riskier assets (probably wise given that a lot of asset prices had been pumped up by Quantitative Easing) and (iii) governments are increasingly coming under pressure to borrow and spend on infrastructure.

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).

We expect that the ECB will step in and reduce the deposit rate further in March.

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: ten-year trend

Key Observations

The above graph of the 3-year swap rate shows current rates to be close to all-time lows (which were reached in August/September 2019). Similar to short-term rates, the banks are not quoting negative fixed rates (before margin) despite the fact that they are now as low as (or lower than) short-term (Euribor) rates. They are actively employing a "floor" of 0% for fixed rates in every loan agreement now. Table 3 below shows just how negative the Euro yield curve is suggesting that these rates will prevail for some time yet. We reiterate what we stated last month: one could seek to secure a fixed (pre-margin) rate of 0% for as long a period as possible. Fixing at 0% for 5 to 7 years should no longer be an issue.

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

2.3 UK and US interest rates

UK and US interest rates eased considerably in February with the latter diving by almost 1% in the month which is a huge and rapid movement. Again, last month we noted that the Chinese coronavirus had turned the economic outlook on its head and that there was a high degree of probability that the extent of its reach was underreported implying that we haven't seen the peak impact of this outbreak yet.

Table 3. Comparative Interest Rates as at March 11th 2020

	EUR	GBP	USD
3-m	-0.473	0.518	0.896
2-year	-0.480	0.440	0.530
3-year	-0.490	0.450	0.540
5-year	-0.460	0.450	0.570
7-year	-0.400	0.440	0.600
10-year	-0.045	0.755	1.520
2v10 spread	0.435	0.315	0.990

In the UK, the Bank of England cut the Base Rate by 0.50% taking the market by surprise (on both timing an quantum). 3-year swap rates have eased back to just over 0.40% in line with the general retreat of global interest rates. The new Chancellor has his first Budget this week.

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

In the US, the yield curve shape has become positive again from 2years out due to a collapse in rates at the short end of the curve.

Graph 5 below is for US 3-year swaps over the past 12 months and it highlights the dramatic decline in US rates over the past few weeks – such falls are normally associated with a deteriorating economic outlook.

The US unemployment rate has been 3.5% for four of the last six months and remains very resilient. But unemployment is a "lagging" indictor i.e. it lags the economic cycle. Forward-looking indices such as PMI readings are viewed as "leading" indicators (levels above 50 indicates an expanding economy). Both Services and Manufacturing readings were hovering around the 50 mark in February.

The US economy has been hit by the trade war with China. Coronavirus won't help (in US or China). A large percentage of the US population hold shares so the fall in the Dow will hurt consumer confidence. Not what President Trump would want in an election year. The pressure will increase on the US government to borrow and spend more. But that's against the background of the Budget deficit climbing every year since 2015 (-2.4%) to -4.6% in 2019, a trend that ought to be moving in the other direction given the relative strength of the economy). The 0.5% rate cut by the Federal Reserve last week highlighted just how concerned the US Monetary authority is as it was the largest single cut since 2008 and was also done outside of a scheduled Fed meeting. Markets are forecasting a 73% probability of a 0.75% rate cut at the scheduled Fed meeting next week. 2020 will be an interesting year in the US for a myriad of reasons.

Graph 5. USD 3-year swap rates: twelve-month trend

2.4 Summary

- Interest rates started the year on a negative (i.e. falling) trend. Recent coronavirus fears have caused a collapse in medium to long-term rates.
- Official interest rates were already but by the US, Canada, Australia and UK. Eurozone and Us (again) likely to follow suit this month.
- Negative interest rates likely to become more negative and for longer. Would expect this to hasten the application of negative rates 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 borrowers can achieve in the short-term. But zero rates now available for longer periods.
- The negative interest rate and falling equity values environment globally is proving to be a challenge for investments and pensions.
- Last month we recommended that interest costs would be best managed in 2020 through lowering of margins via refinancing and through better structuring of loans and related cash management. While the structuring and cash management points continue to hold true, a slowing economy is very unlikely to lead to lowering of bank lending margins.
- **Therefore, the suggestion is to use the firm's membership of The Treasury Hub by allowing us to ensure that refinancings are undertaken at lowest available rates through the use of our margin benchmarking service.**

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. But the opening salvos with the EU on the trade negotiations brought it back to reality very quickly in the past 5 weeks.

Narrow range-trading in EUR/USD that had prevailed from 2018 to January 2020 was finally broken with a material weakening in USD over a short period of time.

3.1 EUR/GBP

Background

The EUR/GBP currency pair has been almost totally driven by Brexit since June 2016. However, as mentioned last month, the annual average rate has not varied hugely over that period. But the large moves in the past 2 weeks mean that the high/low % spread for the year to date at 6.3% is higher than the annual spread for 2019.

We also highlighted last month that the requirement for the UK to submit an extension request by the end of June 2020 implied that the risk of increased volatility in the first half of 2020 was high and that this risk was NOT priced into the exchange rate at that point in time. Between February 18th and today, the rate has moved from EUR/GBP0.8280 to EUR/GBP0.8840, a 6.3% move. Or to put it into euros, GBP1million in sales are now worth over €76,000 less today than less than 4 weeks ago.

Key Observations

Last month we suggested that "Current EUR/GBP rate looks attractive when put in the context of exchange rate averages since the Brexit vote…….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….. 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." We saw it trade through EUR/GBP0.88 this morning.

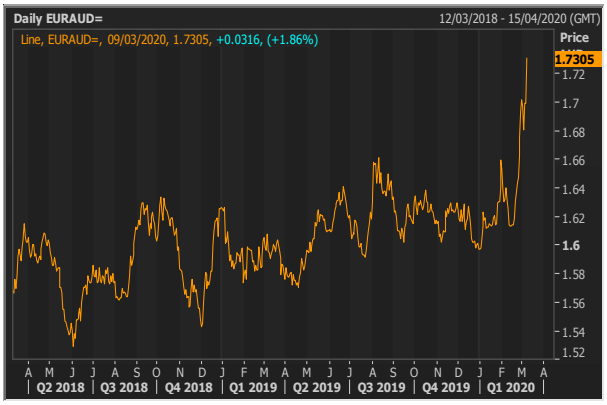
The above was based as much on common sense/failure to price risk in the markets as anything else. The coronavirus outbreak now causes both the UK and EU a problem. Focus will now turn to managing their respective economies in the short-term while the clock continues to tick down to the June deadline for an extension request.

To layer in further negative economic prospects due to a hard(ish) Brexit would be foolish. But it would require a U-turn by the UK (justifiable on the grounds of unforeseen circumstances). Weakening towards EUR/GBP0.9000 remains a distinct possibility in the coming weeks. The markets would probably reward GBP for the announcement of an extension. Good article in FT last week suggested that UK could crash out but the cost to both the UK and EU of WTO tariffs would hasten a deal within 2 years. It was a plausible scenario before the coronavirus broke in Europe. A lot will depend on how quickly the virus can be contained, thereby limiting the economic damage.

Graph 6. EUR/GBP in 2020

The impact of "black swan" events on a currency are best exemplified by the weakening of the Australian Dollar (AUD). As Australia is seen as a commodity-based economy with heavy dependence on China, negative Chinese growth impacts materially on it. Chart below highlights the trend over the past 24 months.

Graph 7. EUR/AUD: two-year trend



Summary

Risk continues to be for weakening GBP over the coming months. 6 and 12-month forward points are 0.50p and 1.00p 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 narrow exchange rate range which has existed since Q3 2018 has been broken (upwards).**

Graph 8. EUR/USD: two-year trend

Key Observations

EUR/USD has been quite been stable on average over the past five years. However the high/low range in 2020 to date at 6.65% is higher than the 2019 figure for the year. Last month we stated that "we await the long-anticipated breakout from these narrow ranges and average rate trends". Cold this be it? With a further interest rate cut now expected in the US (see Section 2), the recovery of the USD will depend on how effectively they contain the coronavirus in the short run.

EUR/USD forward points for 6 and 12 months have fallen to +0.0080 and +0.0150 respectively.

Summary

Volatility in wider financial markets almost always impacts on the currency markets. And the fact that 90% of all currency trading is done for speculative purposes (by investment banks, hedge funds, etc.) implies that they like volatility as it creates opportunities to make (and lose) money. This creates more short-term volatility such as we have seen in the past 2 weeks. Containing the coronavirus is the primary concern in the short run. But with the probability that it will return in the Autumn unless there is a major breakthrough on the vaccine/treatment front, the Q3 and Q4 outlook remains very uncertain. And that will lead to more volatility.

4. Oil and Gold Markets

- ***Oil price is hammered due to fall out between Russia and Saudi Arabia***
- ***Our decision to monitor the price of Gold over the course of 2019 as a possible recession hedge remains very valid.***

4.1 Oil Price Trends

Graph 9. Oil prices: twenty-year trend

Saudi Arabia and Russia met with a desire from the former to reduce output thereby keeping prices up. However, the latter refused. The Saudis decided to do the opposite then and increase their production levels which, against a backdrop of falling demand due to slowing economies was a double-whammy for the oil price and we saw it dramatically drop in the past few days. The graph above is a 20-year trend in order to highlight where current levels are over the course of this century to date.

These levels not only cause some problems for the Russians but they are also a major problem for the US as it produces shale oil but the breakeven level of this type of exploration is generally felt to be at $50 per barrel. We suspect that a lot of these exploration companies have also been users of the high yield bond market in the US so a continually low oil price will cause large scale defaults on such loans. Last month we suggested that “risk is probably on the downside for now”. This has proven to be an understatement.

4.2 Gold Price Trends

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 easing back quickly thereafter. However the price has surged again as a result of the worsening global economic outlook.

The graph below is also a 20-year trend to highlight current levels in a historic context.

Given the continuing economic and political uncertainties, we will continue to include it in our metrics to watch.

Graph 10. Gold prices: twenty-year trend

5. Banking Market Review

5.1 AIB and BOI Results

Main points of the 2019 results

- Net Interest Margin is falling for both – partially due to deposits costing them (invested at negative rates)
- Loan:deposit ratio is under 100% meaning that their loan book is totally funded by deposits
- Cost:income is lower in AIB. This is a key KPI for them and they would both probably target a level close to 50%
- BOI have significant loans in the UK and Rest of the World with the latter corporate loans being larger than ROI equivalent
- Treasury departments still quite profitable for both on both FX and interest rate hedging fronts
- AIB has a declared strategy to start charging for retail deposits
- Major jobs cuts to come from both to reduce costs further
- BOI IT transformation ongoing – budget was initially €1bn but this is now higher by all accounts
- Lot of stuff in their accounts on non-financial metrics
- Both made operating profits of in or around €1bn
- BOI still had higher impairment costs in 2019 (€215m) while AIB had exceptional costs of (€588m) including a further €300m for tracker mortgage restitution.

Table 4. Key Banking Metrics: AIB versus BOI

	BOI 2019	BOI 2018	AIB 2019	AIB 2018
Net Interest Margin	2.14%	2.20%	2.37%	2.45%
Core Capital (CET1)	13.80%	13.80%	16.40%	17.50%
New Net lending	€2bn		€2bn	
Loan Book	€79.5bn		€60.9bn	
Impairments	(€215m)	€42m	(€16m)	€204m
Cost:Income	63%	65%	56%	43%
Loan: Deposit	95%	97%	85%	90%
Liquidity Coverage	138%	136%	157%	128%
Net Stable Funding	131%	130%	129%	125%
Operating Profit	€934m		€1,087m	
Exceptionals/non-core	(€289m)		(€588m)	
Profit before Tax	€645m		€499m	

5.2 What are we seeing in the Banking Market?

- Reduction in risk appetite across the main banks since the start of the year. 2019 mandate appeared to be to lend more. 2020 mandate is to protect what they have (from going bad)
- This would be consistent with late 2019 global survey of Bank CEOs which put credit risk as the #2 priority (cyber crime risk has been #1 for each of the past 3 years)
- We have also noticed a slowdown in how long it is taking banks to process loan applications
- Non-bank lenders much faster at making decisions and agreeing documentation
- They are also more expensive but, in some cases, still at acceptable levels
- Non-bank providers of FX continue to thrive – openness on pricing and good service standards
- No appetite for significant deposits. Recent work undertaken by The Treasury Hub showed one bank refusing to take deposits while another quoted -1.1% regardless of the maturity periods (in effect, they didn't want deposits either!)
- Sustainability beginning to creep into both credit and borrowing margins decision-making
- Brexit will be a specific factor in arriving at borrowing margins
- So, poor management of both will actually result in increased borrowing costs
- Funding for acquisitions is still available and we are seeing quite a number of businesses for sale, mainly due to lack of family succession interest resulting in owner-managers cashing in.

5.3 Possible Impact of Coronavirus

The government announced a number of measures to help individuals and business including an extra €200m funding through SBCI. What impact could coronavirus have on your banking?

- Banks are trying to work out what it means. They have been told to (and they will) support business in difficulty
- But against a backdrop of reduced risk appetite outlined above, this would be counter-intuitive for them
- The viral contagion will directly impact on the inevitable financial contagion – the longer it goes on the larger the level of financial support required AND the larger the number of businesses that will need it
- But the banks' efforts are likely to be executed on a case-by-case basis. Therefore, similar to the medical profession, if they have to handle 500 cases over a few weeks, that's possible on a 1:1 basis. If they have to handle 5,000 cases, then it is unlikely that they have the staff
- Should this arise, this will mean that they will focus on those that are most likely to survive
- Availability of hedging lines may also decrease (as these also carry credit risk) but there are a number of alternative providers who can fill that gap
- SBCI scheme details are yet to be launched. However their Credit Guarantee Scheme already in place has capacity.

Action Items?

- Assess stress point (time and quantum) in funding from now to the end of June
- Do you have sufficient credit available (e.g. overdrafts, unused loan facilities) to meet this peak requirement?
- If not, need to address this immediately with advisors and funders
- If current facilities expire in 2020, need to start working on the refinancing now. This will be a more challenging prospect against the current backdrop so the level of preparedness will be crucial
- Act quickly and decisively
- Remember those that survive will thrive – there will be causalities so don't be among them
- Get in touch for strategic advice on how to deal with your banks.