THE TREASURY HUB
Banking and Treasury Markets

August 2020 Report

1. Executive Summary

1.1 Introduction

Welcome to the end of Summer edition of THE TREASURY HUB Banking and Treasury Markets Bulletin. This is a slightly shorter than usual publication given that Summer holidays tend to result in lower market activity.

On the currency front, the biggest mover was USD which has weakened considerably over the Summer and broken out of a downward (i.e. strengthening dollar) range that has existed for almost two years. Last month we stated that "EUR/USD has been stable for a few years but we expect more action in this currency pair in the second half of the year". It appears to have kicked off quickly in July.

EUR/GBP has continued within the range that we had indicated would likely persist for the Summer pending more definite outcome, either way, in the UK/EU trade negotiations.

From an investment perspective while all three equity indices that we track (ISEQ, FTSE and DOW) are down in the year, the DOW is close to recovering to where it was at the start of the year. The NASDAQ has continued to power ahead to new highs with Apple now valued at $2 trillion.

On the Brexit front, UK/EU talks have recommenced this week but no news to report yet. October is the deadline for any deal as it would have to be approved by all EU governments individually**. UK government not having a great time at the minute (exams fiasco being the latest) so a deal of some sort would make a lot of sense and remove one problem from their agenda. We will find out soon enough if sense prevails.**

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	-0.1040%	-0.3790%	-0.4830%
Interest	EUR 3-year	-0.1500%	-0.2600%	-0.4100%
Interest	GBP 3-year	-0.6940%	0.8140%	0.1200%
Interest	USD 3-year	-1.4360%	1.6560%	0.2200%
FX	EUR/GBP	6.3648%	0.8459	0.9034
FX	EUR/USD	6.1532%	1.121	1.1945
Equities	ISEQ	-12.973%	7315	6366
Equities	FTSE 100	-19.753%	7604	6102
Equities	Dow Industrial	-3.391%	28869	27890
Gilts	IE 10-yr	-0.143%	0.098%	-0.045%
Gilts	GB 10-yr	-0.6540%	0.794%	0.140%
Gilts	US 10-yr	-1.2730%	1.882%	0.609%

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.

We continue to keep the report short and focused on key aspects that companies need to manage from a financial perspective.

We get a sense that there could be increased corporate activity in the remainder of the year, some negative (examinerships) and some more positive (mergers/acquisitions). Brexit will have a bigger impact than is currently forecast as it could provide opportunities as well as threats.

Business Owners in their late 50s+ would be strongly advised to start considering their medium-term exit strategies and all owners should look to improve the quality of their long-term funding. It has been a weakness for many companies that the pandemic has exposed.

Banking will become more challenging in Q4 as the banks could struggle to deal with the sheer scale of the intervention required for companies and sectors that will find themselves challenged. Please continue to avail of the financial planning grants from Enterprise Ireland and LEOs.

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1.3 Forward-looking Indices

Forward-looking indictors known as Purchasing Manager Indices or PMIs are useful to monitor the economic outlook for Ireland and the UK. Readings above 50 indicate expansion while below 50 denote contraction. Current month readings (July) continued to indicate recovery and all of the readings below are now in expansion territory again. As previously mentioned, we see risk in the construction sector in 2021 rather in than the remainder of 2020 and government action on housing projects could well be crucial for that sector.

Table 2. Irish and UK PMI readings

Variable	Ireland	UK
Manufacturing PMI	57.3	53.3
Services PMI	51.9	56.5
Construction PMI	53.2	58.9

1.4 Brexit

Not a lot to report due to the Summer recess. We called a range of EUR/GBP0.88 to EUR/GBP0.92 for the Summer in June and that range has held since then. We expect this to continue for August but as September will require progress to be made due to time constraints on reaching any deal, positive or negative steps in that regard will have the potential to move the exchange rate out of this range. It's a risk that is largely off the radar for too many companies but, like Covid, it won't go away just because it's an inconvenience. Unlike Covid, we are likely to have an outcome, good or bad, before year end.

1.5 Treasury Hub Activities

All members of The Treasury Hub continue to work closely with their clients to guide them through the Covid storm. Summer has been a source of relief to many, especially in the hotel and tourist sectors as staycations appear to have generated reasonable momentum. But Autumn and Winter will be a challenge. Early engagement with your advisors would be encouraged.

1.6 Conclusion

Pace and shape of economic recovery will directly correlate with public health policy efficacy. We are entering a key phase that will determine economic wealth for the next 3 years at least.

For further details, please email Chris Ball.

2. Interest and Economic Review

2.1 EUR 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

ECB has continued to maintain high levels of liquidity in the markets. As a result, the 3-month euribor rate has fallen again and at -0.483% is just off the all-time low of -0.489%.

As previously mentioned, these lower rates are not being passed on by the banks and this is now becoming a material cost to Irish corporates, especially SMEs as many of them have loans priced off a basis other than Euribor and these bases can be above zero%. This downward move in official rates is also putting increasing pressure on deposit rates with negative rates now widespread.

Despite the growth in public sector borrowing for all governments, the cost of borrowing for such governments has remained remarkably low although there was a slight uptick in US bond yields in the past month.

The debate about Modern Monetary Theory or MMT as it is known continues**. To put it simply, the theory includes the proposition that countries that can issue money in their own fiat currency cannot default on their debts as they simply print more money to repay maturing debts. It also proposes that governments can achieve full employment through job guarantees rather than private sector stimulus and it suggests that interest rate targets don't work as a policy instrument.**

The printing of money, especially in the US, has been cited as the main reason why stock markets have rebounded so quickly. As mentioned above, low interest rates are causing problems for banks and savers alike. The debate is an important one as, at an extreme, it suggests that governments never really have to repay borrowing. The US appears to be heading that way with the sheer scale of new money printed/borrowed in 2020 but there is a growing concern that it can be "overdone" and both Russia and China have started to use currencies other than USD in their trading to reduce the power of same. Time will tell how this pans out.

Graph 1. 3-m Euribor: five-year trend

Graph 1 above highlights the (relative) volatility in 3-month Euribor since March although it must be noted that this range is still between -0.16% and -0.49%. As referenced above, banks are not passing on the benefit of negative interest rates to borrowers so, at best, borrowers are achieving a cost of funds of 0%. We are getting a sense that margins will be under upward pressure in the coming months as banks seek to plug a hole in their P&L from negative interest rates. Our relationship with Treasury Hub firms nationwide will ensure that we can benchmark your borrowing margins in an objective manner. There is also scope to negotiate other means of reducing interest costs based on our experience in these matters.

Graph 2. EUR 3-year swaps: ten-year trend

Graph 2 shows the trend in 3-year (fixed) rates (pre-margin) over the past decade. The white line is 0%. Same comment applies to these longer-term rates: banks are not providing the benefit of the negative rates to borrowers. Borrowers continue to seriously consider fixing interest rates for up to 5 years at 0% (pre-margin) having taken the view that negative rates are not likely to be passed on and securing a zero rate cost of funds will be as good as it gets on that front.

2.2 UK and US interest rates

UK and US interest rates bottomed out and started to recover a little over the course of the past 4 weeks. UK inflation data out today shows core inflation at +1.8% and this should keep pressure off any downward move/suggestion that the Bank of England will use negative interest rates. For now, the markets do not seem to require higher yields for buying more bonds that are financing ballooning deficits.

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

Graph 4. USD 3-year swap rates: twelve-month trend

2.3 UK Economic Outlook

While PMI readings are improving from all-time lows (see Section 1.3) technically the UK is in recession with Q2 GDP falling by -20.4% on top of a Q1 figure of -2.2%. Consumption fell by 23% in Q2. But retail sales were positive for the second month in a row in June. Unemployment remains at 3.9% as the furlough scheme masks the true level. Tax data suggests that 700,000 people have been laid off. Total employed at the end of May was 32.9 million. The full extent of the state of the economy will unfold as government subsidies and supports decrease. Brexit remains an additional risk/threat to the economy.

We continue to hold a pessimistic view of the outlook for the UK for now.

2.4 US Economic Outlook

Where the US differs from the UK in its reaction is that it doesn't supply employment supports but rather unemployment support. As a result unemployment leaped from 4.4% in March to 14.7% in April, since falling to 10.2%. However, this still implies that the US has recovered only 9.3 million of the 22 million jobs lost between February and April. Q2 GDP fell at an annualized rate of (32.9%), the largest ever fall. However as this figure is calculated on an annualized basis, this is the rate that would be achieved if the Q2 rate of decline was sustained for 12 months. The quarterly decline was under 10%. The housing sector is recovering with housebuilder confidence at an all-time high!

No formal moves on the US/China trade talks although there is speculation that the Chinese recovery is more patchy than previously expected and this, in turn, may encourage a positive outcome.

2.5 Political Outlook

US presidential race is heating up with the formal nomination of Joe Biden by the Democrats. Trump trails in the polls. FT estimates that 121 electoral votes in 9 states could go either way. Success is defined as 270 electoral votes in total. Biden choice of running mate certainly broadens the appeal to a wider number of voters.

In the UK, the Tories continue to stumble along with the latest debacles relating to the marking of GCSE and A level exams. Autumn will see some element of retrenching of furlough schemes and we will get a better picture then of how strong or weak the recovery has been.

3. Foreign Exchange Review

3.1 EUR/GBP

We have previously noted that the 2020 high-low volatility has been greater than ever year since 2000 with the exception of 2008 (financial crisis) and 2016 (Brexit vote). The upward trend in the graph below (which we flagged as likely in April) continues for now. The "holding pattern" of 88p to 92p previously identified as the likely Summer range has remained intact.

The UK government has also been engaged by Covid and other matters (e.g. exams marking) over the Summer and with Europe on holiday for most of August, there has been no Brexit progress over the past few weeks. **We expect the above range to be challenged in September as trade talks between the EU and UK continue and gradually come to a conclusion by October, for better or worse.**

Therefore, the risk of current levels being either very good buying or selling opportunities is high as it is difficult to see GBP remaining around current levels once the outcome of the Brexit talks becomes apparent. The question remains will it be higher or lower? On balance we remain of the view that there is greater potential for GBP weakness than strength. Consider the appropriate use of FX options for the coming 2 months from a strategic perspective but get in touch if we can help. **Be careful to structure them properly if using them and get some independent advice.**

Graph 5. EUR/GBP in 2020

As previously mentioned, the outcome of the Brexit talks will have a material impact on banking discussions where exporters (and, possibly, importers) are either borrowing new money or refinancing existing loans. Thus the financial ramifications will extend well beyond currency.

Get in touch if you require further details on the development of currency hedging strategies.

3.2 EUR/USD

The downward (USD strengthening) trend which has prevailed since Q1 2018 in EUR/USD has reversed. From 2 July to 18 August, it weakened from EUR/USD1.1238 to EUR/USD1.1929. This was the highest level since May 2018.

Graph 6. EUR/USD: five-year trend

Exporters to the US have had a very strong run in that period, in many cases softening the blow where they also exported to the UK. But the pace and scale of the recent weakening is sufficient to reduce the profit on sales of $100,000 by over €5,000!.

The adverse trend would certainly be reflective of a lot of uncertainty in the US and not just in an economic sense. A recent podcast from a leading and seasoned hedge fund manager stated that if you did not know that the data applied to the US, a dispassionate look at it would says it exhibits all the signs of the early stages of a country on the brink of implosion! Two months ago we suggested that exporters needed to move the monitoring of EUR/USD from "do nothing" to "monitor" status. We hope that view was given consideration.

3.3 Summary

We reiterate our view that it is time to push currency management back to the top of the agenda given the knock-on effect of adverse currency movements on cashflows, debt repayment ability and investment capacity.

4. Wealth Management

4.1 Oil

Graph 7. Oil prices: two-year trend

Recovery in oil price has been faster than some previously expected but one recent commentary suggested that it looks overdone as the economic outlook/pace of Covid recovery is worse now than a month ago and that floating storage is on the point of making a comeback (any speculation in oil markets is not like derivatives: the buyer must take actual possession of the product). $50 looks like a challenging target for now, retracement more likely?

4.2 Gold Price Trends

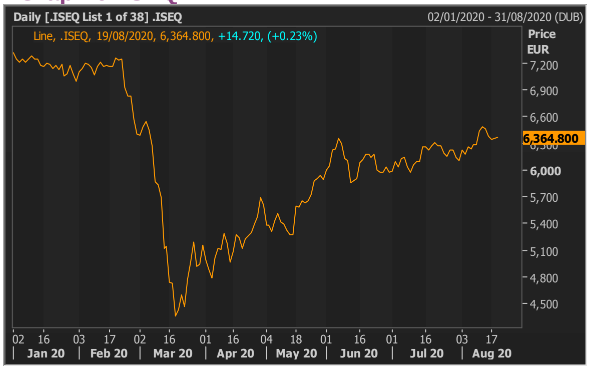
Graph 8. Gold prices: two-year trend

Anyone that decided to considered buying some exposure to this as a hedge against an economic slowdown when we started to watch this 13 months ago must be laughing. It peaked at $2,072 on August 7th from under €1,400 in June 2019. Equity markets have not had a serious retracement since the recovery. So Gold might hold up around $1,800 or thereabouts for now.

4.3 Equity Markets

Graphs below are 2020 trends for ISEQ, FTSE and DOW. All three have recovered to varying degrees and taken time recently as the Q2 results season kicks in. There is little doubt that equity markets have benefitted from loosening fiscal policy as underlying economic prospects would not appear to be as rosy. Markets also seem to forget that if GDP falls by 20% in a quarter (e.g. from 100 to 80), it has to improve by 25% (80 to 100) to get to the previous (same) level. Investors probably still getting back in gradually but buying some equity (option) floors mightn't be a bad idea to consider as we head into Winter and a probable second Covid wave.

Graph 9. ISEQ



Graph 10. FTSE

Graph 11. DOW