THE TREASURY HUB
Banking and Treasury

Markets Report

1. Executive Summary

1.1 Introduction

Welcome to the second edition of THE TREASURY HUB Banking and Treasury Markets Bulletin of 2021. It has been a very active start on all fronts – currencies have made some material early moves, interest rates are moving up, stock markets are a little jittery while oil has raced ahead again. In Ireland, the announcement was made by NatWest to wind down the operations of Ulster Bank although it is fair to say that it had been well flagged. In Section 5, we look at various trends already emerging.

On the currency front, GBP has "exploded out of the traps" mainly due to a very strong vaccination process. Although Brexit is now a reality, the consequences of it are being felt by UK exporters, especially in the SME sector but this is not holding back the currency for now as the vaccination programme and speed of recovery of the economy is taking centre stage. 27% of the UK adult population has received a first "jab" already.

By comparison USD is treading water over the first 7 weeks of the year. Impact of the Biden stimulus plan is currently being evaluated although moves in interest rates suggest the pace of recovery is also expected to be strong in the US. Section 2 covers off currencies in more detail.

From an investment perspective the NASDAQ continues where it left off last year although prices have been volatile in recent (Tesla is 18% off its 2021 high in early January). The ISEQ and FTSE 100 are marginally ahead of year-end but markets are a bit jittery about possible corrections. Oil has stormed into 2021 while Gold has eased back somewhat as economic prospects improve along with increased vaccination rollout.

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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	0.0010%	-0.5460%	-0.5450%
Interest	EUR 3-year	0.0700%	-0.5400%	-0.4700%
Interest	GBP 3-year	0.2287%	0.0813%	0.3100%
Interest	USD 3-year	0.0710%	0.2330%	0.3040%
FX	EUR/GBP	-3.7979%	0.8937	0.8610
FX	EUR/USD	-0.2866%	1.2248	1.2213
Equities	ISEQ	1.3151%	7376	7473
Equities	FTSE 100	3.3591%	6460	6677
Equities	Nasdaq	5.5012%	12888	13597
Gilts	IE 10-yr	0.4320%	-0.300%	0.132%
Gilts	GB 10-yr	0.6050%	0.207%	0.812%
Gilts	US 10-yr	0.5175%	0.930%	1.448%

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.

The start of the year is best summarized as :

- **First sign of upward pressure on interest rates in a long time**
- **Government borrowing globally will still be high in 2021 due to the severity of the latest lockdown**
- **Pace of recovery will be uneven and very much linked to vaccination rollout rate in Q2 and Q3**
- **Currencies have started the year quite volatile with GBP being the best performer**
- **Withdrawal of Ulster Bank from the Irish market is bad news for SMEs**
- **But PTSB indicate a strong desire to fill a large part of that void.**

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. Irish Services PMI fell from 50.1 the prior month, the third largest monthly fall on record while Construction PMI collapsed due to the third lockdown. New orders were also at an 8-month low. There was a strong recovery in the UK Services PMI but Construction PMI eased back due to a fall off in commercial activity..

Table 2. Irish and UK PMI readings

Variable	Ireland	UK
Manufacturing PMI	51.8	54.9
Services PMI	36.2	49.7
Construction PMI	21.2	49.2

1.4 Brexit

Realties are biting for UK exporters (and to some extent Irish importers) due to increased paperwork on movements to/from the EU Trading Area. FT carried an article recently suggesting that increased administration costs will make exporting unviable for a lot of UK SMEs. There will, of course, be teething problems so one would hope that they will be ironed out as the year progresses. Market intelligence suggests that valuation of UK firms is below Irish firms so opportunities may emerge to buy good companies but stronger sterling will impact negatively on such value.

1.5 Conclusion

2021 has started apprehensively. It would appear that the pace of vaccination will impact on many markets in 2021 from general GDP and Consumer Spending to interest and gilt rates and currencies. If this continues to be the case, UK appears to have a lead on Europe. We will continue to monitor this closely.

2. Foreign Exchange

2.1 EUR/GBP

On the back of 2020 being the third most volatile year (peak to trough) since 2000 at 14.73%, the 2021 YTD move has been already been 6.37%. Good news if you are an exporter, bad news if you are an importer. The YTD average EUR/GBP rate is EUR/GBP0.8854, in line with previous 2 years, but this will likely lower as the year goes on due to strengthening Sterling.

Graph 1 below shows the trend for the year to date and says it all. The trend has been driven initially by market relief at the avoidance of a hard Brexit but subsequently by the success of the UK vaccination programme vis-à-vis Europe.

The former has not been easy for small exporters in the UK and will have a negative impact on GDP but the latter is likely to lead to a faster opening of the UK economy which with very high deposit levels as a result of the pandemic is expected to lead to a spike in consumer demand and, consequently, GDP. For now we stick with our forecast of 85p being the bottom of the range. But further delays in availability of vaccines in Europe is likely to be EUR negative and GBP positive.

Graph 1. EUR/GBP: 2021 to date

Graph 2. EUR/GBP: 5 year trend

2.2 EUR/USD

The weakening of EUR/USD over the second half of 2020 has stabilized somewhat over the first weeks of 2021.The graph below shows the trend for the past 12months and the trendline is still upwards i.e. weaker USD. Against that background as we shall see later in the bulletin, US interest rates are rising again due to the prospect of a strong bounce back with the huge stimulus promised by the Biden administration. However, there remains a risk that after the initial “euphoria” of a lockdown release and hike in consumer spending, matters settle back to a below-trend pattern as the cost of paying for the pandemic becomes apparent and governments start taking appropriate actions (probably targeted tax hikes). As mentioned in the previous bulletin, the weakening of USD has had a material impact on margins for exporters to the US, after a positive (strong USD) trend for a numbers of years prior to this. **Likely 2021 trend is still unclear so we continue to encourage exporters to plan for the rate staying close to current levels.**

Graph 3. EUR/USD: 12 month trend

3. Interest and Economic Review

3.1 EUR Short-term Rates

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

The graph below goes back to the end of August (6-month trend) and is used to highlight how this rate has bottomed out since the end of the year. As previously referenced, the main impact of these sustained levels of negative interest rates has been on deposit rates and these are gradually turning negative for SMEs with no likely change in this trend in 2021. We have received an increasing level of enquiry on this topic since the start of the year but there does not appear to be a silver bullet. Growth in GDP and inflation along with reduced QE by central banks is the likely required trend to move rates back into positive territory.

Graph 4. 3-month Euribor: 6-month trend

3.2 EUR Medium-term Rates

3-year swap rates (i.e. fixed rate before lending margins) followed a similar trend to 3-month Euribor and, as previously mentioned, for as long as there is little or no gap between these and short-term rates, the interpretation would be that there is no change expected in Eurozone interest rates for the foreseeable future.

A slight gap (7bp) has emerged over the past week or so and we will monitor this trend but fear that the exit of Ulster Bank from the Irish market will drive lending margins up thereby increasing the all-in cost of borrowing (see Section 5).

Graph 5. EUR 3-year swaps: 5-year trend

3.3 Summary

The feared exit of Ulster Bank from the market was announced last week. We do not see non-bank lenders filling this gap (which is circa 15% of SME lending) but would be hopeful that PTSB will step into the breach over time. In the interim, margins may come under upward pressure.

The other variable to watch is inflation – there is no evidence yet of any re-emergence of price increases but as economies open up, there will be increased demand pressure. In addition, higher oil prices (see Section 4) will feed through from Q2.

3.4 UK and US Interest Rates

In the previous bulletin we stated "As fixed rates are quoted as a spread over gilts, gilt yields could increase in 2021 driving UK swap rates higher". The UK 3-year swap rate has risen from 0.07% on January 4th to close to 0.40%. Again, this may be linked to a vaccine-related positive economic outlook. We need to keep a close eye on this trend as interest rates have been low for so long that small moves in absolute terms could be large moves in relative terms.

Graph 6. GBP 3-year swaps: 12-month trend

Graph 7. USD 3-year swap rates: 12-month trend

US rates following a similar trend and levels to the UK.

The focus in the US is very much on the price of government gilts as a possible indicator of inflation expectations. In particular, the gap between 2-year and 30-year rates is monitored. Therefore, we will measure these rates and the gap between them for 2021 for the above reason.

What is notable about this table is that although short-term rates are at similar levels in both UK and US, the long-term rates in the US are much higher signifying a more positive outlook on the pace of the recovery in the US. As mentioned earlier in the bulletin, some analysts are concerned that the initial increase in economic activity post-lockdown will be short lived and, as a consequence, gilt rates will retreat. We will track this over the course of the year.

Table 3. Government Bond 2yr vs 3-yr spread

	2-year	30-year	Spread
Ireland	-0.5260%	0.6960%	1.2220%
UK	0.1200%	1.2200%	1.1000%
US	0.1400%	2.2100%	2.0700%

3.5 UK Economic Outlook

GDP grew by 1% in Q4 2020 resulting in an annual contraction of -7.8% for the year. Retail sales slumped by -8.2% in January resulting in an annual fall of -5.9%. Unemployment rose again to 5.1% in January but 4 million people (25% of all employees) are supported by the Job Retention Scheme.

Household savings grew by 16.5% in Q3 over Q2 which, in turn, was 26.5% higher than Q1. So there's a lot of consumer firepower to be deployed when shops re-open. Inflation is a benign +1.4% although that should change post-lockdown.

The other big item on the agenda soon is how to finance the huge levels of government borrowings as some taxes will have to be raised to starting paying the related interest for starters.

3.6 US Economic Outlook

US unemployment continues to fall from 14.7% in April to 6.3% in January. Services and Manufacturing PMI are both quite healthy close to 60 while building permits (planning permission) rose by another 10.7% in January indicating a strong housing market outlook (highest level since May 2006). Retail sales also performed strongly in January (up 5.3% on the previous month) with consumer credit also growing. Inflation remains under control for now (steady at +1.4%).

Of course, the economic policies pursued by the new administration will drive or assist a lot of the recovery and the scale of the stimulus package reflects a "borrow now and pay later" strategy. The stock markets have held up well and as a significant % of the US population hold stocks (much higher than on this side of the world) so, all in all, the data for the US looks good.

4. Wealth Management

4.1 Oil

Graph 8. Oil prices: 12-month trend

The performance of Oil since Q4 2020 has been a story in itself. Since the start of November, the price per barrel of Brent has risen by €27 or 70%! It has surprised markets (e.g. airline fuel demand is expected to be only 38% of 2019 demand this year) but most think that $70 per barrel is on in the near term. Are hedge funds speculating on this asset class driving the price up? The demand/supply dynamic does not seem to explain the price rise. Like so many other asset classes, trying to figure out the impact of so much liquidity on pricing is a challenge…but probably a factor also.

4.2 Gold Price Trends

Graph 9. Gold prices: 12-month trend

As expected, rising hopes for recovery in global GDP have corresponded with a fall in the price of gold over the past few weeks. This has been a decent (inverse) indicator of GDP prospects since we started to monitor 18 months ago and merits continued coverage on that basis.

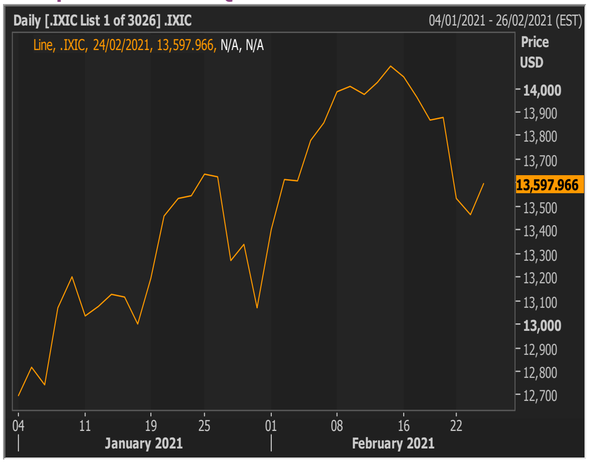
4.3 Equity Markets

Similar to 2020, the US (NASDAQ) continues to outperform the others into 2021 although tech stock have topped out (Apple down from $133 to $124, Tesla down from $705 to $690, Facebook down from $273 to $365). Analysts in general are somewhat worried about stock market valuations and with increasing talk about the re-emergence of inflation, equity markets may tread water for now.

Graph 10. ISEQ 2021 trend

Graph 11. FTSE

Graph 12. NASDAQ



5. Sundry Developments

5.1 General Banking Trends

There has been a cautious start to the year on the lending front. Banking, like other sectors, is trying to assess when the economy will re-emerge from lockdown, if this is the last lockdown and how strong the rebound will be.

Hospitality will be challenging and there is also a risk that margins and terms/conditions will be adversely impacted for those in that sector that can and will survive as the sectoral risk will be higher with bank risk models reflecting (and pricing) this. We know that it's not what players in this sector will want to hear so our suggestion is to get in touch with us and ensure that communications with your lenders are properly managed.

The amount of outstanding loans from Irish corporates continues to fall (meaning banks have lower loan assets on which they achieve a return) and when this is coupled with rising deposits on which they receive no return or incur a negative return, the squeeze on net margins is obvious. Add to this the inevitable increase in loan provisions that will result from the pandemic and you have a challenging current outlook for the sector.

Margins, in general, are not falling and the banks are also increasing the number of clients that are now suffering negative deposit rates. In fact, we have seen a large increase in the number of queries on where to place surplus funds against that backdrop but the honest answer is that negative interest rates are a market norm for now. Care would need to be taken in investing in alternatives as most if not all of the alternative "products" do not provide a guarantee of capital protection. For owner-managers, we would recommend a comprehensive review of your likely funding requirements of the business over the coming three years along with a personal/pension financial health check to ensure that all angles are covered off. We will review the 2020 results of the banks in the next bulletin.

5.2 Ulster Bank

The announcement that Ulster Bank was to wind down its operations did not come as a shock to many as there had been a bit of "kite flying" last year on the topic. Nevertheless, it is a disappointing development for SME borrowers as is reduces the number of players in this market segment. The corporates (generally defined as loans of €10m and higher), remain reasonably well served as there are players in that segment such as Barclays, HSBC and Rabobank that do not operate in the SME and Business Banking space.

PTSB has indicated a plan to fill some of this gap and we met with them (virtually) at our recent Treasury Hub forum. Ulster Bank indicated that it was in talks to sell its corporate loan book to AIB and its SME loan book to PTSB. However, it is estimated that Ulster Bank has 15% or thereabouts of the SME loan market so that would be a challenge for PTSB to fill a material part of that gap but we are hopeful of developments in that regard and we will keep you posted.

Non-bank lenders will continue to play a role but they tend to be niche players (leasing, asset finance) or focus on area that banks are less comfortable with. However, they are still part of the lending landscape so we will continue to work with them as demanded by our clients needs.

Although the press releases indicated a wind down over a few years for Ulster Bank, we think that a lot of the loan books as indicated above could be sold quite quickly. This will leave a rump of loans that may be more difficult to offload and there is the inevitable danger that some loans will find themselves being sold to distressed debt lenders before the end of the year.

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