THE TREASURY HUB
Banking and Treasury Markets

March 2021 Bulletin

1. Executive Summary

1.1 Introduction

Welcome to the third edition of THE TREASURY HUB Banking and Treasury Markets Bulletin of 2021. It is 12 months since the first lockdown and the seismic impact on all of our lives. The changes required in the way we work, etc. have accelerated trends that had been emerging or "bubbling under", but not all of it is negative. In fact, it could be a catalyst for a lot of positive developments. Of course, the impact has been very uneven – the hospitality/hotel sectors have been decimated while other sectors have thrived.

On the currency front, USD has regained some of the losses that it incurred over the course of 2020 and into 2021.EUR/GBP has also strengthened due to the avoidance of a hard Brexit but both USD and GBP are gaining against EUR due to weakness of the Euro which is primarily (directly and indirectly) linked to relative success of vaccine rollout programmes (slow in Europe, much faster in UK and US).

From an investment perspective, stock market trends are generally positive although NASDAQ has retreated in recent weeks. We have added Brent Crude and Gold to the table from this month.

Interest rates are climbing off the bottom and we review them in more detail this month. US trends are particularly strong.

Section 5 covers the banking market and analyses the recent results of AIB and Bank of Ireland as well as emerging trends in that sector.

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

Table 1. Key Metric Movements: 2021

Heading	Metric	YTD move	From	To
Interest	3-m euribor	0.0090%	-0.5460%	-0.5370%
Interest	EUR 3-year	0.0750%	-0.5400%	-0.4650%
Interest	GBP 3-year	0.3487%	0.0813%	0.4300%
Interest	USD 3-year	0.2150%	0.2330%	0.4480%
FX	EUR/GBP	-4.5263%	0.8937	0.8550
FX	EUR/USD	-4.1320%	1.2248	1.1762
Equities	ISEQ	9.9105%	7376	8107
Equities	FTSE 100	4.9226%	6460	6778
Equities	Nasdaq	0.5975%	12888	12965
Commodities	Brent Crude	25.058%	51.80	64.78
Commodities	Gold	-10.186%	1896.49	1703.31
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.

Emerging trends already are :

- **Strong performance of Oil but weak performance of Gold**
- **Strong rebound in government gilt yields, especially in the US. The trend is replicated in the swaps market**
- **NASDAQ lags the (non-tech) companies so far this year**
- **GBP already heading towards EUR/GBP0.8500 as EUR looks weaker for the first quarter.**

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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. February readings in Ireland showed all three measures improving after poor January figures reflecting the January lockdown. In the UK, all three readings are in expansion territory with Services recovery being particularly strong.

Table 2. Irish and UK PMI readings

Variable	Ireland	UK
Manufacturing PMI	52.0	57.9
Services PMI	41.2	56.8
Construction PMI	27.0	53.3

1.4 Macroeconomic Outlook

IBEC downgraded their 2021 GDP forecast from 5.3% to 3.1% this week. They expect the 2022 figure to be a strong 4.3% on the back of the vaccination rollout. In the UK, HMT produced forecasts in the past two weeks upgrading their 2021 GDP growth figure to 4.7% (4.4% a month earlier) with a further 6.1% growth in 2022. Their report is an aggregation of 20 forecasts from banks and others. Capital Economics who are an independent consultancy with a good track record are forecasting 5.2% and 7.2% for 2021 and 2022 respectively, even more bullish than the average.

1.5 Conclusion

Macroeconomic data for 2021 will likely be dominated by the speed and efficacy of the vaccination rollout. The UK and US appear to be very successful thus far compared to the Eurozone. As of March 29th, the vaccine doses per 100 people were 50.4 in the UK and 42.9 in the US. By comparison, the numbers in France and Germany (as reasonable proxies for Ireland) were 15.3 and 15.4 respectively.

The speed of opening up will permit faster economic recovery, probable higher inflation and higher interest rates and these, we believe, will impact on currencies.

We may consider inclusion of this data for a few months as it could be THE key metric to monitor from an economic perspective in 2021.

2. Foreign Exchange

2.1 EUR/GBP

We have long had the view (regularly expressed in this bulletin) that a soft Brexit would see EUR/GBP back towards 85p. Having touched EUR/GBP0.8533 in mid-March, it retraced by over 1p but the past 3 days has seen renewed downward pressure which we attribute mainly to positive UK/negative European vaccination recovery.

Accordingly, we are making our first call on currencies for 2021 whereby we think that EUR weakness could see this exchange rate move lower in the coming months to 82p. This is an opinion and strategies need to be developed and personalized by GBP buyers/sellers but its an indication that GBP buyers in particular need to move currency management to its highest priority level again.

Graph 1 below shows the trend for the year. The gradual strengthening briefly reversed but a downward rends has re-emerged this week. Graph 2 overleaf shows the trend over the past 10 years. In a table prepared for a recent presentation we noted that GBP1m sales were worth €500,000 less in 2020 than they were in 2000. That's a huge depreciation in the value of UK exports.

We think that the probability is skewed towards GBP strength in Q2 and suggest that importers take note accordingly.

Graph 1. EUR/GBP: 2021 trend

Graph 2. EUR/GBP: 10-year trend

2.2 EUR/USD

As mentioned in recent bulletins, EUR/USD weakened over 2020 - average rate swung from EUR/USD1.10 in the first 6 months to EUR/USD1.18 for the second half of the year. However, as the graph below highlights, USD has reversed this trend over the past few weeks.

We believe that this trend is more to do with EUR weakness than USD strength and this, in turn, due to pace of vaccination rollout and forecast for the strength of the US economic recovery. President Biden has signed off a large stimulus programme ($1.9 trillion) and an even bigger infrastructure plan ($3 trillion) is in the offing. The combination of all of these should give a very strong impetus to the US recovery – Morgan Stanley is calling 2021 GDP growth of 8.1%! **Add in higher interest rates (see Section 3) and we think that USD could have a good year versus EUR. USD importers take note.**

Graph 3. EUR/USD: 5-year 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 shows how the markets reacted to the first lockdown in March/April 2020 quickly retreating as ECB swung into action with further quantitative easing (printing of money). However, the easing trend has reversed albeit slowly. What is more interesting from an interest rate management perspective is what is happening at the longer end of the yield curve. As previously stated in these bulletins, when 3-month and 3-year rates are at similar levels, then the interpretation is that rates are going nowhere. When longer-term rates start to increase, then that interpretation falls away. We shall see that this is happening faster in the UK and US. However, there is no current upward pressure on Eurozone interest rates.

Graph 4. 3-month Euribor: 12-month trend

3.2 EUR Medium-term Rates

3-year swap rates (i.e. fixed rate before lending margins) have followed a similar trend to 3-month Euribor and dropped as low as it also for a long time now. Long-term rates such as this are a better indicator of the likely direction of interest rates. 3-year rates have moved 15bp higher since the start of the year thereby widening the gap with 3-month rates.

We continue to hold the view that **the cost of borrowing is more likely to be driven up, in the short-term at least, by higher bank lending margins (especially with Ulster Bank leaving the market). But we will watch market rates more closely in 2021.**

Graph 5. EUR 3-year swaps: 12-month trend

3.3 Summary

The variable to watch when monitoring interest rates is inflation. There has been more focus on it over the past 6-8 weeks than at anytime in the past few years. A rise in it is inevitable - one look at the price of oil over the past 12 months for example (see Graph 8) makes it mathematically inevitable. The question is: will it stay higher? European inflation pressures look low for now…but see below.

3.4 UK and US Interest Rates

The change in market view of UK interest rate prospects is very apparent from the graph below. From a low of 0.07% in January, it hit 0.44% midweek. Inflation more likely to be higher in the UK due to opening up of economy and a large level (or part of them at least!) of deposits waiting to be spent. UK imports more than it exports so stronger GBP could exacerbate that problem but consumption will drive the recovery in the short-term at least.

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

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

The spike in international interest rates is most apparent in the US. The graph above shows a move of 20bp+ in this rate over Q1 2021. But if one looks further out the yield curve, 10-year swap rates are up from 0.90% to 1.74% over the Quarter. This is significant on two fronts: firstly, it is a doubling (almost) of rates in less than 3 months and, secondly, the spike applies for each of the next 10 years. Thus, anyone with a 10-year USD debt will pay 9% more in absolute terms than they might have in January but, in relative terms, it is a very large move.
Example: Borrower has a 2% margin. All-in cost of 10-year funds in January would have been 2.90%.Now it is 3.74%. **This represents a 29% increase in the annual interest bill of such borrowers.**

3.5 UK Economic Outlook

Q4 GDP came in at +1.0% resulting in annual GDP contraction for 2020 of -7.8%. This was a poor performance compared to the US (-2.4%), China (+6.5%) and Eurozone (-4.9%). The drivers of the fall were consumption (-8.4%) and fixed investment (-3.5%).

Retail sales were down -3.7% in the year to end February resulting in subdued inflation (+0.4%). Unemployment eased back from 5.1% to 5.0% in January with furlough schemes hiding the true figure but youth unemployment remains stubbornly high at 14.5%.

In the short-term the impact of the poor economic performance (added to post-Brexit uncertainty) will be on government borrowing. Debt:GDP jumped from 84.4% in 2019 to 100.2% in 2020. To put it in perspective, the same measure was 27.2% in 2001. In absolute terms, it increased from circa GB£500bn pre-2008 financial crisis to GB£2,131 billion by the end of last year.

3.6 US Economic Outlook

US unemployment continues to fall from 14.7% in April 2020 to 6.2% in February. PMIs are in expansion territory while business and consumer confidence are both high. Housing trends remain very strong – building permits are at levels last seen in the first half of the noughties. Housing inventories are down and prices up 15.8% since February 2020!

Retail sales have had a strong first two months in 2021, up +6.3% YonY in February. Annual inflation to end February 2021 was+1.7% and it has been at or above 1% since July 2020.

The economic outlook for the US is currently very positive largely driven by policies pursued by the new administration. All the signs point to a strong 2021 performance with some concerns about possible overheating of certain parts of the economy.

Breaking news in the past few days has been the failure of a hedge fund, Archegos Capital Management. It had been funded particularly by Nomura and Credit Suisse. Many publications are also noting that both Goldman Sachs and Morgan Stanley got out before Nomura and Credit Suisse…..faster to the exit is less likely to get caught!

Their problems came to light when an equity derivative position on the shares of Viacom went sour, they were required to put up more margin to cover the position and they didn't have the funds, prompting a fire sale of $20 billion of assets. The worrying questions from this are how did they manage to take such leveraged positions using derivatives and why is this happening in a relatively calm equity market? We're betting that we will see more hedge fund failures this year and there could be a few such stories bringing leverage and large banks under the microscope again.

This is the second time in recent weeks that Credit Suisse has been caught in a bad news story - see Guardian article (https://www.theguardian.com/business/2021/mar/09/greensill-capital-collapse-shows-city-watchdog-needs-shake-up-say-mps.

4. Wealth Management

4.1 Oil

Graph 8. Oil prices: 2-year trend

Using two-year graphs in this section to show pre and post-Covid trends. Oil is the classic rollercoaster. Having slumped to $20 (per barrel) in April last, Brent Crude peaked at $71.38 on March 8th last before falling to $60.27 on March 23rd. It has since steadied around $64. If investing in it as an asset class, it is clearly not for the fainthearted. Supply and demand trends don't seem to explain the movements. So speculators then?

4.2 Gold Price Trends

Graph 9. Gold prices: 2-year trend

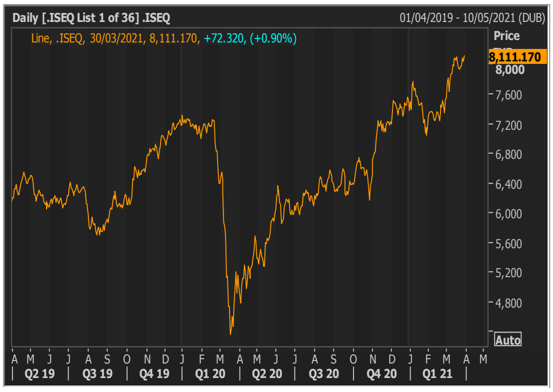
As previously referenced here, we included this as a "hedge" against a slowing economy from mid-2019. True to form it rose as economic data worsened. The recent sell-off is probably reflective of improving 2021 economic outlooks.

4.3 Equity Markets

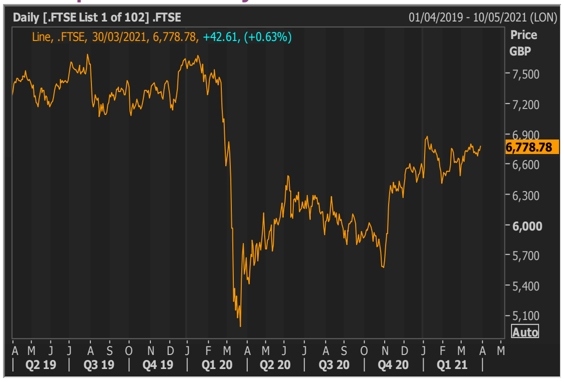
Performance over past 12 months is best summarized as:

- Tech was the big 2020 play (see NASDAQ performance)
- Focus now is back on value/recovery stocks (see NASDAQ recent fall back)
- UK market underperformed the others in 2020 but may be underpriced?
- Irish market dominated by a small number of stocks so need to be tuned in to their relative merits.

Graph 10. ISEQ 2-year trend



Graph 11. FTSE 2-year trend



Graph 12. NASDAQ 2-year trend

5. Banking Review – BOI and AIB

5.1 Main points of the 2020 results

- Net Interest Margin ("NIM") continues to fall for both – impact of negative rates on deposits. AIB presentation noted that the bank exited Q4 at a Net Interest Margin of 1.70% meaning that the trend has continued to deteriorate into Q1 2021. BOI trend unlikely to be different although their UK NIM improved over 2020
- Loan:deposit ratios are well under 100% meaning that their loan books are more than funded by deposits. In AIB's case, for every €100 of deposits they had only €69 of loans last year
- AIB deposits up over €10bn of which retail counts for €5.5bn, with rest in SME/Corporate
- Both banks recorded a reduction in net lending (i.e. loan repayments were higher than new loans issued)
- Capital ratios are strong in both cases
- Cost:income is lower in AIB but it has risen over the past 2 years (banks like to see this falling)
- Both have recorded loan provisions of over €1billion in 2020 although payment breaks requested were nearly all back on track by year-end (well in excess of 90%)
- However, they continue to record high levels of exceptional costs - €386m for BOI (including €189m for restructuring, €136m for write-off of intangible software assets and €39m for customer redress) and €215m for AIB (including €117m for customer redress, €36m for UK restructuring and €30m write-off of intangibles)
- Loans Mix

Table 3. Mix of Loans

2020 Loan Book	AIB	BOI
Mortgages	30.6	44.7
Personal	2.8	5.3
Property	7.4	8.6
Corporate/SME	18.7	19.9
Total	59.5	78.5
Geographic Spread	**AIB**	**BOI**
ROI	77%	52%
UK	15%	41%
ROW	8%	7%
Total	100%	100%

5.2 AIB Future Strategy

Three key trends:

- Ways of working
- Sustainability
- Digitalistion

- Plan to reduce their Dublin office space capacity by 40% in the years to 2023 (vacate 3 of remaining 6 Dublin head office locations)
- Will move certain skills back in-house (change external:in-house mix in these areas from 75%:25% to 50:50)
- Exit UK SME market
- Increased focus on non-lending (hence Goodbodys purchase, Great-West Life Co JV). 2019 benchmark of non-interest income as % of total income was 23% for AIB versus 40% European bank average).

5.3 BOI Future Strategy

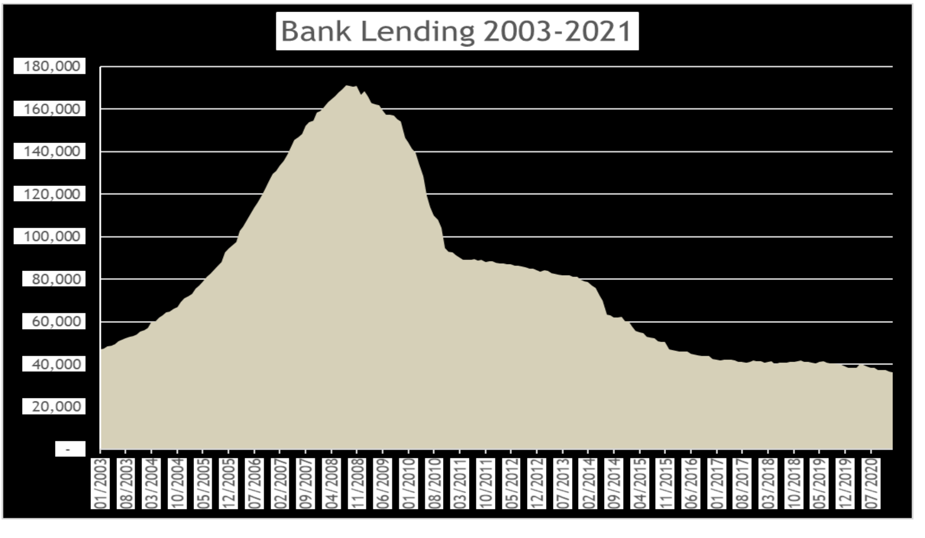
- Drive away from cash/towards digital
  - Closing 103 branches on the island including 50% of NI branches
  - Sale/outsourcing of ATM network
  - Continue drive to digital, especially for applications (mortgages, insurance, etc)
  - But app satisfaction ratings higher for older cohorts – 19-30 cohort being the least satisfied with the (new) app
- Lower costs driven by voluntary redundancy programme (circa 1,450 FTE)
- Difficult to ascertain how the IT transformation programme is progressing against time/cost budgets!

5. Banking Review

5.4 What are we seeing in the Banking Market?

- More cautious approach to lending in 2021 pending when and how quickly we come out of the current lockdown
- SME Credit process alone (approval, not documentation) taking 2-3 weeks
- Margins not likely to go any lower, especially with lower short-term competition due to exit of Ulster Bank
- Competition from non-bank lenders very much driven by niche offers (leasing, Invoice discounting, property development)
- Flexibility in documentation negotiation varying by bank
- Non-bank providers of FX continue to thrive – BOI presentation specifically referenced lower profits in Treasury and lower FX business in the branches (although some of that could be tourism-related)
- No appetite for deposits at all. Both will continue to apply negative interest rates to more deposits
- Sustainability still slowly creeping into credit decision-making
- (Hard) Brexit bullet was dodged (luckily for many exporters, especially in the food sector). But with both BOI and AIB reducing/eliminating their UK SME offer, this could be an operational challenge for exporters
- UK exposure could yet be positive if their economy benefits from vaccination–related opening up before Europe
- But we would have concerns about the impact of headcount reduction on lending practices in the SME/Business Banking market. Lending is part art, part science. Art requires interpersonal engagement
- Technology offering lags international peers. Danger that move online (which is inevitable) reduces the barriers to entry and actually plays to the strengths of others
- However, we see an appetite to fund acquisitions and deals in general that we believe will materialize in 2021 as older owner/managers transition out of their businesses
- PTSB is getting an “early” opportunity to scale up its SME lending due to purchase of Ulster Bank loan book. Challenge will be to scale up its lending personnel quickly. We presume that some of this will be solved by recruiting from Ulster Bank
- Debt levels continue to fall. Corporate lending at €38bn is below 2003 levels (peaked at €171bn in 2008 - see below) while personal debt:disposable income is now 107% from 210% in 2011. This is causing the banks to move to generate income from a wider range of activities (as outlined in 5.2/5.3 above)
- So, expect more calls on insurance, pensions, wealth management.

Graph 13. ROI Lending to Corporates: 2003-2021



5. Banking Review

Table 4. Summary of key banking metrics 2018-2020: AIB and BOI

	BOI 2020	BOI 2019	BOI 2018	AIB 2020	AIB 2019	AIB 2018
Net Interest Margin	2.00%	2.14%	2.20%	1.94%	2.37%	2.47%
Core Capital (CET1)	14.90%	13.80%	15.00%	15.60%	16.40%	17.50%
New Net lending	(€0.7bn)	€2.0bn	€1.3bn	(€2.0bn)	€2bn	€0.6bn
Loan Book	€76.6bn	€79.5bn	€77.0bn	€59.5bn	€60.9bn	€60.9bn
Impairments	(€1,133m)	(€215m)	€42m	(€1,460m)	(€16m)	€204m
Cost:Income	66%	63%	65%	64%	56%	53%
Loan: Deposit	86%	95%	97%	69%	85%	90%
Liquidity Coverage	153%	138%	136%	193%	157%	128%
Net Stable Funding	138%	131%	130%	148%	129%	125%
Operating Profit	€763m	€934m	€935m	€729m	€1,087m	€1,196m
Exceptionals/non-core	(€386m)	(€289m)	(€100m)	(€215m)	(€588m)	(€167m)
Profit before Tax	(€760m)	€645m	€834m	(€931m)	€499m	€1,247m

Graph 14. AIB Share Price: 5-year trend

Graph 15. BOI Share Price: 5-year trend

5. Banking Review