THE TREASURY HUB
Banking and Treasury Markets

April 2021 Bulletin

1. Executive Summary

1.1 Introduction

Welcome to the fourth edition of THE TREASURY HUB Banking and Treasury Markets Bulletin of 2021. Domestically and internationally, there is increased focus on the speed of the vaccine rollout and, hopefully, a gradual return to normality.

But the one sector that is looking like anything but normal is the Irish banking sector with the announcement of the exit of KBC from the market. Following on from the Ulster Bank announcement the previous month, the SME and Business Banking offerings will be dominated by a duopoly of AIB and Bank of Ireland. The growth of PTSB and the non-bank providers will be crucial for the wider macroeconomic development of the country.

On the currency front, the last week has seen USD retreat but GBP rebound. As Table 1 indicates, both currencies are stronger against EUR since the start of the year. Although the cost of borrowing has increased for most governments in 2021, the move has stalled in Eurozone and UK but US rates continue to ease up as inflation prospects continue to be very actively debated (is it returning for the medium-term or just a temporary phenomenon?). Economic outlook for the US looks very positive at the minute.

From an investment perspective, stock market trends are generally upwards again after some pause for breath. Coinbase was a high profile IPO in the US while the Deliveroo flotation in London was a disappointment.

Section 5 covers interest rates, especially the spectre of negative deposit rates and ask if we can do anything to mitigate their impact?

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	0.1100%	-0.5400%	-0.4300%
Interest	GBP 3-year	0.3287%	0.0813%	0.4100%
Interest	USD 3-year	0.2070%	0.2330%	0.4400%
FX	EUR/GBP	-3.5334%	0.8937	0.8632
FX	EUR/USD	-1.7868%	1.2248	1.2033
Equities	ISEQ	7.9176%	7376	7960
Equities	FTSE 100	6.2229%	6460	6862
Equities	Nasdaq	6.6962%	12888	13751
Commodities	Brent Crude	26.892%	51.80	65.73
Commodities	Gold	-6.353%	1896.49	1776
Gilts	IE 10-yr	0.4180%	-0.300%	0.118%
Gilts	GB 10-yr	0.5240%	0.207%	0.731%
Gilts	US 10-yr	0.6300%	0.930%	1.560%

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.

On the investment front, the focus is now on what is likely to be the new normal post-pandemic. But care also needs to be taken. We have seen spectacular failure of the Archegos family office and Greensill Finance (invoice discounting).

In an excellent article in the Financial Times last week, John Plender wrote about these two plus Deliveroo and Coinbase. The nub of the article was that "one thing they have in common is a dependance on regulatory arbitrage to attempt to extract value from pedestrian core businesses in which fancy technology plays an ancillary role" Deliveroo, for example, he wrote "is all about labour market arbitrage and the legal definition of employment". But, at its core, it is about delivering food from A to B and is unlikely to transform peoples lives.

Ultimately, don't forget the basics and don't invest in something you don't really understand!

Chris Ball
Corporate Finance Partner

T: +353 (0)90 6480607
M: +353 (0)86 6075012
E: cball@rbk.ie
W: www.rbk.ie

1.2 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. March readings in Ireland showed a strong rebound, especially in Services (up from 41.2 in February). Construction will pick up as sites reopened last week. In the UK, where the vaccine programme is having a positive impact, the Construction reading is at its highest since September 2104.

Table 2. Irish and UK PMI readings

Variable	Ireland	UK
Manufacturing PMI	57.1	58.9
Services PMI	54.6	56.3
Construction PMI	30.9	61.7

1.3 Macroeconomic Outlook

The global outlook is generally positive. China announced Q1 growth of a staggering 18.3% although one must bear in mind that they closed their factories in Q1 2020 due to Covid. US data continues to impress but Capital Economics in London reckon that the GDP rebound in Europe will be behind both US and UK and that the ECB will be later than the Fed and Bank of England in raising interest rates.

1.4 Vaccines

Vaccines doses per 100 residents

Ireland: 24.4
European Union: 25.5
UK: 64.5
US: 63.9
Israel: 114.2

(Source: Financial Times)

Last month we promised to include this data for a few months. We believe that there will be a direct correlation between the speed of vaccine rollout and economic growth in 2021.

2. Foreign Exchange

2.1 EUR/GBP

Last month, we suggested that we may see the EUR/GBP rate lower in the coming months to (possibly) 82p as a result of problems with vaccine deliveries in Europe versus strong rollout in the UK.

It subsequently rose as high as EUR/GBP0.8719! However, it has retraced back by 1p in the past 4 days. As we get more positive data from the UK over the coming weeks, it should support it around 85p/86p levels - there is a strong line of resistance on the charts around EUR/GBP0.8305 should it continue to fall. UK household savings have increased by £16bn over the pandemic. So, retail sales will be a key early indicator to be watched.

Graph 1 below shows the trend for the year. The recent weakening was brief and the rate has gradual strengthened again. Graph 2 overleaf shows the trend over the past 5 years since before the Brexit vote. There is a long-term (wide) range with support around EUR/GBP0.8305. The markets appear to indicate that a lot of UK good news is already priced into the rate while we are starting to see a significant ramping up of vaccine rollout in Europe in Q2 which could/should support EUR. Longer term, Italy has ongoing budget deficit issues, ECB policy requires further refinement and, in Germany, Angela Merkel retires. Throw in a French election next year with Le Pen very much to the fore and there is potential for a lot of disquiet in Europe in H2 2021.

Graph 1. EUR/GBP: 2021 trend

Graph 2. EUR/GBP: 5-year trend

2.2 EUR/USD

Exporters to the US benefitted from the strengthening of USD for 2 ½ years. The weakening in EUR/USD over the second half of 2020 was both sharp and material. Exporters got some respite over Q1 2021 but since the end of March it has weakened from EUR/USD1.17 to over EUR/USD1.20 again. Last week, Goldman Sachs called EUR/USD1.25 over the coming 3 months with a 12-month target of EUR/USD1.28. Why?

With very strong data coming from the US, especially compared to the Eurozone, the recent reversal can only be attributed to both profit-taking (good news all priced in), a very bullish interest rate outlook now being reconsidered by some and the eventual closing of the vaccine gap between both areas. We still think the scale of the Biden stimulus programme (including the infrastructure plan) is huge but it may already be factored into prices. **For now, we have to remind exporters to remain alert. Last year's average rate was EUR/USD1.1415. The 2021 year to date average is EUR/USD1.2025. That's a weakening of over 5% on average.**

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 below shows how the markets reacted to the first lockdown in March/April 2021. It may be difficult to discern from it, but the rate has bottomed out and increased very slightly since the start of this year. So, the first conclusion is that we have probably seen the bottom of this "downcycle". However, the pace of any rate increase is likely to be slow. The gap between 3-month and 3-year rates is what we need to watch for early warnings on interest rate increases. This gap is currently only 10bp (0.1%). The first signal we are likely to get about "normalization" is a reduction in bond buying by the ECB. We don't expect to see that before June

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 have been negative for most of the period since Q1 2015. So they need to move almost 0.5% upwards before the rates are positive. No risk of this in the short-term at this point in time.

Our view last month that "**the cost of borrowing is more likely to be driven up by higher bank lending margins (especially with Ulster Bank leaving the market)" has increased in likelihood as a result of the announced retreat of KBC from the Irish market. Bad news for borrowers and depositors alike (see Section 5).**

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

The key variable to watch when monitoring interest rates is inflation. Eurozone inflation, having been negative for the last 5 months of 2020 has been positive and increasing (+1.3% in March). Increasingly, the market view is that while a short-term increase is inevitable – (see impact of oil prices alone), longer-term pressures look low for now.

3.3 UK and US Interest Rates

UK (and US) longer-term interest rates rose steadily for Q1, partly due to the possibility of higher rates of inflation. We would expect to see more evidence of this in the UK in the coming months due to the opening up of the economy and a large level of deposits waiting to be spent. March inflation (CPI) in the UK was +0.7% but manufacturing prices were up 1.9% while input prices rose by 5.9%. 2% is the rate to be sustained before the Bank of England gets concerned. We think it could be reached sooner than may in the market.

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

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

US interest rates have risen the most as evidenced above but it has run out of steam in the past 10 days, despite the positive economic data and the vaccine rollout being even better than originally forecast). Government bond yields have stabilised, which is good news given the huge levels of current account deficits forecast globally in 2021. This also has implication for wealth management as bond prices were sold off in Q1 (bond prices move inversely to interest rates – if rates (yields) increase, bond prices fall…and vice versa)**.**

3.4 UK Economic Outlook

Q4 GDP was revised upwards to +1.3% (from the estimated +1.0%).

Retail sales rose by +2.1% in March with inflation also up by 0.3% to +0.7%. Unemployment decreased yet again to 4.9% with the Labour Force Participation Rate holding up at 79.1%. As already covered in Section 1, Services, Manufacturing and Construction PMI readings are all above 50 signaling expansion.

With the very significant jump in Debt:GDP from 84.4% in 2019 to 100.2% in 2020, the pace and strength of the economic recovery is crucial to the stablisation of the Government finances. There remains problems in certain areas as a result of Brexit and Covid has probably papered over some of these cracks. We await the Q1 GDP data in the near-term.

3.5 US Economic Outlook

US unemployment continues to fall from 14.7% in April 2020 to 6.0% in March 2021. PMIs are well into in expansion territory while business and consumer confidence readings were both higher again in March. Housing trends remain very strong – building permits are very high while housing supply continues to be very tight.

Retail sales rose by the most in 10 months, up +9.8% YonY in March. Annual inflation rate to end March 2021 jumped from +1.7% to +2.6% (highest since August 2018).

Nothing has arisen to alter the view that the economic outlook for the US is very positive as a result of the stimulus and infrastructure packages.

Last month we referred to breaking news about the failure of Archegos Capital Management. We had referred to it as a hedge fund but it was a family office and this was part of the problem: they are not as regulated as hedge funds. The person responsible for it was previously convicted of wrongdoings in the early part of the last decade. The losses were made on total return equity swaps. It would appear that its banks were unaware of the size of their mutual exposures. Losses were $4.7bn for Credit Suisse, $911m for Morgan Stanley and an estimated $2bn for Nomura. Goldmans apparently got out with little exposure. JP Morgan estimate that the total losses of all banks could be as high as $10bn. For Credit Suisse this is the second debacle in recent months having lost an estimated $3bn for their high net worth clients on the Greensill Capital scandal.

These developments, while manageable for the investment banks in question, also raise questions around how losses of this size can be run up by individual companies/customers of said banks.

The opposite has been the case for the main street banks with the post-financial crisis regulatory capital requirements being blamed for the high bank lending margins in Ireland relative to our European neighbours. The Currency had a good article on this if you are a subscriber to that online publication.

Watch this space! There will be more.

4. Wealth Management

4.1 Oil

Graph 8. Oil prices: 5-year trend

The graph above shows how volatile this asset class is from an investor perspective. The price has held up remarkably well considering that international (flight) travel is unlikely to return any time soon, India (a consumer of 5m barrel per day (bpd)) is going into partial lockdown and oil production is likely to increase by 1.7million bpd in the coming months. All of this should point to a price correction in the market. But the trends have ignored demand/supply fundamentals for quite some time. Watch with interest.

4.2 Gold Price Trends

Graph 9. Gold prices: 5-year trend

Given the view of this as a “hedge” against a slowing economy, this will ebb and flow for another while based on changing economic outlooks.

4.3 Equity Markets

Equity markets had a bit of a blip over the course of Q1 but have gained momentum again. Table 1 shows year to date returns of 6% to 8%. Q1 results are hitting the wires and these will drive trends over the coming week or two. The argument about which is a better bet right now: growth or value shares continues to rage. It would appear that focus is currently back on growth stocks.

Graph 10. ISEQ 5-year trend

Graph 11. FTSE 5-year trend

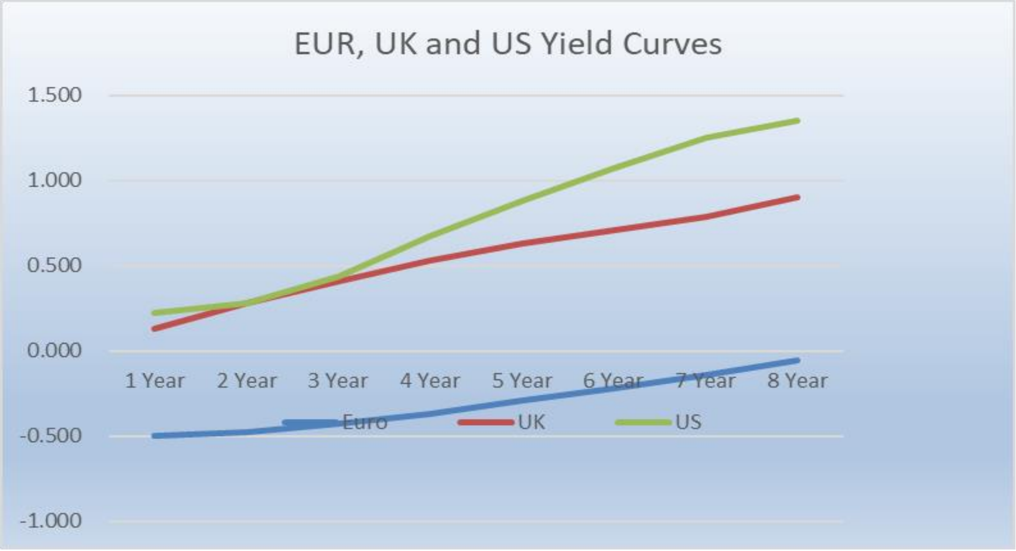
Graph 12. NASDAQ 5-year trend

5. Negative Deposit Rates

5.1 Current Global position

- Investment practice since the last financial crisis has focused on Security (how safe is the investment), Liquidity (how quickly can I realise it into cash) and Yield (return) in that order
- Longer-term interest rates, as highlighted in Section 3, have been negative in the Eurozone for almost 6 years now. The problem is not replicated in the UK or US
- A Yield curve is a line that connects short term and long-term interest rates for a currency. Yield curves are almost always upward sloping i.e. short-term rates are lower than long-term rates. This is because long-term rates require returns for higher uncertainty, inflation, etc.
- Current Yield curves are as per the graph below

Graph 13. Yield Curves



5.2 Current Irish Position

- The purpose of negative interest rates is to promote borrowing to stimulate investment and spending…with depositors losing out
- In Denmark last year they were charging 1% for deposits …but offering mortgages at 0%!
- We have had the worst of both worlds in Ireland – banks have NOT passed on negative rates to borrowers but are charging negative rates on deposits and other investment categories.

5.2.1 Bank Deposits
Initially negative rates were imposed on larger deposits (€10m+) but this has reduced and if not already imposed on your positive balances (deposits and current accounts), negative rates will apply to all credit balances.

Negative rates are currently around -0.65% but we have seen up to -1.00% (and higher around reporting period end dates). Be careful around June 30 and December 31 as banks don't want deposits on these dates.

We do not see any change to this in the short to medium term.

5.2.2. Government Bonds

These were often seen as an alternative to deposits as the risk is generally low (better than the banks). Rates are worse for shorter terms. For example, Irish government bond yields for 2,5 and 10 years on 22/4/21 are -0.59%, -0.43% and +0.09%.

One could invest in other eurozone countries bonds as this does not require taking on currency risk but one must then assess the credit risk. We deal with Credit ratings in 5.2.5 below.

5. Banking Review

Table 3. Selected Bond Yields

	2-year	5-year	10-year	Rating
Ireland	-0.5900%	-0.4300%	0.0900%	AA-
Germany	-0.6900%	-0.6000%	-0.2600%	AAA
Italy	-0.3400%	0.0800%	0.7600%	BBB
Greece	Not quoted	0.1400%	0.9100%	BB-

The most telling observations about this table are (i) the Greek long-term credit rating is non-investment grade (know as "junk") yet the 5-year yield is barely positive, (ii) the multi-annual nature of the investments makes them even less attractive (is there going to be value in locking in a negative return of -0.6% for 5 years on German bonds) and (iii) if interest rates start to increase, the price of the bonds fall making exiting such investments less attractive. Also, the longer the time to maturity, the larger the impact on the price of interest rate moves.

5.2.3 Money Market Funds ("MMF")

Money Market Funds are established by the major international banks and are a means of outsourcing the surplus fund management but keeping the funds safe by ensuring that the Fund has a AAA rating. To achieve this rating, the investments may only be made in liquid products (deposits and bonds) with a high credit rating and a short duration. The banks charge a fee in return. The most recent MMF fund that we have seen for March generated a return of -0.63% after fees. Again, this is not surprising given the emphasis on investment in safe products.

5.2.4 Stockbroker Offerings

The stockbrokers have started to offer investment products which are funds that they put together with a focus on credit quality and medium-term duration but having a longer investment timeframe. Allied to this approach is a stratification of surplus cash into three categories: "regular" monthly working capital cyclical needs, "safety" level of cash for unexpected requirements and "core" cash levels not required for 12 months or more. These would not be capital-guaranteed products as they are invested in funds which would have elements of equities, bonds and alternatives. And while it would be expected that these investments are liquid, they would not be sold as products that generate steady consistent return but rather a good return over time. Anecdotal evidence is that there is interest (flow of funds) into such products for cash that can be put away for 12 months (or longer).

5.2.5 Credit Risk

There are three credit rating agencies generally used by investors: (a) Standard and Poor ("S&P") (b) Moody's and (c) Fitch.

There are two categories of ratings: investment grade and non-investment grade (also known as "junk"!). Within the investment grade, there are 10 notches ranging from the highest rated (AAA) to the lowest (BBB-). In non-investment grade there are a further 11 notches.

There are also short-term credit ratings which, technically, could be used to evaluate counterparties but we tend to focus on the longer-term ratings to be more conservative.

The table on the next page sets out the credit ratings ladder from highest rating down and indicates the current long-term credit rating by S&P of Irish market participants. A couple of pointers when using credit ratings:

- Ensure that the legal entity with the rating is the entity accepting deposits (e.g. Bank of Ireland has a rating for both its main holding company and the main operating subsidiary (which is the entity taking deposits))
- Where a bank operates in Ireland as a branch of another entity, the applicable rating is of that entity. Rabobank, when taking deposits here before it exited the market, was a branch of the Dutch bank and, accordingly, benefitted from the strong rating of that entity
- Banks cannot have a credit rating that is higher than the credit rating of the country in which it operates
- Some products, e.g. bonds, issued by a bank can have different rating to the bank issuing it. This can be because it may be junior rather than senior debt
- Companies can also have credit ratings. Gas Networks Ireland, for example, has an investment grade rating.

5. Banking Review

5.3 Other Considerations

- There would appear to be little value in tying up investments for long periods of time as the loss of liquidity (access to the funds) is not sufficiently compensated with better interest rates
- Companies that have simultaneous cash and debt balances should consider better structuring of their debt to reduce the cost (and levels) of surplus cash
- Another alternative may be to seek to pay suppliers earlier in return for an early payment discount. If that approach is adopted, ensure that the decision can be reversed if you need the funds again e.g. for capital investment or acquisition
- Identify bank accounts that don't attract negative interest rates (there are a few "exceptions" but we don't expect them to last for long)
- In light of the recent announced exit of Ulster Bank and KBC from the market, borrowers may want to use any surplus cash that they have as a source of extra liquidity or buffer if they are scheduled to refinance loans in the coming 12-18 months as the jury is out as to how the banking market will react to the lack of competition. Negative interest rates will be the cost of having such surplus liquidity. But maybe a price worth paying in such circumstances.

Table 4. Credit Ratings of Irish banking market participants

Standard & Poor	Moody's	Fitch	
Long Term	**Long Term**	**Long Term**	**Bank***
AAA	Aaa	AAA	
AA+	Aa1	AA+	
AA	Aa2	AA	
AA-	Aa3	AA-	
A+	A1	A+	HSBC Bank, Rabobank
A	A2	A	Danske Bank, Barclays Bank Ireland, Ulster Bank Ltd (NI operations)
A-	A3	A-	Ulster Bank Ireland, Bank of Ireland,
BBB+	Baa1	BBB+	AIB Bank plc
BBB	Baa2	BBB	KBC Bank Ireland
BBB-	Baa3	BBB-	PTSB
BB+	Ba1	BB+	
BB	Ba2	BB	
BB-	Ba3	BB-	
B+	B1	B+	
B	B2	B	
B-	B3	B-	
CCC	Caa1	CCC	
CC	Caa2	CC	
C	Caa3	C	
D	Ca	D	
	C		